

2nd Annual Senior Living Finance Conference

**“Entrance Fee
Refunds-Attractive
in the Market,
Difficult to
Manage”**

by

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Presentation Outline

- Section 1 - Introduction & Basic Concepts
- Section 2 - Funding Issues
 - Risk Management
 - Accounting
- Section 3 - Business Issues
 - Marketing
 - Credit-worthiness
- Section 4 - Questions/Answers

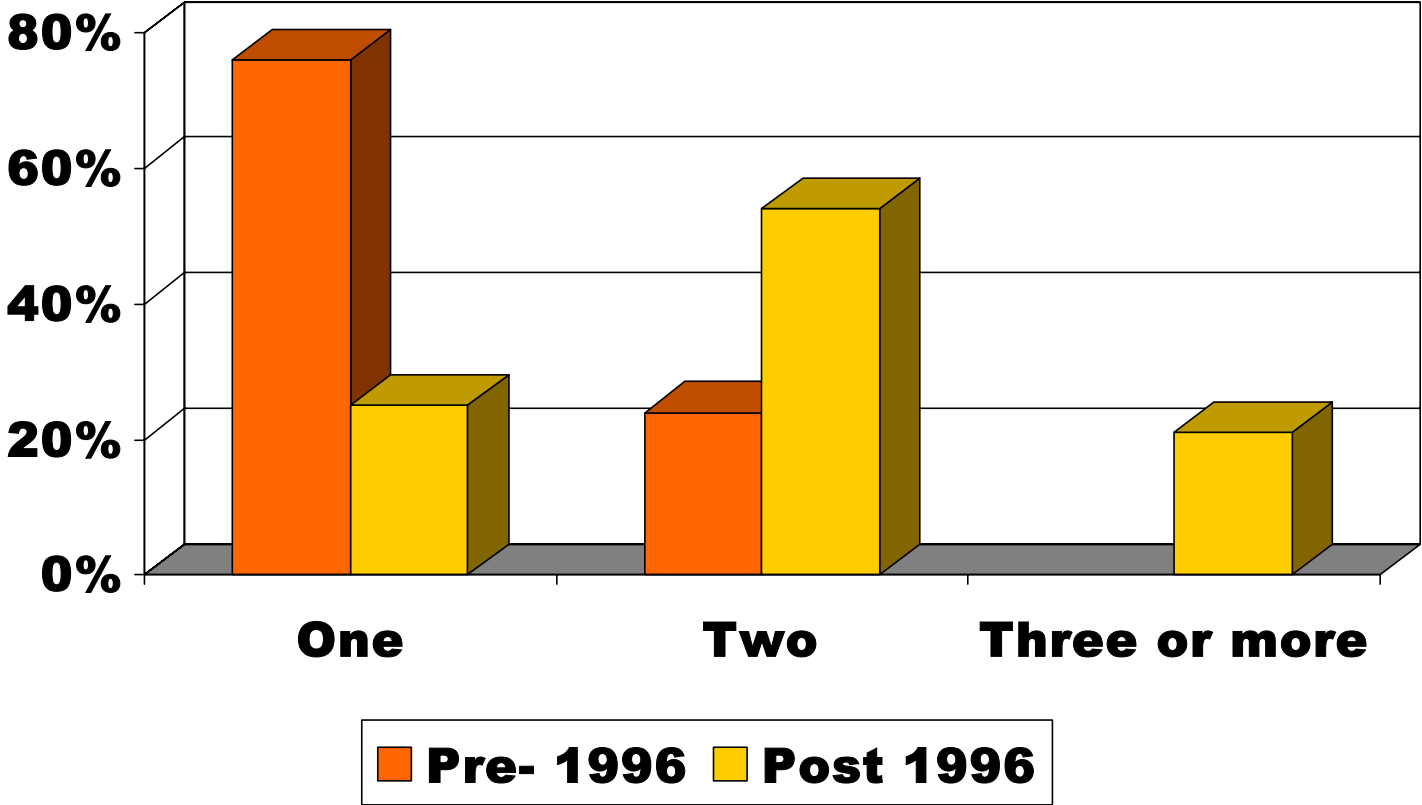
Introduction

- One of the key revenue sources for a CCRC contract is the entrance fee
- The entrance fee is a prepayment of future monthly fees
- In the 1970s, an entrance fee refund was unusual

Introduction (continued)

- The current trend for CCRCs is to offer residents several contract (refund) options
- Challenge for CCRCs in the new millenium is not whether to offer a minimum refund option, but how to fund these options

Distribution of Number of Contract Types Offered



Glossary of Terms

- Minimum Refund Provision
 - Refund payout may decline initially, but level percent thereafter
- Nonrefundable Refund Provision
 - No refund payout or payout is decreases to \$0 (prorated) over a fixed number of months

Glossary of Terms (cont.)

- Actuarial Pricing Model (refer to “APM”)
 - Compare present value of revenues with present value of expenses
- Actuarial Self Funding of Refunds
 - Set aside a portion to accumulate with interest to expected refund payout
- Market Funding of Refunds
 - Mimic what competitors are charging

Glossary of Terms

- Pay-As-You-Go Funding of Refunds
 - Portion of entrance fees receipts from turnover is used to payoff refunds due
- Third Party Funding of Refunds
 - Purchase insurance to pay refunds for death benefit
- Escrow Funding of Refunds
 - Escrow entire refundable portion immediately

Funding Issues

- Is a minimum refund option necessary?
 - Consumer demand
 - Competition
 - Public policy and consumer protection

Risk Management of Refund Liabilities

- What are the possible funding options?
 - Cash flow funding
 - Pay-as-you-go
 - Self-funding
 - Market
 - Escrow
 - Actuarial
 - Third party insurance

Philosophical Decision

- Board should give direction about their beliefs regarding the “fairness” of the CCRCs pricing policies
- Should benefits (related to contract provisions) promised to the current residents be funded by their fees or from the fees or future generations; if yes, concept is call “generational equity”

Pay-As-You-Go Funding

■ Methodology

- Project annual apartment turnover
- Estimate annual refunds
- Add amount to nonrefundable entrance fee
 - $\text{Projected refunds} \div \text{Projected turnover}$

■ Advantages

- No advance funding requirements
- Simple to estimate since based on one-year projections

Pay-As-You-Go Funding

■ Disadvantages

- Does not meet generational equity objective
- Depends on similar units being reoccupied by residents select same type of refund option
- May have substantial variances in annual costs that affects DSCR
- May face significant annual funding deficits particularly in times of low occupancy

Market Funding

■ Methodology

- Obtains fees from competitors
- Set spread between nonrefundable and minimum refundable contract to match competitors fees

■ Advantages

- Simple to calculate
- Resulting fee structure should be competitive
- May meet generational equity objective

Market Funding

■ Disadvantages

- Do not know if you are covering costs
- Can't reflect variation that affect refunds
 - Age
 - Double occupancy
 - Investment earnings and policies
 - Contract provisions
- May be difficult to get accurate information

Escrow Funding

- Immediately set aside portion of entrance fee that equals amount to be refunded
- Facility can use amount not set aside plus interest earnings on entire amount
- Advantages
 - No financial risk
 - Simple to calculate
 - Easy to show assets behind refund promise
 - Meets generational equity objective

Actuarial Funding

■ Methodology

- Determine base nonrefundable entrance fee
 - This amount reflects prepaid monthly fees
 - APM is a break-even fee calculation
- Calculate additional amount to be added to base, or nonrefundable, entrance fee
- This “add-on” or reserve along with interest earnings will accumulate to refund payout at resident’s life expectancy

Actuarial Funding

■ Add-on calculation

Add-on $\times (1.05)^{12}$ = 90% of entrance fee

Entrance fee = Nonrefundable + Add-on

Add-on $\times (1.05)^{12}$ = $0.90 \times (\text{Nonrefundable} + \text{Add-on})$

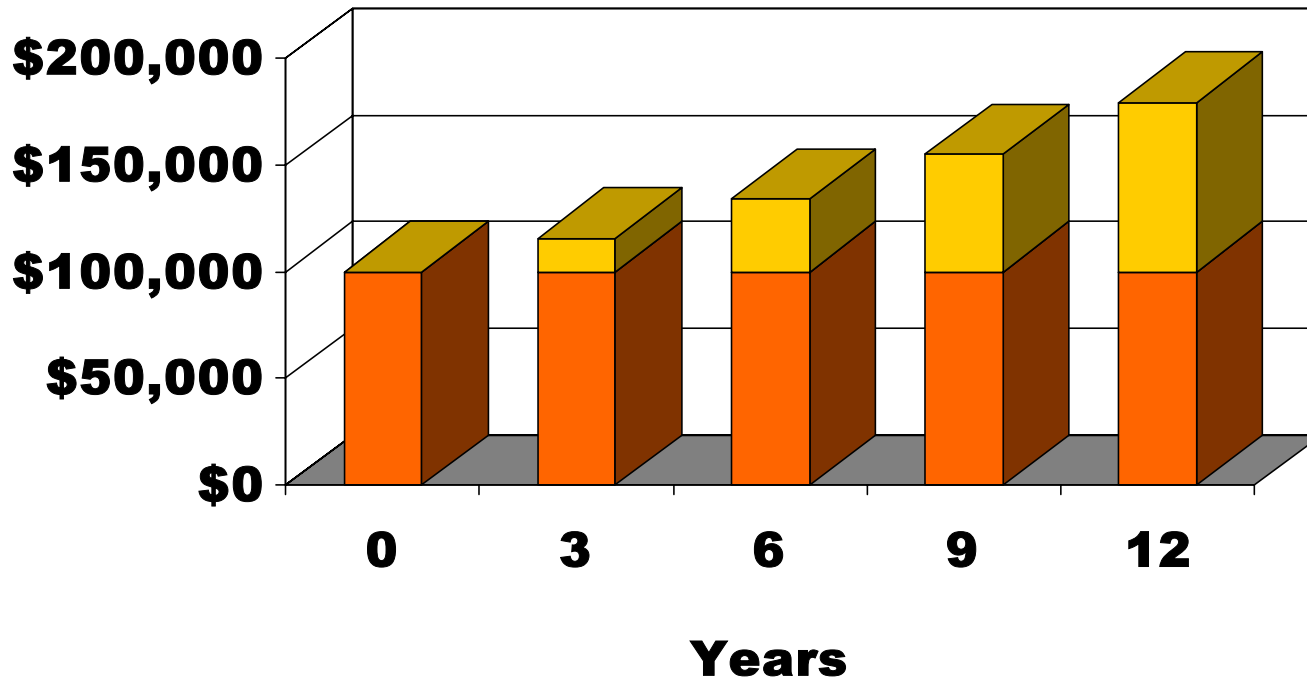
Add-on percentage = $1.005 \times \text{Nonrefundable}$

Add-on percentage = 100.5%

ASSUMPTIONS:

Interest rate = 5%, Life expectancy = 12 years

Expected Refund Payout \$200,000 with 90% refund



Add-on **Interest Earnings**

Sample Add-on and Percentage-of Funding

Interest Rates	Life Expectancy	Minimum Refund	Add-on
5%	12	90%	100.5%
5%	12	50%	38.6%
6%	12	90%	80.9%
6%	12	50%	33.1%

Actuarial Funding

■ Advantages

- Meets generational equity objective
- Adjustments are independent of base
(nonrefundable) entrance fee
- Can reflect demographic characteristics

Actuarial Funding

■ Disadvantages

- Complicated calculation
- Potential for adverse selection
 - Limit participation by age
 - Requires a minimum number of participants
- Sensitive to move-out and earnings experience

Third-party Funding

■ Methodology

- Set-aside portion of entrance fee to pay a one-time premium for life insurance for designated amount of refund
- Resident or a third party owns insurance policy and names a beneficiary
- Upon death, beneficiary receives proceeds
- Upon withdrawal, resident can continue coverage or elect a premium refund
- Obtain quotes from insurance companies

Third-party Funding

■ Advantages

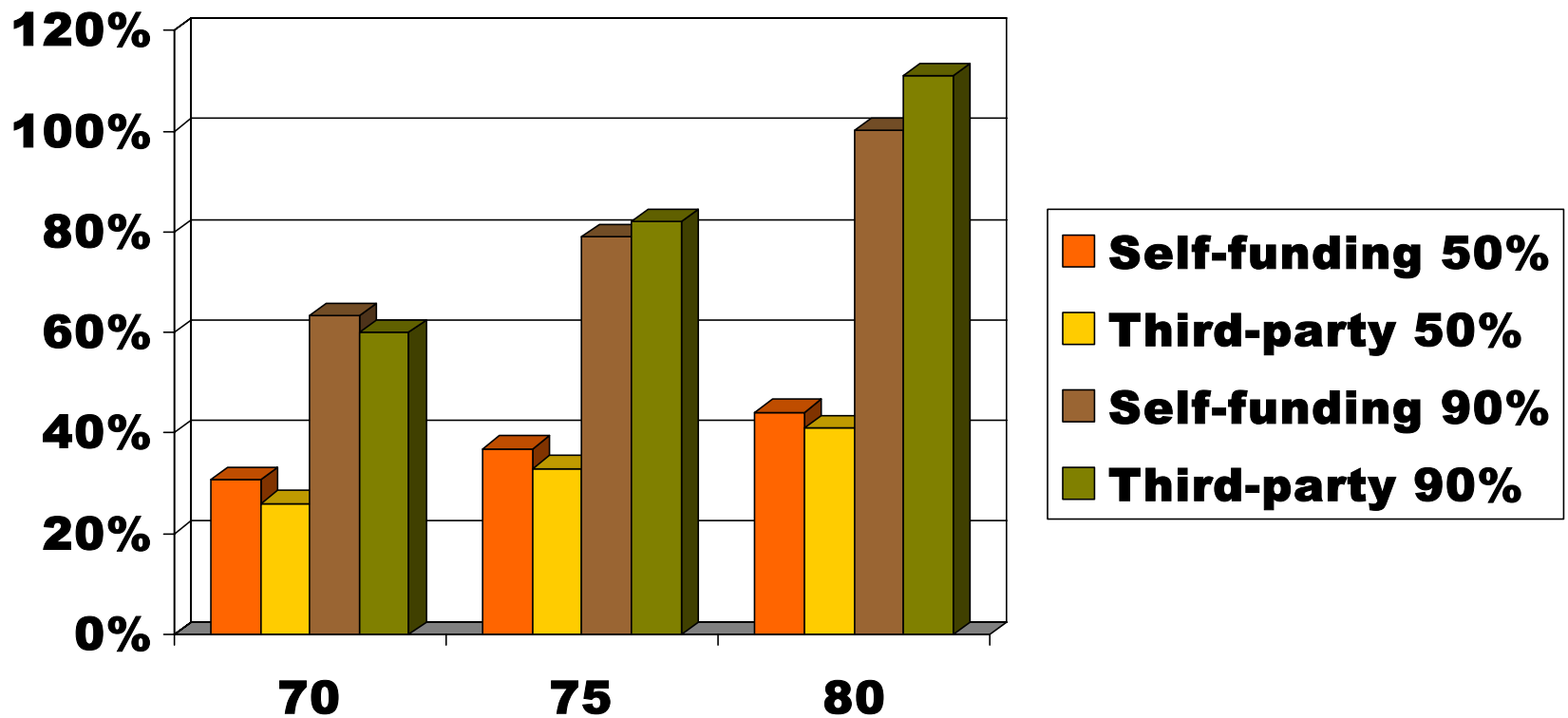
- Meets generational equity objective
- Refund payout is immediate
- Avoids income tax and minimizes estate taxes
- Avoids probate costs issues
- Avoids imputed interest issues
- Shifts financial risk from community
- A portion of refund amount may be accessed in advance in the case of a terminal illness

Third-party Funding

■ Disadvantages

- Reduces source of revenues that are available for debt service
- Potential gap in coverage for voluntary move-out refund, although resident could continue insurance or receive 90% refund of fees paid
- Some residents may not qualify for coverage
- Entrance fee may not appear seamless

Comparison of Self- and Third-party Funding



Accounting Issues

- Entrance fee amortization affects income statement and balance sheet
 - Refundable fees are not amortized
 - Contingent refundable fees are amortized over remaining life of building
- Does amortization really affect the CCRCs financial condition?

Summary of Risk Management Issues

- Does management want generational equity?
- How much risk is management willing to accept?
- Definition of refund payout provisions affect GAAP financial statements, but do not change funding requirements