Fitch Rates Fellowship Senior Living's (NJ) Series 2019A Bonds 'BBB+'; Outlook Revised to Negative

Fitch Ratings - New York - 27 November 2019:

Fitch Ratings has assigned a 'BBB+' rating to approximately $96 million of series 2019A revenue bonds to be issued by the Wisconsin Public Finance Authority on behalf of Fellowship Senior Living (FSL):

In addition, Fitch has affirmed the following series of debt:

--$32 million (Fellowship Senior Living), variable-rate tax-exempt revenue bonds series 2013A;

--$34 million (Fellowship Senior Living), variable-rate tax-exempt revenue bonds series 2013B.

The Rating Outlook has been revised from Stable to Negative.

The 2019A bonds will be issued as fixed rate. Bond proceeds will fund Phase III of FSL's campus repositioning project, which involves the renovation and expansion of the current assisted living (AL) and skilled nursing (SN) building, refunding of the series 2013A and series 2013B bonds, reimbursement of FSL for past equity contributions and paying the costs of issuance. The series 2019A bonds are expected to price the week of Dec. 9.

SECURITY

The bonds are secured by a revenue pledge, mortgage, and a debt service reserve fund.

KEY RATING DRIVERS

EXECUTION RISK: The Negative Outlook reflects higher execution risk as FSL rebuilds its IL occupancy after a large construction project in the center of its campus is finished. With the 2019 debt issuance, FSL's balance sheet weakens, but is offset by a lower debt service and improved maximum annual debt service (MADS) as a percentage of revenue. A pro forma analysis of cash to debt shows it falling to 44.2%, which is thin for the rating level. However, Fitch expects that figure to improve as IL occupancy returns to historical levels, above 90%, over the next two years and the lower debt service brings coverage up to 2x. Failure to improve the balance sheet over the next few years would likely lead to a downgrade.

STRONG MARKET POSITION: FSL is located in Basking Ridge, NJ, a desirable and affluent suburb, with household income levels and housing prices well above state and national averages. Prior to the construction project, FSL had IL occupancy in the mid-90% range, despite the presence of competition. IL occupancy has softened over the last few years, falling to 90% in fiscal 2018 and 84% through the first nine months of fiscal 2019, due to various on-going construction projects which have disrupted marketing efforts. However, with the largest component of the project completed in the spring of 2019, occupancy has already started to improve, with entrances fees on vacant units improving significantly through the third and fourth quarters of fiscal 19.

ADEQUATE OPERATIONAL PERFORMANCE: Operations continued to soften through the first nine months of fiscal 2019 as FSL had an 95.6% operating ratio, 3.9% net operating margin (NOM), and 16.2% NOM-adjusted, mixed results compared with Fitch's 'BBB' medians of 96.5%, 5.9%, and 23.0%, respectively. Weaker operations have been driven by a decline in occupancy as FSL completes its current campus repositioning project. Fitch expects operations to improve in fiscal 2020 now that the majority of the project is complete.

MIXED LONG-TERM LIABILITY PROFILE: On a pro forma basis, FSL's debt burden is mixed as cash-to-debt is expected to decrease to around 44.2% compared to Fitch's 'BBB' category median of 63.6% and debt to net available rises to 12.1x in the interim period compared to Fitch's 'BBB' category median of 7.1x. However, maximum annual debt service (MADS) is expected to decline from $7.3 million to $5.5 million which equates to 12.3% of pro-forma 2019 revenues, in line with Fitch's 'BBB' category median of 12.9%. Cash-to-debt is expected to improve over the medium term as benefits from the project and other service line initiatives grow FSL's cash position.

SUFFICIENT LIQUIDITY: At Sept. 30, 2019, FSL's pro-forma unrestricted cash and investments is expected to total around $42.5 million, which translates into 432 days cash on hand (DCOH), 44.2% cash to debt and 7.7x cushion ratio. Cash-to-debt declined year over year as FSL drew down bond funds to pay for its capital project and is issuing additional debt to fund Phase III. However, DCOH and the cushion ratio improved as FSL is using $10 million of the series 2019 bond funds to reimburse itself for equity contributions.

ASYMMETRIC RISK FACTORS: There are no asymmetric risk factors considered in this rating determination.

RATING SENSITIVITIES

FINANCIAL PROFILE IMPROVEMENT: FSL's proforma metrics are somewhat more in line with that of a 'BBB' rated credit. However, Fitch expects that with FSL's strong market demand, additional cash from entrance fees as IL occupancy improves, cash flow and liquidity growth will improve the longer-term financial profile to levels that are consistent with the current 'BBB+' rating. Nevertheless, a failure to improve occupancy closer to historical levels or grow unrestricted liquidity would likely put negative pressure on the rating. Any additional debt would also pressure the rating.

CREDIT PROFILE

Located in Basking Ridge, NJ, FSL is a senior living organization with several distinct service lines. Fellowship Village (FV) is FSL's continuing care retirement community, which offers Type-A (Lifecare) contracts. FSL offers traditional contracts which become non-refundable after 48 months and 90% refundable contracts; however, currently all residents except one have chosen the traditional option. FV currently has 257 independent living residences/units (ILUs), 81 assisted living suites/units (ALUs; includes 14 memory care units), and 54 skilled nursing (SN) beds. FSL's other service lines includes Fellowship Freedom Plans, which is a CCRC 'without walls', Fellowship Helping Hands, a home health agency accredited in 2019, and a Hospice program which was accredited in December 2017.

All service lines of FSL are included in the obligated group. FSL's total operating revenues in fiscal 2018 were approximately $44.0 million.

CAPITAL PROJECT UPDATE

Following an extensive delay, FSL received all the necessary approvals for its campus repositioning project, which began in April 2017. The project entails constructing a new AL and SN building, expanding and renovating existing AL and SN suites, constructing two dedicated memory care households, building a new 239-seat cultural arts center, extensive renovations to its main entryway, and completing minor capital projects around campus. The renovation and expansion of skilled nursing, AL, and memory care should be financially accretive to FSL, while the cultural arts center is expected to enhance FSL's already strong market position.

The cultural arts center, new entrance and lobby, and the new AL and SN building were completed in 2019. However, challenges with construction have led to significant delays and cost overruns, as a result the renovation and expansion of the existing AL and SN suites is now expected to be completed in the spring of 2021 and will cost around $20 million which is approximately $3 million more than initial expectations. FSL is also constructing a new 100 seat bar and lounge in existing space on the campus that is expected to be completed in the spring of 2020. Fitch expects that these projects will help position FSL positively for current and future residents.

ADEQUATE FINANCIAL PERFORMANCE

FSL's strong market position, good census levels and successful expansion of service lines have translated into adequate operational performance. Over the last three fiscal years, FSL has averaged a 94.2% operating ratio, 4.5% net operating margin (NOM) and 19.6% NOM-adjusted, which are mixed to Fitch's 'BBB' medians of 96.5%, 5.9% and 23.0%, respectively.

However, operational decline through the first nine months of fiscal 2019 is attributed to a softening census in ILUs and lower net entrance fee receipts, with IL occupancy falling to 84% in the interim period, relative to historical occupancy in the mid-90% range. The lower occupancy was due to the ongoing construction projects, which significantly hindered marketing efforts as well as above average attrition. FSL has had considerable improvements in occupancy in recent months, with 19 total move-ins in the third and fourth quarters of fiscal 2019, compared with only five total move-ins in the first and second quarters. This positive IL trend will have to continue through 2020 in order to support the current 'BBB+' rating.

Another driver of FSL's operational performance has been its ongoing expansion of auxiliary service lines, which has diversified its revenue base and is viewed as a credit positive. To date, FSL's additional services include a home health agency and a hospice program that have been accretive to FSL's financial profile and have been a key driver of revenue growth in recent years.

SUFFICIENT LIQUIDITY POSITION

As of the nine-month 2019 interim pro-forma period, FSL unrestricted cash and investment position is estimated to be $42.5 million, which translates into an adequate 432 DCOH, 44.2% cash to debt and 7.7x cushion ratio. These are below Fitch's 'BBB' category medians of 465, 63.6% and 8.3x, respectively. Despite strong historical operational performance, FSL's liquidity position has declined in recent years due to elevated capital spending for the project, weaker operations and the expected debt issuance. Over the last three fiscal years and nine months into 2019, FSL's capital expenses have averaged 238% of depreciation.

Fitch expects FSL's overall liquidity position and cash to debt position to improve now that the majority of the campus repositioning project is now complete. However, FSL's liquidity position is thin for its current 'BBB+' rating level and the rating would likely face negative pressure if liquidity metrics do not improve in 2020.

DEBT PROFILE

The series 2019A will refinance all of FSL's current outstanding long-term debt as well as adding an additional $31 million to the debt position. The series 2019A will refinance the approximately $32 million of series 2013A outstanding and the $34 million in series 2013B outstanding as well as the termination of the four associated fixed payor swaps. Proceeds from the series 2019A will also be used to reimburse FSL for $10 million in equity contributions to Phase I and II of the campus repositioning project and fund the projected $20 million cost of Phase III.

While this issuance will increase FSL's outstanding long-term debt from around $66 million to $96 million, MADS will decrease from $7.3 million to $5.5 million. This will improve FSL's MADS as a percentage of revenues to 12.3% for the nine month interim period, which is in line with Fitch's 'BBB' medians. MADS coverage is also projected to be approximately 2.0x in fiscal 2020 and 2.2x in fiscal 2021, which is above Fitch's 'BBB' median of 1.9x. Debt to net available is projected to increase to a very high 12.1x, but is expected to moderate as occupancy rebounds. Although Fitch expects FSL's operations to improve significantly going forward, the increase in leverage from the series 2019 bond issuance reduces the margin of error in FSL's operational turnaround and heightens the risk of negative rating action in the near term.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Fellowship Senior Living (NJ)			
Fellowship Senior Living (NJ) /General Revenues/1 LT	LT BBB+ Affirmed		BBB+

Additional information is available on www.fitchratings.com

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Applicable Criteria

U.S. Public Finance Not-For-Profit Continuing Care Retirement Community Rating Criteria (pub. 30 Mar 2018)
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 07 Nov 2019)

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