

**Health Care
Criteria Report****Rating Guidelines For Nonprofit
Continuing Care Retirement
Communities****Analysts**

Jim Mitchell
(813) 223-6600
james.mitchell@fitchratings.com

James LeBuhn
(312) 368-2059
james.lebuhn@fitchratings.com

Michael Borgani
(415) 732-5620
michael.borgani@fitchratings.com

Alex Bumazhny
(212) 908-0341
alex.bumazhny@fitchratings.com

Michael Burger
(212) 908-0555
michael.burger@fitchratings.com

Anthony Houston
(312) 368-3180
anthony.houston@fitchratings.com

Jeff Schaub
(212) 908-0680
jeff.schaub@fitchratings.com

Gary Sokolow
(212) 908-9186
gary.sokolow@fitchratings.com

Carolyn Tain
(212) 908-0259
carolyn.tain@fitchratings.com

Eva Thein
(212) 908-0674
eva.thein@fitchratings.com

Related Research

- *2007 Industry Outlook for Continuing Care Retirement Communities, March 13, 2007*
- *2007 Median Ratios for Continuing Care Retirement Communities, Sept. 14, 2007*

This report updates Fitch Ratings' Oct. 27, 1998 published guidelines.

Summary

Fitch Ratings defines a continuing care retirement community (CCRC) as a community that provides or arranges for housing and designated health-related services to an elderly person pursuant to a residency agreement, effective for the rest of a person's life or for a specified period exceeding one year. Fitch views a CCRC as a health care-related entity that provides housing and other services rather than as a housing-related entity that provides health care. It is the continuum of care provided throughout the remainder of a resident's life that distinguishes a CCRC from other housing arrangements for the elderly. To provide such designated health-related services, the CCRC may charge an entrance fee or other type of advance fee, a periodic (usually monthly) fee, and a full or discounted monthly service fee for assisted living, dementia-related, or nursing services.

As the industry has matured and become a more accepted and popular lifestyle option for the elderly population, the number of CCRC borrowers rated by Fitch has increased. In its credit analysis, Fitch evaluates both quantitative and qualitative factors that affect the financial profile and creditworthiness of a CCRC. However, financial position, contract type, facility location, competitive environment, occupancy, and management practices continue to be the foundation of Fitch's analysis.

Fitch's credit analysis begins with an examination of a borrower's financial position as reflected in audited financial statements. From those financial statements, Fitch has developed an array of financial metrics used to assess a particular borrower's financial condition. Fitch does not weigh any one quantitative measure more heavily than another but, instead, will evaluate ratios in conjunction with each other to formulate a quantitative evaluation of the borrower. For example, a CCRC with relatively low liquidity may not be penalized due to a low debt burden or unusually high capital expenditure patterns. In addition, Fitch will analyze the relative stability and year-over-year trends of financial measures when evaluating a borrower and comparing an individual CCRC's financial ratios with Fitch's median ratios for CCRCs and with other CCRCs rated by Fitch.

While quantitative factors are an important tool in measuring creditworthiness, qualitative factors such as contract type, pricing, historical occupancy, market position, competitive environment, management practices, sponsorship, length of time providing services, and disclosure practices are highly important in determining Fitch's rating. Fully understanding the qualitative factors of a borrower is critical to understanding that borrower's financial profile relative to similar credits in Fitch's rated CCRC portfolio as well as the CCRC medians. While quantitative factors may frame the rating of a CCRC, qualitative factors can determine the overall outcome of a rating.

Fitch's CCRC rating criteria will continue to be adapted to reflect any changing trends within the CCRC industry that could strengthen or weaken credit quality. In addition, Fitch will continue to evaluate changing legal structures to assess their effect, if any, on credit quality. Specifically, the use of the obligated group has been prevalent in the CCRC industry. Fitch has studied the rationale of rating CCRC systems on a consolidated

basis compared with rating only the obligated group. Fitch has concluded that obligated groups can be rated separately from a consolidated entity. Investors have accepted the obligated group structure and have financed projects secured only by revenues and property of obligated groups. Fitch believes rating a CCRC system on a consolidated basis could mislead investors about the credit quality of the underlying obligor. While Fitch takes into account non-obligated entities to determine what, if any, financial support the underlying obligor has committed, an obligated group can receive a separate rating from the parent system. In fact, the parent corporation's rating may be higher or lower than the obligated group's rating. Fitch believes that rating the entity obligated to bondholders, without assuming consolidation in bankruptcy, provides investors with the most accurate ratings. Should consolidation be ordered in a bankruptcy situation, Fitch's rating would be adjusted accordingly. Fitch will document when an obligor is rated as an obligated group and there is a risk, in bankruptcy court, of consolidation.

As previously mentioned, Fitch does evaluate non-obligated group affiliates in the rating process. In cases where obligated group members would lend support to non-obligated group affiliates through lines of credit or credit support agreements, the full amount of the line or credit support is deducted from cash as if it had been drawn on day one. Fitch believes systems can grow through acquisition or construction without deteriorating the credit quality of the obligated group. Fitch will monitor growth to determine whether it is happening in a controlled manner so there will be minimal to no adverse affect on the credit rating. Large financial commitments made by the obligated group to facilitate growth can result, and has resulted, in downgrades.

Absent third-party enhancement, start-up CCRCs will usually not have investment-grade characteristics. Debt issued to finance construction of a start-up venture presents a credit profile with too many significant risks to warrant an investment-grade rating.

Fitch is rarely asked to provide a credit rating in the below-investment-grade market sector. Many start-ups have the potential to reach investment-grade status once the community has reached stabilized occupancy and shown a favorable trend for at least two complete fiscal years following stabilization. In an effort to service this market sector, Fitch, if requested, will provide a nonrated descriptive report. Absent a formal rating, these reports will detail the CCRC's organizational structure, project description, credit strengths, and risks and Fitch's opinion regarding the potential success of the project.

Fitch evaluates the following factors when assigning a rating to a CCRC:

- Plan of finance.
- Organization and history.
- Management and governance.
- Residency contract.
- Service area and competition.
- Utilization.
- Financial performance.
- Security and business covenants.

Plan of Finance

A standard sources and uses of funds statement should accompany the financing plan. Sources of funds can consist of debt and equity. Typical financing plans are long term

(30 or more years) and have fixed or variable interest rates and level debt service payments. Fitch regards a borrower's equity contribution favorably, as it is an indication of the organization's commitment to a project.

Uses of funds may include construction costs, funded (capitalized) interest, a debt service reserve fund, and applicable closing costs. In any project financing, construction-related risks may arise. Fitch expects the architects, general contractors, and builders to be well experienced. For larger replacement and/or expansion projects, Fitch expects to see an executed guaranteed maximum price (GMP) contract with identified and reasonable construction contingencies and allowances, all based on design documents in the advanced stage. Failure to have an executed GMP will be viewed negatively.

A well-managed CCRC should employ a construction monitor to coordinate the work of the general contractor, the design team, and others, ensuring compliance with the various contracts' terms and conditions. Performance and payment surety bonds, if reasonably priced, lessen bondholders' risk in case a contractor fails to complete the project on time or make required payments to others. In some projects, provisions in the construction contract for liquidated damages (usually equal to a minimum of the daily interest expense) when project completion is delayed beyond contract terms should be included.

The importance of a funded debt service reserve fund (DSRF) at closing is detailed in the legal section of this analysis. Almost all Fitch-rated CCRC debt issuances include a DSRF. Fitch views the DSRF as an important security feature, as it can ensure timely payment of principal and interest for at least one year, thus giving a facility time to correct any operational shortfalls.

In addition to the details of the financing plan noted above, Fitch is interested in the genesis of the project. What was the impetus for it? When did planning begin? Is the project part of a long-term capital plan? Who was involved in the various stages of the plan? Have outside consultants been retained to assist management in identifying risk and reviewing assumptions? What priorities were established? How does the final board-approved project plan differ from original plans? The answers to these questions provide Fitch with important insight into the board and management's philosophy, mission, and strategic goals and help form some of the qualitative factors in the rating process.

Organization and History

To gain an understanding of the background and scope of a CCRC's operations, Fitch will review descriptive narratives of the organization's history, community ties, and development of services offered. The size and diversity of the organization is noted based on geographic location and service lines. Borrowers with a long, successful history of operations are viewed favorably. Special ties with any religious or affinity-sponsored entities may have positive influence in a CCRC's operating history and future plans.

In addition, Fitch views accreditation by the Commission on Accreditation of Rehabilitation Facilities/Continuing Care Accreditation Commission (CARF/CCAC) favorably. The CARF/CCAC represents the only accrediting body strictly for CCRCs. To be accredited, a CCRC must undergo a self-study examining its governance structure, resident services, health care program, and financial stability. CARF/CCAC accreditation, while viewed favorably, will likely not influence a rating.

Fitch does not assume a multisite operator is more sophisticated than a single-site operator. Among multisite communities operated as either operating divisions or separately incorporated and part of an obligated group, Fitch gauges overall integration

and the economic, shared service opportunities present. Fitch views geographic diversification as a favorable credit factor, as credit risk associated with a particular market or area of the country may be mitigated by market diversification.

Regarding system growth, Fitch believes systems can grow by financing new facilities outside its existing obligated group. While the new entity's self-sufficiency or potential drain on the group's overall creditworthiness is evaluated, Fitch believes organizations that limit support and force newly developed CCRCs to stand on their own can grow without negatively affecting existing ratings. Fitch reviews, but often does not consolidate, affiliated but non-obligated group members to evaluate the probability of financial support that may be necessary from the obligated group. However, in limited cases, Fitch may choose to consolidate non-obligated entities if Fitch believes there is a strong moral obligation on the part of the obligated group to support a non-obligated entity. For example, if a non-obligated entity is located on the same campus or is physically attached to a facility that is a member of the obligated group, Fitch would likely consolidate the financials of that non-obligated entity.

A site visit is required as part of Fitch's credit review process. A tour of the facility allows Fitch to view the CCRC as a potential resident would. It is also helpful to gain a better understanding of the level of investment in the physical plant and the need for a renovation or expansion project. The site visit includes a service area tour. This allows Fitch analysts to become familiar with the economic condition of the area and driving distances to the nearest competitors. In addition, proximity to other establishments that might be of importance to prospective residents, such as shopping centers and churches, is noted.

Management/Governance

A CCRC's financial position and operating performance is highly influenced by the strategic direction and management oversight exercised by the organization's board of directors. Moreover, the effectiveness of the executive management team is critical to the success and long-term viability of any organization. Yet, the evaluation of management quality is the most subjective part of Fitch's rating analysis. For this reason, a site visit to meet with board members and key senior management is essential. The purpose of the meeting is to develop an understanding of management's mission, philosophy, and strategic goals. If a new capital project is being undertaken, Fitch will try to assess how the board and management have interacted to identify all risks and rewards in an effort to maximize the probability for successful execution. For example, have mission goals been adequately weighed against financial risks of the project?

Based on discussions with a CCRC's board members, administrators, and other industry participants, Fitch has compiled a list of management practices currently instituted at investment-grade CCRCs. These practices include the following:

- Dissemination and adherence to a detailed and flexible strategic plan.
- Existence of a detailed and flexible marketing plan (sales force).
- Resident satisfaction.
- Patient quality and safety standards.
- Existence of a long-term physical plant improvement plan.
- Existence of a debt policy (liability management), investment policy (asset management), and swap policy, if applicable.
- Continued maintenance of existing facilities.

- Active board participation and discussions with management and staff.
- Maintenance of data for evaluating competitive position.
- Interim reporting of actual to budgeted results.
- Establishment of innovative insurance programs.
- Industry regarded best-practice disclosure practices.

Throughout its credit analysis, Fitch will focus on management best practices and assess operational tools (management information systems) in measuring and evaluating performance and efficiency. Management practices are one of the leading qualitative factors that Fitch evaluates. Superior management practices may result in a gradation change within a rating category but will rarely move the rating between categories.

Residency Contract

CCRC residents sign a contract that may remain in effect for the rest of the resident's life, for a period in excess of one year, or only while the resident occupies an independent living unit (ILU). This legal document details the obligations of the resident and the CCRC. In addition to the financial obligation of both parties, the contract outlines supportive services and amenities available related to the property (maintenance, gardening, and parking), hospitality (dining, housekeeping, and laundry), and care (assisted living, nursing, and medical checkups).

There are basically four distinct residency contracts — extensive, modified, fee-for-service, and rental. Each contract may differ in its refund provisions, with all but rental communities collecting an up-front entrance fee. Each contract presents a different risk profile.

Life Care Agreement (Type A): In addition to housing, residential services, and amenities, this contract includes an unlimited amount of assisted living and nursing care with limited or no increase in the monthly service fee. Residents pay the same fee for care while occupying a nursing unit in the health center as they would in a residential unit. For all contracts, management may increase fees for all residents (usually limited to annually) for operating costs and inflation. Due to the health care liability risk, Fitch views type A facilities as having the riskiest credit profile.

The health care risk inherent in a type A contract emphasizes the importance of pricing these contracts accurately along with appropriate increases in ongoing fees. Investment-grade ratings are predicated on the type A CCRC having accurate and reliable actuarial studies to help maintain fiscal soundness. Fitch expects actuarial studies to be performed at least once every three years. The presence of an unfunded future service obligation on a CCRC's balance sheet is a major credit concern.

Modified Agreement (Type B): This contract includes housing, residential services, and amenities. Health care services are offered under two pricing arrangements — a discount to full market rates (i.e. 10% discount) or a limit of free days (i.e. 15 days per year) then payment at prevailing market rates. This contract is viewed as less risky than a type A contract due to its limited health care liability.

Fee-for-Service Agreement (Type C): This contract includes housing, residential services, and amenities. Residents have guaranteed access to the CCRC's nursing units but pay prevailing market rates. All contracts may be adjusted (usually annually) by management. Under a type C contract, an entrance fee is charged to a prospective resident. This contract presents the lowest health care risk profile.

Rental Agreement (Type D): This contract includes housing, residential services, and amenities. Residents may not have guaranteed access to the CCRC's nursing units and, if admitted, pay prevailing market rates. All contracts may be adjusted (usually annually) by management. Under a type D contract, no entrance fee is charged to a prospective resident. This contract presents the lowest health care risk profile.

Another contract feature that merits attention is the refund provision (full or partial) for those residents who have paid an entry fee. The contracts that provide for refunding some or all of an entry fee necessitate higher pricing. Key analytical considerations include the accounting treatment of advance fees, credit implications surrounding their cash flow, obligation to provide future services, and refund liability.

Notably, it is becoming more difficult to neatly categorize individual CCRCs as type A, B, C, or D facilities. Due to increased competition in various markets and greater resident demand for choice, many providers will offer a variety of contract types. It is important to identify a CCRC's contract type, as financial metrics can vary depending on the contract offered. For example, a type A CCRC should be expected to have higher all-in coverage and more liquidity than a type D or rental CCRC. Fitch's review of resident contracts places particular emphasis on the following policies:

- No material limitation exists on management's ability to raise monthly maintenance and service fees.
- The health service obligation of the CCRC is clearly stated.
- Receipt of a reoccupancy entrance fee may precede any entry fee refund.
- Provisions exist for transferring a resident to an assisted or skilled nursing unit.

Service Area/Competition

The elderly population that can afford and may choose the lifestyle of an ILU in a CCRC has a variety of options. Rental housing with services and senior communities that offer an equity position are alternatives that compete with CCRCs. The most frequent choice for potential residents is remaining in their own homes. As such, the demand for CCRCs and related services is discretionary. An investment-grade CCRC must clearly exhibit detailed knowledge of its service area and the capability to constantly monitor and adjust its strategic plan to changing consumer tastes and service offerings to maintain its competitive position.

A CCRC's market area is defined by two main interconnected principles:

- Specific geographic limits.
- The number of eligible persons (or households) living within such geographic limits.

For an established CCRC, existing residents define its geographic market boundaries. Their previous home addresses serve as the best indicator of new potential residents' origins. Historical data has shown that a CCRC's geographic service area usually does not exceed a 15–20 mile radius. Most residents, after selling their former residence, elect to stay in the general area. Immediate family may be close by, they have established a social network of friends, and shopping locations, recreation facilities, and churches are familiar. There are exceptions to this rule. Some CCRCs, mainly due to religious, military, or other affinity-sponsored affiliations, may demonstrate a regional or national service area.

Once the market area is established, socioeconomic characteristics are examined by Fitch. Unemployment trends, employment growth, income growth, population growth, industry mix, and top employers can all affect a CCRC's long-term creditworthiness.

Management should be in a position to evaluate local economic trends. In analyzing the market area's creditworthiness, Fitch may rely on other research and expertise of other credit sectors within Fitch. For example, the tax-supported group may address credit concerns about a city or county, or the housing group may opine on the value of homes in the primary market area.

After establishing its geographic service area (or market), CCRC management must quantify its potential market in terms of eligible persons or households. Eligible residents are defined via age and income. Most residents of a CCRC enter the facility while they are still independent, that is, not an assisted living candidate or nursing home patient. Traditionally, the CCRC industry has assumed that eligible persons (or potential residents) are age 75 or older. In fact, Fitch believes the average age of residents moving into CCRCs, nationally, is closer to 82. While admission of younger residents occurs, it is not the norm. As such, management must stratify the market area's population or households in five-year intervals, usually starting with the age of 65. For established CCRCs, Fitch gauges continued demand by occupancy data and the number of potential residents on the waiting list. Often, updated population data by age cohort is not available.

The income factor identifies a prospective resident's ability to meet the monthly fee. Generally, a potential resident is a retiree whose main income sources include pension payments, other retirement funds, Social Security, interest on investments, and return on capital. Management must obtain and evaluate income data for households in the defined service area. Living in a CCRC usually requires an annual income equal to a multiple of the annualized monthly service fee. Management should have an established screening process in place to evaluate a resident's financial wherewithal for living in the CCRC.

Home Sales

For CCRCs that charge an entry fee, Fitch will review home sale data in the primary and secondary service area, since many potential residents prefer to sell their existing home prior to occupancy of an independent living unit. Entrance fees collected from the sale of new units or resale of existing units are critical to generating sufficient revenues to pay debt service. In particular, for large expansion of new independent living units, entrance fees are often used to pay down a portion of the debt that was issued to fund construction of the project. A CCRC must quickly fill newly constructed units and/or vacated existing units. How quickly and for what price a prospective resident can sell a home before entering a CCRC is a demand-related risk. As a result, Fitch will evaluate the housing market in the primary service area by looking at the following information, if available:

- Home sales over the past three years.
- Median home price in the market over the past three years.
- Average length of time homes remain on the market.

Competition

The number and type of senior independent living options within a CCRC's market area may affect demand. Fitch expects proactive management to conduct market surveys identifying other available senior housing options, including rental facilities and advance fee communities. Information collected should include the number, type, and size of units, services included in monthly fees, amenities, current fee schedules, copies of resident agreements, waiting list data, occupancy rates, and sponsorship. In addition, management should be aware of any potential entrants into the market area. Fitch will meet with marketing personnel to inquire about other facilities that potential residents consider in the market.

For existing facilities, Fitch rarely receives current demographic data to assess the current market penetration rate. Therefore, a greater emphasis is placed on occupancy and waiting list data. When available, Fitch will assess the penetration rate in the market. Many times, up-to-date penetration rates for a particular market are only available if a new project is being constructed in the market and a feasibility study has been completed. While Fitch is concerned with the potential saturation of a market, historical occupancy rates and the size and growth of the waiting list provide a better assessment of demand than the penetration rate.

Utilization

A CCRC maintains utilization statistics for each of its care levels — independent living, assisted living, skilled nursing, and dementia, if applicable. In most cases, Fitch expects occupancy rates to be more than 90% on available units across all levels of care. However, failure to maintain occupancy rates above 90% may not result in a lower rating, depending on the circumstances. Fitch inquires about the length of time between a unit being vacated and reoccupied. Longer periods could be a concern.

In conjunction with occupancy data, Fitch will examine a CCRC's waiting list to assess potential demand. Waiting lists identify prospective residents' interest in moving into the CCRC at a future date and provide a good indication of demand for a CCRC. Maintenance of a waiting list serves as a management tool in constantly testing the validity of demand. However, when not properly assessed, the list can be misleading. Validity depends on how the list is maintained and how an applicant gets (and stays) on it. Fitch will inquire about a facility's waiting list and assess its demand indicators based on the size, length of time a resident has been on it, and amount of money charged to be on it.

Financial Performance

Fitch's financial analysis focuses on five main components — cash flow, revenue, expenses, assets, and liabilities. Fitch utilizes its annual median ratios heavily in the financial analysis of a CCRC and when comparing financial metrics with other credits of a similar rating level.

The cash flow statement is the most important of the three main financial statements. Absent estimates and accruals, a cash in/cash out statement presents the most accurate picture of a CCRC's performance. Fitch also believes that preparation and dissemination of internal financial statements without a cash flow statement may present an inaccurate, or certainly incomplete, credit profile.

Non-Operating Revenue

Fundamental credit differences exist between contributions and returns on investments. For analytical purposes, Fitch separates contributions into two categories — campaign fund raising for a specific project and annual fund raising related to ongoing operations. Nevertheless, contributions will be classified as non-operating revenues. Capital funds related to a specific fund raising campaign are obviously viewed as a positive credit factor.

In contrast with one-time campaigns, a consistent history of obtaining philanthropic contributions may indicate strong market area acceptance and support. However, heavy dependence on ongoing fund raising to subsidize operations and debt service is viewed negatively. Fitch believes a CCRC's ability to continue raising philanthropic funds for the life of a typical tax-exempt bond issuance (30 years) is too unpredictable to forecast accurately.

It is essential that an established CCRC have ample, unrestricted cash balances. Management's asset management policies should detail its investment strategy, portfolio diversification, use of outside portfolio managers, and monitoring procedures. Compared with contributions, a well-managed investment strategy should result in more reliable returns. However, Fitch believes that rising liquidity at the expense of physical plant investment is a concern, as deterioration in the physical plant can have serious negative repercussions on an organization's ability to maintain high occupancy rates.

Expenses

Salary costs and related benefits are the largest component of a CCRC's expense base. Fitch expects management to discuss its history of full-time employee headcounts, the use of outside agencies, part-time employees, and annual salary and benefit increases. For the larger CCRCs, training and succession plans are becoming a more important issue.

Fitch has not seen the widespread labor issues that pressured profitability several years ago. Fitch will request annual employee turnover rates by segment, including nursing, housekeeping, and food service. In addition, Fitch will inquire about the presence of organized labor unions and what employee retention policies are currently in place. Given the demand for both skilled employees and unskilled labor in the industry, labor issues remain a focus of Fitch's analysis.

Assets

As noted in a prior section, a CCRC's rating improves with a strong historical and projected liquid asset base. Strong unrestricted cash and investment reserves allow a community financial flexibility and the ability to weather temporary adverse changes in economic conditions. Fitch's expectations for an individual CCRC's liquidity position are influenced by the types of resident contracts offered and currently in force. A community with a larger percentage of type A life care contracts is expected to have a higher level of balance sheet liquidity compared with a similarly sized facility that offers a type C contract.

The real property asset accounts reflect the historical cost of construction. Fitch does not rely on loan-to-value ratios during its analysis. Debt issued by a CCRC is repaid through the revenues of the organization. Although a mortgage is generally granted to secure the bonds, Fitch does not view bondholder security and repayment as an asset-backed or overcollateralized transaction. Timely payment of debt service from cash flow is the sole determinant in Fitch's ratings and is more important than realizing any residual value from a foreclosure and asset sale. Therefore, CCRCs with negative fund balances may still be rated investment grade due to other strong credit indicators.

Fitch believes that capital needs are a major concern in the industry. Fitch's rated portfolio continues to demonstrate an increasing average age of plant. Investment-grade CCRCs tend to be older, more mature communities. As a result, these communities face significant challenges in keeping physical plants updated and ILUs properly sized to meet changing demands of the senior consumer. As new competitors enter certain markets, existing providers may need to add larger units and more amenities and upgrade common areas to stay competitive. While Fitch believes the repositioning and growth of facilities could pressure profitability margins in the short term, it also understands that proper repositioning and expansion of facilities is critical in determining the long-term success of a senior living organization. As such, Fitch expects management to have a long-term capital plan addressing these issues.

Liabilities

The more important aspects of Fitch's analysis address debt levels, advance fee refund liability, and future service obligations.

Debt Levels

Debt levels receive ample attention during Fitch's analysis. Of the 14 ratios that Fitch currently tracks for its rated portfolio, seven are debt-related. As discussed in the assets section and elsewhere in this report, a long-term capital plan is essential. New competition and changing market demands dictate that management be proactive rather than reactive in establishing its CCRC as the CCRC of choice. A delicate financial balance must be exhibited between the use of available cash and manageable debt levels. Increased debt in and of itself will not necessarily trigger a downgrade. Fitch will weigh the short-term effect on a borrower's capital-related ratios versus projected long-term benefits of the proposed project. Hence, the importance of an asset/liability management program enters the equation.

Advance (Entry) Fee Refund Liability

Advance fee refunds, if offered, are paid either directly to the resident or, if the resident is deceased, to the estate. The industry is gravitating toward offering full or partial refunding contracts to meet market preferences. Fully refundable entry fees can affect both debt service coverage and liquidity levels. With a fully refundable policy, a CCRC's net cash flow from unit resales may be substantially reduced. Without unit appreciation, a new resident pays the same, or less, as the resident who vacated the unit. Partial refunds have the same effect but to a lesser degree. This credit factor highlights and emphasizes the importance of a long-term capital plan that addresses the maintenance and modernization of existing units and grounds.

Another credit factor affected by the presence of refund contracts involves the timing of a refund payment. The resident's contract will stipulate when a refund of the original entrance fee is paid. Generally, the entrance fee refund is paid once the vacated unit has been resold and the new entrance fee has been collected. Fitch views this provision positively, as it prevents a sudden and material draw on cash reserves should a large number of units be vacated.

Future Service Obligation

If the residency contract is type A (extensive) or type B (modified), it includes the provision of health care services at a discounted rate. Creditworthiness is enhanced when fees are priced to ensure no unfunded liability. In recent years, Fitch has rarely seen CCRCs in our rated portfolio that have a future service obligation liability on their balance sheets. The presence of a future service obligation liability is viewed negatively and could result in rating pressure.

Determining the costs of providing future services to current residents is one aspect of the liability calculation. The service cost is then compared with the related unamortized deferred revenue from advance fees. The difference is either a surplus or a deficiency. Only a deficiency is booked and, therefore, shown as a liability on the balance sheet. In contrast, if a surplus exists, there is no asset account. The amount of the CCRC's obligation is a present-value amount, recalculated annually.

More specifically, the calculation, usually verified by the CCRC's actuaries or auditors, compares the unamortized amount of deferred revenue with the sum of estimated future net cash outflows, depreciation of facilities to be charged relating to the contracts, and amortization of costs associated with contract acquisition (marketing costs). If this sum exceeds the unamortized amount of deferred revenue, an unfunded future service obligation liability must be booked.

When a CCRC estimates the costs of future contracted services, actuarial assumptions play a critical role in determining whether a potential liability must be booked. Actuarial calculations and assumptions concerning morbidity and mortality rates dictate the required

level of reserve funds needed to satisfy the obligation. Using more- or less-conservative assumptions can produce dramatic differences in expected financial results.

Fitch expects management to have recent actuarial studies available. The study provides existing residents' mortality and morbidity assumptions, which aid in making cost assumptions. The expected turnover rates included in the study illuminate financial assumptions. Studies must be updated to ensure the accuracy of the liability surplus. Fitch will ask whether a CCRC has a future service obligation liability and, if one exists, will expect management to have a plan to address it. Failure to address a future service obligation liability could pressure a rating.

Ratio Analysis

Fitch has published median ratios for CCRCs since 1992. Over the years, Fitch has added or deleted ratios depending on their usefulness and applicability in measuring credit quality. In the coming year, Fitch plans to add ratios that address a CCRC's activities regarding physical plant investment and also add three profitability ratios — operating margin, net operating margin, and net operating margin adjusted. These ratios better reflect the CCRC business model.

Currently, Fitch utilizes 14 ratios that address the following three main areas:

- Liquidity.
- Profitability.
- Capital and cash flow.

Fitch's ratio analysis is performed in conjunction with trend analysis, usually covering three to five years. Note that three years of bottom-line losses followed by one year of profitability does not constitute a trend. When possible, comparisons are made among CCRCs with similar contract types. An accurate credit evaluation explores the relationships of various ratios, neither overemphasizing nor isolating any single ratio. For example, the negative credit implications of a high debt leverage ratio may be mitigated by a strong cash position (days cash on hand or cash to debt). During Fitch's credit analysis, profitability, unrestricted liquidity, and debt levels attract the most attention. It is important to stress that ratio analysis is just one of many factors Fitch relies on when assigning a CCRC's debt rating. A CCRC's management practices and competitive position in its respective service area draw just as much attention during a rating committee. Readers are encouraged to view Fitch Research on "2007 Median Ratios for Continuing Care Retirement Communities," dated Sept. 14, 2007, available on Fitch's web site at www.fitchratings.com, keeping in mind the medians represent a benchmark and not absolute levels necessary for a particular rating category.

Security and Business Covenants

Fitch's legal analysis covers two basic areas — security features and business and financial covenants. Generally, while Fitch examines legal provisions governing a CCRC's debt, legal provisions have little effect on the overall rating. Poor security features and business covenants will be viewed negatively and commented on as part of Fitch's new issue report.

Security Features

Given current industry practices, little variety exists in the security features of most CCRC debt offerings. Fitch expects to see debt issuances secured by a first mortgage or fee simple deed of trust lien on real property and a perfected security interest in personal property, including a gross revenue pledge. Security provisions should protect a bondholder's lien position by limiting senior liens and preserving secured creditor

status. In some debt issuances, a permitted senior lien basket may be included. This should be addressed in terms of either debt or encumbered asset limits.

While not by definition a security feature, most CCRC debt issuances should provide for monthly payments by the CCRC to the trustee. Fitch believes this provides an excellent early warning signal of potential credit deterioration. If a monthly payment is late, the trustee should be empowered to collect gross receipts via a lock box provision.

An additional security feature expected to be included in most CCRC debt issuances is a debt service reserve fund. Debt service reserve funds are important to provide payment of at least one year of debt service in the event of a credit problem. The fund should be established at bond closing at the legally permitted maximum. Substitution of the fund by either by bank letter of credit or a surety bond should be avoided.

Business and Financial Covenants

Fitch expects standard protective business and financial covenants for all debt issuances. The necessary covenants vary according to the issuer, bond counsel, underwriter, and CCRC. Such items are more in line with underwriting standards than with rating guidelines. The business and financial covenants may provide early warning triggers of credit deterioration, allowing the bond trustee to take remedial action. However, this is often too little, too late. Nonetheless, covenants should provide management and bondholders clear financial minimums at which a CCRC must conduct business while it has outstanding debt.

A balance exists between operational flexibility and bondholder protection. In most cases, covenants should not affect a rating. However, should Fitch see business covenants that are overly weak or deviate from industry standards, those covenants will be highlighted and viewed as a credit risk.

Compliance with business and financial covenants does not ensure a rating's maintenance. A CCRC's bond covenants establish minimum, not expected, performance parameters. This applies to virtually all covenants, including debt service coverage levels, additional debt tests, insurance coverage, liquidity levels, actuarial updates, and ongoing disclosure practices.

Fitch will continue to stress the importance of continuing disclosure. As a key indicator of best management practices, Fitch expects full, timely, and accurate disclosure. Fitch views industry best practice disclosure to consist of annual audited financial statements within 120 days of each fiscal year end and quarterly unaudited financial statements including a balance sheet, income statement, and statement of cash flows within 45 days of each fiscal quarter end. In addition, management should provide occupancy and payor mix data and a management discussion and analysis that explain budget deviations and wide variances in revenues or expenses from one reporting period to the next. Poor disclosure practices, with a tendency to hold back rather than share data, are symptomatic of weak management practices. Credits with excellent disclosure methods are appreciated by market investors. Management teams that exercise poor disclosure practices are viewed with skepticism and caution. While Fitch has not seen the implementation of all Sarbanes-Oxley provisions in the CCRC industry, many providers in its portfolio have created separate audit committees and implemented auditor rotation policies, which Fitch views positively.

Definition of Ratios

Liquidity

To obtain unrestricted liquidity, unrestricted cash and investments are added to a portion of assets limited as to use. Within assets limited as to use, Fitch Ratings includes board-designated assets set aside for capital improvements or investment as unrestricted because these funds are limited at the board of trustees' discretion and can be used for operating purposes. The footnotes of financial statements usually indicate what portion (if any) of the assets limited as to use are board-designated assets set aside for capital improvements. Going forward, Fitch will consider cash reserves held pursuant to state statutory requirements as unrestricted cash for purposes of calculating liquidity ratios.

Daily cash operating expenses and daily operating revenues are used in several of the ratios defined below. Daily cash operating expenses are defined as total operating expenses less noncash expenses, such as depreciation and amortization expenses and provisions for uncollectible accounts (bad debt expense), divided by 365 days. Daily operating revenue is defined as total unrestricted revenue, gains, and other support, divided by 365 days.

Days Cash on Hand: Unrestricted cash and investments divided by daily cash operating expenses.

Cushion Ratio (x): Unrestricted cash and investments divided by MADS.

Cash to Debt (%): Unrestricted cash and investments divided by long-term debt less current maturities.

Profitability and Operational

Operating Ratio (%): Total operating expenses minus depreciation and amortization expense, divided by total revenues minus amortization of advance fees.

Operating Margin (%): Income or loss from operations divided by operating revenues (total revenues minus contributions).

Net Operating Margin (%): Resident revenue minus resident expenses (expenses less interest expense and depreciation and amortization) divided by resident revenue.

Net Operating Margin Adjusted (%): Resident revenue plus net entrance fees received minus resident expenses (expenses less interest expense and depreciation and amortization) divided by resident revenue plus net entrance fees received.

Excess Margin (%): Total operating revenues minus total operating expenses plus non-operating revenues, divided by total operating revenues plus non-operating revenues.

Investment Income as % of Total Revenues: Investment income divided by total revenues.

Resident Service Revenue as % of Total Revenues: Total revenues less amortization of advance fees, investment income, and contributions, divided by total revenues.

Personnel Costs as % of Resident Revenues: Salaries, wages, and benefits, divided by total resident revenues.

Capital Structure and Cash Flow

Debt Service Coverage Ratio (x): Excess income/(loss) plus interest, depreciation, and amortization expenses, minus amortization of advance fees plus net advance fees received (only turnover entrance fees and not initial entrance fees from the sale of new units), divided by MADS.

Debt Service Coverage Ratio (Revenue Only Without Benefit of Resident Turnover Fees; x): Excess income/(loss) plus interest, depreciation, and amortization expenses minus amortization of advance fees, divided by MADS.

MADS as % of Total Revenues: MADS divided by total revenues.

Debt to Cash Flow (x): Long-term debt divided by excess income/(loss) plus interest, depreciation, and amortization expenses minus amortization of advance fees plus proceeds from net advance fees received.

Capital Expenditures as a % of Depreciation (%): Purchase of property, plant, and equipment divided by depreciation expense.

Adjusted Debt to Capitalization: Long-term debt plus capital leases minus current maturities, divided by long-term debt plus capital leases minus current maturities plus deferred revenues from nonrefundable advance fees plus unrestricted net assets.

Average Age of Plant (Years): Accumulated depreciation divided by depreciation expense.

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