AEW RESEARCH

SENIORS HOUSING RESEARCH PERSPECTIVE

Q1 2018

AEW

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Seniors Housing Research Perspective

The task of putting money to work at attractive risk-adjusted yields has become more challenging for not only seniors housing, but also for the broader commercial real estate marketplace. Pricing for higher quality assets is holding up well, with plenty of capital chasing the dearth of newer stabilized deals brought to market. Cap rates for the best seniors housing assets are in the low to mid-5s, with broader seniors housing rates still drifting lower despite an uptick in Treasuries. There remains a strong appetite from buyers for newer, stabilized assets, while the number of willing sellers is more limited, making for a competitive buying environment. The more challenged segment component of the market is lower quality "B" assets where fundamentals are weaker and trades are occurring at notably higher cap rates for individual assets. Portfolio premiums remain available for sellers across all classes of properties. All told, investment returns continue to outperform the other commercial and residential real estate sectors with the sole exception of the industrial sector according to NCREIF.

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Despite the depth of equity and debt capital available, aggregate transaction volume across the seniors housing and health care (nursing care) sector dropped 8.8% from last quarter to $2.6 billion in the first quarter. This seasonal dip was less severe than the balance of the overall real estate market where volumes declined 12.8%. Excluding health care, seniors housing fared better in the first quarter accounting for $1.7 billion of the total, eclipsing the weak fourth quarter pace of $1.3 billion. Looking beyond the quarterly volatility, overall volumes have slowed from several years ago when REITs were aggressively expanding their holdings. At that time, REITs paid lesser attention to asset quality as they tried to expand their platforms. Over the past two plus years, REITs have become much more selective while also diversifying away from the nursing care. Concurrently, seniors housing has become more mainstream in the eyes of institutional investors who accounted for nearly half of the sector's transaction volume in 2017. Through April of 2018, REITs have been more active with select buys tipping the balance in their favor but we anticipate institutional investors will end the year having been the most active capital source. Debt remains widely available as both new and existing lenders allocate more capital to the sector for existing assets. Construction loans remain available to proven sponsors albeit with stricter covenants typically involving recourse.

From a fundamentals perspective, the downward trend in occupancies resumed in the first quarter of 2018 with a 40 basis point dip to 88.1% across the primary and secondary markets tracked by the National Investment Center for Seniors Housing & Care (NIC). Occupancies had been essentially flat during the second half of 2017. Seasonal factors typically contribute to weaker demand in the first quarter. Demand turned in its second weakest quarterly performance since the GFC with only 1,148 units absorbed, which slowed the annual pace of absorption to 2.4%. Inventory growth also slowed during the quarter with the addition of a net 5,654 units to stock equating to annual growth of about 3.3%. The disparity in demand and supply during the quarter should narrow but we believe a trend of gradually softening occupancies will likely persist through the balance of the year. Overall, the macro dynamics underpinning demand such as generally healthy economic conditions, strong housing and equity markets, and favorable demographic trends remain solidly in place. Given these demand dynamics, the challenges over the next 18 – 24 months remain more on the supply side.

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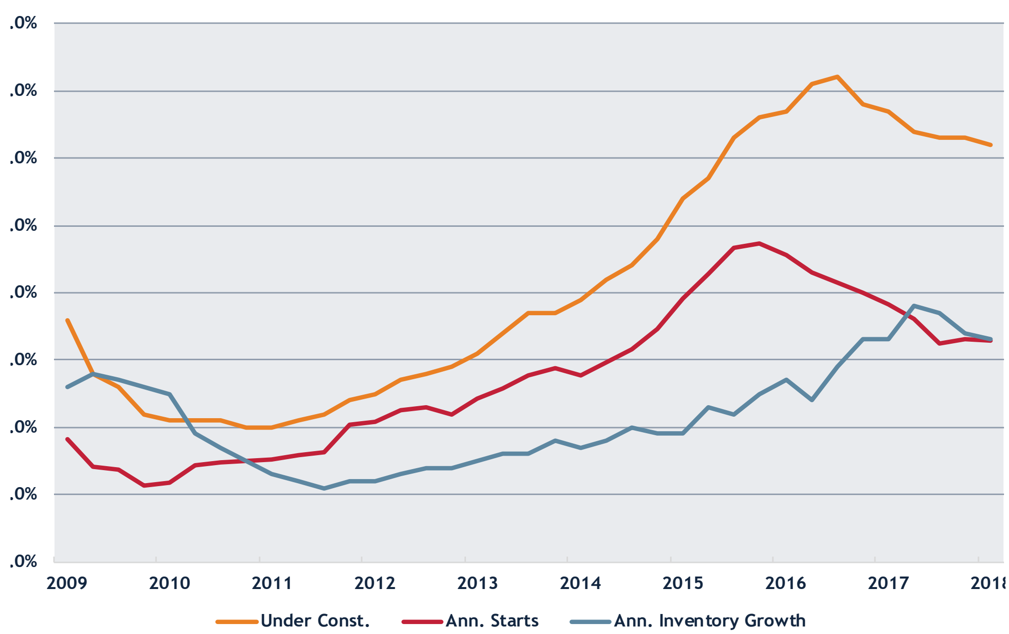
SENIORS HOUSING FUNDAMENTALS
PRIMARY AND SECONDARY MARKETS Q1 2018

Quarter	1Q2018	4Q2017	1Q2017
Properties	7,524	7,472	7,281
Units	926,884	921,230	897,240
Occupancy	88.1%	88.5%	88.9%
Stabilized Occupancy	89.7%	90.2%	90.5%
Median Occupancy	91.7%	92.3%	92.4%
Absorption	1,148	6,873	3,182
Annual Absorption	2.4%	2.6%	2.4%
Inventory Growth	5,654	7,851	6,480
Annual Inventory Growth	3.3%	3.4%	3.3%
Properties Under Construction	519	553	637
Units Under Construction	57,439	57,674	60,326
Construction vs. Inventory	6.2%	6.3%	6.7%
Average Rent	3,810	3,762	3,716
Annual Rent Growth	2.2%	2.3%	3.0%

Source: NIC

CONSTRUCTION AS A SHARE OF EXISTING INVENTORY
PRIMARY AND SECONDARY MARKETS



Source: NIC

The higher acuity segments of the market, namely assisted living and memory care, remain in a state of elevated supply growth. A weak first quarter for demand after keeping pace with supply through the second half of 2017 was a setback. Occupancies for majority assisted living (AL) properties, which includes memory care, declined 50 basis points in the first quarter to 85.6%

after holding steady in the fourth quarter. After adjusting for seasonal factors, the pace of annual net absorption (rolling four quarters) suggests demand remains on a healthy footing at 3.4% growth in the first quarter of 2018, above the 3.0% recorded a year ago. This provides some comfort to our expectation that demand should continue along its pace of gradual acceleration as acceptance of the product and demographics provide support. The backlog of projects in the pipeline remains the larger challenge. The number of units under construction is elevated at nearly 8% of existing inventory, or 32,950 units, but still down from 37,900 units 6 quarters prior. The pace of new starts has slowed materially from an annual pace of 25,300 in 2015 to 17,450 in Q1 2018 boding well for 2019 after a healthy dose of new supply this year. Inventory growth over the past year has been running at 4.6%. Overall, the supply picture is improving but the benefits will likely be more apparent in 18 to 24 months.

The majority independent segment (IL) was slower to ramp up on the supply side this cycle. The pipeline of units under construction peaked at 5.2% of existing inventory or roughly half the 9.8 % level in the AL segment. While the IL pipeline of units under construction was down slightly to 4.9% or about 24,500 units in the first quarter, the pipeline has remained near 5% of existing inventory the past 2 years. Demand, for the most part, has kept occupancies within a 100 basis point band over the past several years despite the softening trend and a weak first quarter. IL occupancies dipped 30 basis points to 90.3% in the first quarter after holding steady at 90.6% for two quarters according to NIC. Similar to the AL segment, the IL segment experienced a more dramatic drop in demand to under 500 units absorbed while inventory growth also slowed to just over 2,000 units. On an annual basis, the more discretionary segment saw absorption growth slow to 1.6% while inventory growth averaged 2.3%. The pace of new construction starts have been fairly consistent over the past two years suggesting inventory growth will continue at this pace for at least the next 18 – 24 months.

Looking ahead, the pace of deliveries over the next several quarters will likely remain elevated at levels above what can be absorbed, especially for assisted living communities with memory care. NIC has adjusted its forecast to be more in line with this view. It is important to note the underlying strength of demand across all sectors of seniors housing despite the near term effects of supply. To the extent the current trends remain in place, the underlying dynamics look favorable in aggregate albeit with more challenges appearing in markets where supply issues are more pronounced. That said many markets are running at occupancies well above 90% with limited supply pipelines and AEW is finding attractive infill opportunities in select markets highlighting the fact that this is a trade-area dependent property type.

SENIORS HOUSING	
Vacancy Rate	11.9%
12-Month Trend	
Vacancy Change	↑
Rent	↓
Absorption	↔
Completions	↑
Cap Rates	↔
Transaction Volume	↓

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