INVESTING IN THE GREY BOOM
A role for senior living real estate in Asia
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Real estate, given its functional and intrinsic value, is a corollary of social forces. It is the brick-and-mortar response to how we live our lives and which goods and services we demand. As an asset class, it naturally evolves as society evolves; whether it is the emergence of data centres in response to the rise of cloud computing, value propositions in building design being influenced by a growing environmental consciousness, or trends in land use being driven by urbanisation.

Demographics is arguably the most interesting of all these forces. Given the power of demographics to fundamentally shape society’s demand pattern for all real estate sectors, it should be a key consideration for any long-term investor in the asset class.

One such example is the connection between ageing populations in Asian economies such as Japan, China, and Korea, and the potential emergence of senior living real estate as a large, investible sector in the region where there is none today. There would appear to be an intuitive causal link between the two. However, there is certainly more than meets the eye within this thematic.

A QUICK PRIMER

Firstly, it is important to establish the nuances of senior living real estate as an investment class and how it can be accessed through listed markets elsewhere in the world. In regions with relatively mature senior living industries, such as North America, there has been a marked development in healthcare-focused REITs and senior living operators. The REITs will typically partner with these operators through a symbiotic relationship: REITs offer access to capital and the ability to support growth via acquisition in a still fragmented industry whilst the operators offer managerial expertise and operational capability. There are also examples of senior living operators, which are themselves listed entities.

The investment opportunity presented by senior living is therefore generally bucketed under healthcare real estate, which itself is seen as a core sector alongside office, retail, industrial and so forth. In the US, the senior living real estate assets owned by these REITs are split between triple net lease structures and structures that allow the REIT to share the operational risk and reward with the operating companies. The former provides more certainty of income as it is derived from consistent rent receipts whereas the latter provides more income growth potential albeit with the risk of greater cash flow volatility. This is enabled through various REIT-related legislation, which itself demonstrates the importance of a robust legal framework to empower investment.

It is worthwhile drilling down a level further and establishing the range of property types within the senior living subsector particularly due to the differing service component and thus the operational burden.

Figure 1: US healthcare REITs with large senior living holdings

<table>
<thead>
<tr>
<th>NAME</th>
<th>Ticker</th>
<th>Market Cap (USD bn)</th>
<th>Senior Living Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welltower</td>
<td>HCN</td>
<td>25</td>
<td>~65%</td>
</tr>
<tr>
<td>Ventas</td>
<td>VTR</td>
<td>21</td>
<td>~65%</td>
</tr>
<tr>
<td>HCP</td>
<td>HCP</td>
<td>15</td>
<td>~40%</td>
</tr>
<tr>
<td>Omega Healthcare Investors</td>
<td>OHI</td>
<td>7</td>
<td>~10%</td>
</tr>
<tr>
<td>Senior Housing Properties Trust</td>
<td>SNH</td>
<td>4</td>
<td>~50%</td>
</tr>
</tbody>
</table>

Figure 2: Listed US senior living operators

<table>
<thead>
<tr>
<th>NAME</th>
<th>Ticker</th>
<th>Market Cap (USD bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brookdale Senior Living</td>
<td>BKD</td>
<td>3</td>
</tr>
<tr>
<td>Capital Senior Living Corporation</td>
<td>CSU</td>
<td>0.5</td>
</tr>
<tr>
<td>Five Star Senior Living</td>
<td>FVE</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Information as at December 2015
Senior living holdings shown as a percentage of net operating income
Source: CBRE Research, Greenstreet Advisors, Bloomberg

Demographics is arguably the most interesting of all these forces. Given the power of demographics to fundamentally shape society’s demand pattern for all real estate sectors, it should be a key consideration for any long-term investor in the asset class.
In North America, the congregate care property type has become the backbone of the contemporary senior living market. Whilst the traditional nursing home model evolved into the skilled nursing property type, the congregate care property type emerged to fill an obvious gap for those seniors who needed more assistance than is available in a retirement community but less care than is provided in heavily medical service-oriented skilled nursing facilities. This segment has been particularly attractive for operators and REITs as it offers higher profit margins than skilled nursing, which is subject to a greater degree of regulation and requires a more operationally intensive business model. In addition, congregate care is overwhelmingly based on a private pay model, which again offers more attractive margins, rather than social security or government subsidies due primarily to the lack of a federal program1.

There is a case to suggest that congregate care might experience a similar emergence in Asia, driven by its overwhelming demographic shift and a clear supply gap.

In North America, the congregate care property type has become the backbone of the contemporary senior living market.
Evidently, the populations of Japan, China and Korea are aging – and rapidly – which would appear to be conducive for greater investment in senior living real estate. Yet these are societies that have traditionally cared for aging parents in the family home, so is this a genuine opportunity or a mirage?

**NEW REALITIES CHALLENGE CULTURAL NORMS**

The cultural tradition of filial piety has played a meaningful role in Asian societies for centuries. This is a tradition that emphasises multigenerational households with adult children as the providers of support and care for their elderly parents. However, this family support system is increasingly being challenged on a number of fronts.

Firstly, the declining birth rate suggests that elderly parents will have fewer children on whom they can rely for support. For example, the One Child Policy in China has led to the “4-2-1 phenomenon” – one child has to be responsible for two parents and four grandparents. This presents a significant burden that threatens the practicality of the family support system.

Secondly, urbanisation trends and the unequal geographic distribution of job opportunities means that children may have moved away from their ancestral homes to gateway cities such as Tokyo, Seoul and Shanghai. For example, Greater Tokyo has seen a net internal population inflow for 20 straight years and continues to grow whilst the population of Japan as a whole is in decline. Most tellingly, more than 90 per cent of the people who moved to the capital in 2015 were aged 15 to 29.

Thirdly, the overall increase in workforce participation rates across Asia means that there are fewer people available to provide in-home care for elderly family members on a regular basis. For example, the female workforce participation rate in Korea has increased from 46 per cent in 1980 to 57 per cent in 2014 whilst the male workforce participation rate has remained steady.

Fourthly, there is also increasing focus on the efficacy of in-home care by family members. In practical terms, it is often the case that such caregivers are not trained health professionals let alone specialists in geriatric health. As such, even the most well-intentioned person may find it challenging to identify, monitor, and address the needs of elder family members as they age from recognising early signs of Parkinson’s disease to measuring blood pressure accurately. There are significant social implications in play which transcend the debate about cultural tradition.
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It should be noted that the tradition of filial piety and the family unit is not being challenged, but rather the tradition of elderly care being provided within a multigenerational household. Clearly, there are a number of long-term structural trends that question the sustainability of this approach, and prevailing attitudes towards institutional care will be forced to give way. However, if the resultant shift in attitudes to senior living is a positive for the sector, the question remains: will it be accessible to listed real estate investors?

GOING PUBLIC

The above question about accessibility is first and foremost an existential one for REITs in general, which is best tackled with a quick look at history. In the US – the world’s oldest REIT market – the development of REIT legislation was borne out of a basic supply/demand dynamic. Real estate owners and developers sought greater access to capital beyond traditional senior bank financing. Meanwhile, with the portfolio diversification benefits and total return potential of real estate increasingly apparent, smaller investors sought a means to invest broadly in large scale, commercial real estate in an efficient and liquid manner.

This dynamic was brought to the fore in the early 1990s. Following a prolonged period of unchecked overbuilding in the 1980s, real estate developers were hit hard by the subsequent decline in property values. Regulators clamped down on traditional real estate lending by banks, causing a credit crunch in commercial real estate markets. At the same time, an equity bull market meant that REITs could tap public markets at a low cost of capital and use the funds to acquire real estate assets at bargain prices in the flailing private market. Thus the so called “modern REIT era” was born with listed real estate going on to establish itself as a large, investible asset class in the years that followed. The aforementioned basic supply/demand dynamic that drives the securitisation of real estate is as relevant as ever – as is the pricing differential between public and private markets – and REITs continue to be a very important market participant for this reason.
SEURITISATION IN ASIA

With the above in mind, is it reasonable to expect that senior living real estate assets will securitise in places like Japan, Korea and China?

The answer harks back to the issue of demographics. The self-same force that is driving an increase in the demand for senior living real estate is also driving major pension reforms in these countries. These reforms are designed to encourage the growth and sustainability of the corporate pension market (ie. earnings-related pensions) to ensure old age income support, and alleviate what would otherwise be a crippling burden on the public purse if too many people rely on social security from the government in retirement (ie. subsistence pensions).

China introduced a legislative framework for externally funded corporate pensions in 2004, known as Enterprise Annuities (EAs), which are defined contribution schemes. The EA market currently stands at around US$100 billion in assets and is forecast to grow to US$600 billion by 2020.

Korea first introduced its corporate pension framework in 2005 and initiated a number of enhancements in more recent times including tax incentives, expanded coverage and less restrictive investment parameters. Its corporate pension market also currently stands at around US$100 billion in assets, having trebled in the past five years alone, and the bulk of future growth is to come from the defined contribution segment.

Japan is already the third largest pension market in the world with almost US$3 trillion in assets following a range of reforms in the mid-2000s. It is also home to the world’s single largest pension fund – the Government Pension Investment Fund (GPIF) – with around US$1.2 trillion in assets. Historically a defined benefit market, Japan is also beginning to shift towards defined contribution schemes.

The upshot is that each of these markets has a large, growing pool of domestic capital that will assuredly look to invest part of the portfolio in domestic real estate. In addition, since much of this capital will be held in defined contribution schemes, there is also an important liquidity requirement. This suggests very strong, long-term structural demand for local listed real estate investment opportunities and, in turn, the development or enhancement of local REIT frameworks.

AUSTRALIA’S EXAMPLE: PENSIONS AND A-REITS

Since the introduction of compulsory superannuation (pensions) in 1992, Australia’s pension market has risen to fourth in the world by assets and is also very much dominated by defined contribution schemes. By the early 1990s, Australia’s REIT framework was already two decades old but the considerable capital accumulation that came about as a result of compulsory superannuation has been a key supporter of the local REIT market ever since.

Australian REITs have risen from a market capitalisation of A$5 billion in 1992 (at the introduction of compulsory superannuation), or 2 per cent of the overall market, to A$116 billion or 9 per cent of the overall market in 2015. In 2015, the average allocation of Australian superannuation funds to A-REITs was around 3 per cent, which alone represents A$60 billion of demand.
Japan has a very well-established REIT market and is the largest such market in Asia. The country’s long history of near-zero interest rates and the resultant appetite for yield from other asset classes mean that REITs are already a mainstay in domestic investors’ portfolios. During the past 10 years, senior living real estate assets have been among the holdings of some Japanese REITs such as Invincible Investment Corporation, Orix JREIT, and Advance Residence Investment Corporation. However, this type of asset has typically represented very small portions of the overall portfolio. In 2013, the Abe government began actively encouraging investment from the private sector in senior living real estate as a matter of economic policy, which paved the way for the first healthcare REITs with a focus on residences for the elderly. The market has subsequently seen the establishment and listing of Japan’s first healthcare facility dedicated REITs.

In 2013, the Abe government began actively encouraging investment from the private sector in senior living real estate as a matter of economic policy.
KOREA AND CHINA WAITING FOR A CATALYST

Korea has had REIT legislation in place since 2001 but has fallen behind other early movers in the region due to an absence of the typical tax advantages that one associates with REITs, as well as somewhat restrictive guidelines. China continues to edge ever closer to a REIT framework, with the landmark listing of Penghua-Qianhai-Vanke in 2015 representing another step forward. Importantly, both Korea and China do offer very deep, liquid domestic share markets, ranking 15th (the Seoul-based Korea Exchange) and 5th (Shanghai Stock Exchange) in the world respectively, by market capitalisation.

Given the nature of the senior housing opportunity – which is very much based on new supply – it could be the catalyst for both Korea and China to redouble efforts on developing their REIT regimes to satisfy local demand and attract foreign capital away from the more established regional REIT hubs such as like Singapore and Hong Kong. The sheer scope of the capital required, especially considering that this is essentially the birth of congregate care real estate in these geographies, means that it flows logically for holders of assets to want to tap the veritable “capital menu” on offer as a REIT including common equity, preferred equity, senior and subordinated loans and corporate bonds.

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Further bolstering the case for the emergence of senior living real estate in Asia is the clear evidence of government support. In the absence of an established congregate care market and with the decline in the feasibility of the multigenerational household, the only alternative for seniors requiring assistance with activities of daily living is the skilled nursing home. These institutions emphasise costly medical care, which is typically state-funded or subsidised, and the addition of residents who do not actually require this level of care creates an unnecessary financial burden on public coffers. In addition, this would come at a time when the government can least afford it since one of the most serious challenges as the result of the demographic shift in Asia is a shrinking tax base.

For example, in order to encourage private sector investment in senior living, the Chinese government incorporated the issue into its National 12th Five Year Plan in 2011. China’s Ministry of Commerce and Ministry of Civil Affairs have shown strong interest in tapping foreign expertise in senior living, jointly issuing the “Circular on Various Issues on Foreign Investment in For-profit Senior Care Facilities” in December 2014, which provides a detailed platform for foreign investment and partnerships in senior care businesses in China. This has been further supported by the inclusion of provisions for foreign investment in senior living in various free trade agreements between China and other countries. As a result, one can expect experienced players from mature senior living markets such as North America to begin sizing up the opportunity more closely and assessing potential local partners.
WHAT ARE THE HEADWINDS?

Investors in listed real estate face a number of challenges to the emergence of senior living as an investible sector in the region.

In-home care

An alternative to residential care, this approach focuses on delivering services and assistance to the elderly in their own homes on a regular basis, removing the real estate investment element. However, in-home care cannot handle unscheduled assistance and there is inconsistency in the service quality and availability across regions, especially rural areas.

Political risk

As a result of the nascent nature of the senior living industry in Asia, there is generally a shortage of the skilled labour required. This not only presents a human resourcing challenge for first movers, but also has the potential to derail the industry in its infancy if strict quality control is not in place (due to reputational risk for companies and the sector as a whole). This presents an opportunity for highly experienced operators from mature senior living markets to partner with local developers in order to address and mitigate these risks, a trend which has been particularly prevalent in China.

Value paradigm

Cultural differences extend to the concept of value. Conservatism in spending on services and a reluctance to cash in home equity for retirement spending are but two influences on the willingness of a society to support the senior living sector. Quality, long-term senior care has intangible value that may not be readily accepted by both adult children and potential residents especially when it goes against the grain of broader cultural traditions of filial piety.

Lack of a model

The congregate care property type remains relatively unfamiliar in the region, particularly in Korea and China. Key aspects such as regulation, pricing structure, operational models, architectural tradition and market education still need to be established. Whilst lessons can be drawn from more mature senior living markets such as the US, it would certainly be naïve to assume that successful approaches elsewhere in the world are readily exportable to Asia.

Clearly, challenges do exist and must be acknowledged, but the sheer weight of the demographic change suggests that these will be hurdles rather than roadblocks over the long term.
WHAT DOES ALL THIS MEAN FOR INVESTORS?

The potential emergence of senior living as a large, investible sector in Asia underscores how real estate can provide investors with access to some of the most meaningful, long-term trends of today. Structural shifts of this nature will inevitably produce leaders and laggards, trailblazers and holdouts, winners and losers. In addition, as is the case with senior living real estate, a trend might be new to a particular region but have been seen before elsewhere in the world.

As such, expertise matters in picking those winners and understanding trends as they become increasingly global.

Listed real estate investment managers that are able to tap into experience and information across regional bounds within the same global team have a distinct advantage especially if cross-border activity is anticipated from established players in mature markets into the new frontiers. Investors should therefore consider managers that are set up to generate and share local insights by design, with a clear focus on building a genuine global portfolio.

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