

FITCH ASSIGNS 'A-' IDR TO CAROLINA MEADOWS SENIOR COMMUNITIES & SERVICES, INC. (NC); OUTLOOK STABLE

Fitch Ratings-New York-09 January 2020: Fitch Ratings has assigned an 'A-' Issuer Default Rating (IDR) to Carolina Meadows Senior Communities & Services, Inc. (CM).

The Rating Outlook is Stable.

KEY RATING DRIVERS

CONSISTENTLY STRONG INDEPENDENT LIVING DEMAND: CM's independent living (IL) occupancy has averaged 95% over the past three fiscal years. The community benefits from a favorable location in Chapel Hill, NC, near universities and Research Triangle Park. The strength of demand is also reflected in the pre-sales for CM's 40 unit IL hybrid home expansion. All the units have been pre-sold, with a 10% deposit; construction for the expansion began in October. While assisted living (AL) and skilled nursing (SN) occupancies have been lower than IL occupancy, they remain adequate. SN occupancy in the 70% range is particularly low but not a concern given CM budgets to that level of occupancy, takes no outside admits and has a Type 'C' contract. Additionally, CM does not participate in Medicare or Medicaid in its skilled nursing.

IMPROVING OPERATING PERFORMANCE: CM's operating ratio has materially improved over the last three years, lowering to 89.3% in FY18 from 98.5% in FY16. The improved performance was driven by good expense management--with expenses nearly flat over the last two years--and steady rate increases. CM needs to maintain operating ratios at approximately 90%, as overall cash flow is limited given an entrance fee contract that is fully refundable (except for renovation and remarketing fee), and shares the appreciation in the unit as part of the refund. In FY18, CM's net operating margin - adjusted was 14.2% relative to an 'A' median of 22.9%.

MODERATE LONG-TERM LIABILITY PROFILE: CM's long-term liabilities show maximum annual debt service (MADS) of \$1.05 million, equating to a very low 2.3% of FY18 revenues compared with the 'A' median of 9.5% and debt to net available of 1.6x at year-end FY18 also compared very well with the 'A' median of 4x. CM's revenue only coverage--at a very solid 3.4x in FY17 and 6.8x in FY18--and CM's cash to debt of 280.3%, also reflects low debt burden, as well as the improved operating performance, which has supported growth in CM's unrestricted liquidity.

IL EXPANSION; LONGER TERM CAPITAL PLANS: CM will use a line of credit to fund the hybrid home expansion, which it will pay down with the new units' initial entrance fees. The project, the Birchtree, will be built in phases, so the loan drawdowns are expected to remain manageable. The project cost and the entrance fees are expected to be roughly equal at approximately \$28 million. The project started in 2019 and is expected to be completed in 2021. CM is also contemplating a repositioning of its skilled nursing center. That project is at an early planning phase and is not expected to start until after the expansion project. Given the light leverage, CM does have some debt capacity at the 'A-' rating level. However, upward momentum on the rating will be very limited until clarity is available on the potential SNF project.

ASYMMETRIC RISK FACTORS: There are no asymmetric risk factors affecting the rating determination.

RATING SENSITIVITIES

OPERATING PERFORMANCE: Fitch expects Carolina Meadows Senior Communities & Services, Inc.'s operating and financial profile to remain stable. A material and sustained fall of in performance or a sizable debt issuance could lead to negative rating pressure. Despite CM's relatively light leverage, potential for an upgrade is limited through the Outlook period, given the need for CM to complete the current expansion project and the uncertainty regarding the potential skilled nursing repositioning project.

CREDIT PROFILE

Carolina Meadows Senior Communities & Services, Inc. is a North Carolina nonprofit corporation and the sole member of Carolina Meadows, which operates a Type 'C' LPC. The campus is on approximately 166-acres of wooded land in north Chatham County, NC, approximately three miles south of Chapel Hill, NC. The community offers three levels of care and currently consists of: 156 IL apartments, 287 IL villas, four guest apartments, 78 AL units (with a license for 95 beds), and 90 skilled nursing beds Fitch analysis based on consolidated financial statements. CM has total operating revenue of \$42.3 million in FY18.

CM offers a unique Equity Advantage refundable contract. The contract is fully refundable, except for a renovation and remarketing fee. Additionally, if the resale value of the turned over unit appreciates above the sales costs, the resident is entitled to one half of the net appreciation.

CONSISTENTLY SOLID ILU OCCUPANCY

CM's independent living (IL) occupancy has averaged 95% over the past three fiscal years. While there is competition in the area, including Forest at Duke (IDR A/Stable), the community benefits from a favorable location in Chapel Hill, NC, near universities and Research Triangle Park, which has created a market that is deep in terms of income eligible seniors in the region. Most of CM's competitors have occupancy above 90%. Fitch visited the campus and found it well maintained and attractive with updated amenities that include a pool and nine hole golf course. CMS is unusual in the number of villas it offers, but they remain fully occupied.

CM has a very strong waitlist of over 600, which requires a \$3,000 deposit (fully refundable), and a Ready List with approximately 170 prospective residents. A five percent (5%) deposit is required to be on the Ready List. Additionally, members on the Ready List can pay an entrance fee and monthly service fees to gain full access to the campus amenities, including access to healthcare. This program, Early Advantage, has approximately 100 people currently utilizing its services. Both the Ready List and Early Advantage programs are relatively unique compared with other LPCs that generally have only the waitlist that requires a small deposit. Fitch believes the higher level of commitment required of CM's Ready List and Early Advantage programs, and the number of people currently on the lists, speak to CM's good competitive position in the market, despite the competition.

While assisted living and skilled nursing occupancies have been lower than IL occupancy, they remain adequate. SN occupancy in the 70% range is particularly low but not a concern given CM budgets to that level of occupancy, takes no outside admits, and has a Type 'C' contract. Additionally, CM does not participate in Medicare or Medicaid in its skilled nursing.

IMPROVING FINANCIAL PROFILE

CM's financial performance has materially improved over the last three years driven by steady revenue growth and very good cost management. In FY18, CM posted an operating ratio of 89.3% and a net operating margin of 12%, much better than the 98.5% operating ratio and 3% net operating margin posted in FY16. The improved performance was sustained through the first nine months of 2019 as CM posted a 90.6% operating ratio and a 10.5% net operating margin. CM's

needs to maintain operating ratios at approximately 90%, as overall cash flow is limited given the entrance fee contract. CM's net operating margin - adjusted was 14.2% relative to an 'A' median of 22.9%.

The improved operating performance has led to solid growth in unrestricted cash and investments, which has increased by 41% since year end 2016. The \$35.7 million of unrestricted cash and investments at Sept. 30, 2019 equated to a 393 Days Cash on Hand and 280.3% cash to debt compared with Fitch's 'A' category medians of 638 days and 122%, respectively.

Capital Projects

The largest current project is the 40-unit Birchtree hybrid home expansion. The 40 units are pre-sold. Fitch notes that the hybrid homes are a new product to CM and should blend well with CM's villas and IL apartments. CM will use a line of credit to fund the expansion, which it will pay down with the new units' initial entrance fees. The project will be built in phases, so the loan drawdowns should remain manageable. The cost estimate and the entrance fee are expected to be roughly equal at approximately \$28 million. Once the new units are filled, the additional IL revenue should be accretive to CM's overall financial performance. The project is underway and is expected to be completed in 2021.

CM is also contemplating a repositioning of its skilled nursing center. The current skilled nursing center is located in the middle of CM's campus next to the golf course. Fitch does not expect that project to begin until after the Birchtree is built and filled.

MANAGEABLE LONG-TERM LIABILITY PROFILE

CM recently closed on a \$12.7 million bond issuance that is a direct placement with SunTrust Bank. The bonds are variable rate, and CM has a fixed rate swap that hedges half of the variable rate debt. The issuance refunded CM's outstanding debt. The term of the placement is through 2034, which is the remaining length of the bond amortization. Fitch views the matching of the amortization and the placement length as a credit positive.

CM's long-term liabilities, not including the line of credit that's funding the IL expansion, show maximum annual debt service (MADS) of \$1.05 million, equating to a very low 2.3% of FY18 revenues compared to the 'A' median of 9.5% and debt to net available of 1.6x at year-end FY18 also compared very well with the 'A' median of 4x. CM's revenue only coverage--at a very solid 3.4x in FY17 and 6.8x in FY18--and CM's cash to debt of 280.3%, also reflects low debt burden, as well as the improved operating performance, which has supported growth in CM's unrestricted liquidity. Revenue only coverage is a key coverage metric for CM, given its refundable contract.

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Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)

<https://www.fitchratings.com/site/re/10099396>

U.S. Public Finance Not-For-Profit Continuing Care Retirement Community Rating Criteria (pub. 30 Mar 2018)

<https://www.fitchratings.com/site/re/10024657>

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