FEATURE

2017 Seniors Housing and Care Market Outlook

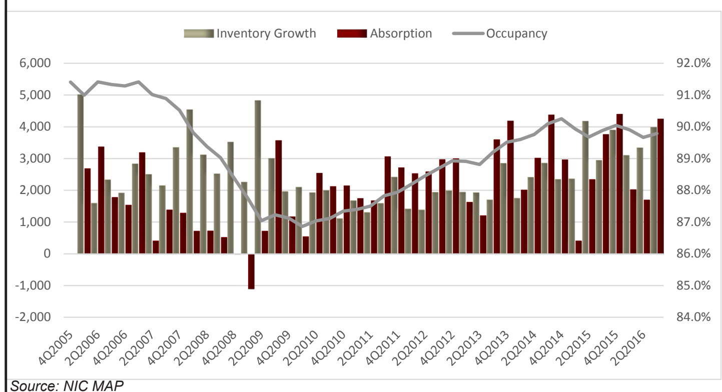
The past 12 months have been quite eventful for the health care market, especially the seniors housing and care sector. There have been massive deals, real estate investment trust (REIT) divestitures of skilled nursing facilities (SNFs), concerns of overbuilding and changes in payor mix. While there are a number of uncertainties regarding the health care market and 2017, one thing is certain—changes are coming. We take a look at recent market data to shed light on the past 12 months, identify trends, and provide a big picture analysis of what the industry looks like as 2017 begins.

Seniors Housing Occupancy Trending Sideways

After establishing its recessionary trough of 86.9% in 2010, the seniors housing occupancy rate had been in recovery mode through 2014, recovering all the way to 90.3%. But since 2014, the occupancy rate has been trending sideways in a range between 89.7% and 90.3% (Figure 1). Higher levels of supply growth are to blame for the meandering. Counting the third quarter of 2016 and the previous seven quarters, the seniors housing inventory in the top 31 metropolitan statistical areas (MSAs) has been growing by an average of 3,277 units per quarter. That is a rise of 50% over the previous eight quarters when it was growing by an average of 2,189 units per quarter.

Looking to 2017, the occupancy rate will likely be challenged by elevated levels of supply growth. At the end of 2016, in the primary markets, there were over 32,000 units at seniors housing properties under construction per the National Investment Center (NIC). Assuming 60% to 80% of the construction pipeline delivers in 2017, the primary markets stand to see inventory growth of between 4,843 and 6,457 units per quarter. As such, expect choppiness in the NIC primary markets occupancy rate in 2017.

Figure 1: Seniors Housing Occupancy Trends 2006 to Present, NIC Primary Markets



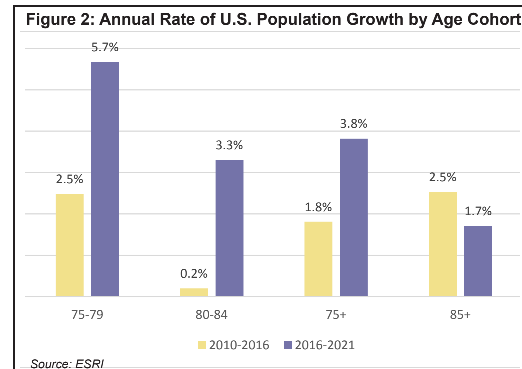
Source: NIC MAP

Medium Term Outlook – Will Demand Outpace Supply?

As we look at the likelihood of higher supply growth it is important to understand the key component of underlying demand—the age eligible population that seniors housing communities appeal to. The growth rate of population aged 75-and-older is key to the industry's prospects for future growth. It also stands to reason that the supply of seniors housing units should not be growing materially faster than the age eligible population. According to NIC MAP, the seniors housing supply has been growing by an average annual pace of 2.8% for each of the past four quarters. In the fourth quarter of 2016, the growth rate was 3.1%. So how does the growth rate of age eligible population stack up?

Figure 2 shows the annual rate of U.S. population growth by age cohort for the period 2010 to 2016 and 2016 to 2021. The 75-and-older population is expected to grow by 3.8% from 2016 to 2021. The 75 to 79 age group is expected to grow by 5.7% and the 80 to 84 age group is expected to grow by 3.8% from 2016 to 2021. All these age groups are expected to grow at a faster rate during 2016 to 2021 than they did from 2010 to 2016. They are also all expected to grow faster than current rates of inventory growth (3.1%). The one exception is the 85+ age group which should see its growth slow from 2.5% to 1.7%.

Figure 2: Annual Rate of U.S. Population Growth by Age Cohort



Source: ESRI

Underlying Payor Mix Trends Leading to a Challenging Operating Environment

The skilled nursing industry, which had been enjoying a benign reimbursement environment, has seen a noticeable change in payor mix trends since 2015. Figure 3 shows the payor mix trend for Medicaid, Medicare and Managed Care for SNFs.[1] It shows that the Medicaid mix has risen from 62.2% in 2015 to 66.5% as of the third quarter of 2016. It also shows that the skilled mix (Medicare plus Managed Care) has declined in SNFs from 27.4% in 2015 to 23.8% in the third

1. National Investment Center, "Skilled Nursing Data Report: Key Occupancy & Revenue Trends," based on data from October 2011 through September 2016.

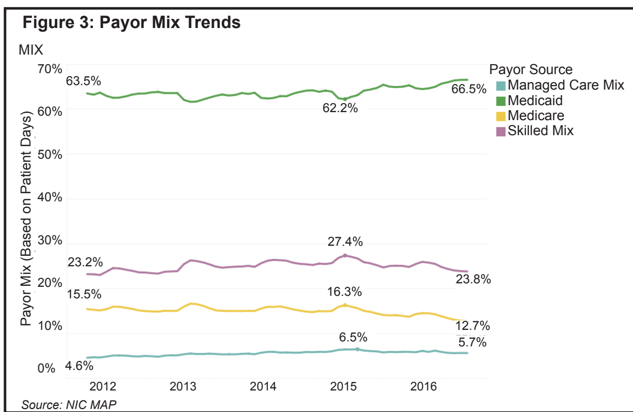


Figure 3: Payor Mix Trends

quarter of 2016. This paints a challenging picture for SNF operators as they are likely trading higher revenue Medicare and Managed Care patients in favor of more lower-revenue Medicaid residents. This has led to an overall year-over-year (YOY) decline of 2.2% in revenue per occupied bed (as of the third quarter of 2016).

What is driving this change? Taking a look at the publicly traded operators and owners can provide some insight. For example, Genesis Healthcare (NYSE: GEN) reported that in the third quarter of 2016 they experienced a decline in occupancy and skilled mix. That was due principally to the impact of health care reforms resulting in lower lengths of stay (LOS) among the skilled patient population and lower admissions caused by initiatives among acute care providers and Managed Care payers to divert certain skilled nursing referrals to home health or other community based care settings. Several SNF companies have suggested that lower length of stays are being driven by Medicare Advantage which has an average LOS of around 19 days versus approximately 23 days for traditional Medicare. Quality Care Properties (NYSE: QCP) is also reporting a challenging operating environment for its tenant, HCR ManorCare (HCRMC). QCP reported that HCRMC's quarterly earnings before interest, taxes, depreciation, amortization and restructuring or rent costs (EBITDAR) declined by 10% on a year-over-year basis in the third quarter of 2016 and attributed the decline to a weaker flu season, continued payor mix shifts, shorter lengths of stays, and operational disruptions from non-strategic asset sales.

The Financing Environment is Mostly Open

Given the supply concerns in seniors housing and the challenges skilled nursing operators are facing, are we seeing any reaction from lenders and investors to the sector? The answer is—sort of.

For investors, we can examine volumes and pricing trends. According to Real Capital Analytics (RCA), transaction volume for seniors housing and SNF properties was $15 billion for the year ended third quarter of 2016. This is down 30% from one year earlier. Transaction volume has slowed primarily due to a slowdown in buying activity on the part of REITs. RCA says that REITs have made up 30% of the buying activity in 2016 versus 57% in 2015. Regarding pricing, average cap rates are showing a pause from their recent trend of compressing. The average third quarter 2016 capitalization rate was 8% and 12.5% for seniors housing and skilled nursing, respectively. These rates are up from recent figures of 7% for seniors housing and 11.5% for skilled nursing. This implies, on average, that valuations have ticked down from recent peaks. It is too early to tell if this is a trend but it bears watching as 2017 unfolds. Interestingly, there was a ten percentage point drop from 2016 to 2017 in Lancaster Pollard's "2017 Seniors Housing Survey" among respondents who stated a likelihood to pursue an acquisition in the next 12 months. Relatedly, there was a 43 percentage point drop (22% vs. 65%) in respondents who are likely to sell a facility in the next 12 months.

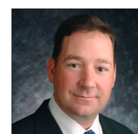
Bank lending was generally slow to recover after the great recession. According to the Federal Reserve, commercial real estate lending did not begin to recover after the recession until 2011 and 2012. Regional and local banks generally are the main source of construction financing for the seniors housing industry. They became active and were increasing their lending between 2012 and 2016, which enabled industry construction levels to rise. However, the Fed's data is showing a recent slowing of loan growth and other data from the Fed suggests that lenders are beginning to tighten underwriting standards. This may help to slow new construction starts in 2017.

Fortunately, for the industry, the U.S. Department of Housing and Urban Development (HUD) and the government-sponsored entities (GSEs) remain active. The Federal Housing Administration (FHA) Section 232 program reported that 2016 full year commitments totaled $2.84 billion, an increase of 5% over the previous year. Lancaster Pollard's "2017 Seniors Housing Survey" reflects a shift toward HUD/FHA as well. Thirty-five percent of respondents said they are considering HUD for financing construction/acquisition debt in 2017, up five percentage points versus 2016. In addition, Fannie Mae had a strong year as it recently reported it had $1.6 billion in seniors housing production in 2016.

So what does all this data mean? In the short term, while the lending environment will remain active, new construction lending, particularly from banks due to High Volatility Commercial Real Estate (HVCRE) regulations, should constrict as underwriting becomes more conservative and interest rates gradually march higher. Additionally, the SNF sector should continue to see a pullback from valuation highs given the previously referenced headwinds and retreat of some REIT capital. However, the pullback should be softened by an increasing amount of private equity, both domestic and foreign, flowing into the sector. The large spread between SNF cap rates and today's low-cost of borrowing capital simply cannot be ignored.

And while the seniors housing market (AL/IL) is being overbuilt in some metro markets, sub-markets are what matter. Top operators will still be able to capture necessary market share, even in developed markets, to succeed; sometimes at the expense of less sophisticated operators with older assets. And of course, the forecasted surge in demand for senior living is not adequately being met by new supply, providing a bedrock of relative stability to the sector for the foreseeable future.

That's how things look now. But, with all of that said, those in the seniors housing and care industry would be wise to keep one eye on Twitter because who knows what curve balls may come from Washington that could affect reimbursement, construction and financing.



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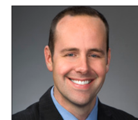

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