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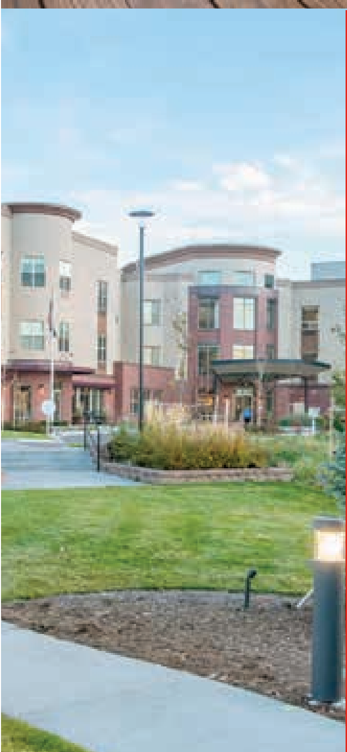

Growing pains

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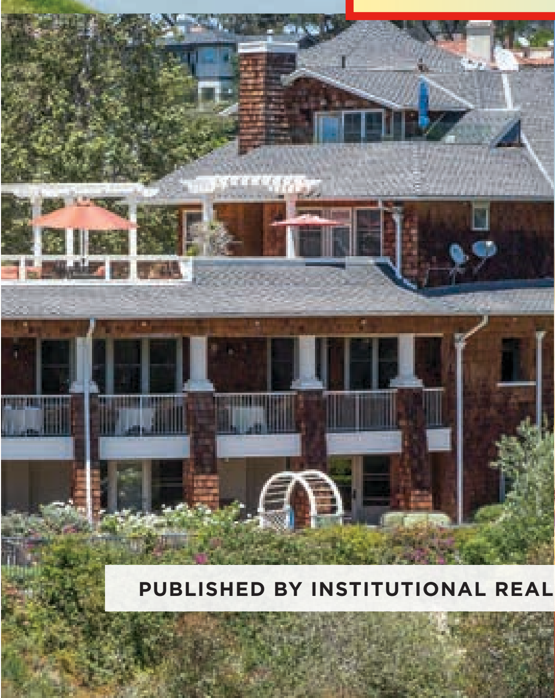

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Maravilla Scottsdale in Scottsdale, Ariz. (Photo courtesy of Senior Resource Group)

Growing pains

Aging population, however, fortells promising future for senior housing

By Steve Bergsman

Although it sounds ironic, even absurd, here it is: senior housing, which is incumbent upon the older citizens in our population, is not a mature industry. In the past two decades, senior housing has physically sprouted up on vacant lots around the country like boys stretching in height as they move from elementary to high school and, as what occasionally happens to the young, the industry is currently experiencing a bout of growing pains.

No worries. Growing pains are not an affliction — just a sign that expansion may have happened just a bit too quickly and, given time, all things will catch up and thrive. In the case of senior housing, the demographics have not changed, but a lot of new construction is coming to market now, while the great wave of baby boomers expected to embrace senior housing will not arrive for another 10 years.

Baby boomers were born between 1946 and 1964, so the leading edge of that cohort is now at 72 years of age. Typical senior housing attracts those in their early- to mid-80s, so the market is not quite there yet. However, the population will not suddenly pop come 2028 when the first baby boomers turn 82; rather, it will move gradually to that point. According to the National Investment Center for Senior Housing & Care based in Annapolis, Md., in 2016 there were 14.2 million people between 75 years and 84 years of age and 6.4 million at 85 years of age and older. By 2020, that becomes 16.6 million and 6.7 million, respectively, and by 2025, 21.1 million and 7.4 million. So, we can generously say, the senior housing market is preparing for the mini-waves of population growth that are coming sooner than the baby boomer tsunami.

“The average age is creeping up because people are living longer, and I’m very optimistic about baby boomers — we can see them from here,” notes Michael Grust, CEO and president of the Senior Resource Group in Solana Beach, Calif., and chairman of the American Seniors Housing Association based in Washington, D.C. “The linchpin for the surge of age-qualified seniors is a little way off, probably five years out.”

The Village at NorthRidge in Northridge, Calif. (Photo courtesy of Senior Resource Group)

Senior Resource Group is currently developing two new communities: one in Austin and the expansion of an existing campus in Los Angeles. In addition, last year it acquired a community in Sun City, Ariz. “We’ve been developing and operating senior living communities for nearly 31 years now; it’s been a great run and the future is bright,” says Grust.

Another company that has been working its way through the senior housing industry for a long time (a long time in this industry means 20 years) is PGIM Real Estate, the global real estate investment management business of Prudential Financial Inc. In 1998, it created the first institutional commingled fund dedicated to senior housing. The company is currently on its fifth dedicated fund, called Senior Housing Partners V, for which it has raised $629 million in equity. The vast majority of the funds are raised from state and municipal pension plans around the country, but there is also private money and foreign capital. With the monies PGIM Real Estate raises, it will engage in acquisitions, development and even value-add deals. After three to four years of investing in independent living, assisted living and memory care properties, it will begin to sell the investments.

“It used to be when we raised funds, we had to convince investors to consider senior housing, but that changed, says Steve Blazejewski, a managing director at PGIM Real Estate in Atlanta. “Investors today are knowledgeable about senior housing, and we have been in a healthy transaction market going back 10 years, since coming out of the global financial crisis.”

Slow hand investment market

The first signs of growing pains in senior housing, however, can be found in the more recent investment, or transaction, market. “This is a natural slowing due to the heavy transaction volume that has occurred since the global financial crisis. Senior housing transaction volume fell in 2017 compared to 2016,” says Blazejewski. “It is too early to tell for 2018, but the year should come in much the same as 2017.”

In 2015, the volume of senior housing deals totaled $21.9 billion, reports NIC. By 2016, the numbers tumbled all the way down to $14.5 billion and then rose to $16.1 billion in 2017. In the first quarter of 2018, preliminary data showed the closed-deal total was $2.3 billion, down 17 percent from the prior quarter and way off the first-quarter pace of 2017, which saw $4.7 billion of senior housing transactions.

Aron Will, a vice chairman and co-head of National Senior Housing Debt & Structured Finance for CBRE Capital Markets in Houston, uses similar numbers: “Mergers and acquisitions [activity] in the senior housing space has been flat, totaling $15 billion to $17 billion the past few years. It peaked in 2015 at $25 billion. We expect the numbers will be flat to slightly down this year.”

The main cause of the decline of the transaction volume is not that there is no demand — buyers are out there. Rather, it is that the biggest acquirers, the publicly traded and nontraded real estate investment trusts, which gobbled up senior housing properties as if they were candy, have had to pull back dramatically. Here is a telling statistic from NIC: When the investment market peaked in 2015, the share of transactions by the public market (publicly traded REITs and public companies) reached 53 percent; a year later, public market share levels dropped to 26 percent, and in 2017, it was 24 percent.

The comparison of the first quarter 2018 to 2017 "is a tough one considering it was unusual in that there were a few large deals, including one over $1 billion, which was not the case in the past quarter," says Beth Burnham Mace, chief economist at NIC.

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The nontraded REITs have issue

The decline of the senior housing REITs in the investment market has been due to a number of divergent factors, none of which was endemic to senior housing.

First, let's look at the nontraded REIT sector.

The initial stumble here was the 2014 accounting scandal that brought down American Realty Capital, which was the dominant nontraded REIT — that shook the industry. Then came the 2016 implementation of the Financial Industry Regulatory Authority Inc.'s Notice 15-02, which required broker-dealers to include a per share estimated value for an unlisted REIT on customer statements. Finally, there was the Department of Labor fiduciary rule, which required investment advisers to justify the high fees charged to investors.

Life just hasn't been the same for the nontraded REIT industry since those three actions. Fundraising fell off a very steep cliff: nontraded REITs raised $20 billion in 2013; by 2014 that number dropped to less than $5 billion and in 2017 it was only $3.9 billion.

Some nontraded REITs have survived the apocalypse, including Irvine, Calif.-based American Healthcare Investors, which invests in all sorts of healthcare real estate. However, for each of its portfolios, assisted living makes up 20 percent to 40 percent of the properties. If one throws in skilled nursing facilities, those numbers would grow to 50 percent.

The company, which began raising investment dollars in 2006, would build a nontraded REIT valued between $2 billion and $4 billion and then create a liquidity event, either selling the portfolio or taking it public. So, its first nontraded REIT became Healthcare Trust of America and its second was sold to NorthStar Realty Finance Corp. A third nontraded REIT, Griffin-American Healthcare REIT III, is now valued at $3 billion, and the company has begun raising capital for Griffin-American Healthcare REIT IV.

Back in the glory days, 2012 to 2014, the company raised billions of dollars, and it would buy $400 million to $1.5 billion in properties annually. Then when the nontraded REIT industry began to quake, acquisition volume dropped to $550 million in 2016 and $450 million in 2017.

"This industry used to raise about $6 billion annually; now it raises $2 billion," notes Danny Prosky, a founding principal of the company. "Our fundraising has picked up

Welbrook Southbay in Torrance, Calif. (Photo courtesy of Capitol Seniors Housing) a little bit this year. There are not a lot of us remaining in the business. At 20 percent of market, I believe we have the largest market share of business among the independent broker-dealer network, which is how we raise our money. Our market share has gone way up, but there are a lot fewer competitors out there today."

The Carillon at Boulder Creek in Boulder, Colo. (Photo courtesy of Blue Moon Capital Partners)

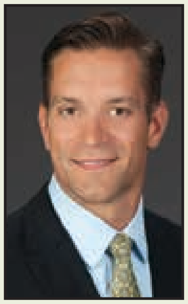
Senior housing REITs get the flu

Despite all the negativity about the REIT sector, REITs did not perform badly in 2017. The FTSE NAREIT All Equity REITs moved up 8.67 percent last year despite persistent concerns about rising interest rates, which increase REITs' borrowing costs, as the industry carries above-average debt to finance purchases and do redevelopment. The other thing about the rise in interest rates is that it makes alternative investments such as Treasurys more appealing.

While REITs in general have suffered, healthcare and senior housing, subsets of the healthcare REIT sector, have a contagion of their own. For the wider healthcare sector, the Trump administration has been a miasma with its attacks on Obamacare and confusion as to how the Republican tax bill will affect this part of the industry. As to the small cluster of pure senior housing stocks, analysts and investors have worries about weak industry performance and some very big asset aggregations that are in flux.

PGIM Real Estate

Investing in Senior Housing



Steve Blazejewski is a managing director with PGIM Real Estate and based in Atlanta, Georgia. He is responsible for the development and implementation of the strategy and oversight of PGIM Real Estate's senior housing fund business.

Can you provide a short overview of PGIM Real Estate and particularly its experience investing in senior housing?

Blazejewski: PGIM Real Estate's roots date back to 1970, when we launched the first ever commingled, open-end equity real estate fund. Currently, we have approximately $49 billion in gross AUM invested throughout the Americas, and have expanded capabilities to a full range of investments across core, core-plus and value-add strategies around the globe — and, of course, certain specialized strategies such as senior housing. PGIM Real Estate pioneered the senior housing investing space in 1998 with the first institutional fund dedicated purely to senior housing. Today, we are investing our fifth fund in the sector — the $629 million Senior Housing Partners V. Over the years, we have invested nearly $4 billion gross assets in senior housing, or approximately 17,000 units in 150 properties across the United States. Obviously, the industry has changed since 1998 and we have changed along with it.

How has senior housing changed over the past 20 years?

Blazejewski: The changes over the last couple of decades can be grouped into three major themes. First, seniors have changed. When we first started investing in senior housing, the residents in our communities were born around or shortly after the turn of the century. It won't be long, however, before the Baby Boomers start to trickle in. With the oldest of the Boomers at about 73 years old, and our residents typically about 83, their tenancy really is on the horizon. Second, because of the changing resident profile through the generations, there is more differentiation of care within the communities, ranging through independent, assisted and memory care. The communities and the individual units are also generally larger and have many additional lifestyle aspects such as multiple dining venues, rehabilitation services, and occupational or physical therapy. Residents are demanding more urban and vibrant living conditions — so communities look quite different from the nursing homes of 20 years ago. Third, the way we attract investment capital has also changed.

How has the business of raising capital changed over that same time period?

Blazejewski: When we entered the senior housing fund business, this was a very niche sector, so our focus was on helping investors understand the demographics and the investment opportunity. Today, the sector is much more mature, so our focus is on articulating our long, successful track record investing in senior housing and partnering with best-in-class operators. We believe this creates a competitive advantage compared to newer entrants to the sector.

Talking about changes, what trends are you seeing in the market today?

Blazejewski: Aside from the Boomers' changing preferences and subsequent impact on design and location, we are seeing new capital coming into senior housing. This capital includes entirely new investors or funds, additional funds from existing players, and new operators to the sector, and we would expect to see consolidation of some and expansion of others through the economic cycle. Another important change is the financial means of families to pay for senior housing. In the past, there was a heavy reliance on pension income (which is still largely the case), Social Security and, to a lesser extent, long-term care insurance or Medicaid. In the future, residents will likely need to fund their care more independently, particularly as the role of Social Security and pension income will decline over time. However, despite senior housing becoming increasingly expensive and affordability becoming more of a challenge, we do think those general demographics — or the "Silver Tsunami" of Baby Boomers coming into senior living — will impact demand enough to overcome some of that risk.

Speaking of risk, what do you view as the greatest challenge facing the senior housing industry at this time?

Blazejewski: A common theme in many of our conversations with investors and operating partners is the shortage of talent. This shortage is at two levels. The first is at the individual community leadership, or executive director, level of the various communities, and the second is at the line-staff level. The low level of unemployment in the country affects our industry, and it feels like a war for talent with communities competing to hire. The competition is putting upward pressure on wages, which our operators are certainly feeling. We are also seeing some generational transitions as the senior leaders that started in the industry 20 or 30 years ago with both corporate and community-level experience start to retire. Soon, a totally different generation will be working in and operating these communities. Just recently, I visited a senior living community where the executive director was a millennial who had previously been a concierge at a W Hotel. A very different background than one might expect for a retirement community, but a sign of the changing dynamic of the tenants and the communities.

Going forward, what opportunities do you see in the U.S. for senior housing investment?

Blazejewski: Despite a lot of noise around new supply and oversupply in senior housing, we still think there is a lot of opportunity. The "Silver Tsunami" will start to hit our industry in the next five to 10 years meaning that we will see up to 1 million new potential residents per year coming of age and possibly seeking senior housing, some of whom we think will want a more urban lifestyle. A lot of our current investment activity, particularly on the development side, is therefore focused on opportunities where we can build an urban environment or suburban "urban-like" environments with a town center. Walkability will be key for seniors — whether to the library, coffee shop or theatre. Another opportunity is seeking investments outside of what is typically considered a primary market. We have invested in some markets in the upper Midwest, for example, where there is a sizeable market, but no new supply.

Looking outside the U.S., where are the senior housing investment opportunities?

Blazejewski: PGIM Real Estate previously developed a number of communities in the United Kingdom in partnership with Sunrise Senior Living, and successfully sold those assets to another institutional investor about eight years ago. The U.K. is following similar trends to the United States, albeit probably a decade or so behind the maturity of the U.S. market. We see opportunity in the U.K., Spain and France, and are currently evaluating investment options in the region. We also see opportunity in Asia Pacific, where Australia and Japan have very mature and active senior housing markets with rapidly aging populations. In China, the population is aging and there are fewer and fewer relative workers to take care of the generational population bulge that is coming, particularly with the single-child generation. While the opportunity in China is probably a handful of years away, we are already laying the groundwork for some senior housing investment, and other demographically driven investment opportunities, for when the time is right. This is where PGIM Real Estate's global footprint, and the reach of our parent company Prudential, becomes a real competitive strength.

Speaking of global, what differentiates PGIM Real Estate from some of the other global managers?

Blazejewski: First and foremost, we have a long and successful track record raising, investing and selling for our dedicated funds since 1998. While there are a lot of startups out there, there are very few firms that can point to two decades of history in this space. Another key aspect is that we effectively operate as a senior housing specialty boutique, but within a large firm. We have the resources and backing of a large institutional investment manager, but are able to function as a boutique-type manager. The ability to leverage the broader platform applies to our global reach, but also with respect to our relationships. For example, we are working with some multifamily developers from our other funds to link them with senior housing operators. We think that this will help us to design and build better, but also potentially access real estate that others may not have access to.

I know we talked about the evolution of the facilities, and before we started, we talked jokingly about robots taking our jobs. Where do you see the industry going in the next 20 years?

Blazejewski: The other day I was talking with an industry colleague who had been in a hotel where a service robot delivered an item they had requested from housekeeping, demonstrating that technology with regards to labor is already evolving. Because senior housing communities are very labor focused and might need dozens of employees for a single building, this is something we need to be focused on. In addition, with communities becoming more walkable and more community focused, they will become more integrated. Already, multigenerational communities are popping up with respect to some of these town centers. The industry itself is also changing — with residents becoming far more discerning. Even the word "senior" will soon be out of favor because it is not something the Boomers want to be called, so operators are looking to replace their company names with new options. With the changing perspective that seniors have with respect to themselves, it is really an evolving industry.

What can investors expect from an investment in senior housing? Not just from PGIM Real Estate, but in general, as far as characteristics, diversification and performance?

Blazejewski: Number one is that while no industry is entirely recession proof, we think of our industry as being recession resistant. We performed very well throughout the global financial crisis with favorable occupancy statistics and positive rate growth, demonstrating that senior housing may not experience some of the swings that other real estate asset classes such as multifamily do. With income typically accounting for more than half of the returns in our investments, a high, steady income is also a huge opportunity. Further, the demographic changes I've described mean that the number of new seniors coming into the sector over the next two or three decades will double the potential resident base — a characteristic unique to senior housing and that no other real estate asset class has. Finally, because our residents are usually retired and may not have jobs to lose, even if a recession were to occur, they would still need care and services. All of these factors point to a successful future for the industry.


The Village at Belmar in Lakewood, Colo. (Photo courtesy of Blue Moon Capital Partners)

So just how has the stock market been treating senior housing? The stock of Newton, Mass.-based Senior Housing Properties Trust peaked five years ago at $29.38 per share. In April, the stock price had dipped below $15 per share before climbing back above $16 in early May. The stock price of New York–based New Senior Investment Group hit a peak in 2015 of $19.30 per share. In 2018, it hit a 52-week low of $6.92 per share before recovering to $8.56 during the first week of May.

By far the biggest panda in the senior housing playpen is Brentwood, Tenn.-based Brookdale Senior Living, and it has sucked all the air out of the room. After peaking at $38.72 per share, the stock price in early May was slightly above $7. That includes a 21.5 percent drop after the company released its full-year 2017 results, which showed a $571.6 million loss for the year, topping the $404.6 million loss in 2016. According to analysts, the company has been "facing financial and operational challenges" since its 2014 merger with Emeritus Corp. Leadership changes and restarts on whether to sell the company have not helped.

Brookdale's portfolio of properties numbers over 1,000, and it and other big firms in the industry have come under fire for being too large.

"On the operations front, we have a seen a couple of operators get really big and that's not a good thing," says Scott Stewart, founder and managing partner of Capitol Seniors Housing in Washington, D.C. "When a seniors housing company gets too big, the footprint is too large and corporate loses touch with clients. We tend to work exclusively with operators that have a regional footprint and know all their properties. Those guys have a better grip on the business."

Although the senior housing industry has seen successful portfolios operated on a national scale, particularly focused on independent living, the complexity of housing, hospitality and health care has kept most from approaching the scale of hospitality giants, like Marriott.

The REITs are still buying, but very selectively. Over the past three years, the publicly traded REITs have exited the senior housing buy market in a big way, says Will. "They have become net sellers in the main, pruning away non-strategic assets."

Healthcare REITs, which buy senior housing properties, purchased a lot of assets in the 2014 and 2015 period, says Mace. "These REITs are seeing which of those assets are accretive to their portfolio and selling those properties that no longer fit business plans."

All REITs, not just those in senior housing, have been trimming the poorer performing assets from portfolios, which improves the average net operating performance for the companies. In the shopping center sector, for example, it may not be such a great time to be a seller because the buyers are few and far between. That is not the case in senior housing where there are a host of new buyers who have supplanted the REITs.

Private equity to the rescue

Capitol Seniors Housing has acquired and developed more than 90 senior housing communities and deployed more than $2.2 billion of investment capital in its 14-year history. Today, it sits with 55 properties in its portfolio. The company operates on the private equity model of buy-fix-sell or build-lease-sell.

"Back in 2005, seniors housing was more of a pariah than an investment because it was operationally intensive and had a big insurance component that was hard to figure out," explains Stewart. "Institutional investors stayed away because they were afraid of it. Then we got into the market along with AEW and a couple of others groups. Not only didn't we get burned but we were doing quite well with the high-yielding assets. When the market saw that, it jumped and that served to drive down cap rates. Flash forward to today and all institutional groups have some component of seniors housing."

Stewart thinks there is still a lot of gas in the tank for the transactional market, as a number of new players have entered the business from private equity to offshore investors. "A lot of folks in this space have the problem of more capital to deploy than there are opportunities out there," Stewart says. As for Capitol Seniors Housing, its acquisition program has given way to new development. It has 10 properties currently in some form of construction. It recently opened a new property in Naperville, Ill., and two in Northern New Jersey.

With the REITs mostly selling and new players buying, the investment market looks and feels different. "If you peruse the NIC numbers, it seems transactional volume has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hit a plateau; however, small to mid-size transaction activity has been strong," notes Rick Swartz, a vice chairman and head of Cushman & Wakefield's National Senior Housing Capital Markets Group in Boston. The reason for the discrepancy is that the REITs could pull off billion dollar transactions, and those kinds of massive deals obviously excite the market in a big way. Unfortunately, not many of those deals are around anymore, having been supplanted by many smaller deals.

"If you look at the small to mid-sized transactions, anywhere from $10 million to $300 million, there has been consistent growth in the number of these types of trades," Swartz explains. "If you look at the composition of buyers during the 2016–2017 period, you see non-REITs growing their share of transactions activity. At Cushman & Wakefield, we have seen steady volume growth year over year for the past few years, and 2018 is looking to continue that trend."

So, who are the buyers? Swartz drops them into three categories: senior housing specialty funds such as those managed by AEW, Harrison Street, Kayne Anderson, Prudential, Bridge, Blue Moon, Harbert, Artemis and Focus, etc.; diversified private equity shops such as Virtus, Och-Ziff, Blackstone and Apollo; and offshore investors.

Bridge Investment Group is a privately held real estate investment company that manages $10 billion in assets. It launched its first senior housing fund in 2014, deploying the fund's capital to acquire 65 properties across 26 states. In 2017, Bridge launched its second fund, which has so far acquired 18 properties. Total capitalization of the two funds stands at just over $2 billion. About 80 percent to 85 percent of Bridge's investments are within the NIC 100 markets.

"The move into senior housing usually happens within a five-mile radius of where they lived most of their adult life," observes Robb Chapin, CEO of Bridge Seniors Housing Fund Manager in Orlando. "That's because the major decision maker in moving mom or dad into a service-enriched senior housing is the eldest daughter who is about 50 years of age. Most people are not migrating to Florida to live out their final years. They move into senior housing when they need incremental services and not because of lifestyle."

The company's peak year of investment was 2015 when it acquired $1 billion in properties, then slightly less in 2016 and 2017. In 2017, the pace of acquisitions slowed to between $400 million to $500 million. That change was not due to economic factors, but to it being a shoulder year for Bridge as it started raising capital for a second fund, says Chapin.

Also relatively new on the scene is Boston-based Blue Moon Capital Partners.

Not a core investment, but behaves like one

Institutional investors generally put senior housing into the value-added or opportunistic bucket, often depending on whether one is acquiring an existing property or building from the ground up. The sector has a more significant operational component than other commercial property types, and its total return performance is not based solely on its real estate component. So senior housing properties will probably never be regarded as pure core real estate and will always carry some operation-related risk premium.

But because data and transparency have improved dramatically for senior housing in the past decade, investors can now see many core-like attributes in it. Beth Burnham Mace, chief economist for the National Investment Center for Seniors Housing & Care, says these include steady and predictable income and cash flow characteristics, high income yield, and relatively strong tenant credit quality, especially for the private pay that dominates independent living, assisted living, and memory care properties.

Because of these core-like qualities, investor interest in senior housing is likely to continue expanding, bringing more capital into the sector and increasing overall liquidity, which gives it an additional core-like trait. In addition to domestic capital, Mace says foreign capital flows into the United States are continuing to rise, and she says that as sovereign funds try to hit their commercial real estate targets, a share of those dollars will be going into senior housing.

Kathryn Sweeney, co-founder and managing partner/CIO for Blue Moon Capital Partners, says senior housing investments have not been considered core by most investors due to the historical niche categorization and leverage levels. While most institutional investors define core as having limited leverage, senior housing operators tend to like fixed-rate debt. Operators prefer to enter into joint ventures with institutions that allow 60 percent to 65 percent leverage. That has been a standard leverage amount for over 20 years, Sweeney says. "Because of the leverage and niche status, senior housing tends to be in the value-added bucket, although it behaves like a core investment, with truthfully better growth tailwinds," she says.

StoneRidge in Mystic, Conn. (Photo courtesy of Bridge Seniors)

Formed in 2013, the company raised $250 million for its first senior housing investment fund, for which it acquired four properties and did ground-up development on eight. The company closed on two ground-up developments in the third quarter 2017, one in Aliso Viejo, Calif., and the other in Atlanta. It did make two purchases last year, a 117-unit senior living community in Boulder, Colo., and 188 units of assisted living and memory care in Northbrook, Ill.

The public REITs are mostly on the sidelines and are highly selective in buying. Investment activity will mainly come from private equity investors. Foreign investors are in the market, but not nearly to the volume that folks expected.

"For the industry, the volume of transactions will be about the same in 2018 as the year before, but it will come from different cohorts," says Kathryn Sweeney, co-founder, managing partner and CIO of BMCP. "The public REITs are mostly on the sidelines and are highly selective in buying. Investment activity will mainly come from private equity investors. Foreign investors are in the market, but not nearly to the volume that folks expected."

Cap rate meandering

There are more investors in senior housing, but most everyone agrees the smart ones are very selective in terms of the investments they are pursuing.

"The newer buildings tend to outperform, and that is where a lot of capital is trying to invest," observes Blazejewski. "The industry has bifurcated into class A and B pricing levels. Pricing for class A is extremely strong because there are few opportunities out there, while class B has softened."

According to Blazejewski, capitalization rates, on A properties range from 5.5 percent to 6.5 percent, while cap rates on class B properties are higher at 6 percent to 7 percent. PGIM Real Estate looks for properties with a range of care levels and near to where the adult children of seniors live. It focuses on high-barrier-to-entry, dense and affluent markets, so the Northeast is just as good as the Southeast, perhaps even better.

Bridge takes a different approach. It is a buyer of value-add opportunities, so it puts dollars into capital expenditures to grow net operating income during the hold period. "The going-in cap rate is less important to us," says Phil Anderson, CIO of Bridge. "The selling cap rate is our big kick. We are in this really interesting period of time when interest rates are modestly climbing, and the amount of capital looking for income with some level of growth is moderating the cap rate."

Bridge sells its properties after two to five years, looking to do so at cap rates in core markets in the high 5 percent range to low 6 percent range and 25 basis points to 75 basis points higher in other markets, says Anderson. "As we look into the future, we still see a relatively stable cap rate environment for stable properties."

Sellers are looking at cap rates for a premier product in a coastal market "in the low fives going up to the low sixes for second-tier markets," says Swartz. "When you get into class B, you are looking at high sixes to sevens."

"If you are a seller of senior housing, you are in a good position because there are a lot of people who want to grow their portfolio or get into senior housing for the first time," says Stewart. "Cap rates depend on if you are looking forward or backward; it's trailing versus forward. On a forward basis, a good assisted living with a memory care component, relatively new and purpose-built in the top 31 NIC markets, will be in the 5.5 percent to 6.5 percent cap rate range. On a trailing basis, it is below 5 percent to 5.5 percent."

If you are a seller of senior housing, you are in a good position because there are a lot of people who want to grow their portfolio or get into senior housing for the first time

For expanding, less dense cities with good economic drivers such as Charlotte, you will see cap rates at about 5.75 percent, which would have been about 6.25 percent five years before, notes Will. "In the immediate terms, cap rates will likely rise given the magnitude of supply

Arbor Terrace Morris Plains in Morris Plains, N.J. (Photo courtesy of Capitol Seniors Housing)

that has hit the market and the rising interest rate environment we're in," he continues.

The good, the bad and the ugly

As noted, the senior housing industry is going through some growing pains, and investors have valid concerns about senior housing REITs. None of this is a slam on the future of the industry, but positive trend lines are currently crossing with some negative trends, which is giving players and analysts some pause.

Two things to note: first, the price per unit for senior housing has not deteriorated. The industry's average price per unit since 2015 has consistently oscillated in the $160,000 to $180,000 range. The price per unit in the first quarter was $166,000, NIC reports.

As with other real estate sectors, the pace of new construction in senior housing ebbs and flows. Starting around 2012, new units of senior housing began to climb, with 2015–2017 peaking in terms of new community starts, says Blazejewski.

"Construction starts in 2015 and 2016 passed the prior peak building levels of the late 1990s and early 2000s," Will adds.

Since construction of senior housing takes between 12 to 24 months, many projects that started in 2016 are currently hitting the market. New product can affect certain markets in terms of occupancy and eventually rent growth.

"Occupancies had a hit in the first quarter 2018, which was equally demand and supply driven," says Sweeney. How good or bad occupancies are depends upon the market and the product. Generally, the occupancy rate for senior housing fell to 88.3 percent in the first quarter of 2018, a six-year low, while the occupancy rate for assisted living fell to 85.7 percent, a record low, reports NIC.

"Occupancy rates are not going in the right direction," Mace adds. "However, if you look at the largest 31 markets for senior housing, we see a wide variation in occupancy, from 95.1 percent in San Jose to 78.3 percent in San Antonio."

At Bridge, occupancy rates at stabilized assets have not been impacted by new competition and "our occupancies are still in the low 90 percent range," says Anderson.

"For the industry as a whole, occupancy levels are heading south; for PGIM Real

Estate's portfolio we are generally flat," says Blazejewski. "Our portfolio occupancy is in the mid-90s, but with new supply coming online, we may see an impact on occupancy and rent growth. However, we have a positive outlook on occupancy given the long-term demographic trends."

Stewart reports stabilized properties at Capitol Seniors Housing reside in the low 90 percent range, and the company has been able to raise rents on those properties, trying to keep these to 3 percent to 5 percent increases.

NIC reports asking rents grew by 2 percent from the first quarter of 2017 to the first quarter of 2018 and by 2.9 percent solely for assisted living.

"Wages [labor expense] are about 60 percent of a typical operator's expenses, and data from the Bureau of Labor Statistics shows that, as of the fourth quarter 2017, average hourly earnings were up by 5 percent on a year-over-year basis for assisted living employees," says Mace. "We are seeing a deceleration in rent growth and an acceleration in expenses as expressed by average hourly earnings, and that is putting greater pressure on NOI."

The industry is seeing expense growth of 3 percent to 4 percent, and most of that is due to labor, adds Blazejewski. "That comes in two fronts, community-level leadership and the staff line. There is a war for talent on both levels. Staffing can be difficult depending on where you are located. When we look at new investments, one of the important things we scrutinize is if the community is accessible to the labor force via, for example, mass transit. You could be in a wealthy community but if the line staff has no way to get there, the community will be difficult to staff."

"The big challenge right now is expense control because of wages," Grust adds. "That's the Achilles heel in the business right now — finding enough of the right employees. Many markets have experienced runaway wage increases because of the competition for staff. Other senior housing communities and hotels a mile away are all vying for the same workers. This has absolutely put pressure on NOI — especially when you are committed to delivering on the promise of great service, hospitality and care."

However, no need for investors to get despondent. Senior housing starts are already beginning to slow, which will relieve the pressure on same-store performance.

As for investors, two things to note: first, the price per unit for senior housing has not deteriorated. The industry's average price per unit since 2015 has consistently oscillated in the $160,000 to $180,000 range. The price per unit in the first quarter was $166,000, NIC reports.

According to NCREIF, in the first quarter 2018, total investment returns for senior housing on a 10-year basis were 10.5 percent, well above that of National Property Index's return of 6.1 percent, while the one-year return totaled 12.8 percent, which looks very strong compared to the 7.1 percent for the NPI.

Finally, if one looks at the senior housing penetration in the top 31 markets as delineated by NIC, penetration still stands at about 10 percent, which is relatively low. Says Mace, "There is plenty of room for senior housing to grow in penetration. If we increase penetration to some degree, we'll pick up that new supply." ❖

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