KaufmanHall

July 2024

The Strategic Implications of Evolving Industry Dynamics for Life Plan Communities

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Life plan communities (LPCs), also known as continuing care retirement communities, are uniquely situated in the healthcare and senior living marketplace. They cater to a growing demographic as the Baby Boom generation moves toward full retirement (by 2031, the youngest Baby Boomers will reach Social Security's full retirement age of 67). Yet they are subject to—and in some cases more exposed to—the same forces that have buffeted other healthcare organizations in recent years: staffing shortages and increased reliance on agency utilization, inflationary pressures on wages and supplies, and higher interest rates.

Some LPCs are doing better than others. Organizations that have more expansive platforms with diverse product arrays or regional density see opportunities for continued investment in the sector, especially in markets with strong embedded growth opportunities. Stronger headwinds are challenging the performance of smaller and middle-market not-for-profit LPCs, the latter of which face greater challenges in offsetting labor increases through higher monthly fees, and LPCs with significant exposure to skilled nursing, which face lagging third-party payer reimbursement rate increases. While there are many exceptions—both high-performing, middle-market LPCs and higher-end LPCs that have experienced financial distress—the higher costs of labor, supplies, and capital are especially acute for single-site and smaller organizations, which lack the broader scale needed to spread fixed costs and back-office infrastructure across a portfolio of communities. These dynamics have led to financial distress—and in some cases bankruptcy—for several not-for-profit LPCs.

Indicators of Financial Distress

A significant uptick in bankruptcies and industry-wide credit rating degradation are indicators of growing financial distress within some sectors of the LPC market, particularly single-site LPCs:

- In 2023, $3.2 billion of senior-living bonds were in default of a payment (7% of outstanding senior-living bonds).
- According to public filings, there have been 19 bankruptcy filings involving not-for-profit senior living owners/operators since 2021.

While these industry dynamics have fueled a number of LPC partnerships, affiliations, and acquisitions, the LPC sector remains highly fragmented. But the sector likely will face new pressures: many organizations have upcoming debt renewals, for example, and will face mandatory tenders in a higher interest rate market with fewer banks active in the sector. Other organizations face significant capital needs to keep up with other market alternatives and limited debt capacity, particularly considering the costs of borrowing.

We anticipate that these evolving industry dynamics will facilitate further consolidation among not-for-profit LPCs, especially as organizations look to add scale to their platforms. This activity will have strategic implications for LPC organizations of all sizes, which will require leadership teams' time and consideration.

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Implications for smaller LPCs or those needing access to capital

Boards and executive leadership teams have spent the last few years dealing with operational issues related to the Covid pandemic and its aftermath, but now is the time to take a step back and think strategically about their organization's future. This includes thinking not only about how the organization will navigate near-term headwinds, but also what the organization's trajectory will be over the next three to five years.

Organizations that are in a position of strength, with a significant financial cushion, will have the broadest range of strategic options. But even these organizations should consider the extent to which that cushion might be depleted by ongoing industry challenges. There is a risk for any organization in waiting too long to make strategic decisions; what is a minor issue today may be compounded in the future, limiting the available options or even forcing an organization's hand to make a decision to remain financially viable.

"Throughout the challenges of the last several years, it became increasingly clear that long-term care operations such as Clement Manor would find it challenging to survive operating alone," said Dennis Ferger, CEO at Clement Manor. "Across the industry, senior living organizations have strengthened their operational, financial, and market positions by collaborating in some fashion with other like-minded entities. Clement Manor embraced the vision of becoming closely affiliated with another quality organization to share best practices, leverage each other's strengths, and create a more robust, effective, and fiscally fit operation. 'Collaboration, because no one can do it alone' became a strategic imperative of Clement Manor."

Key Questions for Boards and Executive Leadership Teams

As boards and executive leadership teams evaluate their organization's long-term trajectory, they should consider the following questions:

- Is the board and the leadership team aligned on the long-term vision, strategy, and goals for the organization?
- Assuming no change to the status quo, what is the organization's financial outlook over the next three to five years?
- Does the organization have the resources to withstand another operational or financial shock (e.g., a real estate downturn that drives down occupancy rates or monthly fees, or the opening of a new competitor)?
- Has the organization identified and implemented innovative strategies or opportunities to improve performance and enhance its ability to achieve its mission (examples could include revenue-enhancing or partnership opportunities)? If already completed, what other options are available?
- Does the organization have access to the resources needed to reinvest in its facilities to remain competitive in the market and adapt to evolving consumer preferences?
- What type and scale of growth (e.g., construction, affiliations, acquisitions) can the organization support?

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For organizations that are already feeling financial constraints, leadership should consider whether there are financial turnaround or other operational improvement initiatives that could be implemented to provide more liquidity headroom. If the organization is considering a partnership, strengthening its financial position can also expand the range of interested partners and allow negotiation from a position of strength to best protect the interests of residents, employees, and other legacy stakeholders. In certain situations, these efforts could be coupled with negotiated bondholder restructurings, facilitating more sustainable debt structures and better positioning the community for future financial success and flexibility.

Implications for larger, multi-site LPC operators

The same dynamics that are challenging smaller LPCs are creating opportunities for larger, multi-site LPC operators seeking to broaden their scale, strengthen their regional density, or expand their geographic footprint. In a third-quarter earnings call in November 2023, Ventas CEO Debra Cafaro noted "the most favorable supply demand fundamentals the industry has ever experienced," which create "a compelling back-drop for multi-year growth ahead." Cafaro also commented on opportunities to capitalize on the coming wave of debt maturities for LPC owners in the years ahead: "There's a huge pool of quality senior living communities with attractive return portfolios that are coming to market as a result of debt maturities and higher debt service cost."

With consolidation among not-for-profit LPCs primed to accelerate, larger, well-capitalized not-for-profit LPCs should see emerging opportunities to partner with one-to-two-site not-for-profit LPCs, with member substitution offering a potentially attractive transaction structure (see sidebar). These organizations should position themselves to capitalize on these opportunities by:

- **Identifying potential opportunities** in markets that align strategically with their current portfolio and developing affiliation/acquisition criteria with management and board alignment.
- **Fostering relationships** with other LPC leaders to determine whether opportunities represent a good cultural fit for a partnership.
- **Maintaining financial strength and credit rating** to be viewed as a strong option for smaller LPCs seeking a partner and to comfortably allow for the ability to backstop the smaller LPC's debt.
- **Effectively vetting acquisition opportunities** as there are a myriad of factors that determine the long-term success, or failure, of acquisitions. Factors include cultural fit, price/capital commitment, risk allocation between buyer/seller, improvement opportunities, and areas of deficiencies, among others.

The Member Substitution Option for Strategic Partnerships

One option for smaller LPCs or those needing access to capital is acquisition by, or affiliation with, a larger organization. While asset acquisitions have been common for smaller LPCs, tighter access to and higher costs of capital have put a greater focus on member substitutions in a change-of-control transaction involving two not-for-profit organizations. Member substitutions involve the replacement of a not-for-profit "seller's" corporate member entity with another, often larger, "buyer" entity. Member substitutions have a number of benefits for both organizations. They can:

- Reduce or eliminate the cash outlay required from the buyer
- Allow most, if not all, long-term liabilities to be assumed by the buyer, while still allowing for restructuring of the seller's debt
- Allow for creation of a separate subsidiary that fulfills legacy, faith-based, or capital commitments of the seller
- Offer a less complex transaction structure than an asset purchase

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While growth should be an objective for most organizations, opportunities should be evaluated carefully and in the context of an organization's strategy, rather than growing to achieve a certain threshold of scale. It is imperative that leadership teams and boards examine current and post-acquisition financial position/debt capacity and assess anticipated credit rating impacts.

Larger LPC organizations have also considered combining with similarly sized—and similarly well-capitalized—organizations to build scale (a recent example is the merger of Well-Spring and Brightspire to form the largest not-for-profit LPC in North Carolina). The combined strength of the two organizations can support efforts to fulfill long-term objectives of continuing not-for-profit status and mission, reinvesting in facilities and employees, and providing high-quality offerings to residents. In addition, enhanced scale can support:

- **Strengthened credit ratings**, especially for multi-state organizations. Of the universe of Fitch rated credits, approximately 85% of multi-campus or multi-state LPC operators (defined as LPC sponsors operating more than three communities) maintain investment grade ratings compared to 64% for stand-alone communities. The rating agencies view geographic diversity positively, and the potential boost this diversity can give to a rating can subsequently lower the cost of borrowing, as partially evidenced by the fact that approximately two-thirds of Fitch downgrades over the past 12 months were on stand-alone communities.
- **Better management of employee recruitment and retention**, as a larger organization can afford a full-time, in-house recruiter or start its own staffing agency.
- **Sharing of operational best practices and expertise** across the larger organization.
- **Scaling of Medicare Advantage contracting** for skilled nursing sub-acute referrals and getting "preferred" site designation with local health systems.
- **Savings with vendors and suppliers** in such areas as food services, pharmacy, and rehabilitation services.

A Fragmented Market Offers Opportunities

A fragmented not-for-profit LPC industry bolsters the acquisition opportunities for larger not-for-profit LPCs. A comparison with the for-profit senior living sector reveals the degree of fragmentation in the not-for-profit senior living sector.

- Only 3 of the top 25 senior housing property owners are not-for-profit
- Only 8 of the top 50 senior housing property owners are not-for-profit
- Only 11% of units owned by American Seniors Housing Association (ASHA) Top 50 companies are not-for-profit

Source: American Senior Housing Association, *2023 ASHA 50*, May 9, 2023

"HumanGood is the coming together of several not-for-profit senior living providers and the bedrock of our affiliations has been the alignment of culture, mission, and strategy," said John Cochrane, president and CEO of HumanGood. "As our industry adapts to global demographic and economic shifts, the benefits of consolidation—geographic diversity, access to talent, resources, and brand recognition—will be necessary for organizations seeking to grow their missions and improve the experience they provide to their residents, team members, and families."

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Positioning for the future

Regardless of size, LPC leadership teams should be thinking about how they can best position their organization and its stakeholders to ensure the broadest range of future options. We anticipate an accelerating trend toward consolidation of the LPC sector, and building or maintaining a position of financial strength is a "no regrets" strategy whether or not an organization ultimately decides to seek a partnership. Beyond cost reduction efforts, options include pursuing additional revenue streams to offset rising expenses and exploring financing or debt restructuring opportunities.

Certain markets have already witnessed significant partnership activity among not-for-profit LPCs. Of particular note are North Carolina, with EveryAge's recent acquisition of Providence Place and the Well-Spring/Brightspire merger mentioned above, and Pennsylvania, with Diakon's recent divestiture of its four LPCs to Lutheran Senior Services and Presbyterian Senior Living's acquisition of Pine Run Village.

In all circumstances, leadership teams should be closely monitoring the dynamics of their local market or markets, and anticipating how these dynamics might affect their organization's financial performance over the next few years. A proactive approach is always preferable to a reactive response and will help ensure the continued viability of the organization and the continued support of the communities and stakeholders it serves.

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