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Healthcare Economic and Policy Update: Fourth Quarter 2009

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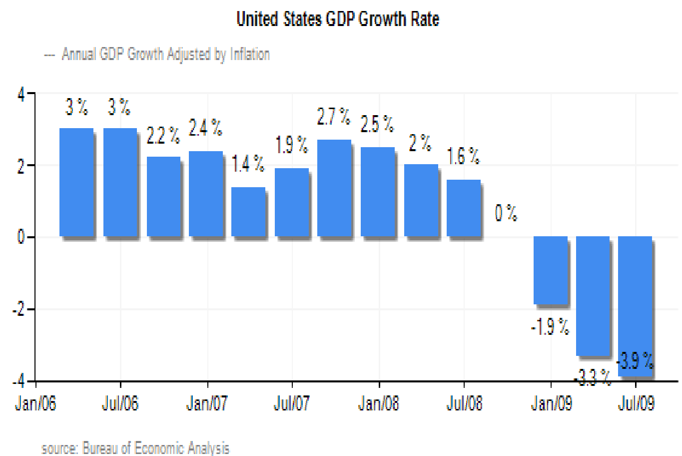
Introduction

By all indications and a consensus of economists, the recession which began in fourth quarter 2008 has abated. This is not to say that the economy has recovered or is approaching wholesale recovery as typically recessionary activity comes on far faster than it ends, especially when recessions are as broad and as deep as this recession.

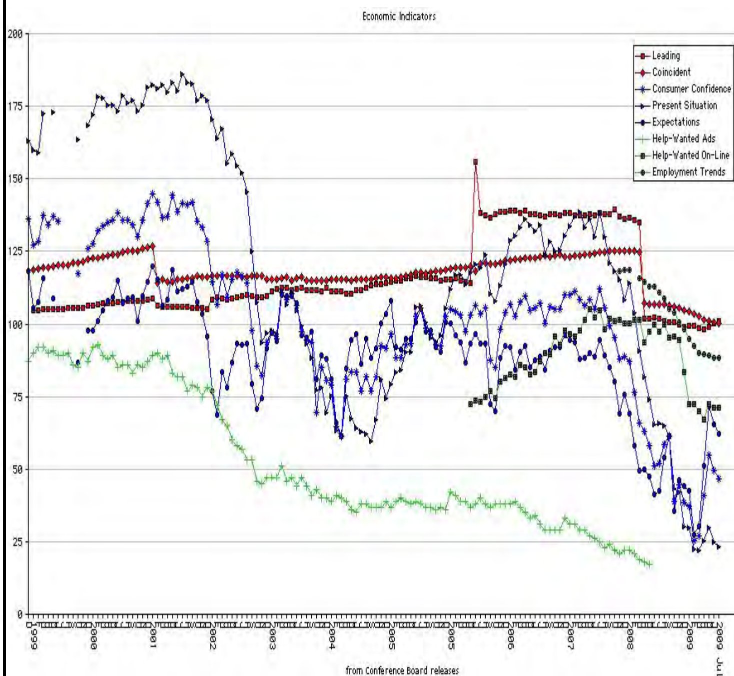
Using the classic "recession" definition of two consecutive quarters of negative GDP growth, the end or bottom of this recession will occur in the third quarter of this year when projections for a 0% to 1% growth in GDP will be realized. In all likelihood, the realization of this meager GDP growth will turn principally on the "cash for clunkers" stimulus program and the $8,000 first time home buyer tax credit program. Other Federal stimulus spending also has contributed to this positive change in GDP albeit, less dramatically.

What is yet to be determined is where or when actual recovery will take place as opposed to merely the attainment of the "bottom" of the recessionary



period. Using alternative recession definitions such as levels of unemployment (a recession is a period where unemployment rises 1.5% in twelve months) seem to suggest that the U.S. has yet to hit the bottom and that actual recovery is farther out than foretold by the GDP numbers.

If one turns to Leading Economic Indicators, the views of recession and recovery become a bit more esoteric, as one would expect based on statistical analysis. According to the Conference Board, the period of recession began in December 2007 (despite GDP growth) and reached bottom in June of 2009. This is based on the Composite Economic Index turning downward or negative in December of 07 and bottoming out in June of 09. The Leading Economic Index began to rise in March of this year.



The difficulty with using Leading Economic Indicators as a predictor of recession and recovery is the number of indicators factored in such as labor and consumer sentiment. Employment for example is generally a lagging indicator, indicative of more fully realized recovery rather than early-stage recovery.

The stock market is often called the great harbinger of economic trends; capable of foretelling downturns and recoveries as investors react to economic data on a micro and macro basis. If such is the case this time around, one would believe that the economy has truly begun to rebound as the market has risen by more than 3,000 points since March. The difficulty now in determining how prescient the stock market is regarding recovery are the lack of true signs of recovery present and true top line revenue (sales) and resulting earnings growth (the true measures of economic vitality) that have not been present in the companies that make up the value in the market indices. The question that begs is, "Is the stock market an accurate leading indicator for this recession?"

When we turn our attention to healthcare and primarily post-acute care, we look at policy trends as much if not more, in terms of preparing our economic outlooks. Healthcare has become somewhat intertwined with the overall economy in this recession as for the first time we saw an overall downturn in economic activity directly related to healthcare spending (non-governmental). We also have witnessed a first as far back as memory serves when the President proclaimed that overall economic health and to a lesser extent recovery, would hinge or rest on the success or failure of reform legislation. There is no question that today the economics of healthcare in the United States is front and center in the news, in the halls of Congressional office buildings and in the psyche of many Americans. What this foretells for the industry is that issues of spending, cost, quality and access will dominate the healthcare economic playing field for some time to come and without question change is forthcoming – positive and negative.

CURRENT ECONOMIC STATUS AND 2010 OUTLOOK

We are confident in our position and the consensus of most economists and the Fed Chairman that the economy has reached its low ebb and while contraction remains highly probable on an industry by industry basis, zero to a 1% growth in GDP will occur in the fourth quarter of 2009. We are also confident that employment will not begin to rebound in any materially positive manner until late first quarter 2010 or early second quarter 2010. This said, it is our conclusion that jobless numbers and unemployment may still tick upward by just a bit but we believe that most of the wholesale lay-offs are nearly if not totally, complete. Hiring will

remain sluggish and the first uptick in economic activity will not produce many new jobs as companies have taken the downturn period time to build in productivity enhancements and gains, negating an immediate need for additional labor resources.

The modest positive turn in consumer confidence that produced hearty auto sales and renewed activity in the home real estate market is likely to wane through the fourth quarter and into early 2010. Most of these gains were the result of Federal subsidies (stimulus) propping up short-term demand. As the stimulus dollars evaporate, so will a good portion, if not all of the economic activity in these sectors. Our view is that in-spite of low interest rates, consumers will not re-enter the buying mode until employment begins to build. Since we see no real indicator of new job growth for the next four to six months, we see no real increase in consumer appetite. This lack of appetite foreshadows a lack-luster Holiday buying season, in spite of retailers having very slim inventories and aggressive discounting policies.

Our view of the stock market is that correction is likely to happen in the fourth quarter of this year and 2010 will start with extremely mixed results, playing to about par through the first quarter of the year. We support this conclusion by analyzing the internal data of the companies that make up the market indices. What we are seeing is no real top line revenue or sales growth across the board and as a result, no real potential for earnings growth. Where gains have come to date has been principally via companies shedding expenses. Without reinvestment and marketing to grow top-line sales, the revenue versus expense picture across these companies is predominantly flat. Until we begin to see consumers return to the party, we are skeptical that the market can sustain the run it has produced over the last four to six months. As consumers make-up seventy percent of all economic activity in the United States economy, their current choice to put a dollar into their pocket versus spend or lever the same dollar for consumption implies that the economy is a ways away from turning the corner, and so are the companies that are traded in the markets.

In our opinion, there is a real possibility that the stock market will contract by as much as 15% to 20%, trading at year-end closer to a Dow of 8,500 versus 10,000 today. There has been very limited positive economic news other than a lack of continued bad news to support the recent runs. If sentiment alone is bolstering the present rise, sooner or later the same sentiment will need positive, real economic results and news to sustain it.

We see the signs that recovery is still probable and believe that the likelihood for true signals or signs won't occur until 2010 – first quarter best case. Leading indicators suggest the same. For example, there has been a modest increase in new housing starts, particularly in multi-family construction. This kind of news implies anticipation on the part of builders of increased housing demand over the six to nine month horizon. Other bits of information we treat a bit more skeptically. For example, while positive news we discount information such as an increase in household wealth as principally, this result is due to the recent market rise and individuals saving versus spending or paying off debt. We also discount news such as reductions in job-less claims as it is more indicative of a bottoming out of a recession than an increase in economic activity. We also believe that the residential housing market will remain soft, both in terms of overall sales and per unit prices. Succinctly stated, it is our belief that no other significant good economic news of any magnitude is imminent and as a result, investor sentiment will turn from positive to ambivalent and negative, producing a modest correction.

When we look at the policy and economic fundamentals, we see a very mixed and somewhat negative accumulation of structural issues. These structural issues can be considered the building blocks of a recovering economy; cast in steel, concrete or soft mortar. From our perspective, governments often create policy with a blind eye to the law of unintended consequences – short-term

reaction versus long-term implications. When integrated and deployed, these same policy decisions viewed perhaps as stimulating or positive can leave unintended structural issues that present a drain or drag on a recovering economy. Moreover, these same structural issues left unaddressed often beget new and more complicated policies designed to counteract the negative effects of the last series of bad policies that begot the current structural problems. A case in point is Fannie Mae, Freddie Mac, relaxed lending standards and the banking crisis.

Our principal concerns for the future rest in current monetary policy and government deficit spending. The Federal Reserve has been exceedingly willing to free-flow dollars into the financial system in the hope of staving off bank liquidity crises and to propel lending. While we won't argue that to a certain extent the first objective has been met (staving off liquidity issues) the second is far from being achieved. Not coincidentally, we won't fault the Fed totally for a lack of bank lending as the demand for loans (residential, commercial and general credit) has been soft. Nonetheless, the argument can be made that even with significant support from the Fed banks have been unwilling to step up their lending activities, instead shoring up reserves and improving short-term earnings.

Government deficit spending is our largest area of concern for the economic future of the U.S. Recently released figures from the Treasury show a bleak picture of the Federal budget with declining revenues from tax receipts and rising expenditures due to Stimulus spending and other initiatives and of course, a widening deficit. Numerically, Revenues decreased by $360 billion (compared to 2008) and Expenses increased by $530 billion. The deficit for the first ten months of the fiscal year is $1.3 trillion, up from $420 billion for the same time period in 2008. All tolled, the deficit is projected at $1.8 trillion for the full fiscal year of 2009 – more than twice the size of the largest Reagan era deficit. The $1.8 trillion deficit will equate to 13% of the nation's GDP. All of these amounts exclude the costs associated with healthcare reform which perhaps fortunately, due to the present rate of discussions in the House and Senate, will not be enacted in any form until Fiscal Year 2010.

The above numbers are part and parcel of recessionary times, especially when a government intercedes with stimulus programs and industry bail-out packages. Our concern however is not so much laden in the numbers but what is behind the numbers and the structural issues that may continue to arise. For example, $252 billion of the total jump in spending occurred as a result of bail-outs to Fannie Mae and Freddie Mac. Another third of the spending increase came as a result of the federal government temporarily picking up the cost of Medicaid for the states at a price tag of $188 billion. There were also increased outlays for unemployment insurance claims, and the enlargement of food and nutritional programs. Without substantial economic recovery coming forward fairly soon, the federal government cannot remove itself from continued subsidy of this type and perhaps greater.

As we look forward into 2010 and a bit beyond, we see the effects of federal spending and a slowly recovering economy on future budget estimates. The OMB (Office of Management and Budget) has indicated that the Administration projects deficits in the $1 to $1.5 trillion range through 2011 and $500 billion thereafter. This level, if correct and not ultimately higher as is typically the case, places the public debt level at $12 trillion or 70% of GDP. It is important to note that these figures presume a faster recovery and stronger economic growth rate (plus 3.5% to 4.5% in GDP) than most economists and of course, we believe is plausible.

Not too surprising, the numbers above do not reflect the costs associated with healthcare reform. If we assume reasonably that a compromise package of House legislation and Senate legislation becomes law, sans any new tax increases, the deficit above grows conservatively by $200 billion in the first year of implementation and ultimately to $1 plus trillion over ten years. (Note: Our assumption of $200 billion in the first year is based upon

provisions going into effect (spending) faster than savings realized from Medicare spending reductions and other imbedded revenue sources).

As there appears to be no signs that the red ink will run dry in Washington anytime soon, our concern turns to the economic structural flaws that seem to be building. These structural flaws, left unaddressed in our opinion, pose problems for longer-term economic recovery and stabilization (2011 and beyond). These structural issues are as follows.

- With the need to continue to finance deficits with public debt, will there be a large enough foreign appetite (China) to continue to buy this debt without a rise in interest rates? Assuming that the Chinese economy continues to develop internally, reducing its reliance on U.S. imports, China may find it less beholding to the U.S. and constrain its appetite for Treasuries thereby demanding a hike in interest rates. Today, there is no other foreign consumer sufficiently large to offset even a modest decrease in China's consumption of U.S. debt.
- Continued deficits raise the pressure on the Fed to inject more liquidity (dollars) into the system, above what it already has done. This activity is inflationary and fortunately for at least now and perhaps through 2010, the general weakness of the U.S. economy and the World economy will hold inflation in-check. Without the Fed taking action to reduce some liquidity and the government slowing the red-ink express, we see an unquestioned rise in inflation forthcoming.
- The value of the dollar internationally continues to be in longer-term question – negatively. If as we predict, inflation begins to rear-up in 2011 due to inaction by the Fed and Washington to reduce liquidity and stem the tide of deficits, the dollar will weaken. The weakening of the dollar internationally only bolsters inflationary pressure into the long-term, adding to the domestic inflationary issues.

Concluding, our general outlook for the balance of 2009 and 2010 is cautious and skewed unfortunately, less optimistic than what is often heard via Washington. We believe that the near horizon is an opportune time for Washington to address first and foremost, key economic issues such as deficits and short-term liquidity surpluses and then, using a more balanced approach, return to domestic policy issues such as healthcare. Adding additional deficits to the existing and rising deficit levels via new healthcare and energy policy will only serve to slow the pace of recovery and weaken structurally, the economic elements critical for long-term, sustainable recovery and growth. In short, our forecast is for a zero to 1% growth in GDP for the fourth quarter of 2009 and an annualized growth in GDP of 2 to 2.5% for 2010. Within this horizon, we forecast that unemployment levels will begin to drop and job growth initiate toward the middle to end of the first quarter of 2010. We also forecast a slightly upward trend in interest rates with rates remaining relatively flat for the balance of 2009 and gradually increasing from the mid first quarter of 2010 on. Our market expectations are for a short-term correction in the last quarter of 2009 by perhaps as much as 15% to 20%. We forecast the market to take the bulk of 2011 to recover the correction with a modest improvement realized over today's level (approaching 10,000) of approximately 8% to 10% (to the 10,5000 to 11,000 range).

THE HEALTHCARE ECONOMIC OUTLOOK AND POLICY STATUS

As our firm is focused on healthcare and more succinctly, post-acute healthcare and senior housing, we follow overall economic trends and conditions and translate the same for the healthcare economy. As healthcare remains a private industry today, albeit one that is heavily tied to the Federal government, the general economy does impact the healthcare industry. Arguably, as with the current state of the general economy, public policy has the greatest ability to impact the healthcare economy, in the short-run and structurally, for the long-term.

Healthcare in General

Healthcare is the largest private industry in the U.S. economy, accounting for 17.5% of GDP. The U.S. spends more on healthcare in total than any other country in the world and when taken as an economy by itself, the U.S. healthcare economy (in total dollars) is larger than the GDP of nearly all world nations save five (Great Britain, Germany, Japan, China and France). This means that the U.S. spends more on healthcare for example, than the total dollar value of the Canadian GDP. Its economic wealth and value as part of the U.S. overall economy is enormous and as many would argue (and we agree), its prospects in the future as related to the overall U.S. economy are critically important.

Today, the spending profile on healthcare in the U.S. is at the center of public and governmental debate. The rate of spending on healthcare as a percentage of governmental budgets and personal or household budgets continues to grow at rates exceeding the rate of consumer inflation. As a percentage of governmental budgets, healthcare spending is practically unsustainable in its present form without significant modification to the financing side of the various entitlement programs. In other words, without a broader and deeper taxation base, there is no way that governmental healthcare spending in its present form and at its present trajectory can be sufficiently paid for. The forecast for example for Medicare in its present configuration shows a $46 trillion deficit over the next seventy-five years.

Important to understand about the healthcare economy is the role two separate parties play; government and the private sector. In 2009, government spending as a percent of total healthcare spending will represent 30%, principally on Medicare and Medicaid. There are estimates from various sources that within three years, government spending will account for 50% of all healthcare spending in the U.S. We of course, are skeptical that the amount will rise to quite this level but agree in principal that government entitlements will continue to consume a larger share of total spending in the near future. The largest driver of increased government spending on healthcare is U.S. demographics; an older population living longer, particularly with chronic disease and disability. Another driver of this trend is the economy itself and public policy. As governments continue to create more entitlement programs (state and federal) with easier or more fluid eligibility criteria, the government effectively "buys" more insureds or beneficiaries. An example of this is the changes to SCHIP that increased the income level for eligibility and increased federal funding.

The private portion of the healthcare industry is not directly connected to the government portion but interdependent nonetheless. As government becomes a larger and larger consumer, the inadequacies of government payment and the inefficiencies and bureaucracy of government programs add costs to the private portion of the industry. For many provider groups, government programs are the largest customer (e.g., nursing homes) and therefore, the largest contributor to inflation realized by the provider. Arguably, no other private industry has as much of its economic outlook and revenue and expense profiles controlled by government as healthcare. When the private industry portion is reviewed and its inflationary profile examined, one cannot discount the large role government is playing in contributing to the increasing costs and declining real revenue via reimbursement, arising from its own bureaucracy and legislative tinkering.

Given the present public policy environment, our outlook for the overall healthcare economy through 2010 is somewhat less clear than perhaps at any time prior. We assume that the continued reform debate will produce some legislation though our assumption is for a package that is significantly different than what exists in HR 3200 or the Senate companion, Baucus bill. Below are our general economic and policy assumptions for the healthcare industry.

- Our forecast is for inflation to run at 10% in 2009 and slightly lower in 2010 – 9%. History indicates that economies in a

recession and then in the early stages of recovery produce higher healthcare inflation as a greater share of GDP is consumed by healthcare. Further compounding the inflation problem is the relative weak value of the dollar and the higher interest or debt costs providers are facing as a percentage of revenue (revenues in the industry are flat or slightly down). Even though interest rates are at historic lows, providers are finding that the debt markets are less than open for refinancing.

- We expect bad debt to continue to run higher than in prior years as typically, every 1% increase in unemployment produces 1.1 million uninsured citizens. Even though non-urgent and elective healthcare spending has fallen, care will still be required by people who have less means of paying for it now and in the near future than two to three years ago.
- We continue to believe that the credit markets will remain fairly tight through all of 2010 and while interest rates will remain lower than normal, the accessibility of credit will be tighter than recent past. This assumption means that credit may likely be accessible but appraisals will continue to produce lower than historic values and creditors will require more equity as a condition of financing.
- We are forecasting only modest increases in supply costs and energy costs, unless of course legislation such as Cap and Trade becomes law. The continued weak economy, even with a modest growth profile, will not produce inflation across these commodities in more than modest amounts.
- The non-specific, general labor market will remain favorable for providers although the skilled, allied health professions will remain competitive, especially in certain clinical areas such as pharmacists, nurses, and physical therapists. Combining the two pools, we see minimal wage inflationary pressure on the horizon as jobless rates will remain high. On average, we see overall wage and benefit increases averaging less than 3% and certainly, could come closer to 2.5%.
- Without a general shift in unemployment looming and a more rapidly growing economy coupled with new insurance mandates from Washington, the trend toward high deductible health plans and Medical/Health Savings Accounts (MSA and HSA) will continue. Plans such as these impact health consumption as consumers seek lower cost treatment alternatives or forego non-urgent medical care entirely.
- As a result of the point immediately above, we continue to see a strong growth profile for non-institutional delivery models of care such as clinics within grocery stores and Wal-Marts. We also see strong growth for continued use of generic medications although the total number of generic alternatives to brands is relatively saturated with no high dollar brand patents set to expire in the near term.
- Merger and acquisition activity will be strongest in the pharmaceutical and bio-tech segments, as has been the case in 2009. While we believe this activity will also pick-up in other segments, the dollar value of transactions and the overall number will continue to be down from prior years.

- Capital spending trends will remain depressed for the balance of the year and 2010 across the industry, principally due to financing availability and a continued focus by the industry in general on achieving margins. We believe this is an area of concern going forward as inadequate investment levels for infrastructure and aging plants could produce negative equity worth and operating inefficiencies across the industry.

Our next series of comments and forecasts concern particular healthcare industry segments namely, Skilled Nursing Homes, Assisted Living, Senior Housing and Home Health/Hospice. These

segments are focal areas for our practice and as such, we believe that they are worthy of tailored commentary.

Skilled Nursing Facilities

To avoid redundancy, we believe that most of the economic forecasts applicable to the general healthcare industry are applicable to SNFs as well. The comments we made for example, regarding labor and supply and energy cost inflation would be identical for this segment. There are twists however, in our thoughts regarding other aspects such as bad debt and the impact of health welfare plans on utilization – some of our thoughts are applicable but in different ways, while others are not at all. To that end, we will start with a general policy overview and then move to specifics regarding our forecasts.

Skilled nursing homes are a focal point within the healthcare reform agenda. Despite the fact that coverage for skilled nursing care is minimal under Medicare and supposedly, a priority under Medicaid for only the indigent, the overall growth in spending for skilled nursing care continues to outpace the growth in general healthcare spending. One needs only to take a brief look at the aging U.S. demographic to understand why. Even with a push in recent years toward deinstitutionalization and a decline in total bed capacity, the cost per patient or resident stay has increased. The reason: SNF care has risen dramatically in acuity levels, now serving a more medically intense patient profile. Without question, the changes in recent years to Medicare reimbursement (paying more for more acute and medically complex patients) has led the industry to gravitate to a more acute patient mix. It is this factor from the Fed's perspective that is causing the SNF industry to become a focal point within healthcare reform; a target if you will, for cost cutting.

Medicaid has issues unto itself, exacerbated by the recession. The recent economic recession significantly changed the financial fortunes of nearly all states in the Union. Medicaid, being administered and partially funded by each state has been exposed as an enormous, principally unfunded liability on State's books. Without a literal bail-out by the Feds with stimulus money, most states would be forced to raise taxes substantially and/or cut benefits to beneficiaries and providers via reimbursement reductions. Aside from the economic woes of the states, new beneficiaries became eligible at rapid rates; rates far faster than seen in decades. The stock and investment market drop instantaneously reduced the estates of millions of seniors, in many cases substantially. The freeze-up of residential real-estate markets made homes illiquid and lenders shy about offering reverse mortgages or equity mortgages to seniors as means of producing liquidity. The result: Seniors with some means became Medicaid eligible at a rapid rate. For SNFs, this means a good paying customer turns to a poor paying customer (rate) far faster than projected.

As Medicaid remains the dominant payer in SNFs, its fortunes foretell the fortunes of many SNF providers. Medicare, viewed by providers as a means to offset Medicaid losses, is the target of significant spending reductions and resulting, reimbursement reductions to providers. CMS proposed rates for FY 2010 include a 1.1% reduction in reimbursements. Further program changes include additional RUGs and MDS refinements, all foretelling more reimbursement cuts. When the current level of healthcare reform proposals are factored in, additional cuts would be in the offing such as an elimination or freeze of the market-basket update, an introduction of a productivity adjustment factor (counter-acts the market basket increases) and a provision for bundling of payments between SNFs and Hospitals across certain patient categories.

When we integrate these policy and economic conditions with our overall view of the industry near term, our outlook is logically, a bit negative. It is difficult for us to find a lot to be optimistic about in our forecast for 2010 and even frankly, beyond. What we principally see is declining reimbursement, a soft private pay market and

increased regulatory pressure and activity. While we are calmed a bit by a lack of general cost inflationary pressure, we can't offset this bit of bright news against the dim revenue prospects. As a result, our forecast is synthesized as follows.

- Medicare cuts are a certainty throughout the time horizon – fourth quarter 09 and 2010. These reductions of 1.1% may get worse with the realization of healthcare reform which uses Medicare spending reductions as a source of financing.
- Medicaid will continue to be a financially troubled payer and the rate forecast is flat to declining. As Medicaid already is a payer that significantly under-reimburses actual care costs, we see no indication that this trend will improve and likely, will continue to worsen. We are also very concerned that an evaporation of Federal stimulus funding will leave many States' Medicaid programs literally bankrupt. If this occurs at all in 2010 or early 2011, providers could see reimbursement IOUs and experience significant cash-flow problems.
- As much as providers will try to soften the reimbursement reductions with more aggressive rate increases to private paying residents, this option is precarious. Residents with remaining means are still feeling the impact of market declines and while the markets have somewhat recovered, this level of recovery has not made them whole. The real estate market has also yet to recover and values will remain below values of two to three years prior. In short, we see private payers as continuing to decrease in overall numbers and the effects of recessionary times prior still pushing more of this group toward Medicaid eligibility.
- Recessions lead to an increase in bad debt and such will continue to be the case for the industry. Bad debt will continue to rise modestly as residents shift from payer sources (private to Medicaid) and providers struggle to stay abreast of timely applications for assistance. We also see and forecast a continued trend in pension and other annuity erosion, leaving seniors unable at a certain point to pay a portion of their bills yet still not eligible for Medicaid.
- We forecast a continued trend toward looser credit markets although as in earlier comments, terms will be still tight. This means that we continue to forecast reductions in capital spending and of course, we are concerned about these reductions. The industry as a whole is typified by aging physical plants and without additional influxes of capital improvements, the general wealth and operating profile of the industry continues to decline.
- On the mergers and acquisitions front, we are forecasting increased activity but at cap rates higher than in the previous three years. We believe that most transactions will occur as large proprietary providers shed poor or sub-par performers, in regions, states or areas that have poor economic outlooks. In general, we believe that most buying will be on a "value" basis.
- We believe that providers in general will continue to look for ways to cut expenses as a means of achieving modest margins. We believe that the industry margin levels will decrease this year by as much as 1%.
- The expense outlook is good for the industry as a whole, with a few labor exceptions (see our general healthcare industry comments).
- Our largest area of concern on the expense side continues to be the cost of compliance. We forecast no reduction but an increase in regulatory scrutiny and activity for the industry. We believe that Medicare Recovery Audit activity will increase as well as Medicare probe activity. We also believe that providers will continue to face mounting regulatory challenges in the areas of environment, dementia care, infection control (H1N1 driven) and nutrition and hydration (as well as other areas). As States continue to balance budget issues, it is logical for us to assume that fines and forfeitures tied to compliance surveys will be targeted revenue sources.

Assisted Living

We've watched this sector struggle a bit this past year to eighteen months as declining occupancy has been the story, principally due to the economy and the soft residential real-estate market. We also believe that this sector has reached a certain level of maturity and as such, certain market areas have become over-built. Today, and for the foreseeable future, we anticipate that a fair amount of shake-out and consolidation will occur across this sector; a separation if you will among the various players and the types of assisted living development.

Over the past decade or so, this industry segment has exploded. This explosion of development naturally caused a fair amount of "me too" thinking among developers and real estate people believing that old adage of, "if you build it, they will come". As to be expected, the adage didn't quite pan out or hold true. Suffice to say, the industry saw some fairly large casualties as Alterra, once the industry leader, became overly leveraged and overly committed to new development and thus, overly riddled with debt problems. Sunrise Senior Living also has had problems as of late as it too was overly leveraged, heavily invested in markets that were over-developed, and ineffective as a marketer/operator in other markets. The net result for Sunrise was the need to reorganize, divorcing itself of certain management deals and consolidating its owned entities via sales. No doubt, a principal strategy was also to raise capital and increase liquidity sufficient to restructure its debt.

The maturation of the market has established a three-sided trend. The first involves the staying power requisite to surviving in down times. Those organizations that are sufficiently capitalized, not over-extended and have consistently shown balance-sheet management savvy are now poised to move forward operationally as the economy recovers. The second involves having a business model that truly offers a discernable product difference within any given market. For the operators that have established "brand" and created competencies in service lines such as dementia care, their prospects are far brighter than those who have sought to compete on real estate and location alone. Third, developers and operators that have managed their location presence and stayed away from over-built, over-developed locations will be better adept at capitalizing on new market opportunities as their portfolio of locations likely has fewer long-term census challenges than their competitors.

The economy and the maturation of the industry have also shown us that pricing and property density does have a significant impact on the success or failure of any one site or group of sites. We have noticed a distinct trend that smaller scale facilities, the genesis of the industry, are nearly out of favor. This is not to say that within some smaller and more rural markets, a small facility (20 units or less) cannot be successful but the trend as a whole is for smaller facilities to have run their course. We also have seen less of a movement toward facility opulence and more of return toward true utility and functionality. We are certain that this correlates to per unit prices in more upscale facilities becoming unattainable, especially when the economy slowed. It is our contention that the top end of the market pricing has run its course for the time being and operators need to become price sensitive or face ongoing discounting as a means of achieving occupancy levels.

On a go-forward basis, we have general good feelings about the Assisted Living industry and its prospects. We of course realize that the continued softness in the economy, the tight credit markets and some advancing regulatory over-sight can dampen the industry's prospects in the near future but some recent solid occupancy increases, decent profitability and some renewed M&A activity allows us to be somewhat bullish. With that said, the following is our forecast for the remainder of 2009 and 2010.

- Occupancy will continue to be an issue across the industry as a slow recovering economy and residential real estate market continue to make new move-ins a challenge.

- Creativity in pricing, marketing and outright discounting will remain the name of the game to achieve increasing occupancy. It may take as long as another year, into 2011 for this trend to subside.
- As a result of the point above, revenue per unit will be down a tad and overall revenue will be once again, below prior year levels.
- We believe margins will improve in-spite of lower revenues, principally due to improving occupancies and expense cutting that occurred in the latter parts of 2008 and throughout 2009.
- Despite interest rates remaining low and credit becoming a bit easier to get, there has been enough struggles among major providers and developers for lenders to remain cautious. We believe that access to capital will continue to be tight and that appraisals will be equally as tight in terms of values. This essentially means that access to credit will require more cash as part of any transaction or re-financing.
- There will be more transaction volume in 2010 both in the form of mergers and acquisitions and management agreements. We believe that this trend will gain strength as the industry continues to rebound in terms of occupancy levels. We don't however, foresee a wholesale reduction in cap rates as most deals will be done as value plays and/ or as part of a larger package where restructuring was the key to the deal. We also believe that there will continue to be a fair number of "one off" deals and a somewhat fluid market for individual, troubled facilities, bought by a stronger provider making a value play.
- We think that most operators will remain very focused on expenses as revenues per unit will remain fundamentally flat.
- We believe that there will be continued trend growth in providers moving into more specialized forms of Assisted Living (dementia, high acuity, etc.). This trend makes sense as providers seek to garner market share and improve soft occupancy. The demand curve for this type of care is less elastic than for traditional assisted living.
- We believe that the non-profit segment of the industry is poised for continued development, particularly as a part of an integrated campus setting. A model we like is an SNF focused on short-stays and higher acuity, paired with an Assisted Living that also has a higher acuity capability. We believe that non-profits willing to access tax credits and HUD products can develop and/or operate income controlled projects that will perform well for the foreseeable future.

Senior Housing

We categorize Senior Housing separate from Assisted Living via the distinction that Senior Housing lacks a distinct package of formalized care or health services. While it is more often the case that Senior Housing has some wellness services available today, the configuration is generally such that real estate and accommodations are the primary features. Whether the style or configuration is congregate (apartment style), side by side (town-home), condominium style, lifestyle in planned unit developments or even part of a CCRC it falls within our definitional box as Senior Housing.

The primary factor influencing Senior Housing is the economy with a strong secondary factor being the real estate market. As one can imagine the demand curve for this product is very elastic with many alternatives filling the bill, the most common being the current residence. Beyond the current residence, there are substitution products such as condominiums and apartments and in some cases, moving in with relatives (typically adult children). As Senior Housing is truly a niche option for a segment of the population, its market dynamics are harder to analyze. The true demand can fluctuate substantially, primarily due to the economy, the real estate market, and the market alternatives for housing that exist in a particular locale. As the senior him/herself must principally decide to

relocate to this specialized from of housing, social factors play as pivotal a role in determining true demand as does the product itself.

Over the time since Senior Housing became a product or industry segment unto itself, there have always been some models that developed naturally. We call these NORCs or Naturally Occurring Retirement Communities. Typically, these NORCs were congregate apartments and/or condominiums predominately occupied by seniors. The rent or cost profile generally fit the senior budget, the location was convenient, and once one or more adventurous seniors occupied a project, they self-marketed to their peer group. It was this genesis that created the initial platform for specialized developments such as Sun City. The unique twist was a desirable magnet location, certain lifestyle features (tennis courts, pools, clubhouse, etc.), a slightly premium price tag but a lower overall cost of living, and a planned marketing approach as a "destination for seniors". Using the leverage of one senior attracting many, the program worked.

As is the case with all truly free-market products, there are variations and price points for Senior Housing developments all along the consumption curve. There are subsidized, rent controlled projects geared to seniors of modest means and extremely high end, single family models in gated communities, limited specifically to seniors. The predominant model however, tends to be a "market oriented" facility, priced and configured to be reflective of the area in which the project is located. Within this market orientation, the typical senior housing project includes a bundled package of common services such as utilities included within the rent, parking, maintenance, grounds care, security, use of a commons area, and some emergency response feature built into the dwelling.

From a demographic perspective, the typical congregate senior housing project has aged in the last decade – the average age on entry continuing to creep higher. We believe this is indicative of a two stage move approach that many younger seniors are undertaking. The first stage is the initial down-sizing from a single family residence to either a smaller single family dwelling or perhaps, a condominium. The second stage is move to a senior housing project. This second stage is usually predicated by either the onset of a limiting health condition or a change in marital status or perhaps elements of both. We still find the dominant sex within congregate senior housing projects to be women, implying that a husband has passed or has become incapacitated to an extent that he requires more advanced care services.

A trend that has escalated over the last decade is the development of senior lifestyle communities. The lifestyle community is a clear attempt to attract younger, baby-boomer generation seniors, arguably affluent enough to afford above market rate housing. The secondary objective is for a developer to capture the "first-phase" move or the initial downsizing move and to ideally, have the senior maintain in-place longer, thereby delaying or perhaps avoiding altogether, the second phase move. Early on, this type of development was principally located in warm, destination locations such as Florida, Arizona, South Carolina and Arkansas. There was a distinct Sun City influence as the developments were very real estate oriented usually with average construction grade homes, heavily laden within a golf community with an expansive club-house. Recent iterations have been in other areas and even northern and mid-Atlantic climates – less "destination" spots. These iterations have improved upon the initial "golf/resort" focus integrating improved quality of construction in the dwelling units, locations such as near or within a university neighborhood and even affiliated with a university, and less focused on integrated amenities such as golf courses and on-site swimming pools. In fact, we have even seen a trend, albeit a small one, for high-rise urban developments where the amenities may be commercial spaces occupied by health-clubs, spas, coffee shops and restaurants. The similarity in each of these types of developments is a focus on bringing a younger cohort of seniors into a development, catering as much to targeted, lifestyle amenities of a targeted

market as well as the real estate and housing needs of the senior.

Reinforced by the recent economic downturn, we still see a large market need for modest cost, decent quality senior housing. There seems to be unlimited market demand in many locations for rent controlled, secure and well maintained projects. The fundamental problems perhaps, in getting a sufficient supply of this type of housing into a market are the initial costs of suitable land, assistance with infrastructure development if required, and long-term, low interest rate financing. As the margins in this type of development are small and the regulations daunting for developers and operators using HUD or tax credits, there appears to be no near horizon where the supply will dramatically increase.

Our general assumption is that as the economy and residential and multi-family real estate market improves, the outlook for the industry will grow stronger. While Senior Housing has felt the recessionary bite, certain elements or segments have fared better than others. For example, moderate to market rate rental properties have not experienced the same level of pain that large entry fee, higher end properties have. Low-income and rent controlled housing actually experienced an upward tick in demand – logically, not surprising. The largest recessionary impact we have seen is on new, upper-scale, lifestyle developments. These developments rely on a solid economy and with investment losses and a non-existent real estate market in certain areas, vacancies have been the name of the game. Not too surprising, we've seen "deals" and pricing creativity widespread in these developments as a means of attempting to build some interim demand. Similarly, we've noticed a slow-down in plans for new development or the outright abatement of plans as financing fell through or pre-sale levels were not attained. Economic improvement over the next year should reinvigorate this segment nicely.
Our forecast for Senior Housing for fourth quarter 09 and 2010 is as follows.

- We remain optimistic that as the economy strengthens, investment markets return to a solid upward trend and real estate prospects improve, Senior Housing will fare exceptionally well. Our only caution here is that location factors still play a heavy role in the ultimate success or failure of any singular project or group of projects.
- We are closely watching the non-profit sector of Senior Housing as preferable tax treatment in the form of no property taxes or lower property taxes is consistently being challenged by states, municipalities, and counties. We believe that a continued erosion of favorable tax treatment for non-profits will occur over the next year and perhaps beyond, especially with respect to Senior Housing. Without question, states and locales with struggling economies will continue to pursue tax-exempt Senior Housing as a potential source of new revenues. We believe that non-profits in the Senior Housing business need to be extremely vigilant and politically astute to the challenges to their tax-exempt status or face certain loss thereof.
- We remain very bullish on low to moderate cost Senior Housing developments as we see no erosion any time soon in the demand for decent, rent controlled housing. We understand the financial and economic challenges to such development but for those capable of accessing the right financing vehicles and sourcing suitable development sites, this type of development will fill quickly and remain full for years to come.
- Similar to our comments regarding Assisted Living, we believe that Senior Housing projects that are part of overall CCRC developments will continue to fare better in general than free-standing projects. We see continued demand growth for this product, especially when well located and priced soundly for the target demographic.
- Despite the weakness of the sector, we believe life-style developments are a strong

part of the Senior Housing future. We like the recent trends of urbanization and developments partnered with Universities and developments in non-vacation locations such as the Upper Midwest and Eastern Seaboard. We realize that as the economy goes so goes the growth in this sector but frankly, we see seniors returning to this market once economic improvement fully takes hold. We also forecast that this style of development is in its juvenile state with many variations on pricing and equity options yet untapped. We also think that the field for development is wide open with options that include mixed commercial, whole planned neighborhoods, green development possibilities, and a list of other options. Essentially, the sky may literally be the limit here for some time to come.

- We forecast that credit and lending activity will remain somewhat tight through the mid to third quarter of 2010. Valuations will continue to be more stringent throughout the period as well.
- We don't foresee a big movement forward in mergers or acquisition activity, though we do see a slight increase as the economy improves. Senior Housing is not typically as active as other healthcare segments and we don't see this changing regardless of economic improvement. We do believe cap rates when deals are done will fall modestly.
- We forecast a continuation of stable per unit rents or revenue as the market will not support a big upward movement in price. As a result, we believe margins will remain about where they are today in the industry and improve gradually in the third and fourth quarters in 2010, principally due to incremental occupancy gains.
- As Senior Housing by its nature is fairly low in operating expenses, we are forecasting no big upward jump in expenses, especially since fuel and utility costs have moderated with the economic downturn. Where there is potential for some upward volatility is in the area of taxes. For taxable operators, there is the real probability that property taxes will rise more dramatically than in prior years. The rise is attributable to lagging economic fortunes within communities and when and where possible, property taxes will be a target for some make-up revenue.
- In a follow-up to our above point, we are forecasting a continued discrepancy between appraised property values and assessed property values. We have seen assessors as of late, push assessed values upward in spite of no real current evidence suggesting an increase in value. The obvious reason is the need to substantiate property tax increases. Comparables in communities for Senior Housing are difficult to come by and as a result, assessors often use what they feel are comparables, such as market rate multi-family housing and condominium transactions. We caution operators and owners to pay attention to this trend and to be mindful of what Senior Housing values truly are in comparison to the assessment basis.

Home Health and Hospice

Similar to Skilled Nursing, Home Health and Hospice have been a focal point in the healthcare reform debate. Both of these segments have grown substantially over the past decade and MedPAC has been advising Congress of the need for payment reductions and program reform for the past three or so years. The MedPAC recommendations are clearly visible in the August CMS releases regarding proposed rates and program changes for Home Health and Hospice and in the legislative language in HR 3200 – the House reform bill. Briefly, what we are seeing is a direct movement on the part of CMS and the Congress to reduce overall spending for these two industry segments.

The two biggest drivers for the near-term fortunes of both of these segments are reimbursement and regulation. In both of these segments, we are seeing a very directed approach to use spending and

reimbursement reduction as well as increased regulation combined, as means of reducing certain levels of utilization and certain lengths of stay. Without question, both Hospice and Home Health have seen dramatic and steady growth in their lengths of service and in Home Health, the acuity of their case-mix. To us, this is not surprising as the industry has learned the well healed economic axiom of, "what gets paid for gets done". Providers naturally will work the system in-place to achieve the highest per diem revenue available and the greatest lengths of stay attainable. Naturally, this is the same trend that we have seen in the SNF industry. As long as reimbursement is tied in greater amounts to higher acuity patient days, providers will seek this case-mix to achieve better operating margins.

The fundamental problem facing both industry segments today is the belief among government officials and politicians that the average margins in the industry are just too good. In Hospice and Home Health, Medicare is a significant payer, typically making up the bulk of patient days. The assumption in Washington is that Medicare has been overly generous and given the economic state of the Medicare program, cuts in reimbursement and refinements in regulations are necessary to trim the margins and constrain the growth. Naturally, we are suspect of governments when they attempt to change the economic fortune of any industry segment, principally because they often lack the vision to truly foresee the unintended consequences that routinely occur.

As we look forward, we can't ignore the turbulence surrounding Home Health and Hospice in regard to spending reduction. We believe that even with the looming softening of healthcare reform that both programs will see out and out attempts from CMS and Congress to significantly reduce reimbursement levels while ramping up regulatory provisions and activity designed to shorten stays, increase substantiation of services provided, and to target perceived "overpayments" to providers. Similar to the SNF industry, we believe that Hospice and Home Health will see an expanded amount of government targeting on reducing what is being called, "waste and inefficiency". Our translation is that there will be more Medicare Probe activity and Medicare Recovery Audits in the near future. As evidenced by the language in HR 3200, Congress has convinced itself that it can reduce overall healthcare spending by direct and targeted cuts to Medicare as well as via enhanced fraud and overpayment auditing activity.

In general, both Home Health and Hospice have done well as industry segments. It is not unusual to see the margins of publicly traded home health and hospice companies in the mid-teens to nearly twenty percent range. Both industry segments have seen overall year over year growth in volume and revenues and the prospects for continued growth, at least in volumes, remain good as demographics remain favorable and utilization and referral patterns remain similarly favorable. The prevailing trend of patients desiring to be treated at home and physicians becoming more comfortable with even complex care being rendered in the home shows no signs of eroding. The question remaining is whether reimbursement and regulatory provisions will remain somewhat favorable for this trend to continue and for the companies in these two industry segments to stay profitable. Our assumption is that the utilization and referral patterns will not change substantially (negative) but the reimbursement and regulatory aspect favorability will gradually erode. As this erosion takes place, it will have an inevitably negative impact on referral and utilization patterns.

Below, we have divided our forecast to accommodate each industry segment.

<u>Home Health</u>

- CMS has proposed to reduce Medicare spending by $100 million via a direct payment reduction (continuation of a four year phase-in of rate reductions to reflect case-mix changes) netted against a 2.2% market basket adjustment.

- Regulatory changes on top of the above reimbursement changes include a requirement for providers to submit quality data. Failure to do so on the part of a provider reduces the market basket inflationary adjustment by 2% - down to 0.2%.
- CMS will increase its activity put forth toward recovering over-payments. A regulatory provision enacted calls for the reduction in outlier payments to 10% per agency and 2.5% of total Home Health payments, down from 5%. This is a direct reaction on the part of CMS to the belief that agencies are being over paid. Increased probe activity and recovery audit activity will span the industry in 2010.
- For 2010 to 2011, we are forecasting additional cuts in Medicare spending and it would not surprise us to see the market basket increase frozen or eliminated, replaced by some other contrived formula.
- The agencies hardest hit in 2011 will be small to medium size agencies bearing the brunt of the rate reductions. Proprietary agencies in urban areas can expect to see a negative revenue impact of 4%. Rural, free-standing and non-profit agencies will fare the best seeing rate increases of about 3%.
- Health reform, though again less likely to pass in its current form, promises additional reductions in reimbursement for Home Health agencies. We would not be surprised to see even compromise legislation pass including the elimination or freeze of the market basket, an acceleration of the case-mix adjustment (eliminating the fourth year) and a re-basing of PPS rates. Our forecast is that these changes alone would reduce overall spending in Medicare on Home Health by an additional $5 to $6 billion for the rate year 2010 -2011.
- We continue to see generalized staffing difficulties for the industry as turn-over remains a problem for many agencies and a general shortage of skilled nurses and therapists pushes wage inflation higher. In short, agencies will be forced to continue to pay more if they wish to keep intact, the services of adequate numbers of registered nurses, physical and occupational therapists.
- Separate from wage inflation as mentioned above, general inflationary prospects for the industry are better than in prior years. A significant drop in fuel costs provides agencies with an expense reduction in an important and expensive line-item.
- We are forecasting a modest contraction for the industry as whole over the next year to eighteen months in terms of the number of agencies. Reimbursement reductions and regulatory changes of the magnitude forthcoming fuels merger and acquisition activity. We believe that larger, better positioned and better capitalized agencies will seek to acquire market share by consuming smaller agencies.
- We forecast that agencies with a substantial Medicare book of business will begin the process of altering their case-mix (realigning patients, lengths of stay and acuity with reimbursement) and shedding some of their Medicare days. There will be an increased effort within the industry to pick up incremental days from private insurance sources.
- Medicaid, given its financial difficulties and lower reimbursement levels will not be a sought after payer source.
- We are forecasting revenues to be down just slightly from 2009 levels for most agencies or alternatively, flat – overall down by 0 to 0.5%.

Hospice

- On the reimbursement front, Hospice fares better than most Medicare post-acute industries – an increase of 1.4%. This increase however is down from prior years due to CMS continuing phase-out of the Budget Neutrality Factor. Frankly, without

an increase of 2.1% in the market basket, the industry would have seen a 0.7% reduction.

- As with Home Health, the language in health reform legislation calls for elimination or freezing the market basket. We believe that this is still quite possible for the rate year 2010 to 2011, producing potential direct cuts in Medicare reimbursement.
- CMS has also introduced a provision requiring expanded certification documentation from physicians supporting a diagnosis of terminality within six months or less.
- CMS and OIG will target providers with exceptionally long stays (180 days or greater) and/or large numbers of patients in Skilled Nursing Facilities as the belief is that these stays may be unqualified for coverage. We believe that there will be a significant increase in Medicare probe reviews industry wide, searching for opportunities to deny claims.
- Physician billing practices for Hospice patients will also come under scrutiny as there is a belief in CMS that physicians may be double-billing for hospice care (physician services are covered as part of the Medicare benefit paid to the Hospice).
- We forecast that proprietary agencies will receive the bulk of payment review attention and potential fraud enforcement activity as CMS and MedPAC have concluded that this segment of the industry has profited too much from longer Medicare stays and relationships with Skilled Nursing Facilities.
- We are forecasting a modest increase in revenues across the industry of 0.5 to 1%. The contributing factors are slightly increasing reimbursement netted against a modest decrease in average lengths of stay.
- Inflation for the industry should be in check for 2010 as minimal pressure exists, save a modest degree of wage inflation for skilled staff, principally registered nurses. As with Home Health, Hospice will benefit from continued low fuel costs.
- We believe that the scrutiny of Hospice agreements with Skilled Nursing Facilities will increase dramatically over the next twelve to eighteen months. There is widespread belief in the government that these agreements breed illegitimate utilization, especially lengthy unwarranted stays.
- Greater regulatory scrutiny will be paid to certifications that claim terminality due to Alzheimer's disease and Failure to Thrive. We are forecasting a substantial up-tick in denials for portions or all of these stays on an agency by agency basis.
- Hospices will need to become far more sophisticated in documenting the need for continued care and will need to work aggressively with the physician community to assure that detailed documentation is part of their certification process. Poor or vague documentation will produce an increasing number of denied claims.
- We see a bit more merger and acquisition activity occurring over the upcoming twelve months, principally secondary or as a cause of the Home Health activity. As many Home Health agencies also include Hospice as part of their profile, it is natural for some of the Home Health consolidation to bring Hospice consolidation along side.

The opinions presented are based on information available as of the date of publication and are subject to change. Sources used to provide this information are deemed reliable by Grubb & Ellis/Apex Healthcare; however, Grubb & Ellis/Apex Healthcare does not warrant the accuracy or completeness of the information.

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