Senior Housing Development & Investment

Navigating the New Landscape

Once considered highly specialized assets with only limited appeal, senior housing properties endeared themselves to mainstream commercial real estate investors during the last decade. The category emerged from the Great Recession in better shape than other property categories, and for most of the past decade, it maintained steady rent growth of about 5 percent annually, according to the National Investment Center for Seniors Housing & Care's (NIC) latest investment guide. Stabilized senior housing assets also generated an average return of 8 percent annually over a 10-year period, NIC reports.

As with some other real estate property categories, that reliable performance hit an extended rough patch after the onset of COVID-19. Operators halted or severely restricted property tours and move-ins; prospective residents, worried about serious illness, elected to remain in their homes. The industry's valuation shrank from $475 billion at the end of 2019 to an estimated $437 billion as of the third quarter of 2021, according to Beth Mace, NIC's chief economist & director of outreach. Profitability has also declined between 4 percent and 8 percent during the pandemic, estimates Mel Gamzon, principal at Senior Housing Global Advisors.

Sobering as these metrics are, recent trends suggest that the industry is already rebounding from the depths of the downturn and offers a prime opportunity to investors who can be both savvy and strategic.

A recent study by CBRE conveys a growing sense of optimism among real estate's senior housing stakeholders. The firm's Seniors Housing & Care Investor Survey of private investors, developers, brokers, institutional investors and REITs yielded telling highlights:

- Active adult communities rank highest for investment potential in 2022, named by 34 percent of respondents. Assisted living (28 percent) ranks second, followed by independent living (23 percent).
- A strong majority, 82 percent, believe that occupancy across the board in senior housing communities will return to pre-pandemic levels in 18 months. For active adult and independent living communities, that percentage rises to 86 percent.
- More than 70 percent of survey respondents overall are underwriting rent increases of 1 percent to 7 percent.
- For active adult communities, 80 percent of survey participants expect rent hikes of between 1 percent and 7 percent.

This increasingly optimistic outlook is borne out by significant upticks in key senior housing fundamentals. From the fourth quarter of 2021 to the first quarter of 2022 alone, independent and assisted living senior housing occupancy rose 20 basis points to 80.6 percent on a combined basis, according to NIC's survey of 31 metropolitan markets. Significantly, this improvement also represents a 2.6 percentage point increase from the pandemic-induced low of 78 percent during the second quarter of 2021.

In particular, independent living occupancy has fared the best among the senior housing segments tracked by NIC. Although occupancy in the segment remains well below its pre-pandemic rate of 89.7 percent, it rallied from a pandemic low of 81.7 percent in the second quarter of 2021 to 83.1 percent by the first quarter of 2022.

Assisted living occupancy also remains well below its pre-pandemic levels but improved to 77.9 percent in the first quarter. By comparison, nursing

home occupancy reached 77.6 percent in the first quarter of 2022, up 3.5 percent from its pandemic low a year earlier.

Pent-up demand and muted construction activity pushed overall absorption in the independent and assisted living sectors to an annualized rate of 5.1 percent during the first quarter, compared with a meager 0.2 percent in the second quarter of 2021, NIC reported. Meanwhile, rental rates in the two categories increased an average of 3.3 percent between them in the first quarter of 2022, up 180 basis points from the second quarter of 2021.

For the senior living sector's long-term outlook, inescapable demographic facts speak volumes. Residents typically move into senior housing facilities after they turn 80, and the population of 80-year-olds will grow from 13.2 million in 2020 to more than 23 million in 2034, according to a recent presentation by healthcare

Senior Housing Snapshot (Q1 2022)

	Overall	Independent Living	Assisted Living	Nursing Home
Occupancy	80.6%	83.1%	77.9%	77.6%
Annual rent growth	3.3	2.7	4.1	2.5
Annual absorption	5.1	3.1	7.4	4.1
Annual inventory growth	1.8	1.3	2.4	-0.7
Construction vs. inventory	5.3	4.7	5.9	0.4

Source: NIC MAP data. Fundamentals represent majority independent living, assisted living and nursing home facilities in 31 top metropolitan markets.

infrastructure REIT Welltower. Yet, as CBRE noted in a second-quarter 2021 senior housing report, the top 100 markets offer only 2 million beds of institutional investment quality.

"The industry is in reset mode—operators are tightening their belts and moving toward innovation," said Gamzon, a 40-year senior housing veteran. "There is substantial room to grow to pre-COVID levels and even to exceed them."

Pandemic Pains

Key fundamentals such as occupancy, absorption and rental rates are gradually improving as senior living owners, operators and developers face an extraordinary confluence of issues. Chief among them are labor shortages, materials shortages, rising operating costs, health and safety issues, and staff burnout. "There has been a wide disparity among operators and properties; not all are under the same pressures," Mace said. "But overall, the industry is still challenged."

Finding labor is arguably the most pressing problem. Respondents to CBRE's senior housing study named staffing as the number one headwind facing the industry, followed by inflation and interest rates. Nearly every assisted living and nursing home in the U.S. is facing staff shortages, according to a recent survey of 1,183 assisted living and nursing home providers conducted by the American Health Care Association (AHCA) and National Center for Assisted Living (NCAL).

Additionally, the survey found that almost all the facilities are asking employees to work overtime or extra shifts. To a lesser degree, the providers

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are limiting new admissions or filling roles with temporary agency staffing, and a large majority indicated that the workforce challenges could force them to close.

Providers surveyed in the AHCA/NCAL study blame the lack of qualified candidates as a main obstacle to hiring new personnel. Sponsors have repeatedly put project plans on ice in areas with an inadequate labor pool, Mace noted.

Operating costs are on the rise, too. Labor makes up about 60 percent of all expenses, and senior housing nurses generally earn $20 to $25 an hour while unskilled staff is paid less, according to Gamzon. The cost of using temporary nursing staff agencies is typically double the normal wage, and changes to state or local minimum wage laws and competition are also putting upward pressure on compensation for non-nursing personnel. In many cases, companies that provide care to seniors in their homes and pay better wages are out-competing senior housing operators, Mace confirmed.

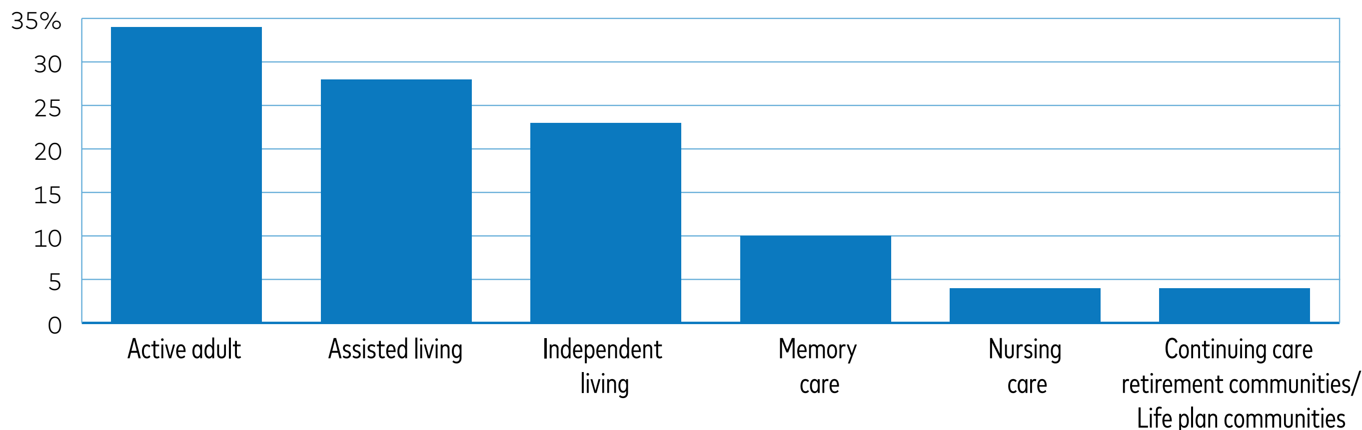
Meanwhile, operators are experiencing fallout from the insurance industry's navigation of a hard market cycle. Over the past several years, a jump in claims has fueled premium hikes and a tenfold increase in deductibles to $250,000 or more, according to an October 2021 Willis Towers Watson study on senior living insurance claims.

Adding to the financial burden is the cost of infection control measures for staff and residents, like personal protective equipment. Welltower's presentation notes that the rapid spread of the omicron variant caused sudden increases in testing, PPE and labor costs.

All told, this combination of added expenses and declining revenue has led to $30 billion in industry losses, according to Argentum, an association of senior housing operators. In a press release, the organization contended that the federal government's determination of COVID relief payments for assisted living communities was "unconscionable."

The financial squeeze is forcing operators to close. About 130 nursing homes shuttered in 2021 on top of 170 closures in 2020, according to the Kaiser Family Foundation. Reports of bankruptcies and closings of independent and assisted living facilities are growing, too. Eclipse Senior Living, one of the nation's largest senior housing operators, announced in late 2021 that it was ending corporate operations and pulling out of 90 communities it managed for Ventas, the health-care REIT.

Biggest opportunity for senior housing investment



Source: CBRE Seniors Housing Investor Survey, 2022

Finding Opportunity

Against this backdrop, developers, equity investors and lenders are pursuing opportunities with added caution, especially considering the rising cost of development. This trend was already underway before the pandemic began in 2020; in 2019, average construction costs for senior housing climbed 6.4 percent year-over-year to $317 per square foot, according to CBRE. Key building materials such as lumber, steel and copper spiked to all-time highs in May 2021. Even after receding later in 2021, costs remain elevated; in February 2022, the lumber futures price was $1,250 per thousand board feet, 370 percent higher than pre-pandemic prices, according to data from investing.com.

Inflationary trends have helped constrain new supply. Inventory growth and construction activity remained flat at 1.8 percent and 5.3 percent, respectively, in the first quarter of 2022, according to NIC. But that will change in the coming months as the housing needs of aging baby boomers beckon developers and give renewed confidence to capital sources. From the first quarter to the third quarter of 2021, construction loans for senior housing increased 45 percent, according to NIC.

For developers, site selection considerations remain largely the same as before the pandemic. Many still prefer to build in states with high barriers to entry, such as California, but they are also leveraging population and economic growth across the "smile" region, which stretches from California through Texas and into the Carolinas, according to Charley Bissell, a managing director of senior housing capital markets with JLL.

"We're seeing more developers pursuing infill locations—or sites that are just harder to acquire and entitle—to keep competitors at bay."

—Charley Bissell, JLL

"In some cases, markets in some of those states are oversupplied, but there has been a boom in demand as the population grows," Bissell said. "We're seeing more developers pursuing infill locations or sites that are just harder to acquire and entitle to keep competitors at bay."

Just as supply and population growth are influencing site selection, consumer preferences are driving scale and amenities. Expect to see developers build larger properties that target mixed uses or locations near retail, recreation and hospitality, Gamzon advised. New models for senior communities provide not only care but also wellness, fitness, sports activities and preventive healthcare, possibly in affiliation with a university or health system, he added.

Operators are also increasingly adopting new technology and processes to better control costs. One such digital solution that emerged two years ago helps facilities connect with healthcare professionals who want flexibility. Hiring these professionals costs more than paying the prevailing wage, but it is still more economical than bringing in a temporary staffing agency, Gamzon noted.

Plentiful Capital

As development demand is rebounding, investors are returning to the market with gusto. Some $14 billion in senior housing and skilled nursing transactions closed in 2021, well below the pre-pandemic total of $17 billion in 2019 but up 55 percent year-over-year, according to Real Capital Analytics Inc. Cap rates have largely remained compressed, Bissell noted. Newer, well-located and stabilized properties are trading at cap rates below 5

percent, while older properties in secondary or tertiary markets might trade in the 8 percent range, Bissell observed, citing RCA data.

Senior housing experts anticipate 2022 investment activity to be even busier. In 2021, JLL produced more than 2,000 valuation and market study reports for senior housing clients; by early 2022, requests for those studies were already ahead of the pace set in 2021, reported Brian Chandler, managing director & national platform leader for senior housing with JLL's valuation advisory group.

Additionally, some of the biggest private-equity investors in senior housing are replenishing their war chests with often-oversubscribed fund raisings. Between them, Kayne Anderson Real Estate, Harrison Street, Bain Capital Real Estate and KKR have recently raised $12.5 billion.

Lenders returning to the space are gravitating toward deals in prime locations and markets that feature sponsors with solid track records, strong balance sheets and deep equity sources. Near-term opportunities include providing permanent financing to borrowers that opened projects during or just before the pandemic and needed short-term bridge loans to buy more time to stabilize.

But whereas lenders were willing to provide financing at 80 percent loan-to-value for the highest-rated assets prior to the pandemic, today leverage typically maxes out at 75 percent.

By early 2022, the 10-year Treasury was consistently trading around 2 percent, the highest level since July 2019. That higher trading range largely anticipated the Federal Reserve's decision in March to hike the benchmark federal funds rate by 25 basis points.

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Because some interest rates are tied to the 10-year bond, the Fed's action is creating uncertainty about the cost of capital, as is its plan for several more increases in 2022.

But debt providers have a cushion to absorb an orderly increase in rates; when the 10-year yield plunged to well below 1 percent midway through 2020, lenders set a floor on the price they were charging for capital.

"Lenders are definitely more cautious. They're looking at the market and at insurance premiums and staffing costs—all the expenses that have gone up and that may not be going away for a while," Chandler says. "They're also looking at historical performance: How did the assets perform during COVID, and how are they going to perform going forward?"

The Takeaway

Despite the multiple challenges the senior housing sector faces, many factors bode well for the medium and long term. The combination of demographic trends, the demand for new supply and discounted asset valuations presents an attractive investment opportunity. Developers and investors intending to capitalize on the potential upside must be strategic, however. It is clearly to their advantage to target hard-to-duplicate locations that offer a mix of uses and a deep labor pool. Additional key priorities are creating amenity-rich communities focused on health and wellness and partnering with technology-driven operators. By focusing on these principles, senior housing developers and investors can lay the groundwork for success.

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