LTC Properties, Inc.

2022 Third Quarter Conference Call

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CORPORATE PARTICIPANTS

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Steven Valiquette, *Barclays*

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PRESENTATION

Operator

Before management begins its presentation, please note that today's comments, including the question-and-answer session, may include forward-looking statements subject to risks and uncertainties that may cause actual results and events to differ materially. These risks and uncertainties are detailed in the LTC Property filings with the Securities and Exchange Commission from time to time, including the Company's most recent 10-K dated December 31, 2021. LTC undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation.

Please note, this event is being recorded.

I would now like to turn the conference over to Wendy Simpson. Please go ahead.

Wendy Simpson

Thank you, Operator.

Welcome, everyone, to LTC's 2022 Third Quarter Conference Call.

I'm joined by Pam Kessler, Co-President and Chief Financial Officer, and Clint Malin, Co-President and Chief Investment Officer.

With pride, I can say LTC has accomplished much over the last few years, especially in the face of a pandemic that has significantly altered our industry. We have sold assets that were no longer core to our strategy or were not performing to our standards, transitioned a substantial number of assets, and deployed capital into several investments that should serve us well going forward.

Year-to-date investments have totaled over $170 million, which represents our highest level of investment activity since 2015. We are continuing to aggressively identify additional opportunities to fill the financing void that has been created as banks take a wait-and-see approach to investments in our sector. As a result, over the next 12 to 24 months, we believe that LTC's investment activity will continue to ramp up as we become even more competitive, bringing flexible and creative financing to strong regional operators who are seeking growth capital at fair rates.

I'd like to highlight our recent $62 million investment with PruittHealth, and Clint will provide more detail shortly. This off-market transaction was the result of our building a relationship with this very strong regional operator over many years. In particular, Doug Korey, our Executive Vice President and Managing Director of Business Development, has done an outstanding job of identifying strong regional partners, nurturing those relationships and working closely with them to provide the right financing solutions at the right times for our potential partners.

The Pruitt investment not only adds newer skilled nursing centers to our portfolio, helping lower the portfolio's average age, but also adds a formidable operator with more than five decades of experience and a substantial footprint in the Southeastern United States. We were able to utilize a creative financing package that worked well for PruittHealth and that makes good strategic and financial sense for LTC and our stakeholders. Pruitt is just the kind of operator with whom we like to grow, and we look forward to our ongoing relationship with them.

We have a solid balance sheet with no looming debt maturities and no secured debt. We have locked in attractive rates for both our long-term debt and term loans, including locking in a rate of 3.66% for our newly-issued senior unsecured notes for a period of 11 years and entering into swap agreements to lock in our term loans at 2.56% and 2.69%, respectively, based on our current applicable margins for a period of four and five years, respectively. Our only floating rate debt is our line of credit.

As a result of our conservative balance sheet approach, we were able to support our operators during COVID and maintain our regular monthly dividend, with a third quarter payout to our shareholders of $23.1 million. Our FAD payout ratio was 88% for the third quarter, which was comparable to the second quarter, and we are continuing to target our long-term payout ratio of 80%.

As we said last quarter, our operators still have some work to do to successfully meet the challenges brought about by the pandemic, but the news is not all bad. Anecdotally, our operators are reporting lower utilization of staffing agencies, allowing them to increase salaries in certain cases, making jobs in the sector more attractive. Rent increases continue to be implemented by several of our private-pay operators, and occupancy in our portfolio continues to gradually improve. However, with inflation and labor challenges, our crystal ball is a bit murky, so we can't predict when, or if, NOI and margins will return to pre-pandemic levels for our industry.

Our guidance for the fourth quarter anticipates that FFO will increase between $0.09 and $0.10 per share from the third quarter. Approximately $0.08 of the increase relates to the $2.4 million payment of Anthem's temporary rent reduction and resumption of agreed-upon rent, and anticipates $1 million increase in rent from HMG. Our assumptions exclude the $500,000 lease termination fee paid in the third quarter.

LTC continues to manage through a tough economic cycle, but we have operated through tough markets before, and we believe we are well-positioned to weather the current environment. We truly believe that our intractable, and some might say boring, conservatism does prove that LTC is a good investment now and in the future. I am a strong believer that needs-based care is and will remain a vital part of our society.

Now, I'll turn things over to Pam.

Pam Kessler

Thanks, Wendy.

Total revenue for the third quarter of 2022 increased by $6 million from last year's third quarter. This growth was attributable to a $2.3 million increase in rental revenue, primarily due to rent received from transition portfolios and from our recently acquired Texas properties.

Other factors contributing to the increase included higher property tax income and rental income from completed development projects. The increase in total revenue was partially offset by lower rent due to second quarter property sales, the temporary Anthem rent reduction, and deferred rent.

Interest income from sale-leaseback financing increased by $357,000 due to the acquisition of three skilled nursing centers in Florida. In accordance with GAAP, we are required to record this transaction as a financing receivable, since we purchased the properties from an entity and leased the properties back to the same entity under a master lease with a purchase option. Interest income from mortgage loans increased by $2.5 million, primarily due to mortgage loan originations in 2021 and 2022. Interest and other income increased $954,000 from last year's third quarter, mainly due to a 2022 first quarter mezzanine loan origination and additional funding under working capital loans, partially offset by loan payoffs.

Interest expense increased $1.3 million from last year's third quarter, due mainly to the origination of term loans in the fourth quarter of 2021, the issuance of $75 million in senior unsecured notes in the second quarter of 2022, and higher interest rates offset by scheduled principal paydowns on our senior unsecured notes.

Transaction costs decreased by $3.4 million from the third quarter of 2021, mainly related to the settlement payment we made to a former operator in last year's period. Property tax expense increased by $247,000, primarily due to our acquisition of a four-property portfolio in Texas during the second quarter of 2022.

Our provision for credit losses increased by $727,000, mostly due to the just-discussed acquisition of three skilled nursing centers that were accounted for as a financing receivable and additional funding under our mortgage and notes receivable, partially offset by principal paydown. As a reminder, upon origination, we record a loan loss reserve estimate equal to 1% of the loan balance. This reserve is amortized as the loan principle is paid down.

G&A increased by $570,000 year over year due mainly to higher costs related to property maintenance expenses for closed properties, higher incentive compensation, and increases in overall cost due to inflationary pressures.

Income from unconsolidated joint ventures remained unchanged year over year.

During the third quarter, we recognized a $434,000 loss on sale of a closed skilled nursing center in Texas. Additionally, we have a master lease covering two assisted-living communities that is scheduled to mature during 2023. One of the two communities is located in Kentucky and has been classified as held for sale as of September 30, 2022. We wrote this community down to its anticipated selling price, recording an impairment loss of $1.3 million, and we are presently negotiating a new lease for the other community, which is located in Ohio.

Net income available to common shareholders increased $2.3 million, principally resulting from loan origination, the increase in rental revenue previously discussed, and a decrease in transaction costs. This was partially offset by a lower gain on sale of real estate, higher interest expense, the impairment charge I just described, increases in the provision for credit losses, and higher G&A expense.

Fully diluted NAREIT FFO per share for the 2022 third quarter was $0.60 versus $0.45 in the third quarter of 2021. Excluding nonrecurring items, FFO per share was $0.63 in the current year third quarter compared with $0.55 in the year ago period. The increase in FFO, excluding nonrecurring items, was due to loan originations and the increase in rental revenue, partially offset by higher interest expenses and G&A.

Moving next to our third quarter investment activity. We contributed $61.7 million into a newly-formed joint venture with PruittHealth for the purchase of three skilled nursing centers in Florida. As previously stated, GAAP requires the purchase assets to be presented as a financing receivable on our balance sheet. Clint will provide additional details about this investment shortly.

Regarding our former senior-lifestyle portfolio for the six buildings under two separate leases with quarterly market-based rent resets, we received $80,000 in the third quarter, in line with our expectations. We anticipate receiving $120,000 in the fourth quarter of this year. Going into 2023, we plan to either sell these assets or set negotiated rent based on our operators' budgeting, which is currently in process.

Regarding the former senior care portfolio now leased to HMG, we received rent of $2 million in the third quarter, which is down $500,000 from our prior projections of $2.5 million for the quarter. However, our projections for the full year remain unchanged as we anticipate receiving $3 million in the fourth quarter of this year. We also funded $220,000 of principal on the $25 million working capital loan we provided to HMG. The loan has a current outstanding balance of $13.5 million.

We paid $36.2 million in regular scheduled principal payments under our senior unsecured notes in the 2022 third quarter at a weighted average rate of 4.75%. We also borrowed $95 million under our unsecured revolving line of credit at a weighted average rate of 3.24% and paid $23.1 million in common dividends, as Wendy mentioned. We also sold 125,200 shares of common stock for a total of $4.8 million in net proceeds under our ATM program and used the proceeds for general corporate purposes.

Presently, we have $6.5 million of cash on hand, $249 million available on our line of credit, with $151 million outstanding, and $160.3 million available under our ATM. This provides us with total liquidity of approximately $416 million. We have no significant long-term debt maturities over the next five years.

At the end of the 2022 third quarter, our credit metrics remained solid with the debt to annualized Adjusted EBITDA for real estate of 5.9 times and annualized adjusted fixed charge coverage ratio of 4.2 times, and a debt to enterprise value of 34%. Although our debt to annualized Adjusted EBITDA for real estate metric remains higher than our long-term target, we continue to work towards reducing this metric to below five times.

During the 2022 third quarter, we provided $300,000 in rent deferrals to a single operator not in our top 10, and received $100,000 of deferred rent repayments from a different operator. We also provided $720,000 in rent abatements to the same operator for whom we have been giving assistance. These amounts do not include Anthem, for whom we temporarily reduced the monthly agreed upon rent for the month of May through September 2022.

The 2022 agreed-upon rent from Anthem remains $10.8 million, of which $6.6 million was paid to the end of September 2022. In October to date, we received an additional $1.2 million of rent. This represents $900,000 of our October 2022 agreed-upon rent and $300,000 in repayments towards the temporary rent reduction. We continue to expect receipt of the total $10.8 million by year-end upon Anthem receiving additional money from the Employee Retention Tax Credit and from improving operating results.

In October, we provided $240,000 of abated rent and agreed to provide rent abatements of up to $215,000 for each of November and December 2022 to the same operator previously mentioned.

Now, I'll turn the mic over to Clint.

Clint Malin

Thank you, Pam.

I'll start today with a discussion of our transaction with PruittHealth, an operator new to LTC. Our $62 million contribution to the joint venture for the purchase of three skilled nursing centers in Northern Florida makes LTC the majority owner. The three centers were constructed between 2018 and 2021, now they combine 299 licensed beds, primarily in private rooms. They are being offered under a 10-year master lease with two five-year renewal options with an affiliate of PruittHealth.

As Pam discussed, the master lease provides Pruitt with a purchase option which is exercisable between years three and five. The exercise price is subject to an IRR hurdle. The initial yield of the lease is 7.25%, increasing annually up to 8% by year four. After that time, rent will increase annually by 2% to 4% based on the change in the Medicare market basket rate. We expect to receive net revenue of approximately $700,000 during the fourth quarter of this year and approximately $4.6 million next year.

Last quarter, we discussed the 12-property, 625-unit, private-pay portfolio that we transferred to an affiliate of ALG Senior, a current LTC partner. Working with ALG, we are currently determining whether we will retain all of the communities, or sell all or a part of the portfolio. We will update you on our progress as we move through the process.

For the one operator we have been providing rent abatements, we decided not to sell the underlying 180-unit, private-pay campus offering services ranging from independent living cottages to memory care. This community faced many challenges as it was especially hard with COVID, both at the onset of the pandemic, and again during the ensuing surge, and has also struggled significantly with labor shortages.

However, positive occupancy gains have been realized throughout the summer months. After evaluating multiple options and seeing occupancy gains, we have decided maintaining our relationship, and retaining the campus, provides the best value creation path forward at this time. We have not been receiving, nor have we projected, any rental income in 2022. But upon finalization of the operator's 2023 budget toward the end of this year, we will establish negotiated rent for 2023.

Last quarter, we discussed providing rent assistance to a lessee that operates eight living communities for us. This operator, who requested the assistance due to a protracted lease-up of their portfolio during

COVID, is not in our top 10. We have received full rent for October of $445,000, and in 2023 we expect to receive repayment of approximately $300,000 of the rent we previously deferred upon the operator's receipt of funds from the Employee Retention Tax Credit.

Next, I'll provide an occupancy update on the former senior-lifestyle portfolio, which includes 18 communities. Occupancy at September 30, 2022, was 88% compared with 85% at June 30 and 83% at March 31. For the six communities under two separate leases with quarterly market-based rent resets, occupancy was 88% at September 30, 2022, compared with 80% at June 30 and 76% at March 31. For the 11-property portfolio leased to HMG, occupancy for the month of September 2022 was 57% compared with 56% for the month of June and March. We extended the lease to January 2024, and concurrently extended our working capital loans to the same date.

Moving next to our portfolio numbers, with the usual disclaimer that we don't believe coverage is currently a good indicator of future performance at this time, given the challenging environment created by the pandemic. For clarity, recently transitioned properties, including the 11-property portfolio leased to HMG, the former senior-lifestyle portfolio, and the 12-property private-pay portfolio already discussed, no longer qualify for our same-store metrics, so they are excluded from these numbers.

Q2 trailing 12-month EBITDARM and EBITDAR coverage, as reported using a 5% management fee, was 0.95 times and 0.73 times, respectively, for our assisted-living portfolio. Excluding stimulus funds received by our operators, coverage was 0.91 times and 0.7 times, respectively. For our skilled nursing portfolio, as reported EBITDARM and EBITDAR coverage was 2.01 times and 1.55 times, respectively. Excluding stimulus funds received by our operators, coverage was 1.5 times and 1.05 times, respectively.

Now I'll share some recent occupancy trends, which are as of September 30, 2022, and are for our same-store portfolio. As I've noted in the past, our operators gave this data to us on a voluntary expedited basis, so the information we are providing includes approximately 66% of our total same-store, private-pay units and approximately 88% of our same-store skilled nursing beds.

Private-pay occupancy was 81% at September 30 compared with 79% at June 30 and 77% at March 31. For our skilled portfolio, average monthly occupancy was 74% in September of this year compared with 73% in June and 72% in March. As a point of reference, our private-pay occupancy in 2019 was approximately 87% and our average skilled nursing occupancy was 80%.

Before discussing our pipeline, I'd like to spend a moment on potential divestitures. While we are not prepared to provide granular details at this time, in 2023 we expect to see similar levels to our 10-year average of $35 million to $40 million of capital recycling. To repeat what was said earlier: by selling assets that are no longer core to our portfolio or are underperforming, we can redeploy capital into more strategic assets that reduce the average age of our portfolio while strengthening it for the long term.

We've had a strong investment year in 2022 to date, as Wendy discussed, closing on more than $170 million in transactions. As I've mentioned previously, with rising interest rates which spread between bank rates and LTC's rates has continued to contract, making our flexible and accretive solutions even more attractive to strong regional operators.

As we identify new opportunities, we'll continue to build and nurture relationships so that we maintain access to off-market deals that we may not otherwise have had.

We believe there are strategic and accretive deals out there, and we're working to identify investments that allow us to provide financing in numerous areas, including bridge and construction financing. Additionally, we are closely watching pricing for sale-leaseback transactions, and we believe we could see some price moderation, which will allow us to put additional capital to work for our stakeholders.

Now, I'll turn things back to Wendy for closing remarks.

Wendy Simpson

Thank you, Pam and Clint.

I'm very pleased with our accomplishments. Under less than stellar national economic conditions, we have put capital to work in a way that benefits all of our stakeholders, strengthens our portfolio, and maintained a strong and flexible balance sheet. LTC has the ability to meet strong regional operators where they are, with financing solutions that best suit their needs.

Operator, we're now ready to take questions.

Operator

Thank you. Our first question comes from the line of Steven Valiquette with Barclays. Please go ahead.

Steven Valiquette

Great. Thanks. Hello, everyone. Thanks for taking the question.

First one here, just on the 12 assisted-living facilities where you terminated the master lease, you're transitioning to the new operator within the existing stable of operators. You mentioned that the new master lease would be mutually agreed upon from fair market rent.

But I guess I'm just curious, aside from all the accounting noise in the short term, once the dust settles, how would that fair market rent today compare to the annualized run rate of rental income you're receiving on an annual basis under the old master lease? I mean, do you think directionally it's going to be higher, or lower, or about the same? I know it's not quite finalized yet; but just directionally, is there a bias for that to be higher, same, or lower versus the prior annual run rate?

Clint Malin

I guess to answer that question, we were not receiving rent for the last year or so. So, it's going to be positive compared to what we were receiving previously. Compared to the contractual rent that was being paid pre pandemic, that will take time to build back. But we were not receiving much income, if any, during the last year and a half.

Steven Valiquette

Okay. Yes, I was kind of talking before all the abatements and deferrals and everything. But yes, if it's still unclear, that's fine, we can just maybe follow up offline on that later.

Another quick follow-up or just another question I had, you mentioned that $35 million to $40 million of portfolio recycling potentially for ’23. Just curious, is there a bias for those divestitures to be skewed more towards AL versus SNF the way you see it right now? Or is it just there serendipitous, depending on the opportunities?

Clint Malin

At this point, it would probably be more serendipity targeting.

We've had a number of assets we've sold the last couple of years, so at this point it would be a mix of the two.

Steven Valiquette

Okay. Got it. Okay. All right, that's it for me. Thanks.

Clint Malin

Great. Thank you.

Operator

Thank you. Our next question comes from the line of Michael Carroll with RBC Capital Markets. Please go ahead.

Michael Carroll

Yes. Thanks.

I wanted to touch on your 2023 lease expirations. Obviously, Brookdale is the biggest one out of that bucket. Their renewal option was that comes in at, what, the end of this year? I mean, have you talked to them about if they wanted to extend that lease from 2023 to further out? Or what's the progress with that specific lease?

Clint Malin

Hi, Mike. Good morning.

We have met with Brookdale over the summer, and their window opens up next week, and they have until the Twenty-eighth of February to go ahead and execute or to extend the lease. So, they're going through that evaluation process. We did make a capital commitment to them as we extended the lease last time. Right now, we funded about $1.5 million on that $4 million commitment, which this $4 million commitment is on top of the original $4 million that's been fully funded, and we're actively working with them to approve additional projects to fund on that $4 million commitment. We view those to be positive.

The one thing that we did do, when we extended the lease for the one-year time frame, is we extended the time frame to renew. Right now, it's set at February 28, whereas before it was at the end of June, so we have four additional months, should Brookdale choose not to renew the lease, for us to be able to reposition the portfolio between sales or re tenanting.

Obviously, we're taking actions internally to be prepared if a renewal didn't happen, but Brookdale has not advised us yet if they are going to renew or not, but their window has not yet opened.

Michael Carroll

How has the operations of that portfolio been? I mean, have they started to recover versus the pandemic lows? I mean, has that recovery kind of accelerated towards the end of this year?

Clint Malin

I would say, Mike, based on updates that Brookdale provides publicly, I would say our properties tend to track along with those updates that Brookdale has provided.

Michael Carroll

Okay. Great. Related to the master lease covering the two assisted-living communities that's going to mature in 2023, is that tenant paying rent on those assets today? I know you're agreeing to sell one of them, and trying to release the other, but is rent currently being paid on those properties?

Pam Kessler

Yes, it is. There's current rent being paid is paid on that, Mike.

Michael Carroll

Okay. What was the expected sales price? I see that you recorded a $1.3 million impairment, I didn't see what the expected sales price is for that one property. Also, where is right coming out on the negotiation of the property in Ohio? Is that going to be the same as what it is right now?

Clint Malin

In regard to the rent on the Ohio property, it would probably be in line with some of the other leases we have, where we do quarterly market resets as we build back occupancy, so that would likely be how we set the rent for a period of time for the Ohio building.

Pam Kessler

Yes. We currently have the property in Kentucky held for sale on the balance sheet, so you'll see that at $11 million.

Michael Carroll

Okay. Great. So then for the Ohio property, we should assume that when you re-lease it, the rents are going to start on the low base and then build up over time as it kind of restabilizes. Is that fair?

Clint Malin

Correct.

Michael Carroll

Okay. What else is expiring in 2023? I think I know that you highlighted in your footnotes those specific tenants. But are there other larger tenants that are also expiring in there? I think that there's still about 15%, 20% of those expirations that's not accounted for in that footnote.

Clint Malin

The majority of it really is Brookdale. I mean, there's a few other one-offs here and there, but the majority of it is Brookdale.

Michael Carroll

Okay. Just finally for me, can we talk a little bit about HMG and the former SLC assets? I know you upped, or you increased, your forecast for 2022. I'm assuming that means HMG is doing a pretty good job operating that portfolio, same with the six former SLC assets. I mean, is that the reason why rents are trending higher, just because operating results are better than expected?

Clint Malin

They have been making improvements. Mike, HMG has been in the properties now for about a year. There was a heavy lift coming in. It was in the middle of the surge. Obviously, these buildings have gone through a lot of changes over the past few years. So, HMG had to come in and change the culture of the buildings, work on stabilizing staffing. There was a huge uptick in agency utilization that happened early on in 2022. They've been working hard on entering into new managed care contracts to be able to build up census.

We've been working with them on funding Capex into the buildings, which we think is important to be able to drive occupancy, as well. I did indicate occupancy has been somewhat flat over this year. We're at 57% now. But we think with what HMG has been doing from culture, stabilization of staffing, new managed care contracts, Capex we're putting into the buildings, that hopefully that positions the buildings to be able to continue increasing occupancy.

Also, there's the potential for the state of Texas to increase rates, as well, so that would be a possibility that's been a discussed outcome.

Michael Carroll

Okay. Great. Thank you.

Clint Malin

Thank you.

Operator

Thank you. Our next question comes from the line of Daniel Bernstein with Capital One. Please go ahead.

Daniel Bernstein

Hi. Good morning.

I have a couple of questions on the asset recycling for next year, the $35 million, $40 million. Do you anticipate those assets, or are those assets currently receiving rent? I was just trying to understand if those are going to be assets that are currently not contributing to FFO or FAD.

Clint Malin

It's going to be a combination, Dan. There will be some that does have rent associated with it, and there'll be some that does not.

Wendy Simpson

But I think it's important, Dan, to take into consideration that, as Clint said, we have a pipeline that we will be able to invest those dollars into, that is in dollars that we think are more in keeping with what LTC wants to invest in now. So, we may lose the dollars of rent from these assets that we sell, temporarily, we'll be able to pay down our line of credit, which is not cheap anymore, and then we have an opportunity, really a great opportunity, to reinvest in, not better assets, but different assets in 2023. So, I think it's a positive that we're selling or looking to sell some of these assets.

Clint Malin

Wendy has a good point there, too, Dan, because really we're looking at—as we continue to talk about reducing the average age of the portfolio, what this will do, a lot of what we're looking at and selling older assets.

Daniel Bernstein

Okay. Do you anticipate any seller financing? I mean, you talked about the pullback in bank lending in the opening comments, and so is there any anticipation of seller financing that could mitigate some of that, if there is any loss of income?

Clint Malin

No.

Daniel Bernstein

Okay. Okay. Just on a broader basis on the pipeline outlook, I guess there's two ways to look at it, right? There's a broad transaction pricing. Has that moved? Then on a micro basis, I guess probably this is where you're heading, it's just there may be some distressed sellers or sellers having trouble refinancing. What kind of yields you can get on that specific targeted transaction, is it 8%, 9%? Or is it 7%? I'm just trying to understand where pricing is heading within the transaction market, both on maybe like a broad basis, and maybe on some of those more specific transactions you may be looking at.

Clint Malin

What we're looking at, Dan, I would say probably on owned assets we're looking probably still in the 7.5% to 7.25% for private-pay. Skilled is probably still in the 8% range, depending on the type of asset and the security behind it. So, not a tremendous amount of change, but we're evaluating the market right now. As we've seen, the rates keep changing, and we haven't had a lot of transactions that have closed here recently, so that's something that's evolving right now in the market.

Daniel Bernstein

Okay. I guess it's TBD, still evolving.

The other question I had was there's been some noise on the early flu season or increase in respiratory illness, and especially when you look at Texas and Florida, which is your largest state geography and third largest state geography. They're both showing high levels of flu and respiratory activity. Any early signals or comments from your operators on occupancy, whether it's move-ins, move-outs, or expenses? Or on the flip side, has there been any kind of enhanced COVID protocols, has that been mitigating any flu impacts across properties in those states? I don't know if you've heard anything. I know it's a little early.

Clint Malin

It's early, but we've heard a few operators have seen upticks. But that's been more one-off; it's not been broadly across the country. But I do think the COVID protocols that have taken place the last couple of years definitely have an impact and influence on the overall flu season. Plus, just vaccination rates between residents and patients has been high, and vaccination rates among employees and staff has been increasing, as well.

Daniel Bernstein

Okay. All right. That's all I have. I'll hop off. Thank you.

Wendy Simpson

Thanks, Dan.

Clint Malin

Thank you.

Operator

Thank you. Our next question comes from the line of Austin Wurschmidt with KeyBanc. Please go ahead.

Austin Wurschmidt

Hi, how's everybody doing out there?

Sorry, I hopped on a few minutes late. But I was just curious, I think you guys touched a little bit on the Brookdale lease next year, but I'm just curious with sort of the rumored Brookdale sale out there, given your exposure. I'm just curious if you have any initial thoughts on what a potential sale could mean or how you think about that in the context of that expiration in 2023.

Wendy Simpson

Well, we have a lease that provides for change of control provisions. That lease, if they don't renew it, expires at...

Clint Malin

End of next year.

Wendy Simpson

End of next year. So, if they get purchased after end of next year, and they haven't renewed the lease, it's a jump ball at that point. We are not sitting here waiting for them to toss us the jump ball; we're doing strategic planning on what operators we would possibly bring in to look at the portfolio. The portfolio is nicely grouped so that it's not one asset in one state. They are nicely grouped assets.

I believe, if not all of the assets, the majority of the assets are positive cash flow. As we stated, we've been putting capital into them. It might be a little disruptive for us, but we are as prepared as we can be with the information we can get either through *The Wall Street Journal*, or through rumors, or Brookdale. Now, Brookdale is not calling us and telling us what's going on, which is appropriate.

We're hoping that we don't have to make a change, but we're prepared if we have to.

Pam Kessler

We're very experienced in transitioning assets.

Clint Malin

There definitely is a diversification of operators from that perspective, if that were to occur.

Austin Wurschmidt

No, that's really helpful. I realize there's a lot of uncertainty there, but certainly meaningful enough exposure to prepare in the event of something taking place.

Secondly, again, I don't know if this was covered, but with respect to the former senior-lifestyle portfolio, what are the thoughts on sort of that market rent reset? I think it was November of this year. And then where are you in the process of just evaluating options for these assets and the range of potential outcomes?

Clint Malin

Well, as Pam mentioned, we're looking at the budget that will be coming up and provided to us soon. The encouraging part is occupancy has grown. But I think a lot of that occupancy growth has come at the expense of marketing dollars, so as occupancy has ramped up and operators are looking at rate increases going into 2023, hopefully there's some moderation on those marketing dollars that then will increase NOI and margins.

Pam Kessler

Yes. What we've seen is, and I think the industry has experienced this, as well, the rapid rise in costs happened first, and the rent increases are happening next. They're happening right now. Operators have pulled rent increases forward earlier than they typically do. January is about the time frame that the industry typically increases rents, some have been pulled forward or planning to be pulled forward in November and December. But you'll get your rent increases coming in January, and then that will take time to build through the operating results. Right? So, the revenue is lagging, a little bit, the expenses.

We should expect to see margins moderate next year, because we've seen that compression of margins this year.

Austin Wurschmidt

With that being said, when you pull and talk to your operators, where do you see, on average, rental rate increases shaking out for January?

Pam Kessler

High single digits is what we hear mostly. Some markets can get low double digits, but primarily we're hearing mid- to high single digits. Also, levels of care are being looked at, as well.

Austin Wurschmidt

Very helpful. Thanks for the time, everyone.

Wendy Simpson

Yes, not just base rent, but levels of care are also being looked at, because that's also where you've seen cost increases through significant labor cost increases.

Austin Wurschmidt

Understood. Makes sense. Thank you.

Wendy Simpson

Thanks, Austin.

Operator

Thank you. Our next question comes from the line of Michael Carroll with RBC Capital Markets. Please go ahead.

Michael Carroll

Yes. Thanks. I wanted to transition back to Brookdale. I think Wendy said that those assets are cash flow positive. I guess, what definition is that? Is that cash flow positive after the rent and after Capex or after the rent? Or, I guess, can you provide some color on what that statement meant?

Clint Malin

Well, on the management fee on this, we have an allocated 5% that we use internally to evaluate this. I would say that the management fee expense associated with these buildings are probably not that full 5%. So, when you take that into consideration, I mean, they are, I would say, covering operating expenses as well as rent.

Michael Carroll

Okay. Great. Can we go back to Anthem, too? I guess, what's the confidence level that they're going to be able to pay that back-dated rent in the fourth quarter? I know they paid a little bit in October. I mean, do they need to get that government funds to be able to achieve that?

Clint Malin

I mean, the government funds would be helpful. But as we mentioned a few months ago when we first gave Anthem the temporary rent reduction, their occupancy and cash flows ebb and flowed previously, and they have started to recover incentives and also in operating performance. So, there is some benefits they are receiving, and hopefully they can get back before the end of the year to where they are improving cash flow and not solely reliant upon that. So, we're glad to see that they actually did get the money from the ERC credit that started to flow, and we're also starting to see cash flow improvements, as well. So, we're encouraged by both.

Michael Carroll

Okay. Great. Thanks.

Clint Malin

Thank you.

Operator

Thank you. Our next question comes from the line of Tao Qiu with Stifel. Please go ahead.

Tao Qiu

Hi. Good morning.

I wanted to ask a question about the Texas rate discussion on the SNF side. I think there has been some talk about a larger Medicaid increasing the sale of taxes, but the timing may be later in the year. The first part of my question is, how significant do you think that rate increase will be?

Secondarily, thinking about the timing. At the same time, we know that if we don't get another extension of the public health emergency, that would end in the first quarter next year. Between when the PHE (phon) ends and the new Medicaid rate goes in the effect, we may have one to two quarters of air pocket, just curious, what does that do to your coverage on the SNF side, given that it's the largest or the second largest market in your portfolio?

Clint Malin

Well, any base rate increase in the State of Texas is huge. We had a meeting with the Head of the Texas Health Care Association a few months ago, and obviously we're advocating for this. But one item that was pointed out is the base rate in Texas has not been increased for almost 10 years now. It's a substantial amount of time without an increase in the base rate.

When you look at that historically, plus all the inflationary pressures that are being experienced from a staffing standpoint, I think that puts more pressure on the state to look at a rate increase. So, it would definitely be significant.

Again, we've been supporters of and working with the Trade Association, and helping fund some of their efforts for lobbying, and then there's been a few years where this has taken place without success. But hopefully, this year, after 10 years of no base rate increase, will be a year that is positive for the state of Texas for Medicaid rates.

Tao Qiu

Clint, what about timing? Do you foresee any air pocket in between the two, I guess, the increase in the rate and the public health emergency?

Clint Malin

It's hard to say on the timing, but also the state is looking at, would the FMAP money that's coming through from the pandemic to the emergency health order, the state is also look at potentially continuing that, as well, so those could be additional dollars, as well, for the state of Texas.

Tao Qiu

Got you. That's helpful. Thank you.

Clint Malin

Thank you.

Operator

Thank you. Our next question comes from the line of Tayo Okusanya with Credit Suisse. Please go ahead.

Tayo Okusanya

Yes. Good morning out there. I apologize for any of the background noise.

You had a quarter where, again, nice pickups in occupancy, but a lot of pressure on rent coverage. Some discussion today about moderation in margin compression, or in margins for operators. As you look into 2023, just seems to suggest the profitability will be lower at similar levels of occupancy versus pre pandemic. Against that backdrop, how should we really be thinking about the overall health of your tenant base? Any potential risk of need for additional help, and also how you end up underwriting deals going forward if the overall operating margin of these businesses seems to at least be temporarily impaired?

Pam Kessler

Well, I think, because you're referencing the comment that I made earlier on the call about the margin compression, which that's what we experienced this year, and that's what you're seeing reflected in the increase in occupancy, but the decline in coverage. Right? As revenues start to increase as the rent increases roll through our operators' financial statements, and assuming that expenses don't continue to increase at the rate they've been increasing, you should start to see margins increase.

I don't know if they're going to approach—I don't think anybody's crystal ball is good enough to predict if or when they approach pre-pandemic norms, but they certainly were expecting they should be higher in 2023 than they were in 2022. That's just kind of the math.

Clint Malin

Then you look Florida, with our recent investment with PruittHealth, the State of Florida had a pretty healthy Medicaid rate that came through there, which is definitely helpful. One thing that in talking to operators about is what they see going into 2023, and nobody is hoping for a recession, but I think our industry has seen in times of distress and economic challenge, the industry, as a needs-based business from a staffing level, can be attractive from a job security standpoint, so I think that also helps out from a wage pressure standpoint

Pam Kessler

We're not calling the end of the pandemic, so I think we've got to get through this flu season that we're hearing now, RSV, which that can affect older people, as well. If we get COVID, RSV and the flu all at once, what’s that going to do to our industry and admissions bans? We're hoping that those won't be instituted again, because those were very harmful for both assisted-living and skilled nursing. But if occupancy does not continue to increase, or it decreases because of a surge in the fall, that could delay the margin recovery.

Tayo Okusanya

That's helpful. Also, there was some talk about scaling (phon) in place and regulation kind of making that a permanent thing going forward, rather than the temporary thing that it was during the pandemic. Could you give us any update from a regulatory perspective, if that's potentially going to happen?

Clint Malin

We don't have any update if that would potentially happen. I think a lot of the skilled operators would like that to happen, but I'm sure on the hospital side that may not be the case. To get that accomplished regulatorily, that would be probably sometime before something like that would happen. But you effectively have that through the managed care side, right? So, if you increase your managed care census, you don't have that same three-day stay provision on the managed care patient.

Tayo Okusanya

Great. Thank you very much.

Clint Malin

Thank you

Operator

Thank you. There are no additional questions waiting at this time. I would like to pass the conference back to Wendy Simpson for any closing remarks.

Wendy Simpson

Thank you all for joining us today. Have a great weekend and a happy Halloween. Bye-bye.

Operator

That concludes today's conference call. I hope you all enjoy the rest of your day.