Commercial Mortgage Insight®

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Mid-Cap REITs Aim To Change The Seniors Housing Landscape

With transactions for seniors housing assets now regularly passing the billion-dollar mark, the landscape of the sector is changing.

BY W. JOSEPH CATON

When Louisville, Ky.-based Ventas Inc. first announced its $1.2 billion deal to acquire the assets of Provident Senior Living Trust and add 68 private-pay independent and assisted living properties containing 6,819 units to its portfolio of assets, it was expected to result in the company's jump-start of a significant stream of revenue from private-pay sources.

The deal pushed the Ventas portfolio to a level where it is comprised of 369 seniors housing and healthcare facilities with a geographic distribution across 41 states. The company's annualized rental revenues are slated to increase to more than $370 million for 2005, up from $232.9 million in 2004, prior to the buyout. These are pretty impressive growth numbers for a company involved in the niche business of seniors housing and care facilities.

The company continued its buying spree by announcing shortly afterwards an agreement to acquire and lease six seniors housing assets to subsidiaries of Capital Senior Living Corp. for a cost of $85 million, which represents $89,000 per unit and $71,000 per bed. The assets - all private-pay, non-government reimbursed facilities - contain approximately 950 units and 1,200 beds, and are located in mostly suburban markets in six states.

With that level of investment being poured into the seniors housing and care space, there is no question that the sector is not only recovering from several years of the doldrums, but that investors are prepared to place large bets on the success of this business in the future.

To give our readers further insight into why these deals are happening and why they are commanding the attention of publicly traded organizations like Ventas, *CMI* caught up with Ray Lewis, the chief investment officer of Ventas, and asked him to give our readers some of his candid thoughts on these and other deals that are impacting the seniors housing space.

Ray Lewis

We began by asking Lewis about the pure-play real estate investment portion of seniors housing and healthcare facilities.

CMI: How popular are sale and leaseback transactions today compared to, say, less than three years ago, when the seniors housing and care space just started to recover?

Woodside Terrace is located in Redwood City, Calif., and is operated by Brookdale Living Communities Inc. The property consists of 270 seniors housing units.

Lewis: Sale and leaseback transactions have definitely gained in popularity over the past three years. Ventas has more than doubled its balance sheet over that time, and we are not alone in that regard. All of the healthcare REITs have shown strong investment growth in recent years.

Many public and private companies have used sale-leasebacks to create liquidity for their investors or to recycle their precious equity out of mature properties into higher-yielding redevelopment or development opportunities. Consequently, demand for sale and leaseback and sale and manage-back financing has been on the rise.

I think we will see this trend continue for the near future, as many of the short-term, start-up investors are looking to exit their mature investments in a favorable capital environment.

CMI: When you did the Provident and Capital Senior Living deals, what were some of the driving forces behind the decisions? Please give us some thoughts on the deals as both strategic business decisions as well as real estate investments.

Lewis: The Provident transaction was a transformational event for Ventas. The $1.2 billion acquisition accomplished our strategic objectives of diversifying our portfolio with high-quality assets and strong operators.

The high-barrier-to-entry, private-pay, independent living assets we acquired are among the best in the industry, and our tenants Brookdale and Alterra are among the highest regarded operators in their respective sectors. In terms of diversification, private pay now represents about 40% of our run rate revenues, up from zero three years ago. In addition, our primary tenant, Kindred, now accounts for about 54% of our run rate revenues, down from almost 100% three years ago. So our portfolio is more diverse, our assets are better quality, and our cash flow is even more reliable as a result of the Provident acquisition.

Additionally, and most importantly, the transaction is accretive to our shareholders.

Supply concerns

As some lenders, as well as property investors, begin to consider the natural course of the business cycle, they become concerned about good performance in the sector leading to a rush to build more facilities, as was the case in much of the 1990s.

We asked Lewis to weigh in with regard to those concerns.

CMI: The seniors housing and care business is nervous about potential overbuilding as a result of such good sales prices being realized. Have these acquisitions served to insulate Ventas from any negative impact of a rush to build?

Lewis: One of the big positives of the Provident transaction is that we believe we purchased the portfolio at well below replacement cost. In fact, given the infill locations of many of the Brookdale assets, I don't think you could replicate the portfolio at today's costs - certainly not with any acceptable yield.

As for overbuilding, I am not seeing any evidence of significant development activity in the market yet. Furthermore, any projects started now probably wouldn't open up until at least 24 to 36 months from now.

Finally, construction costs have been skyrocketing as developing countries, like China and India, have been driving up demand for steel and other raw materials. Current market rent levels would not likely provide an acceptable yield to current construction costs. So, I am not as concerned about a lot of new supply in the near future.

Devonshire of Hoffman Estates is located in Hoffman Estates, Ill., and is operated by Brookdale Living Communities Inc. The asset has 262 independent and assisted living units.

CMI: Is Ventas actively involved in building new facilities today?

Lewis: Ventas is not currently involved in the development of new facilities. Quite frankly, we have not seen as much demand for capital in the seniors housing development area as we have seen in the sale and leaseback area.

That having been said, there may be opportunities in other areas of healthcare real estate - such as medical office or laboratory space - where development capital may be in more demand. We are constantly evaluating these sorts of opportunities, and if we were to find them attractive, we would invest the resources to pursue them intelligently.

CMI: How long does it generally take for new construction in the seniors housing and care space to come online? And, how long does a typical business cycle in this space last?

Lewis: The development cycle for new construction in seniors housing can take upwards of 36 months from concept to completion. My experience is that it can take 12 to 18 months just to get the site selected and entitled.

Financing and predevelopment planning can take another six months, and then a minimum of twelve months to build. But that is not the whole story. A typical development will be 20% to 40% pre-leased at opening and then lease two to four units net per month.

So, depending upon the size and type of project, as well as the strength of the market, there is a 24- to 36-month lease up to stabilization.

Corporate insight

In the final analysis, the Ventas deals - like much of the acquisitions of similar mid- and large-cap players - are corporate transactions designed to strengthen balance sheets and grow revenues. To maintain growth in shareholder value, REITs like Ventas are eager to have more beds and units under their business umbrellas. Lewis is in one of the pivotal positions for growing the business of a property investor or developer.

CMI: As someone who has been at the forefront of a couple of mega-deals, what were some of the major challenges, opportunities and risks involved in acquisitions of this nature?

Lewis: When you are looking at a merger or stock acquisition, there is a whole other level of analysis required beyond just the property level. When you acquire the stock of a company, you are taking on all of the liabilities as well as the assets, so you better know what you are getting into.

Fortunately, our chief executive officer, Debra Cafaro, and our chief financial officer, Rick Schweinhart, are both seasoned veterans of merger transactions, and we have a top-notch general counsel in Rick Riney. We are also very careful to select the best external professionals to support our due diligence and structuring.

We not only do traditional real estate due diligence, but we also thoroughly evaluate the target from a legal, accounting and finance, tax, securities compliance and human capital standpoint. It's a team effort, and each person has to take the lead for their area of expertise and make sure they actively support the rest of the team throughout the process.

CMI: How are acquisitions generally financed by organizations like Ventas?

Lewis: Ventas finances its acquisitions with a combination of debt and equity. On the debt side, we use primarily high-yield and revolver borrowings, but we also sometimes assume secured mortgage financing as part of an acquisition.

On the equity side, we try to maximize organic sources - such as internally generated cash flow and recycling of assets - and augment it with periodic secondary issuances as needed for growth. For the long term, we try to fund our acquisitions 50% with debt and 50% with equity.

CMI: Following in that vein, are there any regions or MSAs that you find more attractive than others? Does one region or MSA hold better potential for, say, independent living facilities vs. skilled nursing ones?

Lewis: Nursing homes and seniors housing (i.e., independent living) are fundamentally different animals. Nursing homes are highly regulated businesses that rely, in large part, on state and federal reimbursement for their revenues.

While nursing home supply is governed by various forms of building moratoriums in most states, it is also subject to varying levels of funding from state to state. The key to success in the nursing home business is staying power. We achieve this by having strong rent coverage at our facilities such that if there is a decline in reimbursements, the operator still has enough income to pay our rent.

Seniors housing, on the other hand, is primarily private pay and not subject to any volatility in government funding. As such, it has a much different risk profile. The key elements to success in seniors housing are operations, market and facility quality. For the last five years or so, there has been relatively little new development in most markets.

At the same time, there has been continued growth in the aging population. Consequently, we have found that operations and facility quality have been a more important decision criteria than markets in most circumstances. That having been said, we still look closely at the supply and demand balance in each new investment that we make.

Capital markets

Until as recently as one year ago, many in the Wall Street investment banking world were still in the process of evaluating the stability of seniors housing assets as a platform against which to run an asset securitization program. To better gauge the involvement of Wall Street and the capital markets today in seniors housing and care facilities, we asked Lewis to share some thoughts on capital markets committing more resources to this business.

CMI: Is Wall Street still noticeably absent from seniors housing and care facilities lending? Does the real estate asset appeal more to these lenders/investors than the business itself?

Lewis: Wall Street is becoming much more active in the seniors housing and care space, particularly on the single-borrower, large-loan side. A great example is the $900 million loan provided by CS First Boston to fund the buyout of Mariner earlier this year.

On the conduit side, things have not been as active. Wall Street and the rating agencies are proceeding cautiously after experiencing severe losses in the asset class in the late 1990s. However, I think you will see an increasing level of activity as the sector proves that, if properly underwritten, it can provide an excellent risk adjusted return.

CMI: How much of Ventas' business is considered real estate investment management, and how much of it is considered managing a seniors housing and medical care business?

Lewis: Ventas leases its properties on a 'triple net basis,' which means, among other things, that the tenants are responsible for all operations at the property. As such, Ventas acts only in the capacity of a landlord. Therefore, 100% of our business is considered real estate investment management.

We identify the most experienced and qualified tenants to manage the seniors housing and medical care businesses in our properties, but we do not get involved in any of the day-to-day operations.

Conclusion

In sum, Lewis continues to be quite optimistic about the seniors housing space. He believes that the recovery of the sector, along with improving fundamentals on the care services side of the business, makes for a greater level of interest from places like Wall Street and the cash-rich capital markets.

Lewis also believes that investors are beginning to value the publicly traded players in this space at higher levels, and he looks forward to the point at which the improving fundamentals spread across the nation to certain lagging MSAs.

CMI: Please give us your candid thoughts on where this industry stands today and where you see it going down the road. What can we expect to see coming out of Ventas (and others in this industry) in the near future?

Lewis: I think the seniors housing industry is at a very positive inflection point. We have seen limited new construction over the past five years and continued demand growth driven by an aging population.

Occupancies are trending upwards, and we are experiencing strong year-over-year rent growth. Even the skilled nursing industry - which had been on the trailing end of the sector - is experiencing a relatively stable reimbursement environment.

These factors are contributing to the strong flow of capital into the industry that we have seen over the last 12 to 18 months. I think you will continue to see Ventas and companies like us remain bullish on the opportunities in the industry. ●