

SENIOR HOUSING INVESTMENT

S U R V E Y

VOLUME 5

SENIOR LIVING VALUATION SERVICES, INC.

SPRING 1998

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 fifth annual *Senior Housing Investment Survey* was sent to 245 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, 1998 cutoff date, 71 surveys or 29.0% of the total sent had been returned. Ideally, we would prefer sending the survey only to those parties actually making or involved in investment decisions. However, because the senior housing industry is relatively new and limited in size, we have included other parties such as brokers, appraisers, consultants and other knowledgeable parties with opinions or perceptions of investment criteria used by market principals. Because the industry is relatively immature, these secondary parties can more significantly influence investment decisions. Of the respondents, 49% represent market principals such as owner/operators or financial institutions/investors, a lower percentage than in 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. We also noted no material difference in the survey results by classification of the respondent. More respondents this year identified themselves as having a national perspective than in previous years. The respondents indicated a fairly tight range of annual cash flow growth factors in revenue (3.4% average) and expense (3.2% average) projections. These cash flow growth factors were slightly above projections of overall inflation (3.0%

average). 59% of all respondents noted that capitalization rates for senior housing properties in general are not expected to significantly change in the next 12 months. 24% of respondents expected cap rates to increase up to 100 basis points in the next year and 17% expected cap rates to decrease up to 100 points in the next year. The percentage of respondents who expect no significant change in cap rates in the next 12 months increased by 15% to 59% in 1998 from 1997, while the percentage who expect cap rates to increase in the next 12 months decreased by 13% to 24%. The percentage of respondents who expect cap rates to decrease in the next 12 months showed no material change from 1997 to 1998, suggesting that current cap rates may have bottomed out within the current real estate cycle.

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 illustrated.

The rate averages range from the lowest for age restricted apartments to the highest for licensed conventional skilled nursing facilities and subacute skilled nursing facilities. These results are not surprising given the higher degree of management specialization, smaller profit margins and greater reliance on uncertain government reimbursement 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. The equal cap rates for conventional skilled nursing and subacute skilled nursing projects is somewhat surprising given most subacute facility's reliance on more volatile

**SENIOR LIVING VALUATION SERVICES, INC.
1998 SENIOR HOUSING INVESTMENT SURVEY**

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

<u>18%</u>	Owner/Operator	<u>30%</u>	Appraiser
<u>31%</u>	Financial/Institution/Investor	<u>4%</u>	Consultant
<u>16%</u>	Broker/Mortgage Banker		

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

<u>12%</u>	East	<u>21%</u>	West
<u>7%</u>	South	<u>43%</u>	National
<u>17%</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%-6%</u>	<u>3.4%</u>	Revenues
<u>2%-5%</u>	<u>3.2%</u>	Expenses
<u>1%-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>1998</u>		<u>1997</u>	<u>1996</u>
<u>0%</u>	Increase more than 100 basis points	<u>1%</u>	<u>0%</u>
<u>24%</u>	Increase 0 to 100 basis points	<u>37%</u>	<u>12%</u>
<u>59%</u>	Flat, no significant change	<u>44%</u>	<u>49%</u>
<u>17%</u>	Decrease 0 to 100 basis points	<u>18%</u>	<u>37%</u>
<u>0%</u>	Decrease more than 100 basis points	<u>0%</u>	<u>2%</u>

Overall Capitalization Rate

	1998		1998		Basis Point Change from 1997
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	7.8%-12%	9.5%	8.5%-11.5%	9.4%	-30
Unlicensed Congregate Living	8%-14.5%	10.4%	9%-12%	10.3%	0
Licensed Assisted Living	9%-13%	10.7%	9.8%-12%	10.7%	-40
Licensed Alzheimer/Dementia Care	9%-14%	11.3%	10%-13%	11.3%	+10
Licensed Skilled Nursing-Long Term Care	9.5%-14%	12.5%	10.5%-14%	12.6%	-20
Licensed Skilled Nursing-Subacute Care	9%-15%	12.5%	10.5%-14%	12.5%	-90
Continuing Care Retirement Community	9.5%-15%	11.1%	10%-12.5%	11.1%	-50

Internal Rate of Return (Discount Rate)

	1998		1998		Basis Point Change from 1997
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	10%-20%	12.3%	10%-14%	12.0%	0
Unlicensed Congregate Living	10.5%-30%	14.3%	12%-20%	13.5%	+10
Licensed Assisted Living	9%-30%	14.4%	11.2%-20%	13.9%	-40
Licensed Alzheimer/Dementia Care	9%-30%	14.3%	12%-20%	14.1%	0
Licensed Skilled Nursing-Long Term Care	9%-20%	14.7%	12%-16%	14.3%	-20
Licensed Skilled Nursing-Subacute Care	11%-18%	14.7%	12%-18%	14.7%	-30
Continuing Care Retirement Community	11%-25%	15.4%	12%-22%	15.0%	+90

Equity Dividend Rate (Cash on Cash Return)

	1998		1998		Basis Point Change from 1997
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	6%-16.5%	11.4%	9%-16%	11.4%	-30
Unlicensed Congregate Living	6.5%-18%	13.7%	9%-18%	13.7%	-60
Licensed Assisted Living	7%-30%	15.0%	11%-20%	14.5%	-170
Licensed Alzheimer/Dementia Care	6.5%-24%	16.5%	12%-20%	15.4%	-30
Licensed Skilled Nursing-Long Term Care	7%-25%	16.0%	10.5%-21.5%	15.9%	+140
Licensed Skilled Nursing-Subacute Care	7%-25%	16.8%	13%-22%	17.1%	+10
Continuing Care Retirement Community	7%-25%	15.1%	8%-20%	15.0%	+80

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

and vulnerable Medicare reimbursement. This may reflect the growing importance of contracted and relatively stable managed care reimbursement for subacute care. Cap rates for continuing care retirement communities which are typically combinations of each of the above categories of senior projects, fell within the average range of the other categories of project types (near the middle). Alzheimer/dementia care capitalization rates were within the range of cap rates for assisted living and skilled nursing care, slightly closer to assisted living cap rates. Capitalization rates declined materially for age restricted apartments, assisted living facilities, subacute nursing homes and continuing care retirement communities. 1998 cap rates for alzheimer/dementia care projects actually increased slightly from the 1997 results. Equity rates of return were higher for alzheimer/dementia care projects than for conventional assisted living project equity rates of return, which showed a material decline from 1997 to 1998. It appears that alzheimer/dementia care has emerged as a distinct property type within the senior housing continuum and not just as specialized assisted living.

The 1998 survey results confirm the anecdotal impression of continued declines in capitalization rates for most senior housing property types, although the rate of decline is less than in previous years for most property types. Changes in discount rates were positively correlated to declines in capitalization rates. An interesting result in the survey is the decline in equity rates of return for the less intensive senior housing property types and the increase in equity rates of return for the more intensive senior housing property types. This may reflect a current focus on expansion of market share over short term rates of return for the more active senior housing property types, particularly assisted living.

Survey Relevance

1997/1998 saw the intensification of trends which had

begun over the prior 18 to 24 months as almost all geographic markets and senior housing property types could be considered active. Liquidity in the debt and capital markets continue to feed the current activity. Indications that the market overall may be at or approaching the peak of this real estate cycle include greater concern about overbuilding in the more attractive geographic market areas, slower absorption rates for some new projects in some markets, sale prices of improved properties equaling and sometimes exceeding replacement cost and the emergence of less experienced senior housing developers.

The results of this survey can be an asset in the evaluation of new development or acquisitions by lenders and investors. However, overall market illiquidity, and the specialized, management driven characteristics of the industry mute the impact of more traditional measures of analyzing real estate such as discounted cash flow 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 reliable future cash flow projections and their unproven relevance for not-for-profit owners/investors. Other investment criteria used included increasing reported earnings per share, debt coverage ratios, relationships to replacement cost, increasing market share 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 investment decisions occur, 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.

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