

# CLEANING *House*

Use a “facility review” to identify and eliminate the under-performers in your portfolio and then create a new model of excellence

By Adam Heavenrich



**A**s a high-level executive in a senior housing company, your primary duty is to maximize returns to your investors. On a daily basis, of course, that means working to ensure that your company’s strategy, culture, and operations are meeting the needs of your residents. But it also means monitoring and trying to maximize the value of the company—for instance, by identifying strategic opportunities to acquire or dispose of assets. And as this month’s cover story notes, you’re likely to find some eager buyers in the market.

But how do you know which properties to tag for divestiture? How do you identify those strategic opportunities? To make smart decisions about your portfolio of properties, step back from the fine grain (such as an individual residence’s latest profit-and-loss statement) and look at the big picture. Conduct a “facility review”—a formal process of assessing the strengths, weaknesses, and overall direction of your senior living organization, taking into account all of the properties currently in your portfolio. In the facility review, you’ll ask which residences really *belong* in the portfolio and which are “outliers”—those

that don’t fit into the overall strategy of the organization, drain vital resources away from the core assets, and stunt the company’s overall growth.

Outlier facilities may differ from core facilities in terms of target market, areas of competence, quality of service, reputation (which is not always in line with actual quality), location, or even facility size or age. Their presence in your portfolio can blur the company’s image and scatter your day-to-day focus. Identifying and selling those outliers enables your company to redeploy its capital and human resources to where they are most needed: in the

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operation and improvement of your core facilities, and the acquisition of additional core communities as the company grows.

### VIEW FROM PRICE PEAK

Today, the senior housing transaction market stands—or perhaps teeters—at a historic moment. Facility prices are at unprecedented and possibly unsustainable highs. Some experts are speculating on whether cap rates are hitting dangerously low levels, at least in the top quality tier. (A facility’s cap—or capitalization—rate is a ratio calculated by dividing its income from operations by its selling price. So when we’re talking about lower cap rates, we’re talking about higher selling prices.)

That doesn’t mean you should sell off strategically valuable assets just to make an easy profit. But it does mean that if your portfolio includes one or more outliers, now may be the time to put them on the market.

Today’s pricing advantage also has to do with another historic—but probably temporary—shift. Real estate prices in the assisted living market have always included a “risk premium,” a factor that increases the price to account for all the potentially costly unknowns associated with senior living operations, such as regulatory, litigation, and health-care costs. As the transaction market has heated up in recent years, however, the pricing difference between assisted living and equivalent traditional commercial real estate has narrowed. To some extent, the premium has been squeezed out.

But this can’t last either, according to experts. With assisted living, although real estate is a large component there is always the possibility of regulation and other unknowns. Once the real estate boom starts to dissipate, the risk premium may return.

## SWOT Analysis of XYZ Senior Living

### Strengths

- Established reputation in Midwest
- Strong management team
- Urban orientation

### Weaknesses

- Lacks expertise in new development/construction
- Poor performance in dementia services
- Relative to competitors, poorly capitalized

### Opportunities

- Use existing infrastructure to grow through acquisitions
- Look for Midwest assisted living facilities in urban areas and close to downtown shopping

### Threats

- Larger and better capitalized competitors build competing facilities in existing markets

Buyers and lenders alike share the concern that cap rates are too low and soon will increase. For those who have already bought the low cap rate (that is, expensively priced) properties in recent years, though, any reduction in selling prices would erode their equity. This would place stress on both lenders and investors. Meanwhile, the cost of carrying debt has been trending upward. (The Federal Reserve has hiked interest rates 13 times from June 2004 through Dec. 13, 2005). So, we’ll see increasing downward pressure on prices from several directions.

### BEGIN WITH SWOT ANALYSIS

The first step in your facility review is to define what characteristics do fit into your organization strategically, and why. Think of this as your “sweet spot.” In senior living, your sweet spot depends on your company’s strategic plan, business goals, core competencies, and other factors. Facilities that occupy the sweet spot are your core facilities. Those that don’t are your outliers.

Your sweet spot isn’t a fixed target; it evolves over time as your company grows and builds its reputation. But at any given moment in your company’s history, the sweet spot can be defined—and it should be kept in mind by the CEO and other key figures in the company.

The best way to define your sweet spot is to conduct a SWOT analysis (for Strengths, Weaknesses, Opportunities, and Threats). In SWOT analysis, you and your colleagues use internal and external data and analysis to construct a simple, one-page

grid, like the example shown above.

In this example, the management team at XYZ Senior Living has listed among its strengths a thorough understanding of, and ability to meet, the needs of the Midwest, urban, upper-middle-class elderly population. The company knows that its target market has household incomes around \$100,000–\$150,000, and XYZ Senior Living has developed an excellent infrastructure and high-quality services to meet the needs of this clientele. It enjoys highest occupancy in communities within walking distance of a shopping area.

Under the Weaknesses category, the team has listed its lack of expertise in developing or constructing new facilities, along with its low ability to provide care for seniors with dementia. On the Opportunities side, the team has noted several possible acquisitions within its geographic area that would result in real growth.

Finally, under Threats, the team has listed consolidation in the senior housing industry and larger, better-capitalized operators whose greater economies of scale and jointly run back offices allow them to squeeze out the smaller operators through price competition.

Through this SWOT analysis, a picture of XYZ Senior Living’s sweet spot for properties readily emerges. The company’s properties should be located in major urban areas with upscale demographics, and in areas where the labor market can provide a stable workforce. Competition is limited by the scarcity of available land in infill locations. Ideally, XYZ Senior Living prefers a market where there is a dedicated dementia

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unit that can be both a source of referrals and a place to refer residents.

With that picture in mind—a picture of the company itself as well as who its target clients are and what they expect from it—XYZ Senior Living's CEO can easily identify the portfolio's outliers.

## OUTLIERS REPRESENT LOST POTENTIAL

Outliers may exist in your portfolio for a variety of reasons. Sometimes they result from a multi-facility acquisition that included many strategic "fits" along with a few outliers, and you simply never got around to cleaning house. Or perhaps you did all the right research and hard work but the

community never quite lived up to its potential. Maybe the quality of the local labor pool was a challenge, or a single negative incident washed away the community's goodwill.

The point in your facility review is not to point fingers, or to examine the past at all. It is to identify assets that are now more valuable to you out of your company than in it.

You're better off without the outliers because of the 80/20 rule. Even if only 20 percent of your residences are outliers, they're probably taking up 80 percent of your time, not to mention other scarce organizational resources like capital, reputa-

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tion, and human resources. Imagine freeing up those resources to plow into your core residences, thereby making that sweet spot even more productive and solidifying your company's identity.

This holds true even if the outlier in question is making money. Positive cash flows do not necessarily mean a residence is right for your organization. Higher returns overall occur when your company's resources are allocated in a focused, strategic way. By redeploying your energies from outliers to core facilities, the company enhances investors' returns many times over. In addition, as you shed outlier facilities that have, for example, less-than-stellar reputations for service, you enhance your organization's reputation and the image you project to clients and the investment community.

As the senior housing market continues to mature, distinct operating niches are carved out and the whole field becomes more competitive. In this climate, the efficient use of capital becomes increasingly important. Freeing capital to serve your core business units will do more to grow your company than any outlier facilities, no matter how successful they may be on their own terms. So, in addition to focusing your attention on acquisition and growth, it's important to take the time to clean out assets that don't belong. Doing so will put you in the best position to continue to grow and care for more residents in the long run which is what those investors are counting on you for. ▼

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## Maximizing the Sale Value

The process of valuing, packaging, offering, and closing on the sale of outlier facilities can be complex and time-consuming. Use these common-sense steps to ensure you earn top value in the marketplace.

■ Bundle the assets you're trying to sell. You will fare better if you can offer a group of assets all at once, rather than a single facility here and there. The more active acquirers of senior living properties realize that the due-diligence process they must go through requires a good deal of manpower, time, and money. If they can spread that cost over a multiple-asset

purchase, it makes their investment more attractive. It's also usually easier for buyers to secure financing for a multiple facility acquisition than for a smaller, one-off deal. Acquisition deals involving larger portfolios of properties attract more competition among potential lenders, and therefore more attractive financing terms for the buyer. So buyers are always looking for multi-facility opportunities.

■ Second, take the time to understand and describe what is valuable in the outlier properties you're selling. This may seem an obvious point, but a surprising percentage of sellers neglect to do it. Write down the facilities' strengths and what you think would enhance their value in the future. That kind of information—essentially a strategic plan for each facility you're selling—will help buyers recognize the true value of the assets you're offering, and will attract a more serious pool of buyers in the first place.

■ Be sure that cosmetic repairs and maintenance are completed before you go to market. Unlike the acquisition itself, capital improvements are difficult and expensive for buyers to finance. Most lenders consider repairs or capital expenditures as additional equity that will be required from the buyer. By increasing the overall equity requirements in the transaction, it raises the weighted average cost of capital for the buyer, and reduces the likely sale price. By making the repairs or necessary improvements yourself prior to the sale, you will make the whole package more attractive and generate the highest possible sale price and level of interest in your sale.

