Yes, the Market's Even HOTTER

The now mature assisted and independent living sector continues to attract capital, with some conventional lenders now offering fixed-rate loans

By James J. Pieczynski

Not too long ago, the assisted and independent living sectors could barely attract a small amount of attention, let alone significant investments, from the capital markets. But now that the senior housing business has demonstrated sustained stability and strength, investors have come calling. Concerns about market over-saturation (as happened in the late '90s) are minimal, as most underperforming operations did not survive the last downturn. Though financial markets can be fickle and broad economic factors (i.e., interest rates) are potentially troublesome, the solid fundamentals in these sectors likely will continue to attract both debt providers and equity investors over the next 12 to 18 months.

Consider this: Project financing for the entire senior housing and long-term care industry reached a record high $1.46 billion in fourth-quarter 2005, up from $1.143 billion in fourth-quarter 2004 and nearly double the $763 million in fourth-quarter 2003, according to research from the National Investment Center for the Seniors Housing & Care Industry (NIC). More than 95 percent of this loan volume was attributed to permanent debt and short-term financing in independent living ($859 million) and assisted living ($432 million). Further, average stabilized occupancy in independent living increased to 92.7 percent (fourth-quarter 2005) from 90.6 percent (fourth-quarter 2004). In assisted living, it grew to 91.7 percent from 88.7 percent. These key financial and operating indicators held steady in the first quarter of 2006, with NIC data showing that the industry's permanent debt financing volume grew 25 percent over the first quarter of 2005.

As competition among financing sources has intensified, capitalization rates have continued to fall. Fourth-quarter 2005 averages were 8.9 percent in assisted living and 8.5 in independent living, compared with 10.9 and 10, respectively, for fourth-quarter 2004.

The seniors housing market has never been so dynamic. With an abundance of capital now available, investors are carefully searching for the right opportunity and operators are determining how best to respond to market demand and investor interest. As the market continues to show both strength and stability, the time is right for opportunistic owner/operators to execute their growth strategies.

WHAT THE MARKETS FIND APPEALING

What has spurred financial markets' increased interest in the entire senior housing sector? The industry's maturation has been a key factor, since a growing number of facilities now have lengthy track records of proven success. To survive the industry downturn that began in the late '90s, these properties have become much more proficient in running lean operations, and the cost-efficiencies they have gained are now boosting their profits.

In addition, certain characteristics of assisted and independent living operations make them particularly appealing targets. Because they are not primarily dependent on reimbursements from federal (Medicare) or state (Medicaid) programs, they are less vulnerable to changes in government policies, budget allotments, or reimbursement rates. Assisted living communities also are generally less burdened by the challenges (and risks) of regulatory compliance and liability issues.

Assisted and independent living companies also measure up quite well against comparable real estate investments, such as multifamily properties. Occupancy levels for assisted living and independent communities have demonstrated stability and, in many markets, are now nearly as high as apartment occupancy rates. Some investors have begun to view independent living properties as apartments for older people that offer a few extra amenities. Assisted living communities likewise can be seen as apartments with an added care component, which savvy operators have no trouble

Pension Funds Move In To Senior Living Market

By Jon Peterson

More pension fund capital is finding its way into the assisted living and senior housing market. These funds generally are interested in buying and developing either a typical assisted living project like those developed over the past five years or a more upscale hotel-type project.

For example, the California State Teachers Retirement System fund recently made its first-ever investment in senior housing, setting up a joint venture relationship with Newport Beach, California-based Vintage Senior Advisors. The joint venture includes $83.3 million of equity. The pension fund contributed 90 percent, while Vintage contributed 10 percent.

Vintage's principals include three executives from the now-defunct ARV Assisted Living. The venture will put half its efforts into acquiring existing projects and half into developing new properties—all focused in the western United States.

Already an active player in senior housing, California Public Employees Retirement System pension fund continues to invest in the business. Earlier this year, it made a new $50 million allocation to its real estate manager, Boston-based AEW Capital Management, to invest in a variety of senior housing properties over the next 12 months. The Pennsylvania State Employees Retirement System also has committed new capital to the industry.

"The key to success for these strategies is to make sure that the capital is teamed up with a strong local operator that really knows the senior housing business well," says Bob Kochis, principal with the Townsend Group, a real estate consultant on pension funds.

"I think the more pension funds investing in our industry is a good thing,"says Joe Eby, chief operating officer of Olathe, Kansas-based Bickford Senior Living Group, which continues to develop new assisted living properties. "We know what it's like to use this capital source. In the past, we have used capital from the Detroit Firefighters pension fund for our developments."

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managing in a cost-effective manner.

While capitalization rates for these properties have dropped, they are still considerably higher than those in the multifamily sector where cap rate averages hover around 6 to 7 percent. Given the similarities in operations and the sizable discrepancy in cap rates, it's easy to understand why more investors consider assisted living a viable alternative to multifamily that offers higher, relatively low-risk returns.

On a broader scale, oft-noted demographic factors also enhance the entire senior housing sector's promising potential for steady, long-term growth. The 76 million baby boomers born from 1946-1964 not only are getting older (and living longer), but also are healthier and wealthier than their parents, making them prime candidates for independent and assisted living. According to the U.S. Census Bureau, the number of Americans age 65 or older is expected to climb from 36 million in 2003 to approximately 54 million by 2020. Life expectancy for women at age 65 is more than 19 years and men's expectancy is about 16 years. In 2004, a study released by the Federal Interagency Forum on Aging-Related Statistics found that, between 1984 and 2001, the median net worth of households headed by people age 65 and over increased by 82 percent (after accounting for inflation). The study also reported that the age-adjusted proportion of older Americans with a chronic disability declined from about 25 percent in 1984 to 20 percent in 1999.

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WHAT THEY'RE OFFERING

With its financial health more robust than at any time during the last decade, it's no surprise that the assisted and independent living sector has attracted an unprecedented level of investor interest. Large banks have returned to the market, and even non-traditional health-care lenders such as private equity funds are joining the fray. Many of the new lender entrants are primarily interested in securitizing these large loans, which will serve to keep capitalization rates relatively low.

Lenders have brought new products into the market, including fixed-rate loans, resulting in substantial interest savings for companies. Assisted and independent living companies planning an expansion or acquisition also are taking advantage of short-term (3 to 5 years) variable-rate bridge loans, which are particularly popular for strategic property acquisitions. This type of funding often can be secured much more quickly than HUD loans (which can take 3-6 months to originate) and may provide owner/operators with increased loan leverage over this short-term period. When this "bridge" loan matures, successful providers may be able to take cash out from the sale of their business or upon a long-term refinancing (e.g., 10 year-loans with Fannie Mae and Freddie Mac or 30- to 35-year loans from HUD) at relatively low interest rates. Once they obtain long-term "permanent" debt, providers no longer have to worry about interest rate increases or other risks associated with refinancing short-term loans. Instead, they can focus their energies on the profitable operations of their facilities, plus have the opportunity to develop and implement long-term plans for growth and expansion.

For companies that want to maximize the amount of the loan and are unconcerned about building equity, real estate investment trusts (REITs) are another good option. The typical REIT transaction is structured as a sale-leaseback (with lease terms usually 10-15 years), which gives the REIT full ownership of the property. The operator can monetize equity while maintaining a steady cash flow from operations, but it's priced higher than long-term debt. REITs essentially enable owner/operators to "have their cake and eat it too," since they can take some of their money off the table yet still stay in the game, all the while generating additional revenues by effectively managing and operating the businesses they know well.

PROFITABLE GROWTH ON TAP

Deals done at 8 percent capitalization rates were unheard of just a year ago, and might make some lenders and investors a bit nervous. Yet while intensifying competition has fueled more aggressive funding practices, lenders for the most part have maintained a discipline that was glaringly absent in the 1990s when runaway investors exacerbated the sector's underlying problems. This level of caution bodes well for the entire senior housing sector, especially independent and assisted living properties that appear well-positioned for profitable growth.

Despite compression in the cost of financing and cap rates, capital markets remain generally bullish about the long-term care industry. Valuations are up and market demand is strong. And today's borrower has considerably more financing options with favorable terms. As long as interest rates don't rise at an unreasonably fast clip, senior housing companies should continue to have plenty of opportunities to recapitalize and grow their businesses. ▼

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