SeniorsHousing
RESEARCH REPORT
Marcus & Millichap
Second Half 2010

Operators Getting Creative to Protect Margins

Now that the initial shock of healthcare reform has passed, short-term challenges in the seniors housing market are moving to the forefront of operators' concerns. State budget cuts and a housing market that continues to lag the national economy out of the recession will remain the most significant challenges in the sector for at least two more years. Several states grappling with revenue issues have reined in Medicaid reimbursements, which typically are sufficient for skilled nursing and assisted living facilities to break even. As this source of income diminishes, operators of these facilities will increasingly look for new ways to protect margins. Contracting with hospitals to aid in the rehabilitation of post-orthopedic surgery patients has proven very lucrative, for example, while delaying a transition from assisted living units to skilled nursing helps manage bottom lines. In the independent living and continuing care retirement communities segments, weak conditions persist due to ongoing turmoil in the single-family housing market, and a recovery remains unlikely for several more quarters. Seniors on the cusp of downsizing and likely to move into a continuing care retirement community or independent care facility will continue to postpone selling their homes until the single-family supply/demand balance becomes more favorable.

As operating margins have compressed, investors have begun to target assets that provide the most consistent returns. Facilities with assisted living, skilled nursing and dementia care components remain the most sought after. Demand for dementia care beds is high, as relatives have few alternatives for their stricken family members. Financing for these properties is now available through several government entities, including FHA, SBA and USDA. Independent living facilities can be purchased with Fannie Mae and Freddie Mac funding, though current lending standards and loan-to-value ratios remain hurdles. As a result, most buyers of these assets purchase with all cash in the hopes of obtaining financing when the properties stabilize.

Seniors Housing Market Highlights[1]

Occupancy down 70 basis points

Independent Living (IL): Occupancy in the IL segment will fall to 86.9 percent this year, down 70 basis points from year-end 2009. The average rent will finish 2010 at $2,570 per month, an annual climb of 0.9 percent.

Occupancy up 60 basis points

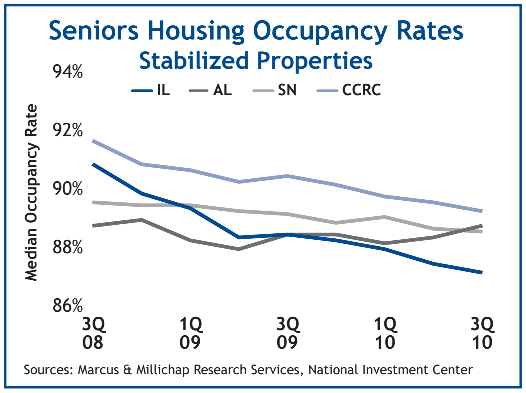
Assisted Living (AL): Operators of AL facilities will post a 60 basis point occupancy improvement this year to 89 percent, while rents will slip to $3,655 per month, a decline of 0.6 percent from 2009.

Occupancy down 20 basis points

Skilled Nursing (SN): Healthy conditions in the SN sector will result in an occupancy rate of 88.6 percent at the end of this year, 20 basis points lower than at the close of 2009. Average per-diem revenue will finish 2010 at $243 per occupied bed, up 3 percent from last year.

Occupancy down 110 basis points

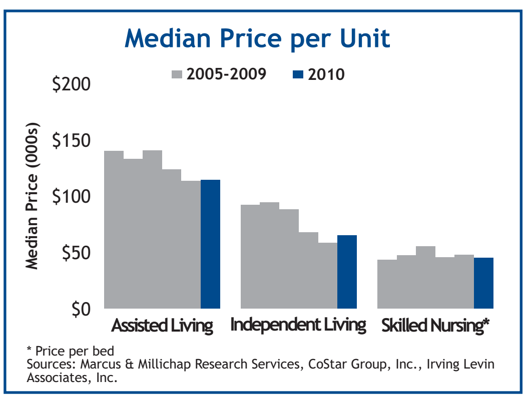
Continuing Care Retirement Communities (CCRCs): Due to ongoing challenges in the housing market, occupancy in CCRCs will slide 110 basis points this year to 89 percent.



Independent Living Facilities (IL)

The IL sector will continue to struggle for several more quarters as the weak housing market takes a toll, despite gradual recovery in the national economy. IL occupancy fell 110 basis points so far this year to 87.1 percent in the third quarter, per NIC MAP, and will retreat to 86.9 percent by year end. Even seniors in a strong home equity position remain unwilling to liquidate until foreclosures and short sales begin to dissipate. This transition may not occur for another two years, however, when the Mortgage Forgiveness Debt Relief Act of 2007 expires and the federal government starts taxing the write-down value of the mortgage. Termination of this program will curtail foreclosures dramatically, particularly strategic foreclosures, as most homeowners will refuse to assume the resulting large tax bill. As occupancy has fallen, rents have faltered; rents averaged $2,566 per month in the third quarter, up just 0.8 percent from the same period last year, and rates will tick up only marginally in the fourth quarter to $2,570 per month.

Although weakness in independent living operations will persist, buyers have begun to re-emerge to take advantage of an eventual turnaround that will support more robust rent gains. The number of deals conducted during the first three quarters of this year surpassed those in all of 2009. While investors are waiting for rent growth to return, the outlook on occupancy gains in the short term remains bleak, encouraging buyers to target stabilized properties. The average occupancy rate at IL properties that have changed hands this year has increased dramatically when compared to 2009, and few buyers want to pursue value-add deals in the current environment. As a result, IL assets have traded at $64,900 per unit year to date, up 11 percent over last year. Cap rates average in the low-8 percent range but can extend much higher for nonperforming assets in less desirable areas.



Assisted Living Facilities (AL)

Occupancy in the AL sector will continue to rise through the end of the year as seniors once cared for by unemployed family members move into units. In the third quarter, the nationwide occupancy rate for AL facilities averaged 88.7 percent, up 30 basis points from year-end 2009 and 60 basis points above the cyclical low recorded during the first quarter of 2010, according to industry-tracker NIC MAP. While only half of all major U.S. markets posted occupancy improvements in the last 12 months, the rate of increases in these areas was significantly more pronounced than the pace of declines elsewhere. Improving markets averaged an occupancy rise of 170 basis points, more than double the 80 basis point average loss in areas where occupancy slipped. Rents, meanwhile, gained 0.5 percent year over year to $3,668 per month. Stabilized properties continue to drive rent growth; facilities that reported occupancy below 90 percent also registered a 0.5 percent decline in monthly rents. Despite a projected uptick in nationwide occupancy to 89 percent by year end, rents will fall to $3,655 per month, an annual decline of 0.6 percent.

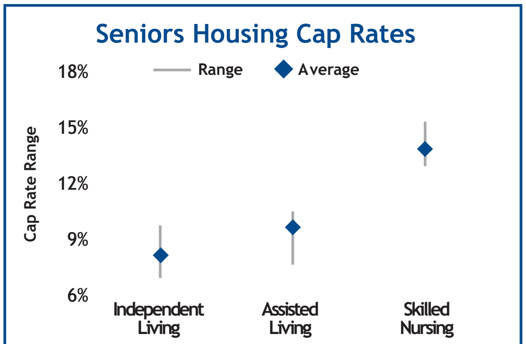
The relative strength of the AL sector compared to IL facilities kept investors active through the downturn. As a result, deal flow will rise only modestly in 2010 compared to last year. Prices remain stable, with AL properties selling at $114,300 per unit thus far in 2010 and cap rates averaging near 10 percent. Large buyers will be the most active in the coming months as REITs continue to deploy accumulated cash. Fewer private buyers are equipped with the capital necessary to overcome financing hurdles, which will maintain the price disparity between best-in-class assets and lower-end properties well into 2011.

Occupancy, rent and construction data throughout this report measure the 31 largest MSAs unless otherwise noted.
NIC MAP Data and Analysis Service, 3Q 2010, www.nicmap.org

Skilled Nursing Facilities (SN)

Operating conditions in the skilled nursing sector remained steady through the recession and continue to demonstrate strength through the early stages of the recovery. Occupancy in the third quarter averaged 88.5 percent, down 30 basis points year to date, according to NIC MAP. The rate has stayed within a 100 basis point range over the past two years and should rise to 88.6 percent by year-end 2010. Although occupancy remains below historical levels, shorter stays in skilled nursing facilities have begun to shift the equilibrium. More owners are favoring a change in census composition to Medicare or private insurance patients recovering from surgery rather than Medicaid-sponsored residents, whose reimbursement rates are close to the cost of care. As a result, occupant turnover is higher, but the average daily revenue continues to climb. In the third quarter, the average daily revenue rose to $240 per occupied bed, a year-over-year gain of 3.2 percent. Revenues will inch up to $243 per occupied bed per day in the fourth quarter, representing an annual gain of 3 percent. Nonetheless, operators will still need to find alternative revenue streams to overcome steep state budget cuts that will hamper Medicaid reimbursements over the next several years.

Investor sentiment in the SN sector remains positive, though transaction velocity has not improved considerably thus far in 2010. Fewer properties within the sector fell into distress due to healthier operating conditions, and buyers seeking sharp discounts have been left out of the market. In the coming months, more deals are expected to transpire as owner/operators begin to list properties. Large REITs and management companies, however, are positioned to take advantage of cost savings through economies of scale. Exceptional small-property owners also can realize significant returns by improving resident mix and the cost structure of poorly run facilities. Financing for smaller assets in suburban areas remains available through SBA and USDA loans. So far this year, the median price for an SN facility has fallen 6 percent to $44,900 per bed, while cap rates average in the 13 percent range and vary widely by property census and market.

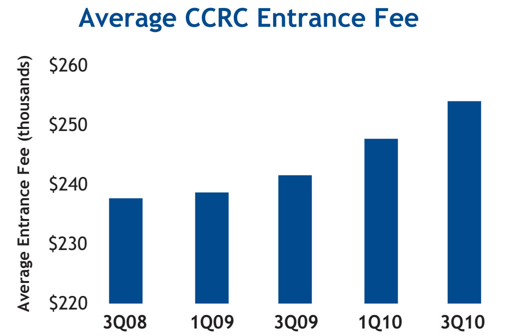


Sources: Marcus & Millichap Research Services, CoStar Group, Inc., Irving Levin Associates, Inc.

Continuing Care Retirement Communities (CCRCs)

The housing market downturn continues to challenge CCRC operations, particularly entrance-fee CCRCs. Occupancy declined steadily over the past several quarters, as seniors who had considerable wealth tied up in housing just a few years ago were forced to reconsider retirement plans due to an inability to sell in the current environment to cover high move-in costs. Occupancy fell to 89.2 percent in the third quarter, per NIC MAP, and will slide to 89 percent by year end, an annual decline of 110 basis points. The average entrance fee, meanwhile, rose 5 percent over the past 12 months to $253,800 in the third quarter. Despite the fee increase, falling occupancy has halted growth at most facilities. In the third quarter, over 80 percent of existing CCRCs left rates untouched. Weakness in rental CCRCs is significantly less than at entrance-fee facilities; in the third quarter, occupancy for rental CCRC units slipped only 10 basis points.

Sales of continuing care retirement communities have increased this year, though activity still involves just a handful of deals, mostly smaller communities. Opportunities within the segment exist, notwithstanding the limited number of transactions. Creative operators are converting entrance-fee CCRCs to rental CCRCs or are targeting states with favorable reimbursement rates, mitigating some of the risk of ownership. A lost decade of retirement account growth and longer life spans will likely generate more of these types of transactions.



Sources: Marcus & Millichap Research Services, NIC MAP

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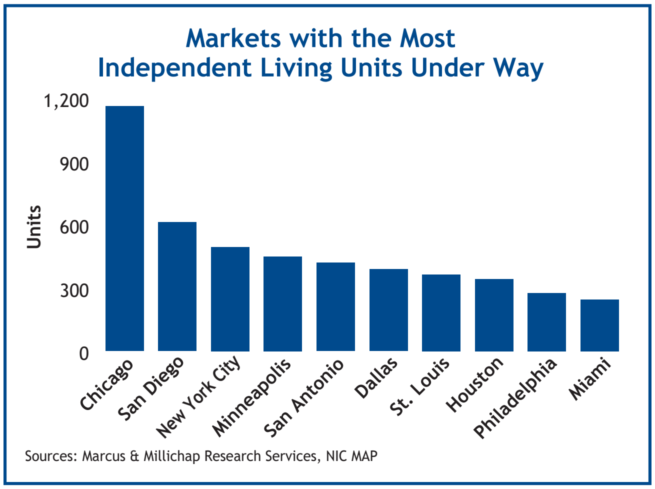

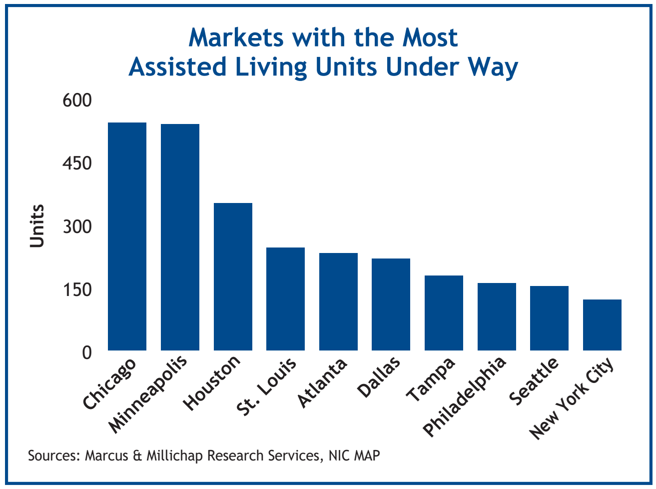

Metro Occupancy Ranking*

Rank	Metro, State	IL Occupancy	Y-O-Y Basis Point Change	AL Occupancy	Basis Point Change
1	Minneapolis, MN	94.4%	-10	92.6%	-180
2	Pittsburgh, PA	93.7%	120	92.4%	-40
3	Baltimore, MD	92.3%	-210	88.5%	-50
4	San Jose, CA	91.9%	-200	87.6%	160
5	San Francisco, CA	91.0%	50	89.0%	200
6	San Antonio, TX	90.8%	-180	91.0%	-170
7	Philadelphia, PA	90.3%	50	88.4%	-110
8	Washington, DC	89.6%	-230	90.8%	-50
9	St. Louis, MO	89.0%	70	87.3%	-80
10	Los Angeles, CA	88.7%	-150	85.9%	-150
11	Boston, MA	88.4%	-440	91.8%	-100
12	Detroit, MI	88.4%	50	86.5%	160
13	New York, NY	88.3%	-270	94.4%	80
14	Atlanta, GA	88.2%	-150	86.1%	40
15	Cleveland, OH	87.9%	30	91.5%	170
16	San Diego, CA	87.7%	-50	87.5%	-80
17	Sacramento, CA	87.5%	-210	88.8%	220
18	Kansas City, MO	86.4%	70	89.8%	450
19	Orlando, FL	86.2%	-70	90.5%	-40
20	Denver, CO	86.1%	-180	87.8%	-80
21	Seattle, WA	86.0%	-270	88.4%	150
22	Chicago, IL	85.9%	-20	86.5%	-70
23	Houston, TX	85.8%	-180	91.5%	60
24	Riverside, CA	85.8%	-100	90.0%	200
25	Tampa, FL	85.8%	-160	92.2%	170
26	Phoenix, AZ	85.7%	-310	87.9%	50
27	Portland, OR	85.7%	-260	88.4%	-90
28	Cincinnati, OH	85.4%	-460	92.4%	290
29	Miami, FL	85.0%	-110	89.1%	140
30	Dallas, TX	83.9%	-140	86.9%	-20
31	Las Vegas, NV	82.6%	450	85.2%	-20

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