HILLIARD LYONS

Healthcare Real Estate Investment Trusts
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COMPANY UPDATE/ESTIMATE CHANGE

Key Metrics

HR - NYSE -	(5/3/2017)	$31.70
Price Target		N/A
52-Week Range		$26.66 - $36.60
Shares Outstanding (mm)		104.4
Market Cap. ($mm)		$3,309.5
1-Mo. Average Daily Volume		680,000
Institutional Ownership		96.2%
Debt/Total Capital	Mar-17	25.3%
Est 3-year FFO Growth Rate		4.0%
Est 3-year Dividend Growth Rate		0.0%
Book Value		$12.71
Dividend		$ 1.20
Dividend Yield		3.79%
Est. Fixed Charge Coverage		3.5X

FFO

	2016	Prior 2017E	Current 2017E		Prior 2018E		Current 2018E
1Q	$0.41	--	$0.39	A	$0.42		$0.42
2Q	$0.42	$0.43	$0.41		$0.45		$0.44
3Q	$0.39	$0.43	$0.42		$0.44		$0.44
4Q	$0.41	$0.43	$0.43		$0.45		$0.45
Year	$1.63	$1.68	$1.64		$1.76	*	$1.75
P/E	0.0x		19.3x				18.1x

* - May not add due to rounding, numbers historical, not adjusted

Revenue ($mm)

	2016	Prior 2017E	Current 2017E		Prior 2018E	Current 2018E
1Q	$100.0	--	$ 104.6	A	$114.8	$112.4
2Q	$102.6	$109.1	$ 106.1		$117.2	$114.8
3Q	$103.7	$111.4	$ 109.2		$119.5	$117.1
4Q	$105.3	$113.3	$ 111.6		$121.5	$119.1
Year	$411.6	$440.7	$431.5		$473.0	$463.4

Company Description: *Healthcare Realty Trust, Inc., headquartered in Nashville, Tennessee, is a real estate investment trust (REIT) that invests primarily in properties associated with the delivery of healthcare services through mortgage loans and direct real estate property ownership. The company also undertakes development of the same class of properties.*

Healthcare Realty, Inc.

HR -- NYSE – Underperform-2

Conference Call Update

Investment Highlights

- With the two cent miss in Q1 and based on additional dilution from asset sales, offset by purchases that were discussed on the conference call, we are fine-tuning our estimate for HR's 2017 FFO to $1.64 a share. On the conference call, management noted that they were still anticipating acquisition activity for the year in the $175-$225 million range. They noted that cap rates continue their move even further to all time lows, and they anticipate their purchases to be consummated in the mid 5% range for the on-campus sites they are targeting. They noted that a recent sale of a medical office building (MOB) portfolio by a public REIT drew a lot of interest and was consummated at a cap rate in the mid-4% range when backing out the non-core MOB assets from the sale. As we noted in our past report, this pushes up the value of the underlying assets of the company, but unless it is selling its portfolio wholesale, this means little in comparison to the cash flow thrown off by the portfolio.
- HR shares have moved down with the group lately as worries about interest rate increases push down share prices. Despite that, our lowered estimates results in valuation that still is outside of where we feel comfortable holding the shares.
- With all of that in mind, our rating on HR remains Underperform on price/valuation. While the share price has come down a bit, we believe dilution from asset sales is likely to continue to hold back growth in the near term. And while asset sales are indicating an increase in NAV, the negative dilution is more important to us. Valuation remains above the peer group, and with earnings growth stalled near term we do not see any reason to wish to add the stock currently. As a result, we continue to believe there are better places in the group to invest, thus our continued Underperform rating on HR shares.

Note Important Disclosures on Page 5-6.
Note Analyst Certification on Pages 5.

Conference Call Discussion

Management continued to emphasize its development activity. The three active development and redevelopment projects that are being worked on are currently 66% pre-leased. Management anticipates that its Denver development property will be over 45%-leased when opened in the current quarter. The company also anticipates continuing work on its Seattle development, which is expected to approach 80% leased when it opens near the end of the year. The total development pipeline is $250 million, which should be completed over the coming 2-3 years. Management anticipates that this activity will provide returns that are 100-200 basis points higher than acquisitions, while increasing its tenant relationships.

In looking at HR's acquisition activity beyond Q1, management noted that they had three properties under contract for $68 million with a first year yield of 5.3%, the lowest we have seen for the company. They also expect to continue to re-position the portfolio by selling properties not fitting with the company's long-term strategy repositioning the capital raised into new assets. The problem with this strategy is that the yield on the assets sold has been exceeding 7%, so the impact of the "swap" is initially rather dilutive. While it may position HR's portfolio for long-term growth, in the near term cash flow is very likely to fall on the swap of assets. Of course, we are also worried about the long-term impact of purchases at very low yields when rates rise.

Management also discussed the new health care bill that passed the House this afternoon. They do not anticipate any negative impact on their properties, as they anticipate a watered-down version of the bill to come from the Senate with most positive Affordable Care Act policies remaining.

In looking at operational trends, management noted same store NOI growth of 4.4%, lower sequentially. Cash leasing spreads were up 4.5%, while same store occupancy rose to 89.1% from 88.6%. The retention rate for the quarter was 79.2%. For the year, guidance on retention rate is 75-90%, NOI growth of 4.5-6.0% on its multi-tenant properties, and a yield on new investments of 5.25%-6.0%, yield on divestitures of 7.5-8.5% and of 6.75%-8.0% on development. This shows the dilutive impact of the sales. Management expects a penny a quarter of dilution from the assets sold in Q1 and another penny a quarter from the remaining asset sales. This is the major factor behind our reduction in estimates.

2nd Quarter and 2017 Outlook

With the first quarter result two cents below our expectations and looking at the additional dilution that is likely from the asset sales the company is projecting, we are lowering our estimate for HR's full year FFO to $1.64 a share. Our Q2 estimate is $0.41 a share. The FY17 consensus estimate is currently $1.67 a share, although we expect that number to come down with the Q1 miss. We are now assuming a net level of acquisitions (net of divestitures) and investment of just over $100 million for the remainder of 2017, with much of that being from development activity. We are also assuming the cap rate environment remains the same. Note that if the timing of reinvestment is pushed out we could be high. We are fine-tuning our 2018 FFO estimate to $1.75 a share, below the consensus estimate of $1.76 assuming a similar amount of acquisitions, although most of the positive impact is expected to come from development properties.

Valuation and Rating

Using our $1.64 a share estimate for 2017, HR shares are trading at 19.3 times current year's FFO. This is a premium to the company's peer group, as shown in the table on page 3. As such, we do not believe that HR is attractive on a pure valuation basis, especially in light of below group dividend growth and earnings growth that it is largely in line with its peers. While HR's property mix is among the most sought after by investors and acquirers at the current time with its low level of government reimbursement and lack of exposure to skilled nursing, we believe that is more than reflected in the current asset value with cap rates sitting near all-time lows. We note that all of the large healthcare REITs are touting their lack of exposure and the downward trend in exposure to government payment risk. However, we are very worried about what happens to the cap rate environment when interest rates eventually rise and when the property group goes out of favor. The current cap rate environment seems unsustainable in the long term, in our opinion.

As a result of these issues, in our view HR shares are yet to become attractive, all things considered, due to the extended valuation. Thus our rating remains Underperform.

Health Care REITs	Symbol	Closing Price 5/3/2017	Current Dividend	Yield	2017E Payout Ratio	2017E	2018E	2-Year Average Growth Rate	Price / FFO 2017E	Price / FFO 2018E
Welltower, Inc.	HCN	$69.81	$3.48	5.0%	80.2%	$4.34	$4.57	0.2%	16.1x	15.3x
National Health Investors	NHI	$72.18	$3.80	5.3%	73.1%	$5.20	$5.40	5.3%	13.9x	13.4x
Physician's Realty Trust	DOC	$19.03	$0.90	4.7%	73.8%	$1.22	$1.32	16.1%	15.6x	14.4x
HCP, Inc.	HCP	$30.53	$1.48	4.8%	74.4%	$1.99	$2.07	-13.1%	15.3x	14.7x
Ventas, Inc.	VTR	$62.79	$2.92	4.7%	68.9%	$4.24	$4.44	3.7%	14.8x	14.1x
LTC Properties, Inc.	LTC	$46.95	$2.28	4.9%	72.8%	$3.13	$3.29	3.7%	15.0x	14.3x
Health Care Sector Average		**$50.87**	**$2.52**	**4.9%**	**70.7%**	**$3.40**	**$3.56**	**1.5%**	**15.0x**	**14.3x**
Healthcare Realty	HR	$31.70	$1.20	3.8%	68.6%	$1.64	$1.75	3.6%	19.3x	18.1x

Note: DOC is rated Long-term Buy, NHI, VTR and HCP Neutral and HCN and LTC Underperform by Hilliard Lyons. Source: NAREIT, Baseline and Hilliard Lyons' estimates.

Suitability

HR has a suitability rating of 2 on our 1-4 scale, which we pushed up from 3 due to the recent equity offering. We find the company to have a strong balance sheet, and its tenant base is very diversified with a number of small tenants, as well as larger, credit tenants. Its lease rolls are also solid, with leases rolling off over an extended period of time. Its real estate ownership is also a positive factor, as is the company's geographic and operator diversification. On the other hand, the company is focused on a single asset class, albeit one that is relatively well thought of by investors currently. This reliance on medical office buildings could also be an issue if changes arise in doctor reimbursement.

Risks

There are a number of risks in owning HR shares and REITs as an investment group. REITs in general need access to debt capital to grow, if such debt capital is unavailable, the company may have difficulty in growing. The company's dividend is attractive to shareholders and REITs in general could see their prices decline if rates rise, as investors switch to lower risk, higher yielding bonds, potentially hurting HR's share price. Because of their thirst for debt, changes in interest rates can also impact a REIT's cash flow and ability to make accretive acquisitions. HR's current capital structure and falling cash flow may limit its ability to make larger acquisitions. It is always possible that the company could make a poor acquisition in the future. HR's geographic exposure to Texas might be an issue should energy prices collapse. The company's construction business, while small, does create some additional issues versus those REITs that just own and lease properties.

Annual yield is calculated by dividing the distribution amount by the current market price of the security. For US income tax purposes, the Company may classify all or a portion of its distributions as dividends or other non-dividend distributions. Note that for some investors, for US income tax purposes all or a portion of the Company's 2016 dividend or distribution was treated as return of capital and not as "dividend income" as reflected on the IRS Form 1099-Div for the 2016 tax year. The Company generally makes a final determination regarding the proper tax treatment of distributions after calendar year end. We urge each shareholder to consult with his or her own tax advisor to determine the tax consequences of the distributions received, including any state, local or foreign tax considerations.

Table 1. Consolidated Income Statement
In Thousands

	2014	2015			2016					2017E					2018E		
	Year	Year	Q1	Q2	Q3	Q4	Year	Q1A	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Master Lease Rent		$0					$0					$0					$0
Property Operating/Rental Income	$365,006	$383,333	$98,740	$101,472	$102,534	$104,736	$407,482	$104,088	$105,660	$108,712	$111,063	$429,523	$111,920	$114,265	$116,517	$118,569	$461,271
Straight Line Rent	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Mortgage Interest	$3,666	$91	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Other	$5,669	$5,047	$1,281	$1,170	$1,125	$573	$4,149	$481	$488	$502	$513	$1,985	$517	$528	$538	$548	$2,132
	$374,341	$388,471	$100,021	$102,642	$103,659	$105,309	$411,631	$104,569	$106,149	$109,214	$111,576	$431,508	$112,437	$114,793	$117,055	$119,117	$463,403
Expenses																	
General & Administrative	$22,824	$26,925	$10,246	$8,129	$8,724	$8,707	$35,806	$9,280	$8,067	$8,846	$9,317	$35,510	$10,400	$8,323	$9,130	$9,648	$37,502
Property operating expense	135,631	140,195	35,406	36,263	37,504	37,285	146,458	37,834	37,245	38,756	38,972	152,807	38,612	39,764	41,363	41,321	161,061
Other Operating	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Impairments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Bad Debt Expense, net	31	(201)	(39)	78	(47)	(13)	(21)	66	-	-	-	66	-	-	-	-	-
Interest Expense, net	71,903	65,442	14,852	14,722	13,636	13,839	57,049	14,159	13,989	14,281	14,519	56,948	14,928	15,512	15,959	16,381	62,780
Amortization	10,820	10,083	2,700	2,762	2,712	3,033	11,207	3,040	2,800	2,800	2,800	11,440	2,800	2,800	2,800	2,800	11,200
Other	-	9	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation	100,586	106,529	27,693	28,528	29,273	30,989	116,483	31,412	30,463	30,849	31,191	123,914	30,514	30,954	31,372	31,746	124,587
Total Expenses	$341,795	$348,982	$90,858	$90,482	$91,802	$93,840	$366,982	$95,791	$92,564	$95,533	$96,798	$380,686	$97,255	$97,353	$100,625	$101,897	$397,130
Income from Operations	$32,546	$39,489	$9,163	$12,160	$11,857	$11,469	$44,649	$8,778	$13,585	$13,681	$14,778	$50,822	$15,182	$17,441	$16,430	$17,220	$66,273
Minority interests	($313)	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Other income/loss	$0	$78	$0	$0	$0	$74	$74	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Oper. Income from discontinued opers.	$629	$16,276	($7)	($12)	($23)	$40,894	$40,852	$0	$50	$50	$50	$150	$50	$50	$50	$50	$200
Income taxes	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Impairments	($3,105)	($37,094)	$0	($4)	$0	$0	($4)	($323)	$0	$0	$0	$0	$0	$0	$0	$0	$0
(Loss)/Gain on sale of assets	$2,130	$50,687	$0	$1	$0	$0	$1	$23,390	$0	$0	$0	$23,390	$0	$0	$0	$0	$0
Income Bef. Preferred div	$31,887	$69,436	$9,156	$12,145	$11,834	$52,437	$85,572	$31,845	$13,635	$13,731	$14,828	$74,362	$15,232	$17,491	$16,480	$17,270	$66,473
Preferred dividends	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Net Income for common	$31,887	$69,436	$9,156	$12,145	$11,834	$52,437	$85,572	$31,845	$13,635	$13,731	$14,828	$74,362	$15,232	$17,491	$16,480	$17,270	$66,473
Per share bef. Extra	$0.33	$0.70	$0.09	$0.12	$0.10	$0.45	$0.78	$0.28	$0.12	$0.12	$0.13	$0.64	$0.13	$0.15	$0.14	$0.15	$0.57
Extraordinary item	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Net (loss) income per share	$0.33	$0.70	$0.09	$0.12	$0.10	$0.45	$0.78	$0.28	$0.12	$0.12	$0.13	$0.64	$0.13	$0.15	$0.14	$0.15	$0.57
Quarterly dividend rate	$1.20	$1.20	$0.30	$0.30	$0.30	$0.30	$1.20	$0.30	$0.30	$0.30	$0.30	$1.20	$0.30	$0.30	$0.30	$0.30	$1.20
Shs Outstanding (diluted)	96,744,500	99,888,250	102,165,000	104,770,000	115,052,000	115,408,000	109,348,750	115,507,000	115,819,500	116,136,960	117,104,702	116,142,041	117,314,380	117,524,057	117,749,864	117,975,670	117,640,993

Table 5. Funds From Operations Calculation
In Thousands

					2016					2017E					2018E		
	Year	Year	Q1	Q2	Q3	Q4	Year	Q1A	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Net income for common shareholders	$31,887	$69,436	$9,156	$12,145	$11,834	$52,437	$85,572	$31,845	$13,635	$13,731	$14,828	$74,362	$15,232	$17,491	$16,480	$17,270	$66,473
Add Back:																	
Depreciation	108,859	114,533	30,800	31,716	32,557	34,699	129,772	35,555	34,244	34,642	34,993	139,434	34,297	34,750	35,180	35,565	139,793
JV Adjustment	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other	$1,235	$41,871	$0	$229	$0	$0	$229	$915	$0	$0	$0	$0	$0	$0	$0	$0	$0
Non-recurring																	
Deduct:																	
Gain/loss on sales of real estate	($666)	($65,863)	$1,707	($1)	$730	($40,001)	($37,565)	($23,390)	$0	$0	$0	($23,390)	$0	$0	$0	$0	$0
FFO Available for common	$141,315	$159,977	$41,663	$44,089	$45,121	$47,135	$178,008	$44,925	$47,878	$48,373	$49,821	$190,406	$49,529	$52,241	$51,660	$52,836	$206,266
Diluted FFO available for common	$141,315	$159,977	$41,663	$44,089	$45,121	$47,135	$178,008	$44,925	$47,878	$48,373	$49,821	$190,998	$49,529	$52,241	$51,660	$52,836	$206,266
Basic FFO per share	$1.46	$1.61	$0.41	$0.42	$0.39	$0.41	$1.63	$0.39	$0.41	$0.42	$0.43	$1.64	$0.42	$0.45	$0.44	$0.45	$1.76
Diluted FFO per share	$1.46	$1.60	$0.41	$0.42	$0.39	$0.41	$1.63	$0.39	$0.41	$0.42	$0.43	$1.64	$0.42	$0.44	$0.44	$0.45	$1.75
Shares, basic	96,505,000	99,538,250	101,815,000	104,420,000	114,702,000	115,058,000	108,998,750	115,157,000	115,469,500	115,786,960	116,754,702	115,792,041	116,964,380	117,174,057	117,399,864	117,625,670	117,290,993
Shares, diluted	96,855,000	99,888,250	102,165,000	104,770,000	115,052,000	115,408,000	109,348,750	115,507,000	115,819,500	116,136,960	117,104,702	116,142,041	117,314,380	117,524,057	117,749,864	117,975,670	117,640,993

Table 6. Funds Available for Distribution Calculation

FFO Available for common	$141,315	$159,977	$41,663	$44,089	$45,121	$47,135	$178,008	$44,925	$47,878	$48,373	$49,821	$190,406	$49,529	$52,241	$51,660	$52,836	$206,266
Less:																	
Recurring real estate CAPX	($12,900)	($13,900)	($2,950)	($3,000)	($3,050)	($3,075)	($12,075)	($2,950)	($3,000)	($3,050)	($3,075)	($12,075)	($2,950)	($3,000)	($3,050)	($3,075)	($12,075)
Debt adjustments	$0	($4,750)	($1,200)	($1,200)	($1,200)	($1,150)	($4,750)	($1,200)	($1,200)	($1,200)	($1,150)	($4,750)	($1,200)	($1,200)	($1,200)	($1,150)	($4,750)
Other	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Funds available for distribution	$128,415	$141,327	$37,513	$39,889	$40,871	$42,910	$161,183	$40,775	$43,678	$44,123	$45,596	$173,581	$45,379	$48,041	$47,410	$48,611	$189,441
Per share	$1.33	$1.42	$0.37	$0.38	$0.36	$0.37	$1.48	$0.35	$0.38	$0.38	$0.39	$1.50	$0.39	$0.41	$0.40	$0.41	$1.62

Source: Company reports and Hilliard Lyons estimates

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 base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	36	30%	14%	86%
Hold/Neutral	71	58%	6%	94%
Sell	15	12%	7%	93%

As of 5 April 2017

Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

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