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Senior Living Business INTERACTIVE

Financial News, Growth Strategies, and Best Practices for Providers and Suppliers

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Benchmarking Strategies: Operate Smarter, More Efficiently

Why should organizations benchmark? Senior living providers are currently having to deal with a number of operating pressures: the economy, the housing market, the impact that the housing market and the economy have had on occupancy levels, uncertainty related to government and third-party reimbursement programs, aging physical plants and access to capital, an ever-changing technology environment, intensifying regulatory oversight, and issues related to health-care reform. The more frequently a provider looks at benchmarks, the easier it is to react. Benchmarks also help an organization effectively implement its strategic plan.

Benchmarking rationale

The building blocks of any senior living organization are high-quality care and operational efficiency, which lead to financial stability, according to Mark J. Ross, Partner at **ParenteBeard** in Wilkes-Barre, Pennsylvania, and practice leader of the firm's senior living services practices.

To improve operating results, organizations must focus on revenue growth (e.g., home and community-based service initiatives, increasing Medicare volumes in the nursing facility), the cost and efficiency of delivery systems (e.g., staffing, benefit programs, the procurement process), creating a team culture and empowering team members to lead, and challenging the status quo.

"There's a lot of change in today's environment and, to adapt to it, people need to be prepared," Ross said. "When focusing on core operations, try to eliminate redundancies and create a structure that allows the organization to operate as efficiently as it can."

A number of organizations are using a zero-based budgeting concept. Starting with a clean sheet of paper, they ask: What should our revenue targets be? How should we staff the various departments across the organization? And based on that, what should our cost structures look like? "Make sure you're setting realistic and achievable revenue and cost goals, with the ability to adapt to change," he stressed. And, of course, establish benchmarking initiatives.

Benchmarking is a process that assists organizations in the measurement of key financial reporting/operating drivers. It's an exercise that is generally done for internal purposes, although the results may be shared externally in certain circumstances. The process may be performed internally, although the assessments are often better received and more effectively executed when outside auditors or consultants are brought in to analyze the situation and communicate an action plan. And while the frequency of formal benchmarking is an organization-specific decision, management needs to be proactive in terms of analyzing the

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financial performance or assessing operations. "Don't wait until you're in financial distress," Ross warned. "Analyze your operation consistently to make sure you're running as effectively as possible. And provide the management team and department directors with information that they can understand and use to execute their responsibilities."

Call it what you like—benchmarking or an operations assessment—it's all about achieving financial strength, according to Ross. "You've got the revenue side of the equation and the cost side and go through the analysis, which sometimes results in programmatic or strategic changes," he explained.

And you want to make sure that everyone is "rowing in the same direction," he emphasized, with respect to operating as cost-effectively as possible and that they "own" the benchmarking process, participate in it, and then use the resulting information. Giving a voice to all members of the team, at all levels in the organization, is also tantamount to the process being successful.

Operational benchmarking

While many providers focus on financial benchmarks, operational benchmarking can be instrumental in preparing an organization to meet its future challenges. Operational benchmarking embraces everything from staffing and productivity to office flow and an analysis of procedures performed—hours per patient day utilized in the health center, for example, or dining costs per meal. Essentially, operational benchmarks impact the efficiency of the business.

Operational benchmarking provides management with the tools to ask the right questions, according to Paul Shelton, Vice President and CFO at **Westminster Canterbury Lynchburg** in Virginia. "Establishing the mechanisms or collection tools to have the data available for analysis when you need it is important," he said. "And in most organizations, the information tracking systems are missing. As a provider, it behooves an organization to put in place methods that allow the easy collection of data, so that the testing and analysis of problems—and the solutions—are not painful to reach." The lack of manager/department head buy-in—and training so they can read and understand the feedback—are barriers to effective operational benchmarking, as well.

In fact, establishing tracking mechanisms can be quite simple. Basically, it involves designing the spreadsheets to track data on the operations of various departments within

the organization and then having the accounting department periodically update those spreadsheets. The metrics tracked can be limited, extensive, or anywhere in between.

Westminster Canterbury Lynchburg, for example, tracks dining statistics, food and labor costs per meal served (including for contracted services), census and staffing indicators, maintenance services costs, and utility costs per square foot. It then benchmarks those metrics against its own historical data, its budgets, industry trends/ratios, and comparative data from similar organizations. Comparing the internal cost of renovations per square foot to benchmark contract costs per square foot, for example, helps determine whether to use internal resources or external contractors. And having the ability to monitor kilowatt hours and gas usages in graphical form and review the trends over time allows the organization to track the results of equipment installed to reduce peak loads.

"We find it helpful to share data with the entire management team," said Shelton. "Team members review their own metrics and those of the other team members. All feedback, whether positive or negative, is educational and informative and, we've found, can lead to great discussions and insight."

Westminster Canterbury Lynchburg benchmarks its operational metrics to its own historical data but also to data from other CCRCs. "We compare our metrics with CCRCs in our region three times a year," Shelton said. For those meetings, which have taken place for more than 25 years, seven CCRCs (two of which are multi-sites) meet at one of the locations to share best practices, financial data, operational metrics, and a topic of choice presented by a professional organization. In the meetings, the CEOs bounce ideas and issues that are of particular interest at their facilities; the CFOs then share pertinent information with peers. The group also compares industry trends and ratios, whenever appropriate.

The benchmarking process and resulting productivity data has helped Westminster Canterbury Lynchburg assess organizational effectiveness and allocate its resources. The process has also empowered managers to take action sooner rather than later, as they don't have to wait for a monthly financial report. Results are measured and operations are controlled through a detailed reporting system. Some metrics, in fact, are gathered on a daily basis (per patient day). "Operating benchmarks allow us to put quality first," Shelton added. "They help with governance, compliance and accountability. Ultimately, the benchmarks allow us to achieve high standards of performance and management."

Benefits of Benchmarking

- Provides high-level direction for management, including department heads
- Helps identify easy changes, the low-hanging fruit
- Drives increased accountability
- Improves interim financial reporting
- Enhances the long-range planning process
- Provides insight into an organization's strengths and weaknesses
- Focuses efforts on improvement and best practices

Challenges of Benchmarking

- Distorted comparisons due to unique attributes among organizations (e.g., contract types, unit complement, number of sites, capital structure, operating philosophy)
- Limited access to quality published information
- Varying financial statement benchmarks due to variations in financial reporting treatments
- Too easily explains away variances
- Operations improvement initiatives viewed purely as economic initiatives rather than their impact on quality care

— Mark Ross

Actuarial benchmarking

A decade or so ago, **A.V. Powell & Associates**, financial consultants for retirement communities based in Atlanta, Georgia, began regularly collecting and tabulating statistics for the firm's clients in order to advise them on noticeable trends in their businesses. The data reflects variations in contract mix, age, demographics, etc; the sample includes more than 125 of the 2,000 currently operational CCRCs. "Understanding management characteristics is very important," explained A. V. Powell, Managing Partner. "A Type A CCRC, for example, may have a set of financial characteristics that differs from a Type B CCRC."

For this process, the firm identified a limited number of key statistics as actuarial benchmarks to ensure consistency over time and allow accurate trending. Some actuarial benchmarks overlap operational benchmarks; but the actuarial benchmarks were primarily selected to identify outliers that may require further investigation, as well as to indicate progress toward certain targets—such as:

Interpretation of benchmarks only by the management team can cause you to be blindsided by your own results. At some point, at least every five years, it's good to have a fresh set of eyes—an outside consultant—perform an operating review to see which data is useful and which isn't. You want to be sure that you're following the right numbers.

—Paul Shelton

• *Unified and traditional funded status*. Are the obligations being met by the accumulation of listed reserves and future fees? Using same-site figures, the data indicates that communities that adopted actuarial principles into their pricing strategies were able—even through the economic downturn—to maintain reasonable reserves due to the rigor of the benchmarking process.

• *New entrant pricing*. Is the pricing adequate? Regardless of the contract type, the fees charged to new entrants (a combination of the entrance fee plus future monthly fees) should cover lifetime liabilities. Median fees for communities reflected in the database indicate a 10% or greater surplus over the last five years.

• *10-year liquid reserve factor*. What is the projected cash flow, and what is the cash-on-hand ratio? In terms of actuarial liabilities, a fairly consistent trend over time is that a community funds roughly half of its liabilities with cash. Therefore, a CCRC should have a fair amount of accumulated cash and liquid investment.

"To be at the median or above for each actuarial benchmark is certainly a best practice for a community that wants to be on a sound financial status and meet its bond covenants," Powell noted.

Demographic statistics—mainly, a description of the community—collected in the database include items such as average age at entry, average attained age, life expectancy, and the health-care ratio. While there's little control over many of those items, benchmarking them provides important information. With regard to health-care usage, for example, the data indicate that the best-run CCRCs require, on average, 24 health-care beds (assisted living, memory care, or nursing care) for every 100 independent living residents—very useful information.

"That number has been fairly consistent," said Powell. "Some communities are higher or lower based on apartment density and resident mix; but if you're much higher than 30 health-care beds per 100, you may want to review your transfer policies or take a look at whom you're allowing to enter the CCRC."

Financial statistics are, of course, important to benchmark; e.g., average occupancy by level of care, per capita expense per day (based on gross operating costs before deductions), average monthly fee increase, average entrance fee increase, and independent living attrition. Of particular relevance, according to Powell:

• If occupancy falls below certain percentiles that data indicate have been fairly consistent (e.g., 88% for independent living, 91% for assisted living, 90% for nursing care), the provider should look into the cause of the numbers being low compared to the benchmark.

• Even though independent living occupancy rates have been lower since 2007, median operating costs have increased during that period to about $72 per day on a gross basis (before considering any reimbursements or direct billing to offset the expenses). If a community's operating costs per day are more than $86 or $87, the provider should investigate the cause to ensure that the higher costs are justifiable—which, of course, they may be.

• Monthly fee increases have mimicked inflation over the past few years, rising only 3-4% from 2010 to 2011. That is helpful marketing information for providers to have when considering whether to raise monthly fees. Entrance fee increases in Powell's sample, however, remained lower than the rate of inflation due to the still-challenging real estate market, ranging from 0% to 3% during the period.

"Virtually all actuarially sound entrance-fee communities will have adequate cash flow to easily meet their bond covenants," Powell said. "Actuarial benchmarking is simply the next level of best practices." It's also useful as a tool to ensure pricing fairness for residents and to minimize intergenerational transfers; that is, the need to depend on future generations to pay a share of the current generation's costs.

A.V. Powell & Associates has also been at the forefront of providing publicly available benchmarking statistics through one of its website tools, whereby people can participate by inputting their data and running analyses to compare to (benchmark against) other sites. "It's an easy way to access some of this information," he said.

Financial ratios

Financial ratios, the key drivers of financial strength for senior living providers, are effective baseline operations

and net entrance fee receipts, supported by contributions, effective management of the capital structure, and the treasury function. Those don't change much over time. What does, can, and, in many instances, should change, according to Michael D. Kelly, Managing Director at **Ziegler**, is the degree of focus on financial success—beginning at the board level and running through senior management directly to the front line.

Financial ratios measure key financial drivers both internally against year-to-year measurements of one's own performance and externally against industry benchmarks. Financial ratios are also a tool for effectively communicating an organization's needs and capability for fulfilling its mission to key stakeholders (residents, staff, donors, the financial markets, regulators, or otherwise). But financial ratios should not be used in isolation, Kelly warned, as the interpretation may vary due to a variety of issues, including: financial reporting treatments, unique attributes of a provider, significant expansions or divestitures, significant operational change, and/or entrance-fee contract type. Most importantly, the use and measurement of trends are more instructive to providers and their constituencies over the long haul than as point-in-time values.

> An actuarial analysis during our budgeting process shows where we're headed and whether our internal inflation level is fine. If it's not, we can adjust the budget before presenting it to the board. We do everything we can to prevent hiccups in the future.
>
> *—Paul Shelton*

CARF-CCAC and two rating agencies, **Standard & Poor's** and **Fitch**, publish financial ratios for rated senior living organizations, of which there are approximately 151. The median financial ratios, as reported, typically overlap, but all focus on the measures of profitability, liquidity, and capital structure.

Some of the most important ratios that apply to senior living communities include:

Profitability measures

Profitability measures indicate a provider's annual excess or deficiency of revenues over expenses and the ability to generate operating surpluses—both of which are critical to covering future resident-care expenses, meeting capital and program needs, and handling unexpected

> Actuarial benchmarking provides the information that you need to set pricing targets each year so that you're charging sufficient dollars to cover your lifetime obligations. It's a tool to help quantify the kind of information that you need to stay on a steady course and avoid financial difficulty. The best managers in the business choose to benchmark voluntarily rather than by regulation.
>
> *—A. V. Powell*

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Profitability measures

Profitability measures indicate a provider's annual excess or deficiency of revenues over expenses and the ability to generate operating surpluses—both of which are critical to covering future resident-care expenses, meeting capital and program needs, and handling unexpected external and internal events. "To function effectively, senior living providers must understand the revenue and expense components associated with the delivery of services to residents," said Kelly. "They must also identify and understand their financial reliance on nonresident income—such as contributions, investment earnings, and ancillary income—and certainly must understand their degree of reliance on third-party funding."

• *Net Operating Margin Ratio (NOM)* focuses on core operations. It measures the margin generated by cash operating revenues after payment of cash operating expenses. For 2011, NOM remained well above recent averages. The median of 6.9% for multi-site providers was the highest since CARF-CCAC began measuring NOM in 1996; the median of 7.0% for single-site providers was only slightly weaker than the previous year, which followed years of sustained improvement.

• *Operating Ratio*, which is a companion to NOM and has been tracked by CARF-CCAC for 21 years, is a measure of the operating expenses divided by operating revenues but includes interest income/expense and net assets released for operations. A declining ratio is favorable, because the goal is to spend less than a dollar for every dollar of revenue. Therefore, values of less than 100% (or 1.0) are the norm for upper quartile organizations. CARF-CCAC data indicates that the operating ratio for single sites weakened slightly to just over 98% in 2011; multi-sites, at just under 98% for 2011, improved for the third consecutive year.

Liquidity measures

Liquidity measures indicate a provider's ability to meet short-term (one year or less) cash needs of its ongoing operations. "A CCRC must insure that it has sufficient cash or investments readily convertible to cash to meet payroll, pay for goods and services, fund debt-service payments, and provide for essential maintenance and repairs," Kelly explained.

• *Days Cash On Hand Ratio* measures the time required for the organization to meet its current liabilities; high values often indicate a lack of liquidity. For 2011, the multi-site median was 263 days—down from record levels but in the range of the past 10 years; for single sites, 290 days—a decline of 6 days from prior-year figures. When looking at a same-site sample comparison, the median for multi-site providers declined 17 days but, for single-site providers, improved by 7 days.

• *Days in Accounts Receivable Ratio* measures the average time it takes for an organization to collect its receivables. For 2011, the multi-site median was 23 days; for single sites, 19 days. The shorter the average collection period, the lower the dollar amount of receivables and, hence, the lower the carrying cost.

• *Cushion Ratio* measures the ability of current cash to cover future debt obligations. The 2011 multi-site median of 7.0, for example, indicates that an organization has seven times its debt payment obligations available in cash and "near-cash" to meet those obligations. For single sites, the 2011 median was 6.2.

Capital structure ratios

Capital structure ratios focus on the relationship between and among debt, assets, and fund balances, as reflected on the provider's balance sheet. This data is critical in measuring long-term solvency, particularly in relation to the amount of debt undertaken. "Obviously, a higher debt load relative to assets or equity is an important indication of risk, since higher leverage typically means that the debt-service obligations put pressure on the availability

of revenues for critical resident and operating needs," Kelly explained.

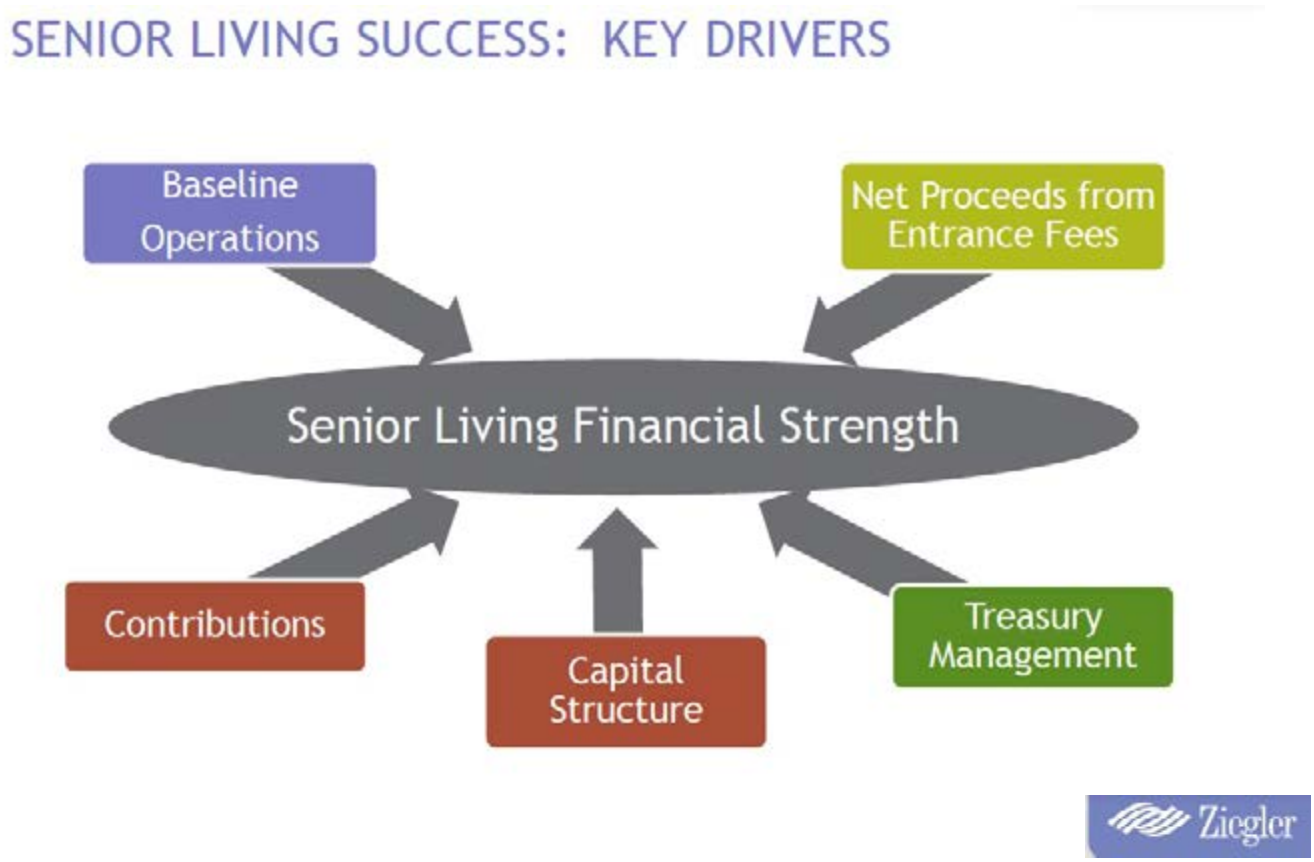
• *Debt-Service Coverage Ratio*—generally considered the most important ratio for evaluating an organization's financial viability—measures the capability to fund debt service with cash flow from net cash revenues and net entrance fees. The medians reflecting 2011 performance were 2.41 for multi-sites and 1.91 for single sites—reasonably healthy under challenging economic times. Both provider types were impacted by an increase in both entrance-fee refunds and principal payments.

• *Unrestricted Cash & Investments to Long-Term Debt Ratio* measures the provider's ability to withstand annual fluctuations in cash, either as a result of weak operating results or temporary declines in entrance-fee revenues.

• *Age of Facility Ratio (AGE)* measures a provider's commitment to maintaining its physical plant. An increasing AGE ratio in 2011 for multi-sites suggests that current repositioning and renovation investments are insufficient to counter the aging of the physical plants.

• *Capital Expenditures as a % of Depreciation* (annual expenditures on a property divided by depreciation expense) should be monitored closely in concert with the AGE ratio to ensure that the commitment to maintaining a robust physical plant—which is critical to maintaining a robust marketing presence—is supported. In 2011, multi-sites were disciplined in terms of those capital expenditures. Single sites, on the other hand, dropped to 70%; that is, for every dollar of depreciation, the organization put back into the enterprise only about $0.70 of new assets

Whether operational, actuarial, or financial ratio, the purpose of benchmarking focuses on two questions: 1) Where are we today? 2) Where do we need to go? The answers to those questions inform decisions about the actions that management must take, according to Kelly. "Cash is absolutely critical to any provider's ability to act strategically," he stressed. "And in this environment, any provider that is not acting strategically is—perhaps unbeknownst to its key stakeholders—in a state of decline." But the key to cash accumulation is not simply for its own sake or to maintain a rating; it is also to identify anticipated uses and timely deployment in the physical plant to offset actuarial liabilities. "Cash is not only king," he said. "It is



the ace, king, queen, jack…perhaps even the 10."

When making strategic decisions about when to borrow money and whether to carry a significant debt load, however, keep in mind that the awareness gleaned from the various ratios must be balanced against one another.

Benchmarking sources...

- *CARF-CCAC/Ziegler Financial Ratios & Trend Analysis*, published annually
- Rating agencies: Fitch and Standard & Poor's
- **Centers for Medicare & Medicaid Services** (CMS) website (www.cms.gov)
- Medicaid/Medicare cost reports
- *State of Senior Housing*, published annually by **ASHA**
- **American Health Care Association**
- **National Association for Home Care & Hospice**
- Peer group surveys (state aging or faith-based associations)
- Proprietary benchmarks produced by consulting or accounting firms

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