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Unhealthy Prognosis for Health Care REITs | May 2014

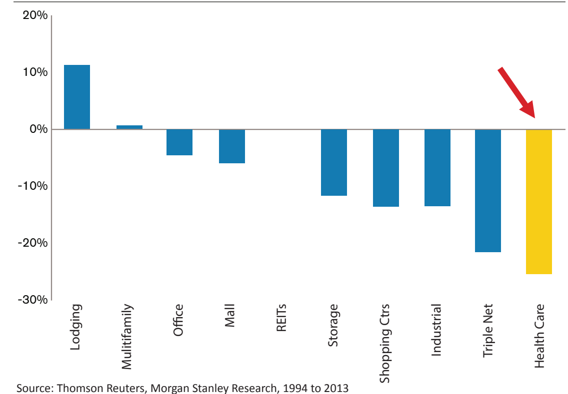
In April, REITs were able to squeeze out another positive month of performance thanks to low interest rates. Trouble abroad in Ukraine seemed to cause a flight to safety in the 10 year US Treasury Note, which has continued to attract yield-seekers to REITs. April's positive performance of +3.3% brings the year to date (YTD) total to +13.7%. Though we believe that REIT performance should be de-coupled from interest rates, it seems the market still wants to reward and punish REITs in the same manner as fixed income investments.

As interest rates continue to wag the REIT dog, health care REITs in particular are proving to be the most rate-sensitive property type. Since 1994, the sector's performance was worse than 2000 basis points (bps) behind the REIT index (see Figure 1). From May to August of 2013 during the 'taper tantrum', the adage worked as health care REITs were the biggest underperformer. Similarly, YTD in 2014, the decline in interest rates has been a driver for health care REITs to perform better than the REIT index through April 30. The simple thesis for being underweight health care REITs would be that we are positioning the portfolio for a gradually rising interest rate environment. However, we are not only underweight to health care REITs - we have nearly zero exposure to the sector. Interest rates are a part of the thesis, but do not explain it all.

Why Are Health Care REITs Sensitive to Interest Rate Changes?

Health care REITs (and triple net REITs), on average, have the longest lease durations among all property types. Approximately 80% of net operating income (NOI) from health care REITs comes from long term leases. The exception is RIDEA senior housing, a form of senior housing ownership which allows the owner to participate in the underlying operator performance, which contrasts to a "triple net" lease where the owner receives a fixed payment agreed upon in the lease. Conventional wisdom says longer term lease property types should be the most sensitive to interest rates because it takes them longer to sign all of their leases to the new, higher market rates caused by inflation (assuming inflation accompanies higher interest rates, which may not always be the case).

Figure 1: NAREIT Subsector Returns vs. Index in Times of Risings Rates



Source: Thomson Reuters, Morgan Stanley Research, 1994 to 2013

These leases usually include either Consumer Price Index (CPI)-based or 2-3% annual rent bumps, but Generally Accepted Accounting Principles (GAAP) requires that the average annual lease rate be applied to the income statement, which negates any growth in Funds from Operations (FFO) due to contractual lease bumps (Adjusted Funds from Operations, or AFFO, does adjust for this however).

External Growth

Health care REITs (and triple net REITs for that matter) still have the ability to grow via external growth. Trading at a premium to Net Asset Value (NAV) allows a REIT to acquire properties that are accretive to both NAV and FFO, meaning that their implied cap rate is lower than the initial "capitalization rate"

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(cap rate, or NOI/purchase price) of the properties acquired, or the REIT's FFO multiple is higher than the properties being acquired. Said differently, their cost of capital is lower than the initial returns available on acquisitions. A higher premium would indicate that NAV and FFO growth opportunities are more attractive. Trading at a 31% premium to NAV as of April 28, health care REITs are included in the elite group of REITs that can raise capital and make acquisitions that will increase both NAV and FFO per share. However, health care REITs on average acquired less than 1% of their portfolio size in 4Q 2013...why?

Two potential effects of rising interest rates are a higher cost of capital and a higher cap rate on properties. Given the long lease durations, the acquisition decision is dependent upon the spread; that is, the difference between cost of capital and the acquisition cap rate. In 2013, the 100 bp rise in the 10 year US Treasury yield caused a sharp increase in the cost of capital for even the highest-rated health care REITs, but the demand in the private market for REIT quality properties proved strong across all property types, including health care. As such the spreads available on acquisitions diminished quickly, causing investors to second guess the 70% premium at which they were trading before May 21, 2013. Although they were still trading at NAV premiums in the fourth quarter, most health care REITs remained on the sidelines, reluctant to lock in the diminished spreads.

So what is the proper premium for health care REITs? Given that health care REITs only own 20% of the industry and *should* have a lower cost of capital than private players over the long term, there likely should be a premium, but the current 31% premium is still above the 27% 10 year average. We saw in 2013 how quickly investor perception can change, eroding earnings growth prospects for the REIT, along with returns for shareholders.

Ultimately, the lack of internal growth combined with potentially diminishing external growth opportunities will translate to lower AFFO growth, and therefore lower dividend growth. As we have stated in our publications for the past two years, a REIT's best defense against rising rates is the ability to increase dividends. As of April 28, health care REITs have a dividend payout ratio (dividend/AFFO) of 84% on average, which compares to the index average of 75%. Therefore, the slower earnings growth and higher current payout ratios make health care REITs the second worst sector for projected dividend growth after the triple net sector.

"...a REIT's best defense against rising rates is the ability to increase dividends."

Sub-Property Types

The health care REIT sector is one of the more complex REIT sectors, if not the most complex. Lumped into one property type are several 'sub-property types': senior housing (independent living), skilled nursing facilities (SNFs), hospitals, medical office buildings (MOBs), and life science/lab space. As analysts, we must employ our rigorous process to the specific supply and demand dynamics affecting sub-sectors to determine whether a REIT presents an attractive risk-adjusted return.

Senior housing and skilled nursing facilities comprise over 70% of health care REITs' NOI. Furthermore, the top three health care REITs by market capitalization, Ventas (NYSE: VTR), Health Care REIT (NYSE: HCN), and HCP (NYSE: HCP), have an average of 74% of their portfolios invested in the two property types. Combined, these three REITs represent over 80% of the market cap of the health care REIT sector, so it's fair to say that the group's performance is heavily influenced by senior housing and skilled nursing facilities.

Senior Housing

Senior housing comprises 44% of the health care REIT sector, and 50% of the top three health care REITs. Senior housing has some similarities to the apartment sector, including claiming employment and demographics as top demand drivers. Higher employment by the adult children of retirees increases their ability to help pay for their parents' senior housing bills. And while the 18-35 year old segment is key for apartment owners, 80 and older is the key demographic for senior housing. Furthermore, higher home prices help both apartment owners and senior housing owners, though for different reasons. Higher home prices skew the buy versus rent equation for 18-35 year olds toward renting, which helps apartment owners;

for seniors, higher home prices result in higher proceeds from selling their home, which can be used toward their senior housing payments.

Looking out the next few years, the job and housing data projections call for increases, but with caution. Higher interest rates could choke housing price increases, while job growth appears to be range-bound. Additionally, the demographics may not be as favorable as most think. The annual growth in the 80 year old and up demographic is projected to be less than 1.5% from 2014 to 2017, only slightly higher than the overall population growth. Though these signs point to positive demand growth, it will likely be modest.

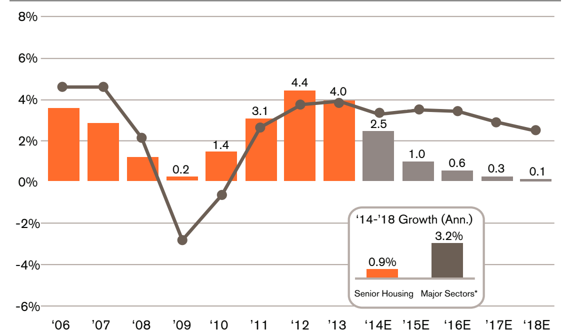
One huge similarity to apartments has been the construction boom in the senior housing sector. The capital chasing returns to take advantage of the 'aging population' may have swung the pendulum too far. According to the National Investment Center MAP (NIC MAP), senior housing construction as a percent of inventory was 4.1% as of 1Q14, and will average over 3% for the next three years. Houston, San Antonio, Denver, and Minneapolis currently have over 5% of their current inventory under construction, with Houston leading the way at over 10%! Barriers to entry are extremely low in the sector, where the 'location, location, location' motto is not applicable due to the residents' profile and on-site services. New residents travel an average of over 100 miles from their previous homes to live in a senior housing facility, tending to pick facilities with the best on-site amenities (read: newest). As such, obsolescence is high, and new construction is a large threat to current landlords.

The combination of the supply and demand analysis leads Green Street Advisors to project same store NOI growth to average only 0.9% annually from 2014 to 2018 (see Figure 2), by far the lowest of all REIT property types (recall we project 3% annually for the entire REIT sector).

Skilled Nursing Facilities

Skilled nursing facilities (SNFs) generate 27% of NOI for the health care REIT sector, and about 20% for the top three health care REITs. At a $300/day average, SNFs provide a relatively cheap alternative to staying at an Inpatient Rehab Facility (IRF) for $1,000/day or a Long-

Figure 2: Historical and Projected Senior Housing Same-Property NOI Growth



**Major sectors is an equally-weighted average of apartment, industrial, mall, office, and strip center.*
Source: Green Street Advisors

Term Acute Care Hospital (LTACH) for $1,300/day on average. Examples of operators include Kindred (NYSE: KND), Skilled Healthcare Group (NYSE: SKH), Emeritus (NYSE: ESC), and Genesis. As with all real estate property types, a tenant's profitability directly relates to their ability to pay rent. In the SNF world, approximately 2/3rds of operators' revenue comes from government sources. About 21% is from Medicare, while 45% comes from Medicaid. As such, an SNF owner's ability to increase rents is heavily dependent upon federal and state budgets.

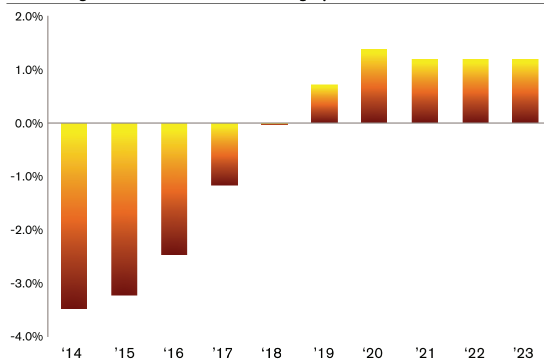
As we have seen throughout history, predicting government actions is a risky business. The Balanced Budget Amendment of 1997 made significant cuts to reimbursement rates to SNF operators causing a massive backlash of operator bankruptcies from 1999-2001. SNF owner Omega (NYSE: OHI) saw its share price fall over 90% during that period while many other REITs had positive total returns. Another 11% cut was announced in 2011, sending OHI shares plunging 35% in one week. Most recently, the Affordable Care Act (ACA, or "Obamacare") reduced the Medicare reimbursement rate by 1% in 2012 and another 0.7% in 2013. Though the cuts have not been enough to push operators into bankruptcy yet, the lower profitability of operators will make it difficult for owners to increase rents as leases come up for renewal.

We don't claim to know what the future holds for government reimbursements to skilled nursing operators, but it does seem that they will continuously be targets of politicians either to lower profits of operators or to use funds for other purposes. For example, a bipartisan bill for a 'doc fix' to better compensate doctors

that serve Medicare patients will be proposed in DC this summer, which could pull resources from SNFs (estimates call for a 2-4% cut).

Even without further reimbursement cuts, Green Street Advisors projects EBITDAR (Earnings Before Interest, Depreciation, Amortization, and Rent) growth for SNF operators will be negative for the next four years (see Figure 3). Consequently, Green Street Advisors estimates 2014-2018 annualized same store NOI growth of the two REITs with the most SNF exposure, AVIV REIT (NYSE: AVIV) and OHI, will be 2.1% and 2.3%, respectively – the lowest in the health care REIT sector.

Figure 3: Estimated Skilled Nursing Operator EBITDAR Growth



Source: Green Street Advisors

Valuation

Despite all of the risks associated with over 70% of the health care REITs' NOI, the sector trades at the highest NAV premium of all REIT property types. Dividend yields are the second highest, but they also have one of the highest payout ratios. The sector's historical reputation for slow and steady growth may be in jeopardy for the next several years, which we do not feel is adequately reflected in current stock prices. Combined with our view that we are in a gradually rising interest rate environment, we believe there are much better risk-adjusted return opportunities for the rest of this commercial real estate cycle.

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