



INSIDE THE WORLD OF SENIOR CARE MERGERS, ACQUISITIONS AND FINANCE SINCE 1948

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In late April, the Centers for Medicare and Medicaid Services released some preliminary "thoughts" on how it might change the RUGs-IV Medicare rates for skilled nursing facilities. The reaction was not too positive, as could be expected.

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The economy certainly had an impact on CCRC occupancy rates, especially those that are old and those new ones trying to fill. But troubled CCRCs should act sooner than later to maximize value, and not wait for things to "work out."

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## SKILLED NURSING STOCKS DROP

### CMS Announcement Sends SNF Investors Fleeing

There was a fair amount of "big" news in the skilled nursing market in April, not the least of which was the rather unusual announcement from the **Centers for Medicare & Medicaid Services (CMS)** proposing new SNF Medicare rates for fiscal 2012 with a net increase of 1.5%, or maybe not. Behind Door #2 was a net decline of 11.3% for fiscal 2012, which investors latched onto and viewed as devastating to the sector, sending most of the public companies' shares spiraling downward after the announcement. The industry was caught off guard because "the consensus thinking" was that CMS

needed more time to determine the full impact of the new RUGs-IV rates beyond the few publicly traded companies that reported better-than-expected profits, mostly from Medicare, for the fourth quarter of 2010 when the rates went into effect. The consensus was they would want a full year of data before making any recommendations. Beware the consensus.

As a result of the announcement, and the fear that the reality will be a rate cut sooner than later, **Kindred Healthcare (NYSE: KND)**, **Sun Healthcare Group**

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## MORE CCRCs FOR SALE

### Better To Act Quickly In Distressed CCRC Sales

When the Great Recession hit, with the subsequent decline in single family home values and sales, stock portfolios, and investment returns for the elderly in general, the impact on the CCRC market was greater than most people expected back in 2007 and 2008. The development of new CCRCs was in high-gear, filling what many people thought was going to be a strong continuous demand through the aging of the baby-boomers. As we now know, it

didn't go exactly as planned.

One of the problems in the CCRC market is that there are several different "types" of communities, split basically between entrance-fee CCRCs and rental CCRCs, but within the entrance-fee category there are several different subdivisions. And providers and developers seem to be splitting in terms of favoring one type compared with the other, and are having

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and then worry about market rates once the reputation had been turned around; street rents are significantly higher. Historically, and we mean several years ago when New Seasons was running the facility, the EBITDA had been close to \$1.0 million with a census above 70 residents. Focus and Chelsea believe they will be there within a year, which would put the value close to \$11 million, or almost \$175,000 per unit. The purchase price for the note has not been disclosed, but our guess is that it was in the area of 50 cents on the dollar, which would mean they will more than double their money, if they choose to sell. Not bad.

## TURNAROUND TIME

About 15 months ago we wrote about an acquisition with the prospect of the buyer, **Kandu Capital, LLC**, and its management company affiliate, **Bloomfield Senior Living**, turning a **Sunwest Management** "lemon into sweet lemonade." One of the problems, of course, was neglect from Sunwest during its financial meltdown and the 3,000 mile distance from the property in South Carolina. The buyer, however, was not local as well, and because one of the buildings on the campus was never opened by the previous owner, we thought there might be too many variables to really turn this property into a cash cow, at least anytime soon. The campus includes an 81-unit independent living component which had oc-

cupancy of about 77% at the time of purchase in January 2010. Revenues and EBITDA were about \$1.33 million and \$200,000, respectively. At 90% occupancy, Kandu's forecast at the time of purchase was for revenues and EBITDA of \$1.8 million and \$433,000, respectively. The 23-unit memory care building was empty, but management projected stabilized revenues and EBITDA to be \$1.08 million and \$560,000, respectively, which implied an aggressive profit margin of 52%, or more than double the independent living margin. The purchase price was \$3.154 million, or \$38,900 per unit for the occupied building, with the memory care building coming at no cost (we called it a Sunwest buy-one-get-one-free sale), other than about \$50,000 for mold remediation and \$800,000 of other improvements.

So how did they do? The independent living building has current occupancy of 88% which, while an improvement, is not where management thinks it will be by the end of the summer. They had spent most of their time on the memory care building, both with renovations and marketing, which meant they did not focus as much on the part of the campus that had fewer needs. Annualized revenues and EBITDA (after management fees) are currently about \$1.87 million and \$472,000, respectively, which is a little better than the original forecast at 90% occupancy. They expect to hit 96% by the end of the summer, and at that



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point they may introduce other initiatives (see below). When stabilized, revenues and EBITDA are projected to be \$2.06 million and \$624,000, respectively. Based on that cash flow alone, and with current valuation metrics, they would have realized a \$3 million profit on their total costs in the project. But there is more.

The time was really spent on the memory care facility, and although it is small at just 23 units, it seemed to fill a market void. Kandu didn't start renovations until June 2010 but was able to open it on December 18—not exactly the best time of year to fill units. They projected 12 months to reach stabilization. The all-inclusive monthly rate of \$4,500 (which was the projected rate and is lower than other competitors), didn't hurt the marketing, and the “new” look had to help as well. As of May 1, the units were full with a waiting list, with eight months to spare. Based on 96% occupancy (more prudent than 100%), annualized revenues and EBITDA are currently running at about \$1.19 million and \$432,000, respectively. So, the revenues are a little higher and the EBITDA a little lower than forecast, which makes sense and puts the operating margin closer to industry norms. Right now, combined annualized revenues and EBITDA are approximately \$3.06 million and \$904,000, respectively, which is surprisingly close to the original forecast at purchase. At a 9% cap rate (take your pick) the value is about \$10 million, or \$96,600 per unit, or 2.5 times the entire original purchase price plus the cost of renovations. That's some sweet lemonade.

The story, however, doesn't end there. Once the IL portion hits 96% occupancy, they will start to move rents up to at least \$2,400 for new residents based on their analysis of the market. In addition, they will be adding “IL Plus” services, which will be assisted living “lite” in the units, and they believe that will increase annual revenues by more than \$200,000 with a margin in excess of 65%. In the memory care unit, now that occupancy is full, at some point they plan to start charging between \$5,000 and \$5,500 per month for new residents, and that will increase annual revenues by up to \$200,000 when fully implemented. They also may convert a part of the IL building to assisted living, but that may be more to fill a market need than a necessity for the community's performance.

All told, by the beginning of 2012 the annualized EBITDA will very likely be close to \$1.2 million, which will push the value up by another \$3 million or more, which is quite remarkable just two years after taking over ownership. There were a few decisions that did help them get to where they wanted to be. One was a

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key hire to run the campus, who also happened to have a specialty in memory care. In addition, previously there was no “licensed” administrator, and there is one now. Third, the previous marketing was ineffective and almost non-existent, and that changed quickly with a one-time \$40,000 investment. These initiatives are not necessarily rocket science, but common sense decisions and good staffing. Truth be told, we were a little suspect of their rosy projections at the time of the purchase, because of the empty building and the mismanagement, not to mention the location being pretty far from headquarters, which was one reason why we wanted to circle back and find out what happened. Our suspicions were obviously laid to rest, and we now believe that Kandu Capital can do what it says it is going to do.



#### FINANCING MARKET NEWS

There have been several large portfolios trying to make their way through the HUD refinancing queue, but a few of them may have found some other options. Take the case of the **Golden Living** (the former **Beverly Enterprises**), which has been trying to refinance close to \$1.5 billion of outstanding debt. **Citigroup** and **RBC Capital Markets** went to the market in mid-April with two parts of a new loan. The big piece is a \$1.5 billion loan expected to be priced at 99.5% with a spread over LIBOR of 350 to

375 basis points and a 1.25% LIBOR floor. The smaller part is a \$75 million revolving credit facility. The debt to be refinanced was put in place nearly five years ago by Credit Suisse. If successful, we assume this large slug in the HUD pipeline would be removed.

The other bit of news we heard was that the holders of about \$850 million of CMBS debt from **SavaSenior-Care** and **Fundamental LTC** have agreed to extend (and amend) the loans for at least another two years. The maturity date was coming up soon, and the borrowers were also in the HUD queue and running out of time. We assume this also gives the principals involved in the companies (the landlord and the tenant) more time to continue in their various lawsuits against each other. Our understanding is that as part of the agreement to extend, the interest rate went up a bit and that there was a change in the amortization. In addition, the holders of about \$200 million in mezzanine debt also agreed to extend, receiving a higher rate as well. **GE Healthcare Finance** picked up part of this mezzanine debt with its acquisition of **Merrill Lynch Health Care Capital** several years ago, and we believe **Fortress Investment Group** holds a piece of it as well. In both this situation and the Golden Living case, both borrowers would be better off with long-term HUD debt, but it was never clear they could get the entire portfolios through the queue, and time was running out.



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