

Creative Financing: Creating a Seller's Market in Assisted Living

New sources of capital are creating new opportunities

by Adam Heavenrich

In the cutthroat race for market dominance in the assisted living industry, many owners and operators are using creative financing and partnering techniques that allow them to acquire and develop new facilities at a faster rate. Real Estate Investment Trusts (REITs) are aggressively raising capital to create liquidity for facility owners and, in many cases, acquiring in their own right. Pension fund money is also providing operators with "war chests," backing experienced but smaller operators with large pools of funds earmarked for acquisitions and development.

These and other forms of creative financing are fueling the demand for a limited supply of existing facilities, driving acquisition prices to all-time highs, forcing industry consolidation and creating the almost certain prospect of a more competitive market. All these factors have combined to create ripe conditions for opportunistic owners who are considering the sale of their facilities.

REITs have had a high-profile role in creating liquidity and acquisition demand for facility owners and operators. There are currently 15 publicly traded REITs that specialize in long-term care financing. These 15 REITs together have a market capitalization in excess of \$12 billion (see table). For example, G&L Realty Corporation, a healthcare REIT, announced recently that it expects to close in the next 30 to 60 days more than \$60 million in new acquisitions and development projects, part of a \$150 million investment program it plans to implement in the next 18 months.

Under Federal tax guidelines, REITs are permitted to have equity or debt interest secured by real property. For long-term care operating companies that are seeking to expand rapidly, it is often advantageous to gain equity financing from the REITs. Equity financing may mean that the REIT becomes the owner of the real estate and improvements, and then leases the facility back to the operator.

In a typical deal this February, Meditrust, the largest of the healthcare REITs, completed the sale/leaseback of a 104-unit assisted living community in Folsom, Calif., with Regent Assisted Living, Inc. Regent realized net proceeds of \$3.5 million and a \$5.9-million reduction of long-term debt. Regent will remain as the operator of the facility. Regent is thus an example of one operator that was able to reduce some of its leverage through its relationship with a REIT. In fact, Regent has increased its bed count 161% since December 31, 1996. Without a combination of off-balance-sheet and on-balance-sheet financing, this pace of growth might not have been possible.

Several long-term care operators see benefits to separating out their real estate holdings from their operations in order to allow continued and rapid facility acquisitions. In January,

Table. REIT Capitalization—12/31/97

	(millions)
American Health Properties	\$649
Capstone Capital	426
ElderTrust	125*
G&L Realty Corp.	85
Health Care REIT	679
Health Care Property Investors	1,143
Health & Retirement Properties	1,983
Healthcare Realty	557
LTC Properties	499
Meditrust	3,221
National Health Investors	1,023
Nationwide Health Properties	1,100
National Health Realty	182*
Omega Healthcare	743
Universal Health Realty	196

*As of 3/27/98

National HealthCare split off much of its nursing home real estate into National Health Realty REIT. Manor Care also intended to separate its real estate and development activities into a new entity as of the end of May. Vencor announced recently that it intends to create a REIT that will own all of its land, buildings and improvements. The overall market capitalization of Vencor's REIT is expected to be \$2.5 billion. Through these and other off-balance-sheet techniques, long-term care companies can aggressively continue their acquisition and development efforts.

Another creative off-balance-sheet financing mechanism that has fueled the acquisition appetite of owners is the "Black Box." The Black Box is a financing technique used ostensibly to improve a company's operating performance. It is usually employed by public companies or organizations seeking to go public as a way to improve stated earnings. For example, a public company may contract with an outside developer to construct, staff and lease a new facility on its behalf. The Black Box owns the facility while it incurs these operating losses. Once the facility is built, staffed and filled, the public company will then acquire it from the Black Box at an agreed-upon price. Because the public company is acquiring the facility through an acquisition, the costs are capitalized rather than expensed. If, on the other hand, the public company had developed the facility on its own, all the costs associated with building, staffing and leasing the facility would have been considered operating losses, thus offsetting corporate earnings.

The Black Box technique therefore removes some of the

earnings drag traditionally associated with new facilities. By eliminating earnings drag, companies circumvent a traditional financing braking mechanism, whereby they would have to digest new facilities' operating losses before they could raise additional capital to build new ones.

Pension real estate fund money is also employing creative partnering to fund assisted living facility acquisition and development. They are creating blind pools to roll up existing operators or facilities and to fund new acquisitions. A recent example is the announced partnership of The RREEF Funds, which manages in excess of \$7.8 billion in pension real estate investments, and Parkside Senior Services, LLC, a leading senior housing company with more than 15 years' experience in the industry. The RREEF Funds and Parkside will invest \$800 million in the acquisition and development of independent and assisted living housing communities over the next 24 months. By any standards, this is an enormous amount of capital to be deployed in short order. If successful, Parkside and RREEF will be creating one of the largest assisted living organizations in the country.

All these mechanisms have created enormous facility demand. They have also caused some of the smaller operators to consider cashing in while the market is good. With so much money chasing a limited number of quality facilities, it is not surprising that acquisition prices for retirement housing have jumped dramatically. The average price per unit for retirement housing rose from \$38,000 in 1993 to about \$74,000 in

1997, according to Irving Levin Associates. This represents nearly a 95% increase over the past five years.

Smaller operators have an added incentive to sell. The better capitalized operators bring with them the marketing expertise and budgets to attract residents in a highly competitive atmosphere. Competition will surely heat up as more facilities come on-line. With the run-up in facility values, and with intense and growing competition for elderly residents, selling their facilities is an attractive proposition for the smaller operators.

In summary, the creative financing and partnering techniques that have driven the retirement housing market have created opportunities for operators to gain critical mass quickly. It has meant separation of facilities' ownership and operations in many cases, and even separation of the development phase and stabilized phase of ownership. These techniques have helped to drive up facility prices and have created a profitable exit strategy for those operators who do not want to become large, or who simply want out in a new and more intensely competitive era of long-term care. **NH**

Adam Heavenrich is president of Heavenrich & Company, Inc., a senior housing and healthcare merger and acquisition firm, based in Chicago. For further information: (312) 422-8921; fax: (312) 422-8007; e-mail: AHeavenric@aol.com.