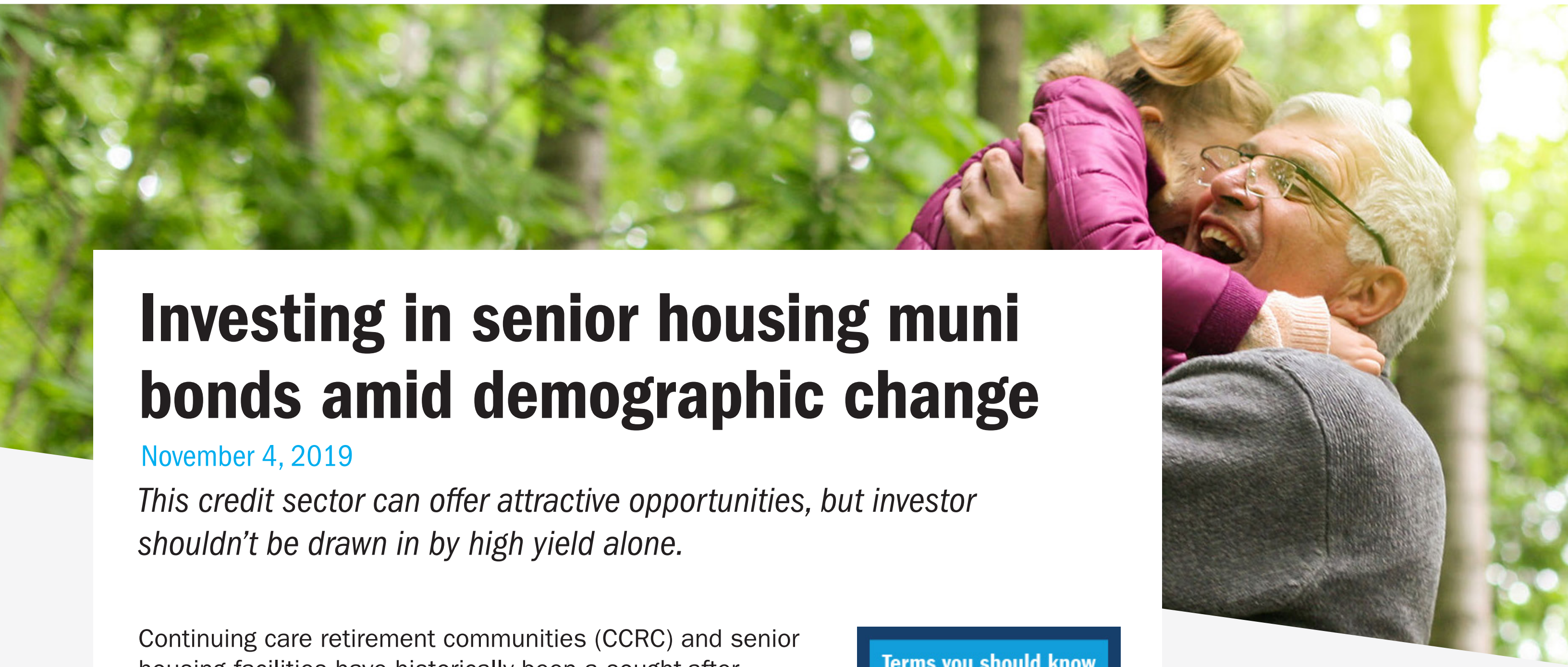


Investing in senior housing muni bonds amid demographic change

November 4, 2019

This credit sector can offer attractive opportunities, but investor shouldn't be drawn in by high yield alone.

Continuing care retirement communities (CCRC) and senior housing facilities have historically been a sought-after category by institutional investors, who are often attracted to this credit sector because of its higher yield. Yield aside, investing in the senior living sector is supported by positive demographic fundamentals that should expand opportunities in this sector.

CCRCs fall within a broader category of municipal bonds called private activity bonds (PABs). Local and state governments issue PABs on behalf of private users — in this case mainly developers and operators of CCRCs — to meet the housing needs of their older residents. In a similar fashion, a municipality might issue school bonds, which also support a certain segment of the overall population.

The overall size of the CCRC market is still relatively small ($5 billion of issuance in 2018), but it's doubled in size over the past decade.[1] As a percentage of total new issuance, the CCRC and senior living sectors accounted for 1.4% of tax-exempt issuance in 2018, compared with 0.7% a decade ago. We anticipate that CCRC issuance will continue to increase, which may present attractive opportunities for investors who understand the intricacies and nuances of this corner of the market.

Data from the U.S. Census Bureau and the Joint Center for Housing Studies at Harvard Univeristy examind the senior population trend and its impact on housing and care services in the next 20 years.

Terms you should know

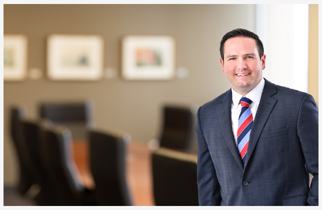
Continuing care retirement communities (CCRC)
A growing sector of the municipal bond market.

Private activity bonds (PABs)
A type of municipal bond issued by state or local government on behalf of a private entity.

Entrance fee-based communities
A type of CCRC where residents pay large upfront fees. Bond issuers of this type may be more vulnerable during economic and housing downturns.

Rental-based community
A type of CCRC where residents pay monthly rent instead of an initial lump sum. Bond issuers of this type have historically weathered economic and housing downturns better than entrance-fee based communities.

Catherine Stienstra
Head of Municipal Investments



Douglas Rangel, CFA
Vice President, Fixed Income Client Portfolio Manager

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Demographic trends and senior housing

The U.S. Census Bureau projects that the 65+ age group will reach 79 million by 2035 — an **increase of more than 30 million**. The 80+ age group will double in size in the next 20 years, from 12 million to 24 million.

Historically, older adults have the highest homeownership rate of all age groups, but this declines with age, especially after age 80. The demand for senior housing, especially rental housing, **will increase significantly in next 20 years**.

Based on current trends, there will be a **4.9 million unit gap** between demand and supply of affordable senior housing units by 2035. This highlights the degree to which the lower-income senior housing market is underserved.

Source: Data from the U.S. Census Bureau and the Joint Center for Housing Studies of Harvard University.

CCRCs offer residents a range of options from independent living to assisted living to full-service healthcare-based options with skilled nursing. Many of the negative connotations once associated with traditional nursing homes have dissipated because these communities offer a range of amenities for residents like swimming pools, fitness centers, libraries and art studios. Moving into these communities is a lifestyle choice that allows for a seamless transition through the various stages of care necessary as residents age.

The financial success of these communities depends on a number of factors, but in general, there are two types of retirement living communities consumers can choose from (and that bond investors can invest in). The first is an entrance fee-based community, which requires a new resident to pay the entrance fee up front, usually in hundreds of thousands of dollars and is often financed by the proceeds from the resident selling their house. The second is a monthly rental-based community; there is no entrance fee requirement, so residents could move in first and sell their houses later. Typically, residents pay a monthly service fee to reside in the community, but it varies by property and is usually much lower than monthly fees in rental-based communities. Other services, such as housekeeping, medication assistance or bathing assistance are usually considered additional charges. The financial resource requirements for eligible seniors considering the two living options differ significantly, and **these two types of senior living facilities behave differently from a credit risk standpoint.**

According to Columbia Threadneedle Senior Credit Analyst Ben Woo, who has been following the sector for 26 years, entrance fee-based CCRCs experienced a significantly higher level of financial stress during the 2008 recession and housing downturn, mostly due to eligible seniors' reluctance to list their houses and move to a CCRC when home valuation was down. CCRC borrowers had much lower than expected turnover entrance fees to pay debt services and operating expenses, leading to deteriorated debt service coverage, elevated cases of liquidity stress and even loan indenture covenant violations. In contrast, rental-based communities reported less marketing and occupancy challenges during the same period. Their financial performance declined noticeably less relative to entrance fee-based communities.

Be aware of the risks

Despite favorable demographic trends, investing in senior living poses multiple risk elements to investors, making fundamental credit analysis, security selection and ongoing credit surveillance paramount. Risks such as construction cost overruns, local market competition, low occupancy or simply poor management execution can lead to adverse outcomes for investors.

Bottom line

With a potential yield advantage over AAA munis, CCRC issues can offer attractive tax-exempt income in a well-diversified portfolio. The incremental yield and uncorrelated performance (relative to larger portions of the municipal market such as state GOs or transportation bonds) can make CCRCs an attractive option for many investors. However, it's important for investors to refrain from being drawn in by high yield alone. Understanding the differences between opportunities requires comprehensive analysis and experience.

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