FEATURE

2018 Seniors Housing and Health Care Market Outlook

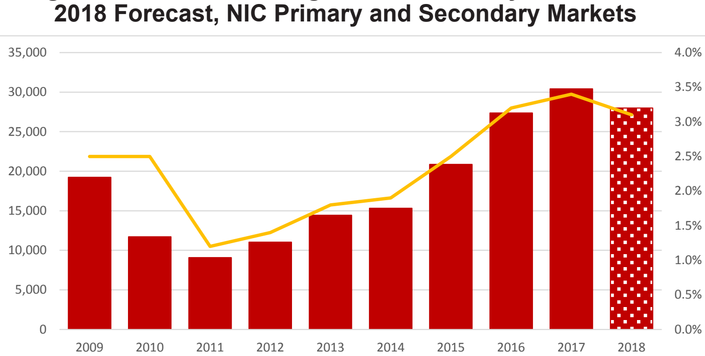
The past 12 months have provided a challenging operating environment within the health care market, especially the seniors housing and care sector. New supply growth within the seniors housing sector has constrained occupancy and the skilled nursing sector has experienced several dislocations, all while the property transactions market has remained active. While 2017 was a year of challenges, data suggests the market may stabilize in 2018. We take a look at recent market data to shed light on the past 12 months, identify trends, and provide a big picture analysis of what the industry looks like as 2018 unfolds.

Seniors Housing Occupancy Likely to Stabilize in 2018

Overall, the seniors housing industry faced heightened challenges from competitive supply growth in 2017. Over 30,000 new seniors housing units (Figure 1) opened within the National Investment Center (NIC) primary and secondary markets in 2017, which marks the highest level of inventory growth recorded by NIC. The seniors housing occupancy rate, as a result, trended slightly down in 2017, starting the year at 89.0% and finishing 2017 at 88.6% (Figure 2). The occupancy rate declined despite significant gains in the economy, jobs, housing and stock markets. This suggests to investors and market participants that seniors housing occupancy rates are ultra-sensitive to heightened levels of supply growth.

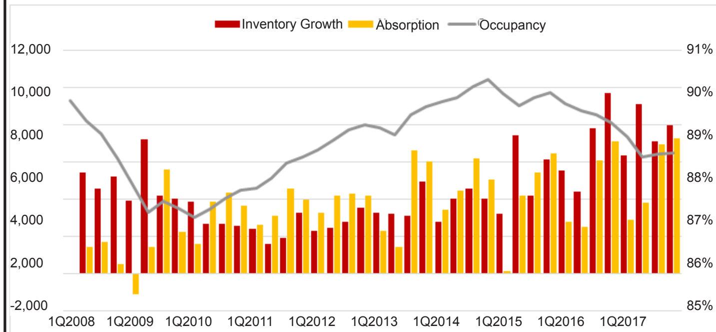
Heading into 2018, expect supply growth to moderate from current levels. Using historical inventory growth patterns, we can reasonably forecast that approximately 28,000 new units should open in 2018. This equates to forecasted inventory growth of 3.1%, which is lower than 2017's inventory growth of 3.4%. Additionally, the construction pipeline has fallen from 7.1% in 3Q16 to 5.9% at the end of 2017, according to NIC. Fewer seniors housing units are starting construction as compared to a few years ago. These factors, in addition to continuing positive economic news, should provide the necessary ingredients for stabilization in seniors housing occupancy rates in 2018 and the potential for occupancy growth beginning in late 2018 or early 2019.

Figure 1: Seniors Housing Annual Inventory Growth with 2018 Forecast, NIC Primary and Secondary Markets



Source: NIC MAP New Units Opened Inventory Growth

Figure 2: Seniors Housing Quarterly Occupancy, Inventory Growth and Absorption, NIC Primary and Secondary Markets



Source: NIC MAP

Changes in Reimbursement and Regulations

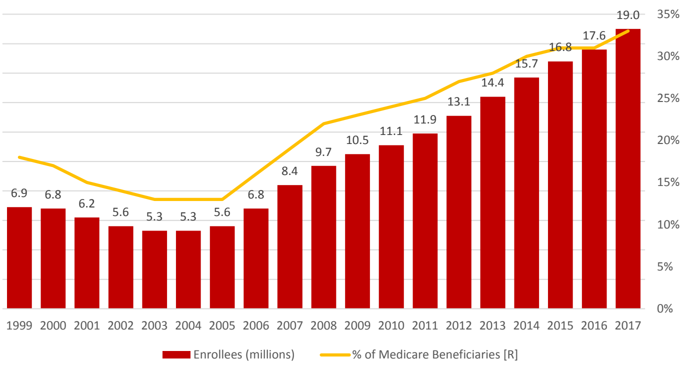
Three high profile skilled nursing facility (SNF) operators experienced significant challenges in 2017. Kindred Healthcare (NYSE: KND) decided to exit the skilled nursing business in order to focus on its transitional, rehabilitation and home care businesses.[1] Genesis Healthcare (NYSE: GEN) saw its stock price fall below $1 per share as it sought to renegotiate lease terms with landlords in the face of continuing reimbursement pressures.[2] And HCR Manor Care has struggled to pay rent to its landlord, Quality Care Properties (NYSE: QCP).[3] The bulk of these struggles can be blamed on changing reimbursement trends. Specifically, each of these companies have found challenges adapting to an increasing population of Medicare Advantage (MA) enrollees.

Medicare Advantage was born out of the 1997 Balanced Budget Act. It was originally named Medicare+Choice under

1. http://investors.kindredhealthcare.com/news-releases/news-release-details/kindred-announces-definitive-agreement-divest-skilled-nursing
2. http://www.genesishcc.com/about-us/press/press-releases/ctl/readgenesis/mid/653/articleid/195
3. http://www.qcpcorp.com/2017-07-21-Quality-Care-Properties-Provides-Update-on-HCR-ManorCare

Part C but became known as Medicare Advantage in 2003. It is essentially the managed care option under Medicare which pays for managed health care based on a monthly fee per enrollee (capitation), rather than on the basis of billing for each medical service provided (fee-for-service). Enrollment in MA plans has risen dramatically in recent years (Figure 3). In 2017, there were 19.0 million enrollees which represented one third of all Medicare enrollees. Most experts expect MA enrollment to continue to rise and some believe it may reach as high as 70%.[4] MA has a profound impact on reimbursement to skilled nursing. MA rates, on average, are 13% lower than traditional fee for service rates and the average length of stay is ~19 days compared to ~23 days for traditional Medicare. The bottom line for SNF operators is that operating structures need to be prepared for an increasing MA population which carry with it lower average reimbursement and shorter length of stays.

Figure 3: Total Medicare Private Health Plan Enrollment, 1999-2017



Source: CMS, Kaiser Foundation

Despite the challenges posed by increased MA penetration, many SNF participants see opportunities ahead. Blue Mountain Capital, LLC has made several large SNF acquisitions in recent years including much of the Kindred SNF portfolio from Ventas (NYSE: VTR).[5] The Ensign Group (NASDAQ: ENSG) has been in growth mode, acquiring eight freestanding SNFs with 905 beds and opening three new SNFs with 385 operational skilled beds during the first nine months of 2017, according to their third quarter report. SABRA Healthcare REIT (NASDAQ: SBRA) has also been active in 2017. It acquired another skilled nursing REIT, and in the fall announced a plan to buy 24 skilled nursing and transitional care properties on the West Coast, as well as take concrete steps to sell off its remaining 43 properties operated by Genesis Healthcare by the end of next year.[6]

The Acquisition Market Remains Active in 2017

The acquisition market for seniors housing and care properties remained active in 2017. The largest deal of the year was SABRA's purchase of Care Capital Properties in an all-stock deal.[7] This REIT to REIT deal was valued at over $2 billion and turned SABRA into one of the largest health care REITs with an enterprise value of $7.4 billion.

Another health care REIT was sold in 2017. Kayne Anderson Real Estate Advisors (KAREA) acquired the assets of Sentio Healthcare Properties, a public non-traded real estate investment trust. KAREA paid $825 million for Sentio's 33 seniors housing and medical office properties across 16 states in September 2017.[8] According to Sentio's 2016 10K, it had approximately $475 million in real estate investments which should have provided an attractive return for Sentio's shareholders.

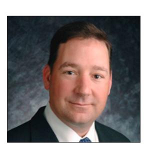
Overall, seniors housing and skilled nursing transaction volume was still active but down slightly in 2017. According to NIC/RCA (Real Capital Analytics), seniors housing transaction volume was $8.6 billion during the 12 months ending 3Q17. This was down 4% from one year earlier. Annual skilled nursing transaction volume was $6.5 billion as of 3Q17, which was down 6% from one year ago. The NIC/RCA 3rd Quarter Transactions report contains a wealth of information and data on transaction volumes, pricing, trends as well as listings of individual deals.

On a cap rate or initial yield basis, most market participants report that investment yields are flat on a year-over-year basis. LTC Properties (NYSE: LTC) reported on its 3Q17 earnings call that, directionally, they are seeing cap rates about the same. They reported yields around 7% for existing assisted living properties, and 7.5% on development, and with skilled nursing they are 8.5% to 9% on initial lease yields (source: LTC 3Q17 earnings call transcript). SABRA Healthcare REIT reported on its 3rd quarter earnings call they were seeing initial lease yields (aka REIT cap rates) from 8% to the mid 9% range for skilled nursing assets and yields of 6% to high 6% for assisted living and memory care assets. National Health Investors (NYSE: NHI) has reported initial yields in the 7% to 7.5% for assisted living assets. They have stated this is due to their strategy of buying assets away from coastal cities where higher prices prevail.

Keep an eye out on interest rates in 2018. The 10-Year Treasury rate has risen to north of 2.5% and several experts believe it will hit 3% by the end of 2018 as the economy continues to improve. This could work to raise the cost of capital for investors in the space, which could impact the price they are willing to pay for assets.

One thing is for sure, 2018 will be an interesting year to watch in the seniors housing and care sector.

4. https://www.lek.com/insights/why-medicare-advantage-marching-toward-70-penetration
5. http://investors.kindredhealthcare.com/news-releases/news-release-details/kindred-completes-additional-transaction-closing-its-skilled
6. http://ir.sabrahealth.com/file/Index?KeyFile=390406575
7. https://seniorhousingnews.com/2017/05/07/sabra-health-care-reit-care-capital-properties-combine-7-4-billion-merger/
8. https://sentioinvestments.com/news-announcements/2017/7/3/kayne-anderson-real-estate-advisors-to-acquire-kkr-backed-sentio-healthcare-properties-in-an-825-million-transaction



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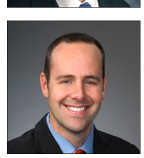

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