Challenged Senior Housing Sector Struggles to Endure a Pandemic

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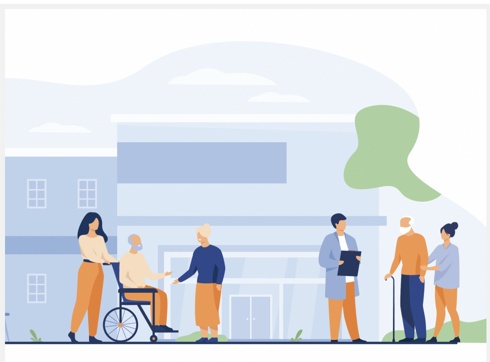

Senior housing is vast sector of the healthcare industry consisting of numerous providers, both taxable and tax-exempt, ranging from independent living housing to skilled nursing homes to comprehensive life plan communities and just about everything in between. Operators and capital sources have inundated the sector in hot pursuit of unmatched demand levers, such as attractive demographics and relatively lower costs of care compared with many other alternatives across the care continuum.

Despite these favorable market characteristics and overflow of capital, senior housing—prior to the COVID-19 pandemic—was already experiencing significant headwinds involving oversupply, mounting operating costs, heightened competition, and weakening demand within a capital-intensive business. In addition, the ensuing pandemic further ravaged many long-term care providers across the country, with 40% of all U.S. COVID-related deaths occurring in nursing homes. As 2021 continues to unfold, more challenges than opportunities are likely to weigh on the sector, creating more distressed operators in need of strategic affiliation and/or financial restructuring solutions.

Industry Tailwinds

The "graying of America" is a well-documented theme driving investment capital to the long-term care sector, as the 80+ population is expected to grow from 2021 to 2023 at double the growth rate of 2017 to 2019. Also, according to the U.S Census Bureau, the 65+ age group as a percentage of all Americans grew from 12.4% in 2000 to 16.9% in 2020 and is projected to reach to 21.6% by 2040. All other age groups as a percentage of total Americans are projected to experience negative growth rates over this same time frame. By 2060, roughly one in four Americans will be 65 or older.

As an additional long-term positive for the sector, members of this age cohort, relative to others, typically possesses assets to deploy in support of their residential options once they elect to downsize. Driven by these economics, capital sources have invested heavily in the sector in the form of new project construction, both REIT and tax-exempt bond financing, and capitalization of new senior care operators. According to the National Investment Center for Seniors Housing & Care (NIC), construction of senior housing units in primary markets reached all-time highs in 2014 and subsequently grew further each year thereafter through 2019. Commensurate with this trend, construction as a percentage of available senior housing inventory escalated to 7% over this same time period, well above historical norms of 3% to 4%, according to NIC.

Nearly all of this recent investment was in the form of taxable independent living and assisted living providers, often backed by private equity entering the market to chase underlying demand demographics. According to Bloomberg, there is more than $220 billion in real estate-related private equity dry powder seeking to be deployed, which compares with $87 billion in 2007, just prior to the Great Recession.

Further to the inflow of capital to the long-term care sector, M&A has been active both prior to and during the pandemic. In 2019, there were 453 senior care transactions, according to Irving Levin Associates, and, despite a huge drop-off in activity during Q2 and Q3 2020, there were still more than 330 transactions last year. Many of these transactions occurred in Q4 in the form of larger portfolio transactions to drive purchases from sellers in need of liquidity as investors saw COVID-related challenges subsiding. Important to this transaction trend, many of the facilities changing hands were in larger primary and suburban markets, where more upside is likely to be realized on a post-pandemic basis, and broadly excluded stand-alone senior care facilities in rural markets.

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'Haves' and 'Have Nots'

This investment trend represents a larger thesis within the senior housing industry, as the pandemic accelerated the transition of "have" and "have not" facilities in the marketplace. Occupancy throughout the sector had been on a steady decline prior to the pandemic, as utilization rates had steadily declined every year since 2014. Key drivers to this longstanding trend include: baby boomers electing to age in place longer at their residences; would-be nursing home residents staying healthier into their elder years, deferring the need for care; home health care options providing a cost-effective diversion, coupled with growing demand for Medicare Advantage programs that allow for care services in the home; and bundled payment reimbursement programs that incentivize shorter lengths of stay.

Nursing homes face increasing scrutiny and penalties from payors if they experience increased hospital readmissions, and partnering acute care hospitals are keenly focused on discharging patients only to skilled nursing facilities with low readmission rates, which can negatively impact the "have nots"— providers possessing weak resources and limited ability to address adequate staffing levels and quality controls.

Falling occupancy rates. With this backdrop, the industry then experienced a colossal downfall last year, as national occupancy rates fell by nine to 10 percentage points to all-time lows in the low to mid 70% range. Yet, these precipitous declines affected each market differently, as some states saw mild declines to 80% of normal levels, whereas other states, particularly in the mid-South, experienced drops to 55% of normal levels (and in some cases even lower). Like so many other industries—retail, telemedicine, tele-networking—the pandemic revealed an ability of certain competing alternatives to provide effective care access with patient monitoring and remote care and to do so cost-efficiently.

The pandemic also caused families and patients to reassess alternatives to traditional skilled nursing and assisted living facilities, such as home health, to avoid living in close quarters with other residents and never again having to endure visitation bans. In light of these occupancy trends, the American Health Care Association in October 2020 noted that 72% of all nursing homes would not be able to sustain operations at that pace for another 12 months absent governmental support.

Challenges in reinvesting capital. In addition to the severe declines in occupancy, senior housing operators all face reinvestment challenges given the inherent capital-intensive business model. To attract and accommodate residents, these facilities must display curb appeal, offer desired amenities, and provide preferred models of care. This reality significantly impacts operators with weaker balance sheets and limited ability to reinvest capital to address their average age of plant. In fact, according to NIC, nearly 40% of the senior housing properties in primary markets have an average age of plant of 25 years or greater.

Further, the sector faces infrastructure obsolescence, as two out of every three senior housing facilities were constructed prior to 2000. Meanwhile, better capitalized operators are able to take advantage of the current low interest rate environment as pandemic risks begin to subside and borrow funds to further improve their facilities to address COVID-related patient safety shortcomings (*e.g.,* private rooms, infection control, new spacing options, etc.) and technologies to support patient monitoring and interaction. Some have refined new capital plans to address revisions to campus and residential layouts for resident safety needs and also to address investment in patient connectivity infrastructure to be more resilient in the face of future crises.

Mounting cost structure. Next in the growing list of industry headwinds for senior care providers is their mounting cost structure. The primary operating cost driver in long-term care is labor, which typically represents 50% of operating costs and has been escalating throughout the pandemic as workers experience fatigue and burnout. Providers have been facing wage inflation and stay bonuses to maintain staff, while also having to incur overtime costs, temporary staffing, and travel nursing to ensure they have appropriate and qualified staff on the floors every day despite declines in patient volumes. Additionally, many facilities struggle with inadequate nurse staffing levels to properly address higher acuity care, which often leads to poor readmission rates and, consequently, higher operating costs.

The second challenge with senior housing cost structures is the increase in supply costs, as manufacturers and associated supply chains have been strained for the past year. Perhaps costs of certain consumables will moderate once normalcy is realized with production and delivery costs. However, the incremental supplies now necessary to properly operate senior care facilities in this new normal of patient safety protocols, testing, cleaning, and spatial distancing are permanent and impactful to long-term cash flows of the operation.

A third factor compressing potential earnings is that many senior care clients are experiencing increased insurance premiums, which are particularly associated with patient care liability and COVID infection exposures.

All is Not Lost

Despite these various challenges in the sector, senior housing is experiencing some green shoots led by a reduction in newly confirmed COVID cases and the vaccine rollout. According to NIC, the all-occupancy rate for senior housing facilities declined in February 2021 by the smallest month-over-month change since the pandemic began in March 2020. Market analysts anticipate stabilization in the occupancy trends over the next few months, followed by an inflection in current occupancy trends.

Additionally, senior housing demand is highly correlated with the residential real estate market, which has been robust throughout the pandemic, as home ownership and housing prices increased throughout the country. This provides broad consumer confidence and enhances seniors' ability to make the jump into independent living or a life plan community.

Next, underlying aging demographics have only accelerated through this pandemic cycle to enhance potential demand. Also, nursing homes most often provide better outcomes and a more efficient rehabilitation time frame than home health providers, so fundamental demand for these services should remain solid. Further, there has been a decline in new construction starts in the industry for approximately 24 months as inventories rationalize effective demand.

Government support both last year and in 2021 was essential to the viability of the senior care industry. With the CARES Act, health care providers had access to (i) $178 billion of stimulus in provider relief funding, including $9.4 billion allocated to skilled nursing facilities (of the total amount, an estimated $15 billion remains available for funding), and (ii) Paycheck Protection Program (PPP) loans, of which $68 billion was distributed to the healthcare industry, including $5.1 billion to long-term care providers.

However, compliance with the COVID-related use of funds includes governmental monitoring, and recoupment of some of the Medicare Accelerated and Advance Payment Program funding will be required over time. With the more recent American Rescue Plan legislation, $450 million has been appropriated for COVID-related mitigation strategies and support to the skilled nursing sector. Importantly, this legislative package did not include support for senior living communities. Congress is looking to temporarily suspend the 2% Medicare sequestration cuts by CMS, which were scheduled to take effect on April 1, 2021, and will be a credit positive for the sector.

From a capital markets perspective, the tenor among financing sources is positive and improving, given the recent emerging signs of recovery. Default rates in the tax-exempt sector have been very low since the beginning of the pandemic due in large part to government stimulus. In conversations with lenders, a favorable outlook for many of the providers in the sector is expected with an attractive interest rate environment to continue driving loan volume demand. Understandably, financing sources are keenly focused on the strength of sponsorship and are more often looking to recourse financing. Anecdotally, real estate investor demand has remained aggressive through this cycle as capitalization rates rose only slightly during the pandemic and are well within their historical norms. Senior housing rates rose over the last year from 8% to just 8.75%, and skilled nursing bumped from 13% to 13.5%.

Key Considerations

As capital constituents, both investors and lenders, assess these market dynamics and realities, the following key items should be addressed in a decision-making framework for evaluating the long-term performance of the credit. These steps will assist capital providers in maximizing the recovery of their senior housing investments.

Shifts in reimbursement. Provider-based healthcare concerns are continually under the scrutiny of payors, both commercial and governmental, to evaluate and adjust channels of reimbursement in an effort to more effectively align consumer behavior and wring costs out of the care delivery system. Senior housing operators are not immune to these pressures. In fact, the highly popular Medicare Advantage (MA) programs have spurred significant changes for the industry, even leading certain senior living providers to launch their own MA plans. This type of adjustment has made senior living a more attractive partner to healthcare organizations, including health systems, to maintaining greater connectivity with an elderly patient base. Such adjustments almost certainly will continue, and capital providers should continually evaluate the impact of these changes to their underlying credit of the organization.

Marketing activity. As the long-term care industry begins to rebound, marketing activities will be of utmost importance to attract new resident and/or referral activity flow. These plans will need to be dynamic in reaching not only the baby boomer resident but also their family members, who so often participate in or drive decision making regarding senior housing moves. These family groups want to make informed decisions and rely heavily on word-of-mouth reviews from current residents to tell their stories, even challenging experiences during the pandemic.

Management teams will also need to leverage social media to continually push resident stories and news announcements and proactively address any potential negative sentiment. Further, management will need to tout its health care data regarding readmission rates, prevalence of falls, and other quality metrics, as consumers demand access to this information.

Rationalization of services. Capital providers should expect management to report operating results by certain service lines to ensure appropriate performance is being realized or is to come in a time frame established by management. An open-minded approach to the evaluation of service lines should be expected of leadership teams in long-term care, with management taking steps to improve any service lines that are underperforming and, as necessary, to rationalize services if the market demand or projected performance cannot be realized.

Capital reinvestment. Senior housing is a capital-intensive business requiring reinvestment every year. As operating performance declines for so many providers, there is often minimal cash flow available to address competing demands from debt service and capital reinvestment. Capital providers should be mindful that capital spending must occur and may impede debt service for some period of time. Patience through a down cycle can be warranted, and many lenders stepped up during this pandemic by entering into forbearance agreements.

Lack of or deferral of capital spending will ultimately show itself in reduced resident interest, fewer walk-throughs, weakening occupancy, and/or declines in referrals. The sector is simply too crowded with competing providers and alternate settings of care. Importantly, requisite capital spending does not necessarily need to consist of bricks and mortar; rather, operators need to also invest in patient connectivity technologies, electronic medical infrastructure, patient safety measures, and the consumer experience.

Timeline for implementing a turnaround. In the realm of turnarounds and restructurings, a key element to conflict resolution is timing. When operating concerns are underperforming and seeking to implement a turnaround, all parties involved must address realistic time frames by which an operational improvement plan can be realized. Capital sources must remain vigilant regarding management transparency and agreed upon time frames for the company to produce such results. An organized and measured approach to timing of a turnaround plan is critical for a successful outcome.

Conclusion

While 2020 was a challenging year for senior housing operators due to the pandemic, emerging trends throughout the sector highlight a dichotomy between well-capitalized operators and those with limited resources to address these current headwinds and mounting future challenges. More prosperous senior living operators should take time to refine capital plans to address patient technologies and marketing strategies that reach all decision makers in a family. Given the current trends with stabilizing occupancy levels and improving visibility on revenue activity, recovery will be maximized by investing in and stabilizing operations until market demand recovers.

For those capital-challenged senior care providers, the most cost-effective solution may be monetization through disposition of assets to a well-capitalized provider, an institutional investor, or a health care concern looking to invest further in the senior care sector and augment its post-acute care strategies. Size and scale will take on greater importance in this increasingly competitive sector to allow larger post-acute operators to expand their footprint, diversify their revenue streams, and gain cost efficiencies.

Topics:

HEALTHCARE (/ARTICLE-TAGS/HEALTHCARE) **RESTRUCTURING** (/ARTICLE-TAGS/RESTRUCTURING)

About The Author

Matt Caine is a managing director with SOLIC Capital Advisors, where he provides financial advisory services, including investment banking and capital restructuring support, to taxable and tax-exempt facilities-based providers, such as life plan communities, skilled nursing providers, independent and assisted living facilities, regional health systems, community hospitals, ambulatory surgery centers, home health and hospice organizations, and multispecialty physician practices. Caine is a Chartered Financial Analyst (CFA) and a CIRA, and holds a Certification in Distressed Business Valuation (CDBV).