CNL *Healthcare Properties II*

SPECIAL REPORT

# COMMERCIAL REAL ESTATE TRENDS

## Spotlight on the Seniors Housing and Healthcare Sectors

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# Seniors housing and healthcare assets have continued to provide income and growth opportunities to retail investors. This report explains the current market conditions and trends that have led to a continued interest in commercial real estate investments.

Commercial real estate (CRE) — or a property that is used for business purposes — has been a staple for investors seeking portfolio diversification through the inclusion of investments that are less correlated to the publicly traded equity markets. While CRE investments were first available to high-net-worth and institutional investors, they have been making their way into the portfolios of retail investors through vehicles such as real estate mutual funds, real estate exchange-traded funds and real estate investment trusts (REITs).

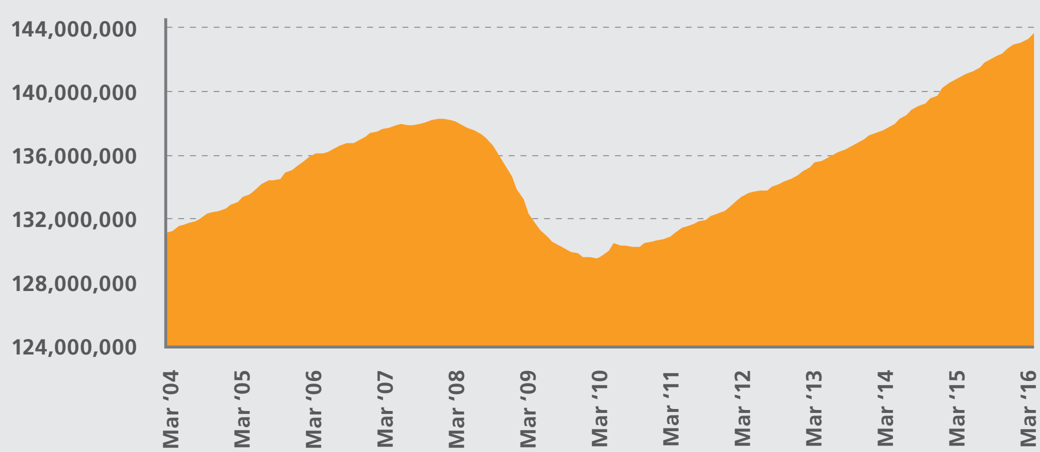
Today's CRE market has not been immune to the effects of the economy. Interest rates, inflation and other world events, such as the mortgage-induced recession of 2008, have impacted the real estate industry, especially in regions where a supply and demand imbalance existed. However, two asset classes in the CRE industry — seniors housing and healthcare — have continued to hold steady over the long term, providing both income and growth opportunities to investors. This report discusses the trends in today's market that have led to a rise in CRE investments, with a special focus on the seniors housing and healthcare sectors.

## TODAY'S MARKET CYCLE AND THE CRE LANDSCAPE

Improvements in the U.S. economy, strong market and property fundamentals, and the availability of different lending sources are continuing to bolster investments in the CRE sector.[1] Key to these investments is the potential impact interest rates could have on property capitalization (cap) rates if the Federal Reserve (Fed) raises interest rates in the near future. However, while higher interest rates could impact cap rates and the cost of financing real estate projects, it is believed that the CRE sector in general will provide returns to investors.[1]

Although there is no guarantee about future performance, any enhanced returns will most likely stem from an improved U.S. economy that is leading to further rent growth, higher occupancy rates, and global and domestic investments in CRE across the country.[1] This section will discuss the key forces that are impacting CRE development and its viability as an investment opportunity.

**Figure 1. Total Number of U.S. Nonfarm Employees**




**14.04** **million**
employees have been added since February 2010

SOURCE: "All Employees: Total Nonfarm Payrolls," *Current Employment Statistics*, U.S. Bureau of Labor Statistics, accessed on April 5, 2016.

## WHAT ARE CAP RATES?

A key metric in real estate valuation is the cap rate, which compares a property's annual net operating income to its overall value.

Several variables impact the rise and fall of cap rates, such as interest rates, inflation, lending availability for CRE development, and market supply and demand forces.

SOURCE: "Capitalization Rate," *Investopedia*, accessed Oct. 14, 2015.

## ECONOMIC AND MARKET FACTORS

**THE JOB MARKET.** Macroeconomic factors such as employment, as well as the continuing rise of media companies and firms in the science, technology and engineering sectors are affecting the demand and supply dynamics of CRE in many U.S. markets.[2] During the Great Recession starting in December 2007 and ending in June 2009, the United States shed 8.7 million jobs.[3]

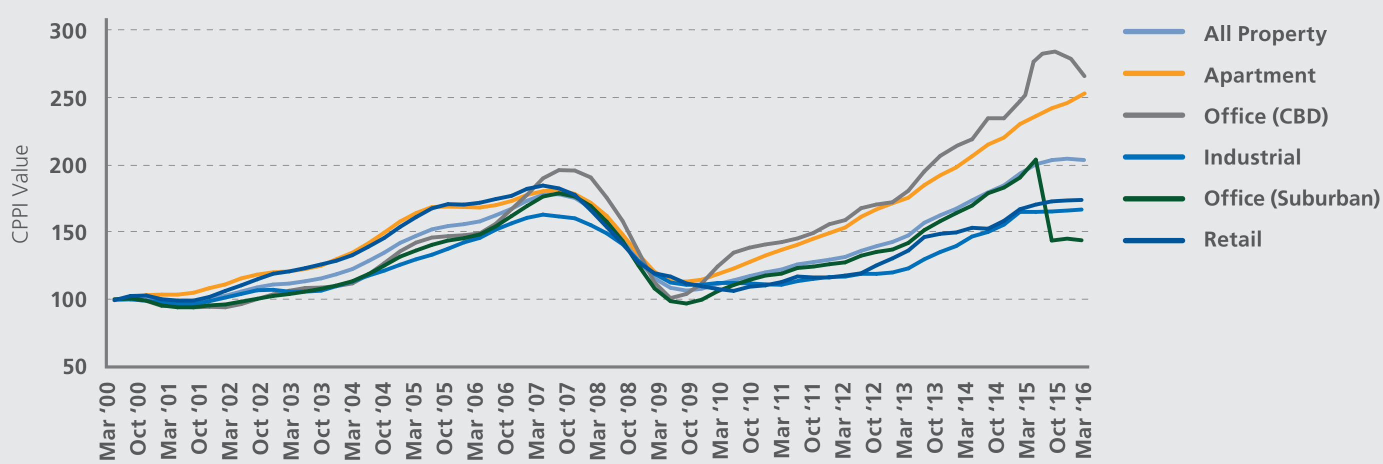
However, not only has the United States more than regained the jobs lost during the recession, over 12.6 million employees have been added since February 2010 (refer to Figure 1 on page one). As more jobs are added in key job sectors and unemployment figures continue to decrease, demand for CRE, whether through new development or leasing of existing facilities, may be expected to increase across multiple markets.

**PROPERTY PRICES.** The commercial property price index (CPPI), which captures the prices at which CRE transactions are currently being negotiated in several sectors, has trended upward since its low in 2009 (refer to Figure 2 below). Specifically, increased investments in sectors with trophy assets, such as central business district (CBD) offices and apartment buildings, have driven up prices more quickly than in other asset classes (e.g., suburban offices, industrial properties and retail buildings). As explained earlier and will be discussed later in this report, CRE development and investment opportunities are presenting themselves in several U.S. markets and real estate sectors.

**BORROWING COSTS.** Besides property prices, another consideration in today's CRE markets is borrowing costs. The spread between the annual return on a commercial property (or its cap rate) and base borrowing costs continues to remain somewhat the same as in previous years, creating a potentially favorable environment for deploying leverage to invest in real estate.[4] It is important to note that the financial cost of borrowing for pre-existing properties is typically lower than the cost associated with financing properties under development.

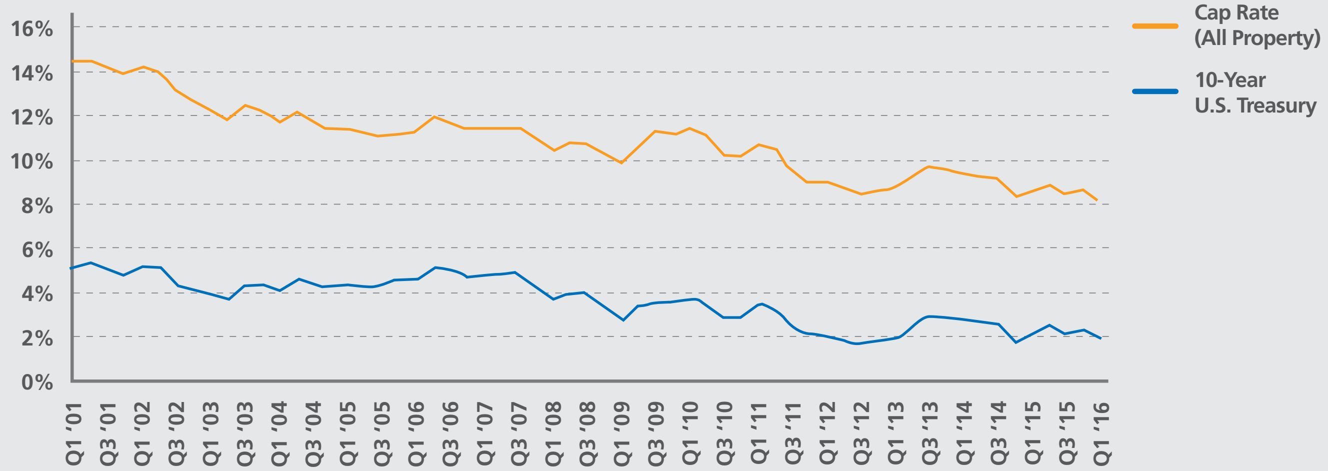
Figure 3 on page three shows the spread between cap rates and the rate on a 10-year U.S. Treasury note, the latter of which is typically used as the baseline for borrowing costs. The spread between the two rates represents potential gains generated from loans used on investments. Therefore, in theory, the wider the spread, the more income the real estate portfolio could potentially generate during its first year after accounting for investment fees and costs.

### Figure 2. Commercial Property Price Index (CPPI) Real Estate Values




SOURCE: "Commercial Property Price Index," Real Capital Analytics, May 2016.

## Figure 3. Spread Between Cap Rates and Base Borrowing Costs

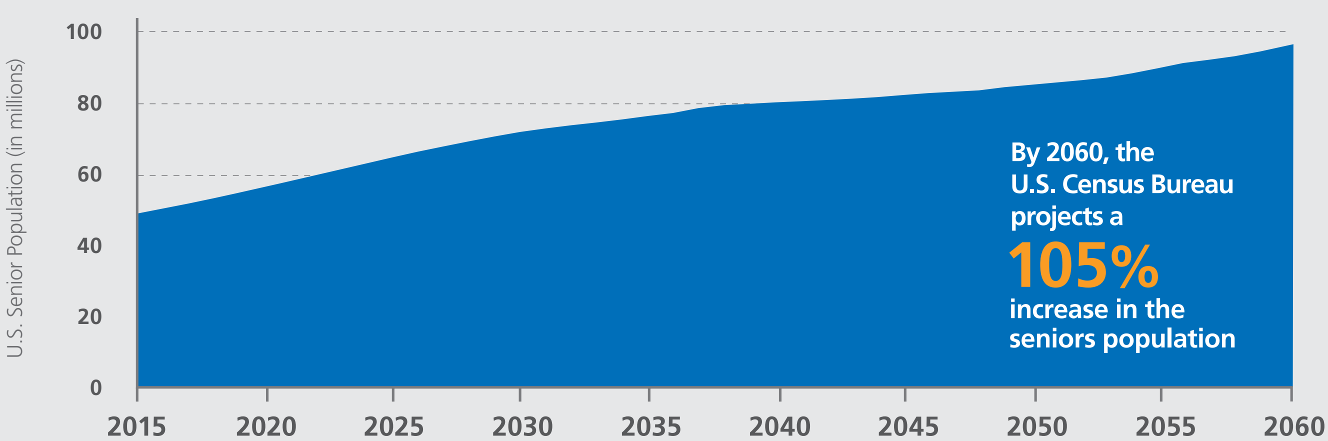



Past performance is not a guarantee of future results. Real estate is a long-term investment. As a result, the data above may change over the asset's holding period. In addition, the cap rate above pertains to the CPPI and represents an aggregate amount. Cap rates for different real estate sectors may be more or less than those represented above. CNL Healthcare Properties II is a blind pool and, therefore, has no buildings or capitalization rates to reference.

SOURCES: "Commercial Property Price Index," Real Capital Analytics, May 2016. "10-Year Treasury," *Yahoo! Finance*, accessed May 9, 2016.

**CHANGING DEMOGRAPHICS.** Finally, shifting demographics in the United States are altering the demand for CRE in many markets across the country. As millennials (ages 16–34) — who are now the largest demographic group in the United States[5] — continue to join the workforce, their tastes and preferences will influence the design and location of workplaces. The aging population in the United States also is increasing demand for healthcare properties, such as seniors housing. Between 2015 and 2060, the U.S. Census Bureau projects a 105 percent increase in the number of senior citizens (refer to Figure 4 below).[6] This "aging of America" also may usher in an increased need for medical-related services that, in turn, have the potential to lead to an increased demand for medical office buildings and seniors housing facilities.

## Figure 4. Projected Increases for the Nation's Senior Population




SOURCE: "U.S. Population Projections: 2014–2060," U.S. Census Bureau, Dec. 10, 2014.

## CAP RATES, RENTAL INCOME AND DEVELOPMENT

Borrowing costs for CRE properties will likely increase once interest rates start to rise. However, rental rates typically rise due to higher inflation levels as long as demand for CRE properties remains strong in a geographical area. As a result, a future narrower spread between cap rates and borrowing costs may be mitigated by income generated from higher rental rates if the property is located in a market with strong demand.

In markets where it is less expensive to build new properties than buy existing ones, or in which distressed properties might be too expensive to renovate, investors may chose development opportunities. In fact, according to the summer 2015 report by PricewaterhouseCoopers, *U.S. Real Estate Insights*, most property types are moving into either the recovery or expansion phase of the real estate cycle, with increased construction activity taking place in many metropolitan areas across the United States.

In addition, newer buildings create a younger portfolio, which may enhance valuation, and many tenants prefer more up-to-date buildings that incorporate sustainable technologies and automation features. Given these trends and the current spread between cap rates and borrowing costs, CRE development can be expected to pick up in markets with strong demand throughout the country.

## THE SENIORS HOUSING AND HEALTHCARE SECTORS

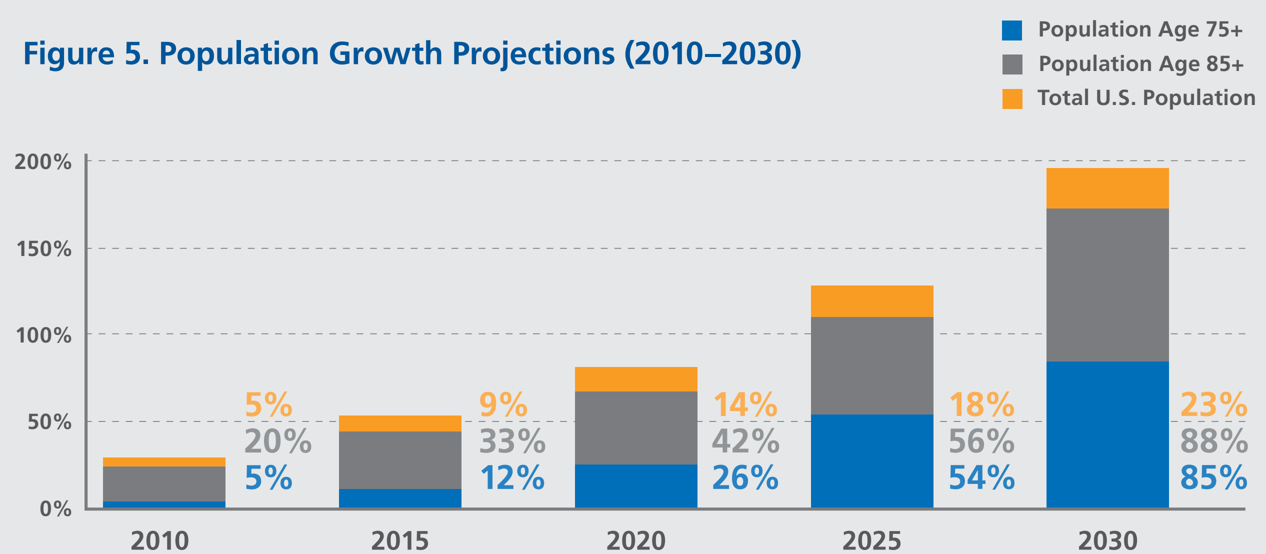
There are several ways a portfolio can invest in CRE, including, but not limited to, the purchase of existing properties or through new construction in geographical areas with strong demand. While income-producing CRE assets are available in many markets across the United States, development is projected to continue its upward trajectory in two particular sectors — seniors housing and healthcare. For example, healthcare properties outside of hospitals, such as medical office buildings, will continue to comprise a significant portion of the total real estate development and investment sector, according to a 2015 report by real estate firm Marcus & Millichap.[7]

The seniors housing and healthcare sectors are poised to continue expanding by taking advantage of existing market opportunities, thus providing retail investors with a great way to invest in this vital industry. This section describes key market and economic factors that are driving demand for the development of seniors housing and healthcare facilities.

### DEMOGRAPHIC TRENDS — THE "SILVER TSUNAMI"

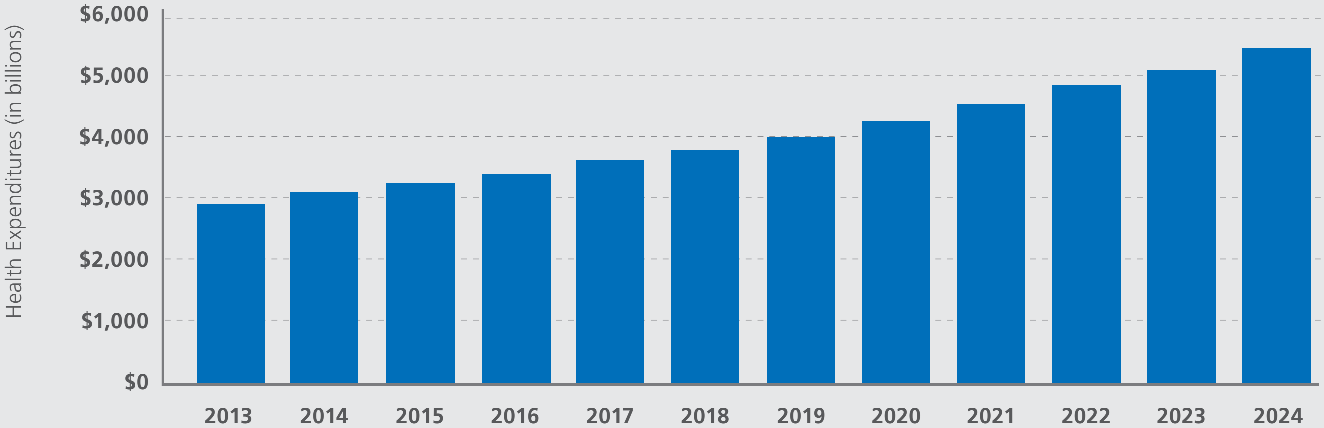
The U.S. Census Bureau projects that 24 percent of the population will be 65 or older by 2060 (refer to Figure 5 below for more population trends).[6] Consequently, seniors will continue to seek housing and healthcare options to meet their growing needs. This population growth also is projected to impact federal spending on healthcare programs, such as Medicare, which everyone qualifies for at age 65 or older.

**Figure 5. Population Growth Projections (2010–2030)**




SOURCE: *Discussion Materials*, CBRE, June 26, 2014.

## Figure 6. Projected National Health Expenditures




Actual results may vary materially from projections.
SOURCE: "National Health Expenditures," Centers for Medicare and Medicaid Services, accessed on April 5, 2016.

## CONSUMER-CENTRIC HEALTHCARE DELIVERY

In recent years, there's been a shift toward a more consumer-centric, outpatient delivery model.[7] According to data from a 2015 report from the American Hospital Association, outpatient surgeries have increased by 38 percent since 1993, and more than 65 percent of surgeries do not require an overnight hospital stay.[8] Together, these findings point to an expanding need for medical office buildings and post-acute care facilities.

## FEDERAL HEALTHCARE SPENDING

In addition, national healthcare spending is expected to rise to 25 percent of the gross domestic product by 2040 (refer to Figure 6 above).[9] Healthcare spending consists of costs pertaining to Social Security and the government's major healthcare programs — Medicare, Medicaid, the Children's Health Insurance Program and subsidies for health insurance purchased through the exchanges created by the Affordable Care Act.

The rise in federal healthcare spending is anticipated to be more than twice the 6.5 percent average increase experienced over the past 50 years.[9] In addition to the aging population, this boost in expenditures will occur due to growth in per capita spending on healthcare and, to a lesser extent, a rise in the number of exchange subsidy recipients and Medicaid benefits attributable to the Affordable Care Act.[9]

With that said, since the advent of the Affordable Care Act, there has been continued pressure to reduce healthcare-related costs, including Medicare, Medicaid and insurance reimbursement percentages to healthcare providers.

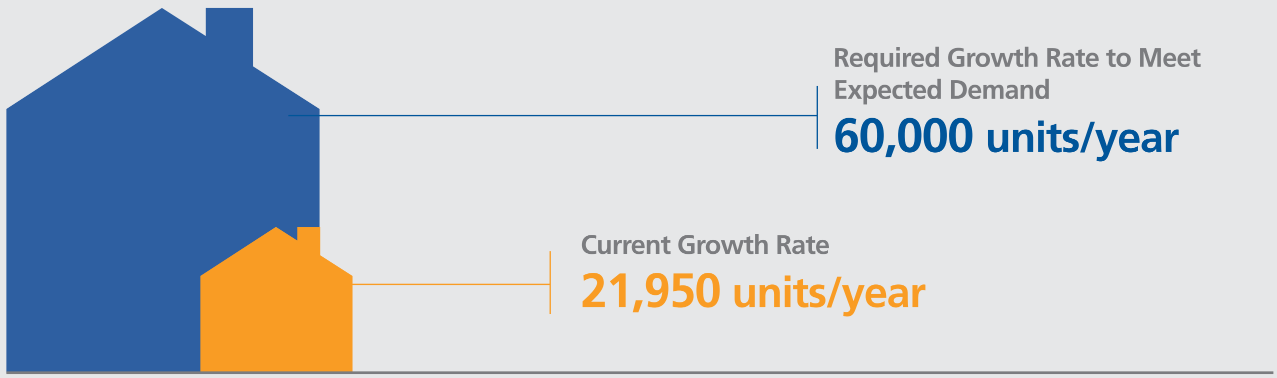
## INSUFFICIENT SUPPLY OF SENIORS HOUSING

Seniors housing and medical office buildings have been attractive real estate sectors.[10] As the need for medical services outside of the hospital setting continues to grow, the existing supply of seniors housing will be insufficient to meet future demand. In fact, according to the American Seniors Housing Association, a 173 percent increase in seniors housing units is needed to meet average demand projections by 2020–2030.[11]

## RISE IN HOUSEHOLD HEALTHCARE EXPENSES

Individuals aged 65 years and older account for an outsized share of all doctors' visits.[12] According to the *2015 Retirement Health Care Cost Data Report* by HealthView Services, healthy couples retiring at age 65 in 2015 will likely spend more than $266,000 on doctors' visits, outpatient services, prescription drugs and supplemental Medigap insurance over the rest of their lifetime.[13] What's more, this dollar amount is projected to increase as cost-of-living adjustments rise — there's been a 6.5 percent growth in retirement medical costs from projections made in 2014.[13] Finally, lifetime cost estimates for the same 65-year-old couple increase to nearly $395,000 when expected dental, vision and hearing costs not covered by Medicare are included, as well as co-pays and other out-of-pocket medical costs.[13]

**Figure 7. Seniors Housing Growth Rate**




The growth rate illustrated above is based on demand projections from 2020 to 2030. Factors could cause actual results to vary materially from those expressed in forward-looking statements.

SOURCE: *A Projection of Demand for Market Rate U.S. Seniors Housing 2010–2030*, American Seniors Housing Association, Winter 2013.

### THE RESULT: TWO "NEEDS-BASED" ASSET CLASSES

When combined, the market forces and demand drivers explained earlier point to the resilience of seniors housing and healthcare CRE as an investment opportunity. Additionally, while other CRE sectors are impacted by economic events that trickle down to a particular market, seniors housing and healthcare property developments are "needs-based"— the primary drivers for investments in these two sectors are the ongoing need for medical care and demographic shifts (refer to Figure 7 above). "Needs-based" development and the resiliency of these asset classes are part of the reasons why medical real estate sales transactions totaled more than $11.3 billion in 2014.[14]

## TYPES OF SENIORS HOUSING AND HEALTHCARE PROPERTIES

Seniors housing and healthcare properties are durable asset classes that show strong market fundamentals. These properties vary in nature, thus providing individuals, especially those considering a portfolio of investments, with different options and levels of asset diversification. Both seniors housing and healthcare real estate assets can be divided into two distinct categories: seniors housing and care, and medical facilities.

### SENIORS HOUSING AND CARE

Seniors housing and care communities offer services to residents age 65 and older, ranging from basic dining and transportation to assistance with daily living activities. These communities typically include independent-living communities, assisted-living communities, continuing care retirement communities (CCRCs) and skilled nursing facilities.

### MEDICAL FACILITIES

Medical facilities include medical office buildings, ambulatory surgical centers, general and specialty hospitals, long-term acute care hospitals and inpatient rehabilitation facilities. While some medical facilities provide inpatient care only, such as hospitals, many inpatient services are continuing to move into outpatient settings — a trend that, as discussed earlier, is expected to continue increasing the demand for medical office buildings in the years to come.

It is important to note that in certain markets, there is increased competition for seniors housing residents. This, in turn, may cause property managers to offer concessions to entice new tenants or limit tenant turnover, thus negatively impacting a real estate portfolio's net revenue.

## INVESTING IN CRE

Today's market offers options for retail investors seeking to add CRE to their portfolios. Traded investment products have included real estate mutual funds, traded real estate investment trusts (REITs) and real estate exchange-traded funds, among others. Investors, for example, have been taking advantage of traded real estate options for many years. According to Deloitte's *2015 Commercial Real Estate Outlook*, REITs will continue to benefit from today's favorable transaction pricing and financing environment, as well as improved rental income growth and higher occupancy levels.[15]

### NON-TRADED CRE INVESTMENT OPTIONS

Although traded real estate investments are easily redeemable, they experience daily stock market price fluctuations based on consumer sentiment. Non-traded options exist for retail investors looking for access to CRE, such as private equity real estate funds and non-traded REITs. Like all investments, these non-traded CRE options are not immune to general movements in the markets that impact real estate values.

In addition, these non-traded investments are illiquid and limit the number of shares that can be redeemed at any given time. However, their structures are aligned with the long-term nature of the real estate in which they invest. For instance, non-traded REITs also seek to provide the diversification benefits that are associated with direct portfolio investments in real estate assets.

### A NOTE ABOUT REIT INVESTMENTS

Both traded and non-traded REITs provide individuals with an opportunity to invest in CRE. However, each has its own associated benefits and risks. For example, traded REITs, which are easily redeemable, may move in concert with other types of traded securities. On the other hand, non-traded REITs, which are illiquid and limit share redemptions, have historically shown lower correlation to assets that are traded daily.

In addition to limited liquidity and possible illiquidity, investments in non-traded REITs are subject to significant risks. These risks include: Limited operating histories, reliance on the advisors, conflicts of interests, a higher expense model and payment of substantial fees to the advisors and their affiliates. Investing in these products is not suitable for all investors. A financial professional should determine whether the risks associated with an investment in the shares are compatible with a client's investment objectives.

As always, individuals should discuss all investment options with their financial advisor. Investors and advisors also should consider carefully the factors that can impact a REIT's performance before making an investment decision.

## IN BRIEF

Today's economic and social trends are continuing to bolster interest in CRE investments in markets with strong demand. Unlike other real estate asset classes, seniors housing and healthcare are primarily impacted by the needs for ongoing medical care, an older population and technological innovations that are moving the focus of care outside of hospitals.

As this report demonstrates, seniors housing and healthcare properties will continue their upward development trajectory, as long as market and demographic fundamentals remain strong. Individuals interested in investing in real estate in these two vital economic sectors should consult with their financial advisor to determine if such an offering is suited to their investment and financial needs.

CNL Healthcare Properties II is a non-traded REIT[16] that provides an opportunity for investors seeking income and growth for their portfolios. For more information about CNL Healthcare Properties II, or to download the prospectus, please visit **CNLHealthcarePropertiesII.com**, or contact the managing dealer, CNL Securities, member FINRA/SIPC, at **866-650-0650**.

## RISK FACTORS

Investing in a non-traded REIT is a higher risk, longer term investment than many listed securities and is not suitable for all investors. Shares may lose value, or investors could lose their entire investment.

The REIT was recently organized and has yet to establish any operating history on which investors may evaluate operations and prospects for the future. The REIT is a "blind pool" offering: It has not acquired any properties, assets or investments. Investors also will not have the opportunity to evaluate future investments before they are made.

CNL Healthcare Properties II intends to qualify and elect REIT tax status for the fiscal year 2016. If the REIT fails to meet the REIT qualification standards now or in the future, the REIT will be subject to increased taxes, which will decrease investors' returns.

This is a "best efforts" offering, and if the REIT raises substantially less than the maximum offering amount, it may not be able to invest in a large variety of portfolio assets, which will subject investors to greater risk.

Non-traded REITs are illiquid. There is no public trading market for the shares. The REIT does not expect to offer a liquidity event in the near future. Therefore, investors should be prepared to hold shares for an indefinite period of time. If investors are able to sell their shares, it would likely be at a substantial discount.

There are significant limitations on the redemption of investors' shares under the REIT's redemption plan. The REIT can determine not to redeem any shares or to redeem only a portion of the shares for which redemption is requested. In no event will more than 5 percent of the outstanding shares be redeemed in any 12-month period. The REIT may suspend, terminate or modify the redemption plan at any time. Holding periods may be waived for qualifying events. For more specific information, including redemptions for special circumstances, please refer to the prospectus.

The REIT is obligated to pay substantial fees to its advisor, managing dealer, property manager and their respective affiliates for their services in managing the day-to-day operations of the REIT based on agreements that have not been negotiated at arm's length, and some of which are payable based on factors other than the quality of services. These fees could influence their advice and judgment in performing services. In addition, certain officers and directors of the advisor also serve as the REIT's officers and directors, as well as officers and directors of competing programs, resulting in conflicts of interest.

Distributions are not guaranteed. During the REIT's initial phase, distributions will not be fully covered by cash flows from operating activities due to the high levels of investment costs and fees. Distributions will be supported by activities such as borrowings, investment proceeds, and advisor expense waivers, which are not sustainable over the long-term and can reduce the amount of capital available for investments. In addition, future liabilities may result in dilution of an investment.

The per-share amount of distributions on class-A, class-T and class-I shares will differ because of the timing of certain class-specific expenses. Specifically, distributions on class-T shares and class-I shares will be lower than distributions on class-A shares because the company is required to pay ongoing distribution and servicing fees with respect to the class-T and class-I shares. These fees are not applicable to class-A shares.

If the REIT fails to maintain its qualification as a REIT for any taxable year, it will be subject to federal income tax and net earnings available for investment or distributions would be reduced.

The use of leverage to acquire assets may hinder the REIT's ability to pay distributions and/or decrease the value of stockholders' investments.

There are significant risks associated with the seniors housing and healthcare sectors, including market risks impacting demand, litigation risks and the cost of being responsive to changing government regulations. The REIT's success in these sectors is dependent, in part, on the ability to evaluate local conditions, identify appropriate opportunities and find qualified tenants, or, where properties are acquired through a taxable REIT subsidiary, engage and retain qualified independent managers.

## GENERAL NOTICES

No offering is made to residents of New York, Maryland or any other state, except by a prospectus filed with the Department of Law of the state of New York, the Maryland Division of Securities or the respective state securities administrator. Neither the U.S. Securities and Exchange Commission, the attorney general of the state of New York, the Maryland Division of Securities nor any other state securities administrator has passed on or endorsed the merits of the REIT's offering, the adequacy or accuracy of this piece or the REIT's prospectus. Any representation to the contrary is unlawful.

This is not an offer to sell nor a solicitation of an offer to buy shares of the REIT. Only the prospectus makes such an offer. This piece must be read in conjunction with the prospectus to understand fully all the objectives, risks, charges and expenses associated with an investment, and must not be relied upon to make a decision. The information herein does not supplement or revise any information in the REIT's public filings. To the extent information herein conflicts with the prospectus, the information in the prospectus shall govern.

Forward-looking statements are based on current expectations and may be identified by words such as believes, expects, may, could, and terms of similar substance, and speak only as of the date made. Actual results could differ materially due to risks and uncertainties that are beyond the REIT's ability to control or accurately predict. Investors should not place undue reliance on forward-looking statements.

Managing dealer of CNL Healthcare Properties II is CNL Securities Corp., member FINRA/SIPC. Shares are offered to the public through other broker-dealers or with the assistance of registered investment advisors. Broker-dealers and investment advisors are reminded that communications from or about CNL Healthcare Properties II must be accompanied or preceded by a prospectus.

An investment in the REIT is subject to significant risks, some of which are summarized in the Risk Factors section of this piece and are fully detailed in the Risk Factors section in the REIT's prospectus. Investors should read and understand all of the risks and the entire prospectus before making a decision to invest. The prospectus is available on SEC.gov and CNLHealthcarePropertiesII.com.

**REFERENCES AND ENDNOTES**


1 "Commercial Real Estate: 10 Issues to Watch in 2015," *CFO Journal*, March 4, 2015.

2 *Emerging Trends in Real Estate*, PricewaterhouseCoopers and the Urban Land Institute, 2015.

3 Jim Puzzanghera, "Economy Has Recovered 8.7 Million Jobs Lost in Great Recession," *LA Times*, June 6, 2014.

4 Leverage can magnify the potential for loss or gain, thus impacting volatility and returns.

5 U.S. Census Bureau, July 2013.

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14 "Medical Real Estate Sales Topped $11.3 Billion in 2014," *Healthcare Real Estate Insights,* March 26, 2015.

15 *2015 Commercial Real Estate Outlook*, Deloitte Center for Financial Services, March 2015.


16 CNL Healthcare Properties II intends to qualify and elect REIT tax status for the fiscal year 2016. If the REIT fails to meet the REIT qualification standards now or in the future, the REIT will be subject to increased taxes, which will decrease investors' returns.

## ABOUT THE AUTHOR

Kevin Maddron serves as chief operating officer, chief financial officer and treasurer for CNL Healthcare Properties II, and previously for CNL Healthcare Properties. Prior to rejoining CNL in 2011, Mr. Maddron was the chief operating officer and chief financial officer of Servant Healthcare Investments. Currently, he is a member of the executive board of the American Seniors Housing Association and has a master's degree in Accounting from the University of Central Florida.



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