BB&T Capital Markets

The Need for High Cash Levels for Entrance Fee CCRCs

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As head of BB&T Capital Markets' Healthcare Finance Group, Franklin is responsible for leading one of the most active tax-exempt health care investment banking groups in the nation. During his 26-year career as an investment banker, he has completed more than 100 health care transactions totaling more than $5 billion in 15 states.

"Future access to capital" will be a key factor in determining whether stand-alone CCRCs remain independent, and access to capital on attractive terms may require larger liquidity positions (more cash) for senior living providers. Money will probably only be loaned to those who have money, like the old days, and only to those who can pass significant tests to assure lenders will be repaid. **Specifically, there are four dynamics that will drive the need for high cash and investments (high liquidity) for nonprofit senior living communities**.

The first dynamic is how nonprofits access capital compared to their for-profit counterparts. Nonprofit senior living providers have two basic sources of capital – cash on the balance sheet (internal) and debt (external). In addition to cash and debt, for-profits can tap other sources of capital including real estate investment trusts (REITs) and equity. This gives for-profits a great deal of flexibility when it comes to raising capital. In fact, this advantage is part of the reason the growth of for-profit senior living providers has far outpaced the growth of nonprofit senior living providers. **Therefore, as the only alternative to debt, cash on the balance sheet will continue to be a very important source of capital in the future for nonprofit CCRCs to remain competitive**.

The rating agencies (Fitch and Standard & Poor's) who rate the debt of for-profit as well as nonprofit senior living providers reflect this belief through their credit ratings of nonprofit CCRCs. To achieve a credit rating in the "A" category, which is the rating nonprofit CCRCs strive for and is the rating of most nonprofit hospitals, a CCRC needs to have over 600 days cash on hand according to Fitch and S&P. **This is important because the higher a CCRC's credit rating, the lower the interest rate on its debt, which lowers debt payments and allows the organization to keep rates lower for its residents**. Fitch and S&P recognize that cash and debt are the only two sources of capital for nonprofit CCRCs and as a result, they believe that nonprofit CCRCs will need lots of cash to remain relevant.

The second dynamic is change. While change is challenging for many organizations, it is also very necessary to maintain healthy, vibrant communities. Change is inevitable, and though we all know that change will happen, it is nearly impossible to predict in what form change will occur. A quote from General Shinseki, 34th Chief of Staff, U.S. Army sums it up. "If you don't like change, you're going to like irrelevance even less." **Nonprofits can equip themselves to remain flexible and adaptable to change by having a strong balance sheet with plenty of cash**. Possible changes that will require capital (cash and/or debt) include: future increases in construction costs to maintain and expand existing facilities; increase in risks associated with skilled nursing strategies; the need to expand into home and community based programs, and; future increases in interest rates which decrease debt capacity requiring more cash to fund necessary initiatives.

Speaking of change, the third dynamic is the advent of accountable care organizations or integrated health care delivery systems that will focus more on quality and outcomes rather than volume. There will be increasing costs in all levels of post-acute care coupled with downward pressure on payment/reimbursement levels as residents are being discharged sicker and quicker from hospitals. Therefore, it will be critical for nonprofit CCRCs to not only deliver quality care, but also articulate value through measurable outcomes. **This will take capital (cash) to invest in the people, systems and technology to create the ability to measure and articulate measurable outcomes**. Those that do so will be sought-after partners in the new quality-based economic model. In addition, this has the added benefit of creating a very important differentiator for your organization in an increasingly competitive market.

The fourth dynamic is increasing competition in the senior living industry, especially from the for-profit sector. As mentioned earlier, for-profits are growing faster than nonprofits and have increased their market share of continuing care retirement communities from 10 percent twenty years ago to more than 30percent today and the trend is accelerating. Over the past five years, independent living unit construction has averaged approximately 3,000 units per year. During that same time period, for-profit construction has gone from 7,500 units per year to more than 14,000 units per year. In addition, like the acute care industry, there will be increased consolidation of providers along the post-acute continuum. This will lead to new and larger competitors for CCRCs including acute care hospitals, long-term care hospitals, sub-acute care hospitals, rehab hospitals, skilled nursing facilities, assisted living, independent living, outpatient therapy providers, home health and hospice.

With the increase in for-profits and the growth of larger nonprofit systems, there will be more "sharper elbows" with less industry collaboration. As a result, nonprofit CCRCs may find it difficult to maintain a "nonprofit" culture of collaboration and service. **Having a strong balance sheet with sufficient cash will help keep a nonprofit culture intact by allowing the organization to make decisions based not only on the "bottom line," but to act as a true partner in the community**. For example, though demand for Senior Living services will increase, the pool of asset and income qualified seniors may likely shrink, and the affordability factor will be more challenging in the future, creating a need to provide more affordable alternatives to a wider range of residents/customers. Therefore, keeping a unique nonprofit culture alive will be a differentiator in a more competitive market. CCRCs that are well-capitalized with sizable cash balances will have more choices to pursue or fend off other providers.

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