The Genesis Nemesis and a Bundle of Other Healthcare Topics Debated at NAREIT

Summary

We debate what matters most to the healthcare REITs during NAREIT, and used the conference to investigate longer-term theses that have yet to fully materialize. While the group may ebb/flow with interest rates, we focus on four topics: Genesis, Spins, MOBs and management. We reiterate our "rent coverage" thesis, which means Buy ratings on VTR and LTC. We note that, so not to distract from the intent of this report, a few price targets are slightly out of sync with our rating system. We expect to address those issues shortly.

Key Points

- **Genesis on the Turntable?** The two REITs in our coverage universe with the largest exposure to Genesis Healthcare (GEN, not rated) are SBRA (33% of the portfolio) and HCN (13%). One common thread to our conversations last week was at least the contemplation of selling GEN assets privately as a means to reduce or eliminate exposure. Although we have no information about the validity of the concept, nor the timing of such an event if pursued, we do think it is interesting that two smart shops separately arrived at a similar fork in the road. We debate the question if now is the time to sell, i.e., after the GEN problems are well-documented.

- **SpinCos:** We think VTR's spin-off of CCP in August 2015 was far more investor-friendly than HCP's proposed spin of HCRMC. That said, HCP was in a very difficult (no-win?) spot, and the market may ultimately chalk the spin up as the best of several evils. A lot of unknowns remain for HCP, but the aftermath may be better than the present.

- **MOBs -- Is "Off" the new "On"?** HTA thinks cap rates will continue to trend downward, and characterized the sector as "the next multifamily." We don't know if four-handles will be the next paradigm for MOB cap rates, but the comment does provide us a basis from which to measure in the coming years. Among the other takeaways from that meeting is HTA's willingness to have a larger off-campus presence than its most relevant peer.

- **Management:** We discuss the growing bench at HCP, and what the company may do about that (short of a bigger G&A line item.) For example, we briefly debate if the changes at the company are just step one in the reinvention of HCP. Separately, we give a shout out to NHI, where relatively new leadership continues to make its presence known on various inherited issues.

Company	Symbol	Price (6/10)	Rating Prior	Rating Curr	PT
Care Capital Properties	CCP	$26.36	–	Neutral	$27.00
HCP, Inc.	HCP	$34.43	–	Neutral	$32.00
Healthcare Realty Trust Incorporated	HR	$33.58	–	Neutral	$29.00
Healthcare Trust of America	HTA	$31.37	–	Neutral	$28.00
LTC Properties	LTC	$49.29	–	Buy	$53.00
National Health Investors, Inc.	NHI	$71.54	–	Neutral	$66.00
Sabra Health Care REIT, Inc.	SBRA	$22.09	–	Neutral	$20.00
Ventas, Inc.	VTR	$68.58	–	Buy	$71.00
Welltower, Inc.	HCN	$72.14	–	Neutral	$68.00

Source: Bloomberg and Mizuho Securities USA

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Important and Incremental Healthcare NAREIT Takeaways: Sticking with our Coverage Thesis

We discuss below a few of the key healthcare themes and/or company-specific observations we took away from our NAREIT experience last week. Among them are: a) what the future holds for Genesis Healthcare (GEN) as an operator/tenant, b) our modestly-revised view of HCP's spin-off plan, c) a unique perspective from HTA on the future value of medical office buildings (MOBs), d) the new tweaks from the (still relatively new) NHI senior leadership team, and e) our personal view that public bickering does the sector no good. The bottom line is we are sticking with our "focus on rent coverage" thesis on the sector, which favors our Buy ratings for VTR and LTC (see our more comprehensive notes here and here). Meanwhile, while we remain in Neutral territory on the MOB REIT for valuation reasons only, we do expect the secular story to continue, and we like how the individual companies are distinguishing themselves from one another.

Is Genesis on the Turntable?

The two REITs in our coverage universe with the largest exposure to GEN are SBRA (33% of the portfolio) and HCN (13%). One common thread to our conversations last week was at least the contemplation of selling GEN assets privately as a means to reduce or eliminate exposure. What is interesting is the contrast to the proposed spin of HCRMC by HCP (discussed below), which implied there was no reasonable market to sell those assets privately. For all of GEN's problems, it is in far better shape than HCRMC. So finding private buyers is at least logically possible. Here are our takes on both situations:

- **SBRA:** The company has stated in the recent past, and reiterated last week, the possibility of selling some of its non-core GEN assets as a means to dial down its exposure. Management quantified the possible dilutive impact in the $0.10 to $0.20 per share range. If that does come to fruition, we would expect the stock to knee-jerk down – SBRA's relatively low trading liquidity leaves it open to wide daily swings in performance, and we believe the initial reaction would be negative. However assuming the price was right, it could also be the correct thing to do with a long-term perspective. So we will keep an eye on this issue as it unfolds.

- **HCN:** Management is strongly against a spin-off of its GEN exposure, although with two such deals already completed (VTR's spin of CCP) or announced (HCP's proposed spin of HCRMC), we think that window was effectively closed anyway. Regardless, we think selling at this point would be far more investor-friendly if executed effectively, although there is no guarantee of a positive outcome from either a pricing or timing perspective. HCN estimates its GEN portfolio is being valued at an implied cap rate of between 14% and 20%+. Hypothetically speaking, if it is able to execute a sale of some or all of its GEN assets in the single digit cap rate range, that would be a win in our view.

In both cases, we emphasize that there is no certainty of anything happening, and we have no specific sense of a timeline if/when some GEN assets are sold. But we do think it is interesting that two very thoughtful shops are discussing a similar option. So maybe there is some validity to it.

A Counterpoint Comment

In the event selling GEN assets turns out to be the path taken in some form, the counterpoint may be that management is being reactive rather than proactive. It is rarely a good thing to "cut bait" after a situation has already gone bad – bailing out at an inopportune time. We see VTR's spin of CCP being early and forward-thinking by handing it off to a dedicated team to focus all of its attention.

That being said, GEN has a chance of going from bad to worse (at least in the intermediate term.) Bundling programs are just in their infancy, and that says nothing about the risk of the preliminary DOJ investigation that GEN disclosed in its public filings. So we are neutral on this debate, but we thought it relevant to include it in the conversation nonetheless.

HCR ManorCare Spin may be the Lesser of the Other Evils?

There is no question in our mind that VTR's spin-off of CCP in August 2015 was far more investor-friendly than HCP's proposed spin of HCRMC (plus other SNF assets). As we have stated in the past, we think VTR was operating from a position of strength whereas HCP had its back against the wall. It is true CCP inherited some question marks in the form of impending vacancies, weak same store optics related to previous rent cuts, and about $300mm of purchase options over the next three years. But at least VTR shareholders were given a security that was immediately tradable – they could have gotten out in August if they wanted to, with minimal pain. The same can't be said about HCRMC, at least as we see it today. Investors will receive a stock where the first order of business will likely be a rent cut (we have estimated a 35% reduction, see that note here), and there may be no window to get out of that stock without suffering a major loss.

However, HCP was in a very tough spot, and we offer these balanced thoughts:

- As we stated when it made the first rent cut in April 2015 (see that note here), we didn't think the company went far enough – and that thesis is now proving itself out.

- But the past is the past, and while the proposed spin is far from perfect and could possibly leave a lingering bad taste in the mouths of some investors, we also think "RemainCo" will be in a much better position than "Legacy HCP". An over-exposure to senior housing operator BKD will be the main challenge, but that appears much more benign relative to HCRMC.

- We also think the expectations are so low right now regarding the tradability of the spin-off that even the slightest indication of the reality exceeding the expectation could help shepherd the process along.

So while we are not anointing the HCRMC spin-off as a positive consideration at any level of thought, we do think markets are generally forgetful, and the long-term outcome could work out okay. We are expecting more details on the spin transaction when HCP files its Form 10, possibly within the next few days.

More on HCP – A Comment on Management

Beyond the HCRMC issue, we note that HCP has successfully amassed an extremely strong bench of talented executives, particularly with the addition of incoming CFO Tom Herzog joining CIO Justin Hutchens and current CEO Lauralee Martin. Executive Chairman Mike McKee, who will also have day-to-day involvement, stated that the company will communicate a management game-plan in the Fall. The objective will be to address this high-class problem of having several CEO-quality people under the same roof – the overriding message will be to "make everyone happy" (should we be watching the G&A line?).

Here's a thought: Post-spin, maybe there is another layer of restructuring/divisions in the future? MOBs, life science and senior housing will make up the vast majority of RemainCo. Crazier things have happened, but maybe the spin is just step one in a multi-tiered process to unlock value.

MOBs: The "Next Multifamily"

Turning to MOBs and HTA specifically, management thinks cap rates will continue to trend downward (assuming no material change to the interest rate environment) – calling the sector "the next multifamily." We found that an interesting observation, as long as HTA wasn't talking about the deceleration of same store growth that the apartments are feeling now (he wasn't). We don't know if four-handles will be the next paradigm for MOB cap rates, but the comment does provide us a basis from which to measure in the coming years.

Is Off the new On?

Separately, we think CEO Scott Peters deserves some credit for putting his somewhat contrarian view out there that HTA will pursue off-campus assets as a part of the company's ongoing strategy. He isn't necessarily alone (both HCN and VTR maintain an off-campus focus), and this has already been a part of the HTA game-plan (i.e., more formalized now). And the cynic may say off-campus is a necessary condition for HTA to continue to communicate 6%+ acquisition cap rates.

Regardless of where investors and analysts come out on this issue, we think fully off-campus (meaning a significant distance from the area hospital) could be 30% to 35% of the HTA portfolio on a steady-state basis. This also stands in contrast to its key rival, HR, where on-campus (or very close) is currently over 80% of its portfolio, and growing. Contrasting itself to a company that has been in the business much longer does require some bravado and commitment, and we like the concrete nature of HTA's conviction. Time will be the judge but here are our broad take on this:

- **Contrasting Styles:** We think it is good thing for investors to have choices within the confines of a relatively small universe of MOB-centric REITs. Whether it is the on- versus off-campus issue, or development, or cost of capital considerations, the investment strategies between the three (including DOC, which we don't cover) are different. Contrasts in style create a healthy investment landscape from which to choose; a good thing, in our view.

- **It Comes Down to One Word: "Convenience".** We see the individual on versus off campus strategies being a focus on convenience, either for the doctors or the end-user patients. We think specialty practices or even imaging services may be best positioned on-campus (convenience for the healthcare provider), whereas primary care, surgery centers or pediatrics (to name a few) may be better located out in the community – convenience for the patients. Either way, the marginal opinion on how to best position an MOB platform adds to the healthy debate, in our view.

The Ground Lease Debate

HTA is also on the lookout for fee-simple ownership rather than ground-leased arrangements, with nirvana (in its eyes) being fee-simple and on-campus. For example, its three Forest Park assets (which have now been sold – thank you SBRA) are on-campus and not subject to ground leases. The company thinks the market will eventually attribute higher value to fee-simple over time, regardless of its location, and maybe in the form of a 50bps lower cap rate. For now, the transaction market makes no material distinction in HTA's view.

We investigated this issue beyond management's comment in our meeting, and provide these additional observations:

- **A Rare Find:** The combination of on-campus and no ground lease is the exception, and clearly great if you can get it. To put that into context, for the 66% of the HR portfolio that is actually on campus (and not "adjacent), about 11% is sans a ground lease (i.e., 55% have ground leases).

- **Other Restrictions:** Usually on-campus assets have deed restrictions that exercise some control over the building's tenancy, although HTA has no medical tenant restrictions at the (soon-to-be former) Forest Park campuses. However, the lack of a ground lease would always preclude the loss of the asset when the ground lease expires, and that the core advantage of a fee-simple arrangement in our opinion.

The bottom line is the most important factor for any MOB asset, ground leased or not, is the quality of the hospital – and its ability to compete in a changing environment for healthcare delivery. Any nuances behind that consideration represent rounding-error gravy, in our view.

The Tennessee Tweaker

Our meeting with NHI was a continuation of a recurring theme – CEO Eric Mendelsohn calling it as he sees it. Often when a new CEO takes over, he/she toes the line in terms of how the company was being run under the previous leadership. Former CEO Justin Hutchens left NHI in good shape, but we continue to like Eric's willingness to tweak the system. This has included the following:

- **LTC Shares:** The company previously converted its LTC preferred stock and sold much of the common stock in late 2015. As of 1Q16, NHI owned 1.3 million LTC shares. The conversion of the preferred itself was a departure from the previous leadership's game-plan, but the amount and timing of the stock sales have thus far avoided the need for a special dividend (which was one of the reasons the company continued to own the preferred stock in the first place). While no detail was given regarding mid-quarter activity, we expect some of the remaining LTC stock has been, or will be sold, by the time NHI reports in early August. NHI has been clear that selling LTC shares is a first priority in terms of capital-raising, and LTC stock has performed well. So we are just connecting logical dots here.

- **Bickford Purchase Options Exercised:** NHI also reversed course from previous leadership when it exercised its purchase options on five of the six that were outstanding (the sixth option was ripped up). And in an interesting twist, the five are not included in the 32 properties housed in the RIDEA/JV structure. At 93% occupied, management concluded there was not enough upside in the five to contribute them to an operating model, so those assets will be subject to a triple-net structure. We view this as another thoughtful approach to an issue that has been outstanding for a while. The decision to exercise the purchase options now was at least two-fold: a) the options were in the money, and b) debt was coming due on the assets – both opportunities for NHI. We would also note that the transaction WAS contemplated in 2016 guidance.

- **Mezzanine Strategy:** With less than $50mm invested in mortgages, NHI has some room to grow its debt platform. We can see it pursuing the skilled nursing (SNF) business not through equity investments, but rather through a participation in the capital stack for other buyers. For example, NHI could piggy-back through investing in mezzanine debt – earning itself a double-digit (albeit short-term) return, and a sideline approach as the post-acute/SNF issues work themselves out.

- **Monitoring Holiday:** When it considers the entirety of its portfolio, the Holiday exposure (16% of the portfolio) ranks as NHI's number 1 concern. That has to do with the multiple leadership changes at Holiday, and the uncertainty that comes with that – very thin rent coverage of just over 1x doesn't help either. NHI has traveled to Portland, OR to meet with Holiday, and did a deep dive into the new organizational structure, etc. It came back feeling incrementally better, but question marks remain that only time will resolve. Further, with several REITs owning a slice of Holiday assets, there is some risk that a rent waiver for one will impact others. So while the Holiday situation is far from ideal, we do like that NHI is not sitting idly by hoping for the best.

The Multifamily Way

Finally, while not every healthcare REIT is participating in public (or semi-public) bad-mouthing of their peers, and the intention of this note is not to point fingers, we think the sector should take a page from the multifamily REIT sector. There, management teams are publicly cordial with one another – a complementary environment that acknowledges that the fortunes or shortcomings of one company are generally contagious from a stock performance perspective. In its most basic form, we understand the multifamily CEOs regularly dine together, including once a year as a full group, while the investor relations departments coordinate earnings season such that companies don't have conflicting conference calls. There are clearly differences between the multifamily REITs (e.g., suburban vs. urban, high-barrier vs. low-barrier, balance sheet structures, etc.), and we assume internal debates are far less polite when companies take their own corners. But we think the public perception of the sector, on this issue alone, presents as one of strength and confidence – do your job and let the market make the determination.

To the contrary, some healthcare REITs are using public channels to disparage their peers, and while it creates interesting theater, we haven't heard from a single investor that finds it even remotely useful. We understand the natural instinct of competition, and we appreciate the spirit of the motivation. But we also think it does the sector virtually no good to waste time and effort talking about any other company but their own. Each of the healthcare REITs we cover have unique platforms and strategies to offer investors, some that are truly extraordinary. We think inter-company bickering is at least unnecessary and defensive-sounding, and at most, value-destructive.

Price Target Calculation and Key Risks

Care Capital Properties

Our price target is based on an 10x our 2016 AFFO estimate which is a discount to its immediate peers. Should bundling programs and other regulatory forces negatively impact the business of nursing homes, our price target may not be achieved.

HCP, Inc.

Our price target is based on a range around 12x our 2016 AFFO estimate. To the extent the company's exposures to HCRMC and other troubled tenants cause more problems than we expect, our price target may not be achieved.

Healthcare Realty Trust Incorporated

Our price target is based on a 5% range around 20x our 2016 AFFO estimate. Should the company's same store growth fail to maintain its historic pace of performance, our price target may not be achieved.

Healthcare Trust of America

Our price target is based on a 5% range around 19x our 2016 AFFO estimate. If the company's active investment platform result in weaker than expected performance in future periods, our price target may not be achieved.

LTC Properties

Our price target is based on a 5% range around 18x our 2016 AFFO estimate. To the extent the regulatory environment negatively impacts rent coverages in the company's skilled nursing portfolio, our price target may not be received.

National Health Investors, Inc.

Our price target is based on a 5% range around 15x our 2016 AFFO estimate. Should senior housing development negatively impact the company's RIDEA growth prospects, our price target may not be achieved.

Sabra Health Care REIT, Inc.

Our price target is based on a 10% discount to our current NAV estimate. If the company encounters difficulty finding investments that meet its quality and growth criteria, our price target may not be achieved.

Ventas, Inc.

Our price target is based on a 5% range around 19x our 2016 AFFO estimate. Should the company's fast pace of investment activity result in some missteps given the numerous moving parts, our price target may not be achieved.

Welltower, Inc.

Our price target is based on a 5% range around 17x our 2016 AFFO estimate. If the company's significant exposure to the RIDEA structure results in declining same store prospects in the face of new supply growth, our price target may not be achieved.

Companies Mentioned (prices as of 6/10)
GENESIS HEALTHCARE INC (GEN- Not Rated)

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