

Strategies in Capital Finance

V o l u m e 5 9

THE FINANCIAL CRISIS HITS THE SENIOR LIVING INDUSTRY

*Operational and Debt Restructuring Considerations
for Trustees and Executives*

CAIN BROTHERS

INVESTMENT BANKERS & CAPITAL ADVISORS TO THE HEALTH CARE INDUSTRY

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This white paper discusses both business and legal issues in relation to the senior living sector. Although Cain Brothers has significant experience in the senior living sector and restructuring, it is not qualified to provide legal advice. Should they find themselves in financially stressed circumstances, trustees and executives should engage legal counsel experienced in the special concerns of financially troubled health care organizations.

EXECUTIVE SUMMARY

THE SENIOR LIVING INDUSTRY HAS GROWN RAPIDLY

Over the past five years, nonprofit organizations either expanded or developed a large number of senior living facilities. Market factors stimulated growth. Low cost tax-exempt debt dramatically lowered borrowing costs; a buoyant housing market allowed seniors to sell their homes at high prices; and a rising stock market provided seniors and project investment portfolios alike with higher investment incomes. Since January 2004, 300 senior living bond issues with par value of \$25 million or more came to market, including more than 100 bond issues sized over \$50 million. These amounts were dramatically larger than in the prior five-year period.

THE MARKET CONDITIONS THAT ENCOURAGED GROWTH HAVE EVAPORATED

Sadly, the conditions that encouraged growth have evaporated. Few predicted the confluence of the current turmoil in the housing, stock, and debt markets that has dramatically and without precedent altered each of these three critical dependencies for senior living facilities. The housing market's downturn makes it much less likely that potential residents will commit to sell their homes and move to a new senior living facility. The decline in the stock market has caused a decline in investment income and net worth. Seniors have fewer resources to pay current and future increasing monthly fees. Senior living facilities are also earning less on their investments. And, the tax-exempt debt market is currently closed for all but the highest rated senior living facilities. Each factor on its own would be a major issue. Together, these factors have led to a significant crisis. Many senior living facilities across the nation find their future existence under pressure and potentially threatened.

The severe disruption in the municipal debt markets that is negatively impacting credit availability for senior living facilities cannot escape the attention of executives and trustees of these organizations. Unfortunately, many organizations are content to wait for the capital markets to stabilize and interest rates and credit quality spreads to return to previous levels. However, this approach ignores the changes that have taken place in the housing and investment markets, changes that, when combined with those in credit markets, are unlikely to be resolved quickly and in favor of the senior living sector.

GIVEN THE INCREASING CHALLENGES, TRUSTEES AND MANAGERMENTS MUST ACT QUICKLY TO PRESERVE THEIR FACILITIES

Most trustees and executives of nonprofit senior living organizations did not take on their roles with the expectation that they would be responsible for dealing with troubled financial performance and questions of organizational sustainability. It is not, therefore, surprising that many have not fully understood the potential implications of the current financial crisis for their organizations or the important fiduciary obligation to act on behalf of the interests of their creditors when an organization is suffering financially. The financial and housing market downturns may be brief. Or, they may last years. While the duration of the downturn is unknown, it is imperative for trustees and executives to prepare as if it could last for years. The consequences of delay are severe. Prudent senior living organization trustees and executives will, therefore, take steps now to protect their organization's financial strength, before they drain existing financial reserves to levels where corrective action can no longer be afforded.

Trustees and executives of senior living facilities who identify early warning signs of financial stress will be in a better position to assure their organization remains financially healthy to meet the needs of its residents. While recognizing that external changes driven by the global financial crisis are a vital starting point, a proactive approach should include examining the strategic focus of the organization, addressing internal challenges such as the cost and management structure, and even governing board composition.

A FINANCIALLY CHALLENGED ORGANIZATION HAS ADDED RESPONSIBILITIES TO ITS CREDITORS

An organization is considered insolvent when it cannot fully pay its debts or when its liabilities are greater than the market value of its assets. Due to declines in facility market values and current or upcoming letter of credit renewals, many senior living facilities, even some with steady current cash flow that never thought of themselves as financially troubled, have already entered what is known as the “zone of insolvency” without being aware of it. Trustees of organizations that have entered the zone of insolvency have fiduciary obligations to creditors, as well as to mission, and responsibilities and priorities shift.

When an organization is solvent, it can place more emphasis on its duty to its mission than its responsibility to its creditors. A trustee of an organization that is either insolvent or in the zone of insolvency needs to balance with equal consideration the mission of its organization and obligations to its creditors. These dual obligations carry with them specific legal and fiduciary implications for how trustees make decisions.

When trustees and executives first recognize that their organization is facing financial instability, the idea of bankruptcy is rarely considered. Rather, the focus is on identifying strategies to improve the situation, with an expectation that those strategies will be effective. While bankruptcy should almost always be a last resort, trustees and executives need to understand its implications, because avoiding the possibility of eventual bankruptcy is part of the reason creditors may be willing to restructure outside of the bankruptcy process. Understanding the leverage that an organization may or may not have with creditors is, thus, one of the critical issues that trustees must consider when performing their fiduciary oversight in any financially troubled situation.

One reason for this is that turnaround plans often include changes that restructure components of the organization’s operations and capitalization. Understanding how the Bankruptcy Court works will help the organization know that it has fully considered all of the options available to it to achieve the best outcome. Trustees will also want to understand any exposure they may have if the organization ever does go into bankruptcy and creditors attempt to hold them personally liable for not acting appropriately.

In most cases, boards and executives need outside advice to navigate through the complex issues facing financially challenged organizations. Objective outside advisors with experience in senior living and debt restructuring, who can rapidly assess the situation on the strategic level and who can help develop an action plan, should be employed to confirm or enhance the organization’s internal plans. Trustees and executives need advisors that are free of preexisting debt-linked conflicts of interest to identify and execute a plan to fix a troubled situation so its mission can be preserved on the organization’s terms. Acting swiftly and decisively to respond to diminished debt capacity and declining balance sheets is the best strategy for protecting an organization’s future.

GETTING GOING TO ADDRESS THE CHALLENGES

This *Strategies in Capital Finance* white paper is aimed at helping board members and executives of nonprofit senior living organizations understand that the fundamental drivers of their facilities' financial success have changed dramatically for the worse and to recognize what new fiduciary and legal responsibilities they have when they suspect they may be heading into financial trouble. The paper discusses the impact of recent market disruptions on senior living facilities to help trustees and executives proactively identify warning signs of potential problems, and it provides guidance for solving the challenges their organizations face.

SENIOR LIVING INDUSTRY TRENDS

SENIOR LIVING FINANCIAL DEPENDENCIES

Stable housing markets, the availability of reasonably priced debt, and positive investment returns over the past decade supported the rapid growth of senior living facilities. In the decade leading up to the 2008 financial crisis, credit costs for senior living projects generally became much cheaper. Financing structures that took advantage of lower-cost variable rate financing became more prevalent during this period, and the cost of bank letters of credit, which were used to provide credit enhancement, declined meaningfully. Interest rate swaps were often used to lock in fixed rates that would ensure debt costs would not rise above feasibility projected levels. Overall, bank-letter-of-credit-backed variable rate debt was considerably cheaper than fixed rate, unrated bond debt. Fixed interest rates also generally fell to, and remained at, historically attractive levels.

As credit became easier and the housing and equity markets continued to rise, many senior living projects responded by adjusting development models to meet the opportunities. Sometimes it was in stretching to purchase a more expensive piece of land. Other times it was designing a project that offered more luxury and amenities to meet the preferences of local seniors. At other, older senior housing facilities, attractive interest rates encouraged facilities to catch up on deferred capital replacement costs by borrowing significant amounts of money to modernize aging facilities, but, unfortunately, without the addition of many new revenue generating units to cover the added per-unit debt burden. In addition, project debt grew because of a substantial increase in real estate and construction costs that occurred during the period. Overall, projects became larger and more heavily leveraged. During this period, senior living balance sheets grew as investment earnings contributed supplemental, nonoperating income, and projects came to depend on investment returns to produce positive bottom lines.

The current financial crisis has radically altered the financial results of many senior living facilities.

The current financial crisis has radically altered the financial results of many senior living facilities. The affordability of senior housing projects has declined materially in many parts of the country, and income statements and balance sheets of projects have been severely negatively impacted.

Affordability has always been the key to sustainable senior living development. Soaring housing prices and a run-up in the stock market that gave seniors more disposable income combined to support the feasibility of projects that were "affordable," assuming

that these factors continued to be positive. In a 2005 *Strategies in Capital Finance* white paper on CCRC development we urged caution:

Ignoring affordability sows the seeds of future risk. When affordability is pushed to its limits, the project fills up more slowly; this in turn increases development costs by extending marketing fill up periods. As more debt is required to offset the higher marketing cash flow requirements overall costs increase even more, and the market shrinks further. Projects that are barely affordable today, based on comparing entrance fees to area median home sales prices, naturally possess higher risk as it is harder to find a market in the future for units that become available through turnover.¹

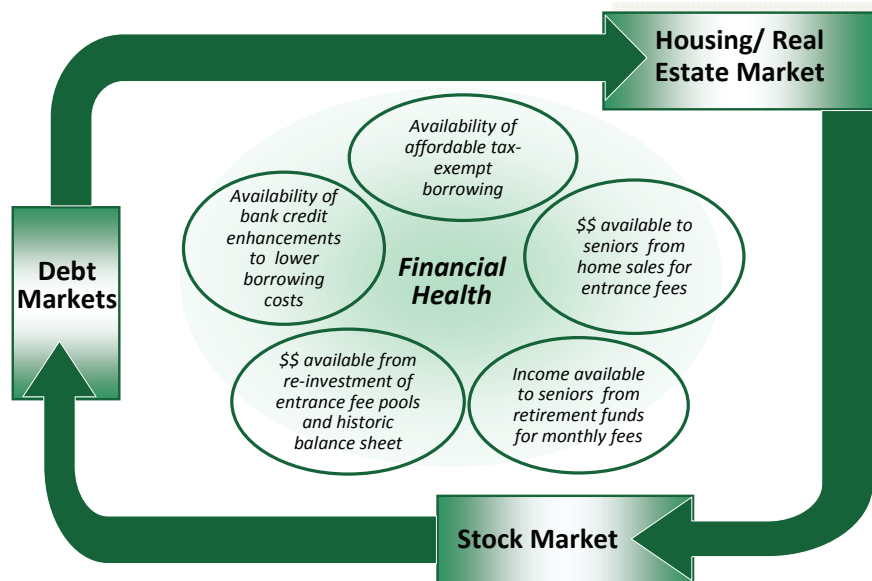
Figure 1 illustrates the senior living industry’s dependence on the state of the housing/real estate market, the stock market, and debt markets for its financial health. Unfortunately, all of these sectors have experienced dramatic and negative changes during the

...the housing/real estate market, the stock market, and debt markets ... all of these sectors have experienced dramatic and negative changes during the past year.

past year. Seniors’ ability to afford entrance fees for CCRCs is highly influenced by their ability to sell homes at high enough prices. Monthly income levels of seniors, some of which is based on stock market performance, also needs to be high enough to afford current and future monthly fees. In addition, debt markets have a big impact on financial health in three ways: facilities need to get adequate returns from reinvestment of entrance fee pool money, they are often dependent on bank credit enhancements to lower borrowing costs, and availability of tax-exempt financing at favorable rates is also important. We examine the current trends in each of those areas below.

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FIGURE 1. Senior Living Financial Health Depends on Housing, Stock and Debt Markets



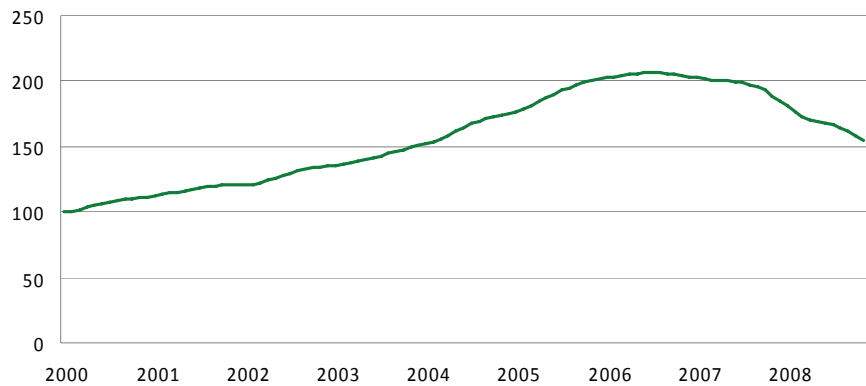
¹ Cain Brothers, “CCRCs: Bringing Transparency to the Development Process—The Key to Greater CCRC Viability,” *Strategies in Capital Finance*, Volume 48, (October 2005): 10. Available on our website at www.cainbrothers.com

HOUSING MARKET

The subprime mortgage meltdown and general financial crisis have impacted all facets of the mortgage market, and many home mortgages are under water. Home prices have fallen, and, in market after market across the country, home buying and selling within the middle to upper income communities, from which most CCRC and senior living facility residents originate, has either slowed materially or almost stopped completely.

Figure 2 shows that home prices have fallen since their mid-2006 peak. The dramatic inflation in home prices that started early in this decade was accompanied by dramatic increases in senior living entrance fees. As of November 2008, the 20-city composite S&P/Case-Shiller index of home prices is down 25%. Because home prices have decreased so materially in many markets, the challenge for senior living facilities is that they cannot afford to reduce their entrance fee levels to match declining home value levels.

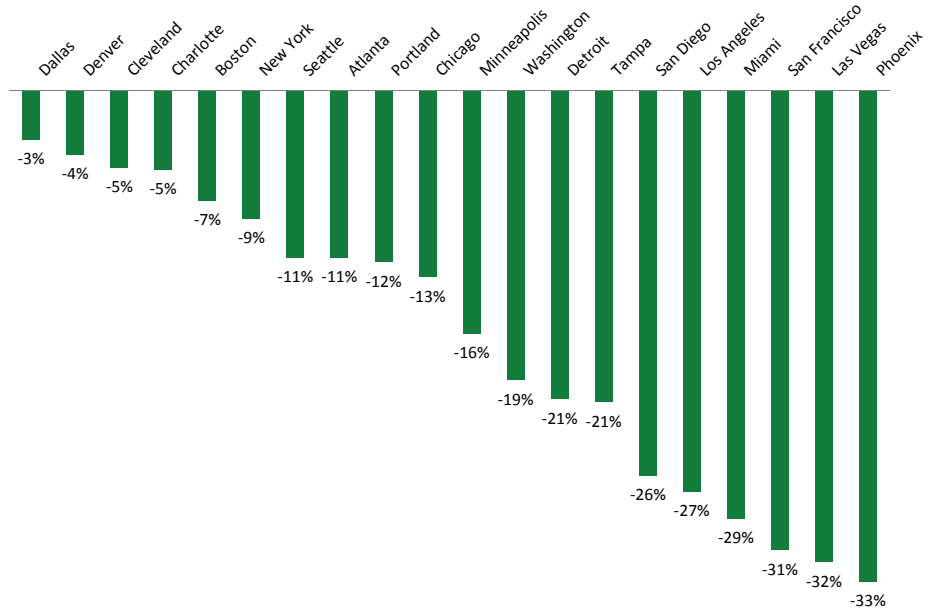
FIGURE 2. Housing Market Indicator: 20-City Composite S&P/Case-Shiller Home Price Index 2000-Present



Source: www.standardandpoors.com, as of November 2008

Senior living facilities are impacted most directly by housing prices in their local and regional areas. Figure 3 shows that there are significant differences in the drop in housing prices across the country. While 11 of 20 metropolitan areas showed record rates of annual decline, and 14 also reported declines in excess of 10% in November 2008 compared to the previous year, some areas have shown more moderate decreases.

FIGURE 3. The S&P/Case-Shiller Home Price Index Has Dropped 18% from November 2007 to November 2008 with 11 of 20 Metro Areas Showing Record Rates of Annual Decline



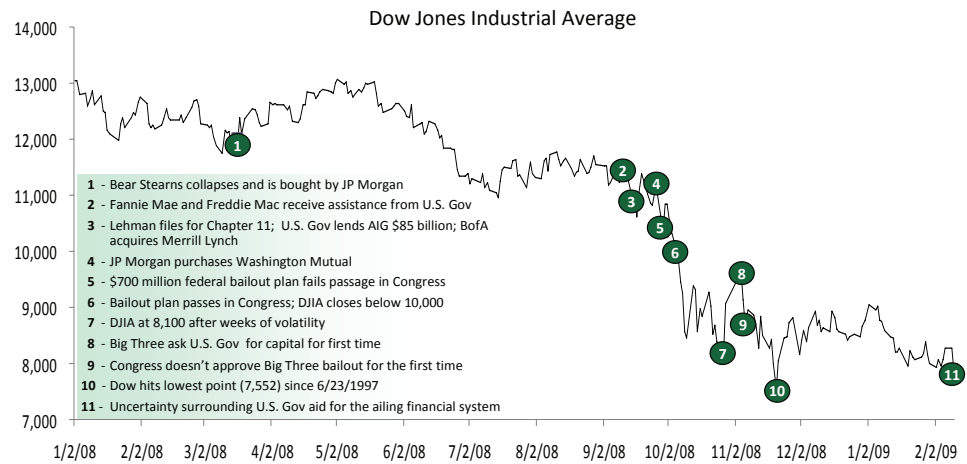
Source: S&P Press Release January 27, 2009, "Home Price Declines Continue..."

These housing trends make it very difficult for prospective senior living residents to count on being able to sell their homes in a timely manner. Even if they can sell their homes, lower home price values will make it harder for many to afford to move into a nearby senior living facility. Further, many homeowners are reluctant to sell when they perceive the market has fallen from previous levels, even if they can still afford to move into a senior living facility after the sale.

STOCK MARKET

Figure 4 shows the dramatic equity market decreases and volatility since January 2008. These changes have had a dramatic impact on resources available to many universities, hospitals, and senior care sponsors as endowment values have plunged and earnings decreased. While the direct impact of changes in the equity markets has been less dramatic in dedicated senior living facilities, the changes in the equity markets have nevertheless caused additional challenges.

FIGURE 4: Equity Market Volatility Milestones Since January 1, 2008



Source: Cain Brothers Analysis.

Gone are the days when retirees could be assumed to have all of their retirement savings invested in fixed income securities. Many seniors planning for a potential 25+ years of retirement are dependent on dividends and hoped-for appreciation in equity investments that continue well into their retirement years. However, with 30%+ declines in retirement equity portfolios and dividend cutbacks, these seniors are experiencing and expecting lower income levels. Seniors who were counting on returns from retirement funds to make future expected increases in senior living monthly fees are now worried and uncertain about their ability to afford them over their lifetimes.

Senior living facilities that are part of a hospital system may also find that, as systems reconsider their capital strategies in light of significantly lower investment income, senior living operations may now come under increased scrutiny, although they may have provided an acceptable level of value to the system in previous periods.

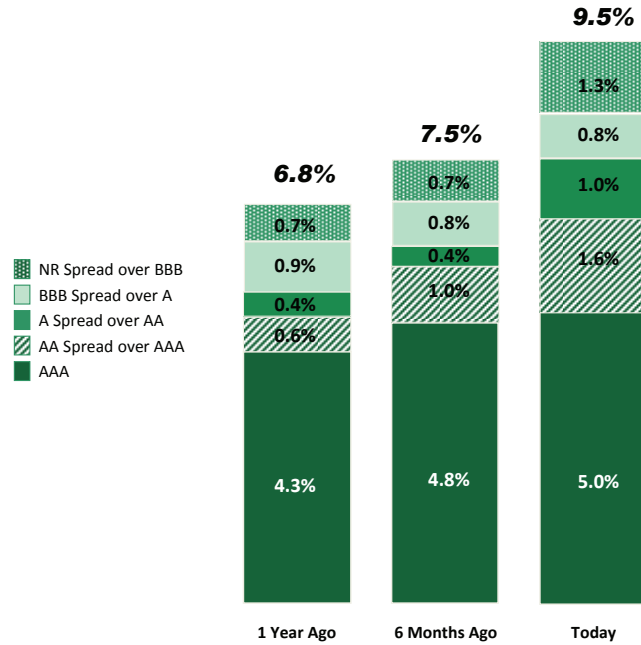
DEBT MARKETS

Senior living facilities are also facing negative pressure from the financial crisis that has overtaken the debt markets. Subprime mortgage and other non-municipal losses had negative implications for banks, brokers, and monoline bond insurers that, in turn, have had a very negative impact on the tax-exempt bond market.

... borrowing costs for senior living facilities, which are often non-rated, are out of the range of feasibility for many facilities, and most investors are avoiding nonrated and lower rated senior living projects altogether.

In the present market environment, new tax-exempt bond issues are difficult to sell, and, currently, only single-A and double-A health credits are able to successfully market their debt. Secondary trading is also illiquid. Investor flight to quality has driven credit spreads higher. Figure 5 illustrates that rates for all but the highest-rated borrowers are under pressure. The widening in spreads for AA and A ratings compared to six months ago is putting pressure on all rating categories. In turn, borrowing costs for senior living facilities, which are often non-rated, are out of the range of feasibility for many facilities, and most investors are avoiding nonrated and lower rated senior living projects altogether.

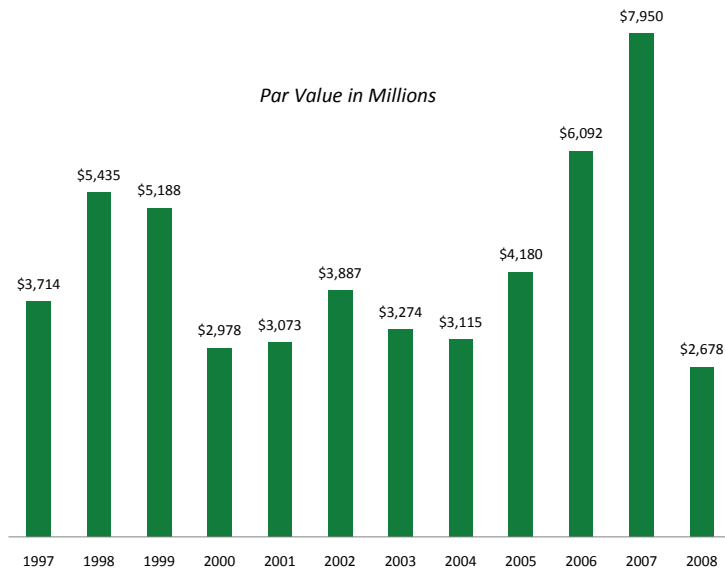
FIGURE 5: Rates for 30-Year Tax-exempt Health Care Lending to Non-rated Credits Have Increased in the Current Market and All But the Highest Rated Issuers are Under Pressure



Source: Cain Brothers Analysis as of 2/3/09. Non-rated Rates are Illustrated Along with Incremental Credit Spreads Across Rating Categories. Numbers do not add due to rounding.

The impact can be seen in Figure 6. The volume of senior living sector tax-exempt bond issuance fell off significantly in 2008 compared to previous periods.

FIGURE 6. Tax-exempt Bond Volume: Senior Living Sector



Source: Thomson Securities Data Company.

Letters of credit are much less available for senior living facilities and more expensive when they can be obtained.

Sources of senior living credit enhancement are also under severe pressure as shown in Figure 7. When the monoline bond insurers saw their credit ratings downgraded and the tax-exempt auction-rate market collapsed in 2008, hospitals and health systems were forced to seek credit and credit enhancement from banks, and this has served to displace credit availability for existing and new senior facilities. Commercial bank capital positions have materially eroded in the wake of the financial maelstrom, and this has significantly reduced their ability and interest in extending credit in general, including to the health care and senior living sectors. Letters of credit are a low margin product for banks, so most banks are restricting letters of credit to top-line clients and credits. Letters of credit are much less available for senior living facilities and more expensive when they can be obtained.

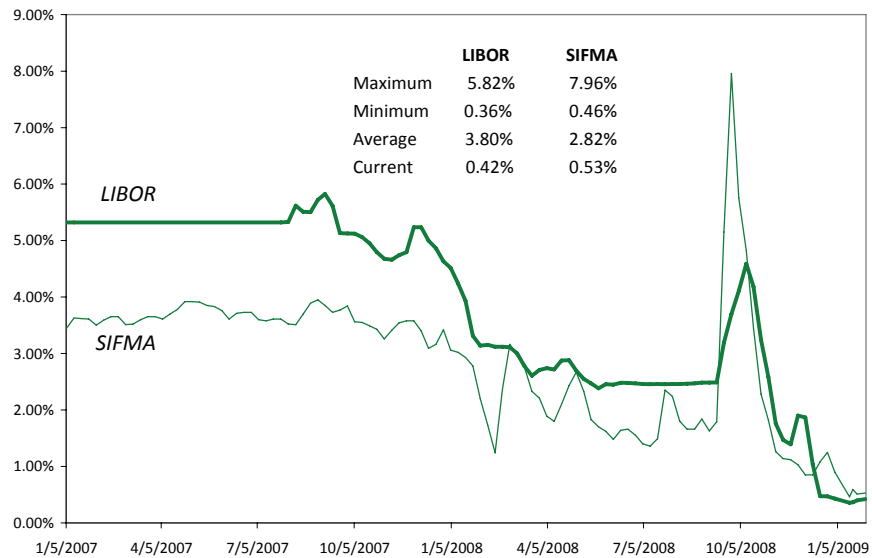
FIGURE 7. Top 10 Senior Living Lending/LOC Banks During 2007 and 2008

BANK	STATUS
LASALLE BANK	Acquired by Bank of America; capital position under pressure
BANK OF AMERICA	Capital position under pressure
SOVEREIGN BANK	Acquired by Banco Santander; capital position under pressure
BANK OF SCOTLAND	Acquired by Lloyds; very selective – few deals being undertaken. Pressure to lend in Europe
WACHOVIA BANK	Acquired by Wells Fargo; capital position under pressure
KBC	Currently not pursuing new senior living business
JP MORGAN CHASE	Currently not pursuing new senior living business
FIFTH THIRD BANK	Strongly favoring A- or stronger credits; very selective with lower-rated credit possible in some regions
KEY BANK	Status on hold – not undertaking any new deals, but appears willing to renew existing credits
US BANK	Very selective – limits participation to less than \$25 million and tends not to be lead bank, but some regional variation

Source: Cain Brothers Analysis

In addition, two of the most active lenders in 2005 and 2006, HSH Nordbank and BNP Paribas, stopped lending to senior living providers in 2007.

Historically, tax-exempt variable rate debt has provided a cost effective borrowing solution for many senior living facilities as investors have often priced these instruments at a discount to taxable variable rate debt, reflecting the benefit they anticipate getting from not having to pay taxes on the tax-exempt investment income. Figure 8 shows that during 2007 that relationship held as the tax-exempt rates (SIFMA) were lower than taxable rates (LIBOR). During 2008, however, those rates came much closer together, and there were periods when tax-exempt rates were actually higher than taxable short-term rates.

FIGURE 8. Historical Variable Taxable (LIBOR) and Tax-exempt (SIFMA) Interest Rates 2007-Present

Source: Bloomberg, rates as of 1/31/09 and Cain Brothers analysis.

The effect of these financial market disturbances is that senior living facilities need to be highly concerned that their lines of credit and letters of credit will not be renewed. In addition, many senior living projects utilized interest rate swaps in their financial structures, and, because of the changes in the overall interest rate environment, their swaps are “under water” and will produce losses when closed out, if variable rate debt insured by bank letters of credit has to be substituted with other debt forms. In addition, swap terms and credit criteria have dramatically tightened with many lower-investment grade credit borrowers unable to attract swap counterparties. In some cases, even those that can attract swap counterparties are likely to be required to post collateral.

Senior living facilities also need to be concerned that cap rates used to calculate market values are rising, and the resulting market values of facilities are declining. In turn, this means that if lender loan-to-value ratios were to remain the same, the amount of credit made available would be reduced. Of course, lenders have become more conservative in their credit underwriting, which only exacerbates the problem of obtaining credit for senior living facilities and sustaining operations. It was not uncommon as recently as 12 months ago for some lenders to approve 90% to 100% loan-to-value loans. For most banks that loan-to-value ratio has now dropped to 65 to 75%.

Overall, debt market trends have significant negative implications for senior living borrowing.

Overall, debt market trends have significant negative implications for senior living borrowing. The U.S. and global economies are likely to be weak well into 2009 and possibly beyond. Credit in general will stay tight due to investor reluctance to take risk; banks will continue to employ more restrictive lending standards; and there will be limited capital availability. Credit spreads will likely remain wide by historical standards and slow to return to more normal levels. Although the tax-exempt bond market has begun to thaw for higher quality credits, it will remain volatile; and the ability to sell new debt will remain problematic for lower- or non-rated senior living issuers.

IMPLICATIONS FOR SENIOR LIVING

The combined implications of the market changes in the housing, stock, and debt markets on senior living facilities are significant. Initial fill up, resales, and total occupancy levels will likely underperform. Performance metrics and financial ratios will likely decline. Financing costs have risen significantly just as cash levels are declining, which makes the search for replacement financing that much more difficult. Borrowing covenant violations and creditor accelerations are possible. Facilities will defer upgrades and replacements to attempt to respond to these trends. Executives and trustees need to proactively assess and address these challenges.

ARE YOU IN TROUBLE?

The list of senior living bankruptcies is filled with stories of organizations that delayed making necessary changes until it was too late. In most cases, the earlier changes are made in a troubled organization, the better the likelihood of success. While that statement is certainly easy to make in hindsight, often the hardest job for trustees and executives is to recognize when the circumstances in their organization have gone beyond business as usual. There are inevitable financial cycles and unexpected negative events in even the best-run organization. Major restructuring is not the best response to each of these events. Trustees and executives need to hone their skills to recognize when the organization is heading into a prolonged challenging period that might result in insolvency.

A study by the United Hospital Fund of New York identified three categories of organizational vulnerability that apply to senior living organizations as well:

- *In-Jeopardy*: An organization in jeopardy incurs large and recurring operating losses, working capital deficits, and has a net asset deficit. It is dependent on significant positive change (internal or external) to continue to meet its financial obligations.
- *At-Risk*: An organization at risk currently can meet its financial obligations, but continued negative changes (internal or external) will have a high likelihood of negative impact on the ability to continue to do so.
- *Low-Risk*: An organization with low risk has positive working capital and a net asset surplus, and is usually not operating at a loss. Negative changes (internal or external) may lessen but not impair the ability to meet financial obligations.²

These categories provide a useful framework that differentiates at-risk and in-jeopardy operations from those with lower risk. They are also helpful because they point to the need to consider organizational vulnerability as a question of risk. That risk cannot be understood by looking at the objective financial measures alone; it must be assessed in light of internal or external challenges the organization faces.

² United Hospital Fund, "Losses Continue at NYC Hospitals; Viability of One-Third in Doubt," *Hospital Watch* 14, no. 3 (July 2003).

EXTERNAL CHALLENGES

The changes in housing, stock, and debt markets described above related to the global financial crisis provide significant external challenges to the senior living industry. When external changes such as these negatively impact the financial operations of the organization, difficulties in identifying and reacting to changes in the availability of financing, missed marketing projections, and the resulting impacts on revenue and expenses can lead to financial instability. The challenge for trustees and executives is to sort through the available information about these external challenges, analyze the implications for their particular organization, and make judgments about timing and specific responses.

A good starting point is to understand the implications of the external changes on projections made in the past.

A good starting point is to understand the implications of the external changes on projections made in the past. Many projects are now lowering expected levels of entrance fees and monthly rate hikes to respond to the current market. When the impact of forgoing even a few years of planned rate increases is combined with lower-than-expected earnings on invested balances, many facilities will find that they can never fully recover, even if they become fully stabilized in the future. Trustees and executives need to take a realistic look at what their project's financial status will be, even assuming it will become fully occupied and stabilized, given the current environment. Revised projections should take into account expected low rate increases, depleted balance sheets, and lower investment earnings for the next two to three years. Many facilities that are marginally surviving today will discover that the survival of their campuses could be in jeopardy within a few years.

INTERNAL CHALLENGES

Boards and executives will most likely focus first on the significant external industry-wide challenges that may impact their organizations' financial health. Identifying and making judgments about internal challenges can be especially difficult for trustees and executives. It is often challenging for even the most diligent executive team to step back and objectively evaluate its own internal situation. It is common for the board of a nonprofit health care organization that is experiencing financial difficulty in its senior living operations to spend significant time reviewing external challenges that management has identified as the cause of the situation. Only months or sometimes years later, as the situation continues to deteriorate, will the board begin to consider how it can effectively identify internal challenges that may be contributing to the problem.

Internal challenges in the areas of operations, technology, personnel, and management need to be considered as part of the oversight of any organization, but they need particular emphasis as an organization begins to show signs of financial trouble. If debt needs to be restructured as part of solving the financial challenges of the organization, lenders will expect the organization to demonstrate that it has exhausted all possible operational improvement before asking for debt restructuring. When a course correction can be initiated early, it can often result in much less dramatic changes to move the organization back to financial health than if action is postponed until circumstances are dire.

WARNING SIGNS

Drawing down cash reserves and violations of debt covenants are well-known warning signs of financial trouble. Other signals that there may be significant problems are declines in occupancy and liabilities that are greater than the market value of assets. Facilities in the start-up phase can be particularly difficult for trustees and executives to monitor, because variances from the original plan are common and start-up comparative business norms do not exist. It is also sometimes easy to see the turnaround of negative trends “just around the corner.”

Figure 9 highlights example warning signs for senior living facilities. Trustees and executives will want to observe these and other warning signs that allow them to take action earlier in the process. Thresholds will be different for various kinds of facilities as the operating and capital performance targets are influenced by and reflect specifics regarding resident contracts and the relationship between entrance fees, monthly service fees, and refunds. Assessments cannot be based solely on a current snapshot of financial performance. Trustees and executives should look for longer-term trends to signal potential deterioration. Using a single year-to-year comparison that reflects what appears to be a small decline in occupancy may mask a troubling trend, when looking back three years would reveal that the small decline has continued and on a cumulative basis is, say, 5%. Appropriately conservative two- to three-year projections that include the cost of maintaining the asset’s physical appearance during this time need to be evaluated. Five years of ongoing deferral of necessary capital replacement will make facilities vulnerable when an economic recovery eventually comes and competitive facilities are making a facility look old and tired.

FIGURE 9. Warning Signs for Senior Living Facilities

WARNING SIGNS	AFTER STABILIZATION
Debt Service Coverage <i>Including Turnover Entrance Fees</i>	<1.25x for the first three years after fully stabilized
Cash-to-Debt	< 25% with days cash declining at a rate of 10% of the total per year < 200 days cash for CCRCs
Operating Ratio <i>Cash Expenses Including Interest Costs/Cash Revenue</i>	>105%
Expenses to Revenue Prior to Debt Service <i>Doesn't clarify whether revenue is too low or expenses are too high</i>	>70% CCRC >65% AL >85% SNF
Average Age of Physical Plant	>12 years
Time to Reach 90% Occupancy	Census lower than 85% for new construction component 20 months post opening
Weighted Average Entrance Fee/ Median Sale Price in Primary Market Area	>110% ratio with the affordability ratio rising relatively rapidly
Entrance Fee Pool/Total Debt	<75% once stabilized
Some to Full Deferred Management Fees or Parent Corporation Subsidy	Yes
Covenant Violations	Yes

Source: Cain Brothers Analysis

GETTING ORGANIZED TO SOLVE THE PROBLEM

It is easy to give the advice that trustees and executives need to act quickly when first signs of trouble appear, but trustees can often have a hard time translating that advice into specific actions. Most management teams are not experienced in dealing with the particular focus required when organizations are in trouble. Many times it can be hard for management to step back enough from its day-to-day commitment to making the status quo succeed to assist the board in its oversight process. Implementing the kinds of decisive actions that many situations demand can, therefore, be challenging.

Can the situation be turned around by operational changes, capital plans, and other initiatives? Can current management make changes to effectively make positive changes? In cases where these actions are not enough to fix the problem, the organization may need to consider its restructuring options.

Restructuring means rewriting or renegotiating the contractual relationships that exist between the organization and its creditors, employees, and suppliers.³ In circumstances when the current community mission of the organization is untenable, it could also mean rewriting or renegotiating the current mission with the community. The purpose of restructuring is to cut expenses, improve internal incentives, or improve the organization's position in its market, so that it can be better positioned to meet its mission objectives over time.

Unless management is experienced in turnarounds and restructuring senior living organizations, bringing in outside financial, legal, and business experts to do a review can be an important first step. Outside advisors that can rapidly assess the situation on the strategic level will help trustees know how quickly they need to act. Establishing benchmarks and other milestones at this stage will give the organization a framework to develop an action plan. The objective is to bring appropriate advisors in early so action can be taken and the organization can survive to meet the needs of its residents.

Trustees of troubled senior living organizations need to go beyond their usual focus on their fiduciary responsibility to residents of the facility. The needs and perspectives of investors in the organization's debt should be considered when outside advisors are

Investors and creditors need to be assured that the advisor representing the senior living organization will not favor one class of creditors over another based on historic investor relationships and current and ongoing self-interests.

brought in. Institutional investors, for example, will be concerned about potential historic conflicts of interest on the part of outside advisors and will want to be comfortable about an advisor's objectivity. Different kinds of creditors, which can include banks, bond funds, institutional investors, retail investors, interest rate swap counter parties, and vendors all have different interests.

Investors and creditors need to be assured that the advisor representing the senior living organization will not favor one class of creditors over another based on historic relationships and current and ongoing self-interests.

³ Stuart C. Gilson, *Creating Value Through Corporate Restructuring: Case Studies in Bankruptcies, Buyouts, and Breakups* (New York: John Wiley & Sons, Inc., 2001), 1.

Trustees should be able to have direct access to financial, legal, and business experts that are free from such conflicts to enable them to perform their oversight responsibilities with impartial advice. In some cases, the board may want to bring in its own advisors. During this effort, the board needs to be in a position to adopt a plan to fix the situation.

Even contemplating some necessary changes can be difficult for trustees and executives, because the kinds of changes involved often impact individuals and the community. Experience has shown, however, when trustees move forcefully to restructure when it is necessary, they can more often conduct the restructuring process on terms that benefit the organization, thereby preserving more of the mission in the long run than is possible by avoiding the hard choices.

IN THE ZONE OF INSOLVENCY

As they develop and implement their plan, trustees and executives need to consider ways that their fiduciary duties may have shifted in light of the organization’s financial situation. A surprisingly large number of senior living organizations may be insolvent and not realize it. A state of insolvency exists when an organization meets either of one of two tests:

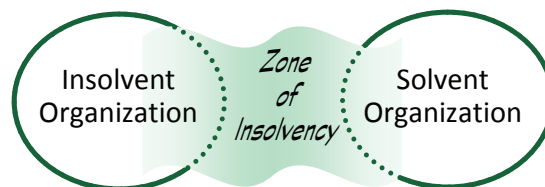
Equitable Insolvency –
Inability to fully pay one’s debts when due

or

Balance Sheet Insolvency –
Inability to assure that assets exceed liabilities

The notion of an “area of insolvency” or a “zone of insolvency” is illustrated in Figure 10. It relates to a period or transition state in which an organization is neither fiscally sound nor in bankruptcy proceedings. It implies that the organization is either insolvent, will soon become insolvent, or is so close to insolvency that its board members must act as if it were insolvent. There are perhaps many organizations that receive clean audit opinions and are considered solvent for purposes of generally accepted accounting principles but are actually operating in the area of insolvency. For example, it might be difficult for many senior living organizations to be valued or sold for an amount that would be sufficient to repay all creditors.

FIGURE 10. The Zone of Insolvency



When a for-profit company is fiscally sound, the foremost duty of its board of directors is to its shareholders. When the organization is either insolvent or in the zone of insolvency, the board must consider its obligations to both creditors and shareholders. This duty has been confirmed in a substantial number of legal decisions.

For a nonprofit organization, the obligation is parallel. A nonprofit organization's equity consists in using its assets in a prudent manner to serve its mission as established in its corporate charter or bylaws. When a nonprofit senior living community is fiscally sound, the trustee's primary duty is to the residents of the community as set out in its bylaws. However, most lawyers would agree that a trustee of a nonprofit organization that is either insolvent or in the zone of insolvency also owes an obligation to the organization's creditors.

Disputes with creditors can sabotage a successful outcome.

The tension between mission and creditor obligations can end in destructive dynamics, litigation, or even bankruptcy filings. When the courts have ruled on issues related to whether the mission or the creditors was paramount, there have been different outcomes. Sometimes, the mission triumphs over creditors. Sometimes, the creditors' rights trump the mission. Disputes with creditors can sabotage a successful outcome. Trustees must consider their obligations to creditors and try to work cooperatively with them to achieve a solution that works for the creditors and still serves the organization's mission.

These issues are complex but capable of being defined and resolved. Trustees whose organizations are in the area of insolvency would do well to ask for assistance from advisors experienced in senior living restructuring when they first suspect they may have entered the zone of insolvency.

RESTRUCTURING OUT-OF-COURT

When trustees have identified that some kind of restructuring of the organization is necessary, they can start by asking themselves some basic questions:

- What are the goals of the organization?
- Can they be met through a restructuring of operations, the organization's capital structure, or both?
- Would it be better to leave the debt in place?
- Would it be better for the organization and its creditors to sell or merge the business and assets with a stronger related organization rather than restructure?

As the above questions indicate, restructuring can focus on operations, capital structure, or both. The goal of the out-of-court restructuring process is to create a financially stable and sustainable organization that can meet its obligations to its community, employees, vendors, and lenders going forward. Most organizations will benefit from outside advisors to help them understand their options and shepherd them through the process, whether it results in operational changes, merger, debt restructuring, or a bankruptcy in some cases.

OPERATIONAL RESTRUCTURING

Operations restructuring is often described as a “turnaround.” The organization’s particular circumstances will determine whether the existing management team can devise and implement the operational restructuring on its own, whether it would benefit from the assistance of advisors with experience in restructuring senior living organizations, or whether changes need to be made in the management team to have the restructuring succeed.

Organizations often start restructuring initiatives with revenue strategies, because they can improve the bottom line with less pain than expense reduction programs.

Operational restructuring usually also involves changes to expense levels. Benchmarking of expense levels compared to other organizations with similar characteristics can be a useful way to pinpoint targets for expense reduction. In most senior living organizations, salaries are the largest component of the budget, so expense restructuring often involves reducing headcount through attrition or layoffs and constraining wage rates when the competitive situation permits. Restructuring benefit levels and such areas as the pension plan or post retirement health care expenditures also can be considered.

Other options may include outsourcing key service delivery components such as skilled therapies in a Skilled Nursing Facility (SNF), gardening, or security services. The fastest operational turnarounds are often achieved in the higher levels of care, such as through possible outsourcing or joint ventures for rehabilitation services in SNFs that attract higher third party payers, such as Medicare and private insurance.

Existing facility residents may have to share in the pain of operational restructuring. For example, residents that have been promised no rate increases might have to experience some modification of rates. Rate increases, outsourcing, revenue diversification, expense benchmarking, and staff reductions all need to be considered. As unpleasant as each of these alternatives are, trustees in the zone of insolvency need to consider that their fiduciary responsibility to pay attention to the needs of creditors has increased.

Vendors may be very dependent on the organization for business, so renegotiation of payment rates or arrangements can be a possible option. Use of supplies can be reduced in a variety of ways. Taking advantage of all group purchasing options can be powerful in some cases, for example, and negotiating with targeted vendors with the added leverage of the willingness to move business can be effective.

CAPITAL RESTRUCTURING

In a for-profit company, capital restructuring can include changes to both the debt and equity funding of the organization. While capital restructuring for nonprofit health care organizations usually focuses on the debt, trustees in some organizations should also consider the equity segment of the balance sheet if donations are a source of potential restructured funding.

The purpose of debt restructuring is to establish a capital structure that the operations can support, either to take advantage of a lower interest rate or debt balance. Existing debt may be able to be called and replaced with new debt at a lower interest rate. An investment banker can identify potential opportunities to restructure existing debt. The banker usually starts with exclusive and confidential negotiations with the trustee bank of the bond issue(s) and major debt holders. Debt restructuring involves attempting to

change the terms of the contract between the lender and the health care organization. Revisions to the terms of the debt instrument can include the principal amount of the debt, the interest rate (current or future), the call period, the call premium, and the term.

Holders of the organization's debt will not want to change the terms of the debt to those that are more favorable to the borrower unless they can be convinced that it is in their best interest to do so. Organizations will benefit by working with an investment banker who is experienced in restructuring troubled senior living debt for the delicate negotiations that most often accompany the debt restructuring process. These advisors can help oversee the organizational and operational self-evaluation of operational restructuring alternatives and assessment of whether turnaround initiatives are likely to solve the problems. They can assemble the legal team and any specialized consultants that may be needed.

BANKRUPTCY

In some circumstances, the board of the nonprofit senior living organization may determine that the out-of-court restructuring described above is not going to result in the best outcome for the organization and that filing for bankruptcy is a better option.

Filing for bankruptcy can be done under one of two chapters of the bankruptcy code.

Chapter 7 is used when a company or organization intends to stop doing business and the orderly liquidation of the company's assets is planned. Under a Chapter 7 process, the organization's (i.e., the debtor's) management is replaced by a trustee whose job is to liquidate and disperse any remaining assets of the business.

Chapter 11 is used when the intent is to reorganize the enterprise under the direction of the Bankruptcy Court and to continue as an ongoing business. Under Chapter 11, the company's management remains in place and continues to control the debtor's business while attempting to create a reorganization plan. The goals of the Chapter 11 process are the same as those of an out-of-court restructuring, but it uses a fundamentally different methodology that is more rigorous and process oriented. To allow the debtor time and to continue to operate while the reorganization plan is developed, the process protects against legal action to seize assets by creditors and provides a way to obtain financing for working capital needs. It also provides flexibility in restructuring leases and some advantages that allow assets to be sold without as much risk to the purchaser. Approval of the plan of reorganization is required for the organization to emerge from bankruptcy.

Unlike for-profit firms, creditors cannot force nonprofit health care organizations into involuntary liquidation under Chapter 7. They can apply pressure by enforcing loan covenants and security interests in assets, and in time this pressure can force a nonprofit to seek protection in Bankruptcy Court.

Boards of nonprofit senior living facilities almost exclusively choose to enter bankruptcy under Chapter 11. Since a bankruptcy filing is almost always a last resort, organizations should expect to have already taken the organizational restructuring steps outlined above, developed a proposed debt restructuring plan, and undertaken an arms-length valuation/appraisal to demonstrate that the proposed restructuring plan is better than what a forced liquidation would generate from an auction. Creditors may be willing to negotiate terms of a debt restructuring, hoping they may do better in recovering assets as a result of the organization reorganizing outside of the bankruptcy process.

The bankruptcy process is an adversarial proceeding that can be contentious or harmonious depending upon the facts of each situation and the participants. Once the filing occurs, time deadlines drive the process. The debtor senior living organization will want to develop a plan that will allow it to emerge with a focused mission and the financial resources to accomplish that mission. Creditors, on the other hand, are interested in protecting as many of their at-risk assets in the plan as possible. While the board of trustees can represent the interests of the debtor organization, there are often many different creditors with divergent interests. Creditors of the organization are therefore organized into classes or groups that are designed to represent their interests in the outcome of the process. The state's Attorney General often has an interest in the outcome as well as a responsibility to advocate for the community.

The bankruptcy process is an adversarial proceeding that can be contentious or harmonious depending upon the facts of each situation and the participants.

These divergent interests can create tensions whereby creditors may prefer a plan that sells the assets of the organization to repay at-risk debts or sells the nonprofit facility to another bidder, if that plan will allow them to collect a higher percentage of their assets. Different groups of creditors may favor different solutions, and the debtor organization's board of trustees may favor a different outcome than the Attorney General. Any "impaired" creditor (those with a claim that will not be paid in full) has a legal right to vote for or against the proposed reorganization plan. To be confirmed, the plan must be accepted according to standards of the Chapter 11 code by at least one class of "impaired" creditors. The bankruptcy judge is responsible for overseeing the process on behalf of these competing interests and approving or confirming the plan of reorganization.

While a bankruptcy process is challenging in any industry, it can be more so in a nonprofit senior living organization.

While a bankruptcy process is challenging in any industry, it can be more so in a nonprofit senior living organization. Residents will often be distressed by the uncertainties of bankruptcy. Unless a reorganization plan is identified quickly, marketing to new entrants can be severely impacted. This means, as a practical matter, most nonprofit senior living organizations that enter Chapter 11 intending to reorganize and keep operating are either sold or closed, unless they are able to develop a reorganization plan rapidly. Otherwise, the revenue base will shrink.

Filing for bankruptcy protection under Chapter 11 can provide the time and procedural mechanisms to permit an orderly restructuring of the organization while the creditors wait for a resolution. It can also provide the framework to generate needed liquidity through debtor-in-possession financing structured to meet liquidity needs of the organization, although debtor-in-possession financing has become much harder to obtain as a result of the financial crisis.

Bankruptcy can be a useful alternative, but it also has many negatives. It is an expensive process, with significant expenditures for legal and restructuring consultants. It is also not always successful. Some organizations that enter Chapter 11 end up being sold or closed as a result of the process. Trustees and executives who have experienced a nonprofit senior living bankruptcy proceeding will usually describe it as a last resort.

CONCLUSION

The senior living sector has suffered significantly from the material deterioration in the housing market, the stock market, and the debt market. Many relatively new senior living facilities that responded to previous market conditions and project development and financial structuring fundamentals, which were suitable for those conditions, are experiencing financial stress. Many others are likely moving in the same direction without fully understanding their potential vulnerability.

We recommend that trustees and executives pay attention to the implications that the global financial crisis has on their organizations. Early and forceful action by the board and management can often prevent the kinds of deterioration that would ultimately result in a bankruptcy process. Recognizing when the organization is first entering the zone of insolvency and getting the right kind of help to make necessary changes can best assure that the organization will successfully regain financial strength.

CAIN BROTHERS SENIOR LIVING GROUP

Our senior living bankers generate solutions for the firm's clients in four distinct areas: mergers and acquisitions, tax-exempt bond underwriting, strategic and development advisory services, and capital restructuring assistance.

We are one of the top ranking underwriters nationally in the tax-exempt senior health and housing sector. Our clients are nonprofit entities that range from start-up continuing care retirement communities and small nursing homes to hospitals and large, well-established organizations with multi-state operations.

We also provide strategic and development advisory services to clients seeking to acquire or dispose of land/property, develop new senior living campuses, or modify the use of existing campuses. Our bankers advise clients on project development and feasibility.

Restructuring is a significant activity of the firm. In the current environment, many organizations have been unable to develop successful solutions for overcoming financial challenges and have been forced to restructure their balance sheets through creditor negotiations or, as a last resort, to seek the protection of the bankruptcy courts.

Cain Brothers is often retained by organizations' boards and management teams, or by creditor groups, to coordinate solutions between borrowers and lenders. Our efforts can include leading negotiations, restructuring debt covenants and payment terms, arranging interim and/or long-term financing and equity investment, and selling selected assets or the entire organization. Our objective on each assignment is to reach a consensual solution, sustain the viability of operations, and enhance creditors' recoveries in the event of a sale or liquidation. This needs to be done in a framework that honors the underlying mission of the organization and addresses both state and federal regulatory issues.

SAN FRANCISCO

Bill Pomeranz, Managing Director bpomeranz@cainbrothers.com 415-962-2954

LOS ANGELES

Kathy Kirchhoff, Senior Vice President kkirchhoff@cainbrothers.com 562-889-9119

CHICAGO

Amy Hayman, Managing Director ahayman@cainbrothers.com 312-604-0578

ST. LOUIS

Joe Mulligan, Managing Director jmulligan@cainbrothers.com 314-800-0441

NEW YORK

Matt Goldreich, Managing Director mgoldreich@cainbrothers.com 212-981-6946
Scott James, Managing Director sjames@cainbrothers.com 212-981-6943

MANAGEMENT

James E. Cain
Chief Executive Officer
jcain@cainbrothers.com

Robert J. Fraiman
Head of Corporate Finance
rfraiman@cainbrothers.com

Andrew McB. Garvey
Head of Capital Markets
agarvey@cainbrothers.com

Scott D. Smith
Head of Special Products
ssmith@cainbrothers.com

James M. Moloney
Head of Real Estate
jmoloney@cainbrothers.com

HEADQUARTERS

360 Madison Avenue, 5th Floor
New York, NY 10017
212-869-5600

OTHER LOCATIONS

CHICAGO

HOUSTON

SAN FRANCISCO

ATLANTA

INDIANAPOLIS

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