

Changes in Financing Senior Housing Developments: How to Succeed in Today's Market

WHITE PAPER:
Realistic Approach Required to Prosper



Special Report Prepared by: Ebenezer Management Services and Piper Jaffray



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SECTION TWO

Executive Summary

For a number of years, the anticipated surge in senior retirees has served as open invitation to developers. Developers of all kinds have jumped onto the bandwagon of building housing for Minnesota's aging population — it's one of the few remaining construction opportunities with access to capital and the prospect of profits. In Minnesota alone, the number of persons over age 64 will double by 2035 (U.S. Census Bureau) / (Smetanka, Mary Jane. "Surge in Seniors Will Reshape State." *Star Tribune* 18 July 2010: A1+.) In fact, by 2020, for the first time in state history, retirees will outnumber schoolchildren (U.S. Census Bureau) / (Smetanka, Mary Jane. "Surge in Seniors Will Reshape State." *Star Tribune* 18 July 2010: A1+.) Healthcare for retirees may change swiftly, and soon.

However, the landscape has changed dramatically over the past couple of years. Developers in the past few years increasingly find themselves with higher costs and empty units due to changes in senior demographics and behaviors, the prolonged economic downturn, and an increasingly

volatile financial industry. The first wave of sweeping health care reform requirements, which took effect in September, promises new layers of complexity and potential opportunity for those who can offer services that comply.

The two most common reasons for failed developments right now include 1) outdated/incomplete pro forma data; and 2) financial instability from the volatile economy and/or faulty or overly optimistic assumptions. As a result, an accurate pro forma has never been more important. It must be realistic from the beginning of the project. Similarly, acquiring financing should follow a linear process, with ample cash reserves that must be available when a facility opens. These are critical considerations for choosing management and financial partners.

Never has it been more important to have a track record of success. The following white paper outlines how the changing landscape can be navigated through a strategic planning process.

SECTION THREE

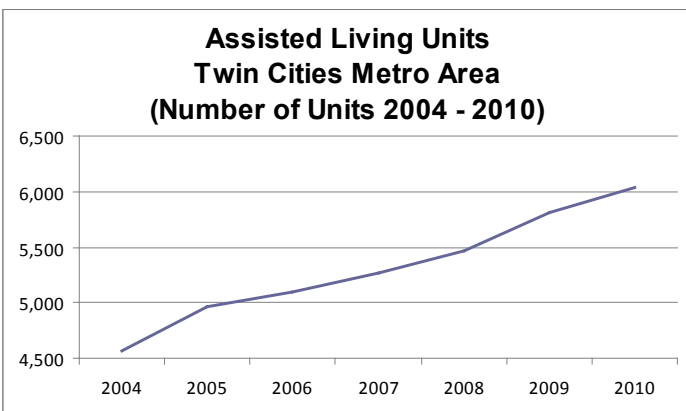
In northwestern Illinois, one recent senior housing project is a textbook example of poor planning. A developer constructed a 60-unit assisted living facility, but failed to take into account the necessary unit and common area amenities that prospective residents in that region would find attractive. Additionally, he inaccurately assessed the lease-up period, resulting in personal cash drain. Finally, the developer didn't anticipate the necessary number of employees and training needed to address the needs of higher-acuity residents.

any demographic, will respond to certain local and regional amenities.

Any good pro forma will provide financial projections that realistically analyze what is needed for a project to succeed in terms of financing and operating results. Unfortunately, too many developers use high-level or outdated assumptions that don't necessarily work. For example, they may expect the community to fill in 18-24 months based on data from

“The number one concern (when starting a new project) is the market and the acceptance of what you're going to do in the market.”

– Arnie Gregory, Owner, GRECO, LLC, and Developer of Nine Mile Creek Senior Living



The number of assisted living units in the Twin Cities metro area has increased by nearly 25% since 2004, yet penetration hovers just over four percent, indicating market oversaturation.

Source: Maxfield Research

Build a Winning Pro Forma for Assisted Living Developments

Market saturation impacts how fast a development may fill up and affects corresponding cash flow. Developers, unable to build condominiums or custom homes due to a depressed real estate market, have entered the senior world, resulting in an oversupply of assisted living units within certain market housing areas. For example, despite an increase in the number of units available in the Twin Cities market, penetration rate hovers just over four percent (source: Maxfield Research). Seniors and their adult children, like

a booming economy and vibrant real estate market, when in the current climate 24-30 months is more realistic.

While the average age at entrance to assisted living has increased only slightly over the past ten years, acuity has gone up significantly, likely due to stressors such as the housing market (would-be residents can't sell their homes), the availability of unemployed family members providing in-home care, and the economy in general (pensions, jobs, etc., lead to fewer resources available). In short, seniors are trying to cope with their health concerns on their own for longer periods of time than in the past.

Pro forma considerations must go beyond demographics, too. For example, expectations of assisted living care are increasing, and the common attitude is that “assisted living has become the rich man's nursing home.” More amenities, continuum of care with clinics/hospitals, and more general community taste preferences also play a role. These trends are reflected in newer developments, particularly in contrast to communities built 10-15 years ago.

For example, Ebenezer's Arbors at Ridges assisted living facility in Burnsville opened in March of 2002 and is considered a “second-generation” facility as compared to facilities that were built 20-25 years ago. First- and second-generation assisted living facilities contain small units and have little to offer in the way of amenities as compared to today's communities. Today, facilities offer many lifestyle opportunities, including fitness rooms, theatre rooms, putting greens and restaurant-like dining options. Contemporary settings provide a broad continuum of care

including independent living, assisted living, memory care and care suites, in contrast to the earlier generations that included only assisted living.

To avoid falling short, developers must understand the market for which they are building. Considerations include:

- Pricing, including local real estate, cost of living, and access to medical care, from both a base rent and a la carte service perspective, which can greatly impact the accuracy of a pro forma.
- Understanding the diverse needs of varying demographics when determining the demand for certain services or accommodations in a marketplace, including lifestyle expectations and religion or culture-specific needs.
- Tailoring a project to fit a market and its needs rather than employing a one-size-fits-all approach. On a practical level, unit amenities and features such as size and layout need to be desirable to the community.

So how does a developer go about understanding the core needs of a potential market? Ebenezer Management Services uses historical operating reports from its own and other managed properties, as well as other developments, to help create realistic financial projections. Similarly, developers must be familiar with the local housing market, including rentals and services. Local physical plants need to have the capacity to deliver the expected or included services. Using these data points can help ensure adequate cash flow reserves to pay the bills at opening and during the initial lease-up period.

Beyond general marketplace considerations, developers must also be attuned to trends and needs in the local assisted living industry. Increasingly, individuals are choosing to go into assisted living facilities instead of nursing homes, and upon entrance they may be more frail than ideal, having waited to sell their homes and undergone the stress of a major life change. Other times, people have delayed entering assisted living while unemployed family members have provided care. When they finally move into assisted living, residents want larger units with more generous square footage than typically found in a nursing home setting.

Health Care Reform and its impact on senior housing

Health Care Reform expects to introduce sweeping changes to the way in which health care is delivered, organized and paid for. The three core themes of health care reform include:

1. **Payment Structure Reform** – whereby governmental payers (Medicaid and Medicare) will introduce value based reimbursement, bundled payments and across-the-board payment reductions;
2. **Care Delivery Reform** – this includes creating the Center for Medicare and Medicaid Innovation, creating comprehensive effectiveness panels, expanded use of multidisciplinary teams and expanded use of electronic health records;
3. **Organization of Care Reform** – introducing the concept of Accountable Care Organizations (ACOs), medical homes and health information exchanges.

Accountable Care Organizations have been defined as a group of health care providers working together to manage and coordinate care for a defined population that share in any savings achieved by reducing the total cost of care while maintaining/improving patient outcomes. ACO goals include reducing the growth in cost per enrollee through prevention/wellness programs, reduce/eliminate duplication and improved care coordination. It is also hoped that ACOs could improve/maintain quality through the elimination of avoidable readmissions and improved patient outcomes.

While the ACO concept is generally thought to apply to Medicare and Medicaid populations, it also has commercial insurance implications. Fairview Health Services, the parent company of Ebenezer, is moving toward the creation and implementation of an ACO. Fairview already has a risk-sharing arrangement with Medica whereby any costs savings realized by improved care coordination is shared between the providers and the insurer.

Developers creating and implementing an ACO would need to provide the full continuum of services to the population that they are managing, including skilled nursing, transitional care, assisted living and care suites. A less costly alternative to a hospital inpatient stay would be, if clinically appropriate, transitional care, assisted living and care suites. Developers would need to be in a position to fully participate in the ACO continuum by providing the less-costly post acute care network. This would be comprised of company-owned and managed facilities which would include transitional care units, assisted living and other senior housing options. In the ACO world, it is clearly an advantage to be linked to a larger health system as opposed to being a stand-alone facility.

SECTION FOUR

The Right Partners Can Help Navigate New Lending Mine Fields

“We use [Fairview] as a referral point for everything that we do [to demonstrate that] the larger system has benefits, such as programmatic relationships and clinics.”

– Stephan Grygar, Vice President and CFO, Ebenezer Society

2006	2010
<ul style="list-style-type: none">• 85% Loan to Value	<ul style="list-style-type: none">• 75% Loan to Value
<ul style="list-style-type: none">• 90% Loan to Cost	<ul style="list-style-type: none">• 75% Loan to Cost
<ul style="list-style-type: none">• 1.25 proforma debt service coverage	<ul style="list-style-type: none">• 1.35 debt service coverage
<ul style="list-style-type: none">• Moderate lease-up assumptions	<ul style="list-style-type: none">• Extended lease-up assumptions
<ul style="list-style-type: none">• Moderate reserve funding requirements	<ul style="list-style-type: none">• Increased reserve funding as a result of the extended lease-up
<ul style="list-style-type: none">• Partial recourse; several liability	<ul style="list-style-type: none">• Full recourse at multiples of equity ownership; joint and several liability
<ul style="list-style-type: none">• Accelerated payment of development fee	<ul style="list-style-type: none">• Deferred payment of development fee
<ul style="list-style-type: none">• Funding for less experienced owners with moderate balance sheet	<ul style="list-style-type: none">• Funding generally restricted to experienced owners with strong balance sheet
<ul style="list-style-type: none">• Allowed for less experienced management	<ul style="list-style-type: none">• Critical to have experienced management under contract prior to closing

The economic landscape of the last two years has made financing a challenge for all new projects. Lenders, including banks and local HUDs have made the loan process increasingly tedious as applicants are more closely scrutinized. Banks have changed deal terms to become stricter and loan-to-value ratios have increased, requiring higher equity up front. In 2005, a lender might require 15 to 20 percent equity; that trend has been replaced by terms requiring 25 percent equity up front.

A July 2010 *Wall Street Journal* article reported that “[s]ome lenders...viewed the current lending standards a return to more normal conditions following a period of lax standards” but that Federal Reserve Chairman Ben Bernanke said “‘it seems clear’ that some creditworthy borrowers [are] having trouble getting credit, even when strong cash flow is compensating for a loss in collateral.” (Barkley, Tom. “Bernanke: More Needed To Boost Small-Business Lending.” *Wall Street Journal* 13 July 2010)

Working with a partner can ease the process of raising capital. Similarly, aligning with clinics and hospitals for senior living referrals and placement for elderly care provides a marketing campaign with built-in connections. Ebenezer Management Services, for example, benefits from referrals from Fairview hospitals and clinics. Having a guaranteed referral system ensures a steady stream of inquiries from prospective residents and their families, and ultimately contributes to the bottom line and financial stability of an assisted living unit.

To avoid potential bumps in the road, several basics can help the financing process run smoothly:

- Developing credibility and a positive reputation in the relatively small senior housing marketplace by highlighting past successful projects

- Being a good steward of money
- Being upfront about investors and financial backers from a cash reserve perspective
- Maintaining truthful and accurate balance sheets and financials
- Creating and fostering strong relationships with those involved in a development
- Being proactive in completing a market feasibility study—lenders need to see that there is demand for assisted living projects in the community.

In many cases, lenders are telling developers without experienced operators to work with specific, proven partners. They will request to review and approve the management contract as part of the funding application process.

“We can take a project from A to Z on behalf of a developer.”

– Mark Thomas, President and Chief Executive Officer, Ebenezer Management Services

Case Study: York Gardens



Architectural sketch of York Gardens (Source: Pope Architects)

York Gardens represents a prime example of a successful assisted living facility evolution. When finished in April 2011, the Edina, Minn., development will be connected to the nationally recognized 7500 York Cooperative, originally constructed in 1978. York Gardens includes some of the best practices and newest features for assisted living facilities, including Healthsense® technology—a Wi-Fi based service that provides data to sense health and safety issues and resolve them before they escalate. A Fairview pharmacy provides a sustained medical partner presence in the building, and will offer the option of on-site prescription refills, a convenience considerate of the cold climate. Amenities, tailored to the taste of the surrounding communities, will include rooftop patios, outdoor fireplaces, an in-house spa and fitness room, and a concierge to schedule appointments, secure event tickets or make reservations.

Residents and guests will also be able to take advantage of an on-site café/coffee bar to satisfy a sweet tooth or grab a sandwich or a favorite coffee drink, and an indoor play nook provides an area for young children to run around without disturbing residents. Those looking for entertainment may enjoy York Gardens’ club room during happy hour, a theater, a library and Life Long Learning programming.

The York Gardens facility is a successful project not only because of its cutting-edge care technology, amenities and overall appeal to prospective residents in the Edina community but also because, from planning to ribbon cutting, the entire project has followed a carefully planned timeline, with realistic pro forma projections and careful consideration for the preferences of future residents.

Timeline

(Source: *Ebenezer Management Services*)

- Summer 2006: York Gardens, an addition to the 7500 York Cooperative campus in Edina, Minn., is conceived.
- Preliminary – Aug. 2006/Final – Feb. 2009: Market studies for York Gardens are completed.
- June 2009: Ebenezer Management Services finalizes design for York Gardens. The \$17 million, 111,000-square-foot senior housing development will feature four levels and 76 units (47 assisted living apartments, 15 memory care apartments, and 14 care suites).
- Dec. 2009: Ebenezer Management Services finalizes financing for York Gardens with partner Piper Jaffray.
- May – Oct. 2010: Premarketing for York Gardens begins, including groundbreaking, hosting information sessions and preparing the sales office.
- Oct. 2010: sales office opens and premarketing campaign ramps up.
- Sept. 2010 – March 2011: Staff is hired for York Gardens.
- April 2011: New facility, featuring assisted living, memory care and care suites, opens.
- May 2011: Public grand opening celebration

For more information please visit yorkgardensedina.org

“I want sound financial information — good and timely financial information, and the financial reporting systems that Ebenezer has in place are top-notch.”

– Terry McNellis, Developer of Martin Luther Campus

Best Practices in Financial Management

While securing financing for a project is often the major hurdle for assisted living projects, prudent fiscal management over the life of a project will help ensure long-term success, long after development is complete. Cash flow breakeven generally occurs around 85% occupancy, or 24-30 months out from opening. The product mix within the facility can also impact breakeven, i.e., assisted living with services and memory care typically generate more margin than independent living—thus affecting breakeven.

Financial management begins with adhering to an operating budget – usually outlined in the pro forma. Choosing an architect experienced with senior housing also helps ensure that building planning is on track from the beginning of the development process and can result in significant value engineering opportunities. Naturally, choosing the most reputable contractors and engineers will also streamline the building process and can result in significant value engineering opportunities. Finally, involving the management company in the beginning of the design phase brings a practical voice to the table.

Having the proper amount of operating deficit reserves when the building opens is important and will help insulate developers from draws on guarantees during the first several years. Ongoing expenses, such as chef, maintenance team and other staff salaries will be covered by these reserves, and can ease the pinch of a slow fill. To avoid slow fill—and corresponding slow cash flow—allocating resources for appropriate marketing can positively impact a new project.

Marketing a new senior assisted living facility before it opens is crucial to filling up the building. Front-end sales and marketing activities can ensure high occupancy at opening and can increase fill in the first 18 months after opening. Projects in the marketplace that have experienced cash flow difficulties have usually filled up slower than pro forma, which underscores the importance of realistic expectations and adequate financial planning from the beginning.

Appropriate, experienced staffing also plays an important role in financial management. People with a commitment to serving seniors well will help to reduce turnover and help an assisted living unit run smoothly. Hospitality plays a significant role in resident matriculation and retention. Ebenezer Management Services has a hospitality program in place that includes training by industry experts.

Having a lead care attendant supervising other staff on site at all times ensures that orientation for all new residents is consistent. The lead care attendant can then often do on-the-spot training with the staff throughout the day, so lack of training doesn't affect customers. Knowledge of staffing ratios for different assisted living products is important with respect to both quality and cost. Higher acuity residents require more thoroughly trained employees and different staffing than low-acuity assisted living residents. Initial assumptions should consider the staffing ratios and experience needed for the facilities being built, along with lease-up rates.

SECTION SEVEN

“Before everything else, getting ready is the secret to success.”

– Henry Ford

Conclusion

The opportunity is there for developers. The number of seniors is growing and many local markets are far from saturated. However, their preferences and health behaviors are changing, making facility amenities a moving target. At the same time, the economy and new health reform laws have made serving this population more complicated than ever before. Never has it been more important to be prepared with the right data and processes. Never has it been more important to have a precise pro forma and financial assumptions. Never has it been more important to partner with organizations that understand the changing target market and the new financial processes. Organizations such as Ebenezer Management Services and Piper Jaffray Companies can help navigate both aspects of the development process that get it right in this market. Don't settle for less than success.

About Ebenezer Management Services

As part of Fairview Health Services, Ebenezer has provided older adults access to a full range of housing options and community-based programs and services since 1917.

Ebenezer's current portfolio includes over 50 operating entities serving over 5000 seniors each day.

Ebenezer's management division, Ebenezer Management Services (EMS), manages a range of senior properties including: senior condominiums and cooperatives; market-rate senior rentals; assisted living and memory care; skilled nursing facilities, transitional care units, care suites, small house concept and quality affordable senior housing.

EMS provides consulting and expertise to owners and developers of senior living communities, offering a variety of management packages, working alongside our clients to address areas such as:

- Start Up and Development (including architectural design, construction and interior design)
- Property Management and Operations
- Financial Feasibility, Pro Forma Development and Return-on-Investment Analysis
- Human Resources
- Maintenance
- Marketing and Sales
- Nursing Systems Consulting
- Purchasing Discount Program
- Technology

For more on these or other Ebenezer consulting and management services, contact Susan Farr, Vice President of Business Development at **612.879.1400** or visit us online at **ebenezermanagementservices.com**.



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