Guide to Evaluating the

Financial Viability of a CCRC

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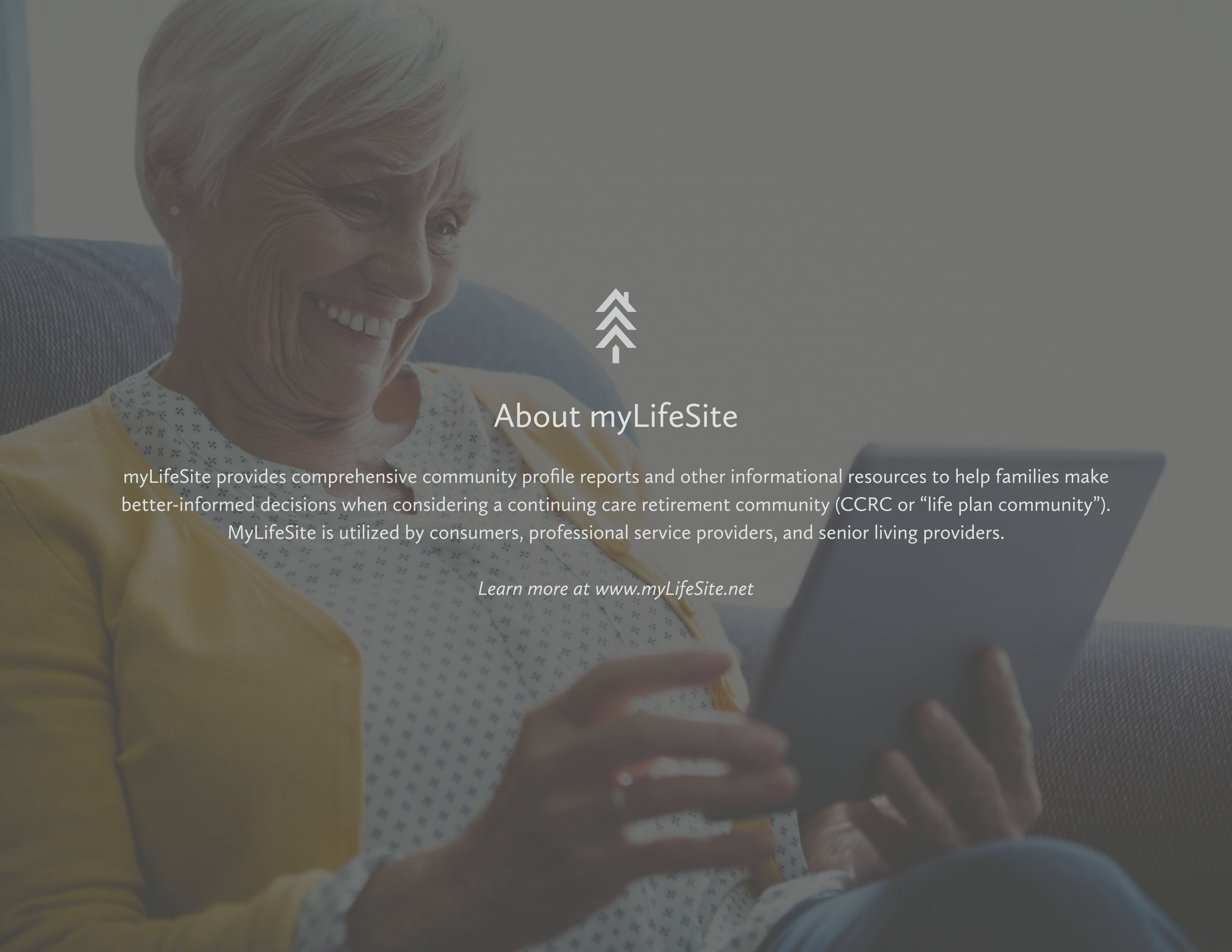

About myLifeSite

myLifeSite provides comprehensive community profile reports and other informational resources to help families make better-informed decisions when considering a continuing care retirement community (CCRC or "life plan community"). MyLifeSite is utilized by consumers, professional service providers, and senior living providers.

Learn more at www.myLifeSite.net

Introduction

Continuing care retirement communities, also known as CCRCs or life plan communities, can be a great choice for those who are proactive in planning for their future care needs, while taking advantage of these communities' many social and wellness benefits available today.

But choosing a CCRC is a big financial decision. Residents of a CCRC expect that the community will be managed with financial responsibility to ensure that it will have the operational cash on hand to meet contractual obligations to residents over their lifetime.

But how do you know?

For the average person, analyzing the financial viability of a CCRC can be difficult. Even tax and financial professionals may have trouble with this analysis if they are not familiar with the unique business model of CCRCs, the various types of residency contracts, and the associated actuarial impact on accounting. The purpose of this guide is to equip you to more effectively evaluate the financial viability of a community. It should not be viewed as a way to guarantee an organization's future viability, but rather to help you form a better view on whether the provider is taking the appropriate steps to ensure its long-term financial success.

Before addressing financial evaluation, it is helpful to first understand a little bit about the business structure of CCRCs and how they are regulated.

This guide can help you form a better view on whether a CCRC is taking the appropriate steps to ensure its long-term financial success.

CCRC business structures

The large majority of CCRC operators are structured as 501(c)(3) non-profit organizations (approximately 80 percent), although the share of for-profit CCRCs is growing. Many non-profit CCRCs are owned by religious or charitable groups and may either be part of a multi-site organization or operate as a stand-alone provider. Likewise, a for-profit CCRC may be part of a multi-site organization or operate as a stand-alone provider, but the majority of for-profit communities are part of a larger parent corporation. In the case of multi-site organizations, it is important for the consumer to evaluate the finances of not just the community they are considering but also of the parent organization.

The overarching business structure of some CCRCs may actually involve both for-profit and not-for profit entities. For example, a CCRC may create a non-profit management firm that enters into a housing agreement with residents, but which also contracts with a for-profit developer or parent company to lease the property and provide services. Although this may be a viable approach, it is critical that the non-profit entity's interests are not too closely aligned with the for-profit entity, and that there is truly a charitable mission, or else it could put its non-profit tax status at risk. A sudden loss of non-profit status could be financially detrimental to a non-profit CCRC.

Regulation of CCRCs

CCRCs are regulated at the state level, but not every state regulates CCRCs. For those that do, there may be specific financial conditions and/or document submissions that need to be met each year. For example, in the state of North Carolina, CCRCs are regulated under the Department of Insurance. Providers are required to submit updated disclosure statements each year, including audited financials. Additionally, North Carolina requires that a CCRC's cash reserves must be equal to 50 percent of forecasted operating costs for the next 12 months. For CCRCs that have an occupancy ratio of 90 percent or higher, the cash reserve requirement drops to 25 percent of forecasted operating expenses. Other states may have requirements that are more or less stringent than North Carolina's.

Some states provide less oversight than others and require little more than annual submission of a disclosure statement to the state's regulatory body.

Although regulation of CCRCs can serve as another layer of oversight and consumer protection, there is no research showing that CCRCs in unregulated states are more prone to financial distress than those in regulated states. The meaningfulness of such a study would likely be in question since the degree of oversight varies so much from one state to another.

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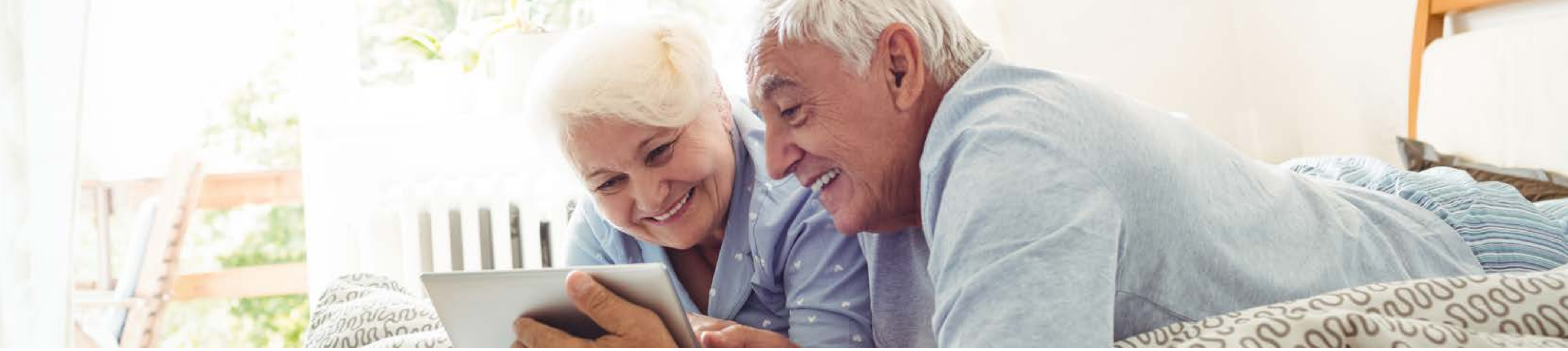

Financial statement evaluation

The evaluation of a CCRC's financial statements can help paint a picture of its current financial situation. There are a variety of factors that one might ultimately consider; yet, for the purposes of this guide, we're providing information on a few that we think will help give you a balanced overview.

Balance Sheet

Maintaining a strong balance sheet is a reflection of a viable operation for any business, and the same is certainly true for a CCRC. A positive net asset balance is equivalent to a having a positive net worth, as measured by total assets minus total liabilities. **The greater the net worth as a percentage of assets, the stronger the entity will be financially.**

There is some debate within the industry related to this point about net asset balance. One line of thinking is that if the community maintains high occupancy levels and has the cash to cover obligations then a negative asset balance isn't of concern. The other line of thinking is that an organization shouldn't maintain a negative asset balance with the assumption that occupancy levels will remain high indefinitely. The full details of this debate are beyond the scope of this report, but suffice it to say that a prolonged negative asset balance is something that should be more thoroughly examined by a prospective resident to find out the underlying reason and if there is a plan for addressing this issue.

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How to determine net asset values

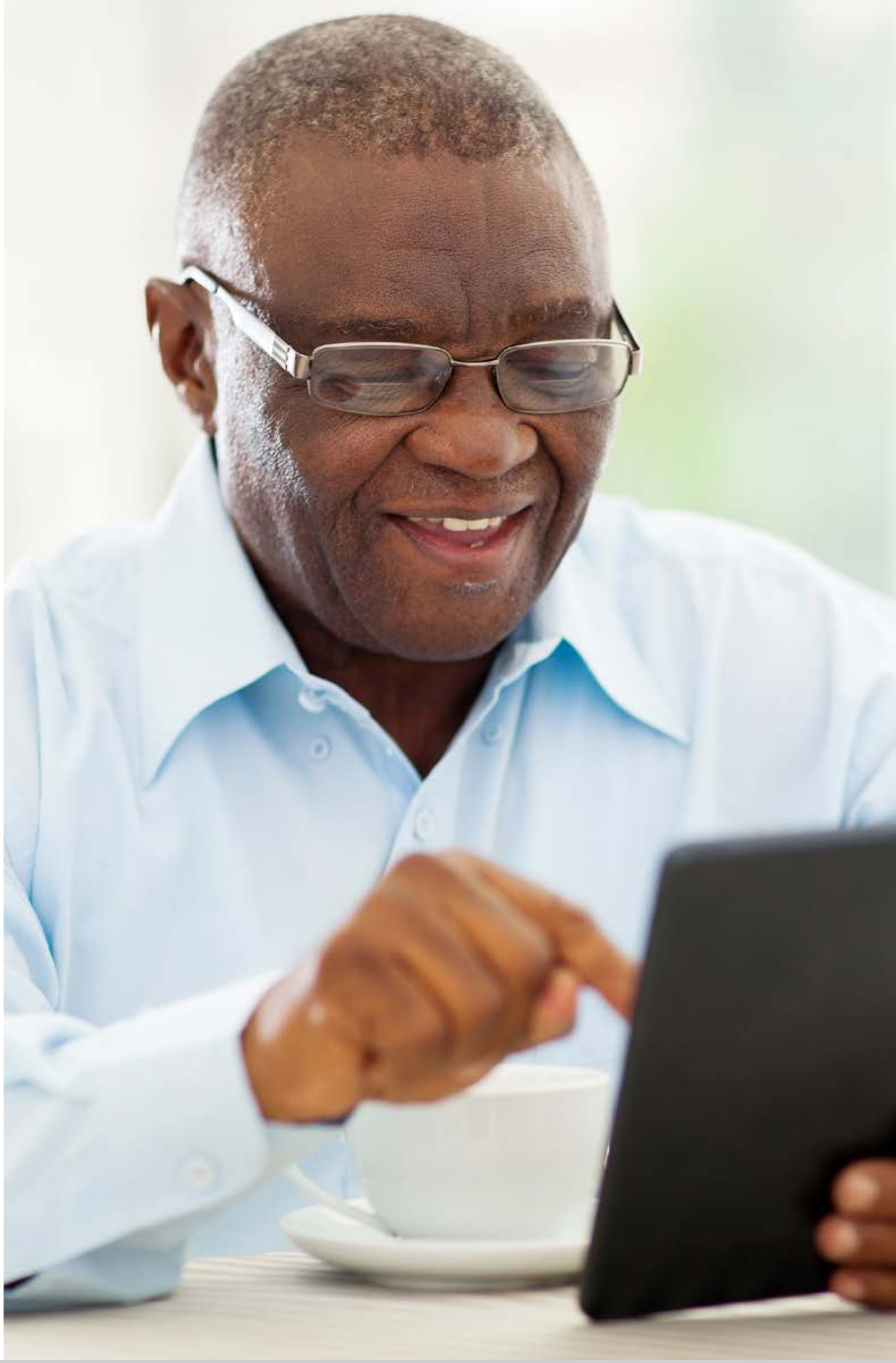
There are two easy ways to find the net asset values for a CCRC:

ProPublica: As an independent source for non-profit news, ProPublica offers a "Nonprofit Explorer" tool that includes financial information on non-profit CCRCs, which is gathered from form 990 that is required to be submitted to the IRS annually (**https://projects.propublica.org/nonprofits/**). The nice thing about this tool is that it also provides net asset value in prior years so you can see the trend. If the CCRC is part of a larger entity with a different name you may have to enter the parent company's name. **Note:** If the CCRC you are evaluating is a for-profit entity it would not show up on ProPublica.

Audited financial statements: You can obtain audited financial statements directly from the CCRC. Alternatively, in states that require the submission of disclosure statements annually, you can request the disclosure statement from the state agency under which the CCRC is regulated. The audited financial statements will include a balance sheet (also referred to as statement of financial position) with a line item for Net Assets. Often the financial statements also will include projected net assets for future years.

Impact of FASB guidelines

If you find that a CCRC's net asset balance dramatically changed from a positive to a negative sometime after 2013 it may be due to a required accounting change coming from the Financial Accounting Standards Board (FASB) related to how CCRCs book refundable entry fees on the balance sheet.



Financial ratios

As with the balance sheet, the financial ratios described in this section can help you gain an understanding of a provider's *current* financial standing. **Financial ratios are not necessarily the best indicator as to whether a CCRC is on track to meet its future financial obligations to residents. (This will be addressed further in the section below labeled "Actuarial analysis.") Nonetheless, knowing a provider's current financial situation is useful.**

Calculating financial ratios can be quite a challenge for someone without a financial background. This is particularly the case with CCRCs because they often receive a lot of money up-front from new residents, but only a portion of these funds is considered income during the accounting period in which the funds are received. It's also difficult because different financial organizations may use different terminology and methods for presenting financial information. Therefore, a CPA who understands the CCRC business model can be helpful in calculating these ratios.

While a poor result in any of the following ratios may indicate financial strain, this is not always the case; there may be a temporary and valid reason for it. A less favorable ratio in one area may be offset to some degree by a favorable ratio in another area. Be sure to get an explanation from the appropriate staff member.

Keep in mind, too, that new communities will typically have less favorable ratios than more established ones. A CCRC is generally considered “mature” after seven years.

Days cash on hand

Even if the CCRC has a positive net asset balance, it’s important to make sure there is enough cash on hand to meet obligations as they come due.

Looking at the CCRC’s cash on hand is one way to do this. This ratio measures the number of days of operation a provider could cover with its unrestricted cash and investments. A high number indicates financial flexibility and protection against a decline in operating profit. Of course, if this ratio is too high it could mean that the organization is not utilizing its cash resources in the most effective ways.

What to look for

Rating services suggest that greater than 450 days of cash on hand indicates considerable financial flexibility and less than 200 indicates less financial flexibility, which may be okay if debt burden is low.

Net operating margin

Net operating margin measures the CCRC's ability to generate annual operating surpluses to provide for future resident care expenses, capital, and program needs. In other words, it is a measure of an organization's core operations based on cash (operating) revenues and cash (operating) expenses. It also provides an indication of cash available from core operations for payment of debt service.

What to look for

Margins of 3 – 12 percent generally indicate the ability to provide adequate margin to cover debt service.

Debt service coverage

This ratio is only applicable for CCRCs that actually have debt. It is viewed by financial professionals as one of the most important ratios to analyze.

The debt service coverage ratio reflects a CCRC's ability to fund annual debt payments with cash flow from net revenues and net entrance fees. This is important because a CCRC that is able to do this does not have to rely on non-operating revenues, such as endowment funds, to fill the gaps.

What to look for

Debt service coverage of greater than 2.5 indicates a strong position, and coverage between 1.5 – 2.0 indicates adequate profitability and/or moderate leverage levels.

Actuarial studies

While an analysis of the balance sheet and financial ratios is helpful for gauging a CCRC's current financial standing, it's also important to determine if the community is well-positioned for the future. One of most reliable ways for management to ensure that future obligations to residents are properly funded is by performing a detailed actuarial analysis at least every few years. While it is often thought that a projection of future cash flows is adequate to ensure future financial soundness, this approach does not fully take into consideration the size of deferred obligations associated with resident contracts. **In other words, without a proper actuarial analysis, it is nearly impossible to know if future obligations to residents, which are impacted by mortality and morbidity rates, are properly funded.** When such obligations are not properly funded it can lead to an increasing actuarial deficit, which likely would require significant resident fee increases to avoid a financial crisis.

It's important to know that the type of residency contracts offered by the CCRC have some bearing on the importance of an actuarial study. CCRCs that offer a Type A contract, often referred to as a *lifecare* contract, are on the hook for the cost of healthcare services, and sometimes even assisted living services, to the extent that such costs exceed the resident's pre-determined monthly rate. This places additional financial risk on the CCRC, so funding these obligations is critical to long-term financial viability.

Learn more about the different types of CCRC residency contracts by visiting www.myLifeSite.net.

Other CCRCs offer Type C contracts, referred to as fee-for-service, whereby the resident bears some or all of the cost of these care services. In this case, there is less financial risk on the CCRC, and therefore, an actuarial analysis may not be as critical. However, this does not mean there is no need at all for such a study. Virtually all *non-profit* CCRCs promise (either explicitly or implicitly) lifetime housing and healthcare services even if a resident should exhaust their assets on these services. Therefore, the financial risk for a CCRC offering fee-for-service contracts is the possibility of residents outliving their assets. This could put an increased strain on the CCRC's finances and thus the community's ability to fulfill its promise of lifetime housing and healthcare to residents.

What to look for

Ask if the CCRC has performed a recent actuarial study. It's not necessary to read the entire report, but you'll want to know the result and whether it shows that the community is carrying an adequate actuarial balance to meet projected obligations.

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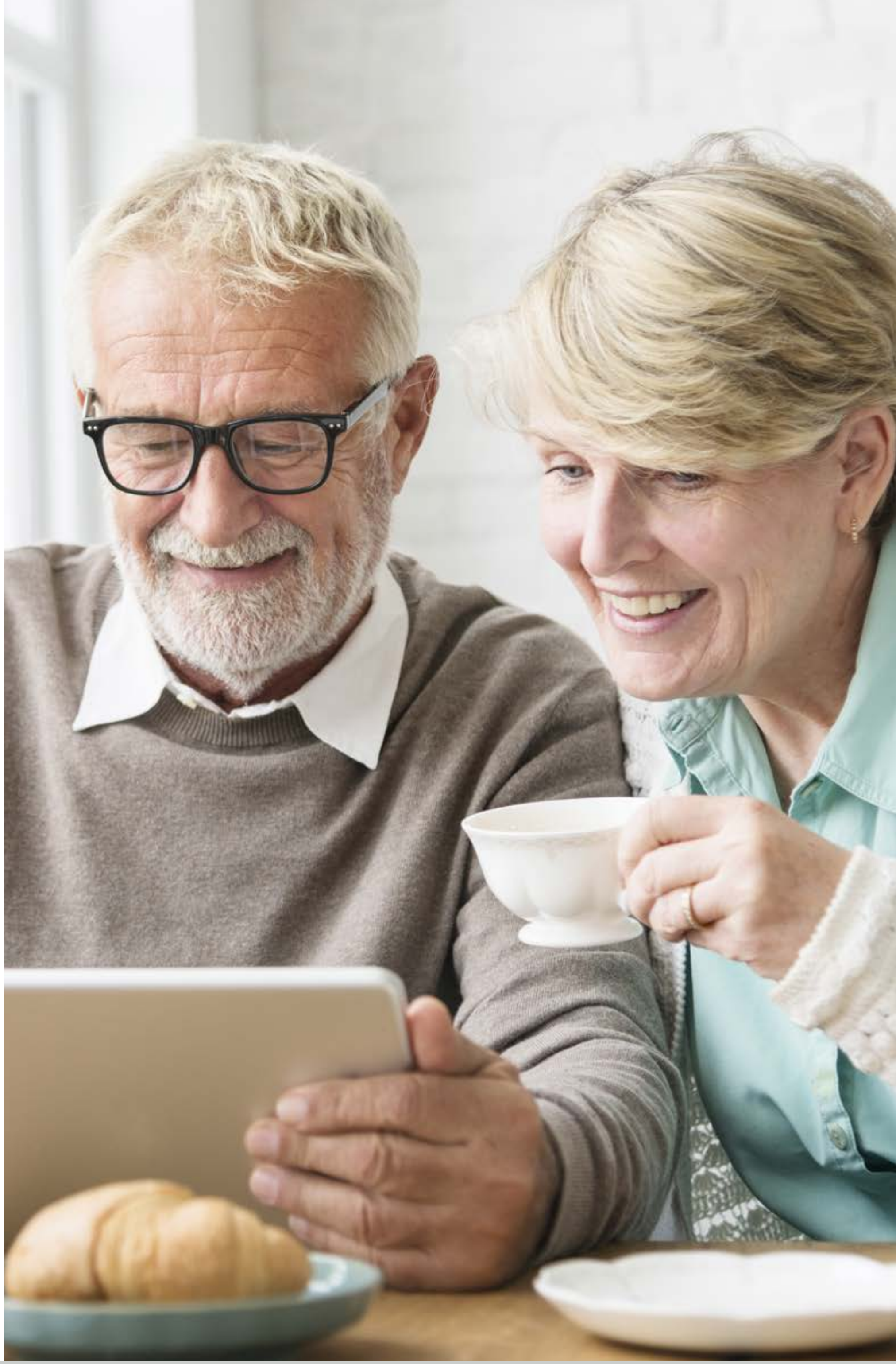
Occupancy ratios

A CCRC's occupancy ratio undoubtedly has an impact on the organization's financials. Empty units are a cash drain, so the fewer, the better. In general, you want to look for an occupancy level above 90 percent across all levels of care. The industry considers 95 percent full occupancy because there are almost always a percentage of units empty for refurbishments at any given time.

Rather than looking only at current occupancy figures, it's important to take into consideration circumstances and the trend over the past few years. A provider who has experienced low occupancy recently but has taken appropriate steps to increase demand for their community should not necessarily be dismissed. This may include things like the hiring of a new management firm or an experienced sales director, revised marketing and strategic plans, or community enhancements. Likewise, a community that has historically experienced high occupancy may now be on a downward trend.

The economy also has an obvious impact on occupancy rates. Following the great recession of 2007–2008 and the resulting housing market decline, CCRCs found it much tougher to maintain 90 percent occupancy or higher. The industry has since rebounded, and as of early 2018, average occupancy rates across the industry well-exceed 90 percent.



Other factors to consider

In addition to the guidance provided above, there are a few other factors to consider that are more subjective but nonetheless important. For instance, some providers are self-managed while others hire outside managers. Members of the management team and board of directors should be experienced in a variety of business backgrounds, such as healthcare and long-term care, real estate, finance, hospitality management, insurance, accounting, and more. Also, consider whether the board is culturally diverse. A culturally diverse board can help increase employee retention, improve staff members' productivity, and foster an inclusive environment that encourages innovation.

You should also ask whether there are up-to-date marketing and strategic plans. This is important for maintaining consistent demand in the marketplace, and thus high occupancy levels. The CCRC provider should have a deep understanding of its target market's size, needs, and preferences, and how the community will continue to position itself as a forward-thinking community. And all of this should be well-articulated in plans for new services and physical designs. Of course, keep in mind that overoptimistic marketing projections are one of the main reasons why start-up or expansion projects fail.

Finally, is there an active residents' council that has a voice in the annual budgeting process? Many CCRCs have access to a wealth of free financial guidance from residents who have extensive backgrounds in finance and business management. By giving residents a voice in the budget process it not only helps provide another layer of financial oversight but also gives the residents a sense of inclusion, which is ultimately important to the overall culture and well-being of the community.

Start-up communities

Start-up communities–those developed within the last seven years–should be viewed somewhat differently from established providers. For example, new providers will naturally have higher levels of debt in many cases. This is okay as long as cash flow is sufficient and is on track with projections. For newly developed CCRCs bond defaults are more likely to occur when management underestimates the amount of time they will need to fill the units, and as a consequence, funds are exhausted. Therefore, it is important to inquire about whether the community is on track with its initial projections. Of course, other aspects such as an experienced board and management team, and comprehensive marketing and strategic plans are still very important for start-up communities.

Summary

There is no single measurement to judge the financial viability of a continuing care retirement community. Regardless of the results of your financial evaluation, there are still other circumstances that could ultimately impact a provider's finances. Economic downturns, a poorly timed expansion, or the development of a new competing community would all be possible examples. However, the risk and impact of such occurrences can be mitigated by a community with appropriate financial, risk, and strategic planning.

Beyond all of the details provided in this guide, one of the biggest red flags of all may be a lack of transparency about financial viability on the part of the CCRC's staff. If representatives of the community are not open with you or willing to answer questions on this topic in a satisfactory manner, then it should give you pause.