Senior status

Is there a bubble in the senior housing market?

by Beth Burnham Mace

"Whenever you find yourself on the side of the majority, it is time to pause and reflect."

— Mark Twain

Like other commercial real estate property types, the senior housing and care market is hot. Transaction volumes are near record-high levels, and pricing is close to a cyclical peak. Institutional interest in the sector is growing, developers from other property types are actively building senior housing pipelines, and the cadre of capital providers continues to expand. In addition, today's low interest-rate environment is fueling activity as high relative investment returns draw investor interest, and the cost of capital for both acquisition and development is historically low.

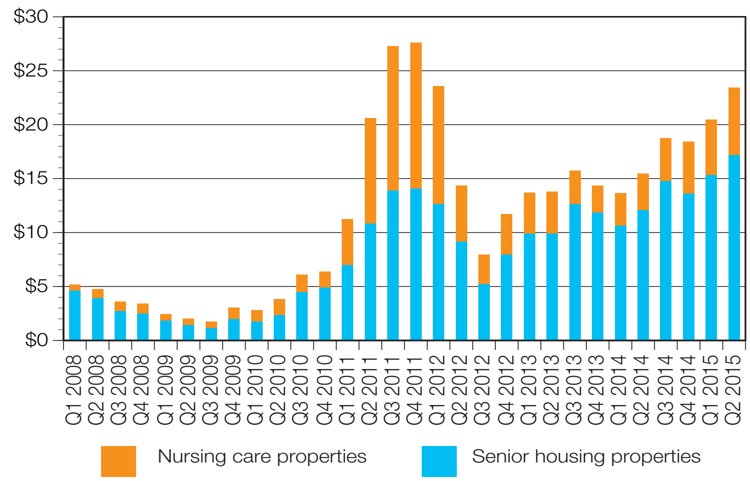
As a result of these trends, "Are we in a bubble?" is being asked frequently. While that question is answered easily in hindsight, it is not as easy to answer in foresight — unfortunately.

An active transaction market

Favorable market fundamentals, a compelling investment thesis, an improving economy and obtainable credit at attractive rates have contributed to vigorous sales, with U.S. senior housing and nursing care transaction volumes rising to more than $23 billion for the 12 months ended June 2015, according to Real Capital Analytics and the National Investment Center for Seniors Housing & Care (NIC). This was the strongest rolling four-quarter aggregate since first quarter 2012. More than 101 deals closed during the second quarter, the eighth consecutive quarter of more than 100 deals closing. Over the past four quarters, 554 transactions closed, a near-record high. This translated into 1,737 properties that traded hands.

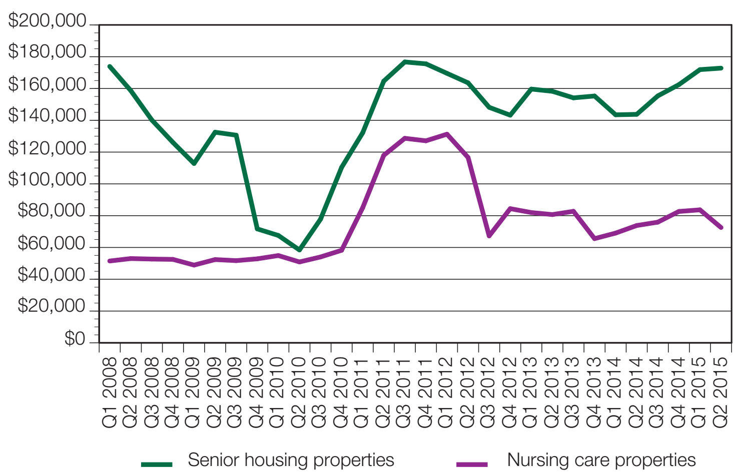
In the senior housing sector — defined as the combined independent-living and assisted-living property types — transaction volumes reached $17 billion on a moving four-quarter pace in the second quarter, the strongest volume since NIC and RCA started tracking the data. Nearly 1,000 properties were traded during those four quarters. Nursing-care property deals continued at a healthy pace, registering volume of more than $6 billion (see "Senior housing and care transaction volumes," left).

Senior housing and care transaction volumes ($ billion, rolling four-quarter aggregate)



Sources: Real Capital Analytics, NIC MAP Data Service

Senior housing and care transaction price per unit, four-quarter moving average



Sources: Real Capital Analytics, NIC MAP Data Service

To some degree, transactions beget transactions. As the volume of deals increases, liquidity grows in the market; as liquidity expands, additional investors consider investing in the sector because an exit strategy will be more secure. And, at today's prices, many owners are selling to take advantage of high unit pricing.

From the buyers' point of view, however, the growing number of investors in the sector has made the auction market extraordinarily competitive and a very challenging arena to close deals. For many investors, long-term relationships between capital providers and capital seekers are more important than ever in closing transactions because it has become difficult to compete on price alone. The flip side of this situation for sellers, however, is deal scarcity and reinvestment risk, as it becomes more challenging for them to redeploy capital at rates of returns that are comparable to the assets they have shed.

Strong pricing

High demand for properties has pushed prices ever higher and compressed cap rates. Senior housing per-unit prices averaged $172,800 in the second quarter, near peak levels (see "Senior housing and care transaction price per unit," left). The range of prices is wide, with the most favored properties exceeding $500,000 per unit and less favored properties less than $40,000 per unit. Property location, the quality and reputation of the operator, a property's age and demographic characteristics, as well as its competitive position in the market, help to explain some of the price differences.

Meanwhile, NIC and RCA report senior housing transaction cap rates have averaged 7.7 percent on a four-quarter moving average since 2012 and are down roughly 130 basis points from 2010. (Notably, the most-preferred properties are trading below 5 percent.)

Based on the RCA/NIC cap rates, the risk premium for investing in senior housing remains relatively high at 500 basis points over the risk-free 10-year Treasury rate, compared with a risk premium of roughly 300 basis points for multifamily units. But strong capital flows into senior housing potentially could reduce this differential over time and lend support to today's valuations.

Market fundamentals set to improve

Occupancy rates for senior housing properties fell 50 basis points during first half 2015, slipping to 89.9 percent in the second quarter from a seven-year cyclical peak of 90.4 percent in fourth quarter 2014, according to the NIC MAP Data Service. The decline was the result of move-outs associated with a severe flu season in the first quarter and the strongest six-month growth in inventory since 2009 (5,300 units, or nearly 2 percent of existing inventory on an annualized basis).

While supply continues to be added, a number of markets continue to grab the lion's share of construction activity. Indeed, about one-fifth of the 99 U.S. metropolitan markets NIC tracks had no senior housing construction during the second quarter, while some markets had construction in excess of 15 percent of existing inventory (Austin, Houston, Sacramento, Salt Lake City and San Antonio). Construction remains relatively concentrated, with 35 markets representing 80 percent of all senior housing construction activity.

Looking ahead, NIC expects occupancy rates will be relatively stable over the course of the next 12 months, with growing demand largely matching new supply. The number of new assisted-living units will exceed that of independent-living, but development activity in independent-living units is projected to accelerate. The need-based component of assisted living, an improving economy, a fuller residential housing market recovery and more buoyant consumer confidence should support additional demand. Demographics also will play a role, and sooner than many think.

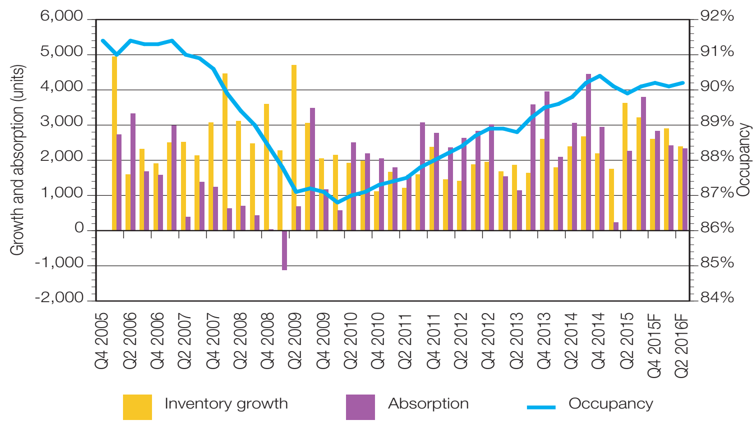
A different take on demographics

Conventional practice for estimating demand for senior housing creates a "senior household cohort" that starts at age 75. Data for this cohort are readily available and often reported by the U.S. Census Bureau and many of the demographic provider groups.

But it is possible to look at senior demand differently, and NIC recently has done so. An official and exact statistic on the average age of people moving into senior housing is not readily available; however, anecdotal evidence indicates it is between 82 and 84 years of age. Also, the *2014 State of Seniors Housing* reports the median length of stay for a resident in a senior housing property is roughly two to three years (longer for independent living than assisted living), implying the typical age of a resident in senior housing is likely between 82 and 86. Hence, we created the 82-to-86 population age cohort, based on data from the U.S. Census Bureau's 2012 Middle Series projections. We also created the 75-to-81 age cohort and the 87-plus cohort.

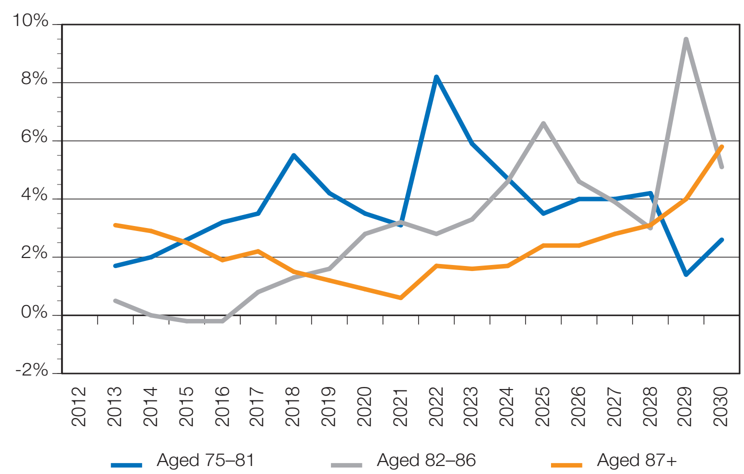
As the chart on the left shows, growth in the 82-to-86 cohort started to decelerate in 2013 and is projected to become nominally negative in 2015 and 2016. This deceleration in growth largely reflects the effects of the Great Depression, when fertility rates fell sharply, causing births to hit a low point in 1933 (see "Births per year," page 66). Those born in 1933 are 82

Senior housing supply, demand and occupancy projections through Q2 2016



Source: NIC MAP Data Service

Population growth by select age groups



Sources: NIC MAP Data Service, U.S. Census Middle Series Demographic Projections

today, the lower end of the cohort residing in senior housing.

All this suggests a demographic slowdown will occur in the primary age cohort of senior housing residents, which could affect demand for senior housing this year and next. By 2017, however, the 82-to-86 cohort will start to accelerate again and generally will continue to do so until 2025, providing a nice demographic driver for senior housing. Between 2017 and 2025, this cohort is forecast to increase in size by 1.5 million persons, or 29 percent, from 5.1 million to 6.6 million. This cohort's share of the U.S. population will grow from 1.6 percent to 1.9 percent over this period.

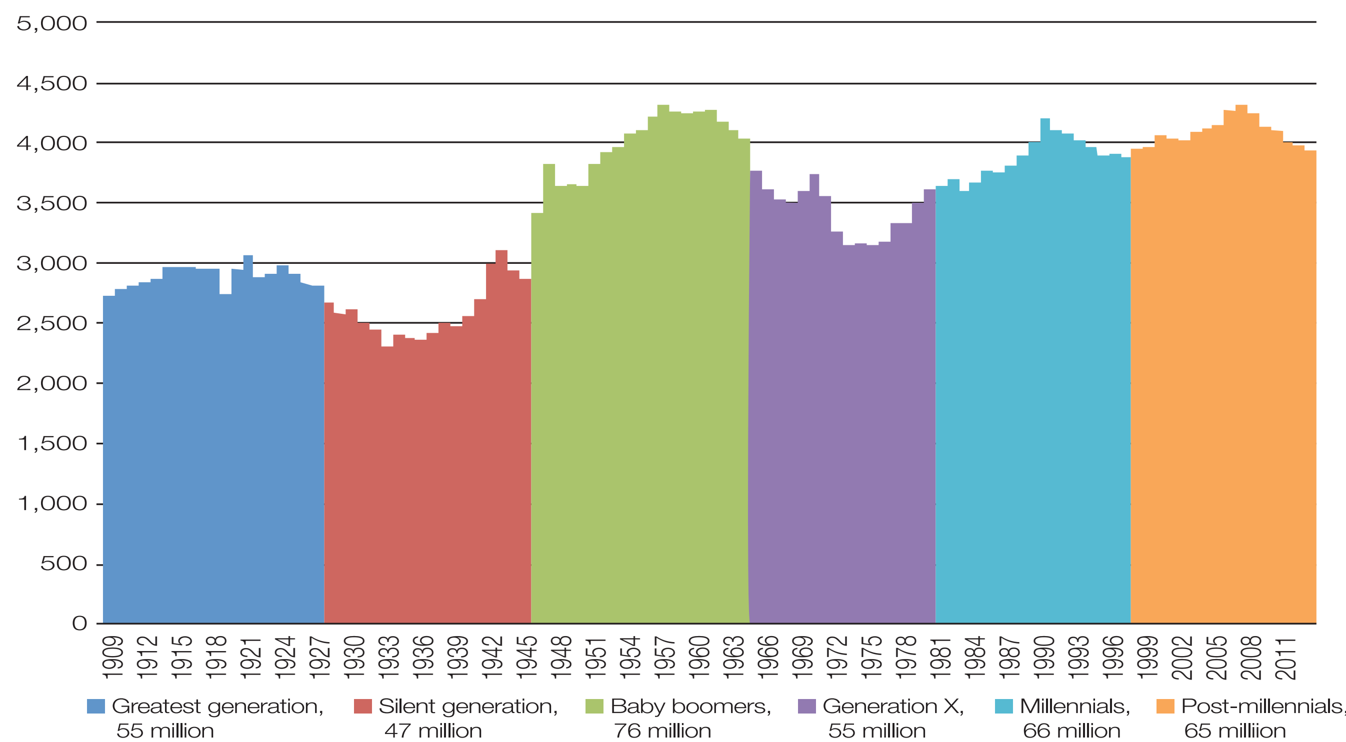
Growth for the 87-plus age group decelerates through 2021 and then accelerates. Again, this reflects the births of the 1930s, which accelerated after 1933. Although growth decelerates, it remains positive, allowing this cohort to grow in absolute numbers by 800,000, or 17 percent, between 2015 and 2025.

Growth in the 75-to-81 cohort accelerates through 2018 and then slows a bit through 2021. After that, the baby boomers start to affect this cohort, with the first baby boomers turning 75 in 2021.

For operators and capital providers of senior housing, these demographic trends have many implications. Among these are:

- The 82-to-86 age group, a significant cohort residing in today's senior housing properties, slows in growth through 2016, after which it will accelerate from annual gains of 42,000 persons aged 82 to 86 in 2017 to 400,000 in 2026. Hence, near-term demographic demand drivers for senior living may be less of a demand driver than broad economic conditions. By 2017, growth in the 82-to-86 age cohort will become an ever-larger influence on demand.
- Growth in the 82-to-86 age group, as well as accelerating growth in the 87-plus cohort beyond 2021, has important implications for demand for memory-care services. Dementia, Alzheimer's disease and other conditions that impair memory become more prevalent with age. According to research from both the Centers for Disease Control and Prevention and the National Institutes of Health, the risk of developing Alzheimer's disease, for example, doubles every five years starting at age 65. For ages 85 years and older, between 25 percent and 50 percent of people typically exhibit signs of Alzheimer's disease.
- The growth of the 75-to-81 cohort through 2018 is an opportunity for skilled-nursing operators catering to the rehabilitation needs of baby boomers, who often require reintegration services as they recover from knee- and hip-replacement surgeries.
- The combined growth of these three cohorts presents opportunities for post–acute care coordination among hospitals, skilled-nursing properties, assisted-living properties and independent-living properties because the prevalence of hospital care and service needs rises with age. Opportunities will be created by those businesses that can best align themselves

Births per year ('000s)



Source: U.S. Census Bureau

in the shared-risk environment (such as accountable-care organizations, managed-care organizations or bundled-care groups), where costs can be optimized between the post–acute care and acute worlds of hospitals, skilled-nursing properties and senior housing properties. Moreover, those operators that can effectively and efficiently integrate systems and big data to measure outcomes and reduce costs stand to benefit.

- The growth of the 75-to-81 cohort through 2018 is also an opportunity for the development of new types of alternative active-senior housing options.
- Baby boomers (born between 1946 and 1964) are currently between the ages of 51 and 69. This cohort is large, comprising an estimated 76 million Americans. While much of this group currently acts as the adult-child decision maker for today's residents in senior housing, this cohort soon will be seeking housing options for themselves that offer enticing social environments, active lifestyles and low home maintenance.

Investment returns are stellar

Institutional-quality, private-pay senior housing consistently has produced both strong income and strong appreciation returns for more than 10 years. Since 2002, NCREIF has been collecting return performance data from tax-exempt institutions, such as pension funds, that have invested in the senior housing sector. While still a relatively small number of properties, the 10-year total return performance was 14.2 percent as of second quarter 2015, outpacing the overall NPI return of 8.2 percent and beating returns for all other property types (see table to the left). Both the income and the appreciation components of return — 7.1 percent and 6.8 percent, respectively, on a 10-year basis — have outperformed.

Bubble or not?

With the discussion of investment returns, demographics, market fundamentals, and transaction pricing and volume as background, the bubble question for senior housing can be more fully explored. This is particularly relevant now because U.S. monetary policy is about to shift from being highly accommodative to a more "normal" stance, where interest rates will be rising as the economy presumably gains more even footing.

With compelling arguments on both sides of the bubble question (see box, page 69), it is difficult to conclude the outcome with any certainty. That said, like all commercial real estate, senior housing investment is locally based, and individual properties and operators can prosper under many disparate circumstances. The key for success in holding or growing valuations will be creating and maintaining product offerings that appeal to both today's and tomorrow's growing populations of elderly and their adult children with best-in-class services, care, hospitality and housing. ❖

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Senior housing returns vs. NPI and apartment subindex

Total returns

	NPI	Apartments	Stabilized senior housing
Q2 2015	3.14%	2.98%	2.45%
Q1 2015	3.57%	2.85%	4.66%
One-year	12.98%	11.60%	15.50%
Three-year	11.63%	10.74%	17.12%
Five-year	12.72%	13.30%	14.33%
10-year	8.16%	7.77%	14.23%

Income returns

	NPI	Apartments	Stabilized senior housing
Q2 2015	1.26%	1.18%	1.47%
Q1 2015	1.24%	1.18%	1.53%
One-year	5.20%	4.85%	6.56%
Three-year	5.47%	5.06%	6.69%
Five-year	5.75%	5.25%	6.93%
10-year	5.86%	5.19%	7.11%

Appreciation returns

	NPI	Apartments	Stabilized senior housing
Q2 2015	1.89%	1.81%	0.98%
Q1 2015	2.33%	1.66%	3.13%
One-year	7.49%	6.52%	8.54%
Three-year	5.92%	5.48%	9.95%
Five-year	6.68%	7.75%	7.03%
10-year	2.21%	2.48%	6.77%

Sources: NCREIF, NIC Research & Analytics

There is no bubble; valuations are secure

- Senior housing is becoming a core property type, with steady and predictable income and cash-flow characteristics. It is also a property type that has demonstrated strong capital appreciation. As the sector continues to shift from being perceived as a value-add or opportunistic investment opportunity to a core-plus or core asset, investor interest will expand further, more capital will flow into the sector, bidding will become more intense, prices will rise further and cap rate compression will continue. In addition to domestic capital, foreign capital flows into the United States will continue to rise as sovereign wealth funds try to hit their commercial real estate targets, with a share of those dollars going into senior housing as an alternative asset type.
- The risk premium for senior housing is 500 basis points or more, compared with the risk-free 10-year Treasury bond, and 200 basis points greater than for multifamily. Yet the sector's investment returns are less volatile than multifamily, its rent growth is more stable, and the sector is less tied to the business cycle because of its need-based characteristics. Adding senior housing to a multi-asset portfolio also adds diversification and reduces cycle risk. As the sector becomes better understood, its present sizable risk premium may no longer be justified and will shrink accordingly.
- Compared with the 2008 commercial real estate bubble, lending is more restrained and loan-to-value ratios are lower today, lessening the risk of values falling below mortgage levels and borrowers defaulting on their loans. This implies today's commercial real estate pricing — including that of senior housing — may be more rational than yesterday's.
- The senior housing and care sector exhibits greater transparency today. Information about market fundamentals and capital market conditions from sources such as NIC, as well as active REIT participation in the sector and Wall Street analyst coverage, allows lenders and borrowers to better understand current conditions and provides a more disciplined capital market.
- Long-term demographics alone are sufficient to justify investor interest and provide a foundation for solid market fundamentals in the coming decade.

There is a bubble; valuations are at risk

- We have re-entered perfection pricing, where underwriting assumptions are stretched to their limit for rent growth, lease-up, and exit cap rates, as well as assumptions regarding the direction of interest rates and the cost of debt. As the economy gains more steam and the Federal Reserve increases interest rates later this year and/or next, cap rates will rise and values will fall. (In this scenario, however, the stronger economy could justify aggressive rent and leasing assumptions that would result in higher NOI growth, which could offset the risk to values to some degree.)
- The labor markets are increasingly tight, with the national unemployment rate recently falling to 5.3 percent. Many states are increasing minimum wage rates. While official government statistics do not show wage pressures yet, the combination of these events will push wages higher, causing margins to decline and pressuring NOI growth. Valuations will be pressured, as well.
- Asset pricing in general, beyond senior housing, is in a bubble because of years of aggressive accommodative monetary policies, which have driven money into risky assets, making a correction inevitable.
- Rents are rising to the point development makes sense, in many instances. Developers are an overly optimistic sort, however, and will believe they have the best product offering in the best market, thwarting any competitive threats. Such thinking easily could create a bubble, led by excess supply, and result in falling occupancy rates, rents and values.
- Not all markets behave the same. The United States is a panoply of micro real estate markets, and select metropolitan area markets already may be flashing signs of the early stages of a bubble, while other markets, typically those in secondary locations, hold less risk.
- There is no bubble yet, but it is inevitable. The U.S. economy is well into this cycle's recovery. The average length of the past 11 business cycles was 58 months. As of October 2015, the economy was 76 months into the upswing phase of this business cycle. If and when a contraction occurs, commercial real estate valuations, including senior housing and care, likely will fall. That said, the 1990 expansion lasted 92 months, and the 2001 expansion lasted 10 years.