

Rothschild, Storer, Fogarty Agree: Congregate Care Looks Healthy

**Dave Rothschild, SVP
Leader of CB Richard Ellis
Senior Housing Services**



By Peggy Caylor, Senior Associate Editor

Bellevue, WA- Seniors housing, an industry that once was building at breakneck speed in segments such as assisted living and skilled nursing, has been forced to slow down, refocus and reorganize. Players in and observers of the industry have a variety of takes on its health.

"I think the general state of seniors housing is that it is going through a transition of some overbuilding in key markets and some lower-than-expected census in fill-ups," said president & CEO of Leisure Care Inc. Dan Madsen. "Pretty confusing depending on what area you are talking about," said CB Richard Ellis Services Inc. senior vice president of seniors housing and long-term care David Rothchild.

Principal analyst Jerry Doctrow of Legg Mason Wood Walker Inc. said the industry has to be broken down into its various segments to make any real sense of what is going on in the marketplace. "The uninformed may see total chaos when in reality, there is only partial chaos," PricewaterhouseCoopers L.L.P.'s director Alan Plush agreed.

Congregate care without assisted living is by far the healthiest segment of the industry, observed Rothchild. "So much emphasis the last couple of years has been on building assisted living or Alzheimer's (projects) that they've kind of forgotten about the congregate care part of the marketplace," he said. "Most of those operators seem to be doing fine."

John Fogarty, senior vice president & manager for GMAC Commercial Mortgage, agreed that independent living is the healthiest portion of the industry, attributing that status to the fact that it is not as badly impacted by oversupply as other segments. Senior vice president of development for Marriott Senior Living Services Mike Giacopella concurred, adding that there is now a strong interest in the segment, which has been overlooked for the past 10 years. "The supply is much less than where the demand is currently," he said. "I think you will see that occupancies are very strong, pricing is very strong and you'll see a lot of waiting lists."

Occupied independent-living facilities are stable while those that are new or under development are having problems, added Dan Storer, senior vice president & managing director of Key Healthcare Finance. Causes of the problems include long absorption periods-typically 15 months-and slower move-in rates. Giacopella said independent-living facilities are larger and need to be in infill locations to be successful in the long term.

Congregate seniors-housing construction is up from 17 percent of all seniors-housing construction in 1999 to 29 percent in 2000, according to the American Seniors Housing Association. Assisted living is ranked second. A significant shift in congregate care has taken place during that time, with 63 percent of congregate-care units under construction in 1999 having an assisted-living component but 62 percent of new properties under construction in 2000 not including assisted living.

In fact, congregate seniors housing without assisted living units was the only property type to experience an increase in number of properties and units under construction from 1999 to 2000, according to ASHA. By mid-March, there were 58 congregate properties without assisted living being built compared with 38 properties without assisted living in all 1999, an increase of 53 percent. Total unit capacity for congregate care without assisted living increased 80 percent in the same time frame, from 3,942 units in 1999 to 7,074 units in 2000.

New construction of congregate with assisted living, on the other hand, dropped from 65 properties in 1999 to 35 properties in 2000, a decline of 46 percent. Total units under construction for congregate care with assisted living decreased 41 percent from 9,100 units in 1999 to 5,341 units in 2000, according to ASHA.

Overbuilding in the assisted-living segment has caused new construction in this segment to drop off; capital sources have become more conservative in their lending, making it harder to develop or acquire assisted-living facilities, said Madsen. Rothchild agreed. "There just isn't any real interest in developing freestanding assisted living," he said. "There is not a lot of capital in the market to help support the acquisition of those kinds of facilities."

"I think the assisted living segment is going through a period of consolidation and a slow up in terms of development and supply because of the overbuilding that has gone on for about the past four years," said Giacopella.

Mark Schulte, chairman, president & CEO of Brookdale Living Communities Inc., agreed that freestanding assisted living has dropped off, and added that he also believes part of the reason for the dropoff has been a tightening in financing. This is happening, he said, all across the spectrum of seniors housing, and for reasons other than overbuilding and the tightening of the capital markets, too. Alterra Healthcare Corp., for instance, has stopped building not because the market is saturated but because it has reached its goal. "We have arrived at the capacity that we had planned on all along, and we have stopped future development," said Steven Vick, COO of Alterra.

The assisted-living segment is an area that is being watched closely by both lenders and companies that are active in owning and operating assisted living, noted Fogarty. Plush said that although there are some notable bankruptcies and financial distress among health-care operators, 70 to 75 percent of the facilities are doing fine. The problem comes with perception. "What has happened is when assisted living was hot it became the barometer of the health of the industry. But that is inaccurate because assisted living is a component of the industry," he observed.

For the fourth consecutive year assisted-living residences-both freestanding and those combined with skilled-nursing or specialty-care units-comprised 51 percent of all seniors-housing properties under construction this year. Although this statistic may imply that assisted-living construction is thriving, if one looks at the decrease in number of freestanding assisted-living properties only-from 258 properties in 1999 to 76 properties by mid-March-there is a drop of 71 percent, according to ASHA.

Jerry Flentje, corporate director of marketing for Holiday Retirement Corp., observed that assisted living is starting to grow into itself-with some of the space that was overbuilt beginning to be absorbed-after major developers like Marriott, Alterra and Sunrise Assisted Living scaled back construction. Once they do that, he said, they could start building again.

Storer said that parts of assisted living are struggling because they are not yet filled up and stabilized. "The

assisted-living sector is digesting what it has and is really refocused on operations and filling up existing facilities and keeping them full," said Philip Brooks, senior vice president with GMAC Commercial Mortgage.

"Assisted (living) is doing phenomenally well with some providers and is a disaster with others at the public market level," Paul Klaassen, founder, chairman & CEO of Sunrise, contended.

The continuous-care retirement community segment has also had its problems, according to Flentje. "That whole continuum of care, the buy-in situation, we've seen drop off. I don't think that is necessarily a bad thing," he said. "Nonprofits will still continue to do CCRC but I don't think you are seeing a lot of those being built any more because they are so huge."

Although his company does not develop this type of housing, Schulte disagreed and said the segment seems healthy. "There's been less building in that segment, and I think business models of those particular properties can work better than for nursing or smaller freestanding assisted living."

New CCRC units under construction decreased 65 percent from 17,749 units in 1999 to 6,244 units by mid-March. This decline in units is due to several very large, 2,000-plus unit CCRCs being completed last year. On a property basis, CCRC construction has decreased 30 percent from 44 properties in 1999 to 31 by mid-March, according to ASHA.

Skilled nursing seems to be the segment having the most problems, and at the forefront of those problems are government regulatory issues. The situation is so serious for nursing-care providers that Rothchild equates the bankruptcy of four of the six largest nursing home operators to government changes in health-care reimbursement and the prospective pay system. Doctrow concurred that these top nursing home operators are in bankruptcy because of problems with reimbursement as well as regulatory changes and liability issues. And Flentje said there are skilled-nursing companies like Beverly Healthcare Services and Manor Care Inc. that are losing money every quarter because of the changes in Medicare.

Development of skilled nursing facilities also has been influenced by the certificate of need requirement, which states that a document must be issued to a company to allow construction or modification of a health facility, acquire new medical equipment or offer a new or different health service. "I don't think anyone is building any new nursing homes," said Flentje. "The change in Medicare reimbursement laws has really affected that."

Storer cited CON issues as a reason for the decline in development in this sector, too. "I think there is very limited development of new skilled-nursing facilities because many states still have a CON requirement that is really a barrier to entry for new nursing home projects," echoed Fogarty. And, he added, in those states where there is no CON requirement, nursing homes are not finding capital sources. "There has been a vacuum that has developed because a lot of lenders have left the financing market completely for skilled-nursing facilities. There are just a handful of lenders around."

Although skilled nursing may be at the bottom of the cycle and may take some time to recover, its outlook is positive, according to Rothchild. "Like most markets we're not going to bounce right back. We are going to run the bottom for a little bit and work our way through some of these bankruptcies," he said. Plush added that although there are some high-profile bankruptcies that paint the picture of an industry in the tank, a lot of the properties are really doing well. Doctrow agreed that there is light at the end of the tunnel. "If you use the stock market as a gauge as well as some of the earnings reports that have come out in the last couple of weeks, you will see (skilled nursing) has taken a turn off the bottom," he said.

Financing and access to capital is one of the biggest issues affecting seniors housing. Jean Swenson, a director with Credit Suisse First Boston, noted that a primary source of funding for the seniors-housing companies was the public equity market, and that like other REITs and public real estate companies, they are capital constrained. "Most of them are having to pay down their credit facilities, which means they are actually selling assets as a way to try and raise capital. So they have no money to lend," she said.

"We are just coming back from the REIT debacle. The REITs fled the industry in early 1999 to go chase the dot-com companies because the returns for the assisted-living operators were not what had been projected two years earlier," noted Dave Stolte, director of seniors housing for Charles Dunn Co.

Howard Capek, executive director of Warburg Dillon Read, agreed funding has slowed as a function of the market as well as of the companies' operations and balance sheets. "How much debt can they support? When you weigh all the major lending institutions and how much money they've lent to health-care providers, (it is obvious why) financial lending institutions are not lending very willingly right now."

An infusion of capital has helped some seniors-housing companies survive, though. In the assisted-living segment Alterra and Balance Care Corp. have received private equity infusions, according to Doctrow. And Omega Healthcare Investors Inc. recently received a \$100 million equity investment from Explorer Holdings L.P.

And if two recent mortgage loans by Prudential Mortgage Capital Co. are any indication, it appears assisted living will receive the capital it needs once again. Sage Harbor at Baywinds, an 84-bed assisted-living facility in Rochester, N.Y., will receive \$6.3 million, and Rosedale of Glastonbury, an 81-bed assisted-living facility in Glastonbury, Conn., will receive \$12.1 million. Both are 40-year fully amortized loans with interest rates of 8.4 and 8.25 percent, respectively.

But the most interesting development of late, Doctrow said, is the acquisition of Brookdale by an outside independent investor who is taking the company private. Brookdale Acquisition L.L.C., an affiliate of Fortress Investment Fund L.L.C., purchased Brookdale Living Communities through a joint venture with an affiliate of Capital Z Partners. It was Fortress' first seniors-housing investment.

"I think that is an indication that (investors) believe that despite the stock market valuations, it is a viable business going forward and there are opportunities for consolidation and growth in that sector," commented Doctrow. Another boost to Brookdale has been the appointment of John P. Rijos as president & COO. He will bring 25 years of experience in the hospitality sector and the experience of having served Lane Hospitality Group as president & COO.

So what is the future of seniors housing? "I think the outlook is very good, and I think it has always been good," said Schulte. "There's no argument that there are swelling demographics."

It will get better once the industry has worked through the current nursing home bankruptcies and overbuilding in assisted-living situations, added Rothchild. "There will be minor development and with the demographics increasing, at some point and time, we will absorb all these units and it will become a healthy business again," he said.

Flentje sees seniors housing as a young industry that has barely gotten started yet. "All you have to do is look at the demographics. The fastest-growing segment of our population is over 80 years of age," he observed. "(The population) gets older and older and healthier and healthier, so we are just at the tip of the iceberg."

There is significant demand for every type of seniors housing, said Swenson, due to that growth of the population. "I think it is an industry that will continue to grow. Even Wall Street's dissatisfaction with the industry has not stopped the growth," she said. "It has just inhibited the growth among the public companies for the time being."

In fact, the industry, after having gone through a boom cycle, is stabilizing itself, according to Fogarty. "It's really taking time to digest what is in the pipeline, and I think that is very healthy for the industry."

In the meantime, some companies, because of better organization and balance sheets, are healthier than others. Capek favors Sunrise and Emeritus Assisted Living. "Sunrise has hit their numbers and they are the only company that has delivered a positive earnings number and has everything on their balance sheet," he said.

"Their costs seem to be in check vs. the rest of the industry and their operating trends are more favorable and more encouraging." Emeritus also has everything on their balance sheet, he added, although they do not have positive earnings.

Swenson agreed on Sunrise, but adds another provider to her favorites. "The only two that appear to be surviving and still continuing to make money are Sunrise Assisted Living and Brookdale."

There are similarities in those two companies' strategies. "We've stayed very focused on a certain niche and that is in larger urban areas with relatively large properties," said Schulte. "Our properties average 220 units and that gives us good economies of scale at the property level and at the corporate level." He added that the company sets conservative growth targets putting only two or three properties in development a year.

Sunrise's strategy, according to Klaassen, falls into four categories: the model (one building type), location strategy, operations execution and capital. "I think one reason we are doing better is we stayed predominately in the major metropolitan top 20 cities. (Another) reason we are having an easier time is we have only been doing 25 properties a year for the last five years," said Klaassen. "We took that very steady, every year doing 25 more."

The prognosis for seniors-housing companies will likely depend on their ability to stabilize financially and reorganize their operations. "When we get through these cycles there will obviously be fewer companies, stronger companies, better operated companies than there were in the past," said Madsen.

Rothchild concurred. "As we go through this downturn and weed out some of the weak, we are going to come back as an industry that will have more expertise and understanding. (Seniors housing) will be better and healthier. It is just a matter of time."