

SPOTLIGHT ON: Covenant Violation

With the daily challenges our industry faces – declining home values, expenses trending up, revenues trending down, investment returns low to non-existent, to name a few - the last thing a CEO or CFO wants to hear is that their community has missed a loan covenant. In recent months, however, the nation's economic climate has significantly impacted providers of senior housing and care, and Dixon Hughes has seen a marked increase in the number of covenant violations.

Whether or not you run a “tight ship,” you still may find yourself writing that dreaded letter to your investors and hiring a third party consultant to evaluate your community's ability to operate.

Loan covenants are put into place as a borrowing requirement. Along with reporting requirements, these covenants serve to notify lenders and investors of a potential problem early enough for course correction. Typically, covenants will be set to measure: **occupancy** (for a new or expanding community); **the ability to repay debt service** (the Debt Service Coverage Ratio); **the ability to support operating requirements** (the Operating Ratio); and **the ability to build and maintain cash reserves** (the Reserve Ratio).

Some of the more common causes of covenant violations that we have seen include:

- **Declining investment returns:** Many providers rely on investment income to pay debt service or cover other operating expenses. Most have seen a dramatic decline in returns and cash balances. Those providers relying heavily on investment income or cash reserves may violate the Operating Ratio, the Debt Service Coverage Ratio or the Reserve Ratio.
- **Occupancy:** Who isn't struggling to stay full these days? Competition, loss of wealth and the slowdown in the housing market are impacting occupancy across the board.
- **Decline in operating income:** The largest factor that is within your control. Expense “creep” can creep up on you when you're not looking!
- **Timing of turnover of entry fee units:** Communities that rely on entry fees from independent unit turnovers can miss the Debt Service Coverage Ratio covenant in a year with lower than expected turnover. This scenario could create a temporary cash crunch which may impact a provider's ability to pay its operating expenses and debt service.

So What Is A Provider To Do?

The Best Defense is a Good Offense

- Get to know your loan documents. Make sure you understand what is measured, how the ratios are calculated and how often.
- Provide timely disclosure to your lenders.
- Check your calculations. Twice. Proper reporting relies on accurate presentation.
- Keep an eye on operations. Monthly budget variance analysis, trend analyses and annual benchmarking is a good way to keep things in check.
- Don't forget marketing! Stay current on the competition and market conditions.

Okay, I've Done All That. Now What?

Even the best run communities may find themselves in violation of one or more covenants. We recommend the following:

- Be forthcoming. Your underwriter or banker can provide guidance and advice if they understand the situation early.
- Let your lender know there is a problem early. Bring solutions to the table.
- Seek a remedy in a timely manner. Meet or exceed what is required and provide a plan of action which includes forecasted financial results.
- Seek the advice of those best qualified to help. A thorough look from an outside, objective party may be necessary.

Unless the economic picture improves dramatically in early 2009, providers of senior housing and care will continue to battle challenges on the marketing, financial and operations fronts. A proactive approach to these challenges will have you better prepared in dealing with them as we see what 2009 has in store for us all.

To learn more please contact Jodi Bleier at 404.215.7508 or by e-mail at jbleier@dixon-hughes.com.

About Dixon Hughes: With a staff of over 1200 located in eight states, Dixon Hughes ranks among the nation's top 20 CPA firms and provides a wide array of assurance, tax and consulting services to clients of all sizes. For more information, visit www.dixon-hughes.com.