

Trends in Nonprofit Senior Living

As we approach mid-year, it's a good time to reflect on what's improved and what continues to be challenging for nonprofit senior living providers.

The senior living sector is influenced by the real estate, equity, and debt markets. These factors affect residents and prospective residents and owners/operators. All have shown improvement from this point last year. In this commentary I identify and discuss relevant data in two of the three factors: real estate and debt markets.

Real Estate

Residential Home Sales

Data released in late April for the S&P/Case-Shiller Home Price Indices, the leading measure of U.S. home prices, showed that the annual rates of decline of the 10-City and 20-City Composites improved in February 2010; and, for the first time since December 2006, both indices were positive. However, 11 of the 20 markets showed a decline when comparing February 2010 to February 2009 – an extended trend perspective. But, 18 of the 20 markets showed an improvement when comparing annual rates for February 2010 to January 2010 – a current trend perspective. This information highlights the geographical as well as cyclical differences in the real estate market. Experts are concerned that the expiration of the new home-buyer tax credit on April 30 accelerated home sales and created temporary improvement that may disappear when May data is released. The fact that mortgage rates remain at very low rates may offset this factor and allow the market to continue improving. The activity in the residential real estate market influences the ability and willingness of individuals to make the move from their personal residence to a retirement community. This in turn impacts occupancy levels at retirement communities.

The National Investment Center for the Senior Housing and Care Industry (NIC), a leading provider of historical and trend data for the sector, reported that average occupancy rates for senior housing (independent living and assisted living) continued to decline in the first quarter of 2010, with average occupancy at 88.0% compared to average occupancy of 88.3% in the fourth quarter of 2009. Although overall average occupancy for the senior living sector declined, average occupancy for the nursing home subsector increased slightly in the first quarter of 2010 after eleven quarters of steady decline, 89.0% in first quarter 2010 compared to 88.8% in fourth quarter 2009. While occupancy levels indicate a continuing challenge, rent growth remains positive, although the growth rate has slowed to less than 2%.

Capitalization Rates and Asset Values

Capitalization rates, which incorporate market views on investment risks, have remained generally flat for the past nine months. Data from NIC show a meaningful increase in reporting transactions from 200 in third quarter 2009 to 396 in fourth quarter 2009. This is an indication of improvement on both the sell-side and buy-side. However, many of the transactions represent troubled-asset sales, and, as a result, the range of trading values is significant. Capitalization rates for performing assets may be more favorable, but will be heavily influenced by geographical market and subsector positioning. Capitalization rates translate the operating cash flows of a facility into an estimated value. As capitalization rates have an inverse relationship to values, so as cap rates rise, the resulting values decline. While cap rates have been relatively flat for the past nine months, there was a significant rise from pre-2008. At the same time, many lenders have tightened their loan-to-value limits, which in turn often reduces the maximum amount of credit a lender is willing to extend. The combination of higher cap rates/lower asset values and tighter loan-to-value limits has made refinancing for some senior living providers more difficult.

Debt Market

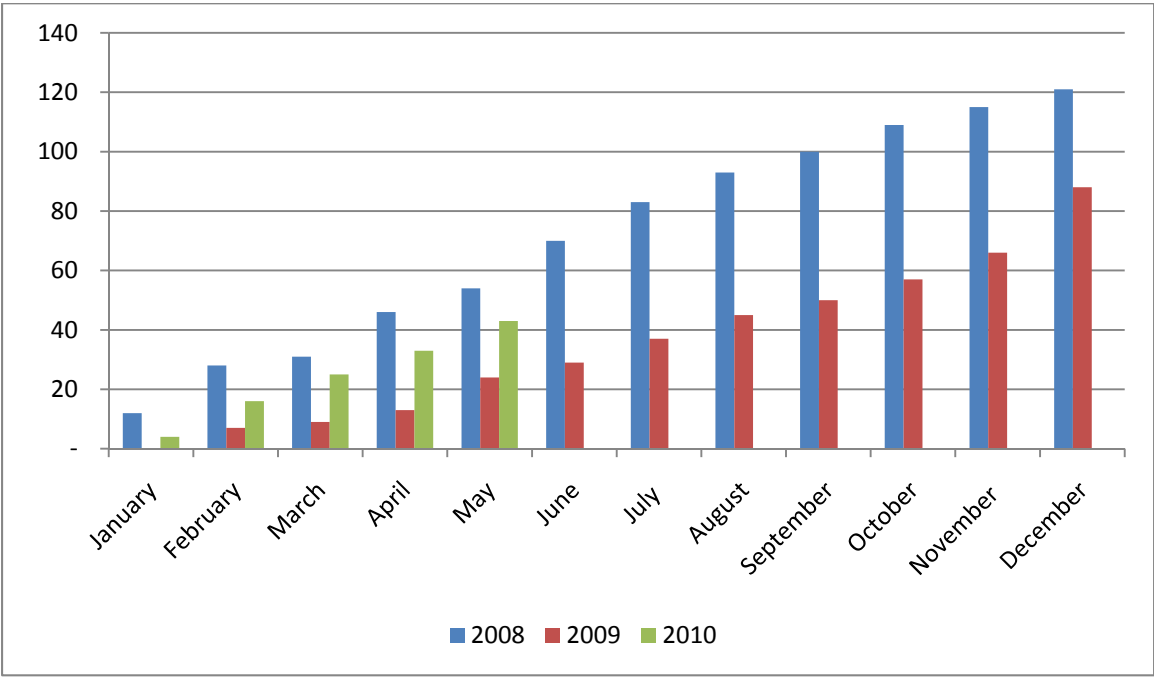
What's Improved:

The tax-exempt bond financing market, which historically has been the primary funding source for nonprofit senior living providers, has seen a dramatic increase in activity. Based on data from Securities Data Corporation (SDC), last year at this point only 13 senior living tax-exempt bond financings had closed; this year there have already been 33 senior living tax-exempt bond financings that have closed.

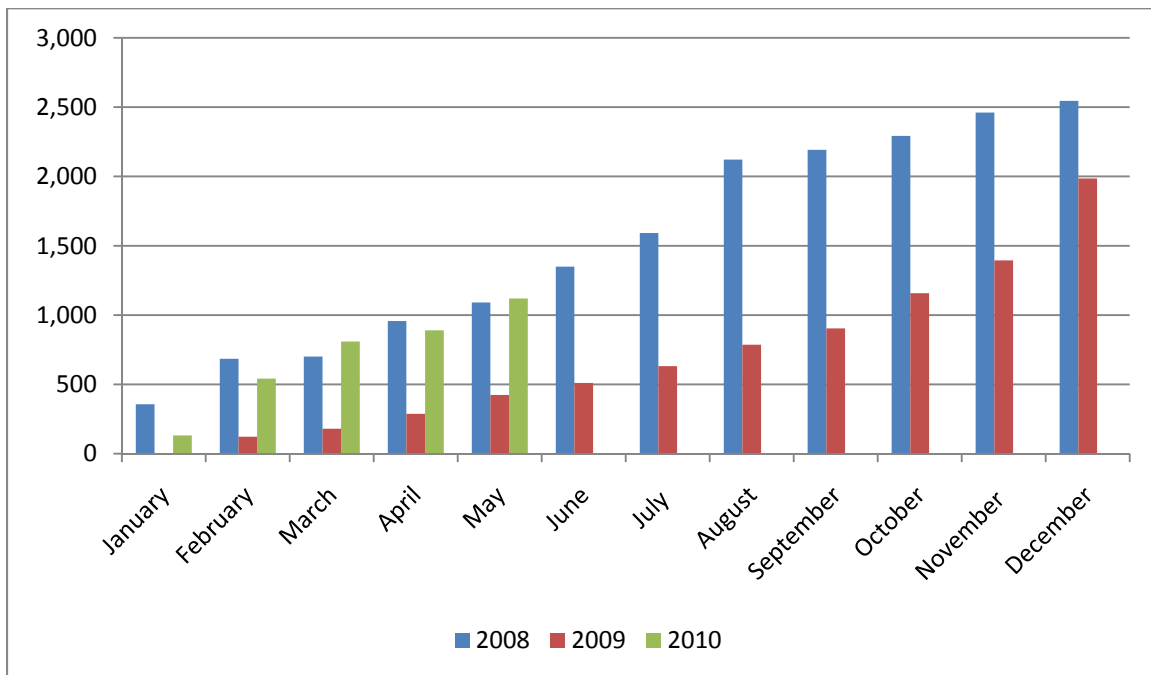
Cumulative Number of Tax-exempt Senior Living Bond Financings

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Cumulative Monthly Tax-exempt Senior Living Bond Financing Volume



Access to other sources and structures of capital has also improved.

Although a tried and true source of funding for for-profit senior living providers for many years, historically nonprofit senior living providers have not utilized agency debt (FHA and Fannie Mae programs) as a funding source. These programs provide favorably priced long-term debt that for eligible projects can be more attractive than traditional tax-exempt bond financing.

Bank lending through a variety of structures has also become more active, although it is still significantly below the 2006/2007 levels.

Privately placed bank qualified bonds, which became a more viable structure due to changes contained in the Stimulus Act, continue to be a preferred structure for both regional and community banks, as well as national banks.

For banks that are members of the Federal Home Loan Bank system, the Stimulus Act also contained provisions that allow the FLHB to wrap a member bank LOC such that the enhanced bonds secure a rating of “AAA.” This rating then allows the bonds to meet the investment/rating requirements of money market funds.

Another provision of the Stimulus Act, which is just starting to receive attention within the senior living sector, is the 2% de minimis provision. This provision enables a financial institution to invest up to 2% of its assets in municipal bonds and receive tax-exemption on a portion of the return. This savings is then passed

on to the borrower through the negotiated bond rate. There are specific requirements for eligibility, but the basic rule is that the bonds must be new money bonds or refunding of new money bonds originally issued in 2009 and 2010. Refinancing of new money bonds originally issued before 2009 are not eligible.

Traditional bank letters of credit are also available again for selected providers in selected geographies, primarily for existing borrowers with refinancing or modest expansion projects.

As we talk with commercial banks, it is clear that they are still cautious in extending new credit, but, unlike last year when they were hesitant to receive new credit requests, now they are interested to see new requests and review them for bank specific criteria.

Ongoing Challenges:

Although the residential real estate recovery has started in selected markets across the country, many markets continue to struggle. This has led to slower sales and move-ins and lower occupancies for both new start-up retirement communities, as well as for existing mature retirement communities. A review of publicly available data on the fill-up of new independent living units reveals that move-ins are now generally occurring at a rate of 2 – 3 per month, compared to an average of 4 -5 move-ins per month historical experience and industry standard. As a result of lower occupancy and concerns about general economic pressures, many providers have worked hard to trim operating costs and minimize rate increases. With this trend we see a risk for providers of deferring needed maintenance and capital replacement projects. This can then contribute to a further downward spiral when the facility appearance declines and the provider is then forced to keep lower rates to maintain census, and that makes funding of deferred maintenance and capital replacement projects that much more difficult. Once started, it is difficult to reverse this cycle.

Finally, for good or bad, changes in the health care system will continue to keep providers on their toes to identify changes impacting their operations (employee benefits), understand changes impacting their revenue (Medicare and Medicaid reimbursement), anticipate changes impacting their position within the health care continuum (dollars for home and community based services), and develop strategies to thrive under the new system. With change and uncertainty come opportunities for providers that are innovative and proactive.

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Despite the challenges, the fundamentals of the senior living sector are strong. Demographic data alone indicates an increasing demand for programs, services, and facilities designed for our aging population. The increased funding activity in the tax-exempt bond market and the growing number of financing structures and sources are positive signs for the sector. Providers will be challenged to develop and evaluate a variety of growth strategies which may involve alternative ownership and financing structures.