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U.S. Research Report

HEALTHCARE SERVICES: SUMMER 2019

The Role of Post-Acute Care in the Healthcare Delivery System

Part 1: Inpatient Rehabilitation Facilities

Post-Acute Care (PAC) facilities represent the next stage in treatment after hospitalization for severe health episodes. The pressure to reduce the length of hospital stays in the general acute care setting is fueling growth in the number and range of PACs.

There are several types of PACs, which are outlined below. In Part One of our two-part report, we provide an overview of PACs and focus on Inpatient Rehabilitation Facilities (IRFs), a key segment of the PAC continuum. In addition to defining the nature of IRFs, we focus on their growth; policy and income considerations; sales and pricing trends; and provide some pointers for investors.

In part two of this report to be published this Fall, attention will be centered on Behavioral Health Facilities and treatment, another major inpatient segment.

Key Observations

- Post-Acute Care (PAC) is playing a crucial and increasing role in the healthcare delivery system
- Inpatient Rehabilitation Facilities (IRFs) represent the fastest-growing area of PAC
- The key challenge for IRFs is reimbursement, given their high proportion of Medicare patients
- Freestanding, off-campus IRFs have the greatest operating margins
- IRF investment performance is on par with mainstream medical office
- Specialization and joint ventures are on the rise as IRFs seek to stay ahead

Post-Acute Care

The core role of PAC is to provide care to patients following a traumatic health event and reduce the need for rehospitalization. There are three broad categories of inpatient PAC facilities centered on providing long-term acute care (LTAC), rehabilitation and behavioral health treatment.

The PAC spectrum ranges from community services to inpatient treatment as follows:

- Community Services (wellness programs, geriatric assessment)
- Home Care (home health agencies, palliative care)
- Senior Living (independent, assisted and hospice care)
- Skilled Nursing (both outpatient and in skilled nursing facilities (SNFs))
- Inpatient (IRFs, behavioral health and LTAC facilities)

Medicare pays for the majority of PAC treatment and, as with most aspects of healthcare delivery, PACs are facing the pressure of controlling costs while remaining competitive through the provision of best-in-class services. Hospitals, which are often responsible for the quality and cost of services after discharge, are heightening these pressures by narrowing their PAC referral networks and prioritizing high-quality, low-cost settings. IRFs face some of the greatest challenges due to their high-cost, high-acuity nature as well as competition from SNFs.

Five companies dominate the PAC landscape, each with annual net revenue of higher than $3.5 billion in 2017: Kindred Healthcare, Genesis Healthcare, Brookdale Senior Living, Select Medical Corp. and Encompass Health. While most companies focus on a variety of models (mostly LTAC, IRFs and Skilled Nursing), Encompass Health is the only company in the top five with a principal focus on IRFs. Encompass has 364 facilities located across 36 states. Looking at the top 25 PAC companies, 12 (including the top 11) are public, 10 are not-for-profits and three are privately owned.

Largest PAC Companies

COMPANY	SPECIALIZATION	NET REVENUE 2017 ($M)	TOTAL FACILITIES	TOTAL STATES
Kindred Healthcare	Long-Term Acute Care	$6,034	94	45
Genesis HealthCare	Skilled Nursing	$5,373	470	30
Brookdale Senior Living	Skilled Nursing	$4,747	988	46
Select Medical Corp.	Long-Term Acute Care	$4,443	2,052	47
Encompass Health	Inpatient Rehabilitation	$3,971	364	36

Source: Modern Healthcare

Inpatient Rehabilitation Facilities

The central focus of IRFs is to provide treatment for medium-to-high acuity conditions through a combination of intensive rehabilitation and high-level clinical supervision. IRFs seek to improve patients' functional ability and build upon gains achieved during hospitalization.

Stroke and neurological conditions dominate IRFs' patient profile followed by a combination of musculoskeletal or orthopedic factors such as fractures, amputation and major joint replacements. Intensive therapy is at the core of IRF services covering three main areas: speech, physical and occupational. IRFs also focus on transitioning patients back to daily, or into new, life routines.

There are strict criteria governing qualification for IRF treatment. First, patients treated in IRFs must require at least five days of rehabilitation per week. Secondly, there is the "60% rule." Medicare dictates that 60% of IRF patients, whether Medicare or commercial, must have at least one of 13 conditions.

Cost and competition pressures are two-fold. Medicare pays IRFs less for their services than they do for treatment at an acute care hospital. Medicare patients represent an estimated 58% of IRF discharges. Payers are also directing patients away from IRFs to the lower-cost setting of SNFs. This is impacted further by SNFs enhancing their clinical capabilities in response to greater demand for their services.

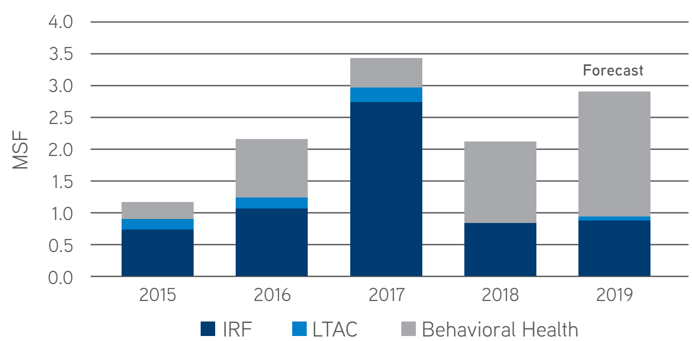
Some IRFs are responding to these challenges by increasing specialization and narrowing their services to focus on high-demand conditions that cannot be successfully treated in a SNF. Stroke and spinal cord injuries are examples of specialized conditions. Another approach is to focus on patients with a specific comorbidity, such as morbid obesity.

By the Numbers

There are approximately 1,200 freestanding PACs located across the U.S. Within this total, there are 375 IRFs, 250 LTACs and 600 behavioral health facilities. This excludes further IRFs located in acute care hospitals. Freestanding units report a greater all-payer margin at 10.4%, compared with hospital-based facilities at 7%.

IRFs have dominated the PAC construction landscape. There were 117 freestanding PAC facilities completed from 2015 to 2018, over half of which (62) were IRFs. A further 18 IRFs are due to be delivered in 2019, totaling 910,000 square feet at a total cost of $426 million. This equates to an average cost per unit of $23.6 million. This is down from an average cost of $27 million per IRF facility in 2018.

Inpatient PAC Hospitals: New Construction 2015–2019

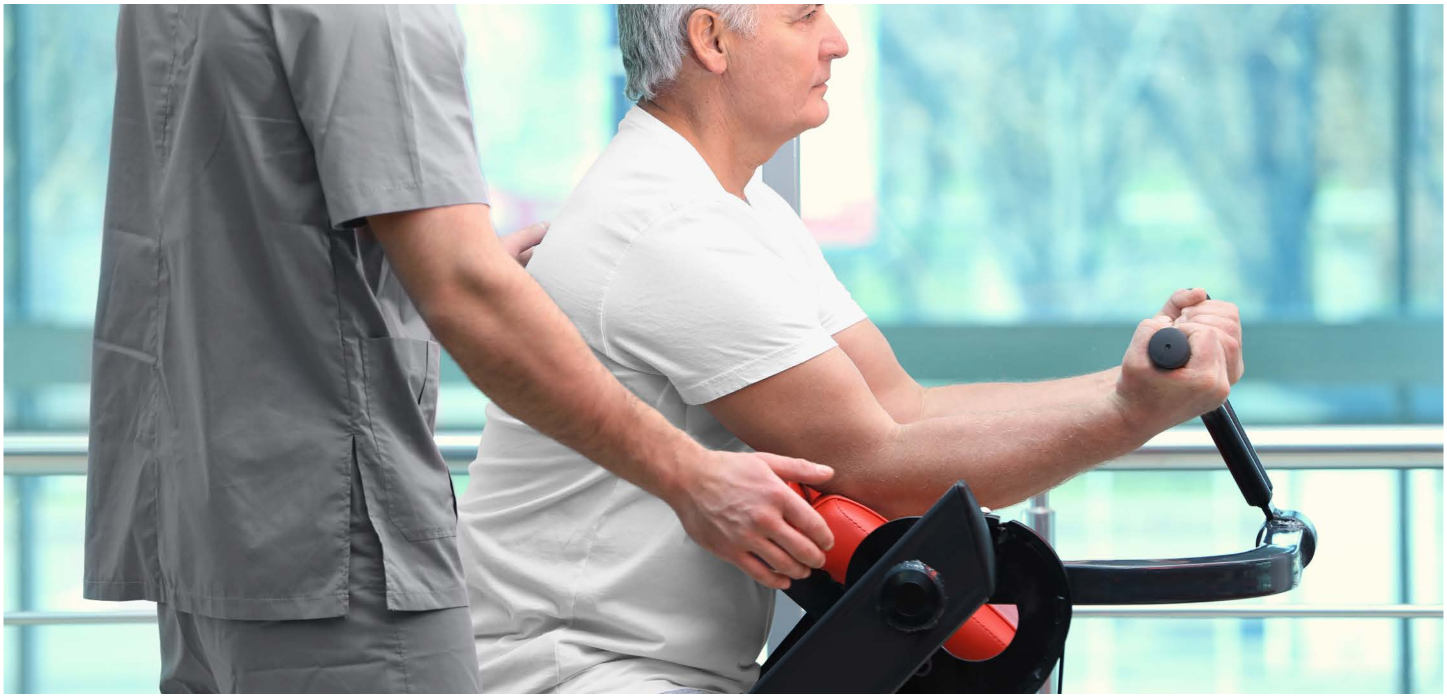


Source: Revista

Joint ventures between IRF companies and acute care hospitals are becoming more commonplace. Encompass Health has opened eight such IRF facilities since 2017, while Select Medical Corp. has entered into joint ventures with Oschner Health and Banner Health to operate IRFs.

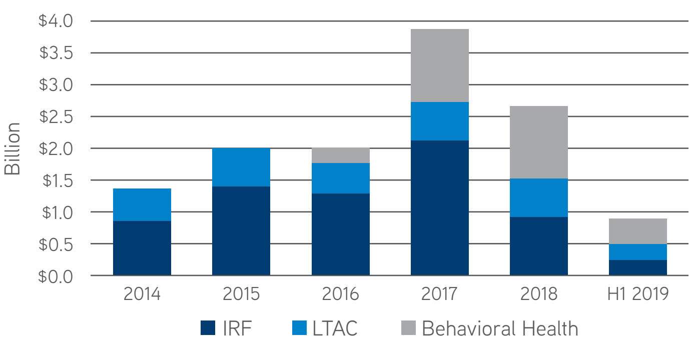
Capital Markets: Sales and Pricing

As with the medical office sector, PACs have become established as a real estate investment vehicle in recent years. Annual investment in PACs rose from $1.6 billion in 2014 to a peak of $3.9 billion in 2017. PAC investment fell in 2018 to $2.8 billion, reflecting broader trends in the medical office sector. However, this decline is more indicative of a limited supply of available product in the market rather than any waning investor interest in the sector.



IRFs account for the majority of funds invested in acquiring PAC assets. Cumulative PAC sales volume from Q1 2014 to Q2 2019 was $13.5 billion, of which IRFs accounted for 55% ($7.4 billion) of the total. IRFs have significantly lower capitalization (cap) rates and higher pricing than other PAC assets. The higher pricing is partly a reflection of the higher costs of construction and fit-out for IRFs.

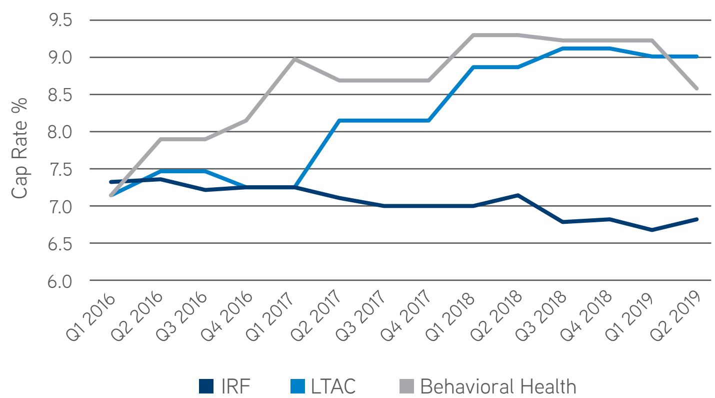
Inpatient PAC Hospitals: Sales Volumes 2014–H1 2019



Source: Revista

Average IRF cap rates stood at 6.8% as at Q2 2019, compared with 8.6% for behavioral health hospitals and 9% for LTACs. Average pricing exhibits a similar pattern at $408 per square foot for IRFs, $299 per square foot for behavioral health facilities and $319 per square foot for LTACs.

Inpatient PAC Hospitals: Cap Rates Q1 2016 - Q2 2019*

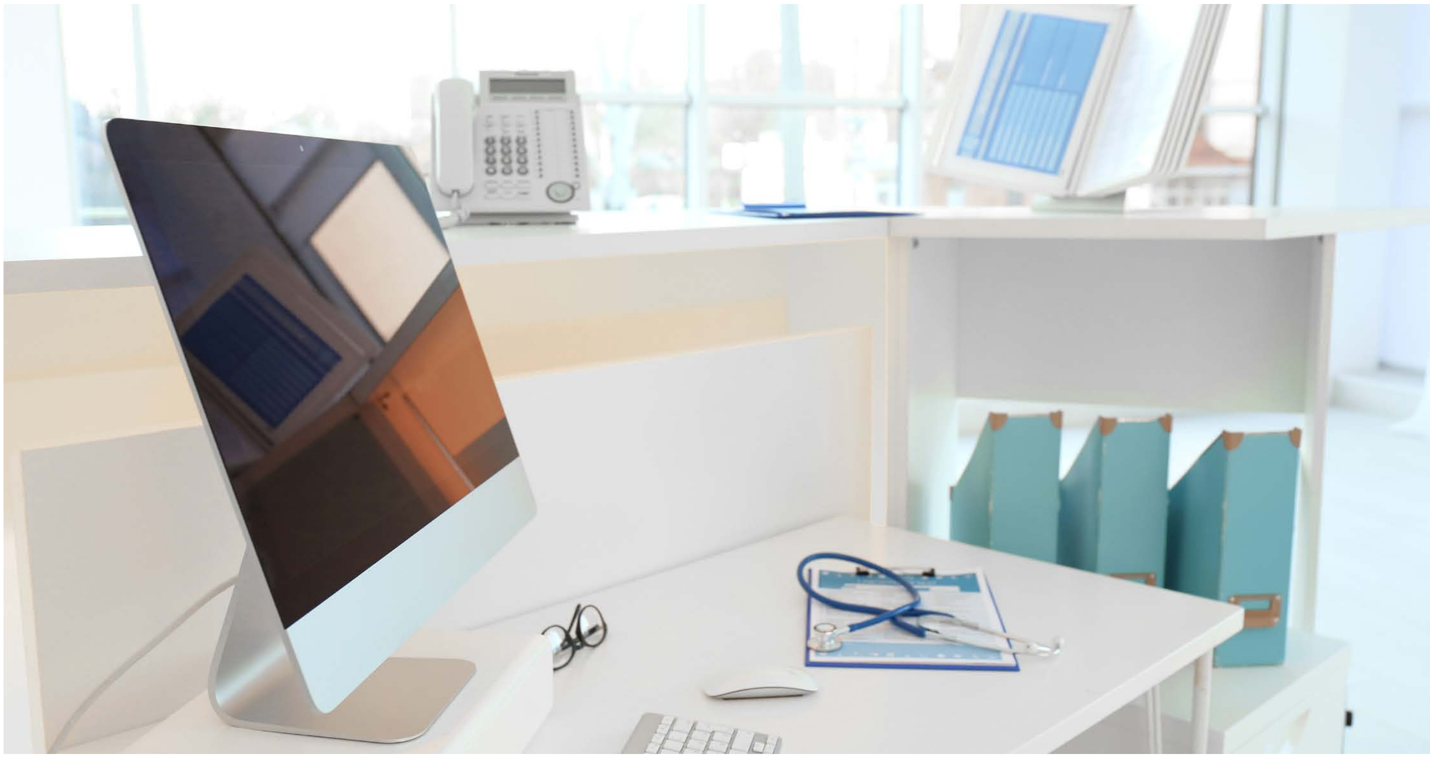


* 6Q Moving Average

Source: Revista

IRF cap rates are virtually on par with those for medical office, which stand at 6.7%, but whose average pricing is markedly lower at $286 per square foot. The pricing differential is partly due to the greater universe and wider range of asset types and ages among medical office properties.

There have been several IRF sales greater than the average price of $408 per square foot since Q1 2018, including a series of transactions in the $450 to $460 per square foot range. The high watermark during this period was set by the acquisition of Warm Springs Rehabilitation Hospital in Austin, TX by The Sanders Trust for $27 million at a price of $495 per square foot.



Inpatient Rehabilitation Facilities: Top Sales: Q1 2018 to Q2 2019				
PROPERTY	CITY	PRICE ($M)	PRICE ($PSF)	BUYER
Warm Springs Rehabilitation Hospital of Kyle	Austin	$27	$495	The Sanders Trust
PAM Rehabilitation Hospital of Tulsa	Tulsa	$24.5	$461	The Sanders Trust
Mercy Rehabilitation Hospital	Oklahoma City	$24.2	$453	Global Medical REIT
Southern Indiana Rehabilitation Hospital	Louisville	$22	$342	Omega Healthcare Investors Inc.
Saint Joseph Rehabilitation Institute	South Bend - Mishawaka	$20.8	$453	Global Medical REIT

Source: Revista

Investor Considerations

IRFs play a vital and expanding role in today's acute care healthcare continuum, especially as new delivery models evolve. The transition from hospital to home is critical for patient recovery as hospitals look to avoid readmissions, which can incur financial penalties. General acute care (GAC) hospitals are able to focus on treating and discharging patients as quickly as possible, as long-term care in the GAC setting is not profitable.

Conversely, freestanding IRFs tend to have a healthy operating margin, and help expedite the patient out of GACs and into a lower cost of care setting, and hopefully, better patient outcomes. IRFs are an attractive investment option in the healthcare real estate spectrum.

The key concern surrounding IRFs is reimbursement, as they are heavily reliant on federal reimbursements, and Medicare patients dominate their client profile. As with most aspects of healthcare, legislative changes in policy and payment models, plus their impact on financial performance, need to be closely monitored. However, the mandate to lower healthcare costs is industry-wide and IRFs are generally considered a lower cost of care setting which should help sustain their attraction to investors.

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