HEALTHCARE & SENIOR HOUSING

TIME FOR A LONG-TERM PERSPECTIVE

The level of fear experienced in the earlier stages of the COVID-19 outbreak have subsided, and occupancy and revenues are generally returning to pre-pandemic levels across the healthcare and senior housing sector. However, higher wage costs continue to depress NOI margins and higher interest rates will also put pressure on values. This report provides a comprehensive examination of the challenges and opportunities facing the industry, offering a long-term perspective on the trends that will shape its future.

Pandemic Influence

The COVID-19 pandemic, officially declared by the WHO in March 2020, has deleteriously impacted the U.S. healthcare and senior housing (HSH) industries. In the early stages of the pandemic there were restrictions imposed at various levels of government that constrained business activity. Out of concern for their vulnerability to coronavirus infection and other health complications, people became more cautious about seeking HSH services and making the lifestyle choice for communal living. This combination of impositions and fear resulted in lower levels of admission in all HSH settings and lower routine operating revenues as a result.

The pandemic also changed the dynamics of the labor market dramatically. The added care and disease prevention activities were draining on HSH employees, and employers expected and needed employees to abide by sound healthcare policy that in many cases included mandatory COVID-19 immunization. Misinformation was rampant and some employees were unwilling to comply. Workplaces were politicized; thus, the work environment was less than ideal. Meanwhile, asset values were high and early retirement became more appealing to staff with longer tenures and more experience. Above-normal unemployment benefits also served to reduce the availability of labor.

The confluence of so many counterproductive labor market influences contributed to an imbalance in the supply and demand conditions, particularly for nursing labor. With high demand and a combination of discontented employees and fewer participants in the labor pool, the need to staff adequately to provide services and to accommodate patients and residents resulted in a spike in labor costs. In particular, nurses were financially enticed into temporary staffing positions by agencies, which paid them more and provided added flexibility to their schedules. Conversely, providers and facilities were compelled to pay far more for the agency staffer than an equivalent employee. Higher supply costs, influenced by supply chain problems, have been the other drivers of excessive operating expenses.

Rural HSH providers and facilities have been impacted disproportionately. Staffing for skilled positions in the rural setting has long been difficult, but that phenomenon was exaggerated by workers needing or choosing to stay home more, retire, and become travelers for greater pay.

Federal and state pandemic relief monies and other assistance programs helped many facilities survive the pandemic-fueled downturn in business. Facilities were able to maintain staffing better than they would have without the assistance. However, in a perverse way, the money received probably contributed to the higher labor costs operators are still working to bring under control.

> With NOI growth uncertain, values seem poised to decline.

Operating Performance

While the pandemic is not yet over, the level of fear experienced in the earlier stages has subsided materially and HSH utilization and revenue are generally returning to pre-pandemic levels. Per NIC MAP data, senior housing (Independent Living, Assisted Living, and Memory Care) occupancy rates started declining from around 87.3 percent at the beginning of the pandemic to around 78.2 percent in 1Q2021 (worst quarter) but have since increased to 82.9 percent in 3Q2022. Thus, the 3Q2022 occupancy level is only off the pre-pandemic level by about 440 basis points. For nursing facilities (SNFs), occupancy rates started declining from around 86 percent at the beginning of the pandemic to around 73.7 percent in 1Q2021 and have since increased to 79 percent in 3Q2022. Therefore, the 3Q2022 SNF average occupancy rate is about 700 basis points below pre-pandemic level. Generally, it seems as if all market participants (investors, operators and lenders) have become more comfortable with occupancy rates that are lower than what was traditionally considered stabilized level.

Senior housing private-pay rates grew modestly during the first year of the pandemic, in the 1.5% to 3.1% range. Those rates have been increasing since their lowest point in 1Q2021, to an annualized rate of 4.4% in 3Q2022. Thus, rent growth is occurring, although somewhat lagging the spike in inflation rate that began in mid-2021. Private-pay rates in nursing facilities have followed a similar growth pattern but have only reached an annualized growth rate of 2.8% in 3Q2022. Nursing facilities in many states received financial assistance during the pandemic, but it will take additional time before higher operating expenses are better reflected in Medicaid reimbursement rates.

HSH operating costs remain relatively high in relation to revenues, depressing NOI margins generally. As is always the case, some facilities have weathered the storm better than others, a function of various location, operator, and market specific considerations.

Most SNFs, which tend to be dependent on Medicaid (state shared funding) reimbursement, have been burdened materially by the pandemic.

An unusually high level of nursing home closures occurred in 2022. SNFs that lack the requisite census counts to operate efficiently, and/or which are in locations that struggle to maintain qualified staff, will likely remain weaker performers. SNF values maintained surprising strength during through much of the pandemic; however, pandemic-related financial support from government sources is mostly behind us now, and the reality of higher wage-related operating costs is reducing NOI margins. Meanwhile, higher interest rates are placing additional pressure on SNF values.

Construction Activity

Construction costs increased substantially during the pandemic. Per Marshall Valuation Service data (as of November 2022), Class D (combustible) construction costs are roughly 10.5% higher than they were one year ago, and roughly 33% higher than they were two years ago. Class A (structural steel frame) construction costs are roughly 15% higher than they were one year ago, and roughly 37% higher than they were two years ago.

High construction costs, a more cautious lending market, and operators focusing on operations during the difficult times slowed new HSH development activity from pre-pandemic levels, when the inventory of senior housing (IL, AL & MC) units had increased at 6% to 7% a year for about five years running. As of 3Q2022, the new construction rate of increase is near an annualized rate of 5%. New construction in the SNF sector is much more limited than for senior housing.

Interest Rates

Interest rates have risen precipitously since the Federal Reserve, starting around May 2022, began to address inflation in a more aggressive way. Higher interest rates create an expectation of rising overall capitalization rates (OARs). But it's not easy to determine if the interest rate spike has increased OARs -- and the level of increase -- because NOIs, in many cases, are below stabilized level. And at this point, it's not certain what the stabilized level will be, since the degree to which labor cost controls can be achieved is uncertain. There is some concern among market participants that access to investment capital could decrease, but we have not seen much evidence of that occurring to date.

> A high number of nursing home closures occurred in 2022 and those lacking census counts to operate efficiently will remain weak performers and risk closure.

Values

Investor sentiment for senior housing has tapered rather mildly given the backdrop of high inflation, rising interest rates, and staffing issues that are complicating operations and reducing NOI margins. The uncertainty has contributed to sales activity; 2021 and 2022 were strong years for HSH brokerage firms. As with other real estate sectors, prices and cap rates are stratified by property type (care levels), quality, age, and location, all of which influences the prospective buyer pool. OARs for the most select properties remain low and are still relatively low by long-term standards, although they are presumed to be marginally higher than they were before interest rates started rising, and probably moving upward somewhat as borrowing costs increase. With NOI growth uncertain, values seem poised to decline.

Conclusion

The HSH industry has experienced a great deal of tumult since the pandemic began. Various externalities of the pandemic, including labor shortage issues and a jump in interest rates induced by high inflation are still at play and continue to muddy the water. Valuations have held up better than expected, but now seem poised to give up some of their strength. With weaker operating performance, prospective buyers have been compelled to evaluate acquisition opportunities from a longer-term perspective. Often, the measurement of value to buyers is simplified to unit measures like per bed and per unit. As such, replacement cost is an implied consideration. Private equity has been more active in this time, which reflects its staying power and opportunistic mindset.

SOURCE & REFERENCE

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ABOUT VIEWPOINT

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ABOUT IRR

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