Senior Housing: An Update

The senior housing and care sector continues to garner growing attention from institutional investors. Private equity funds, pension funds, public and private REITs, banks, the government-sponsored enterprises (GSEs), life insurance companies, high-net-worth individuals, and others now provide debt and equity to the sector. As of the second quarter of 2017, more than $14 billion of transactions occurred on a rolling four-quarter total.

The mix of players is changing, and large institutional investors are now replacing some of the larger public REITs as buyers. Pricing remains favorable for sellers, with the average price per unit remaining near record highs, while cap rates remain relatively low. Private sector returns continue to outpace broader property returns, with the ten-year senior housing total investment return beating the NCREIF NPI by more than 400 basis points as of the first quarter of 2017.

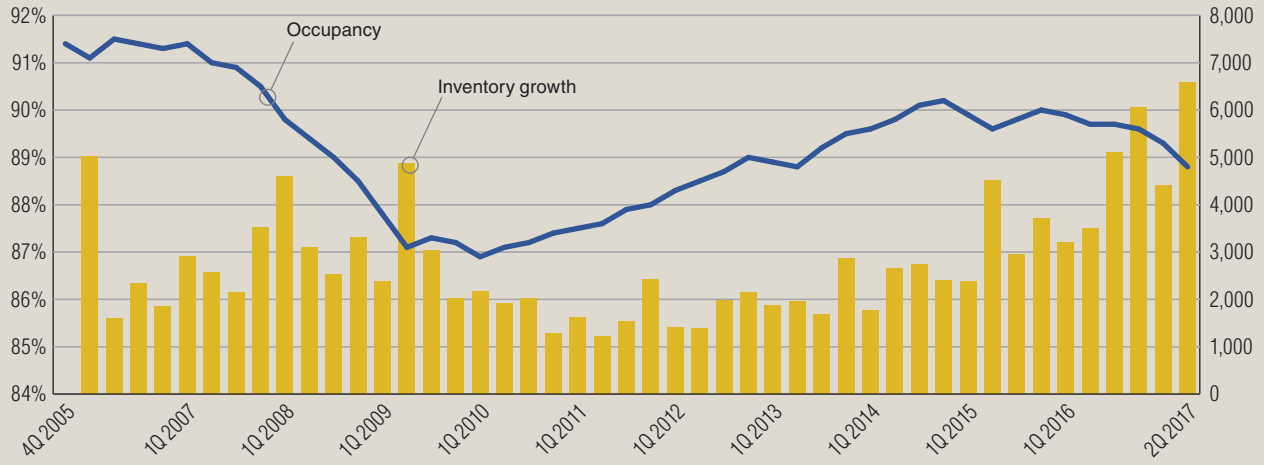
Investors are attracted to the sector for a number of reasons.

- **Enticing demographics.** While the baby boomers will not reach 80 until 2026, demographic tailwinds are quickly advancing. Growth in the 82-to-86 cohort (the cohort that dominates assisted living and independent living properties) starts to accelerate this year and will generally continue to do so until 2025, providing a nice demographic driver for senior housing. Between 2017 and 2025, this cohort will increase in size by 1.5 million persons, or 29 percent, from 5.1 million to 6.6 million.
- **Compelling investment returns.** Institutional-quality private-pay senior housing has consistently produced steady income and strong appreciation returns for more than ten years, consistently beating total returns for apartments, retail space, offices, industrial properties, and hotels.
- **Greater liquidity.** As transaction volumes increase, investors have become more comfortable knowing that multiple exit strategies are likely.
- **Rising transparency and understanding.** Information about market fundamentals and capital market conditions from sources such as NIC MAP and Real Capital Analytics (RCA), as well as active REIT participation in the sector and increasing Wall Street analysts' coverage, allows investors, lenders, and borrowers to better understand current conditions, providing for a more disciplined capital market.
- **Emerging post-acute-care coordination opportunities.** The Affordable Care Act and changes in Medicare's payment structure have changed the payor landscape. Alternative payment plans and networks, such as accountable care organizations (ACOs), managed care organizations (MCOs), and bundled payments, are displacing fee-for-service payment plans in both Medicare and private health plans. Senior housing operators, as well as skilled nursing and post-acute providers, have new opportunities to become part of the emerging care continuum.
- **Mounting understanding of the benefits for residents.** Anecdotal evidence suggests that the hospitality and social aspects of living in a senior housing setting offers physical and psychological benefits that can extend and expand a person's quality and length of life.

Rarely does an opportunity occur where there are no challenges. For senior housing, two challenges currently dominate: unit supply and labor shortages.

First are inventory supply concerns. As debt and equity capital have become more available in the years since the Great Recession, development activity

Inventory Growth and Occupancy Rates: 31 Primary Senior Housing Markets, 4Q 2005–2Q 2017



Source: National Investment Center for Seniors Housing & Care (NIC).

has ramped up. Since early 2010, when occupancies reached a cyclical low of 86.9 percent, 79,000 units have come on line within the NIC MAP 31 Primary Markets, a 16 percent increase in supply. More recently, in the year ending in the second quarter of 2017, 22,000 units have come on line.

However, it is notable that not all markets have seen significant development activity. Nearly half (i.e., 48 percent) of this growth occurred in seven metropolitan markets: Dallas, Chicago, Minneapolis, Atlanta, Houston, Miami, and Boston. Dallas and Chicago alone accounted for nearly one of every five new senior housing units of new inventory in the past 12 months.

The second challenge is the labor market. Increasingly, operators are reporting labor shortages in all occupations across their operating platforms, ranging from care managers to executive directors. With the national unemployment rate falling to a 16-year low of 4.3 percent in July 2017, the challenge of recruiting and retaining employees is expected to only grow. Shortages in the health care professions as well as in other industry sectors, such as the construction trades, are slowly putting upward pressure on wage rates. In the 12 months ending in July, average hourly earnings rose 2.5 percent—down slightly from 2.6 percent in 2016, but up from 2.3 percent in 2015 and 2.1 percent 2014.

In this environment, operators will need to boost their operational efficiency and staff productivity through technology, training, and mentoring in order to grow their net operating incomes (NOIs) and maintain their bottom lines.

National Investment Center for Seniors Housing & Care (NIC).

Single-Family Homes

In the housing market's upward climb out of crisis, experts are trying to get a firm handle on the inflection point. In the U.S. Census Bureau's *Residential Vacancies and Homeownership* July report for the second quarter of 2017, a pivot point emerged: homeownership rates had inched up consistently from a 50-year low of 62.9 percent in the second quarter of 2016 to 63.7 percent in the second quarter of 2017.

What the data point may signify, in the long run, is uncertain. If Yogi Berra were around, he might say that homeownership in the United States and its role in American dreams of opportunity are 90 percent mental, and the other half based in statistical reality. After all that has happened in housing, a rising homeownership rate is a psychological bright-line moment.

For strategic or financial investors in residential development, two immediate important sub-themes stand out anew within this tiny quantitative blip. One is that homeownership rates among the young adult part of the ownership spectrum are stabilizing after an extended period of decline. That said, the change here is that ages 35 to 39 have usurped the role that ages 30 to 34 once had as the dominant age-range for people entering homeownership for the first time, with homeownership rates of 55.8 percent and 45.2 percent, respectively. As the leading edge of the 77 million–strong millennial generation crosses that 35-year-old benchmark—with a starting line of January 2016—one may look back at July 2017's year-over-year increase of 0.8 percentage point in homeownership rates as a turning point.

Also, homeownership rates among 65-plus-year-olds—where baby boomers are swelling the ranks by the minute—are also holding strong versus historical patterns, according to data from Gallup. Gallup analyst Jeffrey M. Jones notes, "Senior citizens have been immune from the trend of declining homeownership. Between 2001 and 2009, an average of 81 percent owned a home. Since then, 82 percent report owning their home."

Looking in a bigger-picture way at housing's mountain of moving-target indices and indicators, the measure's directional shift from decline, to flattening, to ever so slight an increase provides a fresh context for looking at otherwise well-established and familiar trends. If the homeownership rate continues to inch back from here toward its 65 percent historical level, one might look at this as one more emancipating event from the long-tail gravity of the Great Recession.

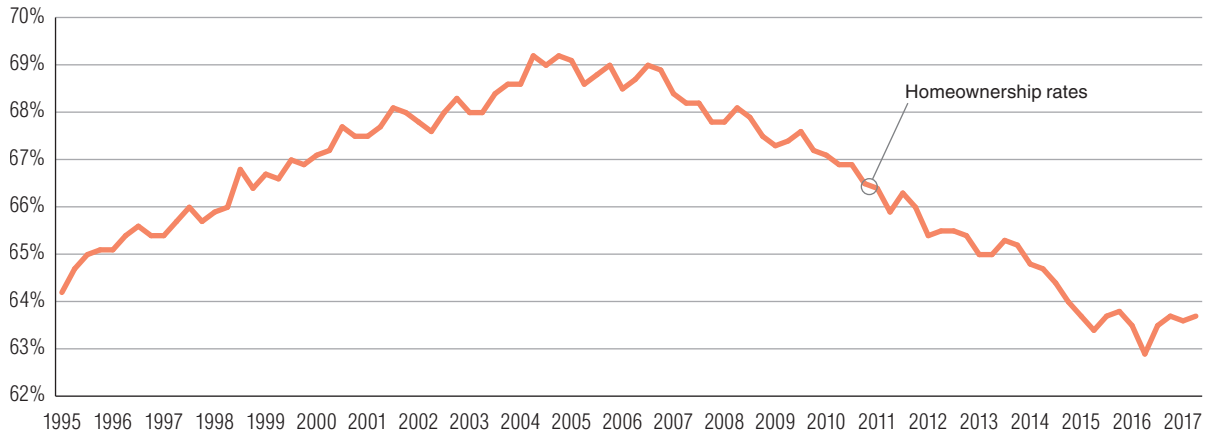
Housing's Goldilocks Recovery

Within this freshly defined framework, the housing business community's thought and practice leaders gut-check their assumptions and recheck their strategic priorities around a constructive, steady-as-she-goes fundamentals environment heading into 2018.

An executive-level lender in the builder acquisition, construction, and development space describes that environment this way: "Demographics, jobs and wage growth, moderately low interest rates, still-affordable prices, and pent-up demand—layered on top of this very low for-sale inventory situation."

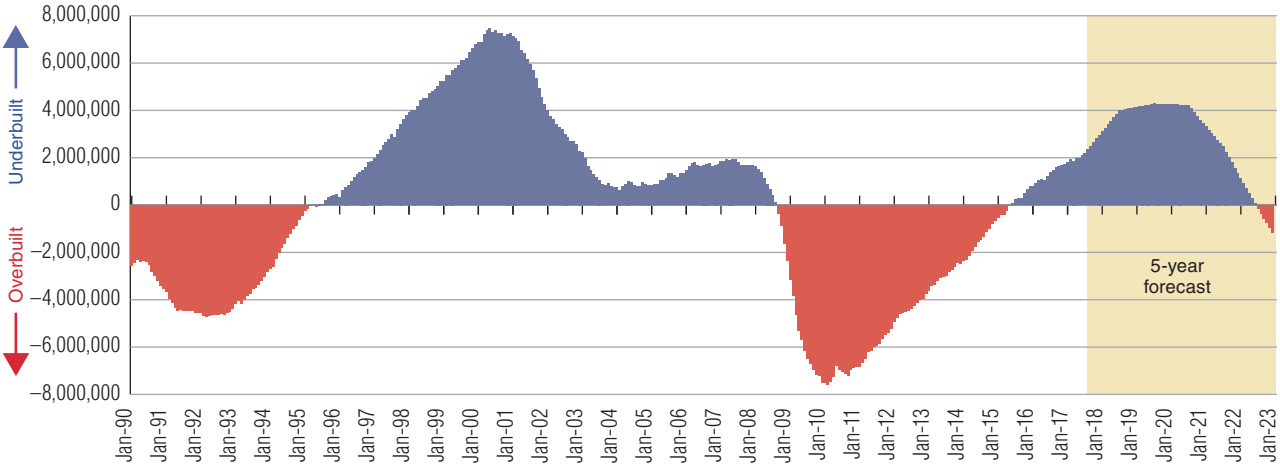
Demand trends—particularly among the barbell generational cohorts of young adults and aging baby boomers—are solid and sustainable through the next decade or so, but not without the noise, mess, unevenness, and elusiveness of the real world to make profitably serving those unmet needs an ongoing chal-

Exhibit 4-8 **Homeownership Rates: 1995–Q2 2017**



Source: Current Population Survey/Housing Vacancy Survey, Series H-111, U.S. Census.

Exhibit 4-9 **Housing Over/Under Supply Patterns, 1990–2023**



Sources: Bureau of Labor Statistics; Moody's Analytics; Real Estate Economics.

Note: Over/Under supply measures based on current jobs-to-housing relationship relative to long-term relationship between jobs and housing.

lenge. College loan debt, ever-tight mortgage lending criteria, less policy support, scant choice among attainable house price ranges, even some level of secular shift toward renting by choice are real and potential suppressors of demand today. At the same time, supply capacity barriers—land, labor, lending, and "lumber"—have by turns and collectively metered the pace of new construction to a most-gradual of upward trajectories. One well-regarded residential investment adviser on the equity side has his own nickname for housing's Goldilocks, just-good-enough recovery.

"We like to call it 'the CFO's recovery.' It's not as fast, flashy, or dramatic as a CEO would want the recovery cycle to be, but it's manageable, predictable, and it allows for prudent planning for the future the way good finance people prefer."

This same executive characterizes housing's supply and demand factors as two separate hoses feeding into the same bucket, which is the current housing market. Both hoses have a relatively consistent flow, but each of them has kinks that can interrupt or reduce the flow.

Housing observers mostly focus on "kinks" in the supply-side hose—the disruptive shortages of subcontractors, the cost and difficulty of bringing new lots on line, the ongoing scarcity of debt financing for land acquisition and development, and the more recent inflationary spike in building materials.

Demand, too, has its share of challenges. Pricing has surfaced as a point of worry around momentum, especially in supply-constrained, mostly coastal markets like California, Seattle, Maryland, and New Jersey, but also in Denver.

One worry that nobody in single-family housing has—with new-home inventory levels at a 5.4 months' supply nationally—is about overbuilding. "We couldn't build an excessive number of single-family houses if we tried to right now," one investment adviser notes, suggesting that the market may be under-delivering single-family demand by as much as 25 percent on a continuous basis, creating more pent-up demand as time passes.

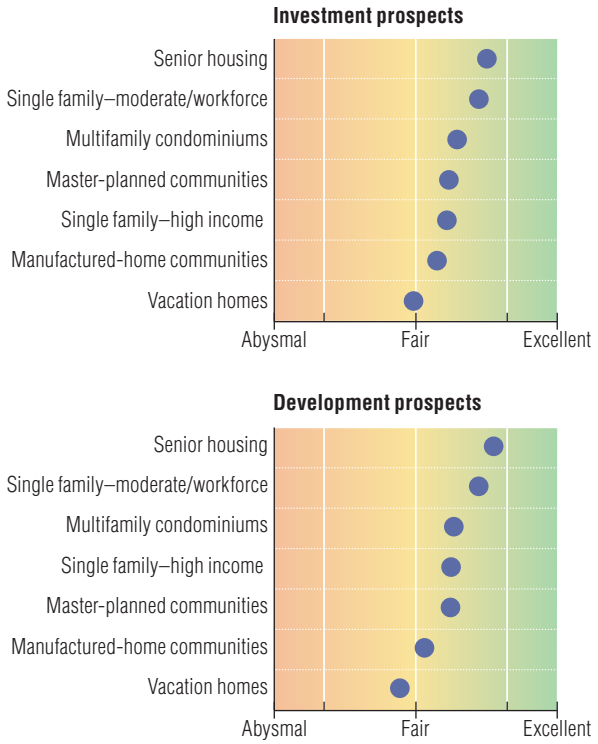
Lower Prices: Risk or Opportunity?

That said, demand is not homogeneous, evenly distributed, or constant. It is always in flux, and right now the biggest wave is coming from households who want attainable pricing. While higher-end, first- and second-time move-up, and luxury customer segments have been where most of the action concentrated during the first six-plus years of the recovery, a distinct shift has occurred. Most builders are now activating rebooted scalable, value-engineered, limited-option entry-level programs, and are busy looking to open new neighborhoods in the drive-until-you-qualify path of growth tracts accessible to job centers.

Meanwhile, the new variations on age-targeted and age-integrated 55-plus communities are where strong and deep demand exists for an alternative to "the Del Webb model" that put active-adult communities on the map a generation of retirees ago. Entry-level homes in lower-cost-base peripheries and strategically connected, attainable 55-plus communities are essential programs on strategic roadmaps through and beyond 2018.

One top-ten public homebuilding enterprise CEO, who has guided his firm to double-digit volume growth in 2016 and through the first nine months of 2017, notes strong growth in most of the company's geographical footprint, but sees a distinct shift in price points that are working best. "The bottom end of the price spectrum in the market is absorbing at a higher pace than other segments, but we still have demand in our move-up and second-time move-up segments, especially in California."

Exhibit 4-10 **Prospects for Residential Property Types in 2018**



Source: *Emerging Trends in Real Estate 2018* survey.
Note: Based on U.S. respondents only.

Still, broad consensus supports a coherent climb in most of housing's key performance indicators through 2019, with total starts stepping up from 1.26 million in 2017, to 1.36 million in 2018, to 1.44 million in 2019—jumps of almost 8 percent and 6 percent, respectively. Single-family starts, most forecasts assert, represent about three out of four total housing starts during that period.

The homeownership rate tipping point, and its two accompanying demand trends—millennials have now emerged as a homebuyer group, and 55-plus adults are kicking in to a greater degree as well—set up a scenario of equally critical parallel realities for residential real estate investors and operators.

One reality is a present set of conditions taking more pronounced shape around customer segmentation, with a fully activated millennial market clamoring for homeownership as well as a nascent move among aging baby boom generation buyers for a new and improved, more attainably priced, more connected, age-integrated via proximity, lower-maintenance-lifestyle 55-plus community. The other is a housing market whose