THE
SeniorCare INVESTOR

Volume 26, Issue 12
December 2014

INSIDE THE WORLD OF SENIOR CARE MERGERS, ACQUISITIONS AND FINANCE SINCE 1948

IN THIS ISSUE

FORMATION CAPITAL BUYS IN U.S. AND UK

Two More Mega-Deals Top Off Record M&A Year

After the blistering pace of M&A activity the past several months, the number of transactions in November appeared to taper off a bit. But don't tell that to **Formation Capital**. In the span of five days, the private equity firm announced two transactions totaling just over $1.6 billion. Each of the two may end up being in the top 10 deals in terms of dollar value this year. And they come just 11 weeks after one of Formation Capital's operating companies, **Genesis HealthCare LLC**, agreed to take **Skilled Healthcare Group** (NYSE: SKH) private in a $710 million transaction.

In early November, Formation announced an agreement to purchase 261 nursing and residential care facilities in England and Scotland from **The NHP Group** that are operated by **HCOne**. The purchase price is approximately $761 million (GBP 477 million) which comes to about $61,000 per bed for the approximately 12,500-bed portfolio. Annual revenues are approximately $479 million. The majority of the properties were purpose built and the overall occupancy is approximately 88%. They are also relatively small, with an average size just over 45 beds per facility, and they are more comparable to a blend between the old intermediate care facilities and assisted living in the U.S., rather than skilled nursing. We did manage to visit one facility in Dundee, Scotland, and it was well-kept at the end of a cul-de-sac in a residential neighborhood. The UK has been a popular acquisition market recently, with **Griffin-American Healthcare REIT II** purchasing a portfolio of 44 care facilities for $472.2 million last year, and more recently, **Health Care REIT** (NYSE: HCN) and **Sunrise Senior Living** buying the assets and management company, respectively, in another transaction. Unlike many of Formation's acquisitions, these assets will most likely be viewed and operated separately from the rest of Formation's portfolio companies. Formation teamed up with its frequent acquisition partner, **Safanad Limited**, to complete the deal. **HCP, Inc.** (NYSE: HCP) will be providing $630 million of financing (GBP 394.5 million), consisting of GBP 362.5 million funded at closing plus up to GBP 32 million for future capital improvements. Including fees, this is expected to provide HCP with a blended yield of 8.2% over the five-year term. It also represents one of the largest debt financings for any REIT this year.

A few days later, Formation Capital announced, again teaming up with Safanad, an agreement to purchase almost all the U.S. assets of **Extendicare Inc.** (TSX: EXE), which includes a little more than 15,000 owned beds. This has been a transaction we have been waiting for, because months ago Extendicare disclosed that it wanted to exit the U.S. market and its more difficult regulatory and reimbursement environment. Part of the reason for the delay was the regulatory problem the company had in Kentucky, and after settling with the government, they were able to lease those 21 nursing facilities to a third-party operator, **Preferred Care**. With that accomplished, the way was cleared to complete its U.S. exit for all but 10 remaining properties that will still be held for sale. Formation had been rumored to be the leading candidate for the acquisition, and having 21 properties in Kentucky already leased out may not have been a bad development for them.

The purchase price came to $870 million, or about $58,000 per owned bed, consisting of $635 million of assumed debt and the rest cash, after $30 million of debt is paid off at closing. The debt includes $130 million of variable rate debt with a five-year term, plus about $544 million of HUD debt with an average remaining term of 29 years and an average interest rate of 4.3%. From a cost-of-capital perspective, that should be huge for Formation and its partners. Formation will get a bit of a hodge-podge of assets, including 141 owned and operated skilled nursing facilities that will be parceled out to four different operating companies that have been identified, four SNFs that are leased from other owners, 10 managed facilities and the 21 owned properties in Kentucky that are leased to Preferred Care.

The SeniorCare Investor

ISSN#: 1075-9107
Published Monthly by:
Irving Levin Associates, Inc.
268-1/2 Main Avenue
Norwalk, CT 06851
(203) 846-6800 Fax (203) 846-8300
info@seniorcareinvestor.com
www.seniorcareinvestor.com

Publisher: Eleanor B. Meredith
Editor: Stephen M. Monroe
Analyst: Benjamin Swett
Advertising: Jeanne Aloi

Single Subscription Rate: $697
Multiple Subscription Rate: $1,997

The financial performance of this portfolio has been somewhat stagnant from 2013 to 2014, which could be explained by the fact that Extendicare was already in the mindset of exiting the U.S. market, not to mention the focus on resolving its regulatory problems in Kentucky. For the year ended December 31, 2013, revenues and "adjusted EBITDA" were $1.152 billion and $83.1 million, respectively. This increased very slightly to $1.155 billion and $83.4 million, respectively, for the trailing 12 months ended September 30, 2014. We doubt the Formation management team will be content with a 7.2% EBITDA margin. One reason for the relatively low margin is because Extendicare includes its self-insured liability expense, and it has been increasing its prior period reserves by an undisclosed amount, resulting in lower reported EBITDA.

Extendicare reported the purchase multiple as 8.8x "normalized EBITDA" of $99.0 million for the trailing 12 months, which represents an 11.4% cap rate. This higher EBITDA number excludes the additional reserves for liability costs. The cap rate based on the "adjusted" EBITDA figure above comes to about 9.6%. Both are in range for large SNF portfolio acquisitions, but what is missing from this calculation is that 62.5% of the capital structure comes with 29-year, non-recourse debt with a 4.3% weighted-average cost. That provided a lot of pricing flexibility to Formation Capital, and perhaps allowed it to be beat out any potential REIT bidders because, in general, REITs do not like transactions with significant HUD debt. Consequently, before making any improvements to costs, census and operations, about 50% of the existing cash flow will go toward debt payments, with the remainder available for the investors or for capital improvements. In theory, that would represent a nearly 19% return on equity without doing anything. So despite what some may consider to be an aggressive cap rate for a somewhat troubled Extendicare portfolio, the acquisition should be at least a triple for Formation and its partners.

For Extendicare, the company will now be able to focus exclusively on its Canadian operations and it will receive net cash proceeds of approximately $222 million when the deal closes, which is expected to be in the second quarter of 2015. In addition, EXE will receive a minimum of $6.0 million annually for 15 years, which we assume was just another part of the deal and will come out of the improved cash flow that Formation Capital expects, plus the potential for some additional profit sharing. It will also receive proceeds from any sale of the 10 nursing facilities still held for sale not purchased by Formation Capital. These are located in Ohio (five), Wisconsin (three) and Washington (two) with just over 900 beds. **Guggenheim Securities** was the financial advisor and **Bennett Jones** was the legal advisor to Extendicare, and **BofA Merrill Lynch** and **Desjardins Capital Markets** acted as financial advisors to the buyer, with **Skadden, Arps, Slate, Meagher & Flom** as well as **Goodmans LLP** as the legal advisors.

So, what makes Formation Capital so successful, and what's next? And just for the record, when we refer to Formation Capital, we are really referring to it and all its various financial partners and investors over the years, without whom most of the deals would not have been possible. From an initial, counterintuitive investment in the Florida skilled nursing market for 49 facilities, bought for $165 million in 2001, or $26,900 per bed, to the billion-dollar deals of the past few years, Formation Capital has grown into a dominant, if not *the* dominant, investor in the senior care space. It is also a somewhat unique investor, as it competes with the Big Three REITs, but also partners with them, borrows from them and sells to them.

It buys portfolios, large and small, as well as entire companies and then strips out the real estate, when appropriate. It also has its portfolio companies buy other companies, as in the pending acquisition of Skilled Healthcare Group by Genesis HealthCare.

When Arnie Whitman started Formation Capital, there were doubters a plenty. Having learned the business at the side of legend Abe Gosman for many years, first at **MediPlex** and then at **Meditrust**, it was quite another thing to go out on your own without the backing and contacts of who at the time was perhaps the most powerful person in the industry. Yes, there were many who had to kiss the ring when arriving in Boston. And the timing and location of FC's first investments, the very troubled Florida skilled nursing market, was questioned by some and laughed at by others. And then there was his partner, Steve Fishman, with people wondering if that was a good fit. How long would it last with two people who seemed, at least at the time, to be polar opposites? How do you get off the ground when you are in different offices? Would Fishman's analytical training go well with Whitman's gut instincts? The face of FC has always been Arnie Whitman, but Fishman's importance behind the scenes has been crucial, from what we hear. There were a lot of questions, especially when the first Florida acquisition was followed by a $26.8 million deal ($20,000 per bed) for 11 Genesis SNFs in Florida in early 2003 and an $86.0 million purchase ($36,000 per bed) of 19 **Mariner Healthcare** SNFs a few months later, also in Florida. There was a public company fire sale going on in Florida because of the disruption in liability insurance and the constant "billboard" lawsuits, and these two partners sensed an opportunity, and no one else wanted to take the risk. The rest is history, and this partnership not only survived, but thrived, and there is nary a large deal in the market without Formation Capital having an opportunity to bid.

To date, including the three major current transactions that have yet to close (for a tidy $2.34 billion), Formation and its partners have been involved in well over $6.5 billion of acquisitions in the senior care market, with the vast majority involving skilled nursing facilities. In fact, it is fair to say FC has been the largest consolidator in the skilled nursing sector in the country (and maybe now outside the country), but unlike a strategic buyer which basically puts the acquisitions into the same bucket, FC can choose from a range of options in terms of who the operator will be, keeping the real estate or stripping it out, and with lenders maybe falling all over themselves to finance the acquisitions. It should be noted that FC has also sold at least $4.85 billion of assets in a constant chess game, making opportunistic and sometimes bold moves, and taking profits when the timing is right.

But perhaps the key has been Formation's access to equity capital. After the blockbuster sale of 186 SNFs to **GE Capital** in 2006 for $1.4 billion, which included most if not all of the original Florida facilities, Formation Capital was on the map in a big way with its first investment cycle completed, and at a substantial profit. Smiles and relief were all over the place as the transaction closed during the annual NIC Conference. With that sale done, lining up investors became much easier, and the key has been a ready stable of equity investors, large and small, who have been known to wire funds for a deal based on a phone call. That is the level of trust that has developed for Whitman's and Fishman's analysis and strategic thinking. One of the aspects of their investment strategy is that they have often seemed to be one step ahead of the competition. The Florida acquisitions were an obvious case in point, and while real estate ownership and value creation had always been what "it" was all about, later on they began to think about operations in a new post-acute environment. They bought the **Sun Healthcare** operations after the remaining real estate had already been sold off to a REIT; they took Genesis HealthCare private and then sold the real estate to a REIT at a higher price than the original deal for the business and real estate; they finally pounced on Skilled Healthcare, which owns most of its real estate, through Genesis, with the structure yet to be determined. And, we believe they may have been involved in the bidding contest for home health and hospice giant **Gentiva Health Services** (NASDAQ: GTIV) last summer, perhaps coming to the same conclusion that winning bidder **Kindred Healthcare** (NYSE: KND) did, that Gentiva's breadth of coverage would be a good fit with Genesis and its soon-to-be additional assets and operations from Skilled Healthcare. In fact, we have heard that Formation Capital is about to make a substantial acquisition in the hospice space. Readers may also be surprised that in 2013 they purchased a mobile imaging and clinical services company for approximately $750 million. And guess who the customers are? Senior care providers. So it is obvious that they are already thinking about where they want to be positioned as the post-acute environment evolves.

If they did try to buy Gentiva, it wasn't the first time they were not successful, and it won't be the last time either. In 2005 they made a run at the former **Beverly Enterprises**, forcing another private equity firm to up its price in a deal close to $2.0 billion. Three years later they tried to buy a major New England skilled nursing company, **Haven Healthcare**, in an $85 million deal that had more problems than anyone would like to admit, and ended up walking away. While we are sure there are others we don't know about, you can't always be the winning bidder, and if you are, then there becomes an issue of discipline. So far, that has not been a problem for FC. And so far, that may explain how they have been successful buying at market lows (all those Florida SNFs) as well as market highs (Genesis HealthCare just before the Great Recession). The key has been knowing how to structure the acquisition and what the longer-term plan is, when and how to sell, and having equity that is patient enough, or trusting enough, to allow the team to do what they do best. And speaking of the team, as FC grew, the founders knew they needed someone to actually run the business, which is not an easy task with so many moving parts and new acquisitions coming in the door, while Fishman and Whitman sourced the deals. Hiring Brian Beckwith away from GE in 2011 seemed to be the proverbial no-brainer, and it seems to be working like a charm.

So what's next? In addition to overseas expansion (did we mention the new rehab and wellness center in China?), we believe we will see an expansion out of the traditional comfort zone of senior care real estate assets. Not that FC will be ignoring the juicy deal or two, but there is always that focus on what's next in the post-acute market. Whether it is other post-acute services with or without real estate, such as the pending hospice acquisition, is anyone's guess, or possibly something in the technology sector that could change the way we take care of the elderly. They know the market well enough to have many ideas, and equally as many opinions, and the only thing that is definite is that we will not be bored reporting on their activities.