Credit CRUNCH No Crisis

While other businesses feel the pinch of a nationwide credit crisis, senior living continues closing deals

By Adam Heavenrich

Fast Forward

- Senior living's fundamental business qualities are keeping it afloat despite an uncertain economy and dwindling lines of credit.
- Senior housing value is expected to continue to rise as earnings increase and outpace inflation—unlike the conventional multi-family real estate sector.
- Senior living sellers can still put healthy price tags on communities, but potential acquirers must bring more equity to the table because of the current credit crunch.

THE CREDIT CRUNCH THAT BEGAN IN SUMMER 2007 HAS RESULTED IN A NATIONWIDE CREDIT CRISIS IN THE FORM OF FORECLOSURES, A SLOWDOWN IN THE MORTGAGE-BACKED SECURITIES SECTOR, AND CROSS-INDUSTRY UNCERTAINTY ABOUT THE FUTURE OF THE CREDIT MARKET. Plus, declining confidence in the market is being fueled by tangible losses for major lenders as mortgage-backed securities plummet in value, and many industries are experiencing a general slowdown in deals and increased difficulty in obtaining credit.

On a global level, it seems the credit crisis will get worse before it improves. The International Monetary Fund recently estimated a loss of almost $1 trillion from the world economy as a result of the subprime mortgage crisis, the effects of which will continue to become more evident as it moves more deeply into financial markets. It is becoming increasingly difficult for investors to obtain credit as lenders who relied on mortgage-backed securities are unable to sell them and are reporting increasing losses. The resulting lack of liquidity is trickling down from lenders to the rest of the financial system, stalling deals in many industries and making them difficult to finance and close.

Many health-care sector investors are asking themselves how this news is going to affect the senior living industry and how they can continue closing deals. Although credit is more difficult to obtain right now, senior living's unique business attributes will ensure that investors remain engaged and that the deals keep coming.

SOLD: A senior living property transaction, showing the same scenario before and after the credit crunch

	Pre-credit crunch	Post-credit crunch
Revenue	$3,000,000	$3,000,000
Expenses	$2,000,000	$2,000,000
EBITDA	$1,000,000	$1,000,000
Debt Service	$833,333	$769,231
Debt Required	$7,343,649	$6,788,758
Equity Required	$2,656,351	$3,221,242
Interest Coverage Ratio	1.20	1.30
Transaction Price	$10,000,000	$10,000,000
Interest Rate	8.00%	9.50%

Future Fundamentals

Senior living's strong fundamentals are characterized by its dual health-care and real estate role and by the strong demographic trends that typify the senior living industry, and these fundamentals make its outlook positive despite the current credit crisis.

Industry and financial experts agree: Senior living provides needs-based services that will continue to be in high demand—and, as a result, assisted living community values will continue to increase. In fact, assisted living communities are poised to be among the least affected by the current housing recession because demand for assisted living will continue despite the decline in traditional home sales. The difficulty of selling a home in the current market is independent of the need for assisted living services. Therefore, occupancy also is expected to be minimally affected.

Moreover, average occupancy rates in the long term are expected to increase as the demand for senior housing rises with the aging of the American population. The baby boomer bubble is on the immediate horizon with the first wave of boomers turning 65 in 2011, and is expected to last for 19 years. As experts throughout the industry have been saying for some time now, baby boomers will cause an explosion in demand for senior care services. And, as a senior living property buyer or seller, it is important to note that the credit crisis and resulting economic downturn are tied to conventional real estate. Specialty sectors like senior housing are not expected to be as strongly affected because they behave differently than conventional real estate.

In addition to strong fundamentals, there are many ways in which the value of senior living communities is expected to increase in the future. Value will continue to go up because senior housing is more likely to experience earnings increases and outpace inflation—unlike the conventional multi-family real estate sector. Since individuals in senior communities receive daily services critical to everyday life, they are less sensitive to price increases compared to residents of traditional residential real estate.

Closing the Deal

All these factors also support high average pricing for senior living communities and are expected to continue to do so in the long term. In 2007, average pricing hit highs as cap rates hit record lows—and, as a result of strong industry fundamentals, senior living expects minimal cap rate increases as a result of the tightening credit market. Despite the current credit crisis, prices for senior living communities are as good as they ever have been. According to a recent industry report, assisted and independent living prices are at new highs.

The credit crisis does, however, pose a few unique challenges to closing deals successfully. Obtaining debt is one key success factor as it is becoming more difficult to get deals funded. Banks are demanding better terms from their borrowers, both by increasing interest rates by approximately 100-300 basis points and by simultaneously tightening their underwriting standards to include higher interest coverage ratios. In any particular deal, this results in less of the capital structure originating from debt and more of it originating from equity.

See the chart on this page for a case-in-point example. This is a scenario of the same senior living property, sold before or after the credit crunch. As this example illustrates, the equity required to complete this transaction increased dramatically as a result of the credit crisis underwriting standards.

Sellers can still achieve high values for selling their communities, but they need potential acquirers to bring more equity to the table than they have in recent years. As a seller, ensure that potential acquirers have credible lending sources who will actually lend, not ones that merely say they are lending. At this time of uncertainty, it is useful for buyers to have a mergers and acquisitions advisor who can navigate the minefields of completing a transaction in this environment. To increase the likelihood of successful transactions, encourage buyers to consider using a HUD loan or a bridge-to-HUD lender because interest rates for FHA-insured HUD loans, Fannie Mae, and Freddie Mac programs have remained favorable during the current credit crisis.

Overall, the outlook is positive for senior living. Values in the senior living industry are expected to remain stable because industry fundamentals are strong and because the current credit crunch will result in a downturn of senior housing construction, decreasing the supply of housing in the future. Simultaneously, the increasing size of the senior population will intensify demand of senior housing opportunities in the future, making current senior living communities even more valuable. ❑

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