



A PERIODICALS SUPPLEMENT TO INSTITUTIONAL REAL ESTATE AMERICAS, OCTOBER 2020

Big picture

Seniors housing outlook
remains positive despite
COVID-19 challenges



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Briarcliff Manor in New York (Photo courtesy of Senior Lifestyle)

Big picture

Seniors housing outlook remains positive despite COVID-19 challenges

By Steve Bergsman

In the spring of 2020, the spreading COVID-19 pandemic put owners and operators of senior housing on high alert. Procedures, guidelines and personal protection equipment (PPE) were put in place, and facilities were able to better safeguard their environments to help protect residents and staff from contracting and spreading the virus.

Although COVID-19 has produced these operational changes in the industry, it will not alter the course of demographic convergence. In the near future, the demand for space in senior housing developments will only increase, not diminish.

For need-driven senior housing, such as assisted living and memory care, age 80 is the appropriate threshold, argued Frank Rockwood

in an American Seniors Housing Association report. While that might be accurate, most people currently in seniors housing are in their mid-80s, and as Beth Mace, chief economist and director of outreach at the National Investment Center for Seniors Housing & Care, points out, the first baby boomers will not hit 82 until 2028.

“Right now, the cohort that typically lives in seniors housing [those born in the 1930s] is expanding, just not at the pace people anticipate when considering the baby boomers,” says Mace. Indeed, a lot of the residents of seniors housing are the parents of baby boomers.

Mace estimates about 23 million Americans are 75 years and older, and that cohort will expand to 29 million by 2025 and to 34 million by 2030. The current pace of development is needed

because the penetration rate of senior households age 75 and older is about 11 percent. In 2020, 17 million Americans comprise the younger part of the cohort, ages 75 to 84. That number will grow to 21 million by 2025 and to 25 million by 2030. “This is where baby boomers are going to immediately have an influence,” explains Mace.

Another data point to consider is caregiver ratio. If someone is over age 80, his or her adult child is probably between the ages of 45 and 64. In 2020, the available adult children to care for



The Conservatory at Champion Forest in Spring, Texas (Photo courtesy of Discovery Management)

every senior over the age of 80 is estimated at 7-to-1. By 2030, that shrinks to 4-to-1 and by 2050, the ratio is only 3-to-1. Simply put, fewer caregivers means more community-based, congregate settings will be needed.

“A couple of years ago at a seminar, industry executives were sitting around brainstorming about what could disrupt seniors housing,” recalls Steve Blazejewski, a managing director at PGIM Real Estate in Atlanta. “No one thought of a global pandemic, proving you can prepare as best you can, and there is still going to be something that comes up that you weren’t prepared for.”

Nevertheless, he adds, when you look at long-term trends, “we still believe in seniors housing. It may be vulnerable at times, but when you have approximately 1 million new, potential residents a year aging into the target demographic for senior care, it keeps us bullish on the sector.”

Construction

Pre-COVID, seniors housing new construction, which had been on a multi-year tear, finally began to slow. Inventory growth for independent- and assisted-living seniors housing in the National Investment Center’s NIC MAP ® Primary

Markets — the 31 largest metropolitan areas — reached 21,400 units in 2018, reports Mace. NIC data shows construction as a share of seniors housing inventory for majority assisted-living properties decelerated to 6.6 percent, or 20,560 units, in second quarter 2020, which was the lowest rate since 2014 and down from a peak of nearly 10 percent in late 2017.

Since March 2020, if construction hadn’t already begun, many projects were delayed or cancelled, as some lenders backed away from the market due to the pandemic. “I don’t think construction will accelerate in 2020 because there is still great uncertainty,” says Mace. “Lenders are going to be gun-shy for awhile; they will want to see how this all plays out.”

Richard Swartz, an executive managing director at Cushman & Wakefield in Boston, agrees: “Oversupply slowed down new construction, and that trend has been more significant because of COVID. Both debt and equity are being very cautious in terms of capitalizing new development. New supply will be constricted for awhile.”

The pandemic environment has become a “governor for new lending activity,” and banks are tightening their books in terms of new construction loans, Blazejewski concedes, but that has only made PGIM Real Estate more bullish on new development, as opposed to acquisitions.

“I have a contrarian bent,” he says. “When times become more constricted, that’s when we should be developing. We are in the depths of the pandemic, and occupancy rates are relatively low, but we still intend to develop. There is a lag effect. It takes a couple of years for these projects to be constructed, and the demographics haven’t significantly changed. Seniors housing is still a need-driven business, and seniors will still need care.”

Before COVID-19, PGIM Real Estate closed its newest fund, SHP VI, which raised \$996 million. Its predecessor, SHP V, closed in 2019 with \$629 million. “It’s time to leverage some of the long-term advantages that we have,” says Blazejewski.

Transactions

The merger and acquisitions market for seniors housing had been in the \$12 billion to \$18 billion range for the past few years. That won’t happen in 2020, says Aron Will, CBRE vice chairman and co-head of National Senior Housing, Houston, “It is going to be way down, almost certainly under \$10 billion.”

How far will the 2020 transaction market drop? “It is going to be down 60 to 70 percent compared to prior years,” predicts Brian Sunday,



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a director with Boston-based AEW Capital Management and senior portfolio manager for AEW Senior Housing Investor Funds. “Just to get back up to \$10 billion might not happen til 2022, as next year will get off to a slow start.”

If vaccines and therapeutics manage to get the COVID virus under control sooner rather than later, the transaction market could recover more quickly, perhaps by third quarter 2021.

If vaccines and therapeutics manage to get the COVID virus under control sooner rather than later, the transaction market could recover more quickly, perhaps by third quarter 2021, as the lower interest-rate environment will be helpful, he adds.

The mergers and acquisitions market had been in its own type of quarantine from March through the end of the summer. In September, Matthew Whitlock, managing director and CIO of seniors housing at Berkshire Residential Investments in Boston, described the situation this way: The “transaction marketplace is without price discovery,” which was due to so few deals closing.

“The stuff that is on the market is not on the market based on premium, but placed into the market by sellers deciding to dispose of properties for whatever reasons necessary,” Whitlock

explains. “For class A, institutional grade, we see very little price discovery. The pandemic introduced a level of risk, which we as an industry haven’t discovered the price for yet.”

The general view is the pandemic hurt the bottom line of individual owners and operators. Whether that will force a sale has yet to be determined; lenders have abstained from putting pressure on borrowers because of COVID-induced problems. That interregnum will end, though. Lenders have been working with borrowers but, after a while, pressure on their own bottom lines will force action.

“What comes out of the pandemic will be a bifurcation of the industry in terms of pricing perspectives,” Whitlock says. “Institutional-class, well-built, well-located, occupied assets will command a premium. A price differential will spread between that type of asset and the 20-year or 30-year-old building with condition issues. The pandemic will drive a delineation between class A and class B product.”

NOIs that are far below budgeted or forecasted numbers will eventually cause a level of distress that will force a deal, probably starting at the end of 2020 or first two quarters of 2021.

“New facilities that were not leasing up fast enough even before the advent of COVID could be in trouble,” says Blazejewski. “While this is not happening as fast as people think it should happen, it is just a matter of time. In the fourth quarter 2020, we think the amount of distressed deals will uptick.”



Allegro Senior Living assisted living community in Winter Park, Florida (Photo courtesy of Allegro)



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“For assets that were stabilized pre-COVID, NOI should hopefully get back to positive by the end of 2021,” says Sunday. “For properties that were not stabilized or in lease-up, you’ve got to look further ahead, into 2022. Those assets will take a lot longer.”

Recently developed projects that were built to be sold quickly had been shelved due to the pandemic. By fourth quarter 2020 and first quarter 2021, these developments will come back into the market, anticipates Swartz.

How they will do depends on how strong pre-leasing was prior to the pandemic and if leasing was restarted during it. “Those projects that had stumbled or had leasing problems pre-COVID have now gone backwards,” explains Swartz. “Two scenarios here will develop: Ownership will wait it out until it sees stronger momentum on leasing, or there will be a distressed sale.”

Cap rates

“People ask me all the time whether there has been a degradation in cap rates, and the answer is no,” says Will. “But, the underlying net operating income is less.”

The problem is, in the time of COVID, there has not been enough current transactional data, including direction of property values, to see if cap rates have been substantially affected.

“In order for sellers to transact today, there has to be an acknowledgement that the property is worth less than it was before COVID, and that has not been apparent,” explains Will. “We lost



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Allegro Winter Park Florida (Photo courtesy of Allegro)

four months of transactional volume, there is a big disconnect between buyers and sellers, for many months investors didn't know which way was up, and the capital markets were disjointed."

Swartz adds, "You are not going to see a difference in either cap rates or IRR levels. Core buyers are not expecting a change. Cap rates on class A properties in coastal metros are still in the low-5 percent range. Further inland or in smaller markets, cap rates are more in the low-6 percent range."

In regard to valuations, Swartz suggests the only pandemic-related impact will be on the cost of PPE, which could at most be 1 percent or 2 percent of value. That's a short-term impact. On the other hand, if an operator has experienced a decline in occupancy from, say, 85 percent to 75 percent and needs to sell quickly, that will hurt value.

Artemis Real Estate takes the view that senior housing is evolving to a real estate-basis market rather than a cap rate market. As such, Artemis will be reviewing investments based on "price per pound," says Kelly Sheehy, principal and managing director of healthcare business at Artemis Real Estate Partners in New York. "We recognize that this crisis is different, in that COVID-19 disproportionately impacts seniors and the senior

care industry and, thus, we believe opportunities will look different than prior cycles."

REITs and private equity

Real estate investment funds that raised capital prior to COVID-19 continue to invest, reports Kathryn Sweeney, managing partner and co-founder of Blue Moon Capital Partners in Boston. "However, for some, the investment flow has slowed as managers seek to refine underwriting and adjust to operate within pandemic conditions. Fund sponsors include pension plans investing via fund vehicles. The usual names predominate — AEW Capital Management, PGIM Real Estate, Harrison Street, Blue Moon Capital Partners. These groups all have funds with capital available to invest."

The funds mentioned above include institutions, such as public pension funds, among their investors, but private pension funds and offshore investors are inside those investment vehicles, as well. "The funds invest across the spectrum, with the exception of skilled nursing," says Sweeney. "You will see the private equity funds invest in active adult, independent living, assisted living and memory care."

AEW Capital is not selling assets, says Sunday. "We think there is too much value in our assets to bring them to market. The buyer pool is small, and buyers are going to want a significant discount in order to purchase. As to acquisitions, we are looking at a few deals, but we are less active than we were in 2019."

As for PGIM, Blazejewski affirms the pension plan still leans toward development.

"REITs are not as active," observes Sweeney. "The private equity players have taken up more of the investment flows of late. The REITs have been put on the sidelines, in large part because share prices have declined since the onset of the pandemic. Their operators are reporting declining occupancies. Profit margins and falling occupancies have really hit the publically traded REITs, more so than private equity"

Danny Prosky, founding principal of American Healthcare Investors in Irvine, Calif., has noticed a few REITs were still in the market. "I don't expect there to be blockbuster deals for assisted living or skilled nursing, but there has been some activity," he says. "Private equity is still out there as well, although there were a lot fewer large transactions in the second and third quarters of 2020. A lot of investors are hesitant. Why invest in assets when you don't know what is going to happen next?"

As summer 2020 rolled into the third quarter, Sunday began noticing more distressed deals

transact. “For a lot of properties, occupancies dropped from 5 percent to double digits percent-wise; that’s a big hit, especially for properties in mid-lease-up or [that] were not stable prior to the pandemic,” he says. “You are starting to see people without good capital structures, or with debt coming due, moving to market.”

Opportunistic investors are beginning to circle, says Sheehy. “We are seeing opportunistic capital with limited seniors housing experience coming into the space and looking to capitalize on distress; however, it is important to remember that healthcare real estate, in particular seniors housing, is different than traditional real estate asset classes, in that it is as much about care as it is about real estate.”

On the “healthy” side of the transaction table, all was quiet. “I’m not seeing a lot of cashflow properties in the market,” says Sunday. “Companies that own those assets have good balance sheets and have been able to work with lenders to extend or modify debt — push the puck down the ice until they are in a more stable capital environment.”

The one positive is debt is cheap. If a buyer is able to get a lender to loan on terms, low interest rates can make up for some of the decrease in NOI.

“Toward the midpoint of 2021, we are going to see private equity and REITs in the transaction market be more active,” Sunday predicts. “Groups that were planning to sell assets in 2020 obviously paused for the pandemic. Assuming there is a vaccine, and seniors housing can get back to normal, the transaction market will open up. Rates will stay low for some time and, with a low interest-rate environment, people will need to place capital, and if values rise to pre-COVID levels, REITs and private will be active when that happen.”

Occupancy and rents

In the halcyon days of yore — actually only 2019 — occupancy in primary markets for seniors housing reached 87.9 percent, a slight improvement over the eight-year low of 87.7 percent in the second quarter of that year, according to NIC. For assisted living, occupancy inched forward to 85.6 percent at the end of 2019, the highest level since fourth quarter 2018. Before the advent of the pandemic, rent growth had been consistent, notes Mace. In fourth quarter 2019, asking rents rose 3.2 percent for independent living and 2.7 percent for assisted living, on a year-over year basis. Since the pandemic, data from NIC shows asking rents have slowed down but are still tracking positive.

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The biggest surprise has been operators' ability to raise rents, and those increases have been widely accepted by the resident population, says Whitlock. "Residents sense a comfort; they are receiving the services they need and being provided for in a professional manner."

Prior to the pandemic, depending on geography, downward pressure had been building on rents due to free-rent offers and discounts in competitive metros. The exact opposite happened during the pandemic, as the resident population showed very strong confidence in the level of security in the communities. "The increases that we have seen had been accepted," reiterates Whitlock. "We haven't seen resistance to either a rise in care service costs or rent."

That might change depending on the duration and various waves of the pandemic in the future, as states and localities have imposed moratoriums on visitations, which means potential new residents cannot tour facilities or cannot move in.

"The typical annual turnover in a senior community is around 40 percent, so if you have a 100-unit community, 40 residents will move out and 40 new residents will move in annually, on average," explains Blazejewski. "If you are unable to move in residents, this is a one-way

door. As a result, occupancies gradually eroded through the course of the pandemic. Depending on geography and demand, occupancies have generally dropped anywhere from 2 percent to 10 percent."

Blazejewski predicts occupancy will experience a gradual recovery. "We won't recover that 2 percent to 10 percent occupancy loss between now and the end of 2020," he says. "Occupancy rates will be flat to slightly upward between now and January 1. Gradual recovery will continue through 2021 and beyond."

Seniors housing occupancies are down 500 basis points, on average, from pre-pandemic to end of June, reports Sheehy. "This brings occupancy back to levels the industry hasn't seen since 2009. We believe there are many other similarities to 2009, including abrupt halts to new construction starts — starts have fallen 75 percent year-over-year — and significant lender pullback. We believe these trends will present opportunities to acquire high-quality assets at a more attractive basis, as well as force some borrowers to seek rescue capital for refinancing in the depressed earnings environment."

"Experienced operators that have proven their ability to proactively manage COVID-19 will prevail on occupancy and profitability," says



Sweeney. “Those operators will be rewarded with continued access to discerning capital, at costs reflective of the lower risk.”

“Specific to our company and our markets, we have seen rent levels drop a tad, but mostly what we are seeing is an individual promotion or a type of concession initiated to entice individuals to make a move to community seniors housing and be willing to live with current restrictions,” notes Douglas Schiffer, president and COO of Allegro Senior Living out of St. Louis, and chairman of the American Seniors Housing Association. “We haven’t moved on rent a whole bunch but have substantially employed concessions.”

American Healthcare Investors doesn’t expect a V-shaped recovery, where it would lose, for example, 4 percent occupancy and regain it in three months, says Prosky. “We do expect occupancies to recover because demographics are on our side and development has dropped off.”

As for operational issues, Prosky notes, “we haven’t dropped rents substantially anywhere that I know. Maybe we’ve done some move-in specials. Generally, in our markets, we have not seen wholesale declines in rents.”

Labor

Before COVID-19, labor markets were extremely tight and seemed to be getting tighter. Now with

so many people unemployed, the market has turned 180 degrees. Labor supply is once again plentiful. The question going forward is, how expensive will the new labor be?

“The minimum wage was already rising but, for the most part, the high-quality operators were already paying labor above minimum wage,” says Sweeney. “Further rises in minimum wage shouldn’t affect the higher-quality facilities.”

She also suggests, as the supply of labor becomes more available, the pressure to go above and beyond on salary levels will not be as severe as it was pre-pandemic and, as a result, labor-rate growth will slow.

At the start of third quarter 2020, the difficulty was not future salary levels, but rather the higher labor costs that developed during the worst weeks of the pandemic.

During the height of the pandemic in early and mid-2020, seniors housing employees feared coming to work, and facilities had to resort to agencies. “That’s come way down,” says Prosky. “There is less pressure having to raise rates for labor right now.”

Hero pay — additional pay to incentivize staff to come to work — had affected communities and overall labor costs, adds Blazewski. “The industry was also seeing the impact of government stimulus programs, which partly propped up some



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of the labor costs. As a result, seniors housing is continuing to see labor costs stay high.”

Blazejewski expects communities will continue to pay a little more to keep talented people because of COVID-19, but as unemployment recedes and the stimulus fades away, by fourth quarter 2020, the industry could experience a deceleration of labor-cost growth.

Schiffer offers this observation: “Most people who work in senior living have a passion for it, so employment will get back to where it was pre-COVID. This may not be 12 months from now, but it shouldn’t be longer than 18 months.”

The new norm

When asked if and when the industry will achieve a “new normal,” Sweeney offered a radical thought: The seniors housing industry is already in the new normal. What she meant is, to operate efficiently and safely today and for years into the future, a senior facility has to have a sufficient supply of PPE, a relationship with a testing lab, and labor that is trained and capable of providing services to seniors in a slightly different way.

Before there is a vaccine, the industry needs to have rapid testing, Sweeney adds. “To get the communities back to near pre-pandemic operations, communities need to be able to allow more free-flowing visitations and a full menu of activities, and that can only be done through rapid testing. Advancements are coming, but they need to be accelerated.”

A lot is weighing on the advent of a vaccine. “The industry is in a bit of doldrums now, but it will come out of it when there is a vaccine,” says Schiffer. “Even the optimists predict there won’t be a vaccine readily available until early 2021, and there probably won’t be in-depth usage for seniors until about six months following vaccine availability. The industry won’t be profitable again until that happens.”

Sweeney believes for the industry to get back to stability, or even to pre-COVID levels, with a vaccine, it will take a year.



The Sheridan at Oakbrook in Illinois (Photo courtesy of Senior Lifestyle Photos)

“Not until 2022 will the industry get back to a new normal,” concurs Will. “When that happens, policies and procedures will be much more robust on the operating side. There will be ongoing expenses that didn’t exist before that will make margins thinner. While there will be more expenses associated with sanitation, protective equipment and testing, labor might be cheaper because the market won’t be as tight. In many markets, the labor markets are already less tight, given rising unemployment.”

On the bright side, adds Will, “People will come back into the sector because the sector is resilient. We are now acutely aware that home health as an alternative is expensive, as well as the increased risk of caregivers coming in the home. Current concerns will be reduced, and seniors housing demand will continue and will be stronger than today.” ♦

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