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HOUSING BUSINESS

Developers Prefer High Barriers to Entry

When the going gets tough, top developers are drawn to sites where the competition is limited.

In Coral Gables, Florida, Watermark at Coral Gables will offer 196 independent living, assisted living and memory care residences featuring 50,000 square feet of amenity space, including a rooftop pool on the eighth floor.

By Bendix Anderson

Developers are building fewer new seniors housing units today than they have in years. Rising interest rates and the high cost of land, labor and construction materials have made development more expensive than ever.

A potential new seniors housing community would need income from strong, steady rents to justify these high costs. But after years of overbuilding before the coronavirus and the shock of the pandemic itself, seniors housing vacancies remain at elevated levels in several markets across the U.S.

Consequently, many of the places where developers are building a significant amount of seniors housing today are not quite as active today as they were a few years ago.

The exceptions tend to be markets and submarkets with high barriers to new development and strong, growing demand for seniors housing – places like Coral Gables in Miami-Dade County; Portland, Oregon; and Boston, among others.

"In today's world, projects in high-barrier-to-entry markets are the ones that get capitalized," says Stephen Ordway, senior vice president for **ZOM Senior Living**, based in Orlando, Florida.

Developers wait and watch

In the 31 primary markets tracked by NIC MAP Vision, seniors housing developers had 35,000 units of seniors housing under construction as of the second quarter. That's the smallest number of units under construction since the third quarter of 2015.

"Starts remain at moderate levels and well below their peaks seen in the 2016 to 2018 period," says Beth Burnham Mace, chief economist and director of outreach at the National Investment Center for Seniors Housing & Care (NIC) based in Annapolis, Maryland

Developers started construction on 3,400 units of seniors housing in the second quarter of this year, down 29 percent from 4,800 units during the same period in 2021 and down more than a third from the second quarter of 2019.

What follows are the five busiest markets where developers have the largest number of seniors housing units under construction relative to the existing inventory based on NIC MAP data.

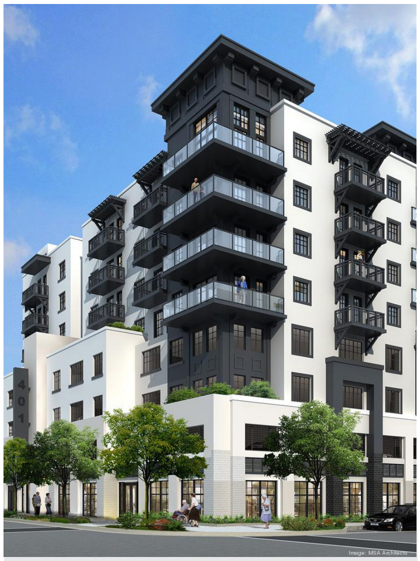
Miami-Dade County: Hot Spot No. 1

The inventory of seniors housing is growing at a faster rate in the Miami metropolitan area than anywhere else. Developers had 2,900 units under construction in the second quarter. That's equal to 11.2 percent of existing inventory.

It's nearly the largest number of units that seniors housing developers have ever had under construction in Miami. The only quarter when developers had more units under construction was the second quarter of 2021.

Though some parts of the metro area have land available to build, a surprising number of new seniors projects are rising in Coral Gables, a city in Miami-Dade County where sites are difficult to find and where developers spend years trying to win municipal approval for their projects.

For example, construction started in the summer of 2021 on Belmont Village Coral Gables. Belmont will open the community's mix of independent living, assisted living and memory care units in 2023.



In West Palm Beach, Florida, Watermark at West Palm Beach will offer 154 independent living, assisted living and memory care units and 30,000 square feet of amenity space.

In 2018, Belmont partnered with Baptist Health South Florida, a local seniors housing company, which already had a site under contract. The approval process for the development took several years.

"If you look at very pristine jurisdictions, the communities are very particular about what development is allowed to occur and what it looks like and who it serves," says Patricia Will, founder and CEO of Houston-based Belmont Village Senior Living.

As of June 1, Belmont owned and operated 31 communities and 4,520 units, making Belmont the 42nd largest owner and 41st largest operator of seniors housing nationally, according to the American Seniors Housing Association (ASHA).

To win municipal approval for the construction of Belmont Village Coral Gables, the development partners promised to create a great deal of public space.

"We had to dedicate a fair amount of outdoor space to create walkable paseos for the community with very meaningful landscaping to add a vibrancy to what is already there. It is a very walkable area of Coral Gables," says Will.

Belmont is now developing roughly as many properties as it was during the boom before the pandemic.

"We never stop developing," says Will. "Because our development process is so long and complex and expensive, we can't really time the out-of-the-ground development to any economic cycle."

ZOM also recently topped off its own new, eight-story seniors building in Coral Gables. When it opens by early 2023, Watermark Coral Gables will include 196 units of independent living, assisted living and memory care.

"The Coral Gables market has a high barrier to entry for sure," says **ZOM**'s Ordway. "There isn't a lot of supply in place, and the supply that is there is very well-occupied."

To build in Coral Gables, developers like **ZOM** and Belmont Village face a big challenge finding the land on which to build.

"There is a lot of competition for the real estate," says Belmont's Will. "Other developers who plan to build high-rise condos, hotel and tourism can all afford to pay top dollar."

'Supply overhang' persists

Developers still think twice before committing to new projects partly because seniors housing properties in many markets have more vacant units than is considered healthy.

Just 81.4 percent of seniors housing units were occupied as of the first quarter of 2022 in the 31 primary markets tracked by NIC MAP Vision Data Service, including majority independent living and majority assisted living properties.

That's much less healthy than the fourth quarter of 2014, the strongest year for seniors housing in the last decade, when 90.2 percent were occupied.

"The industry has a supply overhang," says Kathryn Sweeney, co-founder, managing partner and chief investment officer for Blue Moon Capital Partners, a private equity fund manager focused on seniors housing.

That's one reason Blue Moon is not currently investing in development. "We just need a year or so – three to five more quarters – of continued net absorption to get back to pre-pandemic occupancy levels," explains Sweeney.

In the past, Blue Moon invested roughly half of the capital from its funds in the development of new seniors housing. But the firm is not currently planning new development projects, even though it has more than $100 million in equity to invest. Approximately 40 percent of the $260 million Blue Moon raised for Blue Moon Fund II has not yet been invested.

"There is no chance any of that will go toward development," emphasizes Sweeney.

The consensus among industry experts is that developers opened too many new seniors housing communities in the years before the pandemic. The percentage of units occupied at seniors housing properties slipped from its high of 90.2 percent in the fourth quarter of 2014 down to 87.6 in the fourth quarter of 2019.

"Many markets were suffering occupancy declines because of oversaturation from new supply, and the pandemic only made this worse," says Taylor Russ, senior vice president of the senior housing group at BOK Financial.

In May, the U.S. officially surpassed 1 million reported COVID-19 deaths, according to Johns Hopkins University. About 70 percent of the deaths have occurred among persons age 65 and above.

During the worst years of the pandemic, seniors housing communities across the U.S. were unable to admit new residents – or even visitors – to slow the spread of the disease. The percentage of units occupied in the first and second quarters of 2021 dropped to a low of 78 percent.

Since then, the percentage of occupied units has begun to improve and is likely to keep getting stronger.

"Anything that is under construction now is going to open up in a very good environment," says Max Newland, senior managing director for Kayne Anderson Real Estate who works out of the firm's office in Boca Raton, Florida. "That is our investment thesis."

Kayne Anderson plans to break ground later this year on a 250-unit seniors housing development in the Raleigh-Durham area that will offer independent living, assisted living and memory care, according to Newland.

Given the large number of baby boomers in this country, over the next few years a significant number of them are going to become old enough to need seniors housing.

"The silver tsunami is here," says CSH's Stewart. "There are going to be 10,000 Americans turning 65 every day until 2030."

CSH has 15 different development sites under contract and is working through the entitlement process while negotiating construction financing. The development pipeline today is much bigger than it was just a few years ago, says Stewart.

For its independent living and assisted living projects, CSH is focused exclusively on suburban submarkets located around large gateway cities in the Northeast and Mid-Atlantic such as Washington, D.C., Boston or Northern New Jersey.

Morningstar Senior Living and Kayne Anderson Real Estate broke ground this summer on a new seniors housing community in Fort Collins, Colorado. 'Our base case internal rate or return (IRR) dropped about 300 basis points as a result of higher interest rates and construction costs, partially offset by value engineering and higher than anticipated rate growth: says Kayne senior managing director Max Newland. 'We still love the project at a slightly lower IRR (more than 20 percent gross)!

Other developers are building new seniors housing in urban centers.

"With baby boomers coming of age, there is a huge unmet demand for luxury senior living options in major metropolitan areas," says Gregory Smith, president and CEO of Maplewood Senior Living based in Westport, Connecticut.

"The aging population continues to require a vibrant lifestyle paired with social and cultural opportunities. There is plenty of room for development without worry of oversaturation in these key metropolitan markets," adds Smith.

Homework required

Some investors who are not currently willing to risk developing new seniors housing today expect to be building new product soon.

"Patience pays in this business," says Blue Moon's Sweeney. "The demographics clearly warrant new development in the not-too-distant future."

Whenever developers consider an opportunity to build new seniors housing in a particular market, they take into account the demand for the product and the number of new projects coming online.

That starts with simply counting income-qualified seniors living nearby and the adult children of qualified seniors. "If the demographics don't support it, we won't do it," says **ZOM**'s Ordway.

Developers also consider factors like the area median income, which often correlates to the number of income-qualified seniors in the area. The local price of a home is also important because some seniors use the sale of their home to pay for seniors housing.

Developers balance the demand for seniors housing against the competing product from other seniors housing developers.

"We draw a five-mile circle around the site," says CSH's Stewart. "If there are four or five competitors planning 1,000 new units of seniors housing and the occupancy rate is already on the edge, maybe 88 percent , that is enough to give us pause."

Construction costs remain sky-high

The prices of construction materials and labor costs also keep rising. "In the last two years, the cost escalation has been pretty extreme," says CBRE's Sweeny.

General contractors who once kept their bids low are passing more and more of their own high costs on to developers. The producer price index for nonresidential construction – a measure of the price contractors say they would bid to build a fixed set of buildings – grew 23.9 percent over the 12 months that ended in July 2022, according to the Associated General Contractors of America. And prices were already high.

Building these properties also often takes months longer than even a few years ago. Appliances and other factory-made goods are inconsistently available and skilled construction labor has been hard to find.

Some of these costs have begun to stabilize. "There is some cautious optimism that labor costs 12 months from now won't be rising as quickly," says CBRE's Sweeny.

The price of lumber has also dropped from its dizzying highs earlier this year. The cost of lumber and plywood was 14.2 percent less in July than in April. However, "the gift of cheaper lumber has been offset by higher interest rates," says Newland.

If developers didn't have to pay so much for land, that would help make up for other rising costs. Several sources say they are driving harder bargains with land owners.

"If the cost of development is out of whack with what we had in our underwriting, we have to go back to the seller of land and let them know that we are still committed to the deal, but maybe we have to pause for six months until things cool down," says CSH's Stewart.

Some sellers have lowered their prices, but not by much. "While we are seeing sellers of existing operating communities adjust their pricing expectations, land sellers' expectations have not adjusted in line with the rise in interest rates," says **ZOM**'s Ordway. "That is causing us to take a pause, potentially, on some sites and focus our time on sites in high-barrier-to-entry markets."

Says Newland: "These periods of dislocation are a good time to be making deals. Anecdotally, I would say that landowners are starting to adjust." ■