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BTN Research

Welltower Inc. (HCN)

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Welltower (HCN) owns senior housing facilities including assisted living, acute care centers, and retirement communities where residents can move among independent living, assisted living, and long-term care. It is widely believed that HCN is a prime beneficiary of the "aging of America" macro-trend. Growth is expected to simply come with the calendar. HCN owns properties in 45 states and has added Canada and the UK. We think investors buying into this growth macro-trend via senior housing may be missing several key points:

- HCN's ROI has been poor and declining despite remaking the business and pruning weaker assets and adding new ones. Dividend coverage is tight and we calculate that it is not out earning its cost of equity capital.
- The company is changing its business mix and will focus more on investments where it participates in the actual returns of the property which will subject it to changes in occupancy and rates paid instead of pure leases.
- Occupancy for senior housing has been poor and discounts are being offered to entice people to move in. The industry must replace its entire base of residents about every 30 months. Move-ins are often tied to the ability to sell homes, but higher interest rates and limits on home-related deductions may hurt housing transactions in key HCN markets.
- HCN's customer base is reporting severe problems as they deal with weak occupancy, lower revenue growth, and rising wages. Margins are under pressure and some of these companies have never reported a profit.
- Genesis (GEN) is one of HCN's largest customers and it has a going concern warning. It has been asking for rent concessions. HCN has given rent relief in exchange for debt in Genesis and HCN has been selling its percentage of ownership down in many Genesis properties.
- Brookdale is another large HCN customer and it is writing down assets and asking for rent relief and restructured partnerships with other landlords it works with. Despite this, HCN wants to increase participation in arrangements where it is exposed to the operating results of tenants.

- Unconsolidated joint ventures (JVs) are a part of HCN's business. We have seen HCN selling assets from Genesis into JV's where it is a partner. HCN has bought businesses and sold them to other JV partners. It recently bought 10% more of a privately-held customer from another customer. The debt levels at the JVs are rising and HCN is looking very much caught up in the restructuring of this industry.

- The industry debt figures are very high. HCN is dealing with companies that report meager to negative cash flow after paying interest and maintenance spending. Debt levels are over 8x EBITDA as margins are being squeezed by costs rising faster than revenues. HCN has debt of 5.5x EBITDA and little cash cushion for its dividend with many wild card issues appearing such as what if a big customer restructures, or what if they sell more ownership percentages to JVs which reduces income as stock count and the hefty dividend remains flat?

Executive Summary:

Welltower's (HCN) dividend growth is already stalling and is now 1.2% vs. 4.2% in 2016. The return on capital has also been falling and that is with debt enjoying declining interest rates. ROI has been only about 6% (using EBITDA less maintenance spending) and falling. Its cost of capital on the dividend is 6.4% now. (Preferred stock is paying 6.5%, unsecured debt 4.3% and secured debt 3.7%) As a REIT, HCN is expected to pay a high dividend, and it carries a considerable debt load of 5.5x EBITDA. That doesn't sound too high for a REIT, but HCN is changing its business model and is constantly selling and buying new properties which effectively repays debt and replaces it with new debt. With rates ticking up, interest costs may rise faster than the debt maturity schedule would make investors believe as ROI could weaken.

The company used to focus only on triple-net leases with its clients. This is the ultimate passive real estate investment where the customer operates the property, covers taxes, insurance, repairs, and capital improvements, and pays HCN rent with an annual escalator regardless of business results. In the short-term, there are not many variables under that model and having a high debt ratio and paying out essentially 100% of free cash flow as HCN does is sustainable.

However, HCN is finding out that the industry troubles are having impacts. Two of its largest customers are facing problems of lower occupancies, reduced fees for new entrants, more Medicare/Medicaid payments that are under pressure, along with higher wages, insurance and regulatory costs. These companies are very leveraged also. Both are already reworking leases with HCN and other landlords to cut rent expense. HCN has also become a lender and stockholder in one of these companies that has a going concern warning. Essentially, HCN is a leveraged entity with little cushion on its dividend that is relying on cash flow from other leveraged companies who were not profitable in more stable times and are now seeing margins squeezed further. Losses cannot last forever, and the source of HCN's cash flow is starting to be reworked.

HCN has responded to these pressures in two ways. The first is by selling assets with renegotiated leases. Some of these are even going into JVs that HCN is part of but controls less than 50% so they are not consolidated on HCN's financial statements. There is a history here of HCN selling properties with higher cap rates and buying more assets with lower cap rates. That also has played a role in reducing ROI. The second change is HCN is investing more often with deals with partners where it splits operating costs, repairs, taxes, etc. and receives a share of the cash flow and profits. That effectively boosts HCN's exposure to the operating problems of the industry. The problem is it already is paying out 100% of free cash flow as the dividend. Moreover, the restructuring of this industry isn't done yet and as Starwood (STWD) has pointed out – the math says the sweet-spot for demand in this industry may be more than 10 years away.

Since HCN started to become more involved in projects where it is more directly exposed to changes in occupancies and operating costs, its ROI has fallen further. ROI used to be in the 8%-9% range and now it's about 6%. The leverage in its JVs is increasing, and they are losing money and consuming more cash than they are paying out. Adding more volatility to results is probably not what REIT investors ordered as this industry restructures. The company even recently added a 10% additional stake in a third large customer, which it purchased from a JV partner also in the business.

We also think one of the biggest risks of this industry is not realized by many. The focus is on having a long-term lease with someone who manages the property. We've already mentioned how those customers are being squeezed now on both revenues and costs and that is a big problem. In reality, **this industry is built on attracting older and often less healthy people to move into an Assisted Living Center**. We have looked at parts of this industry in the past with Brookdale Senior Living (BKD). **A key point to remember is people do not live in assisted living for very long. Brookdale used to see an average stay of about 2.5 years – meaning that the entire tenant base has to be replaced every 30 months or so just to avoid negative growth**. Even HCN's CFO John Goodey, noted this on the November 2017 conference call, talking about how fees charged to residents are more a function of what new occupants will pay as rate changes happen on new residents:

> *"When you think about the math of this, the average length of stay means that residents only on average see a couple of increases [in rates] in their stay. So it's not that you have a very long cycle of resident increases with in-place [residents]…"*

As the largest owner of senior housing properties, replacing churn is a big deal for HCN. This is a very high fixed-cost business and small drops in occupancy rates can quickly cut profits. Home sales are a big driver in how many people can afford to move in at all. HCN used to not be overly-concerned with this on a short-term basis, but now it will be as it becomes more exposed to actual profits and losses of operating properties rather than booking an annually rising lease payment regardless of underlying property performance.

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The Smart Money Hates This Whole Industry

In our opinion, the people at Starwood Property Trust (STWD) are exceptional property people in identifying risks and rewards. They were asked on their 2Q17 conference call why they are not buying into this sector:

> *Barry Sternlict – CEO: "We have been looking at the assisted living space. We think the train wreck that we anticipated is not going to abate for a while. Senior housing is overbuilt and rents are falling. That is a very tough segment to lend into. So we knew that. We could see the construction. I can't believe the numbers. We just talked about it in the investment committee and 8% increase in supply and rents are falling in many markets. So that is an area of assisted independent living we are kind of staying away from. We are staying away from it. We don't have a single loan that's exposed to that business."*
>
> *Jeff DiModica – President, "Sorry, on the assisted living side, I think I read recently the average age of occupants is 82. But Baby Boomers are still in their mid-60s. So all the supply came in early. And you are going to have a decent amount of time before you can sop it all up in addition to Barry's point."*

As we will address in this report, the decay in the operating numbers that Starwood mentions are clearly visible. Brookfield Asset Management (BAM) has invested in real estate (including REITs) in all sectors and infrastructure assets very successfully for years also. In their last presentation on January 22, 2018 they noted,

"While we continue to be cautious on the health care [real estate] sector due in part to elevated amounts of new supply the seniors housing space and the uncertainty surrounding healthcare reform. However recent underperformance has improved valuations."

A Primer on Three Ways HCN Operates

Triple-Net Leasing: When HCN began operations, 100% of its leases were structured as triple-net leases. Essentially, it owned a senior housing center and leased it on a long-term basis to another company that ran the center. That operator paid rent to HCN and in most cases there was an escalator for rent built in of 1%-3% per year. The lease rate was not based on occupancy or the profitability of the operator. The rent paid to HCN was a defined rate regardless of how the operator/center performed. On top of that, the operator pays all other fees associated with owning a center such as property operating costs, maintenance, repairs, utilities, taxes, and insurance.

Triple-net leasing has counterparty risk in the long-term if the property underperforms for a long time. It also has an opportunity cost to HCN if the property does very well, as it does not participate in the upside. The forecasting of future cash flows is fairly simple, and normally this structure can support higher leverage to enhance the return.

Seniors Housing: In these cases, HCN owns the property and may split ownership in a joint venture with the operating partner. HCN pays its share of all the property costs including operating costs, maintenance, repairs, utilities, taxes and insurance. In order to remain a REIT, an operating partner is hired to do the work of running the property and is given an incentive-based fee contract. This flips the equation. In triple-net, HCN has few variables and the operator bears all day-to-day costs and variables. In this structure, the opposite is true. Now the actual performance of the facility determines HCN's return on capital.

Outpatient Medical: These are essentially facilities that provide medical care such as labs, surgery centers, diagnostic centers, and doctors' offices. In these arrangements, HCN owns the property and is the operator too. This has some diversification in that there are multiple tenants for many of these facilities paying rent. However, industry pressures come from many of the tenants being subjected to Medicare/Medicaid payments for revenue. Also, pressure is coming from all payers to limit time in hospitals and rehab as well as higher wages.

RIDEA: – Investors in HCN have heard this term from the company quite a bit of late. It comes from the 2007 REIT Investment Diversification and Empowerment Act. This law allows a REIT to own what is known as a Taxable REIT Subsidiary (TRS) and thus participate in the operating income of a property rather than only allowing the REIT to earn a set rent payment with an annual escalator. This is what made the move possible from passive income from triple-net leases toward participation in operating income. This is part of the Senior Housing space.

HCN discusses on its conference calls its desire to build more RIDEA deals with long-term customers. It sees this as way to move the relationship forward and utilize more of its expertise in dealing with these properties to enhance operating performance. This sounds like a win-win situation. In reality, many properties are not going to switch to this structure away from a triple-net.

If a property is very full and profitable, why cut HCN in on the deal? Just keep paying them the triple-net rent and keep the higher profits to yourself. On the other hand, if you have a struggling property and the rent expense is onerous as it consumes a higher percentage of revenue – why not let HCN cancel the lease and cut them in for a share of the losses? If the property improves, both sides win. If it improves just a little, maybe it becomes profitable but you're still paying HCN less than under the triple-net lease. If it doesn't get better, you have a partner who will want to sell/close the place too as opposed to one looking at your losses and saying "sorry to hear that, but where's my rent?" The last conference call for HCN showed this philosophy at work several times in discussing a new RIDEA deal with a partner Sagora. Sagora and HCN converted 11 Triple-Net Leases to a RIDEA structure of sharing costs and operating profits. The company was asked if more of this should be expected:

> Merecedes Kerr, EVP of Business & Relationship Management - *"these 11 properties that we converted to RIDEA, which stood out from what is otherwise a very solid portfolio, a very consistent performing portfolio, as a group of properties that had outsized growth. And so those were the ones that we decided fit very well in this RIDEA model. As you probably know, we are very selective about what we want to own in that kind of a joint venture structure. We try to, I suppose, manage volatility by really picking properties that we think have the opportunity for outsized growth and performance. So in any event -- the rest of the portfolio, which we thought was very suitable for the triple net lease structure because they are, by all accounts, cash cows for Sagora but don't have the same growth prospect. It's kind of the decision that we made with them."*

Reading between the lines, Sagora had no desire to convert high-occupancy, profitable locations to a profit sharing situation – thus those remain "very suitable for the triple net lease structure." Instead, Sagora was happy to convert properties that had troubles. According to Jason Skiver adding more color to the Sagora deal:

> *"three [of the eleven] are about three years old, on average, with occupancy in the low 60s. And I think, an important point to make here is that, we are acquiring these at below replacement cost. So we see a tremendous value upside in making this acquisition with Sagora."*

We will discuss occupancy more later in this report, but suffice it to say if HCN is willing to take on properties with occupancies in the low 60% range, it is probably losing money. Senior housing has

many fixed costs and requires much higher occupancies to make money. We're not going to ascribe the same numbers to other deals at HCN and just view this as one anecdotal deal. But we think the logic is clear. Deals that work, the operator doesn't need to cut HCN in for the upside. Deals that have more warts, HCN can probably get involved and forgo the safety of the Triple-Net Lease. That should add to volatility of results.

HCN's History and Some Long-Term Figures

Until 2006, the company did all triple-net leasing of properties. That means that the tenant agrees to operate the property and cover all expenses including all taxes, utilities, insurance, maintenance and repairs. In return, HCN receives a rent payment from the operator and in most cases an annual rent escalator. The rent was the same and the escalator in place whether the operator had 100% occupancy or 0% occupancy. The story for investors was HCN would get a growing revenue stream with minimal costs and could post further growth by acquiring/building more properties to feed the increase in demand for senior housing.

Table 1

HCN 2003-2009 Cash Flow, ROI and Dividend Coverage

	2003	2004	2005	2006	2007*	2008*	2009*
Income Cont. Ops	$78.50	$84.90	$79.20	$103.50	$125.20	$150.20	$161.70
Depreciation	$51.10	$73.00	$80.00	$93.10	$145.90	$156.20	$157.00
Interest	$54.10	$72.00	$80.00	$94.80	$134.70	$130.80	$106.20
EBITDA	$183.70	$229.90	$239.20	$291.40	$405.80	$437.20	$425.00
Capital	$2,183	$2,521	$2,931	$4,177	$5,109	$6,075	$6,222
ROI	8.40%	9.10%	8.20%	7.00%	7.90%	7.20%	6.80%
Cash from Op	$130	$144	$174	$216	$264	$336	$381
Dividends	$111	$136	$151	$175*	$233*	$277	$334
Coverage	1.2x	1.1x	1.2x	1.2x	1.1x	1.2x	1.1x

- There was a forward dividend of about $25 million for 2007 paid in the last days of 2006, we adjusted the dividend figures to show 2006 as $25 million higher and 2007 as $25 million lower.
- Non-triple net leasing programs began in 2007 as material item.
- All figures were pulled from the specific year's 10-K. HCN routinely changes the properties that make up income from continuing operations via asset purchases and sales each year.
- ROI is EBITDA/Capital
- Dividend coverage is Cash from Operations (which would account for the interest expense being paid) divided by the dividends paid.

Other segments involving actual operations of property (essentially, medical office buildings and hospitals at first) were about 17% of total income in 2007 and 2008 and 16% in 2009 and first

appeared in 2006 for a very small amount. The reason this is important is until that time, HCN had essentially no capital spending related to existing operations – only for growth. By no means is all current capital spending related to maintenance. However, in years 2007-09, there was only a margin of safety of cash from operations versus the dividend of $30-$60 million. It simply wouldn't take much maintenance spending to make free cash flow equal to or even below the dividend. The ROI was already starting to decline.

We are not going to focus on any one year as great or poor. The timing of when new deals came online can impact that as well the timing when things are sold. Also, HCN owns a large portfolio of real estate. In addition to buying properties, it sells others. We are going to give them credit that they would be selling less profitable operations, ones that may be at the edge of a manager's territory and more costly to service, or ones that need some larger investment to maintain quality. The goal should be to improve operating metrics by gaining economies of scale and dumping laggards. As HCN began to own more property away from the triple-net structure, the company did start to break out capital spending for existing properties. As we will discuss, moving toward more properties where HCN participates in the operating results of the property versus simply collecting a rent payment on a triple-net lease is something the company wants to do more. However, looking below, this trend has already gone from 100% of operating income from triple-net to only 43% of operating income in 3Q17. We are not seeing improving returns on capital:

Table 2

HCN 2010-Present Cash Flow, ROI and Dividend Coverage

	2010	2011	2012	2013	2014	2015	2016	9m 17
Income. Cont. Ops	$78.00	$156.40	$180.50	$86.60	$358.00	$608.20	718	$342.50
Depreciation	$197.10	$418.40	$555.90	$865.80	$844.10	$826.20	$901.20	$683.30
Interest	$157.10	$318.40	$367.10	$458.40	$481.00	$492.20	$521.30	$357.40
EBITDA	$432.20	$893.20	$1,063.50	$1,410.80	$1,683.10	$1,926.60	$2,140.50	$1,383.20
Capital	$9,202	$14,519	$19,052	$22,408	$24,301	$28,327	$27,639	$27,153
ROI	4.70%	6.20%	5.60%	6.30%	6.90%	6.80%	7.70%	6.80%
Maint Cap Exp	n/a	$89.20	$135.50	$135.80	$133.00	$188.00	$219.00	$159.10
Adj. ROI	n/a	5.60%	4.90%	5.70%	6.20%	6.10%	7.00%	6.00%
Cash Ops	$364.70	$588.20	$888.10	$988.50	$1,138.70	$1,373.50	$1,628.70	$1,162.50
Free Cash Flow	$364.70	$499.00	$752.60	$852.70	$1,005.70	$1,185.50	$1,409.70	$1,003.40
Dividend	$370.20	$544.20	$722.50	$906.30	$1,035	$1,210.10	$1,299.00	$992.60
Coverage	1.0x	0.9x	1.0x	0.9x	1.0x	1.0x	1.1x	1.0x

- Ratios are calculated the same as above
- Maintenance capital expenditures are listed by HCN as investments in existing properties
- Adj. ROI subtracts maintenance spending from EBITDA before doing the calculation.
- Free cash flow is Cash from Ops less maintenance spending.

The cushion on the dividend has gone to zero. ROI after maintenance spending has been falling. This is despite the bullish story that the industry is being driven by a demographic growth tailwind and an improving economy. Shouldn't investors expect rising ROIs, especially with HCN getting a larger slice of variable profits from growing properties? Instead, the ROI is lower than the cost of equity capital for both common and preferred stock.

The company prefers to use FFO (Funds from Operation) to show cash flow available to shareholders. The primary difference from EBITDA is interest expense is deducted in FFO resulting in a smaller figure. The primary difference from Cash from Operations is working capital changes and stock-based compensation – but FFO is normally very close to Cash from Operations. By that measure less maintenance capital spending, HCN still has little cushion on the dividend:

Table 3

HCN FFO Dividend Coverage

	2014	2015	2016	9m 2017
FFO	$1,174	$1,410	$1,583	$986
Maint.	$133	$188	$219	$159
Free FFO	$1,041	$1,222	$1,364	$827
Dividend	$1,035	$1,210	$1,299	$993

As HCN frequently adds and sells off properties, we added some additional data showing why the ROI may be dropping. Quite simply, the company seems to be selling properties at a high cap rate and buying new properties at a lower cap rate each year. Higher cap rates can indicate lower property prices and vice versa.

Table 4

HCN Cap Rates on Property Transactions

	2014	2015	2016	9m 2017
Cap Rate on purchases	6.70%	6.50%	6.30%	6.50%
Cap Rate on sales	8.70%	7.70%	8.80%	6.80%

Lower property values may have helped boost cap rates slightly in 2017. Looking at things in more detail, HCN breaks out various classes of investments, but did not give yields on sales transactions until 2014. But, we can track trends in areas of heavy interest. That table follows. We did not want to break out areas where there were only 1-5 transactions as that may skew the numbers for any given year:

Table 5

Cap Rates of HCN Deals by Segment

	2011	2012	2013	2014	2015	2016	9m 2017
Triple Net buys	7.20%	7.10%	7.00%	6.50%	6.70%	6.40%	6.50%
Sr Housing buys	6.80%	6.70%	6.60%	6.90%	6.20%	6.20%	6.50%
Acute Care buys	8.30%	8.90%	-	7.50%	7.70%	7.50%	-
Triple Net sells	-	-	-	6.30%	4.80%	6.70%	6.40%
Acute Care sells	-	-	-	12.60%	8.70%	9.10%	9.20%

HCN Is Changing Its Business Mix and Source of Profits

The company was 100% triple-net lease prior to 2006 before it started to move into other areas. The company reports triple-net is becoming a smaller part of revenues over time, but what isn't touted is the triple-net is still the most profitable part of the business.

Table 6

HCN Sales and Operating Profit %s by Segment

	Revenue % HCN				Operating Inc.% HCN*			
	2014	2015	2016	9m 2017	2014	2015	2016	9m 2017
Triple Net	31%	30%	28%	23%	53%	53%	50%	44%
Sr. Housing	57%	56%	59%	64%	33%	31%	34%	39%
Outpatient	12%	13%	13%	13%	14%	16%	16%	17%

**The Operating income is before depreciation, G&A expenses, and interest.*

There are several conclusions from looking at the various changes to HCN's business model. The largest source of profitability that has the fewest variables to getting paid is getting smaller. Triple-net leasing is simply a rent payment, which ranks as a higher seniority payment by the client than many other expenses. Regardless of the client's actual results, it has to pay the rent to stay in business. By boosting the percentage of its business in other areas, HCN's results may become more volatile. Occupancy rates, patient payments, employee wages and skills may all become concerns for HCN.

With both Triple-Net and Outpatient generally get a rent escalator every year tied to the CPI (Consumer Price Index) up to 5% for inflation. Some rent increases in Triple-Net can be tied to the underlying revenue growth of the tenant. Looking at the changes in same-store operating income, these areas are showing growth, while Senior Housing is not:

Table 7

Same-Store Growth by Division

	2015	2016	9m 2017
From 2016 10-K/2017 10-Q			
TripleNet	6%	2%	3%
Sr. Housing	-2%	1%	1%
Outpatient	1%	2%	0%

	2014	2015
From the 2015 10-K		
TripleNet	3%	3%
Sr. Housing	9%	-3%

We included the information from two 10-Ks because there was such a big change in the same-store operating income for Triple-Net and Senior Housing. In the 2015 10-K, Triple-Net was $691 million in-same store operating income for 2014 and $713 million for 2015. Because HCN is selling and modifying many properties, the same-store Triple-Net operating income in the 2016 10-K for 2014 was $536 million (not $691 million) and for 2015 it was $566 million (not $713 million.) Senior Housing jumped from same-store operating income in 2014 of $274 million in the 2015 10-K to $626 million in the 2016 10-K. Same-store operating income in 2015 went from $267 million in the 2015 10-K to $614 million. The trend is evident. HCN's Triple-Net business is getting smaller and Senior Housing larger.

Occupancies in Senior Living Are Weak

One of the big reasons people are buying this sector is they see a demographic growth story. The actual numbers are showing something different. We found several companies involved in Senior Living – many others are private. The common theme is occupancy trends are fairly poor. Among the companies mentioned in the following tables, HCN does business with Genesis and Brookdale. The others we added just to paint more of an industry picture:

Table 8

Occupancy Rates at Major Senior Living Companies

	2012	2013	2014	2015	2016	9mth 2017
Genesis	n/a	n/a	89.20%	86.80%	85.60%	85.10%
Brookdale	88.70%	88.00%	88.30%	86.80%	86.00%	84.80%
Kindred	83.50%	81.60%	80.70%	79.40%	77.40%	sold
Ensign	79.00%	77.50%	77.30%	75.30%	76.00%	76.60%
HCN*	n/a	-10bp	+160bp	+20bp	-100bp	-310bp

In the case of HCN, they change their portfolio of property every year, so we simply listed the change in same-store occupancy rates for the senior housing unit. For Genesis, we opted not to report 2012 and 2013 because at that time their assisted living operation was small and the company only reported a company-wide occupancy that was primarily determined by its hospital portfolio. Kindred sold its assisted living operations within the last year so there is no figure for 2017. However, it almost does not matter which company you look at – the occupancy rates are either low and steady or are declining.

We noted at the start of this report that residents do not move in and stay for 20 years. Most residents only there for a couple years and may see only 1 or 2 rent increases. That means two things: HCN has to replace everyone in its system and so do its Triple-Net customers every couple of years just to post flat results. Giving discounts to attract new residents equals negative growth even if occupancy is flat. This contrasts with the typical senior living narrative of how rents only rise automatically and people are only getting older so the demand is growing too.

Here's how Brookdale, one of HCN's biggest partners, addressed how it attracted new residents in 2016 in its 10K:

> "*During 2016, we experienced an adverse change in the competitive environment for our consolidated senior housing portfolio, with significant new competition opening in a number of our markets.* ***We have addressed such competition through our increased use of discounts and incentives."***

Brookdale notes another risk too-many residents need to sell their home to afford to live in Senior Housing Centers:

> *"Downturns in the housing markets, such as the one we experienced beginning in 2007, could adversely affect the ability (or perceived ability) of seniors to afford our entrance fees and resident fees as our customers frequently use the proceeds from the sale of their homes to cover the cost of our fees. Specifically, if seniors have a difficult time selling their homes or their homes' values decrease, these difficulties could impact their ability to relocate into our communities or finance their stays at our communities with private resources. If national or local housing markets experience protracted volatility, our occupancy rates, revenues, results of operations and cash flow could be negatively impacted."*

Let's add in two other issues. Interest rates are increasing and homes are sold based on what the monthly payment will be for the buyer. That should mean that homes values will face some pressure unless wages rise at the same pace. The difference of borrowing $500,000 for 30 years at 5% instead of 4% is $300 per month and at 6% the payment increases $600. Looking at it backwards, if a buyer can needs the same payment on a 5% loan, he can only borrow $445,000 instead of $500,000, that's 11% less home value. If the buyer needs top price to afford to move and pay for senior housing, this could create a lag for occupancy growth too and more discounts in the market.

The new tax law could also impact the flow of finding buyers for the homes of the elderly. The tax law limits mortgage interest on to the first $750,000 of the mortgage. That doesn't impact Kansas much, but it's a big deal for California. **Also, the tax law limits deductions for local property and income taxes to $10,000**. So, the home buyer is not only looking at higher home payments from interest rates, but also higher living costs for owning a house. We looked at HCN's properties for 2016 and focused on its exposure to high housing cost/high tax states: California, Illinois, Massachusetts, Maryland, New York and New Jersey. Those six states are 31% of HCN's revenue exposure in Triple Net properties and 57% in the Senior Housing sector.

Remember the churn is about 30 months to lose 100% of occupants. That time is unlikely to change very much. However, the rate at which new replacements move in can change. Arguably, the housing market has been stronger in recent years compared to 2009-12 and occupancy rates are still lagging. Occupancy rates may fall further if new changes in the housing market that sees higher funding costs and lower tax deductibility slow the movement of new residents. HCN has significant exposure the markets where this risk is most pronounced.

Customers Are Reporting Multiple Operating Problems Too

Here are the top five customers for operating income and the percentage for HCN:

Table 9

HCN's Top 5 Customers by Operating Income

	2014	2015	2016
Genesis	16%	17%	16%
Sunrise	15%	13%	13%
Revera *	4%	5%	6%
Brookdale	9%	7%	6%
Benchmark	4%	4%	4%

**Revera owns Sunrise*

We can see information on Genesis and Brookdale as they are publicly-traded. Remember, these are growing companies with an expanding tailwind at their backs. Let's look at the growth:

able 10

Genesis Sales and Revenue Growth (2014-present)

Genesis	2014	2015	2016	9m 2017
Rev. Growth	1.20%	17.90%	2.00%	-6.50%
Same-Store Growth	-	-1.10%	-2.00%	-3.50%
Net Income	-$254	-$426	-$64	-$490

In 2015 and 2016, much of the growth came from acquisitions. We adjusted both acquisitions and divestitures to compute same-store sales growth. The negative growth is being driven by lower reimbursements from government programs and lower occupancy.

Table 11

Brookdale Sales and Revenue Growth (2014-present)

Brookdale	2014	2015	2016	9m 2017
Rev. Growth	32.50%	29.50%	0.30%	-9.00%
Same-Store Growth	-	1.40%	0.30%	-0.60%
Net Income	($149)	($458)	($404)	($587)

Just like Genesis, Brookdale showed some growth from acquisitions to drive results and asset sales to push it down. Pressure on growth came from lower occupancy rates and some lower reimbursements.

Brookdale adds a special risk factor that we seldom see for a non-biotech firm:

> **"We have incurred net losses in every year since our formation** in June 2005. Given our history of losses, there can be no assurance that we will be able to achieve and/or maintain profitability in the future. If we do not effectively manage our cash flow and business operations going forward or otherwise achieve profitability, our stock price could be adversely affected."

Let's look at the stock prices for these companies too:

Genesis Healthcare (GEN) 5-year stock price

Brookdale Senior Living (BKD) 5-year stock price

This has been during a time that the stock market has been rising strongly. These stocks aren't participating at all. What is going on besides negative revenue and losses?

Genesis reported in its 3Q17 10-Q that the company is seeing higher wage costs, lower occupancy, and lower payment levels from Texas MPAP (Minimum Payment Accounts Program.) It was also busy selling more properties in 2017, selling or closing 28 facilities and 24 were losing money.

On the 3Q17 conference call, CEO George Hagar noted the problems with the whole group:

> ***"The margin compression we are seeing across the industry is driven by a confluence of events. Total occupancy and, in particular, skilled patient occupancy continues to be under significant pressure,*** *caused by the growing number of utilization management strategies occurring across the continuum as value-based initiatives are further developed and implemented. Furthermore, within the more profitable skilled mix category of patients, migration toward* ***Managed Medicare products continues to occur. Managed Medicare admissions inherently yield about a 20% reduction in length of stay and about a 10% to 15% lower rate per patient day as compared to traditional Medicare. These top line pressures are further exacerbated by the fact that government-sponsored reimbursement rate growth is not keeping pace with inflation*** *and cost, particularly nursing labor costs amid a strengthening labor market. And unfortunately, unlike other industries, with the majority of our revenue coming from government-sponsored payment plans,* ***skilled nursing operators have no ability to pass these incremental costs along to our customers."***

Brookdale noted in its 3Q17 10-Q:

> *"**Weighted average occupancy decreased 130 basis points** at the 800 communities we owned or leased during both full periods, primarily due to the impact of new competition in our markets. Additionally, Brookdale Ancillary Services segment revenue decreased $30.0 million, or 8.3%, primarily due to a **decrease in volume for outpatient therapy services and a decrease in reimbursement rates** for home health services.*
>
> *These decreases (in expense due to dispositions) were partially offset by an **increase in salaries and wages arising from wage rate increases** at the communities we operated during both full periods and a $19.2 **million increase in insurance expense** related to positive changes in the nine months ended September 30, 2016 to estimates in general liability and professional liability and workers compensation expenses."*

From the 3Q17 conference call, CEO Andy Smith reported:

> *"The market remains challenging for pricing in Seniors Housing as we continue to compete for market share. Our in-place rate increases continue to offset overall negative mark-to-market pressure. As a result our average revenue per occupied unit grew by 1.9% in the quarter versus the prior year quarter. We continue to see labor tightness and wage inflation of around 4%."*

CFO Cindy Baier confirmed this:

> *"Reflecting wage pressure, our same-store salary and wage expense increased 4.4% on a y/y basis. Further including benefits by our medical plan expenses and workers' compensation, we experienced a 6.1% growth in total same-store compensation expense."*

HCN is very proud that it does not get paid much revenue from government programs – especially in Senior Housing. However, its customers get paid that way and are facing lower payments, fewer people moving in, people with shorter stays, and cost inflation. The customers are not making any money and they have to pay HCN. Moreover, it doesn't matter if the customer has private pay for the bulk of their senior housing either, they are still getting squeezed in areas that involve nursing, higher regulations, and Medicare and that is sapping their income and growth.

Brookdale gets 18% of its revenue from 3rd parties including Medicare and Medicaid. Genesis has more Skilled Nursing and Outpatient business and it is getting 79% of its revenue from Medicare and Medicaid. Of the two programs, Medicaid pays about 40% of what Medicare does and Genesis has about 2.5x the number of Medicaid patients vs. Medicare.

We actually like the way Brinker international – the owner of Chili's restaurants - talks about things like this. The restaurant is not in the oil business at all. However, it acknowledges that many of its stores are in areas with many oil-related jobs. Thus, if the oil market is strong and exploration is hot, Chili's benefits from more people in the area eating at its restaurants, and they lose business

when oil is weak. HCN has many of these characteristics. Being the landlord of someone getting paid via Medicaid makes your payments dependent on Medicaid rules too.

Even Triple-Net Is Feeling the Squeeze – Look at Genesis

Triple-Net, as we have noted, basically requires little involvement from HCN. The company has several leases with built-in escalators with operators. It sets these up in a Master Lease arrangement where an operator cannot default or ask for rent concessions on a couple troubled locations. It is supposed to be a situation where both HCN and the operator can spread risks over a portfolio of several properties. Thus, HCN gets to be the passive owner of real estate and collect a rising rent stream and not worry about operating problems.

The problem is one of its largest Triple-Net customers has run into severe problems and as the stock price plummeted to under $1, HCN started to make some changes. We should first note that HCN bought the properties of Genesis in April 2011, so it has long experience with them and they have been among the top sources of operating income. Dependence on Genesis even gets its own risk factor disclosure in HCN's 10-K:

> ***"We depend on Genesis Healthcare, LLC ("Genesis") and Brookdale Senior Living for a significant portion of our revenues and any inability or unwillingness by Genesis and Brookdale Senior Living to satisfy their obligations under their agreements with us could adversely affect us."***

As we noted above, Genesis is getting squeezed on higher wages, regulations, and lower payments for medical care. The results have been dismal of late prompting it in 2017 to begin restructuring.

Table 12

Genesis Operating Results (2014-present)

Genesis	2014	2015	2016	3Qs 2017
Free Cash Flow	$36.70	-$77.10	-$24.70	$18.90
Operating Margin	4.40%	5.40%	4.30%	3.80%
Occupancy Rates	89.20%	86.80%	85.60%	85.10%

Genesis already has a going concern warning and is carrying over $5billion in debt and leases. Any free cash flow here is also overstated because nearly $1 billion of the debt is capital leases. The accounting policy for capital leases boosts cash from operations by only recording the interest expense for the lease in income. The principal payment is recorded in the financing section of the cash flow statement. Thus, it is likely that there has never been positive free cash flow, yet HCN's operating model is built on receiving a rising lease payment from Genesis.

What is HCN doing? According to the Genesis 10-K, HCN has been selling Genesis properties.

"On November 1, 2016, Welltower sold the real estate of 64 facilities to Second Spring Healthcare Investments (Second Spring), a joint venture formed by affiliates of Lindsay Goldberg LLC, a private investment firm, and affiliates of Omega. We continue to operate the facilities pursuant to our new lease with affiliates of Second Spring effective November 1, 2016 and there was no change in the operations of these facilities.

On December 23, 2016, in a separate transaction, Welltower sold the real estate of 28 additional facilities to a joint venture among Welltower, Cindat Capital Management Ltd., and Union Life Insurance Co., Ltd. Similar to the new lease with Second Spring, as part of the Welltower sale, we entered into a lease at closing of the sale. We continue to operate the facilities pursuant to our new lease and there was no change in the operations of these facilities."

Note that the second sale, HCN sold properties to a JV that it is part of and likely reduces its interest to under 50% so these properties are no longer consolidated. We will discuss some of the JV and Variable Interest Entities later on. But, Genesis also reports that the rents are being cut by 5% and the future annual rent increases have been reduced. So much for the continual rise of demand and rent hikes for this industry

"The 64 facilities had been included in our master lease with Welltower and were historically subject to 3.4% annual escalators, which were scheduled to decrease to 2.9% annual escalators effective April 1, 2017. Under the new lease with Second Spring, initial annual rent for the 64 properties is reduced approximately 5% to $103.9 million and annual escalators will decrease to 1.0% after year 1, 1.5% after year 2, and 2.0% thereafter. The more favorable lease terms are expected to reduce our cumulative rent obligations through January 2032 by $297 million. As part of the transaction, we issued a note totaling $51.2 million to Welltower, maturing in October 2020.

The 28 facilities had been included in our master lease with Welltower and subject to 3.4% annual escalators, which were scheduled to decrease to 2.9% annual escalators effective April 1, 2017. Under the new lease, the 28 properties' initial annual rent is reduced by approximately 5% to $54.5 million and the annual escalators are expected to decrease to 2.0%. The more favorable lease terms are expected to reduce our cumulative rent obligations by $143 million through January 2032. As part of the transaction, we issued two notes to Welltower, each with five-year maturities due in 2021, including a $12 million convertible note, exchangeable for 3 million common shares, and a non-convertible note for $11.7 million. Upon completion of this transaction, Welltower still leases to us 75 skilled nursing and assisted/senior living facilities."

So now, HCN is also a lender to Genesis as well as a stockholder as the company is warning it may file bankruptcy if it cannot restructure its debt. In the 3Q17, here is what HCN said about its loans with Genesis:

> *"In 2016, we restructured two existing real estate loans in the triple-net segment with Genesis Healthcare. The two existing loans, with a combined principal balance of $317,000,000, were scheduled to mature in 2017 and 2018. These loans were restructured into four separate loans effective October 1, 2016. Each loan has a five-year term, a 10% interest rate and 25 basis point annual escalator. In 2016, we recorded a loan loss charge in the amount of $6,935,000 on one of the loans as the present value of expected future cash flows was less than the carrying value of the loan. We expect to collect all principal amounts due under the loans and, due to the passage of time, at September 30, 2017, the allowance for loan losses related to these loans is $5,406,000. At September 30, 2017, we had no real estate loans with outstanding balances on non-accrual status and recorded no provision for loan losses during the three months ended September 30, 2017."*

We again point to Genesis' free cash flow that normally negative to immaterial and the fact that is carrying about $5 billion in debt. We expect a much larger valuation allowance to impact these loans. Here is the Genesis note that if it cannot restructure its cost and capital structure it may need to file for bankruptcy from the November 2017 10-Q:

> *"Our results of operations have been negatively impacted by the persistent pressure of healthcare reforms enacted in recent years. This challenging operating environment has been most acute in our inpatient segment, but also has had a detrimental effect on our rehabilitation therapy segment and its customers. In recent years, we have implemented a number of cost mitigation strategies to offset the negative financial implications of this challenging operating environment. These strategies have been successful in recent years, however, the negative impact of continued reductions in skilled patient admissions, shortening lengths of stay, escalating wage inflation and professional liability losses, combined with the increased cost of capital through escalating lease payments accelerated in the third quarter of 2017. These factors caused us to be unable to comply with certain financial covenants at September 30, 2017 under the Revolving Credit Facilities, the Term Loans, the Welltower Bridge Loans and the Master Lease Agreements and other agreements. We have received waivers from the parties to the Term Loans, the Welltower Bridge Loans and the Master Lease Agreements at September 30, 2017. We are engaged in discussions with our counterparties to the Revolving Credit Facilities to secure a 90-day forbearance agreement through late January 2018.*
>
> *Our ability to service our financial obligations, in addition to our ability to comply with the financial and restrictive covenants contained in the major agreements and other agreements, is dependent upon, among other things, our ability to obtain a sustainable capital structure and our future performance which is subject to financial, economic, competitive, regulatory*

and other factors. Many of these factors are beyond our control. As currently structured, it is unlikely that we will be able to generate sufficient cash flow to cover required financial obligations, including our rent obligations, our debt service obligations and other obligations due to third parties.

We and our counterparties to the Restructuring Plans have entered into preliminary and non-binding agreements in an effort to attain a sustainable capital structure for us. See Note 16 – "Subsequent Events." We believe that it is in the best interest of all creditors to grant necessary waivers or reach negotiated settlements to enable us to continue as a going concern while we work with our counterparties to the Restructuring Plans to strengthen significantly our capital structure. However, there can be no assurance that timely and adequate waivers will be received in future periods or such settlements reached. If future defaults are not cured within applicable cure periods, if any, and if waivers or other forms of relief are not timely obtained, the defaults can cause acceleration of our financial obligations under certain of our agreements, which we may not be in a position to satisfy. Accordingly, we have classified the obligations of the effected agreements as current liabilities in our consolidated balance sheets as of September 30, 2017.

In the event of a failure to obtain necessary and timely waivers or otherwise achieve the fixed charge reductions contained in the Restructuring Plans, we may be forced to seek reorganization under the U.S. Bankruptcy Code. See Part II. Item 1A, "Risk Factors."

The existence of these factors raises substantial doubt about our ability to continue as a going concern."

Genesis is supposed to be producing stable returns for HCN. Much of it is supposed to be a simple triple-net lease with an annual escalator. HCN is not supposed to have exposure to the daily ups and downs of the Genensis business. However, that does not appear to be the case.

Brookdale Is Also Seeing Problems

Brookdale primarily operates Senior Housing properties with HCN, which is the business HCN wants to grow even more. As noted above, Brookdale is also considered vital to HCN's business in the risk factors from the 10-K. Look at Brookdale's results:

Table 13

Genesis Operating Results (2014-present)

Brookdale	2014	2015	2016	3Qs 2017
Free Cash Flow	-$61.50	-$118.70	$32.60	$143.10
Operating Margin	-2.00%	-0.60%	4.60%	3.60%
Occupancy rates	88.30%	86.80%	86.00%	84.80%

Brookdale's free cash flow was helped in 2017 by a steep cut in capital spending. Over time, this company is not producing much if any free cash flow either, and it is supporting $5.5 billion in debt and leases. We added back the impairment charges in the margin numbers. These figures do not reflect cash outflow for investments in affiliates. Industry metrics will tout cash flow before lease payments. We would point out that the free cash flow numbers are certainly after leases, and show this company has little margin left to service debt.

Cindy Baier, the CFO of Brookdale, acknowledged more reality recently too:

> *"Finally, turning to goodwill and asset impairment; we recorded approximately $369 million of non-cash impairment charges for the 3Q17, which primarily related to our Assisted Living segment. We performed an interim impairment analysis as a result of the significant reduction in our stock price and market capitalization as well as decreases in the current and expected results of our Senior Housing and Florida Home Health business."*

Brookdale is responding to its problems by selling assets as well:

> *"The Company completed dispositions, through sales and lease terminations, of 139 communities during the period from January 1, 2016 through September 30, 2017, including three communities disposed of prior to June 30, 2016. The Company's condensed consolidated financial statements include resident fee revenue of $4.0 million and $115.1 million, facility operating expenses of $3.3 million and $87.4 million, and cash lease payments of $0.9 million and $27.5 million for the 136 communities for the three months ended September 30, 2017 and September 30, 2016, respectively. The Company's condensed consolidated financial statements include resident fee revenue of $96.6 million and $361.1 million, facility operating expenses of $74.4 million and $272.6 million, and cash lease payments of $26.8 million and $82.4 million for the 139 communities for the nine months ended September 30, 2017 and September 30, 2016, respectively."*

Selling assets may reduce some the percentage of locations losing money. However, it may also cut into economies of scale in operating a smaller company. **Brookdale isn't done there – it is asking another landlord HCA to restructure leases:**

> *"On November 1, 2016, the Company announced that it had entered into agreements to, among other things, terminate triple-net leases with respect to 97 communities*

The Company (BKD) and HCP, Inc. ("HCP") agreed to terminate triple-net leases with respect to eight communities. HCP agreed to contribute immediately thereafter four of such communities, to an existing unconsolidated venture with HCP in which the Company has a 10% equity interest. During the three months ended December 31, 2016, the triple-net leases with respect to seven communities were terminated and HCP contributed four of the communities to the existing unconsolidated venture. The triple-net lease with respect to the remaining community was terminated during January 2017.

The Company and HCP agreed to terminate triple-net leases with respect to 25 communities. During the three months ended September 30, 2017, the triple-net leases with respect to two communities were terminated. The Company's triple net lease obligations with respect to the remaining 23 communities either have been terminated, or are expected to be terminated, during the three months ended December 31, 2017. Following the termination of the Company's triple net lease obligations for these communities, the Company will continue to operate certain of these communities on an interim basis, and such communities will be reported in the Management Services segment from and after termination of such triple net lease obligations."

Again, we see that Triple-Net Leases are being renegotiated and terminated. HCN works with Brookdale primarily in the Senior Housing division where both parties shares expenses, cash investments and net income. Some of that can fall under a RIDEA structure that HCN is very excited about. Brookdale is reworking its deals in this area with landlord HCP too:

"On November 2, 2017, the Company announced that it had entered into a definitive agreement for a multi-part transaction with HCP. As part of such transaction, the Company entered into an Amended and Restated Master Lease and Security Agreement ("Master Lease") with HCP effective as of November 1, 2017. The components of the multi-part transaction include:

The Company and HCP amended and restated triple-net leases covering substantially all of the communities it leases from HCP into the Master Lease. The Company will acquire two communities for an aggregate purchase price of $35 million, upon which time the two communities will be removed from the Master Lease. In addition, 32 communities will be removed from the Master Lease on or before November 1, 2018. However, if HCP has not transitioned operations and/or management of such communities to a third party prior to such date, the Company will continue to operate such 32 communities on an interim basis and such communities will, from and after such time, be reported in the Management Services segment. In addition to the foregoing 34 communities, the Company continues to lease 44 communities pursuant to the terms of the Master Lease, which have the same lease rates and expiration and renewal terms as the applicable prior instruments, except that effective January 1, 2018, the Company will receive a $5 million annual rent reduction

> *for three communities. The Master Lease also provides that the Company may engage in certain change in control and other transactions without the need to obtain HCP's consent, subject to the satisfaction of certain conditions.*
>
> *Pursuant to the Company's agreement with HCP, HCP will acquire the Company's 10% ownership interest in two of the Company's existing RIDEA Ventures with HCP for $99 million. The Company provides management services to 59 communities on behalf of the two RIDEA Ventures. The Company will acquire four of such communities for an aggregate purchase price of $239 million and will retain management of 18 of such communities."*

So, Brookfield represents the direction where HCN hopes to expand the most. However, Brookfield is still writing down assets and reworking leases and RIDEA deals with other landlords and partners. It does not sound like this industry is improving in the new future, nor does it sound like the problems are isolated to a handful of small players.

The Case of Sunrise and Revera

HCN has two other large clients that are both privately-owned and we do not have current data for them. We find it difficult to believe they are not experiencing similar issues that Genesis and Brookdale are seeing. There is some history that can be reviewed here.

Sunrise was once the largest publicly-traded Senior Housing operator. It fell on very hard times in 2008 and the *New York Times* wrote an article pointing out several of the problems. There was an accounting problem where the SEC forced Sunrise to restate several years of earnings. Sunrise's model was to build new properties with joint venture partners, then sell those properties while retaining a management contract, or into a sale-leaseback transaction and set up a triple-net lease. After, the market fell in 2008, HCN backed out of a deal to buy many properties, and Sunrise was left with short-term loans coming due. On top of that, the weak housing market made it tough for new residents to move in to the Sunrise properties.

Over the next few years, Sunrise sold assets to meet its cash needs and HCN returned to buy the whole company in 2012 in conjunction with one of its JV partners, Revera. HCN and Revera were already buying Canadian Senior Housing together in a 75% HCN, 25% Revera JV. Under the deal, HCN worked with Revera and buyout firms such as KKR to buy all of Sunrise with HCN owning 20%. The following year, the other partners were bought out so that HCN owned 24% and Revera 76% of Sunrise. So, two of HCN's five largest customers are closely-held and HCN is a significant investor with them. In 2017, HCN raised its stake in Sunrise to 34%.

Let's also not forget that many of the current issues with Genesis are related to its Skilled Nursing centers and patient treatment. Genesis sold assets to HCN in 2011. In 2015, Revera sold the bulk of

its US nursing and rehab to Genesis. At that time, Genesis became a larger portion of HCN's business as it financed the real estate – the same real estate now being refinanced and sold.

This leads us to another area – HCN's JVs.

Unconsolidated JVs and Variable Interest Entities

There is not much information on these areas, so we're not going to draw too many conclusions and just list some of the data. First on Joint Ventures, HCN is losing money on these deals:

Table 14

HCN's Contributions from Joint Ventures

	2013	2014	2015	2016	9m 2017
Income from Unconsolidated	-$8.20	-$27.40	-$21.50	-$10.40	-$23.70
Contributions to	-$99.80	-$353.50	-$160.30	-$101.40	-$78.80
Distributions from	$30.90	$57.20	$130.90	$119.70	$58.80

The company stopped reporting the balance sheet for the JVs but the debt to equity ratios had been increasing. It was 3.4x for 2015 compared to 1.4x in 2014 and 2013.

The highest concentration of investments has also been in Senior Housing and Outpatient Medical where those investments are more subject to the actual business trends of the market:

Table 15

HCN Investments by Market Segment

	2013	2014	2015	2016	9m 2017
Triple Net	$27.50	$31.50	$36.40	$27.00	$22.50
Senior Housing	$263.80	$539.10	$499.50	$407.20	$332.40
Outpatient	$188.30	$173.50	$6.40	$23.00	$52.70

The amount invested in these deals has been falling, yet the cash outflow continues to exceed the inflows in most years. We know from the Genesis transactions that HCN is selling Genesis properties into JVs where HCN itself is an investor. Genesis will remain the operator too, but the lease will change. ***Other than taking a restructured lease out of consolidated financial results and putting it into unconsolidated is there another reason to be doing this?***

The consolidated Variable Interest Entities have only been broken out as VIEs since 2015. They are assets operating in the same type of businesses and same type of customers. The size doubled from 2015 to 2016 to just over $1 billion. The debt to equity rose from 0.6x to 1.3x now.

We Think There Is Too Much Debt in this Industry to Avoid Major Restructuring

If we look at the companies where we have some recent results, the picture doesn't look very healthy:

Genesis has $5.3 billion in debt. Trailing 12 months EBITDA is $448 million, so debt-to-EBITDA is 11.8x. That, on the surface, sounds impossible to sustain. But, let's look further. Interest expense is $500 million per year based on annualizing 3Q results. On top of that, $1 billion of the debt is capital leases, which require principal payments every year, which we estimate to be another $40 million per year. Maintenance capital spending is about $90 million per year as well.

Thus, EBITDA less minimum cash costs, interest, maintenance, and capital lease payments is already negative at -$182 million.

Margin compression is well established, as revenues are rising slower than costs. 50bp of margin reduction costs the company $27 million in cash flow. They are selling facilities and may lose management of some. If Genesis loses 5% of its revenue at the same margin – that costs them $22 million in cash flow.

This already does not look sustainable without a major cut in expenses including rents and reductions in debt and interest expense. HCN is a creditor here, as well as a leaseholder. Genesis was 16% of HCN's operating income in 2016, and even after selling many properties, it was still 9% of operating income for 2017. Some of the properties being sold are going into unconsolidated JVs in which HCN is a participant. If this company goes bankrupt, it is likely to hurt HCN.

Brookdale has $5.5 billion in debt and capital leases are $1.5 billion of that. Trailing-12 months EBITDA is $679 million. Debt is 8.1x EBITDA. Compared to Genesis, that sounds OK. But, let's look deeper. Maintenance capital spending is about $150 million and another $50 million is listed in cash flow from operations – so $200 million. Adjusting for just this, EBITDA less maintenance is $479 million and the debt to EBITDA becomes 11.5x. Interest on debt is about $175 million and capital leases require $160-$200 million per year. That totals $350 million.

Thus, EBITDA less minimum cash costs leaves the company only $129 million of free cash flow under the current situation.

As we have discussed, margin compression has been a problem here from lower occupancy against fixed costs, and wage growth exceeding revenue growth. 50bp of margin change is worth $24 million in EBITDA. If Brookdale loses 5% of revenue at the same margin as a result of pruning assets, that costs it $34 million.

Brookdale is 6% of operating income at HCN, and Brookdale is restructuring leases and partnership deals. This situation does not look as bad as Genesis, but if HCP is restructuring, will Brookdale ask HCN to do the same?

HCN has $11.5 billion in debt and EBITDA is $2.1 billion for a Debt-to-EBITDA of 5.5x. Maintenance capital spending is about $200 million, and that is expected to rise as the business model switches away from as much triple-net leasing. After maintenance, a necessary cash cost, the ratio rises to 6.0x. That still sounds tolerable for a REIT.

HCN has about $500 million in interest to pay as well, and the dividend is $1.3 billion. After maintenance and interest, cash flow left over is about $1.4 billion against the $1.3 billion dividend.

If the story ended there, HCN might be OK. But look at what is happening:

1. HCN is selling assets and investing more into non-consolidated JVs. Selling wholly-owned assets to own less than 50% is going to cost it revenues and income. We also know that the JVs have already boosted leverage and may require more cash commitment.

2. HCN is negotiating leases down – that is also going to cost it revenue that is also nearly 100% margin. We do not believe that only Genesis and Brookdale are asking for rent concessions.

3. HCN may also become more of a banker to try to lead some of the reorganization. It has become creditor to Genesis. It bought 10% of Sunrise from JV partner Revera so far. That consumes cash or boosts debt.

4. Changing the focus to be more involved in operating costs makes results more volatile and lowers margins. Before interest and depreciation, Triple-Net is essentially 100% margin, while Senior Housing is about 30% against a much higher revenue figure.

5. Senior housing deals means maintenance spending will increase too.

6. Customers may downsize and cost HCN revenue.

7. Trading properties boosts interest expense at HCN as rates increase. Essentially, an older mortgage is paid off when property is sold and a new property is financed at today's higher rates.

8. The initial deals into Senior Housing may result in HCN converting profitable Triple-Net deals into variable results based on currently low occupancy. There's potential upside there, but it may require years of work.

9. HCN operates heavily in markets that are more likely to suffer from the new tax bill limiting deductions and higher interest rates which could hurt housing sales and make it more difficult to drive occupancy in Senior Housing.

There is only $100 million of cushion here on the dividend. Also, if HCN doesn't grow the dividend, the stock will trade like a bond substitute amid rising interest rates. A 1-cent increase in the dividend is 4-cents per year and is $15 million in cash against that $100 million. It doesn't take much to use up that money. In 2016, Triple-Net lease revenue was $1.1 billion. If HCN sells off 25% of the portfolio down from 70% ownership to 40% ownership into JV, that costs it $82.5 million offset with some lower interest expense.

If 20% of the Triple-Net lease portfolio wants a 5% cut in leases, that's $11 million. Boosting capital spending at Senior Housing by $50 million would not be tough to imagine. Trading property will result in lower-priced mortgages being paid early and new mortgages at higher rates. An increase in debt cost of 25bp is almost $30 million. 100bp of margin in the Senior Housing sector is about $25 million. Partners in JVs could also be unable to meet cash calls. HCN may have to decide to invest more in a property that has operating problems.

Conclusion

In conclusion, we will admit that HCN is in better shape than some others in this industry. However, the company's cost of capital is rising and its ROI is falling. The level of problems that are impacting many participants in this group may take years to resolve, and HCN relies on those companies generating its cash flow. A key customer is already deeply in trouble and we think as HCN adds more volatility to results, it will be difficult to maintain the current dividend.

Disclosure

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