

## NPI 2009Q3 AT A GLANCE

By Douglas Poutasse, Executive Director

The third quarter of 2009 brought the first signs of economic recovery, with positive GDP growth, rising home prices and resurging corporate profits, but as expected commercial real estate values as measured by the NCREIF Property Index (NPI) continued to decline. But as with employment, the good news was that the rate of decline continued to slow and there were signs that the end might be near. In employment, it came in the form of rising temporary jobs in September, in commercial real estate it came in the form of a positive return in the TBI, the transactions based index developed by the MIT Center for Real Estate utilizing the property information from the NPI. In last quarter's Performance Report, we published an article from Prof. David Geltner describing the 2009Q2 results of the TBI and predicting that "...the fall in property owners' reservation prices is a crucial event that must happen to begin to bring liquidity back into the market and establish a firm bottom in transaction prices. Now if only the demand side would stop falling, we would really be back in business." Now I don't know about you, but I thought this seemed optimistic if not downright pollyannaish. But that is exactly what happened in 2009Q3: as measured in the TBI, the buy side "willing to pay" index moved up in the quarter, closing half the gap between buy side and sell side reservation prices and creating a doubling in transactions in the quarter. While NPI transaction volume remains low by historical standards, the return above 1% is certainly a welcome sign that the extreme illiquidity of the first half of the year has eased.

This quarter we are publishing two interesting but very different perspectives utilizing the NPI and its property data. First, Beth Mace of AEW Capital Management looks at the performance of the Senior Housing industry, utilizing property data which we collect from our data contributing members but which has not been incorporated in the NPI as these properties do not meet the inclusion criteria for property types. The NPI is currently limited to apartment, hotel, industrial, office and retail properties. The NCREIF property database contains many additional non-qualifying properties and Beth has used this data along with the rich dataset of the National Investment Center for the Seniors Housing & Care Industries (NIC) to examine the performance of senior living over the past five years. Second, Andy Joynt of PPR has a piece titled "Mythbusters: NCREIF" which exams some of the issues around valuations and income growth, comparing broader industry data from CoStar to the NCREIF Property Index data. I hope you find both articles interesting and informative.

## SENIOR HOUSING RETURNS OUTPERFORM THE NPI

By Beth Burnham Mace, Director, Research  
AEW Capital Management, L.P.

Institutional investors are increasingly investing in senior housing as an asset class. Up until now, a strong case has been made regarding the asset class' strong demand-side fundamentals - most notably the aging of the baby boom - and more recently, a shutdown in supply associated with the collapse of the credit markets. However, little data has been available on the return potential of investing in senior housing. Using data from NCREIF, this article shows that senior housing has consistently outperformed both the broad NCREIF Property Index (NPI) and the apartment sector on both an income and an appreciation basis for more than five years.

Since 2002, NCREIF has been collecting return data on the senior housing sector. The data currently resides in NCREIF's "other category" and is not part of the NPI. For NCREIF purposes, senior housing does not include traditional institutional "nursing home" facilities, but rather it is comprised of a broader array of housing products and services for more active seniors known as assisted living and independent living facilities<sup>1</sup>.

As of Q3 2009, 13 managers reported data on 66 stabilized senior housing properties to NCREIF. The value of these assets totaled \$2.355 billion. Relative to the universe of properties that exist in the U.S., this is a fairly small sample. Currently, the National Investment Center for the Seniors Housing & Care Industry (NIC) tracks 5,682 majority assisted living and majority independent living facilities in the nation's largest 100 metropolitan areas. The facilities they track are "market rate" facilities with 25 beds or more. As of Q2 2009, these 5,682 facilities housed 742,951 assisted living and independent living units.

For perspective, when the NPI was first created in 1977, there were only 233 properties in the database, with a value of \$581 million, which includes only nine apartment properties valued at \$79 million; other categories included industrial, office, retail and hotel. Today, the entire NPI is comprised of 6,186 properties valued at \$244 billion (apartments account for 1,463 properties valued at \$59 billion).

On a return basis, since inception the senior housing properties in the NCREIF database have outperformed the overall NPI and the apartment component of the NPI. As of Q3 2009, the senior housing category had generated a cumulative return that is 2.3 times its mid-2003 value. This compares with a cumulative gain of 1.4 for the apartment index and 1.5 for the entire index. The outperformance stems from greater gains in both the appreciation component (1.4 versus 1.0 and 1.1, respectively) and the income component (1.6 versus 1.4 and 1.5, respectively)<sup>2</sup>.

FIGURE 2

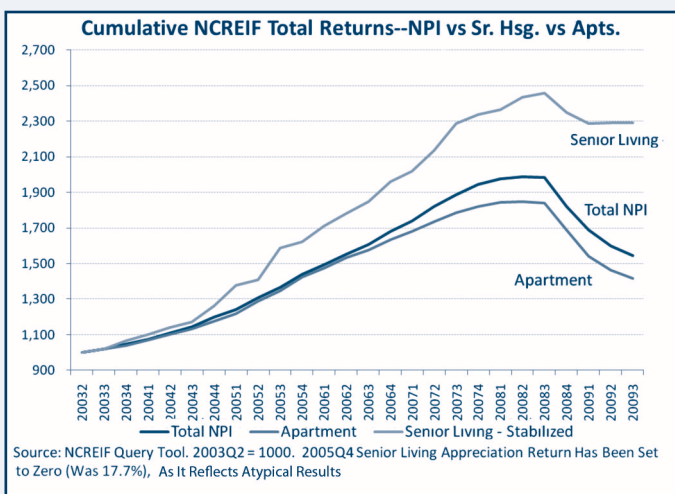


FIGURE 3

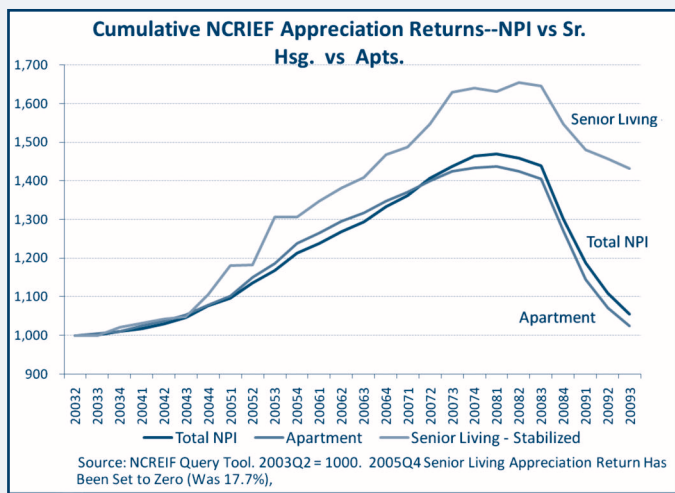
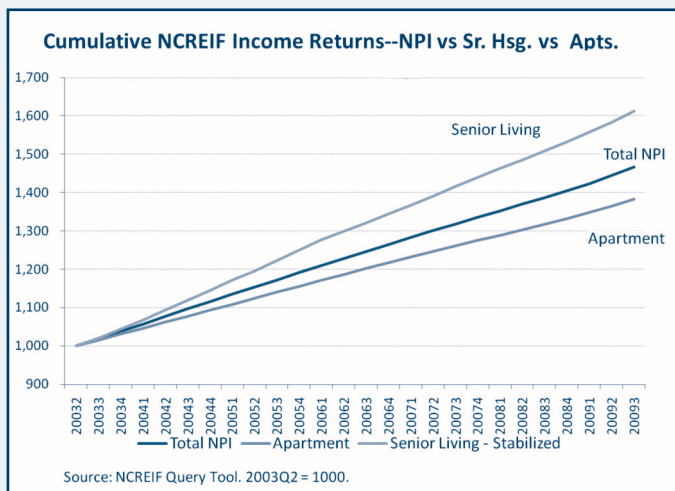


FIGURE 4



More recently, senior housing has continued to outperform the apartment index and the total NPI on both an income and appreciation basis. However, the sector has not been immune to the challenges facing commercial real estate today including a lack of transactions, wide bid/ask spreads and limited debt capital, although the agencies (Fannie Mae and Freddie Mac) are still lending in this sector. The aforementioned trends combined with the weak economy, have caused the appreciation component of the index to decline. On a one-year basis, the appreciation component of the index was down nearly 13% as of the end of the third quarter. Nevertheless, the sector outperformed the overall NPI, which was down 26.7%, and the apartment index which was down 27%.

The income component has also outperformed the index, with a one-year increase of 6.91% versus 5.81% for the overall NPI and 5.04% for the apartment component. The stronger income performance may reflect the sector's large need-based demand component, which may help protect income and cash flows at least to some degree Figures 1, 2 3 and 4 illustrate these returns.

FIGURE 1: Senior Housing Returns

Senior Housing Total Returns			
	Total NPI	Total Apartment	Total Stabilized Senior Housing
3rd Qtr 2009	-3.32	-3.00	-0.04
2nd Qtr 2009	-5.20	-5.13	0.17
One Year	-22.09	-23.03	-6.74
Three Years	-1.28	-3.50	7.42
Five Years	6.16	4.58	14.38
Six Years	7.18	5.63	14.43

Senior Housing Income Returns			
	Total NPI	Total Apartment	Total Stabilized Senior Housing
3rd Qtr 2009	1.56	1.34	1.76
2nd Qtr 2009	1.50	1.31	1.74
One Year	5.81	5.04	6.91
Three Years	5.58	4.79	6.86
Five Years	6.00	5.13	7.58
Six Years	6.27	5.30	7.91

Senior Housing Appreciation Returns			
	Total NPI	Total Apartment	Total Stabilized Senior Housing
3rd Qtr 2009	-4.88	-4.34	-1.79
2nd Qtr 2009	-6.70	-6.44	-1.57
One Year	-26.70	-27.02	-12.97
Three Years	-6.59	-8.01	0.53
Five Years	0.16	-0.53	6.46
Six Years	0.88	0.33	6.17

1 In general, independent living facilities offer apartment or cottage living and provide a limited number of services, often including one or more communal meals, social and educational activities, and housekeeping. Independent living facilities focus on housing options, rather than service options. Assisted living facilities are the more service-intensive and are designed for residents who need assistance with activities of daily living, such as bathing, dressing, and walking. Closely related to assisted living are Alzheimer's or memory-care facilities. These facilities are residences for people with early- to mid-stage Alzheimer's who do not require nursing services and are often part of an assisted living facility.

2 Note that the 2005Q4 senior living appreciation return has been set to zero as it reflects atypical results (was up 17.7%).

## SENIOR HOUSING RETURNS OUTPERFORM THE NPI

By Beth Burnham Mace, Director, Research  
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(cont'd)

Nonetheless, similar to the four major property types senior housing occupancy rates have fallen in response to the weak national economy. A combination of factors has slowed move-in decisions for seniors and the adult children who care for their aging parents. These factors include (1) the loss in wealth associated with the declining home equity and home prices, (2) the loss in wealth associated with the stock market correction, (3) a general negative sentiment about the economy and its outlook, and (4) falling wages and incomes for adult children due to rising unemployment rates (adult children often provide financial assistance to parents in senior housing facilities). As a result of these demand-related factors, occupancy rates for both assisted living and independent living facilities have fallen. For assisted living, median occupancy rates in the largest 31 metro areas tracked by National Investment Center for the Seniors Housing & Care Industries (NIC) stood at 91.6% during the second quarter of 2009, down from 91.8% in the prior quarter and from 93.2% a year earlier. Average occupancies were lower at 88.3% in the second quarter of 2009. In total, median stabilized occupancies for assisted living have fallen 390 basis points from a peak of 95.5% in the first quarter of 2007. For independent living, the median occupancy rate in the nation's 31 largest metro areas was 91.5% in the second quarter, down from 92.2% in the prior quarter and down from 93.7% in the second quarter of 2008. Average occupancies were lower at 89.2% in the second quarter of 2009. In total, median stabilized occupancies for independent living have fallen 480 basis points from a peak of 96.2% in the second quarter of 2006.

Not surprisingly as occupancies have fallen, rent growth has weakened. Face rents increased at roughly 2% on an annualized basis in the second quarter, down from the 4% to 6% annualized gains achieved historically. It is important to note, however, that while slower, rent growth has remained positive, in stark contrast to other property types which have seen steep declines in rents. However, similar to other property types concessions have become more common and are occurring in one-third to one-half of all properties. Concessions take many forms, and tend to be property and operator specific, they can include: one free month of rent amortized over the course of one year; free care that equates to one month of free rent; waiving of community service fees; and permanent discounts on monthly rents for those rooms most difficult to rent.

Looking ahead, the senior housing sector is expected to perform well for a number of reasons. First is the lack of new supply. For the eighth consecutive year,

the net change in inventory of private-pay senior housing remained relatively restrained in 2009. For independent living, growth in inventory translates into a supply increase of about 1.6% annually (0.5% for assisted living). Second, the uncertain economy has delayed move-in decisions suggesting that there is a pool of pent-up demand. Third, the sector is better understood today and penetration rates and acceptance rates are rising, creating a yet untapped source of demand from seniors. Fourth, is the ongoing demographic shift with more than 300,000 individuals shifting into the over-75 age cohort each year in the near-term. As a result of these trends and general economic conditions, the prospects for the sector in the both the near and long-term seem favorable. That said, the current recessionary environment is affecting near-term expectations on move-in rates (adjusted downward for both assisted living and independent living facilities) and rent growth expectations (which are being scaled back). The degree of these modifications depends upon both the location of the property, the demand and supply fundamentals, and the operator's performance.

Q2 2009 Property Type Comparison						
	Vacancy Rates			Rent Growth		
	Q2 2009 (%)	Change from Low Point	Date of Low Point	Q2 2009 (yoy % change)	Change from Peak	Date of Peak
Independent Living	8.9	520	Q2 2006	2.3		
Assisted Living	8.7	410	Q1 2007	2.1		
Retail	11.7	430	Q1 2006	(1.7)	(3.0)	Q4 2008
Office	15.5	300	Q4 2007	(8.3)	(9.2)	Q1 2008
Industrial	13.0	370	Q3 2007	(7.9)	(8.2)	Q4 2007
Multi-family	7.4	340	Q3 2006	(3.3)	(3.7)	Q3 2008

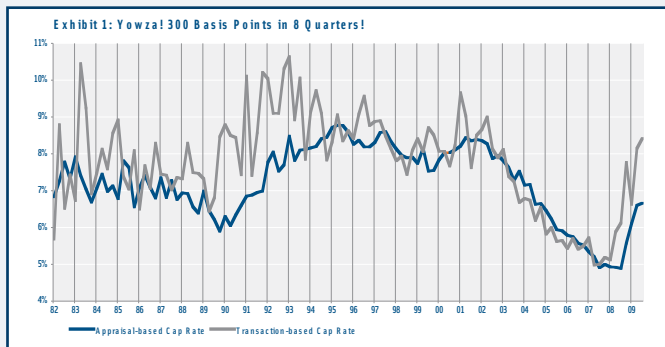
Source: NIC Map, Torto Wheaton  
 Note: AL, IL based on median stabilized rates in Top 31 markets

## MYTHBUSTERS: NCREIF

By Andy Joynt

Property and Portfolio Research (PPR)

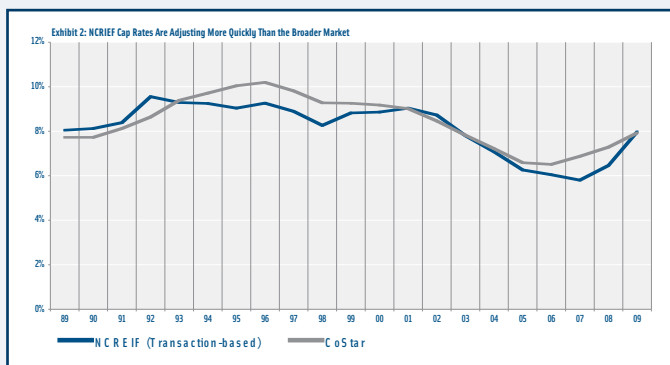
NCREIF's appraisal-based approach to real estate valuations certainly takes its knocks, as appraisals are performed relatively infrequently and are often unreliable without comps. This typically results in a lagged reaction to real market conditions. However, some properties included in the NCREIF Property Index (NPI) are also traded, which means that NCREIF captures transaction-based cap rates as well as appraisal-based. *Exhibit 1* below suggests that cap rates in a mark-to-market environment have corrected more sharply than the traditional appraisal approach indicates.



Source: NCREIF

The key takeaway is that the markets are adjusting and that value losses are being realized for properties that have traded.

However, there are some limitations. The NPI examines a narrower range of assets, namely institutional-quality buildings in large markets. There is a quality bias, a market bias, and a relatively small sample size. So, while it may not be the most accurate representation of the market, it is perhaps the best indicator of where cap rates are in the institutional market. When this series is compared with transaction-based cap rate data from CoStar Group, we can see in *Exhibit 2* that NCREIF's cap rates are generally lower over history (pointing to the quality bias).



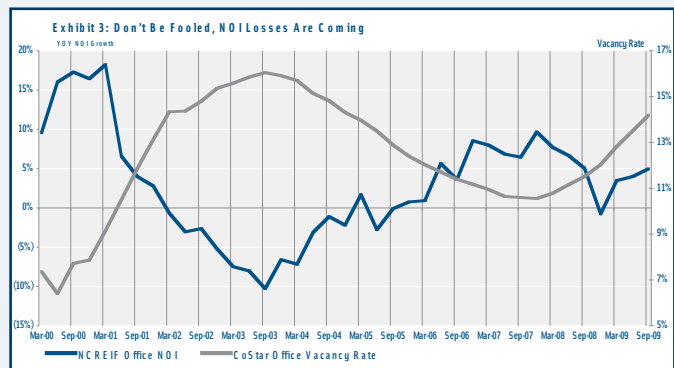
Source: CoStar Group, NCREIF

However, we also see that transaction cap rates on NCREIF assets have moved up more rapidly, suggesting that aggressively priced assets such as a New York trophy office are enduring a bigger correction

than a Columbus apartment complex. Another takeaway: NCREIF is not as slow as people think, if you use this measure.

NCREIF *does* lag behind in one area, incomes. This is because incomes trail the market, particularly for the office property type where long leases take time to roll over. Landlords feel a delayed effect from deteriorating market conditions, as their income streams remain intact until leases expire.

*Exhibit 3* shows year-over-year NCREIF office NOI growth plotted against CoStar Class A vacancies in a sampling of large U.S. office markets. The inverse relationship is pretty evident: when vacancies go up, there's bad news coming for landlords. But after one quarter of falling NOIs in late 2008, the last three quarters of data show positive NOI growth in an environment of rising vacancies. What gives? Were landlords spared from the downturn, suffering only one quarter of income contraction?



Source: CoStar Group, NCREIF

Going back to the beginning of the decade, vacancies in this sampling hit a trough in mid-2000. At this point, fundamentals began to worsen and vacancies swiftly rose, yet it took a full two years before annual NOI growth fell into the red. Likewise, when vacancies peaked in late 2003, it took another two years for NOIs to finally show sustained growth from tightening market conditions.

History tells us that today's positive NOI growth during a period of rising vacancies is not a sign of market resilience, but a lag. NOI growth generally has been shrinking over the past seven quarters, which is certainly a sign that landlords are feeling the pain. The next quarter of data will be the fourth quarter of 2009, exactly two years after vacancies hit a trough at year-end 2007. Will that quarter be the beginning of an elongated period of negative NOIs? Either way, owners will keep a watchful eye on vacancies. Once they peak, it becomes a little easier to determine how far away that light at the end of the tunnel is.