No Quick Win in U.S. Senior Living Sector
Inside Senior Living Investing

Zoe Hughes, Privcap Media:
I’m joined here today by Noah Levy, Managing Director of Prudential Real Estate Investors, and Chris Kazantis, Director at AEW Capital. Thank you both for joining me today.

Chris Kazantis, AEW Capital:
Great to be here.

Noah Levy, Prudential Real Estate:
Thank you.

Hughes: We’re here to talk about senior living investment in the U.S. and, as some of the oldest investors in the space, AEW and Prudential have both been doing this since the late 1990s. I’m keen to get a sense as to how this opportunity has transformed over that time and how you see it potentially transforming over the next 10 to 15 years. Given your longevity in the field, has there actually been a major transformation in your strategies and in the opportunities you’re seeing or none at all? Noah, let me open it up to you.

Levy: Yeah, I would say there’s been surprisingly little change in many respects. Obviously, the product has changed a bit over time. The consumer has changed a bit in terms of aging or getting more frail. We ourselves are doing more development, but it’s interesting how little it’s changed. Senior housing—the operators get better and have gotten better over time. And the strategy has been remarkably consistent, at least across the funds we’ve been doing.

Kazantis: Yeah. To Noah’s point, the biggest thing I would say that has changed a lot is just the education and the understanding of the product, from both the end user (the residents and family members) as well as the institutional investors. And I think when Noah and I first started doing this, people didn’t really know what senior housing was. They conjured up nursing homes—the linoleum floors, fluorescent lights, horrible environments that you never want to go to. And I think [that], over time, people have understood now what senior housing is really all about, and it’s a
residential opportunity. It really fits much better today and people want to go there, [they're] not forced to go there.

Hughes: Obviously, how we define senior living, there are many different components of senior living. Give me a definition as to what you look at. What does AEW look at when you’re investing in senior living? Is it from independent living all the way to memory care? Just talk me through that.

Kazantis: Sure. I think Noah and our footprints are very similar. And we’ve been doing similar investing over this extended period of time. But it’s a residential component and it goes from age-restricted multi-family—which is apartments for seniors—all the way up now to memory care. [It’s] maybe a bit of skilled of nursing, but if you do skilled nursing, it’s going to be private-pay bed. And I think the thread through it all is, this is private pay. We’re really not getting into government reimbursements—Medicare, Medicaid and all the nuances that go along with that.

Levy: We like to tell people, if it’s got a commercial kitchen and you’re serving food, we begin to be interested. Straight senior apartments, in our minds, don’t trade at any more premium than regular multi-family would. So you can have things like cottages or a few stand-alone apartments, but...independent living is where we begin. Then, we move on to assisted and memory care. Obviously, [it’s] combinations of the three and that’s becoming much more common than when we first got involved.

We have had some exposure to a certain number of skilled nursing beds, but again, like Chris said, we would agree with that. We want to be in the private-pay space, so we don’t want to be dealing with Medicaid and Medicare if we don’t have to. We have and can do continuing-care retirement communities, which usually involves some buy-in features, non-rental features and some more exposure to skilled nursing. But we’ve done precious few of those and [we] can contain our enthusiasm at times for that.

Hughes: Now, when we look at senior living, one of the arguments that always comes through—at least in my mind—is [that] transformation is about to happen because of the demographics we’re seeing here in the U.S. Are you even seeing baby boomers in your properties yet?
Levy: We tend to look at the world in terms of, at least it’s got to be 75-plus and the first baby boomers won’t be there until 2021. So we’re still not there yet.

That’s really what’s interesting about this. I think the industry has grown a lot because of penetration of the concept. People have learned that this exists and it’s a great alternative. And their families and their kids have learned. So the baby boomers are still out there and that’s really what gives us this long, projecting forward-demand tailwind that we see coming. But it’s still not there yet.

Kazantis: Yeah, and Noah’s absolutely right. I mean, when people first got into the industry in the late 90s, early 2000s, they saw all the demographics, but they got way ahead of the demographics. And if you look at the amount of product that was delivered in those years—’99, 2000, 2001—they were delivering 40,000 to 45,000 units across the country, which was way too much at that particular point in time. And it slowed down. If you look at over the last 15 years, they’ve probably delivered about 20,000 units. It’s really stayed with the demand.

The numbers now are starting to get to the point where you are on that upward swing. If you look at the amount of seniors right now from 75 or older and you compare the growth in that segment today to the general population, it’s growing two times the general population over the next five years. It’s going to grow three times and, if you get out to 2030, it’s going to grow five times. So you’re really on the upward swing. In raw numbers—today, there’s 20 or 21 million seniors 75 and older. In the next 15 years, that’s going to double. So, that’s going to 41 million. And if you look at our segment, which is probably even older than that, 85, you’re probably talking a little over 6 million seniors today—

Hughes: —Is that the average age of the person?

Levy: 84 to 85.

Kazantis: Yeah, 84 to 85. And that’s extended over time. I think [that]...because of education, because of people living longer, they’re healthier, lifestyles, all that, has moved people up so that they are coming in later.

Hughes: Does it also mean we are seeing particularly your customers—are they becoming more frail? And because of that, if they are becoming perhaps a bit more frail or at least staying longer in your
properties, does that mean you need to have more of a continuum of care? From that independent living through to assisted living through to memory care, do you need to have more of a continuum? How does that work with you?

Levy: Yeah...when I first got into the business (this goes back to the early '90s), you saw much more differentiation between independent only and assisted only. In fact, a lot of people—pioneers in the assisted living business—didn’t even acknowledge they were in the memory care business. Today, however, I think because you want people to age in place and people are entering a little older and frailer at times, you see relatively few properties that only have one level of service.

We've seen that change over time. If you have an independent-living building now, it'll have independent and assisted, if not having memory care as well. And you’ll have memory care with assisted, usually.

Hughes: We talked a bit about performance and the demand drivers that are there for senior living and the pent-up demand you’re going to see. Talk to me about the performance, particularly during the crisis. How well did senior living stand up during the crisis?

Levy: We were pleased by how it went during the last downturn. We were fairly confident...and [we] had experience with the fact that senior housing was pretty recession-resistant. Our residents don’t have jobs to lose. The elasticity of demand is very low, so they’re going to stay. You can continue to raise rents.

Kazantis: Multiple sources of payment, right?

Levy: Absolutely. So, you had a situation where...this was the theory. In practice, it did extraordinarily well during this kind of downturn, which was analogous to a depression. But I think it’s one of those situations where [it’s] the things that took place in this downturn—the return on savings going down to zero is analogous to a pay cut for folks who don’t have jobs to lose—but also the decline in housing prices.

Even our independent-living projects, or projects that had a majority independent living, did well during this downturn. We did have some markets—we had exposure in places like Scottsdale or Southern Florida—that did have issues. But, generally speaking, we were able to push rents throughout the cycle and grew our
NOIs throughout the entire time. So...I don't know if you had the same experience, but our portfolio has held up extremely well.

Kazantis: Yeah...and that’s one of the reasons we started getting into the sector. Even in the late ’90s, when it got overbuilt and we were looking at the sector from a research standpoint, we thought the sector was completely mispriced. Because if you look at the underlying cash-flow streams, there’s not much volatility in the underlying cash-flow streams. And you can compare them over time to the other traditional real estate asset classes—even multifamily has way more volatility than senior housing. Because once people come in and they establish relationships within a community, they're not going to move down the street because they can get a month’s free rent or a free refrigerator like you might do in multifamily. I mean, this is their community. This is where they’re staying.

And if you get your arms around the operational risk and pick the right operators and understand what you’re getting into, you have very solid income streams in place. And it held up through the recession. It was actually the only asset class that did not go negative. They’ve declined. They started at maybe 6% or 5% annual growth and they got close to zero during the depths of the recession, but they never went negative.

Hughes: What are your expectations as you look out? I’m going to make you look out perhaps a bit longer term—seven to 10 years. What are your expectations in terms of rental growth there, Noah?

Levy: I still feel that, again, it’s a very local business, so no two properties will perform the same. No two properties in the same market will perform the same. But I still feel that the persistence of rent growth will be quite good. In fact, I don’t see any reason why it can’t be 3% or 4% a year if properly managed when you’ve got good product with good operators.

Now, that doesn’t mean that if buildings open up down the street from you, that you might not see some softness initially...or lose a couple of points in occupancy. But we’re still not seeing the kind of development in new supply that...at least indicates to me that we're going to have generalized issues in the industry.

Kazantis: I think you can rely on anywhere from 2% to 4% rental growth pretty consistently. And I agree with Noah completely that there might be some pockets of overbuilding, but in general, there is not overbuilding.
And if you look at when people underwrite development opportunities and they say, “What segment of qualified seniors will actually want to utilize the product?” The rule of thumb, and everyone’s go-to, has been a 5% penetration rate. And you could make a really strong argument that that should be much higher, because I don’t think there’s too many markets today that have a 5% penetration rate. They’re all close to double digits and, in some, way above double-digit penetration rates.

Hughes: Does this prompt you to actually do more development? Because you’re not seeing that oversupply in the market. So, is this time to develop now rather than buy an existing?

Levy: We have been developing and will continue to do it with the right operating partners and the right markets. We will deploy anywhere up to 20% of our equity towards development and have been working at that over the last years. So, it’s been a good time to develop as opposed to when we first got in the business in the late ‘90s, when...you didn’t want to develop. You wanted to wait for somebody to fail and you could buy their failed project.

It has changed in that regard. But I think it’s interesting to note in just looking at the issues around supply. There’s been a lot of noise around that. And what’s interesting there is there are certain markets where you’ve seen a large increase, but one thing that’s a bit of a head fake is the fact that there are some markets where there’s been very little supply built. So, one needs to be careful about “percent changes” because we have—as an industry—a very low base.

To give you an idea of the scale we’re talking about, we’re talking about seniors. We’re seeing a very large growth in our age core. This industry has never had a demographic tailwind before. And, in fact, the last few years have been the end of the Depression-era baby bust. So, in some ways, the global financial crisis came at a very nice time. It crushed development generally. We weren’t being overdeveloping going into the downturn, but the number of units being started in a given year went down to as low as about 7,500, which is a nuance.

Today, we’re still not up to a steady state rate of much north of 20,000 a year. Our steady state rate through most of the aughts was 30,000. That’s compared to multi-family, where, in some markets, we’re seeing in the next two years—I can think of two
markets where they’re delivering well over 30,000 multi-family unit in one market.

**Kazantis:** He’s talking about the entire country when he’s saying 20 some-odd-thousand units. That’s the entire country—100 markets in the country.

**Hughes:** So, oversupply is certainly not an issue.

**Kazantis:** No, and the noise is a good point because I love the noise. I want to hear more noise, right? The noise is all the people who don’t know the sector and are looking at the demographics. They’re looking at the rental growth. They’re looking at how it held up over the recession. They’re saying, “Wow, that’d be a great industry. I should get into that industry” but they have no experience operating and these buildings are easy to build because they’re basically like building a large home, if you will. So, you can build it, but you’ve got to know how to operate it.

**Levy:** Yeah, and I think we are real estate-based. So, in theory, we can’t totally discount our ability to screw it up. I’ve said it in public before—if dreams were units, we’d always be overbuilt. There is always that risk, but one thing that happens—especially when the multifamily market starts kicking back up the way it has—is [that] senior housing struggles for…in many instances, it’s not the highest investment use. So, the multifamily players will bid away good sites.

It also takes a longer time to build and title, lease up a project. It’s not a very good build-and-flip business. A lot of equity doesn’t want to be in that space. And when they get into it and dig into it, there are barriers for them. That’s just not the play that they want to do. So…our average hold tends to be longer than most forms of commercial real estate. And because we can continue to grow NOI. A lot of our value is created by growing NOIs, not by just some cap-rate compression—build, flip and walk away.

**Kazantis:** I mean, to echo on Noah’s points you look at—the development cycles as far as actually building the property and delivering it are very similar, 12 to 18 months that you’re going to build 100 some-odd units….Total units are a lot smaller. Multifamily, you’re probably 200 or 250 or something like that. But the multifamily, once it’s built and it’s open, you’re probably going to lease 20, 25, 30 or maybe even 35 units a month. And they get to stabilization within a year, in a lot of cases. Most of our product—you’re going to do somewhere between four and 10, maybe, in a really good
month. So, it could take two to three years before you actually get to a point where you're generating some significant cash flow.

That's one of the nuances of our sector. And that's one of the reasons we're getting such a premium on development. Our development returns on cost versus stabilized cap rates could be 300 to 400 basis points, which is a very hefty premium when you compare it to multifamily, which is 100 basis points or, in some markets, even less than 100 basis points that people are delivering to.