Senior Living

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FINANCIAL NEWS AND GROWTH STRATEGIES FOR PROVIDERS AND SUPPLIERS IN THE NOT-FOR-PROFIT SECTOR

IN THIS ISSUE

LET'S TALK FANNIE MAE AND FREDDIE MAC...

What's The Impact On Senior Housing? A Credit Crisis Worsening?

Rest assured, **Fannie Mae** and **Freddie Mac** are still open for business on seniors housing deals, albeit with higher spreads and more caution. Their senior housing portfolios remain very strong with no defaults. "We've been given no capital allocation or slowdown direction at all," said Steven Schmidt, Director of Seniors Housing at Freddie Mac, "and we haven't slowed down our appetite for seniors housing projects. The multifamily business is very profitable and doing very well. As the bid-ask spreads have widened, however, it is more costly to finance a project. Buyers are looking for lower prices and/or looking for too much of a discount, and sellers haven't quite adjusted to the new reality."

But the bulk of Fannie Mae and Freddie Mac financing for seniors housing projects is on the for-profit side of the industry, with a small percentage for targeted affordable business on the not-for-profit side. So the financial difficulties — and government rescue — of these two mortgage giants are likely to have little *direct* impact on not-for-profit senior care credit. That's good news.

The involvement of Fannie Mae and Freddie Mac in not-for-profit seniors housing financing is "de minimus — and always has been," confirmed Dan Hermann, Managing Director and Head of Senior Living Finance at **Ziegler**, for the simple

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PACE PROGRAMS ADDRESS BOTH MISSION & MARGIN

On Lok In San Francisco, The First PACE Center, Expanding Again

The **On Lok Senior Health Center** in San Francisco opened back in the early 1970s in response to a local need — and that move, in a sense, redefined quality senior health care. At the time, the mostly low-income Chinese, Italian, Korean and Filipino seniors who had lived in the city's Chinatown and North Beach neighborhoods for most of their lives had few alternatives other than entering a traditional nursing home — usually outside the local community and absent of any cultural ties — when they became old and frail. Armed with a fresh idea, some common sense and an initial grant from **The San Francisco Foundation**, On Lok opened the first community-based senior health center that combined clinical services, recreational activities and a social environment, as well as transportation to and from the facility, in an organized way. On Lok now operates seven such centers in San Francisco and one in nearby Fremont.

Last month, **Cain Brothers** structured a $22,710,000 bond offering for **On Lok Senior Health Services**,

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Q&A: Dan Gray, President, Continuum Development Services

*Dan H. Gray is president of **Continuum Development Services**, a consulting company in Chattanooga, Tennessee that offers operational, financial and strategic services to senior health and housing organizations. A licensed nursing home administrator since 1980, Gray has always worked with senior aging services and almost exclusively in not-for-profit organizations. Before starting his consulting service in 1988, he was with **Alexian Brothers Health System** of Chicago for about 17 years. We spoke with Gray about the attributes and challenges of different types of senior care, specifically CCRCs vs. home- or community-based care, and how thinking creatively about these models may help us get through some very challenging times for serving seniors over the next 30-40 years. He will discuss this topic further at The Aging Revolution Summit II, sponsored by **Wesley Enhanced Living Foundation**, in Philadelphia on September 25.*

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How can we deal with the pending aging revolution?
Many solutions will be dependent upon being able to serve people where they're living now. We're not going to be able to create new housing for all the frail seniors that will exist in 2030 and 2040, so we have to come up with programs that allow people to maintain their current housing. And the government is doing a poor job of caring for this population. The 6.8 million dual eligibles that exist today amount to 9% of all **Medicare** and **Medicaid** participants but 32% of the cost — almost a factor of four. Some of the most creative solutions that deal with the future aging population will be ones that allow seniors to continue to live in their community. LifeCare Without Walls programs are an approach that combines the concept of the CCRC with community-based programs such as PACE. LifeCare Without Walls models may be the only way to get us through some very challenging times for serving seniors over the next 30 to 40 years.

What are LifeCare Without Walls programs?
I started a LifeCare Without Walls program, called Alexian Brothers Live-at-Home Program, in Chattanooga. Similar to a CCRC, members join when they are well but don't move out of their own homes. Basically, it is a provider-based program that pays for services similar to long-term-care insurance. Participants pay an entry fee beginning at about $20,000 and a monthly fee ranging from $200 to $400. Both fees vary based on age. Participants receive four levels of service: wellness by design, intervention by design, assistance by design, and care by design. Care by design is triggered when they become nursing home-eligible. And that, basically, involves providing PACE services to continue to keep them in their homes. A reverse mortgage is sometimes used to pay the small entry fee.

Is there any resistance to paying up front?
The Chattanooga program has about 250 participants, but one of the big issues facing us as a society is for people to be willing to pay for some of their future costs themselves. They can't depend on all services being government-paid. And we can't let people divert assets and spend down the way we have over the last 30 years in order to qualify for government funding. I believe the best solution is for people to invest in their own future care while they're still earning income. Otherwise, there won't be enough people in the workforce to pay for all those who need care in the coming decades.

What about CCRCs as part of the solution?
In general, CCRCs have a great advantage, in that they develop a comprehensive continuum of care through which residents have easy access to services — independent living, assisted living and health care — under the same roof. People move in while they're still healthy, are able to rebuild a community of friends, and then age in place within that community. But CCRCs are expensive. If we could create a poor man's CCRC, combining affordable housing and a PACE program that takes on the risk in advance for people who are (or will be) on Medicaid but not clinically eligible for services in a nursing home — then figure out a way for the individual and the government to share the cost of that future care — perhaps that might be a good solution.

What do you expect will happen to traditional nursing homes?
I believe that the need for nursing homes will reduce dramatically, just as the number of hospital days was dramatically reduced in the 1990s. We saw hospital days peak in the 1970s and drop by 40% by 2000. I expect nursing homes will experience a major drop in utilization. The willingness of people to be in institutional settings, along with the advancement of technology and the increase in home care and community-based programs, will continue to cut the market for putting people in a nursing home setting, on Medicaid, with 24-hour in-residence care.

Also, we can't build enough nursing homes for all the frail seniors that will be coming along, and we can't afford to put them all in a nursing home setting. And they don't want to go into a nursing home anyway. Alternatives like the "Green House" and other home-like assisted living and nursing care options will be utilized instead.

And the best model from your perspective?
I believe the best solution is to promote wellness and personal responsibility among seniors, while providing them the opportunity to live in their own homes or in a homelike setting, supported by a community-based program, where they can remain until the end of life.

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Recent Not-for-Profit Financings...

• ***On Lok Senior Health Services**, San Francisco, California,$22.71 million in financing structured by **Cain Brothers**, 8/08*

On Lok Senior Health Services operates seven PACE adult day centers for the low-income, frail elderly in San Francisco, along with supportive housing in some of those locations, and one PACE center in nearby Fremont. The variable-rate revenue bonds were issued through **ABAG Finance Authority for Nonprofit Corporations** with a letter of credit provided by **Wells Fargo Bank N.A.** The Series 2008 bonds were synthetically fixed through a 67% LIBOR fixed pay swap. The proceeds will by used to finance a new PACE location in San Jose, provide a replacement LOC on Series 2004 bonds, and fund future capital expenditures for existing centers.

• ***Mirabella at South Waterfront**, Portland, Oregon, $221.7 million in construction bonds underwritten by Cain Brothers, 8/08*

Mirabella at South Waterfront, a 30-story "green" CCRC, is under construction on a 1.16-acre site in Portland's sophisticated South Waterfront urban neighborhood. This is the second Mirabella CCRC for **Pacific Retirement Services**; it is being developed in affiliation with **Oregon Health and Science University**. The bonds issued by **The Hospital Facilities Authority of Multnomah County**, **Oregon**, include $212.2 million in variable-rate demand revenue bonds and $9.5 million in taxable variable-rate demand revenue bonds. The LOC is from **Bank of Scotland plc**, New York. **Herbert J. Sims & Co., Inc.** served as the senior managing underwriter, with Cain Brothers the underwriter for the issue. Mirabella at South Waterfront is expected to open in 2010.

• ***Bethel Center** in Arpin, Wisconsin, **Colonial Center** in Colby, Wisconsin, and **Karmenta Center** in Madison, Wisconsin, $12.0 million tax-exempt bond financing structured by **Red Capital Group**, 8/08*

These three skilled nursing facilities properties, owned and operated by **American Eagle LifeCare Corporation**, a 501(c)(3) organization, each have between 95 and 111 beds and are cross-collateralized and cross-defaulted through a master trust indenture. The $12 million in unrated and unenhanced tax-exempt revenue bonds issued by the **Wisconsin Health and Educational Facilities Authority** allow American Eagle LifeCare to refinance the existing high-rate senior bonds and maturing subordinate debt for the three facilities.

• ***St. Dominic Gardens**, Miami, Florida, $4.6 million refinancing insured by FHA Section 223(f) and structured by **Lancaster Pollard**, 6/08*

St. Dominic Gardens, a 27-year old affordable elderly housing facility, is one of 14 HUD-subsidized apartment complexes operated by **Catholic Housing Management** in Miami-Dade and Broward County. The five-story, 150-unit facility is located in a flood zone. During the refinancing process, environmental conditions were discovered that took more than two years to resolve. Lancaster Pollard worked closely with the organization's attorney and local agencies to address these matters and move the refinance forward. This $4.6 million refinancing of an FHA Section 202 direct loan significantly reduced the property's interest rate and provided about $1 million for immediate repairs and improvements, including reinforcing building systems, improving energy efficiency, and enhancing market appeal. In addition, $240,300 was deposited into the replacement reserve to supplement funds available for future capital needs. The owner will also receive a developer's fee, and annual debt service savings will be used to provide additional services to the residents.

• ***Plaza Place Apartments**, Parsons, Kansas, $2.2 million refinancing insured by FHA Section 223(f) and structured by Lancaster Pollard, 8/08*

Plaza Place Apartments is a 46-unit affordable housing facility in southeastern Kansas managed by **The Dalmark Group**. Prior to the refinance of an FHA Section 202 direct loan, Lancaster Pollard helped the facility define strategies that ultimately improved its ability to borrow. The firm's associates worked closely with HUD to address HUD concerns regarding the planned repairs and upgrades. Even though rent was unexpectedly cut between issuance of HUD's firm commitment and closing, Lancaster Pollard was able to quickly negotiate and receive an updated firm commitment from HUD, which minimized the reduction in funding. The refinance allows Plaza Place Apartments to perform more than $80,000 in renovations and increase the property's replacement reserve by more than $247,000, which provides funds to continue regular maintenance on the facility. ❑

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Now, a year later, it seems as if nothing has changed, with a soft market continuing to keep prices and deal activity at the lowest level in four years. Or has it? Are buyers and sellers tired of waiting, and will the deal logjam finally break in the second half of the year? Is it possible that fourth quarter M&A activity will total more than the first three quarters of the year combined? We think the answer is yes, but hear what the experts have to say on this crucial topic. Here's just some of what you'll learn in 90 minutes:

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Stephen M. Monroe (Moderator), Editor of *The SeniorCare Investor* and *The Senior Care Acquisition Report*, and Executive Editor of *Senior Living Business*

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Fannie Mae & Freddie Mac, *continued from page 1...*

reason that the not-for-profit independent living model is primarily entry-fee based CCRC. "That economic model works for not-for-profits," Hermann said, "but, historically, it has not been eligible for Fannie/Freddie financing," he said. "It was being explored, but moving at a snail's pace, in a couple of select cases. I'd be surprised if any type of progressive activity like that is even considered now." (Freddie Mac hasn't said it won't finance entry-fee projects, affirmed Schmidt, but isn't doing it to any great degree at this time.)

Frankly, Bill Pomeranz, Managing Director of **Cain Brothers** in San Francisco, doesn't know of any not-for-profit on the West Coast that has been able to get into a Fannie/Freddie program other than for service-enriched housing or as a source for low-income housing tax credits (LIHTC) — although Freddie Mac is not currently buying LIHTC either, according to Schmidt. With its figures down so much this year, Freddie has less need for tax credits. That's undoubtedly true for Fannie Mae, as well. The situation may change, however, when financials are reviewed at the end of the year.

"Fannie Mae and Freddie Mac look mostly for pure rental projects," Pomeranz continued, "and most not-for-profits don't have pure rental projects. They also haven't been involved in projects with a high percentage of nursing beds. They like to keep it strictly housing. Not-for-profit rental projects often have large nursing homes. Not-for-profit CCRCs generally have smaller nursing homes but have entry fees. I'm not aware of any entry-fee projects that Fannie or Freddie ever underwrote. So I agree that any impact of their problems will be minimal."

With the private bond insurance market "tanking," bond buyers in California are looking more and more to the underlying credit even with federal and state guarantees (such as the **Cal-Mortgage Loan Insurance** program), according to Pomeranz. "Buyers like the guarantees at this point in time," he said, "but after the collapse of the private bond insurers such as **Ambac** and **Radian**, there's some skittishness whenever a third-party guarantee is involved. So the bonds aren't trading as well as they had been historically."

As a result of banks having so much difficulty (not necessarily as a result of the Fannie/Freddie situation), Pomeranz sees a more important role for **FHA** going forward. "Bank letters of credit (LOCs) are becoming less available, so FHA will be helpful in that regard."

Possible LOC crunch

A good chunk of Ziegler's not-for-profit financing business (about $1.5 billion per year) involves entry-fee CCRCs, and a high percentage of that involves tax-exempt fixed-rate bonds and variable-rate bonds backed by LOCs from A-rated (or better) banks. "That's the main form of credit enhancement in the not-for-profit senior living market," said Hermann. "The financial market disruption that started about 16 months ago has materially impacted our LOC market; but the principal disrupters have been the financial performance of the banks themselves and their ability to lend, as well as the need to refinance the auction-rate security market with bank LOCs."

The auction-rate security market blew up as a result of the sub-prime mortgage mess. That led to numerous hospitals, universities and governments wanting to keep variable-rate debt, as opposed to refinancing with fixed. Then, according to Hermann, in order to keep variable-rate debt, they had to refinance with floating-rate debt or get a bank wrap. "That sucked up a lot of the supply of bank LOCs," he said. "So the supply of LOCs has gone down and fees have gone up — and that's also what blew up Fannie and Freddie."

Meanwhile, Bill Mulligan, Managing Director of Ziegler's Corporate Finance, Senior Living and Post-Acute Care Group, said, "We're closely watching the liquidity and the capital base of large banks to see whether they'll continue to issue LOCs at the same pace as in the past. All banks are being more cautious about putting out money, because their capital base has been eroded as a result of the sub-prime mortgage crisis."

So while the current Fannie Mae and Freddie Mac fiasco may be symptomatic of the overall credit market, Mulligan believes that the dramatic drop in their stock prices could have an *indirect* effect on not-for-profit seniors housing financing. Several large banks that provide LOC enhancements have significant holdings in the preferred stock of the two entities, and the depressed value of their investments could affect the liquidity level of those banks. That would have a ripple effect on their capital base and, in turn, on the LOC market.

"What everyone is watching with regard to Fannie and Freddie," Mulligan stressed, "is whether they'll continue

to be there as a vehicle to fill the hole for mortgages — residential, commercial or whatever — and to provide liquidity across the housing spectrum."

"Banks are more leery these days, but some are still willing to do short-term LOC enhancements with a Fannie or Freddie takeout," noted Cindy Hannon, VP-Affordable Housing at **Grandbridge Real Estate Capital** and formerly National Account Manager in Fannie Mae's Multifamily Affordable Housing Group. Grandbridge is actually doing one right now — a not-for-profit deal that **Wachovia** approved.

"Nevertheless, it has always been difficult to get a not-for-profit deal done with either Fannie or Freddie," Hannon added, "because a lot of not-for-profits generally don't have a lot of wealth on their balance sheets, although Grandbridge Real Estate Capital currently has two not-for-profit deals in process right now — organizations that hooked up with limited partners for tax-credit deals. A couple of other not-for-profit clients have relatively good cash liquidity on their balance sheets that will qualify them under the current credit standards.

"No matter who runs Fannie and Freddie, they still have to follow credit standards," she added. "They have a credit threshold and still must have a quality asset, a quality borrower. It's not like getting money from **HUD**, which has different credit requirements — and which is why a lot of not-for-profits go to FHA for their financing. FHA looks more at the actual asset — the property and the experience — rather than the individuals behind the project."

Liquidity crisis — or not

"Not much capital is available now," Hannon observed, "except in the form of bonds or tax credits. Tax credits are easy to get, but there aren't a whole lot of investors who are willing to pay top dollar for them. So the problem there is not having enough tax-credit income coming in to cover costs. I also believe that credit standards will tighten even further, so financing will continue to be difficult whether it's a for-profit, market-rate project or an affordable property. So we'll probably see very little affordable housing construction next year, whether for families or for seniors."

Of course, some developers have deep pockets and are investing their own money into their projects, finding an investor, or — if they're really lucky — finding a tax-credit syndicator who will pay 85 to 90 cents a credit. "Right now, the average price that syndicators are getting is in the very low 80s," said Hannon, "and I heard that will slip down to the low 70s by next year."

As a result, a lot of affordable senior housing providers — both for-profit and not-for-profit — are looking at rehabilitating existing properties for $10,000 or $15,000 a unit to maintain or preserve their housing. Funds, whether bonds or tax credits, are generally available to cover those costs.

"Everyone wants to paint the current climate as a liquidity crisis," said Hermann, "but they're reacting to the all-time low rates back in March 2007. Our message to our clients is that capital costs are up, but they're only at about the midpoint of the 10-year average. We're probably at the 60th percentile now. Credit quality is being rewarded across the board in terms of lower costs of capital and easier access to it, whether it's an existing organization, single or multi-site, or a new campus. We're funding a substantial amount of growth. It's not the end of the world."

Merger activity is up for challenged organizations, he concedes, but all markets experience an acceleration of affiliations and mergers in a tough economy. The not-for-profit senior living sector is no different. "But the market has not shut down," he reiterated. "It's just that a year to three years ago was an extremely fluid time."

Ziegler, of course, has a dominant market position in the not-for-profit senior living sector — nearly half the market, in fact — and also brings a national perspective to the table. "Out West, for example, we may have trouble getting an LOC because there aren't enough local banks," says Hermann, "while in Pennsylvania we're still seeing multiple competitive proposals. Most of our multi-facility clients throughout the country are in a great position, with an average occupancy rate of 94-95%. They're just having to work harder on marketing."

Schmidt confirmed that capital will continue to be available from Freddie Mac for qualified senior housing providers, although he agreed that there's definitely been a huge pullback on the part of other lenders. "That most likely relates to residential mortgage exposure in their portfolios," he said. "Multifamily has been very profitable for us, and we don't see it being anything but profitable in the future. We should have no problem having funds available." That's good news. ❑

PACE, *continued from page 1...*

part of which will be used to finance a new center in San Jose *(see details on page 4)*.

On Lok was the prototype for **Program for All-Inclusive Care for the Elderly (PACE)**, a national initiative that integrates acute and long-term senior care with respective funding streams and today boasts 46 centers in 25 states throughout the country. Nearly as many new centers are in various stages of development, including several that are opening this year. A federal grant for rural providers to develop programs in communities that don't have the population density of more urban areas is one reason for so many new openings.

PACE basics

PACE centers provide a full spectrum of adult day health-care services, from primary to acute to long-term care, for poor, elderly, frail individuals who, at the time of enrollment, meet the state's nursing home level-of-care determination and are able to live safely in their own homes with the support of PACE services. Needing assistance with at least three basic activities of daily living (ADLs) is the most common standard. About one-third of current PACE participants live totally independently, another third live with a loved one, and a third live in close proximity to a loved one or in a supportive housing environment. Basically, PACE provides five main services:

1. Intensive primary care — a full-time staff physician and nurse practitioner for every 150 people in the program.
2. An interdisciplinary team — medical practitioners, physical therapists, social workers, the day center CNA, the home-care coordinator and the transportation coordinator meet daily to keep people out of hospitals and nursing homes and in their homes, with loved ones, or otherwise connected to their community.
3. An English-style day hospital — patterned on an English model and the On Lok concept, the components include a physician clinic, a rehab center and adult day care. Participants attend three days a week, on average.
4. Home care — a CNA visits the home to help with basic activities of daily living.
5. Transportation — a van and a full-time driver is required for every 15 people in the program.

"Once a person qualifies for enrollment in the program, we take full responsibility for their health care," explained Robert Greenwood, VP of Public Affairs at the **National PACE Association (NPA)**. "And if they do have to go into a nursing home, we pay for it. Their participation in the program continues until they either disenroll or die."

Organizing the aging process and taking full responsibility for program participants are key to making the model work. "The professional and clinical incentives of the caregiving staff are perfectly in line with the financial incentives of the organization," Greenwood stressed. "There's never any thought that an individual is becoming too frail or too expensive. Since we pay for nursing home care, too, we have every incentive to invest in the person up front with preventive care so the reimbursement funds provided to PACE aren't diverted to a third party."

The average PACE participant is 80 years old. And as a testament to the program's overall success, data from a 2007 study sponsored by **The Milbank Fund** showed that 61% of PACE enrollees reported no decline in functional skills after three months and 43.3% still reported no decline by 12 months. Another interesting statistic: People over 65 have a 14% chance of dying in their own home and a 50% chance of dying in a hospital; for PACE participants, the figures are the exact opposite.

PACE centers are funded through a combination of **Medicaid** and **Medicare** reimbursements for low-income participants and some private pay premiums for those with higher income levels. "The PACE benefit includes all medically necessary long-term care and services, including prescription drugs," said Greenwood. "It's all-inclusive." Private-pay participants pay the Medicaid portion.

Setting up a PACE center

According to Dan H. Gray, president of **Continuum Development Services**, a successful PACE program manages three areas extremely well: (1) end-of-life care; (2) resources for the elder and support for the caregiver; and (3) program compliance by the participant and family members (e.g., avoiding emergency 911 calls that may lead to a stay in a non-participating hospital). Gray is currently involved in developing eight separate PACE centers and has already opened four others.

"Traditionally, PACE has been able to blur the lines between what Medicare or Medicaid pays to benefit the people we serve without worrying about who pays for what. PACE can provide whatever care will help the person remain out of a nursing home or hospital."

The cost of setting up a PACE program depends upon the organization's starting point. Some have a building available or can lease community space for $1 a year, but any space will need at least some renovation. Having a transportation system in place is a big cost saver. And the organization must have (or hire) staff physicians, nurses, therapists and aides with core competencies in delivering chronic care for a geriatric population, including primary care. The need for occupational and physical therapists is much greater in a PACE program, because there's no limit to how much therapy can be provided. Another consideration is whether other health-care providers in the community will support a PACE program and make referrals — or whether they will view it as competition.

As a managed-care organization, PACE receives a set payment for each person enrolled. Typically, it takes 80 to 100 people to meet all the fixed costs and may take up to 18 months to reach that level. Mature PACE programs with one center target 120 and 150 enrollees to stabilize inevitable attrition. So part of the startup cost must include liabilities incurred prior to break-even, which will vary depending on the number of initial enrollees. When opening with 20 enrollees instead of eight, for example, break-even occurs four months earlier and operating losses in the first year drop by $500,000, according to Gray.

A PACE program serving 300 people that costs $3 million to $5 million to set up is likely to generate the same annual revenues as a new, 400-resident CCRC that might cost $75 million or more to develop. "For a minimal investment, PACE is fairly revenue-intensive," said Gray, "in that it provides $60,000 to $65,000 per person per year in revenue from the two primary sources. The average payment from Medicaid is nearly $3,000 per person per month; from Medicare, between $2,000 and $2,200 for Parts A and B and another $500 for Part D. That's almost $6,000 per month per person." PACE is fully capitated for all hospital, nursing home, physician, therapy, and drug costs, but the centers don't have to play by the usual rules — no three-day hospital stays to access Medicare, no therapy caps, no Part D donut hole, etc.

PACE's weakness is that it's harder to address people's needs when they're spread over a large area. So far, PACE programs have all been located in metropolitan areas, because bringing people to the center is more difficult in a rural environment. The 14 rural PACE programs about to open across the country are an experiment.

PACE and housing

Most existing PACE programs look for supportive housing in their communities. "Whenever we can arrange supportive housing instead of placing a person in a nursing home, it's to the participant's benefit and the program's financial benefit," Greenwood explained. So once again, On Lok is ahead of the curve. Its original PACE center has the clinic and day center on the first floor and HUD 202 housing above. Residents pay rent, sometimes with their SSI check, for "very vanilla" studio apartments, according to Bill Pomeranz, Managing Director of Cain Brothers in San Francisco, who spearheaded On Lok's recent financing. "It's home for them and efficient for the caregivers," he said. "Once the new San Jose center is operational, housing will be built around it."

"Combining housing with PACE is the wave of the future," Pomeranz continued. "And banks really like this type of program, because of its very diversified income stream. As an indication of On Lok's strength, we got an A- rating and a 65 basis-point bank LOC for the recent financing. That's about one-third of the market cost."

Since PACE is not a "place-based" delivery system, a lot of theoretical studies have been done on how PACE and CCRCs might work together. Making space available for a PACE center, for example, could enhance the CCRC's offerings and allow residents to remain in their homes longer. The CCRC could also offer PACE services to non-residents, including low-income people who live nearby and could never afford to live on campus. "That would bring in added revenues to keep the program operating properly," Greenwood noted. "The challenge is to figure out a way to finance PACE services for middle-income people. One possibility would be for the CCRC to pre-fund PACE, making it a benefit at the end of the resident relationship. Part of the premium that well elderly pay could be set aside in anticipation of their accessing PACE benefits when they qualify for nursing home care."

Many hospice organizations and adult day centers are interested in developing PACE programs, as well. "A lot of sponsors see the limitation of being one part of a fragmented continuum," said Greenwood. "The attraction of PACE is that it is totally responsible for all the needs of the participant. And the fact that there's a revenue benefit to being a PACE provider is attractive to sponsors, too.

(Detailed information on setting up a PACE program, is available on NPA's website, www.npaonline.org.) ❑

Acquisition Market Trends

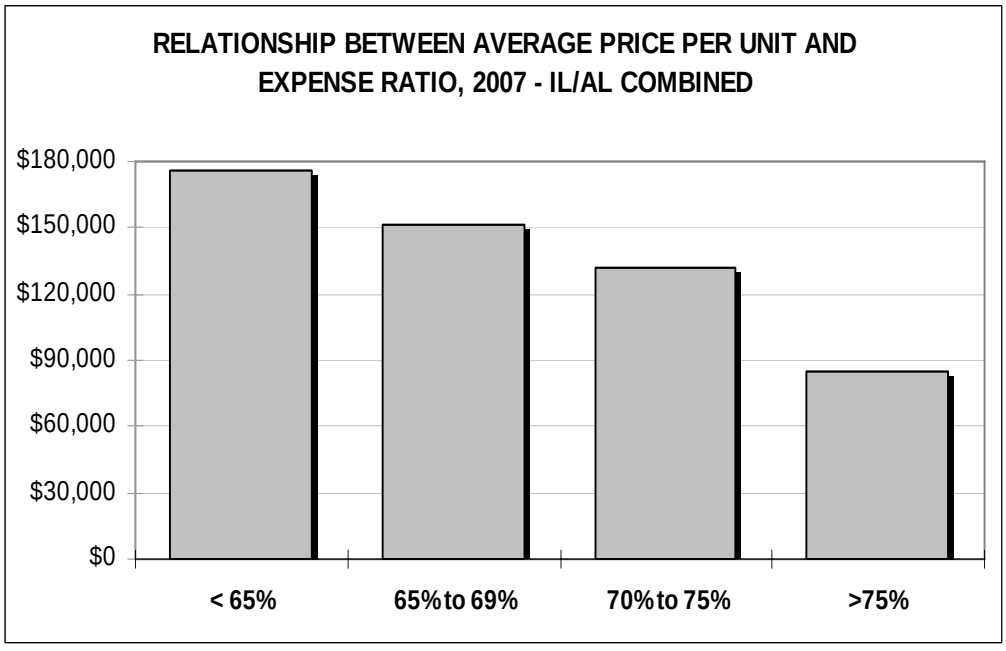
Before we get into the fifth part of our series on financial trends in the seniors housing and care acquisition market, we just returned from the 18th annual NIC Conference, which is the largest investment and finance-oriented conference dealing specifically with seniors housing and care. Prior to the conference, many attendees told us they were expecting the mood among the more than 1,600 attendees to be somewhat morose, given the state of the capital markets and the slow pace of deal-making so far during 2008. We did not think that would be the case, and we are pleased to report that the atmosphere was nearly as vibrant as past years, and the conference was sold out with a waiting list.

So, if the market and the economy are as bad as they seem from the daily news reports (which they are), why does there appear to be such optimism from the seniors housing and care crowd? The easy answer is that, capital availability aside, the sector is in remarkably good shape despite the recent slide in occupancy rates at many communities. The demand for the services from the aging population remains strong, there has not been a significant increase in new construction to compete with existing communities, annual rate increases remain healthy and, on the skilled nursing side of the business, providers with a heavy Medicare census breathed a sigh of relief over the summer when an expected small decrease in reimbursement going forward turned into a 3% increase (at least for now).

What was most interesting was that even though there is not a lot of money around for acquisitions, refinancings or development, all of the lenders were huddled with clients and prospective borrowers talking about capital needs and what can be delivered and at what cost. Whether a lot of this was theoretical or wishful thinking is anyone's guess, but the bottom line is that for most participants it was business as usual, albeit with the occasional glance over the shoulder to see if the other shoe had dropped yet. Perhaps with the bankruptcy filing by **Lehman Brothers** on September 15 and the unforeseen sale of **Merrill Lynch** to **Bank of America**, that shoe (or water-logged boot) has finally dropped, but the speculation is that the end is not here yet, and the pain will only intensify. For not-for-profit seniors housing providers, in addition to the cost of capital rising, a real concern will be a drop in donations as both local businesses and consumers will feel increasingly pinched in this market environment.

On that cheery note, it is time to get back to financial trends in the acquisition market. In previous months, we have talked about changes in cap rates over the years, the impact of occupancy on valuation as well as how the addition of various services and unit types to a community can enhance value, both to the provider and the customer. This month we are going to talk about expense ratios and net operating income per unit and how these operating metrics are perceived in the acquisition market.

In our annual acquisition report (*The Senior Care Acquisition Report*), for many statistics in the seniors housing sector we group together assisted and independent living communities, partly because so many of them have both IL and AL units in the same building or campus. Over the past five years, the average expense ratio for communities sold, which includes all operating expenses plus a management fee (but excludes interest, depreciation and lease payments), has been trending downward. From a high of 77% in 2003, for the past three years the average expense ratio has been between 69% and 70%, while the



median hit a low of just under 67% in 2007. As can be seen in the chart on page 10, in 2007 there was a perfect correlation between average expense ratio and the sales price per unit.

As would be expected, those facilities with a high expense ratio usually sell for a much lower price. In 2007, those communities with an expense ratio of 75% or higher sold, on average, for about one-half of the per-unit sales price of those communities with an expense ratio below 65%. For those communities with an expense ratio below 65% there was a good split between independent and assisted living properties, but most of those below 60% were independent living communities. At the opposite end, the vast majority of sales where the expense ratio was greater than 75% involved stand-alone assisted living facilities.

While watching your expense ratio is important for the overall financial health of your community, the absolute level of cash flow is what matters the most financially, whether for paying off debt or valuing your community for a possible refinancing. For example, in almost all scenarios a provider would rather have a higher expense ratio on a higher level of revenues if it meant that overall cash flow was higher, than a lower expense ratio on lower revenues. In the past three years, the average net operating income for assisted and independent living properties sold increased to about $11,000 per unit compared to about $8,000 per unit in 2003 and 2004.

Part of this was the result of an influx of higher quality communities and portfolios that became available for sale in the bull market years of 2005 through 2007, but it was also the result of providers learning how to segment their services within a community and making sure they were adequately compensated in terms of having an appropriate rate structure. The final result was that these higher cash flows per unit, combined with declining cap rates from 2004 to 2007, caused per-unit acquisition prices to soar to record levels.

As could be expected, similar results occurred in the skilled nursing sector. Those skilled nursing facilities that had an expense ratio below 90% sold for almost twice the price per bed in 2007 than those with an expense ratio of 90% or higher. In addition, one of the drivers for the record average price per bed sold in 2007 was that the average net operating income (or EBITDA) per bed hit a new high in 2007 of $6,700. We assume most of that is a result of the increased emphasis on Medicare census.

Mid-Year Acquisition Results

Since the summer of 2007, when the seniors housing acquisition market began to slow down, everyone assumed that values would decline and cap rates (EBITDA divided by purchase price) would start to rise across all sectors. The most common number discussed was that assisted and independent living cap rates had increased by at least 50 basis points, but people were not so sure about skilled nursing facility cap rates because they had not declined to nearly the extent that the rest of the market did. And if cap rates rise, with everything else equal, prices will fall.

After setting a record in 2007, average per-unit assisted living prices declined by 14% to $136,600 in the first half of 2008 according to our statistics; the median declined by 16%. It should be noted that both of these numbers were higher than the results for the full year 2006, and the median for the first half of 2008 is higher than any full year prior to 2007. The conclusion, of course, is that while there is some softness in the market relative to values, these values can't be looked at simply from the perspective of one record year (2007), but must be looked at from a broader perspective of the past several years. When that is done, the first half of 2008 looks very similar to both 2005 and

2006, and those were pretty decent years for the acquisition market. There was not enough data on independent living sales to derive meaningful statistics for the first half of 2008.

Assisted living cap rates had fallen the most of any property type over the four-year period ending in 2007, with almost a 400 basis point drop, so this is where most market participants thought there was the most vulnerability. According to our mid-year numbers, average assisted living cap rates increased by 40 basis points to 8.7%, which is quite close to what became the "accepted" increase; some people thought the increase could be as high as 150 basis points. Once again, the average cap rate so far in 2008 is lower than all prior years with the exception of 2007. That being said, the market is so thin right now that these numbers are based on the lowest volume we have seen in more than five years and could change dramatically by the end of the year, depending on what happens in the market.

In the skilled nursing market, the average price per bed dropped by 18% to $45,200 in the first half of 2008 compared with the full year 2007; the median fell by just 2% to $43,900 per bed. It is important to remember that 2007 was a record year for the skilled nursing market, helped by some high-end sales in the second half of the year.

In addition, average skilled nursing cap rates for the first half of 2008 increased by just 20 basis points to 12.2% compared with 2007, while the median also increased slightly to 12.3%. With occupancy concerns in the retirement housing sector, and positive news on Medicare reimbursement, the skilled nursing sector has been more stable in 2008 in many regards, but a lot could change by the end of the year.

Recent Acquisition News

Donley County Hospital District in Texas recently sold a 53-bed skilled nursing facility in Clarendon, Texas, for just $1.1 million, or about $20,750 per bed. Based on the nine months ended September 30, 2007, annualized revenues and EBITDA were $1.89 million and $153,000, respectively, with occupancy averaging between 98% and 100%. Here is a case where size does matter (refer to the July issue on this topic), because despite the high occupancy at this facility, it was just too difficult to make a reasonable return with regular fixed costs. This is why the buyer plans to add up to eight beds (probably the most they are able to), which may end up doubling the pro forma EBITDA when they are filled. On existing operations the cap rate was 13.9%, but we have not seen the pro forma numbers with the additional beds. Doug O'Toole of **Marcus & Millichap** represented the seller, and the buyer was **Community Care Management Services**.

Many CCRCs that have come to market in the past several years, in fact, the vast majority, have either been underperforming or in default on their debt. It is a welcome relief, therefore, when a nice property that is full, and in a good location, is put up for sale so that we can try to get a glimmer of what a "benchmark" CCRC sale (and valuation) will look like. Such is the case in Connecticut, where **Stamford Health System** has decided that the time is ripe to sell its **Edgehill Continuing Care Retirement Community**, which is located in Stamford on more than 20 acres. The CCRC has more than 200 one- and two-bedroom apartments plus 20 assisted living units and 60 skilled nursing beds. Apparently, there are about 300 residents plus about 200 people on a waiting list – quite the enviable position in this market.

Greystone Senior Living, a unit of **Sunrise Senior Living** (NYSE: SRZ), manages the property for the hospital system, which wants to focus on its core acute care business, thus prompting the sale. Even though the timing may not be optimal based on the current conditions in the capital markets, snaring a profitable CCRC in the heart of Fairfield County's gold coast is an opportunity that several providers will jump at. **Herbert J. Sims** is representing Stamford Health System in the transaction, and pencils are already sharpened.

The fastest growing seniors housing company from 2005 to 2007, **Sunwest Management**, is under severe financial pressure and is in the process of trying to sell up to 150 of its assisted and independent living communities across the country (nearly 50% of its portfolio). While not-for-profit providers usually do not get involved in this type of auction process, there may be individual facilities or small groups in nearby locations that may make sense to acquire. In addition, there is speculation that the company may be forced to file for bankruptcy protection, which could result in more properties for sale. The San Diego, California, office of **CB Richard Ellis** is handling the sale for the 150 properties, but we do not know whether a transaction will get done for the whole group given what we believe to be the seller's price expectations combined with the state of the capital markets. Stay tuned. ❑