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Holiday Retirement Corporation: The rise, the fall, and the rise again

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IT IS NOT OFTEN THAT A COMPANY CAN GO FROM BEING SOLD AT THE HIGHEST PRICE THE SENIORS HOUSING INDUSTRY HAD EVER SEEN TO BEING WORTH LESS THAN THE DEBT ON THE BOOKS IN THREE YEARS WITH OCCUPANCY LEVELS PLUNGING BY 15 PERCENTAGE POINTS, ONLY TO REBOUND THREE YEARS AFTER THAT. HOLIDAY RETIREMENT CORPORATION HAS HAD A TUMULTUOUS SIX YEARS SINCE THE FOUNDERS SOLD THE COMPANY TO FORTRESS INVESTMENT GROUP, AND THIS SIX-YEAR HISTORY DEMONSTRATES THAT THERE CAN BE A LOT OF RISK WITH LARGE ACQUISITIONS. IT ALSO DEMONSTRATES THAT IF YOU HAVE THE CAPITAL TO WITHSTAND TOUGH TIMES, THE BENEFITS OF WAITING FOR THE GOOD TIMES TO RETURN CAN BE ENORMOUS.

In 2006, **Fortress Investment Group** acquired **Holiday Retirement Corporation** (HRC), at the time the largest senior housing company in the world, for a then-record price of just over $6.6 billion. Within a few years, there was a noticeable occupancy decline and lack of transparency of the then-newly-managed Holiday Retirement Corporation. Holiday, left in good health by the late Bill Colson at his selling of the company shortly before his death in 2007, always had a reputation for high morale, hands-on service, low costs and good management. However, after the acquisition of the company by Fortress Investment Group and the tinkering of the finely-tuned "Holiday way," occupancy levels dropped to rates previously unheard of pre-2006, employee turnover increased within management, and the pressure to refinance the massive debt used to pay for the expensive acquisition led to increased rents and cost cuts. Not helped by exterior economic factors such as the fall in housing prices, the evaporation of liquidity in the throes of the Great Recession and the average decline in their customers' economic welfare, Holiday appeared to be on a foreboding path in 2010. However, three years after the collapse in occupancy, the company staged a remarkable turnaround. Management changed, occupancy rates increased substantially, rents increased and cash flow was no longer a problem for the company. While there is certainly room for continued improvement, Holiday's financial condition was most certainly improved.

There was not always such drama with Holiday, being frugally and efficiently run by Bill Colson since its beginnings in the 1960's. Before starting Holiday, Colson was in the construction business with his father in Salem, Oregon, which would prove to be indispensable experience in growing his retirement community business with lower building costs than most of his competitors. Originally, Colson and his father built these communities through their construction company, Colson & Colson, but did not know how to manage them well. This led to the formation of Holiday Management Company (later Holiday Retirement Corporation in 1987) in 1971 to handle the operations of their growing business. The company, under the leadership of Bill Colson grew steadily for the next couple of decades, boosted by his own development arm in Colson & Colson and effective capital-raising methods. He did not raise money through big lenders on Wall Street, but instead, he did it the "old-fashioned way" from medium-sized lenders or small banks. He owned his real estate and owed nothing to the big REITs clamoring to offer Holiday 100% debt financing for its development projects. Colson also "spread the wealth," raising equity from many private investors in Seattle, Washington. Because of this relative financial security, Colson did not need to go public to finance his construction projects, a reservation about IPOs he kept for his entire tenure at Holiday. Colson also expanded his business into Canada, describing the move as "an incredible success story," with the "Holiday way" traversing the border with the same efficiency and success as in the States. This first international expansion would lead to inroads in the UK and France, making HRC the largest senior living company in the world.

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Colson appealed to customers because he consistently offered no-frills comfort, good food and good service at a low price. His communities were designed for middle class seniors who would use their monthly Social Security check to pay their rent. Bill Colson liked to say, 20% of his residents were below the poverty line (with family members often helping with rent), 20% were very wealthy but did not want to pay for the bells and whistles, and the 60% core were the ones who had always been there, like the retired schoolteacher. He kept costs down through the use of his own development arm, and through squeezing vendors to keep food costs low too. So, rents and rent increases did not have to be as high as those of his competitors. Holiday was the "Wal-Mart" of the industry, or the Chevy. It built quality retirement communities with few bells and whistles.

A unique management style was also employed in Holiday communities that many competitors did not follow: live-in managers. These community operators, who were usually married couples, would live on campus, thereby reporting directly to the seniors. Holiday also tried to promote from within, with the better community managers sometimes becoming regional managers. They would then have a much better understanding of how hard it was to be a live-in manager, the sometimes 14 to 21 days in a row without a day off. Often, these couples would transition to become tenants of the same community as well, adding to the positive culture in the Holiday communities. However, the constant accountability, long work days and infrequency of vacations or weekends created a high turnover for this position, making it quite difficult to manage. Colson asserted, however, that despite the difficulties, he would never run it another way. Residents liked the fact that at 2:00 a.m., the manager or assistant manager living just a few doors down would answer the phone. This "Holiday touch" was what many employees believed to be the heart and soul of the company.

In 2006, with the seniors housing market in overdrive, Colson and his partners decided to put Holiday on the market and received some shockingly high offers. At the time, the seniors housing acquisition market had never been so strong with so much depth, capital, product and willingness to deal. Fortress Investment Group, at the time also the controlling shareholder of **Brookdale Senior Living**, won out among a host of other large-scale buyers with similarly high offers. To finance the large deal, FIG obtained two mortgage loans from **Goldman Sachs** totaling about $4.3 billion with five-year and seven-year terms, and used cash from their investment funds for the remainder of the purchase (incidentally, Goldman Sachs sold the loans to Fannie Mae within a few months). At approximately $6.6 billion, it was the highest-priced sale ever in the industry, coming to just over $189,000 per unit and a cap rate reportedly around 5.5% to 5.75%, which was a shocker at the time and equivalent to a multiple close to 17x in-place cash flow.

While this price was viewed as an exceptionally high number, Holiday Retirement Corporation was an attractive buy at the time. At the closing of the sale, the average occupancy rate at communities open for at least 18 months was about 92%, and nearly 50 of the communities were at 100% occupancy—tops for the industry. It had its development arm that helped lower construction costs, saving sometimes more than $1 million per development project. Colson ran a tight ship, and a few dollars saved here, a food vendor squeezed there, went a long way to keep costs down. But also, as part of the transaction, and why Fortress "overpaid" for the assets, was the development pipeline of 12 to 15 communities a year which they had the right of first refusal to manage and acquire. In the past, these annual developments were expected to throw off more than $1.0 million of EBITDA each once stabilized, so FIG was looking at up to a $75 million increase in annual EBITDA after six years if things stayed on track. Unfortunately for them, the train fell off the track as the Great Recession brought down the housing market, and many other things, and Fortress decided not to take any additional buildings when it looked like occupancy levels might take a hit.

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The problems started sooner than anyone could have expected. A year after the transaction closed, occupancy had dropped by 200 to 300 basis points, which was *before* the real problems in the housing market had surfaced, and was a larger decline than the rest of the industry had experienced in the same time period. Eighteen months later, in early October 2009, census had plunged to about 80% with fewer than 10 communities at 100% occupancy (down from 50 in early 2007). Just six months later, it had dropped still further, dipping to 75% on average for the portfolio (but almost 200 basis points higher when the newer properties were removed). These declines were much more severe than anything the rest of the industry had suffered.

According to the **NIC MAP** data, in the top 100 MSAs, freestanding independent living communities had an average occupancy rate of 91.0% in the first quarter of 2008, very close to the Holiday census at the time of the sale. The industry as a whole (in these 100 MSAs) declined by 615 basis points to 84.8% by the first quarter of 2010, which was a lot higher than the Holiday occupancy levels. And from the fourth quarter of 2009 to the first quarter of 2010, the IL sector's occupancy dropped by just 20 basis points, much less than the decline at Holiday. If most of the Holiday census numbers were included in the NIC MAP data, then the industry as a whole excluding Holiday had actually performed better than these numbers, with Holiday's size bringing the total industry average down further than it had actually fallen. In 2010, based on rent assumptions and the occupancy numbers, we estimated that the value of the Holiday portfolio had declined by well over $2.0 billion in the three years since the acquisition, wiping out the Fortress equity investment. Using an 8% cap rate (not conservative in early 2010 for independent living properties), the value was close to the existing debt on the portfolio, most of which was the approximately $3.8 billion held by **Fannie Mae**.

Amid these problems, in early 2010, the then-CEO of Holiday Jack Callison reported that 2009 revenues were flat with 2008, but declined to reveal what the actual occupancy levels were. He also said that the first two months of 2010 saw a dramatic increase in move-ins. However, with flat revenues and the decreased occupancy levels in 2009, more move-ins surely correlated with a large number of move-outs as well. Another curiosity was that the company, just to retain flat revenue, had to have raised rents, lowered costs, or both. Indeed, this was the case. At the time of the sale, average rents were in the $1,850 to $1,950 range (with some people believing that they were actually lower). Holiday knew its target market, and did not try to be anything else. Normally, its rent increases were usually tied to Social Security increases, being careful not to overburden its middle income residents. However, in 2010, under the new management, the average monthly rent was closer to $2,300 or $2,400, with many new residents at even higher rates. The new Holiday was competing at a different price point and was targeting a different customer, one with more options for senior living than just the no-frills Holiday experience.

Changes were being made within the Holiday corporate office as well. No one ever accused Holiday of having a bloated home office structure—they were never accused of having a bloated anything, and proud of it—but following the deal, the headquarters staff was reduced significantly by both voluntary and involuntary attrition. This was not beneficial at all in trying to turn around a large ship in unsettled waters. Holiday's internal structure was refined and effective, with its live-in community operators reporting to one of 22 regional managers, who in turn reported to four division heads. After Fortress took over, many of the 22 regional managers left, without being replaced. FIG also tinkered with the live-in manager system that made Holiday so unique and ultimately successful. Turnover for this position was high, but this was a cost Bill Colson gladly paid for its many benefits. But the cost was viewed as too high for Fortress, who opted instead to have one resident manager reporting to a general manager who did not live there. The community management system also appeared to have become more centralized. This may have been a more

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effective way to run a large enterprise but it did not necessarily fit into the tried and true Holiday way.

However, not all news was bad in 2010 for Fortress. Despite the drop in census, cash flow was still relatively strong, helped by the cost cuts and the low interest rate on the mortgage debt. Fannie Mae, in fact, extended the term on the five-year debt to match the other tranche with a 2014 maturity, and also cross-collateralized the two portfolios. This gave Fortress four years, instead of the original two, to increase the value of the portfolio, which at the time was dismal. In 2010, the Holiday portfolio was worth about the total debt outstanding, which meant that Fortress' $2 billion-plus equity investment had little, if any value. Fortunately, the outside investors who made the actual investment, including **CalSTRS** as a major investor, did not try to sell the company. But given the 75% loan-to-value parameters in the debt markets at the time, no one could refinance the portfolio either.

Fortress did not foresee these financing problems, given the EBITDA margins of the company at the time of the purchase. Bill Colson believed that the prototype for new developments was to have a 50% EBITDA margin at the community level at stabilization (45% EBITDA at the corporate level). According to the assumptions for the average rents in 2007, the best-case scenario was an in-place EBITDA of about $380 million to $400 million, with a 5.75% cap rate. Fortress probably looked at it from the perspective of the 12 to 15 new developments each year that it expected to grow by, which after year five, would have produced an additional $75 million of potential stabilized EBITDA, worth an additional $1.0 billion or so with some cap rate assumptions at the time. But that did not pan out, because as the housing market and economy deteriorated, they decided to stop taking the option on new buildings, so growth came to a virtual halt by early 2009, or less than two years into the acquisition. At this point, Holiday had to reach 90% occupancy with even higher rents to begin to approach a value equal to the original purchase price, assuming an 8% cap rate derived from the estimated in-place cash flow in 2010. If the new management stabilized operations and staffing, and then increased the census by 50 basis points each quarter through 2014 and increased average rents by 3% each year, the Fannie Mae debt by the time it matured would be about 75% of the portfolio's theoretical value.

Given the struggling housing market at the time, however, even with these improvements it was a tall order. With close to 75% of Holiday's customers selling their houses before moving into communities, fewer of them would be willing to sell with low prices, and thus a smaller number would move in. Fortress was under a lot of strain, putting additional pressure on community management to increase the census, which resulted in more employee turnover and thus more problems for the company. There was criticism that the new senior management had come from the multifamily and hospitality areas of real estate, and that they didn't understand seniors housing. With the debt extension from Fannie Mae, Fortress bought some time as well (until 2014), but at the time, it was unlikely that the company could recover the lost census in just four years, especially across more than 300 properties. It was certainly looking bleak for Holiday in 2010.

Getting back to the significant improvement in occupancy from the lows in 2010, in 2012 overall occupancy increased from 89.1% to 89.9%, which was getting close to 2007 levels. Out of more than 310 communities, at year end 2012 nearly 85 of them had an occupancy rate of 95% or higher, and 11 of these were at 100%. Not many companies can boast having more than 25% of their communities, especially IL communities, with occupancy above 95%. While a far cry from 2007 when 50 communities were at 100%, management must have been happy at the turnaround, to say the least. During 2012, more than 90 Holiday communities had an occupancy gain in excess of 500 basis points. The good news was that just 6% of the properties had a census below 80% at year-end (compared with an overall average of 75% three years ago), but almost all of the them

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had been higher at the beginning of the year, which means these outliers were not the problem children of the past and may have potential to be turned around depending on what caused the 2012 drop. It appeared that Holiday was back on track with a remarkable turnaround.

In just three short years, by 2013, Holiday was faring far better than expected. While the higher rents in 2010, estimated at $2,300 per month, may have had a negative impact during the recession, with the typical Holiday customer paying just with their Social Security, 2013's rents were getting up to $3,200 per month for one-bedrooms in some locations, with occupancy rising. So if average rents were up to $2,800 per month (which is still viewed as high for what are generally considered to be a Chevy product in secondary markets), based on a 90% occupancy level, annual revenues would have been at about $1.1 billion and EBITDA at about $425 million using a lower 40% margin. At the time of the acquisition seven years ago, the annual EBITDA before CAPEX was estimated to be between $375 million and $400 million. If one used the cap rate that was reported seven years ago, you would derive a value of Holiday at more than $7.0 billion in mid-2013. With perhaps $4.0 billion of original debt still on the books, it appeared that the disappearing equity investment suddenly reappeared. Still, despite this turnaround, the portfolio was still not terribly attractive to buyers with a 5.75% cap rate, even in 2013 with historically low interest rates, decreasing cap rates and an outsized demand by REITs for large acquisitions. It must be remembered that these communities are not "A" properties, and are located in "B" communities. Normally, a sub-6% cap rate is reserved for high quality properties in hard-to-build-in, top markets. In addition, that valuation results in a price of about $200,000 per unit, far above the traditionally-low replacement costs for these properties. While the appeal of a portfolio as large as Holiday's is high, few buyers could raise the capital to buy it. These are now older properties with hard-to-manage resident managers serving an independent living market that is not need-driven.

However, there were exit strategies available to Fortress and its investors. If our estimate for EBITDA in 2003 was somewhat close, then the assumed cap rate determines the value of the portfolio. The average independent living cap rate in 2013 was 8.2% (8.0% in 2012 and 7.9% in 2011). While this may seem high, the average quality of some of these communities sold was not that high, and may be more comparable to the Holiday portfolio than Fortress would like to admit. And, a portfolio premium would have to be applied to a purchase this size, or a cap rate decrease. So, we would assume a cap rate between 7.0% and 8.0%. Thus, at 7.0%, the value would be nearly $6.1 billion (not far from the $6.6 billion price in the 2007 deal), which is more than enough to pay off the debt, return most of the equity, call it quits and be thankful the scars were not too deep.

But to whom would Fortress sell the Holiday portfolio? Most likely, they would sell it to a REIT, or take the company public, either as an operating company or through a newly formed REIT. In theory, a REIT structure would get a higher valuation, but a REIT with one tenant with B properties in the still unpopular IL market would not be an investment banker's dream.

One thing was clear, however, and that was that most of the Fannie Mae debt was maturing in the third quarter of 2014, with part of it having already been extended once due to Fortress' probable inability to solve the many problems facing Holiday at the time. FIG's investors, after six years of waiting, would surely want their money back too. However, Fortress could be flexible with its actions in the near term. It knew that Fannie Mae couldn't, or rather wouldn't, throw them into default in 2014. With the LIBOR-based loan probably having an effective 3.00% rate in 2013, the portfolio must have been throwing off some decent cash flow after debt service. But merely refinancing the debt was not the issue, because that left the investors in the Fortress funds empty handed. It would be logical that investors would like an outright sale, but management would like to keep on pushing census. Each 100 basis point increase in occupancy yields an additional $100 million to $150 million or so in value. Therefore, waiting as long as possible made sense, especially

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since no one was predicting a spike up in interest rates any time soon. Whether with a sale to a REIT, or an IPO as a REIT, Fortress needed fresh equity capital to deal with the maturing debt and the equity investors. And it would be easier to refinance a smaller amount of debt than the current outstanding balance, which most lenders would not want to tackle.

There had been rumors in 2013 that **Ventas** was in serious negotiations to buy the entire Holiday portfolio, but there were other rumors as well. The 100 basis point spike in the 10-year Treasury rate in the second quarter of 2013, however, sent REIT shares plummeting by 20% to 25%, which seemed to take them out of the market for large, billion-dollar acquisitions at low cap rates. Other than the Big Three REITs, which may or may not have had an appetite, and the only one that kept popping up in the rumor mill was Ventas, Fortress did have a “captive” REIT that was publicly traded. But **Newcastle Investment Corp.** had a market cap of just $2.7 billion and a high dividend yield of 8.1%, making it unlikely that it could consummate such a large deal with its higher cost of capital than Ventas or another of the Big Three REITs. By the fourth quarter of 2013, investment appetites strengthened, and Ventas announced that a few months earlier it had acquired 26 Holiday properties for approximately $790 million, or $251,750 per unit. This portfolio had an occupancy rate of 94%, higher than the rest of Holiday, and the high price point would indicate that these were higher quality properties as well. We estimated EBITDA for the portfolio to be $49.5 million, which resulted in a 6.25% in-place cap rate, and Ventas agreed to lease them back to Holiday.

This announcement was quickly followed by the sale of 52 Holiday properties with 5,885 units to Newcastle for $1.01 billion, or $171,600 per unit. Occupancy for this group was about 90.5%. The following day **National Health Investors**, which had not been in the rumor mill for a potential Holiday transaction, announced an agreement to purchase 25 Holiday buildings with 2,841 units for $491 million, or $172,800 per unit, on virtually the same terms as the Newcastle transaction. So in rapid succession, Holiday sold 103 properties, or less than one-third of its portfolio, raising nearly $2.3 billion in cash to be used to pay down debt. While it was unclear how much of the Fannie Mae debt was still outstanding by the end of 2013, these sales had certainly given Fortress more breathing room, and with occupancy still on the rise, opportunities to either refinance other properties or look for additional sale/leaseback transactions were open to them. It also appeared that growth was becoming the focus, as Holiday had started buying properties in 2012 and 2013. Fortress has been able to wind down its Holiday debt obligations while keeping the operating business in it stable, which is no small feat. While this part of the saga is over for now, there may be another part of the story in a few years.

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