Healthcare REITs and their Operator Partnerships

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Matt gained real estate work experience at Rising Realty Partners as a summer associate in 2014. While there he focused on asset management and was effective in updating Rising's portfolio of Class A office leases. Matt also has experience in finance; working for fund manager, Roger Engemann and investment bank, Credit Suisse from 1996-2001. Matt's accomplishments at these firms included teaming with Merrill Lynch to save several million dollars worth of accounts. Following his MBA, Matt entered the U.S. Navy due to 9/11. He served as a naval officer on active duty in the Cryptology field through 2013. He has led three divisions of 15-30 troops and in his final fitness report earned the highest rating from senior leadership, while achieving the rank of Lieutenant. His tour postings included various overseas areas while attached to a warship. Upon graduation from Cornell, Matt will focus on asset management and finance of health care real estate. In his spare time Matt enjoys golf, skiing and tennis.

Introduction and Thesis

Over the past 10 to 15 years the senior living industry has grown to become a $315 billion nationwide business. This has spurred the development of healthcare focused real estate investment trusts (REITs) and large-scale senior living operators (REOCs), thus, beginning to consolidate a fragmented industry. In contrast with other real estate sectors, the REITs and REOCs are aligned or partnered with each other due to the vital focus on operational capability. They are also partnered because growth in senior living requires acquisitions of existing senior living businesses. While the large-scale operators bring their managerial expertise, the REITs bring their access to capital with which to acquire smaller operators. Despite the strong levels of growth, in the last few years, healthcare real estate is seen as a sub-sector within the core real estate sectors. With healthcare trading at the highest price to net asset value (NAV) of any real estate sector (or sub-sector), many investors and real estate professionals are still catching on to the idea of senior living as a highly profitable real estate investment area. It is likely the heavy operational focus (and subsequent risk) deters more real estate firms from entering the space.

Going forward, senior living will find itself in transition as it is challenged by factors changing the face of healthcare nationally, including the following:

- Senior living facilities forced to shoulder more acute levels of medical service, as services which have traditionally been performed in hospitals are forced downward to the ambulatory level and currently sub-acute levels.
- An aging demographic, which as a block will be increasingly unable to complete various activities of daily living (ADLs); thereby increasing demand for senior living services
- Advances in technology, which could enable senior living facilities to lower costs overall in what is still a labor intensive industry

Senior living will also be characterized by further levels of consolidation, as scale continues to be a key determinant of lower cost. Instrumental to a smooth execution of consolidation will be healthy REIT-REOC partnerships, in which stakeholder interests are closely aligned. Where partnerships fail to meet this standard of close alignment, operators may seek to move into the REIT space by spinning off their operating assets from the real estate. Finally, growth opportunities will continue to arise for non-REIT, non-private equity firms, who seek to venture with operators hoping to retain their management roles, but who need access to equity capital to grow and compete at a larger scale. These joint teams of operators and non-REIT equity capital providers represent competition for REITs in the quest to gain further market share in the $300 billion plus (and growing) market.

This article will provide the reader with an overview of the senior living industry today, starting with basic terminology and definitions, the history of the industry, existing market conditions, then commentary about the way ahead. It will also investigate the profitability of the top three healthcare REITs – Health Care REIT (HCN), Ventas (VTR) and HCP Inc. (HCP). The focus will be primarily on revenues from senior living – which constitute the majority of revenues within the healthcare REITs. As part of the focus on relationships between REITs and partners, we will also look at Brookdale, the nation's largest operator and view some of its challenges as well as advantages.

Terminology and Definitions

The senior living industry is a complex one, necessitating an understanding of key terminology and definitions. What follows is a description of the different types of senior living and the levels of care each one provides. The term *senior living* refers to age-restricted communities that care for elderly persons. It also refers to both modern multi-level facilities (also known as Continuum Care Retirement Communities or CCRCs) and facilities which operate on a stand-alone basis. Senior living includes broadly – *independent living, assisted living, memory care, and skilled nursing (which is also associated with post-acute rehabilitation)*. The "continuum" of multiple levels, which constitute the CCRC concept, is connected to a concept known as aging in place. Aging in place enables the resident/patient to access additional facilities at the same location and provides a "continuum" of services. The advantage for new residents, who average in age from 80 to 85, is the ability to remain in one venue. If their physical condition declines, they can be moved to a separate facility within that same location and subsequently, receive a higher level of care. For instance, at the independent living level, the services are centered on hospitality, and less on acute healthcare treatment. As the resident moves down the multi-level stack, the services become increasingly medically intensive (as well as expensive).

Exhibit 1 shows a graphic taken from the National Investment Center for Seniors Housing & Care 2014 Investment Guide. This represents the varying degree of service and cost associate within each subsector of senior living.

Exhibit 1

Currently in the US, there are approximately 22,700 investment grade senior living and care properties containing 2.9 million units.[1] Investment grade properties are considered those that are age restricted and have at least 25 units/beds and charge market rates for the housing and services offered. A recent trend in senior living is the rise in needs of residents in all four of the care segments; with a slightly stronger growth rate predicted for skilled nursing care.[2]

Background and History

Appreciation of the background and history of senior living is key to understanding the industry today. This section will address the roots and past including negative

1 National Investment Center for Seniors Housing & Care (NIC) 2014 Investment Guide 3rd Edition

2 The Case for Investing in Senior's Housing and Long-term Care Properties with Updated Projections (National Investment Center for the Senior's Housing and Care Industries) 2001, Chicago, IL

connotations and subsequent regulation, reform by entrepreneurs and the rise of the large-scale operational firm, which also includes modern brand development. Senior living in its modern, multi-level form was produced out of the nursing home model, rooted in federal legislation. The nursing home model emerged out of the 1930s Social Security Act, 1960s Medicare/Medicaid legislation, and assisted living facilities, which in turn originated from boarding care facilities (services which were traditionally provided in small homes, caring for one or several seniors).[3] The more traditional nursing home model was to lead to what is known today as skilled nursing (or sub-acute) care for patients, whose medical condition was not severe enough to qualify for acute, or hospital treatment. While it was necessary for nursing home residents' medical conditions to be monitored by skilled nurses, in-house physicians were not required. John Pratt wrote in *Long-Term Care, Managing Across the Continuum, 3rd Edition, 2009*,

> "Sub-acute care follows a serious illness in a hospital, when you still need antibiotics or physical therapy while recovering… Sub-acute care units are usually classified as skilled nursing facilities by Medicare for reasons of reimbursement…"[4]

It should also be added that skilled nursing consisted of two types of services and patients:

Long-term sub-acute care patients which include wealthier individuals, whose admittance is based on private pay capabilities, and individuals who are funded by Medicaid; and

Short-term rehabilitation patients – usually transferred over from hospitals.

In most skilled nursing facilities the majority of beds are devoted to the former, and a smaller percentage devoted to the latter. The short-term rehabilitation beds are by far the most profitable, usually averaging over $700 per day per bed, while long-term beds average around $300. Generally, several funding sources contribute to the rehabilitative portion of skilled nursing: Medicare, which provides about 75% of full payment, and private pay covering the balance over periods which can last up to 100 days.

In contrast to skilled nursing, assisted living was, and is "a long-term care alternative for seniors who need more assistance than [is] available in a retirement community, but who do not require the heavy medical and nursing care provided in a nursing facility" (NCAL, 2001).[5] The correct set of measures to determine whether an individual was in need of assisted living was deciding how many activities of daily living (ADLs) a potential resident was able to perform. ADLs included the ability to bathe, cook, eat, toilet, and transport. If an individual is unable to perform a majority of these skills they likely will need assisted living services. Of course, those admitted to long-term skilled nursing facilities had an even higher number of ADLs which they are unable to complete.

Eventually, the assisted-living industry underwent significant changes: enhanced type and number of services, branding, image, and scale. Assisted living also helped to produce a similar, but less expensive product – independent living. Beginning in the late 1990s, healthcare REITs capitalized on the robust revenue growth in these two products. Independent and assisted living in effect, became the backbone of modern senior living.

One characteristic of the multi-level model has been the different sources of revenue. "When nursing facility care is the most appropriate solution, the higher cost is justified and accepted. However, when the lower cost assisted living will suffice, it provides

3 Pratt, John. Long-Term Care : Managing Across the Continuum (3rd Edition). Sudbury, MA, USA: Jones & Bartlett Learning, 2009. ProQuest ebrary. Web. 24 December 2014. Page 129.

4 Pratt, John. Long-Term Care : Managing Across the Continuum (3rd Edition). Sudbury, MA, USA: Jones & Bartlett Learning, 2009. ProQuest ebrary. Web. 24 December 2014. Page 99.

5 Pratt, John. Long-Term Care : Managing Across the Continuum (3rd Edition). Sudbury, MA, USA: Jones & Bartlett Learning, 2009. ProQuest ebrary. Web. 24 December 2014. Page 128.

considerable savings."[6] Thus, the full senior living model came into fruition due to the ability of purchasers to discriminate between levels of services for the purpose of saving. Of course, today at the assisted living level, the primary payer is the individual, and not the government.[7]

During the late 1990s, and to a lesser extent today, both the nursing home and assisted living products were heavily fragmented and dominated by small operators. Perhaps because of this, the nursing home arm of the business was plagued during this time by a strongly negative reputation. John Pratt, author of Long-Term Care-Managing Across the Continuum-3rd Edition, wrote in 2010:

> "While there has been organizational and personal abuse in the long-term care system, it is not nearly as rampant or as serious as such articles suggest. Also, nursing homes are fighting a societal perception. They have been seen by an entire generation as places where someone goes to die or places where family members can "get rid of" a burdensome relative. These negative images often translate into tougher regulations and/or opposition to funding of long-term care".[8]

In the years since 2000, senior living has achieved a better reputation. Part of the reason for this was the enactment of the 1987 Nursing Home Reform Act and the intense levels of regulation which it implemented in the skilled nursing/post-acute rehabilitation sector. In contrast, regulation applied directly to assisted living, has been less intrusive and has occurred at the state level only.[9] However, passage of the 1987 Reform Act appears to have ushered in a greater spirit of reform within the overall industry. For assisted living, this spirit of reform has led to a robust level of self-policing. Additionally, the sector's absence of regulatory oversight has enabled the sector to operate more profitably. "The relative lack of government funding has meant a paucity of regulations, making it easier to invest in assisted living than in other types of long-term care."[10]

During the early 2000s large-scale operators and their REIT partners found a majority of revenues stemmed from private payments or private insurance. Thus, the most successful entrepreneurs formulated strategies based on the private pay model, which stressed assisted and independent living. Typically, skilled nursing has lower profit margins due to government regulations, which require a more labor-intensive business model. Cognizant of the inherent value of the industry they had chosen, entrepreneurs continued to self-police; maintaining standards of care overall and dissuading talk of increasing regulation levels.

Those responsible for the transformation of the assisted living model included these same entrepreneurs, mainly at the operational level. They executed reforms that proved to be the right level of change for the marketplace, and their work is largely responsible for the evolution of the industry over the last decade and a half.

The evolution of senior living has been buoyed further by macroeconomic projections about future aging populations and greater longevity; analysis which first came to fruition in the late 1990s. Assisted living, along with the follow on sectors of independent living and memory care, profited from favorable top-down market variables. As an aside, memory care is more closely connected with assisted living than with skilled nursing.[11] That is, like assisted and independent living, it is much less burdened by the heavy regulations which

6 Long-term Care Today, Long-Term Care-Managing Across the Continuum-3rd Edition, by Pratt, John R., Jones and Bartlett, 2010, Page 20

7 Long-term Care Today, Long-Term Care-Managing Across the Continuum-3rd Edition, by Pratt, John R., Jones and Bartlett, 2010, Page 20

8 The US Senior Housing Opportunity: Investment Strategies

9 Bob Kramer (President of NIC) Phone Interview, February 3, 2015

10 Long-term Care Today, Long-Term Care-Managing Across the Continuum-3rd Edition, by Pratt, John R., Jones and Bartlett, 2010, Page 129

11 Bob Kramer (President of NIC) Phone Interview, February 3, 2015

affect skilled nursing. Memory care provides benefits which address the growing problem of Alzheimer's and dementia.

Beginning in the 2000s, senior living saw construction and development decline from the faster pace that occurred in the 1990s. More often what occurred were large-scale consolidations of an overall fragmented industry; bulk purchases of existing facilities operated by small operators. Large-scale operators, both public and private, such as Brookdale Senior Living, Brandywine Senior Living and Benchmark Senior Living employed economies of scale, which facilitated the consolidation process – a process that continues today.

Even before for-profit entrepreneurs were creating the modern form of senior living at the turn of the Millennium, Wall Street analysts observed the favorable demographics and decided to enter the industry, forecasting the profitability. Healthcare related REITs (such as HCN, VTS and HCP) either came into existence at this time or transitioned a large part of their investments into senior living. Over time healthcare REITs, through their access to institutional capital markets, were instrumental in the consolidation and acquisition of existing facilities, along with construction of new facilities.

However, due to rules in effect prior to 2007, REIT operational involvement was limited to contracting triple net (NNN) leases with the operating firms. This changed with the REIT Investment Diversification and Empowerment Act of 2007 (RIDEA), which enabled healthcare-related REITs to participate in revenues stemming from the operating companies. To maximize efficiencies, operators and REITs formed partnerships; the best of which were based on cultural fit and the alignment of interests (incentivized systems include investment waterfalls, along with a sharpened regional focus).[12] Ultimately, this enabled the partnerships to fine-tune growth strategies, while providing operators with easier access institutional capital. However, one drawback of the 2007 Act's effect was that capitalization rates associated with individual investments increased, due to greater levels of operational risk.

Despite the attraction of private pay occurring at such a high percentage, Wall Street began to encourage further diversification of the REITs even before the 2007 change. Today, the top three healthcare REITs are diversified beyond the private pay independent/assisted living model, and now include skilled nursing/sub-acute rehabilitation in their portfolios despite the lower margins.

As industry consolidation continued to escalate during the 2000s, large-scale operators such as Brookdale Senior Living focused on creating brands that encapsulated their operational theme: "purposeful living."[13] Similarly, another large-scale operator, Benchmark Senior Living, focused their brand image on "taking care of vulnerable, frail people" and keeping residents "engaged all day".[14] Brand positioning and development not only helped individual operators break out and gain market share, but also served to sustain the rise in industry reputation.

In executing their strategies, large-scale operators added additional services, including 24 hour on call nurses for assisted living; full-time resident engagement; and the utilization of technology to strengthen patient relationships with family members. They also revitalized customer service, focusing not only on the resident, but also on the oldest offspring, usually a daughter, who made the arrangements for placement in a senior living arrangement. This model increasingly fit with the rising demands of Baby Boomers, the demographic that most often represented the offspring of residents. The Baby Boomers have different expectations - not wishing to relegate their parents to an unseen status; rather wanting to

12 Sarah Laffey, SVP, Benchmark Senior Living, Personal Notes of Lecture before Senior Living Course, Cornell University, November 20, 2014, slide 43

13 John Rijos, Lecture to Senior Living Course, Cornell University, November 7, 2014

14 Sarah Laffey, SVP, Benchmark Senior Living, Personal Notes of Lecture before Senior Living Course, Cornell University, November 20, 2014, slides 45 and 48

maintain connections with them.[15] From an acquisition or development standpoint this frequently meant considering whether a prospective locale for a facility was close to a major city, rendering simpler visitation for family members. For instance, senior living facilities (shown below in Exhibit 2) in or surrounding metropolitan New York City, include the luxurious Atria developments at Roslyn, Ossining (Atria on the Hudson) and West 86 in Manhattan.[16]

Exhibit 2

Left to Right
(TOP) Atria West 86, New York, NY (IL/AL) – Atria on the Hudson, Ossining, NY (IL/AL/MC)

(BOTTOM) Atria on Roslyn Harbor, Roslyn, NY (IL/AL) – Atria on Roslyn Harbor, Roslyn, NY (IL/AL)

The aging in place concept also became vitalized – based on the multi-level (CCRC) structure. The strongest operators attracted the attention of the most successful REITs. Effective partnerships were (and are) based on aligning mutual interests and near seamless operational execution. The quality of partnerships has only increased in importance as investments have moved down the multi-level structure ladder and operations are accentuated.

In addition, both operators and healthcare REITs are keenly aware that increasing sources of revenue in the industry arise from favorable baseline demographics: aging individuals who have accumulated a formidable net worth – often in the form of housing equity or retirement portfolios. The pivotal event is often the retirement of individuals who can afford to pay large sums of money (anywhere from $3,000 to $12,000 per month).

For example, Brandywine Senior Living, an operator which partners with HCN and other top REITs, focuses on buying and developing facilities along the densely populated Atlantic Seaboard, believing strongly in the advantage of regional focus.

Other positive variables are also present which favor the success of the industry. Like Benchmark Senior Living, Brandywine Senior Living is privately held, which provides for the execution of strategy without second guessing from public shareholders. Brandywine Senior Living thrives in environments that contain naturally high barriers to entry: obstinate planning commissions, complicated entitlements/regulations processes (including certificates of need) and land scarcity, the existence of which, ultimately, helps to minimize

15 Pratik Shah, Capital Markets Associate, Health Care REIT, Personal Notes of Lecture Before Senior Living Course, Cornell University, November 20, 2014, Slide 75

16 Bob Kramer Presentation Slides – 7 November 2014

competition. Still, other operators are exploring the use of affordable housing subsidies in some of these communities by developing units in the facility to attract residents in that demographic.[17]

Brandywine also understands their target demographic and develops or redevelops properties with luxury and service in mind. For them, additional amenities consist of developments along the lines of a five star hotel – butler service, underground parking and buildings with inner courtyards. They cater to affluent retirees and their children.[18]

The Senior Living Industry Today

Today's challenges in senior living have been outlined below by Bob Kramer, President of National Investment Center for Senior Housing and Care:

Faster than average revenue growth since 2006
A strong, continued consolidation trend based on still high fragmentation levels of existing product
Robust operational focus, in which REITs and operators are seamlessly partnered
For public REITs, increasing levels of diversification, which renders investors less beholden to the private pay model, thereby putting pressure on profit margins
Vigorous demand levels for enhanced products and multi-level services based on foreseeable demographics[19]

Today's senior living sector can be segmented into four main categories:

- Independent Living – A relatively new product which is a substitute for multi-family residential and trades at higher cap rates to multi-family, but lower than assisted living (it is entirely private-pay funded).
- Assisted Living – Primarily private-pay and private insurance funded, with additional funding provided by Medicaid (Medicare provides no funding).
- Memory Care – The most expensive prototype, focusing on the increasingly visible Alzheimer patient target market. From a regulatory standpoint, this is more closely linked with assisted living than skilled nursing – although it requires additional training for staff beyond the training which assisted living staff usually receive.[20]
- Skilled Nursing/Post-Acute Rehabilitative – Growth has occurred within private pay for this portion of the industry since 2009.[21] Growth in skilled nursing reflects greater medical care capabilities (and an increased deficiency of ADL capabilities), along with short-term status of government subsidization for the post-acute rehabilitative services. Medicare payments for skilled nursing are on a short-term basis, where the patient pays a partial deductible from Day 21 to Day 100.[22] Of course, skilled nursing presents formidable risks for all but the best operators.[23] As a result, capitalization rates are higher than for the initial care levels.

17 James Robert Sellinger, Principal, Senior Living Development, Interview, March 19, 2015

18 Ken Segarnick, SVP, Brandywine Senior Living, Lecture – Senior Living Course, Cornell University, November 20, 2014, Slides 55-60

19 Bob Kramer Presentation Slides – 7 November 2014

20 Robert G. Kramer, Phone Interview, February 3, 2015

21 Robert G. Kramer, CEO, National Investment Center for Senior's Housing and Care, Lecture to Senior Living Course, Cornell University, November 7, 2014 (Slide 40)

22 Professor Robert Brooke Hollis, Executive Director, Program in Health Administration, Cornell University, Lecture before Senior Living Course, November 7, 2014

23 Sara Terry, SVP, Brookdale, Lecture before Senior Living Course, Cornell University, 7 November 2014

As mentioned previously, there has been a lower level of development of senior living since the year 2000, and some of today's product has become obsolete. However, some geographic areas have built more product than others, which requires REITs and (especially) operators to carefully screen possible building locations for oversupply.[24] For instance, Brandywine Senior Living conducts an extensive level of market research prior to pulling the trigger on any new developments. The sum result of this level of analysis should equate to an increased level of building for new, state-of-the-art facilities nationwide in the near future, however, the aftershocks of the Great Recession still remain a deterrent for many projects.

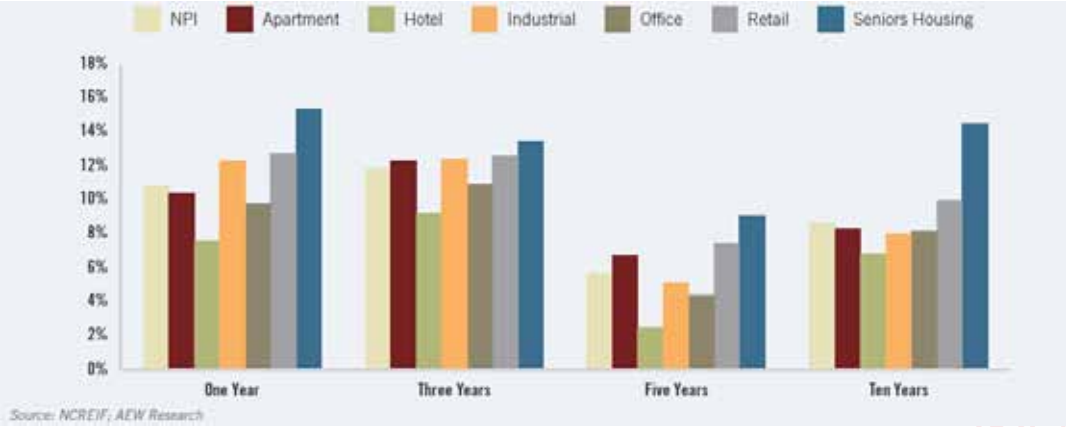
Finances and Profitability

Understanding today's overall profitability of the sector is essential to gain an appreciation of healthcare REITs and their partnerships. For investigation purposes and to better understand the industry overall, we examine the three largest healthcare REITs: Health Care REIT (HCN), Ventas (VTR) and HCP, Inc. (HCP) as well as the largest operator, Brookdale Senior Living (BKD). Key metrics include beta, long-term returns, market capitalization, funds from operations, price earnings to growth (PEG) ratios, debt levels and net asset values (NAV).

REIT Profitability

As demonstrated in Exhibit 3 from the National Investment Center for Seniors Housing & Care 2014 Investment Guide, senior living has outperformed the other real estate sectors in each holding period analyzed. Part of the reason for this was lower volatility (usually reflected by beta). Senior living is the only property type that did not experience declining asking rents during the economic recession, reaching a cyclical low (a positive return) of 1.1% in the fourth quarter of 2010.[25]

Exhibit 3



Weighing long-term returns, HCN has put together a ten year annualized return of 26%, VTR realized nearly 34% and HCP registered nearly 19%. In 2014 the returns were 49% for HCN, 31% for VTR and 28% for HCP. These high returns appear to be the result of pent up demand because the previous three years were relatively flat, therefore, much of the growth in the last ten years occurred from 2005 to 2010, and then again during 2014. This likely reflects the market rewarding the consistent occupancy levels which senior living was able to produce during the Great Recession (while other real estate occupancy types were more

24 Bob Kramer Presentation Slides – 7 November 2014, Slide 51

25 NIC 2014 Investment Guide 3rd Edition

volatile). While the senior living industry wasn't immune to the financial troubles of this period, it seemed to weather them better than most.

Market capitalization not only reflects the overall market value of the stock but the interest that Wall Street forecasts in the operating formula. Currently, healthcare REIT interest by institutions is at an all-time high as reflected by the top three firms. For instance, HCN features a market cap of $23.3 billion for 12/31/2014, while Ventas (VTR) had a market cap of $21.4 billion for the same year. HCP showed a market cap of $20.2 billion.

Beyond market capitalization, REIT performance measurement includes funds from operations (FFO). FFO is particularly useful when computing a ratio related to fund price - that is, fund price divided by FFO. Another key measure is growth rate. Exhibit 4 combines FFO with growth rate to form the price-to-earnings- to-growth rate formula, also knowns as the PEG ratio. Despite HCN's large size, it continues to demonstrate explosive growth in 2014, which could partly justify the large run in the stock - as well as the high market multiple of just under 20.

Exhibit 4

REIT	2014 Growth Rate (FFO)	PEG	Multiple (P/FFO)
HCN	15.06	1.32	19.81
VTR	4.89	3.41	16.67
HCP	1.69	8.66	14.68

An often overlooked downside to healthcare REITs is the presence of interest rate volatility and the subsequent effect on REITs. Due to REIT rules, which require a dividend payout of 90% or more on retained earnings, finding working capital for new projects/ investments can be difficult. REITs must access capital markets debt, which results in their sustaining higher levels of debt, and thus, lower credit ratings. When rates eventually rise, REIT valuation (which moves inversely) drops. Of course, today's rates remain historically low. HCN's debt ratings are BBB.[26] While its debt/equity ratio is .96 and .85 for last two years reporting, VTR has a credit rating of BBB+,[27] and has a higher debt/equity ratio of 1.18 and 1.05 respectively. The higher debt levels for VTR raise the question as to why their credit rating is also slightly higher. HCP has a credit rating of BBB+ from Fitch (as of February 2014), and reveals debt/equity ratios of .87 and .89 respectively.[28] For this reason, HCN has been taking advantage of its strong market multiple to execute equity offerings. Recently, they conducted a secondary offering (led by Goldman Sachs) to help maintain its strong capital expenditure activities. This has been part of their overall strategy in order to reduce debt levels and employ equity for further acquisitions rather than secured debt.

One final helpful measure to determine profitability is NAV. As of 12/31/2014 HCN's NAV was around $60 per share. This indicates that the stock is trading at a significant premium to NAV. Indeed, nearly the entire sector of healthcare REITs is showcasing a premium. For instance, VTR is trading at around $65 per share (NAV) as of 12/31/2014 while HCP is trading at $41.05 (average cap rate around 6%). Thus, HCN's market price to NAV is about 1.22 (76/60), VTR's is about 1.09 (71/65) with HCP at around 1.05 (43/41).

Operators:

While long-term stock performance of individual REITs is the true measure of a company's profitability, their performance is really only as good as that of the operators (both private and public) with whom they choose to partner (of course this overlooks

26 Fitch, November 2014, http://uk.reuters.com/article/2014/11/17/ny-fitch-ratings-hcn-idUKnBw176538a+100+BSW20141117

27 Fitch, July 2014, http://www.streetinsider.com/Credit+Ratings/Fitch+Affirms+Ventas%2C+Inc.+%28VTR%29+Ratings+Following+%242.6B+ARC+Healthcare+Deal/9550008.html

28 http://www.reuters.com/article/2014/02/13/ny-fitch-ratings-hcp-idUSnBw136407a+100+BSW20140213

dispositions of property in which REITs engage). First, there are the privately-held operators. The profitability of privately-held operators who partner with the REITs are tied to their skill at making investments in locations with naturally high barriers to entry, because they indicate the presence of near monopolies, if even just for a moment in time.[29] Again, Brandywine Senior Living and Benchmark Senior Living (which has grown at 9% over the last five years), are good examples of excellent privately-held REIT partners.[30] Both operators co-exist in the northeast – a difficult area to penetrate with new product development. Results of this focus can be seen in higher rent prices, occupancy levels, and what Brandywine Senior Living terms - (higher) price variance upon turnover (which helps to explain higher rent increases).[31] Ultimately, these advantages equate to higher operating margins. Of course, their residents demand a better product; which in turn raises expenses for the operator.

The financials of the large-scale operator Brookdale Senior Living reveal a company that, as of year-end 2013 showed revenue of $2.9 billion (an increase of 4% over the previous year – which was in turn a 13% increase over 2011). For its bottom line, Brookdale Senior Living produced net losses for the three-year period of minus (-) $3.6 million, minus (-) $67 million and minus (-) $69 million respectively, the result of impairment charges, according to their annual report. However, there appears to be additional reasons for the losses, such as the aggressive consolidation schedule that they have undertaken – most recently their expensive 2011 acquisition of Emeritus, a key competitor.

It's also important to remember that while senior living weathered the Great Recession better than other sectors, (operators in particular), the industry did not go unscathed. According to Beth Burnham Mace, Chief Economist at NIC, "the performance of many operators was affected by the Great Recession, which started in late 2007; it took until 2014 for jobs to fully recover. This slow recovery affected demand, occupancy and development practices and ultimately operators' financial results which in some instances did well and in others, less so."[32]

While operator occupancy levels are high (upwards of 90%), it should be noted the stock performance volatility as measured by its beta is 1.67; significantly higher than that of the REITs. Thus, it appears Brookdale Senior Living's challenge now, after having been a pacesetter in the industry, is to comfortably integrate all of their acquisitions and accommodate cultural fit.

Future Expectations

Investigating the future of healthcare REITs and their operators requires first looking at an overall projection of the senior living industry from a demographic standpoint, then focusing on anticipated changes expected to occur in the future for this dynamic industry.

Over the next five years (2015-2020), the average annual growth rate of the 75-84 age group is projected to be 3.5%, while the 85+ age group is projected to have an average annual growth rate of 1.2%.[33] The most significant period of growth for the 75+ age group is expected to occur from 2021 to 2039, when the baby boomers enter this age group (the last baby boomer will turn 75 in 2040, 85 in 2050 and 95 in 2060). The largest concentration of senior population growth in this decade is expected to take place in the nation's western and southern states. Florida, Texas, Virginia, Maryland, North Carolina, South Carolina, and Tennessee are projected to account for 40% of the increase in population for those over

29 Professor Crocker Liu, Cornell University, September 1, 2014, Lecture for Principles of Real Estate

30

31 30 Ken Segarnick, SVP, Brandywine Senior Living, Lecture – Senior Living Course, Cornell University, November 20, 2014, Slides 55-60
31 Beth Burnham Mace, Chief Economist, NIC, quote, email, February 17, 2015

32 Beth Burnham Mace, Chief Economist, NIC, quote, email, February 17, 2015

33 NIC 2014 Investment Guide 3rd Edition

65 over the next decade, with California, Arizona, Washington, Nevada, and Colorado expected to account for another 26%.[34]

Increased life expectancy will continue to play a role in the senior living real estate sector as seniors are now living longer due to healthier lifestyles, breakthroughs in biotechnology, treatment capability, and better access to healthcare. In addition to aging demographics, these factors are leading to increased demand for senior living and the requirement for additional supply of facilities. As the population continues to age in the United States, the number of individuals with ADL deficiencies will also increase – providing increasingly higher demand for assisted living services, as well as skilled nursing.

Due to the paucity of development during the years 2008 - 2014, the senior living sector is poised to have a prolonged period of development, as supply catches up to expanding demand for senior housing. Development opportunities will not only be located in suburbia, but also increasingly in urban locations. This is partly due to the increasing wishes of offspring of the aged (largely Baby Boomers) to be in closer proximity to the senior facilities where they can both visit more often and also monitor the care their parents are receiving.

Despite a steady flow of mergers and acquisitions in recent years, the senior living industry remains highly-fragmented. The top 25 independent living operators in the US represent an estimated 24.5 percent of all units, and the top 25 assisted living operators in the US represent 37.7 percent. The top 25 skilled nursing operators in the US represent 22 percent of all units.[35] Senior living as a whole is 30 percent owned by non-REITs and REITs, while the remaining 70 percent of senior living properties are owned by "mom and pops" (defined as owners of 15 or fewer properties).[36] It should be noted that the non-REIT group also includes a large number of not-for-profit firms.

The fragmentation that currently exists in the senior living industry also presents significant opportunity for consolidation and re-capitalization among the existing smaller senior living operators; especially if they enter into joint ventures with capital providers who are willing to let them make the operational decisions. Many of these smaller operators also find it accretive to recapitalize their portfolios by selling off their assets, retaining the proceeds, and further growing their operating businesses. The value-add that senior living operators bring to the table is increasingly evident, as stated by Isaac Losh, VP of Acquisitions at Senior Star:

"It's very difficult to start a management company from scratch on the operating side. Having context to understand what a good operator is from a poor one is critical to success. Operations drive the value of senior living assets. In general real estate, the mantra is 'location, location, location.' In senior living the value mantra is 'operations, operations, operations,' or maybe 'operations, operations, location.' Senior living real estate is an operations-centric business with a real estate component."

Most indications are that the strong growth in the overall senior living industry will continue in both the near and long-terms overall. This strong growth in rent revenues and demand is largely based on the passing of the baton from the Greatest Generation (born prior to 1925) to the Silent Generation. The Greatest Generation as a whole was largely very independent and may have resisted the senior living format; especially at the upper layers of assisted and independent living. By contrast the Silent Generation (born between 1925 and 1945) will be reaching 85 (the prime age) through 2030.

Of course, it is the hope of both REITs and operators that the Silent Generation will be more open to senior living than their Greatest Generation cohorts. Currently, it is estimated that only 15% of people over the age of 80 who are qualified for senior living choose to contract for it, while 85% do not.[37] If, in the years ahead, higher percentages sign on, the

34 The US Senior Housing Opportunity: Investment Strategies

35 BGL Healthcare & Life Science's Insider, April 2014

36 BGL Healthcare & Life Science's Insider, April 2014

37 John Rijos, Lecture to Senior Living Course, Cornell University, November 7, 2014

senior living industry will be able to take even greater advantage of the Silent Generation's robust savings rate – which should also be higher than the generation to follow: the Baby Boomers.

The Baby Boomers potentially represent a much larger market, and one that will require an even higher level of service offered by the facilities. But the inherent doubt about the Baby Boomers is their savings rate – will they have saved enough to afford the private pay scale that constitutes senior living? This question is underscored by the potential difficulty in selling their homes to provide a portion of the funds – will there be enough demand for single-family homes when this time arrives? The first of the Baby Boomers will reach their mid-80s in the early 2030s and the last some twenty years later.

One outcome of this dilemma is that the Baby Boomers will need to remain in the work force longer, in order to meet the requirements of retirement. This may mean that the average age to enter senior living facilities will also be pushed higher – to age 90 and above. This may result in a marginally slower growth rate for senior living. However, due to the longer life span the growth may be pushed out over a longer period of time. This is reinforced by the above 80, above 90 and above 100-year old demographic cohorts, which are growing at a very high pace.[38]

Other risks to future operations and investments include the threat of greater government involvement and regulations, along with the changing landscape of healthcare overall. If Congress sees that the industry is not self-regulating effectively and numerous complaints occur, they will step in and draft regulations. According to Ken Segarnick, SVP of Brandywine Senior Living, this is the greatest threat facing the senior living industry.[39]

Future competition for the senior living industry (as a market substitute) may arise from multi-generational housing, which, along with multi-family housing, presents direct competition for the independent living layer. Additionally, improving technologies (such as Tele-Health and biometric monitoring) may enable home-based assisted living to continue to compete with traditional senior living. However, those same technological advances may also bend the cost curve for CCRCs; enabling them to be more affordable.[40] That said, it is possible the bundling of services (forcing consumers to become more selective and providers to be more competitive) will replace the current fee for service methodology. The long-term effect of this on senior living could lead to an even greater reliance on private pay (especially at the skilled nursing level) and the provision, including more acute services, will be pushed outward from hospitals to the skilled nursing and even assisted living levels. This will increase the focus on operational capabilities even more.

It is uncertain if more REITs and operators will enter the space, as healthcare increasingly becomes a core investment. The prediction for outstanding forecasted returns may be outweighed by the increasingly stringent operational focus of senior living, preventing many real estate firms from venturing into the space. What is more likely is that consolidation will transpire among operators in order to improve economies of scale further.

Expect to see continuation and perhaps further refinement of the REIT/REOC model. For the operator, this model appears to work better than the private equity model since the latter requires an exit strategy within 3-5 years. In contrast the REIT/Larger Operator model is a long-term proposition. [41]

However, there is also the presence of a newer hybrid model, which represents a potential threat to the traditional REIT/REOC strategy. This is a predicated on the idea of joint partnerships, which operate at a middle market level (acquisitions under $100

38 Robert G. Kramer, Phone Interview, February 3, 2015

39 Ken Segarnick, SVP, Brandywine Senior Living, Lecture – Senior Living Course, Cornell University, November 20, 2014, Slides 55-60

40 Ken Segarnick, SVP, Brandywine Senior Living, Lecture – Senior Living Course, Cornell University, November 20, 2014, Slides 55-60

41 Sarah Laffey, SVP, Benchmark Senior Living, Personal Notes of Lecture before Senior Living Course, Cornell University, November 20, 2014, slides 45 and 48

million), and are based on a going concern strategy, in which the operator (often a family owned business) retains managerial control after establishing a joint venture with an equity firm. The success of this blueprint is dependent on a smooth, long-term relationship between the operator and a joint equity firm. The latter is not looking for a quick exit, but instead relishes participation in the operational side of the business, while letting the operator retain managerial control. In contrast, if the operator in this case sold out to the large institutions or REITs, his managerial involvement would likely cease. The area of operations for this market is not a trivial amount of money, but potentially represents a large portion of the $300 billion senior living market.[42]

Other threats also exist to the REIT model. For instance, some of the operators may decide to spin off their real estate holdings from the operating businesses and go into the REIT business themselves. Already, there is talk about Brookdale attempting this strategy. Other possible trends to anticipate include the proliferation of closed end REITs – smaller REITs whose exit strategy includes being purchased outright by the larger REITs.[43]

A summary of key drivers of the senior living industry includes REITs continuing as active buyers of senior living portfolios, increased product acceptance, improving healthcare (and therefore, life expectancy), private pay continuing to maintain solid profit margins, a relative absence of building since the Millennium, and a still-fragmented industry (HCN's investments constitute just 3% of the market). There are also overseas opportunities, which present a whole new layer of investment focus. Currently, the top three REITs have some investments in Great Britain.[44] While the top three firms haven't yet ventured into the continents of South America and Asia, they are clearly looking in that direction.

Finally, as technology continues to provide assistance in the areas of healthcare, there will be increasing amounts of forays in this direction, which will also facilitate the transition towards the bundling framework within the industry. In essence, as acute services are increasingly pushed downward from the older hospital centric model and towards ambulatory care, the senior living facilities will increasingly offer services which are of a higher level of acuity.

In conclusion, the senior living sector has proven to be a fast-growing, dynamic industry in which top-down demand oriented variables (including the aging demographic) have propelled healthcare REITs into some of the highest REIT market capitalization levels due to multiple acquisitions of smaller operators. Because of the required focus on operating capability, REITs have thrived in their partnerships with REOCs, as both have focused on aligning interests for mutual benefit. The stiff requirement for operational know-how will likely continue to dissuade many general real estate firms from entering the space. It is also likely that the largest, and most successful partnerships will gain increasing market share, but the threat the industry might move in other directions such as operators conducting spinoffs and exiting the partnerships, or other firms becoming jointly linked to the mid-size operators who wish to expand and compete is very significant. Also, as the national face of healthcare changes, senior living providers will also have to adapt to higher levels of acute services; but improvements in technology can provide benefits to help offset this challenge.

42 Mr. Torey Riso, President and CEO of Care Investment Trust, Interview, March 22, 2015

43 Mr. Torey Riso, President and CEO of Care Investment Trust, Interview, March 22, 2015

44 Robert G. Kramer, Phone Interview, February 3, 2015

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