

Our Chicken Pox Theory on the HC REITs

Summary

Upon contracting Chicken Pox, one can expect not to suffer the disease again. As a means to explain our view on the health care REITs, and specifically on past/current/future legal action related to Medicare billing practices of post-acute/SNF operators, we invoke a parallel analogy with the Chicken Pox "one-and-done" nature: KND (tenant of VTR) has had Chicken Pox, HCRMC (tenant of HCP) has it now, and GEN (tenant of HCN, SBRA, LTC, OHI) hasn't had it yet. Raising our PT on VTR to \$71 from \$66 and reiterate our Buy rating.

Key Points

- Under the Microscope:** The \$125mm settlement by KND (related to activities before its acquisition of Rehab Care) and the ongoing process underway at HCR ManorCare (HCRMC) have raised the level of anxiety that additional wrongdoings will be unearthed. The re-emergence of CMS's RAC audits, which we do not view as the formality, may have the benefit of a roadmap to find other infractions. As such, with virtually all of its SNF exposure with KND, VTR seems the most cleansed of the situation on a go-forward basis (assuming KND doesn't replicate bad behaviors). Privately-held HCRMC remains in process, and while its landlord HCP may be closing in on a resolution of its own (see last week's note [here](#)), the timeline and impact stemming from the DOJ intervention remain in a black box. Of the larger operators, this leaves GEN that still hasn't gotten Chicken Pox.
- The GEN Risk:** As we show in Exhibit 1, the 2014 and 2015 GEN 10-Ks mentioned a preliminary investigation by the DOJ, which commenced on February 4, 2015. What we know is the possible infractions occurred at Skilled Healthcare Group before it combined with GEN, and that GEN was aware of the situation prior to the merger and determined it benign enough to move forward. GEN had \$62mm of cash/equivalents as of 4Q15, and the company has established a \$30mm liability (i.e., not a cash reserve) to prepare for the possibility of a future negative event. REIT exposure to GEN as a percentage of the total: SBRA (34%), HCN (14%), LTC (5%) and OHI (4%).
- Longer Term:** While the potential for future settlements could be a slap-on-the-wrist and one-time in a best-case scenario, elevated scrutiny could cause operators to apply a less aggressive approach to the business. As such, rent coverage metrics could trickle down over the longer-term, which we think lends support to our focus on strong rent coverage for those REITs trafficking in the post-acute space. We like VTR, LTC and SBRA, as discussed below.

Company	Symbol	Price (4/01)	Rating			PT
			Prior	Curr	PT	
HCP, Inc.	HCP	\$32.61	-	Neutral	\$32.00	
LTC Properties	LTC	\$45.52	-	Buy	\$49.00	
National Health Investors, Inc.	NHI	\$66.34	-	Neutral	\$63.00	
Sabra Health Care REIT, Inc.	SBRA	\$19.94	-	Buy	\$23.00	
Ventas, Inc.	VTR	\$63.23	-	Buy	\$71.00	
Welltower, Inc.	HCN	\$69.16	-	Neutral	\$71.00	

Source: Bloomberg and Mizuho Securities USA

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Reiterating our Positive Thesis on VTR, Raising Target; Continue to Favor LTC and SBRA

Given that the GEN situation has been underway for over a year and may never amount to anything material, we don't view it as cause for a change in our thesis on those REITs that do business with the company. GEN is a well-regarded organization, and underwrote the risk prior to the merger with Skilled Healthcare. We believe some weight should be given to its determination that it was safe to move forward with the combination despite the early-stage involvement of the DOJ. There are many reasons to like or dislike a stock – and the list is somewhat longer in the healthcare REIT sector. We view the GEN risk as one of several inputs into our stock selection process. And as such, we believe the way to play it is to not sell the impacted REITs, but deploy new money to buy those that stand out when considering the broader picture. We like VTR, LTC and SBRA for varying reasons.

- **VTR** has zero exposure to GEN, and its 1.7x post-acute EBITDAR rent coverage overall appears ultra-safe, in our view (HCN's equivalently-defined GEN coverage is 1.3x). Separately, the reallocation of KND rents and planned sale of seven LTACHs (announced today) helps the story at the margin as well. As such, we are raising our PT to \$71 from \$66, which assumes a one-turn increase to our target 2016 AFFO multiple to 19x. For context, HCN's target multiple remains 18x.
- On the smaller cap side, we also like “low-risk” **LTC** (GEN coverage is 1.65x; see our recent note [here](#)), and “higher-risk” **SBRA** as an event-driven call related to the ongoing resolution with Forest Park (note: the Frisco sale closed today, and a resolution to the two debt investments remain on track).

Exhibit 1: Risk Comment in Genesis Healthcare 2015 10-K Filing

In February 2015, representatives of the DOJ informed the Company that they are investigating and may pursue legal action against the Company and certain of its subsidiaries including Hallmark Rehabilitation GP, LLC for alleged violations of the federal and state healthcare fraud and abuse laws and regulations related to the provision of therapy services at certain Skilled facilities from 2005 through 2013 (the Therapy Matters Investigation). These laws could include the FCA and similar state laws. As noted above, the FCA provides for civil and administrative fines and penalties, including civil fines ranging from \$5,500 to \$11,000 per claim plus treble damages. Applicable state laws provide for similar penalties. Violations of these federal or state laws could also subject the Company and/or its subsidiaries to exclusion from participation in the Medicare and Medicaid programs. Any damages, fines, penalties, other sanctions and costs that the Company may incur as a result of any federal and/or state suit could be significant and could have a material and adverse effect on its results of operations and financial condition. The Company has had discussions with the DOJ regarding both the Therapy Matters Investigation and the Staffing Matters Investigation (defined below). The Company has accrued a combined \$30 million as a contingent liability in connection with those two matters. However, it could ultimately cost more than that amount to settle or otherwise resolve the matter(s), including to satisfy any judgment that might be rendered against the Company if legal proceedings are commenced. At this time, the Company cannot predict what additional effect, if any, the investigation or any potential claims arising under applicable federal or state laws and regulations could have on the Company. While the Company will continue to cooperate with the government's investigation of the matter, the Company intends to vigorously defend against any legal action that may be brought in the matter.

Source: Company reports.

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(As of 4/01)	% of coverage	IB service past 12 mo
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