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Examining the M&A Wave in Health Care REITs

New transactional structures and favorable capital markets have led to a recent surge in M&A activity involving real estate investment trusts in the health care sector, as well as an increase in the level of collaboration between owners and operators of health care properties. While the uptick in deals generally is expected to continue, buyers and sellers need to know about the benefits and potential risks to these structures. This Q&A, with Skadden M&A partner Joseph A. Coco, addresses questions industry participants have about the transactional and regulatory issues they face and provides an outlook for the rest of 2011 and beyond in the health care REIT sector.

What trends or themes have been evident in recent health care REIT transactions?

We recently have seen a surge in M&A activity in the health care REIT sector. This has been driven in part by an increase in transactions structured as sale-leasebacks or employing structures compliant with the REIT Industry Diversification and Empowerment Act (RIDEA).

Prior to the recent economic downturn, many owner-operators reorganized their companies into separate operating subsidiaries (OpCos) and property owning subsidiaries (PropCos) so that the PropCos could enter into CMBS financings. The real estate financing markets currently do not provide sufficient liquidity to refinance many of these loans. Sale-leaseback transactions provide an alternative avenue to address the maturing loans while allowing the OpCos to continue operations. Acquirors have been able to access the improving capital markets to fund these acquisitions and provide a means of paying off the existing CMBS financings. In fact, many industries in addition to the health care REIT sector are considering REIT structures to take advantage of some of these benefits.

We also have seen transactions employing more traditional acquisition structures, including the stock acquisition of publicly traded Nationwide Health Properties by Ventas announced in February 2011.

What are the benefits of the OpCo/PropCo structures in health care REIT acquisitions?

OpCo/PropCo structures are attractive to potential sellers that own and operate health care facilities, as a means to realize proceeds from their real estate investment while continuing the underlying operations, and are attractive to health care REIT buyers, which are generally prohibited, subject to certain exceptions, from operating their real estate assets. In addition, OpCo/PropCo structures are attractive because of the predictable income stream provided by a long-term, triple-net lease.

These transactions typically involve the distribution of OpCo assets followed by the acquisition of the PropCo entities by a health care REIT from an owner-operator. Concurrent with the acquisition, the REIT and operator enter in to a long-term, triple-net master lease (*i.e.,* net of tax, insurance and maintenance expenses).

In recent transactions, including HCP's agreement to purchase the real estate assets of HCR ManorCare and Health Care REIT's agreement to purchase health care facilities from Genesis HealthCare, acquirors have negotiated options to purchase a 9.9% equity interest in the remaining operating companies, to be able to participate in some of the upside associated with the operations going forward.

How has RIDEA affected the heath care REIT sector?

RIDEA was adopted in 2008 and has had a significant impact. Several recent transactions have utilized RIDEA-compliant structures to maximize value. For example, in October 2010, Ventas purchased the real estate assets of Atria Senior Living utilizing a RIDEA-compliant structure.

In June 2011, HCP agreed to enter into a RIDEA-compliant joint venture with Brookdale Senior Living, the industry's largest operator, to own and operate 21 independent living communities in connection with Brookdale's agreement to purchase all of the operations of Horizon Bay Realty. Brookdale also agreed to lease and manage an additional 12 communities from HCP. The HCP-Brookdale transactions present an example of the growing collaboration between health care REITs and operators.

RIDEA permits health care REITs to lease facilities to a taxable REIT subsidiary (TRS) if the TRS hires an unrelated eligible independent contractor (EIK) to manage the operations. Under this structure, the REIT leases health care properties to the TRS and receives rent while the TRS earns income from the properties' operations and pays a management fee to the EIK and rent to the REIT.

RIDEA structures allow owners of health care property to capture more value on their properties and create new opportunities for consolidation in the industry. While these structures may provide for increased operating income for the buyer, health care REITs also need to manage and protect against any associated risks with the operations.

What is the outlook for the rest of the year in the health care REIT industry?

We expect that industry participants will continue to take advantage of favorable market conditions and explore opportunities with REITs using acquisitions to grow their businesses and enter new business lines and geographic segments. Financing markets — both debt and equity — continue to present buyers with access to the cash necessary to fund acquisitions, and valuations continue to be below the levels seen prior to the financial crisis. The health care REIT industry continues to be highly fractured and many further opportunities for consolidation exist. While regulatory moves such as the late-April proposal by CMS on Medicare payment policies for inpatient rehabilitation facilities bear scrutiny, we believe the larger capital markets and industry structure considerations will predominate.

We expect to see a sustained increase in the level of collaboration between owners and operators of health care properties for the foreseeable future, whether by means of RIDEA-compliant structures, OpCo/PropCo transactions or other acquisition or partnership structures.