A road map to valuing CCRCs

First recognize a continuing care retirement community has many moving parts

By Alan C. Plush, MAI

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While often considered a homogenous industry, seniors housing is actually comprised of various subspecialty operational models that include independent living, assisted living, memory care and skilled nursing in various combinations.

The most complex model is the continuing care retirement community (CCRC), which appraisers refer to as the "regional mall of seniors housing" because it includes all of the components described above.

The confluence of these three or four disparate operational platforms under one roof, coupled with an upfront payment that offsets future ownership costs, causes valuation challenges that require a deeper level of analysis than traditional rental seniors housing.

In this column, I will focus on an entry-fee model at a full- campus CCRC, one that includes independent living, assisted living, Alzheimer's and skilled nursing facilities.

The State of Seniors Housing, which HealthTrust LLC co-authors with the American Seniors Housing Association, NIC and Leading Age, defines a CCRC as "a combination of independent living units and skilled nursing beds, as well as properties that combine independent living units, assisted living (and/or Alzheimer's) beds, and skilled nursing beds."

Dissecting entry fees

The life cycle of an entry-fee CCRC presents different valuation challenges depending on the point in the cycle that the valuation occurs. Step one is pre-development leading up to the sale of the first unit. Until unit sales occur, the valuation reflects the full bundle of rights, or fee simple. Once the first unit is sold, the bundle of rights is separated and is rarely reunited.

Residents buying units are given an interest in the property by virtue of the upfront fee paid, which essentially "buys down" occupancy costs during the term of their residency.

Various jurisdictions define this upfront fee paid by residents as a life estate, leasehold interest, life lease, condominium or co-op, but the essence is the same. The resident has prepaid a substantial portion of the capital cost of providing his or her residency, and thus has a defined, partial interest in the enterprise.

From that point forward, the developer/owner position is diluted and is best described as a leased fee, or remainder interest. This can be further complicated by the entry-fee contract, which may or may not transfer to the assisted living, memory care or skilled nursing components when the resident ages in place and requires more intensive care.

When a resident departs a CCRC, different contract options remit various portions, or none, of the initial fee to the residents estate. There is a monthly service fee in addition to the upfront fee that needs to be factored in as well.

Furthermore, the market is not static. CCRCs evolve over time from both a physical and operational standpoint. Entry fee contracts also evolve over time, resulting in assignments that are truly unique each time.

In our firm, we say that "if you have seen one entry fee CCRC model, you have seen one entry fee CCRC model." Each component has its own unique operational aspects. For example, the skilled nursing unit operates as a true nursing home and oftentimes includes Medicaid, Medicare, VA and various insurance payor sources.

Services occurring at each level of care include dietary, housekeeping, activities, maintenance and therapy. Furthermore, each level of care requires separate state and/or federal licensure and compliance. Finally, a marketing department works with each level of care and has a dramatically different focus for each one.

Thus, whether it's the regional mall or the aircraft carrier of healthcare and senior housing, clearly the entry fee CCRC combines all of the complexities of valuation of these assets under one roof.

To further complicate this exercise, CCRCs evolve over time. Upon completion of the initial sale of the units in the independent living portion, the facility is described as having "first-generation residents." As these residents age and units are vacated, resales occur and cash flows (net resale revenues, defined as sales income less refunds) occurs.

Depending on where the CCRC is at on this timeline, these resales can result in lumpy cash flows. That's because turnover rates will vary for the first five to seven years until some stabilization in the average age of residents occurs.

It's impossible to simply impute a normalized turnover ratio to a CCRC since each is unique, given its point in the cycle coupled with the entry-fee structure in place. This aspect has given underwriters and capital markets fits over the years as efforts are made to capitalize these assets with bonds or conventional debt.

It is easy to see why appraisers cringe when asked, "What is the capitalization rate for a CCRC?" We realize that most market participants grossly oversimplify what is involved with their valuation.

Which valuation approach is best?

Appraisal theory recognizes three traditional methods for valuation of real estate assets:

1. **the cost,**
2. **sales comparison approaches, and**
3. **income capitalization approaches.**

Healthcare and seniors housing assets incorporate an active business into the bundle of rights, resulting in a market value of the going concern, which includes real, personal and business components.

The cost approach, which is the most straightforward of the three methods, combines the market value estimate for the site as if vacant, the depreciated reproduction costs for the improvements (including furniture, fixtures and equipment), and a measure of the developer's profit (not business value).

This approach is rather static for all assets that are going concern businesses unless offset with deductions for economic obsolescence, which is difficult to accurately prove. In our practice, we weigh this approach the least for existing assets, given the limited reliance placed on it by buyers and sellers.

Further, once the fee simple estate has been split between resident interests and developer/owner residual interests, the conclusion provided by this approach (fee simple) does not reflect the value of the collateral in the case of a financing (leased fee).

Sales comparison approach is next in complexity. This is not due to its lack of sophistication or relevance, but rather the unique nature of these assets and the extremely small pool of legitimate transactions that have occurred outside of distressed asset sales.

CCRCs are unique given their individual entry-fee agreements coupled with whatever point they are at in their life cycle. Use of alternative comparisons such as rental CCRCs and rental independent living/assisted

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living properties is flawed.

That's because the pricing per unit and cap rate indices reflect a grossly different risk profile on the income stream. Consequently, market participants typically place less reliance on the sales comparison approach, and likewise so do we.

The income capitalization approach is clearly the most relevant for entry-fee CCRCs. Given the complex nature of the assets, one of the most important keys is to accurately forecast revenues, which are generally broken out into two categories:

***1** monthly operational (rent and service fees)*, and

***2** unit resales.*

The first source of revenue is rather straightforward. The second, unit resales, requires estimation of the spread between new-unit sale revenues and prior resident refunds, as well as estimation of the frequency at which they will occur (turnover rate).

Oftentimes, use is made of an actuarial study in this process. Given the importance of unit turnover in forecasting revenues, many properties maintain their own models for predicting revenues.

One additional complexity has been the impact of upheaval in the housing market on unit turnover. We find that the turnover rate generally follows trends in the housing market within the primary market area of a CCRC. After all, most seniors must sell their primary residence in order to move into a community.

Once all of these various revenue sources are tabulated and expenses are deducted, an estimate of net income is derived. We typically use a five- or 10-year discounted cash flow model, given the lumpier nature of revenues from unit turnovers.

Some practitioners attempt to separate the net entry-fee revenues from the operational net income and apply separate cap and discount rates to each. However, that practice is even less reliable because market data, which is slim for the traditional approach, is non-existent for the bifurcated approach.

We strive for accuracy first and foremost in our valuation efforts. Correlation with the methods used by market participants is a key part of that process.

Use all available tools

Given the limited sales data that we typically have to determine cap rates, oftentimes we make use of cap and discount rate surveys conducted with actual investors. In the final analysis, the valuation process includes a large amount of judgment tempered with experience.

We find that buyers and sellers use the same methods, as do lenders and underwriters.

The goal of this brief overview is not to intimidate or confuse. CCRC valuations require orchestration of many moving parts to be accurate.

Our experience has been that oftentimes many of the more substantive elements are oversimplified. That's because the parties involved don't know which questions to ask and how to model these components.

Hopefully, this road map will be useful to readers confronted with opportunities in the CCRC space, which will likely occur with greater frequency as the market steadily improves. ■