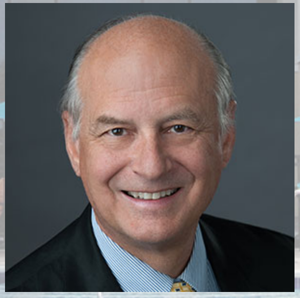
COVID-19 Impact: Senior Housing and Long-term Care Market

Integra Realty Resources



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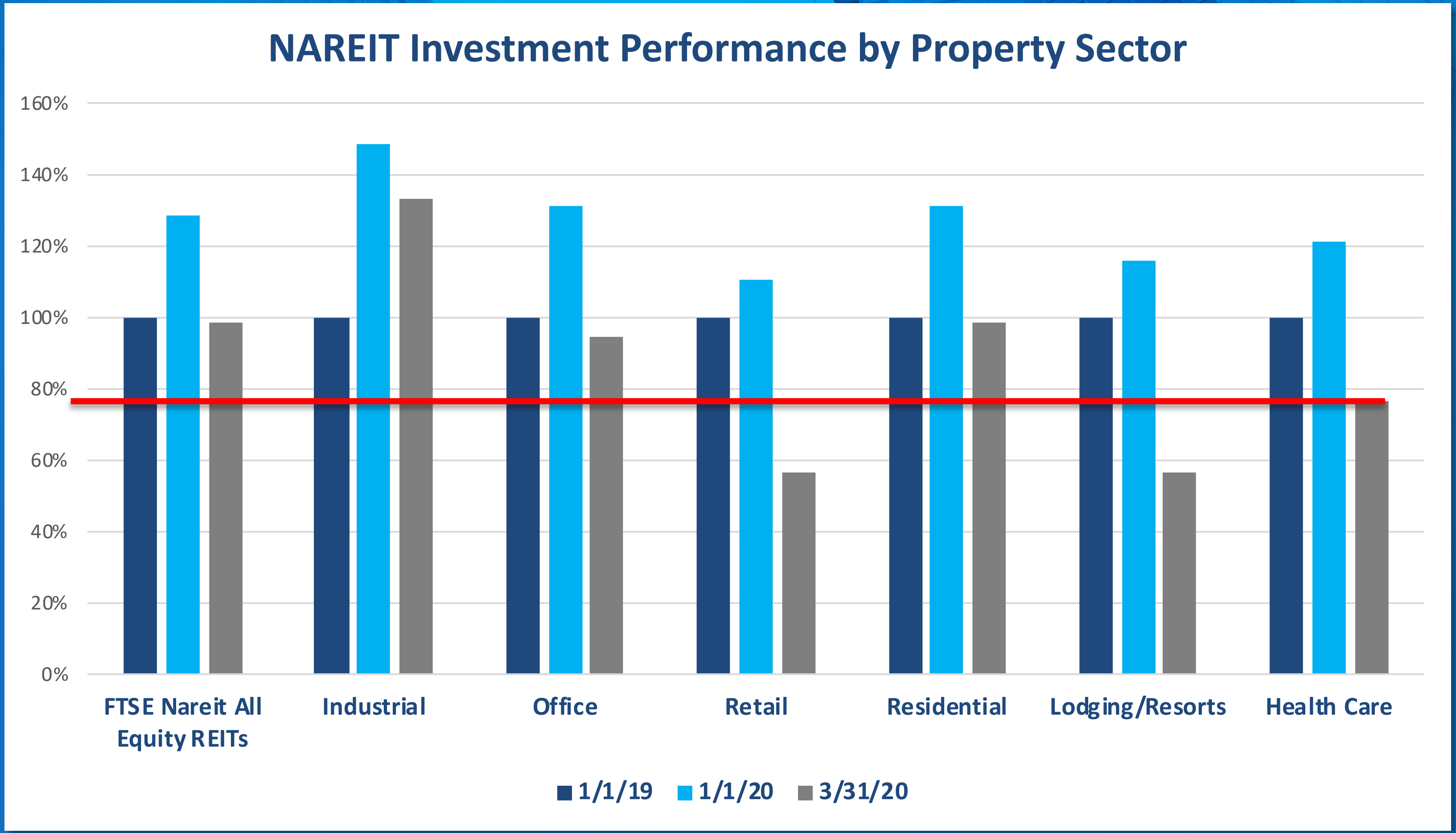
Market Sentiment – Senior Housing & Long-term Care
Not as bad as retail and lodging sectors, but certainly impacted



COVID-19 Issues Impacting Value

Revenues

- Short-run – greater discharges (move outs) than admissions (move ins)
- Long-run – skilled nursing will have stigma to overcome, given the extraordinarily high mortality rates

Expenses

- Labor cost increasing (wages, benefits, and PPE {short run})
- Lower occupancy levels result in higher expense per occupied unit

Capitalization Rates

- Uncertain until transactions with COVID pricing close
- Lower cost of debt is a downward force on capitalization rates
- Elevated risks put upward pressure on rates
- Healthcare REIT dividend yield rates (based off trailing dividends) have increased nearly 200 basis points from January 1, 2020 to April 1, 2020 – Does this speak to individual property cap rates?

Specific Issues for Skilled Nursing – Short Run

- Elective surgery volume is down, generating less Medicare census in SNF
- Medicare census typically represents 10% to 20% of an SNF census, but generates vastly greater contribution to NOI than the other 80% to 90% of census.
- The operating benefits from PDPM (patient driven payment model) which started October 2019, are now eroded – this was going to be a huge positive for many operators
- PDPM permits concurrent therapy, which typically reduces therapy expenses by more than $100,000 per building, but now therapy services have returned to one-on-one, erasing those savings
- Staffing expenses have increased – where possible more nursing hours per patient
- PPE – personal protection equipment – scarcity and added expense (cost to acquire and time changing out gear).

Specific Issues for Skilled Nursing – Long Run

- There is greater risks that federal Medicare and state Medicaid programs will suffer serious funding shortages
- Social distancing may require facilities to convert share rooms (semi-private and wards) to 100% private rooms, reducing census and revenue – think airplanes and restaurants.
- Such a rule changes could lead to a building boom as more building space will be necessary to accommodate private rooms. Currently less than 10% of SNF beds are in private rooms).
- Staff recruiting likely to be difficult for years to come, when labor markets tighten up
- Probable increase in regulatory oversight of care aspects, resulting increased expense, and not necessarily increased reimbursement

Specific Issues for Senior Housing

- During quarantine period, difficult to show facility to prospective tenants
- After coming off a very strong economy that saw senior household wealth levels increase (stock market and home values), that emboldened spending for deluxe senior housing, demand is likely to shift to lower-priced, smaller units
- Many markets have pockets of oversaturation conditions before COVID, and coupled lower demand, higher vacancies levels, more rental concession and extended absorptions are likely

Senior Housing –
Brighter Future Than Many Property Sectors

- The Baby Boomers are coming – starting in about 2025, when they begin to to turn 80 years old
- A large portion of Boomers will have amassed considerable wealth, as their careers span a time of unprecedented economic growth, and as a group, may be in better condition to afford housing than younger population groups.
- Family structures continue to changed in directions that favor senior housing demand

The Valuation Set Up

- Lower NOI - EBITDAR in the short run – but for how long – largely depends on the arrival of effective vaccine regime, and testing for antibodies
- Negative impact likely to be at least 12 months, but probably longer, according to most news reporting sources
- Property transactions in senior housing and long-term care sectors are likely to remain frozen until the pandemic is resolved – so timing is critical
- In the interim, the market is likely to seek out distressed asset opportunities, and rely on greater portion of equity – there will be distressed assets
- Current valuations will be priced through use of simple discounting off pre-COVID perceived values, and/or through discounted cash flows that are sensitive to the short-run disruptions.

Repricing Risk – Using Direct Capitalization

	Senior Housing Capitalization Rate								
NOI Change	6.50%	6.75%	7.00%	7.25%	7.50%	7.75%	8.00%	8.25%	8.50%
0.0%	0%	-4%	-7%	-11%	-15%	-19%	-22%	-26%	-30%
-2.0%	-2%	-6%	-9%	-13%	-17%	-21%	-24%	-28%	-32%
-4.0%	-4%	-8%	-11%	-15%	-19%	-22%	-26%	-30%	-34%
-6.0%	-6%	-9%	-13%	-17%	-21%	-24%	-28%	-32%	-36%
-8.0%	-8%	-11%	-15%	-19%	-23%	-26%	-30%	-34%	-38%
-10.0%	-10%	-13%	-17%	-21%	-25%	-28%	-32%	-36%	-40%
-12.0%	-12%	-15%	-19%	-23%	-26%	-30%	-34%	-38%	-42%
-14.0%	-14%	-17%	-21%	-25%	-28%	-32%	-36%	-40%	-43%
-16.0%	-16%	-19%	-23%	-27%	-30%	-34%	-38%	-42%	-45%
-18.0%	-18%	-21%	-25%	-29%	-32%	-36%	-40%	-44%	-47%
-20.0%	-20%	-23%	-27%	-30%	-34%	-38%	-42%	-46%	-49%

- REIT valuations suggest enterprise values are off more than 20% from January 1, 2020 levels
- Using the table to the left, if dividends remain unchanged, then the "cap" rate must increase from 6.5% to 8.0% – 150 bps.
  For a 20% loss in value
- If cap rates are unchanged, then NOI drops 20%
- The REIT value decline is likely an anticipation of some decline in dividend payments and in increased yield rate.

Direct Capitalization BC / AC (before and after COVID)
Does Direct Capitalization Solve the Riddle?

	Pre-COVID	COVID Market
Gross Potential Revenue (80 Units)	$4,800,000	$4,800,000
Vacancy Losses	7.5%	12.5%
Effective Gross Rvenue	$4,440,000	$4,200,000
Fixed Expenses	$1,400,000	$1,400,000
Variable Expenses	$1,418,000	$1,341,351
Management Fees	$222,000	$210,000
Total Operating Expense	$3,040,000	$2,951,351
NOI	$1,400,000	$1,248,649
Capitalization Rate	7.0%	7.5%
Value	**$20,000,000**	**$16,648,649**
Value Difference		-16.8%

Can a DCF Analysis Provide Better Valuation Insights?

	Pre-COVID	Year 1	Year 2	Year 3
Gross Potential Revenue (80 Units)	$4,800,000	$4,800,000	$4,800,000	$4,800,000
Move Ins	30	15	25	50
Move Outs	30	30	30	30
Average Occupancy	74	59	54	74
Effective Gross Revenue	$4,440,000	$3,540,000	$3,240,000	$4,440,000
Fixed Expenses	$1,400,000	$1,400,000	$1,400,000	$1,400,000
Variable Expenses	$1,418,000	$1,130,568	$1,034,757	$1,418,000
Management Fees	$222,000	$177,000	$162,000	$222,000
Total Operating Expense	$3,040,000	$2,707,568	$2,596,757	$3,040,000
NOI	$1,400,000	$832,432	$643,243	$1,400,000
Reversion Value (NOI / 7.5%)				$18,670,000
NPV @ 9.0% IRR				$15,500,000
Value Change				-17.00%

- DCF is very sensitive to occupancy and operating expense forecasts.
- Duration uncertainties?
- Will capital cost differ once the market/economy rebounds?
- Will management be rattled by their lenders and equity partners, impeding best decisions?

The Post-COVID Senior Housing and Long-term Care Market

- Demand will increase with Baby Boomer arrival
- Will future demand be wounded? -- permanent economic damage (lower incomes and wealth levels) causing demand forecasting to change?
- Will there be building redesigns, especially in skilled nursing, to lower densities?
- Regulatory standards of care will certainly be elevated
- Will public financial support change?

Final Thoughts

- The longer the pandemic stretches out, the more distressed senior assets will come to market
- First investors to return to the market will seek distressed assets, later in a recovery, transactions will involve more typical investor motivations.
- While in the COVID market, expect a lot of extend and pretend relative to valuations that mark to market