Artemis

At the intersection of healthcare and real estate

An interview with Artemis' senior managing directors Kelly Sheehy and Kevin Nishimura about the economic and demographic drivers of healthcare real estate

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with Artemis' senior managing directors and portfolio managers **Kelly Sheehy** and **Kevin Nishimura** about opportunities in the senior housing and medical outpatient building investment space. Following is an excerpt of that conversation.

Would you provide a brief overview of Artemis and its healthcare platform? How do you define healthcare real estate?

Kelly Sheehy: Founded in 2009, Artemis celebrated its 15th anniversary this year, with more than $10.5 billion of equity raised to date across a series of vehicles. We have four primary business lines: value-added, core-plus, credit and our dedicated healthcare business. Kevin Nishimura and I have worked together for more than 20 years, and we manage the healthcare platform at Artemis, which includes 10 additional senior professionals focused on healthcare real estate. We target the entire trillion-dollar healthcare real estate sector, except acute-care hospitals. Our primary focus is senior housing and medical outpatient buildings or MOB. Across investments in debt and equity, we get exposure to the demand generated by 65 million seniors today over the age of 65.

You started investing in the early 2000s. Since then, healthcare real estate has evolved significantly. Can you comment on the institutionalization of healthcare real estate as a niche property sector and how capital flows have increased?

Kevin Nishimura: People have been talking for more than two decades about the aging population in the United States, and we believe our focus on healthcare real estate is positioned to capitalize on that continued trend. While the past five years have been a volatile period, one of the constants has been that overall healthcare spending has continued to grow. One subsector that, in our view, has been extremely stable and consistent has been outpatient medical, which is benefiting from an aging population that visits a doctor three times more than the general population. Nationally, we have maintained extremely stable occupancy in the low- to mid-90s during the past five years, resulting in consistent cash flow. Today, we see a number of investors rotating out of traditional core property sectors, such as office and retail, and into niche sectors, such as healthcare real estate.

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> – Kevin Nishimura

Sheehy: In the early 2000s when we started investing in healthcare, we had data showing the baby boomers coming. Fast-forward to today, that growth is here. The baby boomers are in the 65- to 75-year-old range and driving demand for senior housing and outpatient medical care. As these subsectors have grown, they have become much more institutional from a data perspective, similar to the hotel sector 30 years ago.

As you've said, growth of healthcare real estate has been propelled by strong demographic drivers. Can you comment on their trajectory, moving forward, and what that means for future investments in this property sector?

Sheehy: This population is expected to grow by 25 percent during the next six or seven years, which is a tremendous number of new consumers. That affects everything, whether it is senior living and the housing component, or the need for medical care. We believe we are coming into an investment period supported by significant demographic tailwinds, as well as a good investment cycle post-COVID. We view the next four to five years as a very strong investment opportunity in the healthcare space.

Nishimura: In terms of medical outpatient, specifically, a few statistics stand out. The U.S. 55-plus population accounts for 50 percent of healthcare spending. Healthcare spending is almost 20 percent of U.S. GDP. The 65-plus cohort is going to the doctor three times more than the general population. You can imagine just how many doctor visits that is and how their frequency has multiplied over the years. As everyone tries to contain costs, medical care has continued to shift from the acute care hospital setting to the outpatient medical setting. Since 2000, outpatient medical visits have increased by almost 60 percent, while hospital admissions have actually declined during that same period. This trend is the driving factor behind our conviction in the space and why it's been such a consistent performer.

Artemis' healthcare platform focuses on various types of healthcare real estate. What are the advantages to investing across multiple healthcare property types and across the capital stack within the same vehicle?

Sheehy: Artemis' healthcare platform is 100 percent focused on healthcare and diversified across most healthcare property types, as well as across equity and debt. Let me give an example of why we believe this is important: Prior to the pandemic, senior housing cap rates were pricing at most at a 50-basis-point premium to traditional multifamily. Knowing the senior housing business, we didn't believe this was an attractive price point to invest. During this time, we were intentionally underweight in senior housing during that period and focused more on our medical outpatient strategy.

Nishimura: Typically, medical outpatient is an aggregation strategy in a highly fragmented space. In our view, a significant number of investors are one-off owners, often either developers or medical practices, or both, that own their own building. Our strategy is to aggregate individual buildings into a larger, diversified portfolio, which can then be positioned for an institutional exit. We focused pre-COVID, and in the period immediately following the onset of the pandemic, on medical outpatient. The pandemic obviously had a dramatic effect on senior housing – a drop-off in occupancy, immediately followed by a run up in operating expenses driven by inflation, which was a perfect storm for distress and volatility in senior housing.

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> – Kelly Sheehy

Sheehy: Post-COVID and interest-rate-hike cycle, we saw an opportunity to be overweight in an attractively priced senior housing market, with almost no new supply and stabilized expense growth. Initially, we focused on credit, providing bridge loans in a liquidity-constrained market. Today, we see a return to a more normal 150-basis-point spread between senior housing and multifamily cap rates, coupled with extremely strong rent growth, creating what we believe is an opportunity to pivot back toward traditional senior housing equity investments.

How is investing in senior housing unique compared with other property types, and what should investors consider when moving forward? On the other hand, medical outpatient has shown consistent performance – what is driving this resilience?

CONTRIBUTORS

Kelly Sheehy

Senior Managing Director and Portfolio Manager

Artemis

Kelly Sheehy leads Artemis' healthcare-related acquisitions and asset management. He joined Artemis in May 2017 and is based in Atlanta. Prior to joining Artemis, Sheehy spent six years at Formation Capital as a managing director, where he helped oversee Formation's effort to identify new investment opportunities in healthcare real estate and healthcare private equity. Sheehy managed and co-managed the investment of transactions across a broad range of healthcare investments, products and companies. Prior to Formation, Sheehy served in a variety of roles at the J.E. Robert Cos. (JER), including as a vice president in JER's U.S. fund business.

Kevin Nishimura

Senior Managing Director and Portfolio Manager

Artemis

Kevin Nishimura is responsible for developing and implementing the acquisition and asset management activities of Artemis. He joined Artemis in May 2014 and is based in metropolitan Washington, D.C. Prior to joining Artemis, Nishimura was a director supporting Deutsche Bank's Commercial Real Estate Special Situations Group (DB), responsible for the sourcing, evaluation, and asset management of high-yield debt investments for DB's balance sheet. Prior to DB, Nishimura served in a variety of roles at the J.E. Robert Cos. (JER), including as a director in JER's U.S. fund business.

Sheehy: Senior housing is one-part real estate and one-part operations. We have a team of asset managers who have come from the operating side of the senior housing business and have a collective 60 years of experience. That is critical, particularly in light of the pandemic, which was an especially challenging environment. To recap, COVID-19 triggered a 40 percent decline in NOI, nationally, followed by labor shortages, expense inflation and rate hikes. We believe we navigated these challenges thanks to our experience in the operations side of the business. We've seen many owners who were more recent entrants into the space pre-COVID and now have cycled out of the space due to the difficulty they had during the past five years. Fortunately, we committed the resources and made the investment in our own senior housing asset management team.

Nishimura: During that same time period, one of the reasons medical outpatient was such a consistent performer is high tenant retention — medical boasted 85 percent to 90 percent tenant retention, which is a stark contrast from traditional office. Medical tenants tend to invest significantly more of their own capital into their space than do traditional office tenants. A medical tenant typically customizes their space to accommodate expensive medical equipment. That significant capital investment upfront makes medical tenants much less likely to relocate. Also, the patient base, which is largely skewed to the senior population, is looking for routine. They do not want to have to find the new location for their doctor and their medical needs.

You mentioned senior housing is operationally intensive. Can you elaborate on your approach to asset management?

Sheehy: We can't emphasize enough that you need to have operational experience to properly asset manage in the senior housing sector. In our healthcare asset management team today, we have several members who have come from the operations side. To put it in context, similar to multifamily, we hire a property manager for a senior housing property. The difference is our property manager is going to have roughly 70 to 100 employees at a property. In addition to running a sales, care and dining program, you'll typically have three to five move-ins per month, and a couple move-outs. The point is, there are more operational decisions in senior housing than in a traditional real estate sector, and in order to outperform the market, we believe an experienced and dedicated healthcare team is critical.

Artemis makes both direct and joint venture investments in healthcare. How are you sourcing across the different property types?

Nishimura: We employ a number of different strategies, including direct investment and via joint venture partnerships with operating partners. On the medical outpatient side, with its highly fragmented ownership, the overall transaction size is relatively small. For example, a 25,000-square-foot to

50,000-square-foot building might be valued at $300 to $400 per square foot, resulting in a typical transaction size anywhere between $10 million and $20 million total, which generally is under the radar of many institutional investors. The size creates inefficiencies on the transaction side. We have the ability to acquire when the property is marketed to only a small buyer pool or truly from a direct asset owner. For instance, the seller is sometimes a doctor group that has been involved since they built the building for their practice.

What are you most excited about in healthcare real estate currently?

Sheehy: We see opportunity in all of our healthcare segments given the tremendous secular demand growth driven by the aging population, which is why we are focused on staying disciplined and diversified in our healthcare real estate exposure. Today, we're most excited about the senior housing opportunity. Coming out of COVID-19, as we believe there has been a reset in the basis in senior housing, cap rates have expanded by 150 basis points relative to multifamily, labor costs have stabilized and new-supply growth is low. That creates an opportunity to acquire assets and generate old-school NOI growth with an aim to create true real value creation in the returns. We believe the market today rewards experience and expertise, and we see a real opportunity there in the next 24 months to 48 months.

Nishimura: The continued institutionalization of healthcare real estate and the rotation of investors into core cash flow–oriented product is benefiting medical outpatient. Large institutional allocators see the stability of medical, including sovereign wealth funds, foreign capital and diversified open-end core funds taking more interest in the space. With healthcare, and in real estate more broadly, it takes time for pricing to reset. The interest rate hikes during the past 24 months took time to work through to asset pricing, but today we see positive leverage again. When we think about building our healthcare portfolio, we see medical outpatient as the steady anchor of the healthcare portfolio, generally with higher relative current cash flow and a core to core-plus risk profile. The alpha is coming from senior housing, and we are excited about opportunities in both subsectors.

CORPORATE OVERVIEW

Artemis' mission is to create a successful and sustainable real estate investment management firm that is built on a foundation of performance, alignment of interest and transparency.

Artemis Real Estate Partners is an investment manager based in metropolitan Washington, D.C., with offices in New York City, Los Angeles and Atlanta. Artemis has raised more than $10 billion of capital across core, core-plus, value-added and opportunistic strategies. The firm makes equity and debt investments in real estate across the United States, with a focus on multifamily, industrial, office, retail, hospitality, self-storage, senior housing and medical outpatient. Artemis specializes in joint venture partnerships and direct investments.

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