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Lenders Prefer Existing, but Obsolescent, Product

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Capital raised by healthcare REITs through the first half of 2012 set a record at more than $7.5 billion, according to Jones Lang LaSalle, with much of that investment going for seniors housing portfolio acquisitions. However, in an industry that's facing one of the starkest shortages of property vs. demand, investors are still leery of putting money down for seniors property development.

About 85 percent of spending by healthcare trusts is now going toward seniors housing, which is producing the highest rates of return of any property sector. This rate is even more impressive when you figure that many of the properties are almost obsolete in terms of new demand, says Mindy Berman, a managing director with JLL's healthcare markets group.

Mindy Berman

"The problem with trusts is that they're not general developers," she says. "All this capital chasing seniors housing is not chasing development, and there's an inadequate supply of construction financing." Banks and other debt have pulled back from seniors housing because, however unfairly, of its similarity to the rest of commercial property and the necessity of a strong housing market. Lancaster Pollard Senior Vice President Nick Gesue says the economic downturn shouldn't have affected seniors housing, but banks and other financing sources have blindly pulled up the drawbridge for all real estate classes. And though the National Investment Center for Senior Housing and Care has worked hard in the past few years to make the industry more transparent, Gesue says the financial world needs more education.

"Our occupancy has rebounded in occupancy and rent, and our public companies have outperformed other trusts. This has piqued a lot of interest in our sector," Gesue says. "I think banks are going to come back to the market, though they're going to be cautious. What you have today are smaller banks, that didn't have as much real estate exposure, willing to lend for local senior living."

There are also several large private equity funds, such as Prudential's $500 million spending plan in seniors living, but like the trusts, that cash is earmarked mostly for acquisitions, not development. "Most funds say that new development is a low priority as they work on strategic turnarounds and recapitalizations," Gesue says. "I think as people get a little less nervous about ground-up development and the risk of failed leases, you're going to see private equity filling that gap in seniors housing finance. My hope is that it's a measured growth of development financing, and not a flip of a switch that could result in overdevelopment of the sector."

Harrison Street Principal Michael Gordon says there are many reasons why capital should be chasing seniors housing, including its attractive risk/return profile when compared to other sectors, a growing acceptance of it as an institutional asset class, its diversification impact on a real estate portfolio and the ability to place very attractive low-interest rate debt financing on both acquisition and ground-up development transactions. He says he has witnessed an interesting shift in the general dynamics on the lender side of the transaction equation.

"First and foremost, there are more lenders providing debt to the industry than ever before," Gordon says. "Just as investors have embraced the sector, so has a wider collection of local, regional and national banks, as well as debt funds and insurance companies, among others, though it is mostly for acquisitions."

There is lender interest in financing new projects, Gordon says, but the issue is that the underwriting guidelines that have been set by lenders' credit/risk departments have been largely transaction prohibitive.

"While we have been successful in generating significant lender interest for our senior housing construction deals, we certainly have experienced a level of frustration as it relates to many provisions that have are increasingly making their way into construction loan documents," he says. "Lenders have incorporated significantly more mechanisms in order to protect them from the unknowns that can occur during the construction/lease-up process as it relates to the project, the developer and borrower. Lenders need to check an increasing number of boxes in order to comfortably provide construction debt, and this criterion is largely inconsistent with what developers can and/or will provide to lenders."

According to Gordon, without the marriage of a strong developer/operator, a substantial equity investor and equity commitment and a strategic location/market, lenders are unable to validate moving forward with debt commitments. "In my eyes, this isn't necessarily a bad thing, as it is largely cleansing the system and allowing only the best developers/operators from delivering product in those markets that need additional supply," he says.

Chicago-based Harrison Street has delivered on a few development projects, including properties located in The Woodlands, near Houston, and in Needham, Mass., near Boston. The Woodlands project includes 210 units of independent living, assisted living and memory care, and is 60 percent leased. The 60 units of memory care in Needham are fully occupied, with a waiting list. Both properties rent at higher than initial projections, Gordon says.

"For all of the above deals, we received significant interest from lenders, with anywhere between five to 10 lenders responding," Gordon says. "While the proceeds for our most recent development transactions might be lower than they were a few years back, we are experiencing significantly quicker absorption, allowing us to stabilize sooner and refinance into fixed-rate debt. Additionally, to balance out the higher equity requirements, we've been borrowing at construction loan interest rates of 250 to 300 basis points over LIBOR, which really drives down the interest/lease-up reserve costs within our development budget. To the extent that you assemble the right team, there is tremendous opportunity to deliver product at a very opportune time."