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Who wins in this environment? Anyone with money, and right now health care REITs are at the top

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The following was taken from an article in the October 2008 issue of "The SeniorCare Investor" regarding the financial crisis on Wall St.

Wall St.'s eulogy has been delivered several times in the past 40 years, including the 1970s when fixed-rate commissions were abolished, Black Monday in 1987 with the largest one-day percentage drop in history, and the Long-Term Capital Management bailout in the 1990s. While these events jolted the markets with the proverbial wake-up call, what is happening today is much more pervasive and as such, the impact will be longer lasting. In addition, in each of the past crises, Wall St. bankers were not talking about the end of Wall St. as we know it (the commission change may be the exception). That is not the case today. Because of the immense size of the combined federal bailouts in this crisis, there will be a price to pay, and everyone will pay it.

But what does change on Wall St. really mean? Other than the obvious lower profits and smaller bonuses, risk-taking will decline, competition will decrease, innovation will be hampered by what will be a more intrusive government (protecting its investment) and, most importantly for the seniors housing and care industry, the cost of capital will rise regardless of what happens to interest rates, at least for a few years. While not something that is wanted, there is a positive side to this development, at least for those providers with buildings already open. There may be fewer new entrants to the industry and new construction will be scaled back, helping occupancy rates because the demand for the product will certainly not decline. Operating income should rise when all of these influences start to impact the market.

The name of the game right now is liquidity, and in this market it currently does not exist. The number of large national banks is now down to three, the large finance companies that have been major players in seniors housing are trying to figure out where they can raise capital and what their role will be in the new environment (and they all want a significant role) and the CMBS market is shut down for now. The tax-exempt bond market has seized up, not because there is a credit problem with the issuers, but because the bond funds are seeing withdrawals and letter-of-credit support is hard to find. The big question is what will happen to the role of Fannie Mae and Freddie Mac in seniors housing next year? They are open for business, but if the government decides their entire focus should be to support the residential housing market, and "affordable housing" - not realizing their importance to the multifamily and seniors housing markets - then we will soon learn what a real liquidity crisis is like in that sector.

So who wins in this environment? Obviously, anyone with money, and right now health care REITs are at the top of that short list. Many of these REITs that were instrumental in financing the growth of the industry in the 1980s and 1990s have been diversifying away from seniors housing and care, primarily away from the reimbursement-dependent skilled nursing sector. With a combined $3 - $5 billion of capital to invest, health care REITs are in position to capitalize on their industry expertise and desire to invest. With the cost of everyone else's capital going up, combined with the demand for more equity from traditional lenders, REITs will not be losing out on pricing at this time. In fact, because the demand for capital remains high, they are in a position to be quite selective regarding whom they will deal with.

Others that should benefit from the current environment are mezzanine funds (that are still open and have money) because the demand for their funds will only grow through next year. Any regional bank with a strong balance sheet (and they do exist) is in a great position to provide mortgage financing, and they are doing so on a regional basis with small loans of $5 -$20 million. When the dust settles, with the number of large investment banking firms cut in half, expect to see a surge in boutique firms, not trading for their own account, but providing capital raising and M&A advice.

It is always important to remember that capital is a commodity, it moves quickly and has no boundaries. As such it will always go where the returns are the highest for the relative amount of risk. Despite the gyrations in the seniors housing publicly traded equities over the last few months, with much of that volatility based on fear, uncertainty and a lack of knowledge of the facts, the seniors housing and care industry not only remains a relatively safe investment vehicle, the returns will be favorable for many years and should beat other "real estate" oriented investments as well as other health care investments. For everyone in the industry there will be a renewed lender focus on track record, and it better be a good one.

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