U.S. Municipal High Yield Market

Cautionary Outlook for Senior Living Sector into 2024

Yaffa Rattner
Head of Municipal Credit
214.859.9883
yaffa.rattner@hilltopsecurities.com

Analytic Support
Jack Hanel
Investment Banker Associate
704.654.3456
jack.hanel@hilltopsecurities.com

High Yield Underwriting & Sales Contact:
John Pellicci
Head of Municipal Underwriting & Sales
612.439.6110
john.pellicci@hilltopsecurities.com

HilltopSecurities' outlook for the senior living sector remains cautionary as we head into 2024. The cautionary outlook is a slight upgrade to our negative outlook that we assigned in 2022, and reflects an uptick in senior housing occupancy, a moderation of labor expense increases, and a relatively modest supply of new available units. However, and as detailed in the report, there is significant difference of analytic opinion on the credit quality of transactions, and care should be taken to carefully assess fundamental credit expectations. Finally, the sector remains challenged as it continues to recover in a post-pandemic environment, reflected by 20 impairments and defaults in 2023, according to Bloomberg affecting $661 million of debt, which we forecast will moderate in 2024.

- According to NIC Analytics, senior housing occupancy increased to 84.4% in 3Q 2023 which is a significant recovery from the 77.8% occupancy reported in 2021 driven by the pandemic. However, occupancy is still below 87.1% which was reported in 1Q 2020 before the pandemic set in.
- According to the Bureau of Labor Statics, labor costs increased 4.3% over the year through September 2023 compared to a 5% increase in September 2022; as well, the costs of benefits have similarly declined to 4.1% from 4.9% the prior year.
- According to NIC Data, the supply of new senior housing units starting construction increased by less than half of the new starts in 2019 prior to the pandemic. NIC calculates as of 2Q 2023, for every 10 new added units, 45 units were absorbed. This receptivity can result in increased pricing power over the medium term.

Underlying the investment thesis in the senior living sector are the fundamental demographics of the American population that point to the continued need for congregate housing. According to data provided by Urban Institute, Social Security Administration, and The Alzheimer's Association, the number of adults ages 85 and older, will nearly quadruple between 2000 and 2040; and, this is the group that most often needs help with basic personal care. Furthermore, an estimated 6.5 million Americans aged 65 and older are living with Alzheimer's dementia today. The Alzheimer Association projects that this number could grow to 13.8 million by 2060 barring the development of medical breakthroughs. Finally, according to the Social Security Administration, the number of workers per social security beneficiary will decrease affecting availability of workers to care for the elderly. Taken together, fewer available employees and a growing population that will require care will result in the need for additional senior living communities.

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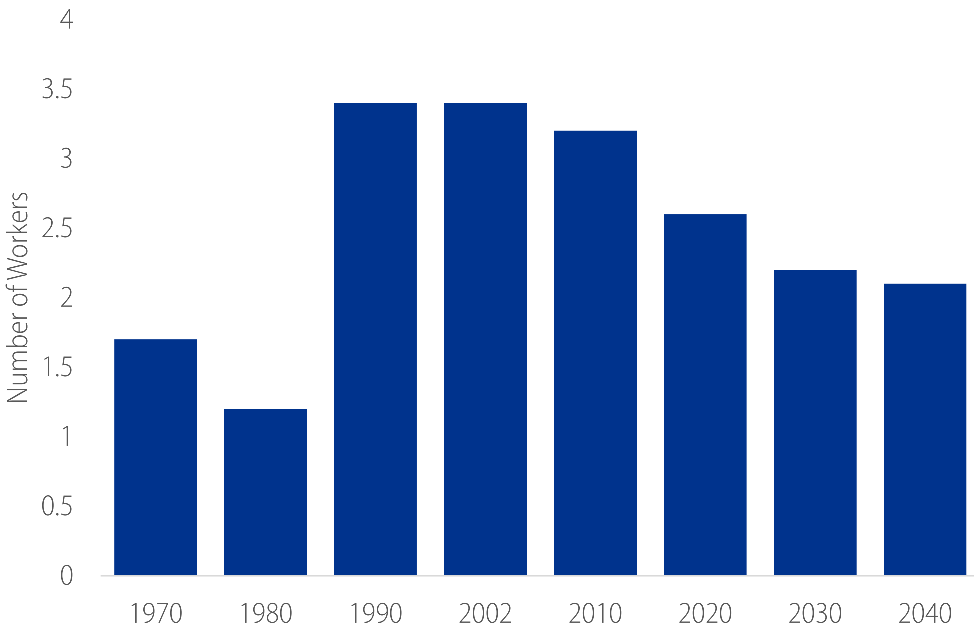
Workers By Decade for Each Social Security Beneficiary



Source: Social Security Administration and HilltopSecurities.

Although these are strong factors that will support the essentiality of the sector, each facility, location, and management team are unique and analytical care needs to be expended to assess fundamental credit quality as there is significant variation among bond issues – including rated and unrated issues.

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There was $1.6 billion of senior living securities issued in 2023 with three quarters of the debt issued in the last six months of the year. Of the 11 deals issued in the second half of 2023, that were $11 million or larger, four were nonrated and seven were rated according to information provided by Bloomberg. The pricing on the non-rated credits was diverse, reflecting the difference in credits from early-early stage finance to the need to refinance entrance fee bonds (2028), as well as the opportunity to expand a facility and another to finance a greenfield development. Notice the pricing differential for the two non-rated bonds with a 2028 maturity with the cost of capital double. The yield differential is understandable given the very different credit profiles for each. However, what is most interesting of all is the pricing of rated credits when compared to each other and other unrated credits, reflecting significant analytic diversity in the investor community. The pricing disparity is evident in absolute yield as demonstrated in the chart below where four transactions (two non-rated, one rated BBB, and one rated BB+) all priced at similar times with a similar final maturity between 2057 and 2059. The yield on these bonds ranged from approximately 6.5% to 7.75% with each of the non-rated bonds pricing similarly to the BB+ and BBB credits. Furthermore, the BB+ transaction had a lower cost of capital than the BBB credit reflecting a significant deviation between buy side analyst assessment and rating assignment.

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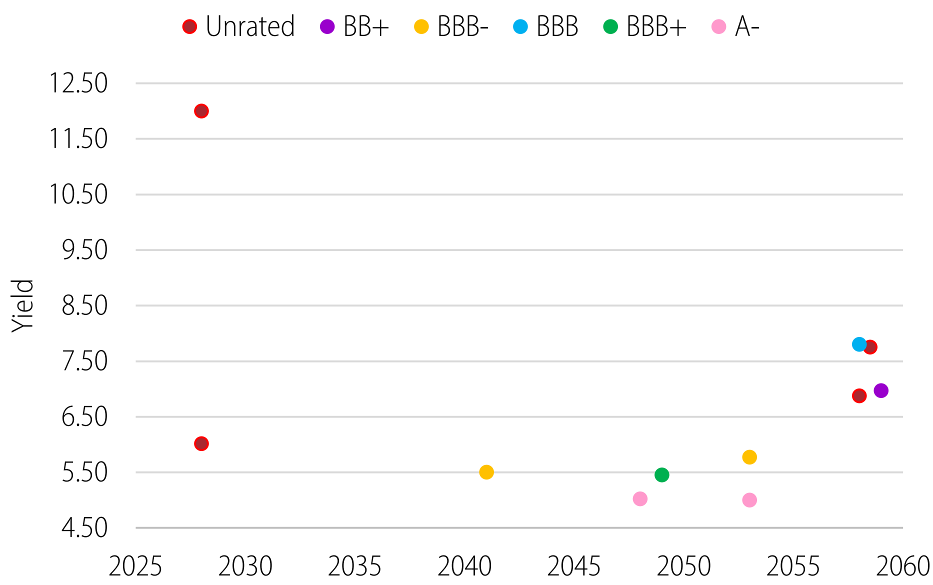
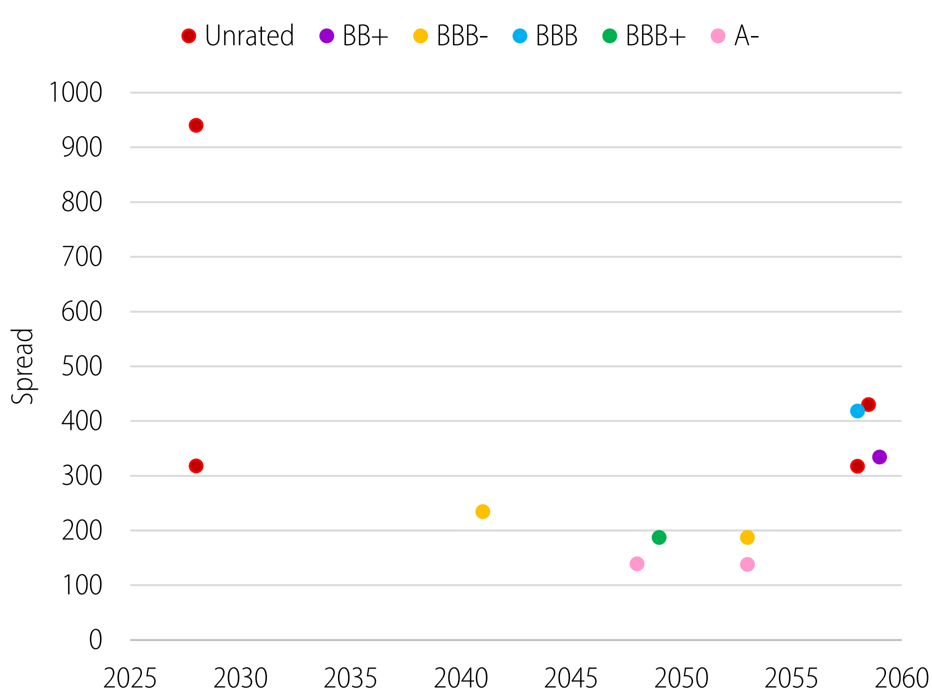
Yield by Final Maturity



Source: Bloomberg and HilltopSecurities.

The divergence of analyst assessment is also demonstrated by assessing these credits by spread, thereby adjusting for MMD movement during the pricing period. The results are the same, again underscoring the divergence between buyside and rating analysts assessment of credit risk.

Spread by Final Maturity



Source: Bloomberg and HilltopSecurities.

Taken together, HilltopSecurities believes that buy analysts should take care to assess credit nuances as opportunities in the senior living space grow in 2024.