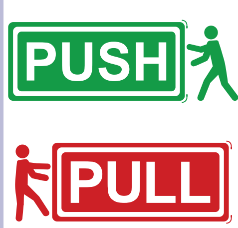


SENIOR LIVING

Push and Pull

Private Equity and Public REITs

In 2017, we saw several high-profile senior living transactions whereby a large public real estate investment trust (REIT) sold to a private equity buyer.

In one example from April, Welltower, Inc. (NYSE: HCN), a publicly traded REIT, sold a $745 million senior lifestyle portfolio to Blackstone Group. Meanwhile, Welltower also announced a strategy to divest itself of its skilled nursing facilities (SNFs) in two primary transactions, one of which included a $1.1 billion sale to private equity firm Lindsay Goldberg for 64 of their Genesis-operated facilities. Then, in June, Harrison Street, a Chicago-based private equity firm, closed its latest real estate fund at $950 million, a fund that will reportedly focus on senior living investments.

Senior Housing News reported in late 2016 that the big three REITs in the senior living space, "HCP, Inc., Ventas, Inc., and Welltower, Inc. all announced major sales [of SNFs]…involving private equity groups." This trend of public REITs divesting themselves of skilled nursing assets reflects public perception of industry trends. While senior living, including skilled nursing, remains an attractive investment for its high yield and upside potential, public investors, including REITs, are wary of regulatory changes and sector trends.

So then, why is it so often that we see REITs and private equity completing transactions but at opposite ends of the table? The largest factors in driving market activity between private equity and REITs are interest rates, accessibility to capital and sector trends. With lower interest rates, and higher accessibility to capital, REITs are in an easier position to make acquisitions with their low-interest lines of credit. The final factor, sector trends, has been affecting market activity more recently. Several REITs have decided that lower-margin skilled nursing businesses, especially those with high reliance on government payer sources, are not compatible with their long-term strategy. For example, Ventas' sale of its 36 SNF assets is a part of its effort to deemphasize its SNF business,

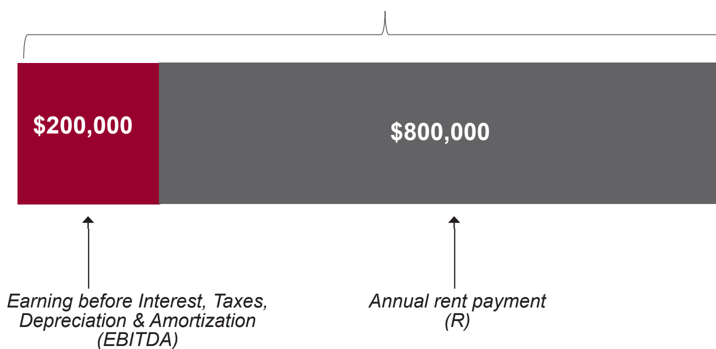
Figure 1:

Private Equity	REIT
What type of asset, facility or portfolio in the senior living space is of interest?	
Private equity looks for assets that can provide upside potential and long term return. A private equity firm or owner/operator purchaser sees the opportunity to improve the operations of the facility as a chance to increase their IRR. Compared to REITs, private equity does not require steady and immediate cash flows.	REITs are most concerned with one item: lease yield. They are more likely to bid on assets with steady cash flows above and beyond annual lease obligations. A REIT generally would not be as interested in turnaround plays, or assets with unstable cash flows, because of the need for immediate return.
How are the post transaction entities structured?	
Private equity has greater flexibility in the legal structure of a transaction because it can have ownership in both the real estate and the operations of a senior living asset. This allows a private equity buyer to be more creative with joint ventures or other ownership structures. A purchasing owner/operator or private equity firm can benefit both from the stream of lease payments as well as any increase in operational profitability. Of course, this is also a riskier structure, and the purchaser can stand to lose more if operational profitability was to drop.	A REIT purchases the asset only, and typically brings in an operator that they trust, or they can structure a sale/lease back arrangement with the existing operator. REITs, by IRS rules, are required to generate most of their income through lease payments. A REIT will typically utilize a triple net lease, where the operator is responsible for real estate taxes, insurance, maintenance and other building-related expenses. In turn, the operator pays a reduced lease rate to the REIT. These lease terms are often 10 to 15 years, with renewal options and annual lease escalators around 3%.
How are operations affected?	
Private equity and owner/operators who invest in turnaround plays will often attempt to improve operational profitability. This may occur by switching out operators, staff, vendors or injecting additional capital expenditures into the business for expansions or new development.	Typically, operations are affected very little by a new REIT owner in a sale/leaseback transaction. Otherwise, the REIT will bring in a new operator. Large, public REITs will remain largely hands off assuming lease coverage remains strong.
At what point will the investor exit the investment?	
Private equity firms invested in turnaround assets may look to exit the investment within a five to seven year cycle, however these terms are specific to each buyer. Owner/operators may stay invested longer and continue to benefit from the full cash flows of the business.	As long as the cash flows are steady and lease coverage remains strong, a REIT may choose to remain invested in a senior living asset indefinitely. However, any changes in a REIT's investment strategy may lead to exiting certain investments, as evidenced by the recent exits of several public REITs from the skilled nursing space.

the majority of which were purchased by Blue Mountain Capital.

In Figure 1, we examine the investment strategy and desired outcomes for public REITs and private equity, respectively, which contribute to market activity between these two types of participants. For purposes of this article, when we discuss private equity, we mean traditional private equity firms as well as large or small owner/operators with private capital. For REITs, there can be publicly traded or private REITS; in this article, we will be referring to large, publicly-traded REITs.

In valuing real estate assets, private equity considers the full cash flows of the business and arrives at an asset value based upon a multiple of total expected cash flows before rent, known as EBITDAR (Figure 2). Equity owners expect to benefit from any increases in cash flow from operations, and alternatively, incur losses with any decreases. REITs on the other hand, consider the cash flows as they compare to lease payments. Therefore, REITs do not pay for the entirety of the cash flows, but rather the portion necessary generated by the lease. Cash flows above lease obligations provide additional surety to REITs that lease payments will be made, and therefore may solicit a premium in price, but the premium is related only to the higher probability that lease payments are met. Private equity can pay for the additional cash flows, above lease coverage, that are only considered as credit cushion to REITs. Because of this, private equity can often be in a position to offer higher bids than REITs.



Typically cap rates, which can be calculated by multiplying lease yield and lease coverage, will be higher than lease yields, since lease coverage is almost always required to be over 1.0. The counterbalance to this fact is that REITs have a much lower cost of capital than private equity firms. While REITs often draw upon their existing lines of credit (LOC) at a very low interest rate, private equity is just that, raising equity in the private market in order to fund transactions. The required levered return to private equity is routinely higher than the cost of capital hurdle return for REITs, consisting of a blend of the interest rates on REITs' LOCs and the cost of the REITs equity.

Because of these dynamics, we often see private equity and REITs on opposite ends of the table in a senior living transaction. While they can compete as buyers, their respective strategies and sources of capital can also affect their ability to produce similar bids. As we move into the final quarter of 2017, we expect these same dynamics to remain. Large, public REITs will keep divesting themselves of their skilled nursing portfolios, as their strategies turn away from assets with high percentages of government reimbursement. On the other end, private equity familiar with the space will continue to raise capital for senior living, and skilled nursing specifically, due to its attractive yields and upside potential. The growing demographics behind the senior living sector are hard to ignore, and we expect that private markets will continue to pay attention.

Kevin Laidlaw is a vice president in the M&A group for Lancaster Pollard. He may be reached at klaidlaw@lancasterpollard.com.

Ali Tierney is an associate in the M&A group for Lancaster Pollard in Columbus. She may be reached at atierney@lancasterpollard.com.