Point of View

Benchmarking and Attracting Institutional Capital to Seniors Housing

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In this paper, we examine the ways in which the seniors housing industry can improve access to equity and debt capital. Currently, seniors housing operations and profits are not well understood by institutional investors, who are therefore reluctant to make investments. Seniors housing is a combination of housing (like apartments), plus hospitality services (like hotels) and health care services (like hospitals), but clear definitions and history of the return components are needed for investors. Investors want to assess the risks they are taking for the returns they are earning and thus need standardized information on income and expenses generated. To be comfortable making investments, investors expect standard accounting practices that facilitate investment comparison and aggregation of data for benchmarks and indices. It is our belief that self-selected standards are better for the seniors housing industry than externally imposed ones.

We analyze the evolution of real estate as a separate asset class in the institutional investment world and the components necessary for the seniors housing property sector to attain similar investor acceptance. History has shown that the keys to investor acceptance include: (1) clear product identification, definition, and differentiation (investors need to be able to understand the differences between options available); (2) consistent and comparable operating data for each subsector

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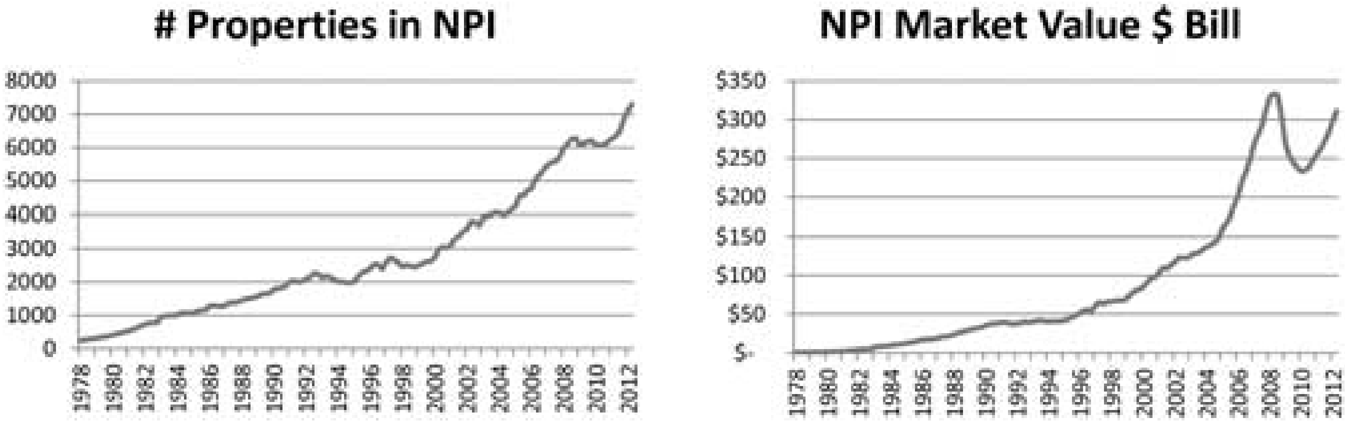
Exhibit 1
NCREIF Property Index



(that is simple, clear, and benchmarked); (3) consistent and comparable return data (that is reported in credible indices); (4) simplicity, clarity, and consistency in all reporting; (5) regular reports and statistics in industry publications that investors read (to provide consistent presence in real estate media and investors' minds); and (6) continuing research on sector issues and performance (to give investors the confidence that their investments are well studied and scrutinized).

The Emergence and Evolution of Commercial Real Estate Investment Indices

In the 1960s, insurance companies began to provide institutional investors with the first investment options for real estate. Insurance company real estate separate accounts were first established by Wachovia and Prudential to give investors access to direct real estate. Then in 1972, the U.S. government passed the Employee Retirement Income Security Act (ERISA) that required all pension funds to "diversify" their investments, which provided additional motivation for institutional investors to consider real estate. But institutional investors were slow to include real estate in portfolios because they did not know what kind of performance to expect. This prompted the formation of the National Council of Real Estate Investment Fiduciaries (NCREIF) in the early 1980s to allow institutional investors to gather the data needed for historic performance reporting and analysis.

NCREIF was established to serve the institutional real estate investment community as a nonpartisan collector, processor, validator, and disseminator of real estate performance information. NCREIF reports return information on income-producing "institutional grade" properties that are owned in a fiduciary setting (and thus periodically revalued) that is located and operating within the U.S. The index is produced quarterly and was back filled with data so the index history started in 1978. Key data that are collected for the index includes NOI (before asset management fees), capital expenditures, partial sales, and market value (appraised internally or independently at different intervals). Data are also collected on property characteristics such as size, age, and location, as well as some additional data useful for evaluating market conditions, such as property occupancy levels. The number of properties in the NCREIF Property Index (NPI), as well as its aggregate market value grew slowly until the mid 1990s when there was enough return history for investors to analyze a full peak-to-trough cycle. It has grown more rapidly since then as institutional investors have a benchmark history to analyze (Exhibit 1).

The creation of NCREIF and the NPI was a major step for investors, as real estate is a private industry where individual building information and especially performance information has been kept secret with the thinking that details about rents and operating expenses could be detrimental if they fell into competitors' hands. NCREIF overcame this problem by guaranteeing the privacy of data on each individual building. During its first decade of operation, only U.S. aggregate and 8 region data were made available. In the 1990s, investors wanted more information, and NCREIF began to allow for more detailed breakdowns, such as by city and property type, but only when there were at least four buildings and three different managers providing data for any sub-index that was created. That way, no individual property or manager information could be uncovered (see Appendix 1 for time line).

Initially the NCREIF index did not include separate indices for any property types, especially apartments and hotels because there was not a significant amount of investment in these property sectors by institutional investors. Over time, however, pension funds as well as their managers and consultants realized that additional diversification benefits could be achieved by including these property types in a portfolio. In the case of apartments, the Tax Reform Act of 1986 also helped put apartments on a level playing field for tax-exempt institutional investors that could not use the tax shelter benefits that existed prior to the tax law change. This allowed investors to obtain diversification benefits without paying for tax benefits that they could not utilize. In the case of hotels, a key for institutional investors was to learn how to structure the investment so that they could get the benefits of owning the "real estate" associated with the hotel while usually having a joint venture partner responsible for the operation of the hotel "business." It is likely that this would also be true for investments in seniors housing where there is also a combination of real estate and an operating business associated with the overall investment. As more institutional investors included apartments and hotels in their portfolios, NCREIF was able to produce separate indices for these property sectors. This, in turn, provided additional transparency to these property types, allowing benchmarks for investors to use to evaluate the performance of their individual investments and portfolios. The availability of benchmarks and indices and associated transparency then serves to attract even more investors and capital to the property sector, which has proven to lower the cost of capital over time.

Retrospective

In 1922, Irving Fisher wrote the highly acclaimed *The Making of Index Numbers* wherein he stated that investors must use measurement not opinions and must use one measure not 40 different ones. Thus, experts must agree on fundamentals so that an ideal or closely similar formula can be developed. That said, different indices can serve different purposes and what is important is that it is clear what fundamentals it is intended to reflect and how it is constructed. For example, in 1938, the Cowles Commission established the Statistics Index of U.S. stock market performance and found the return from 1871 to 1937 was 364%, while the Dow Jones Index was up only 149% for the same period. The difference was market capitalization weighted versus price weighted measurement and a much broader representation of 351 stocks versus 30 in the Dow.

Similarly, indices for real estate can either measure the performance of the entire asset class or a subset such as apartments or senior housing. Properly constructed, indexes benefit all market participants in a number of ways such as allowing them to:

- Analyze the historic performance of different industry or property sectors.
- Have benchmarks to evaluate the performance of different managers and portfolios.
- Make more informed asset allocation decisions based on the risk and return for different sectors.
- Have a better understanding of how economic fundamentals drive the performance of a particular sector.
- Provide tools for doing an attribution analysis of why a portfolio performed differently than the benchmark.

As indices are developed to allow investors to do this type of analysis, more capital tends to flow to that sector because of the enhanced transparency and ability to provide more informed reports to investors.

Setting Standards

Other challenges for the institutional real estate industry included standardizing the terms used, as well as the calculations made because measures such as expenses and rents were subject to a wide array of definitions and interpretations. This challenge was first addressed in 1995 by the establishment of the Real Estate Information Standards (REIS). The first version of the REIS was issued through a joint effort by NCREIF, the Pension Real Estate Association (PREA), and the National Association of Real Estate Investment Trusts (NAREIT) in 1995 and focused on investment and asset information elements, operating property valuation information, performance measures, and market value accounting. A substantial re-write of the REIS took place during 2003, which focused on the Foundational Standards for valuation, accounting, and performance measurement. In 2007, an independent REIS Board was formalized. These standards followed the Global Investment Performance Standards (GIPS) requirements. Most recently, the *2011 REIS Handbook* was released (http://www.reisus.org/index.html). With these standards, a wider group of investors have become more comfortable with reported real estate information and returns. A list of key standards should include:

Standards for Comparison

Definitions

- Property type definitions
- Care segment definitions
- Quality segment definitions
- Government/legislation influences
- Operator involvement/performance/ partnerships

Market Metrics

- Historic occupancy rates
- Historic rental rates
- Historic cap rates & discount rates
- Debt levels and interest rates

Operating Metrics

- Income: Separated into real estate rent, daily living pay, care pay
- Expense: Separated into real estate costs, daily living costs, care costs
- Financing: Separated into real estate and operating financing

Risk Metrics

- Real estate risks: location, building design, and maintenance
- Operating risks
- Debt risks: Default rates
- Liability risks
- Payment risks

The Evolving Transparency for Seniors Housing in Attracting Institutional Capital

In 1991, the first National Investment Conference for the seniors housing sector was held in Washington, DC to bring together debt and equity investors with the owners and operators of seniors housing and care properties. In 1993, the conference's sponsor, the National Investment Center for the Seniors Housing & Care Industry (NIC), incorporated. NIC was founded and has continued to this day as a non-profit 501(c)(3) research, data, and education organization to achieve its mission of serving primarily the investment community interested in the seniors housing and care industry. NIC's structure is unique, whereby it is not a trade association, has no dues-paying members, and does not lobby.

During this same time period, two major seniors housing industry associations were also formed and both were organized as non-profit 501(c)(6) organizations. First, the Assisted Living Facilities Association of America (later to become the Assisted Living Federation of America, ALFA) was founded in 1990, and, in 1991, the American Seniors Housing Association (ASHA) was formed as a subsidiary of the National Multi Housing Council (NMHC). These organizations began to collect and publish data on the seniors housing industry. In 1992, ALFA provided the first directory of seniors housing providers, and ASHA released the first *State of Seniors Housing*, which has been an annual publication ever since, providing detailed operational performance data for seniors housing properties.

In 1994, NIC was invited to the Institutional Real Estate, Inc. (IREI) Advisory Board meeting. Discussions with investors and advisory board members resulted in laying the foundation for NIC's strategic outreach to the institutional investment community. In 1997, NIC published *The Investment Case for Seniors Living and Long-Term Care Properties in an Institutional Real Estate Portfolio* by Glenn Mueller and Steve Laposa. In addition, NIC published a review of the publication by Stephen Roulac. These publications later provided a foundation for the first major allocation of investment by institutional investor CalPERS of $200 million to the seniors housing and care sector. The Fall 2001 issue of the *PREA Quarterly* published by the Pension Real Estate Association (PREA) included an article by Bryan Bailey of CalPERS titled "Merits of Investing in Senior Housing."

In 1999, NIC launched its key financial indicators (KFIs) covering occupancy rates, construction levels, loan volumes, and performance. This was based on sample surveys and was the first national aggregate data to be published on a quarterly basis for the industry. In 2003, NIC worked with ASHA to establish seniors housing and care property type industry classifications for data collection and reporting purposes. These classifications were agreed to by each of the major industry trade associations, including ALFA, ASHA, Leading Age, and the American Health Care Association (AHCA).

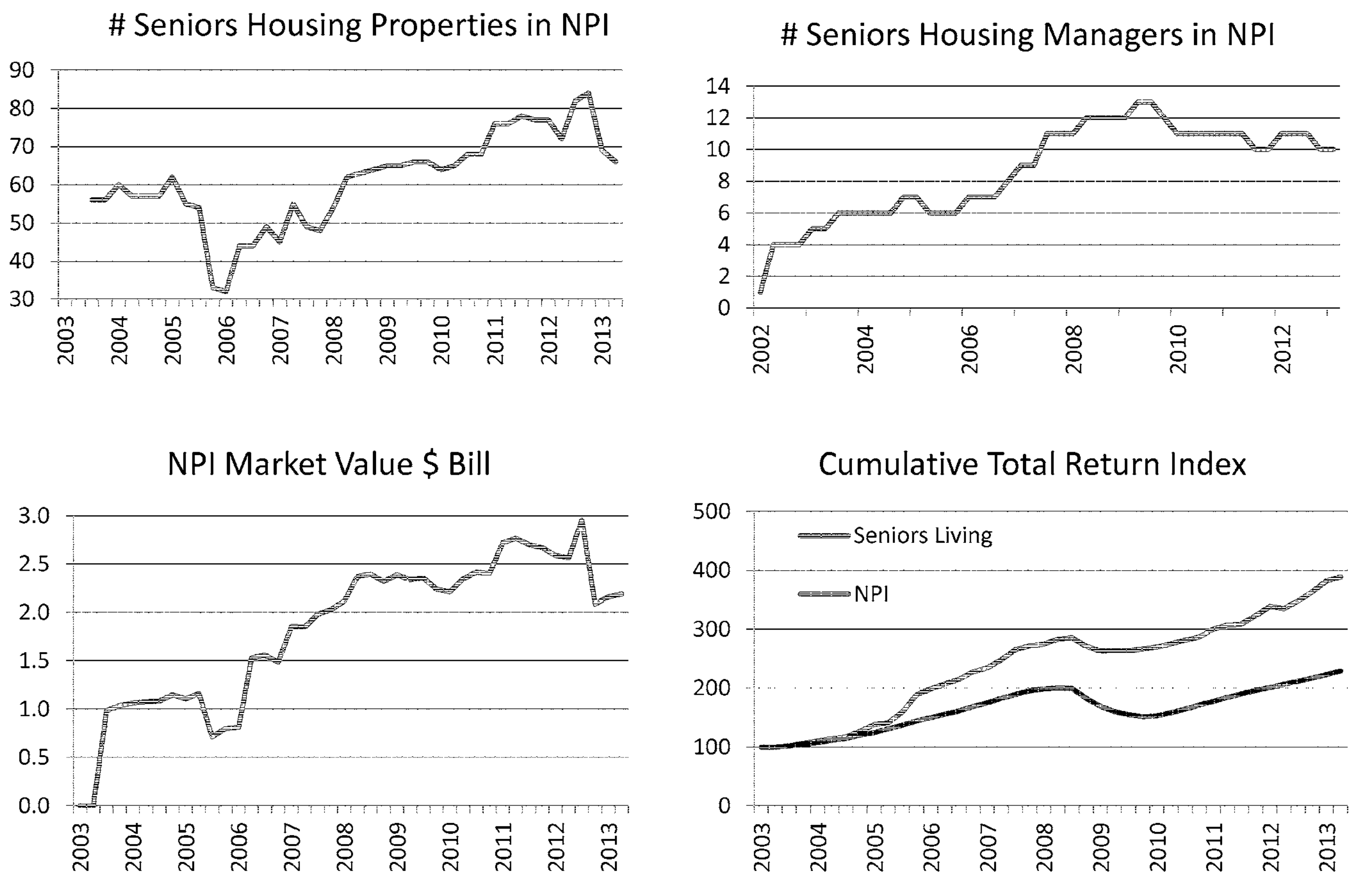
In 2001, ASHA became an independent association no longer affiliated with the NMHC. At the same time, ASHA expanded its annual ranking of the largest market-rate seniors housing operators from the top 25 to the top 50. Since 2007, this report has been published as an annual supplement to the *National Real Estate Investor* (*NREI*) magazine. In 2007, NIC partnered with ASHA to expand the sample size for the *State of Seniors Housing* and to develop a same-store sample for that report.

After providing the first quarterly national aggregate data on industry fundamentals with the KFIs, NIC launched an initiative in 2004 to begin reporting seniors housing and care industry market fundamentals for the top 31 metropolitan statistical areas (MSAs), which is based on comprehensive surveying each quarter of all investment-grade seniors housing and care properties (i.e., those of 25 or more units) within those metropolitan markets. Quarterly reporting by the NIC Market Area Profiles (MAP) Data & Analysis Services began with the fourth quarter of 2005. In 2008, the number of markets covered by NIC MAP® was expanded to the top 100 MSAs, representing almost two-thirds of the U.S. population. The data tracked includes supply and demand metrics, including total units, inventory growth, net absorption, occupancy rates, and asking rents. By the end of 2010, NIC MAP was publishing trend data going back five years for the top 31 metropolitan markets. As of year-end 2012, the number of seniors housing and care properties tracked across the top 100 metropolitan markets totaled nearly 13,000.

In 2008, NIC commissioned a white paper by Linneman Associates led by Peter Linneman at the Wharton School of the University of Pennsylvania. In the white paper, he provided an assessment of transparency for the seniors housing property market and a comparison for other areas of commercial real estate. He identified additional steps that are necessary to provide comparable transparency for commercial real estate investors. Then, in 2010, NIC published the *NIC Investment Guide: Investing in Seniors Housing and Care Properties*, with its second edition released in 2012.

NCREIF began publishing data on members' seniors housing properties in 2010, with data going back to 2003, but the number of properties in the NCREIF database is still quite small. NCREIF

Exhibit 2
Seniors Housing in the NCREIF Property Database



made a commitment to publish seniors housing investment performance data semi-annually. The reported historical investment returns, having outperformed the NPI itself, provide a compelling story for institutional investors to consider seniors housing investments (Exhibit 2).

Also in 2010, NIC formed a strategic alliance with Real Capital Analytics (RCA) to report closed seniors housing and care property sales transaction data across the U.S. and updated weekly. The timing of that strategic alliance was fortuitous, as closed seniors housing and care property sales transactions during 2011 totaled a record $27.4 billion. The transaction volume during this period was fueled by the REITs' ability to invest directly with operators via taxable REIT subsidiaries per the REIT Investment Diversification and Empowerment Act (RIDEA) of 2007. REITs dominated the transactions market during 2011, and as of 2011, the top three health care REITs, whose investment portfolios include seniors housing properties, are all S&P 500 companies and are now among the world's 10 largest REITs. As recently as 2008, only one health care REIT was among the 20 largest REITs.

As of 2012, more than 310,000 global subscribers of the Bloomberg Professional service, which is a leading provider of financial information to business and investment professionals globally, can access NIC MAP seniors housing data via the Bloomberg Industries platform. Most recently, reflecting the increased transparency surrounding the seniors housing property market, seniors housing topped all over commercial real estate property types as the most attractive property type by institutional investors for new investment in 2013, according to the results from the 17th Annual Plan Sponsor Survey conducted by Kingsley Associates on behalf of IREI (see Appendix 2 for timeline).

The growing interest among institutional investors in seniors housing can be attributed to seniors housing's recent and expected future performance relative to that of other commercial real estate property types, its solid market fundamentals, the availability of documented data of its investment and operational performance, the size and prominence of the big three health care REITs' investment in the sector, and the strong forecasted growth in the sector's target resident population. In order to attract the extent of equity and debt capital needed for the investment required in the sector to provide both the housing and care for America's current and future generations of seniors, however, it remains urgent to follow upon the efforts to date and further increase the transparency of seniors housing.

Conclusion

The growth of institutional investors into real estate began in the 1970s. Comparable information, standard definitions, standardized return information, and indexes to compare return information have been the keys to expanding the investor population over the years. Originally NCREIF reported information on the five major property types (office, industrial, retail, apartment, and hotel). Since the 1990s, NCREIF has been expanding property sectors to include additions of the NCREIF database for farmland (500 properties—7 managers), timber (400 properties—11 managers), and seniors housing (90 properties—12 managers). More information, transparency, and historic performance should help these new property sectors to grow in the institutional investor community.

The seniors housing sector has the opportunity to accelerate the historic time line for institutional investment taken by the NCREIF index. With the REIS definitions already established, the guidebook for comparable accounting reporting is available for the seniors housing property sector. Hopefully, the additional modifications specific to seniors housing will be easy to add. In addition, computer property management software and databases are available to collect historic information and create a large and accurate historic index of property performance. Just as NCREIF went back in history when the NPI was established, the seniors housing industry has the opportunity to do the same and create a reliable history that institutional investors can examine and use as they make the decision to add seniors housing as the sixth major property type to their investment universe.

In 2012, NCREIF started the Common Collection Template Initiative to streamline and consolidate the number of data requests NCREIF members receive from various organizations in the industry and thereby reduce their costs for dissemination and reporting of data. NCREIF has a task force working on the common submission template that will be released to the industry for review in August 2012. Once implemented, NCREIF members can choose to either deliver their data on their own or ask NCREIF to provide this service. The common data collection template will allow NCREIF members to maintain a low cost of access to the information for research, reporting or attribution purposes.

In parallel with the Common Template Initiative, NCREIF initiated a "consultant-only" task force in order to streamline the number of reports delivered to the consultant community. The objective of this initiative is to work with all consultants to identify the fields they require, thereby reducing the time and cost that members spend producing multiple templates while, at the same time, creating operating efficiencies for the consultant community. For each of these initiatives, NCREIF will collect, validate, convert, and deliver the data to insure a greater flow of information that should increase aggregate market transparency while reducing a NCREIF member's cost of data transmission. On a non-exclusive basis, NCREIF will also work alongside other industry organizations, such as PREA, to further develop industry standards and disseminate information consistent with

NCREIF's commitment to transparency and "open architecture."

Appendix 1

Real Estate Capital Timeline

Evolution of Commercial Real Estate as Separate Asset Class

1960s: Insurance company separate accounts—Wachovia & Prudential.

1974: U.S. government passes ERISA: Required pension fund diversification.

1975–1985: Poor stock returns and high inflation opens door for real estate investing.

1979: PREA formed to serve institutional real estate investors.

1980: NCREIF formed to produce index of institutional real estate returns.

1986: Tax Act removes real estate tax shelters, which places tax-exempt investors on equal footing.

1991: Timber Investment Advisors propose separate Timber Index to NCREIF.

1992: UPREIT structure tax benefit allows REITs to grow rapidly.

NAREIT Establishes FFO Definitions

1995: Real Estate Information Standards (REIS) first established to:

- Standardize investment elements and definitions.
- Set asset information elements.
- Standardize operating property valuation information.
- Set performance measurements.
- Establish market value accounting.

2003: REIS revised

- Set Foundational Standards for valuation, accounting, and performance measurement.
- Followed the Global Investment Performance Standards (GIPS) requirements.

2007: REIS enhanced

- Independent REIS Board was formalized.

2011: REIS published

- REIS Handbook, Volume 1 released.

PREA = Pension Real Estate Association
NCREIF = National Association of Real Estate Investment Fiduciaries
UPREIT = Umbrella Partnership REIT that allows 1031 tax deferred transfer into REIT

Appendix 2

Seniors Housing Capital Timeline

Evolution of Seniors Housing's Transparency in Attracting Institutional Capital

1990: ALFA established.

1991: ASHA started within NMHC.

1991: NIC's inaugural investor conference.

1992: *State of Seniors Housing*, first edition published.

1993: NIC incorporated as 501(c)(3) with Board of Directors.

1993: ALFA launches assisted living provider listing.

1994: NIC invited to IREI Advisory Board Meeting, resulting in laying foundation for outreach to institutional investors.

1997: NIC publishes *The Investment Case for Seniors Living and Long Term Care Properties in an Institutional Real Estate Portfolio* which provided a foundation for CalPERS making $200M allocation to seniors housing.

1999: First ASHA 25 ranking of the of the 25 largest owners and the 25 largest operators.

1999: NIC launches key financial indicators (KFIs) covering occupancy rates, construction levels, loan volume performance.

2001: ASHA 25 is expanded to ASHA 50.

2001: Fall 2001 issue of *PREA Quarterly* includes article by Bryan Bailey of CalPERS titled "Merits of Investing in Senior Housing."

2003: ASHA launches annual list of Top 50 Seniors Housing Operators.

2004: NIC and ASHA establish seniors housing property type industry classifications for data collection and reporting.

2004: NIC launches NIC MAP® Data and Analysis Service for top 31 MSAs.

2007: NIC partners with ASHA to expand *State of Seniors Housing* sample and develop same-store sample.
2008: NIC commissions white paper by Peter Linneman assessing transparency of seniors housing property market.
2008: NIC MAP® expands market coverage to top 100 MSAs.
2010: NCREIF reports and publishes investment performance data back to 2003.
2010: NCREIF makes commitment to publish investment performance data semi-annually.
2010: *NIC Investment Guide: Investing in Seniors Housing and Care Properties* published.
2010: NIC-RCA form strategic alliance to report closed seniors housing and care property sales data.
2011: Seniors housing and care transaction volume tops $27 billion.
2011: Healthcare REITs begin to make significant utilization of the REIT Investment Diversification and Empowerment Act (RIDEA) of 2007 in partnerships with larger seniors housing operators.
2011: Top three healthcare REITs now S&P 500 companies and among the top 10 U.S. REITs.
2012: Seniors housing workshop presented at VIP-North America conference for plan sponsors and fund managers; workshop will be repeated on biennial basis.
2012: Second edition of *NIC Investment Guide* released.
2012: Bloomberg establishes healthcare real estate dashboard.
2012: NIC and Bloomberg Industries announce strategic relationship through which NIC data will be made available to all Bloomberg terminal users.
2013: Results of the 17th Annual Plan Sponsor Survey conducted by IREI ranks seniors housing as the most attractive property type for new investment in 2013.

Abbreviations

ALFA: Assisted Living Federation of America
ASHA: American Seniors Housing Association
IREI: Institutional Real Estate, Inc.
NCREIF: National Council of Real Estate Investment Fiduciaries
NIC: National Investment Center for the Seniors Housing & Care Industry, Inc.
NMHC: National Multi Housing Council
PREA: Pension Real Estate Association
RCA: Real Capital Analytics, Inc.
REIT: Real Estate Investment Trust
RIDEA: REIT (Real Estate Investment Trust) Investment Diversification and Empowerment Act of 2007