HILLIARD LYONS

Healthcare Real Estate Investment Trusts
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COMPANY UPDATE

Key Metrics

HCP - NYSE - as of 2/12/18		$22.85
2-3 Year Price Target		N/A
52-Week Range	$22.22 -	$33.67
Shares Outstanding (mm)		469.2
Market Cap. ($mm)		$10,721.2
1-Mo. Average Daily Volume		2,793,140
Institutional Ownership		95.3%
Debt/Total Capital Dec-17		39.9%
Est 3-year FFO Growth Rate		4.5%
Est 3-year Dividend Growth Rate		1.0%
Dividend		$ 1.48
Dividend Yield		6.48%
Est. Fixed Charge Coverage		3.5 X

FFO

	2016		2017	Prior 2018E	Current 2018E	
1Q	$0.69	--	$0.51	$0.49	$0.49	
2Q	$0.74	--	$0.48	$0.49	$0.49	
3Q	$0.72	--	$0.48	$0.49	$0.49	
4Q	$0.59	--	$0.48	$0.52	$0.52	
Year	$2.74		$1.95	$1.99	$1.99	*
P/E	8.3x		11.7x		11.5x	

*-May not add due to rounding

Revenue ($mm)

	2016		2017	Prior 2018E	Current 2018E
1Q	$640.8	--	$492.2	$463.00	$463.00
2Q	$662.2	--	$458.9	$472.80	$472.80
3Q	$654.3	--	$454.0	$482.10	$482.10
4Q	$540.0	--	$443.3	$492.20	$492.20
Year	$2,457.3		$1,848.4	$1,910.1	$1,910.1

Revenue numbers not restated.

Company Description: *HCP, Inc., formerly known as Health Care Property Investors, Inc., headquartered in Long Beach, CA, is a real estate investment trust (REIT) that has investments in assisted living, medical office buildings, laboratory facilities and other healthcare facilities located throughout the country.*

HCP, Inc.

HCP -- NYSE – Neutral-3

Fourth Quarter Earnings Highlights

Investment Highlights

- HCP reported Q4 normalized FFO of $0.48 a share, a penny under our estimate and compared to the consensus estimate of $0.47 a share. This miss compared to our estimate was the result of slightly higher operating costs than our expectations. Full year normalized FFO was $1.95. Management initiated a normalized FFO per share guidance range of $1.77 to $1.83 a share for 2018, not including any acquisitions, but including the dilutive impact of the asset sales and expected additional divestitures. As with other healthcare REITs fears of interest rate increases have resulted in the recent price decline, and today's weak senior housing operating numbers are unlikely to turn around that weakness. We will wait until after the company's noon conference call before updating our 2018 estimate which currently sits at $1.99, well above the high end of guidance, although we are including some accretive investment activity, which management does not include.
- The reduction in portfolio size around the various recent divestiture transactions has pushed down the company's forward earnings prospects, only adding to the negative numbers to be generated from the weaker senior housing operating numbers.
- Healthcare REIT shares have underperformed the market sharply so far in 2018 around higher interest rates this year which has held back interest sensitive areas. We anticipate that this trend will continue, at least early in the year, as investors worry about Fed interest rate increases. This could offer an opportunity for patient investors with a long-term investment horizon for the group, although we look for a turnaround to more likely occur in the second half of the year.
- The company's conference call is at noon today, and we will have a full report laying out any changes to our estimate and thesis following what we hear on the call.

Note Important Disclosures on Pages 6-7.
Note Analyst Certification on Page 6.

Fourth Quarter Review

Total revenue was $443.3 million versus $540.0 million, a 17.9% decline as a result of divestitures. Rental income of $255.0 million was off 11.1% (please see income statement on page 3) as rent increases were offset by the sale of non-core assets. Interest and other income was $5.3 million compared to $17.5 million, again as a result of asset sales/debt retirement. Income from direct financing leases fell 7.4%. As we have noted before, the addition of operating properties does increase the company's risk, as HCP will be much more exposed to reimbursement risk which had formerly solely been a source of risk to HCP's tenants, and which has certainly shown up with the negative forward guidance for operating assets. Resident fees and services were down to $132.6 million from $186.1 million as a result of recent sales.

Operating and other expenses were $198.7 million, up 1.5%. General and administrative expense rose 4.3% to $21.5 million, from $20.6 million. Interest expense was down 30.3% to $71.9 million on a 14.3% decline in debt to $7.88 billion from $9.19 billion. Debt to capital at quarter end was 39.9%. We see no issues for HCP on the debt front and they have already taken care of all but $25.9 million of 2018 maturities. Depreciation expense fell 6.9% to $136.8 million versus $146.9 million, due to recent divestitures. JV income fell 58.9% to $6.3 million. Fourth quarter net income available to common shareholders was a loss of $59.3 million on $84.4 million of asset impairments versus a profit of $58.4 million. Loss per share were $0.13 versus EPS of $0.12 on 0.2% more common shares outstanding in this year's fourth quarter.

Ongoing, normalized funds from operations (FFO), which exclude real estate gains as well as other non-recurring items, were $225.5 million compared to $278.5 million in last year's fourth quarter, a 19.0% decline. Normalized FFO per diluted share were $0.48 versus $0.59. For the year, HCP reported adjusted FFO of $1.95 versus $2.74 in 2016. We note that FFO on an apples to apples basis (excluding divested assets) would have been $1.95 versus $2.04 a share, still down but less so.

Other 4th Quarter Activity

Investment Activity – During Q4, HCP ramped up its investment activity, with a total of $424 million in investments which included the $228 million purchase of a 400,000 square foot life science campus in Boston, a 90-unit senior housing community in Watertown, MA for $45 million, and a 378,000 square foot portfolio of 11 medical office buildings that is 97% leased with a weighted average remaining lease term of eight years for $151 million. The company also announced development activity and continued to reduce its exposure to Brookdale Senior Living (BKD-$9.50), expecting to sell six properties to BKD for $275 million soon and purchase BKD's interest in two joint ventures for $95 million. HCP is also terminating leases and management agreements on another 68 BKD properties and selling an interest it holds in a joint venture with BKD to a third party for $332 million. All of these moves reduce the company's exposure to BKD from 27% to 15.7% of total revenue. HCP closed on a total of $562 million in acquisitions during the year, placed $281 million in development and redevelopment project in service and $26 million in loan fundings. The company also completed the sale of more than $1.7 billion in non-strategic assets during the year and saw $1.4 billion in loan payoffs. The company has another nearly $1 billion in assets to sell, including its UK operations.

Capital Activity – HCP closed on a new $2 billion credit agreement during Q4, reducing the cost of the agreement by 5 basis points. It has a maturity date of 10/21 with two six month extension options, as well as an option to increase the size by $750 million.

Dividend – HCP has paid a reduced dividend of $1.48 a share annually since the spin-off of its skilled nursing assets in 2016 ending its place as a dividend aristocrat, with a streak of increasing its dividend that went back 30 years to the company's IPO. The company has kept its dividend steady since then, although we anticipate that the company may go back to raising the dividend in the future. Based on our current estimate for 2018, the payout ratio is 74.4%, which is a little above the peer group average, but is likely to top 80% once we adjust our estimate.

Quarterly Income Statement

(in thousands)	4Q 2017	4Q 2016	% Change
Rental Income	$255,006	$286,968	-11.1%
Tenant Recoveries	$36,702	$34,565	6.2%
Income from Direct Financing Leases	13,701	14,789	-7.4%
Investment Management fee Income	0	0	
Resident Fees and Services	132,587	186,118	-28.8%
Interest and Other Income	5,263	17,510	-69.9%
Total Revenue	443,259	539,950	-17.9%
General & Admin	21,485	20,600	4.3%
Transaction costs/other	5,459	3,760	45.2%
Operating and other	198,669	195,648	1.5%
EBITDA	217,646	319,942	-32.0%
Interest Expense	71,882	103,148	-30.3%
Depreciation Expense	136,833	146,927	-6.9%
Income (Loss) Before Discontinued Operations and Other Items	8,931	69,867	-87.2%
Discontinued Operations (including gain on sale of assets)	33,789	26,847	
Charges/other	(93,677)	(47,430)	
Income taxes	(13,297)	(3,372)	294.3%
Equity in income of JVs	6,330	15,388	-58.9%
Minority Interest	(1,374)	(2,860)	
Preferred Stock Dividends	0	0	0.0%
Net Income (Loss)	($59,298)	$58,440	
Net EPS (diluted)	($0.13)	$0.12	
Avg. Shares Outstanding (diluted)	469,229	468,210	0.2%

Funds From Operations	4Q 2017	4Q 2016	
Net Income	($59,298)	$58,440	-201.5%
Depreciation Expense	147,401	147,416	0.0%
Other (adding/substracting one-time items)	137,407	72,659	
Normalized Funds From Operations	**$225,510**	**$278,515**	-19.0%
Normalized FFO Per Share (diluted)	**$0.48**	**$0.59**	-18.6%

Source: Company reports.

Consolidated Balance Sheet

(in thousands)	31-Dec-17	December 31, 2016
Real Estate Assets		
Land	$1,785,865	$1,881,487
Buildings and Improvements (net of Depreciation)	$8,498,037	$9,043,724
Construction in progress	$447,976	$400,619
Net investing in direct financing leases	$714,352	$752,589
Mortgage Loans Receivable	313,326	807,954
Total Net Real Estate Investments	11,759,556	12,886,373
Cash and Cash Equivalents	55,306	94,730
Investments in JVs	800,840	571,491
Accounts Receivable	40,733	45,116
Restricted cash	26,897	42,260
Intangibles	410,082	479,805
Real estate held for sale	417,014	927,866
Other assets	578,033	711,624
Total Assets	**$14,088,461**	**$15,759,265**
Bank Borrowings	$1,017,076	$899,718
Mortgage Loan payable	466,939	623,792
Bond payable and capital leases	6,396,451	7,665,985
Accrued expenses and other liabilities	415,769	421,136
Intangible liabilities	52,579	58,145
Deferred Revenues	144,709	149,181
Minority interest in JVs	117,045	214,377
Non-managing member unitholders	176,888	179,336
Total Liabilities	**$8,787,456**	**$10,211,670**
Preferred stock	-	-
Common Stock	469,436	468,081
Capital in Excess of Par Value	8,226,113	8,198,890
Other	(24,024)	(29,642)
Cumulative Distributions in excess of earnings	(3,370,520)	(3,089,734)
Total Shareholders' Equity	**5,301,005**	**5,547,595**
Total Liabilities and Shareholders' Equity	**$14,088,461**	**$15,759,265**

Balance Sheet Ratio Analysis	31-Dec-17	December 31, 2016
Net R/E Investments / Total Debt	67.0%	71.3%
Debt to Equity	148.7%	165.6%
Debt as % of Total Assets	55.9%	58.3%
Shareholders' Equity as % of Total Assets	37.6%	35.2%

Source: Company reports.

First Take

While Q4 results were largely in line with our expectations, forward guidance was not supportive of positive future share price gains. Issues with the senior housing operating portfolio, as with its large peers that have gotten into this business, have proven to be a negative factor on financial performance. As we have noted in the past, while participating in facility operations may have been good when fundamentals were positive, the reverse would be the case when things went south, which has now happened. Overbuilding has arisen in many locations, driving down occupancy, and unlike in the triple net portfolio, where the REITs continue to receive rent, we now see profits declining due to the negative operating fundamentals. This supports our belief that the multiples on companies involved in operations should be lower due to the cyclicality of the business. This is the reason we have chosen not to recommend any of the "Big 3" healthcare REITs as they generally received premium multiples, when we believe they should trade at discounts due to the added risk.

The recent decline in share prices have begun to cure this issue, although we continue to see downside risk here, as rents have held up despite the decline in occupancy. We expect rental growth to begin to turn negative in the future, as the increase in occupancy begins to cause landlords to reduce rents to boost occupancy. In HCP's case in the near term this trend is likely to be even more pronounced due to all of the assets recently divested and the assets that will be sold in 2018. As such, we see negative comps throughout 2018 and probably into 2019. While acquisitions and investments will fill in for part of these losses, we expect cap rates here to be lower than what the company has divested, and with the capital raised initially used to retire debt, the dilutive impact of the divestitures will be tough to overcome in the near term. While the new focus on higher growth assets should benefit the company longer term through higher organic growth and top and bottom line growth once these divestitures are done, that will take some time.

Looking at the fundamentals, same property projected NOI growth for 2018 is in the 0.25-1.75% range. We note that Q4 same store NOI growth on the company's operating portfolio was a negative 8.3% and the projected range for 2018 is -4% to 0%. As such, this portfolio is proving to be a major drag on numbers. We see our revised 2018 number ending up within the guidance range, despite our expectations for some added investment activity for the year that is currently not included in guidance, as we see a potential negative impact on rent reduction on the senior housing operating portfolio pushing numbers here toward the lower end of NOI guidance. While management has typically been reasonably conservative in its guidance and although guidance does not include any accretive actions (which we believe are all but assured), we expect 2018 and into 2019 will see a difficult environment for senior housing properties.

We came into Q4 earnings season believing that the market had overdone the decline in REIT shares around the worries on rising rates and anticipating a number of upgrades on price. HCP was a company on our radar for such an upgrade. However, the negative fundamentals have pushed that expectation into the future, as we don't see a rising share price in the near term given the likelihood for continued negative comps over the coming year-plus. Our report after the noon conference call will incorporate any changes on the acquisition front based on management discussion as well as all of the operating issues. We will be looking at adjusting our estimates following discussions with management, especially around the potential for weakness in senior housing rents. Following the company's noon Eastern conference call, we will be putting out a full report with updated 2018 and 2019 estimates and earnings model as well as any change in our thesis, which will incorporate management's commentary on the forward outlook.

Additional information is available upon request.

Analyst Certification

I, John M. Roberts, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings
1 - A large cap, core holding with a solid history
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	31	28%	10%	90%
Hold/Neutral	74	66%	9%	91%
Sell	7	6%	0%	100%

As of 7 February 2018

Other Disclosures

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