FitchRatings

Public Finance
Life Plan Communities
U.S.A.

Exposure Draft: U.S. Public Finance Not-For-Profit Life Plan Community Rating Criteria

Sector-Specific

Scope

This report details Fitch Ratings' methodology for assigning Issuer Default Ratings (IDRs) and instrument ratings to U.S. not-for-profit life plan communities (LPCs). LPCs offer independent living and at least one additional level of care, such as assisted living or skilled nursing. LPCs may also offer home and community-based services like home health and adult day care, either directly or through affiliated entities.

Senior housing and care providers that offer assisted living and/or memory support services, along with skilled nursing care, will be rated under these criteria. In cases where an LPC's bond obligations are guaranteed by a foundation or other third party, Fitch will utilize *Appendix E: U.S. Not-for-Profit Institutions* contained in the "Public Sector, Revenue-Supported Entities Rating Criteria" to evaluate the rating. Other senior living providers, such as standalone assisted living, memory support or skilled nursing providers, will also be rated utilizing the "Public Sector, Revenue-Supported Entities Rating Criteria." Senior affordable housing properties with access to home- and community-based services are also considered outside the scope of the LPC sector and would, instead, be rated under the "U.S. Affordable Housing Rating Criteria." The criteria apply to both new and surveillance ratings.

Key Rating Drivers

Fitch explicitly does not weight the assessments of individual key rating drivers in coming to an overall rating conclusion. There is no standard formula to link the following inputs into an exact rating; the individual assessments inform, but do not dictate, the final rating outcome, as the initial assessments only suggest a rating category. The relationship between individual and aggregate qualitative and quantitative factors varies among organizations in the sector as well as over time.

Revenue Defensibility: This entails an assessment of an LPC's exposure to demand volatility and the capacity within its business model to address shifts in occupancy and cost pressures through its pricing flexibility. Fitch considers the market area characteristics in which an LPC operates, including the level of direct and indirect competition, economic and demographic factors, residential housing market values and trends, the LPC's historical occupancy and waitlists, and pricing characteristics, to gauge revenue defensibility.

Operating Risk: This entails an assessment of an LPC's operating cost flexibility, including predictability and volatility of expenses, as well as current capital expenditures and future capital requirements, and the ability to manage costs over time. Fitch evaluates the LPC's residency contract type, paying attention to entrance fee refund provisions, to assess the flexibility to control or recover costs from its resident base for specific services and the degree of expenses associated with its business model.

Financial Profile: Metrics are used to evaluate the LPC's leverage and liquidity profiles in the context of the borrower's overall revenue and operating risk profile. These metrics are evaluated on both a historical and forward-looking basis, which considers an LPC's overall financial flexibility to withstand a stress scenario over a five-year time horizon.

Asymmetric Additional Risk Considerations: Risk factors such as debt structure, management and governance, and legal and regulatory risks are also considered when assigning a rating. These risk factors are not scaled, and only weaker characteristics affect the rating.

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This report is published as an exposure draft. Fitch invites feedback from market participants on the proposed criteria. Comments should sent to criteria.feedback@fitchratings.com by April 18, 2024. Fitch will publish on its website any written responses it receives, in full, including the names of the respondents, unless the response is clearly marked as confidential.

Fitch will apply the existing criteria to both surveillance of existing ratings and the assignment of ratings to new issuers and transactions during the exposure draft period. The U.S. Public Finance Not-For-Profit Life Plan Community Rating Criteria report, when published in its final form, will replace the current U.S. Public Finance Not-For-Profit Life Plan Community Rating Criteria report, published on April 5, 2023.

Related Criteria

U.S. Public Finance Not-For-Profit Life Plan Community Rating Criteria (April 2023)

Public Sector, Revenue-Supported Entities Rating Criteria (January 2024)

U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria (November 2020)

U.S. Affordable Housing Rating Criteria (March 2022)

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Summary of Proposed Key Changes

Fitch is proposing the following changes to the existing U.S. Public Finance Not-For Profit Life Plan Community Rating Criteria:

- Limitation of ratings of LPCs to 'A' category.
- Limitation of Key Rating Driver assessments of LPCs at 'a'.
- Addition of specific sub-assessments of Revenue Defensibility to better reflect relative credit strength of multi-site vs. single-site LPCs, as well as size and scale by number of units.
- Limitation of Revenue Defensibility of LPCs with more skilled nursing facility (SNF) beds than independent living units (ILUs) at 'bbb'.
- Addition of size and scale considerations to Revenue Defensibility assessment;
- Addition of 'B' category to Ratings Positioning Table and addition of enhanced guidance for ratings below 'B' category.
- Improved granularity in Operating Cost Flexibility assessments with description of expected performance by contract type.
- Revisions to capital expenditure requirement under Operating Risk to better reflect likelihood of large-scale capital project.
- Further guidance on potential rating action based on probability and rating impact of a capital project.

Rationale for Change

Proposed revisions to criteria are intended to better reflect the risk profile of LPCs. They acknowledge the unique risks of LPCs, namely their typically very limited market draw and high industry concentration risk, which limit their rating potential, as well as those attributes, such as high occupancy or an exceptionally large or diverse market draw, that could justify higher assessments of their key rating drivers, despite these limiting characteristics. Limitations on revenue defensibility assessments for LPCs with more SNFs than ILUs reflect the lower price flexibility of these entities given their heavy reliance on governmental reimbursement for revenues.

Revisions to criteria also acknowledge LPCs' propensity for large-scale capital plans relative to their revenue size and provide better transparency on when and how these plans will be factored into ratings. They also provide better guidance on LPCs rated below the 'BB' category to smooth rating transitions in the lower end of the rating scale.

Expected Rating Impact

Fitch anticipates that approximately 10% of LPC ratings could be affected by these changes. Rating changes are likely to occur due to the adoption of 'B' category guidance in the Rating Positioning Table, capping of revenue defensibility for LPCs with more SNFs than ILUs, capping of ratings at 'A' category, more clarity on demarcation between revenue defensibility assessments for single-site LPCs and/or analysis that concludes the rating is vulnerable to downgrade due to a capital project as guided by through the Capital Risk Matrix framework. We anticipate most rating changes, if any, would be downgrades limited to one notch.

General Credit Quality Reflected in IDR

Fitch will assign an IDR to each individual LPC as well as an issue-specific rating for each Fitch-rated security. An IDR reflects our assessment of an entity's relative vulnerability to default on its financial obligations. In general, all of an issuer's individual bonds will be assigned the same rating as the IDR.

IDR and issue ratings in this sector do not incorporate any assessment of recovery prospects, and distinctions between default risk in securities by seniority in this sector are unusual. A specific debt structure may include additional security devices, such as a mortgage or segregated/reserve accounts. These protections are not effective in preventing default in bankruptcy and are not a basis to distinguish the instrument rating from the IDR.

Three Key Rating Drivers

Fitch's three key rating drivers are: 1) Revenue Defensibility, 2) Operating Risk and 3) Financial Profile. The three key rating drivers are assessed using the following guidance outlined in these criteria, which defines general expectations for a given rating category. Subfactors in each of the key rating drivers highlight the components that are most critical in making the assessment. All assessments are grounded in borrower-specific historical data and qualitative analysis to support a forward-looking view on the expectation for future performance, rather than at a single point in time.

Consideration of financial profile in the context of revenue defensibility and operating risk and its correspondence with ratings is presented in the *Rating Positioning Table* on page 17-18. The ratings are not formulaic or model driven, but require qualitative judgment to place metrics in an overall context for each borrower. Key Rating Drivers may be present that support a higher or lower rating than indicated by the table and the metrics, such as a benign operating or competitive environment, market dynamics that reduce potential price or cost volatility, or financial support from related foundations. Key metrics considered in the rating analysis are defined in the table *in Appendix A– Key Terms.*

Key Rating Drivers

	a	bbb	bb	b
Revenue Defensibility				
Size/Scale	Multi-site LPC with locations in at least two states.	Multi-site LPC with locations in at least two non-overlapping markets in a single state. Single-site LPC with affiliation or management agreement that provides resources of scale tantamount to a multi-state LPC.	Single-site LPC in retirement destination location or exceptionally large market.	Single-site LPC in an average sized market.
	LPC with total units in service of >800	LPC with total units in service of 351-800	LPC with total units in service of 200-350	LPC with total units in service of <200
Demand Characteristics: Occupancy	Strong demand: ILU occupancy approximately above 93%. N.A.	Solid demand: ILU occupancy approximately 88.1%–93%. LPC with more SNF units than ILUs, with SNF occupancy above 90%.	Weak demand: ILU occupancy approximately 86%–88%. LPC with more SNF units than ILUs, with SNF occupancy between 85% and 90%.	Very weak or declining demand: ILU occupancy approximately less than 86% with expectations for further decline. LPC with more SNF units than ILUs, with SNF occupancy below 85%.
Demand Characteristics: Market Assessment (not applicable for LPCs with more SNF units than ILUs)	LPC with locations in highly diversified, distinct geographic areas or with a national or multi-market draw, with a significant proportion of residents originating from outside its immediate geographic area. LPC faces minimal competition and competes effectively due to its preferable location, amenities and incentives.	LPC in a stable market area poised to support consistent demand. LPC faces competition, but location, amenities and incentives make it competitive.	LPC in a declining relevant market area that evidences softening demand. LPC struggles to compete with some aspects of preferable location, amenities and incentives.	LPC in a declining relevant market area with a very limited or declining market draw. LPC is unable to compete effectively with or has location, amenities and incentives that are inappropriate for the market relative to competitors.

Key Rating Drivers

		a	bbb	bb	b
Pricing Characteristics: Rates and Affordability		LPC with market assessment indicating a high degree of price flexibility, diversified exposure to pricing characteristics of any given market, or with a highly diversified pricing structure that allows for an exceptionally broad reach for residents.	LPC with market assessment affording moderate price flexibility.	LPC market assessment affording little price flexibility.	LPC with market assessment affording virtually no price flexibility.
		Rate increases occur regularly and are highly affordable relative to resident wealth and income levels.	Rate increases occur periodically and are affordable.	Rate increases are limited and sometimes unaffordable relative to resident wealth and income.	Rate increases are rare, below inflation, or consistently unaffordable relative to wealth and income.
		Weighted average entrance fees are highly affordable relative to home values and resident net worth	Weighted average entrance fees are affordable relative to home values and resident net worth.	Weighted average entrance fees are unaffordable relative to home values and net worth for some potential residents.	Weighted average entrance fees relative to home values and net worth are unaffordable to a large portion of potential residents.
		N.A.	LPC with more SNF units than ILUs with payor mix more than 70% private pay/Medicare.	LPC with more SNF units than ILUs with payor mix balanced between Medicaid and private pay/Medicare.	LPCs with more SNF units than ILUs with payor mix more than 70% Medicaid.
Asymmetric Additional Risk Consideration	Expansion project that may negatively affect revenue defensibility by displaying one or all of the following attributes:				
	• Inadequate pre-sales or pre-sales less than minimum levels prescribed by bank or other direct lender				
	• Expansion adequately pre-sold but with small deposits (less than 10% of entrance fee)				
	• Entrance fees of new units increase relationship to median/average home values in the market, or pricing materially exceeds that of existing units				
	• Forecast monthly service fees on new units are a materially higher percentage of resident income than fees on existing units				
Operating Risk					
Operating Cost Flexibility: Contract Type		Predominantly C type contracts (fee for service contracts).	Predominantly B type contracts (modified life-care contracts that include healthcare services up to a certain extent for no additional fees) or D type rental contracts.	Predominantly A type contracts (life-care contracts that include unlimited healthcare services for a relatively consistent monthly fee).	
Operating Cost Flexibility: Cost Management		Expectations for strong cost management with 5-year averages of: net operating margin approx. 13% or above; operating ratio approx. 93% or below; adjusted net operating margin approximately 28% or above. Other revenue sources are diversified,	Expectations for adequate cost management with 5-year averages of: net operating margin approximately 3.1% to 13%; operating ratio approximately 93.1% to 100%; adjusted net operating margin approx. 15.1% to 28%.	Expectations for weak cost management with 5-year averages of: net operating margin approximately 0 to 3%; operating ratio approximately 101% to 105%; and adjusted net operating margin approximately 11% to 15%	Expectations for very weak cost management with 5-year averages of: net operating margin approximately less than 0%; operating ratio approximately above 105%; and adjusted net operating margin approximately less than 11%

Key Rating Drivers

		a	bbb	bb	b
		consistent and expected to greatly enhance revenue.	Other revenue sources are limited and expected to only modestly enhance revenue.		
Capital Expenditure Requirements		5-year average of capital expenditures to depreciation approximately 175% or above. Average age of plant is strong for the market and approx. 10 years or below. Very low likelihood of large capital plan/expansion in foreseeable future.	5-year average of capital expenditures to depreciation approximately 95.1% to 175% Average age of plant is suitable for the market and approx. 11 years to 13 years Large capital plan/expansion is possible in foreseeable future	5-year average of capital expenditures to depreciation approximately 70% to 95% Average age of plant is weaker for the market and approx. 14 years to 16 years Large capital plan/expansion is probable in foreseeable future. Unit mix/amenities approaching obsolescence.	5-year average of capital expenditures to depreciation approximately below 70% Average age of plant is weak for the market and approx. above 16 years High need to invest in capital projects to forestall obsolescence of unit offerings/amenities and maintain occupancy
Capital-Related Metrics		Revenue-only MADS coverage approximately 1.5x or above.	Revenue-only MADS coverage approximately 0.51x–1.5x	Revenue-only MADS coverage approximately 0x to 0.5x	Revenue-only MADS coverage approximately below 0x
Operating Risk					
Capital-Related Metrics (continued)		MADS/Revenue approximately 9% or below.	MADS/Revenue approximately 9.1% to 16%	MADS/Revenue approximately 16.1% to 20%	MADS/Revenue approximately above 20%
		Expectations for Debt/Net Available approximately 5x or below.	Expectations for Debt/Net Available approximately 5.1x to 8x	Expectations for Debt/Net Available above approximately 8.1x to 12x	Expectations for Debt/Net Available above approximately above 12x
Asymmetric Additional Risk Considerations	• LPC with more ILUs than SNF units at which Medicaid is a significant contributor to skilled nursing payor mix (more than 25% of net revenues).				
	• Facility operates in a state with regulatory requirements that constrain operating cost flexibility.				
	• Expansion project that lacks one or more of the following key project elements may negatively affect the assessment of operating risk.				
	• Guaranteed maximum price construction contracts with provisions for liquidated damages.				
	• Engagement of an owner's representative/construction monitor, who has reviewed the contract and indicated contractor approach is reasonable.				
	• Contractor providing a payment and performance bond.				
	• Satisfactory owner and builder's contingencies.				
	• Expansion of ALU or SNF where intent is to fill majority of units with external residents that is not being done in conjunction with an ILU expansion.				
Financial Profile					
Leverage Profile	See *Rating Positioning Table* on pages 17-18				
Liquidity Profile	Liquidity profile assessments are informed by an LPC's days cash on hand (p. 19).				

N.A. – Not applicable
Source: Fitch Ratings

Revenue Defensibility

Fitch evaluates an LPC's relative ability to defend and maintain its revenue profile within the context of its operating environment. For the LPC revenue defensibility assessment, Fitch considers an LPC's size and scale and demand and pricing characteristics.

Relating to demand characteristics, occupancy trends, the LPC's market position and an analysis of the market area's demographic/economic factors support Fitch's assessment. Fitch's

analysis of pricing characteristics considers the LPC's relative pricing flexibility, along with its pricing structure, historical pricing practices and expectations for the future.

LPCs with manageable exposure to healthcare services and outside admissions (for assisted and skilled care) generally have more stable demand characteristics and show less pricing volatility since lengths of stay for independent living units (ILUs) are relatively long with predictable levels of monthly service fees. Further, ILU monthly service fees are entirely from private sources and, with the exception of life care providers, are increased as residents move through the continuum of care.

Certain senior housing and care providers may not provide sufficiently broad services to be rated under these criteria, but share revenue risk factors substantially similar to LPCs — risks related to occupancy, market assessment and pricing characteristics. In such cases, an analysis of the attributes used to assess the revenue defensibility of LPCs may be applied.

Size and Scale

The size and scale of an LPC is a general gauge of its ability to mitigate the impact of unit turnover, even if individual campuses or unit types are underperforming or undergoing significant capital projects that temporarily disrupt services. A more diversified market reach and larger number of units in service indicate stable demand and the ability to take advantage of economies of scale and generate sufficient cash flow for capital investment. The broader and more diversified a LPC's geographic reach, the better insulated it will be from regional economic or demographic conditions that may affect its pricing flexibility. LPCs can also have affiliations, management agreements or be an obligated group (OG) within a larger system, allowing them to benefit from economies of scale that are tantamount to those of a multi-campus system. Exceptionally small LPCs with narrow market reach and small unit counts will garner the lowest assessment.

Occupancy and Waitlist

LPCs maintain utilization statistics for each of its care levels — independent living, assisted living, memory care (if applicable) and skilled nursing. Fitch requests historical turnover information on ILUs, including annual move-ins, move-outs, transfers and deaths. Historical occupancy rates in the ILUs of approximately 93% reflect strong demand for services and a higher level of revenue defensibility. However, weak historical occupancy or a steady decline in occupancy over time leads to weaker revenue defensibility. Fitch also requests historical information on census within other levels of care, including assisted living units (ALUs) and SNF beds. Stable to increasing census is considered a favorable indicator of demand, while a declining census may indicate expectations for revenue pressure. Occupancy in the SNF is also considered in the context of operating risks, such as cost management and payor mix, as discussed below.

Fitch also evaluates an LPC's waitlists for entry into the community. Waitlists identify prospective residents who have expressed a desire to move into the LPC at a future date and provide a good indication of demand. Fitch will inquire about the depth of a facility's waitlist, how often it is updated and any deposit (and refund provision) required to be placed on the list. Actively managed waitlists that are updated at least every one year to two years indicate definitive demand and allow an LPC to more quickly fill empty units and maintain a stable ILU occupancy rate. An additional indicator of strong market position is a robust waitlist that requires significant deposits from future residents. Deposits can range from requirements of no fee to tens of thousands of dollars. Larger deposit amounts indicate definitive demand and allow an LPC to more quickly fill empty units and maintain a stable ILU occupancy rate. Moreover, Fitch views waitlists additively when potential residents have placed deposits on a variety of units. All else equal, a waitlist where potential residents have selected more common styles of units will help an LPC maintain occupancy more easily than a waitlist where all potential residents are interested in just one style of unit.

Market Assessment

LPCs compete in a market with many alternatives for senior care and senior living. Fitch analyzes the number and type of competing or alternative senior independent living options in an LPC's market area that could potentially limit demand. Management that is proactive will conduct periodic market surveys identifying other available senior housing options, including rental facilities and entrance fee communities. As available, Fitch reviews these market surveys,

which include information on the number, type and size of units; services included in monthly fees; amenities; up-to-date fee schedules; occupancy rates; and sponsorship.

Fitch evaluates the effect that any potential new entrants into the market area may have on demand. Fitch is concerned with the potential saturation of a market, which could lead to lower occupancy, reduced prices, higher labor costs and higher penetration rates for the region. Penetration rates are defined as the number of occupied units in the market area divided by the number of households over age 75. This information is often available in feasibility studies produced by independent contractors to an LPC considering expansion.

A market area with higher penetration rates can either indicate: 1) a market where the LPC product is well known or 2) a highly competitive market due to substantial uptake among potential residents. Where penetration rates are high, Fitch views high historical occupancy and deep waitlists among LPCs in the same market area as an indication of the first scenario. The second scenario may increase the likelihood that less desirable facilities need to increase market incentives or experience declining or low occupancy rates, which could indicate weaker revenue defensibility. Fitch reviews historical occupancy and penetration rates, the depth of the waitlist and comparative fees and unit sizes among facilities to assess the level of saturation in the market area. Fitch also considers competition from home healthcare, standalone ALU, memory support and alternative providers in assessing an LPC's revenue defensibility.

For an existing LPC, barriers to entry, such as state regulatory requirements, that prevent the creation of new facilities can strengthen that provider's market position. Different states, however, may regulate the ability of LPCs to expand or acquire facilities through certificate of need (CON) endorsements. The benefits and downsides of each state's legislation is assessed on a facility-specific basis in accordance with their long-term planning. The presence of price discounting or other marketing incentives (like deferral of a portion of entrance fees) to maintain or bolster occupancy are a leading indicator of increased demand pressures in a market area.

For an established single-site LPC, the origins of its existing residents help define its primary and secondary market areas. Typically, a majority of residents are drawn from a geographic area of 10–15 miles around the community. However, some LPCs have regional or national draws, where a substantial proportion of its residents originate from outside the immediate geographic area and/or other states and are considered destination communities, which provides more demand flexibility and enhances revenue defensibility.

Fitch assesses demand strength by analyzing the primary market area's most recently available economic and demographic characteristics, including employment trends, wealth and income statistics such as median household income, and aging and population growth rates. Analysts evaluate the strength of an LPC's market area and market position using data from multiple sources, including feasibility studies and home value estimates produced by third parties. After establishing its primary market area, management must quantify its potential demand in terms of the number of age and income-eligible persons or households. Most residents of an LPC enter the facility while they are still independent, that is, not requiring assisted living or skilled nursing services. Traditionally, the LPC industry has assumed that eligible persons (or potential residents) are age 75 or older. Typically, management stratifies the primary market area's income-eligible households in five-year intervals, usually starting with age 65.

Pricing Characteristics

An LPC's revenue defensibility is also influenced by its pricing characteristics. Fitch uses the community's current pricing matrix, including entrance fees and monthly service fees by unit size and contract type, as well as historical rate increases. Fitch views a history of regular rate increases as a favorable indicator of price flexibility. Fitch reviews the community's contract prices against home values and competing facilities to assess its revenue defensibility. Fitch also assesses the level of monthly service fees as a percentage of resident income at time of entry into the community. Monthly service fees that are a lower percentage of resident income provide more pricing flexibility. Conversely, monthly service fees that are a higher percentage of resident income limit demand flexibility.

Fitch also examines the primary market area's residential housing market values and trends. LPCs with weighted average entrance fees that are materially higher than median/average home

values are considered to have less revenue defensibility, as they have a smaller pool of potential residents eligible for occupancy in the community. Conversely, LPCs with weighted average entrance fees that are in line with home values or have a wide mix of unit sizes and price points are considered to have greater revenue defensibility, since they have a wider pool of potential residents to draw from. LPCs with weighted average entrance fees that are at or below the primary market area's median home values are better positioned to handle any potential demand volatility.

Importantly, monthly service fees are controlled exclusively by management and are not contractually limited, which provides a high degree of revenue flexibility to address community needs and financial obligations. However, if monthly service fees are increased to a point where they are no longer comparable to those of similar communities, the LPC's competitive position could be negatively affected.

LPCs with more Skilled Nursing Units than Independent Living Units

LPCs with more SNF units than ILUs are more vulnerable to revenue pressures, as they typically have very little pricing flexibility due to their high exposure to governmental payors. Therefore, these entities cannot garner a revenue defensibility assessment higher than 'bbb'.

In particular, state Medicaid programs provide the lowest rates among all payors for SNF services and routinely negatively affect SNF operations for providers that have a substantial long-term nursing care business. Therefore, Fitch considers LPCs where Medicaid is a significant (more than 70%) contributor to the skilled nursing payor mix to be weaker. Many LPCs offer post-acute care services in their SNFs, as they broaden the continuum of care, and the LPCs' Medicare reimbursement for short-stay rehabilitation services is sufficient and, therefore, can support a higher revenue defensibility assessment.

Asymmetric Additional Risk Consideration — Revenue Defensibility

Expansion Projects

Expansion projects can be of strategic benefit to LPCs, as they allow communities to enhance the number and configuration of their unit and service line offerings to meet market demand and remain competitive. However, these projects very often lead to increased leverage and represent a relatively high degree of risk associated with the fill-up of expansion units.

For large ILU expansion projects, which often use initial entrance fee receipts to pay off a portion of the debt issued for construction, a delay in the collection of entrance fee receipts due to slow fill-up on new units can significantly impair a borrower's ability to pay debt service.

To gauge the likelihood of successful project fill-up, Fitch reviews pre-sale levels on the new units and the deposit required to reserve the unit. Generally, if 70% or more of expansion units are reserved prior to construction, that indicates high likelihood of successful fill-up; however, Fitch also considers velocity of pre-sales in the context of the construction timeline and other factors to determine whether adequate demand exists to fill the new units. Banks and other direct lenders very often have minimum pre-sale levels to provide financing to the borrower, in which case, Fitch will also consider pre-sales relative to that prescribed level.

Fitch also reviews the required deposit to reserve an expansion unit to gauge the likelihood that prospective residents will ultimately take occupancy of their reserved unit. Expansion units are generally reserved with deposits equal to 10% of the unit's entrance fee. Smaller deposit amounts may indicate weak demand for the expansion product and may result in residents ultimately not taking occupancy once the unit is constructed.

Additionally, similar to the analysis applied in Fitch's evaluation of an LPC's pricing characteristics, the relationship between the initial entrance and monthly service fees of expansion units and the median/average home values in the market, resident income and pricing on an LPC's inventory of existing units, and the pre-sale status of the most expensive expansion units provide an indication of the likelihood of successful fill-up of the project. Pricing on expansions that materially increase the relationship between entrance and monthly services fees, and prevailing housing prices and resident income levels, or an inability to pre-sell more expensive expansion units can adversely affect an LPC's demand flexibility.

Operating Risk

The second key rating driver is operating risk, which focuses on operating cost flexibility and controls, as well as longer-term capital investment expectations, in the context of historical capital expenditures. An LPC's ability to generate adequate margins is largely a function of its ability to effectively manage operating and capital costs to current (and expected) changes in demand and pricing characteristics. Long-term strategic investments in property, plant and equipment, and/or service line initiatives can limit expenditure flexibility in the near term while enhancing organizational viability over the long term.

Residency Contract Types

Fitch includes the contract type as an operating risk attribute to provide context to expectations for an LPC's financial results and metrics. There are four types of residency contracts — life care, modified, fee-for-service and rental. Each contract may differ in its refund provisions, with all but rental communities collecting an upfront entrance fee. For all contracts, management may increase fees for all residents (usually limited to annually) for general operating costs and inflation. All communities have an established initial financial qualification process in place to evaluate a resident's financial resources for living in the LPC. For cases where an LPC offers multiple contract types, the predominant contract offering will drive this attribute assessment.

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 to the resident's monthly service fee. Residents pay relatively the same fee for care while occupying an ALU or a nursing unit in the health center as they would in an ILU. Type A LPCs rely on a robust process of actuarial reporting and financial and health screening of prospective residents to ensure adequate resources to meet this healthcare liability (also see *Actuarial Studies May Inform Assessment* below). However, due to the healthcare liability risk, Fitch views type A facilities as having a higher risk operating profile relative to facilities that offer type B, C or D/rental contracts.

LPCs with predominantly type A contracts typically rely heavily on turnover entrance fees for operations, and therefore, Fitch expects them to have largely break-even operating performance but robust cash flow margins, reflected in higher net operating margin (NOM)-adjusted (see *Cost Management* below). For this reason, Fitch also expects LPCs with predominantly type A contracts to have low revenue-only maximum annual debt service (MADS) coverage (see *Capital-Related Metrics* below).

Modified Agreement (Type B)

This contract includes housing, residential services and amenities. Healthcare services are typically offered under two pricing arrangements — a discount to full market rates or a limited number of free days, after which the resident pays the prevailing market rate. The type B contract presents less actuarial risk and contract pricing risk and, therefore, less operating expense risk than a type A contract due to its limited healthcare liability.

Fee-for-Service Agreement (Type C)

This contract includes housing, residential services and amenities. Residents have priority access to the assisted living and skilled nursing beds but pay the prevailing market rates on entry. This contract presents the lowest actuarial risk and, therefore, the lowest operating expense risk, among all contracts. LPCs with predominantly type C contracts have virtually full ability to pass on operating cost volatility to their resident base in the form of rate increases. Therefore, Fitch expects these types of LPCs to have stronger core operating metrics, as defined by lower operating ratios and higher NOM (see *Cost Management* below).

Rental Agreement (Type D)

This contract includes housing, residential services and amenities. Residents may have priority access to the ALU and SNF and, if admitted, pay prevailing market rates. As with a type C contract, the resident assumes the healthcare risk; however, rental communities have other attributes, such as higher turnover, that limit their cost flexibility compared to entrance fee communities. Fitch expects LPCs that have a predominantly rental contract mix to have very

strong Operating Ratios of 90% or lower (see *Cost Management* below), given that entrance fees are not available to support cash flow and debt service. For this reason, Fitch also expects that predominantly rental LPCs will have stronger revenue-only MADS coverage (see *Capital-Related Metrics* below)

It has become more difficult to neatly categorize individual communities as a type A, B, C or D facility. Due to increased competition in various markets and greater resident demand for choice, many providers offer a variety of contract types. 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 healthcare service obligation of the LPC is clearly stated.
- Entrance fee refund provisions. Nonrefundable entrance fee agreements provide more financial flexibility.
- Payment of an entrance fee refund is predicated on the receipt of an entrance fee from the re-occupancy of the vacated unit.
- Provisions exist for transferring a resident to an assisted living or skilled nursing unit.

Actuarial Studies May Inform Assessment: Actuarial studies measure the adequacy of the community's entrance and monthly service fee pricing relative to the actuarial life and health expectancy of its resident population. For a type-A provider, Fitch believes actuarial studies should be completed by a reputable actuarial firm once every three years to ensure that entrance fee and monthly service fee pricing is adequate relative to the expected future healthcare service obligation to its residents. LPCs with inadequate actuarial funding ratios are considered to have higher credit risk, even if they currently enjoy healthy cash flow and balance sheet resources.

Cost Management

Fitch will assess the degree to which an LPC has flexibility to control its expenses. Salaries, wages and benefits are one of the largest components of an LPC's expense base. The degree of labor cost flexibility is influenced by regulatory factors, collective bargaining constraints and other market forces that directly affect healthcare workers. For example, minimum nurse staffing requirements reduce flexibility to manage labor costs. Nursing markets remain particularly tight given the demand for qualified staff. The willingness of hospitals and health systems to offer higher compensation than LPCs for nursing staff and mid-level professionals also increases labor cost pressures. Finally, rising minimum wages for many nonclinical positions such as food service and housekeeping can cause cost management challenges. In some cases, low SNF occupancy or reducing the number of SNF beds in service can positively affect an LPC's operating performance as it reduces staffing costs associated with these units.

Operating performance as measured by profitability or margin is viewed as the primary factor that drives long-term viability. Stable, consistent and predictable positive operating results improve balance sheet strength, suggest a strong competitive position and an enhanced ability to fund needed capital expenditures. Profitability also represents the combined strengths or weaknesses of the entity's revenue and cost framework. Generally, communities with consistently strong operating profitability are able to withstand near-term compression and volatility for limited durations. Fitch's profitability analysis excludes certain noncash or one-time items, such as unrealized investment gains and losses, changes in the fair market value of derivatives, impairment charges on the disposal of assets and losses on the extinguishment of debt.

Fitch considers the prior and expected five-year trend of operating expenses as it compares to Fitch's expectations for the LPC's revenues. Fitch considers this trend in revenue and cost management in the context of historical profitability. The assessment supports Fitch's forward-looking view on a borrower's financial flexibility and potential growth or pressure on operating profitability. Fitch will evaluate the impact of certain strategic initiatives in the context in its analysis, particularly if the effect on operating profitability is planned for and one-time in nature.

The key metrics used by Fitch to measure profitability or margin are NOM, NOM-adjusted and operating ratio.

- NOM measures the margin generated by cash operating revenue after the payment of cash operating expenses. NOM is defined by subtracting resident expenses (excluding interest, depreciation and amortization) from resident revenue (excluding interest/dividends, entrance fee amortization and contributions) and dividing by resident revenue. NOM solely evaluates resident-based operations, which are at the core of the LPC's operational performance. Higher percentages represent stronger cost management.
- NOM-adjusted measures the margin generated by cash operating revenue, including net entrance fees, after the payment of cash operating expenses. NOM-adjusted is defined by subtracting resident expenses (excluding interest, depreciation and amortization) from the total of resident revenue and net entrance fees received (excluding interest/dividends, entrance fee amortization and contributions) and dividing by resident revenue. NOM-adjusted is particularly relevant for type-A communities, given their higher reliance on entrance fee turnovers to generate debt service coverage and the provision to provide assisted living and nursing care services as part of the monthly service fee. Higher percentages represent stronger cost management and a higher cash flow margin with which to cover debt service.
- Operating ratio measures the current year cash operating expenses versus current year cash operating revenues. Operating ratio is defined by total operating expenses (excluding depreciation and amortization) divided by total operating revenues (excluding amortization of deferred revenue). Unlike NOM, operating ratio includes dividends/interest income, net assets released from restrictions and interest expense. The lower the operating ratio percentage, the stronger the cost management.

Capital Expenditure Requirements

Ongoing capital reinvestment, particularly for more mature communities, is an important credit consideration. Fitch expects management to develop and continually update a long-range capital plan to maintain the competitive position of the LPC. Routine capital reinvestment costs for most LPCs tend to be very manageable, but strategic capital investment can be substantial. Fitch will evaluate the level of capital expenditures as a percentage of depreciation expenses and average age of plant in the context of stated capital plans and market trends when assessing an LPC's capital reinvestment adequacy, as well as the likelihood of it pursuing a largescale capital expansion project. Communities that do not maintain average capital expenditures at or near depreciation expenses over time or maintain high average age of plant metrics are considered to have weaker facility reinvestment.

Other Capital-Related Metrics Used to Assess Operating Risk

As part of its assessment of a community's operating risk, Fitch factors in an assessment of certain core capital-related metrics — MADS as a % of revenue, revenue-only MADS coverage and debt to net available *(see Appendix A: Key Terms)* — to evaluate an LPC's ability to absorb its debt in the context of its current operations and without negatively affecting its financial position. These metrics can also inform Fitch's evaluation of the completion risk of an expansion project, as they provide indication of an LPC's dependence on project completion to pay debt service. Fitch will consider these ratios in the context of expectations for additional cash flows to be generated from the projects, as well as plans for paydown of any related temporary debt at project stabilization.

Asymmetric Additional Risk Considerations — Operating Risk

Governmental Payor Exposure

For LPCs that conform to the traditional business model (have more ILUs than SNF units), Fitch considers those at which Medicaid is a significant contributor to skilled nursing payor mix (more than 25% of net revenues) to be weaker.

ALU or SNF Expansion Not in Conjunction with ILU Expansion

A large expansion of an LPC's ALUs or SNF, which is not being done in conjunction with an ILU expansion, can also constrain its operating risk assessment, especially if the intent is to fill these

units with residents who do not currently occupy an ILU at the community. There is a high degree of initial costs associated with staffing these units that cannot be passed through immediately to revenues, as these units primarily will fill on an as-needed basis after construction completion, rather than through advance deposits.

Completion Risk of Expansion Projects

For an LPC undergoing an expansion project, substantially higher construction costs or timing delays can add to its operating risk. The presence or lack of the following key project elements informs Fitch's assessment of the risk associated with an expansion project. An expansion project that lacks these elements would justify a lower assessment of an LPC's operating risk, whereas the presence of these elements reduces the completion risk associated with an expansion project, which, in turn, would have a neutral effect on Fitch's assessment of an LPC's operating risk:

- guaranteed maximum price construction contracts with provisions for liquidated damages;
- engagement of an owner's representative/construction monitor, who has reviewed the contract and indicated contractor approach is reasonable;
- contractor providing a payment and performance bond; and
- satisfactory owner's and builder's contingencies.

Fitch also reviews the breadth of experience of the construction contractor in building similar housing types but recognizes that LPC expansion projects are typically low complexity, with short (under three-year) construction periods and, therefore, the ability to replace a contractor is not a constraining factor on the assessment of operating risk.

Financial Profile

The third key rating driver is a provider's financial profile. Having evaluated an LPC's revenue defensibility and operating risk, Fitch considers the entity's financial flexibility through a range of stresses intended to assess its relative capacity to repay debt and other liabilities. This analysis will connect the LPC's overall risk profile, within the context of its revenue defensibility and operating risk assessments, with its leverage and liquidity profile evaluated on a forward-looking and through-the-cycle basis, rather than a single point in time. The evolution of the financial profile, its low point and average through-the-cycle performance, is considered. The assessment considers direct debt liabilities, pension liabilities and capitalized lease obligations, as described below.

Fitch will develop cash flow scenarios to frame the financial profile assessment *(see Appendix B: Portfolio Analysis Model and LPC Scenario Analysis)*. These scenarios will include a base case and a stress scenario, as well as, in certain cases, additional sensitivities as described more fully below. Revenue and operating cost assumptions, together with planned capital expenditures and additional debt, are developed for the scenarios based on Fitch's review of a borrower's historical performance and expectations for future performance. Fitch's expectations reflected in the scenario will be shaped by the revenue defensibility and operating risk key rating driver assessments. Peer analysis will be used wherever appropriate and if ratings for a relevant group of peers with similar operating and revenue defensibility profiles can be compiled.

Expected funding sources for capital investments, including the mix of debt, initial entrance fees, equity and philanthropy, will be considered when assessing the provider's financial profile. Fitch reviews the timing, availability and assumptions regarding expected equity contributions and the effect on the borrower's balance sheet.

Fitch Scenario Analysis

Fitch will evaluate a base case cash flow scenario that serves as Fitch's expected case in the current operating environment. The base case serves as a starting point for further scenario analysis. Fitch's stress scenario will consist of a through-the-cycle scenario that incorporates a combination of revenue, cost or financial risk stresses as described in Appendix B. These stresses are formed by reference to historical performance and Fitch's expectations for the future. The stress scenario analysis will reveal levels and shifts in key operating, leverage and

liquidity metrics contrasted to the base case to determine if these are consistent with a stable rating through that stress.

Fitch's stress scenario highlights expected future financial leverage of the borrower, considering both through-the-cycle elements and forward-looking expectations. The measure of financial leverage considers the level of debt as it relates to the generation of total cash flow, and the level of debt as it relates to cash and cash equivalents. The relative strength of balance sheet and available resources to absorb changes and/or delays in revenues as well as to make strategic investments in operations or physical plant is a key element distinguishing credit risk within the sector.

The choice of the scenario used in the rating determination (the rating case scenario) is a key quantitative and qualitative input into the decision and is typically a central point of discussion in rating committees. Consistent with Fitch's through-the-cycle ratings approach, the rating case will typically be a stress scenario, although the base case may on occasion represent the rating case, particularly for those issuers already recovering from a severe stress or lower speculative-grade issuers.

Establishing the Base Case

The development of a base case begins with Fitch's evaluation of a borrower's recent historical performance based on a review of its audited financial statements and any unaudited financial information (typically interim statements) covering a period of at least three years (typically four to five years). The most recent unaudited financials will usually inform year one of the base case scenario. If provided with three quarters of year-to-date information, Fitch will add those results as a final year preceding the base case scenario.

The base case reflects Fitch's expectation of both historical and projected financial results. Fitch will consider as one indicator of future performance the level of consistency and predictability in the recent financial and operational performance of the borrower, its management team and its market. Fitch will generally start the base case analysis using revenue and expense assumptions reflecting the five-year average annual growth rate. However, there may be analytical reasons to diverge from these assumptions (e.g. nonrecurring events, impact from mergers/acquisitions) and Fitch will evaluate each borrower and develop and communicate expectations based on data.

Fitch will review borrower forecasts and feasibility studies by outside parties when presented; however, the Fitch base case will reflect Fitch's criteria and expectations (including Fitch's macro-economic assumptions).

Fitch notes that communities typically develop annual operating budgets and longer-term forecasts based on past performance and the organization's longer-term strategic plan. If the borrower's forecast suggests future performance is expected to track differently from historical results due to a significant capital project, a new acquisition or development of a new or existing service line, Fitch will consider the reasonableness of the assumptions that drive projected results. Forecasts that rely on aggressive demand assumptions, rate increases or cost reductions will be viewed with analytical caution in the development of Fitch forward-looking base case scenarios.

Stress Scenario Reflected in Forward-Looking Analysis

Analysis of the stress scenario considers potential performance under a common set of assumptions, thereby illustrating how stress cycles affect individual borrowers differently.

Scenario analysis is used to frame and present the base case and a stress scenario. The LPC Scenario Analysis tool, described in more detail in *Appendix B*, highlights how an issuer's financial profile can change through an economic/market cycle. While scenario analysis supports Fitch's through-the-cycle analysis, it is not a forecasting tool. Scenario analysis is a sensitivity tool that can be used to better differentiate among credits and their stability within different rating categories.

Fitch's ratings are meant to anticipate changes in an issuer's financial profile that can occur due to normal cyclical variations. Economic or market downturns are inevitable, and variations in financial performance in many cases can be observed. Fitch believes that ratings should account for this. On the other hand, broad shifts different from the ebb and flow of a normal economic

cycle may also occur. A scenario analysis helps make the distinction between the two and helps communicate both rating sensitivities and what is already anticipated in the current rating.

The typical stress assumed in the stress case scenario for IDRs of 'BB' and above will generally reflect a market downturn affecting investment values and may also incorporate revenue, net entrance fee and cost stresses commensurate with those that an LPC would encounter in its business cycle based on the LPC's specific characteristics, risk attributes and experience. The scenario analysis is meant to establish benchmark measures of liquidity and leverage that are incorporated in the rating through the cycle.

The trend in use of cash and investments to subsidize operations will be reflected in the scenario. Declines due to funding of capital projects or other specific uses may be carried into the scenarios where such declines are expected to occur.

Cash to Adjusted Debt

Future financial leverage in its stress case scenario is reflected in cash to adjusted debt. The ratio measures the total amount of cash, unrestricted investments and debt service reserve funds (DSRF) available to retire an organization's long-term adjusted debt. High values *(see Rating Positioning Table on pages 17-18)* imply greater flexibility in meeting and managing debt obligations. Total cash to debt is reported as a percentage and is calculated as follows: cash, unrestricted investments and DSRFs divided by adjusted debt (including current and long-term debt, draws on lines of credit, unfunded pension liabilities below an 80% funding level, and an applicable level for off-balance sheet debt obligations in the form of capitalized operating lease expense).

Maximum Annual Debt Service Coverage Ratio

The MADS coverage ratio *(see Appendix A for definitions)* is used when evaluating rated organizations to determine its level of cash flow cushion relative to its MADS. The resulting value is expressed as a multiple. Coverage against actual annual debt service (AADS) is also taken into account in the analysis, which reflects the amount of equal-ranking and senior debt service due (principal and interest) in the current year. Where a borrower incorporates balloon indebtedness or bullet maturities, Fitch will request a smoothing debt service schedule to conform to the treatment under the indenture or loan agreement. Fitch will consider these ratios in the context of expectations for additional cash flows to be generated from any projects, as well as plans for paydown of any related temporary debt at project stabilization.

Assigning IDRs: 'B' Category and Below

The 'B' rating category is typically a transitional rating category addressed in surveillance reviews rather than new issuance ratings. LPCs facing material default risk will be rated in the 'B' or below rating categories. When distinguishing between 'B' and lower category credits, Fitch typically assesses an entity's business model and operating profile, effectiveness and appropriateness of management strategy, sustainability of the capital structure and liquidity risk, and the influence of Asymmetric Risk Additive Considerations, in addition to credit metrics.

For a borrower with a base case financial profile indicating little capacity to navigate adverse economic conditions and a rating in the 'B' category or lower, Fitch will use the base case as the stress case scenario. Movement to a 'B' category rating will be considered where material default risk exists but a limited margin of safety remains. For the positioning within the 'B' category a consideration must be given to available liquidity resources when considering whether material default risk exists and a margin of safety remains following the breach of a maximum annual debt service coverage test, for example. Moreover, entities exhibiting a more resilient business model, a history of successful strategic planning and execution, positive of cash flow, a feasible deleveraging plan and a commitment to improved performance are likely to be positioned higher within the 'B' category. Those exhibiting a stressed business model, limited success with strategic planning and execution, difficulty maintaining positive of cash flow, a questionable deleveraging plan and limited incentive to improved performance are likely to be positioned lower within the 'B' category.

Generally, those LPCs with very weak cash-to-adjusted debt, as presented in the Ratings Positioning Table, with no expectation of improvement (i.e. repayment of temporary debt with initial entrance fees from an expansion project) are likely to be rated below 'BB' category regardless of their revenue defensibility or operating risk assessments. Similarly, a 'B' category rating may be indicated for those entities with 'b' assessments of revenue defensibility and

operating risk regardless of their cash-to-adjusted debt metric, as these resources would be expected to quickly erode and provide only a very limited margin of safety given their extraordinarily weak business profile attributes.

A qualitative assessment will be made of default risk and the extent of any remaining margin of safety indicated by the issuer's overall operating and financial risk profile, such as strategic plans to improve declining occupancy or weakened operating performance. In this respect, Fitch will evaluate the likelihood of success of these strategies, the margin of safety that remains to absorb execution risk, and the essentiality of success of these strategies to the LPC's ability to service its debt. The rating definitions associated with rating category 'C' also provide additional guidance (see Rating Definitions for details).

A movement to 'CCC' could occur if Fitch determines that the LPC's cash flow and liquidity margins have evaporated and a favorable adjustment of the business or financial profile is unlikely or if an entity's business model has been compromised, as evidenced by extraordinarily weak revenue defensibility or operating risk. For example, LPCs unable to reverse declining occupancy rates would be subject to substantial credit risk consistent with the 'CCC' category. Finally, entities in which strategic plans are uncertain, cash flow is consistently negative, are unable to cure financial distress and/or refinancing risk is acute would also typically be rated within the 'CCC' rating.

Movement to a 'CC' rating indicates that a default appears probable and is likely to be signaled by de facto insolvency or the commencement of a negotiated restructuring effort. Where a default-like process has begun, an issuer has entered a standstill agreement, or a default is an inevitable or imminent consequence following the breach of a covenant, a 'C' rating is likely to follow.

Liquidity Profile

In addition to the leverage metric analysis described above, Fitch also performs a liquidity assessment. The liquidity profile assessment evaluates the liquidity resources available to a borrower that drives its capacity to cover expected or unexpected operating costs. The first resource available to most issuers is periodic excess margin above operating costs that acts as a cushion to changing circumstances. A second source is unrestricted cash and investments in reserves, and a third is committed liquidity lines from investment-grade-rated financial institutions.

An assessment of a community's revenue cycle and collection practices and efficiency can have a bearing on Fitch's assessment of liquidity profile. Specifically, a build-up of accounts receivable, increased accounts payable balances and draws on working capital lines may foreshadow heightened risk of change in the financial profile.

A weak liquidity profile relative to operations can constrain the overall assessment of the issuer's financial profile. The key metric used by Fitch to measure liquidity is days cash on hand (DCOH).

An LPC's entrance fee type and refund provisions will have an impact on the level of balance sheet liquidity. Generally, Fitch expects communities with a large percentage of refundable contracts to have stronger liquidity metrics relative to communities with predominantly nonrefundable contract mixes. Communities with mostly nonrefundable entrance fee agreements enjoy somewhat more cash flow flexibility and could operate with lower liquidity levels.

Days Cash on Hand

DCOH plays an important role establishing the final rating within a specific rating category. DCOH is measured in the base case scenario as well as in the stress case scenario. The ratio measures the number of days that an organization could continue to pay its average daily cash obligations from its current unrestricted cash and investments. It indicates financial flexibility and cushion against declines in operating profitability and potential delays in payment rates and the revenue cycle.

Days Cash on Hand

DCOH is calculated by dividing daily cash operating costs into unrestricted cash and investments (excluding debt service reserve accounts). DCOH below 200 days is weak and is risk additive. DCOH of 200 days or above is considered neutral to the assessment.

Rationale for Pension Treatment in Leverage Metrics

Debt Equivalent Obligations

Defined benefit (DB) pensions are rare in the LPC sector; where they do exist, they represent a financial obligation that is long term in nature and uncertain in timing and amounts to be paid. This contrasts with defined contribution plans, which are a predictable annual commitment that does not give rise to a long-term liability. Fitch views unfunded DB pensions as being debt-equivalent obligations. The size of the reported liability and the annual payments necessary to amortize it can be subject to a range of institutional decisions regarding benefit levels and actuarial assumptions, economic trends and regulatory considerations. Changes in these factors may affect the size of the unfunded liability over time. However, the most important drivers of unfunded liability tend to be the level of actual returns on the investment portfolio supporting the pension when compared to a target return and the adequacy of the employer contribution actually made. Fitch will review the reported unfunded liability over time versus point in time. Material volatility in a plan's asset values due to market movement is less relevant to Fitch's assessment of pension-related risk than the plan's longer-term prospects for funding improvement over time.

FASB Plans

Some LPCs offering DB pensions are not-for-profit entities whose pensions are subject to federal regulations, which have shifted considerably in recent years and continue to evolve. In general, Fitch expects these issuers to manage their pensions within the existing regulatory framework, which includes provisions for calculating contributions and premiums for mandatory federal pension insurance.

Fitch's starting point for the pension analysis is the projected benefit obligation (PBO) as reported by the issuer, and for purposes of assessing leverage within the FAST analysis, Fitch recalculates the funded status assuming 80% of the PBO. Any resulting adjusted pension deficit is added to debt obligations in Fitch's forward-looking assessment of the financial flexibility. This adjustment to the PBO is intended to serve only as a proxy for capturing the impact of regulations on how pensions are likely to be funded, rather than a precise recalculation of actual liabilities.

The regulatory environment encourages issuers to manage up to an 80% funded ratio utilizing generally conservative investment return assumptions. Funding to 80% based on a lower discount rate generally corresponds to nearly fully funded levels using a normalized 6% long-term return assumption. To the extent that the regulatory environment shifts, Fitch will modify its approach to take into account the expected impact of these changes on a forward-looking basis. In addition, Fitch may incorporate pension contributions and other pension-related cash outflows in the stress case scenario to fully capture near-term liquidity risks from DB pension plans.

Some LPCs are religiously affiliated entities that are not subject to federal regulation but typically manage and report their DB pensions in a manner consistent with regulated plans, motivated by the need to attract and retain employees. Fitch's analysis of these pensions is identical to its analysis for regulated pensions, provided that there is sufficient information to conduct the analysis. Other healthcare providers participate in multi-employer DB pension plans that, while regulated, are jointly sponsored with organized labor and, like DB pensions of religiously affiliated entities, disclose only limited information. For multi-employer DB pensions, clarity on the status of pensions or their likely impact on finances may be limited. If such pensions represent, in Fitch's view, a material risk in its assessment of a health provider's financial profile, it could be reflected as an asymmetric risk factor *(see Information Quality section below)*.

Other Post-Employment Benefits (OPEB)

In most cases, Fitch does not consider the credit impact of other post-employment benefits (OPEB) in assessing the long-term liabilities of healthcare providers. For most entities providing OPEB, the level of benefits has proven much easier to change than pensions, and legal protections appear limited in most cases. In cases where OPEB is exceptionally large and not subject to modification, Fitch may incorporate OPEB as an asymmetric risk factor.

Rationale for Lease Treatment in Leverage Metrics

Recently enacted accounting standards establish principles reporting the assets and liabilities that arise from certain leases. For entities that have adopted these standards, Fitch will include the reported liabilities in its calculation of long-term debt and make further adjustments to income statement metrics for operating lease payments, if appropriate. Where these accounting standards have not been adopted, operating leases that function more like capital leases or debt will be capitalized in a manner described below.

Fitch views operating leases as a debt-equivalent form of funding for operational assets and will adjust its core leverage ratios to include the debt-like features of operating leases. Where operating lease payments are a substitute for long-term on-balance-sheet funding, Fitch will capitalize annual operating lease charges using a 5.0x multiple to create a debt-equivalent figure. This figure represents the estimated funding level for a hypothetical purchase of the leased asset and is included in Fitch's core leverage metrics. This enables a broad comparison between rated entities that incur debt to finance an operational asset and those that have leased it.

A multiple of 5.0x reflects assets with economic lives of 15 years, consistent with the mix of office space and medical equipment typically leased by an LPC, in a 6% interest rate environment. Higher or lower multiples may be used to reflect the nature of the leased assets, with higher multiples for LPCs with operating leases for assets with longer economic lives, such as entire buildings, and lower multiples for LPCs leasing assets with shorter economic lives. Use of multiples different from 5.0x will be noted in Fitch's research on the institution.

Rating Guidance: Applying Analytical Judgment to Align Key Rating Drivers and Ratings

Fitch's criteria in general fits a continuum of risk, from single site to single campus to single market to multiple market; all things being equal, a higher level of financial cushion is required from a single-site or single-market LPC to achieve the same rating as that of multiple-site LPC.

The results of the stress case scenario are used to assess the impact of change on key liquidity and leverage metrics. Together, these create a financial profile on a forward-looking and through-the-cycle basis that is aligned with revenue defensibility and operating risk to obtain an indicative rating level. The Rating Positioning table below provides guidance to the analytical outcome, aligning the assessment of the borrower's overall risk profile (through revenue defensibility and operating risk assessments) with its leverage and liquidity profile. However, the evaluation and importance of key rating factors are specific to the individual credit being considered.

The Rating Positioning table is the starting point in assessing the final rating. For example, ratings may be higher or lower than suggested by the table based on an analytical judgment made concerning whether there are factors present that suggest a higher or lower risk of a shift in capacity for meeting financial obligations than would be suggested by the rating derived from the table. Such factors could include, but are not limited to, greater weight given to revenue stability where a borrower has little to no competition, the presence of a large expansion project with execution and pricing risk uncertainty, or if the borrower has an unusually broad or narrow geographic footprint and/or revenue base. Furthermore, the table is predicated on a borrower having no asymmetric risk factors following an assessment of such factors, as discussed below.

Rating Positioning Table

Revenue Defensibility	Operating Risk	Cash/Adjusted Debt (%)				MADS Coverage (x)		
a								
	a	>100	31–100	20-30	<20	>2.0	1.3–2.0	< 1.3
	bbb	>110	41–110	20-40	<20	>2.2	1.2–2.2	< 1.2
	bb/b	>150	71–150	20-70	<20	>2.7	1.7–2.7	< 1.7
bbb								
	a	>130	41–130	30-40	<30	>2.3	1.3–2.3	< 1.3
	bbb	>140	51–140	30- 50	<30	>2.5	1.5–2.5	< 1.5
	bb/b	>190	101–190	30- 100	<30	>3.1	2.0–3.1	< 2.0

Revenue Defensibility	Operating Risk	Cash/Adjusted Debt (%)				MADS Coverage (x)		
bb/b								
	a	> 220	131–220	40- 130	<40	> 3.6	2.4–3.6	< 2.4
	bbb	> 250	161–250	40-160	<40	> 3.8	2.6–3.8	< 2.6
	bb/b	N.A.	> 250	40-250	<40	N.A.	> 3.8	< 3.8
Financial Profile		a	bbb	bb	b	a	bbb	bb
Suggested Category		A	BBB	BB	B*	A	BBB	BB

Source: Fitch Ratings

LPC's Vulnerability to Additional Debt

Fitch believes that all LPCs are prone to large-scale expansions and are vulnerable to downgrades when financing major capital projects. Given this potential vulnerability, Fitch could take negative rating action, including a downgrade, in advance of a project if Fitch believes a project will likely occur and could lead to a multi-notch downgrade for any LPC.

For these situations, Fitch will use the Capital Plan Risk Matrix (see chart below) as a framework to guide the analysis. The probability of large-scale capital plan or borrowing occurring and the potential magnitude on the rating should this occur are analyzed in the matrix. There are suggested rating actions depending on the outcome of this analysis; for example, a medium probability of occurrence and an elevated magnitude of impact on the rating would suggest a one-notch downgrade. Fitch will keep a rating lower than the financial profile assessment may indicate and relative to peers and/or downgrade the rating if a major capital project seems very likely in a three- to five-year timeframe or if the Rating Positioning table indicates limited rating headroom at a higher rating to absorb additional debt, even if no borrowing plans have been articulated, but Fitch deems are highly probable to occur.

Capital Risk Matrix

Impact/ Probability	Low	Medium	High
Low (1 notch)			
Elevated (2–3 notches)			
Severe (4 notches or more)			

Monitor developments of this risk. Reflect in Outlook and Sensitivities.

Negative Outlook

Factor into rating by one notch.

Factor into rating by one or more notches.

Factor into rating by a category or more. Decision point as to whether rating should be IG or below IG.

Source: Fitch Ratings

Fitch will analyze the following factors, among others, to determine of a project's probability: is there a pressing, often competitive reason, to pursue the project (i.e. need to build new ILs to counter a competitor's expansion or replace older IL units or an outdated health care center to keep the campus marketable); is this project opportunistic in terms of available land but no pressing need to pursue the project; or is the project dependent on some other event that must happen before the project can move forward (i.e. local approval needed to rezone the land).

Fitch will also qualitatively assess management's ability to sustain a material change to the entity's leverage profile in service of a capital project that it deems to be of competitive value to the organization, but may not be imminent. Fitch will factor that risk tolerance into the rating according to the Capital Plan Risk Matrix. To determine the potential impact to the rating, Fitch will estimate a reasonable potential borrowing amount based on disclosure from management and other available information and weigh that against the debt capacity of an LPC at the

current rating. Fitch will also factor in a management team's desire and willingness to pursue the project.

In situations where Fitch believes a project is being contemplated but determines that not enough detail is available with regard to timing, scope, entrance fee/monthly service fee pricing or cost or if there is potential for an LPC to design the project in phases, Fitch will calculate leverage headroom based on the Rating Positioning table and if limited, we would adjust the rating down (likely one notch and very likely with a Negative Outlook) to account for the possibility of a debt issuance. The Rating Positioning Table provides suggested thresholds to the levels of cash to adjusted debt and debt service coverage below which the current rating would be downgraded and, therefore, define the rating headroom to absorb additional debt. These thresholds will also be articulated in the rating sensitivities.

Asymmetric Additional Risk Considerations

The final rating assigned will also consider certain asymmetric risk factors that may affect the rating conclusion. These risk factors work asymmetrically, where only below-standard features are factored into the final rating levels, while more credit-positive features are expected to be the rule.

When multiple risk features exist, the IDR will likely be lower than the rating indicated by the Rating Positioning Table, possibly by multiple notches, based on the severity of the risks. For example, an issuer with a mid-range revenue defensibility assessment and operating risk assessments and net leverage consistent with a suggested analytical outcome of 'A' might only achieve an IDR of 'BBB+' or lower if debt structure were assessed to be weak, reflecting a material exposure to refinance risk or swap risk, or an IDR of 'BBB' or lower if debt structure and management and governance practices were assessed as weak. The final rating will reflect a qualitative assessment of the extent and impact of the asymmetric risk factors. The asymmetric considerations are discussed fully in Fitch's "Public Sector, Revenue-Supported Entities Rating Criteria".

Debt Structure and Contingent Liability Exposures

A weak debt structure will constrain the overall assessment of the issuer's financial profile. Absent unrestricted cash resources to retire substantially all debt, Fitch considers the following debt characteristics and terms consistent with a "Weak" assessment.

- Material exposure to refinance risk (use of bullet maturities; debt not fully amortized at maturity), which distorts near-term financial metrics and increases the uncertainty for both market access and the cost of debt at a future date.
- Highly sculpted and substantial use of deferred amortization instruments that materially distort near-term financial metrics.
- Material exposure to unhedged floating-rate interest. Fitch considers whether the unhedged portion of exposure, if any, would have a material impact to the borrower's financial profile under stressed interest rate assumptions.
- Material exposure to contingent liabilities, including swap and derivative contracts that include collateral posting requirements and termination events that require a payment of the current marked-to-market value of the swap contract.

For more information on Fitch's global approach to analyzing debt structures, see its master criteria report, "Public Sector, Revenue-Supported Entities Rating Criteria."

Management and Governance

The quality of governance and management is an important consideration when assessing the potential performance of a borrower over the life of the debt. Fitch considers this attribute to be asymmetric. Weak governance and management may cause the rating to be lower, all else being equal. In contrast, the presence of strong governance and management will be considered when evaluating the impact of stress scenarios and the ability of an issuer to manage through those stresses.

The effectiveness of governance and management is an important factor in assessing an organization's creditworthiness, as management's decisions and initiatives subject to the oversight and strategic direction of the governing body, such as a board of directors, can

ultimately determine an entity's long-term financial viability. Fitch generally focuses its commentary on management and governance practices where their effectiveness materially influences the rating decision.

Weaker characteristics of management and governance will constrain the rating, when analyzing the ability to execute on organization initiatives and plans as well as the capacity to manage through a business cycle:

- Lack of experience in key management positions or high levels of turnover in key management positions.
- Repeated failure to adopt budgets on a timely basis due to an absence of consensus in the governing body or resistance of key stakeholders.
- Failure to maintain open communications between the borrower and any relevant governing body, which may be revealed in unexpected operating changes.
- Weak or lack of forecasts and resource management plans.
- Limited or lack of policies and procedures.
- Official allegations of substantial corruption or breach of financial reporting law or regulation.

Legal and Regulatory Framework

Forming an opinion of the quality of the legal or contractual framework upon which many assumptions rest is a prerequisite to the credit analysis. For instance, the framework may be purely contractual or rely on statute or codified law, a particular statutory instrument, or the powers of a constitutional or statutory authority. Fitch forms a view on the clarity of the legislation and/or regulation, the scope of regulatory discretion and any effect this may have on facility performance or dispute resolution. The financing documentation (and if appropriate, any legislation it may depend on) or detailed summary documents (such as offering materials) are reviewed for key commercial elements and contract clarity, especially regarding allocation or transfer of risk.

Weaker characteristics of a legal and regulatory framework include:

- Contractual, regulatory or statutory framework dependent on untested or temporary legislation or regulation.
- Weak or no legal opinions; contracts not available for inspection.
- Less effective participation in regulatory process with negative regulatory outcomes.

Information Quality

The quality of information received by Fitch, both quantitative and qualitative, can be a constraining factor for ratings. Information quality may constrain the rating category to a maximum level or, in extreme cases, preclude the assignment of a rating. Information quality for the initial rating and surveillance purposes is considered when a rating is first assigned. Fitch must be confident that adequate ongoing data will be available to monitor and maintain a rating once assigned. Information quality encompasses such factors as timeliness and frequency, reliability, level of detail and scope.

The information provided to Fitch may contain reports, forecasts or opinions provided to the issuer or their agents by various experts. Where these reports contain matters of fact, Fitch will consider the source and reliability. Where the information is a forecast or opinion, Fitch expects these to be based on well-reasoned analysis supported by the facts. The status of the expert and the materiality of their forecast or opinion will also be considered in determining what weight may be given their forecasts or opinions. Factors such as experience in the jurisdiction or location; experience with the technology or transaction type; and formal qualification or licensing are often relevant. When forming its rating opinion, Fitch may place less weight on expert reports that lack clarity or contain extensive caveats or were conducted under less relevant circumstances. Such features may lead to adjustments in Fitch's financial or operational analysis. We expect experts to conduct their reports to professional standards. If possible, reports are compared with similar reports to highlight unusual or optimistic features.

The degree to which Fitch uses expert information will depend partly on the above issues and the relevance of the information to the identified key risks. Where available, if expert information does not address a material issue, but might be expected to, Fitch may request further information or make an appropriate assumption. Where Fitch determines that the reports are not sufficiently supported, complete or reliable, it may choose not to provide a rating.

Fitch considers this attribute to be negative when information is substantially based on assumptions, extrapolated or subject to material caveats, or if the data are often subject to delay, have a history of revisions or errors or are limited in scope.

Obligated Groups

LPCs rated by Fitch are typically part of an OG, which exclude certain entities whose revenues and assets are not legally pledged to the repayment of the OG's financial obligations and are segregated from the consolidated entity. Fitch will consider OGs to be separate entities that are "ring fenced" within a consolidated organization and Fitch's rating on the OG will not reflect the credit profile of the non-OG affiliates assuming, among other things, the members of the OG are clearly defined in bond documents; they publish their own consolidated financial statements, which do not include the non-OG subsidiaries; disclosure and legal documents clearly state that the OG is not responsible for obligations of the non-OG subsidiaries and those creditors have no recourse to the assets of the OG. If Fitch considers the OGs to be ring-fenced from the non-OG subsidiaries, Fitch also considers substantive consolidation of assets of the OG with the assets of the non-OG subsidiary to be an unlikely result if the non-OG subsidiary were to be subject to bankruptcy proceedings.

OG bond documents typically contain certain covenants governing asset transfers from the OG to a non-OG affiliate that are designed to limit permissible transfers to those that will not negatively impact the financial performance of the OG. If these covenants do not exist, the OG will typically take it upon itself to limit its financial commitments to non-OG affiliates to achieve the same outcome and preserve its financial health. In most cases, Fitch does not believe any incentive exists on the part of the OG to compromise its own financial position in the interest of supporting an underperforming non-OG affiliate. However, Fitch will evaluate the financial transactions between the OG and the non-OG affiliates to determine if such an incentive exists and will incorporate that into the rating accordingly.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Rating Assumptions Sensitivity

Fitch's opinions are forward looking and include analysts' views of future performance. The ratings are subject to positive or negative adjustment based on actual or projected financial and operational performance. The following is a non-exhaustive list of the primary sensitivities that can influence the ratings and/or Rating Outlook.

Revenue Defensibility: Ratings are sensitive to changes in revenue defensibility assumptions that affect the overall assessment. Changes in demand and occupancy, the competitive environment and business mix can change the final assessment.

Operating Risk: Ratings are sensitive to changes in operating risk assumptions, including expenditure flexibility, profitability levels and capital plans.

Financial Profile: Ratings are sensitive to changes in financial profile, including debt and other long-term liabilities.

Data Sources

The key rating assumptions for the criteria are informed by Fitch's analysis of information that is provided by obligors, financial advisors, underwriters and/or publicly available sources including, but not limited to, audited and interim financial statements; historical occupancy and turnover rates in the independent living and ALUs; payor mix in the SNFs; the residency contract; the entrance fee and monthly service fee pricing matrix; and housing price estimates in the community's market area.

Fitch typically uses obligated group audited financial statements in its credit analysis. However, there are instances where Fitch is asked to rate a newly formed entity that cannot provide historical audited financial results. In those cases, Fitch may base its analysis on historical pro forma financial statements provided by the entity. Similarly, Fitch may decide to base its analysis on an obligated group that is part of a consolidated entity's financial statements.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in our Ratings Definitions.

Appendix A – Key Terms

Term	Calculation	Significance
Capital Structure and Cash Flow Ratios		
Debt Service Coverage (DSC) (x)	Excess income + interest, depreciation and amortization expense - amortization of entrance fees + net turnover entrance fees received/MADS	A key indicator that indicates the ability of a borrower to meet debt service obligations, including the benefit of entrance fee receipts. A higher number is better.
Revenue-Only DSC (x)	Excess income + interest, depreciation and amortization expense - amortization of entrance fees/MADS	A key indicator that indicates the ability of a borrower to meet debt service obligations without the benefit of entrance fee receipts. A higher number is better.
MADS as % of Total Revenue	MADS/total revenues	Indicates the relative burden of debt service relative to total revenues. A higher percentage indicates less room for erosion in operating profitability. A lower number reflects a lighter debt burden.
Debt to Net Available (x)	Total debt/(excess income + interest, depreciation and amortization expense - amortization of entrance fees + net turnover entrance fees received) * (months/12)	Indicates the borrower's level of total debt against its annual level of core operating profits and net entrance fees available for debt repayment. A lower number reflects a lighter debt burden.
Capital Expenditures as % of Depreciation Expense	Net purchase of property, plant and equipment/depreciation expense	Indicates the level of capital reinvestment into the facility.
Average Age of Plant (Years)	Accumulated depreciation/depreciation expense	Estimates the number of years of depreciation that have been realized by the community. An increasing number may indicate that adequate resources are not being reinvested into the facilities.
Variable-Rate Debt/Total Debt (%)	Variable-rate exposure/total debt	Provides context for an issuer's existing capital structure.
Liquidity Ratios		
Cash to Adjusted Debt (%)	(Unrestricted cash and investments + debt service reserve funds)/(total debt + Fitch-adjusted net pension liability + capitalized operating leases)	Measures the ability of a borrower to repay debt from retained earnings. A higher percentage is considered stronger.
Days Cash on Hand	Unrestricted cash and investments (excluding debt service reserve fund)/ (cash operating expenses/365)	Measures the number of days a borrower can fund operating expenses from existing cash and investment position. A higher number is considered stronger.
Profitability Ratios		
Operating Ratio (%)	Cash operating expenses/cash operating revenues	Measures the ability to cover cash operating expenses through cash operating revenues, excluding entrance fee receipts. A lower percentage usually indicates stronger operating efficiency.
Net Operating Margin (%)	Resident revenue - (resident expenses - depreciation and interest expense)/resident revenue	Provides an indication of margin available from core operations for payment of debt service. A higher percentage indicates stronger profitability.
Net Operating Margin - Adjusted (%)	Resident revenue + net entrance fees received - (resident expenses - depreciation and interest expense)/(resident revenue + net entrance fee received)	Provides an indication of margin available from core operations + entrance fees received for the payment of debt service. A higher percentage indicates stronger profitability from operations and/or a high level of entrance fee turnover.
Other Terms		
Total Debt	Long-term debt + capital leases	
Adjusted Debt	Total debt + unfunded pension liability below 80% PBO + capitalized operating leases	Provides an inclusive evaluation of total long-term liabilities.

Source: Fitch Ratings

Appendix B — Portfolio Analysis Model and LPC Scenario Analysis

The size of an entity's cash and investment portfolio and the asset-allocation policy employed can have a significant bearing on creditworthiness, given the importance of financial reserves to ongoing operations and to an entity's credit rating. Fitch's Life Plan Community scenario analysis comprises two parts: the Portfolio Analysis Model (PAM) and the Scenario Analysis (SA).

Portfolio Analysis Model

Investment returns are inherently cyclical in nature and often tied to the broader economic backdrop. The purpose of the Portfolio Analysis Model (PAM) is to provide broad order of magnitude guidance of how an issuer's reserves or liquidity position (i.e. cash and investment portfolio) might be affected in relation to the general macroeconomic/cyclical scenario specified. PAM is used to generate a moderate, uniformly derived (but issuer-specific) portfolio stress as a means of evaluating an entity's relative financial resiliency through an economic/market cycle. PAM was developed to provide a plausible change in market value estimate of an investment portfolio over the course of an economic or market cycle. It is Fitch's view that such changes within reasonably anticipated ranges should be accounted for in the rating.

PAM is not a forecasting tool but, rather, provides a plausible outcome for through-the-cycle (TTC) analysis by generating a portfolio return estimate that is empirically based, objective and intuitive. Using each issuer's own specific asset allocation mix, we simulate how issuer portfolios might respond to the same negative market scenario.

Stressed and baseline PAM outputs are used as values in the rating and base case scenarios, respectively. The primary effect of a negative change in the investment portfolio value will be to decrease various liquidity metrics and increase various leverage metrics, key elements of the rating process.

For a full detailing of the methodology and assumptions used by PAM, please reference the "Public Sector, Revenue-Supported Entities Rating Criteria."

Scenario Analysis

The assessment of financial profile incorporates forward-looking base and rating cases by putting the portfolio return estimates generated by PAM into context within an issuer-specific cash flow scenario. The stresses imposed in Fitch's stress scenarios— portfolio returns, entrance fees, and/or profitability — allow comparisons between the relative performances of other issuers facing a similar set of stresses.

The scenario analysis should not be interpreted as a forecast of actual performance under stress; it is only intended to illustrate performance under given certain stresses and a set of assumptions for a specific issuer. Management is likely to respond to the declines in portfolio value and profitability in the stress case with available resources or expenditure flexibility. The availability of such flexibility will be factored in considered during the interpretation of scenario results.

Methodology and Assumptions

The scenario analysis uses data from issuer financial statements to create a 5-year forward look and model key ratios described in the criteria.

The benchmark assumptions used in the base case, stress scenarios and rating case are listed in the table below. These benchmark assumptions serve as starting points for the scenario analysis. Fitch's expectations for performance of the issuer, analytical judgement and external information are used to adjust the assumptions in the table below to create final assumptions for the scenarios. Such information may include projections provided by the issuer, organizational strategy and outlook; and debt issuance or capital investment plans.

LPC Scenario Analysis Default Assumptions

Line Item(s)	Fitch Base Case Scenario	Fitch Stress Case Scenario
Resident service revenue, amortization of advance fees, other operating revenue	Year-over-year growth at historical annual growth rate of revenues	Equal to base case.
Depreciation & amortization	Year-over-year growth at historical annual growth rate of expenses	Equal to base case.
Interest expense	Most recent implied rate applied to current year debt outstanding	Equal to base case.
Net entrance fees	Most recent historical average	Base case less a specified stress.
Gains and losses on investments	PAM portfolio sensitivity estimates corresponding to base case GDP growth, multiplied by unrestricted cash and investments, less dividends	PAM portfolio sensitivity estimates corresponding to stress case GDP growth, multiplied by unrestricted cash and investments, less dividends.
Unrestricted capital expenditures	Equal to depreciation & amortization	Equal to base case.
Interests and dividends yield	2.5%	Equal to base case.
Percentage of gains/losses realized (unrealized)	50% (50%)	Equal to base case.
Debt amortization	Total outstanding debt amortized over 30 years	Equal to base case.
Inflation	2%	Equal to base case.

Source: Fitch Ratings

Appendix C: Sector Risk Profile

Sector Scope

An LPC is an age-restricted community with independent living, and/or assisted living, memory support and skilled nursing services, offering residents a continuum of care on a single campus. LPCs allow residents to move between levels of care as required by their health status (physician and acute care services are not part of the services offered directly by an LPC). The aging in place and active lifestyle of LPC residents distinguish it from other senior living options and separately delivered care services. LPCs may be operated as single site communities or may be part of an enterprise that operates multiple campuses. Depending on the community, living accommodations can include cottages, townhouses, duplexes, apartments and hybrid-style units that have features of both townhouses and apartments.

Exposure to Market Demand and Pricing Risks

An LPC is exposed to competitive demand and pricing within a local or regional market area. Demand and pricing power are affected by competing housing and care alternatives as well as other LPCs within the relevant market area. Market position and barriers to entry can be important rating considerations.

The accessible market demographics for an LPC can be limited. LPCs function without subsidy; many individuals with low or even moderate incomes and net worth may not be able to afford this senior living and care option. LPCs typically charge an “entrance fee” and a monthly service fee for occupancy in the community. The entrance fee is typically funded by the sale of a prospective resident’s home, while the monthly service fees are usually paid from income sources such as pension receipts, Social Security income, distributions from 401(k) plans and investment returns. The demand for units can be affected by conditions in the local or regional housing market since home sales are typically a source of payment of the entrance fees.

Exposure to Actuarial Risk

All LPCs whose business model relies on payment of entrance fees are exposed in some degree to actuarial assumptions since the entrance fees are expected to cover or prepay a portion of future costs of the assisted living and skilled nursing services that are part of the resident contract. This risk is greater where the LPC is providing the assisted living and nursing care services with no increases in monthly service fees under the resident contract, which requires assumptions on healthcare and longevity contingencies.

Liquidity Boosted by Entrance Fees

The entrance fees collected by LPCs are typically unrestricted as to use and compose a major source of liquidity and a component of the funds available to pay debt service. A portion of the entrance fee is sometimes refundable when a resident departs the community. The refundable portion of an entrance fee is contractually determined and varies ranging from 90% of the amount paid down to a 0%. The resident contract stipulates when an entrance fee refund is required to be paid. The payment terms (i.e. timing) of the refundable portion of the entrance fee is an important credit factor, as it can have a material effect on a community’s cash flows and liquidity position, which ultimately leads to its ability to repay its financial obligations.

Non-Obligated Affiliates

Fitch typically uses obligated group audited financial statements in its credit analysis. Obligated group statements are sometimes not available when non-obligated affiliates do not have a material effect on consolidated financial results. In those cases, Fitch uses consolidated financial statements.

There are instances where an LPC operator or system owns and controls a non-obligated affiliate (e.g. new campus development or affordable housing facility) that can have a material impact on the system’s consolidated financial results. While Fitch believes that non-obligated affiliates with nonrecourse debt can be utilized without negatively affecting the rating on the obligated group, Fitch will analyze and evaluate the legal, financial, operational and managerial ties between the obligated group and the non-obligated affiliate to determine if there are any credit effects. Fitch will also analyze and evaluate non-obligated affiliates that have additive financial profiles or endowment balances that support the obligated group.

Explicit factors such as guarantees and liquidity support agreements are reviewed to determine enforceability against the obligated group and if they serve to strengthen the relationship. In certain circumstances, Fitch may choose to consolidate non-obligated affiliates if it believes there is a strong likelihood of ongoing support from the obligated group to a non-obligated affiliate beyond explicit factors.

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