NIC INSIDER Newsletter

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A Discussion with Michael Gordon, Principal at Harrison Street Real Estate Capital, LLC

In the latest in a series of dialogues with key players regarding the current capital environment in the seniors housing and care industry, Chuck Harry, NIC's Managing Director, recently interviewed Michael Gordon, Principal at Harrison Street Real Estate Capital, LLC.

NIC: Harrison Street, with approximately $5 billion in assets under management (AUM) began investing in the seniors housing space about 5 years ago. During that time you have become a very active investor. Can you talk about the reasons you entered the space and provide us an overview of your seniors housing portfolio?

Michael Gordon: HSRE invests in needs-based real estate sectors that are supported by long-term demographic trends. Our focus is on healthcare, education and storage real estate. We began deploying capital in these asset classes on behalf of our fund investors in 2005. Our current investment spectrum includes development, value-add and stabilized properties, and we have raised capital specific for these opportunities and the risk/reward spectrum that they cover.

HSRE's senior housing investment thesis has always been tied to favorable demographic statistics and trends and their impact on segment demand. In our underwriting, we consider these demographics, as well as the study of micro supply and demand to create a meaningful and predictable view on potential demand within submarkets and down to our properties. As we all appreciate, the aging US population has largely driven demand in senior housing and the largest cohort of the aging population is at least a decade from requiring broad senior housing (and perhaps longer for assisted living). We have always focused on higher-acuity residents (AL/ALZ) as we believed, and still do believe, that this strategy would largely insulate our performance from a potential economic downturn. Our strategy was validated during the recession. As important, we've elected to maintain environments for staff and residents, as well as providing quality care to seniors. This sector creates the unique ability to benefit from the relationships between care givers and residents on a long-term basis, and this leads to an element of "stickiness" wherein a property can capitalize from annual rent increases that outpace other asset classes. However, operations need to be executed flawlessly and reputation needs to remain stellar in order to benefit from this dynamic. This is why operator selection is so critical.

HSRE currently owns 76 senior housing communities (approximately 8,500 units) in 21 states. These assets cover the acuity spectrum, and the majority of our residents fall under the assisted living and memory care levels of-care. We remain very dedicated to the senior housing space, and we are actively exploring numerous opportunities to acquire and develop senior housing with both existing and new joint venture partners nationwide. Additionally, we are in discussions to expand our brand oversees.

NIC: Harrison Street teamed up with Engel Burman Group as the buyer in one of the highest price per unit transactions thus far in 2013, buying back 7 properties (under the Bristal brand) in the New York MSA in a transaction valued at $370 million. Can you talk about some of the factors that drove your interest in buying at that price?

Michael Gordon: When we assess "core" investment opportunities, I frequently ask the question, what's our insurance policy that will ensure that an asset or portfolio will provide predictable cash flows during a rather long hold period? As Harrison Street Core Property Fund is an open-end commingled fund, we are acquiring assets that will most likely be held for a 10+ year timeframe. As such, this fund is targeting properties that are positioned to stand the test of time. As it relates to senior housing, we believe "core" is Class-A, purpose-built communities that are oriented towards a more affluent and higher acuity resident. We concentrate on assets that are situated in markets with a palpable and favorable supply/demand imbalance, wherein the immediate locations benefit from high barriers to entry (jurisdictional, physical and economic).

We have known the Engel Burman team for years, and we recognize them as the preeminent operator and developer of senior housing in Long Island, NY. We have been circling the greater New York metro area for senior housing opportunities, and we have always coveted the Bristal Portfolio. When Engel Burman approached us with the prospect of forming a venture to reacquire their portfolio, we jumped at the opportunity. HSRE has been involved in the senior housing industry for nearly a decade, and we have canvassed the entire landscape – both operators and assets. In my opinion, there is not another portfolio in this sector that is a better fit for our Core Fund strategy than Bristal. The properties are Class-A, fully amenitized assets that are superior to the alternatives in each of the respective properties' competitive sets. The communities are located in New York, which is an extremely challenging state as it relates to licensing and Department of Health approvals. The portfolio is situated within affluent submarkets throughout Long Island, which is one of the most prohibitive development markets in the United States, due to a scarcity of land, challenging entitlement/permit processes and expensive land prices. The strength of the Bristal brand is the by-product of providing best-in-class care to high acuity residents for more than a decade, and the operator benefits from tremendous word-of-mouth marketing, catering to primarily the high-end, which so happens to be the majority of the demand pool in the communities' respective markets. All of these factors have manifested into a portfolio that is currently 99% occupied.

While the $370M purchase price, which consists of $318M for the former Chartwell REIT / ING

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properties and $52M for East Northport (a property that was owned by Engel Burman and recapitalized by the venture), represents $351K per unit, the YTD (June) 2013 cap rate on this transaction is currently 7.0%. As it is practically impossible to replace and/or duplicate this portfolio in these submarkets, we were more focused on yield than on price per pound. In any case, unit price simply reflects the lofty rents in this market, the near 100% occupancy and the impressive margins generated by this portfolio. HSRE is a very active participant in the acquisition market for institutional senior housing assets and portfolios, and we believe that the Bristal transaction was purchased at a cap rate that is roughly 75-100bps higher than its closest comparable sales transactions that have taken place during the past year, and none of these transactions benefit from the quality of asset, market and operator.

NIC: There are signs across the industry that construction, particularly on the assisted living and memory care side is picking up. Construction levels have risen to 4.9 as a percent of existing inventory in the 31 largest metro markets for assisted living properties and represents a new high since 2005. How is this affecting your investment and underwriting strategy?

Michael Gordon: Our development strategy has always been predicated on forming relationships with best-in-class developers and identifying sites in markets where new Class-A supply NEEDS to exist. Our value-add funds' approach to development has always followed a process of market selection, submarket selection and site selection. We will only break ground on the development of communities that will serve an under-supplied market and match perfectly with the majority of the demand pool. Our emphasis is on venturing with established developers that have a regional focus, and investing in projects that cater to affluent submarkets and high acuity residents. This has translated into the successful delivery of assets and an expeditious lease-up. We try not to let industry statistics or national averages impact our strategy, as we believe this business is very local. We have elected to pass on certain opportunities in markets which have a glut of new supply either under construction or in-planning stages; our typical development deals are situated in submarkets with extremely high barriers-to-entry, where our local operating partner has spent years in site selection, politicking and predevelopment. We find that most developers don't have the patience to focus on projects that require that amount of lead-time and up-front capital.

Development represents approximately 10% of our senior housing portfolio. We have been more active in acquiring existing communities with a business strategy of redeveloping/repositioning (roughly 15% of HSRE's senior housing portfolio) in order to address a specific market's needs.

NIC: Harrison Street invests across multiple asset classes, including core real estate. Several industry participants have recently argued that seniors housing cap rates should trade more in line with multifamily cap rates. What is your opinion on this?

Michael Gordon: The senior housing vs. multifamily cap rate discussion has become more prominent as the senior housing sector has become more widely accepted by institutional investors. These two sectors both cater to "residents" and are both impacted by demographics and the overall dynamic within local markets. Having said that, the similarities begin to diverge when one focuses on the operationally intensive nature of senior housing vs. multifamily. We would suggest that the market discounts senior housing because of the mistakes that investors can and have made in it. Drivers of cap rate spread include: (1) the risk inherent in the potential for mismanagement and the multiple issues that arise from it (e.g. costs/time of replacing poor management) versus similar situations in multifamily, (2) the operational/leasing attributes of senior housing, (3) the limited universe of institutional buyers of senior housing vs. the larger pool of buyers for multifamily and (4) the lower cost of capital, both debt and equity, available to the multifamily market.

While we all have seen a compression in both senior housing and multifamily cap rates, a spread between these two sectors continues to exist. I can tell you that it's a fun time to be a seller of senior housing at the moment, and it will be interesting to see what types of capital trends we encounter going forward.

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