Market Update with Alan Plush, MAI

On Cap Rates, REITs, and the New World of Valuation

In the eyes of an appraiser, perhaps the most problematic outcome from the new paradigm is the influence and confusion resulting from historically low costs of funds for some, but not all, market participants.

Valuation theory, while reasonably complex to a practitioner especially when business values or going concern values are sought, is typically simplified to discussions on "cap rates". I see multi-billion dollar transactions with partial interests, lease options, guaranteed management contract, and more - all summarized into a simple "cap rate" discussion. While market participants love to simplify, in reality there are many pieces to the valuation process, all variable, and all meaningful. However, for discussion purposes we will take the low road and outline how capital costs impact "cap rates."

To be very simplistic, a cap rate (or overall rate) is a balance of return requirements to both equity and debt in market determined proportions. Thus, five years ago we would have developed a generic cap rate as follows:

Debt Component (LTV)	75%	X	0.0750	=	0.0563
Equity Component	25%	X	0.1500	=	0.0375
Implied Cap Rate					0.09375
Rounded					9.4%

Please note, this is GENERIC for illustration purposes and does not apply to any specific asset class. Real cap rates are market determined, but for our purposes this contrast will work fine.

Run the clock forward to 2012 with an expectation that the Fed Funds rate will remain at 0% through at least 2015. Assuming a REIT (one of the big three clearly) can raise "equity" at 6.00%, and they lever assets at 65%, using a bank line that is running between 3-4% produces:

Debt Component (LTV)	3.5%	X	.65	=	2.3
Equity Component	6%	X	.35	=	2.1
Implied Cap Rate					.0438
Rounded					4.4%

Again, this cap rate is intended for illustration purposes only. This explains in large part the continued decrease in cap rates for institutional assets purchased by REITs. Additional risk is factored into a typical cap rate due to the presence of a business operation. Cap rates don't get this low (yet…). The point is to illustrate the concept and the relative impact of lower costs of debt and equity.

What about the rest of the assets? Well, there's the problem. REITs will only purchase assets or platforms that fit very specific criteria. These are assets of recent and quality construction, in the better locations of a market area, have a history of successful operations, and are managed by competent operators (or potentially could be). In short, these are "best of class." A few dogs are always thrown into any portfolio so there will always be strays. The assets that qualify for REIT ownership trade at cap rates that reflect their costs of capital. Not every asset fits these criteria. This reflects what we have always called a bifurcated market.

In many ways the market has always made this distinction. Assets that would qualify for Agency debt until a few years ago were the winners and traded at premiums. This was due to lower cap rates driven by ability to finance at lower costs of debt and equity. Thus, while the REIT phenomenon seems new, in fact this is just the latest manifestation. Dial the clock back 20 years, when IL and AL both traded at 10+ cap rates routinely, and you would have reason to be truly shocked.

However, between then and now much work has been done. This was clearly evident in Chicago at ASHA and NIC conferences last month. Each organization has made continued progress in the packaging of the industry (senior housing in particular) in a more transparent way. ASHA has published the State of Seniors Housing for years and now with a sample size approaching 2,000 properties the data provided is quite relevant. NIC MAP offers increasing insights into comparable data in markets throughout the US. Coupled, a Wall Street analyst with little familiarity in the industry can get a handle on the more major decision criteria when sizing a transaction, be it debt or equity.

This, in turn, allows for a fundamental transformation of how the industry will evolve for its next development phase, which is in fact under way as we speak. A good example of this, and one that I am personally familiar with, involves Sabra and First Phoenix/Stony River. First Phoenix is a developer/operator of properties Wisconsin and was pursuing a strategy of raising capital the old fashioned way. After several years (yes, I know the Great Recession was under way at the time) they had accomplished one project, which went very well. Raising equity was problematic given their size, limited history (recent history that is) and the general environment. On August 17, 2012 they announced a 10 asset JV with Sabra, a publicly traded REIT, that essentially ceases their near term need for generating equity and construction financing on a project-by-project basis.

It is my opinion that this model will be replicated throughout the US over the next several years by the larger REITs with access to capital at low rates. Further, the big three (Healthcare REIT, Healthcare Property Investors and Ventas presented alphabetically) have tied up so many regional or national operators that the way for new development via these relationships, essentially representing a "best of class" in many cases, is clear.

In summary, it is indeed a brave new world. Many changes have occurred, compressed/accelerated by the Fed's response to the Great Recession in the form of 0% interest rates coupled with unprecedented transparency of the industry to the market in general. These changes will continue to be felt throughout the industry and will continue to represent valuation challenges for all of us as we focus on appropriate cap rates, expense ratios, margins, and similar factors.

It was great meeting many of you at NIC and ASHA. If I missed you, I can always be reached at alan.plush@healthtrust.com or visit us online at healthtrust.com.

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