**SENIOR LIVING**

## Market Update and Financing Options

# Memory Care Development

Every 66 seconds, someone in the U.S. is diagnosed with dementia, the most common form being Alzheimer's disease. As of July 1, 2017, there were an estimated 5.5 million Americans living with the disease according to the National Investment Center for Seniors Housing & Care (NIC).

NIC projects that as baby boomers age, the number of people requiring specialized memory care (MC) will grow 29% to 7.1 million by 2025. That number is expected to balloon to 13.8 million by 2050. This demand growth has spurred a proliferation of MC development. Overall, the number of MC units in the country has increased by 62% since 2010, from approximately 43,000 to 70,000 as of mid-2017. That growth, however, is still not enough. Nationally, an estimated 20,000 additional MC units will need to come to market by 2025 in order to match the expected demand.

### Development Options

Although over-supply is always a concern, it has not prevented senior living owners and developers from racing to complete new construction projects, expansions, and conversions in order to keep up with unmet demand. Many options are viable but each comes with unique strengths and weaknesses.

New construction projects have the competitive advantage of incorporating the latest design trends, newest technology, and most attractive amenities. Today, the market prefers designs that are bigger, brighter, and often segregated by different care levels, all of which are difficult to obtain by renovating or converting an older facility. Furthermore, the per-unit cost to build a new MC facility can be less expensive than buying a stabilized facility. Despite the compelling case for new construction, not all owners and developers have an appetite for the lease-up risk or time and effort associated with building new, which leaves expansions, conversions, and acquisitions as attractive alternatives.

In addition to largely avoiding lease-up risk, an expansion or conversion can reduce the risk profile of a facility by offering the complete continuum of care. Allowing residents to age in place without requiring a move for health reasons is very attractive to senior residents, as well as being an embedded referral source for senior living operators. Continuum of care facilities are also typically larger, resulting in smaller percentage fluctuations in occupancy and economies of scale. However, as the industry gains a stronger understanding of Alzheimer's disease and the required specialized care, some providers are opting for stand-alone MC facilities. This largely differs from the assisted living (AL) model, which primarily acts as an optional service to aid in daily activities of living. A stand-alone MC facility offers staff specifically trained in dementia care, floor plans encouraging wandering and sensory stimulation, specialized programming, and built-in technology helping caregivers track residents and compensate for residents' memory loss.

So, which is the right model—continuum of care or stand-alone? From a care provider's perspective, the market suggests continuum of care. According to *The SeniorCare Investor*, average cap rates from 2015 to 2016 were 7.9% for a facility offering AL and MC (i.e. continuum of care), 8.3% for stand-alone AL, and 8.7% for stand-alone MC. In 2016, communities with AL and MC sold on average for $88,800 per unit more ($225,400 vs. $136,600) than stand-alone AL properties according to *The SeniorCare Acquisition Report 2017*. The spread increased 41% over 2015 valuations. Per unit pricing for stand-alone MC facilities was unavailable, but the average cap rates suggest there would be a similar or even greater disparity.

### What's Getting Done Today?

The table below provides a sample selection of some recent projects, as well as key deal facts.

| | | | As-Is Units | | | As-Complete Units | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Facility type** | **Development type** | **State** | **Total** | **AL** | **MC** | **Total** | **AL** | **MC** | **Cost per new unit (excl. land)** | **UW cap rate** |
| MC | New Construction | CA | - | - | - | 42 | - | 42 | $282,351 | 7.75% |
| AL/MC | New Construction | CA | - | - | - | 142 | 106 | 36 | $269,873 | 7.00% |
| MC | New Construction | WI | - | - | - | 54 | - | 54 | $255,944 | 8.50% |
| AL/MC | Expansion | OH | 120 | 120 | - | 156 | 120 | 36 | $214,466 | 8.50% |
| AL/MC | New Construction | TN | - | - | - | 79 | 63 | 16 | $168,761 | 8.00% |
| AL/MC | New Construction | IN | - | - | - | 124 | 108 | 16 | $164,733 | 7.75% |
| AL/MC | Expansion | IN | 72 | 72 | - | 111 | 81 | 30 | $137,000 | 8.25% |

*Source: Lancaster Pollard*

The cost per new unit ranges from $137,000 to $282,351 and averages $213,304. The variance is largely driven by location with the coastal and metropolitan markets driving higher construction costs. Cap rates range from 7.00% to 8.50%. The average cap rate is 8.13% for stand-alone MC and 7.90% for AL/MC. The average unit mix is 78% AL/22% MC for continuum of care facilities.

## Financing Options

Nationally, lenders are looking for strong operating histories. Regional and local owners/operators with a strong history of development and solid credit profiles can expect to be able to finance their project. However, each financing source has its strengths and limitations, so owners/operators must balance the tradeoffs accordingly. When it comes to funding a new build or conversion/expansion project there are a number of financing choices for borrowers:

The U.S Department of Housing and Urban Development (HUD)/Federal Housing Administration (FHA) and the U.S. Department of Agriculture (USDA) offer several programs for construction financing. Low, long-term fixed interest rates and flexible terms make financing options from these agencies more affordable and attainable for many borrowers, provided they meet program requirements.

HUD/FHA has two construction financing programs for MC projects—Sec. 232 New Construction or Substantial Rehabilitation and Sec. 241(a). Both offer construction and permanent 40-year non-recourse loans with fixed interest rates currently below 5.00%, including the mortgage insurance premium. The Sec. 232 construction programs limit leverage to 90% of mortgagable costs which excludes working and operating deficits. The Section 241 program is a second loan for an existing HUD-insured community. Leverage is again limited to 90% of mortgagable cost. However, it is not uncommon for the initial operating deficit to be lower since often the original portion of the building is producing cash flow. For certain conversion/expansion projects, Sec. 232/223(f) may also provide a viable funding option; however, under this refinancing program the total repairs/improvements must be less than 15% of the project's current market value. As such, it works best for small conversion/construction projects. The Sec.232/223(f) program can also be used to acquire facilities. The program allows for maximum loan proceeds equal to 85% of purchase price or 80% loan to value, whichever is less.

USDA finances senior living projects under the Community Facilities (CF) and Business and Industry (B&I) Loan Guarantee programs. The CF program, available to public borrowers and nonprofit organizations in rural areas of up to 20,000 in population, provides both direct loans and guaranteed loans for up to a 40-year term. The CF program is typically limited to permanent financing, so borrowers will need to obtain a construction loan with the CF loan as the takeout mechanism to the construction financing. The B&I program, available to both for-profit and nonprofit organizations, guarantees loans made by eligible lenders for up to a 30 year amortization. B&I loans, generally limited to a maximum of $10 million, can be used for the construction of senior housing facilities in rural cities with up to a population of 50,000; however, priority is given to applications for loans in rural communities of 25,000 or less.

For experienced owners/operators with multiple sites, commercial banks serve as a viable source of capital for new construction and conversion/expansion projects. In general, construction loans will price at some spread above a benchmark index like the one-month LIBOR with a term between three and five years. Like many other financing options, commercial banks will require a first mortgage on the real estate and equipment, security interests in a facility's licenses and accounts receivable, and a priority claim to existing leases and management contracts in the event of a foreclosure. Unlike agency financing, however, a commercial bank will likely require guarantees from the borrower and operating company until the newly constructed facility has reached stabilization. Typical financing terms from commercial banks limit the total loan-to-cost to 70% with pricing being one-month LIBOR (or another comparable index) plus a credit spread between 325 to 450 basis points.

Unenhanced, rated and non-rated bond offerings and private placements also are potential sources of capital for both nonprofit and for-profit organizations. Historically, nonprofit organizations accessed federally tax-exempt financing via a conduit issuing authority. Likewise, for-profit organizations had the ability to access tax-exempt financing pursuant to Section 142(d) of the Internal Revenue Code of 1986. For either organizational type, these bonds are referred to as private activity bonds (PABs). Bond financing is attractive since it carries no personal recourse (except potentially in cases of fraud), amortization periods in excess of 30 years, and high leverage. For example, it is not uncommon to have a leverage point near 90% of cost. The cost of capital varies depending on the organization's credit profile, but ranges from near 5% (rated, nonprofit) to approximately 7% (non-rated, for-profit) in the current market.

However, this funding source is potentially on the chopping block due to tax reform. Presently, the House of Representatives' tax plan eliminates the issuance of PABs. The Senate's markup retains PABs, but this will certainly be a topic of debate as the chambers attempt to reconcile the two bills.

As with many endeavors, the key to a successful financing begins with planning. For owners/operators considering expansion or new development, involving a lender to explore specific financing options is advised as early as possible.

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