Welltower CEO: Senior Living Business Changing as Health Systems Come Calling

July 27, 2018 by Tim Mullaney

Leaders with Welltower (NYSE: WELL) believe the company is positioned to create and seize opportunities in the years ahead, thanks to a major new joint venture and a restructured senior housing portfolio.

On Thursday, the real estate investment trust (REIT) and a nonprofit health system, ProMedica, closed on a joint venture deal valued at $4.4 billion. In that deal, Welltower acquired another REIT, Quality Care Properties (NYSE: QCP), and in a JV with ProMedica also acquired QCP's principal tenant, HCR ManorCare, the second-largest post-acute and long-term care provider in the nation. Welltower, ProMedica and HCR ManorCare are all based in Toledo, Ohio.

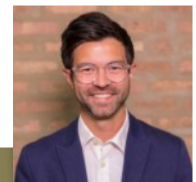
This transaction is a glimpse of the future, Welltower executives said Friday morning, on a call to discuss the deal closing and Q2 2018 earnings.

Specifically, this new JV will be a template for how senior housing and care can be more integrated into health systems, to more effectively manage costs and maximize quality of life for the country's growing population of older adults, said Welltower CEO Tom DeRosa (pictured above).

Going forward, Welltower's strategy will largely revolve around this concept of greater coordination among senior housing providers, health systems and payers. Already, the REIT is in talks with other health systems that took notice of the ProMedica deal, DeRosa said.

Welltower has been restructuring its portfolio with this new strategy in mind, he explained, including through a newly announced move to convert Brandywine Living from a triple-net lease tenant to a RIDEA partner.

'One of the big opportunities'



About Tim Mullaney

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Health systems across the country are paying close attention to what Welltower and ProMedica are doing, DeRosa said.

“Many health systems are now calling us, because they’ve seen the ProMedica announcement and understand the power ProMedica will now have,” he said on Friday’s call.

That “power” would be in controlling more of the care continuum, to create a “circle of wellness” for patients that keeps them out of the hospital and other high-cost settings. This ability to manage costs and outcomes for a large population of seniors is especially attractive to ProMedica, because the organization also is an insurance provider covering about 600,000 lives.

Many other health systems are already in the insurance business or are exploring ways to offer Medicare Advantage or Medicaid managed care plans, DeRosa noted.

In fact, just one day before the earnings call, Welltower met with one of the largest regional health systems in the Northeast, which has a post-acute care division that includes assisted living, he said. The system is having success with directing patient flow and even sharing staff between hospitals and its senior care buildings.

“I think you’ll see many [health systems] looking to partner with Welltower in assisted living,” DeRosa said. “I think that’s one of the big opportunities.”

The exact nature of these partnerships remains to be seen. Health systems are not familiar with all the options available outside a standard triple-net lease arrangement with a REIT, DeRosa noted.

And not every conversation is about doing a JV or striking some sort of lease deal—there are wide-ranging discussions about how Welltower can help create create “linkages” between health systems and senior housing and care providers, to achieve goals such as reduced hospital use, Welltower Senior Vice President of Strategy Mark Shaver said.

Shaver name-checked Silverado as one example, saying the provider is well-known for its standalone memory care communities and could potentially help health systems with patients who are experiencing cognitive issues.

Indeed, memory care in general is another area where Welltower sees a market need and an opportunity for further growth, and as part of the ManorCare transaction, the Welltower/ProMedica JV also acquired the Arden Courts memory care platform.

Located in the Northeast, Midwest, Texas and Florida, Arden Courts communities offer memory care at $6,000 to $7,000 a month—a lower price point than Silverado.

“We think Arden is going to be a very important platform for us due to needs that will be rapidly accelerating over three to five years and beyond,” DeRosa said. “The co-location of Arden Courts with ProMedica/HCR ManorCare post-acute assets will help drive census … We think Arden Courts is a real hidden gem in this acquisition.”

It’s still early innings, with the QCP/ManorCare acquisition having just closed. And there are question marks hovering over the deal, including the fact that ProMedica operates in Ohio and Michigan, while ManorCare buildings are spread across the country. In addition, the ManorCare portfolio needs a CapEx infusion, and ProMedica has pledged to invest as much as $400 million in “growth and upgrade capital” over the next five years.

Still, Welltower is confident that the future will bring more deals like this one.

“You’ll start to see more cooperation, more collaboration [between health systems and senior living],” DeRosa said. “Welltower is really the party that is convening these discussions as well as these opportunities.”

Brandywine conversion

Welltower has been a vocal proponent of RIDEA, and now has converted another of its senior housing tenants to this structure.

This month, the REIT's 27-property Brandywine Living portfolio switched from triple-net leases to RIDEA. Mount Laurel, New Jersey-based Brandywine will continue to operate the properties under an incentive-based management contract. Welltower will be the primary owner of the OpCo and PropCo and a 34.9% owner of the management and development company.

The conversion was not precipitated by a default or by any degradation in operations, Welltower Senior Vice President-Investments Shankh Mitra emphasized on the earnings call. Instead, it was driven by the fact that Brandywine was "over-leased and over-leveraged" from the start of its relationship with Welltower, which began with the acquisition of 19 properties in 2010.

Brandywine's lease coverage was essentially 1x, which was unsustainable in the long term, Mitra stated.

"Brandywine is just another example of fixing a broken capital structure that resulted from a period of time when REITs where valued at how large they could grow their asset portfolio," DeRosa said. "In the last two years, we've been fixing a lot of over-levered situations."

The Brandywine portfolio as a whole is highly attractive from a demographic standpoint given its location in the "super ZIPs of the mid-Atlantic," and Welltower is committed to Brandywine as an operator, he added.

Indeed, Brandywine's revenue per occupied room (RevPOR) of more than $7,500 is among the highest in Welltower's portfolio, Mitra noted. And while there has been some occupancy erosion in the last six months, due in large part to an influx of new supply in the Northeast corridor, the conversion was not based on recent performance.

Brandywine President and CEO Brenda Bacon also confirmed that the company's operations are sound.

"Our operating metrics are at the top of the industry even in these difficult market conditions," she told Senior Housing News. "Brandywine and Welltower have worked hard to develop a structure that works for both of us for the future. We are aligned on the growth and success of Brandywine. There is substantial upside for the shareholders of both companies, from day one."

The conversion should be interpreted as a vote of confidence in Brandywine's ability to flourish as senior living becomes more integrated with health systems, DeRosa argued.

"You hear us repeatedly talk about how assisted living will become much more consequential in the overall health care delivery perspective," he said. "… We're restructuring RIDEA relationships with operating platforms that we believe have the best opportunity, due to the role this real estate will play in the overall health care delivery spectrum."

The Brandywine conversion does indeed follow several other restructuring moves that Welltower has made in recent months, including large-scale changes related to major tenants such as post-acute giant Genesis HealthCare (NYSE: GEN) and Brookdale Senior Living (NYSE: BKD).

Comparing these moves to a game of whack-a-mole, Mizuho analyst Rich Anderson asked if this game will continue or if Welltower now has addressed the major issues.

"We feel we're largely done," Mitra replied.

Cycle nears a bottom

Continued pressure from new supply, tight labor markets and the ongoing effects of a bad flu season are all drags on the senior living operating environment, and this was reflected in Welltower's second-quarter 2018 earnings, said Mercedes Kerr, executive vice president-business and relationship management.

On a same-store basis, the company posted just 0.1% year-over-year growth in net operating income (NOI) for its senior housing operating (SHO) portfolio of 435 properties. For the senior housing triple-net portfolio of 305 properties, NOI growth was 3.1% year-over-year on a same-store basis.

While not satisfied with the operating portfolio's numbers, Mitra characterized the results as a "respectable performance" given the supply cycle. He and Kerr both expect improved numbers in future quarters as new supply tapers in the months ahead.

"We don't want to venture [to guess] what 2019 will look like, but our sense is we're bouncing along the bottom right now," Mitra said.

Total occupancy for the SHO portfolio was 86% in Q2 2018, down from 87.9% a year prior. But the good news is that construction starts have slowed while absorption rates have remained strong, as measured by the National Investment Center for Seniors Housing & Care (NIC), Kerr said. So, occupancy should tick up as supply and demand come more into balance.

In addition, a seasonal uptick in occupancy typically takes place in Q3, and Welltower is starting to see this, according to Mitra.

This seasonality should provide a "lift" to the REIT, but it also needs to "quickly and efficiently" dispose of a portion of the QCP portfolio currently being held for sale, as well as improve SHO portfolio operations, Stifel analysts wrote in a note on the earnings. Overall, Welltower's Q2 was in line with Stifel's expectations.

WELL shares were down 3.89%, trading at $61.81, as of market close on Friday.

Written by Tim Mullaney

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