

6 Reasons to Invest in Student Housing

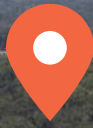


Can you remember a major university folding its tent and going out of business? Can you imagine a scenario in which Notre Dame, the University of Oregon, or Utah State University suddenly just disappear?



The core question is always this one: Why invest in student housing?

- 1 Using Universities as Anchors
- 2 A Wealth of Options
- 3 All the Benefits of Professionally Managed Real Estate
- 4 An IDEAL Investment
- 5 Taking Advantage of Depreciation
- 6 1031 Exchange—Not Just for Moguls



Reason 1

Using Universities as Anchors

“WHAT WE LIKE MOST ABOUT STUDENT HOUSING is using the university as an anchor,” says Brian Nelson. “If you think about a university, you think about some of the most stable institutions in the country. These are well-funded schools that have been around for centuries.”

Most major universities are much older than the majority of blue-chip stock companies, and that stability makes student housing practically immune to fluctuations in the stock market, the real estate market, and even the economy, Nelson says.

According to Stanford economist Caroline Hoxby, **college enrollment has increased during every recession** since the 1960s. “The evidence shows that students were more likely to enroll in college and were more likely to stay in college during the Great Recession [of 2007–2009],” says Hoxby, who co-edited the book *How the Financial Crisis and the Great Recession Affected Higher Education*.

An Education Boom

The need for a college education has boomed in recent decades after well-paying jobs shifted away from manufacturing and into technology. And while enrollment has been rapidly increasing, universities have not been able to keep pace in providing additional dorms.

- Nearly 18 million students were enrolled in postsecondary, degree-granting institutions in 2012, **up 48 percent** from 1990, according to data from the US Department of Housing and Urban Development.
- Over the same period, the number of students living in on-campus dorms increased only by a bit more than 600,000, according to a 2016 article published in **Bloomberg News**.
- The trend for enrollment growth is expected to continue. Undergraduate enrollment is projected to increase to 19.8 million students by 2025, according to the **National Center for Education Statistics**.

All these students add up to a need for housing, and investors have been taking notice in record numbers.

“For three years, the transaction volume has set records,” David Borsos, vice president of capital markets with HMHC, told **National Real Estate Investor**. In 2014, \$3.5 billion in student housing



The booming college enrollment and constant influx of students, combined with the shortage of on-campus housing, provides a large, steady population of renters, and the high demand helps keep rental prices strong.

sales took place, followed by \$6 billion in 2015 and \$10 billion in 2016.

A Global Asset Class

This isn't just an American phenomenon, either. The stability of student housing is being increasingly recognized around the world. At a May 2017 student housing investment conference in London, organizer Andrew Mason told *The Guardian* that the annual gathering had grown from 200 people to more than 500. He described student housing as a "truly global asset class."

In fact, a portfolio of 25 student buildings in the United Kingdom was purchased in 2016 by the property arm of Temasek, the Singapore state investment fund. The Temasek executive behind the purchase, Hiew Yoon Khong, called student accommodation at the time "a big business and relatively low risk."

The booming college enrollment and constant influx of students, combined with the shortage of on-campus housing, provides a large, steady population of renters, and the high demand helps keep rental prices strong. Nelson Brothers' practice of cosigning parents in the tenancy agreements provides further stability.

"I think if you talk to a lot of folks today, they would list stability, monthly income, cash flow, tax savings, long-term growth, and capital gains tax deferral—all of those things are very important to them," Nelson says. "We think well-positioned student housing is well-qualified to hit on every major financial goal or objective that investors are looking for today."



Reason 2

A Wealth of Options

ONCE YOU'VE RECOGNIZED THE BENEFITS of investing in student housing, the next logical question is this: How does one go about it?

“What a lot of people don’t know about commercial real estate is that the primary evaluation tool is the cap rate, which is the net operating income divided by the sales price,” Nelson explains.

$$\text{Cap Rate} = \text{Net Operating Income} / \text{Sales Price}$$

This is an area where student housing has done very well. *The New York Times* reported in February 2017 that capitalization rates—or the rates of return on investment—in the student housing sector typically run **one-half to three-quarters of a percentage point higher** than with traditional multifamily properties.

Still, not all student housing is created equal. Nelson Brothers considers many factors before purchasing student housing properties. These factors can be organized into three primary categories:

- ▶ The university
- ▶ The property
- ▶ The location

The University

“When evaluating student housing, the first thing you want to look at is the university itself,” Nelson says. “You want to make sure that your economic

anchor is stable, that enrollment is consistent year in and year out, decade after decade, without a whole lot of other things impacting it.”

Another factor is the size of the school. As a rule of thumb, Nelson Brothers primarily focuses on universities that enroll more than 20,000 students. However, it doesn’t close the door to opportunities at campuses with an enrollment of 10,000 to 20,000 students.

Nelson Brothers also looks at the school’s economic fundamentals. A mistake that some people make is investing because they are alumni or because they are fans of the sports teams. But just because a school is great in football or basketball doesn’t mean that the property you’re investing in is going to be profitable.

The Property

Nelson Brothers completes a thorough examination of the competition before purchasing any property. It does this by looking at four or five primary competitors and examining their track record over the past several years.

“You don’t want to be in a market where everyone is throwing off concessions or discounts,” Nelson says. “You want to be in a market where everyone is doing really well, and in many cases because they’re leasing up faster, it creates demand for you and you’re leasing up faster.”

For the target property itself, Nelson Brothers will go back further into the books, Nelson says. “How did it perform during the Great Recession? Were they able to raise rents? Were they able to stay full?”

Finally, it’s important to understand the property’s



target market, so that the facility's amenities, activities, and marketing will align with the type of students that you are hoping to attract.

The Location

One of the wonderful things about investing in student housing is that most universities have been around for a long time—in some cases hundreds of years—so the land around the campus is usually built up. That creates a barrier to entry for new competition.

If you invest in a property within a 10-minute walk from campus, as Nelson Brothers strives to do, that provides a competitive advantage in the marketplace that nobody can take away.

"If you're able to find a property that is really well located, well positioned, that is a couple of blocks from campus and a five- to 10-minute walk to most classrooms, we think that is a gold mine," Nelson says.

Being close to campus helps the bottom line in a lot of ways. Most universities have state-of-the-art fitness centers and swimming pools along with game rooms and study rooms. If an apartment complex is close enough to campus, it doesn't have to provide those things to attract students.

"In that case, your square footage is almost 100 percent revenue producing," Nelson says.

In many cases, a well-located property will have a very low expense ratio. There might only be a handful of fixed expenses: real estate taxes, common areas, utilities, and debt service.

"One of the best things about student housing that is often overlooked is how low expenses can be," Nelson says. "In many cases with lower-expense properties, you can escalate the net operating income at a much faster pace than you can on traditional complexes or apartments that have really high fixed expenses."

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Reason 3

All the Benefits of Professionally Managed Real Estate

IN A GALLUP POLL RELEASED IN APRIL 2016, Americans selected real estate as **the best long-term investment opportunity**, far ahead of stocks, bonds, gold, and savings accounts/ CDs . And while we've established the benefits of investing in private student housing, most people lack the funds or expertise to buy and manage their own apartment properties.

A professionally managed real estate company, however, affords you the security of pooling your money with many other investors in a diversified portfolio. At the same time, it offers asset preservation and capital appreciation, as well as a monthly cash flow through dividends. This can all be accomplished in a simple and efficient transaction.

While investments in student housing have gained popularity in recent years, so has the overall market. The professionally managed global real estate market **grew to \$7 trillion by the end of 2014**. At \$2.4 trillion, the United States remains the largest market.

A Stable Asset

"One of the benefits of professionally managed real estate is that it offers a viable exit strategy for highly appreciated equity that can help people align their

next investment or this next round of real estate investment better with their goals," Nelson explains.

"A lot of folks who two or three decades ago really liked appreciation and growing their nest egg have now changed that focus or their core objective into income and freeing up their time."

To help investors meet those goals, Nelson Brothers targets stable properties with a long track record of high occupancy and monthly cash flow. The goal is to provide investments that can pay a compelling monthly pass-through income to investors.

Tax Deferral

The majority of Nelson Brothers' properties are also structured to be turnkey investments that are eligible for a 1031 Exchange, which allows landlords who sell their investment properties to defer all capital gains taxes and recapture taxes if they invest that money in a replacement property or properties.

"Instead of dealing with all of the hassles of tenants and property management and all of the things associated with being a property manager, they can do a 1031 Exchange, sell that property, move it into two or three properties that are income-producing that are managed by somebody else, and they in many cases get a better income and consistent monthly cash flow without having to deal with the hassles of tenants," Nelson says. "So now they can spend their time doing more important things like going to their grandkids' baseball game, going on a cruise, or golfing."

Reason 4

An IDEAL Investment

WHILE IT WOULD BE A STRETCH to say that any investment opportunity is “perfect,” Nelson Brothers Professional Real Estate is confident in stating that its goals for every investor are “IDEAL”:

- I** Income
- D** Depreciation
- E** Equity Growth
- A** Appreciation
- L** Lifetime

“That’s a clever acronym that we use to demonstrate the five different ways that we can grow an investment simultaneously,” Nelson says.

1. Income

By investing in properties that have high occupancy rates year in and year out, thanks to the anchor of a major university and the steady influx of students that it provides, Nelson Brothers is able to benefit from a consistently reliable cash flow. That stability leads to a consistent income for investors.

“Most of our properties procure a monthly income that we pay out to investors on the 15th of every month,” Nelson says.

The monthly payments also help separate Nelson Brothers from the typical real estate investment trust, which pays dividends quarterly.

2. Depreciation

This accounting technique spreads the cost (and depreciation deductions) of residential real estate over 27.5 years, the amount of time the IRS considers to be the “useful life” of a rental property. As **Investopedia** notes, depreciation can be a valuable tool if you invest in rental properties because it allows you to spread out the cost of buying the property over decades, thereby reducing each year’s tax obligation.

For student housing properties, this depreciation schedule—set by the IRS—can often end up shielding 60 percent to 70 percent of the investment income from taxes.

“One of the advantages of owning a brick-and-mortar building is that we’re able to write off the wear and tear and usage of the building and use that loss to shelter a lot of the income from taxes,” Nelson says. “So it’s just a great way to enhance the net cash that you are receiving.”

3. Equity Growth

This is where we introduce the concept of amortization, which is a process that’s easily relatable to anyone who’s ever taken out a mortgage. It means that every monthly loan payment includes both principal and interest, so every payment helps to pay down the principal of the loan. In the case of an investment in student housing properties, the



tenants are, in essence, paying off the loan while investors' equity in the property grows.

"For a lot of our properties, every month we're not just paying off the mortgage but we're also paying down the loan principal, so it's just another way to organically use cash flow from the operation to organically pay off the equity of the property," Nelson says.

4. Appreciation

While student housing properties historically have appreciated over time faster than the rate of inflation, there are ways to accelerate the rate of appreciation, such as remodelling or renovation. Nelson Brothers has its own construction management team, so it can take control of those costs to maximize the benefits.

Accelerated appreciation is accomplished through the due diligence of seeking out well-located, low-expense properties in strong rental markets. Nelson Brothers has been able to check off all those boxes by focusing on student housing.

"We're not going to buy a property without some sort of strategy designed to grow the value of the property so that when we sell it, whether it's three years, four years, or five years down the road, we want your value to appreciate and grow over time," Nelson says.

5. Lifetime

"That's a lifetime of capital gains tax deferral," Nelson says. "What makes real estate so unique is that we have the ability to do a 1031 Exchange. It's one of the only places outside of an IRA where you can defer capital gains taxes and even depreciation-recapture taxes indefinitely. And when you pass away, you pass along to your heirs on a stepped-up basis.

"That's what the L in Lifetime stands for: using the 1031 Exchange to constantly keep that money working and growing for you, rather than writing off a big check to Uncle Sam every time you realize a capital gain."

We'll talk much more about depreciation and 1031 Exchanges in the next two chapters.



Reason 5

Taking Advantage of Depreciation

ONE OF THE BIGGEST ADVANTAGES to investing in real estate is the tax benefits. Because the IRS allows the cost of income-producing property **to be recovered through yearly tax deductions**, in many cases it's entirely possible to create a monthly cash flow without paying any tax on it.

How is this possible? A big part of the equation is depreciation, a noncash—or paper—deduction that allows you to spread out the cost of buying a property over decades.

“Real estate is one of the only assets where you can depreciate or write off some of the wear and tear and usage of the property and shelter some of the income while still having the benefit of appreciation over time,” Nelson says.

There are three main factors that play into depreciation:

- ▶ The classification schedule set up by the IRS
- ▶ The ratio of the land value to the property value
- ▶ Your leverage in the property

1. Depreciation Schedules

The IRS assigns different depreciation schedules to different assets. A retail or office building, for example, is said to depreciate over 39 years, while a residential rental property is depreciated over 27.5 years.

“With student housing properties, the IRS gives a very favorable depreciation schedule so that a lot of folks who own triple net leases or retail properties or office properties, they’re not used to having such strong depreciation,” Nelson says. “Typically, those will shelter 40 percent to 50 percent of the income. For student housing, the depreciation schedule alone allows you to shield 60 percent to 70 percent of the income.”

2. Land Value vs. Building Value

You can depreciate only the cost of the land, not the cost of the building. “So whenever you buy a property,” Nelson says, “you have to figure out how much of the value of the investment is attributed to the land and how much is attributed to the building.”

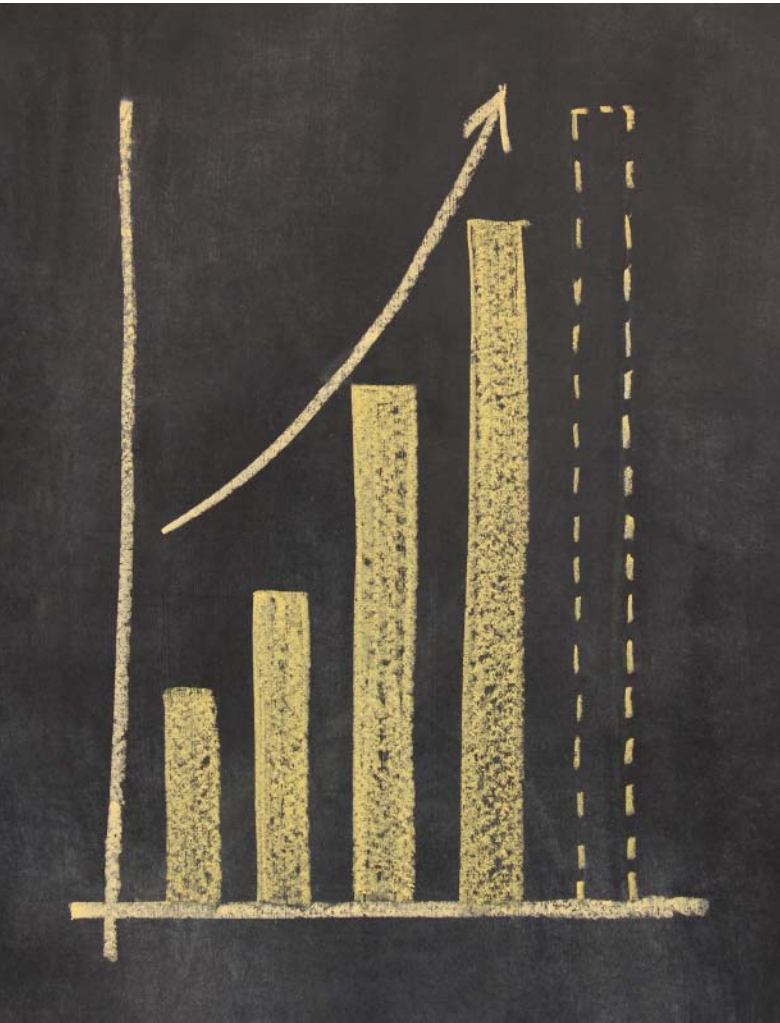
Part of Nelson Brothers’ strategy is to seek out properties in smaller metro areas like Eugene, OR; Provo, UT; and South Bend, IN.

“In these tertiary markets, the land value is minimal,” Nelson explains. “So if you’re buying a property in South Bend, IN, for example, typically 90 percent to 95 percent of your investment is depreciable. It’s in the building itself; whereas a lot of folks who own property in California or New York, 40 percent to 50 percent of their investment might be tied to the land, and that’s not depreciable.”

3. Leverage

The third element is leverage, which refers to the ratio of debt to equity.

“By having a little bit higher leverage, it means that you’re buying a little more of the



building, which we can then depreciate and shelter more income from,” Nelson says.

Nelson Brothers typically takes out a loan that is roughly 50 percent to 60 percent of the property’s value, which protects investors from liability while providing the benefits of ownership.

Nelson Brothers also has its own in-house tax accountant. Investors will receive a K-1 or 1099 every February or March, depending on how their properties are structured, that calculates the depreciation for you.

The Bottom Line

“These three things taken in total are what makes Nelson Brothers so strong on tax shelter,” Nelson says. “Where else can you find an investment where you can have a 6.5 to 7 percent income and in many cases not pay a dime of that to Uncle Sam? It’s 100 percent tax sheltered. We think it’s phenomenal and really unique to our business model.”

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Reason 6

1031 Exchange—Not Just for Moguls

ANYONE WHO OWNS RENTAL PROPERTIES that have significantly appreciated in value and is now looking to take advantage of those gains should become familiar with the 1031 Exchange.

A 1031 Exchange, also called a “like kind” exchange or a Starker exchange, allows a property owner to defer capital gains taxes incurred on the sale of a property as long as that money is invested in another property or properties. A 1031 Exchange is applicable only for investment or business property, not personal property.

“That’s what makes it such a powerful investment tool,” Nelson says. “Institutions and guys like Donald Trump and Sam Zell—big real estate moguls—have been leveraging the benefits and power of the 1031 Exchange for decades and accumulating and amassing large sums of wealth.

“And we think it’s one of the most underused investment tools by mom-and-pop investors. One of the things we want to do is help them find different options and different benefits where they can leverage the power of the 1031 Exchange to find investments that are better aligned with what they’re looking for.”

A Unique Advantage

In their 2015 study **“The Economic Impact of**

Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate,”

David Ling of the University of Florida and Milena Petrova of Syracuse University analyzed more than 1.6 million real estate transactions over an 18-year period. They found that multifamily-related sales recorded the highest use of like-kind exchanges based on both unit and dollar volumes.

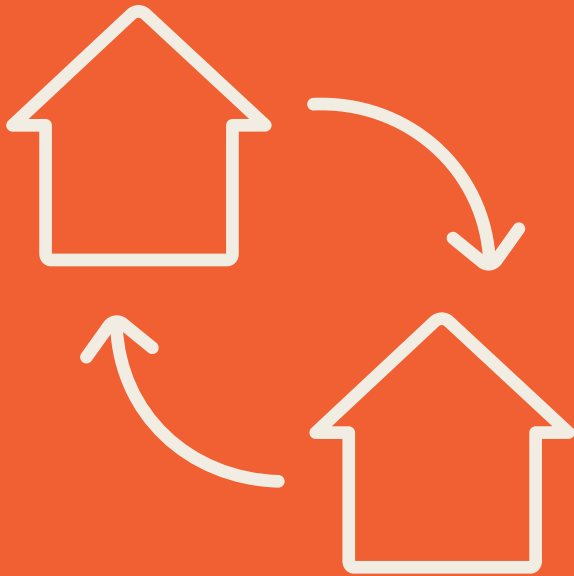
One of the study’s key findings was that, on average, taxpayers using a like-kind exchange acquire replacement property that is \$305,000– \$422,000 more valuable than the relinquished property, while replacement properties that don’t use an exchange are cheaper or of equal value.

Tax Deferral

“A 1031 Exchange is unique in that it’s one of the only areas outside of an IRA where you can potentially defer your capital gains tax indefinitely,” Nelson says.

Property owners with highly appreciated real estate can sell those properties and, instead of paying perhaps hundreds of thousands of dollars in capital gains taxes, can invest that money in turnkey properties that will generate greater monthly cash flow.

For example, people who invested in real estate 20 or 30 years ago have undoubtedly made a lot of money through appreciation. If a property owner has \$1 million in equity, he or she could potentially put that money into three or four different properties, earn an income of \$65,000 to \$75,000 a year, and in many cases not pay a dime in taxes on that by deferring through depreciation.



Property owners who were previously looking for growth and appreciation might now be more interested in stability and tax savings.

“For many of our investors, Nelson Brothers can help by repositioning and restrategizing what their core objectives are, by making sure we’re aligning what is likely a sizable portion of their net worth or their nest egg and moving it into things that are really more aligned with what they’re looking for,” Nelson says.

“That’s why Nelson Brothers tends to focus on assets that are very stable and that are consistently

producing an income—because we feel that that aligns with what a lot of folks are looking for today.”

Benefits for Heirs

The 1031 Exchange is also a powerful estate-preservation tool. When you pass away, your heirs will inherit the “exchanged” property on a stepped-up basis, which means at fair market value at the time of death. Essentially, this means that your heirs will not have to pay any tax on the gain that you deferred.

“One of the best factors of the 1031 Exchange is the stepped-up basis,” Nelson says. “If you’ve owned real estate for 40 or 50 years and it’s appreciated tenfold, and you’re able to do a 1031 Exchange and you pass away, your heirs inherit it on a stepped-up basis. What that means is that you’ve deferred all capital gains and depreciation recapture taxes indefinitely. That’s fantastic!”

Using the 1031 Exchange

The 1031 Exchange allows landlords to sell their highly appreciated properties without paying a dime in capital gains taxes. It sounds almost too good to be true, so it must be complicated, right?

It can be, but it doesn’t have to be.

“One of the biggest challenges people have with a 1031 Exchange is the short timeline that the IRS gives them to find a replacement property,” Nelson says. “So a lot of people feel trapped.”

After a property is sold, the seller has 45 days to identify the replacement property that they want to move their money into to satisfy the 1031 Exchange. They also must close escrow on the replacement property within six months of the original sale date.

“That’s where our company can be a tremendous help,” Nelson says. “One of the biggest benefits of a Nelson Brothers property is the turnkey element of it.”



In other words, part of the beauty of investing into professionally managed real estate is that the difficult groundwork has already been done.

Understandably, the strategy has been growing more popular among mom-and-pop investors. According to the IRS, the number of individuals who have completed a 1031 Exchange has **increased every year from 2008 to 2013** (the most recent year that data is available).

An Equal Swap

There is another important rule governing the 1031 Exchange. To completely avoid paying any taxes upon the sale of your property, the IRS requires that the purchase price of the new property and the new loan amount be equal to or greater than the original sale price and the original loan amount.

So, for example, if you sold a property for \$1 million and your investment in a replacement property is \$500,000, you would need to pay the capital gains tax on the \$500,000 gap.

But an investor with Nelson Brothers might have as many as four or five different properties to choose from.

“So if he has \$1 million in equity, he has the ability to diversify that into two, three, or four different properties all around the country and be better diversified both geographically and also by strategy,” Nelson says. “He could have a brand-new property that is focused on staying full and maintaining really stable income. He could have another property that is really value-added that might have a growth element to it.”

“The diversification element and the timing element and the ability to go into three or four different properties and actually start accruing income and to close escrow long before the 45-day window even comes up are all very compelling benefits.”



Conclusion

ENROLLMENT AT COLLEGE CAMPUSES has boomed over the past couple of decades—even rising during economic downturns—and investment in campus dorms hasn't come close to meeting that demand. Thus, well-located private student housing, anchored by a major university, benefits from a steady influx of potential renters. This stability makes student housing practically immune to outside economic forces and leads to a consistent income for investors. A favorable depreciation schedule can help shelter much, if not all of that income, from taxes.

Whether you've been investing for years and need a way to diversify your portfolio or are late to the game and don't know where to start, private student housing is the place for you. At Nelson Brothers, our team of experts can walk you through every step of the process.

