Seniors Housing Market Report

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Jones Lang LaSalle Incorporated

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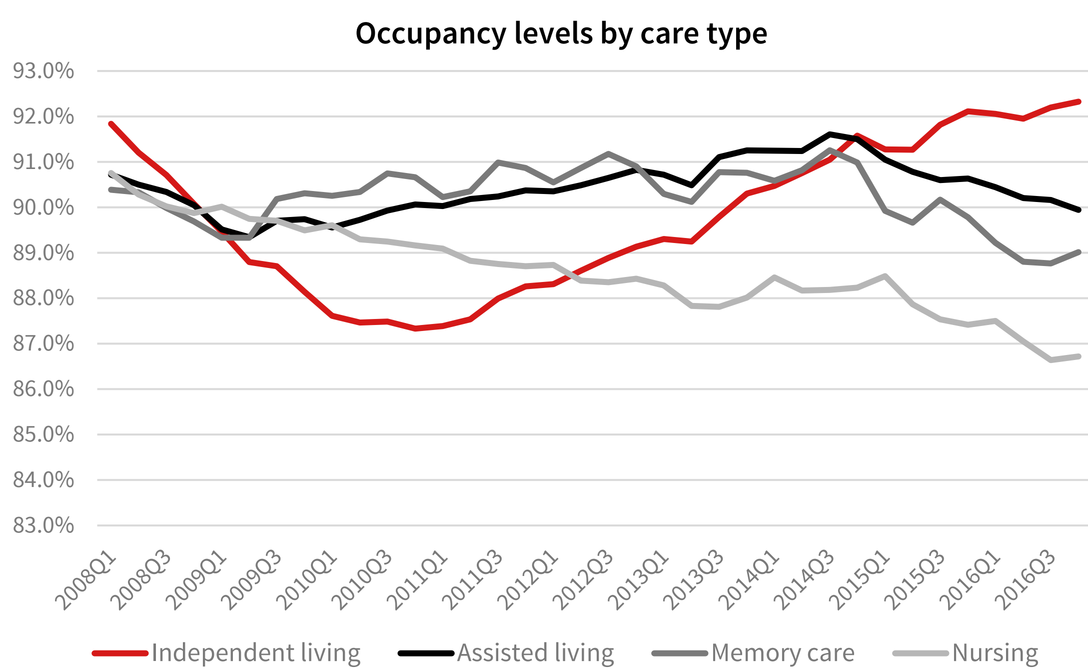
Market headwinds growing?

Seniors housing owners, operators, and lenders are increasingly concerned with overbuilding, and now add rising interest rates and a tight labor market to their list of worries. But new capital continues to seek footholds in the industry, and lenders continue to fund construction projects despite these concerns. So how will the market fare in 2017 given these emerging market headwinds?

Impact of overbuilding

Overbuilding has started to impact occupancy levels, with the average occupancy for seniors housing (independent living, assisted living and memory care), now below 90% according to the NIC MAP© Data Service, down 190 basis points from the cyclical high. But this average does not tell the whole story. Independent living occupancy levels remain strong, helping to keep the overall seniors housing occupancy level up, despite assisted living and memory care occupancy levels plunging in many areas due to overbuilding. In markets such as Dallas, Houston, San Antonio, and Las Vegas, average memory care occupancy levels are 85% or less. These and many other markets have average assisted living occupancy levels in the mid 80 percent range as well.



Source: NIC MAP© Data Service

In some markets, rent concessions are becoming common. A new memory care facility in Texas, for example, was recently offering three months free on a 12-month lease. Absorption rates for some properties in the more saturated markets have also been quite slow. For example, a net absorption rate of one bed per month was realized for a memory care building that began leasing in early 2016. Anecdotally, we are hearing that concessions and slow lease-up rates for new properties are creating pricing pressure on older assets in the more saturated markets. In markets with relatively low occupancy levels, slow lease-ups, and pricing concessions, it is just a matter of time before financial distress begins to become evident for some assets.

Interest rate increases

The Federal Reserve finally increased the federal funds rate to 0.5% in December of 2015. The federal funds rate had been set at 0.25% dating back to December 16 of 2008, and had remained at that level for seven years. A year later, another 0.25% increase was announced, followed by another in March of 2017, bringing the federal funds rate to 1.0% at the time of this writing. The Fed has indicated two additional increases are likely in 2017, potentially bringing the federal funds rate to 1.5% by the end of the year.

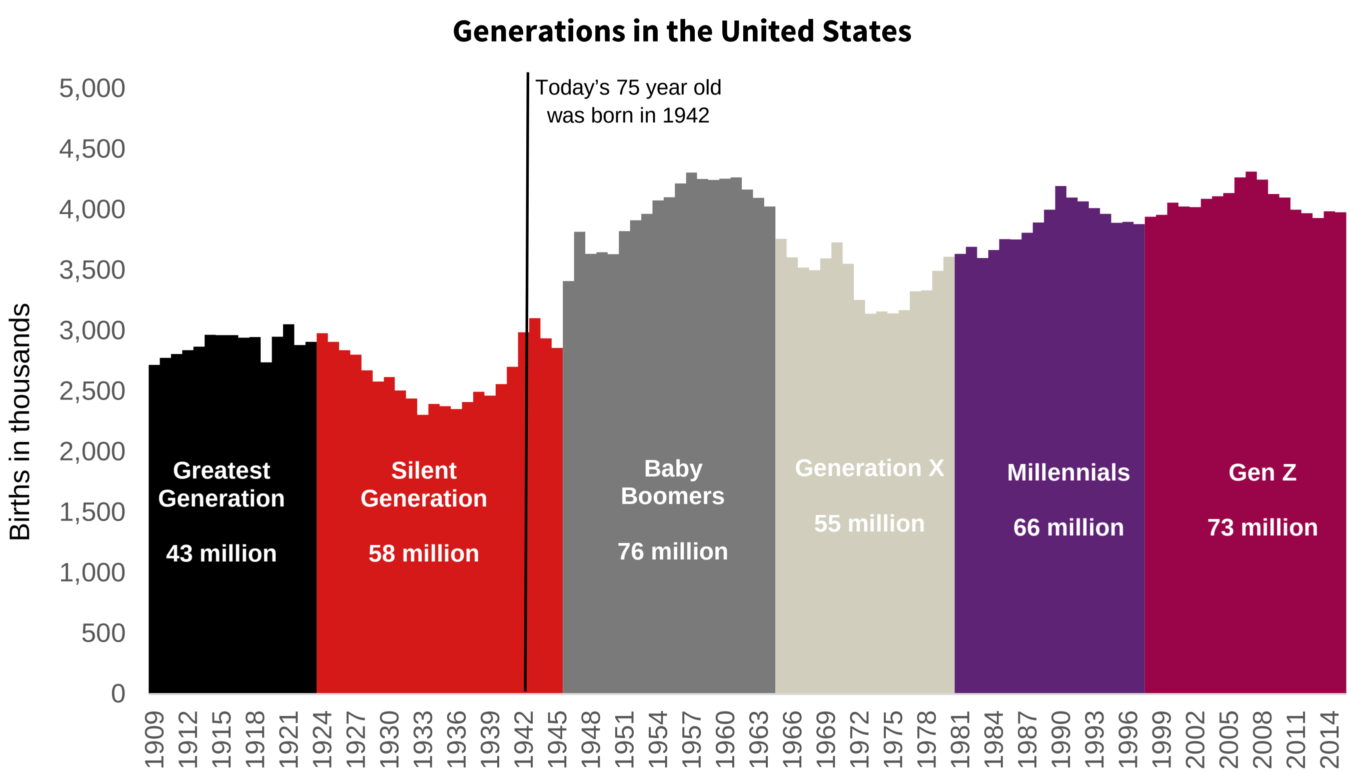
Treasury rates have increased a bit as well, but the 10 year remains below 2.5%, still a very low rate by historical standards. All in financing rates for HUD, Fannie Mae, and Freddie Mac loans remain quite attractive.

Still, astute investors are considering that we appear to have entered an environment of rising interest rates, and over time this will impact the cost of borrowing. Investors modeling exits in five, seven, ten, or more years are considering the impact of higher rates, and this can impact how aggressively they can price an investment today.

Capital seeking to deploy

Investors are attracted to the seniors housing sector by the strong demographic trends. Baby Boomers first started turning 65 in 2011 and are now turning 65 at a rate of more than 10,000 per day! This so-called "graying of America" will lead to significant growth in the demand for seniors housing over the next few decades. In fact, if penetration rates remain static, the demand for seniors housing will more than double between now and 2035.

However, it is important to realize that the average age of entry into seniors housing properties is in excess of 80 years old, meaning that the Baby Boom Generation will not start to have a significant impact on demand until 2026. But many look towards 2021, when the first boomers hit 75, as this should be the leading edge for Baby Boomer demand for seniors housing.



In response to the anticipated increase in the demand for seniors housing, developers have been building new supply at a torrid pace. The NIC MAP© Data Service (NIC MAP©) reports that seniors housing construction continued at high levels, with construction as a share of existing inventory at 5.7% as of Q4 2016.

Will the seniors housing market be the victim of its own success as the inflow of capital results in market saturation and the funding of ill-conceived projects? Or will strong growth in demand be able to keep pace with the new supply being added, allowing market fundamentals to remain strong?

Bigger, better, and urban

An emerging trend in new development is the focus on the development of larger facilities offering continuums of care, often situated on expensive in-fill sites. Early in this development cycle, the focus was on smaller facilities often focused on a single type of care – memory care only, for example. But many developers have shifted their focus to larger communities offering independent living, assisted living, memory care, and sometimes skilled nursing, all under one roof.

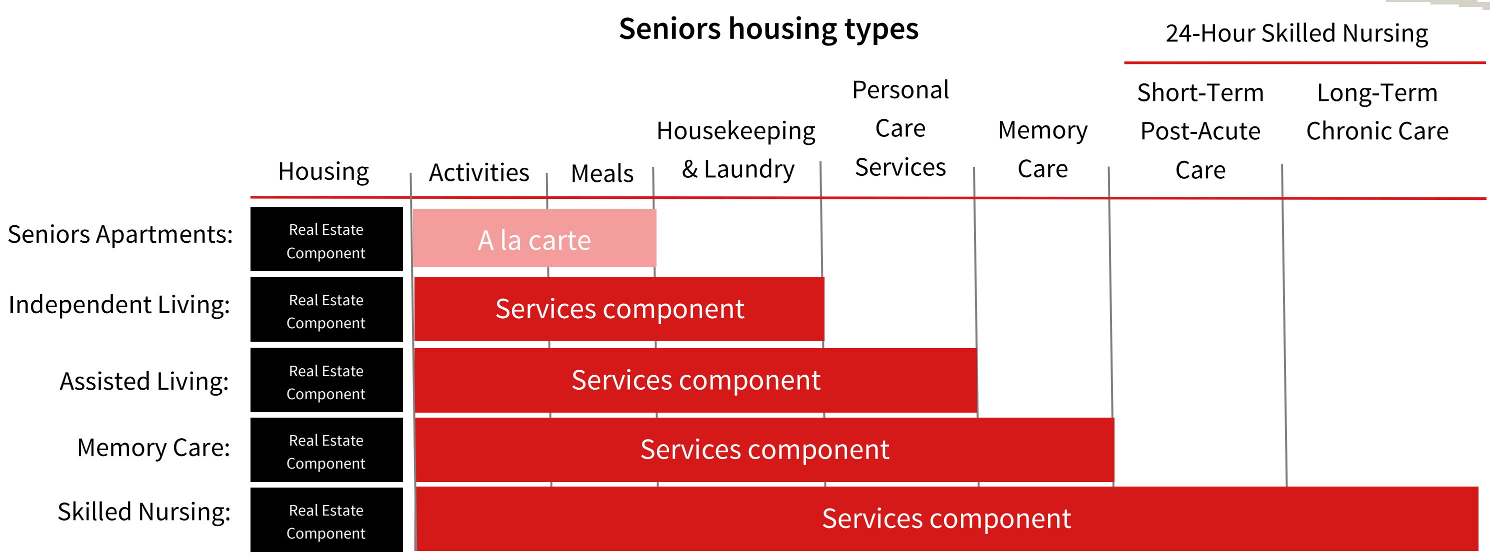
The Village of River Oaks being developed by Bridgewood Property Company in partnership with Harrison Street Real Estate Capital is an example of the new wave of urban in-fill development. The eight-story building will offer a continuum of care, with independent living, assisted living, and memory care. In 2013, the developer purchased the 1.8 acre site, improved with a warehouse at the time. Located just two miles west of downtown Houston, River Oaks is an exclusive enclave of high end housing and support uses.

Consumers are attracted to this model due to the fact that residents can age in place within the same community. This offers significant peace of mind to family members. Also, one member of a household may need a higher level of care than the other, and in a continuum of care facility that need can be accommodated, and the couple is still able to interact with one another on a daily basis. For operators, the ability to retain a resident for a longer period of time is a plus, reducing turnover and marketing costs.

In-fill sites are also in vogue right now. Developers are betting on the fact that urban boomers will not want to relocate to the suburbs, and are building new high quality facilities in in-fill locations in major cities across the United States. This is likely a smart long-term play as well, as institutional capital will be seeking to purchase such facilities and will be willing to pay premium pricing for them.

Sector analysis

Each sector of the seniors housing market serves a slightly different market niche, and market dynamics vary greatly by sector.



Independent living and the Baby Boomer wave

The independent living market is the healthiest of the sectors nationally with an average occupancy rate of 92.3% in the fourth quarter of 2016. Thus far in the current development cycle, new development in the independent living sector has trailed assisted living, but developers have recently begun to focus on independent living. The number of independent living units under construction in the markets tracked by NIC MAP© has increased to 17,465 in the fourth quarter of 2016, compared to just 10,919 two years earlier.

While we do see more developers focusing on independent living in 2017, projects that are entirely or primarily independent living, tend to be larger, and take more time and resources to put together. We forecast the independent living market will remain strong through the balance of 2017. It is also worthy to note that average age of entry to independent living is the lowest of the four sectors, and therefore the independent living sector will benefit from the Baby Boomer wave before the other sectors do.

Supply saturation concerns in assisted living and memory care

Assisted living and memory care occupancy levels declined in 2016, due to significant levels of new construction. Both sectors now have average stabilized occupancy levels below 90%.

The focus on development in the assisted living and memory care sectors is due to several factors. Assisted living and memory care assets performed the strongest during the Great Recession, leading investors to perceive this sector as being recession resistant and thus a safer bet than other real estate sectors. Another factor leading to the focus on assisted living and memory care development is the fact that these assets are generally smaller, less expensive projects, and developers have found it simpler to find sites, equity, and financing for these developments than for larger scale projects. This is especially true of the memory care market where smaller facilities are typical.

In 2017, continued additions to supply are likely to erode occupancy levels in certain markets. Markets at risk include all the major Texas markets, plus Denver, Chicago, Detroit, Salt Lake City, and many markets in Florida.

But even in saturated markets, investors continue to aggressively pursue acquisitions. Much of the capital now seeking deployment is targeted to “opportunistic” acquisitions, and there is more capital of this type than there are deals. As a result, even un-stabilized projects well behind pace on lease-up are likely to receive multiple offers, and sell for aggressive prices.

Skilled nursing – less construction, shorter stays, occupancy declines

The nursing market continues to bifurcate into two sub-segments – long-term care funded by Medicaid, and short-term rehabilitation care funded primarily by Medicare, insurance, and private pay payment sources. This latter type of care is increasingly being lumped into the post-acute care category, and such facilities may compete not only against other nursing homes but also with Long Term Acute Care Hospitals (LTACHs) and Inpatient Rehabilitation Facilities (IRFs).

Although the future of the Affordable Care Act remains uncertain, it is likely that there will be continued focus on “value based purchasing,” and shortening lengths of stay for Medicare. At the same time, the sector continues to be impacted by competition from home health, assisted living, and other post-acute settings. As a result, nursing home occupancy levels have been declining, despite the supply of beds also declining. NIC MAP© reports a skilled nursing occupancy of 81.8% as of the fourth quarter of 2016, down 156 basis points year-over-year.

For 2017, we expect to see minimal new development in the nursing home sector, with the development that does occur focused on the post-acute segment. But this sector has some headwinds, with the increasing prevalence of Medicare Advantage creating revenue declines and average lengths of stay continuing to grow shorter.

Capital Markets

Although commercial banks continue to fund construction and mini perm loans, lending and underwriting criteria are tightening in response to concerns of overbuilding and market performance. Banks are more focused on relationship lending. Nonrecourse loans are a rarity and spreads have been widening.

Fannie Mae, Freddie Mac, HUD and Life Companies continue to have a stronghold on permanent financing. Volume caps implemented by the FHFA remain unchanged for both Fannie Mae and Freddie Mac in 2017 with each enterprise being subject to a $36.5 billion cap. Exclusions apply for properties with an affordability component and/or Green Energy Efficiency standards.

Projects meeting Green standards benefit from pricing reductions with Fannie Mae and Freddie Mac and a reduction on the annual MIP for HUD.

Life insurance companies will compete strongly for high-quality assets with experienced owners/operators in primary and secondary markets. While CMBS lenders have generally been priced out of the market, we may see them start to pick away at financings given the challenges some deals face.

Overall, lenders are much more cautious given concerns on supply, rising interest rates and the market cycle.

Our outlook for 2017

Over the near term, we expect market saturation to occur in some of the markets where development has been the most active, primarily isolated to the assisted living and memory care segments. This will lead to lower occupancy levels and downward pressure on rents in those markets. However, there appears to be a massive amount of capital available to swoop in and scoop up any troubled projects. So, while we may see more distressed deals in 2017, the number of buyers chasing them will likely keep pricing relatively high.

Valuations peaked in late 2015, and we anticipate values to generally remain stable in 2017. While rental rates are increasing, the tight labor market should begin to impact expenses. Thus, we expect only modest gains in EBITDA/NOI. And interest rates increases will continue to push capitalization rates up over time.

Capital will continue to be readily available, with Fannie, Freddie and HUD all expected to have very busy years. Life companies are also expected to be more active in 2017. Equity for new developments and acquisitions remains readily available, with new entrants seeking to enter the market almost daily. The only form of capital that may be a bit harder to obtain is construction financing, as banks are tightening underwriting – especially in the markets with supply concerns.

Every year, the seniors housing market gets closer to the boom in demand that will occur when the Baby Boomers begin moving into seniors housing in large numbers. But the oldest Boomers are turning 71 this year, and few are ready to move into seniors housing at this age. The Boomers will first impact the independent living market, and that would appear to be the sector where the best opportunities are at present. Assisted living, memory care, and nursing all have supply and saturation concerns at present, so investments in those sectors require more discipline. Looking out over the longer term, seniors housing assets should perform strongly, and be a reliable producer of above average returns.

About us

JLL has experts that are fully dedicated to the seniors housing and healthcare industries to help you achieve your seniors housing capital needs.

Our Capital Markets experts have unrivaled expertise in investment sales, financing and loan servicing. Our Valuation & Advisory Services professionals act independently and use sophisticated valuation tools to assess the value of your property through a proven methodology. We use our extensive knowledge and relationships to help you match dollars with opportunity and act decisively and gainfully for your seniors housing investment needs.

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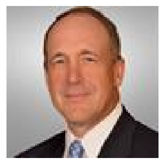

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