

HCP's 5.0% Yield: Increasingly Safe and Worth Considering?

HCP Inc. (HCP) was forced to dramatically restructure its portfolio over the last several years as a distressed sub-industry created major challenges for one of its business segments. However, HCP is now emerging as a much healthier healthcare REIT going forward. This article analyzes the corrective actions taken by HCP to address its operating challenges, and then considers the health of the business, valuation, risks, dividend safety, and concludes with our opinion about whether income-focused investors should consider HCP for stable long-term results.

Key Takeaways:

- Strategic portfolio restructuring on the verge of completion
- Improved operational performance
- Strong acquisition and development pipeline

Overview:

HCP, an S&P 500 company, invests primarily in real estate serving the healthcare industry in the United States. The Maryland corporation qualifies as a self-administered real estate investment trust ("REIT"). The company owns a large-scale portfolio primarily diversified across life science, medical office and senior housing. Recognized as a global leader in sustainability, the company has been a publicly-traded company since 1985 and was the first healthcare REIT selected to the S&P 500 index.

HCP operates through three reportable segments - senior housing, life science and medical office. The senior housing segment includes independent living facilities ("ILFs"), assisted living facilities ("ALFs"), memory care facilities ("MCFs"), and continuing care retirement communities ("CCRCs"), provided by third party tenant-operators under triple-net leases or by third-party manager-operators under the structure permitted by the REIT Investment Diversification and Empowerment Act ("RIDEA"). Life science segment contains laboratory and office space primarily for biotechnology, medical device and pharmaceutical companies, scientific research institutions, government agencies and other organizations involved in the life science industry. Medical offices contain physicians' offices and examination rooms, and may also include pharmacies, hospital ancillary service space and outpatient services such as diagnostic centers, rehabilitation clinics and day-surgery operating rooms.

Dispensing of the Dispensable

In May 2016, the company announced that it was spinning off a portfolio of skilled nursing facilities ("SNFs") and assisted living properties into a separate publicly traded REIT, Quality Care Properties ("QCP"). The move was intended to focus HCP on what it considers core businesses - senior housing, medical offices, and life sciences. A more candid assessment of the situation is that HCP dumped a basket of volatile assets largely dependent on government pay programs in order to improve its overall stability and balance sheet. The spin-off reduced the company's property count from well over 1,100 to 800 but brought its private pay metric up to 94%. Another

objective of this spinoff was reducing debt. HCP started 2016 with \$11.7 billion in liabilities which has now declined to \$6.2 billion. However, this cleanup came at a price as after the completion of the spin-off, HCP reduced its quarterly dividend from \$0.575 to where it stands today, at \$0.37. HCP also lost its status as a “dividend aristocrat” thanks to the dividend cut.

The decision to spin off its skilled nursing facilities business into a new REIT (“QCP”) was painful for investors (QCP shares were initially valued at \$30.85, but ultimately taken private two years later at \$20.75). However, the decision will arguably be very beneficial in the long run considering Medicare Advantage programs have eaten into both reimbursement and lengths of stay at SNFs which coupled with labor and occupancy pressures, have made it a difficult environment to operate in. The average SNF bed sale in 2018 clocked in at about \$77,000, a 5% dip from 2017, where it plunged by 18%, and the lowest level recorded since 2014.

Portfolio Overhaul

After exiting the SNF business through the QCP spinoff, the company has been working on

Project	Market	Total Costs (\$M)	Cost to Date ⁽²⁾ (\$M)	Remaining Costs (\$M)	Leasable Area (000s)	Percent Leased	Est. Date of Stab. Occ.	Est. Stab. Yield Range ⁽³⁾	Est. Stab. Cash NOI (\$M) ⁽⁴⁾
Ridgeview	San Diego	\$72	\$68	\$4	306 SF	100%	Q3 2019	6.6% - 7.1%	\$5
The Cove Phase III	San Francisco	253	178	75	324 SF	100%	Q3 2019	9.2% - 9.7%	24
Sorrento Summit	San Diego	19	6	13	28 SF	100%	Q4 2019	7.7% - 8.2%	1
The Cove Phase IV	San Francisco	107	33	74	164 SF	100%	Q1 2020	9.6% - 10.1%	11
The Shore Ph. I ⁽⁵⁾	San Francisco	224	106	118	222 SF	100%	Q1 2020	5.8% - 6.3%	14
The Shore Ph. II ⁽⁵⁾	San Francisco	292	40	251	266 SF	-	Q4 2021	5.7% - 6.2%	17
The Shore Ph. III ⁽⁵⁾	San Francisco	94	15	79	103 SF	-	Q4 2022	7.1% - 7.6%	7
Grand Strand MOB	Myrtle Beach	26	3	23	90 SF	47%	Q3 2021	7.0% - 7.5%	2
75 Hayden	Boston	160	42	118	214 SF	-	Q4 2022	7.4% - 7.9%	12
Total/Weighted Average⁽⁶⁾		\$1,246	\$491	\$755	1,717 SF	63%		7.0% - 8.0%	\$92

restructuring its portfolio with a specific focus on diversification, giving equal weightings to the medical office, life science and senior housing segments. HCP has been making significant progress in achieving this target with a fully funded \$1.2 billion active development pipeline.

HCP’s active development pipeline is expected to generate an additional \$92 million in cash NOI per year over the next 5 years at a weighted average yield of ~8% as seen in the table above¹. The pipeline is expected to drive value creation of ~\$594 million with a yield which is ~250 bps higher than the market capitalization rates. Out of the total \$1.2 billion pipeline projects, \$675 million are 100% pre-leased.

HCP is also expecting \$500 million of dispositions through 2019 as a part of its transformation strategy. Approximately 35% to 40% of the disposition pipeline is focused predominantly on senior housing assets. And over the last five quarters, HCP has sold \$1.5 billion of senior housing assets, and only in Q1 2019 did it announce a rebalance of the senior housing portfolio with \$550 million of high-quality acquisitions. HCP is also working on converting select prime-located

¹ HCP Investor Presentation March 2019

triple-net leases into the RIDEA structure under management of better operators, where it can earn higher returns from operations compared to the fixed rent it receives from tenants.

Further, HCP has identified \$900 million of acquisition opportunities for the year 2019 and remains confident in its ability to add to growth. Quoting management during its Q1 2019 earnings call:

"We have fully identified \$900 million of acquisitions and are ahead of plan from a sources and uses perspective. The initial cash cap rate across our acquisition is approximately 5%, which is within our guidance range but at the lower end. The initial cap rate is reflective of the high quality nature of the asset and the near term growth opportunity as the property stabilizes. On a stabilized basis, we see the cash cap rate at approximately 6%."

Credit Rating Upgrade

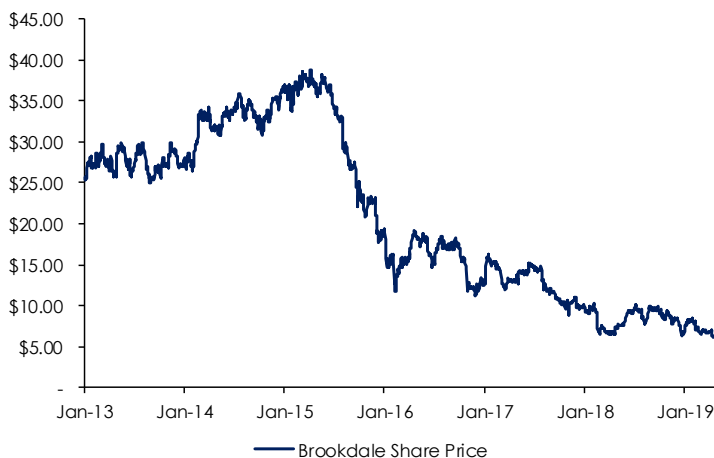
In January 2019, Moody's Investors Service upgraded HCP's senior unsecured debt rating to Baa1 from Baa2. The ratings upgrade reflects HCP's progress in executing its portfolio repositioning strategy, which has improved its asset quality, while also enabling it to reduce leverage. HCP sold, spun-off or transitioned more than \$12 billion of non-core assets over the past three years, including its exit from the volatile skilled nursing business. And as senior housing is expected to face challenges this year, the outlook for the company's high-quality medical office and life sciences portfolio remains strong. Furthermore, Moody's noted that HCP's three core property types all derive most of their income from private pay sources, leaving the company with very low exposure to government reimbursement risk. To quote Moody's:

"Moody's also notes that HCP has meaningfully reduced leverage and lengthened its debt maturity profile. HCP's Net Debt/EBITDA is in the low 5x range pro forma for the completion of significant asset sales and some common equity issuance in 4Q18, down from 6.7x for 2017. Moody's expects the REIT to maintain leverage in the mid-to-upper 5x range as it seeks continued growth via both acquisitions and development. HCP's continued low secured debt levels (1% of 3Q18 gross assets) and strong fixed charge coverage (3.6x as of 3Q18) remain additional credit strengths."

The Brookdale Vulnerability

HCP's senior housing segment accounted for 32% of its cash NOI as of Q4 2018. Under this segment, the company owns properties through triple-net leases with third party tenant-operators or through the RIDEA structure. Under triple-net leases, tenant-operators are typically responsible for the ongoing expenses of the property, including real estate taxes, insurance, and maintenance, in addition to paying the rent and utilities. Additionally, operational risks and liabilities are the responsibility of the tenant-operator. The RIDEA structure allows the company to lease the facility to an affiliate taxable REIT subsidiary (TRS) under a triple-net lease, and for such affiliate TRS to engage an independent qualifying management company (also known as an eligible independent contractor or third-party operator) to manage and operate the day-to-day business of the facility in exchange for a management fee. However, operational risks and liabilities are the responsibility of the tenant-operator.

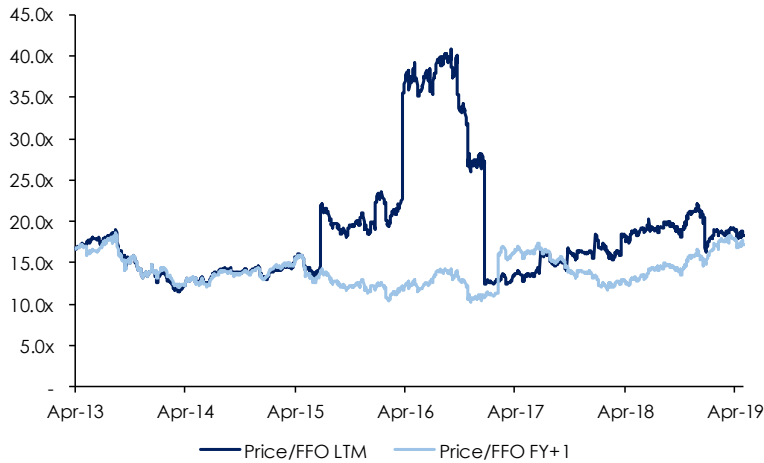
The segment's largest tenant, Brookdale Senior Living, accounted for 36% of segmental cash NOI and 11.5% of cash NOI at the company level. Out of Brookdale's 11.5% contribution to HCP's cash NOI, 6% comes from triple-net leasing agreements while the remaining 5.5% comes from properties operated under the RIDEA structure. Brookdale is currently completing a turnaround effort following years of operational challenges and declining market capitalization, which can be seen in the chart below². In November 2017, HCP entered into an agreement with Brookdale to give HCP the ability to significantly reduce its concentration of assets leased to and/or managed by Brookdale. This agreement also gives HCP the right to sell or transition properties operated by Brookdale or its affiliates to other operators without incurring a penalty.



While this agreement has limited HCP's exposure to Brookdale, it still faces risks associated with uncertain rent payments under the triple-net leases and operational risks and liabilities associated with the RIDEA structure. HCP claims its credit risk from Brookdale is limited to 6% of its cash NOI which comes from triple-net lease agreements. We are taking a conservative view here and assuming that the company's cash NOI will be impacted negatively by ~1-2% due to the current level of exposure to Brookdale.

² Factset

Valuation



	Price/FFO LTM	Price/FFO FY+1
Min	11.5x	10.2x
Max	40.8x	18.6x
Average	18.7x	14.0x
Current	18.2x	17.1x

As seen in the graph above³, HCP is currently trading at a P/FFO LTM below its historical average level over the last 5 years. Additionally, when we look at the industry as a whole, HCP is trading at a multiple which is just close to the average industry level.



Also, on average, Wall Street analysts believe HCP's stock is undervalued⁴ by 6.1%. When combined with increasing FFO estimates in 2020⁵, this indicates an overall positive outlook for

Funds from Operations					
FY Ending	Dec '17	Dec '18	Dec '19E	Dec '20E	
Q1 (Mar)	0.51	0.48	0.44	0.44	
Q2 (Jun)	0.48	0.47	0.43	0.45	
Q3 (Sep)	0.48	0.44	0.43	0.45	
Q4 (Dec)	0.48	0.43	0.43	0.46	
Fiscal Year	1.95	1.82	1.73	1.81	
P/FFO (x)	13.4	15.3	17.3	16.6	
CY Ending	Dec '17	Dec '18	Dec '19E	Dec '20E	
Cal. Year	1.95	1.82	1.73	1.81	
P/FFO (x)	13.4	15.3	17.3	16.6	

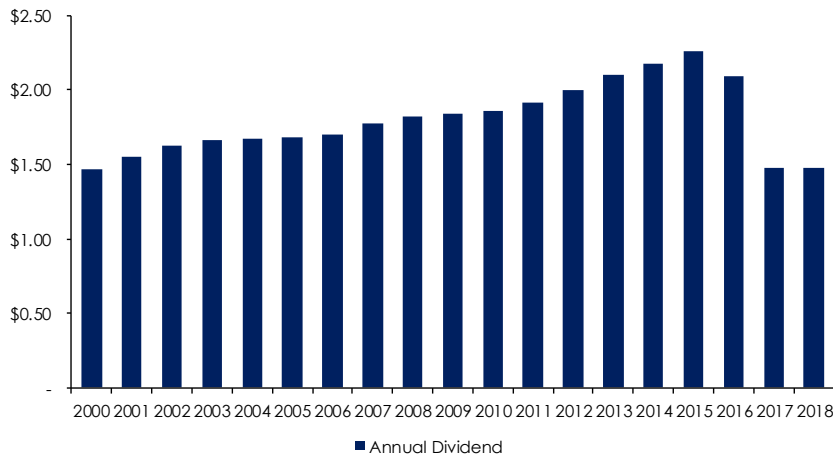
HCP, in our view.

³ Factset

⁴ Factset

⁵ Factset

Dividend Safety



HCP's dividend has remained stable or increased every year since the 2000, except for 2016 and 2017, where it fell by 7.3% and 29.4% respectively⁶. The successive decline in these years was due to HCP's decision to exit the SNF business through the spin-off of QCP (a decision that we view as painful in the short-term for historical investors, but beneficial for long-term investors going forward).

Conclusion

Big-dividend healthcare REIT, HCP, ran into challenges in 2014-2015. However, with major portfolio restructurings on the verge of completion, and a strong development and acquisition pipeline, HCP's multi-year transformation has resulted in a much healthier and stronger business. The company now has a high-quality portfolio of healthcare assets, most of which derive their revenue from predictable private-pay sources.

Segment	% of Cash NOI	Estimated 2019 Growth	% of FY 2019 Cash NOI
Senior Housing	32.0%	(1.5%)	31.5%
Medical Office	31.0%	2.3%	31.7%
Life Science	25.0%	4.5%	26.1%
Inorganic Growth*		4.1%	4.1%
Total	88.0%		93.5%

*Includes Acquisitions - Dispositions + 100% Leased Active Development Pipeline

Also, HCP's income isn't overly dependent on any single tenant, and its improved balance sheet gives it ample liquidity to pursue opportunities as they arise. In our view, HCP is well positioned to take advantage of demographic tailwinds and consolidation opportunities ahead considering the current dynamics of the healthcare real estate market. If you are looking for increasingly healthy and stable long-term, income-focused, returns—HCP is worth considering for a spot in your portfolio.

⁶ FactSet

With a huge, long-tailed, market opportunity ahead, HCP should be a strong and stable performer in the years ahead. From the table below, it can be concluded that even with conservative assumptions, the company is expected to grow in 2019 and is a safe investment opportunity.