GENESIS TO BUY SUN HEALTHCARE
A Changing View On The Future Of Skilled Nursing

A fter a relatively quiet acquisition market in seniors housing and care in 2012, at least compared with the near record dollar volume in 2011, as well as the largest number of publicly announced transactions since the 1990s, activity seemed to heat up towards the end of the second quarter. It was nothing huge in terms of dollar volume, and certainly nothing like last year in transaction volume, but a slightly noticeable change seemed to be in the air. Perhaps it was boredom among the various deal junkies, perhaps cash-heavy investors grew tired of earning 1% (if that) on their cash, or maybe it was just that some good opportunities became available. Most likely, it was all of the above, and all we hear is that the fourth quarter will be very active, despite the election uncertainty (and maybe because of it).

The exciting news in June, of course, was the announcement that Genesis HealthCare had agreed to purchase Sun Healthcare (NASDAQ: SUNH) in the largest skilled nursing transaction since, well, the owners of Genesis sold their real estate to Health Care REIT (NYSE: HCN) last year in a $2.4 billion transaction. Genesis agreed to pay $8.50 per share, representing a significant premium over the $5.28 closing price on the day the deal was announced.

SCOTUS, POTUS...HOCUS, POCUS
Supreme Court Upholds ACA, But Uncertainty Remains

W hile it is not up to us to opine whether the Supreme Court (SCOTUS) was playing politics with its final decision released in late June, any time there is something for all to cheer and decry, you just get that feeling that someone was trying to reach a middle ground. And that someone, obviously, was Chief Justice Roberts, when he opined that the Affordable Care Act (ACA) was constitutional, using the argument that the individual mandate was allowable under the law because it was within the taxing powers of Congress. Although the democrats don’t want to call it a tax, and prefer a penalty, it is pure semantics because either way, it will cost some taxpayers real money, whether they buy insurance or pay the tax, err, the penalty.

Most people thought Roberts was leaning the other way, and they were caught off guard by the “tax” opinion. Perhaps he watched a few speeches...continued on page 2
senting an approximately 38% premium to the closing price before the announcement. Since Sun split into two companies in late 2010, with the owned real estate assets transferred to a new REIT, Sabra Health Care REIT (NASDAQ: SBRA), Sun’s shares have ranged from a high of $15.01 per share prior to the CMS preliminary Medicare announcement in April 2011 to a low of $2.06 in the aftermath of Bloody Friday three months later on July 29 when the actual cuts were announced.

It had been difficult for most skilled nursing stocks to recover from that bad news, but Sun was particularly hard hit, partly because it no longer owned any of its assets and had a significant lease exposure to Sabra, and investors began to question (mistakenly) the ability of Sun to survive. The company had sufficient cash, and a friendly landlord with intimate knowledge of its operations, so survival was not really the issue; it became more a question of whether the best it could do was tread water as a standalone company in the new reimbursement environment with what

will only be increasing reimbursement pressures. Management obviously decided the company would be better off as part of a larger entity, and instead of worrying about protecting their jobs, they did what amounts to the right thing for their shareholders, employees and customers.

So what is Genesis buying? On an annualized basis from the first quarter of 2012, Sun has $1.834 billion of revenues, $209.1 million of EBITDAR and $63.55 million of EBITDA. The EBITDAR margin was 11.4%, down from 13.8% in the first quarter of 2011, and the EBITDA margin was 3.5%, down 6.2% from the year ago quarter. Sun’s EBITDAR margin was 200 basis points lower than both Kindred Healthcare (NYSE: KND) and Skilled Healthcare (NYSE: SKH), but 550 basis points lower than National HealthCare (NYSE: NHC). Currently, Sun operates 158 skilled nursing facilities, 10 assisted living communities, two independent living communities, 13 combined SNF/ALF/IL buildings and seven mental health facilities with a combined total of 21,444 beds in 23 states. In addition, Sun operates a contract rehab therapy business with a revenue run rate of $256 million, a hospice business with revenues of $60 million and a staffing business with revenues of $92 million.

From a valuation perspective, the purchase price is approximately $270 million, which includes the assumption of debt minus the cash on hand ($44.77 million as of March 31, 2012). Based on that, the EBITDA multiple is about 4.25x. After capitalizing the leases at 10% and deducting an assumed value of the therapy, hospice and staffing business of about $200 million, we derive a per-bed value close to $70,000, but we really don’t think that is the way to look at this. Genesis is buying operating cash flow, not real estate, and it is that 4.25x cash flow multiple that appears to be the most relevant. Another way to also look at it is that Genesis is paying 0.15x revenues for the $1.834 billion of annualized revenues, which they hope to grow. As an editorial note, Sun valued the transaction at $275 million, which is what everyone else is using, and we assume they are deducting its cash expense of negotiating and closing the deal.

On the skilled nursing side of the business, which is the main part of Sun, about 15.3% of the patient days in the first quarter were Medicare, plus another 4.0% from managed care and other insurance. But when the other properties are added in, Medicaid represents 63.3% of patient days, up 110 basis points from a year ago, while Medicare is 14.0% (down 50 basis points) and private pay and insurance represents the remaining 22.7%. On a
revenue basis, Medicaid is just 45.9% of total revenues. So while this is not too bad, there is certainly room for improvement, both on the Medicare census as well as the overall operating (EBITDA) margin. We suspect this is what the owners of Genesis are counting on.

For a little history, **Formation Capital** and its equity partners purchased Genesis in July 2007 for approximately $1.83 billion, or $70,900 per bed, but when the managed beds were removed from the calculation, it was closer to $87,000 per bed, and both calculations include the ancillary businesses (worth at the time between $75 million and $125 million). Genesis had about $1.6 billion of revenues, EBITDA approaching $200 million and cash flow of about $10,000 per bed. Less than four years later, capitalizing on a very strong REIT market, which resulted in a record amount of REIT acquisitions, Genesis sold its owned real estate assets to Health Care REIT for $2.4 billion, or $133,000 per bed. Since Genesis was a private company, there were no publicly available financial data, but based on the new HCN lease and the stated coverage ratio, we had derived that Genesis had an annualized EBITDAR of about $300 million, and EBITDA of $100 million (after the new lease payments). That was a tidy profit of about $570 million for the investors in Genesis, and they still owned the Genesis operations.

As part of the sale to Health Care REIT, HCN received an option to purchase 9.9% of Genesis for $47 million for the term of the lease. Although very theoretical, that put a valuation of $475 million on the operating company, most likely in several years if all worked according to plan. We have to assume that the 9.9% interest with the option will be diluted with the Sun purchase on some sort of a pro rata basis, but there has been no word on that yet. Regardless, whether it was George Hager and his team at Genesis, or some prodding by the investors (probably both), the financial results at Genesis certainly did improve over just a few years and created significant value. And we hear that while margins have obviously not been helped by the Medicare cuts, the company is still doing well and has plans to be the winner in the brave new world of health care reform and the growing role of the post-acute sector in an environment where lowering costs will be crucial.

Those plans now involve the purchase of Sun’s operations, but it won’t be easy. So, what are the benefits of this transaction for Genesis? First of all, it just about doubles the size of the company to $4 billion in annual revenues and more than 420 properties. Size can be important, but it can also become unruly (just ask the former **Beverly Enterprises**, which topped out at close to 1,000 nursing facilities before tumbling). If one can manage
a large size, which in particular means maintaining a high level of quality and consistent staffing (a tall order for anyone), size will be increasingly important as other health care providers, especially on a regional basis, look to partner with companies such as Genesis. And they will be looking to partner with companies that can not only control costs, but deliver a high enough quality of care to minimize re-hospitalizations.

Another benefit of buying Sun will be the synergies, primarily dealing with costs. When Formation and its partners purchased Genesis, the plan was not to just let it grow organically, but to put in place a scalable platform to really create a post-acute juggernaut. That is why not many people were surprised about the Sun announcement. Sun has an annual G&A expense of $64 million plus something called “operating administrative costs” of nearly $50 million. Combined, these represent 6.2% of revenues, and while we have not heard how much will be redundant with Genesis, a decent estimate would be up to 50%, which would add more than $50 million to the combined bottom line.

The third benefit is the combination of their ancillary service businesses. Sun’s combined revenues from these services is about $400 million annually, and while Genesis does not disclose its numbers, it is estimated that on a combined basis the ancillary revenues would approach $1 billion. And that is definitely something that Genesis wants to grow, with the full backing of its investors. With continued growth, we could possibly see a spin-off of all the ancillary businesses in an IPO at a later date as part of an exit strategy for the investors. The problem with that is it would take away from the whole concept of a low-cost, post-acute provider to partner with other providers in the health care food chain to keep costs down and quality up in an increasingly cost-hostile environment. Regardless of the exit strategy, it will have a powerful presence in the market.

And finally, another benefit, although not direct, will be the fact that Sabra’s CEO, Rick Matros, has more than 25 years of experience in the skilled nursing business, and he “gets it.” One of his previous companies, Regency Healthcare, was based in California and at the time probably had more managed care contracts at his skilled facilities than any other company in the sector. He understood the evolution of the business, and that was 20 years ago. He should be a great financial partner to Genesis, as well as a very useful sounding board.

Now to some of the risks. The first one is size, and with this acquisition Genesis is diluting its geographic concentration story significantly. When Formation and its
partners purchased Genesis, 71% of the beds were in just four states, 91% in just seven states, and excluding West Virginia, 97% were in the Maine to Maryland corridor. Including West Virginia, Sun has just 55 properties in this corridor. That leaves 135 buildings outside of Genesis’ regional zone, with nine states having five or fewer properties. Sun also has 20 properties in Kentucky, a state that one large chain (Extendicare REIT, TSX: EXE.UN) just exited, with the help of Ziegler, because of the litigation environment, and 15 properties in California, which is straining under larger than expected budget deficits (thank you Governor Moon-Beam), and we all know how much love the liberal California legislature has for the skilled nursing providers taking care of their elderly population. So adding more than 15 states to its portfolio is not going to be easy, and it may be one reason why our estimates for the overhead savings, at least in the short term, may be too high. We are not sure what Genesis will do with some of the outlier states, but Sun has already been shedding some of its dogs, like several of its Oklahoma properties that came with a long-ago acquisition.

The second risk, which is present in almost all large acquisitions, is the cultural difference between the two companies. They are different companies operated from different coasts, and while we can’t speculate as to how they will deal with that, it could make the integration a bit more difficult than they hope for. The flip side of that is that Genesis management will presumably make the case to Sun employees about how they will be part of a larger, better, more powerful company that will be better positioned to excel in the uncertain world of health care reform (perhaps I can write George Hager’s speech for him). All kidding aside, those Sun employees who have a passion for the business will understand what he is talking about and will want to join the bandwagon. But they will also want more resources to fight the good fight (money and staffing), and that may be slow in coming. In addition, there may be a little snobbery factor, as we would rate the Genesis facilities higher on the quality scale than the Sun facilities overall, and we have to assume the Genesis employees also think that to be the case. But they will get over it.

In most large acquisitions, there are always some negatives to weigh against the positives, but in this transaction the positives to Genesis tip the balance, especially relative to the price it is paying. Not to say that it is cheap, as the Sun shareholders come out winners in this, but 4.25x cash flow is not too bad, especially since that is before any cost savings and revenue enhancements. But the real winner is Sabra Health Care REIT, which will have a much stronger tenant, and a tenant that represents
about 75% of its assets right now, although that has been steadily decreasing. The other REITs which own a minority of Sun’s properties, including **Omega Healthcare Investors** (NYSE: OHI) with 40 facilities and **Ventas** (NYSE: VTR) with five properties, should be very happy campers with the transaction.

Perhaps the bigger story in this transaction is that it is the largest acquisition ever in the skilled nursing sector (in terms of beds and revenues) where there was no real estate involved. Real estate was always king because you could leverage it, sell it to raise cash, touch it. But it is almost as if Genesis and its investors are making a statement that the health care service aspect of skilled nursing will be growing so much in importance that real estate will be taking a back seat (the third row?) for the indefinite future, as long as they can deliver on the operations. One only has to look at the valuation of LTACs, which routinely sell at “per-bed” prices in the hundreds of thousands of dollars. Does anyone think there is something exceptional about that real estate? No, it’s in the service they provide, and the acuity levels they deal with. And this is where the good nursing facility companies will be heading. Genesis already sold most of its real estate, and now the merger of two “OpCos” will create the largest skilled nursing operating company in the country. It will not be easy, but management has a definite plan as to where they see the future and their role in it. If George delivers, he will be the man of the hour (no pressure).
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