Health Care
Special Report

# Outlook for Continuing Care Retirement Communities — 2003

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## ■ Summary

Continuing care retirement community (CCRC) managers were eager to say good-bye to 2002, a financially dismal year during which credit quality deteriorated across all rating categories. In 2002, Fitch Ratings downgraded nine non-acute health care bond issues (16% of its rated non-acute issues) and upgraded none. Since Jan. 1, 2001, Fitch has downgraded and/or assigned a Negative Rating Outlook on 16 non-acute bond issues and upgraded none.

Heading into 2003, reduced investment returns are the primary negative force on credit quality, pushing down most financial ratios and illustrating one of the sector's key weaknesses — high reliance on investment returns for financial performance. Other top CCRC sector stresses include rising labor, insurance expenses, and rising employee health care premiums. To a lesser extent, potential cuts in third-party reimbursement for nursing services and underfunded pensions present secondary challenges for CCRCs.

Fitch maintains its Negative Rating Outlook for the CCRC sector for the near term, expecting downgrades to continue at a pace similar to that of 2002, with zero upgrades. Fitch anticipates that 2002 audited results will reduce Fitch's median ratios for CCRCs to all-time low figures. Improvement or stability in the CCRC sector depends largely on stabilization in the capital markets (i.e. better investment returns). Core operations remain solid, as resident service revenue continues to grow and facility occupancy remains mostly stable.

## ■ Credit Positives

- Long-term demand from a growing elderly population.
- Consistently solid occupancy.
- High barriers to entry.

## ■ Credit Negatives

- Diminished returns and losses on investments.
- Insurance, labor, benefit, and pension expenses.
- Declining third-party reimbursement.

## ■ Declining Non-Operating Revenues and Rising Core Revenues

### Investment Returns

Diminished investment returns are the sector's most significant credit concern for 2003, as many providers realized net zero or even negative returns on their invested liquidity in 2002. Aggregate investment returns in 2002 were less than in 2001 and 2000. In response, some providers rebased their portfolios, some significantly, seeking a lower

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risk profile in fixed-income securities. Others fired managers and moved funds, while some simply held on tight. All but a very conservative few incurred large realized losses as a result.

Fitch's CCRC portfolio's median excess margin is now roughly breakeven, as profits have declined substantially since 2000. Prior to 2001, the median annual bottom line margin was usually about 4.0%–5.0%. Fitch's 2002 median is 2.0%. Returns for 2002 proved to be lower than for 2001 and 2000. Most not-for-profit providers cannot maintain strong debt service coverage without substantial non-operating income.

The CCRC sector relies more heavily on investment returns than the hospital sector, which is more profitable on operations. Fitch considers the high reliance on investment returns and charitable contributions to represent a fundamental industry weakness that reduces the sector's overall credit metrics. Fitch plans to publish a report in early 2003 on investment portfolio allocation and returns for CCRCs since 1998.

### Resident Service Revenue

Resident service revenue continues to grow at a favorable pace, similar to that of operating expense inflation. Declines in occupancy are uncommon and, when they occur, are usually due to slower than expected new unit fill-up. Occupancy is generally stable. In Fitch's CCRC portfolio, resident service revenue comprises three-quarters of total revenue.

### Third-Party Reimbursement — Declining Medicaid and Medicare

Fitch expects reductions in governmental payor rates to have a minor negative impact on most CCRCs but certainly not a devastating impact. Fitch expects flat or reduced Medicaid per diem rates in many states, particularly in states facing severe budget deficits, such as California. While many investment-grade CCRCs have minimized their Medicaid census and maximized private pay, some below-investment-grade credits focus more heavily on Medicaid patients, particularly facilities located in inner city areas. While modern CCRCs focus on their independent living configurations, Fitch believes many older multilevel communities rely on Medicaid patients to fill their proportionally larger nursing facilities. Multilevel providers that focus heavily on nursing care will be viewed cautiously.

Fitch is unaware of any of its rated credits facing a severe revenue decline because of changes in Medicare reimbursement. Fitch believes any further decline in Medicare payments in 2003 would probably not generate significant concern for CCRC credits in general, though for nursing homes declines represent a significant concern.

## ■ Rising Expenses — Insurance, Labor, Health Benefit, and Pension Expenses

Expense growth outpaced total revenue growth in 2002, and Fitch expects more than one-half of CCRC providers will show a bottom line loss in 2002. While total revenue growth remains flat, insurance premium expenses continue to soar; a shortage of qualified nurses, nurse's aides, and unskilled labor remains a long-term concern; and employee benefit expenses are on the rise.

### Insurance

Double-digit premium expense inflation, fueled by patient litigation and insurer investment losses, remains the largest threat to profitability on the expense side. While the magnitude of premium increases varies from state to state and increases are not always reflective of claims history, most providers incurred large premium hikes and have scrambled to find a cost-effective solution. Some have looked to establishing off-shore captive holding companies and others have established self-insurance reserves, while others have reduced coverage levels and increased deductibles. All are paying substantially more than they were a few years ago.

Fitch believes the rising insurance expense issue affects long-term care credits more unfavorably than hospital credits. Fitch expects insurance expenses to continue their upward trend similar to recent years, though because doctors and hospitals are facing the same increases, future legislation aimed at tort relief could ease the burden into 2004 and beyond.

### Labor

Labor remains a long-term issue, although more than a few providers reduced agency usage turnover and vacancy rates in 2002. Many providers saw an increased supply of workers over the past year as unemployment rates hovered at about 6%. Furthermore, the increased efforts of providers to retain and attract nursing staff and certified nurse's aides began to produce benefits, though few are long-term solutions. The most commonly implemented approach to staffing issues has been wage increases, signing bonuses, and other monetary incentives — methods Fitch believes will continue through 2003 and beyond.

Illustrating the increase in labor expense is Fitch's median ratio (personnel costs as a percentage of resident service revenue), which increased to 65.8% in 2001 from 61.7% in 2000. Fitch expects this ratio to increase slightly when all 2002 financial medians are tabulated.

While CCRCs generally do not have the skilled labor requirements of hospitals and nursing homes, rapid labor expense inflation at CCRCs remains a long-term concern. And while the pace of labor expense inflation appears to have abated somewhat in 2002 compared to previous years, labor expense growth continues to outpace both the rate of revenue growth and normal economic inflation.

### Heath Care Benefits Expense

Fitch expects most providers to experience sharp increases in premiums paid on behalf of employees for health care benefits. These costs are expected to be greater than normal inflation. Most providers do not have the negotiating clout to avoid substantial rate hikes and will choose between higher payments or reduced plan coverage with higher insured co-pays.

### Pensions

A number of Fitch-rated CCRC credits maintain pension plans for employees. Most commonly, plans provide for executive management only and are relatively small in total assets. Less frequently, plans are open to all staff, and in these situations, Fitch expects a doubling of pension-related costs in 2003. Losses on invested funds and low interest rates have combined to create larger future pension obligations. Fitch considers whether a plan is a defined benefit or a defined contribution in its analysis.

## ■ Industry Volume

Long-term care sector bond issuance volume in 2002 totaled approximately $3 billion, or 11% of the health care municipal market. While volume remains well below the heady days of 1997, 1998, and 1999, it has increased steadily over the past three years. Fitch expects no substantial increase in sector volume, expecting tax-exempt volume of $3.0 billion–$3.5 billion in 2003.

While the sector's credit decline has diminished requests for new ratings, Fitch still expects to rate a handful of CCRC bond issues in 2003, though far fewer than in the late 1990s. Declining credit quality has forced some providers to delay brick and mortar projects even though the cost of capital is very low. In 2003, Fitch will seek to expand its service to the industry through additional nonrated descriptive reports, new speculative-grade ratings, and other initiatives.

Fitch expects continuing expansion of existing independent living units in older facilities and the addition of independent living units and cottages to existing campuses. Most new capital is expected to be used for cosmetic enhancement and expansion of independent living units for competitive advantage, as well as creating or enhancing wellness centers.

## ■ Covenants and Disclosure

In 2002, Fitch tightened its disclosure requirements and outlined best practice guidelines for all rated health care credits. Institutional investors and Fitch have demanded quarterly disclosure from credits on all new bond issues. Continuing disclosure covenants are expected to tighten in 2003, as investor demand and Fitch's requirements continue to take hold.

Due to declining credit quality in the sector, Fitch expects other covenants to tighten, as well, with an increased emergence of liquidity covenants. In its rating analysis, Fitch now places added weight on the legal structure connected with a bond issue. Fitch prefers all new issues for the sector grant a first mortgage on real property, with few exceptions.

## ■ Outlook

The CCRC sector and the hospital sector share several problems, though to varying degrees. For example, reduced non-operating income and rising insurance premium expenses have had a larger impact on CCRCs than on acute care providers, while the nursing shortage and third-party reimbursement pose larger threats to hospitals.

Fitch maintains a negative outlook for CCRCs in 2003, expecting a significant number of downgrades and zero upgrades. Fitch considers diminished investment returns the most significant credit stress on the sector, followed by rising insurance, labor, and pension benefits expenses.

Fitch's long-term outlook remains neutral to positive due to the advancing age baby boomers and the rather high barriers to entry for the fragmented CCRC sector. The growth in resident service revenue and stable occupancy of the sector is encouraging, showing that the sector's recovery depends largely on the reversal of certain external conditions, namely capital market returns and, to a lesser extent, stability in the insurance underwriting of CCRCs. Fitch will reexamine its near-term negative outlook for the CCRC sector in the summer of 2003.