FitchRatings

Fitch Affirms United Methodist Retirement Communities (MI) at 'BBB+'; Outlook Stable

Fitch Ratings-New York-05 July 2018: Fitch Ratings has affirmed the 'BBB+' rating on the following bonds issued by Michigan Strategic Fund on behalf of United Methodist Retirement Communities, Inc. (UMRC):

--$10.635 million limited obligation revenue bonds, series 2013.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by a pledge of gross revenues, a mortgage interest in a property, and a debt service reserve fund.

KEY RATING DRIVERS

SOLID OPERATIONAL PERFORMANCE: Despite some weakening due to softening census levels, UMRC's operational performance remained solid in fiscal 2017 as evidenced by its 91.2% operating ratio, 7.7% net operating margin (NOM), and 7.3% excess margin, which all compare favorably to Fitch's 'BBB' category medians of 97.4%, 7.7%, and 1.7%, respectively. Additionally, UMRC's solid operational performance produced a strong 1.9x revenue-only coverage in fiscal 2017, which remains well above the 'BBB' category median of 0.8x.

MASTER FACILITIES PLAN: UMRC is currently underway on its multi-phased master facilities plan which encompasses adding 54 additional independent living (IL) cottages, renovating and expanding its skilled nursing facility (SNF), constructing a new wellness center, and renovating its existing building for office use. Construction began in April 2016 and total project costs are expected to be between $43 million-$44 million, with approximately $20 million anticipated to come from temporary debt financing. While the total cost is higher than the $35 million-$40 million expected and will require an additional $5 million in temporary debt, Fitch believes UMRC has the financial capacity to absorb the increased costs of the project which is reflected in the affirmation of the rating.

SOLID CENSUS LEVELS: Despite some softening in its overall census levels, UMRC has demonstrated solid occupancy levels across all levels of care in recent years. In fiscal 2017, UMRC's IL units were 91% occupied, its assisted living units (ALU) were 92% occupied, and its SNF beds were 85% occupied.

MODERATE LONG-TERM LIABILITY PROFILE: UMRC's debt profile remains moderate as evidenced by maximum annual debt service (MADS) equating to 9.8% of total fiscal 2017 revenues, which compares favorably to Fitch's 'BBB' category median of 12.4%. Additionally, UMRC's debt to net available of 4.8x in fiscal 2017 also compares favorably to the 'BBB' category median of 6.2x.

ASYMMETRIC RISK FACTORS: Asymmetric risk factors are generally neutral or negative to the rating. The rating is somewhat constrained by UMRC's debt structure, which consists of 75% variable-rate bank debt. However, approximately 28% of this variable-rate bank debt is swapped to a synthetic fixed-rate.

RATING SENSITIVITIES

MASTER FACILITIES PLAN EXECUTION: Any significant project execution issues such as construction delays, cost overruns, or service disruptions that negative impacts UMRC's operating or financial profiles could put negative pressure on the rating. Conversely, successfully completion of the project coupled with a strengthened financial profile may result in positive rating momentum over the medium term.

CREDIT PROFILE

UMRC consists of two facilities, Chelsea Retirement Community (CRC) and Cedars of Dexter (CoD). CRC is a rental continuing care retirement community (CCRC), with 122 ILs, 66 ALUs, 86 memory care beds, and 85 SNF beds located in Chelsea, MI, about nine miles west of Ann Arbor. CRC will have 176 ILUs following completion of phase one of UMRC's master facilities plan. CoD is a 60 unit, Type-C, entrance fee IL community in Dexter, MI. In May 2016, UMRC received state approval to begin providing entrance fee contracts at CRC in addition to rental contracts and began marketing these entrance fee contracts in 2017. The only other member of UMRC's obligated group (OG) is UMRC Foundation, which controls and manages unrestricted and donor-restricted contributions to UMRC.

Additionally, UMRC has multiple non-OG affiliates, which includes three PACE enterprises, three affordable housing facilities, and a market rate IL/AL community. Fitch's analysis is based on financial statements of the OG, which reported total operating revenues of $34.2 million in fiscal 2017.

MASTER FACILITIES PLAN

UMRC is currently underway on its multi-phased master facilities plan, with an expected total cost of $43-$44 million, which is an increase from the $35-$40 million expected during our last review. Despite the increase, Fitch believes UMRC has debt capacity at the current rating level and can absorb the additional costs of the project. Phase I entails renovation of existing IL apartments and adding 54 new IL cottages to its CRC campus. Construction began in April 2016 and is expected to be completed by September 2018. UMRC expects the cottages to be fully occupied by the end of the year.

To date, 50 of the 54 cottages have been pre-sold, with 34 cottages already occupied. All pre-sales require an upfront deposit of 10% of the initial entrance fee. The total costs of Phase I is approximately $16 million. The new 54 IL cottages are expected to generate approximately $13 million in initial entrance fees, of which $6.6 million has been collected and is sitting in a restricted escrow account. The project is being funded by a revolving loan agreement, which UMRC intends to pay down over the next few years with initial entrance fee receipts.

Phase II of the master facilities plan entails renovating and expanding the existing SNF, converting all SNF rooms to private from semi-private, constructing a new wellness center, and renovating its existing building for office use. Construction on phase II began in the summer of 2017 and is expected to be complete by the end of 2019. Total costs of the projects are expected to be approximately $27 million. UMRC has a GMP in place for Phase II. UMRC is expected to fund the project with cash flow from operations, an equity contribution, and fundraising.

The affirmation of the rating reflects the current scope of the master facilities plans Fitch believes UMRC has the financial capacity to absorb the costs of the project. Furthermore, the project is expected to be accretive to UMRC's financial and operating profiles following completion and should enhance the marketability of its SNF. There could be positive pressure on the rating over the medium term if UMRC is able to successfully execute its master facilities plan and improve its net leverage position.

SOLID FINANCIAL PROFILE

While UMRC's operational performance weakened slightly in fiscal 2017 due to some softening census levels, it remained solid for its rating level. In fiscal 2017, UMRC had a 91.2% operating ratio, 7.7% NOM, and 7.3% excess margin, which are all on par with or favorable to Fitch's 'BBB' category medians of 97.4%, 7.7%, and 1.7%, respectively. UMRC's solid performance is attributed to its strong, albeit softening, census levels as evidenced by its 91% occupancy in its ILs, 92% in its ALUs, and 85% in its SNF. Management reports an increased focus on marketing to help improve census levels across all service lines. Fitch believes UMRC's upcoming master facilities plan should help improve the marketability of its SNF beds. Additionally, UMRC remains a preferred provider for Trinity Health which should continue to support short-term rehabilitation demand for its SNF.

UMRC improved its unrestricted cash and investment position by 4% to $29.5 million in fiscal 2017, which translates into 352 DCOH, 80.8% cash to debt, and 8.1x cushion ratio. All three metrics remain on par or favorable to Fitch's 'BBB' category medians of 396 DCOH, 61.5% cash to debt, and 8x cushion ratio. Fitch expects UMRC's liquidity position to decline in the short-term as its funds a portion of its upcoming capital project. Overall, UMRC's liquidity metrics remain solid given its contracts are currently predominantly rental. However, UMRC is slowly increasing its exposure to refundable fee-for-service contracts, which require a refund of the entrance fee regardless of re-occupancy of the vacated unit. This may present some financial challenges if UMRC is unable to fill the unit in a timely fashion. However, these concerns are currently mitigated by UMRC's solid liquidity position and strong IL demand.

STRONG FOUNDATION & IMPROVED NON-OG PERFORMANCE

UMRC owns and operates three PACE programs and multiple affordable housing facilities, which are located outside of its OG. UMRC utilizes the equity method to account for these facilities in its OG financial statements. In fiscal 2017, UMRC reported a $2.3 million gain from joint ventures, which is a large improvement from the $1.8 million loss in fiscal 2016 and the $1 million loss it originally projected for fiscal 2017.

The improved performance from these non-OG entities is a credit positive and lessens concerns regarding future non-OG financial dilution. Furthermore, management reports that UMRC's local reputation and marketing efforts have been aided by its numerous non-OG entities. Additionally, UMRC enhanced foundation activities are viewed positively as the foundation is expected to support UMRC's strategic initiatives. UMRC reported temporarily restricted contributions from its foundation of $3.9 million in fiscal 2017 and $7.7 million in fiscal 2016.

LONG-TERM LIABILITY PROFILE

Currently, UMRC had three bond issuances, two debt guarantees, and a revolving loan agreement outstanding. At March 31, 2018, UMRC had approximately $41 million outstanding in long-term debt. Of this, $10.4 million is comprised of fixed-rate bonds (series 2013) and $17.3 million is comprised of variable-rate bonds. UMRC has entered into floating for fixed rate swaps which effectively hedges 50% of the notional amount of its variable-rate bonds.

The remaining $13.3 million comprises what has been drawn to date on UMRC's variable-rate revolving loan agreement, which has a tender date of October 2021 and the ability for optional prepayments. While the initial revolving loan agreement was for $15 million, UMRC amended the agreement to increase the total amount to $20 million. Management expects to draw down the full amount and pay it off with initial entrance fees and operating cash flow before its maturity in 2021. Additionally, the UMRC OG has guaranteed the debt of two non-OG PACE programs. The currently amount outstanding of this guarantee is $3.5 million.

For calculation of MADS, Fitch includes 20% of the principal and interest of the two loan guarantees and a 30 year amortization on UMRC revolving loan agreement. With the inclusion of the guarantees, the increased par amount of the revolving loan agreement, and interest rate movements, UMRC MADS increased by 22% to $3.6 million. Despite the increase, UMRC's debt burden remains moderate as evidenced by MADS equating to 9.8% of total fiscal 2017 revenues, which compares favorably to Fitch's 'BBB' category median of 12.4%. Additionally, UMRC's debt to net available of 4.8x in fiscal 2017 also compares favorably to Fitch's 'BBB' category median of 6.2x. In fiscal 2017, MADS coverage was sufficient at 2.1x which is on par with Fitch's 'BBB' category median of 2.2x.

UMRC participates in a multi-employer defined benefit retirement plan, which is currently underfunded and in critical status per the Department of Labor Pension Protection Act. While UMRC does not report any liability on its balance sheet from participation in the plan, Fitch views the participation in the plan as a potential risk. UMRC's contributions to the plan were $140,533 in fiscal 2017 and $131,084 in fiscal 2016. UMRC is currently budgeting for a 15% increase in plan contributions moving forward.

ASYMMETRIC RISKS

UMRC's debt profile is aggressive, with 75% of its outstanding debt being variable-rate obligations held by banks. Fitch views this level of variable-rate bank debt, with interest rate, counterparty, and refinancing risks, as an asymmetric risk. However, Fitch notes that approximately 50% of its notional variable-rate bonds ($17.3 million) are hedged to a synthetic fixed-rate.

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Applicable Criteria

Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018) (https://www.fitchratings.com/site/re/10020113)

U.S. Public Finance Not-For-Profit Continuing Care Retirement Community Rating Criteria (pub. 30 Mar 2018) (https://www.fitchratings.com/site/re/10024657)

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