Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

November 1, 2018
www.btnresearch.com

Welltower (WELL)- 3Q18 Update

As the company reported 3Q earnings, the WSJ ran an article on October 30 that highlighted the macro-problem Welltower has been experiencing. Supply continues to rise to meet the needs of aging baby-boomers. However, most people do not move in until they reach at least 82-years old, and the oldest baby-boomers don't hit that age until 2028. In the meantime, occupancy rates remain near historic lows, people find other ways to live with/near family members, and rents are appearing too high for many seniors.

WELL beat FFO forecasts by 2-cents per share, but came in 4-cents below last year. It raised guidance for 2018 from $3.99-$4.06 to $4.02-$4.07. We are not impressed. The company is moving more of its triple-net lease units into RIDEA structures and the Seniors Housing division. Triple-net involves much less risk to WELL as the operator pays all the operating costs and repairs/maintenance. Under the RIDEA structure, WELL gets paid a larger percentage of revenue but is responsible for the operating costs which nets down to an income figure used to calculate FFO. However, FFO does NOT subtract capital spending. So, there is an apples-to-oranges comparison going on here. Adjusting for that, investors are paying nearly 20x cash flow for almost zero growth and a flat dividend.

WELL is moving units from the lower margin Triple-Net Lease unit to higher-margin Seniors Housing. That alone should be boosting FFO rapidly and it's not. However, if we adjust for the fact that WELL is also now paying more in capital spending, Free FFO (think of this as free cash flow) is not growing much. FFO for the 9 months ending September 2018 rose 4-cents, Free FFO rose by only 1-cent. Even worse, for the 3 months ended September 2018, FFO fell by 4-cents and the company cut capital spending so that Free FFO fell only 2-cents per share. That FFO is not increasing faster is a red flag for us.

- Moving Units to Seniors Housing is crushing income growth in that division. That is evidence that the units being added are troubled properties.

- FFO is not a good measure anymore. WELL is now responsible for capital spending at existing properties as a result of converting properties away from Triple-Net.

- Occupancies remain weak at all divisions.

- Strong properties do not convert away from Triple-Net. WELL pointing out improvements in Triple-Net after culling 25% of the properties does not impress us as they concentrate the good tenants in recent results.

Seniors Housing Income Growth Is Falling Rapidly

For several quarters, WELL has been restructuring the portfolio. Triple net lease properties have been declining as the company sells assets to unconsolidated entities, third parties, or changes their structure and moves them into the Seniors Housing unit.

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Triple-Net Units	341	404	405	426	422	432
Seniors Housing Units	587	518	514	504	501	488

The company is focusing investors on Funds from Operation – FFO. FFO is essentially net income plus depreciation and adjustments for any one-time items such as gains, losses, impairments. In the case of Triple Net leases, WELL has a stable rent income with essentially no operating costs. The customer covers all maintenance, taxes, insurance, and operating costs. In Seniors Housing, WELL takes on more exposure to these costs and the payments received are tied to the profitability of the property. In the case of a RIDEA structure, WELL takes on more exposure to the costs and the actual underlying economics of the property and it has more direct control in the situation. In non-RIDEA, WELL hires a third party to be the sole operator.

Because there are fewer capital payments owed by WELL and the operator assumes 100% of the operating risk, Triple Net income is lower than Seniors Housing Income.

($ 000's)	3Q18	3Q17
Profit/Triple Net Unit	$312.6	$330.6
Profit/Seniors Unit	$478.0	$467.9

This is simply the same-store operating income for each unit divided by the number of units for 3Q18 and 3Q17. As operating income goes, WELL makes $140,000-$160,000 more per unit with Seniors Housing than a Triple-Net unit. There are other variables to this such as number of beds, location, and age of each unit. The composition of the portfolio changes too, so don't treat the difference in reported income as something easily extrapolated over time. We just wanted to show that income is higher by design at Seniors vs. Triple-Net. However, the basic fact is because more risks are assumed, the operating profit for Seniors Housing should be lumpier but should also be higher than Triple-Net leasing as there are more capital costs involved.

We're supposed to cheer that FFO is barely rising 1.5% (4-cents) over the last 9-months and it actually fell by 4-cents in the 3Q18? The company has cut the lower profit Triple-Net portfolio by 81 units and grew the higher profit Seniors unit by 86 units in the last year. Shouldn't FFO be exploding upwards given that the higher income unit is growing? Instead Same-Store Operating Income growth at Seniors Housing is vanishing:

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
SSS NOI growth	0.3%	0.1%	0.6%	1.5%	4.1%	3.5%
Units in SSS	470	435	461	441	423	422

As the unit has grown and the early transfers started to show up in the same-store y/y comps – the income growth figure has collapsed. Don't forget the table above, there are 587 units in Seniors now, only 470 were in the comp in 3Q so this has a long way to go before it fully reflects the situation in our view.

Investors Need to Subtract Maintenance Spending from FFO

When WELL was essentially all Triple-Net leasing, FFO was a reasonable metric to use in reviewing results. The tenant was responsible for all the repairs, improvements, and maintenance spending. So FFO per unit was lower, but there wasn't capital spending.

Now that WELL is doing so much more in Seniors Housing, it is responsible for more capital spending needs. We would expect to see the spending increase as well.

($ 000's)	3Q18	2Q18	1Q18	3Q17	2Q17	1Q17
FFO	285.3	378.7	353.2	295.7	384.4	306.2
Maint Cap Ex	62.3	64.8	46.5	66.0	51.0	42.1
Net FFO	223.0	313.9	306.7	229.7	333.4	264.1
FFO/Share	$0.76	$1.02	$0.95	$0.80	$1.04	$0.84
Net/FFO/Share	$0.60	$0.84	$0.82	$0.62	$0.91	$0.72

Not only is FFO declining for the last two quarters, but capital spending looks very low given that the number of units in Seniors has been rising. Also, the age of the units has been increasing and now averages 17 years. Let's also remember what some of these units are. WELL restructured leases with the tenant and then converted the structure. That happened because the tenant was in financial trouble and the lease was onerous. Quick question, "Do you think that tenant was doing all the maintenance spending needed in recent years?"

We think FFO will continue to be pressured by income weakness at the Seniors division where 20% of the units are still not part of the comp. We also believe capital spending will need to rise at those units, which reduces net FFO and gives a more apples-to-apples comparison or results now with those in the past.

Even with the reduced capital spending – the company is likely trading at about 19.5x Net FFO instead of 16.5x reported FFO.

Occupancy Continues to Weaken

As we have been writing in our discussions of Welltower and the WSJ article we linked to at the top of this update, occupancies are not rising for Senior Housing. This is the result of too much supply and fewer people moving in. We still think the other problem is the average stay is very short – under three years. With that much churn, Welltower properties have to sign up a huge number of new residents just to post flat results.

We agree with the WSJ sources that this is a problem for the next decade not a quarter or two – there is too much supply. Welltower's occupancies continue to show this as well:

Occupancy	3Q18	2Q18	1Q18	4Q17	4Q16	4Q15
Senior Triple-Net	86.2%	86.2%	987.7%	87.6%	89.2%	89.0%
Seniors Housing	88.2%	87.6%	87.6%	88.4%	90.7%	91.6%
LT Post-Acute	81.4%	82.7%	82.6%	82.4%	81.5%	85.7%
Out Patient	93.4%	93.6%	94.0%	93.8%	95.0%	95.1%

This is why WELL restructured leases and traded properties around. The story remains that there are lease escalators built in to provide growth, but as we've been pointing out – many of these contracts have had rents cut or waived by WELL, reset at lower levels and then set to increase again.

Welltower Touts Improvement in Triple-Net

Triple-NET SSS	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Op. Income Growth	4.2%	3.1%	3.0%	2.8%	3.0%	3.0%
Number Units	290	305	349	344	368	389

The company wants to say that the Triple-Net business has turned around. We completely disagree. It has culled out problem units and concentrated results around the remaining ones. The number of units is down 25% in how they measure same-store growth. The problem cases have been moved to the Seniors unit as described above.

Operating a senior living home involves rent, utilities, food, labor, taxes, insurance, etc. Many of those are largely fixed costs and do not change much based on having 200 residents or 250. However, the costs also do not change much if only 150 residents are there. However, revenue is a variable item dependent on the number of people living in the place. Thus, the marginal residents determine whether the business is viable or not.

If your place is full, you are making solid profits. There is no reason to cut WELL in on that deal. You're more than happy to pay them their low fixed rent with a 2% escalator and assume the risk of other costs. If your place has lots of empty rooms, and you need to modernize the place to attract more residents, you likely already cannot pay all your bills including rent. You're more than happy to restructure the deal and let WELL share the operating risks, pay some of the bills, lower the rent, and share any potential upside if the property occupancy improves in a big way.

That is why the Triple-Net growth looks better – the operators left are making money. But, Triple-Net is a much smaller part of the Welltower operation. If the operators were losing money and needed a partner with capital – they would be moving to a new deal. It is important to remember that many of the operators that are being replaced or taking new RIDEA deals like this are not inexperienced. Many have decades of experience operating dozens or even hundreds of properties. They are just running into a glut of oversupply in the industry.

Considering the overall change in Seniors Housing, capital spending, and Triple-Net in total – we are not convinced WELL's result results are that strong.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
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2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

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