Ventas' 5.1% Yield: Too Much Risk for This Popular REIT?

Key Takeaways:

- Shaky operational performance
- Declining FFO
- Neutral to Negative overall street outlook

Ventas Inc. (VTR) has significantly restructured its portfolio in the last two years to address a downturn in operational performance. The adverse impacts of these changes are expected to continue through 2019. This article analyzes the various challenges that have brought Ventas to its current position, and then considers the health of the business, valuation, risks, dividend safety, and concludes with our opinion about whether Ventas is an attractive choice for investors seeking stable long-term returns.

Overview:

Ventas, Inc., an S&P 500 company, is a real estate investment trust ("REIT") with a diverse portfolio of approximately 1,200 assets in the United States, Canada and the United Kingdom. Its portfolio consists of seniors housing communities, medical office buildings, university-based research and innovation centers, inpatient rehabilitation and long-term acute care facilities, and health systems. Through its Lillibridge subsidiary, the company provides management, leasing, marketing, facility development and advisory services to highly rated hospitals and health systems throughout the United States.

The company operates through three reportable segments - triple-net leased properties, senior living operations and office operations. Under the triple-net leased properties segment, Ventas invests in and owns seniors housing and healthcare properties and leases those properties to healthcare operating companies under leases that obligate the tenants to pay all property-related expenses. Under the senior living operations segment, Ventas invests in seniors housing communities and engages independent operators to manage those communities. Under the office operations segment, Ventas acquires, owns, develops, leases and manages Medical Office Buildings (MOBs) and research and innovation centers.

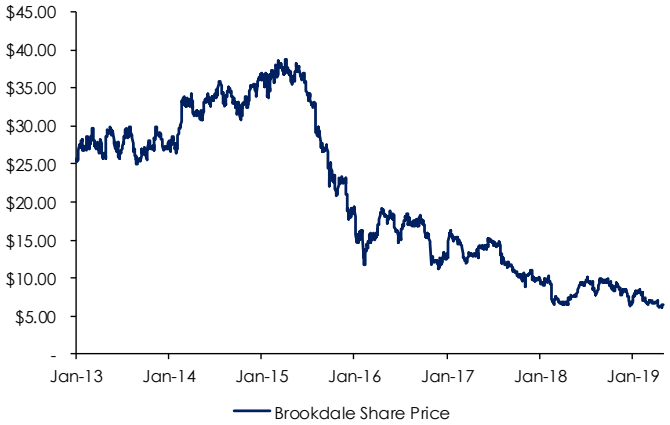
Triple-Net Performance Marred by Turbulence

The triple-net segment accounted for 38% of Ventas' annualized net operating income ("NOI") as of Q1 2019. Over the past few years, Ventas has faced some major operator issues within this segment that have arguably been a significant overhang for the stock. Specifically, two of its three largest tenants, Brookdale and Kindred (which accounted for a combined 15% of the company's NOI as of Q1 2019) were in the midst of a turnaround effort following years of operational challenges and declining market capitalization.

In 2017, Ventas essentially dumped its skilled nursing exposure by way of dispositions that were tied to Kindred going private and exiting the business. The remaining properties leased to Kindred Healthcare (6% of NOI), now owned by private equity TPG Capital and WCAS, continued to operate under the original terms of the lease agreement and were guaranteed

by Kindred Healthcare, under its new ownership. EBITARM coverage of Kindred has improved and we believe it will continue to improve under its private equity owners and by 2020 (2.5 years after the acquisition by TPG), the company will generate sufficient EBITDARM to cover the rent.

In 2018, Ventas completed a significant lease restructuring with Brookdale (9% of NOI) whereby the company effectively extended sizeable near-term expirations and gained more flexibility allowing it to continue reducing exposure to the operator. Additionally, all obligations would be guaranteed by Brookdale Senior Living Inc. along with covenant protections. As per market estimates, Brookdale will generate an EBIT of $15.5 million in 2019 and $54.7 million in 2020 compared to an operating loss of $594.3 million in 2018. However, FCF is forecast to continue its negative trend ($97.1) million in 2019 and ($34.5) million in 2020). Thereby, it becomes pretty clear that rent payments from Brookdale are uncertain at the very least. Brookdale's poor operational performance is clearly highlighted in the following five-year share price chart[1].



The major restructuring combined with rent cuts announced in Q1 2018 has resulted in declining FFO in 2018, and is expected to continue through 2019. Further, while corrective action has been taken on the two major leases, the company remains exposed to the risk of uncertain payment from tenants as the EBITDARM coverage remains below 1.1x for 13%, including 9% of Brookdale, with regards to Ventas' triple-net leased portfolio.

Senior Housing Supply Headwinds

The senior living operations segment accounted for 32% of Ventas' annualized NOI as of Q1 2019. Heightened development deliveries in recent years and rising labor expenses have put pressure on the segment's NOI growth. And the combination of elevated new supply levels and expense pressures are translating into negative growth for this large segment of Ventas' overall portfolio and it's likely to persist into 2019 as well. Per Ventas' recent quarterly earnings call, industry experts believe that if the rate of new openings continues at the current rate through 2025, it will outpace the rate at which demand for senior housing is growing, creating an excess inventory problem.

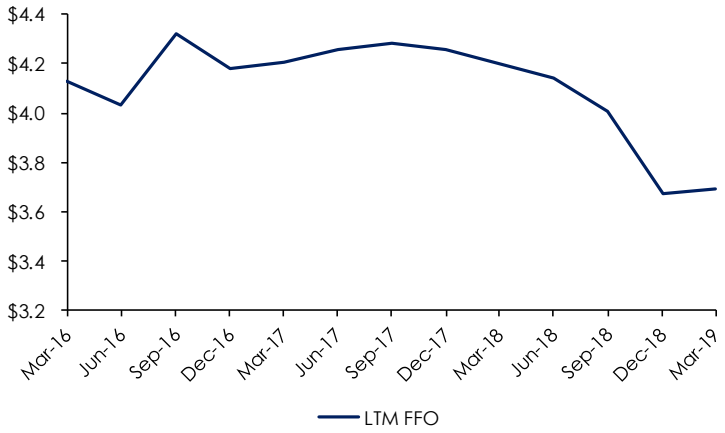
1 Factset

However, the company expects this trend to improve starting 2019. Quoting management,

"Through the first quarter, we are encouraged by the recently reported continued improvement in senior living starts. In the top 99 markets, starts were at their lowest level since the third quarter of 2012 and down 55% from the peak start level achieved in mid-2015. Even more notably, we are seeing early, but unmistakable signs of demographic demand manifesting in the sector. The year-over-year growth in occupied units in the top 99 markets at 2.7% is the highest since Q3 2014 and close to its highest point ever. In the primary markets, annual absorption growth in the first quarter was 3%, the highest on record. Construction as a percentage of inventory remains elevated but is improving gradually."

However, we take a conservative stand on the growth prospects and assume that the segment will decline by 1% in 2019.

Capsizing FFO



As seen from the above chart[2], Ventas' FFO per share has been declining over the past 3 years. Elevated disposition activity, combined with negative senior housing growth, weighed heavily on 2018 earnings growth. The impact of these headwinds is expected to spill over into 2019 and make 2019 FFO growth challenging, as seen in the table below[3].

Funds from Operations

FY Ending	Dec '17	Dec '18	Dec '19E	Dec '20E
Q1 (Mar)	1.03	1.05	0.99	0.97
Q2 (Jun)	1.06	1.08	0.96	0.96
Q3 (Sep)	1.04	0.99	0.95	0.97
Q4 (Dec)	1.03	0.96	0.94	0.98
Fiscal Year	**4.16**	**4.07**	**3.81**	**3.88**
P/FFO (x)	14.4	14.4	16.4	16.1
CY Ending	Dec '17	Dec '18	Dec '19E	Dec '20E
Cal. Year	**4.16**	**4.07**	**3.81**	**3.88**
P/FFO (x)	14.4	14.4	16.4	16.1

As per analyst forecasts, the company's FFO position is however expected to improve in 2020 and there should be a better intermediate-to-longer term setup for the stock given recent

[2] Factset
[3] Factset

moderation in new senior housing supply growth, the company's transition to being a net-deployer of capital, and a compelling demographic trend.

Ripple of Office Optimism

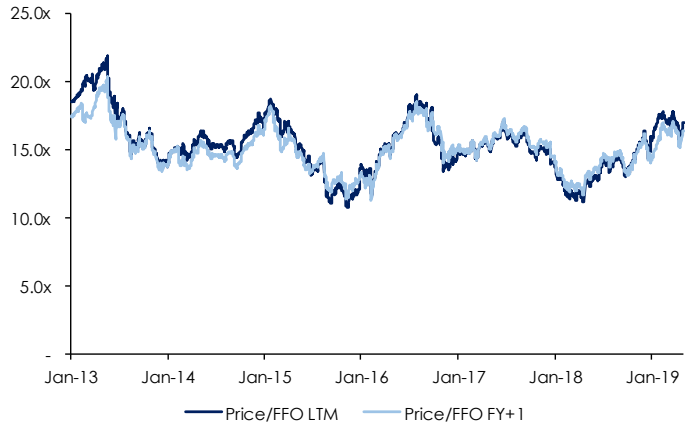
Ventas' office operations segment accounted for 27% of annualized NOI as of Q1 2019. For some history, Ventas initially entered the MOB space with its acquisition of Lillibridge Healthcare Services in 2010 and then announced its entry into the life science space with its $1.5 billion acquisition of Wexford in 2016. This segment ("Office") has the highest occupancy rate among all segments and has high quality tenants. Tenants in the MOB space include top-rated healthcare systems like Ascension Health, Advocate Aurora Health and Providence St. Joseph Health. Ventas has been expanding its relationships with top-rated universities since the initial Wexford acquisition, and has developed affiliations with several leading research centers/universities such as Wake Forest, Alexion, Yale, and University of Pennsylvania.

While Ventas has historically been extremely active on acquisitions, the path for future growth of this segment is through development and expansions. To quote management during the quarterly call,

"We continue to make tangible progress on the $1.4 billion Research & Innovation development pipeline and expect to reach significant additional milestones for a large portion of these identified projects through the balance of this year. We are also confident that substantially all of our $1.5 billion pipeline will be commenced within the next 15 months."

Efficient application of the remaining $1.4 billion pipeline in this segment is expected to partially offset the negative growth in triple-net and senior housing segments.

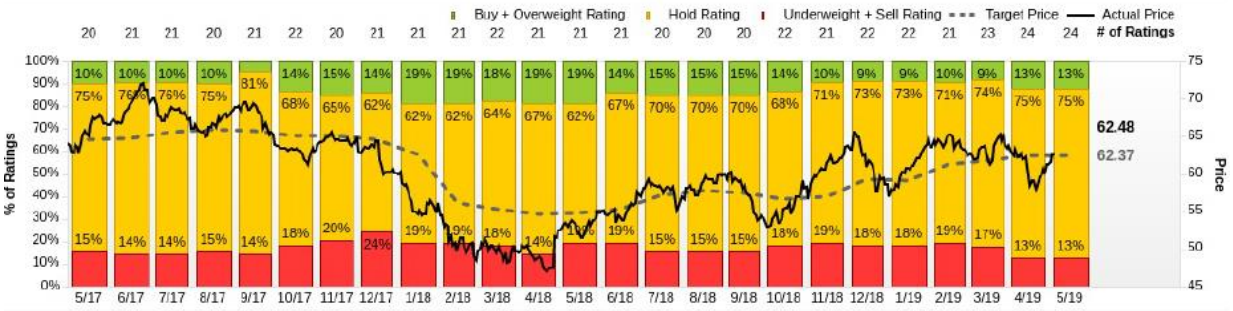
Valuation



	Price/FFO LTM	Price/FFO FY+1
Min	10.8x	11.3x
Max	21.9x	20.3x
Average	15.4x	15.1x
Current	16.9x	16.4x

As seen in the graph above[4], Ventas is currently trading at a P/FFO LTM and P/FFO FY+1 which is above its historical average level over the last 5 years. Although when we look at the industry as a whole, the company is trading at a relatively lower multiple compared to peers.

On average, Wall street analysts believe Ventas is overvalued[5] and estimate FFO to decline further in 2019, thus reinforcing a negative overall outlook for the company.



4 Factset

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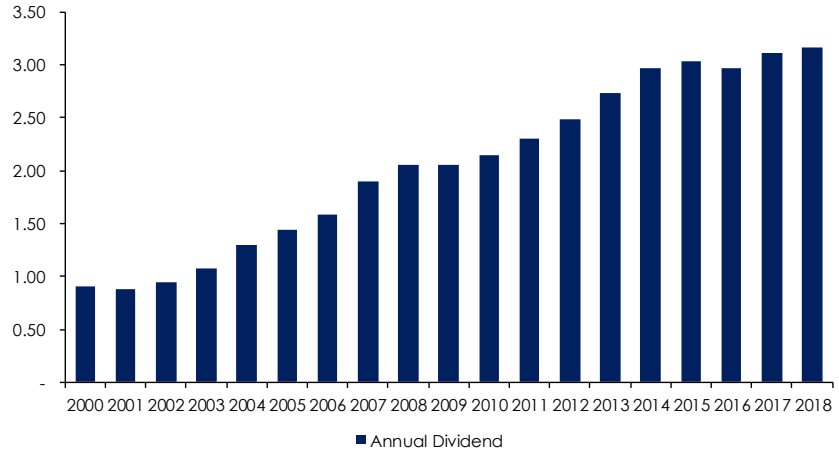
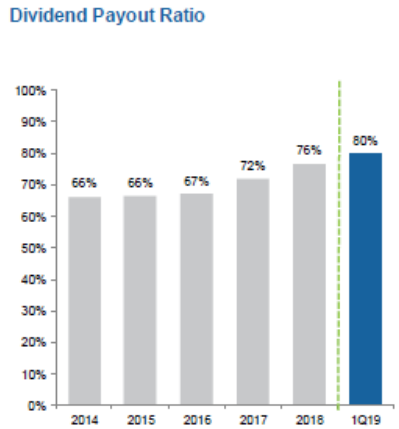
Dividend Safety

The Ventas dividend has remained stable or increased every year since the 2000, except for the years of 2001 and 2016, where the dividend fell by 3.3% and 2.5% respectively[6]. The decline in 2016 was primarily due to Ventas' disposal of skilled nursing facilities following Kindred's exit from the business.



The dividend payout ratio of the company has however increased over the last 5 years reaching 80% in Q1 2019[7], indicating that Ventas has had to allocate a larger portion of its FFO to maintain divided stability and growth.



Higher Sensitivity to 10-year Treasury Rate

Considering Ventas' above average dividend yield in the REIT sector, the stock is arguably more sensitive to interest rate moves than the REIT sector as a whole, and a notable increase in the 10-year treasury rate could cause Ventas' stock to lag further. As REITs are often seen as a bond alternative, higher interest rates could mean decreased demand for REITs, thereby causing a decline in the share price and resulting in a rise in the dividend yield. Higher interest rates also result in higher cost of capital for the REITs . A combination of a higher dividend yield and a

6 Factset

7 Investor Presentation Q1 2019

higher cost of capital often result in a reduction in shareholder value for REIT investors as the capitalization rate of new properties needs to be higher than the cost of capital in order to increase FFO.

Conclusion

Ventas is finding it difficult to maintain FFO stability in an era of strong growth for healthcare spending. The company's major portfolio restructuring over the last two years had a significant negative impact on FFO in 2018, and this is expected to continue through 2019. Further, Ventas' triple-net and senior housing segments, which accounted for 70% of annualized NOI, are facing risks with regards to uncertain payments from tenants as well as supply headwinds too. And while Ventas has allocated $1.5 billion to its pipeline for research and innovation development, we believe that the growth potential of this segment cannot materially compensate for the risks faced by the other two segments. Further, as per Wall Street estimates, the shares are overvalued, and at present, do not entirely justify the valuation given Ventas' operational performance. The following tables reflect three possible growth scenarios that might play out for Ventas under different circumstances, and they are meant to provide an illustrative example of the challenges Ventas faces.

1. Risky triple-net leases written off 100%

Segment	% of Annualized NOI	Estimated 2019 Organic Growth	Estimated 2019 Inorganic Growth	% of FY 2019 NOI
Triple Net	38.0%			**25.1%**
Assets under 1.1x EBITDAR coverage	13.2%	0.0%	-100.0%	0.0%
Assets above 1.1x EBITDAR coverage	24.8%	1.1%	0.0%	25.1%
Senior Housing Operating Property	32.0%	-1.0%	0.0%	**31.7%**
Office Segment	27.0%	1.5%	20.0%	**32.9%**
Total	**97.0%**			**89.6%**
Overall Growth				**(7.6%)**

2. Risky triple-net leases written off 50%

Segment	% of Annualized NOI	Estimated 2019 Organic Growth	Estimated 2019 Inorganic Growth	% of FY 2019 NOI
Triple Net	38.0%			**31.7%**
Assets under 1.1x EBITDAR coverage	13.2%	0.0%	-50.0%	6.6%
Assets above 1.1x EBITDAR coverage	24.8%	1.1%	0.0%	25.1%
Senior Housing Operating Property	32.0%	-1.0%	0.0%	**31.7%**
Office Segment	27.0%	1.5%	20.0%	**32.9%**
Total	**97.0%**			**96.2%**
Overall Growth				**(0.8%)**

3. Risky triple-net leases written off 25%

Segment	% of Annualized NOI	Estimated 2019 Organic Growth	Estimated 2019 Inorganic Growth	% of FY 2019 NOI
Triple Net	38.0%			**35.0%**
Assets under 1.1x EBITDAR coverage	13.2%	0.0%	-25.0%	9.9%
Assets above 1.1x EBITDAR coverage	24.8%	1.1%	0.0%	25.1%
Senior Housing Operating Property	32.0%	-1.0%	0.0%	**31.7%**
Office Segment	27.0%	1.5%	20.0%	**32.9%**
Total	**97.0%**			**99.5%**
Overall Growth				**2.6%**

Even under our most conservative scenario assumptions, the growth achievable isn't compelling compared to government bonds (the 10-year treasury currently yields around 2.5% with far less risk). And even though management expects operational performance to improve

in 2020, we believe the risks outweigh the potential returns at this time (we'd consider buying at a lower price). In a nutshell, even though Ventas may have the financial wherewithal to maintain its dividend—the company will continue to face significant challenges, and the share price may get worse (perhaps significantly worse) before it gets better.