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Senior Living

by Steven W. Kennedy

Revisiting Senior Living Borrowing Trends

On the heels of a 2005 - 2006 surge of 41 percent in senior living tax-exempt bond volume, capital investment in the sector was even more bullish in 2007. Bond volume was up nearly 24 percent this past year to roughly \$7.3 billion, easily besting analyst estimates. Much of this growing stream of capital continues to fund new construction and substantial rehabilitation projects, further upgrading and expanding the country's senior living stock, which now totals an estimated 57,840 facilities.

Today, however, senior living stakeholders have been forced to re-examine the sector's future growth prospects as the sputtering US economy digests the most significant challenges to the housing market in decades. Is the sector finally teetering on the brink of a financial downturn?

Sector Financial Performance: From Negative to Positive

In order to evaluate what lies ahead for the senior living sector, it is first necessary to understand how the industry 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 de-

livering health care 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.

Economic momentum, however, shifted in favor of the sector over the past few years. Profitability ratios have strengthened, 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

The favorable microeconomic results of 2005 through 2007 positively influenced the sector's macroeconomics. Specifically, with upgrades outpacing downgrades, investors were 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 had been the case from 1999 through 2004. Rather, health care credit spreads narrowed from 2005 through much of 2007, providing more cost-effective access to capital to a wider spectrum of senior living credit profiles. This improved

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access, combined with a relatively low interest rate environment and surplus investor liquidity, spurred continued investment into senior living operations.

Housing Slump

During this recent period of positive senior living economic data, the soft housing market 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. Trying to stave off a prolonged economic downturn, the Federal Open Market Committee decreased short-term lending rates 325 basis points from September 2007 through their last meeting in June, as sub-prime related turmoil spread throughout the credit markets. To date, the majority of bond insurers have been downgraded, and some of the country's highest-rated health care providers have found themselves paying upward of 12 to 15 percent on their variable-rate debt as the auction-rate market imploded.

Senior Living: Feeling the Pain?

One might assume that today's economic challenges likely mean the end of the senior living "glory days" of 2005, 2006 and much of 2007. Yet Fitch's 2008 outlook for continuing care retirement communities is stable despite the general market's challenges. While industry analysts project some potential occupancy stress in coming years, favorable age demographics and broadening awareness of the benefits of the lifestyle offered by senior living communities is translating into strong demand. For example, 2007 median occupancy figures totaled 94.4 percent across all senior living sectors, according to the American Seniors Housing Association's "The State of Seniors Housing 2007." And while CCRCs have significant exposure to floating-rate debt, the vast majority of senior living variable-rate debt is made up of remarketed variable-rate demand bonds, the more mature cousin to troubled auction-rate securities. Variable-rate demand bonds continue to exhibit relative stability.

On the other hand, several factors promise to offset at least some of the benefits of strong demand characteristics. First, providers' investment income already has taken a hit due to the reeling equity markets and nearly non-existent fixed-income returns. Second, a decline in home prices eats into potential CCRC residents' equity, decreasing the supply of income-qualified seniors eligible to reside in independent and assisted living units. And third,

the decline in federal and state tax receipts due to a struggling economy strains the Medicaid system, a huge payor that funds the care for roughly 6 of every 10 nursing patients.

With the economic outlook for the senior living sector mixed, but more promising than many other sectors, one microeconomic factor in particular could either make or break individual senior living providers in the coming years.

Cash is King

Liquidity on the balance sheet will likely play the biggest role in determining a senior living provider's fate. Organizations that have successfully built cash on the balance sheet have positioned themselves to withstand the overall market's challenges and volatility. While non-operating income should decrease as investment returns and contributions decline, providers with liquidity have largely evidenced solid core operations and are not overly dependent on secondary sources of income. Cash-rich organizations have an enhanced ability to weather threats to demand resulting from housing sales declines and slowdowns in government payer receipts. Financial cushion allows an organization's leadership to continue to focus on long-term strategy and execution, rather than being focused on continually putting out fires.

On the other hand, relatively cash-poor providers are positioned to face some potentially serious challenges. Dependence on non-operating income, burdensome debt loads, and reliance on a large Medicaid population leaves little margin for error. The market's recognition of this challenge is perhaps best quantified by the 100 basis point increase in the spread between BBB and A-rated health care curves over the past year.

The pressures of today's economy will drive a further wedge between the "have's" and the "have not's." Current liquidity measures will prove to be the best predictor of the future health of senior living providers.