AEW RESEARCH

SENIORS HOUSING RESEARCH PERSPECTIVE

Q3 2018

AEW

Prepared by AEW Research, September 2018

Seniors Housing Research Perspective

Investor sentiment toward seniors housing remains strong, with pricing for higher quality assets holding up well. The impact that new supply is having on occupancies is often noted as a concern over the near term, but most investors are looking at the longer term demand dynamics as the primary driver for the sector. There is no lack of capital looking for newer, stabilized assets and more and more of that capital is coming from institutional sources. In fact, the biggest challenge to placing capital is finding willing sellers, as the durability of seniors housing income streams is becoming more widely known. Despite tightening spreads, debt remains plentiful, although some lenders are reaching their allocations for the year. Nonetheless, in many cases the attractive financing market provides an option to selling assets in an environment where there are fewer attractive investment alternatives. Cap rates for the best seniors housing assets are in the low to mid-5s with the broader seniors housing rates holding steady in the mid 6% range. Portfolio premiums remain available for sellers across all classes of properties. As noted previously, 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. Overall, a strong investment appetite for newer stabilized assets remains but transaction volume is down, largely due to a lack of sellers willing to transact at today's pricing.

Aggregate transaction volume across the seniors housing and health care (nursing care) sector dipped 12% on a trailing four-quarter basis to $12.9 billion from last quarter based on preliminary third quarter estimates from Real Capital Analytics. Seniors housing, which accounted for $6.8 billion of the total dipped a similar a mount (14%) over the same timeframe. On a year-to-date metric, however the dip in volume has been more pronounced with seniors housing off close to 30%. Several factors are likely at play, the most prominent of which is the lack of willing sellers as noted above. Furthermore, interest is very strong for the growing volume of new, stabilized assets. Those that are trading are going at material premiums to previous generation properties. The issue is there just are not a lot of them given the wave of new product started delivering in late 2015. This product has leased up well and stabilized quickly so the expectation is more quality product will be coming to market given new inventory growth cycle. AEW is seeing this start to play out across its Funds.

NCREIF PROPERTY INDEX RETURNS
AS OF Q3 2018

		Average Annual Total Return			
	2018Q3	One	Three	Five	Ten
Total NPI	1.67%	7.2%	7.8%	9.6%	6.4%
Apartment	1.55%	6.3%	7.0%	8.6%	6.4%
Hotel	3.22%	7.3%	6.4%	8.5%	4.0%
Industrial	3.36%	14.2%	13.1%	13.5%	8.0%
Office	1.69%	6.9%	6.7%	8.7%	5.2%
Retail	0.56%	3.9%	7.0%	9.6%	7.6%
Seniors Housing*	2.27%	11.1%	12.3%	14.7%	10.6%

Source: NCREIF; Note: seniors housing is not iincluded in Total NPI
**Reflects 114 SH properties totaling $5.7 billion tracked by NCREIF*

Barring any dramatic changes to the macro economy or the broader capital markets, it is difficult to see the positive pressures on capital flow into the sector easing in the near term. Seniors housing has consistently delivered attractive returns relative to the other property sectors, bringing the sector more to the forefront in institutional investor's minds. Institutional investors accounted for nearly half of the sector's transaction volume in 2017 as the public REITs became much more selective with most of their efforts focused on (1) diversifying out of their heavy exposure to the nursing care segment and (2) modifying triple-net lease agreements with many of their operators. With many of those efforts well underway or completed, AEW anticipates that REITs will re-emerge as more active buyers of seniors housing assets with a focus on higher quality assets favoring the RIDEA structure over a triple net lease. Through the first three quarters of 2018, buyer composition across the seniors housing sector has been evenly split with institutional capital, public REITs and private owner/operators each accounting for roughly a third of transaction volume.

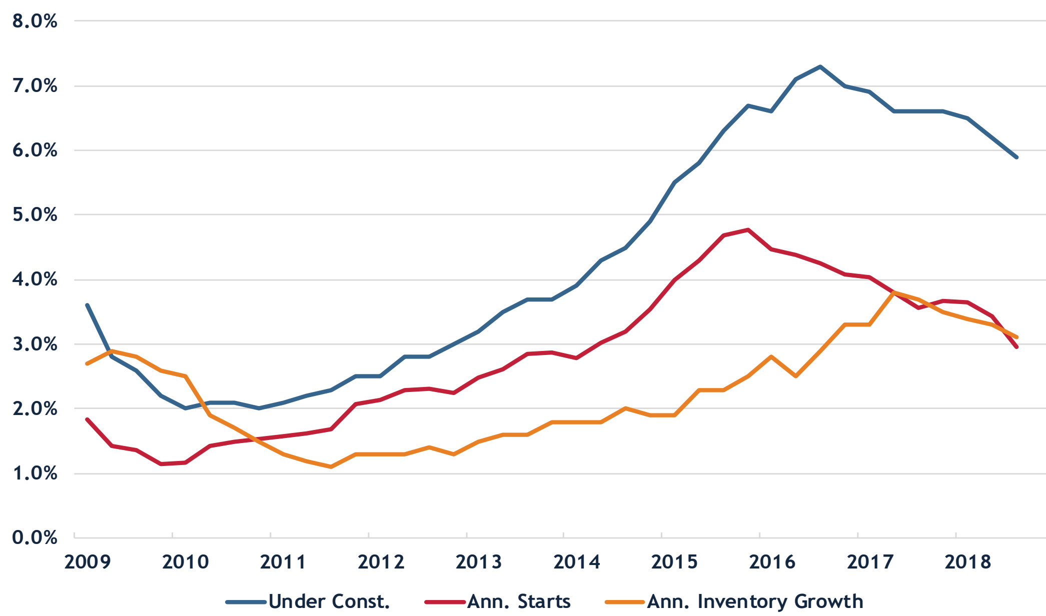
SENIORS HOUSING FUNDAMENTALS
PRIMARY AND SECONDARY MARKETS Q3 2018

Quarter	3Q2018	2Q2018	3Q2017
Properties	7,671	7,628	7,450
Units	944,976	939,261	916,665
Occupancy	87.9%	87.8%	88.5%
Stabilized Occupancy	89.4%	89.5%	90.1%
Median Occupancy	91.8%	91.5%	92.2%
Absorption	5,662	4,049	7,018
Annual Absorption	2.3%	2.5%	2.7%
Inventory Growth	5,715	8,383	7,110
Annual Inventory Growth	3.1%	3.3%	3.7%
Properties Under Construction	498	536	617
Units Under Construction	55,462	58,033	60,609
Construction vs. Inventory	5.9%	6.2%	6.6%
Average Rent	3,888	3,866	3,772
Annual Rent Growth	2.8%	2.6%	2.6%

Source: NIC Map Data Service

From a fundamentals perspective, the downward trend in occupancies took a breather in the third quarter with a 10 basis point increase to 87.9% across the primary and secondary markets tracked by NIC. Demand remained solid with 5,662 units absorbed bringing the annual pace of absorption to 2.3%. Inventory growth also dipped during the quarter from a net 8,393 units last quarter to 5,715 in the third quarter equating to annual growth of about 3.1%. While this is the slowest pace of additions to stock since mid-2016, the dip is likely reflective of the timing of new deliveries and extended construction timetables rather than a shift in trend. The ramp up in construction starts two years ago and the pipeline of approximately 55,500 units under construction suggest a strong pace of deliveries through the balance of 2018 and into 2019. AEW expects the disparity in demand and supply will likely continue over the near term, resulting in continued gradual softening in occupancies in 2019. That said there has been shift in momentum from a construction perspective with the pace of new starts clearly slowing and the volume of units under construction falling as deliveries outpace starts.

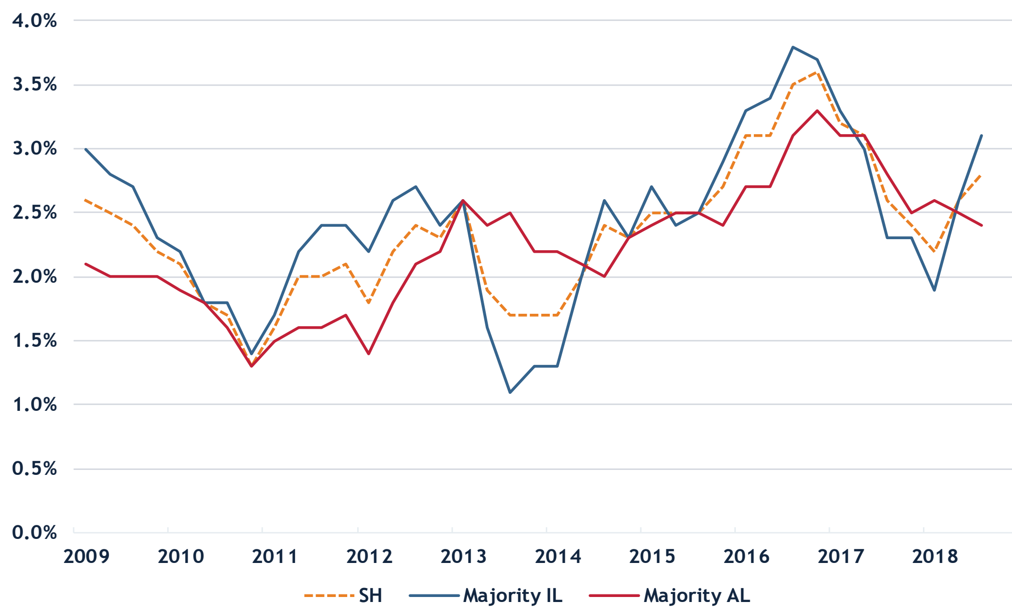
CONSTRUCTION AS A SHARE OF EXISTING INVENTORY
PRIMARY AND SECONDARY MARKETS



Source: NIC Map Data Service

Despite the near-term softness, the macro dynamics underpinning demand such as generally healthy economic conditions, strong housing and equity markets, and favorable demographic trends remain solidly in place. The place where these positive are showing up most notably is in rents. Annual rent growth for seniors housing was 2.8% as of the third quarter, above the 2.6% recoded last quarter and a year ago. Rising labor costs present the most meaningful offset to rising rents but revenue continues to expand at a healthy pace.

ANNUAL RENT GROWTH (%)
PRIMARY AND SECONDARY MARKETS AS OF Q3 2018



Source: NIC Map Data Service

The story across the various segments of seniors housing has not change materially form last quarter. The higher acuity segments of the market, namely assisted living and memory care, remain in a state of elevated supply growth. Demand in the third quarter experienced solid traction after a weak first quarter and better second quarter but new deliveries more or less in line with absorption. Occupancies for majority assisted living (AL) properties, which includes memory care, increased 10 basis points over the second quarter to 85.2% and are 40 basis points below year ago levels. The pace of annual net absorption (rolling four quarters) remains on a healthy footing at 3.1% growth in the third quarter of 2018 albeit down slightly from the same time last year. Overall, we remain comfortable with 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 7% of existing inventory, or 30,919 units, but still down from the peak of 38,800 units 2 years ago. The pace of new starts has slowed materially from an annual pace of nearly 26,000 units in 2015 to 15,533 units in Q3 2018 boding well for later 2019 as the pipeline continues to shrink over the next 12 months. Inventory growth over the past year has been running at 4.3%. Overall, the supply picture is improving but the benefits will likely be more apparent in 18 to 24 months.

PROPERTY TYPE FUNDAMENTALS
PRIMARY AND SECONDARY MARKETS Q3 2018

Quarter	SH Total 3Q2018	Majority IL 3Q2018	Majority AL 3Q2018
Properties	7,671	2,213	5,458
Units	944,976	505,430	439,546
Occupancy	87.9%	90.2%	85.2%
Stabilized Occupancy	89.4%	91.0%	87.4%
Median Occupancy	91.8%	93.3%	91.0%
Absorption	5,662	1,999	3,636
Annual Absorption	2.3%	1.7%	3.1%
Inventory Growth	5,715	1,794	3,921
Annual Inventory Growth	3.1%	2.1%	4.3%
Properties Under Construction	498	183	315
Units Under Construction	55,462	24,543	30,919
Construction vs. Inventory	5.9%	4.9%	7.0%
Average Rent	3,888	3,192	4,746
Annual Rent Growth	2.8%	3.1%	2.4%

Source: NIC Map Data Service

The majority independent segment (IL) remained more or less unchanged from last quarter. The IL pipeline of units under construction was down slightly to 4.9% or about 24,500 units in the third quarter after holding near 5% of existing inventory the past 2 years. By comparison, the IL pipeline of under construction peaked at 5.2% of existing inventory or roughly half the 9.8 % level in the AL segment. IL demand, for the most part, has kept occupancies within a 100 basis point band over the past several years remaining above 90% since late 2013. Despite drifting lower the past two years, IL occupancies ticked up 10 basis points in the third quarter to 90.2% according to NIC. Similar to the AL segment, the IL segment experienced a continued uptick in demand following a weak first quarter that was eclipsed by the higher pace of new project completions. On an annual basis, the more discretionary segment saw absorption growth of 1.7% while inventory growth averaged 2.1%. 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 overall 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. However, it is important to note the underlying strength of demand across all sectors of seniors housing despite the near-term effects of supply, and to the extent that the current trends remain in place, the underlying dynamics look favorable in aggregate. There are certainly challenges appearing in specific markets where supply issues are more pronounced, but many markets are well above the 90% occupancy level with limited supply pipelines. Much like the retail property type, seniors housing is a trade-area dependent property type, and AEW is focused on select markets that exhibit the favorable trends that align with our strategy. From a capital markets perspective, debt remains widely available as both new and existing lenders allocate more capital to the sector for existing assets. Banks have become notably more aggressive along with insurance companies recognizing the durability of the income streams, the available spread relative to multifamily and the long demographic tailwinds that continue to support demand. Construction loans remain available to proven sponsors albeit with limited covenants typically involving recourse. From an equity perspective, patience will remain a virtue over the near term, with a focus on high quality assets with strong operators in locations where a mismatch between demand and supply remains.

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