NEXT BIG THING

HEALTH-CARE REITS COULD BE AN IMPORTANT SOURCE OF FINANCING AS THE ASSISTED LIVING INDUSTRY ENTERS A PERIOD OF EXPECTED CONSOLIDATION

BY RAYMOND J. LEWIS

Assisted living is rife with talk about consolidation due to the industry's fundamental shift from development and growth to maturity and stability. Occupancy levels are rising and facilities are turning cash flow positive, providing an excellent opportunity for the equity stakeholders—many of which have been private equity funds—to take their money off the table. The next stage in the cycle is growth through acquisitions and other kinds of business combinations, which will require new sources of external financing. Health-care real estate investment trusts (REITs), which are now flush with capital, may fit the bill.

The health-care REIT industry has been one of the best-performing sectors of the stock market during the past three years, as investors have sought investment vehicles with dependable earnings growth, predictable yields, and reliable performance. With a health-care REIT industry year-to-date stock price up about 34 percent, successful assisted living providers have access to an excellent supply of capital.

For many assisted living operators, health-care REITs and the advantages they bring to the financing cycle are unknown. Until now, the industry hasn't needed to tap new financing markets. Before the latest consolidation phase takes wing, senior housing providers have an ideal opportunity to learn how REIT financing works, how they can use REIT financing to grow their business or monetize their investments in today's market, and to explore whether their situation is appropriate for REIT financing.

ATTRACTIVE SOLUTION

During the mid-to-late 1990s, when assisted living experienced tremendous growth, much of the growth was financed by private equity funds and bank loans. As these funds are maturing, assisted living owners and developers are looking for an exit strategy that will enable them to pay back their investors, ideally producing attractive returns.

The industry also is returning to profitability, with increasing occupancy rates and improved revenues. At the same time, the low interest rate environment is beginning to drive compression in cap rates. Traditional commercial real estate cap rates have fallen up to 300 basis points over their average historical levels, and assisted living cap rates, although lagging so far, are beginning to follow suit. It's a good time for assisted living owners and investors to weigh their short- and long-term strategic business goals, and evaluate whether they should be growing their businesses or selling to other companies looking to grow.

An alternative is to partner with a health-care REIT that can offer long-term fixed-rate financing, while allowing owners to free up some of their capital by removing the real estate investments from their balance sheet. By selling properties to a REIT, the assisted living operator can in effect raise equity that can be used to finance other acquisitions without diluting ownership in their operating companies. REITs offer operators up to 100 percent financing and an attractive blended cost of capital, allowing them to take advantage of timely business opportunities.

REITs are corporate, tax-advantaged entities designed specifically to own—and sometimes operate—a specific type of real estate, including retail properties, apartments, office buildings, and increasingly, health-care facilities such as nursing facilities, hospitals, clinics, and medical office buildings. Created under the U.S. tax code about 40 years ago, REITs were formed to provide smaller investors the opportunity to invest in diversified real estate assets without directly owning properties and having to bear any management and operating costs or responsibilities. REITs pay no corporate taxes but are required to distribute at least 90 percent of their net taxable income as dividends to shareholders.

AT A GLANCE

- REITs were formed to enable smaller investors to invest in diversified real estate assets without directly owning properties or bearing management and operating costs and responsibilities.
- Because no equity is required, REIT financing becomes a one-stop financing solution for operators, who can cash out some or all of their real estate equity to finance other business opportunities.
- UPREITs are ideal for operators who wish to divest themselves of assets in a way that mitigates potential tax burdens.

REITs typically fall into three categories: equity, mortgage, and hybrid. Most are equity REITs, which invest primarily in fee-simple interests in real property. Mortgage REITs make or hold loans that are backed by real estate collateral, and hybrid REITs both own real estate properties and make or hold loans.

A common REIT transaction is the sale-leaseback in which the health-care facility properties are sold to the REIT and the REIT then leases the properties back to the operator. Typically, these are leased back on a triple net basis, which means the tenant pays for all operating expenses, property taxes, and capital improvements on the properties. If multiple facilities are involved, the transaction may operate under a master lease, whereby one lease governs multiple properties.

The sale-leaseback structure allows operators to maximize their limited supply of capital because no equity requirements are associated with the transaction. Operators can cash up to 100 percent of their equity and use that capital to fund future growth or distribute it to shareholders. For small or medium-sized operators, the sale-leaseback transaction allows operators to monetize their equity in the real estate while maintaining a steady cash flow from operations. In today's market, the lease term is typically between 10 and 15 years and carries an average lease rate of about 11 percent. The operator needs no additional equity to complete the transaction and, in fact, is able to cash out some or all of the equity value that has been created in the assisted living properties.

ADVANTAGES AND DISADVANTAGES

In a REIT financing, the all-in cost of any transaction is always the cost of capital, blended between the debt and equity financing involved. While the lease rate may seem high when considered in isolation, REIT financing involves no equity, so the blended cost of capital is often as competitive and attractive as traditional mortgage financing. Because no equity is required, REIT financing becomes a one-stop financing solution for operators. Operators are able to cash out some or all of the equity they built up in their real estate and use it to finance other business opportunities, while retaining the cash flow from the operations of their facilities.

But REIT financing is not appropriate for every situation—for example, if an operator has property with significant upside, such as a non-stabilized turnaround or lease-up facility. The operator would have no pre-payment option, and any upside appreciation in the value of the real estate is lost upon the sale to the REIT.

Operators will have a lot to consider as they measure the advantages and disadvantages of REIT financing against conventional mortgage loans. No two situations are alike and most importantly, the financing vehicle must be a good match to the needs of the operator.

THE UPREIT OPTION

In addition to unlocking the equity in their real estate, assisted living operators of smaller, family-owned communities might want to consider sale-leaseback financing for estate planning purposes. In these situations, the typical structure is that of the umbrella partnership, or UPREIT.

UPREITs are ideal for operators who wish to divest themselves of assets in a way that mitigates potential tax burdens. In an UPREIT structure, all properties are actually owned by a partnership of the REIT, and the REIT in turn owns interest in the operating partnership. There are a number of advantages for operators who enter into agreements to sell their real estate in exchange for UPREIT units or a combination of UPREIT units and cash. For example, UPREIT units can be converted into REIT common stock at the option of the seller. Tax gains can also be deferred until the units are converted to stock. Other advantages include the ability to recognize gains in share values as earnings, to borrow against units, to participate in upside through stock appreciation, to receive dividend distribution, and to benefit from the REIT's portfolio diversification.

The UPREIT structure offers many of the same advantages as owning REIT shares directly. Because of the unique nature of the instruments, the UPREIT shares can be transferred to heirs tax-free in certain circumstances, making UPREITs particularly attractive to small operators or family-owned businesses that may be facing estate planning issues.

When considering a partnership with a health-care REIT, measure the ability of the REIT to access capital, the soundness of the REIT's balance sheet, whether the REIT has the expertise to understand the provider's business, and whether the REIT has the products and resources to execute creative transactions and solve complex business problems. Also, identify your short-term and long-term business and financial goals.

Understanding the pros and cons of REIT financing is critical to the financial success of assisted living operators, especially with growing signs that industry consolidation looms ahead. Generally, REIT transactions combine both debt and equity, making them a convenient and reasonably priced financing solution. REITs also provide the financial advantages of long-term, fixed-financing and do not require additional capital commitments at the end of a lease term. And finally, REIT financing enables operators to access equity that can be used to fuel the next round of industry growth. ◂

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