FitchRatings

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

Sector-Specific

Scope

This criteria report details Fitch Ratings' methodology for assigning Issuer Default Ratings (IDRs) and instrument ratings to U.S. not-for-profit life plan communities (LPCs), formerly referred to as continuing care retirement communities. 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. Other senior living providers, such as standalone assisted living, memory support or skilled nursing providers, will 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 between 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 while maintaining operating profitability. 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 replaces the one of the same title published April 5, 2022.

Related Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (September 2021)

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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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 securities 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 15. The ratings are not formulaic or model driven, but require qualitative judgment to place metrics in an overall context for each borrower. Key Rating Factors may be present that support a higher 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

	aa	a	bbb	bb	b
Revenue Defensibility					
Demand Characteristics: Occupancy	N.A.	Strong demand: ILU occupancy approx. above 93%	Solid demand: ILU occupancy approx. 88%–93%	Weak demand: ILU occupancy approx. 86%–88%	Very weak or declining demand: ILU occupancy approx. less than 86% with expectations for further decline
Demand Characteristics: Market Assessment	Strong market position: LPC is highly competitive with its preferable location, amenities and incentives	Strong market position: LPC is highly competitive with its preferable location, amenities and incentives	Midrange market position: LPC is capable of competing with its preferable location, amenities and incentives.	Weaker market position: LPC struggles to compete with some aspects of preferable location, amenities and incentives.	Weaker market position: LPC is unable to compete effectively with or has location, amenities and incentives that are inappropriate for the market relative to alternatives.
	A multistate or multimarket LPC.	Single-site LPC in a growing market area or with a national draw poised to support healthy demand.	Single-site LPC in a stable market area poised to support consistent demand.	Single-site LPC in a declining relevant market area that evidences softening demand.	Single-site LPC in a declining relevant market area that evidences softening demand. LPC has a very limited or declining draw.
Pricing Characteristics: Rates and Affordability	Market assessment affords high degree of price flexibility. Rate increases occur regularly and are highly affordable relative to resident wealth and income levels.		Market assessment affords moderate price flexibility. Rate increases occur periodically and are affordable.	Market assessment affords little price flexibility. Rate increases are limited and sometimes unaffordable relative to resident wealth and income.	Market assessment affords virtually no price flexibility. Rate increases are rare, below inflation, or consistently unaffordable relative to wealth and income.

Key Rating Drivers

	aa	a	bbb	bb	b
	Weighted average entrance fees are highly affordable relative to home values and resident net worth.		Weighted average entrance fees are affordable.	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.
	Multistate or multimarket LPC with diversified exposure to pricing characteristics of any given market.		Single-site LPC with demand characteristics supporting high degree of price flexibility.		
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).	N.A.	
Operating Cost Flexibility: Cost Management	Expectations for very strong cost management with 5-year averages of:	Expectations for strong cost management with 5-year averages of:	Expectations for adequate cost management with 5-year averages of:	Expectations for weak cost management with 5-year averages of:	Expectations for very weak cost management with 5-year averages of:
	Net operating margin approx. above 17%	Net operating margin approx. 13% to 17%	Net operating margin approx. 3% to 13%	Net operating margin approx. 0 to 3%	Net operating margin approx. less than 0%
	Operating ratio approx. below 88%	Operating ratio approx. 88% to 93%	Operating ratio approx. 93% to 100%	Operating ratio approx. 100% to 105%	Operating ratio approx. above 105%
	Adjusted net operating margin approx. above 32%	Adjusted net operating margin approx. 28% to 32%	Adjusted net operating margin approx. 15% to 28%	Adjusted net operating margin approx. 11% to 15%	Adjusted net operating margin approx. less than 11%
	Other revenue sources such as investment income and contributions are diversified, consistent and expected to greatly enhance revenue.	Other revenue sources are consistent or diversified and are expected to enhance revenue.	Other revenue sources, are limited or volatile, and expected to only modestly enhance revenue.	Other revenue sources are limited or volatile and expected to detract from revenues and inhibit cost flexibility.	
Capital Expenditure Requirements	5-year average of capital expenditures to depreciation approx. above 250%	5-year average of capital expenditures to depreciation approx. 175% to 250%	5-year average of capital expenditures to depreciation approx. 95% to 175%	5-year average of capital expenditures to depreciation approx. 70% to 95%	5-year average of capital expenditures to depreciation approx. below 70%
	Average age of plant is best in the market and approx. below 9 years	Average age of plant is strong for the market and approx. 9 years to 10 years	Average age of plant is suitable for the market and approx. 10 years to 13 years	Average age of plant is weaker for the market and approx. 13 years to 16 years	Average age of plant is weak for the market and approx. above 16 years
Capital-Related Metrics	Revenue-only MADS coverage approx. above 2x	Revenue-only MADS coverage approx. 1.5x to 2x.	Revenue-only MADS coverage approx. 0.5x–1.5x	Revenue-only MADS coverage approx. 0x to 0.5x	Revenue-only MADS coverage approx. below 0x
Operating Risk					
Capital-Related Metrics (continued)	MADS/Revenue approx. less than 7%	MADS/Revenue approx. 7% to 9%	MADS/Revenue approx. 9% to 16%	MADS/Revenue approx. 16% to 20%	MADS/Revenue approx. above 20%

Key Rating Drivers

	aa	a	bbb	bb	b
	History of Debt/Net Available above approx. less than 3x	History of Debt/Net Available approx. 3x to 5x	History of Debt/Net Available approx. 5x to 8x	History of Debt/Net Available above approx. 8x to 12x	History of Debt/Net Available above approx. above 12x
Asymmetric Additional Risk Considerations	• Medicaid is a significant contributor to skilled nursing payor mix (more than 25% of net revenues) and a significant contributor to overall enterprise 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 page 15.				
Liquidity Profile	Liquidity profile assessments are informed by an LPC's days cash on hand.				

N.A. – Not applicable

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 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.

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 skilled nursing facility (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. The best positioned LPCs tout desirable locations, amenities—including the types of units and levels of care available—and marketing incentives, which lead not only the LPC market, but also the market for alternative senior care and/or housing options. 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 increase market incentives or experience declining or low occupancy rates. Fitch reviews historical occupancy and penetration rates, the depth of the waitlist and comparative fees and unit sizes between facilities to assess the level of saturation in the market area.

Furthermore, competition from home healthcare, standalone ALU, memory support and alternative providers has increased over time and is affecting demand for senior living services. 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 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 miles–15 miles around the community. However, some LPCs have regional or national draws and are considered destination communities, which provides somewhat more demand flexibility and enhances revenue defensibility.

A market area with strong demographic trends would include a sizable resident population nearing average age of entry, relative property values well in excess of the LPC's weighted average entrance fees and net worth metrics well above monthly service costs.

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.

Multistate/Multimarket LPCs

LPCs with multistate or multimarket operations are considered to have the strongest market assessment, and this is the primary differentiator between a 'aa' and 'a' assessment of revenue defensibility, assuming their overall occupancy levels are not weak or declining. Retirement community systems operating in multiple states or LPCs with multiple campuses and/or drawing on geographic diversity strengthen revenue defensibility and reduce the impact of turnover, even if individual campuses are underperforming or undergoing significant capital projects that temporarily disrupt services.

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

Since an LPC's residency contract type has a strong influence on the community's financial results and metrics, Fitch includes the contract type as an operating risk attribute. 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.

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. Due to the healthcare liability risk, Fitch views type A facilities as having a higher operating risk profile relative to facilities that offer type B, type C or rental contracts.

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.

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.

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 believes that LPCs have an adequate degree of expenditure flexibility, as a large portion of staffing cost is directly related to the provision of resident services and care. 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.

For most LPCs, revenues consist primarily of monthly service fees on ILUs and ALUs, and per diem charges for skilled nursing care; amortization of entrance fees (noncash); investment income; net assets released from restrictions; contributions; and ancillary revenue generated from gift shops, beauty parlors and alternate dining venues. To provide a better analysis of core operations, Fitch classifies contributions and realized capital gains/losses as non-operating revenues. Interest income and dividends are included in operating revenues due to the greater certainty of receipt of those revenues.

Salaries, wages and benefits are one of the largest components of an LPC's expense base. Fitch evaluates expenditure flexibility in the context of collective bargaining constraints, staffing levels, the use of agency nurses and part-time employees, and annual salary and benefit increases. Market area demographics and the competitive profile will also have a strong influence on a provider's ability to manage its labor costs. Markets experiencing strong population or employment growth or those that are highly competitive may allow communities less flexibility in controlling prevailing wage and benefit packages. The degree of labor cost flexibility is influenced by regulatory factors, particularly for 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 midlevel 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.

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 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 net operating margin (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. Routine capital reinvestment costs for most LPCs tend to be very manageable. 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. Communities that do not maintain average capital expenditures at or near depreciation expenses over time or maintain stable average age of plant metrics are considered to have weaker facility reinvestment.

Other Capital-Related Metrics Used to Assess Operating Risk

In many instances, the capital requirements to construct, improve and maintain retirement community facilities are significant. LPCs typically need to generate robust cash flows and build substantial liquidity positions to produce adequate financial profiles to support their growth plans and operations. Therefore, 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 the risk of its capital needs 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

LPCs with concentrations in skilled nursing services or significant governmental payor exposure could be more vulnerable to revenue pressures. Fitch considers LPCs that derive the majority of their revenues from skilled nursing services and/or at which Medicaid is a significant contributor to skilled nursing payor mix (more than 25% of net revenues) and a significant contributor to overall enterprise revenues 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. However, entities are migrating skilled nursing services to less costly alternatives to care for post-acute patients. Additionally, Medicare's new patient-driven model is shifting reimbursement patterns. These programs can negatively affect the services and payments provided in SNFs, which can cause an LPC to experience financial pressure. In addition, 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.

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 case, 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.

Base Case Informs Scenario Analysis for Fitch's Stress Case Scenario

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 case 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 case 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.

Leverage Profile Key Focus of Fitch's Stress Case Scenario

Fitch's stress case 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.

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 page 15)* 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 maximum annual debt service (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 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.

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 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: 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

New accounting standards will 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.

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). The most recent unaudited financials will usually inform year one of the base case scenario. If Fitch is 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 grounded in the facts.

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 Case Reflected in Forward-Looking Scenarios

The stress case analysis 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 case. 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 between credits and their stability within different rating categories.

Fitch's philosophy is that ratings should 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. 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. It is the purpose of the scenario analysis 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.

Assigning IDRs: 'B' Category and Below

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. Given the limited number of defaults in this sector, metrics are not useful for scaling ratings from 'B' to 'C'. 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. In this respect, the rating definitions associated with rating categories from 'B' to 'C' provides guidance. See Issuer Default Ratings definitions.

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 LPCs 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 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 on 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.

Rating Guidance: Applying Analytical Judgment to Align Key Risk Factors and Ratings

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 in context of 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 weighting 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)			
aa	aa	> 140	40–140	< 40	N.A.	> 2.9	1.3–2.9	< 1.3	N.A.
	a	> 160	60–160	< 60	N.A.	> 3.1	1.4–3.1	< 1.4	N.A.
	bbb	> 180	90–180	20–90	< 20	> 3.4	1.9–3.4	1.3–1.9	< 1.3
	bb/b	> 220	130–220	60–130	< 60	> 3.8	2.3–3.8	1.4–2.3	< 1.4
a	aa	> 170	80–170	< 80	N.A.	> 3.2	1.6–3.2	< 1.6	N.A.
	a	> 190	100–190	30–100	< 30	> 3.4	2–3.4	1.3–2	< 1.3
	bbb	> 200	110–200	40–110	< 40	> 3.6	2.2–3.6	1.2–2.2	< 1.2
	bb/b	> 240	150–240	70–150	< 70	> 3.9	2.7–3.9	1.7–2.7	< 1.7
bbb	aa	> 190	100–190	30–100	< 30	> 3.5	2.3–3.5	1.3–2.3	< 1.3
	a	> 210	130–210	40–130	< 40	> 3.7	2.3–3.7	1.3–2.3	< 1.3
	bbb	> 220	140–220	50–140	< 50	> 3.9	2.5–3.9	1.5–2.5	< 1.5
	bb/b	> 270	190–270	100–190	< 100	> 4.2	3.1–4.2	2–3.1	< 2
bb/b	aa	> 240	160–240	70–160	< 70	> 4	3–4	1.8–3	< 1.8
	a	N.A.	> 220	130–220	< 130	N.A.	> 3.6	2.4–3.6	< 2.4
	bbb	N.A.	> 250	160–250	< 160	N.A.	> 3.8	2.6–3.8	< 2.6
	bb/b	N.A.	N.A.	> 250	< 250	N.A.	N.A.	> 3.8	< 3.8
Financial Profile		aa	a	bbb	bb	aa	a	bbb	bb
Suggested Category		AA	A	BBB	BB	AA	A	BBB	BB

N.A. – Not applicable
Source: Fitch Ratings

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 indicative rating, 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.

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 assisted living units; payor mix in the skilled nursing facility; 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 be asked to base its analysis on an obligated group that is part of a consolidated entity's financial statements. Obligated groups exclude certain entities whose revenues and assets are not legally obligated for the repayment of certain financial obligations. While Fitch's rating applies to the obligated group, Fitch will evaluate the legal, financial, operational and managerial linkage between the obligated group and the non-obligated affiliates.

Limitations

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

Appendix A – Key Terms

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.
Adjusted Debt to Capitalization (%)	Total debt/total debt + deferred revenues from nonrefundable entrance fees + unrestricted net assets	Indicates the size of debt, compared with the adjusted net worth of the entity. A lower percentage indicates a lighter overall leverage position and reflects capacity for additional debt.
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 stress 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 case scenario – 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 and stress case scenarios 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.

The majority of ratings in the sector ranges from the 'BB’ to ‘A’ category, although individual ratings can be assigned higher or lower due to specific credit features and profile, such as exceptional balance sheet resources or an expansion or repositioning project that encounters a challenging economic environment. The ratings generally fall into the 'BBB' category mostly as a result of the sector's balance sheet strength relative to its operating profile.

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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