

# The U.S. Senior Housing Opportunity: Investment Strategies

BY DAVID LYNN, Ph.D. AND TIM WANG, Ph.D.

With favorable demographic fundamentals and the achievement of higher yields relative to conventional apartments, we believe that the senior housing sector is emerging as an increasingly attractive investment opportunity. The senior population, defined as persons age 65 and older, is growing at twice the national average, with many baby boomers entering retirement. Consequently, the senior housing market is expected to transition from a niche market to a major specialized market, with the long-term outlook for this property sector becoming increasingly positive. Facilitated by a restrained supply pipeline over the past six years, occupancy levels for senior housing assets rebounded from lows recorded in 2001-2002 to near 90 percent today in many metro areas. Operating business models are better-defined, contributing to strong revenue growth and higher profit margins. Annual rent growth in the sector remains a healthy four to five percent. In response to improved operations and increased investor interest, asset prices are increasing to record levels while cap rates are falling to single digits, ranging from seven to nine percent. The cap rate spread between senior housing and conventional apartments has declined from 300 basis points (bps) to 150-175 bps. Since the senior housing market is driven by surging senior population and not directly related to external economic factors such as economic growth and the unemployment rate, the addition of senior housing assets to a portfolio could increase diversification and lower market risk. Different investment strategies are outlined and discussed.

## BACKGROUND

A relatively young industry, senior housing development took flight in the early 1980s when developers and investors recognized the potential to benefit from the anticipated surge of the elderly population in the United States. Numerous small, mom-and-pop and not-for-profit operators dominated the industry during its nascency.

The industry expanded significantly in the late 1980s when a U.S. Department of Housing and Urban Development (HUD) program was implemented, with the senior housing sector in mind, to insure lenders against losses on mortgage defaults. As a result, private capital began to flow into the sector.<sup>1</sup>



## About the Authors

**David Lynn, Ph.D.**, is a managing director of ING Clarion Partners and head of the firm's U.S. Research and Investment Strategy group. He is responsible for the strategy and research support for portfolio management, acquisitions and marketing services. He has more than 20

years of real estate investment experience.



**Tim Wang, Ph.D.**, is a vice president of ING Clarion Partners and senior investment strategist at the firm's U.S. Research and Investment Strategy group. He is responsible for macroeconomic analysis, portfolio strategies, market forecast and client services.

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The mid-1990s witnessed the rapid growth of Real Estate Investment Trusts (REITs) and the emergence of the private commercial mortgage-backed securities (CMBS) market. The securitization of loans collateralized by senior apartments and skilled nursing homes increased steadily during the late 1990s.

Because of excess capital available from the public markets, the senior housing sector, especially the assisted living segment, was overbuilt during the late 1990s. The market outpaced itself as developers built properties at a rate that well exceeded demand, resulting in over-supply.<sup>2</sup> Compounding the problem was the fact that product designs did not meet the needs of target markets. Consequently, average occupancy rates declined, and many projects failed to meet investment expectations.

Depressed stock prices from 1999 to 2000 limited the supply of new equity financing, but offered attractive valuations for acquisition targets, prompting a surge of mergers and acquisitions (M&A) among senior housing REITs. At the same time, several healthcare REITs shifted from growth strategies to liquidation strategies in order to address debt problems. Finally, accounting scandals, operational issues, higher interest rates and excessive debt caused the industry to restructure and consolidate.<sup>3</sup>

Today, industry business models have become more defined. Occupancy and operating margins are improving to near six-year highs and the industry is reporting healthy year-over-year revenue and NOI growth. As a result, institutional investors are increasing their acquisitions in the sector, the result of which is helping to drive cap rates to new lows. Although a variety of reimbursement and operational issues remain, both the near- and long-term outlooks for the senior housing sector are increasingly positive.

### DEFINING SENIOR HOUSING

The senior housing sector is generally composed of five segment types, defined by the level of care and amenities provided in conjunction with the living setting.<sup>4</sup> The industry has developed well-defined business models for each segment.

**Active Adult Communities and Senior Apartments (for-sale and for-rent):** Active adult communities are typically condos, co-ops or single-family homes with minimal or no services offered. These communities have an age requirement of 55-plus and offer a number of

amenities, such as clubhouses, which appeal to active adult homeowners. Senior apartments tend to be larger, multi-unit facilities with a rental payment structure. In addition to age restrictions, many communities have income restrictions because they are developed under low-income housing tax credit programs.

**Independent Living Facilities (ILFs):** Also known as congregate care facilities, ILFs offer a multi-family design to those seniors who are less active and who may have difficulty with routine housekeeping. These facilities are similar to senior apartments, but offer several additional services, such as meals, housekeeping, transportation and organized group activities. Residents typically rent apartments at ILFs at a premium to local market rents in order to cover the cost of common area charges and the additional services provided.

**Assisted Living Facilities (ALFs):** ALFs are multi-family properties with personalized support services for seniors. Typically, ALFs cater to individuals who need assistance with daily activities, but do not require nursing home care. The units and common areas are designed to accommodate a higher level of support, while still retaining the characteristics of residential apartments. ALFs are a cost-efficient alternative to in-home care because they primarily provide non-medically intensive support activities. A property that specializes in the care of residents with Alzheimer's or other forms of dementia is also considered an assisted living property. These memory care facilities can be freestanding properties or wings or floors within a traditional assisted living property.

**Skilled Nursing Facilities (SNFs):** SNFs provide the highest level of care, are hospital-like in nature and are, consequently, the most expensive of all senior housing options. In addition, SNFs are also the most highly regulated of the senior housing facilities, typically requiring state licenses. Many SNFs offer acute and intensive medical care, and post-hospitalization and rehabilitation therapies. Medicare and Medicaid programs cover a large portion of these expenses, with such government reimbursements accounting for a significant portion of revenue at these facilities.

**Continuing Care Retirement Communities (CCRCs):** CCRCs combine attractive residential living with high levels of service designed to address the comfort, health,

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wellness, security and developing needs of aging seniors. Essentially a “one-stop shop,” CCRCs offer comprehensive, continuing-care services at one location, by providing skilled nursing facilities mixed with large numbers of independent living and assisted living units. Residents may also receive medical care on-site, the costs of which are all reimbursable by Medicare and Medicaid programs. In addition to a monthly fee, there is typically a large, one-time entry fee to enter a CCRC. CCRCs, many of which are not-for-profit and are religiously-affiliated, are the smallest segment within the senior housing market because they are costly to build, and due to the complex local regulatory approval process, time-intensive to develop.

**Real Estate vs. Service:** Whether senior housing constitutes a real estate investment or a service industry invest-

ment is determined by the specific type of facility. The services provided by most senior housing facilities include hospitality, healthcare, education and recreation. Clearly, active adult communities provide residences, which represent real estate investments. Conversely, skilled nursing facilities provide support services, and logically should be considered primarily a service business investment. The remaining types of facilities provide a mix of both services and housing. Independent living facilities provide meal and linen services but, for the most part, are primarily considered a real estate investment. The more support-intensive segments, such as assisted living, should logically be considered a form of healthcare real estate—a combination of an operating business and a real estate investment. Finally, CCRCs

Figure 1

### Targeted Senior Groups

Medical Acuity Level	Continuum of Elderly Care	Independence Level
75%	Skilled Nursing Facility (SN)	25%
40%	Assisted Living Units (AL)	60%
25%	Congregate Living Units (CL)	75%
10%	Independent Living Units (IL)	90%
0%	Community Living Options/ Active Adult (AA)	100%

Sources: ING Clarion Research & Strategy, National Investment Center

Figure 2

### Product Offerings Among Segments

	ACTIVE ADULT	INDEPENDENT LIVING	ASSISTED LIVING	SKILLED NURSING
Target Age Group	55-65	65-75	75+	As needed
Service Level	No	Medium	High	High
Care Level	No	No	Medium	High
Structure	Condo	Rental	Rental	Rental
	Rental (limited)	Condo (limited)		
Real Estate Product	Single family Multifamily	Multifamily	Multifamily	Multifamily
Recreational Amenities	Clubhouse	Typically on 1st floor	Typically on 1st floor	Typically on 1st floor

Sources: American Seniors Housing Association, ING Clarion Research & Strategy

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blend substantial care services with residential services.

The above five senior housing segments target different subgroups within the elderly population by providing different levels of housing needs and services. Monthly fees for senior housing increase as the required level of service increases. Historically, the service business has generated higher yields than residential real estate and, not surprisingly, the more service-intensive categories, such as assisted living and skilled nursing, generate higher yields than the less service-intensive active adult communities and independent living categories. The perceived investment risk for the individual categories appears to rise as the service business component increases.<sup>4</sup>

### TARGETED SENIOR GROUPS

There are mainly three large, distinct groups that comprise the senior population:

**Baby Boomers (age 44-62):** The baby boomers are the largest generation in U.S. history, constituting a sizable demographic wave. With 82.8 million people born between 1946 and 1964, the baby boomers represented about 30 percent of the U.S. population in 2007<sup>5</sup>, with estimated annual spending of \$2 trillion.

Baby boomers tend to seek maintenance-free living, easy lifestyles, more leisure time, new experiences, and prefer multiple options, customization and control. As they enter their peak earning years, baby boomers' lifestyle preferences and spending patterns should be closely monitored. By 2011 the first wave of baby boomers will turn 65 years old.

**Silent Generation (age 63-83):** Nearly 50 million Americans were born into the Silent Generation between 1925 and 1945. Members of this cohort experienced the Great Depression in the 1930s and were raised prior to the fast-paced growth of the 1950s. Most of this generation is now retired.

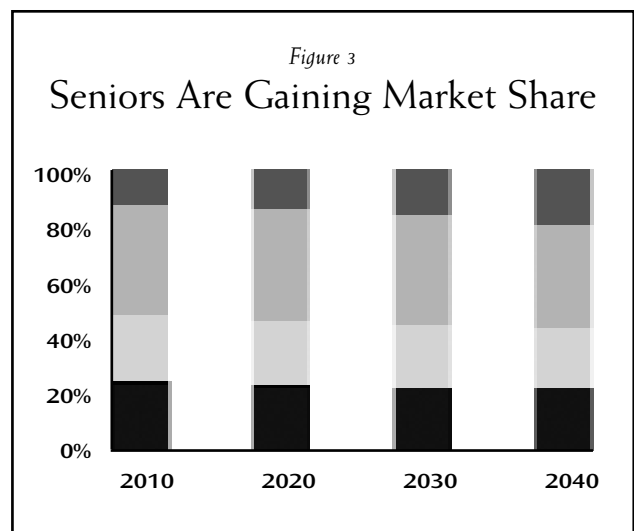
**GI Generation (age 80-plus):** The members of the GI Generation are the World War II-era seniors. In general, this group is fiscally conscious and conservative. Because of their age, members of the GI Generation tend to need considerable medical support and personalized care. Different products target different age groups with different needs.

### DEMAND FACTORS

There are several factors contributing to increased demand for senior housing including: demographic trends, geographic distribution, lifestyle preferences and needs, market penetration and affordability.

**Demographic Trends:** The share of the population age 65 and older has been steadily increasing since 2000, with more than a half million people joining that cohort each year. The U.S. Census Bureau projects that the senior population will account for approximately 20 percent of the U.S. population by 2030, up from less than 13 percent today. It is projected that within five years, the population of persons age 65 and older will increase from 16 million today to about 40 million.<sup>6</sup> Thereafter, the senior population will be the only major age cohort to gain share in the overall U.S. population. By 2010, the senior housing market is expected to transition from a niche market into a major specialized market.

Demographic trends underscore the growing demand for senior housing. In the short-term (2005-2010), demographic trends are expected to support strong demand growth in two groups: the population aged 55-64



and the population age 85 and older. The population growth rate for the U.S. is expected to be slightly less than one percent per year over the next 10 years. Notably, the population age 85 and older is projected to grow at approximately three times the national rate through 2010.<sup>7</sup>

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Figure 4

## Compound Annual Growth Rate

	Short-term 2005-2010	Intermediate-term 2010-2015	Long-term 2015-2020
Population 55-64		2.40%	1.70%
Population 65-74	2.80%		
Population 75-84	-0.30%	0.70%	2.00%
Population 85+		2.00%	1.60%
<i>Source: U.S. Census Bureau, ING Clarion Research &amp; Strategy</i>			

In the mid-term (2010-2015) and long-term (2015-2020), the population aged 65-74 is expected to realize the strongest growth, averaging more than four percent growth annually.<sup>8</sup> This rapid acceleration is expected to commence in 2010, as the baby boomers begin to reach their mid-70s, prompting yet another surge in senior housing demand. The population age 85 and older is expected to grow at a steady level over the projection period, a result largely attributable to advances in medical care and increasing longevity.

**Geographic Distribution:** The largest concentration of senior population growth is in the nation's southern and western states. Indeed, Florida, Texas, Virginia, Maryland, North Carolina, South Carolina, and Tennessee are projected to account for about 40 percent of population increase in persons age 65 and older in this decade, with California, Arizona, Washington, Nevada, and Colorado expected to account for another 26 percent of the same.<sup>9</sup>

**Lifestyle Preferences and Needs:** Demographics play just one role in this complex market as demand from seniors also depends on the nature of their housing preferences. As people age, their need for assistance in daily living activities such as eating, dressing, standing, sitting, walking and taking medications properly will inevitably increase. However, today's seniors are comparatively healthier, and tend to live longer than previous generations.<sup>10</sup> Not surprisingly, many seniors prefer to remain in their own homes for as long as possible, with the majority preferring to own rather than rent. Therefore, the homeownership payment structure and residential qualities of senior housing facilities are becoming increasingly popular.

Growing numbers of seniors are occupying senior-specific residential real estate, suggesting increased acceptance of the senior housing lifestyle. The penetra-

tion rate, or percentage of senior households choosing to move to senior housing, has recently been increasing at a rate of approximately four percent per year. The overall compound growth rate of this trend over the past 10 years has been approximately six percent per year.

**Age Restriction:** Specific age restriction is a gray area in such an age-restricted community. In 1995, Congress passed the Housing for Older Persons Act (HOPA) defining the criteria for an age-restricted community:<sup>11</sup>

- It is intended and operated for occupancy by persons 55 years or older.
- At least 80 percent of the units are occupied by at least one person who is 55 years or older. Or 100 percent of units are occupied by persons 62 years or older.
- It complies with and enforces the age restriction through written policy and age verification.

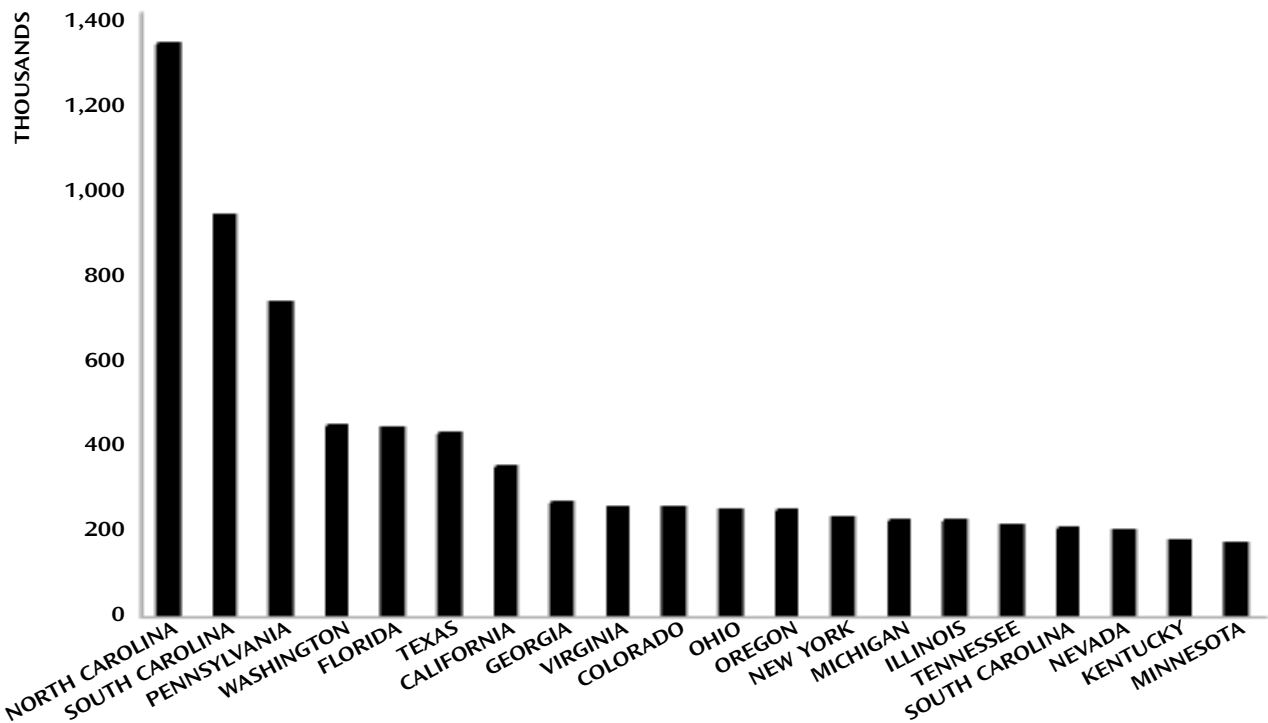
It is noted that the Housing for Older Persons Act is concerned with who is residing in the unit, not who owns the unit. Furthermore, state and local regulations could be stricter than the federal standards. In this case, the community must comply with the stricter legal requirements.

**Market Penetration:** Market penetration is a major factor of demand. The total pool of seniors is actually much larger than the number of seniors currently residing in senior housing. Many of the published estimates for demand, which include individuals already residing at these facilities, understate potential demand. Notably, even without an increase in the penetration ratio of the industry to the larger pool, favorable demographic trends are expected to produce annual demand growth of approximately two percent or greater.

However, not all the senior population will constitute effective demand for senior living facilities. First, a

Figure 5

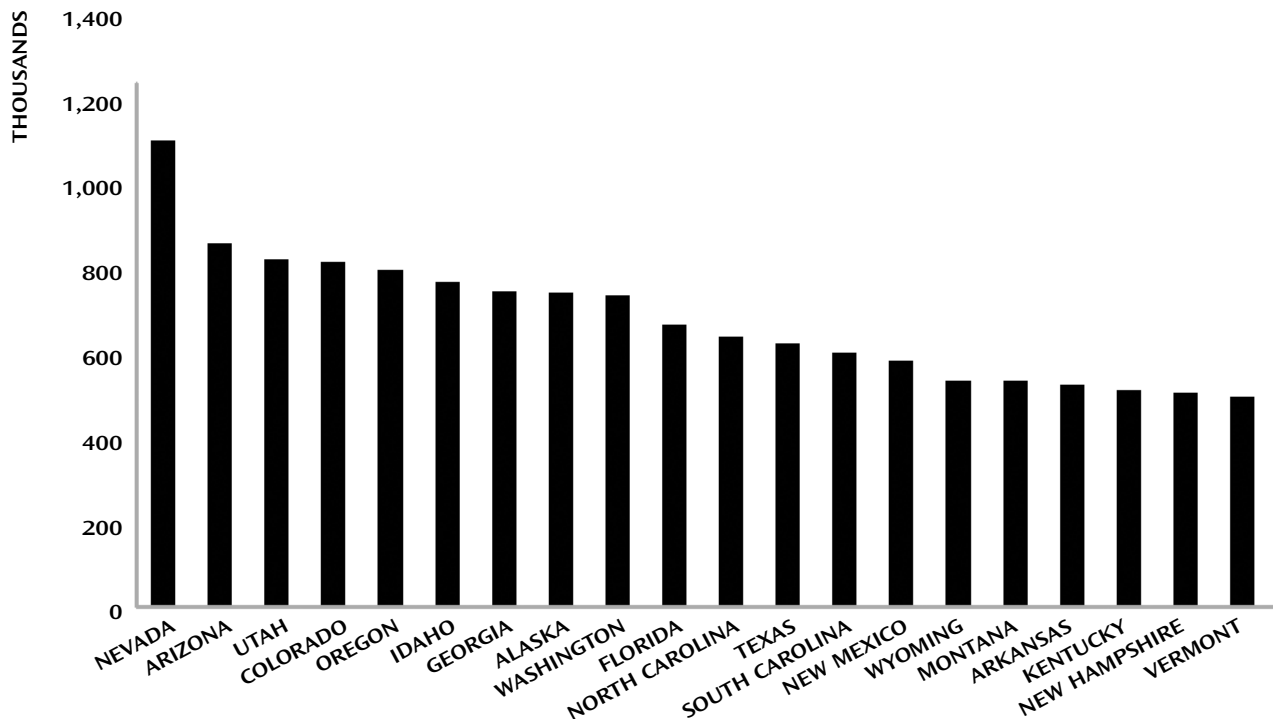
States with the Greatest Numerical Change in Population 65-plus (Projected), 2005-2010



Sources: ING Clarion Research & Strategy, Moody's Economy.com

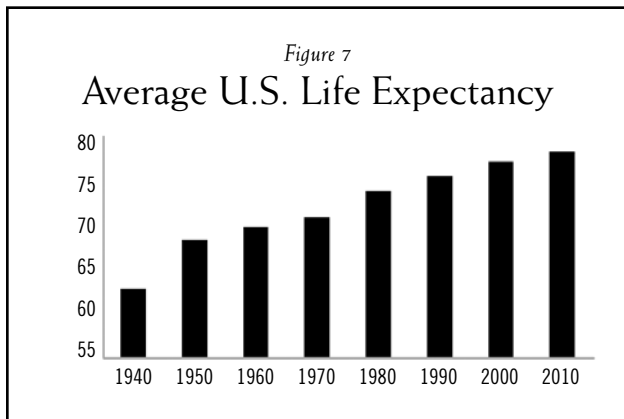
Figure 6

States with the Greatest Percentage Change in Population 65-plus (Projected), 2005-2010



Sources: ING Clarion Research & Strategy, Moody's Economy.com

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substantial number of elderly continue to reside in self-owned single-family homes. Second, many seniors reside with spouses, roommates or family. After adjusting for these factors, the current estimate for the number of seniors who are renting or will rent senior housing in the target demographic cohort of persons age 75 and older is approximately three million (out of 18.2 million). At present, this senior renter group is increasing by approximately 100,000 households per year.

**Affordability:** cost effectiveness may play a significant role in the demand for senior housing. A study by the Assisted Living Federation of America (ALFA) determined that the average daily rate at an assisted living facility is approximately 85 percent of home healthcare cost, and 65 percent of the cost of residence at a skilled nursing facility.<sup>12</sup>

### SUPPLY FACTORS

**Historic Perspectives:** Since the late 1990s, the development pipeline for senior housing has declined significantly. New senior construction in 2002 was approximately 80 percent less than that in 1999.<sup>13</sup> This decrease was largely attributable to the decline in investment interest and invested capital after the late 1990s. Over the past few years, senior housing construction activities have increased; however, the net new construction for independent living and assisted living is still relatively constrained.

**New Development:** The 2007 American Seniors Housing Association (ASHA) and National Investment Center (NIC) Senior Housing Construction Survey identified 35,880 senior housing units that began construction between April 1, 2006 and March 31, 2007,

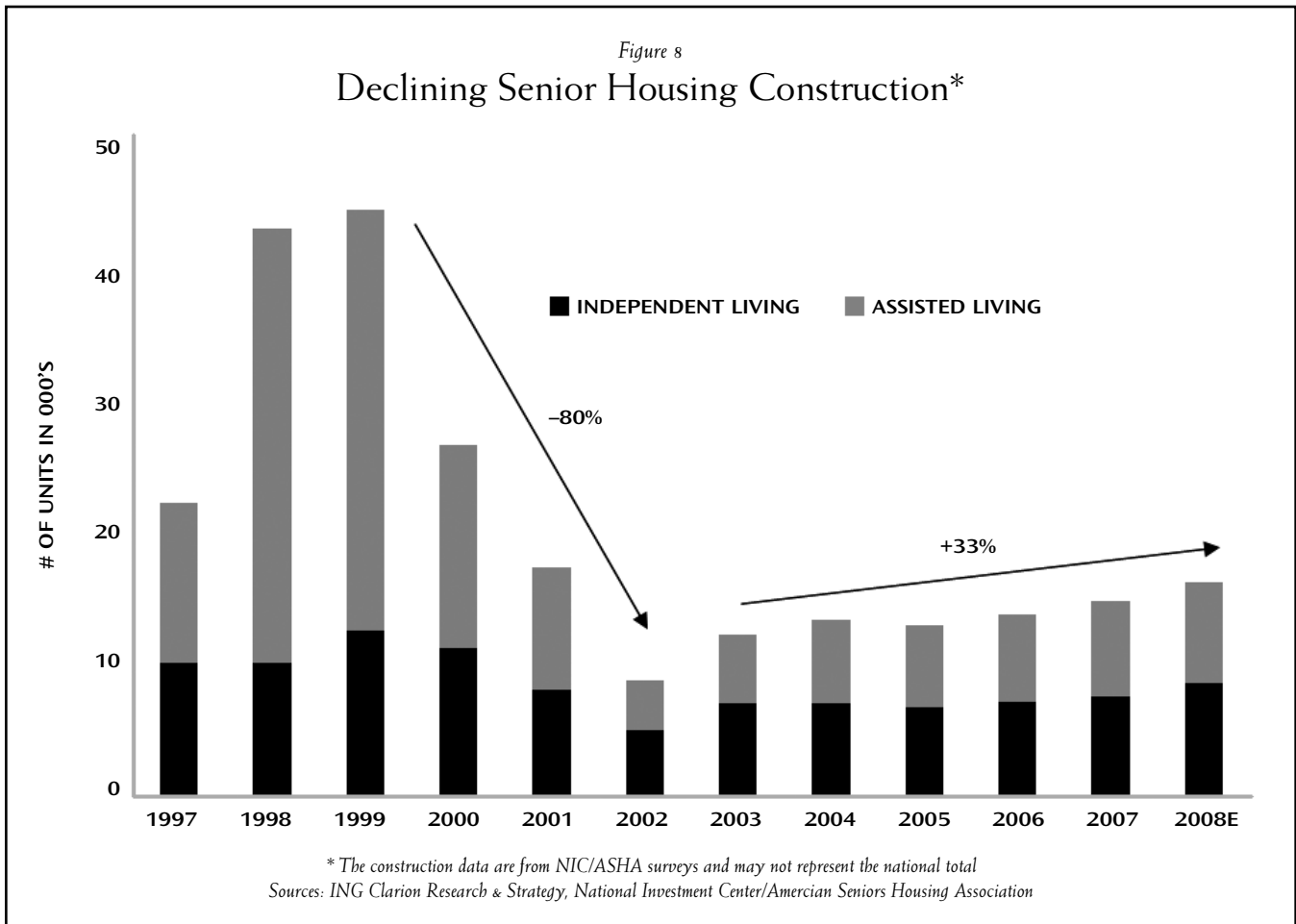
while 14,772 units remained under construction in properties that started construction before this period.<sup>14</sup> These pipeline units represent an approximate 1.6 percent increase to the total national stock of senior housing.

**Geographic Distribution:** While it may be expected that current development follows regional demographic trends, the geographic distribution of new construction reveals a different picture. The F.W. Dodge construction pipeline indicates that the Northeast and Midwest each account for a comparatively larger share of the 100,000-plus senior housing units currently under construction.<sup>15</sup> While the West and the South are, together, expected to account for more than 75 percent of growth in the senior population, the regions only account for a combined 45 percent of senior housing in development. Notably, there are twice as many senior housing units under construction today in Illinois as in Florida.<sup>16</sup>

There are two reasons for the remarkable difference between the regional distribution of new senior housing and the regional growth of the senior population. First, there is simply more existing senior housing in the South and West; regions which, historically, have higher shares of the senior population. In fact, these two regions already account for more than half of the nation's senior population, and well over half of the existing senior housing inventory. Second, increasing numbers of seniors are choosing to remain in their present states after retirement rather than moving to the Sunbelt regions. One recent survey named Chicago as one of the possible retirement destinations for aging baby boomers. Notably, Chicago is typically more affordable than many sunny destinations in parts of Florida and California. Those individuals currently living in Chicago may choose to remain there as they reach retirement, and in so doing, are likely to demand more service-oriented housing to meet their needs as they age.

**Product Characteristics of Active Adult Communities:** Active adult communities can be for-sale or for-rent, and are typically single-family homes, cluster homes and multi-family housing targeted to adults age 55 and older, offering amenities such as clubhouses, walking trails, exercise rooms and onsite security. Unlike the various forms of assisted living facilities, active adult communities do not provide any form of medical care; rather, services are focused on activities. Not only must developers of active adult communities accurately define the

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buyer profile and design to appropriate price points, they must also deliver housing that is superior, in terms of community planning, lifestyle and amenities, to the currently available product.<sup>17</sup> Because of their locations and pricing structures, active adult communities are indicative of the various non-traditional ways in which baby boomers are planning for their golden years.

Active senior demand is similar for both for-sale and for-rent housing, though there remain some general differences. For-sale active senior developments have traditionally been built in Sunbelt locations. These properties tend to be more amenitized, offering larger units, golf courses, higher-end furniture and fixtures, and generally more suburban. For-rent active senior developments are geared to more mobile tenants, who may still be working and living part-time at the property; using the rental as a second home to be near family or familiar surroundings. These properties are often built as urban

infill, in or around the CBD, and in close proximity to shopping and public transportation. For-rent active senior developments are especially attractive to residents who prefer to live without the burden of a mortgage, and the maintenance and capital expenses associated with homeownership. Unit sizes in for-rent senior properties are typically smaller than that of for-sale properties, and amenities are typically lower-end. The market for rental-active senior housing is generally wider and more diverse than for-sale senior market.

**Building and Community Design:** The most successful active adult properties offer spacious units, state-of-the-art amenities, quality locations and high levels of services. The size, in terms of total units, of the typical active adult for-sale community is decreasing.<sup>18</sup> Sun City, Arizona, one of the first retirement communities to be built in the 1960s, had 25,000 homes. In 1996, the average community had more than 1,800 homes, and by 2004, that number



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had declined to 393. Active senior rental communities typically range from as small as 20-30 units to as large as 300-400 units, but are seldom greater than 500 units. This trend is partially attributable to the dearth of large tracts of buildable land in more established urban areas.

**Homeownership:** There is a renewed focus on ownership models such as condos and co-ops in senior housing because 80 percent of seniors age 65 and older are accustomed to being homeowners rather than tenants. The rise in home values over the past five years has likely fueled this trend, as homeowners can enjoy the benefits of building equity and private ownership.

**Industry Players:** The emergence of larger, well-capitalized owners and managers will likely provide investors with reduced uncertainties concerning operations. At the same time, the larger owners and managers will likely gain greater access to investment capital. This trend is expected to fuel future M&A activities because the industry is highly fragmented with many mid-level and small players.

The top 50 largest senior housing owners and top 50 largest managers as determined by a 2007 ASHA survey are listed in figures 9 and 10 below.<sup>19</sup> The top 10 managers and 10 top owners account for 58 percent and 55 percent of the total units, respectively. The top brands include Sunrise Senior Living, American Retirement Corp., Horizon Bay, Erickson Retirement Communities and Encore Senior Living. No single brand or company is dominating the senior housing industry at this point, presenting an opportunity to build a brand name and increase market share.

### SEGMENT PERFORMANCE

**Improved Occupancy and Margins:** The senior housing industry has successfully emerged from a period during which developers and investors, with several different business models, flooded the market. Skilled housing management operators are beginning to dominate the landscape, resulting in improved operations. Average margins for quality properties have increased across all sectors, with the independent living sector reporting margins in excess of 40 percent, while assisted living margins have risen to more than 30 percent for larger communities.

Since 2005, absorption in the senior housing industry

increased significantly, thereby increasing the average occupancy rates in the top 30 metropolitan statistical areas (MSAs).<sup>20</sup> If this positive trend in absorption continues, occupancy rates are will likely remain healthy in 2008. In addition, the number of units under construction increased only moderately in 2007, further improving occupancy levels.

**Cap Rates:** Average cap rates range from 7.4 percent to 9.0 percent for independent living and assisted living facilities as of the third quarter of 2007.<sup>21</sup> It is likely that single-digit cap rates will remain in 2008 as institutional investors continue to show interest in the sector. The average cap rate stabilized in the second half of 2007, while the cap rate for independent living continues to decline by approximately 40 bps.

**Investment Activity:** Senior housing has continued to post strong performance in terms of loan volume, loan performance and equity investment as investors are increasingly interested in the sector. According to National Investment Center, total senior housing loan volume outstanding grew to \$20.5 billion during the third quarter of 2007, 8.5 percent higher than the previous quarter. Loan performance continued to be strong with delinquency rate of only 0.6 percent as of the third quarter of 2007.<sup>22</sup>

**Rent Growth:** rents have increased at an average rate of 4.5 percent annually over the past 20 years, with rental growth trending upwards in 2006-2007.<sup>23</sup> It is likely that rent growth for senior housing will range from four to five percent over the next few years, depending on quality, types and geographic location of the properties.

### RISK FACTORS

Although the investment outlook has improved considerably for the senior housing market, significant risks still remain.

**Regulatory Risk:** A large component of the senior housing industry is affected by complex regulatory requirements at the federal, state and local levels. Development of skilled nursing facilities and CCRCs requires the receipt of special permits from local governments, and the process can be quite time-intensive. Indeed, it may take three to six years from planning to final development of such facilities.

**Healthcare Policy:** The reimbursement requirements of

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Figure 9

## Largest 50 Senior Housing Owners in the U.S. as of July 1, 2007

RANK	COMPANY	HEADQUARTERS	UNITS	PROPERTIES
1	Holiday Retirement	Salem, OR	33,490	285
2	Health Care Property Investors, Inc.	Long Beach, CA	32,170	273
3	Boston Capital	Boston, MA	26,708	591
4	Sunrise Senior Living, Inc.	McLean, VA	25,131	235
5	Ventas Healthcare Properties, Inc.	Louisville, KY	23,906	252
6	Nationwide Health Properties, Inc.	Newport Beach, CA	22,943	300
7	Sunwest Management, Inc.	Salem, OR	21,963	271
8	Brookdale Senior Living, Inc.	Chicago, IL	18,448	167
9	Senior Housing Properties Trust	Newton, MA	18,112	138
10	Health Care REIT, Inc.	Toledo, OH	17,884	237
11	Atria Senior Living Group	Louisville, KY	13,638	120
12	Erickson Retirement Communities, LLC	Baltimore, MD	13,543	14
13	Senior Lifestyle Corporation	Chicago, IL	9,014	67
14	Simpson Housing Solutions, LLC	Long Beach, CA	8,537	89
15	Chartwell Seniors Housing REIT	Mississauga, Ontario	7,036	51
16	ACTS Retirement-Life Communities, Inc.	West Point, PA	6,950	18
17	Horizon Bay Senior Communities	Tampa, FL	6,919	50
18	First Centrum, LLC	Sterling, VA	6,631	97
19	Evangelical Lutheran Good Samaritan Society	Sioux Falls, SD	6,625	112
20	Assisted Living Concepts, Inc.	Menomonee Falls, WI	6,183	153
21	Merrill Gardens	Seattle, WA	5,993	45
22	Classic Residence by Hyatt	Chicago, IL	5,722	18
23	Century Park Associates	Chattanooga, TN	5,557	45
24	Emeritus Corporation	Seattle, WA	5,499	75
25	Presbyterian Homes & Services	Roseville, MN	5,499	36
26	Brightview Senior Living	Baltimore, MD	5,100	46
27	USA Properties Fund, Inc.	Roseville, CA	5,079	34
28	Capital Senior Living Corporation	Dallas, TX	4,724	37
29	Covenant Retirement Communities	Chicago, IL	4,630	13
30	American Senior Communities	Indianapolis, IN	4,404	27
31	Benchmark Assisted Living	Wellesley, MA	4,006	43
32	LTC Properties, Inc.	Westlake Village, CA	3,744	84
33	Retirement Housing Foundation	Long Beach, CA	3,697	21
34	Lytle Enterprises, LLC	Bellevue, WA	3,691	25
35	Kisco Senior Living	Carlsbad, CA	3,651	23
36	Life Care Retirement Communities, Inc.	Des Moines, IA	3,548	11
37	Westminster Communities of Florida	Orlando, FL	3,170	11
38	Starwood Capital Group Global, LLC	Greenwich, CT	3,143	12
39	Life Care Services, LLC	Des Moines, IA	3,142	14
40	Americare	Sikeston, MO	3,100	86
41	American House Senior Living Residences	Bloomfield Hills, MI	3,083	29
42	Mountain West Retirement Corporation	Salem, OR	2,962	27
43	Asbury Communities	Germantown, MD	2,904	7
44	Lutheran Senior Services	St. Louis, MO	2,887	10
45	Cornerstone Affiliates	Pleasanton, CA	2,874	11
46	The Kendal Corporation	Kennett Square, PA	2,615	12
47	Christian Homes, Inc.	Lincoln, IL	2,613	17
48	Front Porch Communities	Burbank, CA	2,554	11
49	Prime Care Properties, LLC	Indianapolis, IN	2,526	21
50	Justus Rental Properties, Inc.	Indianapolis, IN	2,472	7

**Total Units:** 440,420  
**Top 10:** 240,755

Sources: ING Clarion Research & Strategy, ASHA

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Figure 10

## Largest 50 Senior Housing Managers in the U.S. as of July 1, 2007

RANK	COMPANY	HEADQUARTERS	UNITS	PROPERTIES
1	Brookdale Senior Living, Inc.	Chicago, IL	51,638	549
2	Sunrise Senior Living, Inc.	McLean, VA	45,932	419
3	Holiday Retirement	Salem, OR	33,490	285
4	Professional Community Management (PCM)	Lake Forest, CA	29,788	16
5	Life Care Services, LLC	Des Moines, IA	22,075	78
6	Sunwest Management, Inc.	Salem, OR	21,679	266
7	Emeritus Corporation	Seattle, WA	16,463	202
8	Atria Senior Living Group	Louisville, KY	13,809	122
9	Five Star Quality Care, Inc.	Newton, MA	13,764	115
10	Erickson Retirement Communities	Baltimore, MD	13,543	14
11	Horizon Bay Senior Communities	Tampa, FL	11,913	70
12	Senior Lifestyle Corporation	Chicago, IL	9,378	70
13	Assisted Living Concepts, Inc.	Menomonee Falls, WI	8,325	207
14	Capital Senior Living Corporation	Dallas, TX	8,237	64
15	Summerville Senior Living, Inc.	San Ramon, CA	7,931	81
16	Evangelical Lutheran Good Samaritan Society	Sioux Falls, SD	7,297	127
17	ACTS Retirement-Life Communities, Inc.	West Point, PA	7,005	18
18	Merrill Gardens	Seattle, WA	6,770	52
19	Leisure Care, LLC	Seattle, WA	6,630	39
20	American Senior Communities	Indianapolis, IN	5,839	39
21	Classic Residence by Hyatt	Chicago, IL	5,722	18
22	Presbyterian Homes & Services	Roseville, MN	5,572	37
23	Century Park Associates	Chattanooga, TN	5,557	45
24	Brightview Senior Living	Baltimore, MD	5,415	48
25	USA Multifamily Management, Inc.	Roseville, CA	5,079	34
26	First Centrum, LLC	Sterling, VA	4,988	47
27	CRSA Management, LLC	Memphis, TN	4,973	18
28	Covenant Retirement Communities	Chicago, IL	4,557	13
29	Benchmark Assisted Living	Wellesley, MA	4,006	43
30	Hearthstone Senior Services	The Woodlands, TX	3,795	32
31	Kisco Senior Living	Carlsbad, CA	3,792	25
32	Retirement Housing Foundation	Long Beach, CA	3,697	21
33	Senior Care, Inc.	Louisville, KY	3,643	51
34	American House Senior Living Residences	Bloomfield Hills, MI	3,378	31
35	Continuing Care Management, LLC	Wesborough, MA	3,300	30
36	Cornerstone Affiliates	Pleasanton, CA	3,222	14
37	Westminster Communities of Florida	Orlando, FL	3,170	11
38	Lutheran Senior Services	St. Louis, MO	3,001	11
39	Americare	Sikeston, MO	3,000	82
40	Mountain West Retirement Corporation	Salem, OR	2,962	27
41	Asbury Communities	Germantown, MD	2,904	7
42	Front Porch Communities	Burbank, CA	2,828	13
43	Grace Management, Inc.	Minneapolis, MN	2,621	29
44	Senior Care Group, Inc.	Tampa, FL	2,621	21
45	The Kendal Corporation	Kenneth Square, PA	2,615	12
46	Life Care Retirement Communities, Inc.	Des Moines, IA	2,577	7
47	George M. Leader Family Corp.	Hershey, PA	2,564	11
48	Oakdale Heights Management Corporation	Redding, CA	2,528	24
49	Justus Rental Properties, Inc.	Indianapolis, IN	2,472	7
50	Aegis Living	Redmond, WA	2,429	33

Total Units: 450,494

Top 10: 262,181

Sources: ING Clarion Research &amp; Strategy, ASHA

# The U.S. Senior Housing Opportunity: Investment Strategies

Figure 11

## Occupancy Rates 2007 Q3

Property Type	Occupancy Low	Nbr. of Properties Sampled
Independent Living	91%	581
Assisted Living	88%	1,412
Skilled Nursing Homes	86%	1,002
CCRCs	92%	167
Independent Units in CCRCs	93%	165
Assisted Living Units in CCRCs	88%	133
Skilled Nursing Beds in CCRCs	88%	142

Source: National Investment Center

Figure 12

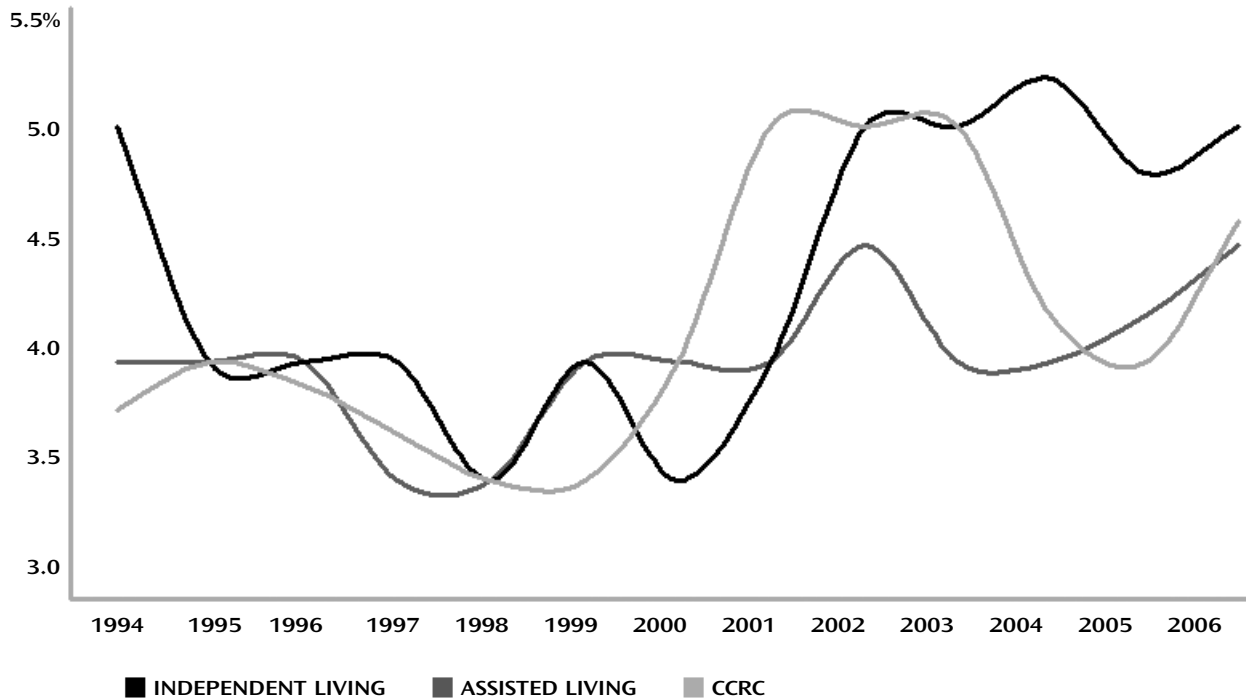
## Capitalization Rates, 2007 Q3

Property Type	Low	Avg./change from 2006Q3	High
Independent Living	4.9%	7.4% (-40 bps)	10.0%
Assisted Living	6.0%	9.0% (+10 bps)	12.5%
Skilled Nursing Homes	9.0%	12.8% (-10 bps)	14.5%
CCRCs	9.1%	(+20 bps)	14.0%

Source: National Investment Center

Figure 13

## Annual Rent Growth in Senior Housing Facilities



Source: American Seniors Housing Association

## The U.S. Senior Housing Opportunity: Investment Strategies

the industry are also complex and unpredictable. Skilled nursing and CCRC facilities receive significant reimbursement for healthcare related services from Medicare and Medicaid, programs which face increasing budgetary constraints.

Age-restricted and independent living facilities are typically non-regulated. As such, Medicaid payments account for just a small amount of revenue to these types of facilities, and have no impact on the revenue of independent living facilities.

**Operating Risk:** The senior housing industry is both an operating service business and a real estate investment and, depending on the level of service provided, may require up to five times the amount of operating personnel than does a multi-family property.<sup>24</sup> It is difficult for management to realize operating efficiencies through the various activities of staffing, catering, administrative expenses and insurance. Operating licenses, too, are difficult to transfer. Finally, healthcare costs are rising much faster than the pace of inflation and show no signs of abating, the result of which we believe could deleteriously affect the medical service aspect of the business.

Operating risk can be mitigated by careful selection of experienced, professional operators who have demonstrated successful business performance. We believe that the selection of operators should be based on both financial strength and industry expertise. Desirable operators are those leading companies with at least five years of experience in the senior housing industry.

**Business Risk:** As a relatively young industry, senior housing has a short track record from which to gauge investment risk. We believe that investment should be diversified not only in different geographic areas, but also by engaging with different operating partners. Institutional investors can establish joint ventures or partnerships with a few large, well-established operating partners. For example, California Public Employees' Retirement System (CalPERS) does not allow more than a third of its senior housing investment to be associated with a single operator.

**Volatility and Turnover:** In general, the annual turnover rates for independent living and assisted living are approximately 30 percent and 50 percent, respectively, which is much less than the annual turnover rate for

conventional apartments.<sup>25</sup> Although skilled nursing facilities have a higher turnover rate, seniors in general tend to be a very stable population with little reason to move. On a risk-adjusted basis, senior housing returns are significantly higher than conventional apartment investments. Cap rates are still approximately 150 bps higher for senior housing product, despite the fact that occupancy rates tend to be more stable than those of conventional apartments.

We believe that most of the mistakes in the senior industry have been made on the development side, with the lease-up period often being long and unpredictable. However, once the property is stabilized, the turnover tends to be less volatile. As such, vacancy loss, marketing and redecorating costs of stabilized properties are comparatively lower.<sup>26</sup>

**Market Penetration Risk:** There are risks associated with the perception that many seniors view these facilities as less desirable than remaining in their own homes. The preference for homeownership and certain lifestyle amenities may significantly undermine market penetration. In addition, some fiscally conscious seniors may find the "entry fee" pay structure unappealing, making them reluctant to give what is essentially an interest-free loan to the facility (assisted living and CCRCs). Finally, there is a lack of clear industry-specific definitions and performance benchmark measures.

**Generation Gap Risk:** There is a big gap between the two largest generations: baby boomers and echo boomers (born between 1980 and 2001). Many baby boomers are counting on cashing in their homes to fund their future retirement. However, their houses may not fetch their current prices several years from now as sellers will likely outnumber potential buyers at that time. The situation certainly poses a significant risk for seniors to make a smooth transition from traditional homes ownership to senior living.

### SECTOR OUTLOOK

The senior housing industry today is very different from its profile in the 1990s, and in fact has improved significantly in several aspects:

- A rapidly growing and more affluent senior population has been driving demand for updated facilities with a residential look and feel, and recreational activities.

## The U.S. Senior Housing Opportunity: Investment Strategies

- Many seniors prefer to retire and live near their social network, instead of migrating to the Sunbelt states.
- Improved research and reporting by industry organizations is leading to improved transparency of supply and demand trends and better estimates of the industry scope.
- The decline in new development is resulting in higher occupancy rates and profit margins.
- Several large, well-established operators with national presence are emerging through industry consolidation. These operators leverage experience and scale leading to improved operating margins.
- The rapid maturation of new channels for real estate finance and investment are providing adequate capital to fuel industry expansion.
- Institutional investors are buying high-quality assets because of improved fundamentals and relatively high yields.
- Cap rates are declining to new lows, and stabilized properties are being sold at record prices.

**Near-term and Long-term Outlook:** Strong underlying demographics, which are projected to persist for several decades, especially after 2010, support industry demand growth at current levels of penetration. Total potential

demand greatly exceeds current industry capacity. Growing industry concentration and improved fundamentals will likely provide investors with an industry structure conducive to institutional investment. Therefore, the long-term outlook for the senior housing industry is positive, suggesting that this secular trend will provide one of the best investment opportunities in the apartment sector over the next 10 to 20 years.

Because of relatively constrained construction activities over the past few years, demand is outweighing available supply. Occupancy rates and operating margins are at five-year highs; therefore, in the near-term, the cyclical trend is also positive. However, because the senior population is growing at just two percent each year, and peak baby boomer demand is not likely to occur for a few more years, a sudden increase in supply could easily tip the balance to over-supply.

As more capital flows into the senior housing sector and properties continue to sell at near record prices, new construction activity will likely increase. The extent to which construction will increase, however, is unknown. It is likely that the slowdown in the conventional residential housing market will encourage some builders to enter the senior housing sector.

Figure 14

### SWOT Analysis

<p><b>STRENGTHS</b></p> <ul style="list-style-type: none"> <li>■ Long-term favorable demographics with rapid growth of senior population</li> <li>■ Cost-effective living options based on well-defined business models</li> <li>■ Near-term low supply and high demand</li> <li>■ High occupancy levels, low turnover rates, and excellent cash flows</li> <li>■ Good portfolio diversification due to low correlation with external economic factors</li> </ul>	<p><b>WEAKNESSES</b></p> <ul style="list-style-type: none"> <li>■ Peak of the senior population still a few years away</li> <li>■ Some segments have high non-real estate component</li> <li>■ Long lease-up period, service intensive; requires an experienced operator</li> <li>■ CCRCs have low transaction liquidity</li> </ul>
<p><b>OPPORTUNITIES</b></p> <ul style="list-style-type: none"> <li>■ Focus on major market with large, growing senior populations and high occupancy</li> <li>■ Rehab and reposition old senior housing properties</li> <li>■ Target the booming 2nd homes for the baby boomers and possible retirement communities near university campuses</li> <li>■ Explore re-development projects in high growth markets</li> </ul>	<p><b>THREATS</b></p> <ul style="list-style-type: none"> <li>■ Uncertainty in market penetration - more seniors prefer homeownership to renting</li> <li>■ Record prices and low cap rates</li> <li>■ Low barriers to entry and new supply can disrupt the market and reduce occupancy</li> <li>■ Rising healthcare costs; dependent on government healthcare policy</li> </ul>

# The U.S. Senior Housing Opportunity: Investment Strategies

## STRATEGIC OPTIONS

### Target Active Adult Community and Independent Living:

We believe that the current supply and demand balance strongly favors active adult communities/senior apartments and independent living properties. Expected population growth in these two segments will likely exceed supply in the foreseeable future due to limited supply growth over the past few years, a consequence of the scarcity of construction financing available to this sector. Active adult community and independent living properties are not constrained by healthcare service requirements, and as such, may be considered as part of an apartment allocation. Based on the underlying

demographic fundamentals, the returns of active adult community and independent living properties are not closely correlated with the returns of conventional multi-family properties, and can potentially increase portfolio returns and mitigate risk.

**Selectively Buying Assisted Living:** The assisted living segment, which targets the fast-growing 85-plus population, was drastically overbuilt in the late 1990s, well in excess of demand for the product. Today, occupancy rates and operating margins are increasing, but remain below their previous peaks achieved in the mid to late 1990s. However, because more seniors prefer homeownership to

Figure 15

## Senior Housing Segment Attractiveness

<b>Active Adult Community/Senior Apartments</b>	Pros	Continued home ownership, appealing to Baby Boomers, suitable for their 2nd homes, 100% real estate	<b>Attractive</b>
	Cons	Competing with conventional single family residential or condo market, more supply in pipeline	
<b>Independent Living</b>	Pros	Simple, cost-effective operation, in demand, preferred by seniors, first mover advantage - waiting for Baby Boomer wave	<b>Attractive</b>
	Cons	Not the peak of population yet, renting instead of owning	
<b>Assisted Living</b>	Pros	Improved margins, 85+ population growing fast, supply slowing, room for further improvement in occupancy	<b>Neutral</b>
	Cons	Big wave still a few years away, renting instead of owning, large non-real estate component	
<b>Skilled Nursing</b>	Pros	Revenue dependent on government reimbursement, recent Medicare Bill positive, cap rates still high	<b>Less Attractive</b>
	Cons	Regulated, some non-profit, healthcare reform uncertainty, increasing healthcare costs, proposed Medicaid cut negative, larger non-real estate component	
<b>CCRC</b>	Pros	High occupancy, improved margins, gaining popularity	<b>Less Attractive</b>
	Cons	Complex to operate, difficult to develop, low liquidity	

## The U.S. Senior Housing Opportunity: Investment Strategies

renting, the effective increased demand in the segment is growing at approximately two percent per year, with a more significant increase in demand likely in the future. Moreover, the real estate component accounts for just 50 percent to 60 percent of the assisted living segment. It is projected that between 2005 and 2010, the population of persons age 85-plus will grow to approximately 6.1 million, a compound annual growth rate of 3.1 percent. Notably, the existing bed stock is only 1.9 million. Overall, it appears that the assisted living segment has the strongest potential within the senior housing sector going forward, with the ideal investment period occurring two to four years from today. As such, we believe that current investments in assisted living must be selectively based on the quality of assets and their locations.

**Avoid Skilled Nursing and Continuing Care Retirement Communities (CCRCs):** Despite improved operating margins, the skilled nursing segment is not recommended for investment. A highly regulated sector, its profits are likely to be squeezed due to the rapidly rising costs of direct medical care and changes in Medicare coverage. We believe that proposed cuts in Medicaid and pending healthcare reforms are likely to negatively impact medical-related services going forward. More important, real estate represents approximately 30 percent of the skilled nursing segment and, as such, investments may not meet required returns.

CCRC is a segment that warrants close monitoring, as the product is gaining popularity among seniors, and current occupancy rates and operating margins are impressive. However, CCRC facilities are challenging to build and must comply with stringent regulatory requirements. Consequently, such facilities are arguably best suited for local operation and ownership. Few CCRC facilities are traded each year, suggesting the sector's low liquidity, and therefore likely making the sector less attractive for institutional investors.

**Focus on a Few Top Markets—Both Sunbelt and Non-Sunbelt Locations:** It is essential to identify those markets that are most conducive to the growth of the senior housing sector, and to clearly understand the supply and demand dynamics of such markets. Of particular interest are those affluent markets (large MSAs) with high percentages of older baby boomers. Because the entitlement process tends to be less rigorous, there is generally more flexibility in selecting locations for new

active senior developments than for other multi-family projects. As such, we believe that senior housing development need not be confined to the Sunbelt suburbs. Potential locations include those in relatively close proximity (up to two hours drive time) to MSAs with populations greater than five million. We believe that new active senior development is likely to occur on the periphery of major metropolitan areas and in exurbs in which residents will have broader recreational options. The greatest new opportunities may well be in non-sunbelt locations that are close to urban areas, but with plentiful, inexpensive and developable land with more relaxed entitlement and development regulations. Ideal locations, as with other multi-family developments, are those that are supply-constrained and have a high barrier to entry.

Based on senior population and median household income, the top 50 MSAs are mapped in comparison to the U.S. average. Clearly, markets with both higher share of senior population than the national average and higher median household income than the nation are desirable for senior housing investment. Accordingly, we believe that it is imperative to design a strategy that accurately matches the appropriate products to their target markets.

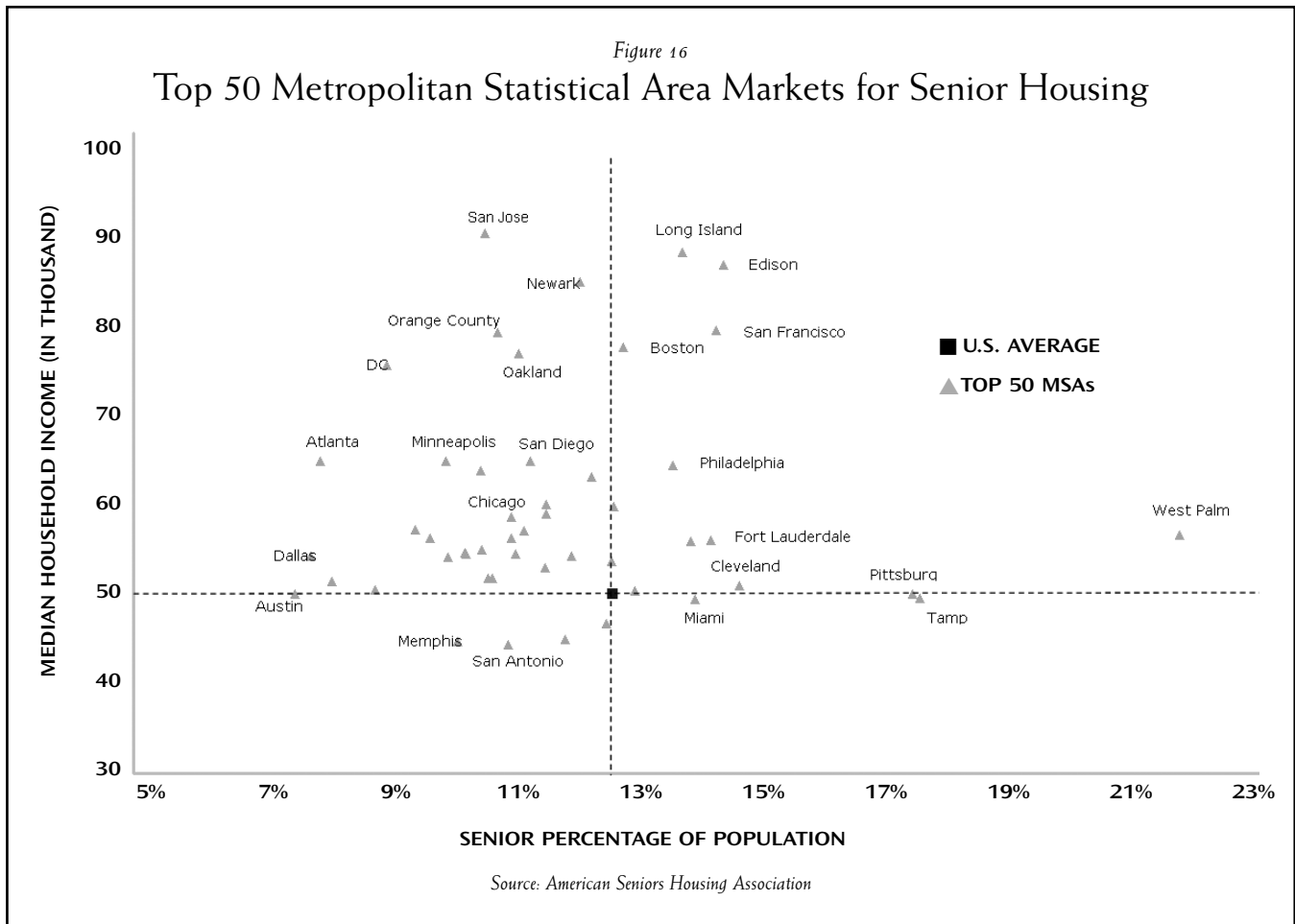
**Investment Criteria:** For most facilities, the breakeven occupancy is typically 80 percent, and occupancy levels in excess of this figure will immediately enhance NOI. We believe that a sound investment portfolio will include active adult communities, senior apartments and independent living assets with stabilized occupancy. To further diversify the portfolio, investment in several geographic regions and partnerships with two to three operators and/or managers is recommended. A properly selected portfolio has the potential to generate five to seven percent cash returns and a total leveraged internal rate of return (IRR) ranging from nine to 12 percent.

An ideal senior housing property has the following characteristics:

- Located in a major MSA with a large and growing senior population
- In areas with household income above \$75,000
- Demonstrated high occupancy and limited new supply in the pipeline



# The U.S. Senior Housing Opportunity: Investment Strategies



- Private pay structure with a minimum non-profit component
- A minimum of 110 units in the property
- In close proximity to medical providers and public transportation
- Limited competition within a 10-mile radius of the property
- Relatively high barriers to entry

**Value-Added / Development Opportunities:** Many senior housing properties are ideally located but require extensive renovation and upgrades. As cap rates continue to compress, the opportunity to engage in value-added redevelopment is increasingly appealing. With the land already selected, such projects have the potential to be quite profitable. Investors, however, must be willing to assume the additional risks associated with the initial

lease-up period.

**Target the Luxury Upper End of the For-sale and Rental Segments:** Baby boomers are the wealthiest generation in history, and many are entering their retirement years having accumulated significant wealth. With discerning taste and a willingness to pay for quality, baby boomers will likely seek luxury developments that offer a wide range of services. Of particular appeal are locations near resort, recreation and social destinations. Investment in the luxury segment offers the potential to realize the highest sale and rent premiums. Moreover, investment in this niche affords both the opportunity to stand apart from commodity developers and to build a brand and reputation.

**Target the Cost-Sensitive Middle Market:** Many baby boomers subsist on moderate, fixed incomes, and do not want to live above their means. For this group, active senior housing could provide an economically prudent

## The U.S. Senior Housing Opportunity: Investment Strategies

lifestyle. In a form of *housing cost arbitrage*, many empty-nesters realize that they have more house than they need, which may prove expensive to maintain. Notably, many empty-nesters' homes are located in high property tax jurisdictions in the Northeast. By selling their homes and buying new residences that are smaller and more energy efficient, we believe that baby boomers can accumulate significant equity while living more cost-efficiently.

**Retirement Communities Near College Campuses:** A unique investment strategy is the development of senior residences aimed at university alumni wishing to live near their alma maters. With a wealth of educational and recreational offerings, universities have clear potential to attract alumni to the vicinity. Because such alumni tend to be well-educated, affluent and willing to donate, universities should benefit greatly from their presence.

Strategic alliances and joint ventures with universities are especially attractive because colleges have the credibility, capability and potential for comparatively lower land costs. In 2005, Hyatt, in conjunction with Stanford University, built a \$170 million four-story upscale retirement residence in Palo Alto, California. Current residents include two Nobel laureates, a former Cabinet member, and the inventor of the cherry-picker truck. Similar new developments have sprung up near Cornell University in Ithaca, New York and Dartmouth College in Hanover, New Hampshire. It is likely that this trend will continue and attractive investment opportunities will arise near other renowned college campuses.

**Opportunity to Build Brand Equity:** The senior housing industry is highly fragmented with no single player dominating the market. We believe that the continued consolidation of owners and operators is likely. Opportunities exist to gain market share and build a national brand through strategic portfolio and property acquisitions.

**Partnering with a Seasoned Operator:** The senior housing sector, with the exception of the active adult community segment, is service-oriented and, as such, operating efficiency is critical to achieving target profit margins. Further, due to frequent turnover of units and a slow initial lease-up period, strategic marketing is essential to reaching and maintaining target occupancy rates. A large, well-established operator can leverage its experience and economies of scale to achieve high occupancy levels

and operating margins.

The senior housing industry is still relatively young and investors are still in the process of learning to understand the industry. Thus in choosing an operating partner, it is essential to review the potential partner's management experience and financial position. Because most senior housing operators have less than 20 years of operating experience, a thorough credit evaluation and review of auditor opinions can prove informative. Just as diversification by property type is important to ensuring a healthy investment portfolio, diversification by partnering with several operators can similarly mitigate operating risk. ■

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