CLEARY GULL

INSIGHTS

2015 Senior Living Study

Executive Summary

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Since the inception of our study back in 2009, we have seen the senior living industry battle economic, regulatory and governmental challenges head on. Organizations have been forced to think differently about the care that they provide as well as where and how those services are provided. Therefore, strategic thinking and planning are more important than ever. Access to timely and relevant information can only help as the industry evolves, which is why we're committed to continuing our study. The silver lining to the challenges faced over the past few years is that the industry continues to get stronger and better prepared to service the needs of our aging population.

Although senior living organization leaders recognize the value in gathering as much information as possible to inform decisions on all aspects of their business, the investment program can be overlooked. This year's study, which presents data as of December 31, 2014, provides valuable information to assist industry leaders in assessing the benefits the investment program can provide.

Investment Program Overview

Reversing a trend from the previous two years, in 2014, the average allocation for participants moved towards a higher allocation to fixed income and cash and lower allocation to equities. This change impacted the average allocation reported by participants: 53.17% fixed income and cash compared to 50.31% in 2013, 40.85% equity compared to 42.46%, and 5.91% alternatives compared to 7.12%. We had actually anticipated seeing a decrease in the fixed income allocations due to the positive equity returns in 2014 and the continued concerns over the impact rising interest rates may have on fixed income assets.

The top concerns regarding future returns in participant's portfolios were market volatility, interest rates and international turmoil. Seventy-four percent of participants anticipated that their portfolio returns will not exceed 6% in 2015. Looking ahead to the next three years to five years, the outlook became less optimistic from last year's study. For the three-year period, 33% expect their average annual returns to be greater than 6%, compared to 39% previously. On a five year outlook, 39% of participants expect returns higher than 6%, compared to 42% previously.

Important Takeaway
We continue to believe that diversification is critical. Given continued uncertainty about when and at what pace interest rates will rise paired with senior living organizations continued high commitment to fixed income and cash in their portfolios, it's important to develop a plan and take steps to mitigate risk. It is also important to establish realistic return expectations for your portfolio as returns going forward may not be as robust as they have been over the last few years.

Investment Governance Overview

The investment portfolio has become an important tool in the strategic planning of senior living organizations, making oversight of investment program a critical priority.

For the majority of participants, the responsibility for oversight of the portfolio lies with a Finance Committee. Some organizations reported shared responsibility among a combination of committees and boards. We believe it is a best practice to overlap reporting to the Finance Committee or Board and the Investment Committee to help ensure knowledge of the organization's debt structure and operating environment and incorporate these elements into the investment strategy. Organizations that have just an Investment Committee may find that the focus is solely to maximize the returns of the portfolio. Often, the risk that is taken to maximize returns may put the organization in jeopardy of compromising strategic plans or debt covenants.

The Investment Policy Statement (IPS) is a critical tool for strategic governance. The IPS should function as a living document that reflects the organization's needs and goals. This requires regular review– at least annually – and revisions as needed. More than 60% of organizations reported they had updated their IPS within the past year, with nearly 30% reporting an update within the past three years and about 8% within the past five years.

Important Takeaways

- The Investment Committee should overlap with the Finance committee or the board to align the investment portfolio with business operations and strategy.
- The IPS is an important tool. Review it annually or whenever your organization makes a strategic or operational shift to ensure that the investment program is aligned with your organizations strategic plans and overall goals.
- Support the board/finance/investment committee with resources and education in order to make sure they can make confident investment decisions and fulfill their fiduciary duty.

Organizational Strategy and Outlook

Uncertainty in health care, the economy and the market environment has made business planning more challenging and more important than ever.

A significant majority -- 72% of participants – indicated they have just completed or are in the midst of implementing strategic plans. That is a telling sign that industry leaders recognize the importance of business planning in order to continue serving residents given ongoing changes in health care. This is an opportunity for organizations to once again consider deferred capital improvements and focus on their long-term viability.

With low borrowing rates continuing, 57% of participants plan to restructure their debt in some way. Fifty-three percent of those planning to issue new debt expect to make an equity contribution to the project being funded – a significant decrease from 71% last year. Most organizations continue to maintaining a balance between cash and debt which is important to long-term viability and creditworthiness.

If you anticipate using investments to fund your strategic plans, we recommend a strategy designed to protect principal rather than maximize returns. Of those organizations planning to make an equity contribution, only 33% have repositioned or reviewed their investment portfolio in advance of funding the project, a surprising decrease from 53% last year. For those who have not repositioned their portfolios, there is no time like the present. Having a plan in place to migrate assets to safer investments helps reduce the possibility of an unpleasant outcome.

Overwhelmingly, respondents saw operational items as challenges and strategic items as opportunities. When asked about specific Operational challenges and opportunities that lie ahead, the top three moderate to significant challenges and opportunities were:

Challenges

1. Maintaining Occupancy Rates
2. Improving Operations
3. Adjusting to declining reimbursement rates

Opportunities

1. Occupancy Rates
2. Expanding Service Lines
3. Maintaining Debt Coverage

When asked specifically about Strategic Planning, the top moderate to significant challenges and opportunities were:

Challenges

1. Funding Strategic Initiatives
2. Expanding/Repositioning a Campus

Opportunities

1. Expanding/Repositioning a Campus
2. Aligning for a Strategic Alliance/Affiliation

Important Takeaways

- The investment portfolio should be part of any strategic planning discussion.
- In a constantly changing environment, the investment portfolio is a significant business tool to help an organization deliver on its mission, values and long-term plans and should be part of regular challenges/opportunities assessments.

Financial Metrics

For the third consecutive year, Fitch Ratings' outlook for the industry remains stable. Their outlook points to steady operating, liquidity and capital metrics that have been helped by improved occupancy rates, lower cost of borrowing and solid investment returns. The financial metrics within our 2015 study provide a similar outlook for the industry.

Increased occupancy rates due to a slow, but steadily improving housing market and economy, have helped organizations generate positive operating margins. This is the second consecutive year we have seen an increase in the average operation margin among the participants, with this year's average of 3.65% compared to last year's average of 3.24%. New to the study this year is Net Operating Margin Ratio. Although there is no comparison data, it is encouraging to see all segments' average NOM is positive. During times of economic uncertainty some organizations may be reluctant to charge adequate fees or raise fees to cover expenses.

Cash to Debt was up only slightly year over year to 92.90% compared to 92.67%. For a third year in a row, we see an increase in the average Debt Service Coverage Ratio, to 3.04x versus last year's average of 2.91x. Increasing occupancy rates, improving operations and low interest rates have helped strengthen this metric over the last few years. This metric is often viewed as the best measure in assessing long-term solvency of an organization, so it's good to see this steady increase.

Although some organizations have been using their cash to help fund strategic plans, Average Days Cash on Hand inched upwards, increasing from 446.87 last year to 448.19 days this year. Positive investment returns and increasing occupancy rates have helped organizations maintain and even build their cash reserves.

As mentioned previously, Occupancy Rates have continued to inch upwards. This year, we split occupancy rates by the type of service provided rather than looking at occupancy on a campus wide level. All segments' average Independent Living occupancy rate was above 90%.

Important Takeaway
Organizations may find it helpful to benchmark financial metrics to others in the industry and analyze the impact of potential changes as they assess business stability and decision-making related to operational or strategic projects.

Download the complete 2015 Senior Living Study

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