Debt, Distress and Default: What Now?

Major Defaults and Restructurings Are Hitting the Seniors Housing and Care Market

An analysis by Editor-at-Large Steve Monroe

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INTRODUCTION

A funny thing happened on the way to the bargain-basement sales market. Well, actually not so funny. Many of you may remember the predictions for the first half of 2021 when a lot of distressed properties and portfolios were expected to hit the market. The cash-rich vulture funds, and others, were lining up to take advantage of big discounts, especially that ubiquitous "discount to replacement cost," some- thing which in this market may lack meaning. There were supposed to be value-add properties and "just have to sell" portfolios.

But this did not happen, at least not at the scale that was expected. Why? First of all, the government financial support at the state and federal levels kicked in and many operators thought they could ride out the storm with this extra cash. Second, lenders were engaged in the "extend and pretend" mentality and really did not want to be known as the bad bully during a terrible pandemic. A wise decision. And bank regulators loosened up as well.

Third, occupancy bottomed out in March 2021, and there was hope. PE firms decided to wait to sell some properties and see if the turnaround was really coming. Optimism increased with the initial surge in census increases across the country and across all senior care sectors in the second quarter and beyond. Finally, interest rates were still so low that holding on for a better day was not that painful.

That was then, but now, fully two years later, the landscape has changed. Census is still increasing, but at a slower pace than in the first year of the recovery. This was to be expected. Many companies are still not at pre-pandemic levels, let alone pre pre-pandemic levels of 2017 and 2018, which were 200 to 300 basis points higher than in March 2020.

Everyone thought that when census returned, margins would follow, and so the focus was filling the empty units. While we agreed with that, there were others who thought margin maintenance was crucial because that would be harder to fix. We still think of our friend Bill Sheriff, former CEO of Brookdale

Senior Living (NYSE: BKD), who scolded us about margins, claiming absolute levels of cash flow were all that matter. He was right, most of the time.

There has been some margin recovery, but not near enough to cover capital costs such as leases and mortgages, which is why we are now seeing defaults, non-renewal of leases and outright give-backs of properties or portfolios. And don't forget, what the government giveth the government can take away, and financial support has dwindled down significantly.

And then inflation reared its ugly head, and operating costs were rising faster than rate increases could be implemented. Labor costs were still high and in many areas labor remained in short supply, with the only good news being that many if not most providers have been able to significantly lower their use of expensive agency labor. However, inflation was so low for so long that it is our belief that the economy will have a three-year catch-up to get prices in line with the new realities, and certainly a three-year catch-up for labor in senior living.

Someone asked us recently, where are all the seniors who would normally be moving into our communities? It's not like there is a lot of new development going on. That is a great question, and the only logical answer that we have would be that they are waiting longer to move in, which means they are more frail and their length of stay will be shorter.

Some are still frightened about congregate living given the media reports during the pandemic (or else their children are). Some are finding alternatives, whether it is active adult, home health, staying put or moving in with family. And then, just look at how much more expensive seniors housing is today com- pared with the cost in 2020 or 2021.

When you add in the necessary 8% to 10% annual rate increases that we believe will be required for the next few years to recover margin and cash flow for "all" necessary expenses, it can be very scary for those potential residents and their families who are on the fence about wanting to pay for it, or even being able to pay for it. This may be the biggest problem for seniors housing providers moving forward. To catch up with costs, we may be pricing ourselves out of the market in some cases.

If your assisted living rates are $5,000 per month, and you have back-to-back-to-back 10% rate increases, that takes you to $6,650, or a 33% increase. There are enough people who will not be able to afford it or will look for alternatives, if they really exist. This is why we may experience a slight decline in the penetration rate despite the lack of new development, and despite the demographic headwinds.

Many people already think of seniors housing as being for the wealthy, and this may be compounded. The sector has certainly developed most of its communities for the wealthier seniors. For every 10% rate increase, we are making the product unaffordable for an increasing number of the elderly. There may not be a choice, but it needs to be considered. One simplistic way to look at it is that for every 10% increase in rate we may lose up to 1% of the potential residents, or maybe 0.5%. But we lose them. That is simple economics, no matter the value of the service.

The other part of this pricing puzzle, which we have to believe is impacting census, is that during the pandemic cash flow was used to cover operating expenses with little to nothing left for ongoing capex, let alone major renovations, in many cases. The priority was taking care of the residents and keeping staff as happy and safe as possible, which was the right decision.

But then here come the rate increases to deal with the inflationary operating cost pressures, and we expect families to pay more for a product that may be a little tired looking in more cases. There is a bit of a disconnect there. Then, think about where we would be if development was more normalized and getting ready for the age wave.

To sum it all up, in a simplistic way, the pandemic killed census, inflation killed margins and profits, and now high interest rates are killing capital and over-leveraged borrowers. Well, not exactly killing capital, but making it too costly for many deals and projects to pencil out. And the first two problems are causing capital providers, mostly lenders, to hit the pause button on the sector just when capital should be pouring into the sector. What a mess.

But it is not a mess for everyone. Just look at some of the companies and properties we have profiled in the past several weeks that are not just back to pre-pandemic occupancy levels, but also surpassing them. What we don't know, since they are private, is how much of their margins and actual cash flow they have clawed back. Time will tell.

DEFAULTS STARTING

So, what is the bad news that is hitting the market right now, and will there be more to come? As of the end of March, the major restructurings and defaults involve Sonida Senior Living (SNDA), Enlivant and its owners TPG Capital and Sabra Health Care REIT (NASDAQ: SBRA), and Ventas (NYSE: VTR) with a $1.5 billion portfolio of a mix of assets. We would bet that there will be more to come, but these just show how different the environment is today compared with two years ago, or even one year ago.

Let's start with the recent announcements from Sonida. In its recent fourth quarter and full-year 2022 earnings report, issued at the end of March, the company gave a "going concern" statement, meaning that there is significant doubt as to whether it can continue as a going concern in a year's time.

This is not the first time the company has issued such a statement, yet they were still here a year later...a few times. This time the declaration sent the shares tumbling by 40%, but also because of some debt problems.

We were not surprised because in our November 2022 issue we stated that we thought the compa- ny would run out of money by April of this year based on its cash burn rate. We are now at the end of March, and cash was just $16.9 million on December 31, 2022, down from $27.0 million on September 30 and $32.6 million on June 30.

That is nearly a $10 million decline in cash in the fourth quarter, and at that rate it will be very tight in the next two months. Interest expense alone is $9.3 million per quarter and rising. Maybe they can make it to May without a new cash infusion, and it appears all hands are on deck to conserve cash and try to boost revenue and cash flow.

The “problem” we have is that everything seems to be going up at Sonida (other than the cash). Weight- ed average occupancy was up 310 basis points year over year, and up 50 basis points sequentially. In fact, occupancy at the end of December was 84.2% compared with 84.0% at the end of 2019, so it is back to pre-pandemic levels already, when many companies are not there yet. But occupancy is still far behind the pre pre-pandemic levels closer to 90%.

Net community operating income was up sequentially, net margin was up sequentially by 70 basis points, RevPOR increased by 110 basis points sequentially, and so on. But despite these improvements, which we assume was what management was “thrilled” about in the opening of their press release, and rightfully so, there is a real concern whether the company will make it through the year.

The new management team is trying, and the problems were mostly inherited. And there is no doubt that we are still in a tough operating environment exacerbated by rising interest rates. This is what has been so confounding to many operators: they are improving most of the financial metrics, but it still feels like they are running in place and handcuffed by debt and lease payments.

During the first quarter, Sonida decided not to make principal and interest payments due in February and March on non-recourse mortgages covering four properties with outstanding debt of $70 million. On March 1, Sonida received formal notice from the lender that it was in default. They are negotiating to obtain more favorable terms, but so is practically every borrower that is having leverage problems. That will be the big question for the next nine months across the sector, who will blink first?

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Most of Sonida's debt is fixed rate, and the variable-rate debt is hedged, but it is the absolute level of debt that is the problem. Currently, the properties are not worth the total debt amount, even using cap rates of yesteryear, even with the recent improvements. According to our analysis last November, they would have to really knock the ball out of the park in the next two years just to break even with the debt from a value perspective. The next debt maturity is in 15 months for 12 Fannie Mae loans.

Will Conversant Capital, the majority shareholder, invest even more money into the company? The only way that would make sense would be if they were able to get lenders to reduce their loan balances. Not many will be excited about this proposition. While we can't blame them for a lack of enthusiasm, they may not have much of a choice. Alternatively, someone will have to come up with a real creative solution.

We do not like to see this much distress in our market, but it does all come down to capital structure. Even though Sonida does not have any lease commitments anymore, and it already handed the keys over to Fannie Mae on 20 communities, we do not see the exit point for being able to pay back the principal on the $625 million of debt.

As we demonstrated in November, even getting to 90% occupancy does not provide the cash flow to create enough value to refinance that amount of debt, which would be at a higher interest rate. And selling assets to raise cash will only decrease the cash flow available for overhead costs.

Apparently, half of Sonida's communities are at 90% occupancy or better, and half of those are at 95% or higher. So the improvement will have to come from the other 50%, and they must really be perform- ing poorly, and many of these we assume are the small ones. Selling them? Not going to achieve a price that is worth it and losing the management income.

Do we think Sonida will not be a "going concern" a year from now? No, their investors, not to mention their lenders, have too much at stake to let that happen. But given the current credit market environment, with lenders being less forgiving than a year ago, they may have to pony up some more cash.

Before they do that, they better do the math in terms of where operations, margins and cash flow can grow to under even the best scenario. The real problem is that they may not like what they see in a realistic forecast.

ENLIVANT

The problems at Sonida were expected, and maybe they should have been expected at Enlivant as well. After all, Sabra Health Care REIT decided not to exercise its option for the 51% of the portfolio it does not own, which was obviously the right decision. But we did not know until recently that the joint venture that owns the majority of Enlivant's communities was in default on pretty much all its debt obli- gations. But let's go back in time a bit.

In 2013, TPG Capital purchased Assisted Living Concepts (name subsequently changed to Enlivant to avoid any stigma) for about $278 million, or close to $50,000 per unit. In their defense, the per-unit price was so low that nothing short of a worldwide pandemic could cut that value down (oops). But TPG did not wait for that unfortunate event to occur. In late 2017 it agreed to sell a 49% stake in the portfolio to Sabra Health Care REIT for $371 million in a deal that valued the entire portfolio at $1.62 billion, inclusive of debt. At the time, this portfolio had 183 communities with 8,280 units and occupancy of 82%, which was up from 60% in 2013. TPG basically got all its equity out, plus some, which is usually part of the PE model.

Sabra was willing to take the risk on the portfolio, and its outsized value at the time, because it was facing pressure from investors to diversify away from its high concentration of investments in skilled nursing facilities. In addition, the REIT thought that if they could get occupancy above 90% for this port- folio dominated by small (under 50 units) assisted living communities, they could boost cash flow and the value. At the time, they targeted NOI of $100 to $105 million before capex, and $10 million less after capex. The one-year unlevered return was expected to be 6.2% to 6.5% before capex.

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Things didn't quite go according to plan. Two years after Sabra's deal for 49% closed, the pandemic hit, and census bottomed out in the Spring of 2021 at 68%. The option to acquire the remaining 51% expired in January 2021, and by August Sabra said it would exit the joint venture with TPG. In late 2022, now with 157 communities and 6,996 units and occupancy of just over 75%, thoughts of selling the joint venture were brewing. Not happening.

Sabra recently filed financial statements for the JV for 2022 and 2021, and in the notes the auditors issued a "going concern" warning. As of February 11, 2023, the JV was no longer current with principal and interest payments to Fannie Mae ($484.96 million total debt) and Freddie Mac ($178.16 million), and on March 1 it did not make its scheduled payment to KeyBank ($28.5 million loan).

On March 15 it received a notice of default from KeyBank, on March 3 a notice of acceleration from Fannie Mae, and on March 3 the special servicer for the Freddie Mac loan portfolio sent a notice of ter- mination for its management agreement with the manager. It looks like the portfolio is in deep doo-doo.

All of the debt had been based on spreads over SOFR, ranging from 221 basis points to 300 basis points. With the recent rise in interest rates, that took the rates up to 7%. If they were having a hard time making payments a year ago, by 2023 it was impossible. And the JV had just $3.7 million of available cash on the balance sheet as of December 31, 2022, with annual interest expense now almost $25 million.

The good news for Sabra is that the agency debt is non-recourse. Still, we have not heard of a health- care REIT defaulting on agency debt, and this is a portfolio that will not have many takers given the average size of the buildings (44 units), the average age and the locations. A lot had to go right after Sabra made its 49% investment, and unfortunately, a lot went wrong. Everyone is in discussions as to how to restructure the debt, or do something else. Sabra has already written off all its debt with the joint venture, not that this provides them with any consolation, but at least it may provide more flexibility in terms of what they do.

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Fannie had already booked a $900 million provision for credit losses in seniors housing on a total seniors housing portfolio of $16.6 billion. We don't know how much more there will be in the coming months, but we are sure it will increase. We heard that a joint venture between KKR (NYSE: KKR) and Cascade Living, with an original loan amount of $342 million from Freddie Mac and backed by 21 senior living communities, was recently put on a watch list with a debt service coverage ratio of 0.80x to 1.0x.

Although Fannie has the larger seniors housing portfolio, Freddie will not be immune to future distress and defaults. The bad news is that both Fannie and Freddie have been very important for the growth of the seniors housing business, and any contraction in loan volume will hurt.

VENTAS

While the Sonida and Enlivant events were not really surprising, the announcement by Ventas on March 31 that it was taking over full ownership of the collateral pool for its $486 million Santerre Health Inves- tors mezzanine loan raised some eyebrows.

The pool has 88 medical office buildings with 3 million square feet representing about 40% of the NOI of the $1.5 billion portfolio, 16 large senior living communities with 1,900 units, operating in a SHOP structure, across five states with current occupancy of 74% and representing 20% of NOI, and 48 skilled nursing and hospital assets representing 40% of NOI.

The portfolio had about $89 million of total net operating income, which means the SHOP senior living assets had about $9,300 of NOI per unit. While we do not know if this is before or after a management fee, the current value appears to come in somewhere between $140,000 and $150,000 per unit based on that number. That is not at the high end of the market.

The problem for Santerre was most likely just too much debt in a difficult operating environment. In addition to the $486 million mezzanine debt at LIBOR plus 642 basis points, when priced in June 2019, there was approximately $1.0 billion of CMBS at LIBOR plus 184 basis points which was non-recourse to Ventas.

Obviously, Ventas is not going to be paying that LIBOR plus 642 to itself, but it will have to deal with the $1.0 billion of other debt, which it can extend for another year when the maturity hits this June. The thought is that at some point they can refinance it at a cheaper rate. Apparently, the LIBOR cap is set to expire in June, which will send total interest expense up by about $20 million annually.

The original deal that Ventas did in 2019 was with Colony Capital, which rebranded as DigitalBridge (NYSE: DBRG) in 2021. Then in 2022, DigitalBridge sold a $3.2 billion portfolio of healthcare assets to Highgate Capital Investments and Aurora Health Network, which formed Santerre to manage the as- sets. Along the way, some assets were sold off. The principal of Aurora is one Joel Landau, who may now control more nursing homes in the country than anyone else through a network of interrelated entities, and others not related.

While we are sure Ventas will miss that LIBOR plus 642 interest income, when the dust settles we do not believe the change will be a big blow to the REIT's earnings. The hope is that the senior living communities can improve from their 74% occupancy, but if they leave the same operators in, who is to say they will perform better for Ventas? Justin Hutchens may have to find some new management to get things moving past mediocre. We hear he is on it.

While this is not technically a default, when a REIT has to take over obligations of $1.5 billion, it does say something about the market, cash flow and operations. We are in tough times, and Ventas will have to deal with its maturing Brookdale Senior Living leases soon as well.

CONCLUSION

Everyone had said, back in 2020, that this pandemic was unprecedented and a once in a 100-year phe- nomenon. True. But no one expected the follow-up to be inflation reaching a 40-year high, followed by interest rates being ratcheted up so high in an unprecedented short time period, all just when we were recovering from COVID.

This triple whammy is truly unprecedented, and while the industry will survive, it is going to be an ugly year. And, we are not sure the bargain hunters will be ready to pull the trigger, nor where the capital will come from.

What is the long-term fix? It is called lower leverage. There has been far too much debt put on prop- erties and portfolios, so much so that when we hit “normal” difficult times, it can be burdensome with some defaults. But when we hit these unprecedented difficult times, it has put a stranglehold on the industry, even on some of its better players. You know the model. Buy a portfolio, improve it, refinance it at a much higher price, either with debt or leases, take out your equity, and hope for the best.

There is usually little alignment between operator and capital provider in these situations (despite what everyone says), and everyone is just trying to make money. We have heard too many people talk about how important it is to align capital providers and the users of that capital, but talk has been cheap and they often do not walk the walk.

The one exception was during the first two years of the pandemic, when most capital providers really did stand by their operators. But patience ran thin in the past six months or so, and some lenders have been forced to make some hard decisions. Unfortunately, capital is not cheap, especially if you have too much of it, and it is getting more expensive.

When looking at leverage, just look at The Ensign Group (NASDAQ: ENSG) and National HealthCare Corp. (NYSE: NHC), two publicly traded companies with conservative capital structures, and two com- panies that are profitable. They were profitable during COVID as well. There is a relationship here. Will it be easy to de-lever the industry? Not at all, as everyone got addicted to abundant and cheap capital, especially on the debt side. But it will be necessary for future success, and a secure operating environment, when the boomers really do need our services.

To invest wisely you need to rely on a thoughtful, independent and experienced voice that has navigated through every crisis that has hit the seniors housing and care industry since 1986. This industry is not going away, it needs to adapt, and when senior care is open for business soon, you need to be prepared with data, perspective and market knowledge.

Read *The SeniorCare Investor* online to see what buyers are active these days, and the valuations they are obtaining. Learn how brokers and lenders are navigating the M&A environment and where they have been creative to get deals across the finish line. And head to LevinPro LTC for a complete suite of senior care deals, news, proprietary analytics, and company directories.