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## Senior Living

by Steven W. Kennedy

## Changing Trends for Lending in Senior Living

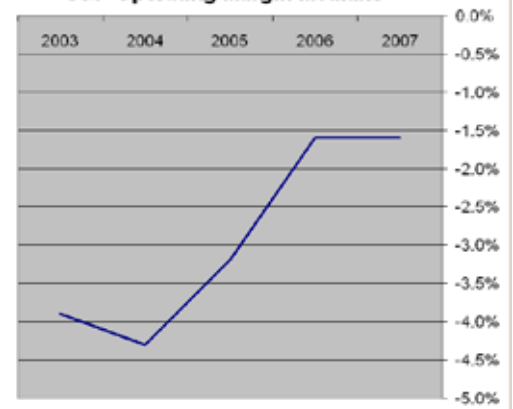
Tax-exempt bond volume in the non-profit senior living sector was up 41 percent during 2006, to almost \$6 billion. Much of this growing stream of capital funded new construction and substantial rehabilitation projects, further upgrading and expanding the country's senior living stock, which now totals an estimated 57,840 facilities. Over the past few months, however, senior living stakeholders have been forced to re-examine the sector's future growth prospects as the economy digests the current subprime mortgage meltdown. Is the current housing slump going to affect senior housing development?

**Sector Financial Performance: From Negative to Positive**

In order to evaluate what lies ahead for the senior living industry, it is first necessary to understand how the sector has performed in recent history.

From 2000 through 2004, bond rating downgrades vastly outpaced upgrades for rated nonprofit senior living credits at a nearly 5 to 1 clip, evidencing sector-wide credit challenges. Senior living operators wrestled with multiple operating pressures, including nursing shortages, increasing liability insurance premiums, and the rising cost of delivering healthcare to skilled nursing facilities. Post-Sept. 11 stock market volatility took an additional toll on the non-operating income of providers, especially providers with asset allocations overexposed to equities. Earnings pressures were compounded for organizations that had funded campus expansions via large debt offerings.

Chart 1: Nonprofit Senior Living S&P Operating Margin Medians



However, economic momentum shifted in favor of the sector over the past few years. Profitability ratios have strengthened (see chart 1), spurred by strong demand. Liquidity ratios have remained solid as providers retain cash flow from operations on the balance sheet while reinvesting cash in business growth. And leverage ratios have gradually strengthened as newly constructed and expanded operations have generated cash flow to pay down debt and bolster balance sheet stability. This positive business climate has resulted in upgrades outpacing downgrades since 2005.

**Micro Affecting Macro**

Recent favorable microeconomic results have positively influenced the sector's macroeconomics. Specifically, with upgrades outpacing downgrades, investors are not demanding such substantial cost of capital premiums for lower-rated and non-rated senior living borrowers when compared with their A-rated peers as historically had been the case from 1999 through 2004.

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# The Capital Issue: Senior Living (cont. from page 1)

Rather, healthcare credits spreads have narrowed (see chart below), providing more cost-effective access to capital to a wider basket of senior living credit profiles. This improved access, combined with a relatively low interest rate environment and surplus investor liquidity, has spurred continued investment into senior living operations.

## The Impact of the Housing Slump

During this recent period of positive senior living economic data, the soft housing market has lurked on the horizon as the highest risk factor to the sector's continued growth and success. In summer 2007, the housing slump finally began to produce high default rates. Borrowing costs rose in August 2007 as the "U.S. housing slump led to an increase in loan delinquencies among borrowers with a patchy credit history, clouding the outlook for economic growth." (Bloomberg, Sept. 2007) The Federal Reserve took action to quell the market's liquidity crunch, first dropping its Discount Rate to member banks by 50 basis points, then cutting the target Fed Funds rate a half-percent, the first cut of any amount by the Federal Open Market Committee since June 2003. Though Alan Greenspan compared recent market behavior to the 1987 stock market crash (Bloomberg, Sept. 2007), he and the majority of economists seem to now agree the worst is over.

## Toward the Future: Cautioned Optimism?

Has the recent credit crunch caused a paradigm shift in senior living lending, or is it just a bump in an otherwise bullish sector? Either extreme is probably just that; too extreme. S&P's 2007 median ratio analysis reiterates stability in the sector. After all, senior living is buoyed by favorable long-term demographics and three years of positive operating trends.

However, lenders and other capital market participants are viewing senior living financings with a more careful eye than in early 2007. "Senior living operations may be strained in the long term due to the current turbulence in the equity markets and softness in the real estate market, which together could result in reduced non-operating income and add pressure to demand characteristics going forward." (S&P, 2007) Specifically, the current softness in the residential real estate market looms large, particularly for that part of the continuum providing little or no healthcare, such as independent living or congregate units. These services are driven primarily by consumer choice and, in many cases, the consumer will choose not to move into a senior living environment until his or her personal residence is sold.

Additionally, interest rates will impact sector growth prospects. Long-term fixed interest rates have remained at relatively low levels despite the Fed increasing short-term rates 17 times from summer 2004 through summer 2006. However, a substantial increase in longer-term fixed rates would most likely slow down new development and make it more expensive to revitalize existing properties. Further, while healthcare credit spreads narrowed significantly during 2005 and 2006, they may be showing indications of widening again, which would increase the relative borrowing costs for non-investment grade or low investment-grade credits.

In sum, lending for senior living continues to be positive, but recent subprime-related challenges may drive a larger wedge between the "have's" and the "have not's." Those borrowers with solid financial profiles and proven operating track records should continue to benefit from today's low-cost interest environment. On the contrary, senior living credits with over-leveraged balance sheets and a dearth of liquidity may discover capital is now tighter than it was earlier in 2007. Overall, the senior living sector's solid fundamentals and compelling demographics provide capital market participants confidence that the economic climate of tomorrow's senior living sector is probably more similar to the last couple years than that of 1999-2004.

