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Health Care: The (Growing) Age-Old Story | May 2012

With the first few weeks of first quarter earnings season under our belt, REITs have reached 2012 and 52 week highs based on the MSCI US REIT Index (RMS). The RMS generated a total return of +2.9% in April, bringing the year to date total to +13.9%. This compares to an +11.9% total return for the S&P 500 over the same period. Overall, there was a positive tone from CEOs on the earnings conference calls, which was reinforced by guidance and dividend increases in several names.

The industry continues to reap the benefits of favorable supply/demand dynamics, low interest rates, and wide open capital markets. This month, our focus is on the health care REIT sector as part of the series, 'All Properties are Not Created Equal'. Specifically, we will explore supply and demand drivers, government influence on the sector, and several of the major players.

All Properties Are Not Created Equal: Health Care Focus

According to the Bureau of Economic Analysis, health care is the largest industry in the US economy based on GDP. The National Health Expenditures Report published by the Centers for Medicare and Medicaid Services (CMS) predicts average annual health spending growth of 5.8% over the period 2010 to 2020, outpacing the expected growth rate for the overall economy by 1.1%. Importantly, the average annual growth rate accelerates to 8.3% in 2014 due in large part to the Affordable Care Act. The report predicts health spending will reach $4.6 trillion by 2020 representing 19.8% of GDP, up from $2.0 trillion in spending comprising 16.0% of the economy in 2005.

Given the anticipated growth in health care spending over the next 10 years, health care real estate should enjoy similar demand growth within the backdrop of limited supply. The total value of health care real estate is estimated to be close to $1 trillion, but only about 8% is owned by public REITs. Due to their superior access to both equity and debt capital, we expect health care REITs to increase their market share versus their private peers through accretive acquisitions and prudent development.

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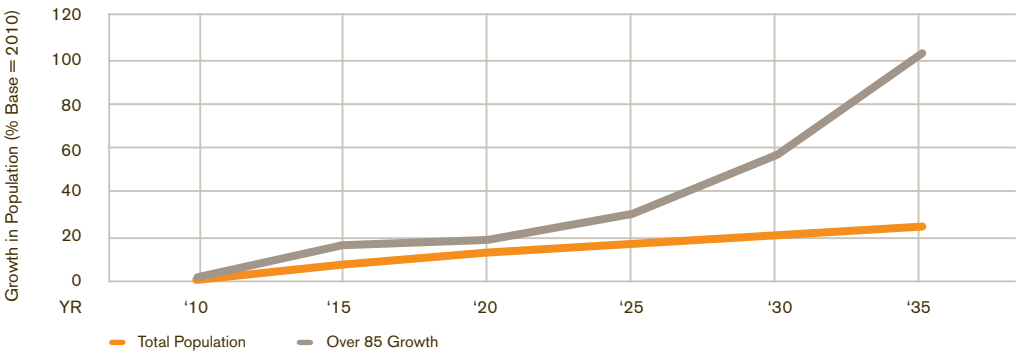
Health Care Real Estate Supply and Demand

Health care REIT properties can be broken down into five subsectors: senior housing, medical office buildings (MOBs), skilled nursing facilities (SNFs), life science (lab space), and hospitals, with each subsector influenced by unique drivers. For example, senior housing demand is influenced by home prices and employment levels. Higher home prices increase affordability for senior housing because tenants often use the proceeds from the sale of their primary home towards rent. Low unemployment contributes positively toward higher rents because more people have the ability to contribute to their parents' rent. The physician tenant base, a derivative of the needs of the surrounding population, drives MOB demand. Government subsidies in the form of Medicare and Medicaid reimbursements are a large factor in the ability to increase rents on tenants in multiple subsectors. Specifically, Medicare and Medicaid fund about 75% of total SNF revenues, leaving tenants highly exposed to government actions.

One of the driving forces behind the projected increase in health care spending is the aging population. Based on US Census Bureau data and depicted in Figure 1, the population

FIGURE 1: POPULATION OF 85+ SENIORS GROWING AT 3X NATIONAL AVERAGE



SOURCE: VENTAS 2011 ANNUAL REPORT

segment consisting of individuals 85 years of age or older is projected to grow at three times the national average.

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Advances in medicine, technology, and treatment have created a self-fulfilling prophecy, where a higher life expectancy increases population and the amount of health care used per person. As demand rises via a higher volume of patients requiring more treatment, tenants will be able to afford to pay higher rent to their landlord and will need more space.

On the supply side of the equation, Certificate of Need (CON) programs play an important role at the state level (not all states participate in such programs). According to the National Conference of State Legislatures, the goal of CON programs is to reduce overall health care and medical costs. In states that subscribe to a CON program, a health care facility cannot be built without the state granting a CON. One of the key variables to determining 'need' is the presence of similar facilities nearby. If they are full and charging rates at or above market, then new construction may be justified to help bring down the cost to the end user. However, if the construction of a new facility would decrease volume of a current facility to the point where it would have trouble covering the fixed costs, the facility would be forced to raise costs. The program would likely reject the request for the CON in this case, thereby protecting the coverage of the facility's fixed costs. Since one of its fixed costs is rent, a side effect of this legislation is that it limits new construction and supply.

A Defensive Sector

Health care is predominantly considered a defensive sector due to its non-cyclical nature – namely, people do not tend to change their health care spending patterns depending on the economy. Health care REITs indirectly participate in the defensive nature of their tenants through their lease payments. Top tenants for health care REITs include Kindred, Sunrise, Baylor Health Care System, Amgen, and Novartis. Many leases in the health care sector are long in duration and triple net, meaning the tenant is responsible for taxes, insurance and common area maintenance fees. The triple net feature allows for a more predictable cash flow stream because the building owner is not burdened with having to pay for the variable costs. Often a triple net lease will contain contractual annual rent escalations, providing the REIT with steady cash flow growth over time. Many tenants enjoy triple net leases because it gives them ownership of a part of the cost equation. Triple net tenants are incentivized to manage their properties efficiently because they can increase their cash flow by reducing real estate expenses.

Due to the non-cyclical demand for their product and above average costs to relocate, health care tenants also prefer long-term leases to make their expenses predictable. As investors, this serves as a defensive governor on earnings because landlords are less likely

to be forced to renew leases at a time when the market is weak. Consequently, rents do not fall as much as in other real estate sectors during economic downturns and alternatively, they do not rise as much during economic upswings.

Despite being widely thought of as a defensive sector, select subsectors of health care facilities can be additive to performance when the economy is strong. For example, RIDEA (REIT Investment Diversification and Empowerment Act) senior housing facilities have many of the same fundamental drivers of its close relative, the multifamily sector. Unlike the other subsectors, health care REITs are able to participate in the profits of the senior housing operators, increasing the volatility and upside potential of their lease payments. As home prices have been declining around the country, many seniors are no longer viewing a home as a good investment and are choosing to lease a unit in a senior housing community.

Chilton Expert Opinion

Another way to break down the health care REIT sector by the manner in which the tenants are paid. 'Private pay' tenants serve customers that pay out of pocket or through traditional insurance methods, while 'public pay' tenants serve customers that use Medicare or Medicaid for their health care needs. Tenants that focus on public pay are subject to the government reimbursement policy and process, which can be slow. In addition, the amount the government is willing to pay can change based on the political climate and other factors that are not in the direct control of landlords. This is especially pertinent as the federal and state budgets continue to get squeezed.

This month we are proud to introduce Nhan Nguyen, MD, JD, MSF from the Chilton investment team. As the health care portfolio manager for other Chilton products, he is able to provide the REIT team with a unique perspective in analyzing, understanding, and modeling growth in the health care REIT sector. Below, he addresses specifically the issues of reimbursements and the Affordable Care Act.

"This month the Supreme Court of the United States heard oral arguments on the controversial Affordable Care Act, focusing on the constitutionality of the individual mandate (requiring individuals to have health insurance or pay a penalty (or tax)) and whether or not that part of the Act is severable from the remainder of the law were it to be found unconstitutional. While focused on health insurance, the constitutional issue was much broader, with the Court having to determine the reach of Congress' power under the Commerce Clause. The significance of the issue was evident in the amount of time the Court allocated for oral arguments, over five hours, where typically hearings are held within one hour.

Based on the administrative appointments of the Justices, with four liberal Justices and four conservative leaning Justices, many pundits believed the swing vote lay with Justice Kennedy. Leading into oral arguments, Constitutional scholars and many investment professionals were expecting the Act to be upheld. These views were likely dramatically changed based on the hard lines of questioning from Justice Kennedy and the lack of robust responses from the Solicitor General representing the government.

A ruling on the Act will likely be announced in June or July this year. While impossible to predict which direction the Court will rule and the market effects of such ruling, the anticipation is that health care stakeholders relying on the additional 32-40 million new covered lives will be the most impacted. Depending on the ruling, health care providers and the flow-through monetary channels (health care REITs, instrument manufacturers, and other services sold to health care providers) will face the most impact. Medical device manufacturers relying on a rebound in procedure volume and utilization will also feel an effect. Less impacted will be pharmaceuticals and biotechnology companies as well as health care information technology (HCIT) companies. In spite of the Act's controversy, citizens of the United States will know in the next 60-90 days a decision that will likely shape the reach of federal powers over its citizens for many decades to come.

Besides the SCOTUS/ACA oral arguments, this month also saw MEDPAC's recommendations to CMS (Medicare) for payment rates in 2013 for various services. A noticeable theme was MEDPAC's position that reimbursement schedules should be shifted and based on clinical outcomes regardless of the setting for the services. For example, Long Term Acute Care Hospital (LTACH) and SNF reimbursements received a 0% increase recommendation, with MEDPAC commenting that the outcomes in either setting were essentially the same (LTACH reimbursement is currently significantly higher than SNF). We anticipate a continued focus on quality metrics for reimbursement versus the traditional fee-for-service model as our government tries to reign in health care expenditures."

Health Care REIT Investment Environment

While there are property specialists in the health care REIT sector, many diversify their holdings among the subsectors. HCP (NYSE: HCP), Ventas (NYSE: VTR), and Health Care REIT (NYSE: HCN) each own a different combination of hospitals, senior housing, SNFs, lab space, and MOBs. However, Omega Health Investors (NYSE: OHI) focuses only on nursing homes, and Healthcare Realty Trust (NYSE: HR) specializes in MOBs. On average, the health care REITs trade at a 6.0% implied cap rate, resulting in a 30% premium to net asset value (NAV) as of April 20, 2012. The implications of this are twofold: first, investors are ascribing to these stocks a premium valuation due to the predictability of their earnings growth, and second, the smart capital allocation decision for them is to acquire accretive assets. When a REIT is trading at a premium to NAV, it means that the public stock is trading at a premium valuation to the price it would command by selling its assets in the private market. For example, on April 1, 2011, HCP was trading at a 6.2% implied cap rate according to Green Street Advisors. During the month, HCP closed on the acquisition of HCR ManorCare for $6.1 billion at an 8.1% cap rate. Upon announcement of the deal in December 2010, Stifel Nicolas increased their 2011 funds from operations (FFO) estimates to $2.69 from $2.24 per share.

At Chilton, we view the health care REITs as steady growth companies, but ones that may not provide the best total return potential at this point in the cycle. We have positioned client portfolios as vastly underweight the sector due to the long lease durations at a point in the cycle when market rents are increasing in other sectors. The contractual rent bumps of 3%+ are certainly attractive, but we can find better growth in other sectors that are trading closer to NAV.

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of REIT Outlook are available at www.chiltoncapital.com/publications.html

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RMS: 1238 (4.30.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

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