Senior Living Investing:

Golden Years Ahead or Troubled Times Instead?

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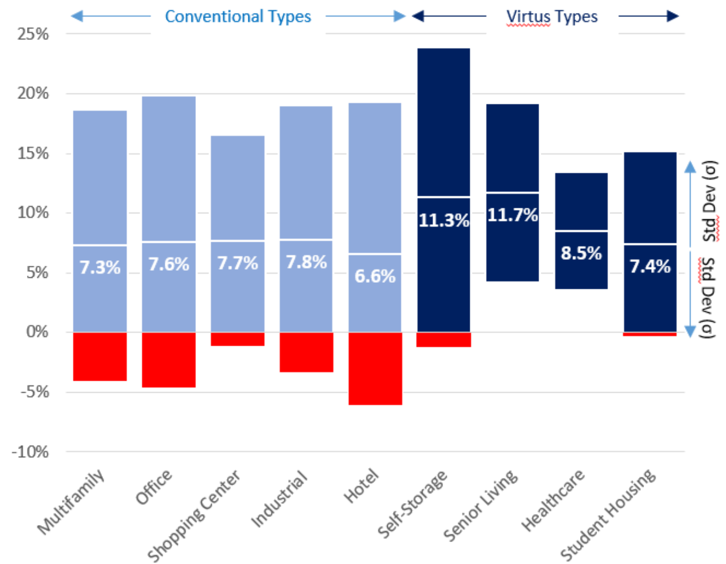
Virtus first began investing in Senior Living assets in the aftermath of the Great Financial Crisis of 2007-2008. In the years since, this has proven a unique vantage point from which to watch as the sector has transformed from a little-known secret into one of the most widely followed "alternative" property types in the industry. To be fair, Senior Living has earned its favorable reputation: it has outperformed widely invested sectors like multifamily, office, and industrial in total returns for privately held real estate (as measured by NCREIF), while at the same time maintaining a much tighter variance in total returns (see Figure 1). Such performance rarely goes unnoticed and has attracted a plethora of new entrants and a record amount of dry powder into the space.

Figure 1: 10-Year Returns and Standard Deviations by Asset Class



Source: NCREIF NPI Index and NPI-Plus Index. Figures cited from "Non-Traditional Property Types: Part of a Diversified Real Estate Portfolio?" by Will Mcintosh, Mark Fitzgerald, and John Kirk. The Journal of Portfolio Management

Nothing lasts forever, and this holds especially true for investment opportunities that seem favorably beyond the risk-reward frontier. Thanks to seemingly insatiable demand from senior living consumers and high yields on construction costs, recent years have seen developers flood the markets, instigating a wave of new supply the sector has not seen in over a decade. The result has been increasingly soft fundamentals and outright distress in certain overbuilt areas. National occupancy in Assisted Living ("AL") properties reached its lowest point of 85% since NICMAP began reporting sector fundamentals in 2005. Independent Living ("IL") properties have seen lower rates of supply growth, but the entire sector has declined modestly from a 2016 high of 91.6% to 90.1% as of second quarter 2018. The sector has inarguably entered a period of lower performance (at least temporarily), and while valuations remain stubbornly high for purpose-built properties with stabilized occupancy, especially those as part of large portfolios, it is only prudent to expect that this new reality will eventually impact investor sentiment.

So how should investors look at Senior Living today? **While the past shows robust outperformance and the present inspires concern, we believe the coming wave in senior growth rates will likely rebalance fundamentals across all but the most oversupplied markets.** But before we dive into that, let us first examine the current state of real estate fundamentals in the category.[1]

[1] This paper discusses *private pay* Senior Living, which encompasses IL and AL, with Memory Care ("MC") treated here as a subset of AL. These segments of the Senior Living sector depend chiefly on the rent and care payments of residents or their families, rather than the Medicare reimbursements seen in categories such as Skilled Nursing. For an overview of the full Senior Living continuum, see Appendix I.

The first thing to note when evaluating recent trends in Senior Living is the nearly direct relationship between supply increases and occupancy levels. AL inventory growth reached a peak of nearly 6.0% during 2017 (see Figure 2), notably higher than the growth rates seen in the run-up to the Great Financial Crisis. The result has been a continual decline in AL occupancy, which has decoupled from IL properties that have seen less new supply.

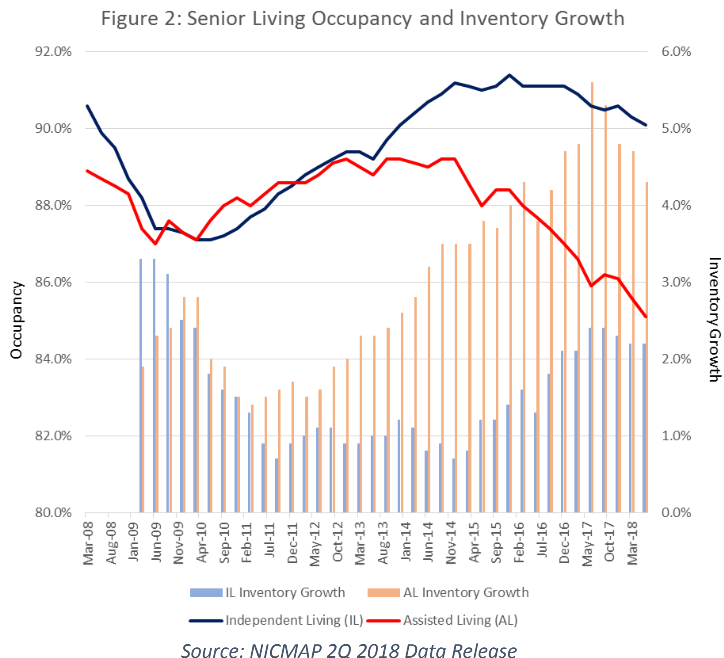


Figure 2: Senior Living Occupancy and Inventory Growth

Source: NICMAP 2Q 2018 Data Release

While this trend may give investors pause, it is important to note that this headline does not say much about the forward trajectory of Senior Living, nor does it provide a complete picture of the current situation. **The impacts of new supply have been concentrated and uneven.** While the national supply growth rate exceeds the current rate of demand growth, the most dramatic stories of oversupply are confined to a small number of lower barrier markets. For instance, 49% of current AL construction is confined to only ten markets. Some of these, like Atlanta, are low-barrier, high-growth cities with a history of rapid rebalancing. Others may have longer trajectories of recovery due to more anemic rates of senior and caregiver household growth.

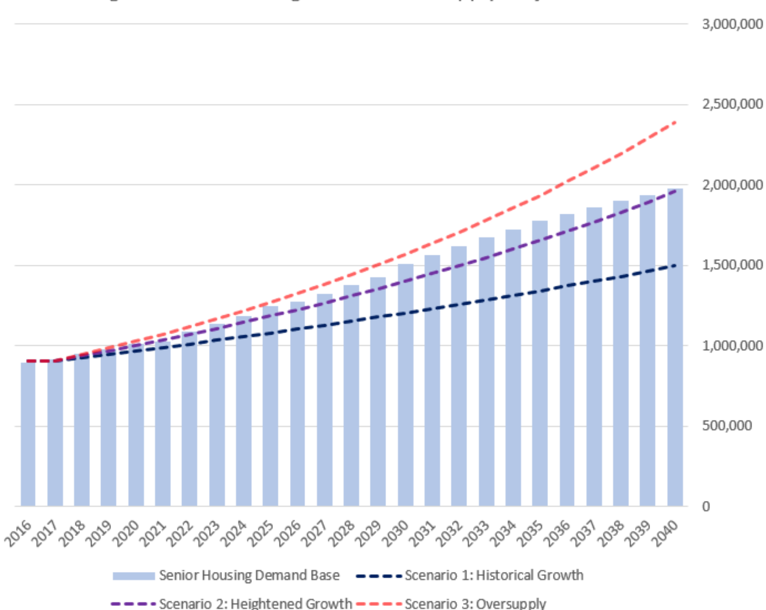
Despite inventory growth hitting record highs, **absorption has kept pace to offset most of the increase in supply.** During the highest periods of AL supply growth in late 2016 and 2017, annual absorption reached record high figures in nominal amounts, or 3.8% annually. In contrast, the Office sector saw 0.8% inventory growth resulting in a net occupancy decline of 0.5% with minimal new supply. While both sectors have entered a period where occupancy is slipping, Senior Living has a much greater capacity for demand growth due to favorable demographics. This advantage is especially notable in a rising rate environment where bond-like investments are at a greater risk of value erosion. Senior Living is unusual in that when new supply comes online in a given market, there is a direct corollary to penetration rates. In other words, the more Senior Living properties built, the more people utilize them. Additionally, the persistence of strong rent growth through this occupancy dip suggests there is still robust demand for the product. There is simply such a large influx of new projects that many markets are taking time to rebalance their supply-demand equilibrium. Further, stabilized occupancies in AL look more promising. While all AL properties hit a cycle low of 85.6% occupancy at the start of 2018 (nearly 200 bps below the previous record low), stabilized properties are only 70 bps below their previous low at 87.9%. **In sum, though the fundamentals of the sector merit concern, they are more properly viewed as the growing pains of a promising and dynamic sector, rather than a definitive signal that the party is over.**

Senior Living's advantage in this environment is even more evident when comparing the demand drivers to those of conventional real estate asset classes. Office demand fluctuates with near perfect correlation to the nation's economic health, with leasing drying up completely when the economy stagnates. When combined with the rising prevalence of the "gig economy" (where firms are slow to hire, eager to consolidate space, and constantly seeking new ways to lower the fixed footprint of their human resources), the result is an erratic and low growth sector with a good deal of increasingly obsolete product. Similar parallels can be seen in retail and hospitality. This explains why even comparably anemic rates of supply growth are still detrimental to occupancy, even in a healthy economic climate. **By contrast, Senior Living and other healthcare-related properties, like Medical Office, are significantly less correlated to the economy at large.** The components of high acuity Senior Living are primarily related to the number of age-and-income-qualified seniors in a market and how much supply is competing for them. Lower acuity facilities have some correlation to the

housing market, but only in distress periods where seniors cannot liquidate their homes to enter a facility. In general, Senior Living is as close to a "closed system" as anything in real estate can be; its chief driver is the growth of the senior population.

While it is widely recognized that rates of demographic growth among the senior population are quite high, it is often overlooked that this demographic has yet to reach their peak in the age groups most conducive to strong senior demand. The average age of entry into an AL center is 83 and climbing; the baby boom generation only recently began cresting the 65+ mark in great numbers. This rising tide has lifted medical office assets, as the demand for health services increases dramatically in individuals' age 65+, but has yet to touch the Senior Living sector to the extent generalist investors perceive. In other words, the tidal wave is yet to come. This presents a huge opportunity for the future as the total senior cohort is growing at roughly 3.4% annually, but today's 80+ households are currently growing at only 1.5% annually. As the crest of the baby boom population wave grows older, the growth rate for Senior Living demand will escalate to a much higher rate, reaching 3.5% by 2026.

What of supply? Despite the recent run-up in development, Senior Living inventory has grown at a much slower rate when measured long term across cycles. Since NICMAP began tracking supply growth (across now two full supply waves and only one downturn), total inventory has grown at only 2.2% annually—including the most recent wave that crested at 4.8% (for AL and IL) in the first quarter of 2017 and has since begun dropping. **There are many ways of looking at demand equilibrium, but at a fundamental level we believe if supply stays within historical average growth rates, then the coming demand wave will supersede it and require higher rates of development.** In Figure 3, we used an industry standard method for projecting demand rates and overlaid three different supply scenarios:

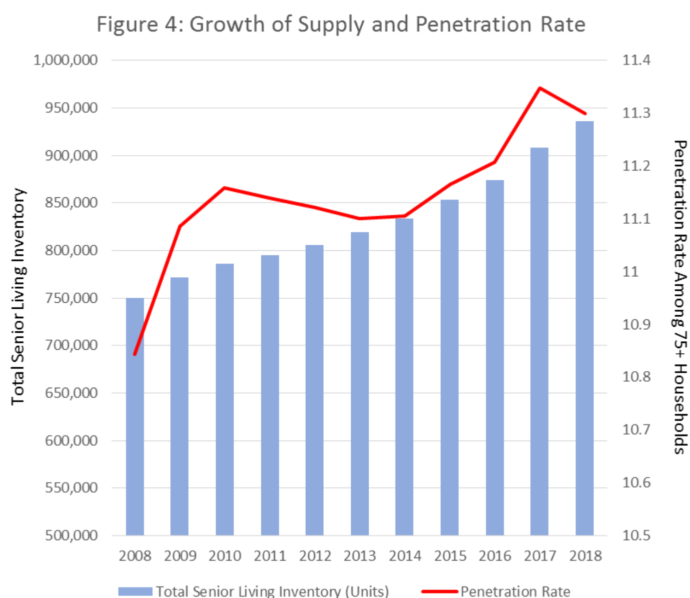


Source: NICMAP and US Census Department

- Scenario 1 uses a historical growth rate of 2.2%, which is easily overtaken by demand.
- Scenario 2 uses a more aggressive growth rate that mirrors population growth rates, but still sees more periods where demand exceeds supply.
- Finally, in Scenario 3, only when current (record-breaking) growth rates are continually extended does supply outpace demand growth. As previously noted those rates are already dropping, albeit more slowly than some new entrants would likely prefer. However, this scenario does not take into consideration that penetration rates increase when new supply comes online.

There are a number of ways to assess demand within the industry. NICMAP uses the population of 75+ *households* as their demand driver whereas CBRE uses 80+ *individuals* for their projections. Despite these two distinct methodologies, both firms arrive at the same conclusion we do: that the current moment represents a "pain point" that will soon be in the rearview as growth rates continue to escalate. We believe the oversupply currently being experienced will pass and investors who weather the storm will be handsomely rewarded, which is why we remain active in the Senior Living sector.

As previously mentioned, "penetration rates," defined as the rate of usage divided by the total demand potential (either households or individuals), are an important final projection necessary for evaluating future demand. According to the NICMAP 75+ households, total Senior Living penetration is 11.3%. By contrast, CBRE's methodology calculates a 7.0% penetration rate among all 80+ individuals using a smaller and more targeted inventory standard. While both firms' figures are worth considering, we believe NICMAP's method provides a more standardized look at the industry today and is more relevant. Both firms show low penetration rates relative to other sectors because Senior Living is prohibitively expensive for most households. AL rates, for example, average nearly $4,700 per month. IL rates are cheaper, but still quite costly. That said, if Senior Living follows the trajectory of similar sectors, it will eventually discover a more cost-efficient means of delivering service to a wider group of households, unlocking vast market potential. While there are admittedly immense technological, regulatory, and operational challenges currently holding this back, anyone who believes, as we do, in the private sector's ability to innovate solutions to such problems should remain optimistic.



Source: NICMAP and US Census Department

The possibility of a reduced care delivery cost or a disruptive lower cost real estate solution (both of which Virtus is investigating) could ultimately drive even greater penetration rates. This is in addition to the already projected overall increase in Senior Living demand rates thanks to ongoing cultural shifts. Historically, placing elderly relatives in an "old folks home" carried a stigma. **Today, the quality of the Senior Living communities, the care they provide, the programming and hospitality are very different than Senior Living 1.0 from decades past.** Not only can residents' quality of life be potentially greatly enhanced after moving to a Senior Living community, some studies suggest the possibility of enhanced quantum of life, especially at properties with multiple levels of care that allow residents to "age in place." This enhanced quality of life also extends to the Qualified Caregivers, typically the children of Senior Living residents, who would otherwise be responsible for the day-to-day care of their elderly loved ones. With more household members working outside the home than ever before, Senior Living communities are an increasingly attractive option. **As cultural assimilation continues its progression, demographic trends demand it, and Senior Living communities continue to offer better outcomes for the elderly, it is likely penetration rates will continue to increase as they have done in recent years.**

In summary, the current state of Senior Living does evidence some concern, even as many established firms view it as a necessary "cool down" that will lead some new entrants and generalist investors to shift back to more conventional real estate sectors. We see positive momentum for this sector in the form of a clear and quantifiable wave of demographic growth. Like a rising tide buoys all ships, this growth will drive demand and positively impact the sector's trajectory for years to come—a sector we believe holds the potential for immense, untapped growth. For these reasons, we remain dedicated to Senior Living and expect it to be a significant part of our portfolio for the foreseeable future.

Based in Austin, Texas, and established in 2003, Virtus Real Estate Capital is focused exclusively on cycle-resilient property types. Since inception, Virtus has invested in 218 commercial properties with a combined acquisition cost of approximately $3.4 billion. Virtus is currently active in Healthcare, Student Housing, Workforce Housing, Education, and Self-Storage.

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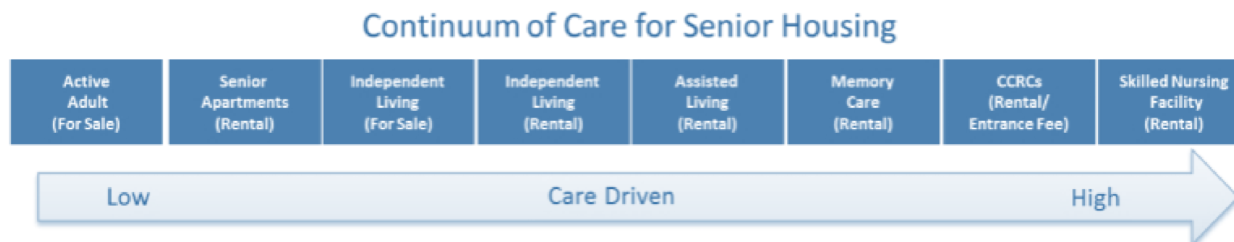
Appendix I: Senior Living Continuum

There are a variety of Senior Living property types and the distinctions among them are largely based on the level of healthcare services offered, often described as the "continuum of care," as illustrated below:



- Senior Living is a real estate plus services business model where the type of property depends upon the amount of care that is delivered (or licensed to deliver).
- Property types are distinguished from one another by the amount of care given at a particular community. This ranges from no care (Active Adult/Senior Apartments) to some care (Independent Living, "IL") to differing levels of "hands-on" care (Assisted Living "AL" up to Skilled Nursing "SNF").
- The majority of the continuum of care is private pay (*i.e.,* not Medicare or Medicaid reimbursable), whereby residents pay monthly rent plus fees for services depending upon the amount of care needed (meals, medication reminders, dressing, grooming, transportation, etc.).
- Service offerings and levels of care tend to be fluid in order for developers to adapt to the needs of the senior population and retain residents for longer periods of time (a single property may be IL/AL/SNF or AL/Memory Care ("MC") to allow residents to "age-in-place").

Generally, Senior Living falls into six property types based on the level of care and lifestyle needs:

1. *Senior Apartments* – Properties which target the 55+ age group, although the average age of residents tends to be in the mid-70's. These properties may consist of multi-family units, garden apartments or even "active adult" single family homes with little to no services offered, yet built, marketed and operated to meet the lifestyle desires of the active adult community.

2. *Independent Living* – Communities targeting the 75+ age group and offering supportive services such as dining, housekeeping, social activities, and transportation typically with little to no healthcare services offered by the Operator. In some cases, there are grades of healthcare services offered ranging from "Independent Light" with no services to "Independent Living with Services" where certain healthcare services may be offered, often by a third-party provider.

3. *Assisted Living* – Similar to independent living properties but offering Assistance with Daily Living Needs ("ADLs") with personal care services such as bathing, dressing and medication management. Because of the services offered, these properties are often state regulated, and in some cases provide financial assistance.

4. *Memory Care* – Typically assisted living residences specifically serving the unique needs of those with Alzheimer's and other forms of dementia.

5. *Skilled Nursing Facilities* – A healthcare facility that meets federal criteria for Medicare for those in need of round-the-clock episodic care due to illness or surgery, and for Medicaid for those 65+ with some frailty who have limited or no financial means to live independently.

6. *Continuing Care Retirement Communities* – Larger properties with the marketing advantage of a combination of the levels of care above but often with a large upfront entrance fee resulting in greater susceptibility to downturns in the housing market.