Senior Housing & Care

Question of the Month

Q: "How has the recent predominance of REITs and the emergence of many new equity funds impacted the more traditional sources of equity and financing for seniors housing, and what do you see as the future role of HUD/FHA lending programs and commercial bank lending?"

Please contact Pyms Capital Resources or The Highland Group if you would like to participate in the Senior Housing & Care Question, or if you have a question that you would like to see addressed.

Peter Wessel

Seniors housing owner-operators have a number of choices in how they capitalize the acquisition, development and operation of their facilities. Choosing between various sources of equity versus debt involves several considerations: a) cost of capital, b) emphasis on ownership versus operations, c) predilection for risk and d) return on investment.

Peter Wessel
Senior director, Love Funding Corp.

Banks offering floating-rate debt generally offer the lowest cost of debt, however, bank loans tend to be lower leverage, shorter term and recourse. Lower leverage requires higher investment of equity, with higher yield requirements, thereby offsetting the nominal advantage of low-cost debt. Shorter terms expose owner-operators to interest rate and market risk upon loan maturity. Recourse provisions trigger personal or corporate guarantee exposure on the debt.

On the other end of the spectrum are real estate investment trust sale-leaseback and other forms of participating or quasi-equity financing structures. These are more expensive sources of capital, but provide high leverage and may be best suited for seniors housing operators who desire to emphasize operations over real estate ownership as a business strategy.

Federal Housing Administration-insured (U.S. Department of Housing and Urban Development) financing offers nonrecourse, high-leverage, fixed-rate debt financing to owner-operators who desire to maximize investment return in the real estate assets as well as operations. Although fixed-rate debt tends to carry a higher nominal interest rate than floating-rate debt, it eliminates interest rate risk. The high leverage of an FHA-insured loan means less equity is required, thereby bringing down the effective blended cost of capital.

Michael Thomas

Private equity and REITs have increased investment in the senior housing demographic based on the industry's favorable risk-reward. Health care REITs now represent the fourth largest sector of equity REITs, comprising 11.3 percent of the market, following behind retail, residential and office.

Michael Thomas
Vice president, multifamily and health care, Gershman Mortgage

Senior housing continues to be bolstered by the retirement community's industry revenue growth, predicted to accelerate in the next five years due to more retiring baby boomers. Industry value added (a measure of the industry's contribution to the overall U.S. economy) is forecast to grow at 5.9 percent annually over the 10 years to 2020; gross domestic product is projected to grow only by 2.5 percent.

While there are multiple lenders in the senior housing space, the HUD/FHA programs will remain a viable option for many developers. The new-construction program is the only one that offers a construction/permanent loan with no recourse and a fully amortizing, 40-year fixed-rate loan. Further, HUD has recently announced lower mortgage insurance premiums for certain affordable projects and also properties that meet a variety of energy standards. This drop is a significant savings to proposed projects that qualify. The other sources, such as bank financing and REITs, also will remain viable options. Banks are limited by "concentrations" defined

Please see **Senior,** *Page 45*

MODERATOR COMMENTS

Elisabeth Borden
Principal, The Highland Group Inc.

"The sources of equity and financing for seniors housing and care have made a dramatic shift over the past few years. It is critical to understand the impact of these shifts and the future of funding for new development. I want to thank these three professionals for sharing their thoughts."

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Finance

Continued from Page 23

egory right now is the commercial mortgage-backed securities market. A number of regulations coming into effect over the next few years are already affecting pricing and certainty of execution. Dodd Frank will soon require CMBS issuers to retain 5 percent of the face value of each class of securities issued in a transaction for a minimum of five years. The inevitable threat of reduced liquidity and tighter regulations is impacting pricing as spreads have widened significantly in the last year to the tune of 100 to 150 basis points. In addition to an increasingly stringent regulatory environment, CMBS is subject to the violent swings in the global financial markets. The same kind of irrational fear that sparked the reaction to the Rocket Mortgage commercial is dictating the pace and behavior of global capital flows. Market turbulence is influenced on a daily basis by a number of catalysts, including (but not limited to) the Chinese economy, the energy markets and turmoil in the Middle East.

With no hedge against moving interest rates, CMBS borrowers are experiencing more re-trades in pricing and structure up to the day of closing, which can significantly impact the return hurdles planned for the investment. The volatility in the CMBS market will have its biggest impact on smaller, private equity investors who rely on aggressive debt structures for commercial real estate investments.

On the bright side, the turmoil in the securitized market has created opportunity for other lenders to provide new structures to be competitive on higher-leverage, "off-the-fairway" requests. While many life companies are conducting business as usual, others are tapping into different buckets of balance sheet or third-party funds in order to offer new loan programs. For long-term, fixed-rate requests, some lenders will offer high-leverage options (in some cases up to 85 to 90 percent) by breaking the loan into an "A-B" structure, which consists of a market spread/LTV on the "A" note with an above-market spread on the "B" note. Another solution for life insurance companies is to offer competitive, short-term floating rate solutions for transitional, value-add or core-plus properties. Spreads on balance sheet, floating-rate loans can be as low as 180 plus LIBOR for trophy assets but are typically in the 300- to 500-plus LIBOR range on an interest-only basis.

Investors seeking value-add to core-plus assets will also look to banks and debt funds for short-term, floating-rate money. Banks are becoming more and more selective with implementation of Basel III in the near future. This regulation will require banks to have more liquidity, which in turn will increase spreads to their customers as a pass-through of funding costs. In just the last few months, banks have increased their floating-rate spreads by 25 to 50 basis points. Debt funds are immune to regulatory environments and for this reason typically will take more risk. A number of groups in this category are offering bridge loans that are fully funded "on book" while others rely on securitizing or creating collateralized loan obligations. The balance sheet debt funds are able to compete more effectively for business since they are in control of their own capital.

In spite of the inefficiencies in the market, real estate fundamentals continue to strengthen on a national basis. The year 2016 will be an active year but will require some creativity and the ability to cast a wide net in order to capture an ideal loan structure.▲

Law

Continued from Page 24

the court, again, stated: "We will sustain respondent's (IRS') adjustments disallowing for 2007 and 2008 petitioners' charitable contribution deductions."

And, as to penalties, the court said that since the taxpayers did not include the appraisal with their tax return filing, the taxpayers "are thus liable for accuracy-related penalties" See Code Section 6662(b).

And, as mentioned earlier, the taxpayers were also charged with a valuation misstatement, causing them to have to pay a 40 percent penalty.

■ **Conclusion.** The moral of the story that one can lose a charitable deduction and face penalties – by failing to comply with the appraisal requirements to claim a charitable deduction – which seems apparent. Yet as mentioned earlier in this article, these types of cases arise far too often. (For a collection of these decisions and related issues as to charitable gifts, see the Levine and Segev Work, Real Estate Transactions, cited supra in this article.)

Clearly, this failure to attach a qualified appraisal to the tax return of the taxpayers was a costly mistake.▲

Senior

Continued from Page 36

as loans extended to a common industry or pool that may perform similarly and may not exceed 100 percent of their total risk-based capital. With all the rapid growth, this may result in some banks scaling back.

Rob McAdams

The growing appetite for stabilized, high-quality assets by publicly traded REITs has made it difficult for traditional private investors and owner-operators to invest directly in those properties. The public REITs benefit from a favorable tax structure and access to public markets, which yields them the lowest cost of capital. And they need cash flow to feed dividends.

The private REITs, which have a higher cost of capital, are typically acquiring individual assets or small portfolios with the goal of aggregating sizeable portfolios that can be sold to public REITs. They'll pursue "A" assets with upside if the public REITs aren't bidding.

Rob McAdams
Vice president, Lancaster Pollard

The traditional private-equity players and owner-operators have patient, albeit more expensive, capital. Their higher return thresholds have steered them toward turnaround acquisitions with the potential for value creation. They've essentially been eliminated from the "A" asset buyer pool because REIT demand has caused cap rates to compress so low that it's not possible for them to outbid the competition and hit their hurdle rates.

With owner-operators and private equity still accounting for around 60 percent of merger and acquisition activity, demand for HUD/FHA financing and conventional loans remains strong. Because HUD/FHA-enhanced financing allows investors to borrow on the credit of the U.S. government, there always will be private-sector demand for the attractive nonrecourse terms provided by that product. I expect to see a reduction in both volume and leverage from commercial banks as a result of increased banking regulations such as the high-volatility commercial real estate rule.▲

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