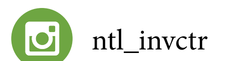
Thoughts on Capital Deployment in the Seniors Housing Sector

by Beth Burnham Mace



Thoughts on Capital Deployment in the Seniors Housing Sector

Seniors housing has arrived. It is no longer at the kids' table. Investors have taken notice. Dollars are flowing into the sector. Debt providers set generous annual allocations. Dedicated and co-mingled private equity funds are being raised as institutional investor interest accelerates. Some core funds even have seniors housing allocations. Nearly 60% of the three largest health care REITs' investments are in seniors housing. And, foreign capital has arrived, with 9% of the top 20 buyers' expenditures originating from China in the past two years.

Much Ado About Lots

Beth Mace

So, what's the fuss all about? Well, a few things. First, private equity returns for seniors housing properties have outpaced that of other commercial real estate for the last 10 years on both appreciation and income return performance. According to 1Q 2018 NCREIF Property Index (NPI) results, the total return for seniors housing on a 10-year basis was 10.52%, far outpacing the overall property index of 6.09% and apartments of 6.10%.

Second, investment in seniors housing provides diversification because the sector is not as cyclical as other property types and was shown to be recession resilient during the Great Financial Crisis (GFC). Its "needs-based" demand characteristics allowed assisted living to withstand many of the downwind recession pressures faced by other commercial real estate (CRE) sectors.

Third, while NOI growth may experience a dip in 2018, Green Street Advisors projects seniors housing will outpace the broader major sector NOI averages in 2020, 2021, and 2022. Fourth, with nearly two of every three properties built before 2000, the inventory of seniors housing properties is old, and often a property refresh is needed for design, functionality, and efficiency. Fifth, seniors housing is increasingly recognized as being part of solution for population health efficiencies and health care cost containment, a growing social, economic, and political reality.

And finally, there are the demographics, which seemingly paint a rose-colored vision for strong demand for many years ahead. Or do they?

Is It an Illusion?

The perception of immediate demographic-driven demand by the Baby Boomers for seniors housing is different from the reality. Anecdotally, today's typical seniors housing resident is estimated to be 83 years of age or older. Today's oldest Baby Boomer is 72 (those individuals born between 1946 and 1964). Based on recently updated estimates from the Census Bureau, in 2017, this equated to 8.5 million individuals. In 2018, an additional 138,000 people are projected to age into the 83-plus cohort. By 2025, the Census Bureau estimates that there will be 10.2 million people in this cohort for an increase of 1.6 million people over the eight-year period from 2017 to 2025.

With a penetration rate of roughly 10%, this suggests the need for 164,000 additional units of seniors housing supply over this eight-year period. If we assume for the nation the continuation of the estimated roughly 45,000 seniors housing units built in 2017, 164,000 additional units could be added in just 3.7 years at this run-rate and, thereby, outpacing the potential eight-year demand requirement and suggesting excess supply at the national level.

There are three ways to prevent this supply-demand balance disequilibrium, of course. The first would be to slow the rate of new supply delivery to below today's fast pace; the second would be to boost demand by growing the penetration rate toward the high-teens from roughly 10% today; and the third would be some combination of the

two. (See January 2018 NREI article on growing penetration rates http://www.nreionline. com/seniors-housing/how-can-industry-grow-penetration-rates-seniors-housing-sector.)

It is notable that not all markets in the nation face the same conditions, however. There is a very wide 17-percentage point difference between first quarter 2018 occupancy rates for the most occupied seniors housing market (San Jose at 95.1%) and the least occupied (San Antonio at 78.3%), according to NIC MAP® Data Service. Supply has been a more notable issue in many of the Sunbelt metropolitan markets, and less remarkable in the higher barrier-to-entry markets such as Northern California.

Challenges Remain

In addition to supply and demand imbalances, a significant concern recognized by savvy seniors housing investors is the challenge many operators have recruiting and retaining appropriately trained staff at all levels in the organization. Moreover, at 3.8% in May, the national unemployment rate was at its lowest level since 2000, with shortages reported by seniors housing operators for front line staff, middle management positions, and executive directors.

And competition for staff is fierce, with frequent stories of incumbent operators losing their highly coveted and trained staff to new comers in a market (see April NREI issue that addresses solutions to labor shortages http://www.nreionline.com/seniors-housing/tight-labor-markets-what-can-seniors-housing-and-care-operators-do).

Indeed, the need for institutional care providers will only increase as the number of adult children who can take care of their aging parents shrinks. Current forecasts by the BLS show that the ratio of caregivers (defined as 45-64-year-olds) to those over 80 will shrink from 7:1 today to 4:1 by 2030.

Taken in its entirety, it's a time for a cautious near-term approach in the seniors housing sector. Currently, some operators face challenging market conditions as supply has outpaced demand. Operators and investors that had underwritten deals with 90% or 95% stabilized occupancy rates a few years ago are facing pressures as they open into markets with 85% or lower occupancy rates. In a time of rising expense pressures, where average hourly earnings for assisted living operators are increasing at a 5% annual clip, achieving NOI expectations may be difficult.

On the other hand, investors that have partnered with strong operators located in strong markets are seeing outsized investment returns today. And for those who are not yet seeing these returns, they can perhaps draw comfort from the prospects of the demographics coming, although perhaps not immediately. For those investors with capital, holding money on the sidelines may be a good near-term strategy, as a growing number of distressed deals need capital infusion, recapitalizations, and new partners.

Note that a shorter version of this article appears in NREI's Mid-year Outlook.

**This document is the extended version of the NREI article that will be published later this summer. The exact date to publish the NREI article will be announced soon.*