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By Ken Mann

Senior Care in Distress: Challenges, Evaluation, Opportunities and Alternatives

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In recent months, there has been an increase in distress among long-term care facilities (LTCFs). These consist predominantly of skilled-nursing facilities (SNFs), assisted-living facilities (ALFs) and memory care facilities. This is a trend that special situations M&A advisors suspect will continue to provide work for insolvency professionals. This article provides a primer on the LTCF challenges that existed prior to the COVID-19 pandemic and how it has exacerbated the issues while adding new complexities. The article also explores how to evaluate opportunities, various concepts of valuation and potential alternative uses for unviable facilities.

Presenting a positive backdrop for the senior care industry is the growing number of seniors and their longer life expectancies. According to the U.S. Census, in 2030 (when all baby boomers will be older than 65) older Americans will make up 21 percent of the population, up from 15 percent today. By 2060, one in four Americans will be 65 years and older, the number aged 85 years or older will triple, and the country will add a half-million centenarians.[1] Of course, as people age, their likelihood of requiring long-term care increases.

Challenges Giving Way to Distress

Despite these favorable trends, trouble in the LTCF space has been predicted for years. As a broken, overburdened system with a bad business model, the sector had already suffered pre-existing conditions pre-pandemic. Most notable, those needing the services are incapable of paying for them.

A bed in a nursing home costs $93,000 for a shared room and $105,000 for a private room annually.[2] SNFs can be profitable when reimbursed at that level, but despite the high demand, most families cannot afford this expense. Such out-of-pocket payments, combined with private long-term-care insurance payments, account for only around 40 percent of the total spend in LTCFs in the U.S. According to one report, "Medicaid is the primary payer for nursing homes, covering more than 60 percent of all nursing home residents and approximately 50 percent of costs for all long-term care services. However, Medicaid reimbursement only covers 70 to 80 percent of the actual costs of nursing home care. This chronic gap in funding has resulted in shoestring budgets and ongoing operating losses for nursing home providers."[3] In other words, the most common payment scheme for the services provided in SNFs pays *significantly less* than the cost of the service. Recent changes in reimbursement models from fee-for-service to value-based have only made matters worse.

While what Medicaid covers varies by state, it does not, however, cover the costs of room and board anywhere. As such, ALFs enjoy a higher level of private pay than SNFs, but the lack of government help means that fewer prospective residents have the means to pay, so many will end up staying at home with relatives or seek the least expensive option in their ALF market.

1 "The U.S. Joins Other Countries with Large Aging Populations," U.S. Census Bureau (Oct. 8, 2019), *available at* census.gov/library/stories/2018/03/graying-america.html (unless otherwise specified, all links in this article were last visited on May 23, 2022).

2 "Long-Term Care Insurance Cost: Everything You Need to Know," *MarketWatch* (Oct. 10, 2021), *available at* marketwatch.com/picks/guides/insurance/long-term-care-insurance-cost-everything-you-need-to-know.

3 "Financial Struggle of Nursing Homes Puts Medicaid Reimbursement Rates Back in the Spotlight," AHCA/NCAL (Oct. 28, 2020), *available at* ahcancal.org/News-and-Communications/Press-Releases/Pages/Financial-Struggle-of-Nursing-Homes-Puts-Medicaid-Reimbursement-Rates-Back-in-the-Spotlight.aspx.

Furthermore, there is too much supply in some markets. Investors followed baby boomers as the generation approached retirement age. In response, more facilities were built, and certain areas are now over-bedded. As new facilities come online, it is harder for older facilities with dated décor, layouts and amenities to enroll new residents.

Competition does not just come from other like-facilities; lifestyle choices as people age change with each generation and with other trends and technological advancements. While some seniors are forced to age at home due to costs, many prefer not to leave their homes. In many respects, technology will become the great competitor to senior-living facilities and, to a lesser degree, senior-care facilities. Telehealth allows medical appointments to occur virtually. A smartphone can summon a ride to an appointment or provide on-demand food delivery. Voice-activated assistants like Alexa, being commonplace in the homes of more tech-savvy boomers, can remind seniors to take medications and accomplish daily tasks. Inexpensive home security systems, wearable medical-monitoring devices and fall alerts can give family members the peace of mind they once relied on an institution to provide.

Another major challenge for the industry over the last 30 years has been the difficulty in recruiting and retaining quality labor. The limited supply of qualified nurses has driven their wages up, creating an imbalance and pushing nurses to other areas of health care.

A Pandemic to Seal the Fate

As if the industry did not have enough to overcome, the COVID-19 pandemic has inflicted devastating consequences, including an estimated 200,000 deaths in LTCFs. In addition to the unthinkable human toll, this has ultimately led to shrinking occupancy. According to the National Investment Center for Seniors Housing & Care, skilled-nursing occupancies plummeted to 70.7 percent, down from the pre-pandemic level of 86.6 percent. More broadly, senior-housing occupancy in the U.S. reached a record low of 78.8 percent in the first quarter of 2021, falling nearly nine percentage points from the previous year.[4]

Early in the pandemic, when hospitals limited procedures, referrals to SNFs plummeted. As deaths mounted, seniors and their families became justifiably scared of the apparent risks. Likewise, many hospitals began to discharge more patients to home health in 2020 rather than to skilled-nursing facilities to avoid those that were overrun by the virus.

The skilled-labor shortages and wage pressures of the health care industry have been made even worse by the Great Resignation. According to the Bureau of Labor Statistics, "[o]verall, long-term care workforce levels are at their lowest in 15 years, with 409,100 jobs lost between February 2020 and January 2022. The decline has been especially noticeable in skilled nursing, which experienced a 15 percent workforce decline during that time."[5]

More than half of all nursing homes have had to turn away new residents due to an inability to staff at the required levels. So, even where demand exists, labor shortages minimize the ability to capture it. The cost of labor is increasing dramatically, as are the costs for goods and services needed for operations, including new costs associated with policies and equipment related to virus containment.

As a result of these factors, 17 of the 33 chapter 11 filings by LTCFs since 2016 were filed in the two years since the beginning of the pandemic.[6] Distress is now more visible in the long-term-care space because operators are running out of various forms of government funds. Simultaneously, with recent upticks in interest rates, creditors are beginning to take a hard look at their underperforming assets, and generous "wait-and-see forbearance" is transitioning to "forbearance with a plan for exit." Furthermore, LTCF operators may face COVID-related litigation, which will increase the number of chapter 11 filings in this space.

Evaluating LTCF Opportunities

Even a nonexpert can ask questions to determine whether a facility is viable and can obtain new financing, sell as a going concern or successfully reorganize. To start, it is important to understand the 13-week cash flow projection and whether the runway to operate and execute a plan exists. The following provides a snapshot of current performance and are standard diligence requests: (1) state survey information and status of licensing and staffing levels/certifications; (2) census, payer mix and net operating income (NOI); and (3) operational key performance indicators, such as case mix index and average cost of care are telling, and referral sources care about things like average length of stay, infection rates and readmission rates. As one attempts to determine the likelihood of reorganization, refinancing or a turnaround, there are key considerations:

- *Demand:* Are there competitors in the area that are thriving? This is the easiest and fastest way to determine whether the struggling facility can be revived with time and the right operator and marketing team.
- *Strength of the Sales and Marketing Team:* Is there a systematic way to consistently generate referrals/leads, and is it well documented? If so, and there is adequate demand and runway, reorganization may be plausible. If not, this can explain deficient performance and be remedied with a change in management.
- *Supply:* Are there newer facilities, particularly at the same price point, or any scheduled to be built?
- *Perceptions:* How has the subject fared through the COVID-19 pandemic, and are there red flags that could chill the ability to rebuild census (accidents or other incidents with or without litigation)?
- *Financials:* When was the subject last profitable? Using conservative assumptions regarding census, what is the available cash flow to service the debt? Are there existing rent concessions that will expire soon, or anything else that will cause a bump (or decline) in revenue? Are there other opportunities for revenue enhancement, such as increasing ancillary services, increasing the level of acuity handled or adding memory care?

4 "U.S. Seniors Housing Occupancy Reaches New Low," Nat'l Inv. Ctr. for Seniors Housing & Care (2021), *available at* nic.org/news-press/u-s-seniors-housing-occupancy-reaches-new-low.

5 "The Employment Situation," Bureau of Labor Statistics (April 2022), *available at* www.bls.gov/news.release/pdf/empsit.pdf.

6 *Debt Wire* (Feb. 10, 2022).

Viable Solutions to Persist

Most LTCF owners will want to pursue a solution that allows them to maintain equity. If refinancing is the goal, a new lender will require a debt-service-coverage ratio of 1.3 to 1.5x depending on variables such as term, amount of equity and the type of services offered at the facility. Absent that cashflow, the borrower has two alternatives to live to fight another day: a bridge loan or sale-leaseback. If management can show a path to profitability in two years or less, the business may be able to borrow 50 to 70 percent of fair market value and pay interest only (or accrue it) as a "bridge" to stabilization, capitalizing on the ability to refinance or sell.

The practice of having an operating company (Op Co) and a property company (Prop Co) for each LTCF is common, so a sale-leaseback of the property, or Prop Co, may allow the troubled operator to keep the Op Co while paying off some debt and buying time for a turnaround. There are numerous real estate investment trusts (REITs) focused on acquiring these facilities. They will require earnings before interest, taxes, depreciation, amortization and rent (EBITDAR)-to-rent coverage of 1.1 to 1.5x depending on the type of care and other factors. Troubled facilities tend not to be Class A (which is what REITs are after) and do not have much EBITDAR, so the buyer pool is often limited for distressed LTCFs.

For most, the next best option is to sell the asset and business together as a going concern to a strategic or financial buyer. Selling the facility for its intended use will almost always maximize value. Despite thin margins, LTCFs continue to garner interest from investors and lenders and, if not in rural areas, enjoy attractive valuations.

Valuation Considerations

While detailed explanations of valuation are beyond the scope of this article, the following may shed light on the basics and provide guideposts. The most common way that income-producing real estate is valued is using the income-capitalization method in which NOI is divided by a "cap rate" to get approximate value. The lower the cap rate, the higher the valuation.

Over the last decade, cap rates for LTCFs have been compressed (valuations high) due to easy and cheap money, the aging population and other factors. Current valuations are driven in part by the high costs of real estate and construction. The cost of building new facilities has inflated dramatically, making buying existing facilities more attractive. Furthermore, rising housing prices provide seniors with confidence and cash for entry fees and expenses, creating demand and room for higher rents. However, we are now in a rising-interest-rate environment, which tends to increase cap rates and stall housing markets.

Within senior living and care, cap rates vary broadly. The following exhibit shows current cap rates for different types and classes of LTCFs, as provided by CBRE's Seniors Housing Investor Survey.[7] Appraisals and values arrived at from cap rates are often very different than selling prices for distressed properties for many reasons, including shorter marketing periods, deferred maintenance, saturated markets and a lack of NOI.

Potential Alternative Uses

Senior-living and care facilities do not lend themselves well to being converted to an alternative real estate asset class without substantial capital and time investment. If a facility is going to be closed and liquidated, its value is only about 50 percent of what it was as a profitable and operating LTCF. If a buyer is not found that wants to improve and reopen the facility for its original purpose, the most common repositioning is to convert some (or all) ALF beds to other related senior-care uses to better meet a market need. The seller's advisors should investigate the local market to deter-

7 "U.S. Seniors Housing & Care Investor Survey 2022," CBRE (April 5, 2022), *available at* cbre.com/en/insights/reports/us-seniors-housing-and-care-investor-survey-2022.

Exhibit: Senior Housing & Care Capitalization Rates

		Class A			Class B			Class C		
		Low - High (%)	Avg. (%)	Change (bps)	Low - High (%)	Avg. (%)	Change (bps)	Low - High (%)	Avg. (%)	Change (bps)
Core	Active Adult	3.0 - 8.0	**4.6**	-26	4.0 - 8.0	**5.7**	-7	5.0 - 10.0	**6.8**	2
	Independent Living	3.0 - 8.0	**5.3**	0	4.0 - 9.0	**6.3**	-12	5.0 - 10.0	**7.3**	-9
	Assisted Living	4.0 - 9.0	**6.1**	-1	5.0 - 10.0	**7.1**	-9	6.0 - 11.0	**8.3**	-12
	Memory Care	5.0 - 10.0	**7.0**	-9	5.0 - 10.0	**7.6**	-16	6.0 - 11.0	**8.7**	-16
	Skilled Nursing	9.0 - 14.0	**10.7**	-17	9.0 - 14.0	**11.5**	-17	11.0 - 16.0	**13.3**	-2
	CCRC/LPC	5.0 - 10.0	**7.0**	0	6.0 - 11.0	**8.0**	-23	7.0 - 12.0	**9.0**	-25
Non-Core	Active Adult	3.0 - 8.0	**5.2**	-31	4.0 - 9.0	**6.2**	-12	5.0 - 10.0	**7.2**	4
	Independent Living	4.0 - 9.0	**6.2**	-5	5.0 - 10.0	**7.1**	1	6.0 - 11.0	**8.1**	-2
	Assisted Living	5.0 - 10.0	**6.8**	-10	5.0 - 10.0	**7.4**	-19	6.0 - 11.0	**8.5**	-7
	Memory Care	5.0 - 10.0	**7.3**	-20	5.0 - 10.0	**7.9**	-19	6.0 - 11.0	**9.0**	-1
	Skilled Nursing	9.0 - 14.0	**11.2**	-35	9.0 - 16.0	**11.7**	-38	11.0 - 16.0	**13.6**	-8
	CCRC/LPC	6.0 - 11.0	**8.0**	-12	6.0 - 11.0	**8.4**	-26	7.0 - 12.0	**9.4**	-31
Avg. Change Per Class				-14			-17			-9

Source: 2022 CBRE Seniors Housing Investor Survey results, change from 2021.

mine the need for related uses, such as behavioral health care, specialized dementia, independent living or other specialty units.

SNFs and ALFs are not easily convertible to typical residential uses, but some asset classes such as affordable senior housing, which do not require larger units, can make sense. Various states and cities are being generous about the availability of tax credits and other funding to support such conversions as affordable or workforce housing, particularly in urban areas. Likewise, there is public and charitable funding to ease homelessness in certain areas, and smaller units can fit that use.

If there is a college or university nearby, targeting buyers for conversion to student housing may be a consideration. Depending on the size of units and construction of dividing walls, in some cases LTCFs can be converted into apartments. Although they generate less revenue per unit than LTCFs, apartments have lower cap rates, and their prices have climbed steadily over the last 10 years. Some of the typical configurations for LTCFs work well for medical offices if they are situated in an area with demand. Conversion to general office space is less likely since the work-from-home movement, but it is possible. Finally, for facilities located in vacation destinations, depending on supply and demand and the configuration and amenities of the subject facility, hospitality operators may be potential buyers.

For all these alternative uses, buyers will value the property by comparing the purchase and repurposing costs to building or buying something already properly configured. Their valuation will be based on their estimated NOI and the cap rates appropriate to their intended use, adjusted for the cost of the repurposing. As a result, these valuations will be much lower than the existing use appraisal.

Conclusion

It is expected that distressed LTCFs are going to need help from this publication's readership. There are options to preserve the going concern, including refinancing, sale-leaseback or a sale of the business and property, and there are many ways to get a sense for the viability of each of those options. In the worst-case scenario, the real estate assets themselves often have value for alternative uses. abi

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