THE
SeniorCare
INVESTOR
A Newsletter Published By Irving Levin Associates, Inc.
Volume 18, Issue 7
July 2006

Formation Capital Deals

Largest Private Sale of Skilled Nursing Facilities Goes To GE

For more than a year, the market knew that privately held **Formation Capital** was looking to recapitalize the vast majority of its skilled nursing holdings. The most talked about option was to transfer these assets into a newly formed Canadian REIT and to then take it public. There are some obvious downsides to being a public company, but the Canadian REIT alternative provided management with some flexibility that a U.S. REIT structure couldn't, especially with regard to acquisitions and some of the ancillary service businesses that come with them.

But the acquisition market over the past year has been so strong, with an abundance of cash looking for yield in a real estate market that has seen cap rates and current yields drop to the lowest levels ever, at least in the seniors housing and care markets. For the past two years, the action has been in the assisted and independent living markets, with scant attention paid to the skilled nursing side of the business, at least with regard to the high profile real estate investors (no, we haven't forgotten about the sales of **Mariner Health** and **Beverly Enterprises**). So while Formation Capital was looking into the REIT alternative, they simultaneously went down the path of an outright sale of their assets, and as the months went by, this option became more attractive, albeit more difficult to consummate. The months of negotiations finally resulted in the late June announcement that **GE Healthcare Financial Services** agreed to pay $1.4 billion for the six portfolios, which include 186 skilled nursing facilities with more than 21,000 beds in 21 states. This represents an historic transaction for GE, as well as for the skilled nursing industry, and less than one week after this sale was announced, Formation was back in the news with yet another substantial acquisition. But before we get into that, a little history lesson is called for to help describe the GE/Formation deal.

At the turn of the century (nice ring to it), the litigation crisis for skilled nursing facility operators in Florida had reached a crisis point, with liability costs and premiums going through the roof, if you could even get coverage in the Sunshine State. After being one of the most popular and sought after states for skilled nursing providers in the 1980s and most of the 1990s, Florida became a pariah state for investors, lenders, insurers and most operators, especially the large ones that the tort attorneys liked to go after because of the perceived "big pockets." Being a public company in Florida was akin to putting a red bull's eye on your back, and the sooner they divested their Florida operations, the better. The only major holdout was **Manor Care** (NYSE: HCR), one of the largest Florida operators, but a company that had a reputation of rarely backing down in fights with lawyers.

So in this nasty litigation environment, Beverly Enterprises decided it was time to exit the state, but it was not an easy process. The company had 49 skilled nursing facilities and four assisted living facilities with a total of 6,130 beds, and with the existing operating environment, there were not too many buyers willing to take the risk and pay a reasonable price. The definition of reasonable, however, was in the eye of the beholder. Then along came Formation Capital, a small financial buyer but with senior management that had a long history in the industry and a willingness to take a risk that others wanted to avoid. The key aspect was that Formation's management also saw opportunity where everyone else saw the whites of the attorneys' eyes.

Formation closed on the acquisition in January 2002 for a price of $165 million, or about $27,000 per bed and 0.62x revenues. The transaction was close to 95% financed, and GE ended up refinancing the original lender on the deal. Talk about a diamond in the rough. Formation hired newly formed **Seacrest Health Care Management** to operate the facilities, and in just three years occupancy increased from 84% to 92.5% and revenues jumped from

$285 million to just over $400 million, with margins increasing and deficiencies declining and the lawyers looking elsewhere for their bounty. While GE has not broken out the values for the six portfolios it purchased, our guess is that this original Florida portfolio was valued at well over $60,000 per bed.

A little over a year later Formation was back in the market in Florida, this time picking up **Genesis Healthcare's** (NASDAQ: GHCI) Florida facilities in a much smaller deal. This portfolio included nine owned SNFs, plus one leased SNF and one leased ALF, with little value attributed to these two. The $26.8 million price was close to $20,000 per bed and 0.29x revenues, with a cap rate of 10.5%, which had little meaning since the EBITDA margin at the time was a paltry 3.0%. Our guess is that within a year the effective cap rate was well above 20%.

Four months later, in September 2003, Formation closed on the purchase of **Mariner Health's** Florida skilled nursing facilities (a theme is developing here), which included 19 facilities with 2,385 beds. The purchase price was $86.0 million, or a whopping $36,000 per bed, which in some cases was less than 50% of what Mariner had paid for them. The price to revenue ratio was 0.60 and the cap rate was 15%. So at an average cost of $28,000 per bed, in less than two years Formation Capital became the largest owner of Florida skilled nursing facilities. While they might not have been sure whether they should have laughed or cried, they and their investors are now laughing all the way to the bank in what may go down as one of the best counterintuitive investment plays in the skilled nursing business ever. But Arnold Whitman and Steve Fishman of Formation Capital understood the business, knew the risks and had a plan to deal with the liability insurance problems that would lower their costs significantly below the sellers. What they couldn't know (or predict at the time) was how the capital markets for seniors housing would turn around in just a few years, driving cap rates down and investment demand up. That was the only "luck" part of the equation.

With geographic diversification a must, and no more Florida portfolios available at bargain prices, Formation next set its sights on **Centennial Healthcare**, a company that had gone public, been taken private and entered Chapter 11 bankruptcy protection. In a live courthouse auction, Formation outlasted the other bidders, paying more than it had thought would be the highest price. When the dust settled, the price came to about $133.5 million for 19 owned skilled nursing facilities, 40 leased facilities, two managed facilities partially owned in a joint venture and six other managed facilities. The total was about 67 facilities with close to 7,400 beds and revenues near $350 million. Since the closing, in August 2004, one lease was terminated and four of the managed facilities were purchased. Although not the highest priced transaction of the group, it was perhaps the most ambitious because of the size and a mixed past for the portfolio.

A year later, in September 2005, came the acquisition of what was known as the **Meridian** portfolio, which included four skilled nursing facilities in Maryland, two in North Carolina and one in New Jersey with a total of 1,087 beds. Formation paid $50.0 million, or about $46,000 per bed. The cap rate was 14.4% and the price to revenue multiple was 0.76x. Some bidders thought this was an inside job and that the facilities were worth more than that, but it may have been a case of sour grapes. These assets have been owned for less than a year by Formation, and it would be interesting to find out the value GE put on them.

And finally, just a few months ago Formation closed on the purchase of **Laurel Health Care**, a company that operates 23 skilled nursing facilities, four assisted living facilities and one independent living facility with 2,736 beds/units. The price was nearly $200 million, or about $72,000 per bed, but the per bed price goes lower when the value of the pharmacy business acquired is removed (GE is not buying the pharmacy business).

In the aggregate, Formation paid about $660 million for the six portfolios, or between $35,000 and $40,000 per bed when the leaseholds are factored out. After the initial transaction with Beverly, which was close to 100% financed, the rest of the portfolios had a more modest 80% financing. What this means is that the equity component for the six was under $150 million, which after doing a little simple math means that the equity investors, in the aggregate, had almost a fivefold return on their investment. As we said, this is simple math, because while there were common investors in the six portfolios, they did not invest in the same proportion in each portfolio. Also, because the initial investments were made at different time periods, each portfolio had a different return. For example, the investors in the Beverly Florida portfolio should have had the best dollar return as well as percentage return because of the high leverage, the low purchase price and the four years to improve the operations. The Laurel Health acquisition, on the other hand, was only a few months old and although we are sure investors made a profit, it will not be the astronomical one made on Beverly.

Kudos have to go to Arnie Whitman and the Formation Capital team, because rarely does a group get the timing close to perfect, both going in and getting out. Four years ago there were some sarcastic snickers in the market about making such a large gamble in Florida, but in this case, he who laughed first didn't make any money, and the gamblers laughed last. Four years ago it wasn't always easy for Formation to obtain the equity commitments they wanted at the terms they wanted; now, they probably have to take the phone off the hook. And to think there are only 11 people in Formation's office.

Now, what about GE? If Formation Capital is doing well, how can the buyer come out ahead? With 186 facilities, more than 21,000 beds and a cost of $1.4 billion, this is GE's most significant investment in seniors housing yet, and it signifies a strategic decision to do more than lend to the industry. After factoring in the Centennial leaseholds, the purchase price comes to more than $70,000 per bed, which is high any way you slice it when looking at historical averages (and this is for the real estate only). But the meaning of per-bed values only goes so far. The historical price-to-revenue multiple in the 1980s and 1990s was 1.0x to 1.1x, and we estimate that this deal is right in the middle of that range.

Neither party would disclose financial information, and while acknowledging that the $1.4 billion price tag does not include the "value" of the operations to the tenants, with an implied lease coverage of maybe 1.2x, the cap rate would in theory be around 10%. This is low, but there is the diversification factor of having six different tenants that does lower the risk for GE. Our guess is that the initial lease rate on GE's investment is between 8% and 9%, and given its low cost of capital, this is profitable from day one and a better return than it gets on some of its loans. And it still represents the highest real estate return around. And speaking of loans, GE is very familiar with the portfolio, since it had loans outstanding on all but the Centennial and Laurel Health portfolios.

Another important factor is that the median age of the portfolio is 22 years, which in the skilled nursing facility industry is considered quite young. And with 50% of the beds in Florida, that high of a geographic concentration could be risky, or so the argument goes. But there are cycles in everything (almost), and Florida nursing facility owners went through a very difficult time. Our guess is that GE believes that the sun will shine once again on the skilled nursing business in Florida, and that it has the operators in place to keep the rent coming in. The major question lingering in the market is what is GE's exit strategy with such a high cost per bed coming in? We will put our response in the form of another question. What is the exit strategy of all the investors paying $175,000 to $300,000 per unit for assisted and independent living facilities not protected by certificate of need regulations? The transaction is expected to close in the third quarter and will bring GE Healthcare Financial Services' real estate investments to over $4.0 billion.

We forgot to mention that while Formation Capital was buying one of the six portfolios, it had also put in a bid to buy Beverly Enterprises, setting in motion the auction of the nursing home giant that ultimately went to another private equity group. But only Formation would announce two of the largest deals of the year within a week of each other. Just days after the sale to GE was announced, Formation closed on the purchase of **Tandem Health Care** in a deal that had been in the works for several months.

Late last year, Tandem filed a registration statement to go public, but there were many in the market who believed the real intent was to sell the company instead. According to the S-1, Tandem owned 51 facilities, leased 19 and managed eight, owning or leasing 6,443 skilled nursing beds, 311 assisted living units and 128 independent living units, and managing 892 beds. The numbers may have changed slightly in the past eight months, but they are still close. The annual revenue run rate was more than $560 million with EBITDAR in excess of $80 million. Excluding the managed facilities, occupancy has averaged between 93% and 94%, which is quite high in the skilled nursing business and one of the best in the country for a company that size. Over 92% of the facilities are in four states, including Ohio (25), Florida (21), Pennsylvania (16) and Virginia (10), and the quality mix based on census is 39% and is over 54% based on revenue.

At a purchase price of $620 million, it looks like Formation is paying close to $90,000 per bed for the owned and leased assets. But the fastest growing part of Tandem may be its ancillary services. In late 2004, Tandem paid $57 million for a rehab, mobile diagnostic imaging and hospice business that had revenue of $63 million in 2004. Add to this Tandem's pharmacy business, and close to 20% of the purchase price (or more) could be allocated to these other businesses. That would take the bed price down to $70,000 or so. While still relatively high, this is a high quality portfolio in good states with exceptional occupancy. We understand that **JER Partners** is contributing about $150 million in equity for the deal, with between $60 million and $90 million of mezzanine financing from **Citigroup**. The balance of $385 million will be first mortgage debt provided by **CapitalSource**. So what's next, a run at Genesis Health?