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For the defense

Evan Lorenz writes:

Nine out of ten American chief executives expect the United States to slip into a recession in the next 12 months, a new survey by KPMG, LLP finds. Possibly, this is very bearish, or—given the low probability of a consensus of expert opinion ever being proved correct about the financial or economic future—bullish.

One thing, at least, is undeniably true: The S&P 500, at 26.9 times its cyclically adjusted price-earnings ratio versus a 50-year average of 21.1 times, is priced for prosperity, not the opposite.

No wonder that defensive investing is in vogue, and at a short, mistaken glance, Omega Healthcare Investors, Inc. (OHI on the New York Stock Exchange), a REIT owner of nursing homes and skilled-nursing facilities, seems to fill the defensive bill. Relatively insensitive to GDP and priced to deliver an inflation-beating, junk-bond-equivalent dividend yield of 9.1%, Omega has an undeniable deceptive appeal. Undeceived, we are bearish on OHI but close our analysis with a handful of constructive alternatives.

As of June 30, Omega was the owner of 743 skilled-nursing facilities (SNFs) dedicated to patients recovering from surgery or undergoing rehabilitation treatment, the most under any American corporate roof. Filling out the portfolio are 185 senior housing communities and a $711.6 million mortgage book. In the second quarter, SNF-generated mortgage and rental income delivered 71.9% of the top line, followed by senior housing (21%), real estate tax and ground-lease income (1.6%) and other (5.5%). Under the company's triple net leases, the tenants, not Omega, bear the cost of taxes, insurance and maintenance spending.

Except for a 5.1% exposure to the U.K., Omega's real estate portfolio is grounded in the 50 states: Florida (13.5% of investments as of June 30), Texas (10.2%), Indiana (6.6%) and California (5.8%) are the biggest markets. In the first three months of 2022, the operators of Omega's properties received 51% of their payments from Medicaid, 35.8% from Medicare and the balance from private payers.

The bullish case for Omega rests on two words, the aforementioned "yield" and "demographics." Since the vanguard of the baby-boom generation reached age 75 last year, the senior-care industry had expected a demand-driven tailwind over the next decade.

Then along came Covid. Naturally, pre-vaccine, the last place a sentient senior wanted to be was a nursing home, even the skilled kind, and occupancy rates plunged by 13 percentage points between February 2020 and January 2021. Operating costs simultaneously climbed.

This virus-induced pincer left its mark in the fixed-charge coverage data registered by Omega's tenant companies. Thus, Ebitdar coverage—i.e., Ebitda plus rent on a trailing 12-month basis with three-month lag—declined to 1.1 times on March 31, 2022 from 1.3 times in the full-year 2019 and 1.4 times in 2015. More alarmingly, through the first quarter, 32.9% of Omega's tenants did not cover rent and interest expense from cash flow and 23.3% covered those fixed costs only by 1.0 to 1.2 times.

Bulls expect that, on this score, at least, the worst is over. Since January 2021, occupancy rates have risen by around five points. "While it is not a great operating environment and there is still risk," John Pawlowski, who rates Omega a hold for Green Street, tells me, "the real ugly downside scenarios are probably off the table for Omega, by which I mean bankruptcies of large tenants that make up a large amount of rent and things like dividend cuts and painful equity issuance. Those seem to have low odds right now."

As if to make an upbeat statement, Omega sold 27 properties from one of its tenants in the first quarter for $332.6 million; the price represented a premium of $113.6 million above carrying value. The sale was all the more impressive given that the tenant in question had filed for bankruptcy protection in October 2021. Proceeds of the sales in hand, Omega repurchased $142.3 million's worth of stock. Still and all, in the first six months of the year, the parent's cash flow of $305.2 million did not quite cover dividend payments of $318.3 million.

Granted, allows Jonathan Hughes, who rates OHI a buy for Raymond James & Associates, Inc., Omega is not strictly an inflation play since the annual rent escalator on a typical nursing-home lease increases by only 2.3% per annum. However, combine that 2.3% with another 2% from growth through acquisitions, and "you are talking about 5% earnings growth just from organic and external sources. Couple that with a 9% dividend yield and you are at a low-teens type of total return profile. That is assuming no multiple expan-

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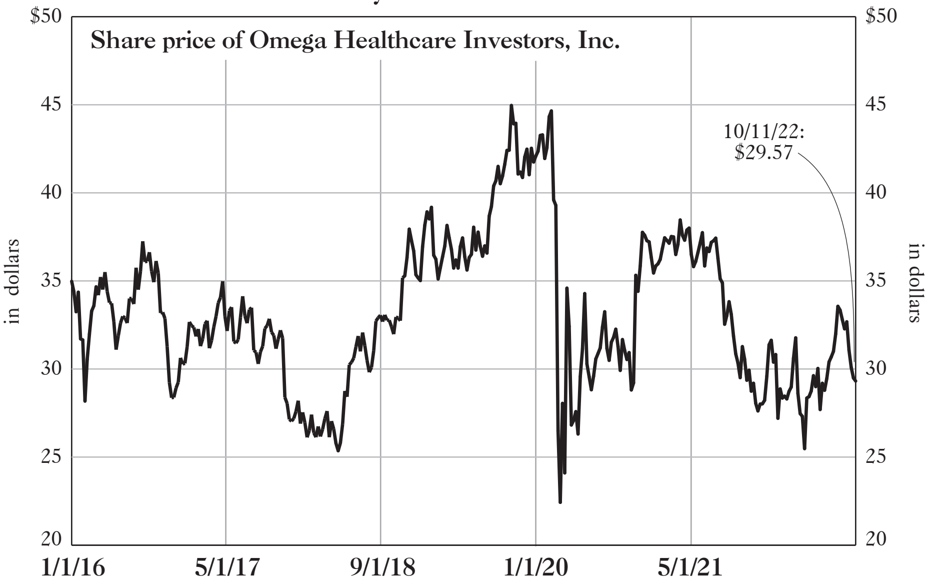
Less than meets the eye



source: The Bloomberg

sion, so that is a pretty attractive total return profile in my book."

As of June 30, Omega showed $5.1 billion in net debt, representing 5.1 times trailing adjusted Ebitda. In the second quarter, operating income before impairments and acquisition-related costs covered interest expense by 2.4 times. Rated Baa3/triple-B-minus, i.e., the basement of investment grade, the company has a doubter in Mr. Market, who prices the Omega 3¼% senior unsecureds of 2033 at $70.80 to yield 7.3%. It's a level closer to the 7.4% on offer from double-B-rated bonds than to the 6.1% yield attached to the average triple-B-rated issue.

Of the 16 analysts who cover Omega, four say buy, none says sell. Short interest stands at 6.3% of the equity float, down from 9.6% as recently as April. In the year to date, insiders have kept their hands in their pockets, neither buying nor selling a share.

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Though Covid dealt a material blow to skilled-nursing homes, the industry was wobbling even before the bug bit. In October 2019 the professional-services firm CliftonLarsonAllen, LLP sized up the state of things in these words: "For the first time in 34 years we have been measuring SNF financial results, the median operating margin has dipped below zero (and currently sits at −0.1%)." Occupancy at those facilities fell by 250 basis points, to 84.6%, between 2014 and 2019, favorable demographics and supply shrinking over the prior decade notwithstanding.

Omega ascribes the weak pre-virus situation, in the first place, to the baby bust that began in the Great Depression and persisted through World War II and, in the second, to the rise in Medicare Advantage (MA) plans. The demographic argument is somewhat vitiated by the fact that the population of Americans aged 65 and older expanded to 54.1 million in 2019 from 40.3 million in 2010. More persuasive is the second contention.

Private insurers, not the government, administer Medicare Advantage plans, which frequently include benefits such as drug coverage and dental care that are not on the Medicare menu. Some 48% of Medicare enrollees belong to an MA plan today, up from 24% in 2010.

Medicare pays private insurers a lump sum for each MA member. To manage costs, administrators such as UnitedHealth Group, Inc., the largest provider of MA plans, negotiate down the rates it pays on services like skilled nursing and limits the number of days that MA members may spend in the facility. Stays in post-acute facilities are among the services on the government-funded chopping block.

Since Medicare pays $450–$575 per patient per day versus $250 per day for Medicaid patients, a loss of MA business has an outsized impact on skilled-nursing economics. Growth in home health care presents another risk to the bottom line.

Late in 2021, Humana, Inc. paid $5.7 billion to acquire the remaining 60% interest in Kindred at Home that the insurer did not already own. In March this year, UnitedHealth announced the $6.2 billion acquisition of LHC Group, Inc. Thus, the first- and second-largest Medicare Advantage plan managers now own the first- and third-largest home health-care companies.

The big insurers view home health care as a source both of revenue growth and cost containment. For example, Andrew Agwunobi, president of the home-solutions business for Humana, told investors last month that "a substantial share of acute-care services

Omega Healthcare Investors at a glance

all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
revenue	$1,025.6	$1,062.8	$892.4	$928.8	$881.7
net income	451.3	416.7	159.3	341.1	281.6
funds from ops.	635.5	655.2	555.9	640.0	587.2
FFO/share	2.58	2.68	2.36	2.88	2.80
shares outstanding	243.3	244.3	235.1	222.1	209.7
cash	164.9	20.5	163.5	24.1	10.3
debt	5,312.0	5,522.1	5,450.1	5,136.1	4,540.6
total assets	9,521.1	9,638.5	9,497.4	9,796.1	8,590.9

*For the 12 months ended June 30, 2022.

source: company reports

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that today are provided in higher-cost settings like skilled-nursing facilities can be shifted to the home. We believe the skilled-nursing-facility-at-home opportunity in particular will be significant with a potential $700 million of Humana SNF spend that could be feasibly shifted to the home." Telehealth and other virtual healthcare delivery technologies only serve to bolster Agwunobi's case.

A shortage of skilled nurses further aggravates the economics of the nursing-home business, and the deficit could become more acute next year if, as expected, the Biden administration issues new nurse-staffing requirements. The aforequoted CliftonLarsonAllen reckons that the new regulations could boost the industry's costs by $10 billion and require the hiring of an additional 187,000 certified nursing assistants, licensed nurse practitioners and registered nurses.

Non-specialized labor, too, is harder to find at prevailing wage rates. "I was talking to a private operator in Cleveland, where I live," relays David Rodgers, who rates OHI a buy for Robert W. Baird & Co., Inc., "and he said on a weekly basis we are 400 hours short from a nursing perspective and we are 1,200 hours short from a back-of-the-house perspective, i.e., making food, cleaning, etc."

Omega's tenants continue to make heavy weather of it. While Omega provides its tenants' trailing 12-month coverage ratios in quarterly supplements, it discloses quarterly figures on the conference calls. Thus, in the three months ended March 31, the company-wide fixed-charge coverage ratio weakened to 0.93 times (and to 0.76 times in the absence of Covid-era subsidy payments) versus 1.19 times (0.98) in the final quarter of 2021.

Nor do Omega's tenants suffer alone. Straining to cover rent and interest expenses from cash flows and skimping on capital renovation, they turn their needy faces to the parent, which helps out with rent deferrals, mezzanine loans and preferred-equity issuance and also funds debtor-in-possession facilities. Naturally, the landlord pays a price in its own profitability; Omega's returns on invested capital have declined to 5.4% in the second quarter from 5.7% in 2019 and 8.2% in full-year 2012.

The crux of the bull case is that past performance is no indicator of future results. With respect to Omega, however, we judge that it may just be.

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Certainly, there are safer income-generating alternatives on offer. For instance, 10-year Treasury Inflation-Protected Securities are priced to deliver a real yield of 1.6%, the highest since April 2010. From January 2020 through April 2022, the 10-year TIPS fetched negative real yields. One can imagine a retest of those yield lows (and corresponding price highs) if Mr. Market gets it into his head to start worrying about the next recession rather than the current inflation. (See page 8.)

Preferred shares in America's too-big-to-fail banks constitute another potential income-generating haven, and the Wells Fargo & Co. Series Q 5.85% perpetual preferreds are one such specimen. Priced at $22.58 versus a par value of $25, the Qs offer a strip yield of 7.7% and a prospective 18% return if Wells calls the issue in September 2023, an option that may become valuable if the Federal Reserve resumes its easy ways.

While Wells is still subject to an asset cap and regulatory swarming on account of past misdeeds (*Grant's*, March 20, 2020), the bank is well capitalized and conservatively funded. As of June 30, total assets amounted to 10.5 times equity and the loan-to-deposit ratio was a conservative 66%. Non-performers summed to 0.6% of the loan book, and loss reserves covered 192% of those problem assets.

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