Survival, Growth & Opportunities in 2011

by Lynne Moore of Moore Diversified Services, Inc.

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The Current Climate of Senior Housing:

We have been experiencing the most significant economic recession since the Great Depression of 1929. Unfortunately, the economic recovery has been slow. Some of the issues that continue to impact the senior housing industry include: continued high unemployment, an ongoing consumer and business credit crisis, depressed housing market, significant consumer net worth declines, and low consumer confidence. Many seniors and retirement community residents are experiencing increased income affordability pressures that are impacting their ability to pay prevailing market rates for senior housing. In addition, 2010 resident turnover indicates that most assisted living communities will have to refill at least 50 percent of their existing assisted living units in 2011 to sustain their current occupancy. All of these issues together are resulting in a "delayed consumer demand" for senior housing.

This is the year to continue to sharpen our strategic focus and lay a solid foundation for realizing a potentially strong future upside for our industry. Astute senior living operators realize that, while they cannot completely control the *external market*, they can control and optimize their *internal operations*. The opportunity for realizing significant growth and upside potential within existing senior living properties in 2011 is significant. One of the most noteworthy opportunities for operators in 2011 will be to focus on "organic growth" or taking an objective and sobering look at the performance of their existing operations. This will involve executing three fundamental strategies:

1. **Optimize stabilized occupancy.**
2. **Enhance existing financial operations – reducing expenses while possibly increasing revenues.**
3. **Consider synergistic growth on your existing campus – new revenue producing living arrangements and/or ancillary services.**

The following page includes a few strategies that will likely have a higher pay-off during these difficult economic times:

<u>Opportunity Cost of a Vacant Unit</u>:

The National Investment Center (NIC) reported assisted living occupancy of approximately 89 percent in late 2010. While this may sound promising in these challenging times, the bottom line impact of filling just one more vacant unit is significant. For each additional occupied unit in 2011, one could reasonably assume that approximately 30 percent of the additional monthly service fee collected would go for new incremental expenses. That is because most fixed costs are already covered, so approximately 70 percent of the additional monthly revenue represents a high incremental profit margin – cash flow that drops right to the bottom line. For an assisted living operation with a typical *baseline* monthly service fee of $3,000 per month, this 70 percent incremental profit margin results in a new cash flow benefit of $2,100 per month or $25,200 per year for each additional occupied unit.

<u>Operating Expense Reduction</u>:

Reducing operating expenses is another strategy that can yield some very attractive results. Two of the biggest areas of potential expense reduction include dietary costs and direct care costs. An operating expense reduction of just $1.00 per resident-day or about 1 percent is reasonable to achieve. For example, an 80-unit assisted living community at 89 percent stabilized occupancy operates with approximately 25,915 resident-days per year (80 units at 89 percent stabilized occupancy = 71 units times 365 days a year). With 25,915 annual resident-days, the $1.00 cash savings represents $25,915. The financial impact of the combination of modest occupancy enhancement and expense reduction has a positive cash flow impact of over $50,000 per year. Capitalizing the positive cash flow impact of approximately $50,000 per year at a 9 percent cap rate can increase the intrinsic value of your community by over $560,000.

<u>Synergistic Growth on an Existing Campus</u>:

The typical new resident profile is changing in 2011. Many are entering communities older and with higher acuity levels. We will also see an increase in the incidence level of Alzheimer's and other dementia related diseases. As a result, many operators are now offering new special care options involving purpose-built Alzheimer's designs with strong programmatic content. Consideration should also be given to other new revenue-producing opportunities. Operators tend to sell traditional senior services, but there are other services that seniors need or want that could be sold within your operation. These could include licensed home health, rehabilitation, hospice and possibly pharmacy services. Existing residents frequently represent more business opportunities than we sometimes realize.

In executing all of these strategies, one must not overlook another important issue – the chronic aging and gradual deterioration of physical plants. A community ages, like its residents, in a predictable and often subtle manner. These subtle changes can affect the viability of a community in all of the discussed areas – stalled marketing momentum, decreasing occupancy and inefficient operations.

The top areas for potential capital improvements include the overall look of the campus and building exterior, interior public spaces, back-of-the-house details and individual living units. These improvements will require capital investments and value judgments will need to be made as to whether or not they are worth the dollars you will have to commit.

Figure 1. illustrates the breakeven increase in resident monthly service fees that would be required to recover various levels of improvement to common areas/physical plants.

FIGURE 1.

COST RECOVERY FOR CAPITAL INVESTMENT
IMPROVEMENTS TO COMMON AREA/PHYSICAL PLANT

Common Area/ Physical Plant Capital Improvement	Break-Even Increase in Resident's Monthly Service Fee to Cover Incremental Increase in Debt Service on Borrowed/Invested Funds to Pay for Improvement[1]				
	7.0%	7.5%	8.0%	8.5%	9.0%
$ 25,000	$1.55	$1.63	$1.71	$1.79	$1.87
50,000	$3.10	3.26	3.42	3.58	3.75
75,000	$4.65	4.89	5.13	5.37	5.62
100,000	$6.20	6.52	6.84	7.17	7.50
125,000	$7.75	8.14	8.55	8.96	9.37
150,000	$9.30	9.77	10.26	10.75	11.25
175,000	$10.85	11.40	11.97	12.54	13.12
200,000	$12.40	13.03	13.68	14.33	15.00
300,000	$18.60	19.55	20.51	21.50	22.49
400,000	$24.80	26.06	27.35	28.66	29.99
500,000	$31.00	32.58	34.19	35.83	37.49

[1]Indicates annual interest rate @ 30 years and a 1.30x debt service coverage ratio.

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Figure 1. (specifically the column on the left) also illustrates various levels of potential capital improvement investments. The interest rates across the top represent the cost of capital or potential annual interest rates on borrowed money over a 30-year time. Using this information, one can calculate the potential new debt at various levels of investment. In the highlighted scenario on Figure 1, a $50,000 investment will require each resident's monthly service fee to increase by only $3.42 per month. To cover the cost of new debt, this particular example assumes that these costs are spread across a 150-unit project operating at 93% occupancy. As can be seen, the leverage of investing in the common spaces/physical plant can be significant as you are spreading the cost of the improvements across all occupied units.

In addition, the improvement could result in a savings in operating expenses. For example, if an improvement could reduce your operating expenses by $1,000 per month (or $12,000 per year), the initial investment of $50,000 would be paid back in approximately four years. And these operating expense savings would be realized far beyond the initial payback period – further increasing the intrinsic value of your community.

In Conclusion:

Senior housing operators must look back on the last few years with 20/20 hindsight and, more importantly, look forward with entrepreneurial vision. When properly executed, all of these strategies can have a significantly positive and largely permanent financial impact that will continue to be realized in future years.

Lynne Moore is president of MDS Research Company, Inc., a national senior housing and health care consulting firm based in Fort Worth, Texas.
Contact: 817-731-4266 or lynnemoore@m-d-s.com.

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