

Senior care real estate is on the rebound

AFTER TOUGH PERIOD, INDUSTRY HAS RESTRUCTURED AND IS PRIMED FOR GROWTH

By Greg Scline & John Cobb

As the senior care real estate market moves into its second year of stabilization, investor confidence remains high and market liquidity is strong. After a difficult period for the skilled nursing and senior housing segments, the industry has restructured and is now positioned for future growth.



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Better fundamentals

The skilled nursing market continues to do well since emerging from the doldrums in early 2003.

Since then, stock valuations of the major publicly traded players have risen substantially and capital has flowed into the segment from a variety of sources, most notably real estate investment trusts (REITs) and private equity funds.

The turning point was solidified last spring when the federal Centers for Medicare & Medicaid Services (CMS) announced a 3 percent Medicare rate increase, which was followed shortly by a one-time error adjustment increase of 3.26 percent. The combined 6.26 percent rate adjustment translates into almost \$1 billion in new revenue for fiscal 2004 and has significantly boosted investor confidence in the segment.

While a variety of reimbursement and operational issues remain, the outlook is better than it has been for quite a while.

Today, the segment sees improving fundamentals with occupancy rates hovering near five-year highs; operating margins also are recovering. To add to the momentum, CMS recently proposed a 2.8 percent Medicare rate increase for 2005, and refinements to the RUG system that would have reduced payments has been deferred once again.

These strong fundamentals have positively impacted the real estate market, driving up acquisition interest and pushing cap rates down.

According to Irving Levin Associates Inc., a firm that tracks healthcare financing issues, average skilled nursing cap rates declined to 13.4 percent in 2003, down from 14.8 percent in 2002.

The senior housing market has also seen improvement over the same period, albeit for different reasons.

While skilled nursing spent the early part of the decade adjusting to reimbursement declines, senior housing has been recovering from an overbuilding hangover driven by aggressive investments of the late 1990s.

Like many sectors in the 1990s, senior housing got ahead of itself as abundant and optimistic Wall Street capital flowed into the segment. This enabled developers to build at a pace that considerably outstripped demand.

By 1998 more than 30,000 new assisted living units were being built annually. As supply continued to

grow, average occupancy began to fall below 90 percent target levels, causing many projects to fail to meet expectations. As a result, the cycle of financial distress and restructurings began.

By the end of 2003 the industry had significantly worked through the difficult process of portfolio reallocation and recapitalization, which contributed to one of the most active senior care mergers and acquisitions (M&A) markets in sometime.

There were 103 long-term care transactions in 2003, compared to the prior year's 69 deals. This high level of activity was largely the result of distressed properties coming to market and bargain hunters eagerly adding them to their portfolios.

By early 2004, the pace of deals had slowed as the number of bargain deals waned and potential sellers began to leverage improved market liquidity. As a result, average cap rates declined 90 bps to 10.8 percent in 2003, down from 11.7 percent in 2002.

At the higher end of the asset class scale, the market was even more optimistic, seeing almost half of the deals come in at below a 10.0 percent cap.

REITs stake claim

Where is the liquidity coming from? REITs are on the short list of sources.

Since January 2003, the stock value of REITs has been on a meteoric rise. Despite the April 2004 correction, REIT values remain high and the appetite for adding to their respective portfolios is strong.

The challenge for REITs has been in finding the volume of projects needed to deploy their capital. This situation is not unique to publicly traded REITs.

A short list of private REITs also plays heavily in the space. Among them, CNL Retirement Properties has been one of the most active.

With a strong ability to continue to raise equity capital, CNL has been a prolific acquirer of senior care assets over the last two years. It has developed one of the largest real estate hold positions in the industry.

With a strong REIT presence in the space, the sale-leaseback structure seems to be gaining momentum.

Most REITs fall into the category of true financial investor since they generally lack operating capabilities; instead, they lease back the facilities to the existing operator on a triple net basis.

In 2003, senior housing sale-leaseback volume exceeded \$1.5 billion. By mid-year 2004, volume had already approached \$1 billion despite an overall slowing of M&A activity.

The trend appears consistent with other real estate intensive service industries, such as the hotel industry.

However, many question whether it will be a long-term preferred structure for the senior housing segment.

Whether or not the sale-leaseback model becomes a preferred model, in the near term the trend has proven a boon for sellers seeking to monetize assets and a challenge for lenders because of the relatively low level of debt typical of REIT sale-leaseback structures.

Private equity

Also in the game are operators and

equity shops. These players continue to selectively and opportunistically acquire new assets to augment their portfolios. When compared to REITs, these players tend to capitalize deals by using a more familiar structure: they're starting with 15 percent to 30 percent equity and leveraging the balance through a first mortgage loan.

Like the rest of the industry, mortgage loan structures have evolved over time with changes in the market and its players. Two years ago, outside of HUD and Fannie/Freddie credit boxes, the only structure available to most operators was a three-year to five-year floating rate bridge loan with little structuring flexibility. Today the options have expanded.

While a long-term fixed rate structure was once only attainable through a government agency deal, commercial lenders are now offering fixed rate deals with up to a 10-year term for their best customers.

The change in offering has been the result of both a rising interest-rate environment and the emergence of a group of seasoned players that have gained the confidence of skittish lenders.

In addition to longer term fixed rate structures, lenders are also offering additional flexibility in loan-to-value requirements, covenants and collateral pools.

One such example is a recent transaction completed by a major commercial lender in which the senior housing borrower was extended a \$200 million revolving credit facility that was secured by a pool of real estate assets. The unique feature of the deal was the borrower's right to substitute assets in and out of the pool without refinancing. The structure provides the borrower with previously unavailable flexibility to manage a

portfolio, acquiring and disposing of assets with minimal costs compared to traditional financing.

Looking ahead

Overall, the number of players and variety of available structures reflect the improving investor outlook for the senior care real estate market. While the near term outlook is positive, significant risks are on the horizon.

For the skilled-nursing segment, Medicare reform is always at the top of the list. The November election raises questions regarding health reform, and many observers see some sort of healthcare cost containment initiative as highly likely in the coming years, regardless of who is elected.

The real question is, how much of it will be taken out of the backs of skilled nursing operators?

In senior housing, the risks are less concentrated, but real, nonetheless. With the recent acquisition boom, some in the industry are concerned that the market may have gotten over heated and that some sale prices do not reflect underlying values.

For the answer, the market will have to wait and see. However, if a significant number of portfolios do not perform up to expectations, investors could expect a market cooling two to three years out.

While these and other risks continue to be challenges to the real estate investor's crystal ball, it looks as if the industry, overall, will be well positioned for the coming year. □

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