

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 tenth annual *Senior Housing Investment Survey* was sent to 270 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, 2003 cutoff date, 68 surveys or 25.2% of the total sent had been returned. Of the respondents, 48% represent market principals such as owner/operators or financial institutions/investors, a slightly lower 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. Approximately 30% of respondents this year identified themselves as having a national perspective, a lower percentage compared to previous years. The respondents indicated no material difference between annual cash flow growth factors in revenue (3.1% average) and expense (3.1% average) projections. Both cash flow growth factors were slightly above projections of overall inflation (2.6% average). 66% of all respondents noted that capitalization rates for senior housing properties in general are not expected to significantly change in the next 12 months (near the 71% from last year). Only 13% of respondents expected capitalization rates to increase up to 100 basis points in the next year (down significantly from 29% from last year). No respondents expected capitalization rates to decrease over 100 points in the next year; a material 19% of respondents expected capitalization rates to decrease by up to 100 basis points (up from only 5% last year). It appears that a majority of respondents believe that the market has already bottomed out with some cause for optimism for lower capitalization rates in the near term.

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 2003 results include a flat trend in overall capitalization rates for unlicensed congregate living and licensed assisted living facilities, with no change from the previous year. Overall capitalization rates for age restricted apartments, alzheimer/dementia care facilities, conventional long term care nursing facilities and continuing care retirement communities all fell slightly from 2002 to 2003. Overall capitalization rates for subacute nursing facilities rose slightly, widening the capitalization rate gap between these projects and conventional long term nursing care projects. The gap between the capitalization rates of assisted living projects and alzheimer/dementia care projects shrank to 60 basis points, down from a 100 basis point difference in 2002. The 90 basis point difference between capitalization rates for unlicensed congregate living facilities and licensed assisted living facilities remained unchanged between 2002 and 2003. On balance, the annual increases or upward trend in overall capitalization rates reflected in this survey in the last few years appear to have halted, with small decreases in many senior housing property types.

Reported discount rates for almost all property types significantly declined from 2002 to 2003, with the exception

**SENIOR LIVING VALUATION SERVICES, INC.
2003 SENIOR HOUSING INVESTMENT SURVEY**

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

<u>34%</u>	Owner/Operator	<u>31%</u>	Appraiser
<u>14%</u>	Financial Institution/Investor	<u>1%</u>	Consultant
<u>20%</u>	Broker/Mortgage Banker		

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

<u>14%</u>	East	<u>28%</u>	West
<u>11%</u>	South	<u>30%</u>	National
<u>18%</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%-8%</u>	<u>3.1%</u>	Revenues
<u>2%-5%</u>	<u>3.1%</u>	Expenses
<u>0%-4%</u>	<u>2.6%</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>2003</u>		<u>2002</u>	<u>2001</u>
<u>2%</u>	Increase more than 100 basis points	<u>0%</u>	<u>2%</u>
<u>13%</u>	Increase 0 to 100 basis points	<u>29%</u>	<u>64%</u>
<u>66%</u>	Flat, no significant change	<u>71%</u>	<u>31%</u>
<u>19%</u>	Decrease 0 to 100 basis points	<u>5%</u>	<u>3%</u>
<u>0%</u>	Decrease more than 100 basis points	<u>0%</u>	<u>0%</u>

Overall Capitalization Rate

	2003		2003		Basis Point Change from 2002
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	8%-10%	8.9%	8%-9.5%	8.9%	-50
Unlicensed Congregate Living	8%-12%	10.4%	9%-12%	10.4%	0
Licensed Assisted Living	8%-13%	11.3%	10%-12.5%	11.3%	0
Licensed Alzheimer/Dementia Care	9.5%-14%	11.9%	10.5%-14%	11.9%	-40
Licensed Skilled Nursing-Long Term Care	10%-15%	12.7%	11%-14%	12.7%	-50
Licensed Skilled Nursing-Subacute Care	11%-17%	13.8%	12%-16%	13.8%	+30
Continuing Care Retirement Community	8.75%-13%	11.1%	10%-13%	11.2%	-10

Internal Rate of Return (Discount Rate)

	2003		2003		Basis Point Change from 2002
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	8%-15%	10.1%	9%-14%	10.4%	-140
Unlicensed Congregate Living	9%-25%	12.7%	10%-20%	12.0%	-100
Licensed Assisted Living	9%-25%	14.6%	11.5%-20%	14.1%	-70
Licensed Alzheimer/Dementia Care	9.5%-25%	14.9%	12%-20%	14.5%	-70
Licensed Skilled Nursing-Long Term Care	12.5%-20%	15.5%	14%-18%	15.4%	0
Licensed Skilled Nursing-Subacute Care	13%-20%	16.5%	13.5%-19%	16.6%	+90
Continuing Care Retirement Community	9.8%-15%	13.1%	10.8%-15%	13.2%	-70

Equity Dividend Rate (Cash on Cash Return)

	2003		2003		Basic Point Change from 2002
	<u>All Responses</u>		<u>Adjusted Responses⁽¹⁾</u>		
	Range	Average	Range	Average	
Age Restricted Apartments	9%-20%	13.0%	10%-17.5%	12.8%	+110
Unlicensed Congregate Living	9%-25%	14.2%	10%-20%	13.7%	-80
Licensed Assisted Living	10%-27%	16.3%	10%-25%	15.9%	-10
Licensed Alzheimer/Dementia Care	10%-35%	19.0%	12%-28%	18.1%	+110
Licensed Skilled Nursing-Long Term Care	8%-35%	20.3%	13%-32%	19.6%	+70
Licensed Skilled Nursing-Subacute Care	12%-35%	22.2%	15%-32%	21.3%	+200
Continuing Care Retirement Community	12%-25%	18.6%	15%-25%	18.5%	+240

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

of subacute nursing facilities which saw a sharp increase in discount rates. One would expect capitalization rates and discount rates to move in tandem but the 2003 survey results indicate a tightening of the spread between capitalization rates and discount rates to more historical and appropriate levels. The 2001 and 2002 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, with the exceptions of unlicensed congregate living and licensed assisted living facilities, which saw declines in equity dividend rates. This may reflect lowered expectations of higher equity returns for unlicensed congregate living and assisted living facilities or a greater familiarity and relative liquidity of these senior housing property types.

Survey Relevance

2002/2003 has seen a continuation and consolidation of industry trends that began in 2000. Market conditions and trends have become more focused than during the transitional and uncertain 2000/2001 period. It appears that 2002 may have seen the peak of the current cycle of upward capitalization rate trends, although widespread financing liquidity is still nonexistent. Though the current period of overall "constructive stagnation" in the senior housing industry is still ongoing, market activity remains strong for preferred developers and already well capitalized buyers of existing projects. During 2002, a growing number of buyers were tempted to purchase existing projects by the lower sale prices for assets of financially challenged companies and historically low mortgage interest rates, when financing was available. In short, it appears that in 2002/2003 the strongest senior housing companies in the industry became stronger and the weaker companies became more stable and consolidated. There still is very limited equity and debt financing available for new or small senior housing developers or buyers.

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 healthier as the growing senior household demand pool has approached equilibrium with a mostly constant supply. The number of markets that would be considered as overbuilt for senior housing has declined. Development and expansions of continuing care retirement communities have remained relatively strong in 2003 due to their longer development periods, an atypical ability to attract below market rate, tax exempt financing, and historically low interest rates. Age restricted apartments saw continued signs of a large scale emerging senior housing property type.

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, exposure to health care liability costs, 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 to 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.

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