HILLIARD LYONS

Healthcare Real Estate Investment Trusts
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COMPANY UPDATE/ESTIMATE CHANGE

Key Metrics

OHI - NYSE - as of 10/30/17		$30.97
1 Year Price Target		$ 38.00
52-Week Range	$28.11 -	$35.14
Shares Outstanding (mm)		197.4
Market Cap. ($mm)		$6,113.5
1-Mo. Average Daily Volume		1,062,000
Institutional Ownership		85.0%
Debt/Total Capital Sep-17		41.2%
Est 3-year FFO Growth Rate		6.0%
Est 3-year Dividend Growth Rate		6.0%
Book Value		$ 21.40
Dividend		$ 2.60
Dividend Yield		8.40%
Est. Fixed Charge Coverage		4.3 X

FFO Per share

	2016	Prior 2017E	Current 2017E		Prior 2018E	Current 2018E
1Q	$0.83	--	$0.86	A	$0.88	$0.88
2Q	$0.87	--	$0.87	A	$0.89	$0.89
3Q	$0.83	--	$0.79	A	$0.90	$0.90
4Q	$0.88	$0.89	$0.89		$0.93	$0.93
Year	$3.41	$3.47	$3.40	*	$3.61	$3.61
P/E	9.1x		9.1x			8.6x

*-May not add up due to rounding, not restated.

Revenue ($mm)

	2016	Prior 2017E	Current 2017E		Prior 2018E	Current 2018E
1Q	$212.9	--	$231.7	A	$249.5	$249.5
2Q	$228.8	--	$235.8	A	$253.7	$253.7
3Q	$224.6	--	$219.6	A	$258.2	$258.2
4Q	$234.5	$247.5	$247.5		$266.6	$266.6
Year	$902.8	$956.2	$934.6		$1,028.0	$1,028.0

Company Description: *Omega Healthcare Investors, headquartered in Hunt Valley, MD, is a real estate investment trust (REIT) that has investments in healthcare facilities, specifically long term care facilities, located throughout the country and in the UK, mainly skilled nursing facilities, although the company also owns a small number of assisted living facilities and specialty hospitals.*

Omega Healthcare Investors, Inc.

OHI -- NYSE – Buy-2

Q3 Earnings Update

Investment Highlights

- OHI reported Q3 normalized FFO of $0.79 a share, compared to $0.83 a share normalized in the year earlier period, our estimate of $0.86 and compared to the consensus of $0.85 a share. The shortfall was a function of a problem tenant, discussed below.
- OHI shares have been relatively weak so far in 2017, as expectations for rising rates and worries about several underperforming tenants have kept the shares in a trading range so far in 2017.
- OHI took a nearly $200 million writedown on a property portfolio with a tenant that is encountering difficulties. Management anticipates leasing the bulk of these properties to new tenants, although sees the lease rent on the portfolio as a whole declining to $32 million-$38 million from the current contractual rent of $46 million. However, as we have noted many times before, OHI is the landlord and not the operator. They still own the properties even though the rents received will likely be reduced as the company finds a new tenant for the problem properties. OHI shares remain solidly below our $38 a share 1 year price target, which is based on a multiple of 10.5 times our projection for 2018 FFO, a solid discount to the peer group, and below historic norms. However, in light of the likelihood of a change based on the above, we mayneed to update our numbers, although we will wait until the company's 10AM conference call and a discussion with management before making a call on any change to our estimate/target price.
- In light of the current interest rate environment, OHI's 8.4% yield on its just increased dividend looks attractive sitting almost three percentage points above the peer group. We note the strong dividend increase history, with the payout now being raised for 21 consecutive quarters. While the likely decline in cash flow will need to be factored into our thesis, we remain positive at this point given the still good dividend coverage even after the cash flow reduction.

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

Third Quarter Review

Total revenue was $219.6 million versus $224.6 million, a 2.2% decline, which was driven almost entirely by a near elimination of direct financing lease income. This was the result of the tenant issue noted above and the fact that the tenant is no longer paying its rent. Rental income of $194.1 million was up 4.4% (please see income statement on page 3), mainly a function of recent investment activity, aided by normal rent increases. Mortgage interest income was up 5.8% to $16.9 million from $16.0 million. Income from direct financing leases was only $0.6 million from $16.0 million in the year earlier period.

General and administrative expense was off 12.2% to $7.7 million from $8.8 million. Interest expense increased 5.0%, due to the acquisition activity and stood at $49.6 million. Depreciation expense rose 5.3% to $71.9 million versus $68.3 million, with a higher property base. The company also recognized non-recurring expenses during the quarter. The company recognized $212.5 million in various impairment charges this year versus $17.3 million in the year ago quarter. The company also recognized no acquisition costs in the current quarter versus $2.3 million last year. Third quarter net loss available to common shareholders was ($131.7 million) versus income of $78.5 million, driven by the charges. The per share net loss this quarter was ($0.67) versus income of $0.40 on 1.3% more common shares outstanding in this year's Q3.

Ongoing funds from operations (FFO) on a normalized basis, which exclude real estate gains as well as other non-recurring and non-cash items, were $163.6 million compared to $169.9 million in last year's third quarter, a 3.7% decline. FFO per diluted share were $0.79 versus $0.83.

Total debt stood at $4.44 billion (please see balance sheet on page 4) at quarter end, up from $4.37 billion at the end of 2016. The company's debt to capital ratio was 41.2% at quarter end up since yearend as a result of a share price decline. OHI has no meaningful debt coming due until its line of credit matures in 2019, including the one-year extension option. We expect no liquidity issues for OHI, as it has been very pro-active in taking care of its maturities.

Other 3rd Quarter Activity

Investment/Capital Markets Activity – OHI reported a variety of new investment activity in Q3, with a total of just over $200 million in new investments. Investments included $190 million for the purchase of 15 skilled nursing facilities encompassing 2,074 beds from two unrelated parties, which were then leased to an existing operator and added to the operator's master lease. The properties are located in Indiana and offer an initial cash yield of 9.5%, while offering 2.5% annual escalators. OHI also entered into a $9.4 million loan with the same operator to purchase the leasehold interest in a 135 bed SNF with a five year term and initial interest rate of 12% with 2.5% annual escalators. Management also noted that it invested $36 million in capital renovation and construction-in-progress projects. OHI also sold four properties for $11.5 million at a slight gain.

Dividend – Following an elimination of the dividend for a period stretching from 2001 through the latter part of 2003, OHI has instituted consistent dividend increases. In fact, OHI has raised the dividend 21 straight quarters over the past 5-plus years. In 2011 alone, the quarterly rate per share was increased to $0.38 (from $0.37) in the second quarter, and then to $0.40 for the third quarter payment. OHI then increased the payment for the first quarter of 2012 by another penny to $0.41 a share and another penny with the Q2 payment to $0.42 a share and two cents more in the fourth quarter, raising the payment to $1.76 annually. Then in 2013, 2014, 2015 and 2016 the company increased the dividend in each quarter, ending with an annual payment of $2.44 a share and then made another bump up early this year for the first quarter pushing the payment to $2.48 a share, another for the second quarter with its payment going to $2.52 a share, another for Q3 pushing the payment to $2.56 a share, and earlier this month, another increasing the number to $2.60 a share annually.

Quarterly Income Statement

(in thousands)	3Q 2017	3Q 2016	% Change
Rental Income	$194,063	$185,837	4.4%
Other Investment Income	$7,245	$7,194	0.7%
Miscellaneous	$796	$0	
Income from Direct Financing Leases	$614	$15,611	-96.1%
Mortgage Interest Income	16,920	15,996	5.8%
Total Revenue	219,638	224,638	-2.2%
General & Admin	7,688	8,755	-12.2%
Legal expense	0	0	0.0%
Restricted Stock Expense	3,872	3,673	5.4%
Acquisition Costs	0	2,309	
Provision for Uncollectables	11,899	-3	
Impairments	212,496	17,275	
Nursing Home Expense for Owned and Operated	0	0	
EBITDA	-16,317	192,629	
Interest Expense	49,607	47,237	5.0%
Depreciation Expense	71,925	68,316	5.3%
Income (Loss) Before Discontinued Operations and Other Items	(137,849)	77,076	
Discontinued Operations (including gain on sale of assets)	788	5,139	
Income Taxes	(999)	(81)	
Investment interest and other	0	0	
Non-controlling interest	6,382	(3,585)	
Net Income (Loss)	($131,678)	$78,549	
Net EPS (diluted)	($0.67)	$0.40	
Avg. Shares Outstanding (diluted)	206,662	204,078	1.3%

Funds From Operations	3Q 2017	3Q 2016	
Net Income	($137,515)	$82,134	-267.4%
Depreciation Expense	73,582	68,316	7.7%
Other (adding/substracting one-time items)	227,574	19,482	
Normalized Funds From Operations	**$163,641**	**$169,932**	-3.7%
Normalized FFO Per Share (diluted)	**$0.79**	**$0.83**	-4.8%

Source: Company reports.

Consolidated Balance Sheet

(in thousands)	September 30, 2017	December 31, 2016
Real Estate Assets		
Land and Buildings	$7,977,043	$7,566,358
Less: accumulated depreciation	$ (1,432,154)	$ (1,240,336)
Total Net Real Estate Investments	6,544,889	6,326,022
Cash and Cash Equivalents	24,318	93,687
Net Investment in Direct Financing Leases	364,997	601,938
Mortgage notes receivable	666,606	639,343
Accounts Receivable	269,746	240,035
Other Investments	273,821	256,846
Goodwill	644,571	643,474
Restricted Cash	10,596	13,589
Real estate held for sale	17,324	52,868
Other assets	73,778	81,458
Total Assets	**$8,890,646**	**$8,949,260**
Bank Borrowings	$365,000	$190,000
Mortgage Loan payable	53,419	54,365
Unsecured Borrowings	4,226,109	4,122,489
Real Estate Purchase Liability	0	0
Bond payable	0	0
Accounts payable and accrued expenses	285,690	360,514
Dividends payable	0	0
Other	17,589	9,906
Total Liabilities	**$4,947,807**	**$4,737,274**
Preferred stock	-	-
Common Stock	19,806	19,614
Capital in Excess of Par Value	4,925,908	4,861,408
Cumulative Net Income	1,776,956	1,738,937
Cumulative Dividends	(3,080,999)	(2,707,387)
Other	301,168	299,414
Total Shareholders' Equity	**3,942,839**	**4,211,986**
Total Liabilities and Shareholders' Equity	**$8,890,646**	**$8,949,260**

Balance Sheet Ratio Analysis	September 30, 2017	December 31, 2016
Net R/E Investments / Total Debt	71.0%	69.0%
Debt to Equity	117.8%	103.7%
Debt as % of Total Assets	52.2%	48.8%
Shareholders' Equity as % of Total Assets	44.3%	47.1%

Source: Company reports.

First Take

The third quarter results were short of our expectations, solely due to the loss of the rent from the problem tenant discussed earlier in the report. Were the company to have received the contractual rent from those leases, we estimate that the company would have reported just over $0.86 a share, equal to our estimate and a penny above consensus. However, the company did not receive this income, so we need to look at what is likely to occur when OHI management eventually finds new tenants, something that is estimated to take about six months. As such, we will likely see FFO along the lines of what we experienced in Q3 for Q4 and in Q1 2018. We will need to adjust our numbers down to account for this. If we assume that management receives the low end of what they have guided, that would result in a loss of about $0.02 a share per quarter or about eight cents annually. We do not see this as enough to impact the potential for the current dividend payment, or for that fact for ongoing increases, at least in the near term.

The investments made during the quarter should result in an incremental level of accretion going forward with the low cost of capital and high yield received. These investments, combined with future ones, and rent increases should largely offset the negative impact of the cash flow loss discussed above. We will be paying close attention to what management says in relation to other tenants to see if there are likely to be additional similar situations. We believe there will be some, the real question at this point is to what degree. Most of the company's tenants seem to be in good shape, but management noted that labor costs were up 6%, while revenue was up only 2% for the problem tenant. Management adjusted its FFO guidance to $3.27 to $3.28 a share to account for the loss of rent discussed earlier. Given the shortfall in Q3, this actually looks to be a reasonable number. We are well above this range at $3.47 a share, and will obviously need to adjust our numbers in light of the issues. However, we wait to hear from management and update our models before making a final call on how to adjust that number.

The tenant issue the company has encountered in Q3 is obviously a concern, although the impact is, we believe relatively modest and should quickly be overcome by investments and development. What we will be pressing management on is whether there are other similar issues in its portfolio (beyond the other which we are aware of) and if other operators are seeing labor cost pressure that might force similar issues. We will also be looking at the forward investment environment, which may very well improve in light of these issues, and adjust our estimates accordingly. There appears to be no issues with the company's capital structure at this point, as the company has stretched out its maturities to a point where it has no appreciable debt due for more than four years and has added debt capacity. The additional investment made during the quarter is likely to more than offset any divestitures as the company fine-tunes its portfolio ridding it of non-core assets. Management's new guidance is going to force us to lower our numbers, but the question is really what that means to our 2018 and 2019 numbers, which are certainly likely to come down a bit in light of the lower rent likely to be secured when OHI re-tenants these problem properties. On the good side is the manageable impact to the entire portfolio expected here even in what is really a worst case scenario. Of course the risk here is if this is not a tenant specific issue, but something that is likely to impact the entire portfolio, something we will be quizzing management on during the conference call.

In summary, while it is tough to sugarcoat losing a tenant, this instance really illustrates why you want to own the real estate, rather than operate the properties. The tenant, is basically going out of business, while OHI keeps the properties, and gains a more secure tenant, albeit at a lower return on investment. In this light, we remain positive on the name and believe that if we do see a decline on these numbers, it could offer a buying opportunity. We are holding to our price target at this point, although we will be looking at the numbers after the conference call. We will also wait until after the company's 10 AM conference call to look at our 2018 numbers. We also may need to re-think our suitability rating in light of the increased risk.

Suitability

OHI has a suitability rating of 2 on our 1-4 scale. We find the company to have a very strong balance sheet in relation to its peers, and the triple net structure of most of its leases limit its property risk. Its real estate ownership is also a positive factor, as is the company's geographic and operator diversification, with the largest portfolio of skilled nursing properties in the industry. On the other hand, the company is highly exposed to the skilled nursing sector, with the bulk of its operator revenue paid by Medicare and Medicaid adding risk due to potential political issues.

Risks

There are a number of risks in owning OHI shares and REITs as an investment group. REITs in general need access to debt capital to grow, and if such debt capital is unavailable, the company may have difficulty in growing. The company's dividend is very attractive to shareholders and OHI, as well as REITs in general, have seen their prices rise with the decline in overall interest rates. Should rates rise, that could hurt OHI'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. OHI's dependence upon the long-term care sector of the health care real estate group could create issues due to government payments being the de-facto source for much of its rent. With reimbursements cut, as the Center for Medicare and Medicaid Services reduction illustrates, there will be a negative impact on its tenant base, which in turn could have a negative impact on OHI. It is always possible that the company could make a poor acquisition in the future or not realize synergies from prior acquisitions. OHI's geographic exposure to Florida might be an issue if the state has further economic problems and is forced to cut reimbursements to providers claiming Medicaid payments.

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.

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.

The author of this report or members of his family has a long common equity position in Omega Healthcare but may not trade the share contrary to Hilliard Lyons' rating.

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	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 2017

Other Disclosures

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