

2010 SENIORS HOUSING STUDY

Bulls Foresee Occupancy Gains



Bulls Anticipate Occupancy Gains

Survey respondents also see transaction activity on the rise. **By Matt Valley**

The fragile state of the housing market

has had a negative impact on occupancy rates at seniors housing facilities over the past year, according to 75% of respondents to an exclusive online survey conducted jointly by NREI and Senior Housing Investment Advisors. Nevertheless, nearly three-fourths of respondents who own or manage seniors housing facilities expect the level of occupancy at their properties to increase by an average of 161 basis points over the next six months.

Meanwhile, one in three respondents indicate that transaction activity has already begun to increase, while 44% expect transaction levels to rise by the end of 2011. The health of the capital markets will be a critical factor in how active deal flow becomes. While only 16% of respondents indicate that the availability of financing already has begun to increase following the banking meltdown and recession, an additional 58% expect the availability of financing to rise by the end of 2011.

“We anticipate an uptick in transaction activity as the gap between buyers and sellers narrows,” says Mel Gamzon, senior managing director of Senior Housing Investment Advisors based in South Florida.

“What will drive this trend is improved operating performance, the availability of equity, and the continued disconnect between supply and demand in most markets. Debt remains the one sticking point in the acceleration of transaction activity,” explains Gamzon.

Of nearly 150 respondents active in seniors housing who took part in the survey Oct. 14 through Nov. 8., the largest group of respondents (39%) describe themselves as owners and operators, followed by developers and brokers (32%

each). Lenders accounted for 8% of responses. Some respondents play multiple roles. Among key findings:

- ▶ Rental discounts and incentives have had a negative effect on occupancy at seniors housing facilities over the past year, according to 36% of respondents. However, 26% indicate that the discounts and incentives have had a positive impact on occupancy, while 34% say they’ve had no effect.

- ▶ Slightly less than half of respondents (45%) say the independent living/assisted living segment of the industry is experiencing the biggest demand, followed by memory care (35%) as shown in Figure 1.

- ▶ About half of respondents (49%) are considering local and regional banks as a debt financing source for acquisitions and new construction, followed by HUD (39%), and Fannie Mae and Freddie Mac (34%).

More skin in the game required

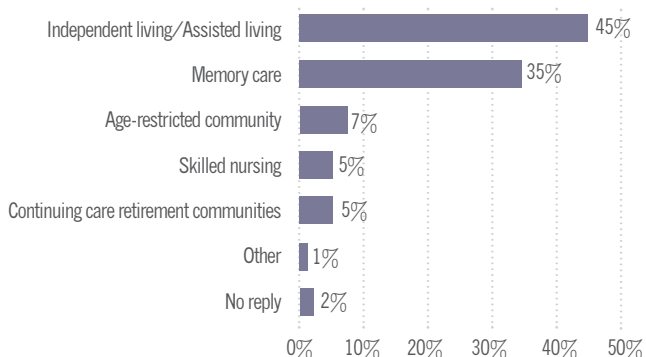
Nearly six out of 10 respondents (58%) say the lender requirement that poses the biggest challenge when seeking to refinance a loan is the higher equity contribution [Figure 2]. More than one in three respondents (35%) cite recourse loans and personal guarantees as the most challenging lender requirement, followed by higher debt-service coverage ratios (31%).

The deleveraging that’s taking place today follows a period in which debt capital flowed freely and deal volume was extraordinarily high, says Terry Howard, president of Irvine, Calif.-based MBK Senior Living. The company owns or manages 10 seniors housing communities totaling 1,100 units in the Western U.S.

“If you go back and look at the height of the market in 2006 and 2007, in 2006 you had close to \$22 billion of publicly announced transactions and in 2007 you had \$17 billion. That was our last zenith in acquisition activity,” explains Howard. “You had a lot of people putting down 20% equity and they were using five-year debt.” Now, many of those loans are about to mature.

How dramatic has the fall in transaction activity been in the seniors housing and care industry since the

FIG. 1. THE INDEPENDENT LIVING/ASSISTED LIVING SEGMENT IS EXPERIENCING THE GREATEST DEMAND, SAY RESPONDENTS



Base: Respondents involved in seniors housing

peak of 2006? The total dollar volume of publicly announced deals in 2009, including skilled nursing facilities, was \$3.2 billion, or 86% less than in 2006, according to *The Senior Care Acquisition Report*, which tracks deal flow on a quarterly basis. Through the first three quarters of 2010, the dollar volume of publicly announced deals was \$2.2 billion.

The drop in real estate fundamentals across the seniors housing industry due to the recession and its aftereffects combined with a wave of maturing debt has forced lenders to substantially raise their equity requirements.

MBK's conservative approach has long been to put 40% equity into every asset it buys. "You couple that with strong performance in our marketplace, and I don't have much of a challenge in refinancing," says Howard. MBK's occupancy rate across its portfolio is 96% compared with an industry average of 88%.

"Because of today's historic low interest rate environment, I'm actually going to enhance my value by refinancing at a lower rate," says Howard. MBK's track record also enables it to obtain favorable loan terms on newly acquired assets.

When MBK acquired The Firs, a 135-unit independent living facility in Olympia, Wash. earlier this year, it tapped Freddie Mac as a financing source. The 10-year loan carried a fixed interest rate of 5.23%.

Granger Cobb, president and co-CEO of Emeritus Senior Living, a giant owner and operator, says lenders have significantly tightened their purse strings and underwriting standards. "There was a time three years ago where you could get 85% loan-to-value on really good properties. Now it's more like between 70% and 75%," says Cobb. Meanwhile, debt-service coverage ratios have climbed from 1.1 to 1.3, he observes.

Seattle-based Emeritus operates 479 communities in 43 states totaling 42,400 units. The publicly traded company (NYSE: ESC) owns 53% of the properties in its portfolio. The typical property in the Emeritus portfolio includes approximately 100 units, 80 of which are assisted

living and 20 are memory care, says Cobb

Despite the tight lending standards, interest rates remain quite low on a historical basis for acquisitions of quality assets, says Cobb. A typical 10-year loan provided by Fannie Mae or Freddie Mac carries a fixed interest rate of approximately 5.4% and a 30-year amortization. For conventional bank financing, the interest rate range rises from 6.25% to 6.5% and frequently has a floating-rate component to it. "Typically it's a three- or four-year loan that could either be interest only or a 30-year amortization."

New construction dwindles

Approximately 9,860 assisted living and independent living units were under construction in the nation's top 31 markets during the third quarter, which represents 2% of inventory, according to the National Investment Center for the Seniors Housing & Care

Industry (NIC). That pales by comparison to the third quarter of 2007, when 19,443 units were under construction, or 4.2% of inventory. The largest group of respondents (60%) say new construction will begin to increase by the end of 2011, while 40% believe it will be 2012 or later [Figure 3].

"I don't believe we will see a pickup in activity that resembles the 2006-2007 period until we see the housing market recover (pending foreclosures have worked through the system) and the economic recovery picks up steam. And that could be a while," says Angela Mago, senior vice president and national health care manager for Cleveland-based KeyBank Real Estate Capital.

"Overlaying that is the length of time it takes for new projects to get through the permitting, approval and financing process in order to become shovel-ready," she adds.

Lenders will fill the pent-up demand for refinancing — the low-hanging fruit — before they will look at new construction, says Marcus Lussier, CEO of Valuation & Information Group based in Culver City, Calif. "Construction has always been looked at as the most risky of opportunities for a banker."

No consensus on cap rates

In which direction are capitalization rates headed in the short run? While 40% of respondents expect a decrease in cap rates over the next six months, about one-third expect cap rates to remain the same, and 24% expect them to increase [Figure 4].

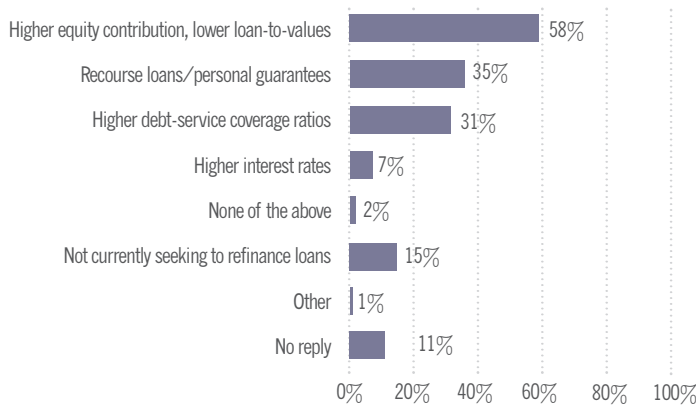
Overall, respondents expect cap rates to fall an average of 4.2 basis points over the next six months. (The cap rate is the annual net operating income of a property divided by the purchase price, a formula used to determine the investor's return in year one.)

"It is somewhat a tale of the haves and have-nots," says Mago of KeyBank Real Estate Capital, which has approximately \$1.6 billion committed to the seniors housing and care industry. "For well-operated, stabilized assets in core markets, cap rates are coming down significantly. For less desirable assets in secondary or challenged markets, cap rates have probably stabilized," says Mago. "If interest rates remain low and the economic recovery gets some traction in 2011, cap rates should trend downward overall for the sector."

She adds that cap rates for skilled nursing facilities have not changed much due to concerns about reimbursement and the fiscal health of many states.

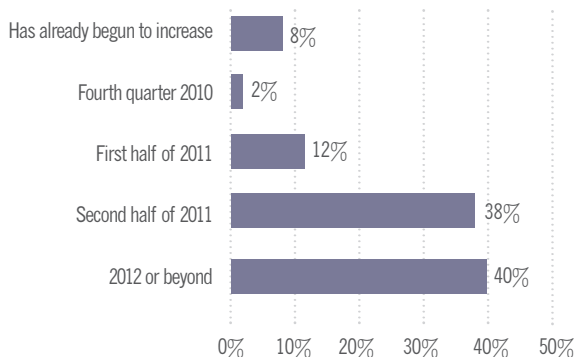
The disparate views that respondents have on the question of where cap rates are headed in the near term doesn't surprise Cobb of Emeritus. "It's a function of nobody knowing when we are going to see a pickup in occupancy. If you had asked me at the beginning of this year when are we going to see occupancy move up

FIG. 2. THE MOST CHALLENGING LENDER REQUIREMENT WHEN REFINANCING ASSETS IS HIGHER EQUITY CONTRIBUTIONS



Base: Respondents involved in seniors housing, multiple answers

FIG. 3. FOUR IN TEN RESPONDENTS DO NOT EXPECT CONSTRUCTION OF SENIORS HOUSING TO INCREASE UNTIL 2012 OR BEYOND



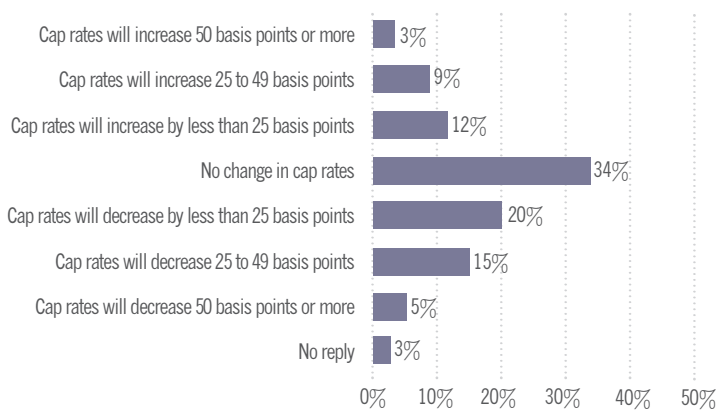
Base: Respondents involved in seniors housing

in a meaningful way, I would have said by the second half of the year.”

But the economy lost steam in the second quarter, fueling fears of a double-dip recession. While those fears have eased considerably in recent months, the average occupancy rate among assisted living and independent living facilities in the top 31 markets in the third quarter was 87.7%, unchanged from the prior quarter, according to NIC.

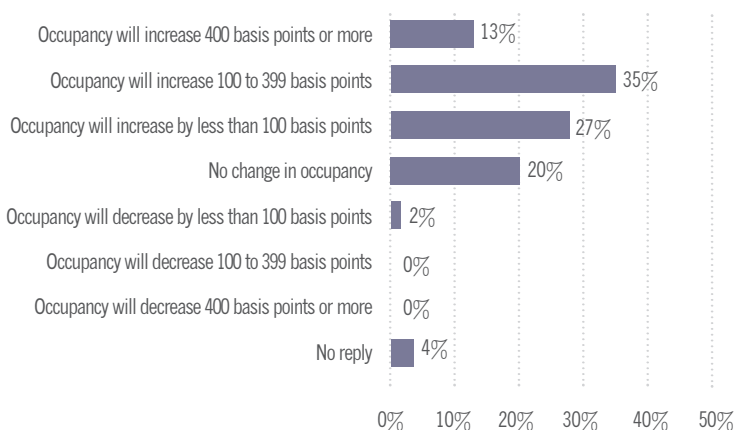
When occupancy moves up, rental rates will start to move up and cap rates will come down, says Cobb. “When is that going to happen? I don’t see that happening in six months, I think it’s beyond six months.” The average occupancy rate across the Emeritus portfolio is 88%, up from 87.7% a year ago. “We are prepared to manage through another year of flat occupancy. That’s the mind-set we’re working from,” says Cobb.

FIG. 4. THERE IS NO CONSENSUS ABOUT THE DIRECTION OF CAPITALIZATION RATES OVER THE NEXT SIX MONTHS



Base: Respondents involved in seniors housing

FIG. 5. RESPONDENTS EXPECT OCCUPANCY TO INCREASE AN AVERAGE OF 161 BASIS POINTS OVER THE NEXT SIX MONTHS



Base: Respondents who own/manage seniors housing facilities (55)

Survey respondents are more bullish than Cobb about the direction of occupancy rates in the next six months. Nearly half (48%) expect occupancy rates to rise by 100 basis points or more, 27% anticipate that occupancy rates will rise by less than 100 basis points and 20% expect no change [Figure 5].

Howard of MBK says one reason the outlook on cap rates is all over the map is that respondents are pursuing different business models. “I have competitors who are very value-driven. They go for distressed assets, they go for assets losing money. There is no question those assets are going to trade at a high cap rate.”

MBK, on the other hand, follows what Howard describes as a more moderate business model. “I’ll buy a stabilized asset and see value in it, so that’s going to be a lower cap rate.” In California, a market in which MBK is active, a Class-A seniors housing campus that includes mainly assisted living and memory care units and some independent living units will trade at cap rates today ranging from 7% to 7.75%. That’s down from a range of 8% to 9% a year ago, he says.

Encouraging signs

Americans are more optimistic about the economy today than they were a year ago, says Howard, which can only help spur consumer demand for seniors housing. Meanwhile, the real estate community is feeling pressure to deploy the capital it’s raised.

“I’m seeing investor groups from outside the senior living industry come into this industry in larger numbers due to the strong economic performance of seniors housing relative to other real estate sectors. That patient money is now saying either put it to use or give it back,” says Howard.

In one recent mega deal, health care real estate investment trust Ventas agreed to acquire the real estate assets of privately owned Atria Senior Living Group for \$1.5 billion in stock and cash. Chicago-based Ventas will own more than 35,000 units across 350 properties. Louisville-based Atria is the fourth largest U.S. operator of assisted living properties.

But it’s not just domestic capital jumping into the game. “Savvy foreign investors also are beginning to realize that the U.S. seniors housing market can work as a defensive real estate play by providing stable, long-term returns at a time when the commercial markets are in flux,” says Gamzon.

Foreign investors can adapt the U.S. model to their own countries. Gamzon says that by the year 2020, the number of people age 65 and older in China is expected to equal the total U.S. population in that year.

To receive the comprehensive 32-page report, please go to www.nreionline.com/seniorshousing

Matt Valley is editor-in-chief.

Health care law draws a mix of jeers and cheers

In March, President Barack Obama signed landmark health care legislation into law following months of debate that continues to this day. The complex legislation is designed to overhaul the nation's \$2.5 trillion health care industry. Here is a sampling of write-in responses regarding the question of how the new law will impact the seniors housing industry.

▶ “The impact will take years to assess. The likelihood is that the overall effect will be to diminish the availability of discretionary dollars in the minds of seniors.”

▶ “Minimal... biggest challenge for senior care is the individual state budgets.”

▶ “Until reimbursement programs are completely understood and established, lenders will not lend on new construction.”

▶ “I believe the health care package will increase demand by 30%.”

▶ “I expect it to impact many employers in the seniors housing industry by adding to their health care/insurance expense. I don't expect any direct benefit to residents of senior housing.”

▶ “Jury is still out on this. The complexity has the potential to paralyze decision making of seniors, or

their adult children.”

▶ “Obamacare is one of the worst programs to encourage any development in the industry.”

▶ “It will boost occupancy and provide stimulus to seniors to sell their homes and move into independent and assisted living communities.

▶ “We expect to see a push down of care to the lowest cost of care.”

▶ “Did anyone read the law yet?”

▶ “It may significantly cut the demand, taking into account consumer spending trends and patterns.” ■

Survey Methodology

Between Oct. 14 and Nov. 8, Penton Research e-mailed invitations to NREI print and online subscribers, asking them to participate in an online survey. Links to the survey also were included in e-newsletter publications. Senior Housing Investment Advisors also sent e-mail invitations to participate in the online survey to a list of seniors housing industry owners, operators, lenders and investors. The survey yielded 217 completed questionnaires. Of that total, 148 respondents are directly involved in seniors housing. Data presented in the charts are based on the 148 qualified respondents unless otherwise noted. For more information regarding this report, contact Editor Matt Valley at matt.valley@penton.com, or (770) 618-0215.