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BUSINESS VALUATIONS IN THE LONG-TERM CARE HOMES SECTOR: THE ONTARIO EXAMPLE

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Introduction

The expected growth in the seniors' age demographic in the coming decades has garnered considerable attention in social, political and financial discourse of late. This has brought attention to expense and capacity issues around seniors' residential care. In addition to the costs of administering care, residential facilities involve substantial capital costs in the form of land, buildings and equipment. Further, while provincial governments have historically provided funding to the sector, we are likely to see significant policy changes in coming years, particularly in jurisdictions facing intense budgetary pressures. These dynamics are common to most jurisdictions within Canada.

Within the seniors housing and residential care industry, market participants typically segment properties as retirement homes (RHs) or long-term care homes (LTCHs). While the two segments are related, the businesses are different enough to warrant the distinction, particularly as it relates to the level of care delivered within the residence, the extent of government operating funding and regulatory involvement in the business operations. Residents of LTCHs most often have more significant care requirements and benefit from government subsidies to cover the personal care services delivered within the property, whereas the cost of RH services and accommodation is most often exclusively the responsibility of the resident.

The valuation of firms that own and operate LTCHs must take into consideration numerous market and government policy factors. Critical market factors include demographics, cost of capital, resident choice, competition, economies of scale, availability of staffing, and the impact of negative media coverage. The principal policy factors can be divided, practically, into those affecting government funding, and those related to governance, which include licensing, regulation of services, inspection and compliance.

Ontario, which is home to Canada's largest population of seniors, is the focus of this paper. Though valuation issues will vary by market and by provincial regulatory regime, the valuation issues in the Ontario context are illustrative of the issues and analyses applicable in similarly structured jurisdictions throughout Canada.

Legal and Regulatory Landscape

Services provided by LTCHs are not within the Canada Health Act (CHA) definition of "medically necessary" services. As such, they are not insured services[I] and are not subject to the CHA principles of universality or comprehensiveness. The CHA classifies them as "extended health services," to be governed by provincial and territorial legislation. This results in differences across the country in terms of service offerings and public-versus-private responsibilities for the cost. It also implies that policy on these matters can change from time to time, though historically all provinces have maintained the practice of funding seniors' residential care in some form.

In Ontario, the Long-term Care Homes Act, 2007 (the Act)[II] and Ontario Regulation 79/10 (O Reg 79/10)[III] address the governance of LTCHs, including licencing, residents' rights, care standards, safety and security, protections against abuse and neglect, powers of inspectors, and the establishment of offences, penalties, appeals and enforcement. In addition, the Act is the authority by which funding is provided to homes through the Ministry of Health and Long-Term Care (MOHLTC). In essence, LTCHs receive full government funding for the costs associated with three "envelopes" including nursing care, therapies and food for residents. Funds are provided on a "pass-through" basis, meaning that all funds received for these envelopes must be spent by the home for the purposes prescribed or refunded to the MOHLTC. In addition, s.245 of O Reg 79/10 specifies that homes may not levy any additional charges on residents for any goods or services to which the funding envelopes are intended to apply. The effect of these provisions is that homes cannot earn a profit from any of these care services, but only from revenues associated with accommodation.

As distinct from care services, the costs of accommodation in LTCHs are generally the responsibility of the resident, unless the resident qualifies for a subsidy based on income. Amounts earned by homes in respect of accommodation and operations charges may earn a profit but these are regulated as to amount. In addition, these dollar amounts apply to all homes, whether they are owned by for-profit entities (FPs), not-for-profits (NFPs), or municipalities, and across all locations, regardless of local real estate or labour costs.

Licensing

Pursuant to the regulations under the Act, LTCHs are now subject to limitations on the term of the license, which is required in order to offer government funded long-term care accommodation in the Province of Ontario. Homes and LTCH licenses are classified based on their structural compliance with MOHLTC design standards, as follows:

TABLE 1. MOHLTC STRUCTURAL COMPLIANCE STANDARDS

License Class	Definition	License Term (Years)
Class **New**	Facilities substantially exceeding the 1998 design standards	30 [1],[2]
Class **A**	Facilities substantially meet the 1998 design standards	25 [3]
Class **B**	Facilities substantially exceeding the 1972 standards but not meeting the 1998 design standards	15 [4]
Class **C**	Facilities determined to be in compliance with the 1972 standards	15 [4]
Class **D** (Compliant)	Facilities not in compliance with the 1972 structural compliance, but were upgraded in accordance with the 2002 Class D Bed Upgrade Option Guidelines	10 [4]
Class **D** (Non-Compliant)	Facilities not in compliance with the 1972 structural compliance, and were not upgraded in accordance with the 2002 Class D Bed Upgrade Option Guidelines	4[4]

[1] Starting on the day the first resident was admitted to a New bed, but in no event shall the term be less than 20 years from July 1, 2010, the date that the Long-Term Care Homes Act, 2007 came into effect

[2] On January 1, 2015, the aforementioned maximum term of Class "New" long-term care home licenses was extended from 25 to 30 years from the later of date a home was constructed or July 1, 2010

[3] On January 1, 2015, the MOHLTC provided a one-time automatic extension of 5 years to the license term of existing eligible LTCH licenses where all the beds meet the Class "A" or "New" design standards; effectively extending the license term of Class "A" homes from 20-25 years

[4] From July 1, 2010, unless redeveloped into a Class New facility

Generally, the Class New/A homes are up to 20 years old, and the consensus amongst market participants is that licenses to operate these homes will be renewed after the initial 25 or 30 year term. Class B/C homes on the other hand are much older and vary considerably with respect to their quality and remaining physical useful life. The uncertainty surrounding the Class B/C licenses beyond June 30, 2025 has resulted in a trend of declining market values for these properties. Class D homes are now few in number and are not referenced further in this discussion.

Sector Dynamics

Increasing demand for seniors' residential care is expected from demographic factors, but the more pressing supply-demand factors in Ontario are related to a dearth of new construction in the sector in the past decade. While both the previous Liberal government and the current Progressive Conservative government have made promises to fund an increase in the stock of homes, the province-wide wait list to enter LTCHs exceeds 30,000 beds, while the number of existing beds has remained fairly static at less than 80,000[IV]. Based on MOHLTC statistics for the period 2010 to 2015, the number of licensed LTCH beds in Ontario grew by only 1.5% over the five-year period, compared to an increase of 12% in the population of Ontarians over 75.[V]

The shortage of beds available for seniors, combined with a provincial policy that encourages seniors to age in place, has resulted in significant increases in the average care needs of residents in LTCHs. According to the Ontario Long-term Care Association (OLTCA), 85% of residents require extensive help with activities of daily living (e.g., dressing, eating, mobility, toileting), 90% have cognitive impairment, 46% exhibit some level of aggressive behaviour and 40% need monitoring for an acute medical condition.[VI]

As of February 2018, there were 627 licensed LTCHs, of which 58% were owned by FPs, 24% by NFPs and 16% by municipalities. The sector is quite fragmented in terms of ownership concentration, with the largest 15 operators in Canada constituting 25.8% of total units. The top five of these firms by numbers of beds (Extendicare, Revera, Sienna Senior Living, Chartwell Retirement Residences and Schlegel Villages) are all FPs and all have operations in Ontario[VII] .

The fixed cost nature of seniors' residential care encourages economies of scale in terms of number of beds per home and the number of homes in the enterprise. LTCHs average approximately 123 beds per home[VIII]. Economies apply to staffing, property management, labour relations, administration, regulatory compliance, supply chain management and bulk purchasing.

Significant regulatory and operational barriers to entry exist. LTCHs must be licensed in order to operate (LTCHA s.95) and care and safety standards are detailed and onerous. Though competition exists among homes, differentiation is muted by several factors. All LTCHs are required to provide the same level of services and all are prevented from earning a profit on the care provided by virtue of the envelope system. In addition, homes tend to be dispersed fairly evenly throughout the province. To ensure that all local areas have at least one home, the Act requires all municipalities to establish and maintain a municipally-owned LTCH. Also, section 96 of the Act requires the number and location of beds throughout the province to be determined with regard to (i) existing LTCH bed capacity in a given area, (ii) other facilities or services available, (iii) demand for LTCH home beds in the area, and (iv) the funds available for LTCHs. These factors, combined with persistently long wait lists, result in occupancy rates in LTCHs that are consistently over 98% across the province.[IX]

Profitability

A discussion of profitability necessarily centres on those LTCHs owned and operated by FPs. Though a non-profit business, by definition, cannot distribute a return, NFPs can be valued on an adjusted equity basis, reflecting the net assets in the enterprise and NFPs can in certain circumstances be converted or sold to NPs with the potential to then earn a return.

The residential care industry is highly capital intensive due to required investments in land, buildings and fixtures. As detailed above, financial returns for LTCHs are affected by the flow-through structures of funding envelopes, which do not provide for a profit margin on care services, and by controls on accommodation charges.

Some of the larger chains that own and operate LTCHs, such as Chartwell, Sienna and Extendicare, are publicly traded and their annual and quarterly financial statements are subject to disclosure requirements. However, returns are difficult to extract from public filings, given the limited disclosure provided by line of business. Reports often combine the results of LTCHs and RHs, though RHs in Ontario differ from LTCHs in terms of service offering, pricing of services, funding and regulatory structure. Reported results from public companies may also include revenues from third party management contracts and related business ventures, which make it difficult to separate margin and return metrics that relate specifically to LTCH operations.

For the reasons discussed above, profits for FPs are principally from accommodation, as distinct from care, with some supplementary inflows from charges for non-care-related amenities (e.g., grooming and other non-care services). These amounts, in turn, are funded by the residents.

As part of its Pre-Budget Submission to the Ontario government, the Ontario Long-Term Care Association (OLTCA), which represents the sector, conducted an analysis of operating costs for LTCHs relative to the operating cash flows that homes are permitted to earn from accommodation[X]. Their study purports to summarize the annual audited financial statements of 50% of the LTCHs filed with the province in 2012, including the expenses to which accommodation revenues are applied. Table 1 shows the percentage breakdown according to expense categories.

TABLE 2. EXPENSES AS A PERCENTAGE OF FUNDS FROM ACCOMMODATION

Salaries, Benefits and Purchased Services	53%
Utilities	9%
Management and Allocated Fees	6%
Maintenance and Building Services	4%
Supplies and Equipment	7%
Property Taxes	2%
Insurance and Communication	1%
Other Items	2%
Debt Service, Mortgage Interest, Capital Expenditures and Return on Investment	16%
Total	**100%**

Adapted from OLTCA Pre-Budget Submission, 2015

As shown, the majority of funds received go directly to salaries, benefits and wage-related expenses, with much of the balance to administrative expenses, such as office supplies, communication (phones and internet), accounting, recruitment, and payroll. In addition, homes must cover 50% of their bad debt expenses (uncollected resident payments) with the other half reimbursed by government. These data suggest that 16% of accommodation funding remains after all expenses listed, to cover returns on capital, as well as capital expenditures, roof and heating system repairs, furniture, hospital bed and technology infrastructure.

Renewal of Aging Long-Term Care Homes: Public Private Partnership

In Ontario, the government and the private sector have a history of public-private partnerships, formed to build and redevelop the available supply of LTCHs. In July 2007, the MOHLTC announced its intent to establish a new capital cost funding initiative, aimed at providing incentives for owners of existing Class B/C LTCHs (at the time ~35,000 beds) to redevelop such properties to current design standards. In 2009, the MOHLTC unveiled the initial framework for the implementation of this initiative through an updated policy in respect of (i) providing capital grants to subsidize the construction of eligible redevelopment projects and (ii) the Long-Term Care Home Design Manual. In October 2014, the MOHLTC provided details of an enhanced capital grant program which increased the level of capital funding available for eligible proponents who committed to the redevelopment of the Class B/C LTCHs before the expiry of the license term in 2025. Separate from the Class B/C redevelopment initiative, announced as part of the 2018 Budget, Ontario is planning to build 5,000 net new long-term care beds by 2022, and more than 30,000 over the next decade[XI].

Capital Costs

Construction cost inflation has been a significant headwind for real estate developers as the current business cycle extends into the late stages of an extended market rally. The cost to develop a LTCH has escalated considerably over the past decade. While estimates vary, it has been observed within a professional practice context that greenfield project capital costs currently exceed an estimated $200,000 per bed, with regional premiums based on several factors including the price of land, municipal development charges and the availability of trades and labour. The increasing cost to develop an LTCH has been a key challenge for the MOHLTC's aforementioned plan to redevelop the Class B/C LTCHs in the province.

Business Risks

Owners of LTCHs are subject to general economic conditions as well as those specific to the sector. Risks associated with the ownership of real property are inherent in the seniors' housing industry. As an equity investment, real property is relatively illiquid, which can limit the ability of Owners to respond to changing economic or investment conditions. In addition, costs associated with repair, maintenance and renovation can be substantial. From a real property perspective, the greatest risks regarding seniors' housing residences are in the development phase, which includes land assembly, zoning approvals, construction and lease-up.

The ability to grow and expand operations in the LTC segment is determined by the Ontario government's willingness to approve new licenses, which is done through a request for proposal process and has resulted in limited new awards in the past decade. The province also regulates the way LTCHs are developed and redeveloped. As detailed above (see Licensing), all bed licenses are scheduled for expiry and there is no certainty of renewal. This is especially a concern for Class B/C beds and it represents a significant risk to cash flow streams beyond these expiry dates.

The labour-intensive nature of the sector exposes LTCHs to increased salary and wage costs, particularly given the prevalence of collective bargaining agreements. These costs are not easily passed through, since accommodation amounts are regulated. In addition, the health care industry continues to face shortages of nurses and other health care workers.

Frailty of the resident population implies health-related risks, such as disease outbreaks. In addition, vulnerability of residents is associated with risks of inappropriate or negligent acts by employees, and limited mobility of residents can amplify the consequences of catastrophic events such as fires. In recent years, reputational risks have become more prevalent for LTCHs, particularly with media coverage regarding incidents of neglect or mistreatment of residents.

LTCHs are subject to numerous regulations pertaining to the safety and security of residents, which are supported by inspections, audits and investigations. Non-compliance can result in severe penalties such as fines or other sanctions.

As indicated, competitive pressures for LTCHs are mitigated by occupancy rates close to 100%, throughout the sector, but competitive dynamics are susceptible to change in the mid-to-long term due to changes in government funding policies. For example, many RHs have overlapping care service offerings with LTCHs, and though RHs currently do not benefit from government funding, modifications to funding policy could occur. Alternatively, the introduction of self-directed care, now common in much of Europe, could alter consumption patterns by placing funding in the hands of seniors to choose their service provider, rather than having the funding flow from government only to designated providers.

Mitigating the risk profile of the LTCH sector are age demographics, which are largely predictable and provide some assurance of continued demand in the seniors' residential care sector. In addition, the funding stream for care services is principally from the Ontario government, which carries relatively low credit risk. As well, the LTCH sector has historically been fairly insulated from economic cycles. This can be attributed to several factors, including (i) the demand for LTCH housing being driven by need rather than discretionary expenditure; (ii) the stability of tenure, as seniors are less able to relocate to other accommodation after having moved into a facility; and (iii) the continual increase in the demand for LTCHs relative to the shortage of supply. All of these factors together help to reduce the risk of revenue fluctuations, though relatively narrow profit margins can have the effect of amplifying volatility in net cash flow should other risks emerge.

Valuation Methodologies

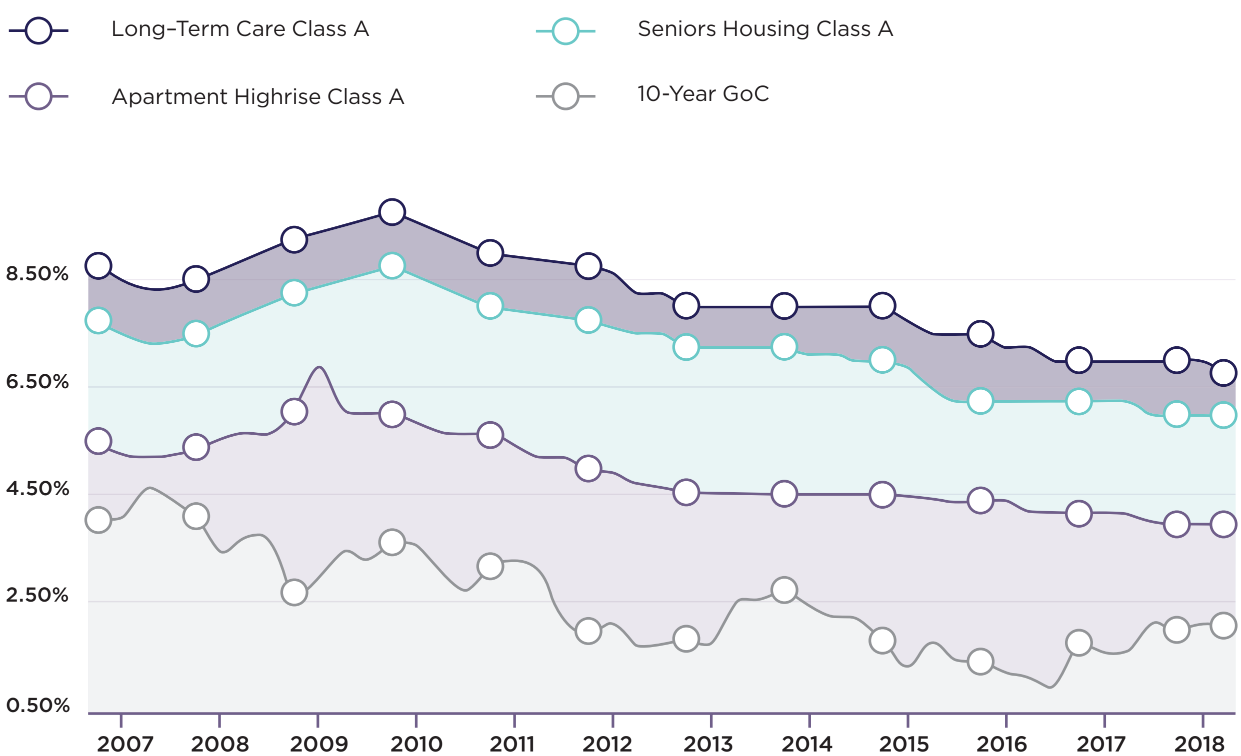
The valuation of LTCHs poses special challenges for business valuators given their capital-intensive nature and the fact that their value is closely linked to the value of the underlying real estate and other fixed assets. Additionally, these businesses are intrinsically tied to the value of the licenses to operate the LTCHs. As discussed, issuances of new licenses have been restricted in recent years and market liquidity has been limited.

Similar to other sectors characterized by capital intensity and regulation, business valuators tend to default to appraised values of the facilities prepared by qualified appraisers to determine the base value of the operations of business. It should be noted that these types of appraised values typically reflect the value of a "turn-key" long-term care facility, with all tangible assets (real property, fixed assets and working capital) and intangible assets (licenses and qualified workforce) available to generate the forecast earnings and cash flows. While technically an asset appraisal, this form of appraisal generates a value that corresponds closely with the operating value of the business. Business valuators would also consider any redundant assets relating to the operations as well as any debt associated with the business in arriving at the value of the equity of the operation. In addition, consideration should be given to any latent taxes associated with the underlying assets and any trapped-in capital gains that may exist within holding company structures, which are typical of real estate investments.

The primary methodology used by appraisers in determining the value of seniors' housing in general and long-term care facilities specifically, is with the application of a capitalization rate (cap rate) to the net operating income (NOI) of the business. The NOI represents a pre-tax return on the normalized operations of the business, irrespective of capital structure. This metric would be similar to a multiple method applied to Free Cash Flow or EBITDA, using a multiple that is the reciprocal of the Weighted Average Cost of Capital (WACC), adjusted for growth. These are metrics often favoured by business valuators. This method is reasonable when valuing facilities without significant capital expenditures, and would be appropriate for Class New/A LTCHs, which are compliant with current regulatory requirements and do not require significant capital expenditures to meet the new design standards. This method is also appropriate for long-life assets and can therefore be used on the assumption that Class New/A LTCHs are essentially evergreen businesses, with licenses that can be expected to be renewed on maturity.   For Class B/C properties, where license renewal is less certain beyond 2025, other methods should be considered including a hybrid methodology consisting of a discounted cash flow for the remaining license term combined with a risk adjusted capitalized cash flow or sale of the assets thereafter, considering the redevelopment prospects at the terminal date.

According to CBRE's recent publication on the Canadian Seniors' Housing & Healthcare Industry[XII] the average cap rate for RHs was approximately 6% to 6.5% nationally, being approximately 200 basis points higher than the average yield on Class A apartment buildings and 400 basis points higher than 10-year Government of Canada bonds (see Graph 1). These unlevered yields and spreads represent historical lows over the past 10 years (see Graph 2). As compared with RHs, which are less regulated and have greater opportunity for revenue and profit expansion, Class New/A LTCHs typically tend to transact at cap rates approximately 100 basis points higher on account of the greater operational complexity and regulatory risks, with even higher spreads applicable to Class B/C LTCHs. As with all real estate cap rates, the above rates vary by location and are typically a function of real estate costs, construction costs, and in the case of LTCHs, the cost of regulatory compliance, which is quite significant in Ontario.

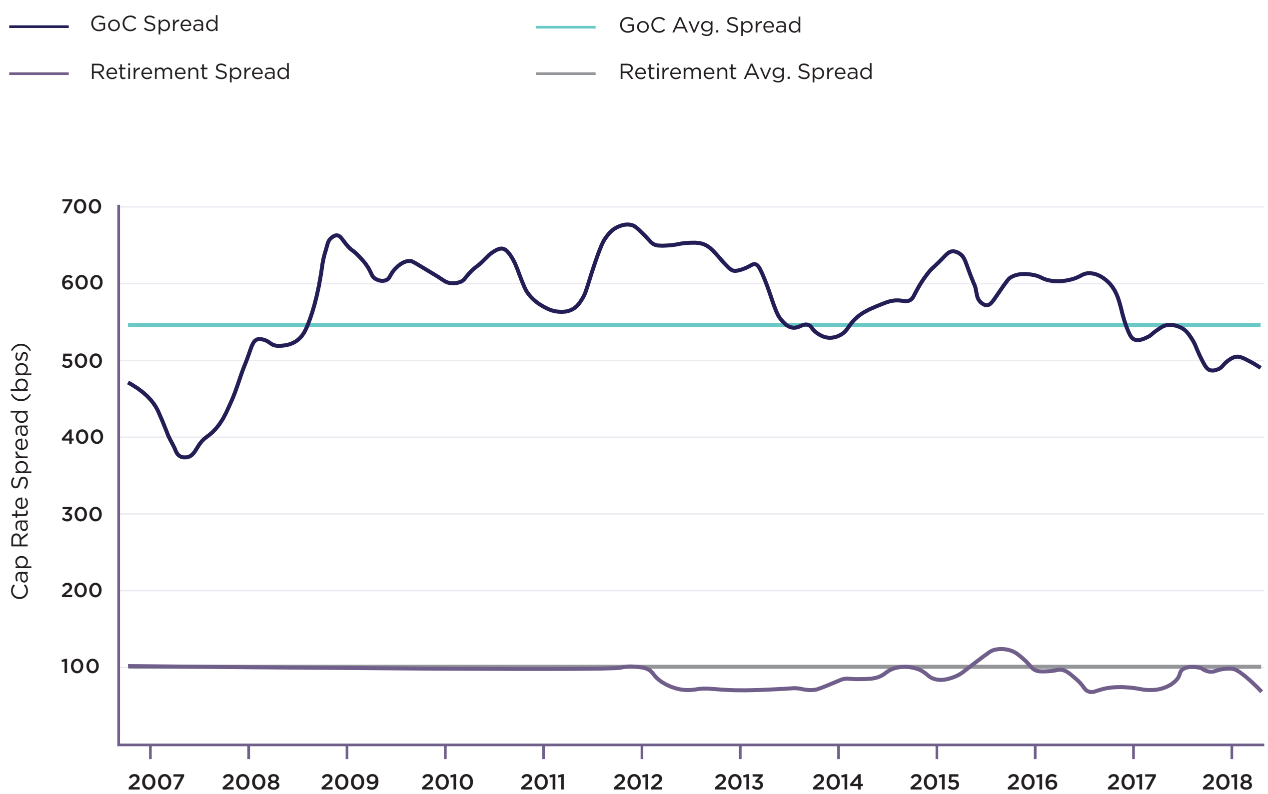
GRAPH 1 - NATIONAL SENIORS HOUSING AND CARE PROPERTY* CAP RATE VS. 10-YEAR GOC YIELD



* Class A seniors housing (IL/AL) assets. Stand alone property sales; not representative of portfolio transactions

Source: CBRE Limited

GRAPH 2 - CLASS "A" LTCH CAP RATE SPREAD VS 10-YEAR GoC YIELD AND RH CAP RATE



Source: CBRE Limited

In valuing the equity of the larger chains in the seniors' housing sector, valuators will often use market-based data, including implied earnings and cash flow multiples of comparable publicly-traded companies, as well as multiples implied by transactions involving comparable companies. However, these measures tend to reflect an underlying portfolio of assets, as opposed to an individual asset, may involve a combination of different types of seniors' housing assets (e.g., LTCHs and RHs) and other earnings streams such as home care or ancillary business ventures. These challenges are in addition to normal challenges a valuator faces in assessing comparability when implementing the market approach due to issues such as size, geography, growth opportunities and capital requirements, to name a few. Valuation metrics most often used by public company analysts include:

- EV / EBITDA (Enterprise Value / Earnings Before Interest, Tax, Depreciation + Amortization)
- P / FFO (Market Capitalization / (Earnings + Depreciation + Amortization – Gains on Sale of Assets)
- P / AFFO (Market Capitalization / (Earnings + Depreciation + Amortization – Gains on Sale of Assets – Maintainable Capital Expenditures)

These three valuation metrics differ in a number of ways. While the first arrives at the value of the enterprise (comprising all forms of capital), the second and third metrics value the equity of the business directly using a market cap as the indicator of value. In addition, while the first two metrics do not consider capital expenditures, the third metric does. This makes the third metric more relevant in situations where significant capital investment is expected, as would be the case with Class B/C LTCHs.

Conclusion

LTCHs represent a specialized market segment, even within the broader seniors' housing and residential care property sector, due to their particular licensing, funding and regulatory structures. These businesses are typically characterized by secure revenue streams, but profitability is limited in Ontario to the accommodation part of the business, while care funding is a pass through from the government. With revenues determined provincially by regulation, local real estate and labour markets can impact profitability substantially, as can economies of scale. Though licensing and regulation place high barriers to entry, they also present risks by imposing high standards on operators who serve vulnerable residents.

Given the sector specialization and the prominence of real estate in the value equation, valuators are well advised to work closely with appraisers with experience in the seniors' housing and residential care property sector. While appraisers employ valuation methods similar to those familiar to CBVs, there is no substitute for local knowledge of the real estate market in these types of valuations.

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