# CBRE CAP RATE SURVEY

## Seniors Housing

### A CBRE Valuation & Advisory Publication

### First Half 2014

**In This Issue:**



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On behalf of CBRE Valuation & Advisory Services, we would like to express our sincere gratitude to all our clients and colleagues who participated in this survey.

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# Capital Markets

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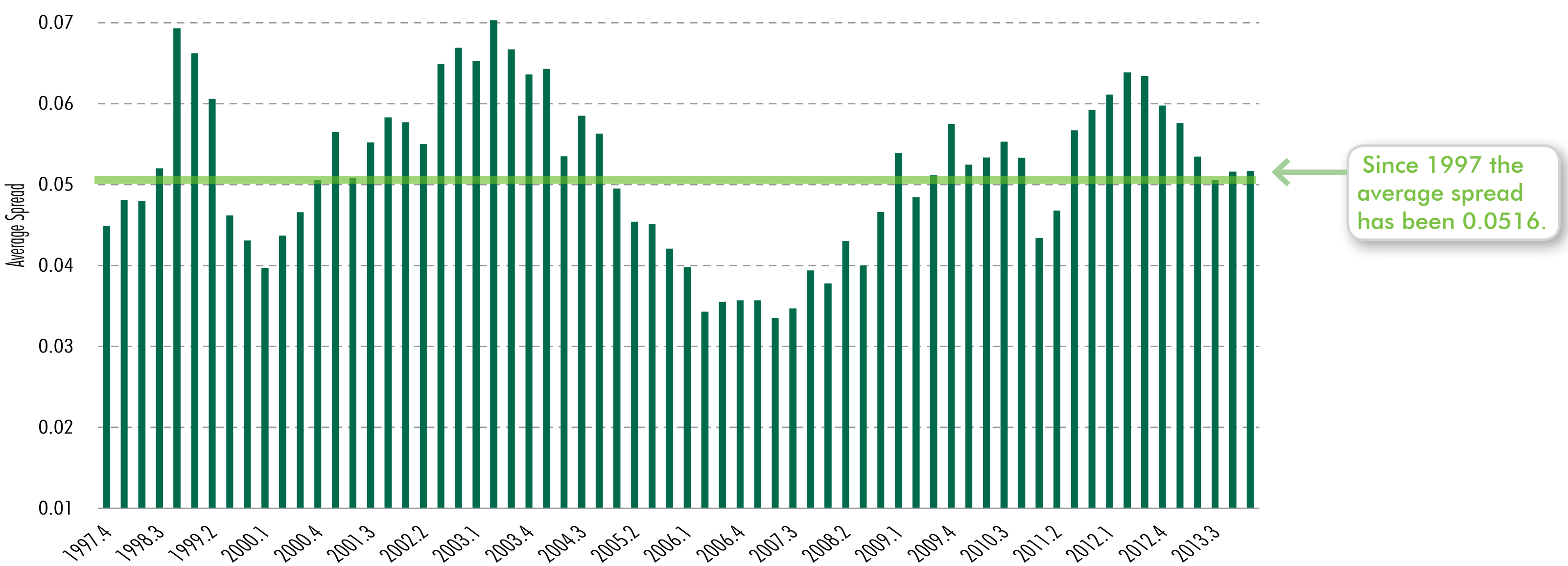
As the 10-year Treasury begins to trend upward, interest rates will certainly follow suit. The question is what impact will rising interest rates have on pricing. More importantly what impact will rising interest rates have on pricing for seniors housing relative to other property types?

We begin answering this question by looking at the 10-Year Treasury. According to CBRE Econometric Advisors (EA), the Base outlook for the 10-Y Treasury predicts a moderate increase to 2.90% by YE 2014 with moderate increases, leveling out around 4.50% near the end of 2016. While this increase in significant, the spread between cap rates and interest rates has not remained constant over time.

**Cap Rate Spreads to the Ten-Year Treasury Are Not Constant**




Seniors cap rates have averaged a roughly 516-basis point spread to the 10-Y Treasury with the most recent indicated spread nearly equal to the historical average, at 517 basis points. This alone indicates room for further compression in the case of rising interest rates, with a bottom (or bubble) expected to fall when spreads are realized in the 350 to 400 basis point range.

While performance will certainly be affected by the interest rate adjustment resulting from the Fed's tapering, CBRE-Econometric Advisors reports that the effect will be relatively muted, assuming the economic recovery stays on track. Adverse effects of the interest rate adjustment are expected to be mitigated by continued improvement in real estate fundamentals and key macroeconomic and capital markets drivers such as capital availability and risk appetite.

*Please visit [www.cbre-ea.com](www.cbre-ea.com) for more information about the 10-Y Treasury outlook and other economic drivers.*

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# Market Fundamentals

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*Operational Trends:* Seniors housing occupancy continues to improve, averaging 90.4% as of year-end 2013, a 62 bps increase over year-end 2012 and 250 bps from the segment's Q1 2010 trough, according to the National Investment Center for the Seniors Housing and Care Industry (NIC). Increased absorption was noted for independent living and continuing care retirement communities, which was mainly fueled by annual growth in single-family home sales and volume. Average rates are also increasing for all seniors housing property types. Skilled-nursing occupancy dipped slightly to 88% over the same period. With a greater focus on quality mix and improved operating efficiencies, the skilled nursing sector did experience an increase in NOI. These trends have continued through the first quarter of 2014.

*Construction Activity:* Seniors housing construction activity has moved toward a high-growth period with inventories expanding at their fastest pace in recent years. Seniors housing inventories grew an estimated 1.4% annually, up approximately 30 bps from its low in 2011 as reported by NIC. Absorption levels improved 2.2% during the same two-year period, suggesting the continued need for new construction. Provided that development capital continues to flow to the sector and developers are able to secure development opportunities with favorable returns, construction starts will increase significantly in the coming years, creating a short-term cause for concern.

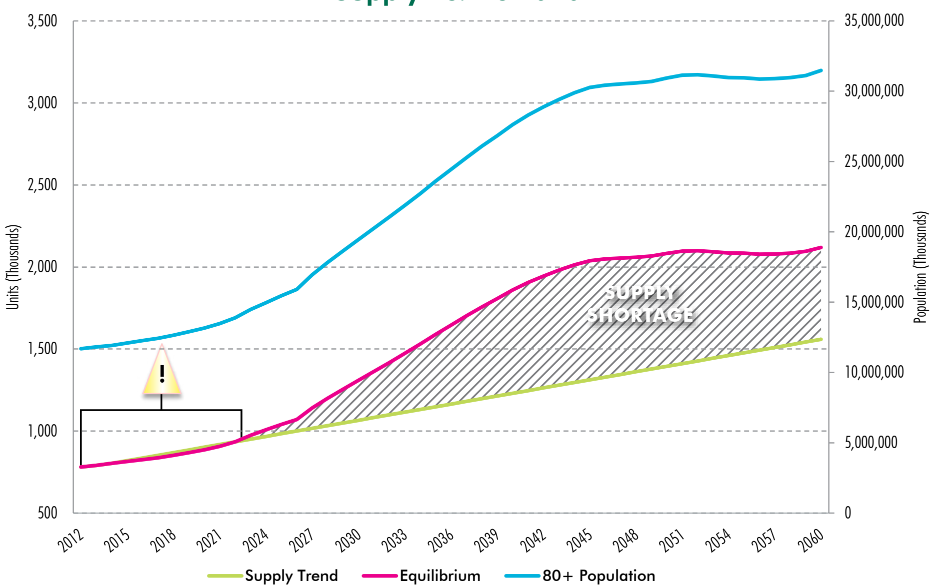
*Supply Vs. Demand:* The baby boomer generation consists of approximately 76.4mm people and makes up 25% of the US population. The leading edge baby boomer is now 67 years old with 8,000 "Boomers" turning 65 every day for the rest of the decade.

By subtracting the average age of a new AL resident by the age of the leading edge boomer, simple math suggest another 17 years before this population segment truly hits the seniors housing space.

What does this surge in supply and demand mean for market balance? The blue line projects 80+ population growth. Assuming the current supply/ demand ratio represents market balance, the Pink line projects the supply requirement to maintain current market balance. The green line projects current supply growth utilizing the most recent construction trends as reported by NIC. This graph indicates a significant supply shortage beginning in 2024 with a cautionary period leading up to that point. That said, penetration rates are increasing with further increase expected as the product becomes more accepted and income levels increase.

Approximately 40,325 units must be added per year in order to meet peak demand in 2044, compared to the current construction rate of approximately 16,440 units per year. The key will be maintaining a balance over the next 10 to 17 years.

**Supply Vs. Demand**



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## Transaction Trends

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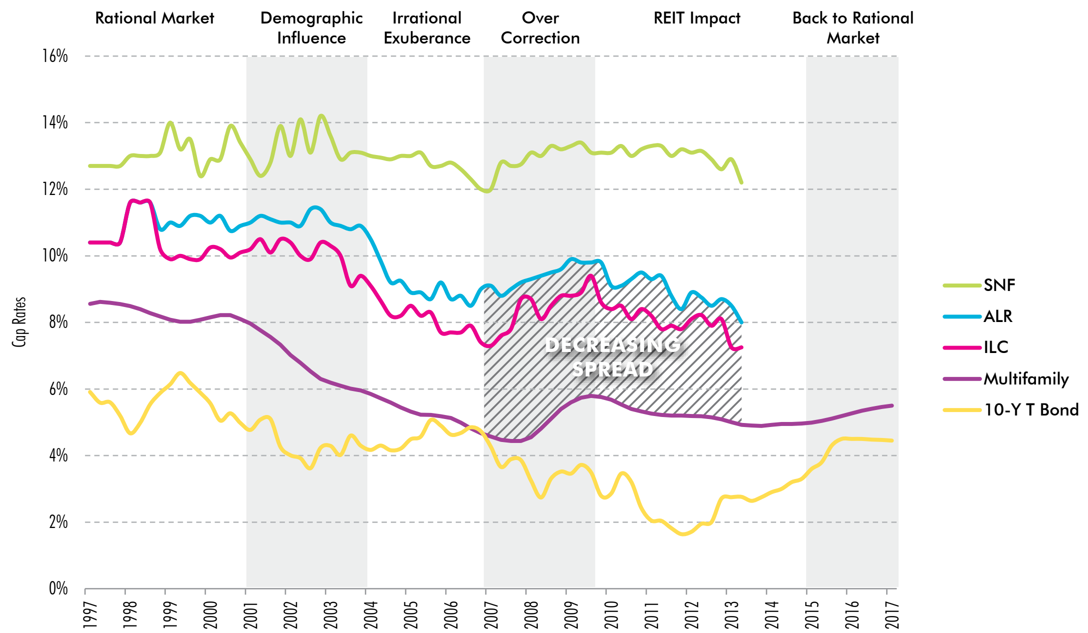
The 2013 seniors housing transaction value totaled $12.16 billion, up 50% from 2012, according to Real Capital Analytics. However, skilled nursing transaction value dropped 32% year-over-year to $2.55 billion. Across all sectors, volume increased 26% from 2012. The number of seniors housing assets changing hands during 2013, rose 35% from 2012, of which one fourth was skilled nursing, suggesting somewhat weaker demand for the segment.

That said, in 2013 skilled nursing achieved the highest ever average price per bed. Transaction volume continues to increase in to 2014, with the SeniorCare Investor reporting a record setting Q1 and Q2, respectively with the question of a sector specific bubble also being raised.

### Cap Rate Trends vs. Apartment Caps & 10-Year Treasury




Seniors housing is the most operationally intensive of all property types, and also one of the most bifurcated in terms of operational consistency. The ability to manage variable expenses such as labor or food, allows the ability to protect operating margins through volatile periods better than any other property type.

With the increase in sophisticated capital, increased operational efficiencies and technological advances are being introduced to the space. This can be compared to the institutionalization that the apartment sector experienced from the mid-1990s to early 2000s.

The chart presented above depicts historical cap rates as reported by NIC, overlapped with historical and projected trends for the apartment sector and the 10-Y Treasury, as reported by CBRE Econometric Advisors. As shown, cap rate spreads for seniors are clearly compressing to apartment levels. Not only is this trend expected to continue, the data presented in this table suggests that the apartment market can be utilized as a leading indicator.

## Seniors Housing Investor / Developer Survey Results

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The 2014 First Half CBRE Seniors Housing Investor Survey was sent to the most influential seniors housing investors, developers, and brokers throughout the United States. In developing the survey, our main objective was to identify trends in the healthcare real estate industry and to share this information with our clients to help them better understand the state of the market. The survey provides a snapshot of investor and developer expectations, and most importantly, their perception of what lies ahead.

*The results of this survey are summarized below:*

| | | Class A | | | Class B | | | Class C | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Low | High | Average | Low | High | Average | Low | High | Average |
| Core | IL | 4.00% | 8.00% | 6.05% | 5.00% | 9.00% | 6.98% | 7.00% | 10.00% | 8.36% |
| Core | AL | 5.00% | 9.00% | 7.00% | 6.00% | 9.00% | 7.80% | 7.00% | 12.00% | 9.02% |
| Core | MC | 5.00% | 9.00% | 7.24% | 6.00% | 10.00% | 8.00% | 8.00% | 12.00% | 9.52% |
| Core | SN | 9.00% | 14.00% | 11.49% | 11.00% | 14.00% | 12.43% | 11.00% | 15.00% | 13.26% |
| Core | CCRC - Rental | 5.00% | 9.00% | 7.66% | 6.00% | 10.00% | 8.39% | 8.00% | 12.00% | 9.83% |
| Core | CCRC - Buy In | 7.00% | 10.00% | 8.10% | 7.00% | 12.00% | 8.88% | 8.00% | 13.00% | 10.06% |
| Non-Core | IL | 5.00% | 9.00% | 7.06% | 6.00% | 10.00% | 7.70% | 7.00% | 11.00% | 8.44% |
| Non-Core | AL | 6.00% | 10.00% | 7.56% | 7.00% | 11.00% | 7.94% | 8.00% | 12.00% | 9.24% |
| Non-Core | MC | 6.00% | 9.00% | 7.75% | 7.00% | 11.00% | 8.36% | 8.00% | 12.00% | 9.49% |
| Non-Core | SN | 10.00% | 15.00% | 12.03% | 11.00% | 16.00% | 13.24% | 12.00% | 16.00% | 13.47% |
| Non-Core | CCRC - Rental | 6.00% | 10.00% | 8.14% | 7.00% | 12.00% | 8.86% | 8.00% | 13.00% | 10.17% |
| Non-Core | CCRC - Buy In | 7.00% | 10.00% | 8.58% | 8.00% | 12.00% | 9.27% | 9.00% | 13.00% | 10.57% |

*The results of the cap rate survey were utilized to better understanding risk profile, or spreads between property class as well as location.*

| | Investment Class Spreads | | | |
|---|---|---|---|---|
| | | A-B | B-C | A-C |
| Core | IL | 0.93% | 1.38% | 2.31% |
| Core | AL | 0.80% | 1.22% | 2.02% |
| Core | MC | 0.76% | 1.52% | 2.28% |
| Core | SN | 0.94% | 0.83% | 1.78% |
| Core | CCRC - Rental | 0.73% | 1.44% | 2.18% |
| Core | CCRC - Buy In | 0.79% | 1.18% | 1.97% |
| Non-Core | IL | 0.64% | 0.74% | 1.38% |
| Non-Core | AL | 0.39% | 1.30% | 1.69% |
| Non-Core | MC | 0.61% | 1.12% | 1.74% |
| Non-Core | SN | 1.20% | 0.23% | 1.43% |
| Non-Core | CCRC - Rental | 0.71% | 1.31% | 2.02% |
| Non-Core | CCRC - Buy In | 0.69% | 1.29% | 1.98% |

| Location Spreads (Core Vs. Non) | | | |
|---|---|---|---|
| | A | B | C |
| IL | 1.01% | 0.72% | 0.08% |
| AL | 0.56% | 0.14% | 0.22% |
| MC | 0.51% | 0.36% | 0.00% |
| SN | 0.55% | 0.80% | 0.20% |
| CCRC - Rental | 0.49% | 0.47% | 0.33% |
| CCRC - Buy In | 0.49% | 0.39% | 0.50% |

## Seniors Housing Investor / Developer Survey Results (continued)

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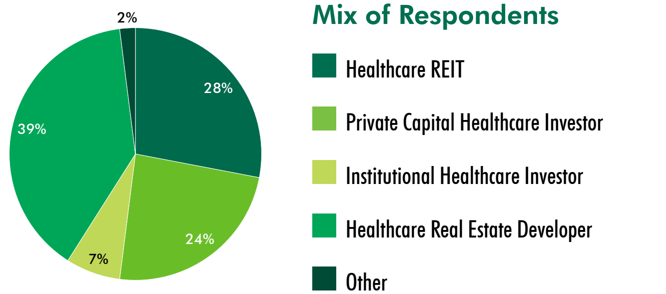
The respondents indicated a noticeable attraction to Class A and B properties respective of independent and assisted living as the spread from B to C is greater than the spread from A to B. However, the opposite is inferred for skilled nursing with the participants being partial to Class A properties, with the largest bifurcation in spreads between Class A and B properties.

In terms of locational spreads, a property's location in a core vs. non-core market is most relevant for Class A and Class B independent living properties. There is also a noticeable bifurcation in locational spreads for Class B skilled nursing facilities.

*The following summarizes the profile of the respondents.*

The professional mix of the participants was split, 45% being specialized investment or sales brokers. The balance identified as investors or owners.

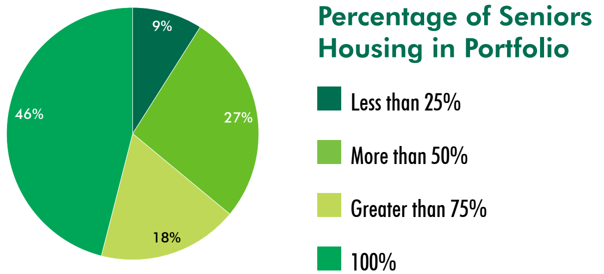
The percentage of investors or owners completing the survey was further delineated between representatives of Public, Private, Institutional or Other companies.




*The investors and developers were asked the percentage of their existing portfolio that is seniors housing oriented.*

9% reported seniors housing as being less than 25% of their overall portfolio. 27% of the respondents reported seniors housing as more than 50%, with 18% of the respondents reported seniors housing as comprising greater than 75% of their overall portfolio. The remaining 46% reported seniors housing as comprising 100% of their investment portfolio.

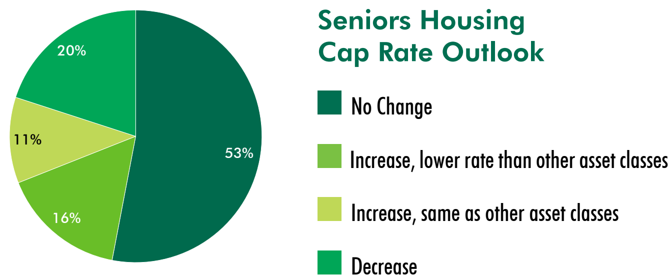
**An overwhelming 100% of the participants are aiming to increase their exposure to the space.**




*All participants were asked their 12-month outlook for seniors housing capitalization rates.*

The participants were asked if they expect capitalization rates for seniors housing to increase in line with other property types, increase but at a slower rate than other property types, decrease in line with other property types, or no change.

53% of respondents expect no change in cap rates over the next 12-month period. 26% expect an increase and 16% of the 26% expect an increase at a lower rate than cap rates for other property types.



## CBRE Seniors Housing Outlook

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We expect prices to continue to appreciate during 2014 with a very strong long-term outlook. The industry's fundamentals suggest the necessity for more capacity over the long term with the possibility of short-term overbuilding in select markets. Given the economic climate and the corresponding operational results within the seniors housing industry, the sector will also continue to generate further organic operational efficiencies and attract new capital sources seeking higher yield.

As new and veteran equity sources (including non-traded REITs) attract and deploy more capital, the relatively constrained supply of product will continue to be priced more aggressively. This will likely narrow the return yield relative to the risks associated with seniors housing operations, offsetting the likely rise in interest rates. The desire to invest in higher-yielding asset classes has begun to eclipse the risks associated with this asset class.

Recent transaction trends do not suggest a slowdown, with underlying market fundamentals indicating a favorable long term outlook, again assuming the economic climate remains stable. The influx of new supply, overextending operators to meet the demands of their development partners, and new players entering the space may push average occupancy levels downward in select markets, over the short term. Recent improvements in design trends and technological advancements will force the more dated product to reinvent their market position especially given the need for affordable product. Overall, market participants with sound due diligence and acute operational market understanding will continue to be successful in this space.

Contact us to arrange a customized presentation of these results and market overview for your firm.

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