Riding the demographic wave

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Senior housing. Demand for this property type is driven by predictable, long-term demographic trends. The sector also has other appealing fundamentals, including an attractive income return and greater opportunities for value creation than in many other sectors. This is particularly true in Europe. In the past two years, investors have been forced to grapple with economic volatility previously unseen in their lifetimes: record declines in economic activity, rapid acceleration in inflation, disintegration of global supply chains, and a reversal of a 40-year decline in interest rates. Many implications of this volatility still lie ahead, creating substantial uncertainty for those needing to invest and safeguard capital. This environment favours investments that are uncorrelated from GDP and which provide a reliable hedge against inflation.

A combination of rising demand, a structural lack of supply and early stages of market consolidation in European senior housing present a compelling opportunity for investors. This is underpinned by the rapid ageing of the global population. Europe is at the forefront, already having the 15 oldest countries in the world after Japan (as measured by median age). It is therefore unsurprising that investment into European senior housing increased through the pandemic, as investors sought delinked demand drivers and opportunities for growth.

Needs-based demand

Investor capital typically aims to address current or future needs in the economy. There has been an unprecedented rethinking of these needs following the COVID-19 pandemic. For real estate investors, this has manifested itself across property types, particularly in the traditional sectors of office and retail. Yet the demand outlook in the senior housing sector has remained robust and unabated. The population aged 75+ is still expected to grow by 11% in Europe by 2027. The direct link between age and acuity (i.e. the complexity of care needs) means a significant share of the elderly will require professional, institutional care in future. For example, a UK study found that around 80% of care home admissions were driven by critical life events uncorrelated with the economy (e.g. a fall or the death of a care-giver).

This demography-driven, needs-based demand is appealing for investors seeking stable, long-term and predictable growth. Chart 1 shows that waiting lists for Dutch care homes doubled in the 24 months prior to the pandemic, despite the country having the best-funded social care system in the world according to the OECD. There has also been a rapid build-up of excess demand since late 2020, following a period when waiting lists declined as care homes sought to maintain occupancy during the pandemic. The waiting list in the Netherlands now includes 18,000 individuals, equivalent to 15% of national capacity and indicating a substantial supply-demand imbalance. Indeed, across the Netherlands, UK, Germany, France, and Spain, the number of people aged 75+ per care bed increased by 6% during 2016-2020. Technology, such as at-home monitoring devices, has mitigated some of the impact on human welfare, yet there remains no substitute for professional, institutional care for those elderly who eventually develop complex care needs (e.g. dementia). At-home care is not a viable option in most of these cases.

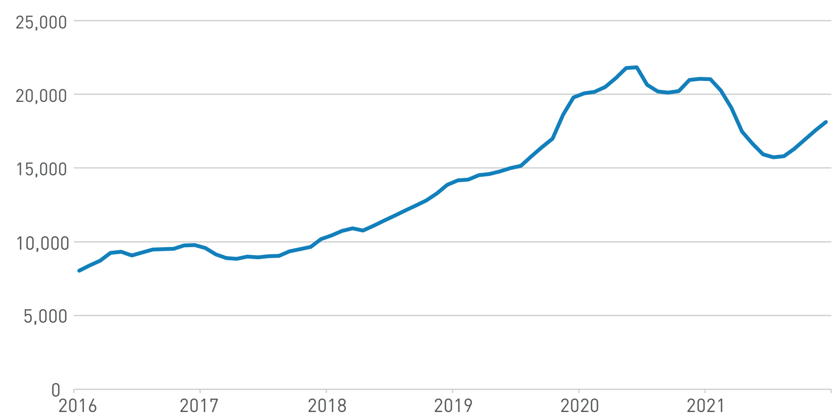
Resilient and uncorrelated performance

The structural demand drivers of senior housing offer greater resilience than in most other property sectors. For example, in Q2 2020 when senior housing itself was at the centre of the pandemic, European senior housing REITs reported rent collection rates exceeding 95%. This compared to steep declines in collections in traditional sectors like office and retail. Senior housing's unique demand drivers also meant that during 2011-2020, UK private market returns for senior housing were largely delinked from GDP and other property sectors, more so than other property types even including residential and student housing. Indeed, the average total return for care homes during 2016-2020 was 8.6%, compared to 4.9% in residential, 3.7% in office, and -3% in retail. This suggests the addition of senior housing to institutional portfolios should enhance risk-adjusted returns.

The private-pay segment of the market is particularly attractive, as fees for self-funding residents can be more easily adjusted to reflect expenses borne by the operator. This flexibility results in part from the high fee-paying capacity of self-funding residents, who typically pay out of accumulated wealth such as home equity. This can be substantial following decades of house price appreciation in most markets. For example, house prices have risen by a 4%+ CAGR in the UK, Netherlands, France and Spain over the past 30 years, creating a reservoir of resilience for the sector. Fee agreements for self-payers are also less constrained by state bodies, who negotiate fees for state-funded residents and can increase the risk that fee growth will lag inflation, eroding the financial viability of the care home. This has been prevalent in the UK since 2010, when public spending was drastically reduced, and is also a challenge in Ireland where 'Fair Deal' rates have lagged cost inflation.

An additional source of resilience, especially compared to the US, is the widespread use of triple-net master leases in Europe. Here the operator pays a fixed rent and assumes risk around most operational and property-related expenses. EBITDAR coverage ratios of >1.2x are typically sufficient to insulate investors from any volatility in operational performance provided the operator is of a sound covenant. Long leases to operators, of 12-25 years, are also common in the sector, reducing vacancy and reletting risk.

Chart 1: Number of people in the Netherlands waiting for a place in a care home



Source: Healthcare Institute Netherlands

> "Needs-based demand is appealing for investors seeking stable, long-term and predictable growth."

Enhanced inflation protection

Advanced economies are currently facing inflation rates unseen since the 1980s. In March 2022, Eurozone inflation reached a record 7.5%, compared to consensus forecasts of 6.6%. Real estate investors can find some comfort in that property tends to provide a partial inflation hedge. For example, long-term US data shows that REITs outperformed the S&P500 in six of the eight high inflation periods since the 1960s. However, empirical evidence shows the ability to 'pass on' inflation to tenants varies according to underlying supply-demand in each sector and lease structures. Senior housing is highly appealing in this respect, given the significant supply-demand imbalance across most markets and the high fee-paying capacity of most residents. For example, between Q2 2020 and Q2 2021, UK fee levels increased by 6.1%, ahead of inflation. Leases between residents and operators tend to be around 12-18 months, allowing for frequent adjustment of fee levels. Leases between operators and landlords meanwhile typically incorporate annual indexation mechanisms which keep pace with inflation.

Senior housing can therefore provide enhanced inflation protection. This in turn means senior housing offers insulation against rising interest

rates, as the ability to raise rents in inflationary periods has historically reduced the sensitivity of property yields to higher rates. This is seen in the lack of correlation between property yields and nominal bond yields, and stronger correlation with inflation-indexed bond yields. Taking Germany as an example on Chart 2, comparing inflation-indexed bond yields and care home yields reveals a spread in line with the long-term average and 160 bps above its all-time low. The spread indicates potential for yield tightening in a stable interest rate environment or at least a buffer against higher rates. This latter scenario appears more likely, with the yield on German 10-year government bonds having increased by 90 bps since 2021. The ability to pass on inflationary increases should allow senior housing yields to remain relatively stable and thus go some way towards mitigating interest rate risk.

Inadequate supply, in quality and quantity

The limited future supply of European senior housing is as compelling an investment rationale as the trajectory for demand. Growth in senior housing capacity lagged growth in the population aged 75+ in nearly all European markets over the past decade. In the UK, capacity even fell by -2,700 (or -1%) in 2016-2021, as limited new supply coincided with a loss of existing units as smaller operators exited the market. Many smaller operators, typically managing a handful of facilities of fewer than 20 beds, have lacked the economies of scale required to absorb rising operating costs. Some homes have been converted to alternative uses such as residential, unsurprising in some cases given the significant house price growth of the past two years. In Germany, states have introduced 'single room quotas' in their senior housing regulations to remove double-occupied rooms from the market. These represent a quarter of all capacity in the country. Meanwhile development has been hindered by competing land uses, surging construction costs, and a lack of investor capital. The chronic shortage of supply in Europe means that while Dutch care home occupancy was only -3% below pre-pandemic levels in mid-2021 (when the latest data are available), occupancy in US assisted living facilities was down -11%.

This presents a significant opportunity for investors to partner with operators skilled in identifying sites and developing new care homes. Facilities with 60-80 beds tend to be the 'sweet spot,' as indicated by EBITDAR margins and the typical size of schemes currently under development. Another strategy involves active asset management of outdated facilities in strong catchment areas, ranging from unit modernisations to changes in operator. The opportunity here is clear and present; UK data shows that care homes rated 'Outstanding' have 12% higher occupancy than those rated 'Inadequate' by the regulator. There is also a 30% differential in fee rates achieved between these two categories. Investors who improve the quality of care accommodation also benefit society, whose elderly are often ill-served by today's available options. This was apparent during the pandemic when, for example, smaller facilities with shared bathrooms and bedrooms were less able to shield residents from contagion risk than more spacious homes.

Increasing capital rotation

In 2021 a record 39% of European private real estate investment was outside the traditional sectors of office, retail and logistics. That share was 25% five years earlier. Senior housing investment has been a key contributor to this growth, with transaction volumes more than doubling to €8.4 billion during the same period. This is shown on Chart 3. Over €1 billion now transacts each year in the UK, Germany, and France, with investors also entering more nascent markets like Spain, Ireland and the Nordics. Economic uncertainty and a hunt for income have been proven to accelerate capital rotation into defensive, nascent sectors like senior housing, as was the case in the US following the GFC. This rotation is also evident in the public markets where the healthcare share (which includes care homes) of the EPRA Developed Europe Index increased from 0.5% to 3.6% in the past decade. In the more mature US market, the healthcare share of the comparative index is currently 9.8%, suggesting further growth ahead in Europe.

There are numerous tailwinds for private investment in European senior housing. Low interest rates and slowing yield compression make the sector's income return particularly attractive. For example, European senior housing offers a yield spread of 150 bps over residential, 120 bps over office, and 70 bps over logistics. The market is also highly fragmented, with the top five operators managing only 14% of private stock in the UK, 9% in Germany, and just 3% in the Netherlands. There is accordingly a vast opportunity set of outdated, under-managed care facilities with reversionary potential, which may be aggregated to achieve portfolio premiums. Finally, the ongoing privatisation of the sector and rising cost of capital for operators present attractive entry points through public-to-private acquisitions and sale and leasebacks.

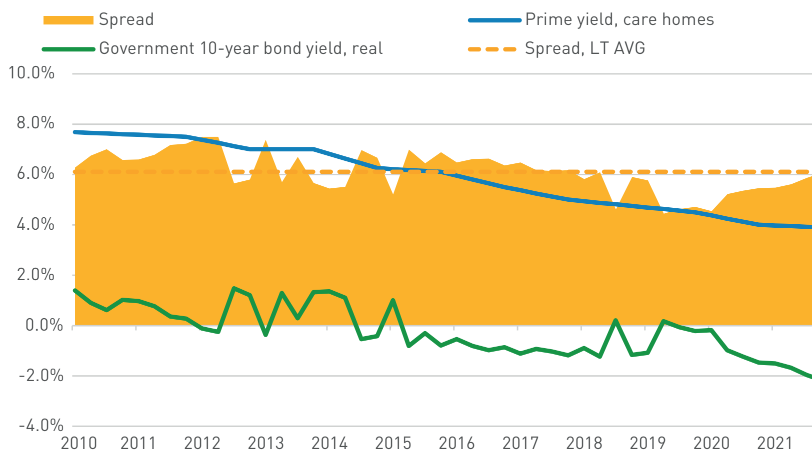
Risks and opportunities

While the outlook for supply-demand, liquidity, and market consolidation all appear robust, the sector is not without risks. These mainly relate to the operator, whose standards of care and financial performance can have important implications for investors. A key example of this recently emerged in France, where a major operator was embroiled in a scandal following allegations of mistreatment of residents. This caused a repricing of listed care operators in that country, given concerns that increased regulation would weigh on margins. The swift rebound in valuations of pan-European listed care home owners suggests the scandal is being perceived as country-specific. There is merit to this, given that the decentralised French regulatory system does not afford the same level of transparency, oversight, and enforcement features found in many other European markets. The care staff-to-resident ratio in the country is also only 0.6x, compared to 0.8x in the UK, 1.0x in Germany, and 1.2x in the Netherlands, which may be seen to contribute to reduced standards of care. Given that labour costs make up around two-thirds of operator expenses, increases in required minimum staffing ratios or general labour costs can have a significant impact on margins. Risk-adjusted returns can accordingly be maximised in markets where current staffing ratios are adequate and by using operational expertise to reduce staff turnover.

While the French system may merely be playing catch up with its European peers, it provides a useful case study of the importance of identifying 'best-in-class' operators. At a high level it appears prudent to focus on markets with already-stringent regulation. At the local level one should target operations supported by strong labour availability, clear lines of internal oversight and enforcement, and self-paying residents whose fee rates can reasonably adjust with cost inflation.

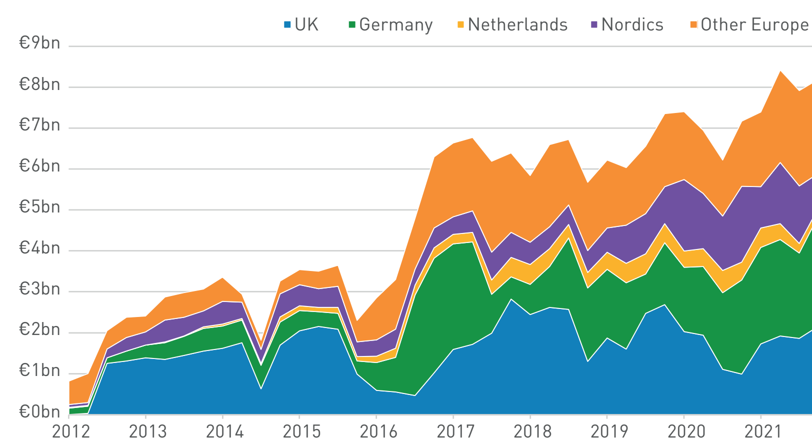
For those experienced managers and investors able to navigate these dynamics, the investment opportunity is compelling. European senior housing offers strong, predictable demand growth, unmatched inelasticity of supply, delinked and inflation-protected cash flows, income-rich returns, and significant opportunities for development and active asset management strategies. We predict a substantial increase in investment in senior housing in the next decade. While the sector presents an appealing opportunity for the reasons cited above, it also has the added societal benefit of improving the quality of care facilities themselves – which is long overdue. As we all adjust to a world with COVID, an investment in high quality, well-run senior housing is not only a good thing to do, it also feels like the right thing to do.

Chart 2: Yield for German 10-year government inflation-indexed bonds and prime care homes



Source: Bloomberg; CBRE

Chart 3: Private investment volume in European senior housing, 12-month rolling sum, € billion



Source: RCA

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