The Bulletin

Senior Housing in the COVID-19 Era

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COVID-19 has upended most of the planet by now. As we survey the damage to different sectors of the capital markets, we explore U.S. healthcare REITs with exposure to senior housing as we question how their stock price performance reflects the disruption we have all witnessed in the delivery of care to different segments of the population.

HEALTHCARE REITS AND THE SENIOR HOUSING SUBSECTOR

Healthcare REITs are one of the largest sub-sectors of the U.S. REIT universe with a total market capitalization of $96 billion and total assets of $156 billion (as of August 31, 2020)[1]. The sector has seen exponential growth over the last decade as its defensive characteristics and positive demographic attributes have attracted investors' attention. Given the strong perceived long-term tailwinds for the sector, companies tended to trade at a premium to their underling net asset value, which in turn allowed them to issue new equity and grow their asset base through accretive acquisitions. The recent COVID-19 pandemic, however, has temporarily put this acquisition-driven growth trajectory at risk. In fact, share prices have dropped, largely due to the sector's exposure to an at-risk population of elderly citizens.

Healthcare REITs have a very broad definition and are comprised of several different underlying asset types (i.e. senior housing, skilled nursing, hospitals, medical offices and life sciences) which differ widely, and provide specific risk return profiles. The largest subsector, which we discuss below, is senior housing that has gone from a more defensive asset class to one of the most negatively impacted by COVID-19 over the last few months.

EARLY CHALLENGES IN A NEW ENVIRONMENT

Senior housing operators are responding to the significant operating challenges brought on by the pandemic, but at a considerable cost. In order to prevent the spread of the virus and to protect residents, operators have needed to secure additional personal protective equipment (PPE) and increase testing to help locate and contain the virus. Contingency plans also need to ensure there are enough employees to implement infection control protocols, including additional cleaning and other precautionary measures. All of this puts pressure on operating costs which include higher staff compensation, additional equipment, and higher material costs and maintenance expenses.

Increased expenses, however, are not being offset by higher revenues as vacancy rates climb. Senior residents typically stay only a few years in a senior housing facility. This means that under normal circumstances, the level of monthly move-outs could be significant but is typically replaced by new move-ins. However, because of the new social distancing measures that have been put in place, either voluntary or imposed by the government, move-ins are often restricted. For this reason, since the start of COVID-19, operators have experienced a significant decline in occupancy levels.

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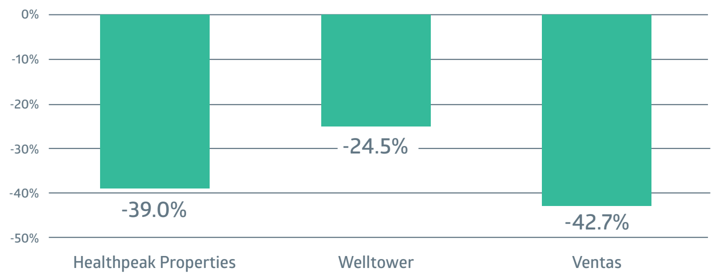
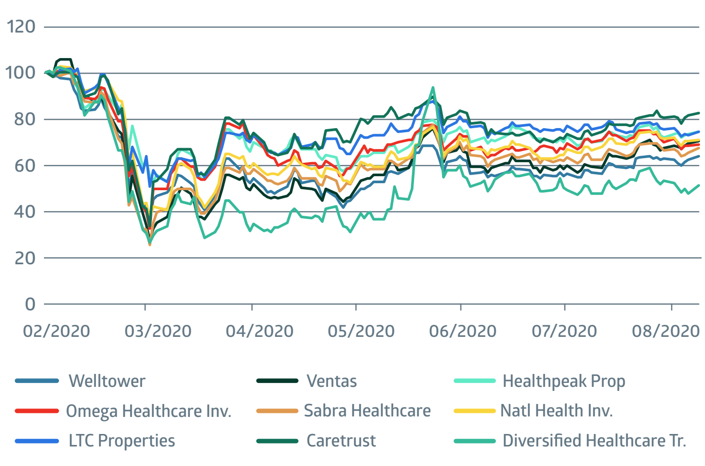


Sources: Presima Inc., Company supplemental disclosures.

And increase in operating expenses and loss of occupancy by senior housing operators have negatively impacted the net operating income (NOI) of REITs that have exposure to the sector.

REITs that collect triple net rents from senior housing operators might have to provide rent deferrals/cuts to tenants which are seeing their profitability eroded, while REITs that participate in the operating income of the senior housing assets are seeing the negative impact of the higher operating expenses and lower occupancy directly on their margins. The financial impact is material on the NOI of the companies and the market has been quick to price the negative implications.

NORMALIZED PERFORMANCE OF REITS WITH SENIOR HOUSING EXPOSURE SINCE MID-FEBRUARY 2020



Sources: Presima Inc. and Bloomberg L.P.

THE OCCUPANCY CONUNDRUM

Senior housing operators and owners are particularly sensitive to high levels of occupancy for their success.

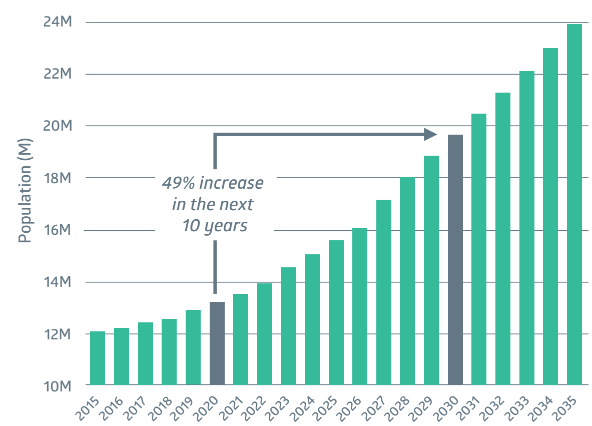
While the best operators can successfully manage variability in short-term occupancy related to factors such as the seasonal flu or natural rates of turnover, the impact of COVID-19 on occupancy levels has so far proven more severe and longer lasting.

Although the virus may somewhat reduce projected levels due to the observed effects of the virus on seniors, we still believe there will be a significant level of natural demand in the future.

Assisted living vs independent living: There are two main types of senior housing facilities: independent living and assisted living. In independent living facilities, individuals live independently but have access to assistance like housekeeping, meal preparation, laundry and entertainment. In an assisted living facility, seniors receive basic daily functions like toileting assistance, dressing, bathing, feeding or the scheduling of visits with doctors. In general, residents choosing an independent living facility do so by choice, while those entering an assisted living facility typically do it by necessity. Assisted living facilities are more "needs-based" and, as a result, should recover occupancy levels faster.

Impact of home prices and jobs: Senior housing rents are expensive and demand is typically higher in a good housing market which allows seniors to monetize their homes to pay for their upcoming stay, or in a good employment market, so children of "to be" residents can finance their stay. If COVID-19 has a detrimental impact on either home prices or jobs, a decision to move into a senior housing facility may be delayed and result in lower occupancy levels.

80+ U.S. POPULATION GROWTH



Sources: Welltower Nareit Presentation Business Update June 2020, United States Census Bureau: Projected Population by Single Year of Age, Sex, Race, Hispanic Origin and Nativity for the United States: 2016 to 2060.

WHERE TO GO FROM HERE?

At the moment it is difficult to forecast near-term demand drivers in the current context. Without a vaccine, we would expect negative impact on demand, lower occupancy rates and higher operating expenses to persist.

Longer-term, however, demographics play in favour of higher future demand as the 80-year-old "plus" cohort of the population is expected to grow significantly over the next 10 years.

Another long-term support for the sector is the declining ratio of adult child caregivers to seniors over the next few years. As this ratio steadily declines, there will be fewer options available when faced with the choice of moving to senior housing. We acknowledge that some will delay move-in decisions as long as they can and, in some cases, may choose home care alternatives.

DECLINING ADULT CHILD CAREGIVER RATIO
Ratio of 45-64 to 80+

Sources: Healthpeak February 2020 Investor Presentation, U.S. Census, American Community Survey (ASC), NIC

> We believe that REITs that partner with operators that have a strong track record of managing revenues and expenses efficiently will show better fundamentals. We also expect occupancy in assisted living facilities to recover faster than independent living because of the demand for the type of services they offer.

Newer and better designed senior homes should also help attract residents over time. As operators rethink the use of their current space, they will likely require higher specifications in new facilities. Some of the potential changes could include more elevators, larger rooms, and better heating and cooling systems.

One aspect we think will remain challenging for senior housing operators are higher costs. Although the level of expenses will likely normalize, it is possible that some measures (and costs) implemented during COVID-19 will stick around after the pandemic. Although operators might be able to reduce the working hours required at some facilities due to lower occupancy, there is a high probability that a portion of the COVID-19 salary increases evolve into more permanent raises.

CONCLUSION

The future stock price performance of U.S. REITs with senior housing exposure will depend on how long the pandemic lasts. In the near term, the sector will continue to see challenges related to COVID-19. Occupancy levels are likely to remain impacted and costs are likely to be more elevated as residents demand better and safer facilities.

In a scenario where a vaccine or a highly effective therapy is found, we expect the senior housing sector to perform well as the demand for senior housing, which is often needs-based, has not changed meaningfully due to COVID-19. This contrasts with other real estate sectors which might see lasting impacts of COVID-19 on the demand for space such as brick and mortar retail (due to online shopping) or offices (due to remote working). The healthcare sector has historically traded at a significant premium to NAV and we believe that in a post-COVID world, considering the low interest rates and recession resilient characteristics of the asset class, such a premium is likely to come back. Over the longer-term, the demographics should also continue to provide a tailwind for the sector.

Special **thank you:**

Given the personal nature in which this sector touches many of us, we would like to extend a special thank you to all the staff and the frontline workers which have stepped up to protect those we love. Their actions and selflessness will be remembered as heroic for years to come.

Sources: [1] Bloomberg L.P. and Presima Inc. estimates.

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