

LTC Debt Financing Strategies

While conditions are improving for providers seeking to finance growth, lenders are targeting solid-performing facilities.

ALTHOUGH NURSING FACILITIES continue to face formidable challenges, financial prospects have significantly improved in the past 12 to 18 months. In October 2003, the Centers for Medicare & Medicaid Services (CMS) announced a 2.9 percent inflationary increase in Medicare payment rates to skilled nursing facilities (SNFs) for fiscal year 2004. In addition, there was a market basket rate adjustment, which, when coupled with the inflationary increase, brought the total increase to 6.26 percent.

At the same time, SNF occupancy rates and other key operating performance metrics have begun to stabilize, albeit at relatively modest levels.

This gradual improvement in the financial environment for SNFs clearly positions providers more favorably to recapitalize their businesses and pursue growth opportunities. To develop effective debt financing strategies, these providers should know what lenders consider to be the crucial factors that will impact creditworthiness, leverage, and terms. They should understand broad economic trends, the regulatory climate, and the basic components of a SNF financial-operational analysis. Armed with such knowledge, they can make well-informed decisions on the financing options best suited to their business goals.

The Big Picture

A useful starting point for formulating a debt financing strategy is to scan some of the major forces that shape lenders' views of the market sector. Two of the most prominent for nursing

■ In 2000, the average life expectancy of a 65-year-old American was 17.9 years, an increase of 3.7 years from 1960.

facilities are the economy and demographic trends and projections.

Most experts agree that there is an economic recovery under way in the United States. The nation's gross domestic product increased by an annualized rate of 8.2 percent in third-quarter 2003—its strongest quarterly increase in 20 years—and another 4 percent in the fourth quarter. Some 60 top economists predicted that, in 2004, the U.S. economy would grow at its fastest pace since the 1990s. In addition, U.S. productivity is on the rise, the stock market rebounded strongly in 2003, and interest rates are hovering at near-historic lows.

A strong economy also will greatly benefit the profession's key demographic segment—the millions of aging baby boomers who are now in their peak earning years. Boomers will be more likely to help pay for their parents' long term care, and, by growing their own nest eggs, they will have sufficient funds available if they require long term care services themselves.

Other demographic trends are likely

to spur growth in the long term care marketplace as well. In 2000, the average life expectancy of a 65-year-old American was 17.9 years, an increase of 3.7 years from 1960. One study found that, among individuals aged 65 or older, the lifetime probability of becoming disabled in at least two activities of daily living or of becoming cognitively impaired was 68 percent.

As the population ages, lives longer, and develops more chronically debilitating conditions, the demand for long term care no doubt will increase. (The Annapolis, Md.-based National Investment Center for Seniors Housing and Care Industries offers useful benchmark data that can help providers to determine their properties' variance from local and national norms on such factors as geographic distribution, net worth, education levels, and general health and disability assessments.)

Components Of A Financial Assessment

With these factors in mind, providers seeking to finance growth or expansion should first research such key variables as the amount of capital available, the capitalization rate used in valuations, interest rates, and lending terms. Providers should also be cognizant of the primary factors that influence lenders, beginning with the financial and operational performances of their

JAMES PIECZYNSKI is director of real estate for the healthcare finance group of Chevy Chase, Md.-based CapitalSource, a specialized commercial finance company

facilities—which are closely linked—and changing developments in Medicare and Medicaid reimbursement. Other factors that providers need to ensure are met include:

- Revenue are supported by collections;
- Property taxes and payroll taxes are being paid on a timely basis;
- Operating costs of facilities are under control;
- Vendors and suppliers are being paid on time; and
- Annual survey results indicate a high quality of care.

Borrowers can also improve their financial leverage by understanding how lenders evaluate potential borrowers' financial statements. In the broadest sense, lenders are primarily interested in two things: the cost of operations and the predictable (and collectible) revenue a business will generate. Cost of operations encompasses a broad variety of expenses, including labor, food, supplies, drugs, equipment, insurance, administration, and other overhead. Labor costs are the largest expense in a long term care facility—about 55 to 65 percent of net revenue. A significant nursing shortage further exacerbates this expense.

Certain costs also are used to develop EBITDAR (earnings before interest, taxes, depreciation, amortization, and rent), a common metric used primarily for loan sizing. Providers who perform their own EBITDAR analysis need to be careful not to inflate this number by underestimating certain costs. For example, the commercial finance company CapitalSource deducts management fees equal to 5 percent of revenue and a \$300 per bed capital expenditure allowance in deriving EBITDAR for SNF loans.

Analyze Payer Mix

On the other side of the ledger, the financial analysis focuses on a nursing facility's three primary sources of revenue: Medicare, Medicaid, and private payers. Generally speaking, SNFs

depend on higher payments from Medicare and private-pay patients—which combined account for one-third of patient days nationally, according to CMS' "Health Care Industry Update, May 20, 2003"—to subsidize lower payments from Medicaid patients, who account for two-thirds of patient days. Nationwide, freestanding nursing facility revenue totaled nearly \$100 billion in 2001, with roughly 48 percent of reimbursements coming from Medicaid; 38 percent from the private

■ **Lenders will carefully examine a facility's payer mix, which is a key indicator of revenue and profitability potential.**

sector; 12 percent from Medicare; and 2 percent from other federal, state, and local sources, according to CMS.

Lenders will carefully examine a facility's payer mix, which is a key indicator of revenue and profitability potential. As a rule of thumb, the larger Medicaid's share of a SNF's patient days, the smaller its margins. The size and quality of a facility's therapy department is another important consideration, since therapy services are the key to maintaining a stable and profitable Medicare census. Lenders also will focus on the private-pay rates competitors are charging to gauge whether revenue is likely to increase or come under pressure.

Just as some costs are not always accounted for, some revenue is not always real, especially in a profession where some charges go uncollected. Lenders will pay special attention to a facility's cash flow, verifying that collections are aligned with revenue as well as per-day Medicare and Medicaid

reimbursement rates. This cash-flow analysis will compare historical collections to revenue recorded in income statements. Any major inconsistencies will be red-flagged for further discussion. Lenders also will take into consideration budget and projections, local market developments (the opening of a new SNF, for example), and current or anticipated reimbursement changes.

Concerns Over Quality Of Care, Liability

Providers must also be aware that lenders' due diligence activities will include other critical factors such as a facility's environmental and property reports and, perhaps most important, a thorough analysis of the state's annual inspection surveys. These surveys always have been a high priority to lenders, since states have the power to deny Medicaid payments or prohibit a facility from accepting new admissions. States generally take these draconian measures only if they find a facility has jeopardized the health or safety of its patients or shows a pattern of not meeting minimum standards for quality care.

In recent years, however, inspection surveys and quality performance indicators have assumed added importance. In several well-publicized patient liability cases, the courts ordered nursing facility providers to pay exorbitant penalties. These public spectacles taint by association all nursing facilities and can indirectly influence the views and actions of state regulators. Equally troubling, they have sent insurance premium costs through the roof.

On a more positive note, nursing facilities may benefit from state tort reform measures in states with high liability costs such as Florida, Mississippi, and Texas. Ohio, which historically has not been highly litigious in terms of nursing facility claims, passed preemptive tort reform measures in January 2003. Some nursing facilities have begun to limit med-

ical liability by having newly admitted patients agree to arbitration to settle disputes (*see Legal Advisor, page 3*)

Financing Alternatives

Until recently, middle-market SNFs have had few sources for obtaining debt financing. Nursing facilities with long histories of impressive financial performance or solid relationships in the local community could get 10-year loans from their local banks. Providers with a long-term commitment to the profession and the desire to comply with strict underwriting requirements could consider a 30- to 35-year Department of Housing and Urban Development (HUD)-secured loan at relatively low interest rates.

Today, for nursing facility providers that harbor entrepreneurial ambitions, short-term (three to five years) variable-rate bridge loans are another

option. This type of funding often can be secured in a matter of weeks—in contrast to three to six months for HUD loans—which is an important consideration when financing an acquisition. Under this program, SNFs can expect to receive leverage multiples up to six times EBITDAR. Transactions with a large number of cross-collateralized facilities will attract the attention of more lenders.

If a provider is not interested in building equity and only wants to maximize financing, real estate investment trusts (REITs) are another possibility. The typical REIT transaction is structured as a sale-leaseback, which gives the REIT full ownership of the property. This financing vehicle enables the provider to monetize equity while maintaining a steady cash flow from operations. Lease terms are usually between 10 and 15 years.

Lastly, for middle-market providers more interested in exit strategies than debt financing, the situation is no longer quite so dire. Industry analysts estimate that private-equity firms have at least \$30 billion available to invest in companies with \$10 million to \$200 million enterprise values.

With the improving prospects for SNFs, these private-equity buyers are looking to make investments in the profession. ■

For More Information

■ The author can be reached at (818) 540-2102 or via e-mail at jpieczynski@capitalsource.com.

■ Additional information on CapitalSource's healthcare finance group can be found at www.capital-source.com/healthcare/healthcare.jsp.