

Embracing the Risks of Senior Living Project Development

By Roger E. Randall, II, Senior Vice President



INTRODUCTION

Not-for-profit senior living organizations are at a crossroads. The organizations who choose to lead the change in their markets will continue to deliver on the promise of their mission, but those who choose to do nothing risk becoming irrelevant.

If organizations can no longer rest on their laurels, how should providers act on the opportunities available to them with confidence? Challenges and risk define senior living development. In fact, we recently came across a plaque posted in a life plan community recounting the fictional "Six Phases of a Project Financing," as recreated below. Anyone familiar with securing a home mortgage or financing a project can likely relate to some or all of the phases.

The stages are (meant to be) tongue-in-cheek, but when a project does not go as planned, initial enthusiasm can quickly dissolve into panic and a search for someone to blame. The process can be difficult; however, choosing to do nothing may prove an even riskier strategy.

SIX PHASES OF A PROJECT FINANCING

- 1) Enthusiasm
- 2) Disillusionment
- 3) Panic
- 4) Search for the Guilty
- 5) Punishment of the Innocent
- 6) Praise and Honors for the Non-Participants

The sheer breadth of opportunities available to senior living providers (independent living, assisted living, nursing care, home health, hospice, PACE, etc.) makes the complexity of senior living nearly unrivaled. This choice creates a seemingly endless list of possibilities to evaluate (whether choosing to enter or exit a particular business line). Each of these opportunities has its own set of quantitative and qualitative means of analysis. There simply is not enough space to address each one, **so this paper will focus on the specifics of senior living community development (new communities, expansions, and repositionings).**

All organizations have finite resources, particularly capital and time. As a result, there is opportunity cost with choosing to move forward with one project versus any of the other strategic opportunities available. This may delay, or forever eliminate, the possibility of embarking on those other initiatives. Therefore, having a well-defined methodology to evaluate such opportunities is necessary.

When evaluating whether to embark on a building project, not-for-profit providers must evaluate market, financial, legal, organizational, and mission-related criteria. Let us consider each one in turn. While doing so, please keep in mind:

- For each project and provider, these categories may have different degrees of importance;
- A separate white paper could be written on how to evaluate each one of the categories of a senior living project, so we will not endeavor to address every element, but rather touch on those aspects that likely have the most impact on future success or failure; and
- While written from the standpoint of evaluating whether to embark on a project, providers can use the same criteria to determine whether to discontinue operations or to divest a community.

MARKET MEASURES

There are four traditional activities to evaluate a market opportunity:

- 1) Defining the Primary Market Area ("PMA"): the geographical area from which the majority of future residents are anticipated to relocate from to move into the community;
- 2) Identifying the number of age, income and need-qualified people in the PMA;

"In the future, there will be two types of providers: the Excellent and the Extinct."

- Suzanne Pugh, CEO
Aldersgate Retirement Community

- 3) Estimating the net assets of that population; and
- 4) Ascertaining the competitive landscape in the market (both existing and planned communities as well as other means by which seniors can get the services and/or care they need).

The market analysis informs the degree of opportunity and how to respond to that opportunity. For example, your goal should be to determine how to meet the unmet needs in the local market and create a value proposition to differentiate from other area providers. The market analysis should allow you to determine which levels of care to offer, number and mix of units to develop, pricing levels supported by the market, contract types and service programming. You should be able to answer very specific questions about how to respond to the opportunity, including:

- Do local seniors understand and expect a health care benefit or prefer a fee-for-service model?
- Do local seniors prefer a rental product or an entrance fee product?
- For entrance fee-based communities, would the market respond to a plan that offers a high refund or a fully amortizing plan?
- Should pricing include all services, or could an a la carte plan attract more residents?

The local market around your project is likely the single biggest factor contributing to future success or failure; so ignore what the market is telling you at your own risk.

FINANCIAL FACTORS

The financial analysis of a project must consider: (i) financial projections and ratio analysis; and (ii) capital needs.

Financial Projections and Ratio Analysis

It is imperative to evaluate the projected financial performance of any project to determine whether to embark upon development or to move on. On the revenue side, the analysis should be grounded by the pricing, unit mix and program suggested by the market analysis. Operational assumptions must be based in reality, representing how your organization will actually operate it.

Once you have realistic projections, you can evaluate the financial viability of the project. Oftentimes this means looking at projected debt service coverage and liquidity ratios, as these are established measures of financial performance and financial health, respectively. Further, these are the same financial ratios that will serve as covenants if financed using bank debt and/or fixed-rate bonds. Accordingly, ensure that your calculations are consistent with how ratios are traditionally calculated in financing documents.

A ratio analysis is more nuanced than may initially appear. Yes, if you expect to access the capital markets to finance the project,

there is going to be some minimal level of performance necessary to attract enough investors to secure the financing. ***However, the board and management must establish a minimum level of performance that is acceptable to them.*** This will allow your organization to determine whether a potential project meets your requirements to proceed with development.

Those providers with existing operations have additional considerations to make. Take an expansion for example. If the existing operations are generating debt service coverage of say 1.75x, then it may appear prudent to require the consolidated performance (existing operations plus the expansion) should project to generate at least 1.75x coverage. In many cases, this is indeed prudent – otherwise, why are you choosing to expand?

However, there is nuance to this, as well. If that same organization is generating its 1.75x coverage on \$4 million of debt service, this means the community is generating \$3 million of excess cash flow, as shown in the table below. If the expansion generates 1.50x coverage on \$4 million of incremental debt service, you could argue that you are diluting coverage (from 1.75x to 1.63x). Based on that analysis, you could potentially decide not to pursue the project. However, this might be a mistake. By pursuing the expansion, you are adding another \$2 million of excess cash flow to the bottom line, thereby increasing the community's excess cash flow from \$3 million to \$5 million, ***thus increasing the credit strength of the overall community.***

(\$000s)	Existing Operations	Expansion Projection	Consolidated Performance
Cash flow available for Debt Service	\$ 7,000	\$ 6,000	\$ 13,000
Less: Debt Service	(4,000)	(4,000)	(8,000)
Excess Cash Flow	\$ 3,000	\$ 2,000	\$ 5,000
Debt Service Coverage	1.75x	1.50x	1.63x

Example: Expansion diluting coverage, but increasing excess cash flow and credit strength.

In addition to the above, there may be specific strategic aspects of a project that determine the decision to move forward. Perhaps your community is older and an expansion is the first stage of a multi-phased campus-repositioning project. When this is the case, it may be clear that while today the existing operations generate 1.40x coverage, the community is at risk of no longer attracting new residents, and thus cannot reasonably expect to maintain or increase its current level of coverage. In this situation, the prudent decision may actually be to move forward with the project (assuming it meets or exceeds all other criteria), despite a short-term dilution of coverage for the community's long-term viability. Regardless of the strategy, it is highly advisable to make sure the project is able to support its own debt service (this would be a debt service coverage ratio of not less than 1.0x).

Capital Needs

Further financial considerations involve whether your organization has access to the capital necessary to develop the project.

Pre-Finance Capital

Organizations must have a way to source the pre-finance capital necessary to support the development of a project until securing permanent financing. Pre-finance capital covers costs including site acquisition and entitlement, architectural design, marketing activities, legal, and consultant fees. Providers often use a combination of existing cash reserves and a bank loan to fund these costs. Some providers may be able to fund their pre-finance capital needs through bond anticipation notes, which involves accessing the capital markets to borrow fixed-rate debt from institutional investors, which will be repaid from the proceeds of the permanent financing.

Permanent Financing

Permanent financing provides the funds to construct the project. Since this is, ultimately, how your organization will fund the creation of the business, it is imperative the initial financial planning of the project is based on reasonable expectation of successfully accessing the capital markets when the time comes. If the project is not market-driven and financially viable based on criteria required by the capital markets, then the project is not viable and development should not commence. Examples of proper structuring for tax-exempt financing include, but are not limited to:

- Projections based on a cost of capital that is commensurate with interest rates that can actually be achieved in the market generating financial ratios at least as strong as minimally required by investors;
- Selecting a contractor that can put up the necessary payment and performance bond and a guaranteed maximum price contract that includes a liquidated damages clause;
- Equity contribution or liquidity support agreement from the parent, if necessary;
- Unit pricing that is supportable in the local market; and
- Budgeting and acquiring the amount of pre-finance capital necessary to achieve the anticipated amount of pre-sales, entitle the project, secure land (if necessary) and complete construction drawings so a guaranteed maximum price contract can be secured.

For organizations that do not routinely develop projects and access the capital markets, it may be difficult to make those determinations in a vacuum. **As a result, it is advisable to assemble an experienced team early (during initial planning) to ensure your project is structured consistent with these requirements.**¹

As mentioned above, some projects may need to have cash equity and/or a committed reserve from the parent (typically called a liquidity support agreement) that can be accessed if the project needs additional capital during construction (cost overruns, construction delays, etc.) and fill-up (to fund larger-than-

anticipated start-up losses). An inability to make such contributions may result in higher-than-anticipated interest rates or even failure to finance the project.

LEGAL LOGIC

Every business decision has legal considerations that must be identified. The decision involves evaluating whether the benefits of the project are worth assuming the legal risks. Senior living project development is impacted by planning and zoning laws, health care regulation and tax law. Some examples of the first two include:

- *Site development*: Most sites will require rezoning, entitlements and variances. Municipalities have varying sophisticated processes for accomplishing those objectives;
- *Health care*: Health care is highly regulated and these regulations have a direct impact on what can be developed (certificates of need for nursing beds), your architectural design (hallway widths and fire access), and operating expenses (the minimum ratio of nursing hours to patient days for direct-care staff);
- *Organizational structure*: Many providers choose to establish separate operating entities to control and operate start-up projects to insulate other entities from the risks and financial commitments of the project; and
- *Marketing*: Many states regulate entrance fee-based senior living communities as specialty insurance providers. There may be numerous approvals necessary to commence solicitation of as well as approvals necessary to start construction or utilize entrance fee receipts (to fund construction, pay down debt, fund start-up losses, etc.).

Being a not-for-profit entity carries its own special set of tax law considerations. When your organization applied for tax-exempt status, it submitted Form 1023 to the Internal Revenue Service. Among the items provided in the application was an indication of the type(s) of business your organization would operate in support of its mission. This was a key component of the IRS's decision to grant the tax exemption. As a result, if you enter a business that would materially alter the operating structure and revenue sources of your organization, such a change could affect your tax-exempt status.

When evaluating an opportunity it is important to understand the requirements to legally develop, market and operate the business. As always, consult your organization's counsel to evaluate the particulars of each situation.

ORGANIZATIONAL OPTICS

Board and management must have the tools to evaluate strategic opportunities and the requisite knowledge to use those tools and interpret their outputs. **Accordingly, board education and preparation is oftentimes the single greatest need when making such decisions.** As noted in the 2016 Global Board of Directors

¹ The capital markets change constantly and it is generally not possible to accurately predict future interest rates. As a result, it is recommended organizations assume a cost of capital greater than the current prevailing rate for similar projects. The amount of such "cushion" is dependent on numerous factors, so requesting appropriate assumptions from your chosen investment banking team is advisable.

Survey,² 60% of board members globally indicate there is a gap between the expectations placed on boards and the board's actual ability, with 25% of the group that perceives such a gap indicating expectations far exceed reality. This deficit has far-reaching implications. It can delay the decision-making process and decisions that are made may be based on incomplete or incorrect understanding. This can result in making the wrong decisions or passing on the right opportunities.

With limited resources, choosing whether to develop a new project must consider whether the organization can effectively provide the resources necessary for success. We have already discussed this from the capital standpoint; however, it is important to understand this from the standpoint of time. Adding a new community will not only require the addition of staff, but existing staff will see their roles grow and change as well.

- Do you have the systems in place to leverage your staff, but not overwhelm them?
- Are your accounting and treasury functions up to the task of accurately reporting the operating performance and paying vendors in a timely manner?
- Can you adequately respond to the regulatory burden if you are entering a new business line?
- Is there another compelling opportunity you have identified that you cannot pursue if you choose to move forward with the one you are currently evaluating?

MISSION DOES MATTER

The motivation behind project development by for-profit corporations is generally cut-and-dry – does the project result in a risk-adjusted rate of return above what the corporation could otherwise generate and drive profit to the bottom line. The motivations for not-for-profit organizations can be far more subtle. Certainly, not-for-profit organizations understand their strategic initiatives must generate positive cash flow; otherwise, they are operating on borrowed time. However, mission also motivates not-for-profits. This can result in making justifiable decisions that devalue (or ignore) the other criteria outlined above. This is not necessarily a bad thing; it is just another business decision.

Before embarking on project development, it is imperative that all stakeholders and decision-makers have a clear understanding of, and agree upon, the mission and vision of the organization.

² Conclusion derived from the additional data compiled in 2016 Global Board of Directors Survey prepared by Spencer Stuart and WomenCorporateDirectors Foundation.

Only when that occurs will an organization be able to define how a project fulfills those objectives. If a project gains traction and management or the board does not believe it is consistent with the organization's mission, the project will become an albatross as other initiatives, which do support the mission, benefit from the allocation of precious resources.

Some providers have chosen to give more weight to mission when considering opportunities such as serving a disadvantaged neighborhood, offering daycare services to attract staff, or continuing to serve declining markets with high concentration of a particular religious or affinity group.

CONCLUSION

There are many factors to consider and this paper has only scratched the surface of how to evaluate an opportunity and how to interpret those evaluations. ***It is imperative the organization's decision-makers agree upon the criteria used to determine whether to proceed, pause,***

"If you dislike change, you'll dislike irrelevance even more."

- General Eric Shinseki (Ret),
former US Army Chief of Staff

or pass. We encourage organizations to create a dashboard with metrics everyone agrees to. Each of those metrics should have green, yellow and red ranges to enable the board and management to monitor the progress of the development at all times. In fact, the best organizations are constantly testing and retesting their decisions as new information is available. During any development, your team must be ready to adjust as challenges arise. In order to ensure the best information is available, you must have a process in place everyone supports and a team you trust to execute that process.

You are creating (or recreating) a business. Things will not go according to plan, despite best efforts – that is the nature of development. The true value in having an experienced team you trust is evident when such adversity strikes.

The reward is worth the risk. Retired General Eric Shinseki said, "If you dislike change, you'll dislike irrelevance even more." Organizations must change and grow. By choosing to do nothing, you have decided to allow your competition to control your fate; and they will not be benevolent.



Information and opinions presented in this report have been obtained or derived from sources we believe to be reliable and accurate, but we do not guarantee its accuracy or completeness.

The information, tools and material presented in this report are provided to you for informational purposes only and are not to be used or considered as an offer or the solicitation of an offer to buy or sell any security or to participate in any trading strategy.

BB&T Capital Markets is a division of BB&T Securities, LLC, member FINRA/SIPC. BB&T Securities, LLC is a wholly owned nonbank subsidiary of BB&T Corporation. Securities and insurance products or annuities sold, offered or recommended are not a deposit, not FDIC insured, not guaranteed by a bank, not insured by any federal government agency and may go down in value.

© 2018, Branch Banking and Trust Company. All rights reserved. BBTCapitalMarkets.com/Healthcare