In the Insider September 2015 Issue

» Veteran Lender Kathryn Burton Gray Sees a Market Shift in the Making
» Seniors Housing Caps Remain Low
» NIC Keynoter David Gergen Previews His Remarks on Politics and Seniors Housing
» Industry Internship Program Builds Momentum, Introduces Improvements
» Crowdfunding: An Alternative Capital Source for Seniors Housing
» Seniors Housing & Care Industry Calendar

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Veteran Lender Kathryn Burton Gray Sees a Market Shift in the Making

With more than 28 years of experience as a commercial lender, Kathryn Burton Gray has first-hand knowledge of economic cycles. She’s seen the impact of the ups and downs on the seniors housing sector and brings that valuable perspective to her current position as Head of Health Care and Senior Managing Director at RED Mortgage Capital, LLC, the mortgage banking arm of RED Capital Group, LLC (RED), Columbus, Ohio.

NIC recently spoke to Burton Gray from her office in Dana Point, CA. She talked about current lending conditions, and why a micro-focus on markets may be the best insurance against overbuilding.

NIC: How would you characterize the lending climate for seniors housing and care?

Burton Gray: It’s a great time for borrowers, but I would say the lending market is frothy. A lot of new lenders have entered the space recently, attracted by the compelling demographic trends driving demand and the increased acceptance of seniors housing as an asset class among commercial real estate investors.

Unfortunately, many of the new lenders aren’t fully educated about the product. Few have significant underwriting experience in the asset class. Moreover, many have not been exposed to the impact of a complete economic and real estate cycle. Frankly, I’m surprised at some of the deals getting done and how aggressive the terms are.

NIC: What’s the impact on cap rates?

Burton Gray: Cap rates have compressed and valuations are becoming a big concern as a result. Three years ago, assisted living buildings were being underwritten at cap rates between 8 and 10 percent. Now, cap rates are in the 6 to 8 percent range.

When underwriting any credit product, you want to start with the right value. At RED, our underwriting approach is more conservative. We want to establish a valuation based on a longer view: what we think will happen in the capital markets over the next three years. That’s our orientation.
NIC: Will cap rates rise?

Burton Gray: I think cap rates are likely to go up. We’re in strange times. We have a lot of capital chasing few deals, and when competition intensifies, lenders forget what happened in the past.

I want to stay ahead of the game and anticipate the direction the market is heading. We want to avoid putting clients in facilities that are over-levered and ultimately too expensive to operate profitably.

If there’s a shift in the market and a borrower’s property value is less than we predicted, then someone has to fill that gap. Typically, it’s the borrower who has to provide more equity to rebalance the loan. We prefer to underwrite prudently at the outset to ensure surprises like this don’t happen.

NIC: Do you expect an interest rate hike?

Burton Gray: All signs are pointing to a rate hike by the Federal Reserve, and it is likely to occur sooner rather than later.

In terms of the impact, lenders are likely to underwrite more cautiously in anticipation of further rate increases to come. In the past, when the Fed signals that it intends to tighten monetary policy, the first move is just one in a series of rate hikes. So lenders may begin to negotiate different types of interest rate protections, such as interest rate caps and floors. Loan covenants will be impacted; borrowers will pay more.

NIC: Is there overbuilding?

Burton Gray: There’s a lot of real estate development across the board, of both residential and commercial properties, including seniors housing. But I’m not worried.

It’s not comparable to the 1990s, when assisted living facilities were overbuilt. Back then, we had a lot of developers with commercial property experience putting up buildings, but they had little understanding of the product, the market or even how to conduct a proper feasibility study. Today is not the “Wild West.” Operators and real estate owners are very thoughtful now.

Moreover, there’s a lot of tired product out there that does not offer seniors the facilities and amenities that the market expects today. So, we’re increasingly looking at development opportunities, not only in markets that are demonstrably underserved, but in markets with older inventories.
I like new, fresh product. But I find the markets are micro-focused: not every market or submarket can support new supply.

I wouldn’t say I’d never lend to build in certain markets. Every proposal is unique. A lending decision, particularly when it involves new construction, depends on a lot of factors, such as the site, the competition, market capacity, population growth, the type of product, and how it may perform 10 years in the future.

NIC: What about existing product and portfolios?

Burton Gray: When we look at a portfolio with older buildings, we want to understand the plan. Is it to replace some of the old, functionally obsolete buildings with something new? Can the portfolio absorb those kinds of costs and still make the payments on the older buildings? What’s the competition? How will older buildings be adapted to accommodate new technology?

NIC: Do you expect more big portfolio deals?

Burton Gray: The number of large transactions will be limited. There is only so much product out there, and we already have seen a great deal of consolidation.

NIC: RED is a big agency lender. What’s the focus at Fannie Mae, Freddie Mac, and HUD?

Burton Gray: The agencies are focused on affordability. There’s a lot of high-end construction going on, but few developments targeted at households with low or moderate incomes. Affordable product is the government mandate, and this is the kind of transaction they prefer to see these days.

The average rent and service charge in an assisted living property in the 31 largest U.S. markets is about $4,400 a month, according to NIC. If the resident has any cognitive impairment, it could cost $5,000 to $10,000 a month. How long can someone afford that?

Owners and operators should think about how the undersupplied affordable market is going to be served. Someone has to address this.

NIC: What's the biggest change you've seen in seniors housing and care in the last 15 years?

Burton Gray: There's been a paradigm shift in the markets served by different segments of the senior housing continuum. Assisted living is picking up a lot of residents who previously would have been living in skilled nursing facilities. As a result, there's been a significant decline in the number of skilled nursing facilities, and many of the remaining ones are tired or obsolete.
Also, independent living increasingly is becoming “assisted living-lite.” Independent living facilities are offering home-health care and other services to residents who need help in order to retain active tenants with moderate acuity health issues that in an earlier era would have transitioned to assisted living.

NIC: How will the shift impact the industry?

Burton Gray: More regulatory oversight is coming. There will be an emphasis on the quality of care.

**Seniors Housing Cap Rates Remain Low**

**Where will they go once the Fed moves?**

**Chris McGraw, Senior Research Analyst, NIC**

Cap rates for seniors housing properties continued to hover near recent lows during the second quarter of 2015, remaining at 7.7 percent. While a historically low rate, cap rates have remained essentially unchanged during the past two years, oscillating between 7.5 and 7.8 percent. As the chart below shows, cap rates for seniors housing have generally been higher than those for the four other property types—industrial, office, retail, and apartment. The exception in recent years has been hotels.

Investment activity is generally consistent with low cap rates, with strong property sales volume. In the second quarter, transaction volumes for seniors housing exceeded $4 billion. Despite registering one of its strongest quarters on record for sales volumes, seniors housing is not the only property type experiencing robust investment. Industrial, retail, and apartment volumes have reached record-high levels in the second quarter, according to Real Capital Analytics (RCA), while office and hotel are at their highest dollar volumes since 2008. Like seniors housing, these high volumes of trades have been associated with rising prices.
Due to perceived risks associated with seniors housing (being an operating business among them), seniors housing has a relatively wider risk premium compared with other property types. As the chart to the left shows, this risk premium is about 550 basis points, more than 200 basis points greater than for apartments (where risk premium is defined as the difference between a property type's cap rate and the risk-free 10-year Treasury bond). As the chart shows, the relative gap with other property types has remained essentially unchanged since 2008. However, there is an argument that the risk premium may narrow in the future as increasing investor interest and rising capital flows as well as greater transparency occurs in the sector. The jury is still out as to whether that will happen and what the timing will be, but for the time being the spreads seem stable.

The big question in the near-term is how cap rates will react once interest rates rise. The fed funds rate has remained near zero since December 2008, but could see its first increase since 2006 in the coming months, when and if the Federal Reserve decides to start normalizing its accommodative monetary policy. How cap rates will react is a big unknown, but we should begin to find out once interest rates start to move higher.

NIC Keynoter David Gergen Previews His Remarks on Politics and Seniors Housing

Ask political analyst David Gergen about the unexpected events and big personalities that have dominated the presidential campaign so far and he’s surprisingly candid. “We’re living through, or enduring, the most unpredictable time in our politics that any of us can remember,” he said.
Gergen will expand on that observation and offer other insights as keynote speaker at the 25th NIC National Conference, Sept. 30-Oct. 2, Gaylord National. Noted author and senior political analyst at CNN, Gergen will provide an inside-the-beltway look at the presidential race and how the ultimate results will impact the industry.

NIC spoke to Gergen in early September to preview his address at the Oct. 1 luncheon. Take note: He's no newcomer to seniors housing. His mother lived for years at a continuing care community in North Carolina, where he gave talks to residents. Here’s a sample of what to expect:

**NIC: How do you think the presidential primaries will unfold?**

**Gergen:** I don’t think any of us know how this will unfold. In the early stages, the candidates have defied gravity. There’s a real sense that Donald Trump and Bernie Sanders are doing much better than anyone expected, and they will continue to affect the campaigns and the next administration.

**NIC: Do you expect outsider or establishment candidates to win the nominations?**

**Gergen:** If you’re in favor of the status quo, you can’t help but feel somewhat endangered. As we speak, in Iowa, respected polls show Donald Trump, Ben Carson, and Carly Fiorina together getting 55 percent of the votes. Not one of them has ever held public office, and what that means is that an outside anti-establishment candidate is likely to be one major alternative for the Republican Party.

**NIC: What about Donald Trump’s prospects?**

**Gergen:** Right now, you have to say that Donald Trump has a surprisingly realistic chance to win the Republican nomination and even a possible chance to win the presidency. Who would have thought that six months ago?

**NIC: What about the Democrats?**

**Gergen:** There’s a lot of pressure on Hillary Clinton to move to the left because of the candidacy of Bernie Sanders. I think the odds are slightly in favor now of Joe Biden jumping in the race. Hillary Clinton is still the favorite, but my concerns are not whether she can win, but whether she can govern.
NIC: What's driving voters?

Gergen: Watching television, you'd think it's all about personality. But I think it's economics. That's one of the reasons why Trump is doing better than expected. He's a businessman who built his own empire.

NIC: Will the Republicans continue to try to repeal the Affordable Care Act?

Gergen: It will be in the Republican platform and the candidates will campaign to see who can do the most wreckage. But they have to come up with an alternative and chances are high that something like the current law will stay in place.

It's similar to the situation with the Iran treaty. The chances are high that something will remain in place. But the big question on foreign policy will be: What are we doing going forward in the Middle East?

NIC: What's your impression of the seniors housing and care industry?

Gergen: The high-end of seniors housing is wonderful and the low-end is awful. Some government regulation or oversight is important, just as child care has to meet certain standards. On the other hand, there are more housing options which are outstanding. I've spoken at a number of retirement homes, and I am impressed with what they offer. They're terrific places to have great conversations, get exercise, and have dinner with friends.

NIC: What changes are ahead?

Gergen: I think there will be pressure from consumers to provide a better experience. There's an approach from Stanford University called Design Thinking. It's all about creating designs with a consumer focus and it's coming to hospitals. It's not the answer to everything, but it puts the experience of the consumer first. I think there will be a lot more of that for seniors in the next few years.

Industry Internship Program Builds Momentum, Introduces Improvements

Amid an industry-wide push to recruit fresh leadership, NIC's internship program is showing signs of success. The program, which places college and graduate students in summer jobs at seniors housing and care companies, has also expanded its outreach.

"We've had a great year," said NIC Internship Committee Chair Aron Will, who cited several noteworthy metrics:
In 2014-2015, the internship program received 159 applications from undergraduate and graduate students at 11 participating universities.

Fifteen seniors housing and care companies participated in the program.

Four schools were added to the program.

The program resulted in six permanent job placements.

In an effort to deepen their understanding of the sector, program interns as well as representatives from the universities, are being invited to the 25th NIC National Conference, September 3-October 2, National Harbor. Will, and several internship committee members, will also hold a program overview session for the schools at the Conference.

Meanwhile, the committee is reaching out to participating companies to see how the interns fared this summer. “We want feedback,” said Will.

The internship program was launched five years ago in an effort to attract and develop talent for the seniors housing and care industry. “A lot of people in seniors housing end up in the sector by happenstance,” said Will, executive vice president and co-head of the seniors housing group at CBRE, Houston.

The premise of the internship program is to create visibility for the industry at universities to find talented students who want to work in the sector, not because they fall into it, he added. Another goal is to raise the industry’s visibility by partnering with a diverse range of established university disciplines in real estate, hospitality, finance, gerontology, and technology.

“Our asset class has grown tremendously over the last few years,” said Will. “But it’s generally not understood within universities.”

The program offers internship opportunities for both undergraduate and graduate level students. And though the internships have traditionally focused on operations, the type of seniors housing companies participating in the internship program is becoming more diverse. Host companies now include REITs, investment banks, health care providers, management companies, consultants, and industry associations.

“We recruit good candidates,” said Will, noting that his company, CBRE, hired its summer intern, an MBA student from the Wharton School of the University of Pennsylvania. Other permanent job placements have been made at Belmont Village Senior Living, Wells Fargo, Healthcare REIT, and New Perspective Senior Living.
The internship program website (nicfutureleaders.org) serves as a central repository for information on the program, industry, and host companies. On-campus recruitment and promotions drive students to the website where they can search for jobs. All applications are submitted electronically. Host companies have access to the online portal, which maintains job postings, records candidate information, and allows a paperless recruitment process.

New initiatives

Several changes have been made to the program to further improve results. The four universities added to the program this year were selected, in part, based on their location in the South, which had been underrepresented. Companies find it difficult to recruit interns from faraway schools because students are more likely to take positions at companies near campus.

“We wanted broad geographic representation,” said Will. The new schools are: the University of Georgia; the University of North Carolina at Chapel Hill; the University of Texas; and Emory University. The seven original partner schools include: Cornell University; the University of Wisconsin School of Business, Center for Real Estate; Washington State University, the Wharton School at the University of Pennsylvania; Columbia University; the University of Southern California (USC), Davis School of Gerontology and Marshall School of Business; and the Erickson School at University of Maryland, Baltimore County (UMBC).

The internship program has also adopted a new software system that automatically tracks intern placements and records their progress. The premise is not just to place best-in-class talent in the industry, Will said, but to follow their careers.

Another fundamental change is the introduction of a new, accelerated recruitment calendar. Top talent is difficult to attract if the effort is launched late in the year, said Will. Many finance companies line up interns in the fall and have already made summer hires by January.

The goal this year is for host companies to confirm and post job descriptions by October 2015. The open recruitment period will run until May, with internship start dates of May/June 2016. “It’s important to start recruitment in the fall,” said Will.

Crowdfunding: An Alternative Capital Source for Seniors Housing

Crowdfunding is one of the newest sources of alternative capital to hit the financial services industry, and now it is being applied to the seniors housing industry. Initially used to provide funding for innovative start-up ideas, crowdfunding has evolved into an equity and debt investment...
vehicle for large-scale projects. Through crowdfunding, investors can pool their money together and buy shares of a specific property. This often offers an investor more transparency and/or control over their investment decision as compared to a traditional fund.

The equity crowdfunding industry grew by 182% in 2014, raising more than $1.1 billion, according to the marketing research group, Massolution. Ranking as one of the top five U.S. real estate crowdfunding deals in 2014, Mainstreet® used the CrowdStreet platform to raise $1.8 million by attracting accredited investors from different cities across the country. Recently, NIC Future Leaders Council (FLC) members Jason Dopoulkos with Lancaster Pollard, Margarita Muzzall with PNC Real Estate, and Amy Coppens with Senior Resource Group spoke about this emerging source of alternative capital to Scott White, executive vice president, investments, with Mainstreet and Darren Powderly, Co-Founder of CrowdStreet, Inc.

What made you consider crowdfunding as a capital option for seniors housing?

Scott White/ Mainstreet: As the nation’s largest developer of transitional care properties, Mainstreet has developed more than $500 million of properties and raised approximately $1.1 billion in capital to date, and we are always looking to match capital needs with innovative real estate investment opportunities.

But it wasn’t until the JOBS Act created rule 506(c) of SEC Regulation D that crowdfunding became a serious consideration. Rule 506(c) lets issuers offer a general solicitation and advertise the offering without running afoul of government regulations as long as the sponsor confirms there is a higher level of scrutiny to ensure investors are accredited. Investors must prove to sponsors that they have met the net worth or income requirements and are accredited.

Whether being used as common equity, preferred equity, mezzanine or debt, crowdfunding offers a new approach to capital raising. Using a capital stack with 75% senior debt, 10-15% mezzanine debt and 10% equity, crowdfunding has become a way to access a broader pool of investors. Generally, we see this as most commonly being used for acquisitions, but it could definitely be used for operations or development.

How did you use crowdfunding financing as part of a capital stack for development?

Scott White/ Mainstreet: Our first project was in Bloomington, IN, and was structured as mezzanine capital with a flat annualized return. The goal was to raise $1.5 million in Q1 of 2014. We received commitments for more than $1.8 million and closed more than $1.6 million. We used CrowdStreet to host the crowdfunding platform and it took about four weeks to raise the capital. We recently completed the development, sold the property and returned all the capital plus a 14% annualized return on investments for investors.
What potential challenges did you encounter with Crowdfunding financing?

Scott White/ Mainstreet: Although it only took approximately four weeks to raise the capital, it took about six months to prepare. This was our first project with crowdfunding and we were pleased with the result. While we found it efficient, there were certainly costs associated with this method of capital raising. The majority of costs were for legal fees surrounding the research associated with crowdfunding. Since it was new, we were also trailblazing a path and not relying on precedent.

We used a third-party company to verify that the prospective investors were accredited once they had made a commitment. We would absolutely do it again. It wouldn’t take much more upfront time to raise many millions of dollars.

What other benefits did you find associated with crowdfunding besides the financial aspect?

Scott White/ Mainstreet: For us, the crowdfunding efforts had tremendous branding and marketing value in addition to the financial side. We feel it allowed Mainstreet to generate meaningful goodwill and brand equity.

At Mainstreet, we are changing the perceptions of what used to be considered a “nursing home” by offering a new model for a new generation—a architecturally beautiful, lifestyle-oriented communities. Crowdfunding provided us with an additional vehicle to get our story out and further enhance our brand. For the offering, we developed a fully branded website, separate from our company website, and linked it to CrowdStreet on the crowdfunding platform. This enabled us to generate increased brand awareness while also generating financing.

Darren Powderly/ CrowdStreet: The success of Mainstreet’s project underscores the value gained by both investors and sponsors when institutional-quality commercial real estate opportunities are made accessible online to accredited investors nationwide. Crowdfunding is the democratization of the capital raising process. Now, investors and especially smaller investors, can access investments that previously would not have been available.

Do you see crowdfunding becoming a more accepted financing method for seniors housing?

Darren Powderly/ CrowdStreet: Yes. Where else can the small investor access 14% return without having personal connections?

Scott White/ Mainstreet: Absolutely. We found crowdfunding offered financial as well as marketing opportunities and benefits.

For more information about Mainstreet or to contact Scott White, visit [http://www.mainstreetinvestment.com](http://www.mainstreetinvestment.com). For more information on CrowdStreet or to contact Darren Powderly visit [https://www.crowdstreet.com](https://www.crowdstreet.com).
### Seniors Housing & Care Industry Calendar

#### September 2015:
- **30-2** 25th NIC National Conference, Gaylord National, National Harbor
- **30-2** 25th Annual Institutional Investor Real Estate Conference, The Westin St. Francis, San Francisco, CA

#### October 2015:
- **4-7** AHCA/NCAL Convention & Expo, San Antonio, TX
- **19-21** 2015 CALA Fall Conference & Trade Show, Westin Mission Hills Resort and Spa, Rancho Mirage
- **21-22** ALFA 2015 Senior Living Executive Forum, Rancho Mirage, CA

#### November 2015:
- **1-4** LeadingAge Annual Meeting, Boston, MA
- **11-13** NCREIF Fall Conference 2015, Orlando, FL
- **17-19** REITWorld: NAREIT’s Annual Convention Las Vegas, NV

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### Congratulations to the 2015 ARES Manuscript Prize Winners!

#### Senior Housing: The Effect of Age-Restricted Housing on Surrounding House Prices

By:
- Karen Gibler, Georgia State University
- Tanja Tyrväinen, Tampere University of Technology
- Velma Zahirowic-Herbert, University of Georgia

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