AEW RESEARCH

SENIORS HOUSING RESEARCH PERSPECTIVE

Q4 2018

AEW

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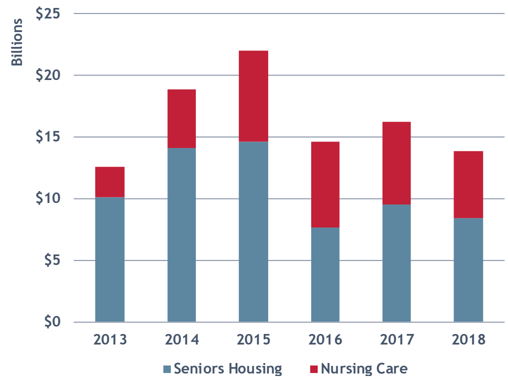
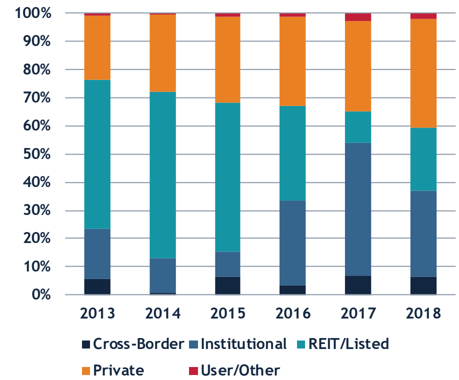
Seniors Housing Research Perspective

Capital continues to flow into the seniors housing space, as investor attitudes remain positive with little change in the pricing for higher quality assets. New supply is an area of concern over the near term in select markets, but most equity investors are looking at the longer-term demand dynamics as the primary driver of optimism. Aggregate transaction volume was off about 11% in 2018, but the headline number masks the fact that individual deal transactions were up about 24% over last year, while portfolio transaction volume was off by 27%. A few large portfolio and entity level transactions in 2017 skewed that volume higher in 2017. REITs in particular have been actively diversifying/repositioning their portfolios away from lower quality assets and nursing care in an effort to increase the overall quality of their holdings. Institutional capital, for the most part, appears more focused on individual deals and smaller portfolios of higher quality, stabilized assets as well as new development. Liquidity for newer vintage assets remains high with those assets trading at healthy premiums to previous generation properties, as there is a limited quantity of these assets available for sale given that the current wave of new deliveries did not start in earnest until 2015. Most of this new product has leased up well, so the expectation is more quality product will be coming to market over the next few years.

Debt remains very attractive with spreads tightening further through the end of 2018 as both new and seasoned lenders court strong sponsorship. Lending remains competitive but disciplined for both permanent financing and construction loans, especially relative to the apartments sector where pricing appears much more aggressive with relaxed covenants. In many cases, refinancing provides an attractive option to selling assets in an environment where there are fewer investment alternatives at comparable yields. Cap rates for the best seniors housing assets are in the low to mid-5s with the broader seniors housing rates in the mid 6% range and holding firm despite an uptick in Treasuries relative to the start of 2018. As noted previously, the more challenged segment 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 but are more pronounced for newer vintage assets.

TRANSACTION VOLUME AND BUYER COMPOSITION





Source: Real Capital Analytics, As of Q4 2018

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 investors' 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 a more active buyer with a focus on higher quality assets while favoring the RIDEA structure over a triple net lease. In 2018, buyer composition showed this shift with REITs doubling their share of activity to 22% of the market with institutional capital accounting for 31% of transaction volume. The private sector, which includes owner/operators of all sizes, accounted for the largest share at 38% in 2018.

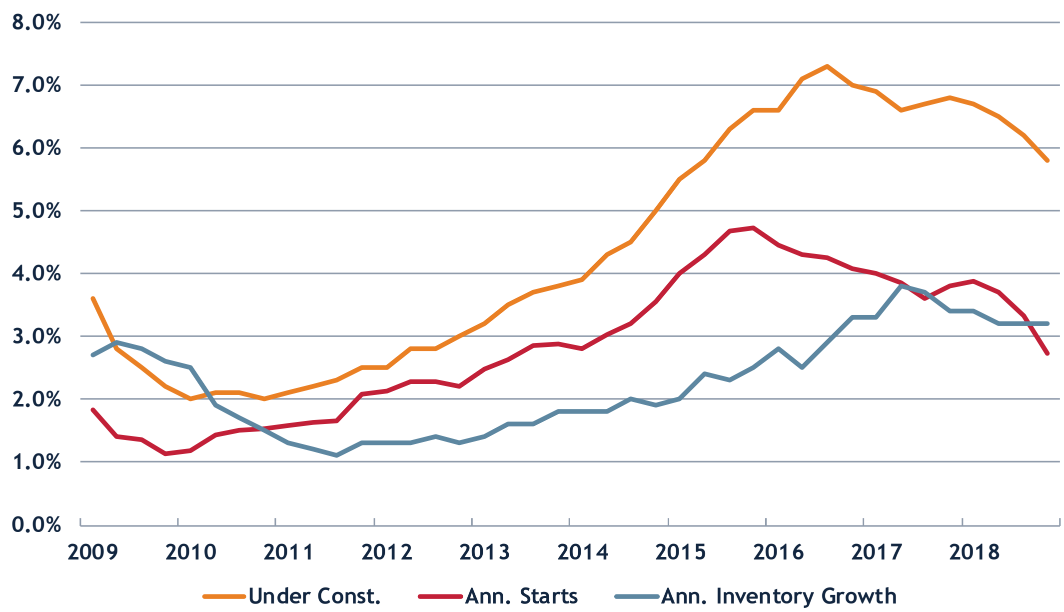
SENIORS HOUSING FUNDAMENTALS - PRIMARY AND SECONDARY MARKETS

QUARTER	4Q2018	3Q2018	4Q2017
Properties	7,739	7,679	7,521
Units	952,945	944,580	923,658
Occupancy	87.9%	87.9%	88.5%
Stabilized Occupancy	89.9%	89.9%	90.4%
Median Occupancy	92.0%	91.8%	92.2%
Absorption	7,704	6,444	7,142
Annual Absorption	2.5%	2.5%	2.6%
Inventory Growth	8,365	6,624	7,942
Annual Inventory Growth	3.2%	3.2%	3.4%
Properties Under Construction	493	536	632
Units Under Construction	55,216	58,765	62,412
Construction vs. Inventory	5.8%	6.2%	6.8%
Average Rent	3,934	3,904	3,803
Annual Rent Growth	3.0%	2.8%	2.5%

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%, and then maintained these levels in the fourth quarter across the primary and secondary markets tracked by NIC. Demand turned in its best quarter on record with 7,704 units absorbed bringing the annual pace of absorption to 2.5%. Inventory growth also climbed during the quarter from a revised 6,624 units last quarter to 8,365 units in the fourth quarter equating to annual growth of about 3.2%. 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 into 2019. AEW expects the disparity in demand and supply will likely continue over the near term, resulting in flat to some additional 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 fall more in line with starts.

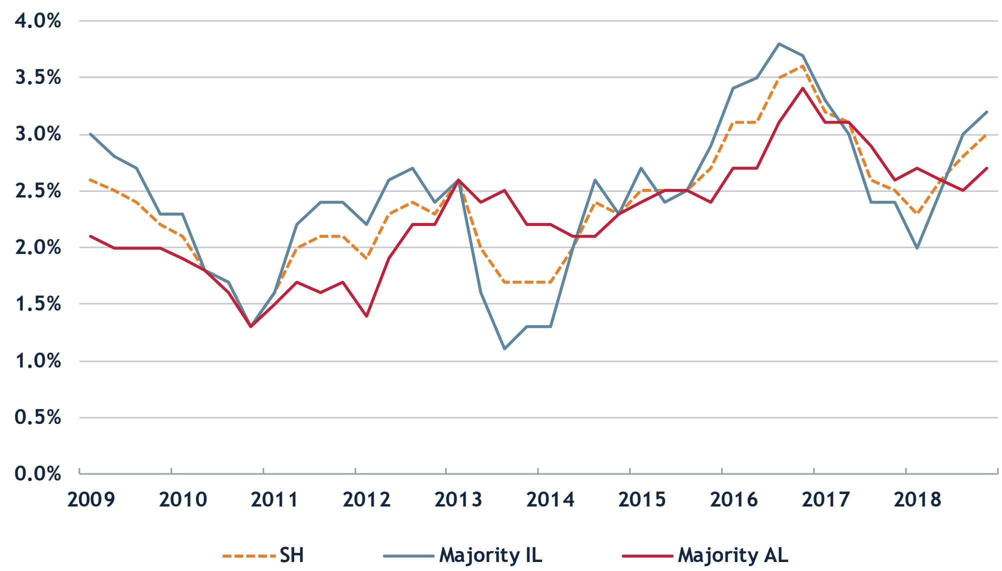
CONSTRUCTION AS A SHARE OF EXISTING INVENTORY
PRIMARY AND SECONDARY MARKETS



Source: NIC Map Data Service

Despite the near-term softness, the macro dynamics underpinning demand such as generally healthy economic conditions, strong housing prices 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 3.0% as of the fourth quarter having trended higher over the past several quarters at a pace well above general inflation. That said concessions are making their way into assets in lease up, especially in markets where new construction is more pronounced. However, once stabilized, the newer assets have been successfully moving rents higher, often at the expense of older assets. While not unique to seniors housing, the most significant operating challenges we continue to see across the sector are labor availability and pressures on wages, both of which present the most meaningful offset to rising rents. Top line revenue continues to expand at a healthy pace while NOIs are coming under more pressure.

ANNUAL RENT GROWTH (%)
PRIMARY AND SECONDARY MARKETS AS OF Q4 2018



Source: NIC Map Data Service

The story across the various segments of seniors housing has not changed materially from last quarter. The higher acuity segments, namely assisted living and memory care, remain in a state of elevated supply growth. Demand in the fourth quarter was the best on record after a weak start to the year helping arrest the downward trend in occupancies that has persisted over the past several years. Occupancies for majority assisted living (AL) properties, which typically include memory care, climbed 20 basis points in the second half or 2018 to 85.4% although still 70 basis points below year ago levels. The pace of annual net absorption (rolling four quarters) remains on a healthy footing at 3.7% growth as of the fourth quarter, keeping pace with the new product entering lease-up. 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 6.8% of existing inventory, or 30,283 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 14,521 units in 2018 boding well for later 2019 as the pipeline continues to shrink. Inventory growth over the past year has been running at 4.5% but the pace of starts is running shy of 3.5%, certainly a positive sign. Overall, the supply picture is improving but the benefits will likely be more pronounced in 12 to 18 months.

PROPERTY TYPE FUNDAMENTALS - PRIMARY AND SECONDARY MARKETS

QUARTER	SH TOTAL 4Q2018	MAJORITY IL 4Q2018	MAJORITY AL 4Q2018
Properties	7,739	2,212	5,527
Units	952,945	506,326	446,619
Occupancy	87.9%	90.2%	85.4%
Stabilized Occupancy	89.9%	91.3%	88.3%
Median Occupancy	92.0%	93.2%	91.2%
Absorption	7,704	2,253	5,455
Annual Absorption	2.5%	1.6%	3.7%
Inventory Growth	8,365	2,490	5,875
Annual Inventory Growth	3.2%	2.0%	4.5%
Properties Under Construction	493	182	311
Units Under Construction	55,216	24,933	30,283
Construction vs. Inventory	5.8%	4.9%	6.8%
Average Rent	3,934	3,217	4,803
Annual Rent Growth	3.0%	3.2%	2.7%

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 25,000 units, in the fourth quarter after holding near 5% of existing inventory the past 2 years. By comparison, the IL pipeline 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 were flat at 90.2% after a 10 basis points increase in the third quarter according to NIC. 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 12 to 18 months.

Looking ahead, the overall pace of deliveries over the next several quarters will likely remain elevated at levels equal to or 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 effect 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. Lenders for the most part remain competitive yet disciplined in terms of both permanent and construction loan financing. 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. Overall, it was refreshing to see a stabilization in the fourth quarter supply/demand dynamics. Capital continues to flow into the seniors housing space, as investor attitudes remain positive with little change in the pricing for higher quality assets during the fourth quarter.

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