BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

February 14, 2019 | www.btnresearch.com

Welltower (WELL)- 4Q18 Update

We maintain our SELL recommendation on WELL as it missed forecasts for FFO (Funds From Operations by 2-cents in the 4Q). We continue to believe this industry remains in trouble as Healthcare Services Group wrote off more bad debts last week and Brookdale Senior Living missed forecasts today.

WELL continues to not subtract capital spending from FFO, which we consider a problem as it is now responsible for a growing share of bills. This trend continues as more properties are converted to an operating partnership instead of triple net leases. To use a car analogy, Welltower has effectively gone from being paid 15-cents per mile to drive a car and turning the gas and maintenance bills over to a third party to now being paid 25-cents per mile and paying for its own gas and maintenance. Welltower is touting the increase in FFO from the higher 25-cent/mile revenue arrangement and leaving out some hefty and cash outflows from the equation.

Guidance assumes a modest 2%-5% FFO growth after a year in which FFO fell by 4.3%. The outlook also appears to use a smaller capital spending figure. We need to spend more time with this company and wait to see the 10-K report for some added figures. Also, we need to review Brookdale's news in more detail too and will follow up on this industry. It currently looks like a company projecting minor growth trading for over 20x 2019's net FFO with a flat dividend.

We will update this group and Welltower in particular more fully with the 10-K and a more reading on recent competitors and customers:

- FFO adjusted for capital spending does not give much comfort for the dividend or the valuation of the stock. The company has not earned its $331 million quarterly dividend in 3 of the last 8 quarters on a gross basis. Adjusting for capital spending,

it may have earned the dividend only twice in 8 quarters. The company's operating model has changed – the way results are viewed needs to change too.

- Again – Where is the growth? Looking at the Senior Housing margins, the profit per unit, and cap rates, not much is pointing up here. Easy comps will soon lap other units.

The Mysteries of Funds From Operation

We have addressed this in the past, but WELL has transitioned from being essentially a triple-net lease company with no funding costs related to the management, maintenance, taxes, etc. of the property. In that case, looking at Funds from Operation is valid as it is essentially gross cash flow with no further capital outlays. The problem is Welltower is still telling investors to focus on gross cash flow – but it is now responsible for many of those operating costs and investments it was able to ignore in the past. Moreover, the gross cash flow increases because it is assuming more risk and operating expenses. So, investors, should wonder why the changes in the portfolio haven't led to FFO rising rapidly?

We showed this after the 3Q results. Profit per same store unit was $474,000 for 4Q18 in the Senior Housing Operating division while for Triple Net Leasing it was $310,000.

Units	4Q18	4Q17	4Q16	4Q15
Sr Housing	568	509	472	431
Triple-Net	361	426	400	446

WELL is expanding the more profitable area by converting lower profit units from Triple-Net to Senior Housing and the cash flow is falling? The company did dispose of a division two years ago and has pared back in other areas too. But, if the profits are growing and the Senior Housing model is a better way to go – why isn't FFO rising already? Instead, FFO was $4.21 in 2017 and $4.03 in 2018 and guided to be $4.10-$4.25 in 2019.

What is more astounding is WELL is responsible for capital spending at the growing Senior Housing unit with much of this recurring -- yet it is not being subtracted from FFO. **Investors are still using the older presentation model even though the core business has changed.**

Here is one area where we need the 10-K. The company breaks down capital spending on the cash flow statement into four items: acquisitions, capital improvements to existing properties, construction, and capitalized interest. WELL does not release its cash flow statement with the press release. We use the capital improvement to existing properties as the proxy for annual spending and it has been running about 12-15 cents per quarter:

($ 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

Here's what we know for 4Q18 vs. 4Q17: FFO was essentially flat $382.8 million vs. $380.3 million. In 4Q17, the company spent $91.2 million on capital improvements to existing properties – there appears to be some seasonality where money spent is higher in 4Q and lighter in 1Q. But the $91.2 still looks high.

WELL reports that its maintenance spending was $31.7 million in 4Q18 and $22.4 million in 4Q17. Looking at last year's 10-K that looks too low. **This is important because the company pays a dividend of $0.87 per share per quarter. That is $330.6 million in dividend payments per quarter. Looking at the topline for FFO – the company is already NOT earning its dividend in many quarters.** In 4Q18, the $382.8 million looks adequate at an 86% payout ratio of FFO to the dividend.

However, subtract the capital spending to existing properties – WELL has never generated enough Net FFO to cover its dividend in the last two years. If the spending in the 4Q18 is above $50 million, they likely didn't cover the dividend last quarter either.

Guidance is for FFO per share of $4.10-$4.25 and only $0.33 in capital spending for existing property. We believe maintenance spending is likely to come in closer to $0.60 – which would let WELL cover the dividend, but at essentially a 100% payout.

Senior Housing Is Still Not Showing Growth

If the company is going to hit forecasts of even 2%-5% FFO growth, it likely needs its largest unit to show some gains. Unfortunately, we are seeing margin squeeze especially in compensation.

What we expected to see happen during the transition from triple-net to operating partner is occurring. Last year WELL was renegotiating triple-net leases, cutting rents, moving those properties into off-balance sheet JVs. As the problem children are removed from that division, the division shrinks, and the good performers are concentrated in the comps. WELL then touts the same-store comps as a basis for growth:

Comp NOI Gain	4Q18	3Q18	2Q18	1Q18
Sr Housing	0.6%	0.3%	0.1%	0.6%
Triple-Net	4.3%	4.2%	3.1%	3.0%
Outpatient	1.8%	2.1%	2.0%	2.9%
L-T Acute	1.4%	2.1%	2.3%	2.4%
	1.6%	1.6%	1.4%	1.8%

The hospital and skilled nursing units have also had portfolio changes. Their easy comps have lapped, and the same-store growth rates are dropping. As noted above, WELL dumped a large number of units out of Triple-Net and it wasn't the top performers. That has unleashed strong comps for that division, but that should be tough to maintain much longer. And look, it is the only area driving the overall same store sales figure up. Senior Housing has been squeezed hard in this area despite holding the number of units at 473 in the comps during 2018 despite the total number of properties rising to 568.

There is more revenue coming from Senior Housing than the other areas. That unit saw a minor tick up in occupancy from 4Q17, but occupancies are still down considerably over the last several years. Looking at 4Q18 to 4Q17, we don't see much happening here:

	4Q18	4Q17
Occupancy	87.2%	87.3%
Margins	30.2%	31.9%
NOI total	$251.9	$223.2
# Units	568	509
NOI/Unit	$443.6	$438.6

Margins are being squeezed and the only thing helping Net Operating Income is it appears the new additions were higher revenue properties. Total revenue per property rose 6.7% but net operating income per unit was up only 1.1%.

From a same-store sales comparison, there isn't much growth here at all. Revenues rose 2.7% but compensation was up 5% and consumed much of that. We also noticed that all operating costs increased except curiously – maintenance and repairs.

SSS	4Q18	4Q17
Occupancy	88.3%	87.9%
Margins	31.9%	32.5%
Rev/Unit	$702.0	$683.4
# Units	473	473
NOI/Unit	$223.7	$222.3

A 2.7% revenue gain produced 0.6% income growth.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.