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Brookdale (BKD Results- More Bad News for Welltower (WELL)

Brookdale Senior Living (BKD) reported results this week. They are a tenant of Welltower (WELL), which we follow more closely and have a negative view. In general, we are negative on this industry as the demographic tailwind doesn't arrive for 10-years and the supply is already here and getting larger. There were several interesting comments from Brookdale's President/CEO Cindy Baier and CFO Steve Swain that relates to trends impacting Welltower and we wanted to point them out.

- Occupancy remains weak at Brookdale too. This problem exists throughout the senior housing industry and new supply continues to come online.

- Brookdale saw significant pressure on move-in rents in 2017 and it is trying hold back on discounting now. Will new supply that is half-full match that approach? Also, never forget churn is over 30% in this industry – a huge number of new residents are needed annually to maintain occupancy.

- Margins are being squeezed at Brookdale due to higher labor costs. That is expected to continue given the tight labor market and their same-store results show that these higher costs are having a larger negative impact on earnings. If occupancy remains under pressure – we think Brookdale lays out the model for lower margins very well that could impact others in this industry.

- Brookdale has new shared cost/shared investment arrangements with Welltower after restructuring many leases. They see their properties in need of some repair and upgrades and expect Welltower to pay for part of that. As we noted last week, this is more reason to deduct maintenance capital spending from Welltower's FFO figure for a more accurate view of the business with these new types of operating arrangements.

Occupancy Remains an Achilles Heel at Brookdale Too:

Brookdale has been fighting weak occupancy for years just like Welltower. We have talked about how the demographics of the Baby Boomers do not point to the oldest ones reaching the typical age of entering a senior living home until 2028. That's a demand problem. Brookdale was commenting about the overbuilt supply side of the equation.

> Cindy Baier:
> "*For 2019, we expect the competitive landscape will continue to be difficult, but there are early indications for improvement.* ***As previously reported by NIC, construction as a percentage of senior housing inventory remains near historical highs, yet it is starting to abate.*** *The number of starts and opens has been and continues to be on a downward trend this year. Through our custom data analysis, we determined that new openings are taking longer to fill up or stabilize. This may put additional pressure on underwriting future new construction. While the slower fill-up may put some pressure on rates, we have not seen widespread discounting.* ***Our current view is the supply headwinds will persist for the vast majority of 2019 before improvement."***
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> Answering a question, Cindy Baier added:
> "*Mary, we as well as the industry have been studying the competitive market pretty intensely.* ***I think virtually everyone sees a lot of new supply being delivered in 2019 and that supply delivery will add growth in 2019. So, when we look at that, we basically say we're going to be in a very difficult headwind."***
> Steve Swain discussed this more in results, **"*The third quarter 2018 same-community weighted average occupancy was 84.5%, a decline of 90 basis points compared to the prior year. This decline is essentially the same as NIC industry year-over-year averages.***
> ***The good news is that even with that rate discipline, we delivered a 20 basis point sequential improvement in the second quarter 2018."***

Low Occupancy Has Pressured Move-In Rents

We have talked in the past that the average resident stays in Senior Housing about 30-36 months on average. Most are unlikely to move if the rent is raised a little as that involves effort by the resident and family. Plus, they may only get 1 or 2 increases during their stay.

Thus, the way to control pricing is on the negotiated fees when the resident first moves in. Also, with the amount of churn, failing to replace a resident has a much larger income impact than replacing him with a person paying less. So that is the pressure in the market as the supply continues to grow and operators look to replace churn, boost occupancy, and fill new supply.

Last year, Brookdale was slashing move-in rates to try to maintain occupancy. Now it is trying not to discount to add new residents but is noting that it still isn't as strong even against easy comps:

Cindy Brier commenting on slower conversions of leads to move-ins for 3Q18:

> "*The lower year-over-year move-ins were also due to a tough comparison since we drove occupancy through deeper discounts in the third quarter 2017. I previously referenced the negative 6% mark-to-market that occurred in the third quarter 2017. We've made significant strides to enhance our price discipline over the past year. And for the third quarter 2018, mark-to-market was within 1% of our existing residents' rate, controllable move outs improved 4% on a year-over-year basis. This was the third consecutive quarter that we saw a significant improvement.*"

Keep in mind four things here:

1) The people moving in last year, are probably now 30% of the occupancy and they paid lower rents when moving in and replaced other residents that may have rolled off from a higher rent figure.

2) The improvement in new pricing this year sounds it still is at or below existing residents and the large group on a discount from 2017 would have lowered the average rent of existing residents.

3) A big part of helping the quarter was preventing additional move-outs. That is commendable, but those elderly people will still eventually churn in the future.

4) Brookdale boosted occupancy in 3Q and 4Q17 with the discounts. That gave them less panic to make cheap deals in 2018. However, as those 2017 residents churn, will Brookdale be able to maintain flat pricing power and risk greater drops in occupancy?

Labor Costs Are Rising and Are Squeezing Margins at Brookdale:

Brookdale is trying to retain staff and salespeople more and is investing in additional people. This plan for growth is expected to last 3-years through 2020. As we have been saying with Welltower, one of the problems with this business is a high fixed cost for operating expenses combined with a variable revenue stream tied to occupancy that is under pressure. Now the operating costs are rising at the same time. The result is deleveraging of the operating model:

> Cindy Baier:
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> "*Regarding community labor costs, I previously mentioned the 2018 was the second of a three year investment plan to bring our product line associates up to our goal threshold.* ***Our 2018 labor cost growth compared to 2017 is expected to commence lately lower than 5.5% which was the low end of our previous range. The labor market continues to be tight and we expect our labor investments will continue into 2019."***
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> Steve Swain:
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> "O*ur third quarter 2018 consolidated same community operating expenses increased 4.5% compared to prior year quarter.* ***Same community total compensation increased 5.5% for the third quarter and 5.1% year-to-date compared to the prior year periods. This reflects a wage pressure due to a tight labor market plus our intentional above industry investments in key resident facing associate salaries along with more robust benefits to improve our ability to recruit and retain the best associates in the industry.***
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> ***With increased investments and compensation and because facility operating expense does not scale perfectly with lower occupancy, our community operating expense increased faster than our revenue growth, leading to a same community operating income decline of 8.2% compared to the third quarter 2017."***

The last paragraph is a key point in our view. Remember, that is with and 84.5% occupancy rate and this business cannot absorb wage increases. The plan for Welltower and others going forward is to partner in shared-cost/shared-revenue structures on lower occupancy units. Most of what we see from this industry points to higher wages and pressure on occupancy continuing. We would not expect many of these new shared-deals to show meaningful results for some time.

Brookdale Expects More Capital Spending Will Be Needed and Help from Partners

Brookdale has been terminating lease deals with Welltower and Ventas over the last year and restructuring other financial deals on other properties. Brookdale noted its leased portfolio is now down 22% since 3Q17. In this year, they terminated more leases with HCP and two more with Welltower.

We talked last week how Welltower's results need to include higher capital spending to be apples-to-apples in comparing results year to year. Welltower has touted the higher FFO (Funds from Operations) as a result of having many fixed rent triple-net lease deals like the ones with Brookdale convert to the RIDEA structure where both parties share costs. Also, we believed that many triple-net properties that were in trouble probably did not get the full amount of maintenance spending by the tenant. As those deals become RIDEA instead of triple-net leases – suddenly Welltower has to pay more of the costs of operation and capital spending. Brookdale could not have said it any more clearly on their 3Q18 conference call:

> Cindy Baier:
> *"The final significant part of our 2019 outlook is related to CapEx. As previously mentioned, I initiated a review of our community CapEx needs immediately after I became CEO. The team recently completed this discipline, bottoms up review* ***for our 700 plus community consolidated portfolio with a focus on ensuring that our communities are in appropriate physical condition to support our turnaround strategy. As part of the review, we also determined what additional investments are needed to protect the value of our portfolio. As a result of that review and based on our preliminary 2019, we now anticipate additional near-term investment in our communities including for 2019 increased spend on our community level CapEx primarily attributable to major building infrastructure projects.***
> ***We expect the portion of this increased CapEx will be reimbursed by our REIT partners.*** *And net of such reimbursement* ***we currently anticipate that our non-development CapEx for 2019 to be up to $75 million*** *higher than our 2018 spend."*
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> Steve Swain:
> ***"In addition, following the quarter end, Brookdale and Welltower agreed to renew the Sallie master lease for the next 8 years. This mutually beneficial agreement results***

> ***in a greater alignment of interests. For example, Welltower will fund the pool of first dollar capital investments which will improve our near-term cash flow."***

Thus, Welltower is expected to spend money to improve Brookdale's cash flow and enhance the deal. Investors need to be subtracting investments to existing properties as capital spending from Welltower's FFO. Doing that shows that Welltower's valuation multiple rises and its growth becomes flat to negative.

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