SENIOR HOUSING

Rebound in occupancies provides tailwind for NOI growth

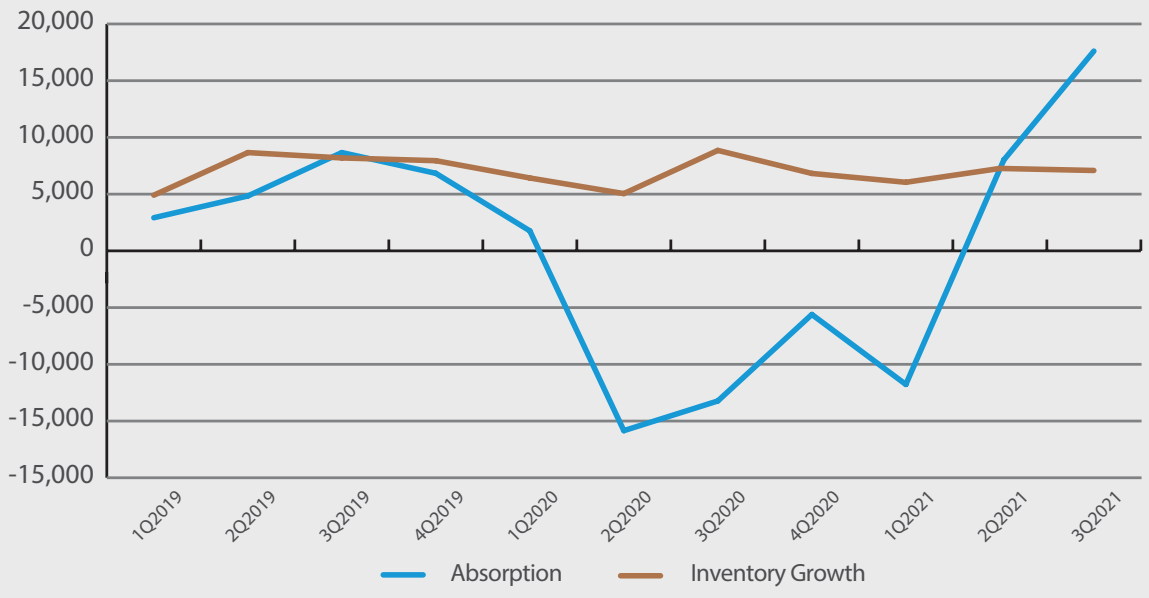
Like many other real estate sectors, senior housing was hammered from several directions following the outbreak of the pandemic. Most obviously, occupancy levels fell. Staffing, the costliest expense, also is experiencing large increases. Lower occupancy and revenue and higher operating expenses in many markets have offset the benefits lower interest rates are having on value. But wait, the baby boomers are coming. The average age of entrance into senior housing is in the low 80s, which means the oldest boomers are less than five years away from hitting the entry doors of senior housing.

IRR performs senior housing and healthcare property valuation services nationally. In 2021 alone, we have appraised proposed and existing senior housing properties coast-to-coast – from Florida to Alaska and Maine to California (no trips to Hawaii this past year). We have seen a broad spectrum of conditions ranging from markets that were oversaturated before the pandemic to markets that have more demand than supply. It is not surprising to know that some markets with high development cost, or barriers to entry (land scarcity and extraordinarily high construction costs), have unmet need, and conversely, lower-entry-cost markets are frequently experiencing low occupancy and pricing pressures.

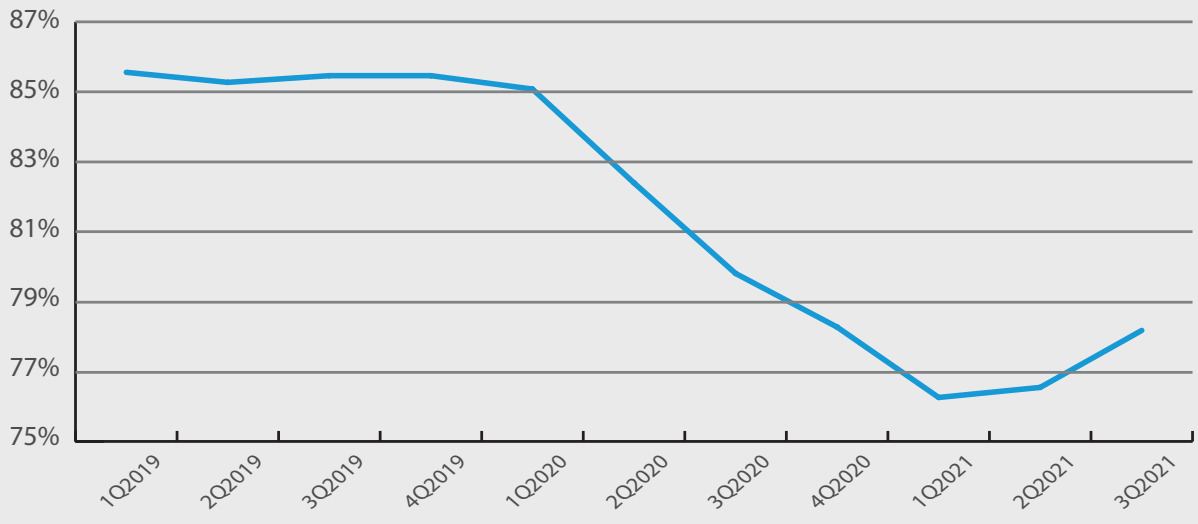
We are seeing a widening spread in capitalization rates in 2021, with several recently built and stabilized senior housing properties selling at rates under 5.0%. Keep in mind, when discussing capitalization rates, everyone should get on the same NOI definition page. Much like stocks, real estate investors are buying future earnings, and valuations are based on anticipated earnings. Therefore, NOI for stabilized properties, as developed for appraisal purposes, involves anticipated occupancy, revenue, and operating expenses over the coming 12 months rather than the trailing NOI. All of the expenses should be applied consistently in extracting capitalization rates from market transactions and developing the NOI forecast for the property being valued. Using trailing NOI to develop a market capitalization and applying to a forecasted NOI for the subject property is a problem. Given that context for the NOI story, several sales of new, stabilized senior housing properties in suburban markets of "major-league cities" commanded sub-5.0% capitalization rates during 2021 from institutional-type buyers. Driving these lower capitalization rates are low mortgage rates and better-than-average prospects for demand growth – the boomers are coming.

On the other hand, we are seeing more senior housing properties that were already suffering from extended absorption caused by market oversaturation get pushed into a corner because of the pandemic. The owners of most senior housing properties were able to obtain forgivable PPP loans and other stimulus, and many actually profited, nicely.

SENIOR HOUSING NET ABSORPTION & INVENTORY GROWTH



SENIOR HOUSING OCCUPANCY TRENDS - PRIMARY AND SECONDARY MARKETS



The pandemic has certainly reduced the project demand growth rate for senior housing for years to come because of increased deaths, and frankly, the stigma that attached to skilled nursing in the early months of the pandemic. IRR expects over the next 12 months that seniors who were standing on the sidelines during the pandemic will start signing residency agreements at rates not seen previously, resulting in extraordinarily strong absorption. Coupled with normal demand growth, occupancy levels and rate increases should exceed paces experienced between the recovery of the Global Financial Crisis and the pandemic. Some of that revenue increase will be consumed by higher staff wages and other expense increases related to higher inflation. From a value standpoint, there also are indications that the Federal Reserve will begin moving interest rates higher in the coming year. Of course, higher interest rates can erode NOI gains through occupancy and rate increases.

Let's take a closer look at supply and demand trends for senior housing, which includes independent living, assisted living, memory care and CCRCs for primary and secondary markets, per NIC MAP Data Services. The supply within the primary markets includes 7,517 properties and 733,216 units as of 3Q 2021. As shown below, senior housing occupancy rates were declining even before the pandemic. The reason for that modest decline in 2019 was that inventory (supply) was growing faster than demand. In fact, the highest occupancy rate was achieved in the fourth quarter of 2014 at 90.0%.

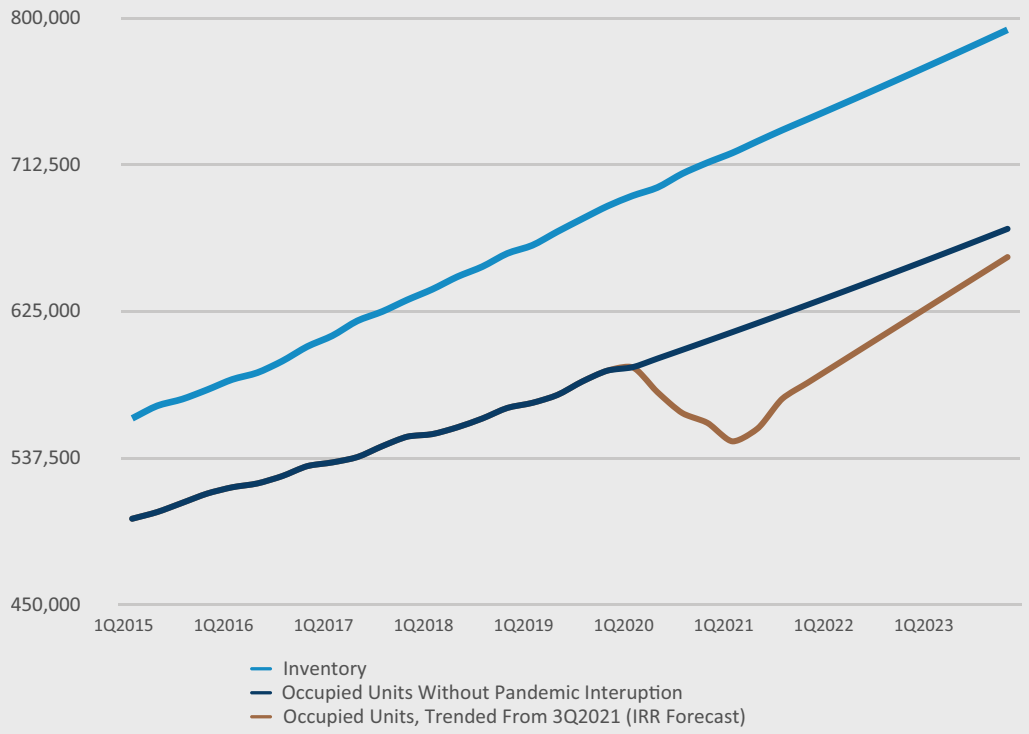
Between 1Q 2015 and 1Q 2020, inventory increased 23.7% (4.7% annually), and demand growth increased 18.0% (3.6% annually), according to NIC MAP Data Services. It also is important to note that inventory growth has been occurring unevenly throughout the country.

The pandemic has had a dramatic impact on occupancy levels. Measuring from the start of the pandemic in 1Q 2020 to the lowest point in 1Q 2021, the total number of occupied senior housing units declined 7.4%. Measuring by occupancy rate, which considers an increase in supply, the occupancy rate fell even further by 9.2%.

Looking at the changes in supply and demand since 1Q 2019, supply growth was steady, and absorption (demand) increases were slightly below supply growth during 2019. During 2020 through early 2021, absorption was negative.

The previous table shows supply and demand for the NIC MAP primary and secondary markets from 1Q 2015 through 3Q 2021. From this last quarter, IRR is forecasting supply to increase at 3.5% annually. The demand lines split in the first quarter of 2021, with actual demand decreasing through early 2021. IRR is forecasting that senior housing demand will increase sharply through 2023, with pent-up demand filling the void. That void between the red and black demand lines on the graph represented by the difference between demand growth had the pandemic not occurred. The black represents demand had the pandemic not occurred, and the historic

Senior Housing Supply and Demand Forecast



3.5% annual demand growth continued. The red line shows IRR's anticipated demand growth, which includes recovery of pent-up demand that held back from moving into senior housing until mid-2021 when confidence returned. It was only 2Q 2021 that demand growth re-emerged. Of course, each market area is different, having different population growth and construction activity, as well as varied local economic factors.

Now, what conclusions can be made for the coming year for senior housing? First, IRR expects the rebound in occupancy levels to be substantial in most markets that are not seeing large increases in supply. The increased move-ins, coupled with higher inflation, should be enough to push rents and service fees higher than seen in the past decade, if not longer. The rate increase may be easier to accept as future residents will be selling their homes at record price levels and tapping their assets in stock and bond portfolios that have experienced significant appreciation.

From a valuation standpoint, occupancy and revenues should see nice increases. Operating expenses are likely to increase beyond the 2.0 to 3.0 annual inflation levels that have been the norm for a number of years. Nevertheless, NOI at most properties should increase. The big wild cards for valuation in 2022 will be interest rates and performance of the economy in general.

PQ: Several sales of new, stabilized senior housing properties in suburban markets of "major-league cities" commanded sub-5.0% capitalization rates during 2021 from institutional-type buyers.

PQ: IRR is forecasting that senior housing demand will increase sharply through 2023, with pent-up demand filling the void.

SOURCE & REFERENCE

Specialty Reports

Senior Housing

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Senior Housing Occupancy Rate Trend, Primary and Secondary Markets, Q1 2019 - Q3 2021
Source: NIC MAP Data Services

Senior Housing Occupancy Net Absorption and Inventory Growth, Primary and Secondary Markets, Q1 2019 - Q3 2021
Source: NIC MAP Data Services

ABOUT VIEWPOINT

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ABOUT IRR

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