Identifying Value Amidst Turbulent Market Conditions

Colleen Blumenthal:

Hello, everyone. Let's get started. So, normally, I would start off the session by telling you to get your phones ready, to have your apps ready to roll. Because this is a very interactive session, we're going to learn from each other. We've got questions for you. However, the polling questions that the app is not working, so we're going to do it old school. So I realize that there's less safety because you won't be as anonymous. But if you could put your sanitized hands up in the air, when it moves you, we'd really appreciate it. So our theme today is, "Identifying Value Amidst Turbulent Market Conditions." And I see enough gray hair and enough no hair in the audience, to know that many of us have been through more than one cycle. And so we're going to focus on cyclical factors as well as what's different with this particular round. I am thrilled to be with such a really august group of industry titans. And although I don't think anyone really needs an introduction. I'm going to go ahead and let everyone introduce his/herself starting with Michelle at the end.

Michelle Kelly:

Sure. Hi, everyone. I'm Michelle Kelly. I'm a senior vice president of investments with NHI or National Health Investors. We're a publicly traded REIT that's based in Murfreesboro, Tennessee. We have about 240 or so buildings in our portfolio, two thirds in the senior housing side of the spectrum, about a third in skilled nursing and we've churned a little behavioral health into the mix as well. So definitely more of a net buyer than a seller these days. But real happy to be here.

Roosevelt Davis:

Hi, I'm Roosevelt Davis. I head up Fannie Mae Seniors Housing Finance product. Right now we have about 17 billion plus in financing. We finance independent living, assisted living, memory care, we also do some CCRC financing.

Ben Firestone:

Ben Firestone, executive managing director and co-founder of Blueprint. We do roughly 50% of our work in the skilled nursing sector and 50% in private pay seniors housing. We've become the most active investment advisor in the space. Last year, we did about 80 transactions and 1.4 billion in volume. So see a lot of deals and excited to be here. Thanks for having me.

Michel Ausburger:

My name is Michel Ausburger. And I'm the CEO of Chancellor Health Care. We're based out of northern California and we operate 16 communities in six states. I should mention that all of our communities are triple net leases in terms of our operations. And so obviously, how we look at the world is affected by that relationship. And we operate essentially very eclectic, assisted living memory care and independent living within our small portfolio.

Colleen Blumenthal:

Excellent. And for those of you who don't know, I'm Colleen Blumenthal, CEO of HealthTrust, a national advisory valuation and clinical assessment firm. And we've been doing this for decades. So I started when I was 12. We're going to go ahead and get started with just looking at cyclical factors that we see impacting. And really, I think the reason why we're all even here is because we have the silver tsunami coming. So the demand number is just the number of folks that are 75 and up, and 85 and up, are growing and they're growing exponentially. Really over the next 10 years, it's going to be a dramatic difference than where we were 10 years ago. And so with that, we also have a lot of new development.

So all of the bars on the left is inventory growth versus absorption and leading up to the recession. Certainly there's a lot of new inventory growth and during the recession, not a lot of absorption. But as we came out, you can clearly see that absorption started to outpace the new supply.

Colleen Blumenthal:

Up until 2015, when supply growth exceeded absorption growth, the lines on the top are occupancy, both stabilized properties on the top, top line and below that you have all properties including those that were in lease up. So, on the skilled nursing side, you have the same demographic tsunami coming, that the supply picture and the occupancy picture are drastically different. Supply is basically flat to slightly decreasing and occupancy is dropping like there was no tomorrow. So when you look at utilization, how many people? 75 and older are actually in a nursing home and the last five years, we see that decreasing at a compound rate of 3% a year. So for a variety of reasons, whether people are just healthier longer and don't have skilled nursing need. Or whether they have more options because there's more assisted living or other housing environments that enable them to stay healthy longer. Or whether they just really don't want to go. And then a combination of all of those skilled nursing demand is the utilization rate is decreasing.

Colleen Blumenthal:

And of course, then skilled nursing facilities always have to deal with reimbursement risk. And every so often how you get paid changes. Right now the latest change was the patient driven payment model, which is supposed to be budget neutral. And we also have pending on the skilled nursing sector right now. CMS has a new rule that will impact bed tax for CCRC that presently right now are exempt from that. As well as a phasing out of the upper payment limits, which impacts properties in Indiana and Texas and some other states more than others. And I think let's pause here for just a minute. And Michelle, you have a lot of nursing homes in your portfolio. What are you seeing as far as how your operators are doing with PDPM and what their experience has been?

Michelle Kelly:

For the most part, it's really not dissimilar than what you've probably heard from others, but it's basically positive. It's only a few months in, so we'll see if that remains the case. But 10ish percent improvement in reimbursement in many cases. Therapy costs have gone down for a lot of our providers. So all in all, it seems like a good thing for the industry, which of course makes me a little nervous, as to what that means from the government's perspective, since it was supposed to be budget neutral, but yeah, we shall see. Michel?

Michel Ausburger:

I think the numbers that were shown in the session earlier today about five months in, is certainly consistent with our experience. In that we've seen in our reimbursement go up in terms of on a daily basis. I do want to follow up based on that session and just track and see what's happening a little bit with our length of stay, to see if in fact, we're being sort of hit on the other side with reduced length of stays, which was sort of alluded to in that presentation this morning.

Colleen Blumenthal:

So you're making more money but they're not there as long?

Michel Ausburger:

Right.

Colleen Blumenthal:

A little more turn on the occupancy side. That's interesting. Ben I mean, in terms of sales and activity, I mean did the looming specter of PDPM, impact volume and all that. Have you seen any kind of increase in pricing before or after?

Ben Firestone:

We're seeing consistent with everyone's hearing here, largely a positive impact. Underwriting has not changed in our perspective, in terms of valuation or multiples on EBITDAR. I think there's a positive favorable outlook for NOIs, moving forward for cash flow. So I think most of the groups out there, they're looking at SNF opportunities or bullish. They remain bullish about PDPM.

Colleen Blumenthal:

So you think it's going to be sustainable?

Ben Firestone:

Yeah. And I think in a relatively, historically speaking, constant cap rate environment. You're seeing growth in NOIs translate to higher per bed prices.

Colleen Blumenthal:

Okay. Cap rates. You can't have a valuation session without talking about cap rates. So at the bottom I've thrown here the 10 year treasuries, middle line is seniors housing and the top line is skilled nursing. And really the skilled nursing line, I could go back almost three decades and it would always be bouncing between 12 and 14% because of reimbursement risk. And I think the uptick that you see there at the end is really just due to the nature, of what was sold. You had a lot of REITs looking to exit the space. You had some operators looking to shed massive portions of their portfolios. And so there were certainly more sellers than buyers and I think that's probably what caused some of that uptick. But seniors housing by and large is basically been trending downwards. And I think we'll continue to see that happen until something changes in the broader economy. So that's kind of the cool stuff that we see typically.

Colleen Blumenthal:

But even though I think a lot of us have seen this movie before, that there's a new twist this time, right? And I'm not certain whether it's a thriller we're watching or a horror movie we're watching. But I think it's going to be one or the other. And right now one of the first things that we see a lot of and this is the state of seniors housing, same store data set from last year's publication. It's about 900 properties and for the first time ever, every property type, saw margin compression. And the industry as a whole saw margin compression, largely due to increases in supply, depression on occupancy, rate concessions in order to compete and keep your facilities full. And then of course, the wage issue, which pretty much anymore when we go out and look at properties. We will try and find out what Target is charging or hiring new hires at. Because we know that that's who you're competing with and it's certainly much easier to hang clothes at Target than it is to take care of senior residents.

Colleen Blumenthal:

But it's not all doom and gloom. So we dug deeper and when we looked at it, it wasn't like every single property saw a decrease in profitability during 2018. Roughly 40% of them actually did better in 2018. Held their own or did better in 2018. And here's the spoiler alert, the age of the property had no bearing whatsoever. It wasn't like the shiny new pennies did really well and the older properties are falling behind. That's not it. We looked at it by decade and there was no correlation there whatsoever. Yes, the older properties have lower rents but by and large, the properties that did better in 2018 consistently had higher occupancy, higher rates. And what I thought was really fascinating was, in spite of the wage increases that we're seeing, they actually only saw expenses on a per occupied unit increase by 1%. So versus 5% for those that were really falling behind. Of course, it's no surprise that this is largely happening, and what you would call barrier to entry, or maybe speed bump to entry markets, over 50% of those that did better in 2018 were located in either the Northeast or the Western regions.

Colleen Blumenthal:

So Michel, I mean, I know you have properties in California and barrier to entry markets. I mean, are you seeing rate compression or emerging compression in those markets?

Michel Ausburger:

Absolutely. Because in quite a number of the communities, we now have $15 an hour minimum wage, and there's directly associated costs, your payroll taxes and workers comp they go up, directly in proportion to increases in wages. Because of the increasingly litigious and very large verdicts in the negotiated agreements on liability suits, the liability insurance market has gotten very hard and very expensive. And property insurance as well, because of the fires and other issues in California, has gotten very pricey. We just renewed and I think we went up like 18% in terms of on those areas.

Colleen Blumenthal:

Ouch.

Michel Ausburger:

And then the other issue is that in terms of our ability to pass on increases, I mean, there's a lot of pushback from residents and families who are seeing you try to get larger increases than what they're hearing their Social Security is going up, even though they're not dependent on that. And so that also helps or pushes down on what we can pass on those increases. So I certainly in terms of our communities, we're not immune from that margin compression at all.

Colleen Blumenthal:

Yeah. Now, that's interesting. And I think more and more in some of these regions, you are seeing more new development. And it may not be widespread and low barrier to entries but you're still seeing more of them come in. Michelle, I mean, do you see, at this point in time, there's such a thing as an operator premium?

Michelle Kelly:

I actually do, whether it's right or not, there's a perception out there in the investment community that there's just not a ton of really good high quality consistent operators. And I think because of that, you're still seeing some pretty aggressive buys on what I would call somewhat broken projects. And the fact of the matter is, I think people are using that as their entry into that relationship. So, it might be that one property that this great operator just can't quite get home on, but they need to recap, and I think

people will pay a premium for that just to get in with that particular group, so that they can then go do the new development or the new acquisition or something else in the portfolio. And I think at the end of the day, everybody in the capital side that I'm aware of, recognizes the value in the operator.

Michelle Kelly:

And if you don't have the right partners, who know how to watch their bottom line and know how to market these communities, you're going to be in big trouble, particularly given how challenging some of these dynamics are. So it's worth paying a little bit more but the right group.

Colleen Blumenthal:

So Roosevelt, how do you assess the operator when you're looking at a deal?

Roosevelt Davis:

Yeah. No, operator is huge. And taking a look at a transaction I think from my perspective, there are three key characteristics that I look for in assessing an operator. Number one, an operator must have experience in the acuity type that they're managing. Also, within that experience, they need to have experience in the local market and reasonably area that they're in. Number two, I think an operator definitely needs to have some type of plan of action for two of the major challenges in the seniors housing market. Number one is having a plan of action or strategic plan in regards to labor. What are they doing to retain, recruit and train employees? In my travels and going around, I've seen a lot of operators do some creative things. Speaking with this one operator, went to this one property and the operator didn't notice that a lot of their staff had issues with daycare. And on this particular property that he owned with this IL/AL memory care facility there was like this house, and he ended up converting the house into a daycare center.

Roosevelt Davis:

And that definitely helped solve some of the problems and issues with some of the single parents and those folks having child issues. So it wasn't a moneymaker for him. But he was able to retain employees just by the simple fact that he was able to get a little bit creative and to convert that house into a daycare center for his employees and staff. Another operator that I met that I thought did something really creative. This property was in a rural, very suburban area. And a lot of his folks were either trying to take public transportation and some of them also had car issues. And what this particular operator did was basically leased a fleet of cars and allow his staff to lease it back from him, at just a break even price. But it was something creative to maintain retention and to provide opportunity for them to be there and to have effective transportation moving back and forth. So those operators that are creatively doing things to recruit and retain and also train employees is definitely key to Fannie Mae.

Roosevelt Davis:

And another thing too, in terms of employees, if they are not investing in showing love to the employees, that should be the highest priority for an operator from my perspective. A happy employee creates a happy resident, and a happy residents definitely help increase a happy bottom line. So, investment in employees is crucial. And I would say the third key characteristic is definitely an operator that's creative and innovative. It's important due to the competitiveness out there that an operator is creative and doing some innovative things to attract employees and bring residents to the property.

Colleen Blumenthal:

So I'll throw this question out to the entire panel. But is anyone underwriting or looking at a deal assuming that the margins are going to continue to decrease and that the pro forma NOI is below the trailing 12?

Michelle Kelly:

I don't know that we are underwriting a lot where it definitely drops. But I think at the end of the day, any deal where there's going to be an operator transition, I think people have gotten smarter that it's not going to be rosy from day one. It's going to take time for that new operator to get in there, implement their systems, get the staff that's hopefully there on site to buy into the new systems. And without a doubt, there's usually a down turn for a period of time. And I think we certainly look at that, last year we had a couple of different transitions. Michel knows one all too well. But if you're not banking on that for some period of time, I think you're just fooling yourself. If it's a situation where you're buying and operator is staying the same, it's a little bit easier to say, "Okay, well, there shouldn't really be that transition noise, that transition downturn." That being said, you have to look at things like insurance, we have to look at things like staffing, so there might be compression in that year one.

Michelle Kelly:

But again, that's for lining up with the right operators who have been through things like this before and know how to manage other expenses to kind of counteract, know how to drive the marketing to try and attract more residents. There's other ways you can kind of combat some of that. And I think that's where experience really comes into play.

Michel Ausburger:

We're also thinking very critically about short term margin compression. And it's a big contributing factor to why cap rates are so low today, because largely people are looking at that we've never seen an environment, even at the interest rate level and the cost of debt out there. Largely the market is indicating that in the long run, this is another reason why a spot cap rate right now is not as relevant as it has been in years past, in other pieces of the cycle. But largely, we're seeing long term growth in NOIs, even if the margin may not grow alongside it.

Colleen Blumenthal:

Make sense.

Michel Ausburger:

So demand is really prevailing in the long run. And that's why investors are looking at total return more than spot cap rate today.

Colleen Blumenthal:

You could argue if the margin is compressed, there's less risk with achieving that and that would merit a lower cap rate anyway.

Michel Ausburger:

Lower hill to fall down.

Colleen Blumenthal:

That's right. All right, get your hands ready. So we've got three cases that frankly we really do want to know what you think. So we're seeing more and more urban land, urban infill. This is a project in the Bay Area that may or may not be real. And development costs are about 800,000 a unit. Its rental rates, revenues per unit, 12,000 a month. And the projected NOI is 6 million, which is roughly a 40% margin. Really no competition in the area, but clearly very expensive to build. So the question today is, the first question is, what's the cap rate? So let's start with the premise that you want this property and you buy the NOI projection. And you could read the answers. I'll give you a minute to digest but very simply, the cap rate begins with a four, a five or a six. So are you ready? Who here thinks that you have to put a four handle on it to get the property? Okay. Roosevelt, you're in charge of counting.

Roosevelt Davis:

Yeah.

Colleen Blumenthal:

Who thinks it's a five handle? And is anyone paying six? Interesting. So I think it's predominantly a five cap rate, which puts the value at 1.2 million. And I've had a lot of conversations in the last day or so, "Hey, I took the cap rate. I took it to the NOI." That's the number it's 1.2 million.

Roosevelt Davis:

I just want to point out that people would have raised their hand for six, credit and asset management. I just wanted to point that out. [crosstalk 00:23:38]

Michelle Kelly:

And I would say and the broker went for four cap.

Ben Firestone:

I would take the counter point here, and that you wouldn't get the deal unless you bid up and I think that realistically, a cap rate again, this is a prime example of why total return and this presumably would go to a long term holder because of the urban infill location, and the vintage of the property of course. So I think someone will look at a core investor at an 8% unleveraged return over time, which includes a reversion value and a lot of assumptions over the length of the investment.

Michel Ausburger:

I think there has to be a lot of consideration into a project like this. In the current environment, if it's San Francisco, what are you going to do about recruitment and retention, where it's impossible for your frontline staff to find housing? Restaurants are closing like flies. I live 45 minutes from San Francisco. And daily, I mean, some of the best known restaurants have closed here over the last year just because rents and that type of thing are going so high. People can't get staff they can't fill positions. And then you add to that all the sort of added labor cost in San Francisco, in terms of the mandatory health care costs, mandatory leave benefits you have to pay in San Francisco. Not to forget a very high minimum wage. Unless you're going to have on site housing, you're going to have a hell of a problem recruiting. I would opt for a not a real low cap rate, because I think this is a real high risk project.

Ben Firestone:

Well, I think counterpoint to that, and again, why we would award a more aggressive, bidder the deal, is that the release valve is rents and rental rate. So because of the limited supply and incredible demand of some seniors wanting to live in San Francisco, and you're seeing this phenomenon right now, in Manhattan, there's five or six projects that are front row news and even now in Brooklyn, with what's been announced. You're just seeing incredible rates. Incredible rate growth potential and somewhere north of $20,000, all in monthly revenue rates per resident. So I think that's the release valve. And in some of these rare demographic areas, the United States, I think these projects would be viable.

Colleen Blumenthal:

And Roosevelt when they come to you for permanent financing, and they're almost stabilized, but they're not quite I mean, you're looking at a tier three or are you insisting that they wait longer. I mean, how do you look at that point?

Roosevelt Davis:

We're taking a look at a tier three, but what we also are paying attention to is the experience of the sponsor, the operator, what's happening in the market, so we're looking at a lot of different factors to determine whether it's a deal that we will be comfortable with.

Colleen Blumenthal:

Okay. And one more question for you all, so get ready. Those of you at Asha, I know that this question was not answered at that valuation panel and I still want to know the answer. So in short, is there a point beyond replacement value where you're like, "That's just insane. And I'm not into it." And I guess we could keep it really simple and say yes or no. But our choices here are up to 50% of replacement, no question whatsoever. No question, if you go double replacement costs, maybe it's something in between or... Ben thinks there's no limit. I don't know what Ben thinks

Ben Firestone:

I'm a no limit soldier, Colleen. I don't think there is one in this case.

Colleen Blumenthal:

So 50%, who's in? Who's up to 50%? Who thinks you could double the property and you're fine with that?

Michel Ausburger:

Cash flow is there.

Colleen Blumenthal:

A few. And so are the rest of you somewhere in between? Or are you falling asleep?

Michelle Kelly:

There's also no limit though.

Colleen Blumenthal:

Oh, yes. No Limit. I'm sorry. Was that no limit from Roosevelt?

Roosevelt Davis:

Not that I would do something that's crazy, but I mean just to follow up with some of Ben's comments. I mean, there's just strong demand out there for this property type. And you have a lot of folks that are new to the seniors housing space looking to get in. But there's private equity funds, financial institutions, and a lot of these different organizations and financial companies are looking for alternative investments. And seniors housing is held up well during the recession, and they're also too thinking about long term demographics, baby boom, silver tsunami. So just the demand for our product type has been incredible, despite so many challenges that we're seeing. And that's one of the things that's been amazing to me. Also in conjunction with that just the availability of capital. There's a lot of cheap capital out here to finance these transactions. So, yeah, you see all types of stuff.

Colleen Blumenthal:

So that's one side of the coin. And one of the things that we're seeing right now is a real spread and demand for class A, which I would argue is pretty easy to figure out how to value versus everything else. So we've had another case for you here. Right now the spread by the end of the 2019, it was almost 250 basis points, which is about the largest I've ever seen. Whereas even five years ago, it really was not that deep. So let's look at that 1990s assisted living memory care, so the last one was a very sexy property, this one is not. It's just a workhorse, it chugs along. It's got predictable NOI. Has not been renovated in 10 years. And frankly, there's no new supply because there's nothing going on. It's blah, blah, blah. But you can predict. It's predictable. You know that the 1.2 million is, you can bank on it. So, you're accepting the 1.2 million. And again, here's the question for you. Is the cap rate, a six handle, a seven handle or an eight handle? You're ready?

Colleen Blumenthal:

Who thinks it a cap rate in suburban wherever 1990s building is, is a six handle? No six handles, how about seven handles? Pretty good. Eight handles? And I'll just throw it out there. Does anyone think it needs to be higher than eight? No, there's nothing special about it. So it looks like by and large some people are in this room anyway are throwing a seven handle on it. I mean, then how does the buyer of this property differ from the sexy one in San Francisco?

Ben Firestone:

See I'd argue that this is a very sexy deal for me because I know we could execute it. Because there would be very, very many bidders. Why? Because those bidders that were looking at San Francisco and didn't get it, they're crowded out of those coastal core bidding wars and they've got so much capital to place. They've got to get aggressive with assumptions and got to find projects that they can actually win. So why I'm actually taking a little bit less of an aggressive evaluation here and I'm a seven handle buyer, or pricer. Because I think that replacement cost actually does play a relevant role in this one. And what we're seeing on this type of vintage ratio is somewhere between most funds are saying, "I hit the brakes at 300 a unit. Hit the brakes at 50% above replacement cost." Some of these things actually will create some rationality with investors, despite having that much demand to place dollars into seniors housing properties.

Colleen Blumenthal:

Michelle, what's the public REIT appetite for this type of property?

Speaker 6:

[inaudible 00:32:14].

Michel Ausburger:

Well, no. No, I mean, this is the type property I think that we would absolutely look at as well. Given it's been 10 years since the last renovation though, I'm also pricing into my investment, what's the next renovation going to be and so that's probably why I'm more of the eight cap buyer, because I know I'm going to have to dump a lot of money into it to get it up to snuff and so I need to reserve a little bit of my investment allocation for that purpose. But at the end of the day, this one comes so down to what else is in that market. So if it's still performing well and it's a stable project, and there's nothing new coming into that area, and you just basically need to keep doing what you're doing and refresh it so that it stays current, I like that deal.

Colleen Blumenthal:

Roosevelt, what's your appetite for it?

Roosevelt Davis:

I would be a seven cap guy on this transaction. But I definitely agree with Michelle in saying that I'll definitely want to know about capital expenditures that need to be put into the property. And would truly be concerned about the new development down the line.

Colleen Blumenthal:

So how would the risk of this older stable building be different for you than the sexy high priced one?

Roosevelt Davis:

Me?

Colleen Blumenthal:

You.

Roosevelt Davis:

Well, I like sexy but-

Colleen Blumenthal:

Don't doubt that.

Roosevelt Davis:

I'm not. Yeah, this is Rated G. I mean, I think for the the sexy high price property, it is very interesting because it's counterintuitive. I know that sexy high price too you have a lot of bidders going after that type of property as well, because you have the private equity fund. You have a lot of people so flush with cash. And there's no private equity fund raising money getting cash back saying, "Oh, I can't find a property." Right? So there's going to be some type of demand there for that property as well.
Even though there are challenges. So it's all about supply and demand. And there's a lot of demand for those types of sexy properties.

Colleen Blumenthal:

So let's move on. If you've been to any other session, or heard anyone collaboration, collaboration, collaboration. So we've got Medicare Advantage, and I know at e-cap they were saying it's about a third but as of February, when I pulled the stats, it's closer to 36% penetration nationally. In some areas it varies more than others. In fact the map there is just the presence of all of the ACOs throughout the country. And more and more groups are forming institutional special needs plans for the residents. It seems like a no brainer, work together and provide better care and better outcomes at a lower cost for residents. But Michelle, is it really that easy? I mean.

Michel Ausburger:

Well, it's not that easy. I went up and talked after the open session this morning to Bob Kramer. And I said, "The problem with this excitement about collaboration is, that there's a couple of factors. One is, that the penalties for readmissions, as far as I'm concerned are not high enough to overcome the capital costs that hospitals have invested in their hospital structures. And so the penalty doesn't equal what it's costing them to have an empty bed. And so it really is not changed for most hospitals that are behaving." And Bob said, "Yeah that CMS is very much aware of that and is trying to figure that out." The other part of the issue is, I think in terms of collaboration, unless we can figure out how we're controlling the pot of money. We're going to be at the low end of the food chain, and the hospital and the physicians and everybody else and so, the talking about margin compressions, what we're being offered from those plans, essentially, by time you factor out the cost of therapy and other ancillary services. You're essentially getting the same or less than what you're getting from Medicaid and Medi-cal.

Michel Ausburger:

And so we got to get higher up on the food chain so that what we're getting in reimbursement is significantly better. We have a number of contracts with hospitals that have their own ACO agreements. And our experience so far is they're terrible payers in terms of timeliness. And secondarily, in terms of what they're paying is just not that great by the time you factor out the cost of providing care for those clients, for those patients.

Colleen Blumenthal:

So what's the solution then? Because I mean, I think more and more of those dollars are going to be dictating whoever controls the resident and then their health care dollars dictates the setting in which they're cared for.

Michel Ausburger:

To me for one off, I think that there's going to have to be, first off, I think, some political will that people are going to be willing to close some hospitals in terms of excess capacity to change behaviors. And I think nobody, no politician wants to have a hospital closed in their community. So that's going to be a very, very tough issue to overcome. But somehow I think we as an industry have to do a better job in terms of maybe selling our value and what we can do in terms of collaboration. But reducing readmissions is not cutting it because the penalties are not large enough to offset their empty units or their empty, patient rooms.

Colleen Blumenthal:

Got it. So, Ben to the extent that you have a property that's selling and they have relationships in place, or they're part of an ACO. Are buyers recognizing a value to that and paying for it? Do those relationships continue after the sale? How does that work?

Ben Firestone:

I think it is a hot topic. And we've seen, particularly on the limited amount of SNF development out there. We've seen people build for one model and this shift is actually really impacted them or even forced foreclosures. But I do think that it's an educational process. I think some buyers are smart on this. Other buyers need to do their homework. I haven't seen it impact pricing yet.

Colleen Blumenthal:

Okay.

Ben Firestone:

But I think people will continue to get smarter on it and figure out where the upside is and perhaps where that risk and that downside is too.

Colleen Blumenthal:

And then Michelle or Roosevelt, I mean, when you're looking at underwriting something and there is a component whether it's, maybe they have their own in house home health, that they're using to act as a feeder to their community, but really, or some sort of collaboration with those off site, how does that impact the underwriting? I mean, how do you look at that?

Roosevelt Davis:

You can go first.

Michelle Kelly:

Sure. To be honest, I don't know that it has a huge effect either. The way that we would think about something like that is one, if it is something where they own, call it a home health or pharmacy or whatever, we're going to make sure that that's actually a real kind of third party contract. Because we want to make sure that the cash flow that's there is the real cash flow. So if all of a sudden there had to be an operator change in the future or something like they decided to get out of that business and had to go to a real third party provider, that they're getting market rates and we don't often get stuck with a lot of extra expense. So that's definitely a key part of the underwriting. And then, to me, it actually comes back to almost thinking more about that operator question, and are they being creative? And are they being progressive and thinking a little bit about the future of the industry? And trying to figure out how do we position ourselves better? How do we show the value of what we're creating with these health systems?

Michelle Kelly:

Because more likely than not that that is going to be a requirement. And so the earlier you can be collecting the data, the earlier you can be showing the value that you're creating and creating a healthful environment for these folks, keeping them healthy longer. I think all of that's really helpful. But I don't know that that ultimately changes the way we think about the value of the property today. Unless it translates into some sort of increased revenue, reduced expenses to get to a better bottom

line, there's not really a direct correlation, because we still have to get a return on the dollars that we put out the door.

Colleen Blumenthal:

Well, it sounds like it's more operator initiative that makes it-

Michelle Kelly:

It is.

Colleen Blumenthal:

Happen rather than unique to a real estate asset anyway.

Michelle Kelly:

I think that's right. And I think it just speaks to the quality of the operator. If it's a group that's just ignoring it, and living under a rock that this is the way things are going. Particularly if you are in the higher acuity side, that doesn't bode well for us may be really wanting to push hard to get the deal done. If you're really thinking about it, I mean, nobody's got the answer yet. But if you're really thinking about and you're trying to position yourself, that's going to carry a lot more weight and maybe help us get a little bit more aggressive because we really want to try work with that kind of group.

Colleen Blumenthal:

Sure.

Roosevelt Davis:

From our perspective at Fannie Mae we don't see a lot of these types of transactions with the collaboration on the assisted living side. But if I can ask a different question and answer it. One of my concerns in terms of just taking a look at cash flow is, I'm concerned with the sustainability of the underwritten net cash flow. That's highly important to us in Fannie Mae and it's like are we truly underwriting what is happening at the property and in the market? And from do we have the right vacancy factor in there? Are you taking into account properties that are being built within a five mile radius? Are you taking into account labor costs? Are you really capturing that increase? Are you capturing the fact that minimum wage is increasing. You may have an opportunity to have a high claims history, so that premium is going to go up. And with these underwritten replacement reserves, no one is doing 300, $400 a unit, that's another topic within itself.

Roosevelt Davis:

So, from my perspective, the sustainability of the underwritten net cash flow is very important because we basically doing 10 year loans, and we definitely want to see the net cash flow continue to go up, and the ability for the borrower to pay the debt service payment.

Colleen Blumenthal:

Absolutely, and I concur that $300 a unit is lie we all tell ourselves, but if we were to put the actual dollars in and they are thousands of dollars per year, seniors housing and their big numbers, it is closer to $3,000 per unit. Our cap rates would be point three. So just keep that all in mind.

Roosevelt Davis:

Yep.

Colleen Blumenthal:

So we have to cover skilled nursing. So here's our last opportunity to stretch those hands. So as the Value-Add SNF, which we see tons of I'm sure Ben you do as well. So we picked something in Indiana just to make it exciting. So we've got UPL revenues in there. If you pull the UPL revenue out, the property's not cash flowing. And someone's going to come in and buy it. They're very realistic as far as the revenue assumptions, they're not going to increase census. They're not going to increase Medicare census, maybe a little case mix adjustment, but by and large, they come in renegotiate all the third party contracts, tighten up on the staffing and bada boom, they're going to have a 14% margin.
Maybe not year one, but by year two, this is where they're going to operate. So that's the story. And the question for you is, all right, first of all, the UPL. Yeah. I already told you CMS is basically going to sunset whatever they have in place right now, you've got a three year window and it will change.

Colleen Blumenthal:

You just don't know how. So knowing that, when you're looking at the UPL cash flow, it's pretty simple. Your options here are cap it, ignore it, do something in between. So ready, shall we say? Who's capping it? Okay. Who is disregarding it entirely? Interesting. All right, so somewhere in between? That might be the winner. I don't know. There is a lot of in-between. Go ahead, Ben.

Ben Firestone:

I just want to clarify. So should be recognized as a non recurring revenue source?

Colleen Blumenthal:

So that is the in-between, right?

Ben Firestone:

Okay.

Colleen Blumenthal:

So applying a multiple to it, as opposed to capitalizing it.

Michelle Kelly:

I may be giving credit to some, but not all.

Ben Firestone:

Because this is in Indiana how I would look at this is, driven by HUD underwriting. And right now HUD is underwriting 25% of VPL revenue in Indiana. If this was in Texas, they give you zero.

Colleen Blumenthal:

Right. And why is Texas zero?

Ben Firestone:

I think it’s just HUD doesn't believe in the viability of the program there.

Colleen Blumenthal:

Okay.

Michelle Kelly:

It's funny. I literally just asked this question in a meeting right before this too, a skilled nursing operator said, "How are you handling UPL revenue?" And Indiana is the one exception where they would maybe give some credit, and it's probably for the same reason, but really, in any other state they're saying no. And so I raised my hand for B, but for Indiana, it's probably more C.

Ben Firestone:

But I would say I would raise my hand for A because you’d cap it at the same cap rate, but only give 25% of it. Not a one time non recurring revenue. So maybe it should have been C.

Colleen Blumenthal:

Fair enough. And for those of you that don't know, I mean, almost 96, seven, percent of the nursing homes in Indiana actually participate in this program. So it's pretty widespread. So it will be interesting to see how this changes. I mean, I think the consensus is it's not going away. But how you access those dollars is going to change. So a little uncertainty. Okay, last question. And we're in the homestretch to cocktails. So assume you buy the 14% margin, maybe you don't buy the 14% margin, but if you're told, "it’s a 14% margin," and we're going to go with the standard 13% cap rate, because that's the HUD safety zone and really cap rates have been between 12 and 14 forever. I'm just curious, do you if you start at 13 looking at this deal, do you go above 13 cap rate, because you're really concerned that they're going to go from negative to 14% margin in a very short period? Does that not concern you?

Colleen Blumenthal:

You're like, "13 is plenty, we don't need to adjust this at all." Or do you say, "Hey. You're not even looking at the UPL at this point, you're just looking at the cash flow. So it should be a lower than the 13 cap." So that's the thought process. Who is increasing it above 13 because they're just nervous about the 14% margin? Maybe, I don't know. Who says no, 13 is good enough.? You got it. We've got a few there. And who's actually decreasing it below 13? Because you carved out the UPL separately, and you're recognizing that separately. So I don't know. Who counted it? Was it no impact or was it a higher? That's pretty close.

Michelle Kelly:

Probably half and half.

Colleen Blumenthal:

I think that's a coin flip there.

Ben Firestone:

Yeah, I've just would respond by saying B is at face value, what I would say but it's because of two offsetting factors. One is the execution risk, and then that dings you but the marginal increase because of the UPL actually helps you kind of get to the same place.

Michelle Kelly:

And ultimately, I think I would probably be 13 too just because it seems to be, especially if you're looking at a HUD takeout. That's the path of least resistance that's their expected cap rate. And I'm sure they would love going above that. But if you go below that you need to have a lot of support to make them comfortable with it.

Colleen Blumenthal:

So the other thing that's different I think this particular cycle than others is we've got this looming middle market crisis. I know Roosevelt just came from that session next door. But over the next really not even 10 years, we're going to see a middle market or folks who, they have income but not enoughto qualify, not so insufficient that they can qualify for Medicaid, but not enough that they can afford to pay 4500 a month for assisted living. Some of them do and when they came up with these calculations, I mean, they're assuming that someone's buying their house, which in some markets,The Wall Street Journal had an article not that long ago, identifying that in Sun City Center and then other retiree markets, that there may not be a younger person who wants to come in and buy that. So there's some issues there. But we've got this crisis looming, where we've got all of these people coming and we don't really seem to have a solution.

Colleen Blumenthal:

So I mean, Michel, I mean, can you talk about from an operational standpoint, what are some of the changes we can do to come up with something that's more affordable for more people?

Michel Ausburger:

Just because I've been doing some modeling, looking at some opportunities here recently, I think, one of the things that becomes abundantly clear that there's a couple things one, it doesn't cost any less to care for somebody that has money versus somebody that has no money. So that's one of the things you have to live with from the very beginning. But I think, beyond trying to figure out a creative way with capital costs, I think larger communities, at least you have more units, to which you spread your overhead cost. I think that small communities in these kind of markets have a hard time because if you're going to pay an administrator, let's say $80,000. Divided over 40 units versus divided over 120 or something like that. It does reduce your cost. And I think that it's going to take some of those type of things to try to figure out how to get to an affordable point. Because we have a ton of people out there who would come in, if they had the resources.

Michel Ausburger:

But with states looking more and more at mandatory staffing patterns and some of those types of things, we're having less flexibility to try to figure out a way to provide a lower or more affordable product.

Colleen Blumenthal:

Michelle do the REITs have any appetite for this space?

Michelle Kelly:

Yeah. At the end of the day, I think the way at least NHI would approach it is, again, not really any dissimilar than how we look at any other investment opportunity. If an operator can successfully

operate the community, generate NOI so that we can buy the project at a level where they can make a rent payment, still have leasehold cashflow above and beyond that and maintain the real estate, we would definitely be interested. But to Michel's point, it's just very tricky to make that math work right now. We are working with one group who's has been pretty successful actually in somewhat smaller markets, but they're so tightly geographically clustered. They have really figured out how to share resources between communities so that they can help spread some of that fixed cost over multiple communities and go from a 40 or 50 unit building to really, a hundred or 150 units across three locations. I think people are, again, are going to have to be creative.

Michelle Kelly:

It gets back to how do you be innovative and do something a little bit differently, to still be able to make a decent margin, but provide that care when you know care staff is not where you can cut. It's really everything else that you got to start thinking a little bit outside the box to try and bring those costs down.

Michel Ausburger:

But I don't think the industry is going to be able to resolve it. I think that there are just a lot of other things that politicians feel have higher priorities. But when the tsunami hits in a serious way and there are a lot of people that can't find... the government is going to have to step in and try to come up with some solutions for some additional funding sources.

Ben Firestone:

I agree, I think it could be the most pressing challenge the industry is facing in the next decade. So I think if Roosevelt and some of his friends in Washington could come up with some kind of new incentive, new financing vehicle that could help some qualified properties in getting some incentives to produce that property type, that affordable model or like Michel said, if we can get states to come up with waiver programs or other ways politicians can come up with ways to pay and subsidize it. I think that's the only way we can get it done.

Michelle Kelly:

In a meaningful way. I agree.

Roosevelt Davis:

From my perspective-

Colleen Blumenthal:

Go ahead.

Roosevelt Davis:

I was going to say from our perspective, I'm gonna stay positive. I'm hopeful. I mean, I think all it takes is definitely as Michelle mentioned, some creativity and innovation there. And is getting the right folks together, whether it's the think tank, with the same mindset to try their best to solve this particular issue. But it's definitely going to take a village in partnerships, public, private. So Fannie Mae, we're definitely willing to do our part in terms of making financing attractive for owners that are willing to provide middle market housing. I mean, you need to get to state and local city agencies because at some

point, these are constituents, right? And so these politicians going to need votes. And so if there isn't enough housing for the middle market folks, that politician may have to go. They're going to want some demands on that. And I can see local city states providing tax incentives, providing properties of things that they may own for redevelopment, to provide that type of housing.

Roosevelt Davis:

So I'm very hopeful. I just think that we just need to start. Just get the ball moving. And then more folks will come in and improve the model. But I think I'm hopeful. And we're definitely going to do our part in trying to help create a product that could bring about better financing to help folks provide this type of housing.

Colleen Blumenthal:

And do you think there's any opportunity for failed or underperforming projects to reposition as the solution? That old 1990s A/L memory care that's not competing in the market where five new ones opened up and it's just struggling?

Ben Firestone:

I mean, for now, where those are clearing, those assets do trade, it's Michel's model. It's, "Okay. I'm going to buy it for X. I'm going to put in Y and I'm going to cash capitalize X plus Y equals Z, so that I can figure out a way to get this property more competitive." And it's going to be aimed largely and likely at private pay, perhaps a low cost provider market positioning, but private pay dollars in today's market.

Colleen Blumenthal:

So we're still I think the consensus is it’s going to be a public private partnership whether it's mandated 30% of your units need to be affordable or however they look at it. I know New Jersey, I think has a Medicaid requirement for new construction, or a completely brand new building. But I think the challenge is no one wants discounted health care.

Ben Firestone:

Yeah.

Colleen Blumenthal:

You're fine getting a bargain on clothing and other things, but health care it's the best right?

Michel Ausburger:

Or just give some even we're here in California and just to talk about California. California is the largest population in the country and yet state has a cap on the number of Medicaid slots they have. In terms of part of a waiver program and up to just a couple years ago it was like 2500. I think it's up to maybe 10,000 in the entire state. I mean, and the rates are paying, doesn't even begin to work for people. So that's why no one is rushing in to sign up for the program. And yet you listen to people talk about what their priorities from a policy perspective and fixing this problem doesn't even get on the radar for.

Colleen Blumenthal:

It's interesting because I was just in California two weeks ago, doing several as it turned out, I thought it was just one but it wound up being a few, transitional care, get the homeless off the street. And not just

Just get them off the street but for people with bipolars, schizophrenia, substance abuse, get them in a program, in a residential setting where they can get back on their meds, learn some life skills and counties are paying between two and $300 a day for that and assisted living it's much less. Right?

Michel Ausburger:

Oh yeah.

Colleen Blumenthal:

So I mean, talk about political priorities in the state of California. The other factors that we're looking at that are different this cycle than other cycles is, we have a tremendous amount of properties that opened three and four years ago, that still have yet to reach stabilized occupancy. But at least covering debt service, we've mentioned it a couple of times, a lot of liquidity in the market, both on the debt side and on the equity side. Insurance increases, LIBOR is scoring away. Besides the broader political and international issues, we've got the election this year and the changes that will ensue from that. We've already touched on the limited supply of operators and just because it is this week. And we've been so conscious of keeping our hands clean. The whole coronavirus too, I'll throw it up there. So I mean, I'll open up to any of you. Which one of these-

Michel Ausburger:

Well, I think the one thing that should be on there, too, is and I think it's hard to know how this is going to impact us. But I think that immigration policy could have a huge impact on our workforce. The fact that if we don't have so many, at least in California and elsewhere, but certainly California, we've been so reliant on immigrants to fill positions. And I think that with a change in immigration policy, this could have a huge impact on our workforce and our ability to fill positions and what it's going to do for our cost and those kind of things.

Colleen Blumenthal:

Who else?

Michelle Kelly:

I do think I mean with the liquidity right now, and we touched on a little bit in the case studies. To certain extent it's almost artificially keeping cap rates so low. Particularly when you've got multifamily investors who are looking for a little bit more yield. So they go, "Oh, sweet, let's go do some active adult or independent living. It's the same thing." And so you're seeing a lot of that and that's why you're seeing four handle cap rates for senior living, they're just not really pricing the risk in. And so it'll be kind of interesting to see. I think somebody yesterday told me that the cap rates on average between some multifamily and senior housing is almost compressing to 50 basis points. If those actually get back on top of each other, multifamily investors I think will go back to multifamily. But I hope those deals do well. They're just not really pricing in the risk for taking care of a frail population. So that does make me a bit nervous, about some of the deals that are getting done.

Colleen Blumenthal:

Ben what's the appetite for all of these cash flowing, non-stabilized assets?

Ben Firestone:

Cash flowing non-stabilized assets? That's considerable. I would say the only thing on this that I would have added other than maybe adding epidemic, would be ample liquidity is an understatement. So, again, I'm a firm believer in efficient markets. I also believe in entitlement programs, but that's a different topic, but-

Colleen Blumenthal:

Don't go there.

Ben Firestone:

I didn't want to. But the efficient market model, where supply and demand for projects in our world for deals. People will go after these deals and continue to take risk as long as they've got capital to spend and there's so much right now. Whether it's commercial real estate dollars, the pie chart is flowing a little more, towards seniors, new entrants or anyone even family offices now that believe in the silver tsunami and the increasing demand, it's inevitable that there will be more people... that are age and income qualified, in the coming decade that want to be in these units and can afford to pay for them Then there are units and people and institutions and investors of all shapes and sizes who firmly believe that. So that's why we're seeing price per units at an all time high, cap rates at an all time low, investors getting creative. And I'd argue that the last bullet here is the prevailing one. And the scarce commodity in our space right now is the quality operator.

Ben Firestone:

So that's where you're seeing just this incredible dynamic right now where it's great to be a seller. It's great to be an investor if you made good investment decisions. And it's probably better than anything if you're a qualified operator with some capacity to go out and take on new opportunities. So really exciting time to be in this space right now.

Colleen Blumenthal:

So it's a thriller for you.

Ben Firestone:

I would say a thriller and a comedy. Romantic comedy.

Colleen Blumenthal:

Love it. Roosevelt, so I guess just to tie this out, I mean, LIBORs ending, how is that going to change? Or what are the concerns with that?

Roosevelt Davis:

With what? Say that again I'm sorry.

Michelle Kelly:

LIBOR ending.

Colleen Blumenthal:

LIBOR ending.

Roosevelt Davis:

LIBOR ending. It will be very interesting, right? Because you have a lot of investors looking, they like the variable rate transactions because they can get out after a year, with a 1% prepay. Versus doing a 10 year, nine and a half fixed rate loan. So the risks with LIBOR going away and Freddie and Fannie will be moving to the SOFR index. And we're doing that September the 30th. You have to sign up your bi-board deal by the end of September 30th and it has to fund by December 1st, close by December 1st. So, but what I'm concerned with is okay, with the SOFR index, we're still in the process of creating a product, whether it's going to be a spread with a built in hedge, or you have to go out and get a hedge.

Roosevelt Davis:

So with people moving to a new index and all of this hedging, all of these LIBOR deals, maybe going to a new variable rate product, like what is the hedge costs going to be? So what is the risk? How is that index going to vary? How is that rate going to change? I mean, it's just a lot of risk in regards to that. And may have an effect on people investing in the future.

Colleen Blumenthal:

We started a little bit late. I know cocktails are next. If there are any questions, we're happy to take a couple right now.

Speaker 7:

Just a quick one on coronavirus and whether or not you think the next couple months, if it could be an impact to the acquisitions environment. Whether it's deals not closing or anything? Or have you seen that already in the last couple weeks?

Colleen Blumenthal:

You want to start Ben.

Ben Firestone:

Me?

Colleen Blumenthal:

Okay, maybe not?

Ben Firestone:

Oh, no. I will. I mean, I do think there are some... I mean, I just got a letter today. A kill letter on a piece of land, really has nothing to do with seniors. And I think everyone's a little cautious and concerned. Hopefully, this blows over. I think if it doesn't, the biggest threat we have is to occupancy. And we had a really interesting conversation today with an operator saying, "Hey, I don't know if I'm going to be able to lease up." Why? Not because my parent has the coronavirus because he doesn't want to be in a controlled environment with frail seniors that are susceptible to getting it and contracting the disease or the virus. So I think if this doesn't blow over, and our hope is this is just another case of those strong flu season. But if it's not, I think it's going to be a very detrimental threat to our business.

Michelle Kelly:

I think the other thing I heard the last couple of days that concerns me almost as much as potential occupancy issues is, as more and more schools are closing for a week or two to sterilize, all of a sudden your workforce can't show up. So that goes back to your daycare idea. I mean, that's going to be critical. So I know a couple of groups are already starting to think about, "What are we going to do in that situation?" But I mean, I'm kind of cynical in this whole thing. I think there's a lot of much ado about hopefully, not much. But I think it's going to be relatively short term. There's probably going to be some people who maybe don't pull out of deals, but at least say, "Yeah, let's just let this ride for a couple more weeks or take a little bit longer and make sure that this stuff stabilizes and blows over." But I am a little bit worried about the staffing impacts, almost equally as much as the potential occupancy if people are passing away.

Colleen Blumenthal:

I think the headline risk in general, right? Is we don't need these stories anymore of, people dying in droves in our communities.

Michel Ausburger:

Well, I don't think you need more. I hear from some of the people in the insurance world that the plaintiff's counsels are already lining up to go against the communities like up in Kirkland. And they don't need any more fuel to go out suing people and it's that is also something that's very concerning.

Roosevelt Davis:

It's very interesting. I was speaking with an operator earlier today at breakfast, and we were talking about the coronavirus and interesting we started talking about staffing. If the kids are at home, how do your staff come in? And he was like, "I don't know you may have to change one of the activity room into a daycare." Because you're going to need your staff there to provide care and service to the residents at the properties. But I think it's a big issue from my perspective and I think there's just a lot of uncertainty surrounding it, right? And so with uncertainty produces fear, produces panic. So I'm hearing more and more about travel bans, right? So you start, if I have to finance a property and I'm on a travel ban, I don't know would I finance that property without doing inspection, without going to see, meet with the borrower or the operator. And also too, I know we at Fannie Mae with our portfolio we require yearly inspections. Operator already told us, "Hey, you can't come and inspect. 60 days you're locked out."

Roosevelt Davis:

So it's very interesting and it's going to be interesting too how we also transact business, in the future with bans and all things like that. So can we still do a deal? Will Colleen still go out and give an appraisal if...

Colleen Blumenthal:

I might be just driving around quite a lot.

Roosevelt Davis:

HealthTrust. So it's very interesting. Great question though.

Colleen Blumenthal:

Very good question. All right. One more than we're out of here. Go for it.

Speaker 8:

Does anyone have concerns about oversupply, coming to the market, given the amount of capital, given the incentive of developers to get developer fees? The money's there. Fundamentals are strong. Does anyone have any concern about that?

Michelle Kelly:

I don't think that's a new concern. I think that's just a continued concern that people have had for quite a while. And to me, it just comes down to again, really understanding that specific micro market that you're looking at. So whether you're buying a project, whether you're developing a project, or just how it's going to affect one's that you already own. There is a ton of capital, there's a lot of development deals, the sheer quantity of development deals I still get every week kind of amazes me. Not all of them are getting done, because I do think people are starting to get a little bit smarter about it. But I think that's just something you always got to keep your eye on.

Ben Firestone:

Yeah, I think the worst of the oversupply is behind us. And again, I think investors are becoming more patient. We've seen some of the investment vehicles and structures change and people are looking at longer investment hold periods. So I think the worst of the oversupply concern is certainly behind us. And I don't think that's as big of an issue as it was three years ago. If you look at slide number two or three, we looked at absorption really picking up relative to new starts.

Colleen Blumenthal:

I can get there. Yeah. Forget it.

Roosevelt Davis:

And I also agree with Michelle, I think is this all about doing further due diligence. Whether due diligence or a sponsor, operator market, I mean, you just need to definitely dig into the deals that you're looking to invest in, finance, buy, what have you.

Colleen Blumenthal:

Thank you all for hanging with us to the bitter bitter end. We're going to drinks. Let's go. I am buying you all drinks.