

HEALTHCARE & SENIOR HOUSING



COVID-19 vs. Baby Boomers



The Baby Boomers are not here yet, but their shadow is looming over senior housing with annual growth rates peaking in 2030 around 5.5 percent. This expected growth has been negatively affected by COVID-19. In skilled nursing alone, over 72,000 deaths as of early December 2020, representing 25 percent of all U.S. COVID-19 deaths.

Cash flows at many properties are disrupted by reduced occupancy, higher operating expenses, possible lowering of rent caused by changes in short-term demand, and additional risk premiums applied to the capitalization processes. Lower interest rates are an offsetting force.

INDUSTRY PERFORMANCE

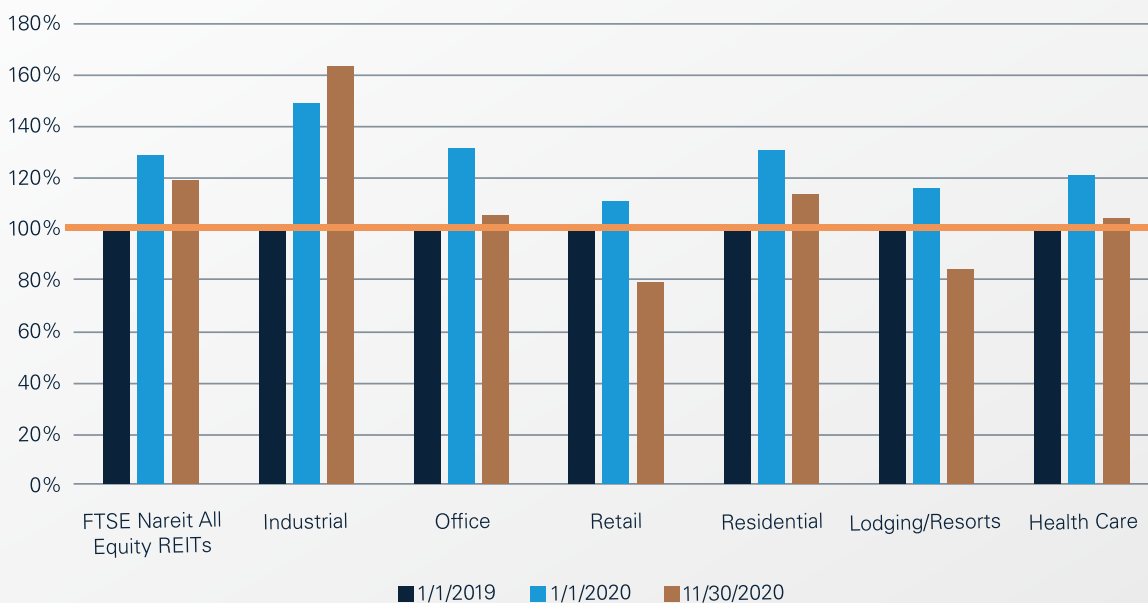
“Healthcare is performing better than retail and hospitality, but valuations have declined more than residential and industrial.”

Using REIT valuations as a reflection of individual asset values, senior housing and healthcare real estate is higher than January 1, 2019 levels but still below the level from January 1, 2020. Notably, healthcare is performing better than retail and hospitality, but healthcare valuations have declined more than residential and industrial. Healthcare REIT enterprise valuations fell 12.4 percent between

January 1, 2020 and early December 2020. For those same REITs, equity valuations have declined 18.0 percent over the same time span. At the lowest point, these REITs experienced enterprise valuation losses in excess of 25 percent, on average.

While the pandemic caused a net reduction in occupied units, slowed move-ins and accelerated move-outs, senior housing continued to grow in 2020. The National Investment Center for Senior Housing and Care (NIC MAP) data service reported occupancy was relatively flat through the first quarter of 2020, as supply and demand remained in balance. Then, as the pandemic emerged in the late part of the first quarter, demand dropped off at an unprecedented pace. A review of public companies, both in the operating and REIT spaces, shows significant declines in census and EBITDAR.

NAREIT INVESTMENT PERFORMANCE BY PROPERTY SECTOR



A CURE ON THE WAY

By November 2020, a partial senior housing valuation recovery began as two major pharmacy groups, led by Pfizer and Moderna, reported successful Phase Three testing of highly effective COVID-19 vaccines. As of this writing, fast-track approvals have been awarded and distribution of the two vaccines are underway. Long-term care facility residents and healthcare workers are the first to receive vaccines. These approved vaccines, along with several others on the way, have injected optimism into the markets, generally.

INDEPENDENT LIVING

Between the third quarter of 2018 and the third quarter of 2020, independent living supply grew 10.8 percent, while occupancy decreased 690 basis points, among the properties that NIC MAP tracks.

SUPPLY AND DEMAND CHANGES Q3 2018 TO Q3 2020

Quarter	Properties	Units	Occupied Units	Occupancy
3Q2018	1,524	233,804	205,981	88.1%
3Q2020	1,655	259,059	210,356	81.2%
Change (Basis Point Occupancy Spread)	-53	25,255	-18,489	-690

- Occupancy rate declined 690 basis points between Q3 2018 and Q-3 2020.
- Occupied unit increase of 4,375 between Q-3 2018 and Q3 2020
- In this two-year period, inventory grew by 25,255 units, or 131 properties. Currently, there are 147 more properties (22,833 units) under development. Most of these units will be delivered in the next 12 months and will add 8.8 percent to the existing supply.

ASSISTED LIVING

Pre-COVID, most major markets were oversupplied with occupancies dropping into the mid-80s. Post-COVID, the average occupancy has dropped to 79.6 percent, a decline of 6.0 percent compared to the fourth quarter of 2019. New construction continues in most major markets, but the pace has slowed, compared to the peak construction years of 2016 and 2017. Absorption has not kept up with supply, and occupancies continue to trend downward in most markets, especially in markets where development costs are relatively low and developable land is readily available. Resident entry age and acuity continue to rise. Wage increases continue to place pressure on net incomes.

SUPPLY AND DEMAND CHANGES Q3 2018 TO Q3 2020

Quarter	Properties	Units	Occupied Units	Occupancy
3Q2018	4,400	358,826	308,232	85.9%
3Q2020	4,719	397,035	315,643	79.5%
Change (Basis Point Occupancy Spread)	319	38,209	7,411	-640

- Occupancy rate declined 640 basis points between Q3 2018 and Q3 2020.
- Occupied unit increase of 7,411 between Q3 2018 and Q3 2020
- In this two-year period, inventory grew by 38,209 units, or 319 properties. Currently, there are 221 more properties (20,818 units) under development. Most of these units will be delivered in the next 12 months and will add 5.2 percent to the existing supply.
- Brookdale's 50,000-plus unit senior housing group experienced a same-store occupancy decline of 480 basis points in their second quarter 2020 and 2019 periods, and a 3.5 percent decline in RevPOR (revenue per occupied unit).

TRANSACTIONS

Many transactions that were set to close in the earliest months of the pandemic were abandoned or repriced to lower levels. Sales transaction data from the pandemic is becoming available and reveals conflicting value trends. Some transactions clearly illustrate price discounting, while others reportedly do not. Obviously, each property and situation differ, and blanket assumptions regarding value trends are not absolute. According to Real Capital Analytics, transaction volume for senior housing declined 22 percent in 2020 after an increase of 35 percent in 2019. Capitalization rates for senior housing properties compiled by IRR have been relatively stable for the last year but are showing signs of increases for mature, stabilized properties and for property in lower-barrier markets. On the other hand, high-quality properties in markets with strong barriers to entry appear to be commanding lower capitalization rates, in tandem with lower interest rates, generally, as explained by IRR clients.

SKILLED NURSING FACILITIES

OUTLOOK

New supply volume is likely to decrease until occupancies recover in many markets. Lenders have shown additional caution in underwriting. Until the oversupply is absorbed, transaction volume is expected to maintain its current level or decrease, and capitalization rates are expected to increase slightly if interest rates rise.

INDUSTRY PERFORMANCE

“Nursing Home occupancy has been declining for years.”

Many factors have kept occupancy compressed. These include a shift to greater home health and hospice use, rising managed care utilization, the influence of value-based care, and immense pressure to shorten the length of stay for rehab-based care. Pre-COVID occupancies averaged 86 percent, dropping to 76.3 percent in the third quarter of 2020. The population now aged 85+ is known as the “Silent Generation.” They experienced the Great Depression and were born in an era of lower birth rates. The Baby Boomers will not reach the 85+ bracket until 2029, when annual growth rates in this bracket are expected to be around 5.0 percent and demand for nursing home services are expected to increase as a result. The Patient Driven Payment Model (PDPM) for

Medicare began in October 2019, and reports have been positive with similar-to-increased reimbursement rates and additional savings on the expense side. Public company Ensign has seen an increase in its valuation, so far, in 2020 due to the remarkable earnings improvement tied to Medicare PDPM changes.

ACTIVITY

New construction volume is likely to remain modest until COVID-19 clears and the Baby Boomer demand changes the trajectory of nursing home occupancy. Wage increases and difficulty staffing continue to place pressure on facilities, especially those with slim margins. The number of facility closures is on the rise due to these pressures. Demand for skilled nursing will eventually increase with an aging population. However, advances in technology and the growing emphasis on value-based care will be offsetting forces.

TRANSACTIONS

Transaction volume has slowed with many of the recent sales being smaller scale operators or underperforming facilities. According to Real Capital Analytics, transaction volume for skilled nursing declined 43 percent for nursing homes after a decline of 9 percent in 2019. Capitalization rates for skilled nursing compiled by IRR have been relatively stable for the last year. Even with the mounting pressures, investors seeking higher potential yields in this sector are resulting in transaction activity.

OUTLOOK

“Valuations will continue to see some price discounting for short-term reduced cash flows.”

The pandemic is expected to gradually wane over the next 12 to 15 months, as the vaccines continue to be deployed. In the meantime, reduced occupancy and higher operating expenses will continue. The PDPM payment model is geared to more appropriately reimburse facilities based on resident needs. Sophisticated, better-positioned companies have gained from this change, and transaction volume will likely consist of less sophisticated owners getting out of the market. The possibility of Centers for Medicare and Medicaid Services (CMS) reducing reimbursement rates does exist, but this concern has been somewhat due

to COVID-19 and the financial strain facilities are experiencing. Additionally, these sectors will need to overcome stigma issues. For example, roughly 25 percent of COVID-19-related deaths are occurring in people who are in long-term care facilities — a matter that is difficult to resolve. Valuations will continue to see some price discounting for short-term reduced cash flows. The impact of low interest rates on values is profound, and without these lower rates, valuations would be more seriously impacted.

HOSPITALS

MERGERS & ACQUISITIONS

The Health Care M&A Report, published by Irving Levin Associates, reported 81 transactions in 2018, 99 in 2019, and 51 through the third quarter of 2020.

“Industry consolidation via mergers and acquisitions remains an ongoing trend in the hospital industry.”

Industry consolidation via mergers and acquisitions remains an ongoing trend in the hospital industry. Affiliations and partnerships, although not as widely tracked, are also occurring at a strong pace. Independent hospitals continue to join larger systems for access to professional, IT, and financial resources. Buyers with profits and proven care models strive to capitalize on their strengths and gain footholds in secondary service areas.

More distressed hospitals are sometimes compelled to sell to smaller private companies with limited track records and investment capital. Most metro hospital markets are highly concentrated, limiting the potential for future like-kind M&A transactions. Rural markets are less concentrated, and most hospitals and systems prefer to remain independent if they can.

COVID-19

Many hospitals suffered through revenue declines in the second quarter of 2020, resulting from limitations placed on profitable elective procedures, lockdown restrictions, and a desire among many people to simply avoid hospitals and other healthcare settings. With the CARES Act and other financial relief, hospitals and health systems have mostly survived, albeit with lower revenues, proportionately greater expenses, some employee layoffs, and reduced earnings. Currently, patient volumes are substantially close to normal and are expected to fully recover by late 2021 or early 2022, in part due to COVID vaccinations. At the beginning of December 2020, Moody’s changed its outlook for for-profit hospitals from negative to stable.

RURAL HOSPITAL CLOSURES

Rural hospital closures, as tracked by UNC’s Rural Health Research Program, hit a 15-year record high in 2019, at 18. There have been 17 closures through the end of November 2020. Of the 17 closures in 2020, four had critical access hospital designations, four had Medicare-dependent designations, and nine were reimbursed by Medicare on the standard prospective payment system.



SOURCES & REFERENCES

Healthcare & Senior Housing

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NAREIT Investment Performance by Property Sector
Source: FTSETM, Nareit®

Supply and Demand Changes Q3 2018 to Q3 2020
Source: NIC MAP Data Service



ABOUT VIEWPOINT

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ABOUT IRR

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