Medical Properties Trust (MPW) & Priory Group

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Asymmetric risk taken by MPW + poor economics + investment in operator + aggressive accounting

- In January 2021, **MPW** announced it was **financing the <u>entire</u> ~$1.4 billion acquisition of Priory Group by Waterland Private Equity Fund VI** via a SLB financing and bridge loan. A GBP ~800 million loan was converted into an ownership interest in the real estate with Waterland putting in only nominal cash.
  - The bridge loan was fully repaid, but with MPW assistance (see below), so not really "repaid." More like "termed out."
  - Priory was a troubled U.K.-based behavioral health provider owned by Acadia Healthcare (ACHC) that had been put up for sale pre-COVID. Negative news flow has continued post-transaction (see final slide).
  - Waterland owns Median Kliniken, which at the time represented ~5.8% of MPW's rent. MPW also owned ~5% of the Median opco.
  - Finally, **MPW acquired a 9.9% passive equity stake in the Waterland fund (which owns the Median & Priory opcos)**.
  - **Familiar threads: MPW acquires real estate via SLB, makes non-real estate loans to operator, acquires equity interest in operator, related party transactions, operator puts in essentially no equity, deal depended on MPW's ability to sell ~$700 million of stock at the time.**
- **MPW initially disclosed 40-asset deal, 25-year leases, 8.6% cap rate (GAAP/straight-line basis)**.
  - **MPW received 35 properties w/o a price adjustment**, 25-year leases, CPI-linked escalators, **really ~6.9% GAAP/5.4% cash yields**.
  - Straight-line rent is calculated by taking the average of total aggregate lease payments divided by the lease term. **MPW includes 2x10 year extension options in the calc**, which increases the aggregate dollars straight-lined but also the GAAP/cash spread.
  - As a result, **GAAP rental income recorded is an estimated ~60% above cash received currently. Mgmt. paid on GAAP FFO.**
  - **We estimate Priory accounts for ~5% of MPW's annualized cash rental revenues**, as well as additional interest income.
- MPW disclosed in the 2021 10-K that it had **contributed another ~$30 million in 4Q21 to maintain its 9.9% interest in the Waterland/Priory opco**, and further disclosed a **~$131 million term loan participation directly to Priory in the 1Q22 10-Q** → aka, it appears MPW effectively "bought" ~40% or so of the deal to refinance out the bridge loan.

How Do We Know Extension Options Included? = MATH!

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Assumptions	
Property Purchase Price (GBP 000s)	800,000
Calculated GAAP Yield - Year 1	6.93%
Lease Term	25 Years
Main. Capex % of Revenue	-
Annual Escalator	2.00%
Implied Cash Yield - Year 1	5.41%

Year	Beginning Capital	Acquisition	Ending Capital	GAAP Rent	Cash Rent	Cash Rent Y/Y Change	Unlevered Cash ROIC
1	-	800,000	800,000	55,476	43,300		5.41%
2	800,000	-	800,000	55,476	44,166	2.0%	5.52%
3	800,000	-	800,000	55,476	45,049	2.0%	5.63%
4	800,000	-	800,000	55,476	45,950	2.0%	5.74%
5	800,000	-	800,000	55,476	46,869	2.0%	5.86%
6	800,000	-	800,000	55,476	47,807	2.0%	5.98%
7	800,000	-	800,000	55,476	48,763	2.0%	6.10%
8	800,000	-	800,000	55,476	49,738	2.0%	6.22%
9	800,000	-	800,000	55,476	50,733	2.0%	6.34%
10	800,000	-	800,000	55,476	51,748	2.0%	6.47%
11	800,000	-	800,000	55,476	52,782	2.0%	6.60%
12	800,000	-	800,000	55,476	53,838	2.0%	6.73%
13	800,000	-	800,000	55,476	54,915	2.0%	6.86%
14	800,000	-	800,000	55,476	56,013	2.0%	7.00%
15	800,000	-	800,000	55,476	57,133	2.0%	7.14%
16	800,000	-	800,000	55,476	58,276	2.0%	7.28%
17	800,000	-	800,000	55,476	59,442	2.0%	7.43%
18	800,000	-	800,000	55,476	60,630	2.0%	7.58%
19	800,000	-	800,000	55,476	61,843	2.0%	7.73%
20	800,000	-	800,000	55,476	63,080	2.0%	7.88%
21	800,000	-	800,000	55,476	64,342	2.0%	8.04%
22	800,000	-	800,000	55,476	65,628	2.0%	8.20%
23	800,000	-	800,000	55,476	66,941	2.0%	8.37%
24	800,000	-	800,000	55,476	68,280	2.0%	8.53%
25	800,000	-	800,000	55,476	69,645	2.0%	8.71%

- **The in-place GAAP and cash yields are an estimated ~6.9% and ~5.4%, respectively,** assuming the 25-year initial term and GBP 43.3 million in-place cash rent. **This is well-below the 8.6% "contractual" GAAP yield publicly disclosed by management**.
- **Again, the 5.4% cash yield is what investors should care about the most,** and is a poor use of shareholder capital.
- Assuming the exercise of the 2 10-year options for a full term of 45 years, the in-place GAAP straight-line yield hits the disclosed 8.6%. **Very aggressive!**
- Recall **management is compensated on GAAP economics**, not cash.
- **Key questions**: (1) will the tenant pay through to term, (2) why is the disclosure so poor, (3) what is MPW's full basis/investment yield in Priory including all loans and equity investments., and (4) **why is the Board ok with this arrangement?**

Select Management Comments on Priory Transaction

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Incomplete at best, but most likely intentionally misleading in our view

- **R. Steven Hamner, MPW CFO**: "After completing our $711 million equity issuance in January, we issued £850 million of senior notes in the pound sterling market to permanently fund our Priory investment at fixed rates. **The 2.9% weighted average interest rate on these sterling notes… is a highly favorable spread compared to the 8.6% yield** in the sale-leaseback of the 35 Priory behavioral facilities." – 1Q21 earnings call
  - Wa what?! They are comparing an (overstated) GAAP straight-line yield to an actual cash cost. This is a completely ridiculous statement, and both the buy- and sell-sides should be calling this out.
- **R. Steven Hamner**: "…and even before we begin to fully recognize the **contractual 8.6% GAAP lease yield** on the recently closed Priory transaction and before any additional 2021 acquisitions…" – 1Q21 earnings call
  - Again, contingent on (1) the tenant paying through to term and (2) the options being exercised. On our math the tenant isn't actually paying anything close to that lease rate on a cash basis until year 24. Not as bad as the first comment, but still not great.
- **R. Steven Hamner**: "And as Ed mentioned, we also made a few non-real estate investments, **immaterial in the aggregate**, **in certain operators** including Swiss Medical Network, **Priory Group**, and Steward." – 1Q21 earnings call
  - No! If the investment in the operator is either (1) supporting the operator's ability to pay rent back to MPW, or in this case in our view (2) directly supporting the acquiror of the operator in repaying the bridge loan on the acquisition, it IS material. Very material.

Some Additional Reference Materials

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U.K. media has been highly critical of the transaction and its effects; optics appear horrible

- Priory clinic group sold to private equity for £1bn – The Times, 12.31.20
- Times investigation: Priory – The Times, 4.29.22
- Is the Priory fit for purpose? – Daily Mail, 5.14.22
- Sale and leaseback deal lands Priory Group with soaring rent bills – The Times, 5.23.22

