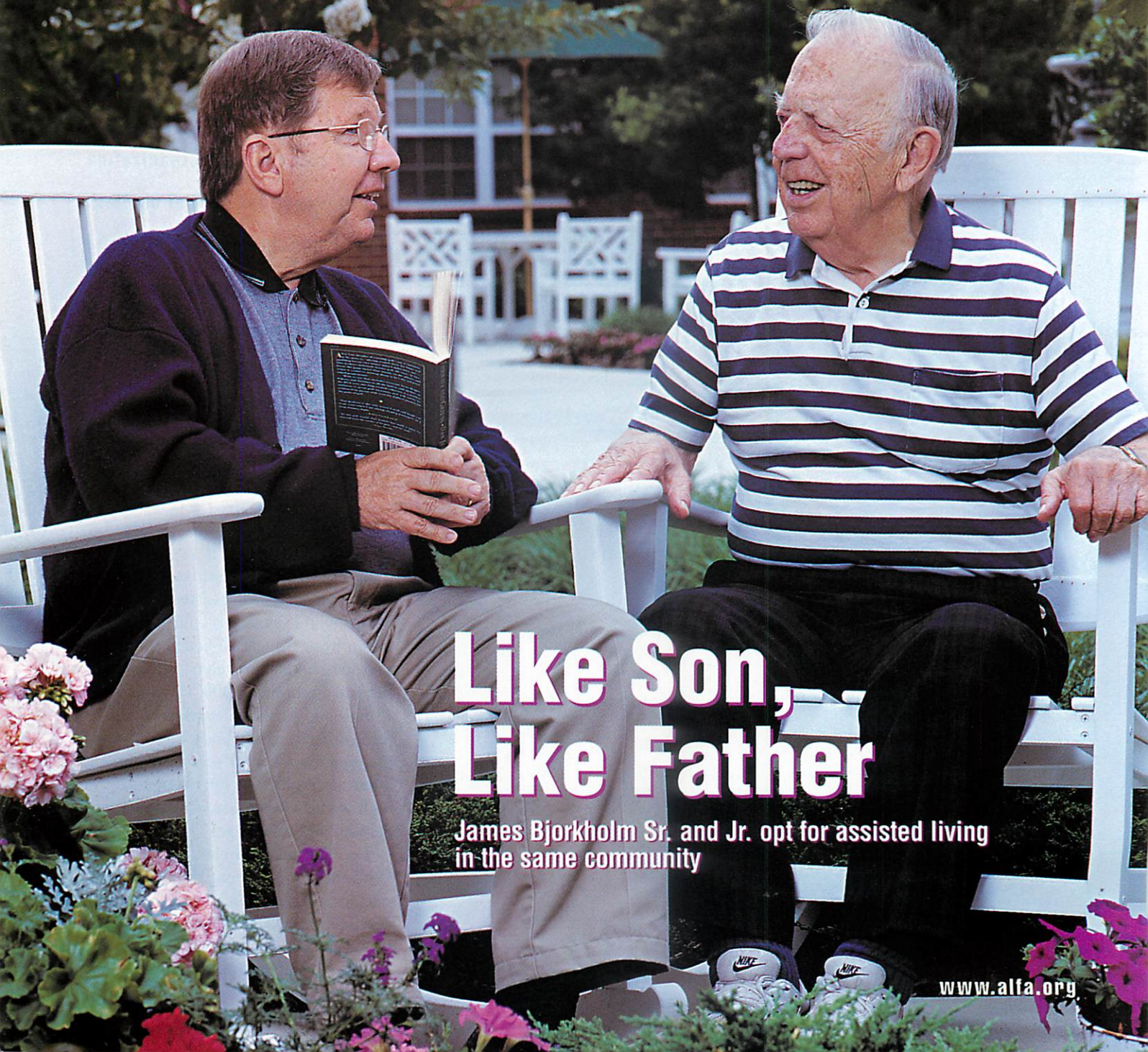


assisted living today

- TOP 50 PROVIDERS RANKED
- PDAs STREAMLINE RESIDENT CARE
- HHS SECRETARY THOMPSON SPEAKS OUT

THE MAGAZINE OF THE ASSISTED LIVING FEDERATION OF AMERICA
SERVING THE SENIOR HOUSING AND ASSISTED LIVING INDUSTRY



Like Son, Like Father

James Bjorkholm Sr. and Jr. opt for assisted living
in the same community

A painting of a boat on water. In the foreground, the dark, textured hull of a boat is visible, with a wooden mast or post rising from it. The water is a deep blue with white, wavy lines representing the wake. In the distance, a large, yellow dollar sign (\$) sits atop a dark, jagged rock. The background is a soft, hazy sky with shades of blue, orange, and yellow, suggesting a sunset or sunrise.

Do You Have Capital Appeal?

To add value to your organization and decrease the cost of capital, view it through the eyes of potential capital providers and then make improvements based on that viewpoint

By Susan Birke Fiedler Esq. and

Adam Heavenrich MBA

Steve Thurman is at a crossroads. In five years, Thurman, who owns a privately held assisted living company in Illinois, has built the organization from a single 20-bed facility into a strong regional provider with six facilities and a capacity of 300. He employs 75 full- and part-time employees in three different communities. Now, with the organization at its present size, Thurman realizes he can't continue to both manage day-to-day operations and develop new residences.

For Thurman, the choice is clear. While he enjoys running the operational side, his real passion is the challenge of developing new facilities. Unfortunately, he has already spent his available capital developing and growing his organization.

So he's considering selling his existing communities to another operator and using the capital to continue developing new communities.

If Thurman does decide to sell, what will he have to know? How should he package and prepare his portfolio of facilities for maximum strategic value on the market? The answers are complex, but they boil down to one simple idea: Thurman must look at his organization through the eyes not only of a potential buyer, but also through the eyes of the buyer's likely sources of capital. This requires familiarizing himself with the benchmarks and analyses capital sources would use. And that's not something Thurman, like most assisted living operators, knows much about. Owners who take the time to understand the capital markets are far more likely to control the outcome of a transaction in their favor.

CAPITAL MARKETS

Debt and equity are the two primary types of capital available to potential acquirers. Debt is borrowing money for a period of time (term), for a cost (an interest rate) and an amortization period. Sources for debt include local banks, HUD/FHA, Fannie Mae and Freddie Mac, the Small Business Administration, and commercial finance companies.

Equity investors become the owners of the business. Equity financing does not require scheduled repayment at a fixed charge. It does receive cash flow from the asset (after all expenses are disbursed) and the value in excess of the debt. Conversely, if the cash flows are negative, the equity investors must continue to support the project. In exchange for the risk of ownership, an equity investor demands greater returns than a lender. In a typical acquisition, a buyer will have to supply between 5 percent and 25 percent of the transaction price in the form of equity capital. The balance of the transaction (75 to 95 percent) may be paid

AT-A-GLANCE

- ▶ Owners who take the time to understand the capital markets are far more likely to control the outcome of a transaction in their favor.
- ▶ Companies should prepare financial statements consistently from year to year; both debt and equity investors like to evaluate trends over time.
- ▶ No matter your company's situation, you can add value to your organization by first viewing it through the eyes of potential capital providers, and second by taking steps to improve the company and its financial picture based on that viewpoint.

with debt. Sources of equity include venture capital companies, private equity buyout-firms, individual investors, and even friends or family.

Because a potential acquirer of Thurman's facilities will probably use a mix of debt and equity financing, Thurman needs to understand both resources. Debt and equity providers will decide whether to fund an acquisition of Thurman's company by analyzing his financial statements and supporting documentation. These will be the critical foundations of a successful deal, because neither the debt nor the equity market will look favor-

ably on a transaction where the financial statements and supporting documentation do not tell a good story.

Thurman can build his appeal to both markets by generating financial statements that clearly communicate his organization's strengths. Companies should prepare financial statements consistently from year to year; both debt and equity investors like to evaluate trends over time. Financial statements should include a line item for earnings before interest expense, corporate taxes, depreciation, amortization, inter-company rent and management fees (a.k.a., EBITDARM). Capital or extraordinary expenses, such as the purchase of a company van or a new roof, must be separated from ongoing operating expenses. In the rent rolls, units should be described by type (double, single, or suite), occupancy status, current rent, and market rent. Information must be clear and, if possible, supported by market research.

DEBT MARKET A TOUGH SELL

Lenders look at all investments from the standpoint of downside risk. A lender wants high stability and high predictability of earnings for the investment. Lenders analyze their investments through a variety of criteria including replacement value of the facility, demographic and market information, and through the all-important coverage ratios,

which include the ratio of EBITDARM to the debt service expense (the cost of paying the interest on the potential debt). Generally, lenders will lend money if the EBITDARM is 1.3 times debt service expense or more.

Of course, lenders don't rely on one snapshot, but look at the long-term financial statements to verify consistent earnings streams.

In Thurman's case, he noticed that over the last year his oldest residence was experiencing a downtrend in occupancy. The residence needed a makeover. To make the situation worse, a competing residence recently had been built less than two miles away. Thurman decided to spend the money to upgrade his facility. He also recognized that the competing facility had created a surplus of beds in the area, at least for the coming year or two. So he adjusted his residence's staff and marketing budget to inventory the extra beds. Thurman's community rebounded into profitability even with its lower occupancy rate.

Providing information like Thurman's decision to inventory beds shows how the organization survived a temporary downturn and assures both a potential acquirer and its debt providers that the earnings stream is easily stabilized. A streamlined organization that is nimbly responsive to its market's needs is far more desirable than an organization that still needs to restructure.

Acquirers prefer not to walk in the door and start cutting jobs or renovating space. Even fewer capital sources want to take the risk that such changes will actually improve the facilities' profitability. Steve acted wisely in making the necessary changes prior to putting the organization on the market. The changes he made will translate to a higher value for his organization and a better chance of his acquirer finding attractive financing.

EQUITY MARKET EVEN TOUGHER

The equity market is even more demanding than the debt market. Not only does an equity investor need to know that the expense of debt service will be covered by revenues, but because he'll be a partial or full owner, he must also consider the organization's upside potential over time. Upside potential may involve a strategic partnership with

other residences in the investor's existing portfolio.

Acquirers often seek properties that complement their current regional profile of residences. Such a complementary fit allows owners to leverage their existing infrastructure, staff, or services to reap economies of scale and boost profitability. In addition, it lets them include the new residence or residences in current marketing and advertising plans without much additional expense. With these big-picture considerations in mind, a strategic acquirer may even consider investing in a facility that has shown negative cash flows for short periods in the past.

Upside potential may also include synergies in the area of referrals. Conversely, if a residence's existing referral stream might be jeopardized by a change in ownership, the potential equity investor may think twice. However, many acquirers bring their own strategic relationship to the potential transaction.

PLAN AHEAD

Whatever path Thurman chooses, he will have added value to his organization by viewing it through the eyes of potential capital providers and by taking steps to improve his company and its financial picture based on that viewpoint.

His efforts will prove wise even if he keeps the company, because they will make it easier and less costly to obtain any kind of financing, from refinancing to growth capital to attracting new investors.

Thurman is on the road to enhancing the value and liquidity of his organization and expanding his own options. And he may be none too soon. In today's tightening market, it never hurts to be "capital friendly." ●

Susan Birke Fiedler Esq. and Adam Heavenrich MBA are with Heavenrich & Co., which provides strategic acquisition and divestiture advising for the senior living industry. Reach them at 312/422-8921 or info@Heavenrichco.com, or visit www.Heavenrichco.com. Editor's note: Steve Thurman is a fictional character, but his experiences are based on issues that most frequently arise with the Heavenrich client base and investors.