Breakout Session:

Avoiding, and Responding to, Debt-Related Financial Stress

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Introductions

			
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Objectives

- Identify key debt-related covenants that come under pressure during times of financial stress
- Explain several actionable strategies for responding to payment and covenant challenges
- Describe key factors to consider when approaching lenders and bondholders about obtaining covenant waivers

What to Expect in the Event of a Default

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Possible Outcomes Following a Default

- Acceleration of Debt
- Reduced Access to Capital Markets
- Increased Borrowing Rates
- Management changes
- More Restrictive Financial/Operating Covenants
- Damage to Credit Rating, if applicable
- Legal Action, including:
  - Penalties/Fines
  - Bankruptcy
  - Foreclosure

Source: Orrick Herrington Sutcliffe LLP

What Happens if You Default?

- Anticipating a Default
  - Understand market conditions and stresses
  - Key officials should be familiar with the various debt covenants that apply and evaluate as financial reports become available
  - Maintain internal procedures for tracking covenants and any cross-default provisions
- Planning the Response
  - Create financial snapshot with financial statements, status of compliance with covenants, identification of the default that has occurred, steps taken to remedy defaults, and long-term budgets, forecasts and plans
- Communicating with the Lenders
  - Communicate early but be aware of legal obligations
  - Work with investors for solutions before and during default
  - Investors don't usually want the keys

Source: Orrick Herrington Sutcliffe LLP

Overview of Current Operating Environment

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A View from 30,000 feet

HOT TOPICS!

- Strategic planning
- Consumer Preferences
- NFP Growth
- Affiliation and Consolidation
- Technology
- Middle-Market and affordability
- Financial Sustainability

Headwinds

- Staffing/Labor Force
- Post-Acute Pressures
- Expense Increases (primarily labor related expenses)
- Near-term Census Pressures
- Organizational complacency (“sacred cows” and “ostriches”)

OPPORTUNITY

- Independent Living expansions
- Utilizing technology to enhance labor efficiencies
- Fostering more NFP Partnerships
- Fee increases

Source: Ziegler Investment Banking

Assessing Impact of COVID-19 on Life Plan Communities

- Occupancy, with the exception of skilled nursing, has generally recovered.
- Investment performances of prospective residents and the cooling housing market have increased price sensitivity for both entrance fees and monthly service fees.
- Cost increases, specifically salaries and wages, will continue to pressure profitability and coverage measures.
- Median monthly fee increases for all levels of care in 2022 were in the mid 4% range, with 2023 coming in at 6%.
- Expecting a higher-than-average number of defaults in the near term.

Source: Ziegler Credit Surveillance

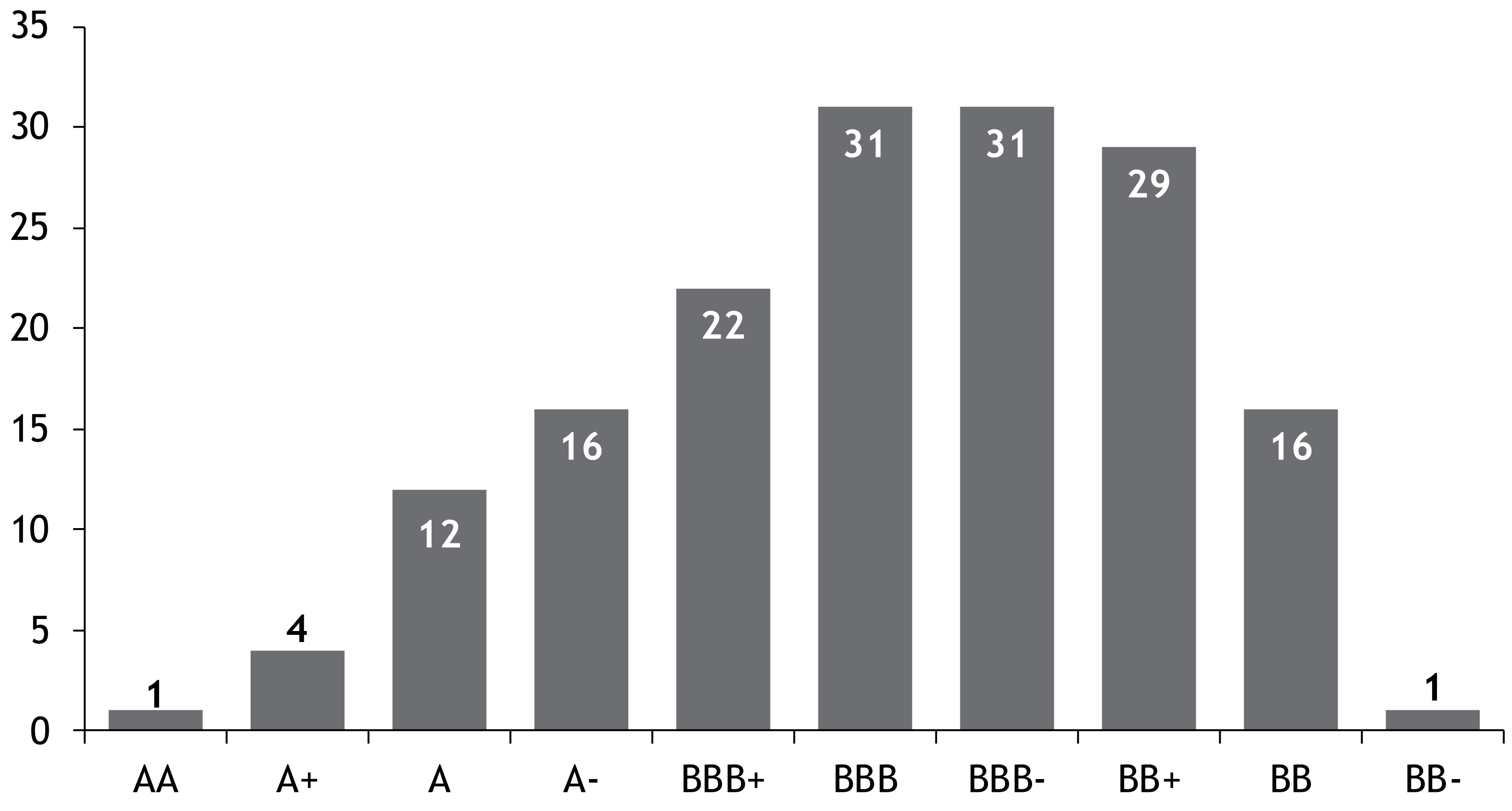
COVID Impact:
Return to the Basics

Top Line Revenue Price x Volume (Occupancy)	−	Key Expenses Salaries, Benefits, Dining, Equipment (Overhead)	+	Entrance Fees less Refunds (If you have them)	=	Cash Flow

Cash Flow needs to cover debt payments, capital expenditures, reserves for the future, and funding for growth initiatives.

Source: Ziegler Investment Banking

Current Life Plan Communities Credit Rating Distribution



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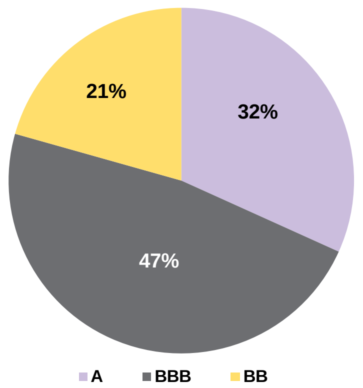

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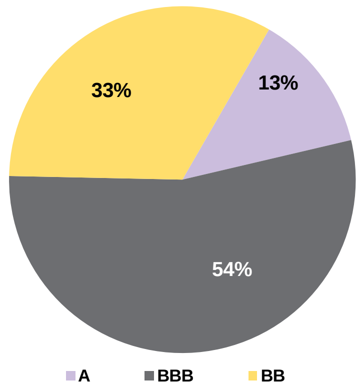
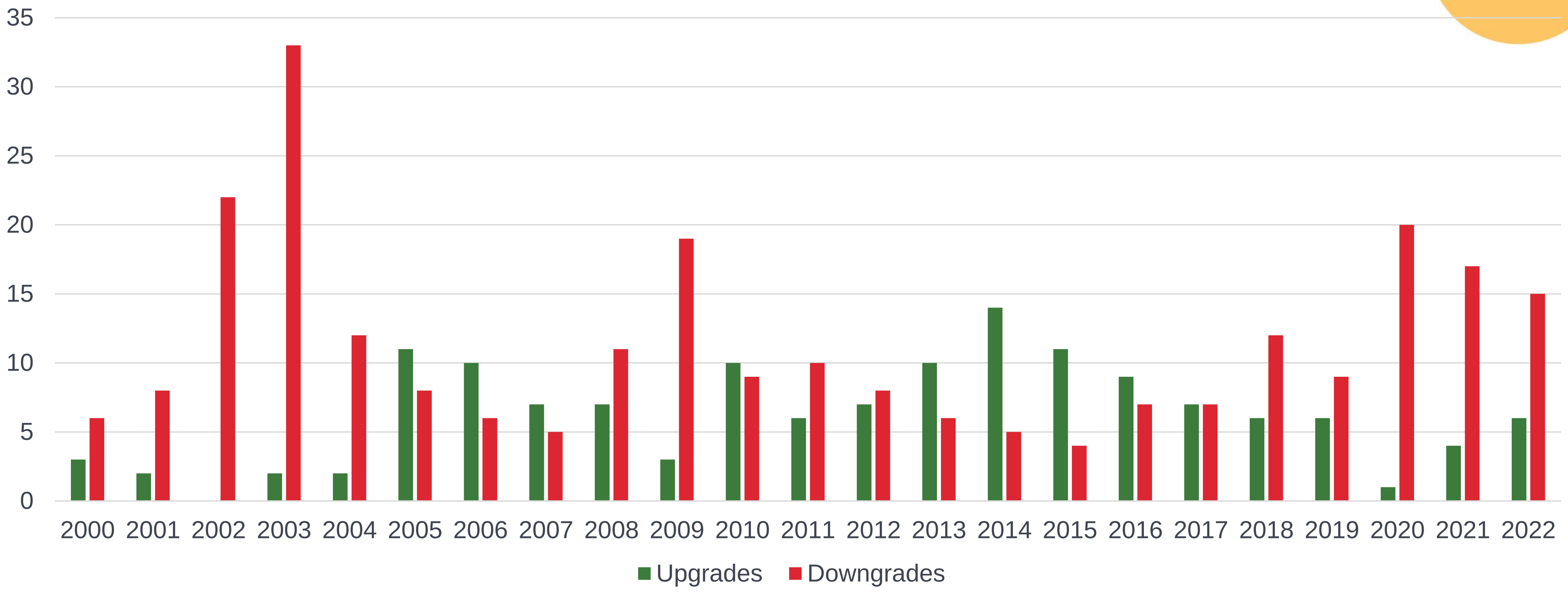


Source: Fitch Rating Service; Ziegler Investment Banking

Life Plan Communities Credit Rating Trends Incremental Upgrades and Downgrades (1990 YTD)



Source: Fitch Rating Service; Ziegler Investment Banking

Key Rating Drivers

Revenue Defensibility	Operating Risk	Financial Profile	Asymmetric Additional Risk Considerations
• Occupancy • Market Assessment • Rates and Affordability • Expansion Project	• Contract Type • Cost Management • Capital Expenditure Requirements • Capital-Related Metrics	• Unrestricted Cash-to-Adjusted Debt • Maximum Annual Debt Service Coverage Ratio • Days Cash on Hand	• Debt Structure and Contingent Liability Exposures • Management and Governance • Legal and Regulatory Framework

Source: Fitch Outlook 12/5/22

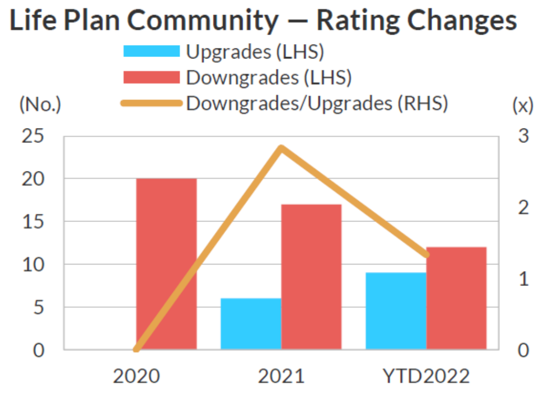
Industry Outlook

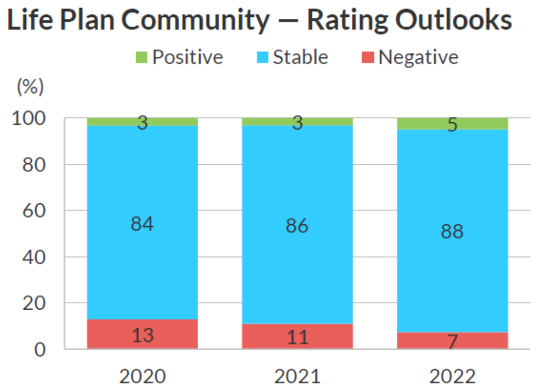
- Increasing costs of operating expenses paired with the decelerated increase of real estate prices are outpacing the growing demand for occupancy in NFP life plan communities subject to entrance fees, per Fitch.

Core Credit Drivers: Life Plan Communities

	Revenues			Expenditures				Financial		
	Personal income/ affordability	Real-estate values	Demand/ volumes	Labor costs	Labor availability	Non-Labor operating costs	Capital input costs	Leverage	Cost of debt	Financial reserves & liquidity
Life Plan Communities	↘	↘	↗	↓	↘	↘	↘	↔	↘	↔

↑ Improving: high relevance. ↗ Improving: moderate relevance. ↔ Neutral. ↘ Deteriorating: moderate relevance.
↓ Deteriorating: high relevance.
Source: Fitch Ratings





Source: Fitch Ratings.

Source: Fitch Outlook 12/5/22

Red Flags That Could Signal Trouble Ahead

- Occupancy has dropped and not showing signs of recovery
- Significant operating losses for two or more years,
- Dwindling financial resources to cover operating losses
- Struggles to provide competitive wages compared to others in your market area
- Payments to vendors are late or being extended
- Difficulty producing consistent, accurate financial statements on a timely basis
- No meaningful upgrades to physical plant in the past 10-15 years, with limited resources to invest

Source: Ziegler Investment Banking

Approaches to Dealing with Early Warning Signs

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Overview of Debt Related Covenants

- Variety of debt related covenants ranging from maintaining corporate structure to asset transfers, incurrence of additional debt and financial related
- Two primary financial related covenants:
  - Debt Service Coverage Ratio
  - Days Cash on Hand Ratio
- Additional covenants related to expansion or new campus projects:
  - Marketing
  - Occupancy
  - Cumulative Cash Operating Loss

Only covenant that will trigger an Event of Default

Tripping these will typically trigger a consultant report

Source: Ziegler Investment Banking

Structure/Purpose of Financial Covenants

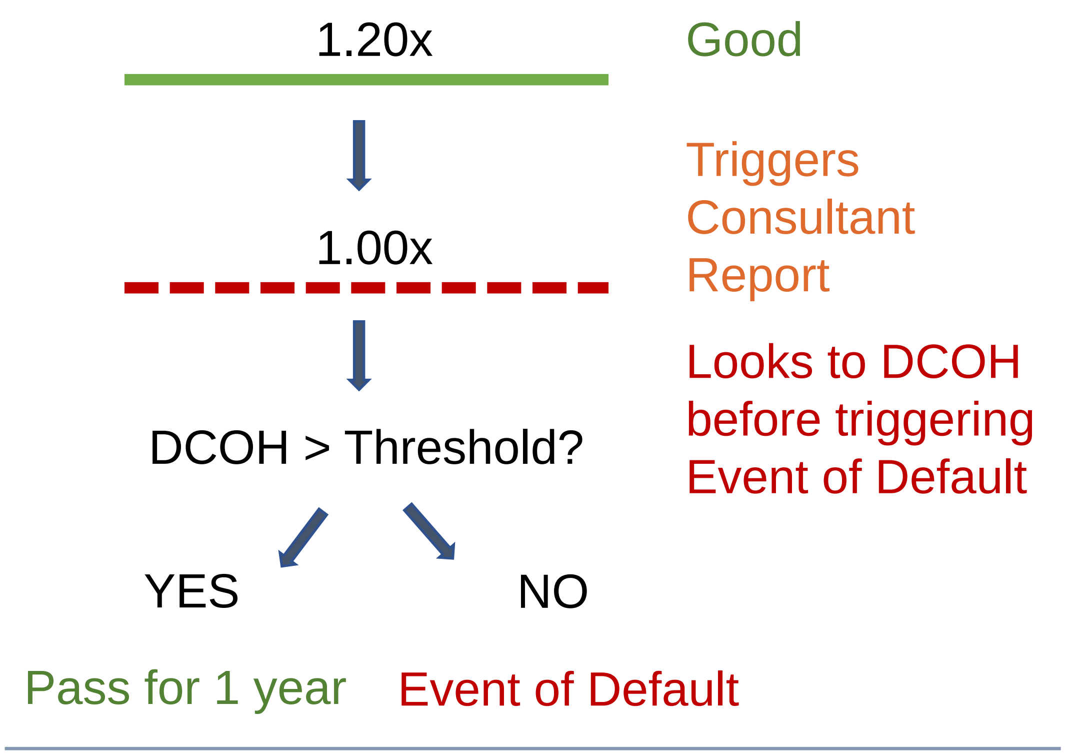
<u>Structure of Financial Covenants</u>

- Typically built with multiple stages, provisions depending on circumstances
- May be two-tiered to address lumpy cash flows
- May have provisions to “cure”, such as transfers from affiliates

<u>Purpose of Financial Covenants</u>

- Give early warning sign to borrowers and investors
- Provide investors a seat at the table, to become part of the solution
- Not designed to punish borrowers
- Investors don’t want the keys

DSCR: Two-Step Event of Default Feature



Source: Ziegler Investment Banking

Types and Consequences of Covenant Violations

- We discuss common items, but your covenants, remedies, and consequences are dependent on your legal documents
- Types
  - Financial
  - Sales/occupancy
  - Reporting
  - Structural (i.e. additional debt, asset transfer)
  - Other (i.e. substitution of ownership)
- Common Remedies/Consequences
  - Internal management report
  - Outside consultant report
  - Receivership
  - Acceleration

Source: Ziegler Investment Banking

Strategies for Responding to Early Covenant Stress

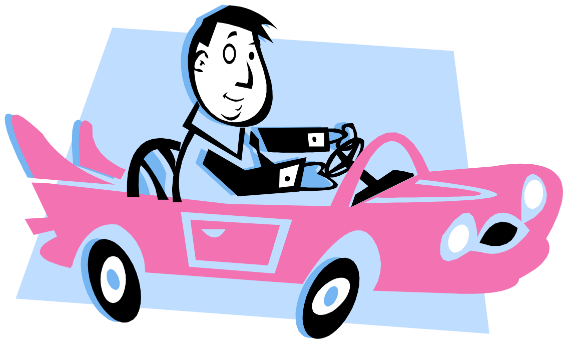
- Paying close attention to covenant compliance now can save a lot of time and stress later
- Assemble management projections with the goal of determining which covenants will come under stress and when that is likely to occur
- ***If debt service coverage is tight, look carefully at the words used in your coverage test***
  - Do realized investment gains increase revenues?
  - Do transfers from affiliates, foundations or donors increase revenues?
  - Can unusual expenses be subtracted?
  - GAAP freeze?

Source: Orrick Herrington Sutcliffe LLP

Key Drivers of a Strong Income Statement Revenues

Three main types of revenue:

1. Resident revenue
2. Charitable contributions
3. Investment income



Which can you control?

Source: Ziegler Investment Banking

Revenues You CAN Control

Resident Revenues

PRICE

- Monthly fee increases
- Entry fee increases
- Refundability provisions
- AL outside admits?
- Leases and ancillary

VOLUME

- Length of time to fill vacated units
- Unit turnover (voluntary/involuntary)
- Moving through the continuum
- Waiting list information: avg age; avg time on wait list
- Actuarial data

Source: Ziegler Investment Banking

Operating Expenses

Expenses

RESIDENT RELATED

- Health center
- Dining and hospitality
- Housekeeping and maintenance

CORPORATE

- General and administrative
- Be wary of “Scope Creep”
- Reducing staff turnover
- Agency usage

Source: Ziegler Investment Banking

Communicating with Investors

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Best Practices

1. Communication with investors
    - Clear, concise financial statements
    - Written MD&A
    - Participation in disclosure calls
    - Availability for investor questions- without disclosing material non-public information
2. Be proactive - Announce early
    - Gives investors more time to digest situation, especially if waiver is requested/required
    - Shows that you recognize the issue and are working to fix it
    - Some borrowers start remedies before official violation- consult your banker
3. Know your covenants
    - Actions during the year may impact ratio results (i.e. realized investment gains or losses)
4. Engage third party consultants with strong reputations
5. Keep your board and your banker involved
6. Leave the ego behind, and try not to be overly optimistic

Source: Ziegler Investment Banking

Communicating with Investors: The Federal Securities Acts

- Securities Act of 1933
  - Registration requirement for most securities, but municipal bonds are not included

- Securities Exchange Act of 1934
  - Creates ongoing disclosure requirements for public companies and regulates brokers and dealers

- Both 1933 Act and 1934 Act contain antifraud provisions which apply to municipal securities
  - Different standards of culpability: Negligence vs. Recklessness or Willful Intent to defraud

- Rule 10b-5, in part: "It shall be unlawful for any person…to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading…"

Source: Orrick Herrington Sutcliffe LLP

Materiality Standard

- “whether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest"
- Guidance comes primarily from court decisions and SEC enforcement cases
- Materiality is determined in context of all of the facts and circumstances
- Quintessential grey area – evolving concept
- Most readily identified on a retroactive basis with the benefit of hindsight

Source: Orrick Herrington Sutcliffe LLP

When do Disclosure Rules Apply?

- Rules whenever a borrower is "speaking to the market"
  - New offerings (official statement)
  - Annual Report under Rule 15c2-12 and other continuing disclosure filings on EMMA
  - Responding to investor questions
  - Requesting covenant amendments or waivers from public bondholders
  - Other circumstances
    - Public statements by company leadership
    - Investor website
- Confidentiality and business sensitivity are not exceptions to application of disclosure rules
- Avoid "selective disclosure (i.e.: disclosing information to some, but not all, public bondholders)

Source: Orrick Herrington Sutcliffe LLP

Potential Consequences of Bad Disclosure Practices

- SEC Investigation – Endless depositions, costly, could go on for years
- Adverse publicity
- Reduced market access
- May have to impose new procedures and oversight to settle SEC actions
- Rating Downgrades (triggers increased interest rates)
- Fines against borrower or culpable senior leadership (increasing)
- Potential adverse impact on employment and/or reputation

Source: Orrick Herrington Sutcliffe LLP

Approaches to Asking for Waivers and Amendments

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Frequency of Covenant Violations

- ZCS Monitored Borrowers (~260 organizations)
  - 31 below covenant required levels
  - 5 additional distressed
  - 1 borrower missing underlying payments
  - 18 borrower operating and in default
- 2021 ZCS Default Study (~120 borrowers)
  - Debt Service Coverage
    - Including PPP: 11 borrowers under 1.20x and 5 under 1.00x
    - Excluding PPP: 22 under 1.20x and 13 under 1.00x
  - Liquidity
    - 15 under 180 DCOH, 12 under 160 DCOH, 2 under 120 DCOH

	Mar-23	Mar-22	Mar-21	Mar-20	
Total Distressed					COVID pushed most challenged over the edge, with some going straight to Default after PPP rolled off. ERC recognition will help, assuming if and when applied.
Entrance Fee Communities	**31**	**24**	**25**	**14**	
Rental Communities	**9**	**7**	**3**	**5**	
Defaulted					
Entrance Fee Communities	13	8	8	7	
Rental Communities	1	0	0	0	
Technical Violations - Stable Communities					Lower in 2023 b/c many who were in technical violation in 2022 went to Default in 2023
Entrance Fee Communities	8	11	10	4	
Rental Communities	6	7	3	4	
Technical Violations - New campus or major expansion					Mainly marketing/occupancy violations due to slowed overall fill. Some CCOL violations with higher staffing expenses, inflation and slow fill.
Entrance Fee Communities	10	5	7	3	
Rental Communities	2	0	0	1	

Note: dataset represents communities monitored through Ziegler's credit and surveillance group

Source: Ziegler Credit Surveillance

Requesting Covenant Amendments Prior to Default

- What kind of an amendment are you asking for?
  - Lower covenant hurdles (lower required debt service coverage, lower required days cash on hand, etc.)
  - Temporary covenant holiday to allow management to focus on overall results
  - Be prepared to articulate an achievable turnaround plan that is endorsed by the Board and senior leadership
- Who are you asking?
  - Check debt documents to determine what percentage of bondholders or lenders need to agree to substantive amendments (often a simple majority but sometimes threshold is higher)
  - Are there a small number of bondholders or lenders that aggregate to the threshold needed to approve amendments?
- Many bank agreements will give the bank veto rights on substantive amendments

Source: Orrick Herrington Sutcliffe LLP

QUESTIONS?

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