SYMBIOTIC DISRUPTION: SKILLED-NURSING-REIT ECOSYSTEM ADAPTS TO MARKET DYNAMICS

WYATT RITCHIE
DAVID W. JOHNSON

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Nature thrives on symbiosis. Its many ecosystems would not exist without important relationships between sometimes strange bedfellows. The oceans' most colorful coral reefs, for example, are often found in clear water relatively devoid of nutrients.

Fish supply nutrients through their waste products. One organism's trash becomes another's treasure! When the fish population declines, the health of the coral suffers, and vice versa. Nature loves finely-tuned systems.

Business ecosystems also thrive on symbiosis. Few organizations are self-contained. Most leverage a range of mutually beneficial relationships from strategic partnerships to long-term supplier contracts. They create ever-more complex win-win relationships.

As markets evolve, participants specialize to achieve greater efficiencies and become more inter-dependent. When business sectors confront disruption, strategic partnerships become vulnerable. Participants adjust and some fail. Survivors strengthen their shared environment by adapting to new market realities in compatible ways.

In the Skilled Nursing Facility ("SNF") marketplace, historical reimbursement formularies have enabled facility operators to flourish within a highly-fragmented delivery system that tolerates waste. This ecosystem created relationships that thrived, but market demands for better outcomes and greater efficiency are exposing SNF vulnerabilities, threatening the long-term sustainability of many.

When times were good, Real Estate Investment Trusts ("REITs") became significant owners of SNF assets. REITs earned steady returns through long-term leases with regular rate increases. SNF operators had predictable costs and avoided the significant capital requirements associated with real estate.

In today's more stressful operating environment, SNFs are struggling to earn profit margins sufficient to manage their rising lease obligations let alone make needed operating and capital improvements. This is stressing historical relationships, with ownership and operator turnover accelerating. Financial relationships between REIT owners and SNF operators are becoming non-economic.

Enlightened REITs and SNFs need to reconfigure operations and capital formation to become leaner, more productive and more profitable. A symbiotic dance between REITs and SNFs is unfolding. Partners willing and able to adapt in concert to emerging market realities will re-engineer a more vital and resilient SNF ecosystem.

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Fortified by a long period of robust reimbursement, the SNF sector today is a $120 billion market with over 15,000 nursing homes. SNFs serve two vital functions in the larger healthcare delivery ecosystem: long-term custodial care and short-term post-acute rehabilitation services.

These two groups of patients require very different services. Long-term care patients require fewer services, are reimbursed at a lower rate and are less profitable.

Rehabilitation patients require intense therapy over a short period of time with the expectation they will return home. While costs for these services are higher, reimbursement has more than offset them. Accordingly, SNFs seek rehabilitation patients to bolster profitability.

The SNF market is attractive to operators because patients are plentiful, SNF services are low-cost, not particularly difficult to deliver and generate steady revenue through Medicare and Medicaid reimbursement.

Capital providers, particularly lenders, are attracted to the market given the heavy real estate nature of the business. The largest capital cost is the facility itself and even small operators can secure mortgages from local banks.

Under these circumstances, "Mom and Pop" SNF operators have proliferated. Today, single operators run 41% of the nation's SNFs. Small operators with 2 to 9 facilities run 26%. Large operators with 10 or more facilities represent only 33% of the SNF ecosystem.[1] Not surprisingly, large operators are generally more sophisticated and adaptable.

REITs are an investment vehicle that have existed since the 1960s. Mortgage REITs focus on real estate assets such as office buildings, shopping centers, and hotels. REITs buy real estate assets from operators and lease them back through long-term contracts. Leases have annual rent increases, typically tied to an inflation index.

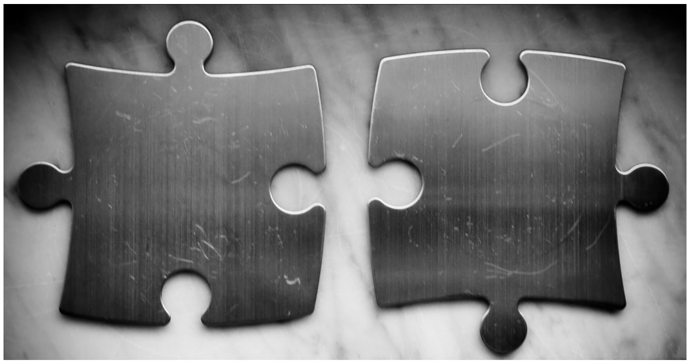
Over time, REITs have become a meaningful owner of SNF facilities, particularly those operated by the large, more sophisticated operators. Steady reimbursement increases and growing patient volumes have historically offset rising rental costs.

Now Medicare Advantage and managed Medicaid plans are managing utilization more intently. Bundled payments for joint replacement surgeries are reducing the demand for rehab services. Skyrocketing costs place SNF services beyond the reach of most private-pay customers.

Given these dynamics, the SNF ecosystem is becoming unbalanced. Operators do not have the margin to meet escalating costs and adapt their facilities to more stringent service demands. Proposed Medicaid funding cuts through the American Health Care Act increase payment uncertainty.

Major market participants, such as Kindred and Sabra Health Care REIT, are reducing their SNF market presence or leaving the sector entirely. Others, like HCP and Ventas, are spinning their SNF assets into separate entities. Golden Living is up for sale. Genesis is seeking private equity investment to build greater regional density.

INCONGRUENT ECONOMICS



Asset-intensive industries, including hotels, benefit from REIT-dominated capital formation. Marriot only owns a handful of the thousands of hotels it operates. REITs accept property ownership risk and provide a predictable cost structure. This frees operators to focus on brand strength, market-share growth and customer experience.

The SNF market, however, is not ideally-suited to REIT ownership because SNF profitability and property values depend upon governmental reimbursement, not free-market supply-demand relationships. Shrinking SNF reimbursement cannot accommodate standard sale-leaseback contracts with regular rate increases.

SNF operators are also confronting flat-to-declining patient volume, rising labor costs and greater demands. Moreover, SNFs are difficult for REIT owners to repurpose. SNFs are single-purpose facilities with narrow regulatory restrictions. By contrast, it is much easier for REIT owners to find new operators for their office buildings, hotels and shopping centers.

Under normal market conditions, economic pressures would catalyze improvements in SNF performance. The marketplace would reward SNF operators that demonstrate superior customer experience and offer value-laden services in attractive facilities supported by cutting-edge technogy.

However, SNF operators in REIT-owned facilities confront both diminishing reimbursement and escalating rental payments. Furthermore, lenders are reluctant to fund new capital investment when their debt offerings are subordinate to REIT funding. Not surprisingly, many SNF operators languish.

INCONGRUENT ECONOMICS

Despite intrinsic challenges, the SNF sector remains attractive to investors because market need for SNF services is growing with America's aging demographics. New investment groups are seeking to consolidate the SNF sector, identify superior operators and apply technology to improve services while controlling costs.

The senior population is about to expand enormously. Between 2015 to 2030, the population of Americans over 85 will grow by 50% to 9 million.[2] Seventy percent of Americans 65 and over will utilize long-term care for an average of 3 years.[3]

In a value-driven reimbursement system, SNFs must deliver post-acute services more effectively and efficiently than upstream providers. High-quality SNF operators will become increasingly valuable as coordination throughout the care continuum becomes more integrated and accountable.

To make that possible, the SNF ecosystem must evolve. There is an imbalance between facility supply (too many custodial SNFs) and demand (not enough high-performing SNFs). Too few SNFs have the facilities, the technology and the care management capabilities needed to participate in coordinated bundled payment arrangements and attract privately-paying long-term care residents.

Given the current harsh economic environment, it's a buyers' market for SNFs. Smart capital is flowing disproportionately to experienced and efficient regional operators.

Investors and operators are incorporating performance triggers into leasing contracts to reward efficiency and provide greater strategic flexibility for longer-term operating sustainability. Overall, the sector's limited profitability and capital access are increasing pressure on SNF operators, further accelerating industry consolidation.

For the capable survivors, this turbulence presents an opportunity to "reinvent" SNF services with new business models that will satisfy market demands. The operators with symbiotic relationships with their capital sources will be the engines of innovation.

High-performing SNFs will become less facility-centric and resource-intensive. They will become more community-oriented and deploy technology adroitly. Sophisticated sensors will prevent falls, monitor health and facilitate timely interventions. Smart communications systems will engage patients, increase social connectivity and enrich daily living. Value-based services and happy customers will proliferate.

TOWARD A HEALTHIER ECOSYSTEM

Market-driven change is healthy for any business ecosystem. Developing market-based "fitness" is hard, but ultimately rewarding. The competitive process amplifies desirable characteristics and weeds out undesirable ones.

In a more rigorous environment, SNFs will operate as a constructive component of a holistic care continuum. REITs will partner with the best operators and provide adequate capital to deliver competitive SNF services. Owners and operators will earn economic returns predicated on delivering superior value to customers.

Ecosystems can become fragile. They require constructive adjustment to flourish. Once adequately nourished, ecosystems become robust and resilient. They blossom. The cycles of creation, destruction and symbiosis come into balance. Fish return to the coral reefs. They engage with other creatures to sustain and enrich all natural life.

The SNF ecosystem has become fragile and needs enrichment. Market participants must adapt or die. New investment and business models will redefine post-acute care. Providers will deliver better care more efficiently. Consumers will have better options with tailored services. The quality of American healthcare will improve with the revitalization of this critical link in the delivery of value-based care. Harmonic symbiosis will triumph.

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[1] http://www.nic.org/blog/are-more-skilled-nursing-consolidations-in-our-future/

[2] https://www.washingtonpost.com/opinions/medicaid-is-out-of-control-heres-how-to-fix-it/2017/03/19/05167e9e-0b2e-11e7-a15f-a58d4a988474_story.html?hpid=hp_no-name_opinion-card-b%3Ahomepage%2Fstory&utm_term=.091f2ed87b5a

[3] https://www.carecapitalproperties.com/sites/default/files/documents/CCP_Nov%202016_NAREIT%20Investor%20Deck_F.pdf

ABOUT THE AUTHORS

David Johnson is the CEO of 4sight Health, a boutique healthcare advisory firm. Dave wakes up every morning trying to fix America's broken healthcare system. He is a frequent writer and speaker on market-driven healthcare reform. His expertise encompasses health policy, academic medicine, economics, statistics, behavioral finance, disruptive innovation, organizational change and complexity theory. Dave's book, Market vs. Medicine: America's Epic Fight for Better, Affordable Healthcare, is available for purchase on www.4sighthealth.com.

Wyatt Ritchie is a senior banker focusing on Post-Acute Care and Outsourced Services. Mr. Ritchie joined Cain Brothers in 2010 with over 23 years' experience advising both public and private companies in a variety of merger and acquisition, capital raising, and strategic advisory transactions.

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