November 18, 2022

Generations Fall 2022 - Opportunities in Senior Living: A Panel Discussion

On October 11th, Peter Bilfield, Co-Head of the Investment Management and Private Funds Group at Day Pitney, led a roundtable discussion on the latest investment trends in the senior housing market. The panel included Vasileios Sfyris, managing partner of Phorcys Capital Partners, Jay Jordan, co-head of Grandbridge Real Estate Capital's National Senior Housing Investment Sales team and Seth Walker, Chief Financial Officer for SRI Management.

Peter Bilfield: I'm going to start by introducing our panelists. Seth Walker is the Chief Financial Officer for SRI Management, responsible for the management of the corporate accounting and finance department, which includes ensuring timely and accurate financial reporting for all its stakeholders, including owners, managers and banks. Seth manages the company's owner and lender relationships and works with its operators to identify and exploit opportunities and spot negative trends before they become issues. He works on deals ranging from $40 million to more than $1 billion, primarily in healthcare, including senior housing. It was this experience that eventually led Seth to the operations side with SRI.

Vasileios Sfyris is the managing partner and portfolio manager with Phorcys Capital Partners, a private investment firm launched in 2014 that manages high-yield and distressed credit, with a focus on asset-backed municipal bonds. Vasileios began his career in the financial services industry in 1999 and honed his skills in analyzing and trading distressed and high-yield municipal bonds working on the Atlantic desk of Bergen Capital in 2010. He co-founded First Southern LLC, a full-service broker-dealer focused on fixed-income sales and trading.

Jay Jordan is co-head of Grandbridge Real Estate Capital's National Senior Housing Investment Sales team, based in Tampa, Florida. Together with David Kliewer, he leads a national sales team first established by industry veteran Allen McMurtry in 1986 that has focused exclusively on representing sellers of senior housing and care properties for more than 30 years. Jay was previously with Cushman & Wakefield.

Thank you, gentlemen. I appreciate your taking the time to sit on this panel on senior housing. I want to start by giving our audience a high-level understanding of what it means to be involved in senior living. Jay, perhaps you can give us a 30,000-foot view of the senior living landscape.

Jay Jordan: Sure thing, and thank you for the introduction. I'll start it off at a very high level, and then, Seth, I welcome your input. If you think about the history of senior living, what prompted such a large boom in the space was really a limited set of options, and those that were available were more institutional and hospital-like in nature. In the early to mid-1980s, there were folks who launched a dedicated practice to create an alternative finding that there was tremendous depth to this market and residents and families seeking more options and more of a lifestyle within retirement communities. And out of this was born senior living as we know it today—a sector that continues to expand into a wide variety of options, spanning from 55-and-over active adult to independent living, assisted living, memory care, and a full continuum of care and types of communities, ranging in price and amenities, giving folks a lot more options. I'll pause for a moment and mention that we have yet to fully realize the coming wave of baby boomers, something like 10,000 people a day in the United States who are turning 65. But it's important to note that many residents do not move into a senior living community until they are in their 80s, so we're not quite at the crest of this demographic wave—for senior housing anyway—but it will really ramp up in the next couple of years. What makes this a really exciting time for the senior housing sector is that it has been growing for some time now, but we're about to have a really large demographic wave come of age. Moreover, senior housing has become a more broadly accepted asset class, distinct from general commercial real estate and, in many cases, the exclusive focus of certain

investment funds. Tremendous amounts of institutional capital, private equity and dedicated lending have flowed into the space for some time, which has helped maintain liquidity and capital flows within the industry. Additionally, customer views and behaviors around senior housing are much more open than in past generations. Overall, health, wellness and lifestyle are key features, and adult children play a pivotal role. With that, I will kick it over to Seth, who can address the more day-to-day senior care and what the lifestyle options are.

Seth Walker: Thanks, Jay. Senior living breaks down into a few different product offerings. And they run the gamut. As far as care and services that are provided, at the highest level of service is memory care, which is a specialized type of assisted living that is geared toward seniors who have Alzheimer's or dementia. You would get your normal assisted living activities on top of additional care more focused on this product type. Also, there is daily living nursing at a basic level, not the high-skilled type of nursing you would see in a full-scale nursing facility, and these services would be provided in a secure and closed environment. So, if you don't have a risk of needing services that move up the care spectrum, this type of service is primarily of use to our seniors who need assistance with daily activities—medication, management, things like that. We'd also provide three meals a day. Generally, housekeeping is included and activities are available three to four times a day. Coming out of assisted living care, there is a need to fill a gap between seniors who are at home and those who don't quite need assisted living. Some of those folks don't necessarily want the same types of structures. You have those living in their home, and that's where independent living comes in. We think of it as a high-service model, having three meals a day in the house, sleeping, laundry and activities. You see an assistant with them, but it does not include the care and nursing tech component. Then the last type of the product would be active adult with no services, no activities. You're just looking at apartments that are designed for seniors. Senior care was very hot for a while, and then it moved to assisted independent living. We're starting to see people get more interested in the active care space.

Peter Bilfield: Thanks, Seth, for giving us that background on the sector, and to Jay as well. It's helpful to set up the discussion for our second question, which is why invest in senior living? We've all seen the headlines with COVID-19 and some of the inflationary pressures. What's the opportunity in this asset class, Seth? Do you have some thoughts on that?

Seth Walker: A lot of people see senior living more on the assisted living and memory care sides. People see it as being less sensitive to recessions. The largest generation of Americans in history are coming of age now. That group is generally used to a higher standard of living than the generation before them, and a lot of people are trying to get ahead of that by providing housing and services for this generation. I think senior living is a great long-term investment strategy. The rates are good and the long-term prospects are encouraging, especially with this age group. That's why, like Jay said, a lot of institutional investors have gone into this space. When historically senior lending was an area for a few specialized firms, it's now becoming a mainstream asset. And you're seeing a lot of different types of investors getting into the space.

Jay Jordan: I would echo Seth's comments. On the equity side, I would broadly categorize three entry points within senior living investment. First, there are what I would call the private friends-and-family type of investment pools. Second are larger-scale funds and private equity. Third are going to be public institutions. Similarly, on the debt capital and lending side, I would very broadly say there are three "buckets" of capital. One is traditional banks. Second is nonbank lenders, such as debt funds. The third is the "permanent" market—meaning longer-dated and most often fixed-rate debt capital that includes the GSEs like Fannie Mae, Freddie Mac and FHA/HUD as well as life insurance company loans and municipal bond debt. During the Great Recession, senior living as an industry performed quite well relative to other real estate classes. This prompted some to coin it as "recession proof." To be clear, senior living is not a recession-proof asset class, but it's definitely shown over the long term to be more stable than many other asset classes. It's unique in the sense that it's very operationally intensive, similar to, say, the hospitality industry in some senses, but it's also residential by nature and so it shares many of the stable metrics of multifamily-type investments. Overall, there's just a tremendous amount of demand coming down the pike—especially as we enter this front line of the baby boomers approaching their 80s. Even prior to COVID-19, there was a slowdown in new construction. That's only become more difficult, with new construction at its lowest levels in more than five years. When you think about the opportunities ahead, what we've seen is a lot of recent pullbacks in the debt markets, which is creating a lot of capital opportunities. There are certainly projects that are strained by their current debt or have underlying challenges, be it liquidity, staffing pressures, capital reinvestments, etc., and I think this will prompt a lot of investment and opportunities in the near term.

Vasileios Sfyris: From our perspective, pre-COVID there was an immense amount of investment in senior housing, which was primarily fueled by the record-low interest rates. Equity investors funded new construction projects, which at that time was fairly easy. Once those projects were completed, they were sold to long-term investors in the municipality or mutual funds, which are typically the end buyers of municipal bonds. Those investors were more than eager to take a private equity risk for a mediocre bond return, with virtually no equity from the sponsor side. Certain markets became oversaturated with this asset class. At that point, it became a very cutthroat operation to sell units. Now, post-COVID, the senior living housing landscape looks completely different. The industry is experiencing operational and financial headwinds, which are impacting balance sheets. We have seen most of that in these facilities having difficulty retaining employees and relying on temporary workers and agencies to fill their job vacancies. Additionally, the recent spike in interest rates has caused most senior living equity investors to take a wait-and-see approach. These investors are not very eager to jump back in, as their focus is on their existing portfolios, which to some degree are still being affected by the pandemic or by leverage. So all the senior housing investors have to consider what happened in the pandemic and how the market is now halted due to rate volatility. That means we have to pay close attention to overall industry trends and continue to recalibrate our underwriting process and be tactical in the way we approach investments in the space.

Peter Bilfield: Thanks, Vas, for your discussion about what market forces are doing in the senior living space. Switching to the topic of municipal bonds—when we think of municipal bonds, we think of building schools and roads. Obviously, there are some tax advantages of investing in municipal bonds. But we don't typically think of municipal bonds as a vehicle for building senior living facilities. Why do borrowers go that route in terms of using municipal financing?

Vasileios Sfyris: Many types of sponsors are eligible under the tax law to issue municipal bonds to finance new construction for acquisition or rehabilitation of senior living facilities. These groups tend to be mission-oriented or have certain religious affiliations. Sometimes they may be part of a larger type of nonprofit organization that will sponsor many types of projects. Now, the sponsors need cash for senior living facilities and they cannot get financing from conventional lenders. Frankly speaking, the municipal bond space is the lender of last resort for this particular group. They have no equity, so they rely on municipal bond investors for financing. New bond investors tend to take unnecessary risks and often overfinance projects, as we saw pre-COVID. Underwriting criteria became pretty slack, and because interest rates were low, demand for municipal bonds was high. We started seeing a lot of transactions downgraded. These projects came to market with a short stabilization runway, and then you had all the COVID restrictions that arose. Construction got delayed, and given the short runway, loan covenants were breached. Then it became a race to the bottom, as the borrowers did not have the financial ability to support these projects. Many sponsors are not operationally focused. Given the aggressive capital stack and leverage, there is little to no wiggle room to adjust rates in order to compete with other facilities. Many sponsors that are not really focused on the space tend to bring in their own operators to manage an asset. What we have discovered in the space is that the senior living industry is a very localized industry and you can't afford to have a cookie-cutter approach across the board or rely on national operators. This means that opportunities have arrived. We look for middle-market opportunities that require minimal capital expenditures and occupancy where you can break even or start to ramp up occupancy quickly. We look for value opportunities where we can acquire assets below replacement cost, where, with decent leverage, we have flexibility and some wiggle room in the rates on top of that. We have a buffer on expenses and wage pressure. So really, the strategy here is to deliver and bring in the right operator.

Seth Walker: I see a lot of issues with these bond deals. We look at a couple of underlying issues. One is when you're trying to build a property from the ground up with bond financing. Your construction period interest is generally exponentially higher than if you were doing a normal draw. You're also going to see high cash reserves that have to be set aside. Once you get the community open and operating, you could be in the right market and have a beautiful product, but you have an overleveraged balance sheet on most of these deals. You have to run them perfectly, and for the first five or six years you wait for your space to appreciate, to be able to get to your debt coverage yields. With COVID, that's just out the window. There are many deals out there with beautiful communities that have terrible balance sheets. That leads to operators having to make decisions to cover the debt rather than maximizing the operating income, so you have to try to drive higher rates, which drives occupancy down. With bond deals, I generally see two types of groups. You see a group that comes in and tries to operate it themselves or you see a group that goes in and gets a large national operator to come and operate it, and both of those approaches have their flaws. Large national operators are falling out of style. The institutional investors, I think, are moving away from large national operators and moving toward more regional operating models because the senior living

market has gotten tighter. It requires a lot more hands-on operational knowledge. On the other side of it, you see a lot of inexperienced operators that don't have the history, the expertise, the systems or the processes. To me, the opportunity is with the generation that's coming through now. It is possible to find very nice assets in good markets and be able to get them at a lower price point. And that enables you to offer lower rates for a quality product.

Jay Jordan: I would echo everything that Vas and Seth have mentioned and note that amid the current environment, we're going to see a lot of debt-driven opportunities. It's not to say there is something fundamentally wrong with the project, the community itself, its location or the residents. It's more a function of being strapped into a deal where you may not have the breathing room to effectuate the changes you need. If you're struggling with, say, resetting rates to meet the market and drive occupancy but now the project is struggling to meet its debt service under the new net operating income, you can quickly find yourself in a corner with limited options. In such instances, a team like Phorcys or SRI can come in to right the ship, particularly in situations where the operators may be overleveraged. We had a transaction called The Glen, a community just east of Atlanta. We ended up being engaged by the creditors to market that community for sale. Our team has done a lot on the creditor-led sales side. By the end of this year, we'll have closed a bit more than $1 billion in creditor-led sales as a team. We're currently launching an additional $200 million in sales for three separate sellers, each with varying degrees of operational or financial strain. I would mention these types of sales really do create a great opportunity for the communities. Often, they may be deprived of cash or they don't have the flexibility with their current lender to execute on a business plan. The Glen was a prime example of that. Beautiful community, very well built, excellent physical plant, but it just couldn't support the debt service. In that instance, Phorcys came in and was able to acquire the bonds, reset the capital stack and partner with SRI to drive the operations.

Seth Walker: It is quite a success story. When we were looking at the plan, we found two main issues. One is that they were trying to operate with independent living support, because they had to fill the units at those rates in order to support the debt, and they had outsourced the food department, which was a decision that was made by the local ownership group. When we came through, the first thing we did was to terminate the third-party food contract, which saved close to $30,000 a month. We ended up dropping the independent living rates. And as of today, that building is operating at about 98 percent occupancy. It is an example of what you can do with a good turnaround when you have the right group taking a long-term approach.

Vasileios Sfyris: Yes, I agree with you. Basically, we took a long-term approach with this asset. We were able to acquire it at a more palatable level on a per-unit basis, and that made all the difference. We were able to make the necessary changes, bring rates to a more market level despite the pandemic, stabilize occupancy and start being profitable. I think the overall theme is debt levels. You have to have leverage at the right level, and we think given where we are in the cycle and the leverage this facility can sustain, it will be on the right track moving forward.

Peter Bilfield: Given everything that we've heard today from the panel, what are people's thoughts about the future? Are we bullish on investing in senior living long term versus other asset classes?

Vasileios Sfyris: We are certainly bullish on the sector. The sector is definitely undergoing a transformation right now. It was impacted by COVID substantially, but given the silver tsunami, we think that the sector is prime for a reversal now. Like any other industry, there will be winners and losers. A lot of the groups that overleveraged and acquired assets pre-pandemic could be harmed by the new paradigm in the industry, the new normal. We believe it's a good time to be bullish, given the rise in interest rates, the uncertainty in the marketplace and the overall market dynamics. We think that forward-looking investors will be compensated for years to come. We have a very nice pipeline of senior living properties that we've financed. Obviously, they will need some work done and you have to have the right operating partners, but again, leverage and operating partners are the main ingredients. We believe that the sector is prime for recovery in the years to come.

Jay Jordan: I think it's a tremendous time to get into the space right now, particularly given the opportunities we see over the next 12 to 24 months. Even with that said, we're very bullish on the sector as a whole and don't see the demographics or consumer demands shifting away from senior living – if anything, they continue to drive more variety and growth within the space. Moreover, senior living is a needs-driven asset class, giving it stability in the face of broader economic turmoil, as the care needs don't change with changes in the economy at large. From a consumer standpoint, it's often the resident *and* the adult child making the decision. The adult child saying, "Hey, you know Mom can't be left alone" or "Dad shouldn't be shoveling the sidewalk." The resident seeking a social circle, active engagement and a positive community culture in addition to their care needs. Overall, it just simplifies life and genuinely enhances the life of the resident to be in a community where

they don't have to worry about the little things—utility bills, home maintenance, laundry, etc.—and there's the care and assistance there for them when they need it. I always start with the consumer and then build up from an investment perspective. This is certainly what is very appealing for senior living as an investment.

Seth Walker: You have to look at the future of senior living in the short and long term. There are a lot of things going on out there that are working against us. Labor costs have gone up 15 percent in the past 12 months and food costs have also gone up. You're dealing with clients who are generally on a fixed income. We're seeing decreasing bargains, and COVID certainly didn't help anything. Now, at the same time, all this is very well publicized. In our place, it looks like the consumers understand and we're able to get rate increases that we need to help cover the costs, to help bring these margins back. This is the short term. I think we're going to see reduced margins and reduced valuations for the next two or three years. And what that's going to do is push a lot of folks who are undercapitalized out of the market because they are not able to stay in this downturn. I believe that's going to create a lot of opportunity for folks who take a long-term perspective. The incomes will be coming back up. We're seeing Social Security adjustments coming. I think the big thing for the market in general is you're seeing a lot of migration, especially to the Southeast. As construction costs increase, we're getting a lot less product. I think that the midrange projection, the five-to-10-year projection, is very, very good for these folks who are coming into this space well capitalized. They can identify the assets that are troubled projects, but they're good projects in good markets, and investors should be able to come in and provide a really nice product for folks.

Peter Bilfield: Thanks, Seth. On behalf of Day Pitney and the Family Office group, thank you again to our panelists for speaking to our readers. We appreciate it.

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