

SENIOR HOUSING INVESTMENT

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SENIOR LIVING VALUATION SERVICES, INC.

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The *Senior Housing Investment Survey* provides information concerning the investment criteria currently used or perceived to be used in the evaluation of senior housing properties. Survey participants included owners/operators, financial institutions/investors, brokers/mortgage bankers, appraisers and consultants.

Survey Methodology

The ninth annual *Senior Housing Investment Survey* was sent to 232 potential respondents including those with membership in various national senior housing associations, parties responding to the survey in previous years and others involved in the senior housing industry and known to the editor. As of an April 22, 2002 cutoff date, 62 surveys or 26.7% of the total sent had been returned. Of the respondents, 57% represent market principals such as owner/operators or financial institutions/ investors, a slightly higher percentage compared with previous years.

Survey Results

Survey respondents were geographically dispersed throughout the country with a slight weighting toward the West. Geographic location did not appear to bias the survey results as responses were not materially different between differing portions of the country. A slightly higher, near 50% of respondents this year identified themselves as having a national perspective compared to previous years. The respondents indicated a material difference between annual cash flow growth factors in revenue (3.2% average) and expense (3.5% average) projections, most likely attributable to recent increases in most types of insurance costs. Both cash flow growth factors were slightly above projections of overall inflation (3.0% average). 71% of all respondents noted that capitalization rates for senior housing properties in general are not expected to significantly change in the next 12 months (up sharply from 31% from last year). 29% of respondents expected capitalization rates to increase up to 100 basis points in the next year (down significantly from 64% from last year). No respondents expected capitalization rates to decrease up to 100 points in the next year; a small 5% of respondents expected capitalization rates to decrease by up to 100 basis points. It appears that a majority of respondents believe that

the market may be near a trough or has already bottomed out.

The specific overall capitalization rates, discount rates (internal rate of return) and equity dividend rates (cash on cash return) used or perceived to be used by respondents is presented on the following pages. The range and average of all responses and the range and average of all responses less the 5% highest and 5% lowest responses are shown.

The rate averages range from the lowest for age restricted apartments to the highest for licensed subacute skilled nursing facilities. These results are not surprising given the higher degree of management specialization, smaller profit margins and higher degree of licensing as one moves up the continuum of senior housing from age restricted apartments to unlicensed congregate facilities to licensed assisted living and alzheimer/dementia care facilities to licensed conventional and subacute skilled nursing facilities. Rates for continuing care retirement communities which are typically combinations of each of the above categories of senior projects, fell slightly below the average range of the other categories of senior housing types.

Highlights of the 2002 results include a leveling off trend in capitalization rates for most senior housing property types except for alzheimer/dementia care facilities which had a material increase in overall capitalization rates. The gap between the capitalization rates of assisted living projects and alzheimer/dementia care projects grew to a wide 100 basis points suggesting a clear market differentiation between these property types. Overall capitalization rates for conventional long term care nursing and short term care subacute nursing homes each fell slightly. Overall capitalization rates for unlicensed congregate living facilities rose slightly. Overall capitalization rates for assisted living projects and continuing care retirement projects were basically

**SENIOR LIVING VALUATION SERVICES, INC.
2002 SENIOR HOUSING INVESTMENT SURVEY**

Indicate the classification that best describes your company or profession (% of total responses):

<u>31%</u>	Owner/Operator	<u>25%</u>	Appraiser
<u>17%</u>	Financial/Institution/Investor	<u>1%</u>	Consultant
<u>26%</u>	Broker/Mortgage Banker		

Indicate the region with which you are involved with/knowledgeable of (% of total responses):

<u>12%</u>	East	<u>19%</u>	West
<u>8%</u>	South	<u>47%</u>	National
<u>14%</u>	Midwest		

What annual growth factors are you using (or perceived to be used by others) for cash flow projections of senior housing properties in general:

Range	Average	
<u>0%-5%</u>	<u>3.2%</u>	Revenues
<u>0%-5%</u>	<u>3.5%</u>	Expenses
<u>0%-4%</u>	<u>3.0%</u>	General Inflation

What are your expectations of overall capitalization rate changes for senior housing properties in general over the next 12 months (% of total responses):

<u>2002</u>		<u>2001</u>	<u>2000</u>
<u>0%</u>	Increase more than 100 basis points	<u>2%</u>	<u>2%</u>
<u>29%</u>	Increase 0 to 100 basis points	<u>64%</u>	<u>74%</u>
<u>71%</u>	Flat, no significant change	<u>31%</u>	<u>24%</u>
<u>5%</u>	Decrease 0 to 100 basis points	<u>3%</u>	<u>0%</u>
<u>0%</u>	Decrease more than 100 basis points	<u>0%</u>	<u>0%</u>

Overall Capitalization Rate

	<u>2002</u>		<u>2002</u>		<u>Basis Point</u>
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		<u>Change from</u>
	Range	Average	Range	Average	2001
Age Restricted Apartments	7.8%-11%	9.2%	8%-11%	9.4%	+20
Unlicensed Congregate Living	9%-12%	10.4%	9.5%-11.5%	10.4%	+30
Licensed Assisted Living	10%-12.8%	11.4%	10%-12.5%	11.3%	0
Licensed Alzheimer/Dementia Care	11.5%-14%	12.5%	11.5%-13.5%	12.3%	+50
Licensed Skilled Nursing-Long Term Care	11.8%-16%	13.3%	12%-15%	13.2%	-20
Licensed Skilled Nursing-Subacute Care	11.3%-18%	13.5%	12%-17%	13.5%	-40
Continuing Care Retirement Community	10%-13%	11.2%	10.5%-13%	11.3%	+10

Internal Rate of Return (Discount Rate)

	<u>2002</u>		<u>2002</u>		<u>Basis Point</u>
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		<u>Change from</u>
	Range	Average	Range	Average	2001
Age Restricted Apartments	10%-15%	11.9%	10%-14%	11.8%	-50
Unlicensed Congregate Living	11.4%-18%	13.7%	11.5%-16%	13.0%	-110
Licensed Assisted Living	12%-25%	15.0%	12.5%-23%	14.8%	-160
Licensed Alzheimer/Dementia Care	12%-25%	15.6%	12%-20%	15.2%	-140
Licensed Skilled Nursing-Long Term Care	12%-20%	15.3%	13%-18%	15.4%	-60
Licensed Skilled Nursing-Subacute Care	12%-20%	15.9%	13%-18%	15.7%	-80
Continuing Care Retirement Community	11%-15%	13.9%	11%-15%	13.9%	+80

Equity Dividend Rate (Cash on Cash Return)

	<u>2002</u>		<u>2002</u>		<u>Basis Point</u>
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		<u>Change from</u>
	Range	Average	Range	Average	2001
Age Restricted Apartments	8%-27%	12.0%	10%-23%	11.7%	+70
Unlicensed Congregate Living	9%-27%	14.8%	10%-23%	14.5%	+130
Licensed Assisted Living	9.5%-27%	17.0%	10%-25%	16.0%	-10
Licensed Alzheimer/Dementia Care	10.5%-27%	17.3%	11%-25%	17.0%	+40
Licensed Skilled Nursing-Long Term Care	12%-27.5%	19.4%	12%-25%	18.9%	+160
Licensed Skilled Nursing-Subacute Care	13%-30%	19.8%	14%-25%	19.3%	+180
Continuing Care Retirement Community	10.5%-27%	16.4%	11%-23%	16.1%	+110

(1) Minus 5% Highest and 5% Lowest Responses

flat between 2001 and 2002. On balance, the annual increases in capitalization rates reflected in this survey in the last few years appear to have abated, although expectations of capitalization rate declines in the short run are minimal.

Oddly, reported discount rates for most property types significantly declined from 2001 to 2002. One would expect capitalization rates and discount rates to move in tandem but the 2002 survey results indicate a tightening of the spread between capitalization rates and discount rates to more historical levels. The 2001 spreads between cap rates and discount rates were unusually high. In our opinion, this may reflect varying interpretations and understanding of what a discount rate is and its relationship to capitalization rates, more than any market trend.

Equity dividend rates increased for most senior housing property types as equity sources when they are available, appear to have become demanding by requiring higher returns.

Survey Relevance

2001/2002 has seen a continuation and consolidation of industry trends that began in 2000. Market conditions and trends have become slightly more focused than during the more transitional and uncertain 2000/2001 period, but still remain generally fuzzy. The senior housing market has bifurcated between healthy and troubled projects, with healthy projects being in demand among a small but well financed pool of buyers who will sometimes bid aggressively for projects. Conversely, the market has punished unhealthy or troubled projects and/or operators by being very conservative in an evaluation of a project's potential over its actual performance. Capitalization rate premiums of 100 to even up to 500 basis points over a base capitalization rate are not uncommon for distressed properties.

New development activity remains isolated to specialty situations and markets with higher barriers to entry.

Many markets in the country that were overbuilt during the late 1990's have become relatively healthier as the growing demand pool has approached a mostly constant supply. Development and expansions of continuing care retirement communities have remained relatively strong in 2002 due to their longer development periods, an atypical ability to attract below market rate, tax exempt financing and historically lower interest rates.

The results of this survey can be an asset in the evaluation of new development or acquisitions by lenders and investors. However, market illiquidity and the specialized management driven characteristics of the industry overall and on individual properties specifically, mute the impact of more traditional measures of analyzing real estate such as capitalization, discount and return on equity analysis. Other limiting factors include a lack of confidence in the uniform application and understanding of these criteria - especially for non-stabilized or more complicated properties, the difficulty in quantifying general and specific property risk and illiquidity, concerns over reliable future cash flow projections and their unproven relevance for not-for-profit owners/investors.

Other investment criteria used including the terms and availability of debt and equity financing, debt coverage ratios, relationships to replacement cost, market share, portfolio affect and geographic concentration value surcharges and opportunities for significant cash flow gains in distressed or underutilized properties. These criteria have their own significant limitations such as the inability to objectively account for property specific risk and more comprehensively assess the impact of a potential default and resale of a property. As the senior housing industry matures and more institutionally driven investment decisions are made, we would expect that the application of capitalization/discount rate analysis for senior housing properties would become more uniform and better understood and consequently, more widely relied upon.

The Senior Housing Investment Survey is compiled and produced by Senior Living Valuation Services, Inc., a San Francisco based firm that specializes in the appraisal of all forms of senior housing. Readers are advised that Senior Living Valuation Services, Inc. does not represent the data contained herein to be definitive. The contents of this publication should also not be construed as a recommendation of policies or actions. Quotation and reproduction of this material are permitted with credit to Senior Living Valuation Services, Inc.

Inquiries, comments or requests of interested parties wanting to participate in the 2003 survey can be directed to:

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