Marcus & Millichap

National Report

Seniors Housing Research

First Half 2018

Changing Outlook on Homeownership Strengthens Demand for Seniors Housing; Crossover Capital Increases Pool of Buyers

Seniors housing demand invigorates as homeownership becomes less advantageous under new tax code. Changes to the tax law beginning in 2018 could benefit the seniors housing market as the advantages of homeownership are reduced, prompting some senior residents to sell single-family homes and move into senior communities. Homeownership in the 75 and older age segment has fallen for four consecutive years after peaking at a high of 80 percent in 2012 and 2013, resting at 76.8 percent at the end of 2017. A healthy housing market and benefits from itemizing housing-related expenses, like mortgage interest payments, fall under new rules that could entice additional seniors to sell homes and use proceeds to live in smaller, age-restricted housing communities. Construction, especially in the assisted living space, has grown substantially over the past few years, but demand for seniors housing should strengthen, boosted by these changes and an aging population.

Solid demographics, favorable economic outlook attract new buyer pool. REITs, private capital groups and owner-operators are all active in the seniors housing sector, and the emergence of crossover capital is growing the buyer pool for available assets. Rising interest rates are compressing yield spreads across commercial real estate assets, but with initial returns in seniors housing historically 50 basis points to more than 200 basis points above other property classes, spreads will remain favorable amid a period of increased borrowing costs. More mainstream awareness of seniors housing is also contributing to a boost in buyer demand, and investors drawn to the business component of the industry will find unique value-add options to generate higher ROIs.

Investment Highlights

- REITs have been restructuring portfolios over the past couple of years and are seeking to redeploy funds this year, targeting robust cash flowing deals in familiar markets.
- Stabilized seniors housing properties in primary markets trade at a premium, with AL and IL facilities capturing first-year returns between 6 percent and 7 percent. Initial yields for skilled nursing assets are often above 10 percent.
- Private funds and equity funds are moving into the seniors housing sector, providing a source of financing options for turn-key assets and development deals.

2018 Seniors Housing Market Forecasts

Occupancy down
20 basis points

Independent Living (IL):

Healthy demand keeps stabilized occupancy close to the five-year average, dipping 20 basis points year over year to 91.3 percent. The minimal decline in occupancy does little to thwart rent growth, and the average rises 1.7 percent to $3,158 per month.

Occupancy down
50 basis points

Assisted Living (AL):

Inventory growth outweighs demand this year, contributing to a 50-basis-point drop in the stabilized occupancy rate to 88.1 percent. Rent growth will slow as a result, reaching $4,663 per month on a 1.5 percent annual gain.

Occupancy down
80 basis points

Skilled Nursing (SN):

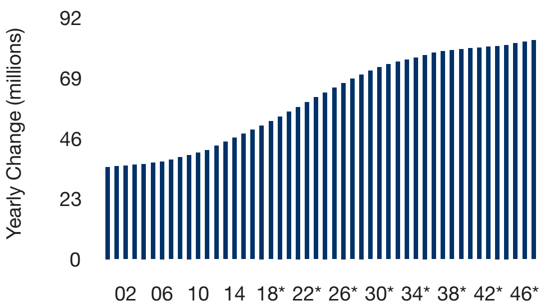
Stabilized occupancy continues to decline in 2018, falling 80 basis points to 85.3 percent, a new low for the last decade. Rising healthcare costs continue to drive up the average daily rate, however, which reaches $318 per bed per day, an increase of 2.3 percent from last year.

Occupancy up
30 basis points

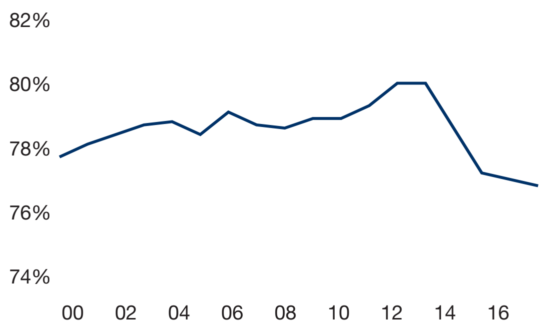
Continuing Care Retirement Community/Life Plan Community (CCRC/LPC):

Absorption remains healthy this year, and the segment will be the only to post an increase in occupancy as the stabilized rate rises 30 basis points to 91.5 percent. Rent growth remains strong, with the average advancing 3.2 percent to $3,322 per month in 2018.

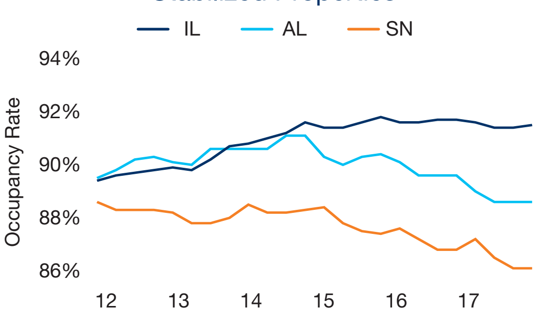
65+ Population (millions)



75+ Homeownership Rate



Seniors Housing Occupancy Rates
Stabilized Properties



* Forecast
Sources: Marcus & Millichap Research Services;
NIC MAP® Data Service

Independent Living Facilities

- The addition of IL units remains elevated. Stock grew by nearly 12,000 rooms during 2017, well above the 10-year annual average of 7,350 units. The construction pipeline remains full, with approximately 22,350 units underway at the end of last year, down from nearly 23,900 at the end of 2016, which will keep deliveries above the long-term average.
- Despite robust construction, stabilized majority IL occupancy has remained in the low-90 percent area for the past five years. In 2017, the rate ended the year at 91.5 percent, down 20 basis points from one year earlier and on par with the five-year average.
- Increased competition from newer units is slowing rent gains in the majority IL segment, with the average advancing 2.3 percent to $3,106 per month. In 2016, the average increased by 3.8 percent, the strongest annual advance in the last 10 years.
- Sales activity in the majority IL sector fell by more than half during 2016, but the segment realized a notable recovery over 2017 as transaction velocity jumped 86 percent. Strengthening demand resulted in a 14 percent jump in the average price to more than $200,000 per unit. Portfolio deals nearly tripled when compared with 2016, and cap rates compressed close to 6 percent for these deals.

Outlook: Demand for IL units remains intense, keeping occupancy above 90 percent again this year. As completions in the segment remain elevated this year, this could potentially place additional downward pressure on the overall stabilized occupancy rate, resulting in a decline again in 2018. Rent growth will continue to moderate as operators compete for tenants, and the average rises 1.7 percent to $3,158 per month.

Assisted Living Facilities

- The annual growth for AL rooms within facilities that comprise a majority of these units increased for a seventh consecutive year, reaching a decade high as roughly 18,500 units were added during 2017. At the end of the year, more than 32,200 AL units in these majority AL facilities were under construction, down from the nearly 36,000 units underway when the year began.
- Elevated deliveries have contributed to falling majority AL occupancy, and the stabilized rate fell 100 basis points during 2017 to 88.6 percent. The rate was flat for three-straight quarters as absorption strengthened in the final six months of the year.
- During 2017, average rent at majority AL facilities rose to $4,593 per month, an annual increase of 2.4 percent. During 2016, rent growth reached a 10-year peak as the rate grew 3.2 percent.
- Majority AL property sales remained flat over 2017, with the average price per unit increasing 9 percent to $167,250. Sales in Florida, California and Texas accounted for one-quarter of all transaction activity last year, with initial returns ranging from 6 percent to nearly 10 percent, depending on property age, condition and location.

Outlook: In 2018, the number of majority AL units underway remains above historical norms, though the figure is down approximately 5,000 units from the peak last year. Developers in the segment are preparing for an increase in demand as the baby boomer generation ages into their senior years. Downward pressure on the overall occupancy rate will persist and rent growth will continue to temper.

Skilled Nursing Facilities

- More than 1,700 units within nursing care (NC) facilities that host a majority of SN rooms were removed from inventory during 2017, continuing a trend of removals over the last decade. In eight of the last 10 years, inventory has shrank by an average of approximately 1,500 units each year. The construction pipeline is also thinning, as 6,800 units were under construction at the start of 2018, falling for a fifth consecutive year.
- Despite the removal of majority NC units from inventory, occupancy continues to fall, with the stabilized rate declining for a third consecutive year. The rate reached 86.1 percent in 2017, down 70 basis points year over year.
- Rent growth remains steady despite falling occupancy, driven by rising healthcare costs. The average daily rate climbed 2.5 percent last year to $311 per bed. The rate has increased by at least 2.5 percent in each of the last 10 years.
- Sales of majority skilled nursing assets soared 17 percent during 2017 with portfolios making up a larger share of trades than the prior 12 months. The average price per unit tempered to approximately $81,400 per bed, with the fall primarily driven by an increase in sales of older properties. Returns in the segment remain in the double digits as buyers seek to underwrite for risks associated with changes in government-funded reimbursement programs.

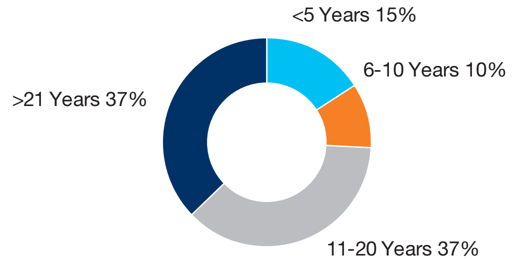
Outlook: The skilled nursing segment is undergoing many changes, and healthcare reform specifically related to Medicare and Medicaid reimbursements is causing some facilities to shift focus from long-stay custodial-care residents to focus on short-term, post-acute care patients to improve profit margins. Occupancy in the segment will continue to decline this year, but the changing healthcare landscape will keep daily rates on the rise.

CCRCs/LPCs

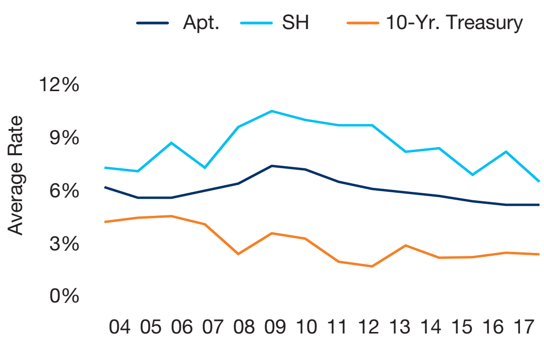
- Inventory in the CCRC/LPC segment grew by 2,000 units during the last year, the slowest annual growth since 2011. As SN units declined overall, demand for IL units within these communities has lifted the construction pipeline over the last four years and presently 8,700 units are under construction at the start of 2018.
- Occupancy at CCRC/LPC communities posted the only increase among seniors housing property types over the last 12 months, rising 30 basis points annually to 91.2 percent. The average occupancy rate has remained in the low-90 percent area for the past 10 years.
- Healthy occupancy in CCRC/LPC facilities generated a 3.4 percent advance in the monthly rent, reaching $3,220 last year. Entrance fees in the segment are also rising at a healthy clip, ending 2017 at roughly $330,000, an annual climb of 5.0 percent.
- CCRCs/LPCs continued to trade in limited numbers, with the number of sales in the segment falling for a second consecutive year. More than half of all trades occurred for properties constructed more than 20 years ago. Properties sold over the last 12 months traded for an average price of nearly $127,800 per unit with initial returns remaining in the high-7 percent to low-8 percent range.

Outlook: A balance between supply and demand in the CCRC/LPC segment will persist this year, keeping occupancy around 91 percent. Stable occupancy trends will facilitate another year of 3 percent growth in the average asking rent and entrance fees will continue an upward advance.

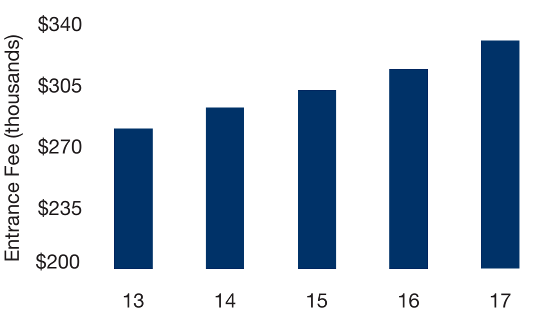
Age of IL and AL Properties Sold Y-O-Y Through 2017



Cap Rates vs. 10-Year Treasury

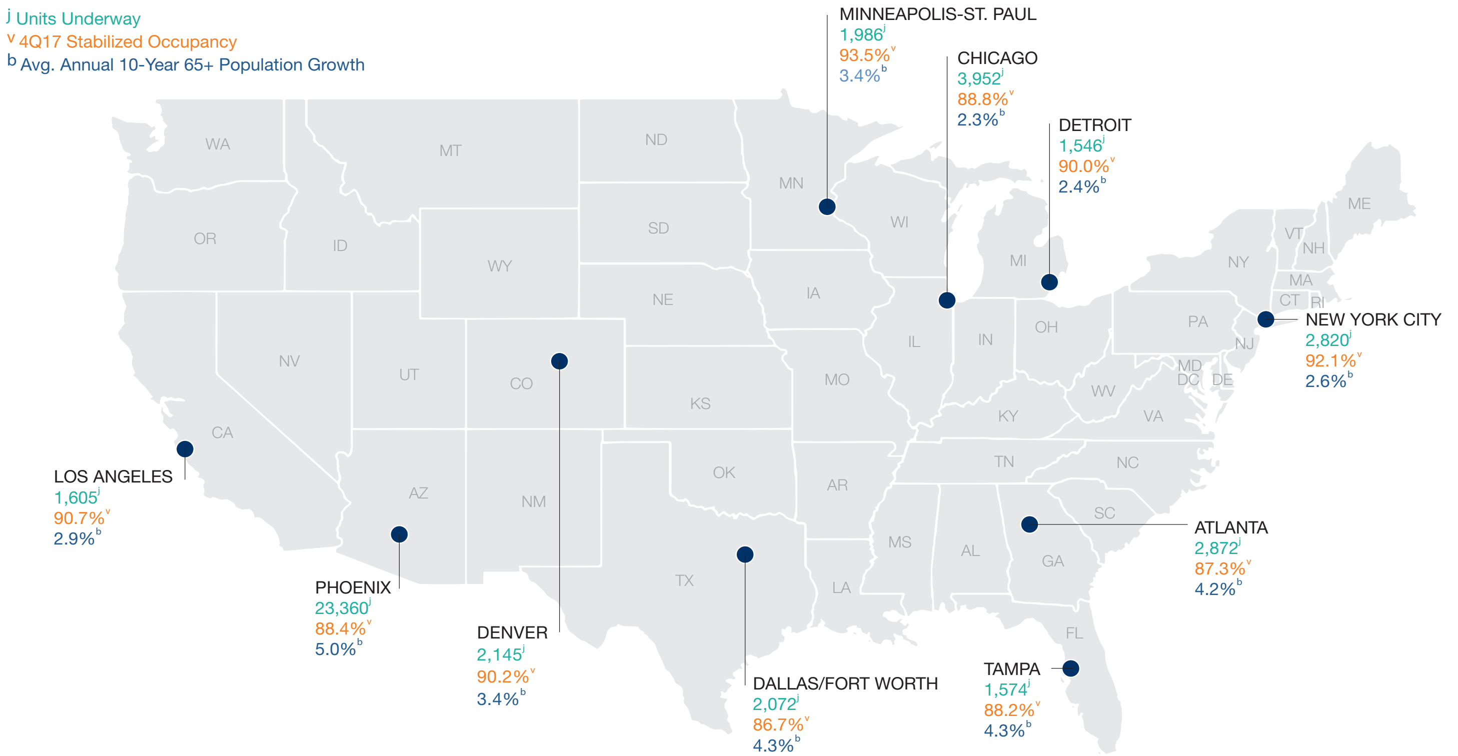


Average CCRC Entrance Fee



Sources: Marcus & Millichap Research Services; CoStar Group Inc.; NIC MAP® Data Service; Real Capital Analytics

Top 10 Seniors Housing Construction Markets 1Q18



Source: NIC MAP® Data Service

Units underway and stabilized occupancy represent IL, AL and NC units.

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Seniors Housing Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The 10-year Treasury note yield neared 3 percent in February, pointing to strong economic data and diminished investor fears over the strength of the post-crisis recovery. The sharp rise in long-term rates this year is an indicator that will influence borrowing costs for consumers, corporations and governments, having the potential to restrain investment activity, particularly for those who apply more leverage.
- A number of financing options are available to seniors housing buyers, including traditional and creative opportunities. Bank financing in particular is becoming more aggressive on transitional assets and offers favorable terms for buyers. LTVs range from 60 percent to 75 percent with 10-year terms and rates in the 5 percent to 5.5 percent span.
- Agency financing is also available, with GSEs preferring to lend on stabilized product operating at market rents. Underwriting for properties with occupancy near 90 percent or higher produces LTVs between 65 percent and 75 percent and rates from 4.5 percent to 5 percent.

Sources: Marcus & Millichap Research Services; American Health Care Association; American Legislative Exchange Council; American Retirement Corp.; American Seniors Housing Association; Assisted Living Federation of America; BLS; Capital Senior Living Corp.; CoStar Group, Inc.; Council for Affordable Health Insurance; Eli Research; Moody's Analytics; Irving Levin Associates, Inc.; NIC Map Data and Analysis Service (www.nicmap.org); Real Capital Analytics; TWR; Ziegler Capital Markets Group.