The Bottom Line: How Summit REIT CFO Pagliarini Evaluates Skilled Nursing Deals

SNN INTERVIEW SERIES

the **bottom line**

Summit Healthcare REIT, Inc. has a bullish outlook on skilled nursing properties over the coming years, but that doesn't mean every property is a winner.

As of the end of 2018, the Lake Forest, Calif.-based real estate investment trust (REIT) owned four skilled nursing properties outright and 27 through various joint ventures — and that was before Summit snapped up 14 more buildings in Indiana through a new JV partnership in a deal that totaled $125 million.

As Summit's chief financial officer, Elizabeth Pagliarini takes an active role in evaluating deals for the REIT, which she joined as the company pivoted from an industrial focus to seniors housing and care about five years ago.

Skilled Nursing News caught up with Pagliarini for our new Bottom Line interview series, which profiles CFOs in the skilled nursing operations and investment space. In our conversation, Pagliarini discussed her strategies for picking winners in skilled nursing, how working in the senior-care sector differs from the other financial leadership roles she's held over her career, and why she's optimistic about the future of the space.

Tell me about your experience, and how you ended up in the health care investment world.

My background is essentially finance. I come from the securities industry and investment banking, so I'm somewhat new — I've been at Summit for five years now, but didn't really have a background in real estate or senior housing. But I was asked by the president of Summit, Kent Eikanas, if I would be interested in joining. The REIT had just been repositioned from an industrial REIT to a health care REIT, specifically focused on senior housing and skilled nursing. They terminated the external advisor that the REIT had and they brought all of the management in house, and so they were looking for a CFO. He and I have known each other for quite a while, and he asked if it was something that I would be interested in, and all the stars aligned and it ended up working out.

I couldn't be happier. I absolutely love it. I love the industry. I really like all the people. It's very, very different than investment banking, where everybody is cutthroat and out to get each other. Where in this industry, what I find is with most people — operators and other REITs — even if they're competitors, they're still collaborative and very friendly to each other, and it's a really, really nice change from the finance background that I've come from.

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As someone who's been covering the industry for about two years now, it's still surprising to hear competitors praise each other so frequently.

Absolutely. We sent a deal over to one of our competitors that we're very friendly with last year, and they ended up closing on it, because it was just something that wasn't working for us at the time. And we would do that again in a heartbeat. We're very friendly with so many of our competitors, and I really do like that. We call each other sometimes to bounce around ideas, see what's going on. And I see the same with other operators speaking very highly of each other. It's just a nice atmosphere. The older I get, that's the kind of atmosphere I want to be in.

What else have you found interesting about the industry as a relative newcomer?

What has really, I think, struck me the most is the special kind of people that work in this business … [on] the operations side. In senior housing and skilled nursing, specifically, you need a special kind of person to work in that industry, somebody who really cares about their residents and the people they're taking care of, and their families and their wellbeing.

I tour a lot of our facilities now, and when we're making acquisitions, I go out and visit all the sites before we do that. And I'm really struck by the amazing people from the top down — from the people who run the company or own the operator, to the nurses and the dietitians and the people in housekeeping. The stories I hear are just amazing, and meeting a lot of those people as you're going through the facilities — it's a job that you can take such pride in.

No one goes into skilled nursing for the money. It's because they have a desire to help people and to take care of people who need it, and I just think that's so admirable — and again, so very different from any of the other industries I've been affiliated with, even in investment banking. I worked for a couple boutique shops, and so our clients were across several industries. And, you know, let's face it — and I'm not saying skilled nursing providers don't want to make money — I'm just saying, when you go into this business, I don't think that's your number-one goal. Your heart has got to be somewhere else as well.

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There are easier ways to make a lot of money.

Yes, that's right.

What do you look for when you're evaluating these properties for potential acquisitions?

There's a number of things. Usually, before we even get to that point, we've done a certain amount of due diligence on the deal, so we know what the financials look like. We've had some conversations with the seller or the owner or the operator, whoever it may be. But we actually go out and look at them. Of course, you're looking at the physical plant just to see what that looks like, how it's been kept up, but again, the thing I like to look at is how the administrator, and the people that are in the building or the facilities, interact with the residents.

The biggest thing for us, I think, [that] we look at in the buildings: What kind of activities calendar there is. We just did a very large acquisition with a new JV partner last month. We acquired 14 skilled nursing facilities in Indiana, and I've got to tell you, [they had] some of the best activity calendars I've ever seen, and every single building we went into, there was a huge group of residents participating in the activities. It's just so great to see.

The worst thing I've ever seen is walking into a skilled nursing facility and seeing seven people in wheelchairs staring at a TV in the lobby. It's heartbreaking, and that's always bothered me, and so when I see people being active and doing the activities and engaging with the staff — you can tell what kind of relationship there is just by watching with how they engage with the staff. And when the administrator or the EDs walk around: Do they know the residents by name? Are they engaging with them as they go through the building? It's amazing how much you can pick up on what's happening at a facility with a half-hour, 45-minute tour.

How often would you say you leave a building feeling confident in the investment? What's the hit rate?

For us, it seems to be pretty often, but again, I think we do a significant amount of due diligence before we make our way out to visiting facilities. We don't really participate in crazy bid processes or anything, where we're going to go out and look at facilities before we know much. So it means we already would have been speaking to the operators, maybe looking at some of their surveys already, things of that nature. Before we even go, we have a pretty good idea. But even still, you can be surprised. And also if it's a situation where we're going to replace the operator, then some of those things don't matter as much, because you know you're bringing in an operator you already know and trust, and are comfortable and confident in how they work.

To answer your question, I would say it's pretty often just based on the amount of due diligence we do before we get out there. But there are surprises.

What are some of the advantages and strengths of the REIT structure? There's been chatter in the industry recently about the whole REIT-SNF relationship breaking down in the wake of some operators' financial struggles.

I know there's been a lot of talk lately, and there's been some comments made about tenants and operators signing leases with REITs that were unrealistic, and they were being escalated out. I think we've been really smart about the leases we've put in place. We're pretty conservative with the lease coverage ratios that we start with from the very beginning, and I think we're really conservative with our escalators as well.

Believe me, we don't ever want our tenants to be in a position where they can't pay rent because of the escalators we put in place. I know we've had a few leases where we didn't even start escalators for three years. Some have been lower than others just based on the market, and what we think is going to happen moving forward with labor costs and other expenses. So I think you just have to be smart about it, and think about the lease specifically as it pertains to each tenant that you have and each location. I have seen some leases that have had ridiculous escalators, and they've started out with really low coverage, and I think you can almost anticipate what's going to happen there.

I don't think that's a REIT problem in general. I think that's just specific to certain REITs that maybe were a little bit too aggressive with their leases, hoping that the operator would be able to keep up. Or, let's face it, we've had some operators — [across] the whole industry — that haven't done well and haven't been able to sustain their businesses for one reason or another. No change in escalator or anything is going to help that.

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Is there an ideal coverage for SNFs, or is it something that depends on each property and market?

We base our lease coverage first on the type of asset, so if it's assisted or memory care versus skilled — we always try to make our skilled coverage much higher than our senior housing. Again, I think it depends on the operator, what we think is going to happen in the future — if there are certain changes that are coming down the pike. We start with our baseline, and then maybe try to adjust it one way or the other based on what we think the future is going to hold. Of course, we don't have a crystal ball.

I also think that if we're looking at a deal, and we're worried about the coverage out of the gate, that's just not a deal we're going to do. We tend to be fairly conservative. I think there's other REITs out there who take a lot more risks than we do. We're pretty conservative overall.

What does the future hold for SNFs, at least over the next few years?

I have a very positive outlook on it. I don't know if we'll ever get away from all of the headwinds, especially in skilled nursing. Maybe we look out farther than a year — maybe once we start getting into 2022, 2023, where we really start seeing the benefits from the change in demographics, where I think we'll be having much different conversations than we're having now. I do believe there's always going to be a need for skilled nursing. I don't think that is going to go away for any reason. I think home health is a great option for a lot of people, but I certainly don't think that is any kind of a true replacement for skilled nursing. No one goes into skilled nursing for the money. It's because they have a desire to help people and to take care of people who need it, and I just think that's so admirable.

I have a very positive outlook. Otherwise we wouldn't be moving in the direction we're moving. Most of our acquisitions over the past few years have been very heavy in skilled nursing, because we believe it's a really good asset class to continue to acquire.

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