Marcus & Millichap

National Report

Seniors Housing Research

Second Half 2018

Investors Watching Evolving Economic Policy and Federal Reserve Action, But Demographics and Yields Draw Investors to Seniors Housing

Economy gets a boost from tax reform; seniors housing operators struggle to find employees. Economic growth surpassed 4 percent in the second quarter, lifted by strengthened consumption and business investment. The new tax law has stimulated the economy by increasing after-tax earnings and pushing consumer and business confidence to near-record levels. This combination has sparked elevated spending and accelerated job creation. Through the first half of 2018, the economy added over 1.3 million jobs, driving unemployment below 4 percent and boosting wage growth to 2.7 percent. Seniors housing operators, however, are facing staffing challenges. Job creation in the healthcare industry has been steady, but hiring for nursing assistants, which comprise a large share of employees for seniors housing operators, has slowed. Operators face employee shortages and a highly competitive compensation climate.

Rising inflation and higher interest rates could cool momentum. Accelerated growth also brings some new challenges to the broader economy. Core inflation has nudged upward to 2.3 percent, raising caution at the Federal Reserve. To rein in inflationary pressure, the Fed has already signaled that it will tighten monetary policy by raising the overnight rate a total of four times in 2018. This will push up short-term interest rates and could impact borrowing costs for commercial real estate loans. The challenge for the Fed is that long-term interest rates have been range bound, with the 10-year rate hovering near 3 percent for the last six months. Unless the Fed can push long-term rates up, its monetary tightening could invert the yield curve, raising short-term Treasury yields above long-term Treasuries — a commonly perceived sign of an impending recession.

Rapid sector evolution a challenge, but aging population will drive demand. Technology, policy changes, and consolidation among providers and services are just a few factors driving today's healthcare industry. These are constantly changing and operators of today's seniors housing properties must be prepared to adapt as new trends emerge. The key ingredient strengthening demand is the aging population. Rising demand has encouraged a flurry of supply additions in recent years and an expanded construction pipeline as developers seek to meet the housing needs of older adults. Deliveries have raced ahead of demand in the near term, resulting in some softening of occupancy for the majority of seniors housing.

Capital widely available as cap rates tick up. Some challenges exist in the market today as operators are faced with staffing shortages, rising costs and changes to reimbursement structures. This has led to a modest reduction of buyer activity and an uptick in cap rates as some investors look at restructuring portfolios. First-year yields and pricing vary widely depending on unit mix and quality of revenue. Properties with a retirement model, like senior apartments and independent living facilities, trade with cap rates on the lower end of the spectrum, while communities providing more medical services, like memory care or skilled nursing facilities, yield higher returns. Positive demographics and higher cap rates compared with other investment options have brought more attention to the property segment over the past few years. Today's seniors housing market is characterized by a wealth of available capital but a limited number of quality operators who have the capacity to expand services.

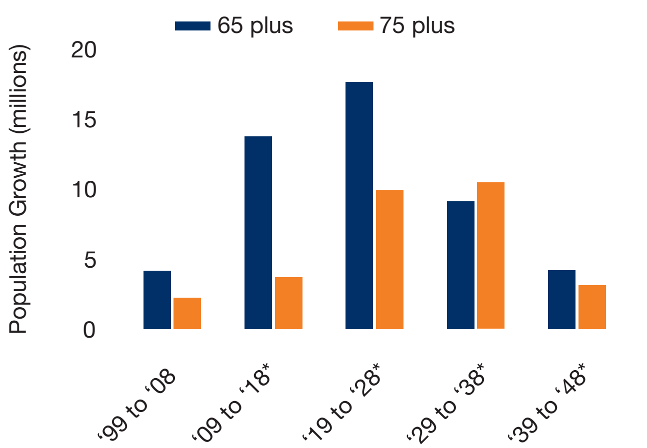
Executive Summary

- An aging population, a declining homeownership rate among older Americans and rapid wealth growth for senior-aged residents are driving demand and development in the seniors housing sector.
- Demand for seniors housing is anticipated to rise, but employee shortages are already impacting the sector. Steadily increasing healthcare costs associated with medical services are also impacting the industry.
- Construction of assisted living and independent living facilities has comprised the bulk of deliveries in the seniors housing sector in recent years, but the development pipeline for these properties is beginning to decline.
- Completions for memory care units have increased substantially over the past couple of years. Alzheimer's cases are on the rise and developers and operators are seeking to meet the needs of dementia care patients by constructing specialized facilities.
- CCRC/LPC communities continue to boast strong occupancy rates as the ability to remain in the community and move through various levels of care and higher barriers to entry, like expensive entrance fees, keep resident turnover lower than other seniors housing property types.

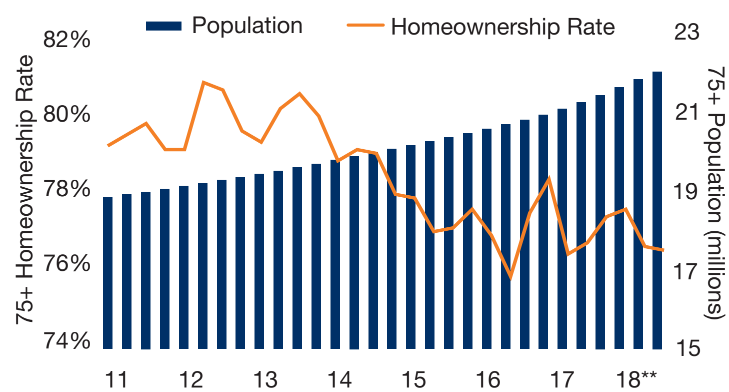
Demographic Trends Driving Future Seniors Housing Demand

- **Aging boomers, longer life expectancy lift future population growth among older Americans.** According to the Social Security Administration, a person turning 65 today will live, on average, well into his or her 80s, with 25 percent of those individuals' lives extending past age 90. As the 65 and older population is set to rise by more than 17 million individuals over the next 10 years, more than half of this growth will occur in Americans older than 75, the cusp of when most people begin moving into seniors housing residences.
- **Homeownership rate for those over age 75 in decline.** A collapse in home values across much of the country following the Great Recession impacted seniors' ability to sell homes and use the equity to move into retirement communities or seniors housing during this time. As a result, homeownership among those older than 75 reached a peak during 2012 and remained elevated at more than 80 percent through 2014. As home prices have risen over the past few years, these seniors are starting to cash out, electing to move in with adult children or into seniors housing communities.
- **Rapid wealth growth among older families.** The transfer of wealth to the oldest of Americans was reported in the Federal Reserve's Consumer Finance Survey released in late 2017. Americans older than 75 experienced a 32 percent increase in median household net worth and a 60 percent increase in mean net worth. Median net worth among this age group, at $264,800, was the highest among age brackets followed by those ages 65 to 74. Seniors housing developers are targeting these wealthy individuals and families by building luxury properties complete with numerous amenities and in close proximity to shopping, parks or other activities seniors enjoy.

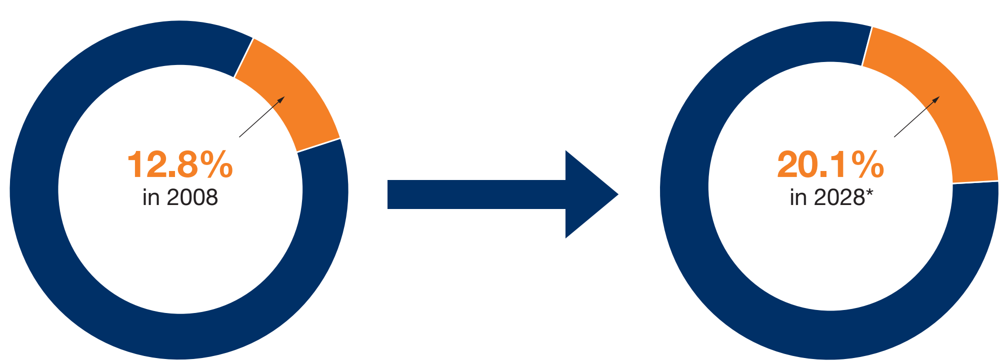
Population Growth Among Older Americans



Homeownership Fades Among 75 and Older



65+ Population Grows As A Percentage of Total Population

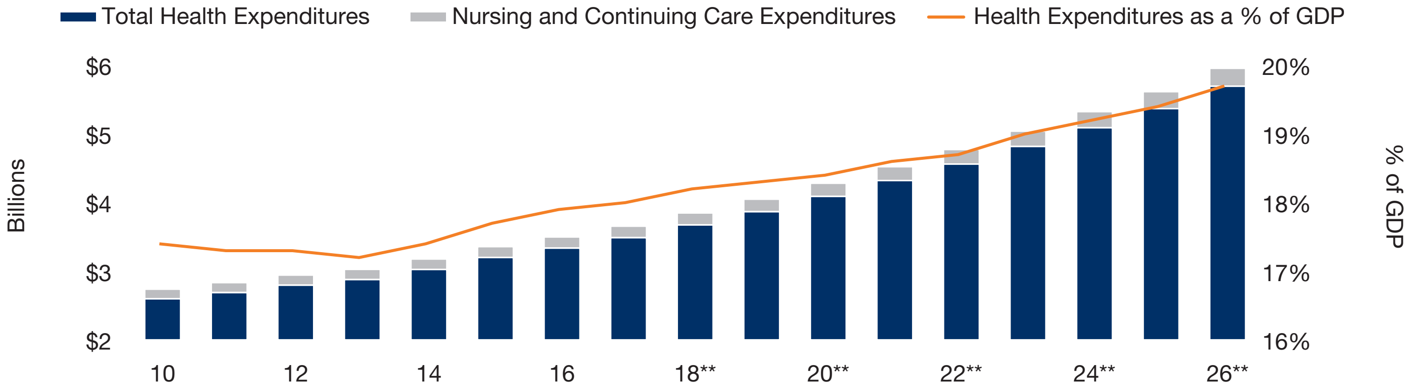


* Forecast ** Through 2Q2018

Sources: Marcus & Millichap Research Services; Federal Reserve: Consumer Finance Survey; National Association of Realtors; Social Security Administration; U.S. Census Bureau

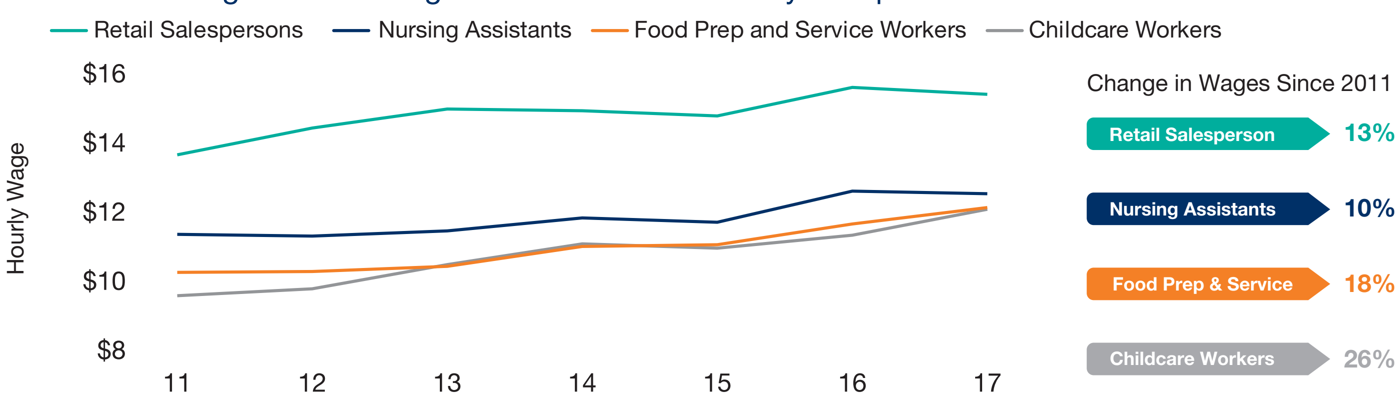
Economic and Operational Challenges That Care Providers Must Overcome

National Health Expenditures Trends



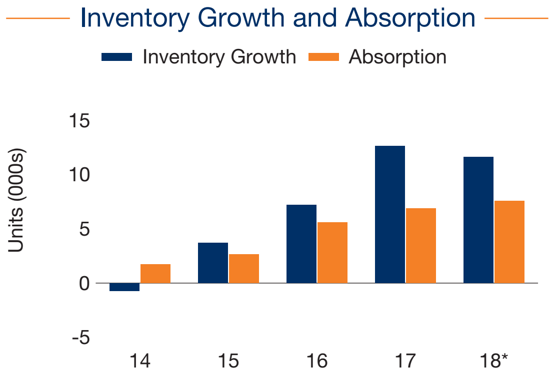
- **Healthcare spending on the rise.** An aging population is contributing to increased spending on healthcare services. In 2017, the estimated total healthcare expenditures climbed to nearly $3.5 trillion, or 18 percent of GDP. The United States leads the world in healthcare expenditures per capita at more than $10,000 per person. Both of these figures are set to rise over the next 10 years, with healthcare spending expected to reach nearly 20 percent of GDP by 2026. Nursing and continuing care expenditures are also included in this total, with expected spending set to grow by more than $100 billion over the next eight years.
- **Healthcare employment outlook bright, but seniors housing operators face challenges.** While the majority of employment sectors faced steep employment cuts during the Great Recession, the healthcare sector continued to grow. Since that time, the industry remains a job engine, adding more than 307,000 positions over the past year. Gains in the sector have been led by ambulatory care services, including physicians and general practitioners. Meanwhile, staffing for nursing and residential care facilities has slowed tremendously. This segment added an average of more than 30,000 positions during each of the previous five years, but just 6,800 were created in the past 12 months. Demand for seniors housing facilities is anticipated to rise substantially over the next several years, and staffing shortages for nursing aids and assistants are already posing a problem in some areas of the country.
- **Wage growth for nursing aids trails other industries.** Nearly 37 percent of nursing assistants work in skilled nursing facilities, while more than 18 percent are employed by CCRC/LPCs and assisted living facilities. On average, these employees earn a mean hourly wage of approximately $12.50, on par with wages for workers in food services, childcare and retail stores. As hourly wages have grown at a slower pace for nursing assistants than other industries, more workers are choosing employment in other economic sectors.

Wages For Nursing Assistants Rise Minimally Compared To Other Industries

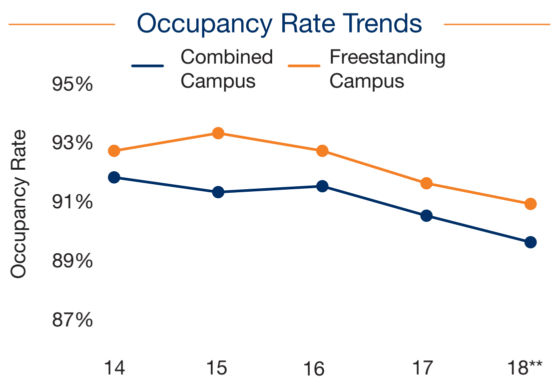


* Forecast
Sources: Marcus & Millichap Research Services; BLS; JAMA

Demand For Independent Living Communities Strengthens Amid Rising Supply Additions



Limited inventory growth at freestanding campuses as developers focus on properties offering a spectrum of services. According to the NIC MAP® Data Service, independent living inventory has grown substantially over the past two years. More than 24,200 units have been added to service during this time, with total inventory rising by nearly 11 percent. Though deliveries have outpaced demand by approximately 10,000 units since mid-2016, healthy absorption has resulted in stabilized occupancy remaining above 90 percent. Freestanding independent living communities are faring better than combined campuses as minimal inventory additions have allowed occupancy to stay above 90 percent, higher than the historical average of 89.4 percent. Despite stronger occupancy, rent growth in freestanding independent living communities has slowed over the past two years, with the average ticking up 1.0 percent year over year to $2,881 per month. This compares to a 2.4 percent annual advance at combined campuses to $3,305 per month. Higher rental rates at these campuses are expected as unit mixes grow to include those with medical services.



Private investors increase acquisition activity, portfolio deals decline. Independent living community sales activity slipped over the past 12 months. The number of properties involved in portfolio trades declined dramatically during the year, while the number of individual asset sales ticked up. Freestanding independent living facilities accounted for 57 percent of trades. Cap rates for freestanding facility sales remain compressed, often trading in the mid-5 percent to mid-6 percent range as they operate more closely to retirement communities with no medical services. Combined campuses command higher returns, depending on the number of units dedicated to other care types.

2018 Independent Living Outlook

Construction
18,100 units

The number of independent living units under construction peaked in the third quarter of 2016 as more than 20,700 were underway. Units underway have steadily fallen over the past two years.

Occupancy
down 100 bps

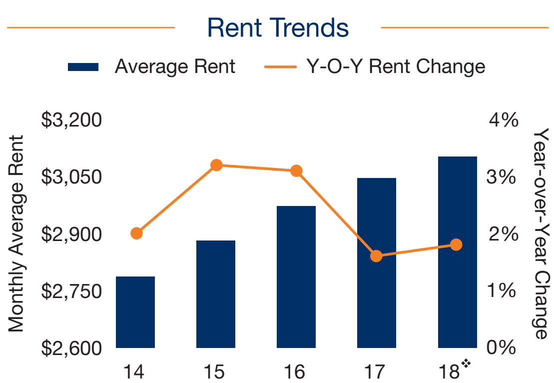
Stabilized occupancy dips to 89.9 percent this year, the lowest level since 2012. Prior to this year, the rate had remained in the low-90 percent range since 2014.

Rent
up 1.8%

Amid increased inventory gains, the pace of rent growth has slowed from the previous four years, when the average increased at a rate of 2.5 percent annually. This year, the average advances to $3,102 per month.

Investment

Crossover capital seeks to capitalize on strong demographic trends. These investors find freestanding independent living communities appealing as they are most similar to other income-producing properties.



* Trailing 12 months through 2Q2018
** As of 2Q2018
❖ Forecast
Source: NIC Map Data and Analysis Service (www.nicmap.org)

Assisted Living Leads Seniors Housing in Deliveries, Rent Growth Remains Healthy

Combined campuses leading the way as operators seek to expand services and reduce resident turnover. The majority of seniors housing construction is taking place in the assisted living sector, and according to the NIC MAP® Data Service, nearly 12,500 assisted living units were completed over the past 12 months. Deliveries in the property segment exceeded 12,000 units annually for a fourth consecutive year, with the majority of construction occurring among properties that provide additional services along the care spectrum, from independent living to skilled nursing. More freestanding assisted living units have been removed from inventory than added over the past three years as operators diversify properties to cater to a wider spectrum of seniors' medical needs in an effort to increase retention. Despite expanded services, demand for assisted living has struggled to keep pace with robust supply additions, resulting in stabilized occupancy shrinking for a fourth consecutive year to 87.9 percent. Rent growth for assisted living communities remains steady, however, with the average rising 2.5 percent to $4,694 per month in the second quarter.

Unit mixes at combined facilities drive future investment returns. Assisted living community sales remain healthy, with private capital dominating acquisitions over the past year. Private groups and individuals targeted individual buildings, trading at first-year returns in the high-7 percent realm. While institutions also comprised a large portion of transaction activity, the majority of these deals were portfolio acquisitions capturing yields closer to 6 percent. Combined facilities, which typically have some independent living and/or memory care units, are in high demand, as these properties allow operators to reduce turnover by moving residents through various stages of care needs. As unit mixes change to accommodate more medical services, investors should expect higher cap rates.

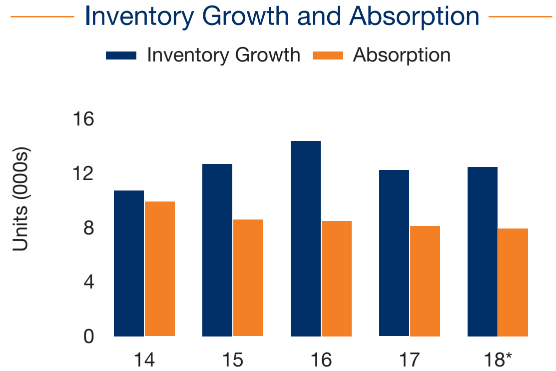
2018 Assisted Living Outlook

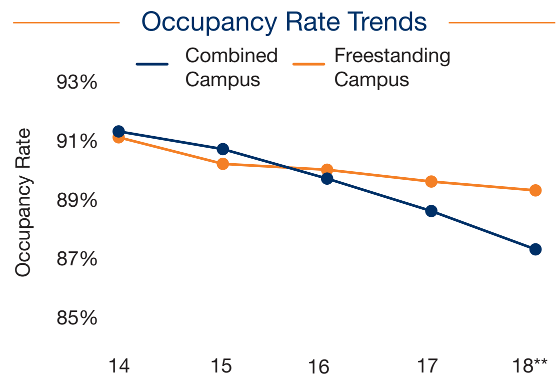
Construction 23,800 units — The construction pipeline for assisted living communities is shrinking. After peaking at nearly 28,800 units in the third quarter of 2016, the number of units underway at the end of the second quarter rested at 23,700.

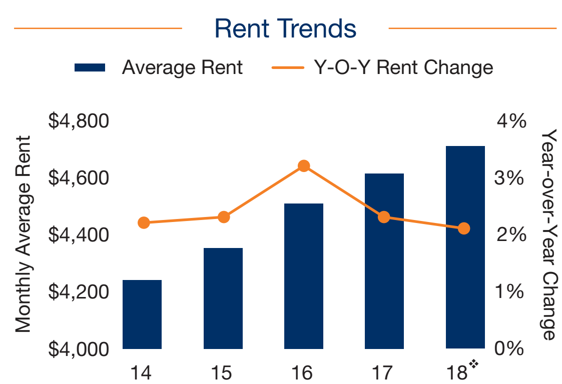
Occupancy down 10 bps — As deliveries remain elevated this year, occupancy continues on a downward slope, reaching 87.4 percent during 2018. The stabilized rate has fallen 380 basis points since peaking in 2014.

Rent up 2.1% — Rent growth remains healthy, though it is rising at a slower pace this year as the average advances to more than $4,700 per month. The rate of growth has stayed above 2 percent annually for eight straight years.

Investment — Heightened completions could deter some investors from assisted living communities this year as stabilized occupancy continues to decline.







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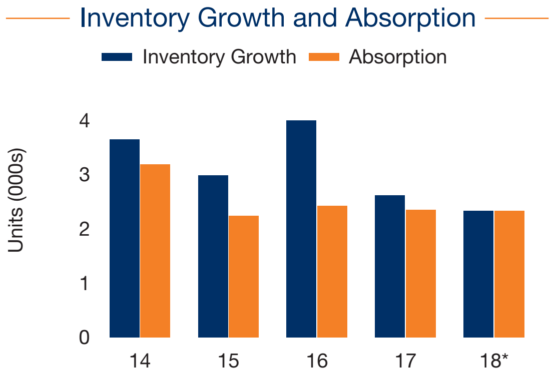
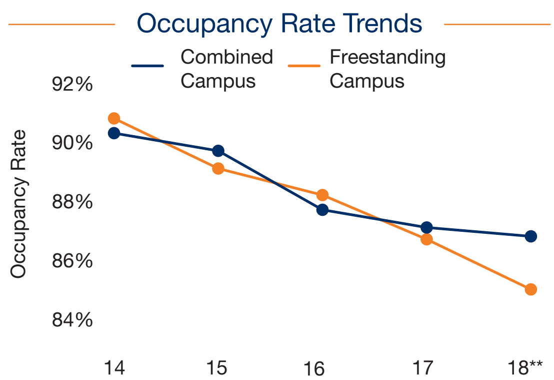
Source: NIC Map Data and Analysis Service (www.nicmap.org)

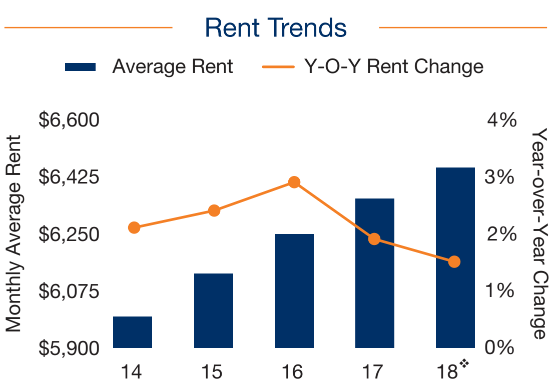
Heightened Deliveries of Memory Care Communities Overshadows Demand

Care needs, rising healthcare costs help push up rents at memory care communities. Based on the NIC MAP® Data Service, a steady pace of construction for memory care communities during the past five years has resulted in the total number of units rising by more than 50 percent since mid-2013. Growth has been strong among both combined and freestanding memory care facilities, with developers adding an average of 2,400 units each year since 2013. Demand has struggled to keep pace with supply additions, resulting in stabilized occupancy falling from above 90 percent five years ago to 85.4 percent in the second quarter. Combined campuses, with a majority of memory care units, have a slightly higher occupancy rate than freestanding facilities. Stabilized occupancy at combined campuses has recovered some over the past year, rising 200 basis points since mid-2017 to 86.8 percent. Average monthly rents at memory care communities are some of the highest among seniors housing property types due to the higher care needs and services of residents. While the pace of rent growth has moderated some over the past year, the average advanced 1.7 percent year over year to $6,437 per month.

Sales activity steady through midyear; investors target freestanding communities. Though the total number of memory care deals traded over the past 12 months matched sales activity from the prior annual time frame, trades of freestanding communities increased. Approximately 50 percent of sales went to private investors, while the limited number of trades to institutional buyers increased. Cap rates ranged between 8 percent and 9 percent, compressing further depending on asset quality and location. Financing for memory care properties is tight, with capital sources preferring to lend on well-performing assets and work with operators who have a proven success record.







2018 Memory Care Outlook

Construction
3,300 units

Low occupancy has developers tapping the brakes on memory care development and the number of units underway at the end of the second quarter reduced by more than 1,000 from the end of 2017.

Occupancy
down 160 bps

Stabilized occupancy reaches 85.2 percent during 2018, the lowest level in 10 years. A thinning construction pipeline and a reduced pace of completions will have a positive impact on future occupancy.

Rent
up 2.0%

The pace of rent growth slows for a second consecutive year, remaining below 2 percent this year as the average rises to $6,453 per month.

Investment

Private capital continues to target memory care facilities this year, though mergers in the industry provide a boost to memory care transaction velocity this year.

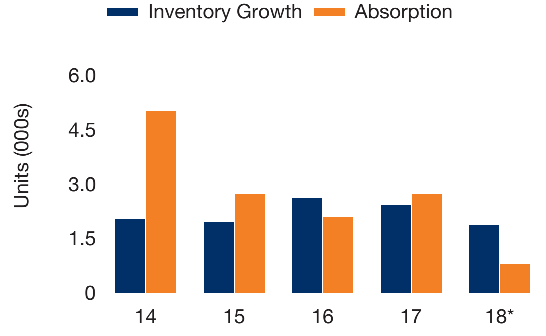
* Trailing 12 months through 2Q2018
** As of 2Q2018
❖ Forecast
Source: NIC Map Data and Analysis Service (www.nicmap.org)

Occupancy Strong as CCRC/LPC Construction Pipeline Continues to Expand

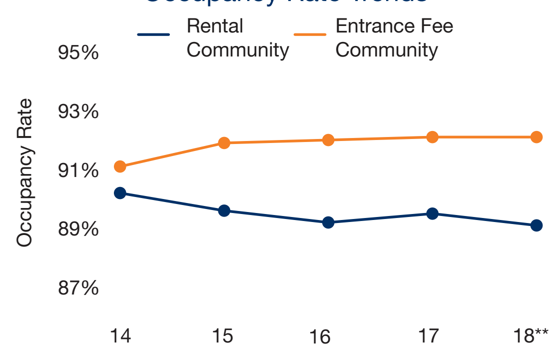
High barriers to entry, range of long-term care options keep stabilized occupancy elevated. Continuing Care Retirement Communities (CCRCs), also known as Life Plan Communities (LPCs), boasted the highest stabilized occupancy rate among all seniors housing community types at 91 percent in June as report by the NIC MAP® Data Service. Entrance fee communities, which carried an average buy-in price of $344,000 during the second quarter, recorded stabilized occupancy at 92.1 percent, compared with rental communities, which posted a stabilized rate of 89.1 percent. Inventory growth in the segment has been steady over the past several years, with additions averaging under 3,000 annually in each of the past six years. The majority of new supply has come online in entrance fee communities. The high costs to move into these facilities deters many residents but also keeps turnover at a minimum as tenants remain in the same community as their care needs change. As a result, monthly expenses can vary and change alongside needs, but averaged $3,192 per month in the second quarter for all CCRC/LPC communities, up 3.3 percent from one year ago.

Transaction activity rising, but overall trading volume still light. A limited number of CCRC/LPC properties change hands each year, but sales activity increased over the past 12 months. The number of entrance fee communities trading doubled from one year ago, and approximately half of all assets were sold to private investors. Sales prices and cap rates for CCRC/LPC communities can vary widely, depending on unit mixes, location, quality and entrance fees. Rental fee properties with a mix of independent, assisted, memory care and skilled nursing units are highly sought after by experienced seniors housing investors.

Inventory Growth and Absorption



Occupancy Rate Trends



2018 CCRC/LPC Outlook

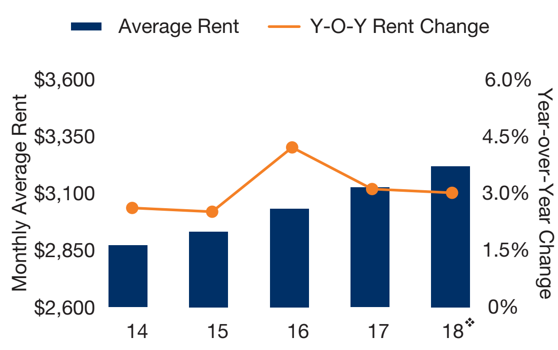
Construction 11,400 units — CCRC/LPC construction has more than doubled over the past five years. At the end of 2013, approximately 5,400 CCRC/LPC units were underway, with the development pipeline growing each year since.

Occupancy down 20 bps — Stabilized occupancy remains above 90 percent this year, a slight dip from one year ago as new supply outweighs demand in 2018.

Rent up 3.0% — Rent growth continues to rise alongside entrance fees during 2018. Average monthly rent at CCRC communities reaches $3,219 per month, building on advances of more than 3 percent during 2016 and 2017.

Investment — Investors in search of communities that serve a variety of resident's needs are targeting CCRC/LPCs this year, and trading volume is on track to outpace activity over the prior two years.

Rent Trends



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Source: NIC Map Data and Analysis Service (www.nicmap.org)

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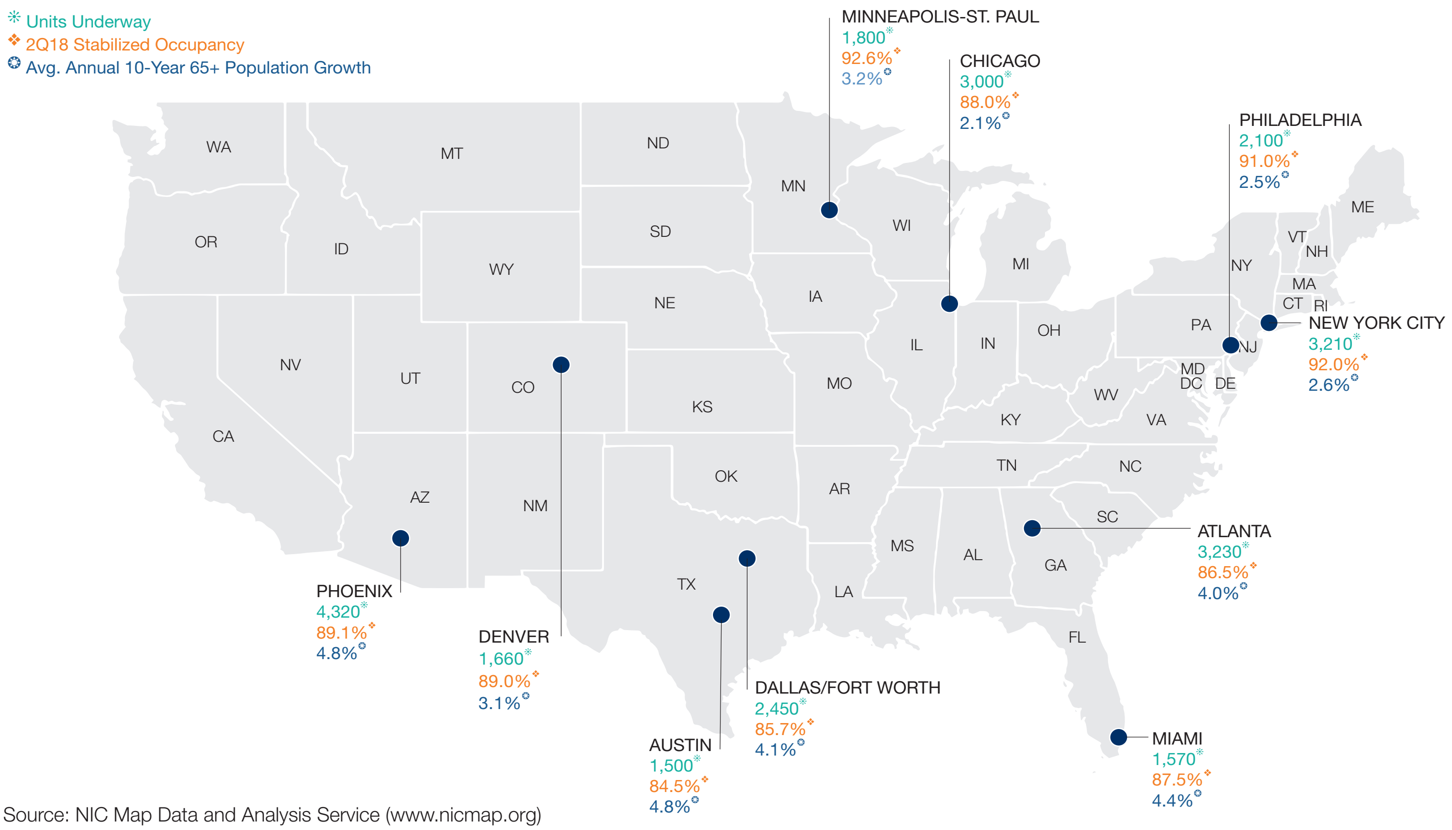
Top 10 Seniors Housing Construction Markets 2Q18



Source: NIC Map Data and Analysis Service (www.nicmap.org)
Units underway and stabilized occupancy represent Majority IL and Majority AL units, which may include some skilled nursing and memory care units when part of a community.

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Price: $250

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Sources: Marcus & Millichap Research Services; American Health Care Association; BLS; Federal Reserve: Consumer Finance Survey; Irving Levin Associates, Inc.; JAMA; Moody's Analytics; National Association of Realtors; NIC Map Data and Analysis Service (www.nicmap.org); Real Capital Analytics; TWR; Social Security Administration; U.S. Census Bureau

Seniors Housing Capital Markets

By DAVID G. SHILLINGTON, President
Marcus & Millichap Capital Corporation

- Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. The Fed appears determined to head off inflation risk by continuing to raise the overnight rate this year. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates, thus increasing recessionary risk levels by weighing on confidence levels and restraining spending.
- A number of financing options are available to seniors housing buyers, including traditional and creative opportunities. Capital is plentiful as lending rates remain historically low, but a bifurcation in buyer and seller expectations, as well as a limited number of operators with the capacity to expand services is impacting the number of deals getting done.
- Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 and again at the beginning of this year, a jump in rates could tighten liquidity. Considering this has happened twice in the past two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.