

Health Care REITs

Senior Housing Stocks Have Tanked – Should REITs Feel Some Pain?

July 28, 2008 ■ DJIA 11,131 ■ RMZ 814

HIGHLIGHTS:

Overview: Health care REITs have been star performers over the past year, delivering an average total return during that time that exceeded the RMS by a stunning 3,200 basis points. The primary reason is that health care real estate is aptly viewed to be defensive in times of economic slowdowns. In sharp contrast, the stock prices of the senior housing operators have been pummeled as the weakened economy and troubled housing market have raised concerns about the operating fundamentals in the sector. The enormous total return divergence is noteworthy because 45% of the real estate owned by the health care REITs is comprised of senior housing.

Concentrated Tenant Exposure: The two biggest senior housing operators, Brookdale Senior Living (BKD) and Sunrise Senior Living (SRZ), manage and/or lease properties that generate 25% of total health care REIT net operating income (NOI). The stocks of these two large operators have both fallen by more than 50% over the past year, which has caused a material decline in their equity foundations.

SRZ's and BKD's Challenges: BKD's woes are magnified by a mix of properties that is vulnerable to the housing slump, a high percentage of fixed costs, and a leveraged balance sheet. SRZ's stock decline stems from its uncertain future as a corporate entity and a marked slow-down in its development machine. The company is in the midst of a major accounting restatement, it replaced its founder/CEO in recent weeks, and the Board has been assessing "strategic alternatives" for many months. The future of these two companies has important implications for the health care REITs.

Protection for the Health Care REITs: Several factors suggest that the health care REITs may be well-protected, even if the fears being expressed by Wall St. about BKD and SRZ prove to be well-founded. First, overall property operating performance remains decent, and cash flow coverage ratios provide a downside cushion. Second, the long-term, triple-net leases of most senior housing assets owned by the REITs insulate them from short-term fluctuations in operating performance. Third, the master-lease structure that covers a majority of the health care REIT properties protect REITs by preventing tenants from walking away from weaker assets without putting the leases on the stronger assets into default as well.

Ventas (VTR) Affected Disproportionately: VTR has the largest exposure to SRZ and BKD. Properties managed by or leased to these two operators generate nearly 40% of VTR's total NOI. Moreover, VTR owns its SRZ-managed assets (20% of NOI) in a taxable REIT subsidiary, which contrasts to the triple-net lease structure used for most health care REIT investments. This structure allows VTR to share directly in the property-level NOI of the portfolio. In the near-term, the NOI growth for VTR's SRZ portfolio is likely to fall below what was originally projected when the acquisition was announced in '07. The slower growth has important cap rate implications.

Raising Cap Rates for BKD- and SRZ-Operated Properties: To reflect the additional risks involving BKD and SRZ, the nominal cap rates used to value the senior housing portfolios leased to, or managed by, these operators have been raised 25 basis points, or roughly 4%. This cap rate increase is in addition to the roughly 60 basis point bump previously implemented to reflect broader cap rate trends. The latest change affects VTR and HCP, Inc. (HCP) more, causing a 3% and 2% decline in net asset values, respectively. In contrast, Nationwide Health Properties' (NHP's) and Health Care REIT's (HCN's) net asset values fell only 1%.

Recommendation: After dramatically outperforming other sectors for nearly a year, health care REITs now look relatively pricey. The top two senior housing operators have faced increasing challenges during this same period. "Defensive, yes, but not immune" is a mantra investors should consider given the lofty valuation currently being accorded to the health care sector versus REITs in other property types.

Our company-specific recommendations are:

BUYs:	NHP
HOLDs:	HCP↓, HCN↑
SELLs:	VTR↓, HR

I. Overview

The health care REITs have been the shining stars of the REIT sector over the past year. The companies in our coverage universe have outperformed the RMS by a stunning 3,200 basis points during that time. The primary reason is that health care real estate is viewed to be defensive, since demand is generally driven by demographic trends (i.e. the aging U.S. population) rather than the current state of economy. As the drumbeat of negative economic news has grown louder over the past three quarters, health care REITs have become a safe haven compared to other property types that are more economically sensitive.

While the health care REITs have been knocking the cover off the return ball, the stock prices of the publicly traded senior housing operators have been pummeled. The weakened economy and troubled housing market have raised concerns regarding occupancy and revenue trends in the senior housing sector. The enormous divergence between the REIT returns versus the senior housing stocks is noteworthy because 45% of the real estate owned by the health care REITs is comprised of senior

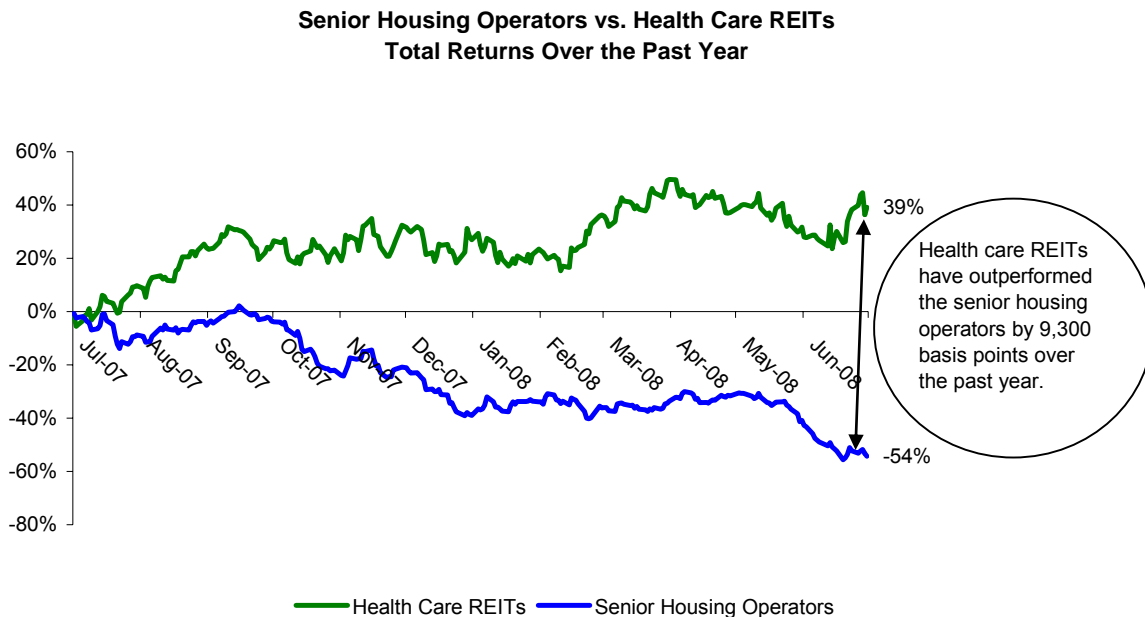
housing. In addition, 25% of total health care REIT NOI is generated from properties leased to and/or managed by the two biggest senior housing operators – Brookdale Senior Living (BKD) and Sunrise Senior Living (SRZ), whose stocks have both fallen by more than 50% over the past year. The eroding equity foundations of these public companies have important value considerations for the substantial amount of REIT-owned properties operated by the two senior housing industry leaders.

II. Who is Brookdale?

BKD is the second largest senior housing operator with over 50,000 senior housing units located in 35 states, with concentrations in Florida (17%), Texas (12%), and North Carolina (8%). The company has a strong operating platform and is led by an experienced management team. BKD is 60% owned by Fortress (FIG), which is a publicly-traded private-equity firm that took the operator public in '05. The company views itself as a service-intensive operator that also has a strong real estate component. Consequently, BKD owns much more of its real estate than the typical health care operator.

Exhibit 1

The stock prices for senior housing operators have fallen dramatically over the last year, which has led to a much smaller equity cushion protecting real estate owners from tenant default. In contrast, the health care REITs are up by a huge amount over the year. The wide divergence is especially hard to understand given the substantial real estate position held by some operators and the operating investment in SRZ-managed properties made by VTR.



¹All data market cap weighted. REIT average only includes those REITs with substantial senior housing investments (HCN, HCP, NHP, and VTR).

²Includes BKD, SRZ, Emeritus Corporation (ESC), and Capital Senior Living (CSU).

Source: Bloomberg July 25, 2008.

Leases with BKD account for 12% of aggregate NOI of the health care REITs in our coverage universe. Over 40% of BKD's portfolio consists of assisted living facilities (ALFs), which are properties that offer their residents housekeeping, meals, and assistance with daily living activities such as bathing. The balance is comprised of independent living facilities (ILFs) and continuing care retirement communities (CCRCs). ILFs are apartment complexes for seniors who want some services, but are generally healthy and mobile enough to live on their own. CCRCs feature a combination of ILF, ALF, and skilled nursing facilities (SNF) at a single property.

Over 95% of BKD's revenue comes from private-pay sources, which generally means residents are paying for rent and services from their family's financial resources. Over the last several years, private-pay revenue has been viewed by health care REIT investors more favorably than the government revenue sources (Medicaid and Medicare) that foot much of the bill at health care properties like SNFs and hospitals. The primary reason is that Medicaid and Medicare reimbursements are inconsistent and often politically dictated, and real estate investors have required a substantial yield premium for the uncertainty.

Given the weak condition of the economy and the troubled traditional housing market, it is interesting to question if the current "risk" surrounding private-pay resources, versus the "stability" of the government sponsored programs, has leveled the playing field somewhat. The angst surrounding private-pay capacity – e.g. can people sell their homes and afford senior housing – is a key reason why the stocks prices of BKD and its peers have tanked.

III. Who is Sunrise?

Sunrise Senior Living (SRZ) is the largest senior housing operator with a resident capacity of nearly 54,000 across 39 states and three countries. The U.S. portfolio is concentrated in California (12%), Florida (11%), and Virginia (6%). Properties leased to, or managed by, SRZ generate 13% of health care REIT NOI. SRZ's operating strategy has involved an operator/developer model whereby SRZ has built properties, sold most or all of the property upon completion, and taken back 30-year management contracts. SRZ's segment breakdown is roughly 75% ALF, 20% ILF, and 5% SNF. Most of the properties it has built are of particularly high quality and command some of the highest rents in the senior housing industry.

Like BKD, SRZ is a top-notch operator, but it faces a mountain of challenges at the corporate level. The company is in the midst of a major accounting restatement, it replaced its founder/CEO in recent weeks, and its Board has been assessing "strategic alternatives" for many months (See Green Street Advisors' recent reports on SRZ: [Sunrise Speaks Again](#) and [All Eyes on Sunrise](#)). The corporate distractions have raised the legitimate question as to whether SRZ has taken its eye off the operating ball. The operator has a reputation for being very good at generating top-line revenue growth, which often has a positive impact on its management fees. It has been less effective at keeping a lid on expense growth.

SRZ's internal problems, softening demand for senior housing, and the credit crunch have significantly slowed the SRZ development machine. Given the importance of the development gains and related management contracts to SRZ's earnings and cash flow, the fate of the company as an independent entity is unclear. To the extent SRZ is sold or broken into pieces (real estate, development, and operations), the ramifications for the health care REITs could be material.

IV. Triple-Net Leases vs. Direct Ownership

Most of the senior housing assets owned by the health care REITs are leased to operators under long-term, triple-net leases. Historically, the U.S. REIT legislation has generally prohibited health care REITs from operating the properties they own, which is why this lease structure is so prevalent. The structure insulates the REITs from short-term fluctuations in the operating performance of individual properties. While occupancy changes, rent increases/decreases, and expense growth directly affect the bottom line for the operators, the triple-net leases provide a steady rent stream to the REIT landlord as long as the operator remains solvent. The leases typically have annual rent escalations in the 2-3% range, yet cash flow growth at the property level can often grow more quickly. That upside is captured primarily by the operator. The trade-off for the REITs is that the tenant also bears most of the operating downside. The triple-net leases of the health care REITs give their portfolios a bond-like characteristic, which is an important contributor to the defensive perception of the sector.

In '07, Ventas (VTR) bought a \$2 billion portfolio of high-end ALFs. Unlike the typical triple-net arrange-

Exhibit 2

The senior housing sector comprises a large portion of the real estate portfolios owned by four of the five health care REITs in our coverage universe

Senior Housing as a % of Current Real Estate Value	
VTR	61%
NHP	53%
HCN	43%
HCP	39%
Weighted Average	45%

A large portion of these assets are either leased to, or managed by, the two biggest operators in the senior housing sector – Brookdale Senior Living (BKD) and Sunrise Senior Living (SRZ).

	% of '08 NOI		
	BKD	SRZ	SRZ and BKD Combined
VTR	20%	19%	39%
HCP	7%	19%	26%
NHP	16%	0%	16%
HCN	9%	0%	9%
Weighted Average	12%	13%	25%

The stock prices for both companies have plummeted due to rising concerns about the impact the traditional housing-market woes and slowing economy will have on senior housing. The weakened credit quality of these two operators, from the perspective of the health care REITs, suggests the cash flow streams from those properties have become a bit more risky. We have increased the cap rates on those assets by 25 basis points (roughly 4%) as a result.

	Impact of a 25 Basis Point Cap Rate Increase on SRZ/BKD-Operated Assets					
	Revised Senior Housing Cap Rate	New NAV	% Change in NAV	Premium/Discount to		Recommendation
				Warranted Price		
VTR	6.9%	\$34.00	-3%	3%		SELL
HCP	6.6%	\$26.25	-2%	-2%		HOLD
NHP	7.2%	\$27.75	-1%	-7%		BUY
HCN	7.2%	\$38.00	-1%	-2%		HOLD
HR	N/A	\$25.00	0%	9%		SELL

Sources: Company disclosures and Green Street estimates.

ment, the REIT elected to hold the assets in a taxable REIT subsidiary (TRS). This structure allows VTR to share directly in the property-level net operating income of the portfolio, which is managed by SRZ on a fee basis. The portfolio generates 20% of VTR's total NOI, so the growth of this income stream will have a meaningful impact on the REITs overall results. It is too early to assess how VTR will ultimately fare with this portfolio, but it is likely that the '08 performance will fall at the low end of the range outlined by management at the beginning of the year and well below the '08 growth figure cited when the deal was announced. While the long-term NOI growth prospects may ultimately prove to be more robust than the typical triple-net lease, an important cost to that growth is the enhanced volatility the income stream will endure as the senior housing market strengthens and weakens throughout different economic and real estate cycles. The future of SRZ is particularly important to VTR given the operating structure of this large investment.

V. A Slowdown in Senior Housing Fundamentals

A. The Problem

Senior housing operators have experienced ideal conditions over the past few years. The increasing wealth of a growing elderly population, combined with reasonable levels of supply growth, has pushed occupancies, rents, and NOI growth to record levels. Rising home prices have figured prominently in the trend, as profits from home sales have provided the means for seniors to pay the high rents (\$2,500-5,000/month) often commanded by REIT-quality senior housing properties.

Recently, the sagging economy has begun to affect senior housing demand. The extent to which demand will be impacted by the economic and housing turmoil has been loudly debated, with no clear answers currently on the table. Many seniors are hav-

ing difficulty selling their homes and are delaying their moves into senior housing. Others are concerned about the economy and the value of their non-housing-related investments, making them reluctant to shift residences. In some areas hardest hit by the economic downturn, unemployment has been another factor hurting senior housing demand, since unemployed children of the elderly have increasingly become their primary caregivers.

In Fall '07, we warned that a marked weakening in senior housing may lie ahead, and this concern has come to fruition. Declines in occupancy at the national level have been significant. While the absolute occupancy remains high (91% for ILFs and 90% for ALFs), 1Q08 occupancy rates fell 120-170 basis points year-over-year in the largest markets. The pace of revenue growth has also slowed for ALFs and fallen sharply for ILFs. One of the clearest measures of market conditions is "revenue per available unit" (REVPAU), which considers changes in occupancy and rent in a single figure. Year-over-year REVPAU in 1Q08 grew at 3.9% for ALFs and about 1.4% for ILFs, compared to 6-7% for both segments a year earlier. Some senior housing executives had previously dismissed various warning signs of operating weakness to seasonal factors, including a particularly tough flu season. More recently, the role of the housing market and overall economic conditions has been more readily acknowledged.

B. Where the Pain is Worst

ILFs have been the senior housing segment where operating fundamentals have slowed down the most, particularly in markets where the traditional housing market has fallen the hardest. The decision to move into an ILF is a lifestyle choice, not a medical necessity. Hence, it can easily be postponed. Although most of the largest U.S. markets continue to perform reasonably well, a handful of difficult markets have been getting worse, with Detroit, Las Vegas, and Riverside, CA at the top of the list. All three MSA's are reporting negative absorption and well below-average occupancy rates.

C. Operator Stock Prices Have Been Whacked

Slowing senior housing market conditions have caused operator stocks to plunge, with BKD and SRZ down 65% and 50%, respectively, in the past year. The falling stock prices have shrunk the combined equity base of the two companies from \$6 billion to \$2.5 billion in less than a year. BKD's woes have been magnified by a high percentage of fixed

costs, a leveraged balance sheet, and a mix of properties vulnerable to the housing slump. More than half of its units are ILFs, the niche where prospective residents are most likely to delay their commitment to a senior housing facility as the value of their home and investments shrinks.

SRZ's stock decline stems from its uncertain future as a corporate entity and its focus on development at a time when the economics of new construction are changing. SRZ's ALF concentration focuses it on a frail segment of the elderly population, which makes it less vulnerable to economic and housing conditions. Nevertheless, it too is feeling the pinch.

D. Protection for Health Care REITs

Several factors suggest that the health care REITs may be well protected, even if the fears being expressed by Wall St. about BKD and SRZ prove to be well-founded. First, overall property operating performance remains decent, and cash flow coverage ratios provide a downside cushion. Property-level cash flow coverage (as measured by EBITDAR after management fee divided by rent) is still 1.25X on average for health care REIT properties leased to BKD. A sensitivity analysis reveals that occupancy would have to drop 800 basis points before BKD's facility-level cash flow dropped below its aggregate rent payment. The coverage on SRZ leases is lower, however. HCP reports cash flow coverage of 1.07X. Occupancy or rent declines of about 300 basis points would result in cash flow levels that fall short of the total rent obligation.

A second cause for comfort is the master-lease structure covering a majority of the health care REIT properties. Master leases protect REITs from struggling operators by tying together bundles of properties under a single lease. The structure prevents tenants from walking away from weaker assets without putting the leases on the stronger assets into default as well. Operators would need to have negative cash flow on an entire group of properties subject to a master lease before default becomes a viable option. VTR vividly demonstrated the benefit of the master lease vehicle in July '07. It sold \$172 million of properties subject to a master lease back to the tenant, Kindred Healthcare (KND). KND immediately announced plans to resell the same portfolio for just \$80-90 million, which reflected the true market value of the properties. The sizable financial hit that KND was willing to endure represented the cost of extricating itself from properties that would have created an even larger financial hit had KND

stayed on as the tenant. For VTR, the master lease proved quite valuable, allowing the REIT to achieve a way-above-market price while improving the overall quality of its portfolio. ([See Ventas \(VTR\): The Financial Power of the Master Lease](#)).

Finally, BKD's sizable real estate holdings, plus the "deep pocket" lurking in the background in the form of Fortress, should provide some additional comfort. BKD owns over \$3 billion of high-quality senior housing properties. After adjusting for secured debt, BKD could raise about \$1 billion of net proceeds if it chose to execute sale-leaseback transactions on these assets. While the Fortress stake provides implicit support, the extent to which it would backstop BKD in the event of distress is uncertain. Fortress has seen its own share price plunge 51% over the past year.

VI. Raising Cap Rates for BKD- and SRZ-Operated Properties

One of the benefits of being a real estate owner with triple-net leases is that tenants take the first hit should occupancy or profits fall. However, in the event of default, the property owner is saddled with the cost of re-leasing the property and the possibility that the replacement rent will be lower than was paid by the prior tenant. In the case of BKD and SRZ, financial strength, as measured by the market value of their equity, has shrunk considerably. This serves as a warning signal that the underlying credit quality of those tenants has diminished. Triple-net lease investments have a bond-like quality. When the credit quality of the "issuer" (i.e. the tenant) erodes, the value of the bond should decrease. This concept suggests that cap rates (i.e. the bond yield) for the health care REIT properties leased by the two operators have risen, and values have fallen.

In the case of VTR's direct ownership investment in SRZ-operated properties, the risks to the cash flow stream have increased as well. The NOI from these properties will likely grow more slowly in the near-term than was originally projected, and the slower growth has important cap rate implications. VTR reported a 5.75% initial cap rate when it acquired the portfolio, and it justified the relatively low initial yield because of the outsized NOI growth expected in '08 and beyond. That pace of growth now looks unlikely in the current environment, and the uncertainty regarding SRZ corporate future has grown as well.

To reflect the additional risks involving BKD and SRZ, the nominal cap rates used to value the senior housing portfolios leased to, or managed by, these operators has been raised 25 basis points, or roughly 4%. The cap rate change causes an average 2% decline in net asset values for the health care REITs.

VII. Recommendation

After dramatically outperforming other sectors for nearly a year, health care REITs now look relatively pricey. ([See Health Care REITs: June '08 Update](#)). The top two senior housing operators have faced increasing challenges during this same period. Since BKD and SRZ are important tenants/operators for four out of five health care REITs that we cover, they warrant a prominent position on investors' radar screens.

The defensive reputation enjoyed by the health care REITs is well-founded. That said, the types of properties in which they invest is evolving, and some segments, such as senior housing, are not completely detached from economic risk. In addition, the investment structure employed by VTR in its SRZ-managed portfolio entails greater potential rewards, albeit with greater risks as well. "Defensive, yes, but not immune" is a mantra investors should consider given the lofty valuation currently being accorded to the health care sector versus REITs in other property types.

Our company-specific recommendations are:

BUYs:	NHP
HOLDs:	HCP↓, HCN↑
SELLs:	VTR↓, HR

Jim Sullivan
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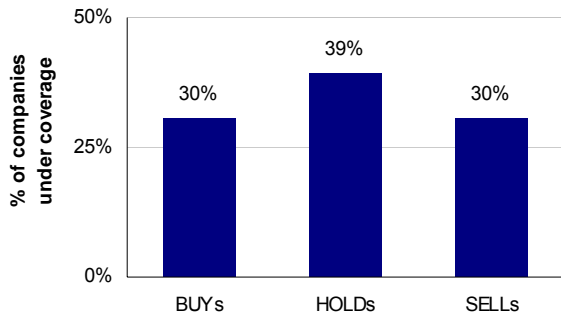
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(as of 7/1/08)**



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Total Return of Green Street's Recommendations

Year	Buy	Hold	Sell	NAREIT Eqty ⁴
2008 YTD ³	3.0%	1.4%	-6.7%	-3.6%
2007	-6.5%	-22.3%	-27.6%	-15.7%
2006	45.4%	29.9%	18.4%	35.1%
2005	26.3%	18.3%	-1.9%	12.2%
2004	42.3%	28.4%	15.6%	31.6%
2003	42.7%	37.2%	20.9%	37.1%
2002	17.7%	2.6%	1.9%	3.8%
2001	35.7%	19.1%	11.9%	13.9%
2000	53.6%	29.3%	4.4%	26.4%
1999	14.2%	-9.2%	-20.2%	-4.6%
1998	-0.6%	-15.1%	-16.4%	-17.5%
1997	37.1%	14.2%	5.8%	20.3%
1996	47.3%	30.2%	17.5%	35.3%
1995	23.6%	14.3%	-0.4%	15.3%
1994	20.5%	-0.7%	-9.3%	3.2%
1993 ³	29.4%	5.4%	6.7%	12.4%
Total Return³	3788.4%	361.6%	4.2%	468.4%
Annualized	26.8%	10.4%	0.3%	11.9%

1) Historical results through January 3, 2005 were independently verified by Ernst & Young, LLP. E&Y did not verify stated results subsequent to January 3, 2005. Past performance results cannot be used to predict future performance. For a complete explanation of study, see 5/9/03 report "How are We Doing?".

2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly", pg. 13-16. Beginning with May 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, are not included in the primary exhibit and therefore not included in the calculation of total return. Beginning with March 2003, all Hotel companies are excluded.

3) Study uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 29, 1993 through July 1, 2008.

4) Not directly comparable to Green Street's performance indices because NAREIT includes more companies and uses market-cap weightings. Green Street's returns are equally-weighted averages.