Skilled Nursing Investment Framework

Skilled nursing plays a vital role of delivering care to patients following hospital discharge and offers the best cost-benefit proposal within the post-acute continuum. From an investment perspective, skilled nursing has driven some of the best risk-adjusted returns we have seen across healthcare and real estate. Returns include an attractive combination of annual rent payments and price appreciation. Cash flows to investors are highly defensive, given the triple net rental payment structure and the inherent needs based care delivery business model. Despite the positive historical trends of the sector at large, there exists a deviation of returns within the sector requiring a selective due diligence process. Solid Rock Group has developed a rigorous investment framework in order to drive investment outperformance. We combine a data-driven approach with a qualitative selection of best-in-class managers in order to identify exclusively off-market opportunities on behalf of investors.

SOLID ROCK GROUP

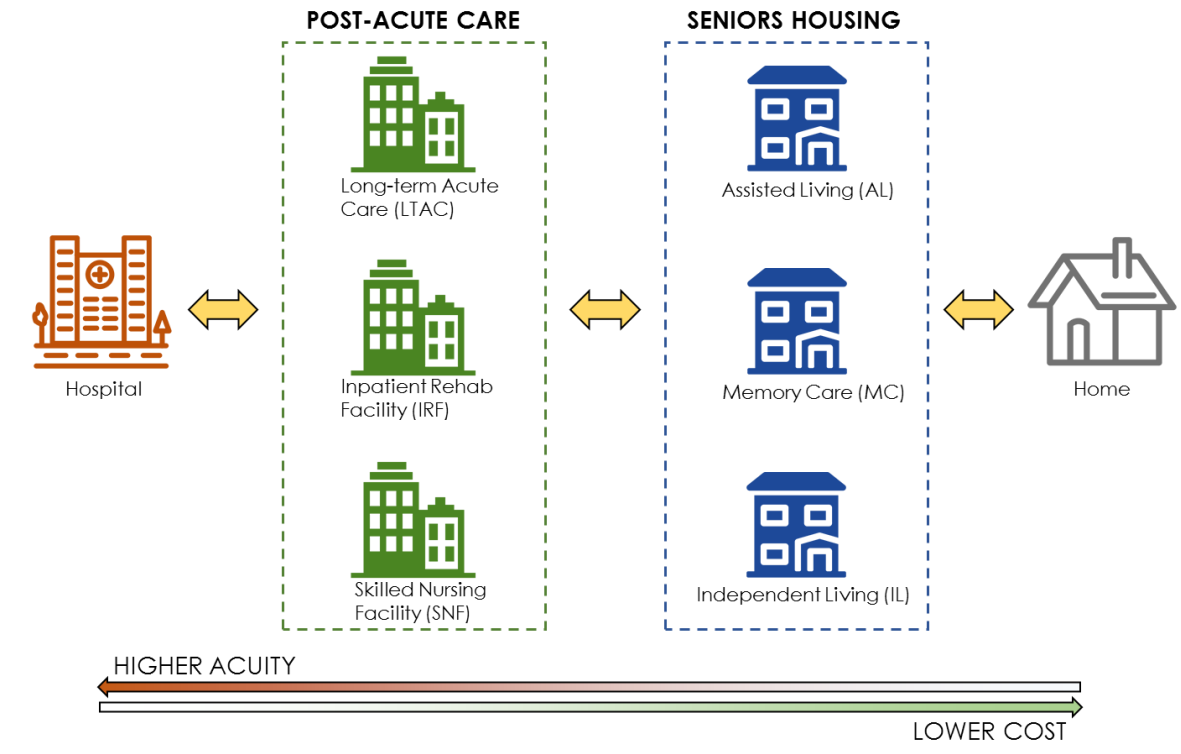
Sebastian Paquette, CFA
Director of Healthcare
sebastian@solidrockgroup.com
(860) 834-0428

Pierre Qian
Senior Analyst
pierre@solidrockgroup.com
(972) 914-2897

Sector Positioning within Healthcare

The ultimate success of a senior living or skilled nursing investment lies in the understanding that value is driven by the service of care delivery and lifestyle improvement. The analysis of asset value, such as construction, positioning, location, and relative age (to be discussed later), is important as well but is secondary in importance to driving financial results. The positioning of senior living and skilled nursing is best described within context to the care continuum, or acuity-based transitions of care (see exhibit 1). At the ends of the spectrum are the inpatient hospitals, where surgeries are therapies are delivered for the most intensively acute patient population, and the home, where care generally consists of diagnostics, maintenance therapies, and prophylactics. Skilled nursing facilities derive their patient population from two sources: 1) discharges (referrals) from inpatient hospitals for patients in recovery and in need of consistent monitoring and treatment by skilled nursing and trained staff (also known as skilled mix or transitional care), and 2) the custodial long-term care of the indigent and sick Medicaid population.

Exhibit 1: Sector Positioning



Source: Solid Rock Healthcare

Solid Rock Healthcare Skilled Nursing Facility Investment Framework

Skilled nursing provides a critical component of the post-acute care continuum. In fact, 73% of the total cost of a 90-day episode of care (from procedure at hospital to stable recovery at home) is controlled by a skilled nursing facility (64% of direct cost and 9% readmissions). We therefore underwrite a long-term position in the US healthcare system. However, skilled nursing typically derives 85% of its revenues from government reimbursement (Medicare and Medicaid). We believe the recently enacted and proposed changes to Medicare and Medicaid will increase operating disparities in the sector and ultimately create attractive growth opportunities for forward-looking operators able to demonstrate a value proposition to payers and providers. Ultimately, the higher risk associated with government reimbursement is incorporated into the more attractive valuations and returns profile of skilled nursing investments relative to independent living (see exhibits 2).

Exhibit 2: Valuation Framework

Propco Valuation Framework, median range

Property Type	Cap Rate	CoC	$/Unit
IL	5.5%-7.0%	10%-13.0%	$135k-$285k
AL/MC	7.0%-8.0%	12.0%-14.0%	$110k-$265k
SNFs	8.0%-9.0%	14.0%-18.0%	$80k-$130k

Opco Valuation Framework, median range

Property Type	EV/EBITDA	EBITDAR margins
IL	9x-12x	30%-40%
AL/MC	7x-9x	25%-35%
SNFs	6x-8x	10%-20%

Source: Solid Rock Healthcare

Solid Rock Healthcare Skilled Nursing Facility Property "Propco" Investment Framework

Investors can achieve exposure to the skilled nursing sector primarily through two avenues- acquiring the property and leasing to an operator, or investing directly in the operator. A property acquisition involves a de-risked NNN (triple net) lease payment from the operator, where the operator will be responsible for running the facilities, all operating expenses, insurance, property taxes, and capital expenditures in order to keep the properties competitive. The lease payments are inflated by annual escalators at a minimum of CPI, typically 2%+ annually. The typical lease rates (rental cap rates) for skilled nursing are 8%-9%, representing a typical valuation per unit of $80,000-$130,000 (see exhibit 3).

In addition to the NNN structure of the lease payments (which shields the investor from volatilities in insurance premiums and capex charges), we look to de-risk the investor from potential changes in government reimbursement by use of a healthy rent coverage ratio (EBITDA/annual rental payment). We typically look for investments with a 1.3-1.5x rental coverage, which means the operator EBITDA can fall by 30%-50% before the rental stream is at risk (see exhibit 3). We will only consider investments of 1.0x-1.2x if we believe we can negotiate a significantly above market cap rate and we are able to underwrite a turn-around improvement in fundamentals driven by a recently installed quality operator or management company. Our assessment of the operator is described in more depth in the next section "Opco Investment Framework." We have identified single site opportunities ($10mn total enterprise value, $3mn-$5mn equity investment) to large portfolios valued at $100mn-$1bn+. Regardless of size, we look for assets that are a part of an operators portfolio which represents significant geographic market share in a specific healthcare market. This ensures a better seat at the table with regards to negotiations with managed care insurance plans and acute hospital referrals.

While capex is the responsibility of the operator, we look for an age of assets and relative age of assets as we have experienced a correlation to patient and hospital preference, particularly for skilled mix business (Medicare and managed care). We would consider capitalizing the cost of an initial capex program in our acquisition underwriting, in the event of an older asset where the seller is under-capitalized if we see solid value in a capex investment (we use a 20%+ return on cost threshold). We prefer states where barriers to entry are higher, including states with CON (certificate of need) requirements or new construction moratoriums. While rental payments are pre-established, we consider average age and construction limitation regulation in forecasting rental coverage over a multi-year period.

Exhibit 3: Solid Rock Healthcare Skilled Nursing Facility Property "Propco" Investment Framework

✓ Quality and experience of operator	Solid Rock assessment (see opco framework)
✓ Rent coverage	1.3x-1.5x (higher is better)
✓ Geographic concentration	Part of operator portfolio >6 per market
✓ Facility age	<20 years (or compelling capex value add)
✓ Relative age to competition	10+ years newer than competition
✓ New construction	CON state or moratorium state
✓ Refinancing	Ability to lever 80%-85% with HUD debt at 3%-4%
✓ Annual escalators	2%-3%
✓ Valuation	8%-10%+ cap rates
✓ Cash on Cash returns	14%-18%+
✓ IRR	18%+

Source: Solid Rock Healthcare

HUD debt availability for skilled nursing facilities: Cheap, high leverage, non-recourse

A particularly attractive component of skilled nursing investing is the access to cheap government-backed HUD (US Department of Housing and Urban Development) debt. The availability of this debt can be assessed in our due diligence period through a standardized portfolio review and subsequent acceptance which includes total principal of debt permitted. A HUD originator will then price the debt, which is available at 3%-4% coupon rates including 25-30 year amortization schedules. Leverage levels can be quite high at 80%-85% and the debt is non-recourse. As such, the initial investment cap rates can be levered for cash on cash returns in the mid to high teens annually for propco investments.

Solid Rock Healthcare Skilled Nursing Facility Operator "Opco" Investment Framework

The second approach to gaining exposure to skilled nursing is through a direct investment in an operating company. We typically see the acquirer interested in retaining and incentivizing key management, either through an acquisition of only 75% or through a promote structure based on improvements in EBITDA, margins, or M&A. In addition, the highest quality operators typically have access to various sources of existing capital, including HUD loans, bank loans, revolvers, private equity, and REITs (which typically provide the financing for property sale-leasebacks and new developments). As such, we seek to differentiate our value proposition through the introduction of a growth JV fund following the initial investment, a strategic partnership to new or under-penetrated markets (such as China), or through our off-market and confidential acquisition advisory for long-term operators looking to diversify their financial exposure (such as a family-owned business).

The identification of quality operators in quality markets requires the most intensive due diligence process across the skilled nursing and senior living sector. Solid Rock Healthcare has a team of analysts dedicated to the discovery of motivated managers with a strong track record who are working proactively in their respective healthcare systems. Our framework (see

exhibit 4) consists of a combination of quantitative analytics and channel checks (industry conferences, site visits, management visits, and discussions with key payers and hospital executives).

The majority (78%) of total skilled nursing residents are long-term care residents who are too sick to transition to less acute providers of care such as assisted living or home health. The majority of these long-term care patients (83% of long term care, 65% of total patients) are custodial patients who can't afford other living options and are paid for by Medicaid. Medicaid compensates the skilled nursing facility an average of $196 per patient per day. The rates are determined by each States Medicaid office and the federal government will typically contribute 50% of the funding (known as FMAP). As such, rates can vary from state to state, which is a function of state politics and affordability (Medicaid is funded primarily by a state's general budget and therefore requires higher taxation or defunding of programs like education). The outlook for Medicaid reimbursement on a state by state level is a crucial part of our due diligence process.

On the federal level, the open-ended FMAP contribution (federal government will match whatever the state chooses to spend) has come under scrutiny by the Republican administration and Congress under the form of the proposed (and failed) Medicaid state block grants. These grants would establish a baseline (proposed as 2016) of cost per capita which would represent the federal contribution based on the total persons enrolled in Medicaid in the state. The contribution would then grow at medical CPI + 1% annually with the states responsible for balancing their budget. This concept received significant pushback by state administrators since the state would become increasingly responsible for Medicaid costs since Medicaid has been growing significantly faster than Medical CPI + 1% (Medicaid growth of 6% versus Medical CPI of 2.4%+1%=3.4%). While the outlook for Medicaid remains uncertain, we believe Medicaid will likely continue to represent the majority of patient days for skilled nursing facilities for the foreseeable future.

There is a lack of alternatives for this population (significant regulatory challenges for residents to move from skilled nursing to assisted living, e.g.) and Medicaid margins are already slim for providers. We look for higher margin operators as reductions in reimbursement, if enacted, would only dent earnings while putting a significant amount of competitors out of business (given that many operators are already operating at slim operating margins). The reality of insolvency in the event of reduced Medicaid reimbursement, and the consequent fallout of the $28 bn HUD (government) debt balance sheet, in our opinion reduces the likelihood of significant cuts or would result in a significant opportunity for market share gains or accretive M&A for best-in-class operators.

Medicare reimburses on average $500 per day for patients, 2.5x that of the $196 average Medicaid daily reimbursement (data per NIC). Managed Medicare (Medicare Advantage) is a supplemental health insurance product seniors elect to purchase and reimburses SNFs $440 per day. Medicare currently contributes 12.5% of patient days, while Managed Medicare contributes 5.5%. Medicare and Managed Medicare are the primary components of skilled mix (national average 24% of total patient days). Skilled mix delivers a significantly better EBITDA margin than Medicaid/non-skilled. We view the skilled mix of SNFs as the greatest lever for outsized investment returns and look for operators geared to dominate their local market skilled mix market share. We present the key indicators we look for in order to discover an investible operator in exhibit 4.

Exhibit 4: Solid Rock Healthcare Skilled Nursing Facility Operator ("Opco") Investment Framework

	Metric	Target expectations, stabilized
✓	Skilled care competency: readmissions rate	5-10% below market average
✓	Skilled care competency: skilled mix	20%+ (growing each year)
✓	General care: Medicare Star Ratings	3-5 (3 is important min threshold)
✓	HCIT integration	fully digital operations and reporting
✓	systems: coding capture	$PPD above market comparables
✓	systems: revenue cycle management	HCIT integration
✓	systems: procurement & purchasing	Scale agreements in place
✓	Provider relationships	Superior skilled occupancy vs market
✓	Managed care relationships	Strong formulary status
✓	Competency with new provider organizations	Value-focsued care: ACOs, Bundled Payments
✓	M&A: Integration	Management experience integration past M&A
✓	M&A: platform scalability	Strong incremental margins with additional M&A
✓	M&A: market experience	Management experience in unpenetrated markets
✓	Financial: track record	Responded well to challenges, steward of capital
✓	Financial: EBITDAR margins	15%+
✓	Employee retention, wage inflation	Wage inflation below rate inflation
✓	Market: State Medicaid rate outlook	Steady growth, stable budget
✓	Market: Medical liability legal landscape	Lack of major adverse rulings
✓	Market: New construction	CON or moratorium state
✓	Market: geographic concentration	≥6 per market
✓	Returns: IRR	20%+

Source: Solid Rock Healthcare

Exhibit 5: Example: Annual cash flow return to equity investors for skilled nursing opco and propco

Opco	
Initial Equity investment[1]	$300
Revenues	$1,000
Operating Expenses	$773
EBITDARM	$227
Management Fee (5% revenues)	$50
EBITDAR	$177
Rental Expense (1.3x coverage)	$77
EBITDA	$100
Capex (2% revenues)	$20
Interest cost (50% leverage @ 5.5%)	$17
Cash Flow to Investor[3]	**$64**
Cash on cash return on equity, Year 1	**21%**
EBITDA growth of 5% drives +8% in cash returns annually	

Propco	
Initial Equity investment[2]	$271
Rental Income	$77
Interest cost (85% LTV @ 3.5%)	$22
Cash Flow to Investor	**$55**
Cash on cash return on equity, Year 1	**20%**
Rent escalation of 2% adds 60 bps to annual returns	

[1] *Assumes 6x EV/EBITDAand 50% leverage*

[2] *Assumes 8.5% cap rate and 85% LTV (loan to value)*

[3] *Excludes property taxes, which are variable based on location (nat'l avg is 1.12% of assessed value)*

Source: Solid Rock Healthcare