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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Welltower Update (WELL)

Late last week, Welltower (WELL) announced another shake-up with a key customer. This time it's the number two customer - Brookdale Senior Living. We think this points to more problems with the Welltower model. The changes come largely in the triple-net lease area, which is supposed to be the calmest area for producing steady results with escalating leases for WELL. We have already shown that ROI has been falling from 8%-9% to 6%-7% as WELL has moved away from being a 100% triple-net lease company. Moreover, the dividend coverage has dropped from 1.2x to 1.0x.

We see the net result of this deal cutting WELL lease payments more and giving it more exposure to the actual operating results of older properties in an industry that is widely considered overbuilt. We cross-matched properties listed on WELL's 10-K with communities on Brookdale's website. We found 106 triple-net lease properties and 15-Senior Housing deals under the RIDEA structure. Of those totals, we only found 11 triple-net and 5 RIDEA properties that were built in the year 2000 or later (7 of the 16 were built in 2000). How well do these compete against new properties?

Under the deal:

- Brookdale will get early termination on 27 triple-net leases that were supposed to run until 2028 and early termination on 10 triple-net leases that were supposed to run until 2020.
- Brookdale will not renew 11 triple-net leases that mature in September 2018.
- Brookdale will sell its 20% RIDEA investment on 15-Senior Housing deals back to Welltower
- Brookdale can identify other triple-net leases it doesn't want with base rent up to $5 million that it leases from Welltower that Welltower will try to sell and give Brookdale a rent credit of 6.25% from the sales proceeds

- For all of this Brookdale is disposing of at least 63 Welltower properties, paying $58 million to terminate some leases early, receiving $35 million from the sale of the RIDEA interest, and receiving something from other sales proceeds.

If these were competitive properties generating good returns, Brookdale would have wanted to keep them. Instead, it is happy to get rid of them all and Brookdale noted that the 37 triple-net leases being terminated early are producing current negative cash flow and that was projected to continue. Welltower noted that its rent coverage from Brookdale would increase to 1.31x on the remaining properties after pulling out the 48 triple-net leases that are leaving Brookdale. That also highlights the poor returns of these properties.

Also, pointing to weak returns of these assets is Welltower will carry at least 49 of these properties in a RIDEA structure. As a recap, a RIDEA structure essentially means the landlord cuts the rent expense on the property and shares in many of the costs such as maintenance and capital spending. In return, the landlord gets a split of the rising cash flows if the property's results improve.

The operator has no reason to want a RIDEA structure if the property is running at a high occupancy and is in great physical shape. Running senior living property is largely fixed cost with utilities, landscaping, maintenance, staff, and management. If the property is at 90% occupancy, the rent should easily be covered and the business quite profitable. Why share those operating profits with the landlord for lower base rent?

On the other hand, if the occupancy is 50%-60% and the building is old and needs greater investment, you're losing money. Having your rent payment slashed and having WELL as a financial partner to pick up some of the new investments is a great solution. If the new changes do not work, you've cut your cash outflow and limited losses. If they work, you give away part of the upside on a marginal property that probably never had a chance to be stellar.

In this case, Brookdale wants out of both triple-net lease deals and RIDEA. And net overall, it's not paying much to leave – it's receiving $35 million on one sale, some potential sales proceeds on other properties, and paying $58 million to terminate leases up to 10 years in advance that are already losing money.

Welltower will now operate the bulk of this property in a RIDEA structure with new operators. It expects to see a $5 million hit to lease revenue on the 37 leases being restructured after all of this and will post lumpy results based on the performance of the properties and sharing the profits. WELL is reporting the restructured leases (the 37 being terminated early) are running at an occupancy of 83.6% now. If these are currently posting negative cash flow and projected to continue posting negative cash flow at that level of occupancy – then we believe the entry fees at these older properties have been cut to attract an 83.6% occupancy rate. Thus, the plan WELL wants to see happen is occupancy rise and fees to residents increase too. It cites the new management as having a long history of operating in the industry.

We will point out that Brookdale also has decades of experience in this industry and couldn't make it work with these properties. Also, WELL has been moving toward sharing profits more and away from simply collecting escalating rent for years too – with multi-year results that show returns on investment are declining. WELL continues to point out that it still has rents with annual escalators in place on the rest of the portfolio and in particular the remaining Brookdale portfolio. We are going to point respond that this is another in a long series of deals we have discussed where WELL essentially cuts the rent for a large group of properties and then says, "after this we get an automatic increase each year." The fact that Brookdale put itself up for sale after its stock dropped from $37 to $7 and received no bids in what is supposed to be a growing market with a demographic tailwind should illustrate what insiders in this industry think of Brookdale's portfolio, which still contains many WELL properties.

This deal has not solved the wage squeeze hitting many operators in this group, nor does it fix the fact that many of the WELL properties being run by Brookdale are old. Adding more to RIDEA structures makes us believe that less and less of the company is set up for automatic rent increases.

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