

CONTRARIAN STOCKS

Brookdale Senior Living

The Devil's in the details

Brookdale Senior Living (NYSE: BKD) is effectively a real estate play – and most of you will know that I have never favoured real estate. I find it incredibly risky, insanely leveraged and heavily reliant on favourable economic conditions.

Growing up learning about the real estate speculation had put prejudices in my mind about real estate as an investment and, for a long while, I refused to believe that real estate could be a genuine investment – for what it's worth, I still don't conform to the idea that housing is an investment and I believe office CRE to be in a precarious position (which is why I also don't think longing regional banks is particularly shrewd).

However, when real estate is wielded intelligently for practical business use, provided the returns on capital are high enough and cash flows are steady, it can be quite splendid for the prospective investor!

Unfortunately, Brookdale isn't the above. Brookdale struggles with profitability and can barely scrape together successive quarters of positive operating cash flows.

As you can imagine, the primary risk to investing in Brookdale (according to the analyst) is the debt. Brookdale have excessive amounts of leverage in their capital structure which can be quite toxic to the balance sheet and overall health of the company.

Large debt burdens and loss-making companies are usually perfect candidates for short-selling opportunities. (I do believe there are some short sellers trying to attack the stock as shown by the 8% short interest.)

However, I do not see debt as a concern (even though long-term debt-to-equity exceeds seven times!) and, to me, generating sustainable liquidity (as soon as possible and however possible) is far more necessary to Brookdale's long-term success.

I also believe Brookdale to be run by competent management but, if results don't begin to feed through within the next twelve months, I would urge activist investors to get involved to unlock value for shareholders.

Finally, I don't think that economic conditions will affect Brookdale in a manner they did during the GFC. We would prefer inflation over recession (out of the two evils) but either or neither would still work.

Buy - Overweight

NYSE: BKD

Price: \$4.18

Price target: \$10

Date: 10/11/2023

Asset management

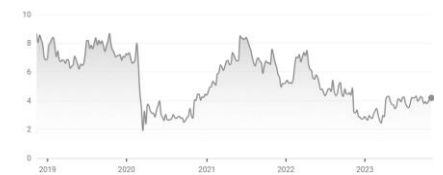
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Price Performance



Brief Metrics (ttm)

P/E: n/a

P/B: 1.6x

P/S: 0.27x

EV/EBITDA: 11.3x

ROE: n/a

Debt/Equity: 7.7x

*Source: Google Finance, Stock Analysis

Share Data

Price: \$4.18

Shares outstanding: 187m

Market cap: \$786m

EPS (ttm): n/a

Dividend yield: n/a

*Source: Finviz

Overview

Brookdale Senior Living operate over 600 communities in over 41 states for the senior living community.

Strategy

I've come to realise, as an investor, that the business is only half of what you invest in. The second half comes down to the management you trust to run the business for you. Remember, as owners of the business, management work for you so if you own enough shares (and voting power) you can change the direction of the business.

Unfortunately, I don't have the means to take an ownership stake in most business I come across. Therefore, I have to have faith in management from the second I buy shares. Hence, the strategy outlined in the 10K or an earlier press release becomes vital. If a company hasn't mentioned any strategy, it's a red flag (usually).

This is what Brookdale wrote as their strategy:

1. *"Get every available room in service at the best profitable rate. We believe that we provide highly valuable services to seniors, and we continue to strive to expand the number of seniors we serve through targeted efforts to increase our occupancy levels and improve controllable expense management, while remaining focused on driving rate and improving margin. With this strategic priority, we intend to ensure all communities are appropriately priced within their market. Through our targeted sales and marketing efforts, we plan to drive increased move-ins through enhanced outreach with impactful points of differentiation based on quality, a portfolio of choices, and personalized service delivered by caring and engaged associates.*
2. *Attract, engage, develop, and retain the best associates. Brookdale's culture is based on servant leadership. We believe engaged associates lead to an enhanced resident experience, higher retention, and ultimately improved operations that drive accelerated growth. Through this strategic priority, we intend to expand successful pilot programs to further support and extend length of employment with Brookdale. We expect to diversify and optimize our recruiting plans, improve training, educational, and career development opportunities for associates and enhance our already compelling value proposition for our associates in the areas of compensation, leadership, career growth, and meaningful work.*
3. *Earn resident and family trust and satisfaction by providing valued high quality care and personalized service. We believe that earning the trust of our residents and their families will allow us to build relationships that create passionate advocates and generate referrals. We intend to create a consistent high quality experience for residents, including through the implementation and execution of our high quality clinical, operational, and resident engagement programs. We are a learning organization that uses multiple tools to obtain feedback from residents, their families, and our associates to improve our services to meet the changing needs of residents. We expect to strengthen associate engagement for an enhanced resident experience."*

Reading the shareholder letter was also enlightening and these three strategic priorities were echoed strongly by Lucinda Baier, CEO of Brookdale.

What did I think of the strategy put in place? I was in agreement with the strategy (largely). I think they are clear and coherent and aligned with what shareholders should want.

At the end of the day, shareholders are only really looking for long-term profits. If that means lots of capital spending today for those profits, they'll invest. If it's a much easier ride since the company has lots of pricing power and strong barriers to entry, investors will also send their cash that way.

However, some factors of the strategy could be quite hard to implement (especially the second target).

If I was CEO of Brookdale, my strategy would be simple:

1. Reduce leverage – make sure RevPOR (Revenue per Occupied Room) is high enough. Further, sell off value destructive assets that aren't performing to your expectation. Use the cash proceeds sparingly and wisely.
2. Make sure consumers are happy with the services you provide. If that means you have to change your strategy by spending less money here and more money there, do it. Have no ego when it comes to overall consumer satisfaction. After all, happy customers usually bring in more customers.
3. After the first two objectives have been satisfied, make Brookdale the cash cow it should have been. Don't focus on expansion. Make sure your operations are as efficient and as streamlined as possible. However, never be stingy with cash at the expense of the overall reputation of the firm. Getting this balance right is vital.
4. Expansion can begin to take place but don't take on too much debt (unless conditions are favourable) and always, always be conservative. From this position, I don't envision expansion projects taking place for the next three years.

Risks

The obvious risk to any company that owns lots of real estate is the debt. Finding out exactly how the debt is structured is incredibly important. Most analysts don't really care enough about the details and that laziness breeds opportunities for the no-lifers like you and me. To the footnotes we...

<i>(in thousands)</i>	September 30, 2023	December 31, 2022
Fixed rate mortgage notes payable due 2024 through 2047; weighted average interest rate of 4.14% as of both September 30, 2023 and December 31, 2022	\$ 2,040,563	\$ 2,055,867
Variable rate mortgage notes payable due 2025 through 2030; weighted average interest rate of 7.70% and 6.68% as of September 30, 2023 and December 31, 2022, respectively	1,528,667	1,568,555
Convertible notes payable due October 2026; interest rate of 2.00% as of both September 30, 2023 and December 31, 2022	230,000	230,000
Tangible equity units senior amortizing notes due November 2025; interest rate of 10.25% as of both September 30, 2023 and December 31, 2022	19,993	25,586
Other notes payable due 2023; interest rate of 5.90% as of September 30, 2023	2,673	—
Deferred financing costs, net	(24,532)	(29,866)
Total long-term debt	3,797,364	3,850,142
Current portion	304,504	66,043
Total long-term debt, less current portion	\$ 3,492,860	\$ 3,784,099

This table looks relatively normal. Naturally, the variable rate mortgage notes have a higher interest rate. It's worth figuring out what the variable rate is tied to – the jargon underneath the table usually helps. “...indexed to SOFR plus a weighted average margin of 239 basis points.” If you're expecting cuts to general interest rates, this (potentially) aids Brookdale.

What should really interest you is this line in the footnotes – “As of September 30, 2023, 92.0%, or \$3.5 billion, of the Company's total debt obligations represented non-recourse property-level mortgage financings.” Let me be very clear in that without this sentence, I'd probably not invest.

What this sentence means is that in the case of default, the banks cannot go after Brookdale's other assets. They are limited to only taking back the collateral (i.e the real estate). You should also note that

this feature isn't applicable to all real estate across the US which is why the footnotes are vitally important to the analyst.

Alongside the leverage threat, there is also a liquidity threat. Historically, Brookdale have maintained a current ratio of about 1x. In recent quarters, that current ratio has dropped to about 0.66x. Why? Because the banks are knocking on the doors requiring payment. \$305m is due within the next year.

Negative working capital isn't necessarily an issue with companies like Expedia but can be with Brookdale. When a company finds itself with more current liabilities than current assets, it usually means that suppliers and customers are financing the business – a “cheap” way to fund growth. Usually, these NWC situations results in large amounts of cash flow generation.

However, when the majority of your current liabilities are lease liabilities and debt, it's a little harder to delay payments. Whilst Brookdale do have about \$439m in cash (\$41m is restricted), management have admitted they expect to refinance the debt.

It is my belief that liquidity is truly the largest risk that Brookdale faces and I feel it's the only one worth considering. And this liquidity problem only gets worse as time goes on. Here's Brookdale's debt schedule:

Year Ending December 31,	Long-term Debt	Weighted Rate
2023	\$ 73,176	6.47 %
2024	310,214	4.70 %
2025	573,885	6.41 %
2026	304,779	2.64 %
2027	959,872	5.53 %
Thereafter	1,658,082	4.81 %
Total obligations	3,880,008	5.08 %
Less amount representing deferred financing costs, net	(29,866)	
Total	\$ 3,850,142	

When you also consider the lease schedule, it's quite a frightening situation Brookdale find themselves in!

Year Ending December 31,	Operating Leases	Financing Leases
2023	\$ 233,409	\$ 48,615
2024	219,311	49,303
2025	217,526	37,184
2026	102,712	37,889
2027	99,566	5,856
Thereafter	135,306	24,172
Total lease payments	1,007,830	203,019
Purchase option liability and non-cash gain on future sale of property	—	135,751
Imputed interest and variable lease payments	(214,099)	(89,910)
Total lease obligations	\$ 793,731	\$ 248,860

For now, management may claim that refinancing is the route to take but I think it's a mistake. How much and for how long can you refinance?

Historical Lawsuits

Brookdale has been in the public eye for the wrong reasons recently. Just two years ago, the state of California sued Brookdale for manipulating ratings by submitting false ratings. This lawsuit was settled for \$3.25m. There was also a second lawsuit alleging violations of federal securities law that was filed in June 2020 and was dismissed in 2021.

Neither of these cases are relevant today but they could be an explanation for the poor share price performance.

Ah, who am I kidding? Skip to the profitability section if you really want to know why the share price has taken a beating!

Balance Sheet

The real value in Brookdale lies in their real estate. This should be obvious by now. Of course, the services that Brookdale provide are vital to the company's success, but, from a purely value investing stance, investors really care about the juicy property the company own.

As of Q3 2023, Brookdale operated 672 communities, owning 346, leasing 295 and managing 31 (on the behalf of others).

In the 2022 10K, land had a cost value of \$507m and buildings (and improvements) had a value of \$5.3b and 87% of the (owned) communities were subject to mortgages. This creates some risk in that if senior living suddenly becomes unpopular, Brookdale are in trouble because they won't have enough cash flow to meet bank demands.

However, it's important that I remind you to remember that the majority of the debt that Brookdale holds on their balance sheet is non-recourse. If the worst happens and Brookdale default, the bank just repossess the property and Brookdale move on.

A practice I have heard is to write-up the value of real estate. Never ever engage in this practice unless the real estate has been bought decades ago, there is no mortgage, it's in "good" condition and it continues to earn a decent amount for the owner. Brookdale's real estate just don't match this description.

The rest of the balance sheet is pretty normal and there weren't any red flags or interesting footnotes so I'm just going to save your time and keep moving on. Actually, there was one interesting line item...

As of Q3 2023, Brookdale had \$492m in shareholders' equity (the current market cap of the company is \$785m) with an accumulated deficit of \$3.75b –

Profitability and Cash Flows

Profitability is an issue at Brookdale – we can easily blame the pandemic but that's lazy. In the last nine years, Brookdale haven't made an operating profit. During those nine years, gross margins were getting squeezed (they started at 20% in 2014 and fell to a low of 11% in 2021 – now they've steadied around 17-18%).

Cash flows haven't been pretty, either. Naturally, when you're dealing with a company with lots of real estate on the books, operating cash flows will be fairly decent. The real trick is free cash flow (as it is with most companies). How much are Brookdale spending on maintaining their housing? The answer is worrying. Just like profitability, there are issues with Brookdale's free cash flow generation. They simply haven't generated (enough of) it in the last decade.

As you can see from this table, capex is bloody expensive when it comes to senior housing!

(\$ in 000s, except for community level capital expenditures, per average unit)	2022					2023			3Q23 vs 3Q22	YTD 3Q23 vs YTD 3Q22
	1Q	2Q	3Q	4Q	Full Year	1Q	2Q	3Q	B(W)	B(W)
Community level capital expenditures, including allocations ⁽¹⁾										
Senior Housing Owned Portfolio	\$ 20,907	\$ 25,934	\$ 24,568	\$ 20,341	\$ 91,750	\$ 27,135	\$ 32,882	\$ 23,066	6.1%	(16.3)%
Senior Housing Leased Portfolio	12,572	12,503	13,128	8,773	46,976	14,734	17,010	14,715	(12.1)%	(21.6)%
Community level capital expenditures, net	(A) 33,479	38,437	37,696	29,114	138,726	41,869	49,892	37,781	(0.2)%	(18.2)%
Corporate capital expenditures ⁽²⁾	5,847	7,249	6,123	10,221	29,440	21,043	14,923	9,467	(54.6)%	(136.4)%
Non-Development Capital Expenditures, net⁽¹⁾	39,326	45,686	43,819	39,335	168,166	62,912	64,815	47,248	(7.8)%	(35.8)%
Development Capital Expenditures, net	861	1,829	1,667	1,836	6,193	519	385	405	75.7%	70.0%
Total capital expenditures, net⁽¹⁾	40,187	47,515	45,486	41,171	174,359	63,431	65,200	47,653	(4.8)%	(32.4)%

The fact is currently Brookdale do not earn a suitable ROIC that is in excess of their WACC which makes them (by definition) a value destructive company and, thereby, a bad investment.

However, because (and only because) Brookdale are sitting on high quality assets, I'm willing to look past the negative ROIC and see if Baier (or someone else) can unlock the value for shareholders.

Personally, I wouldn't be against downsizing if it meant that profitability in the long-term was to improve. (From the basic number crunching I've done on Excel (I may or may not share this in the future), downsizing is definitely the way to go.)

If we look at the Brookdale situation in more detail, you will notice that RevPAR (Revenue per available room) from Q1 22 to Q3 23 has been increasing steadily every quarter from \$4032 to \$4596. The weighted average occupancy has also followed this trend increasing from 73.4% to 77.6%. Clearly, improvements are being made. Is it enough? Recent quarterly statements suggest not despite operating cash flow more than doubling YTD versus 2022. Wall Street isn't impressed, either – and Wall Street are, generally, the easiest of all to impress!

This table should also be considered by management:

3Q 2023 weighted average occupancy (consolidated communities)		
Occupancy Band	Community Count	% of Period End Communities
Greater than 95%	98	15%
90% > 95%	66	10%
85% > 90%	78	12%
80% > 85%	71	11%
75% > 80%	75	12%
70% > 75%	81	13%
Less than 70%	172	27%
Total	641	100%

The worst performing communities should have their leases broken or should be sold (if occupancy rates are consistently less than 70%). There is no point trying to squeeze blood out of a stone because it will only hurt you in the process!

What I also think management should be doing is trying to figure out exactly what the break-even RevPAR for Brookdale is and then price accordingly. Brookdale has unbelievably high fixed costs (over \$2b annually on a conservative, normalised basis) and (as shown above) constantly requires high capex to maintain their market position. My rough maths alludes to the conclusion that Brookdale need to sell off some of their worst performing communities.

Insiders

Luncinda Baier was made CEO in 2018 and began a turnaround plan that was not massively successful. In 2022, she wrote a book sharing how Brookdale got through the pandemic. Personally, I don't like this. Her focus should be on optimising the business and not on writing a book. I think if the

(well-thought) strategy doesn't result in tangible results, shareholders ought to put pressure on her position. Five years to get settled is plenty.

My Final Thoughts

One last time – the only reason I think this is worth any time is because of the non-recourse debt. I feel that in every investment one makes there has to be one primary and simple reason for an investment. One feature that “does it” for you. I don't believe in investing in companies “just because everything's ok.” No. To me, this is wrong. I can go through every company in my portfolio and explain why I chose to invest and why it's better than competitors.

Back on topic, I feel that Brookdale will probably default on a handful of properties in the coming months and that's completely fine and to be expected. As I've said, management aren't incompetent, but they do seem pretty slow to act. Defaults may come as a shock to the market who may sell off shares. Therefore, a starter position or an add to your watchlist is probably the best way to do this.

What I think is important is we see pricing improvements from management and/or fire sales of low-performing assets. It's very hard to cut costs within this sort of business and I've thought long and hard how they could do it. They can't – not without damaging the value of the Brookdale name (which is an absolute no-no to me and readers of this piece!).

Finally, what about inflation/recession?

Well, inflation could reduce the real value of the fixed rate debt but inflation may also result in higher rates which increase interest expense on variable rate mortgages. Further, higher interest rates mean more awkward refinancing terms (due to higher rates and more restrictive covenants). Management have said that refinancing is the way they are going (for now), but I believe it won't be long before they change tack if inflation bites back. I don't think inflation will change whether customers use their facilities or not.

Recession could be tricky to navigate and I think defaults will come thick and fast as banks turn off their liquidity taps and credit becomes harder to access. However, because the majority of debt is non-recourse, it may actually be a blessing for Brookdale. They will have to choose which properties to save and which ones to let die. In a recession this may become even easier as it becomes clearer which communities are failing and which ones are thriving (I do believe that there are Brookdale communities earning a high ROIC (much higher than their WACC) but that's for a second part...).

On the other hand, if the Fed cuts rates aggressively and QE gets introduced because of a recession, Brookdale get “saved” and won't ever cut the malignant cancer out of the business.

It's also possible that neither inflation nor recession occur and we have gotten through the greatest period of tightening (arguably ever) and nothing happens. (To me, that seems unbelievable. Something always has to give somewhere and things do take time to break.)

Best investing,

HV

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Brookdale Senior Living. This may change at any time as the situation changes etc. Therefore, you should not invest because you think the author is also invested.

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