

The Future of Capital Partnerships

Tomorrow's business models require careful business planning and capital management today

By Adam Heavenrich and Jay Beckhorn

FAST FORWARD

- Senior living providers are rethinking their business models and capital structures in response to new risks and opportunities.
- Monetizing assets can provide hedge against risk, fund growth, or allow a business to strengthen its core areas or explore new areas of focus.
- Providers wishing to monetize their assets have options including joint ventures with private equity firms, sale/leasebacks with REITs and investment firms, ESOPs, and outright sales.

As the senior living industry has matured, offerings and care levels have become more specialized, the project sizes larger and more expensive, and the capital requirements much steeper.

This shift is forcing owners and operators to rethink both their business models and their capital structure. Owners and operators will need to establish business models that can deliver in an efficient regionalized footprint and build a market presence quickly.

This drives the need for owners and operators to pair themselves with the right capital partner and put in place an optimal capital structure—one that takes into account their growth needs as well as their ability to absorb risk (see Business Model Matrix on page 14 for more on different models, their risk vs. return, and their capital requirements).

While the business climate overall is improving, some realities remain: The recovery is uneven and slow, unemployment

rates remain high, the housing market is soft, and Medicare and Medicaid cuts are looming. On the positive side, inflation and interest rates remain low, senior housing pricing multiples continue to improve, private equity firms and REITs have money to invest, the percentage of the U.S. population over 65 years of age continues to grow rapidly, and few new senior housing communities have been built in recent years.

In this environment, the senior housing world is rife with both greater opportunities and greater risks. Now is not the time to go it alone. If an owner or operator sees a higher level of risk and business volatility on the horizon, or fears that his or her current liquidity could be inadequate for his or her business plan, now is a good time to consider a capital partner.

Partnering Options

There are many options available to owner/operators for monetizing their assets. They include working with high-leverage



WHY MONETIZE?

A senior living provider's decision to monetize can be driven by a micro force, such as the construction of a new community, where lease-up risk is a reality and liquidity can be critical to weathering unexpected shocks or a protracted lease-up period. Alternatively, it can be tied to macro forces, such as a company that is heavily reliant on state reimbursement facing state budget cuts. Regardless, the goal is to reduce the risk of your holdings.

Any owner/operator that has held its portfolio for five or more years should evaluate the portfolio (as any good investment manager would) in the context of risk and diversification:

- Is your portfolio value tied heavily to the strength of one or two employees?
- Is your community of sufficient size that a turnover shock can be absorbed?
- Are your communities in markets large enough to support construction of competing communities?
- What are the useful lives of your communities with regard to regulatory and market requirements?
- Is the regulatory environment in a state causing you to re-evaluate how you operate?
- Do your operations have too much exposure to state reimbursement from a state that is under significant financial pressure?

non-recourse lenders such as Fannie Mae, Freddie Mac, or HUD; joint venturing with private equity; sale/leasebacks with REITs and investment firms; employee stock ownership plans (ESOPs); and outright sales. No one solution is universally preferred.

Which monetization option is best for you depends on the status of the assets you are seeking to monetize (development, lease-up, stabilized, or mature), your financial situation, and considerations of both control and flexibility.

Increasing leverage. Increasing the leverage on your existing assets is a cost-effective and viable option for tapping equity without taking on a capital partner. It works especially well when your portfolio is generating very strong and stable cash flows, but you need to raise cash to buy out a partner or expand.

This option provides you with the most control over your assets and business. However, if cash flows are or become tight or volatile, additional leverage is a poor option that may lead to financial distress.

Partial sales. Another method outside of capital partnering is a partial sale. There are two critical components of value to a senior housing transaction: the real estate and the operating company. Owners can execute a partial sale of just the operating company through an ESOP or sale to an owner/operator. If the owner wants to disengage from the operating business and simply collect rent, he or she can then own

the real estate and lease it to the employee-owned operating company.

This structure can potentially secure the highest value for an owner while rewarding and incentivizing key employees to maintain and build value in the company. However, the owner may be required to backstop the new employee owners with reserves until they have proven themselves.

Private equity firms. Partnering with private equity is a good option when additional equity is needed and growth expectations justify its use. Given private equity's shorter holding period and higher return expectations, there should be a clear trajectory and opportunities for profitable growth for the company.

In general, private equity will accept a

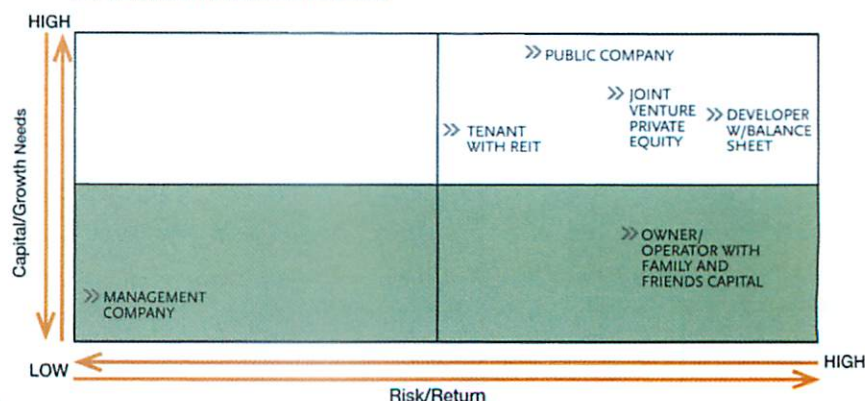
higher level of risk than a REIT. However, the terms under which the commitments for a private equity fund are secured will dictate its risk profile and return requirements. Some funds will only look at stabilized communities and specific asset types, while others will entertain distressed acquisitions and turnarounds and new developments where there is an existing relationship. Regardless of their risk tolerances, good equity partners will share some of the risk in a transaction.

Joint ventures. The most commonly used structure when working with private equity groups is to create a joint venture. The private equity partner acquires a majority ownership interest in the assets being monetized and provides equity for partially cashing you out, frequently committing to additional equity for future acquisitions or development. In addition to retaining some ownership in the real estate and the ability to participate in its upside, you will be the managing member of the venture and exercise considerable control over the assets.

Private equity's shorter investment period necessitates future capital events that should provide you with additional opportunities to harvest equity. In some instances, the joint venture structure may be expanded to include the operating company.

While joint venturing enables you to retain partial ownership and provides you with flexibility and some control, the structures are highly negotiated and transaction costs are significant. Consequently, private equity groups are looking for owner/operators who have portfolios of good size and quality and with which there will be

Business Model Matrix: Capital Needs and Risk/Return for Common Business Models



future development- or acquisition-related joint venture opportunities. Small or one-off transactions are not ideal joint venture candidates.

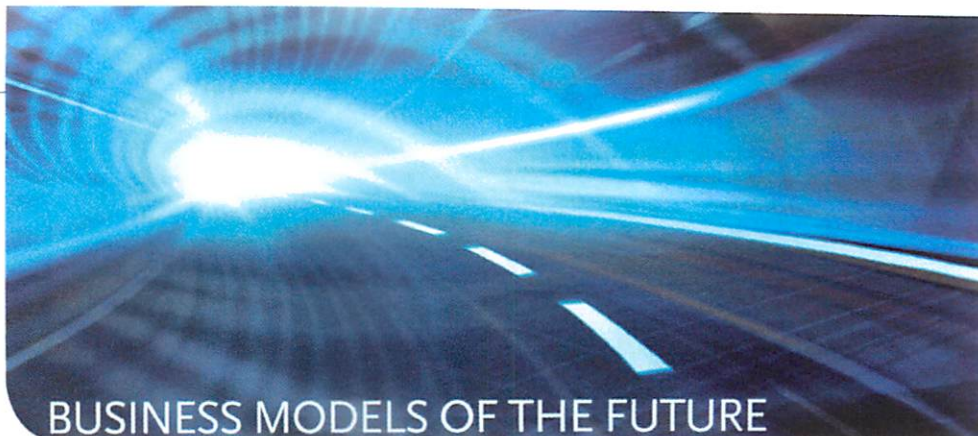
REIT options. REITs represent a cost-effective monetization option for mature portfolios. REITs are flush with cash and have lowered their return expectations. They are looking for coverage on historical cash flows, similar to lenders. They are also becoming more aggressive in executing sale/leasebacks. Traditionally, REITs were not involved in new construction or turnaround acquisitions. As they have become more liquid, they have become more focused on working with their current operator relationships and providing them more funding options at attractive rates.

In the typical sale/leaseback arrangement, the owner/operator sells the real-estate assets to the REIT and leases them from the REIT under a long-term net lease (10 or more years). The operator retains the cash flow remaining after the payment of the rent, real estate taxes, insurance, and any required reserves. In the case of smaller operators, the leases are typically recourse to the owners; however, as REITs compete with one another, corporate guarantees are gaining wider acceptance.

For smaller owner/operators who find obtaining debt challenging, a sale/leaseback with a REIT is an attractive alternative. REITs' cost of capital is low, and they are generally cash buyers. When they do avail themselves of leverage, they tend to utilize corporate lines of credit. Without financing related contingencies, the execution of a sale/leaseback transaction with a REIT is more certain than leveraging or joint venturing. By selling to a REIT, an owner/operator is able to both generate liquidity and free up borrowing capacity with its existing lenders.

Because REITs have standard structures and documents and their own sources of funding, transactions with REITs can be completed much more quickly and less expensively than a joint venture agreement with a private equity firm. An additional benefit to monetizing with a REIT is the possibility to defer taxes through a downREIT structure. In a down-REIT, you can receive liquid and publicly traded stock shares for all or a portion of your consideration.

Conversely, with a sale/leaseback transaction, you have sold the asset and have



BUSINESS MODELS OF THE FUTURE

Future business models for senior housing will need to be responsive and compatible with the new realities of the marketplace and the economy, which include:

- Less equity available to residents for buy-in models;
- More equity available to providers/competitors for new communities as capital continues to flow into the industry;
- Continued need to differentiate and brand, as residents are offered more options; and
- Competition that increasingly comes from allowing residents to age in place. There will be less competition from standalone skilled nursing facilities as they move to higher-acuity care and work in concert with hospitals.

The need to pull residents into a community will be integral to the models of the future. The advantage to senior living communities lies in the social opportunities and community environment they offer. In large markets, providers will increasingly target specific demographic and interest segments, offering residents mutual ties to a university, interests in cultural events, and other connections.

The model of the future will also ensure a seamless lifestyle through end of life, which may include hospice and spiritual care.

limited both your control over it and your potential to participate in its appreciation. Even if you have an option to repurchase the asset, you may be unable to exercise that option in the first 10 years of the lease term.

Sale to another owner/operator. Leveraging assets, joint ventures with private equity, and sale/leasebacks with REITs are monetization strategies for taking some chips off the table. In the event that an owner/operator wants to "cash out," there is a third option: the sale of the asset or portfolio to another owner/operator.

The "cash out" option is attractive when owner/operators are looking for an exit strategy for their estates; are concerned that macro level variables, such as pending changes to regulations or reimbursement rates, will erode both the profitability and the viability of their businesses; or find that their assets are approaching obsolescence and there are limited barriers to new competitors entering the market.

Monetization and Strategy

Any new capital structure must be considered in the overall context of your long-term strategic plan. Monetization can serve several functions: It can fund growth, it can allow you to redeploy your company's equity in its core areas

or new areas of focus, and it can provide hedge against risk.

Good organizations evolve in their focus and core competencies. They redefine themselves and adapt to changing markets. There is no universal capital structure solution that is appropriate for all situations.

In selecting the best monetization strategy for your company, you need to take into account its resources and opportunities and the short- and long-term risks that could hinder you. The best strategy and timing depend on your specific situation. Financial flexibility is key when confronted with uncertainty or heavy losses or when occupancy or reimbursements drop and cash flows are tight. Owners need to routinely evaluate their business plans, strategies, and outlooks to determine the right time to go to market and take some chips off the table. □

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