Seniors Housing Post-COVID-19

Will this crisis be different from others?

*Edited from a story by **Steve Monroe** of The SeniorCare Investor*

The SeniorCare Investor · Irving Levin Associates, Inc. - Publisher
www.seniorcareinvestor.com · 268 ½ Main Avenue, Norwalk, CT, 06851 · (203) 846-6800

First, A Little History

All crises seem to have their own particular targets. Some of you may not remember the Anthrax scare that followed the 9/11 attacks nearly 20 years ago, but that shut down many businesses that relied on mail. People just stopped opening up their mail, fearing that the little white powder would spill out and kill them. Businesses were paralyzed, and now we have people sanitizing their mail and groceries before bringing it inside.

But before the events of 2001, the senior care market had been suffering mightily. In the assisted living market, over-development, too much leverage and not enough qualified staff sent stock values plummeting (sound familiar?). Nine assisted living companies were trading below $1.00 per share, and a few others between $1.00 and $2.00. It was devastating, and most went out of business or were bought, obviously at pennies on the dollar.

In the skilled nursing market, providers had been dealt the Prospective Payment System blow in the late 1990s. No longer being reimbursed based on costs, they struggled with the new system. At the time, many claimed they were blindsided by the change, but they did know it was coming. Those hurt the most were the public companies, which had grown too rapidly, were over-leveraged, and paid too much for their acquisitions (sound familiar?). Most of the large publicly traded skilled nursing companies filed for bankruptcy protection, representing a significant portion of the nation's stock in SNF beds. Only one remains today as it was some 20 years ago, and that is **National HealthCare Corporation** (NYSE: NHC). Why? Strong balance sheet, low leverage and manageable growth. So, we had some self-inflicted wounds followed by a recession and the 9/11 attacks. The recovery, however, was "relatively" quick, as painful as the early years were. The bursting of the dot-com bubble in 2000 didn't help matters.

Average skilled nursing prices had peaked in 1996 at about $43,000 per bed (sounds silly today, doesn't it?). The average flopped around before hitting a bottom in 2003 at about $31,600 per bed. The next rally would take the average to a new peak in 2007 of $55,200 per bed. The market was ecstatic. In seniors housing, the market bottomed in 2002 at an average price of $72,700 per unit for assisted and independent living combined. This market also surged over the next five years, with the average price doubling to $164,500 per unit in 2007. Stock prices were also rising during this five-year period.

And then we had the Great Recession. Other than high prices paid and leverage in the senior care market, escalating at a significant pace in the years leading up to the 2008 financial meltdown, this was an external issue that did not impact everyone equally. If you had a job, there was little impact, other than on your 401-K. Not to downplay its significance, since unemployment hit 10%, but restaurants, stores, airlines, hairdressers and others mostly remained open. Not today.

Until February 2020, the worst week for unemployment filings was the week ending October 2, 1982, when 695,000 workers filed, a level never reached during the Great Recession. Then in mid-March that record was shattered nearly five-fold, when 3.307 million people filed in one week, a record that was shattered the following week when 6.648 million people filed. The suddenness is not only alarming, but very different from any other period of economic turmoil, including the Great Depression.

For the senior care industry, the Great Recession was a period of capital contraction, as some lenders went out of business, others stopped lending and investors sat on the sidelines. Average skilled nursing prices plunged 17% in one year to $45,500 per bed, while average seniors housing prices fell by 23% over three years to $112,400 per unit. Seniors housing stock prices fell by much more. But this was short-lived. Per-bed and per-unit prices bounced back after the 2009 to 2010 period, and then experienced the strongest bull market in values the industry has ever seen.

It was about this time that seniors housing, and more particularly, assisted living, was dubbed as being "recession resistant" or "recession resilient." Your pick. A few even called it recession "proof," but that was overly optimistic. We kept on saying, yes, assisted living is need-driven, but this was just one recession, and in particular, one kind of recession, and that does not make for a good data point. It was as if the Wall Street crisis never occurred. Across the board, average prices doubled, deal volume soared, more lenders and investors jumped in, and a new kind of liquidity crisis set in.

This time the "crisis" was one of too much capital, both on the debt and equity side. Some PE firms in the past several years raised more money than they really wanted to invest, but they had to invest. Helped by continually dropping interest rates to historic lows in 2019, and now 2020, unheard of cap rates were justified because borrowing rates were so low. From an investor's perspective, if you could borrow at 4% and invest with a 12% cap rate for a skilled nursing facility, why wouldn't you do that "arbitrage" all day long? You might, but like all good parties, they come to an end at some point, and for different reasons. The spreads were good for seniors housing, but not as dramatic as in the SNF market.

It all made sense, and some of it was logical (except for the timeframe for the boomers), but most everyone forgot about economic cycles. These tend to happen every 10 years or so. You had the 1990 recession and Resolution Trust Corporation bankruptcies. Ten years later it was reimbursement changes and over building, the dot-com bubble and 9/11. Eight years after that the financial and housing crisis that led to the Great Recession. And now, roughly 10 years after coming out of the Great Recession, after the longest bull market ever, we have COVID-19. No one saw that one coming, but something comes every eight to 10 years. It always does.

The Pandemic

So, enter COVID-19. For the seniors housing side of the business, the timing was horrible because some operators and investors were just coming out of their own recession, with low occupancy, too much development, rising labor costs and a limited supply of labor with unemployment at a 50-year low. The big one of them all, **Brookdale Senior Living** (NYSE: BKD), and perhaps used as a barometer for the industry, was finally turning things around after four years of stress, downsizing, decreasing occupancy, lease re-negotiations and being the punching bag for the industry, not to mention a few of its activist investors getting in the way. While not completely out of the woods by the end of 2019, CEO Cindy Baier has accomplished much in a relatively short period of time. Unfortunately, time is now not on her side. Just when Brookdale could see brighter days ahead, census will undoubtedly drop, costs will rise and

cash flow will fall. And they are not alone.

Before taking a look at what may happen to the seniors housing and care business for the next year or so, let's look at a little history. On the pandemic side, we all know that the 1918 pandemic killed millions worldwide, but that was a different era with different science. More recently, the H1N1 flu in 2009 to 2010 lasted for one year and originated in the United States (although later believed to start in Mexico). According to the CDC, there were approximately 60 million cases, 274,000 hospitalizations and 12,500 deaths in the U.S. Approximately 80% of the deaths worldwide were people under the age of 65. With the traditional flu, it is reversed, with 70% to 90% of the deaths each year occurring with people over 65. COVID-19 is having its worst impact on the elderly, particularly those with respiratory issues and other medical problems. The reality is that anyone who is not in good health is at higher risk with this one, young or old. It is just that the elderly always have more medical issues.

On the financial side, in the week leading up to Black Monday in 1929, the Dow had already dropped by 24.8%, and was down 30% from its historic high set on September 3. By July 8, 1932, it had plunged 89.2% from that September high (three years to reach bottom). It took 18 years to get back to that high. Leading up to the Great Recession, the Dow peaked at 14,164 on October 9, 2007, hitting bottom 17 months later at 6,594, for a 53% plunge. It took five and a half years to recover (March 5, 2013), after wiping out $11 trillion of value. More recently, the Dow peaked at 29,551 on February 12, and in a matter of weeks dropped by more than 30%. It has since recovered a bit, but the stock market most likely will have a phase-two drop, as the long-term economic ramifications of high unemployment and widespread business bankruptcies fully set in.

The Impact on Senior Care

Before we start, there of course has to be a big caveat, and that is no one really knows what is going to happen this time around. We have never had a healthcare crisis start a financial and economic panic, and the magnitude will only grow. That is why we spent some time with an historical perspective. And, please do not get angry at us, as we are trying to take as objective a look as we can at what may happen. Will you find holes in some arguments? Maybe, and we would love to hear from you. But we truly believe that what is happening today is a once in a century occurrence (at least we hope so), and better to take a sober, realistic look at the ramifications than to wear rose-colored glasses and hope it all returns to normal soon. It may, but what will that normal be if the shutdowns continue, even partially, and 30 million people are newly unemployed?

We want to start with how this will impact valuations. Unfortunately, stock values can move rapidly, significantly, and very visibly, and they have already. That is not the case with property values. For at least 18 months, we have been arguing, in writing and in speeches, that the seniors housing market needed a valuation re-set. Too many people had been building, buying, investing and financing at prices that would not be sustainable for the long term, and certainly not when the inevitable recession hit.

The other reason why we believed a valuation re-set was necessary was because of labor. Like it or not,

labor costs have to rise. Forget the ethical reasons (meaning no one can really "live" on $10 per hour), which should be obvious, but they need to rise in order to operate a sustainable business with qualified staff. Unfortunately, there is only one place that extra money can come from to help pay for higher wages. That is capital, the money going to pay lenders, landlords and investors. Please don't shoot the messenger. If values are lower, debt and rent payments would be lower, all else being equal. This would ease up cash flow to pay higher wages. The only way for values to be lower would be for cap rates to be higher and equity returns to be lower, and expected equity returns have already dropped a bit in the past two years. As prices rose these past several years, the more we believed there had to be a tipping point. We just didn't know what would trigger it, and certainly did not expect a coronavirus pandemic where up to a quarter million people could die, and the majority of them elderly, and your customers.

We think any kind of a valuation re-set will hit seniors housing more than skilled nursing for a few reasons. First, prices rose more rapidly in seniors housing, and skilled nursing already had settled into an average trading range of $80,000 to $95,000 per bed the last few years. It could drop from that, but with acuity levels rising and little development over the past many years, there is probably a floor in this average range. Seniors housing, on the other hand, kept on building, and building more and more expensive communities which, of course, needed higher rents. This is great, but the huge upcoming demand is for less expensive communities. Everyone has always known that, but few have wanted to build for the middle market. Values will start to decline as cap rates and interest rates rise, and the true business risk is adequately priced in.

Lenders will most likely have an impact on valuations. They had already started to tighten their underwriting in 2019, and we expect that to continue. A lot will depend on what kind of uptick in defaults occurs, and whether they are for communities that have been around for a while, or for the newly built and not yet stabilized ones. We just think that loan-to-values will come down a bit, and development financing will certainly take a backseat through the summer. The problem is, we just don't know. Will there be another wave in the third or fourth quarter, just before the traditional flu season starts? No one knows. The one thing we do know is that many people have adjusted to working off site, and that may have long-term ramifications in other areas.

Census

Through the end of the first quarter, there had been very little downward movement in census for seniors housing, from both public statements and private discussions. However, as we have said, the COVID-19 cases and deaths did not escalate until the last two weeks of March. In New York City alone, 25% of the COVID-19 deaths have been in nursing facilities. We have not heard comparable numbers for seniors housing, but they are sure to rise. What we do know is that tours and admissions have trickled down to a very low volume.

On **Capital Senior Living**'s (NYSE: CSU) earnings call, Steven Voliquette of **Barclays** asked how the company would withstand a 10% or 20% drop in census, meaning down to 70%, or even 60%. No one

is prepared for a question like that, and it was the first time we had heard it. Some believe there could be a 600 to 800 basis point decline by the end of the summer, assuming few move ins and an increase in COVID-19 deaths. Most providers can deal with that, but it just exacerbates a problem that was just beginning to correct itself.

Labor

There have been many people who believe that with millions of people being forced into unemployment, with few other job prospects, that the labor situation for seniors housing will start to ease. Not so fast. First of all, unemployment insurance and other financial benefits that were part of the $2.2 trillion CARES Act will mean that many people will be able to wait for a few months for their old jobs to return. The wait may be longer, but we are not so sure they would want to make a career change anyway.

Second, with all the negative publicity around working in a nursing facility with a COVID-19 outbreak, some potential employees may begin to think it is just not a safe place to work. Fear trumps rationality nearly every time. Third, the highest need has always been for care givers, especially in skilled nursing. The newly unemployed would need to be trained, if they are even interested. Dining and housekeeping services are the best bet, as hotels and restaurants have laid off most of their staff. The good news is that staff turnover will probably slow. But we doubt this pandemic will be a long-term panacea for the current labor crunch.

Development

Since seniors housing development had already begun to slow, given recent events, that trend will continue and we suspect will soon come to an abrupt halt, other than for projects that were well along, especially those close to being completed. This will be a long-term benefit for the industry, and will also help to put a lid on construction costs, which had also contributed to the higher prices to build, and finance. A continued slowdown in development will also help on the labor front, as there will be less poaching of staff and bidding up of wages. Despite the frequently quoted number that we will have a shortage of hundreds of thousands of senior living units later this decade, we don't think we will be hearing that for a while. Slowing development will benefit everyone and maybe bring some sanity into some markets (are you listening, Sarasota?).

Cap Rates

We have long argued that seniors housing cap rates were going too low, at least at the high end of the market, and were not taking into account operational risk. This was especially true as the business component of seniors housing became increasingly important. Our argument always fell on deaf ears. We certainly understand why, since no one wants to see valuations decline, other than those buyers who

have been waiting on the sidelines (for a long time). But with costs rising to deal with this pandemic, and occupancy rates soon to start declining for the obvious reasons, investors have to start accepting that while demographics are in their favor, this is not multifamily, and a lot of things can go wrong. The operational risk outweighs the demographic safety net, at least today.

At some point, all this trillions of dollars of government borrowing will push interest rates higher, which should force cap rates up. If cap rates rise, the sector will be a lot healthier in the long term. Skilled nursing is another matter. Average cap rates have been in the 12.5% to 13.5% range for 25 years, no matter where interest rates are, no matter what changes to reimbursement have hit them, no matter what the labor situation is, no matter the supply of capital. Maybe there is something to be learned there.

REITs

The healthcare Real Estate Investment Trusts have been the hardest hit in our sector during the recent stock market plunge. Many are worried about their own liquidity and drew down on their credit facilities, even if they didn't need the funds now. Some just went and raised new debt to bolster their liquidity. They are obviously worried about their tenants' future financial performance, and they know that wages, utilities and food bills have to be paid before rent. One REIT, **Ventas** (NYSE: VTR), already offered to defer 25% of April's rent until October. But others are sure to follow, as the environment will only get worse. So far, two REITs have lowered their dividend payout, but we suspect they will not be alone, and for some of the others, a dividend cut is most likely already embedded in their current price.

We hear a lot about how owners and operators should be transparent with their lenders, landlords and investors as to what is going on in their communities. We agree. But it wouldn't be a bad thing for REITs to give more frequent updates to their investors than quarterly earnings during this pandemic, since the economics are changing so rapidly. And when the declines stop, that should be reported just as quickly.

The fallout we expect in the REIT market is some consolidation. Their values have dropped so much lower than the underlying value of the real estate (whatever that may be today) that it would make sense for a few to combine, lower overhead, prune the less desirables, and be ready for the next bull market, which will come eventually. As we said last month, after apologizing for being a little crass, there is going to be a significant buying opportunity, whether it is in the fourth quarter, in 2021, or beyond. And REITs will want to be in position for it. The priority now, of course, is to do what they can to help their current tenants, and be true financial partners.

Skilled Nursing Facilities

As readers know, we have been very bullish on the prospects for the higher acuity SNFs. But the stories from around the country of many facilities having dozens of infected patients, much like the Kirkland, Washington situation, is not helping the reputation. Where were the infection controls two or three

weeks ago, families are asking? We know these facilities are doing their best to prevent the spread of the virus among their patients, and it only takes one slip up for it to infect these most at-risk patients. And we don't think many ventilators are being shipped to the SNFs. Time will tell, but those that got it under control before the visitation restrictions and enhanced protocols went into place, will hopefully not make the front pages of the local newspapers. One fallout is that with tax revenues declining, many states will start to cut Medicaid funding unless the feds step in, and there could be a push again for block grants.

There is currently a fight going on as to which patients SNFs should be required to admit. Some governors want to ease the problems at hospitals and transfer the less serious COVID-19 cases to nursing facilities. But the skilled nursing providers have argued that they do not want to endanger their other patients, not to mention desperately needed staff, by admitting already infected patients. One possibility has been if there is an entire vacant wing that can be isolated from the rest of the facility. But what are they going to do, ask for volunteers to staff it? Hire nurses from outside the facility? Good luck with that. And, there are not many vacant wings just waiting for patients.

CCRCs, IL, Active Adult

The CCRC (LPC) business was the hardest hit in the Great Recession of all the property types because it is choice driven and usually dependent on the customer selling their home. It was the housing market that suffered the most and took the longest to recover. These customers had the luxury of staying in their homes and waiting for prices to rebound. The same can be said for independent living, except they don't need the house proceeds for the large upfront entrance fee. The good news is that these sectors did not see the overbuilding that was rampant in assisted living and memory care during the last decade. So, while demand will drop, they are starting from a better place. It is a question of duration for the upcoming recession, and what the impact will be not just on housing values, but on demand. The little boom-let in active adult will be hitting the pause button, especially with development, as these customers really do have several alternatives, and they will most likely take a wait and see attitude.

Assisted Living

As we stated above, assisted living was recession resilient for just one recession, more than 10 years ago. This one, however, will be very different because it will impact practically everyone and is coming with a potential death toll that a few weeks ago was unimaginable. We don't believe anything will be very resilient this time around. Yes, assisted living is need driven, but when people are fearful about being around anyone other than family members, that can do a lot of harm, even if an assisted living community may be the safest place to be, for multiple reasons. Can we see a 500 to 1000 basis point drop in occupancy before this ends? Absolutely. That is just five to 10 residents moving out for higher levels of care, or dying, but with no one moving in. Trying to predict when the fear will end is another matter, and that is why we see a significant drop in values through the rest of the year.

Conclusion

We are going to be in for a rough ride over the next several months, and it could be longer than that. No one knows if there will be a second wave of this pandemic, or when it will hit. Hopefully, the health-care system will be better prepared. The 1918 pandemic had three waves, which was just one of the reasons why so many millions of people died. But the seniors housing and care business will come out of it stronger in the long run. Wounded? Yes. Bankruptcies? Yes. Smarter? Yes. Fantastic prospects? Yes. We don't know if people will be saying it is recession-resilient again, but we know it will be resilient. And if you want to see resiliency, just look at the skilled nursing sector and all it has gone through over the past 40 years. There is no other business in the country that has the long-term growth prospects of seniors housing and care. It's the short term that is problematic.

Economists have forecast the worst drop in GDP in one quarter ever recorded for the coming second quarter, with unemployment maybe increasing to 30 million or more. Our guess is that your employees will be bending over backwards to keep their jobs. Residents will eventually be moving in, but their ability to pay asking rates will weaken as their wealth diminishes, as well as the ability of their children to help pay. That will hopefully be a short-term problem. This is where reputation and community relations matter. And always remember, where you live does matter.

To invest wisely during and after this pandemic, you need to rely on a thoughtful, unvarnished 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. Go back through our archives to see how this industry has recovered from past crises that also affected census and cash flow, just in different ways.