Find the Right Audience for Senior-Housing Deals

Quality operators are the key to brokering deals and achieving long-term success

By Bennett Johnson

Entering fourth-quarter 2017, the senior-housing and care industry remained active. This sector is comprised of independent and assisted living, memory care, nursing care, or any combination of these care levels, including continuing-care retirement communities.

The senior-housing sector, with long-term demographic appeal, need-driven demand and favorable historical yields, continues to attract interest from potential new investors and those already familiar with the space. Commercial mortgage brokers should also pay attention to the sector's financial viability.

With approximately 10,000 baby boomers turning 65 each day — and the leading edge of that generation turning 71 this year — the longer-term demographic story is attractive for senior housing. By 2050, the 65-and-up age group is expected to be 88 million strong, which is nearly double its current size.

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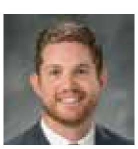

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Yet, recognizing that the average age for a person in assisted living is about 88, the sector still has time before baby boomers make a significant impact.

Nonetheless, the aging of America will have a major impact on health care spending, policies, economic growth and certainly the demand for senior housing. In turn, it will impact the demand for financing these properties.

Financing

Although the space has been active, financing for senior housing in 2017 has been an increasing challenge. It's taking more time to close deals as a higher emphasis is placed on vetting both the investor and the property market. When reviewing new deals, the operator behind the project is the initial indicator for qualification, given the high impact they have on making a project successful or not.

If there is not a strong operator in place, financial institutions will be wary of moving forward. Secondary items pertaining to property-market performance and new supply also come into play, particularly with concerns of overbuilding in specific markets, as well as how this could impact underwriting metrics — such as growth rate, occupancy and concessions over short- and long-term periods. Understanding both the operator's experience and the market dynamics are critical to getting deals financed.

According to a 2016 report from the National Investment Center for Seniors Housing and Care (NIC), there are about 23,350 professionally managed senior-housing and nursing-care communities in the U.S. with 25 or more beds. This represents more than 3 million managed residential units nationwide. The combined projected total value of the sector was $475.1 billion.

Deal flow in the sector hit an all-time high in 2014 and 2015, driven largely by the real estate investment trusts (REITs) that were active buyers coming out of the global financial crisis. While REITs generally pulled back through 2016 and focused on a portfolio-optimization strategy by divesting less-desired properties, there again appears to be an appetite for acquisition.

Although REITs were less active through 2016, institutional buyers largely stepped up their activity and now comprise 29 percent of transactions, a sharp increase from 6 percent in 2015, according to a sales-transaction report from NIC and Real Capital Analytics. Foreign capital from China has begun to filter into the long-term care industry as well, yet current political challenges abroad could curb the ability for capital to flow into the U.S.

Underwriting

Recently, more analysis is being placed on the sustainability of operating performance when pricing deals. Because senior housing is a hybrid between multifamily, hotel and medical, it becomes complex to underwrite. Conventional underwriting models are not easily applied and assumptions to reflect the space — including occupancy rates, rent rolls, growth rates, expense estimates and other revenue sources — should be considered. As such, with consideration to value, it is not simply cap-rate changes but correct underwriting of cash flow that is having a greater influence on pricing within the sector.

Generally, transactions in 2017 have shown more cautious underwriting and, although property sales volume is down compared to 2016, it still outpaces 2013 and 2014 levels, according to a CBRE investor survey and trends report from this past spring. Given the changing economic climate and operating challenges, investors are in a period of more rational pricing with increased scrutiny from lenders. CBRE projected stable valuations through 2017 in its spring report.

Government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac offer some of the lowest floating-rate debt in the senior-housing sector, with interest-rate spreads lower than most balance-sheet lenders. The GSEs underwrite to stabilized performance and are often looking at in-place cash flow.

Meanwhile, bridge and mezzanine lending for nonstabilized assets has grown substantially. Typically offering loans priced 200 to 400 basis points above the GSEs' floating spreads, bridge lenders include both traditional banks and specialized, higher-yield investment companies. Construction debt, although it's increasingly challenging to secure, is sourced through the U.S. Department of Housing and Urban Development, as well as regional and local banks where prior personal relationships with investors and brokers exist.

Profits

The scarcity of Class A product and the relatively high number of buyers for senior-housing deals has propped up pricing to peak levels. Investors also are chasing more moderately priced Class C properties for value-add opportunities in an effort to seek yield as construction costs continue to creep up.

Nationwide cap rates for senior housing increased by 44 basis points year over year in 2016, to 8.14 percent, while nursing-care cap rates declined by 10 basis points, to 11.9 percent. As of this past second quarter, the spread between senior-housing cap rates and the benchmark 10-year U.S. Treasury note remains under the 20-year average at 581 basis points, indicating room for further compression. Hence, rising interest rates could have little impact on cap rates, at least initially.

The stabilized occupancy rate on these properties declined year over year in fourth-quarter 2016 to 90.9 percent, then dipped further this past second quarter to 90.6 percent. According to NIC, the decrease was primarily attributed to the assisted-living and memory-care sectors, with occupancy rates decreasing to 89.7 percent and 88.1 percent, respectively, during first- quarter 2017. Nursing care reported its lowest occupancy rate in a decade, at 86.6 percent. Independent living, however, continues to maintain the sector's highest occupancy, at 92.2 percent, for second-quarter 2017, just slightly below its peak of 92.4 percent in the previous quarter.

Development has been driven by the availability of capital and the demand for more product. While this has led to concerns of having too many senior-housing communities, the industry is expected to stay localized in

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terms of meeting the needs of an individual market. Construction trends and new supply should be examined on a market level, not a metro level, when understanding impacts to property performance.

Because of rising construction costs, a lack of available properties, the high costs of land and increased lender scrutiny, however, there has been a recent decline in construction starts. The percentage of units under construction was 6 percent of total supply in fourth-quarter 2016, and the number declined to 5.8 percent in first-quarter 2017.

Other factors

The federal government continues to seek changes to health care, specifically the Affordable Care Act. That could result in changes to Medicaid reimbursements, which currently cover about 60 percent of the revenues for nursing homes nationwide.

Revenues are often balanced with a portion of shorter-term residents, who are covered under higher reimbursement plans, including Medicare and private insurance. Pressure for shorter resident stays along with a reduction in Medicaid payments, however, could produce performance challenges for senior housing.

Yet, operators have historically shown resilience to what is always a volatile and changing reimbursement market. Further, this dynamic sector still commands the highest cap rates among commercial property sectors, and it has seen only nominal downward pressure over the past 10 years.

The nursing-care industry is facing pressure for continued consolidation, allowing operators to form partnerships with local health care organizations. As a result, pricing was very strong through 2016. This has shown signs of slowing recently, however, which may be an indication that investors are pausing to gauge changes in health care and any consequential risks.

Other housing sectors can be leading indicators for senior housing, with seniors often needing to sell their homes prior to relocation. This is particularly true for independent living, a less need-driven product. The generally strong housing market has spurred growth in the independent-living market, particularly as older products do not align with the demands for today's market.

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The impact of interest-rate hikes, the U.S. housing market and changes in health care, as well as the potential impact of immigration reform on the labor force, will be key metrics for the senior-housing industry going into 2018. Property-level operations, capital inflow from foreign investors and moderated, new development trends will be essential to maintaining short-term valuations. In terms of financing, commercial mortgage brokers should view quality operating partnerships as critical to long-term success. ■