Seniors Housing Newsletter

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Market Update with Alan Plush

Cap Rate Trends

With the ASHA and NIC conferences fast approaching, it seemed a good time to offer some thoughts on the current cap rate environment. Unlike economists, who can take very little data, make invalid assumptions and draw conclusions that are wrong, yet still maintain their professional standing among peers, appraisers seem to be held to a higher standard; hence, we must offer opinions that can withstand careful scrutiny. With that in mind, I offer the following thoughts.

Cap rates are often misunderstood. I speak and write a lot on the topic; however, I am amazed at how little is known about their derivation and application, even by some of the most astute participants in our industry. A point of clarification is in order.

My professional designation is MAI, which stands for Member, Appraisal Institute (not "Made As Instructed" for you cynics). The Appraisal Institute was a founding member of the Appraisal Foundation, an umbrella group of various appraisal organizations that all ascribe to similar definitions on important valuation principles. Why is this relevant? Because FIRREA (Federal banking oversight regulation) requires *all* commercial lenders to ensure that all appraisals are conducted according to USPAP, Uniform Standards of Professional Appraisal Practice and guess who promulgates that? Further, most other lenders (non-bank banks, agency and life companies) also require adherence to FIRREA and USPAP. Thus, if you need financing, chances are you will run into this definition and paradigm that I am about to describe.

Essentially "cap rates" or capitalization rates are determined by dividing the *buyer's expectation of net income into the purchase price* of an asset. This rate is then applied to the *appraiser's forecast net operating income for a single year* and voila, a value indication is developed. Use is made of a market indicated management fee and reserve for replacements as expense deductions.

A "sale" must have the characteristics shown to the right (see Sale Characteristics). Absent any of these criteria, the sale and thus the cap rate, are not considered bona-fide and the resulting cap rate does not meet the test of legitimacy.

Already one can see the difficulty that appraisers and market participants encounter. Take a REIT transaction. While most transactions in our current environment involve REITs, by their very design they do not meet this test. Most REIT transactions leave the seller with an interest in the assets by use of a sale/leaseback vehicle and often the seller retains a repurchase option as well, often times splitting the appreciation in the asset over the term with the REIT.

Another example that often occurs involves the sale of a non-stabilized asset. Given the dearth of cap rate data points, people often times try and extrapolate a cap rate from a non-stabilized asset by assuming what NOI would be if it was stabilized and trying to rationalize that into a cap rate for application to stabilized assets.

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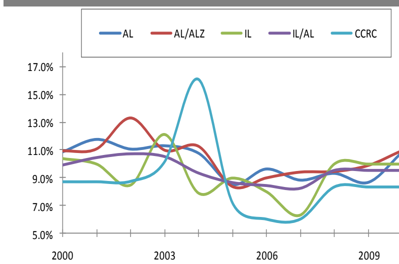
Cap Rate Trends



Source: ASHA & HealthTrust

[Download Additional Charts]

Conference Schedule

20th Annual NIC Conference
September 22-24, 2010
Sheraton Chicago Hotel & Towers
http://www.nic.org/

2010 AAHSA Annual Meeting
November 1-November 3, 2010
Los Angeles Convention Center
http://www.aahsaconference.org/

Contact us to arrange a time to visit during any of our upcoming conferences. We look forward to meeting with you.

Sale Characteristics

- Willing buyer and seller
- No undue duress
- Cash or its equivalent
- Arms length (buyer and seller are unrelated)
- Full bundle of rights / fee simple
- Reasonable exposure to the marketplace

However non-stabilized assets typically require several years to lease up and achieve a stabilized NOI (this from personal experience, I'm afraid); hence, the most that can be hoped for from this type of transaction would be an Internal Rate of Return, or equity yield rate on invested capital. To determine this at the time of sale one must make assumptions on the lease-up, operating cash flows during the interim, and sale price at exit. It's hard enough to forecast NOI for a stabilized asset, but for a non-stabilized asset these assumptions are really a leap of faith and while we perform these forecasts, one must be cautioned that as always the greater the assumptions the less reliable the outcome.

The same is clearly true of a sale of a partial interest, or a joint venture transaction. The seller remains in the deal and, while one would like to extrapolate a cap rates based on the percentage of the transaction that the buyer buys (45% for $100m results in a value of Y for the total portfolio and a cap rate of X based on in-place NOI), we all know that minority interests ALWAYS result in a discount for lack of control, and I know, from personal experience again, that a majority interest doesn't always warrant a premium.

So, what's the cap rate? Well, here is how most competent appraisers approach the problem in the real world.

We do have a few actual sales that meet these tests. Those form the basis for extrapolation and judgment based on our experience and our considerable discussions with industry participants. For example, a question I have received many times over the past few weeks is "do the Merrill Gardens and the other large unnamed deal, which both have cap rates in the 7s, mean that all IL/AL assets warrant cap rates in the 7s?". The answer, I am afraid, is no. For large-cap REIT deals with a lot of moving parts I would say that they form relevant data points, however, the terms on each deal are hugely complex and again remember the definition of an arms length transaction. When applied to each deal they fail on several counts, hence cannot be relied upon to provide solid cap rates for a single asset that is being valued as I described above. That being said, I would be remiss to simply ignore them. So they are part of the "fog of valuation" that we consider when developing a cap rate for an appraisal.

Next, what about a partial interest sale by an equity investor on an in institutional deal involving multiple assets. Again, good for the fog, bad for an individual asset as these deals are often sales under duress (otherwise why would someone sell now?). Further they are partial interest sales, and while relevant, these data points cannot be relied upon as independent marks.

For discussion purposes, and to save much energy in Chicago, we are currently seeing a range of cap rates of 7.5-9.0 for IL, IL/AL, and AL. This would be for institutional quality assets, and for true "trophy" assets we would see a decrease of 50 bps (0.5%) in this range. That being said, it is unlikely that anyone would sell a trophy now unless s/he had to, given the lack of liquidity in the market and the resulting downward pressure on pricing. These rates would be applied to forward, *stabilized* forecast net income estimates.

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Closing Remarks

Appraisal is always art and science combined. In the current economic climate we are drifting more to the art than science, and now more than ever is the time to seek valuation experts with experience in this niche and to trust their opinions.

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Market Indicators

September - 2010

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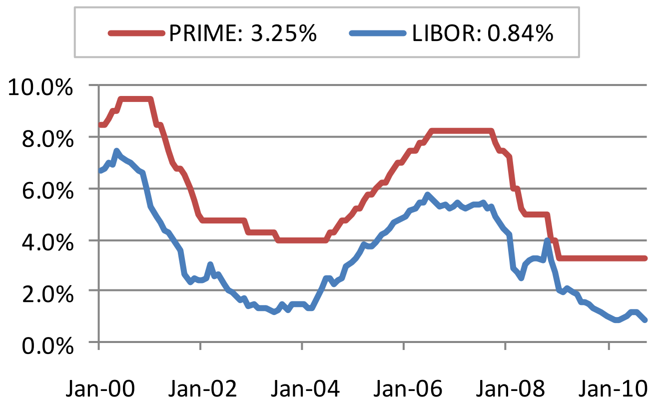
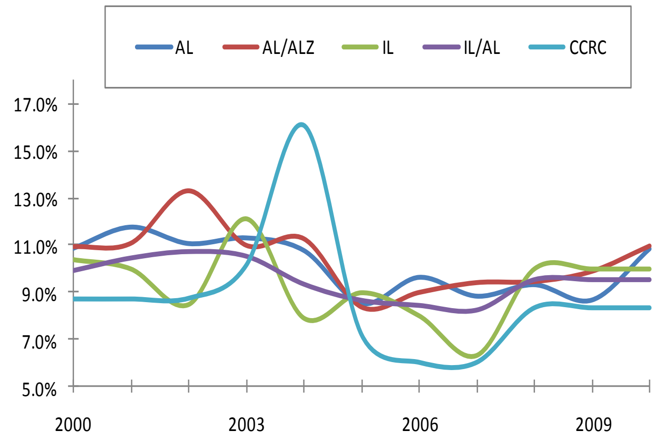
U.S. PRIME AND LIBOR



Source: WSJ

CAP RATE TRENDS



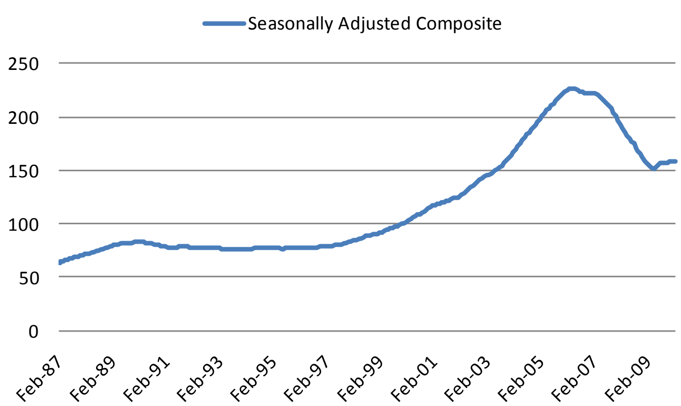
Source: HealthTrust

RECENT TRANSACTIONS

Type	State	Date	Sale Price	% Occ	$ / Unit	Cap Rate
AL	CA	Jul - 2010	$6,550,000	% 84	$86,184	% 10.82
AL/ALZ/IL	WI	Jul - 2010	$14,700,000	% 100	$133,636	% 8.84
IL/SN	TX	Aug - 2010	$4,750,000	% 90	$51,075	% 14.25
SN	TX	Aug - 2010	$4,617,000	% 85	$81,000	% 15.83
AL	IN	Aug - 2010	$2,685,000	% -- --	$24,189	% -- --

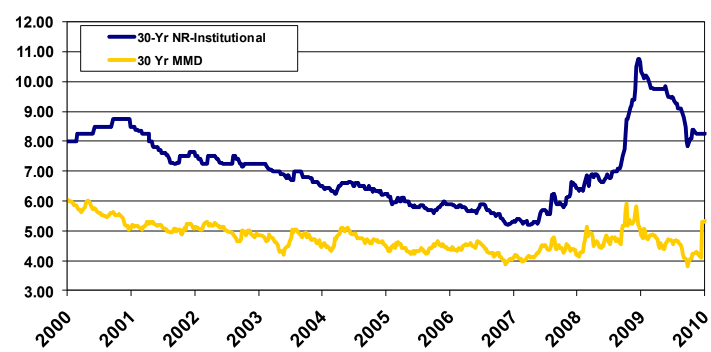
Source: HealthTrust / HealthComps

S&P CASE SHILLER



Source: standardandpoors.com

SENIOR LIVING BOND RATES



Source: Ziegler

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