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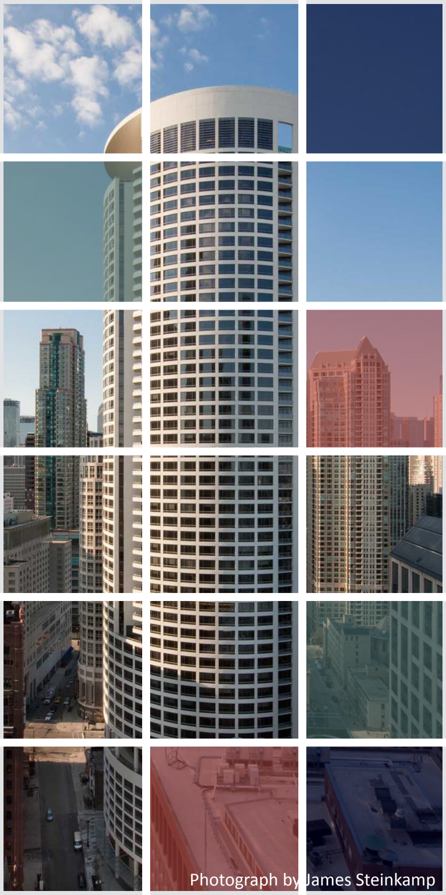

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THE CLARE AT WATER TOWER: BAD TIMING AND BAD DECISIONS LEAD TO OPPORTUNITIES FOR NEW OWNERS

COMPLIED BY STEPHEN MONROE AND BENJAMIN SWETT

The Franciscan Sisters of the Sacred Heart (FSSH), a Frankfort, Illinois-based congregation of nuns, had all the best intentions with its construction of the high-rise CCRC (continuing care retirement community) on Loyola University's Water Tower campus in Chicago. Built during the exceptionally strong real estate market in the mid-2000s, the Sisters sought to develop a high-end community for seniors who wanted a city life. However, not all was well with this non-profit church group's plan. A perfect storm of borrowing too much, construction delays and bad timing amid the Lehman Brothers collapse brought the 54-story The Clare at Water Tower down, at least financially.

The development arm of FSSH, The Franciscan Sisters of Chicago Service Corp. (FSCSC), first announced in 2003 that it would build a CCRC on Loyola University's campus, providing both independent- and assisted-living units. FSCSC had an internal Project Developer Division since 2000, and it was a huge boon to the growth of the company. It could be considered a win-win if you were able to build a new $230 million CCRC and could retain millions of dollars in developer fees. That was pretty much the scenario that the Franciscan Sisters of Chicago Services Corporation was looking at during those heady times. FSCSC provided management services for Franciscan Sisters of Chicago-sponsored organizations, including CCRCs, independent retirement communities, assisted living facilities, skilled nursing facilities, memory support programs, rehabilitation and therapy services, and hospice services. Up until the opening of The Clare, the group already completed two replacement communities and one new CCRC, added an independent living apartment building to an existing community, and opened its first community in the state of Texas. The Clare at Water Tower was its sixth project to be completed. Seven affordable housing communities were also on the drawing board or in various stages of development.

The exterior of The Clare was designed by Ralph Johnson from the architectural firm Perkins & Will, while the interior design was coordinated by Paul Donaldson. It was the building's exterior, with its exceptional height (the tallest for a senior residence), that caused the building to stand out. It was an entire community, with apartments, dining rooms, common areas, spas, an aquatic center, performance center, art gallery, chapel, library and fitness center all in one vertical space. The three-floor atrium was located on the 17th floor, while the ninth floor had a large terrace with a walking path, trees and landscaping. And on the top floor, there was a common area with views of Lake Michigan. The building was obviously quite impressive. Johnson, the exterior designer, put a premium on natural light and superb city views, with windows placed strategically throughout the building to maximize the indoor atmosphere. City life can also be seen as quite advantageous for seniors, with the numerous opportunities for entertainment and culture, as well as with the availability of public transportation. With these conveniences, the prices were consequently on the high side. Entrance fees started at around $540,000 (with some residences costing more than $1 million), with monthly fees at $2,300. Though it was on the high end of the market, there was a demand for the apartments as they were being built in 2006 and 2007. In

2007, Angela Hanson, the marketing director for The Clare, reported that as much as 85% of the units were already reserved for the high-rise, despite the lofty prices. The housing market was in overdrive and seniors were able to sell their nest egg homes at high prices, using those funds to move into the expensive senior community. Also, banks, private equity groups and REITs were pouring money into senior housing developments at the time. The Clare was not alone in its development at that time in Chicago, as many other new buildings, such as Clare Oaks, Park Place and Tallgrass at Mill Creek, were built in competition of each other.

The client organizations were generally, but not necessarily, faith-based not-for-profits small enough that they would not have their own development arm but did not need the services of a huge national development organization. Developer fees ranged from three to five percent of the project cost, depending on whether a co-developer was involved. Five percent was the usual developer fee for FCSCS projects that do not involve a co-developer. In any case, the developer (or co-developer) fees were kept in-house, going directly into the organization's ministry development fund to provide resources for other ministerial work or for new or existing projects or initiatives. Depending on the size and magnitude of the project and where the organization stood with its resources, FSCSC might have shared co-developing responsibilities on certain projects, for which the two entities would negotiate a shared fee.

The Franciscans borrowed $229 million for the project, which was close to 100% of the projected cost. Apparently, up to $50 million of the proceeds immediately went to pay the investment banker fees, a portion of the developer fee (which extends through 90% occupancy), and the return on the seed capital equity (paid out of the developer fee). The fact that more than 20% of the borrowed funds were used to pay fees at closing probably should have raised a red flag. The Clare was certainly a highly leveraged project, as were most projects being financed at the time, but the economy and local market were both strong. From the closing date forward, everything had to go perfectly for the financing structure to work. The Clare had to open on time. It had to come in on budget. And it had to fill up according to projections.

Unfortunately, things didn't go accordingly to plan. The Clare opened in December 2008—13 months later than expected and three months after the Lehman Brothers bankruptcy triggered a financial meltdown. It was perhaps the worst time to open a CCRC in light of the historic plummeting of home values and freefalling stock market.

The Clare also came in over budget, which for the most part was for reasons beyond the sponsor's or the developer's control. For example, it was discovered well into construction that the foundation required extra pilings. And despite test borings, subsoil conditions caused delays. Overall, construction cost overruns pushed up the budget by $9.5 million, or about 8%; development and marketing fees were also higher than anticipated.

And then, fill up didn't occur as expected. A few months prior to the original opening date (November 2007), The Clare had deposits in hand for just under 90% (220) of its 248 units. When the building finally opened in December 2008, only 80 of those units filled—60 original depositors and 20 brought in by Retirement Dynamics, a marketing consulting firm in Charlotte, North

Carolina, that helps CCRCs deal with occupancy challenges, among other issues. The Clare's 160 other original depositors cancelled their contracts because they couldn't sell their houses, their other assets withered away as the stock market plunged, or they just weren't willing to make a move and come up with the $500,000 to $1.0 million entrance fees during such a dire economic time. There were also rumors that some prospective residents had been told not to worry about their deposits, and that if they chose not to move in there would be no problem. Since operating revenues were based on fill-up assumptions, lower levels of cash flow were available to pay operating expenses and to prepay certain outstanding indebtedness. That resulted in the unanticipated utilization of debt-service reserves. This spiraling effect made a restructuring of the debt vital. The other option was filing for bankruptcy protection. A major element of the relationship between a not-for-profit organization and its bond investors is the trust and belief that the organization will act in the best interest of all parties. Once that trust is compromised, however, investors become wary, credit becomes tighter, and debt covenants become stricter.

So, in 2010, The Clare had to take immediate action in the face of a possible bankruptcy and looked to restructure its debt. The bonds were trading at about 30 cents on the dollar—and that was optimistic, according to Thomas Allison, CEO of FSCSC. On July 1, investors holding $91.5 million of bonds in The Clare overwhelmingly agreed to exchange their Series 2005 bonds for a package that included a Series 2010A bond at 70% of par value and a second Series 2010B zero-coupon bond at 30% of the value and due in 40 years. Bondholders owning an additional $137 million in debt, backed by a letter of credit from Bank of America, accepted the same restructuring without participating in the tender offer. The closing date for the new issues was set for July 15.

After the agreement, The Clare had a $10 million debt-service reserve fund. And even though they had no legal obligation to do so, the Sisters agreed to contribute $5 million to ensure that the restructuring would succeed. To cover operating costs and debt-service requirements, the breakeven point was about 200 filled units, depending on the mix of the units sold, according to Allison. But the story of The Clare was not finished. The project lost a lot of marketing time while all the negotiations were going on. Rebuilding the marketing momentum and re-establishing confidence among prospective residents was crucial. Efforts to re-approach some of the people who cancelled were being made, as well.

However, with the economy still in turmoil, the Clare couldn't get enough people to buy into its high-end community. Given the total debt, the local sullied reputation of the CCRC (at least from a financial stability point of view) and an economy that was not going to help it get off the ground, the 2010 restructuring plan never stood a chance. In September, 2011, The Franciscan Sisters defaulted on their September 1st loan payment for the Clare. The FSSH was again seeking a restructuring of their debt. The Clare tried to negotiate an out-of-court restructuring agreement with its lenders, but with that failing and the Clare's financial situation worsening, on November 14, 2011, they finally filed for Chapter 11 bankruptcy protection. For liquidity during the bankruptcy period, the "debtor-in-possession" lender (DIP lender) was picked from a total of seven firms that submitted bids. Normally, you would see a bank as the DIP lender, and they were always protected by having a first claim on any sale proceeds. In this case, the winning bid came from Redwood Capital Investments, which would provide up to $12.0 million. The total debt outstanding was $229 million, or $685,000 per unit/bed, and the various tranches of bonds traded between 15 cents and 35 cents on the dollar in recent months. In addition, Loyola University, which was owed $1.5 million in lease payments from The Clare, was the largest unsecured creditor.

The next step was to find a stalking horse bidder, but the price wasn't going to be very high with more than $62 million of refundable entrance fees as a liability and just 33% of the 248 of the independent living units occupied. The goal was to receive a letter of intent from a stalking horse bidder no later than January 10, 2012, with the entire process wrapping up by mid-May.

It looked as if an offer would come in between $40 million at the low end and $55 million to $60 million at the very high end. However, that was until the potential bidders started looking under the covers and realized it was a lot more complicated than they had thought. Only five of the initial 107 potential bidders ended up touring the property (at least officially) and meeting with management. The two major complications were the Residency Agreements and the lease for the land that the 53-story tower sits on, and only David Reis and his Senior Care Development (SCD) expressed an interest in trying to negotiate modifications to both, which seemed to be a necessary precondition to get the sale process moving along. As a result, SCD's affiliate, Chicago Senior Care, LLC, became the stalking horse bidder with a reduced bid of $29.5 million, reflecting the risks for a new owner that others might not have realized when they first entered the fray. Bids were due by April 10, and if anyone topped the stalking horse bid, minus the break-up fee, an auction would take place on April 12.

All eyes were on Chicago during the second week of April, as two bids were received for The Clare to compete with the $29.5 million stalking horse bid from the affiliate of SCD already approved by the bankruptcy court. It was expected that at least one or possibly two other bidders would take a run at this premier CCRC in downtown Chicago, since it seemed as if topping the stalking horse bid was the proverbial no-brainer at 13 cents on the dollar (at least, based on the par value of the bonds outstanding) and the potential for future entrance fees by increasing occupancy from 33%.

In late March, Redwood Capital (the DIP lender) had filed a "limited objection" with the court claiming that the bid procedure provided "the stalking horse bidder an informational advantage, if not monopoly," and they wanted the bid procedures changed so that all bidders would receive the same information and face the same requirements." One of the reasons for Redwood being the DIP lender, however, was to ensure it knew everything that was going on in case it wanted to make a bid. Apparently, in the end Redwood and its affiliate, **Erickson Living**, thought there was "too much hair" on the deal (and the process) and decided not to make a bid.

After two other submitted bids at least $1.5 million above the stalking horse came from Michael Reschke and of Prime Realty Group Trust and a partner, David Crawford (the Reschke Group) and Senior Star Living, SDC opened the auction with a bid of $42 million, perhaps to show the others who was in charge, and perhaps to see who else was really serious about their bidding. It worked, and the overbid forced Senior Star out. The Reschke Group then approached the debtor with a private "take-it-or-leave-it" bid at an estimated $52.5 million, increasing the price by at least $10 million, certainly good news for the Clare and its creditors. As the bid was private, SCD was faced with making a similar all-or-nothing offer with no knowledge of Reschke Group's actual number. SCD obviously wanted the property, and this was the last bid. Either they made a calculation as to how much higher they thought the Reschke Group would have gone over their last bid, or came up with a number close to what their top price would have been before walking away. Little did they know, but SCD's revised offer of $53.5 million was just $1.0 million above the losing bid. Unfortunately for SCD, having the Reschke Group at the table most likely increased the auction price by at least $10 million, because that initial $42 million would have won it. Following the purchase, SCD hired Des Moines, Iowa-based Life Care Services to manage The Clare. While SCD certainly would have preferred to save the additional $11.5 million it ended up paying for the property, it would not make much real difference in the long run, and here is why.

First, in looking at the local market, one potential competitor had recently backed out of its upscale entrance-fee CCRC development. While it was not known if this CCRC was going to "set the standard" of quality and elegance that they said their CCRC being developed in Westchester County, New York was going to do, we have to assume it was going after a high price point. Apparently, the group, known as Integrated Development Group and based outside of Chicago and backed by an electrical union's pension fund, decided the new development would be a rental community with no age restrictions, perhaps witnessing the problems of The Clare and believing the last thing the downtown Chicago market needed was another high-end entrance-fee CCRC. They might have been right, but the other problem would have been competing with a new owner whose cost basis would end up being a fraction of any competitor's new development. And without the construction debt overhang.

The other new competitor to The Clare was a new development that not-for-profit Kendall Corporation teamed up with after the original sponsors realized they needed a bigger gun with more capital and experience. And they were right. The project, known as The Admiral at the Lake, was set to open in the fourth quarter of 2012 and like The Clare, it was a high-rise (31 floors), with 292 units/beds, offering IL, AL, memory care and private skilled nursing rooms in almost the identical configuration except The Clare has 48 more IL units. Entrance fees ranged from $300,000 to $900,000, which was priced a little below where The Clare was when it opened, with a 90% refund plan. Apparently, the sponsors had deposits for more than 80% of the units. Senior Care Development had already disclosed that it might decrease the entrance fees by up to 30% of the original levels when The Clare opened. The good news was that with more than 80% of the units reserved with deposits at The Admiral, it could have been concluded that demand had returned for high-end entrance-fee CCRCs in the Chicago market and potential residents didn't mind the high-rise concept, although The Clare was different since its "lobby" was several floors up.

One crucial change that the successful bidder was able to make before the bidding began was in the terms of the entrance-fee refunds. Under the old terms, new entrance fees (regardless of the unit sold) were used to provide refunds to residents who left or to their estates. Under the new policy, after the first $2.5 million received went into an escrow account for refunds, all subsequent entrance fees received were available to the buyer. More importantly, current and former residents agreed to only receive their refunds when their units were re-occupied. So, for argument's sake, if all current residents moved out the day after the sale closed, the approximately $58 million entrance-fee liability was contingent on the re-sale of those units, posing no immediate financial burden on the buyer. That contingent liability provided a lot of flexibility to SCD as it started to sell the empty units, and with about 160 IL units available, the total entrance-fee proceeds through stabilization was estimated to be between $60 million and $70 million depending on what assumptions were used for the refund contract chosen by the new buyers. It was expected that for a 90% refund, the average entrance fee would be close to $500,000, but would drop down to $400,000 for a 50% refund and $300,000 for no refund. Prices were, in fact, cut in July, 2012, dropping to around $250,000 for 1-bedroom units, and around $430,000 for 2-bedroom units, discounts of above 70%. While high monthly fees were still in place, at $2,700 per month for one-bedrooms and $4,500 for two-bedrooms, The Clare was still a high-end luxury building in an ideal location.

So, with no debt, lower entrance-fee prices and less pressure on future monthly service fees, once The Clare was stabilized, there was still the ability to increase the entrance fees for the second and third generation of residents. If 30% or more below the original rates was a price below "market," then there could be a waiting list to get in. SCD would have the income and cash flow growth, with no debt. Yes, just like with the original development, everything does have to work out, but at the price that the buyers came in at, and a conservative timetable to reach stabilization, high returns could be achieved for the new equity investors.

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