FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Forest at Duke (NC)'s Rev Bonds and IDR to 'BBB-'; Outlook Stable

Wed 21 Dec, 2022 - 2:43 PM ET

Fitch Ratings - Austin - 21 Dec 2022: Fitch Ratings has downgraded the rating on the approximately $44 million first mortgage revenue bonds series 2021 issued by the North Carolina Medical Care Commission on behalf of the Forest at Duke (FD) to 'BBB-' from 'BBB'. Additionally, Fitch has downgraded FD's Issuer Default Rating (IDR) to 'BBB-' from 'BBB'.

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Forest at Duke, Inc. (The) (NC)	LT IDR	BBB- Rating Outlook Stable Downgrade	BBB Rating Outlook Stable

Forest at Duke, Inc. (The) (NC) /General Revenues/1 LT	LT	BBB- Rating Outlook Stable Downgrade	BBB Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

SECURITY

The bonds are secured by pledged assets, including gross receipts, and a first mortgage lien.

ANALYTICAL CONCLUSION

The rating downgrade and Stable Outlook reflects Fitch's view of FD's weakened financial profile following the issuance of $95.7 million of series 2022 unrated direct purchase bonds, issued to finance the construction of The Terraces, a new 71-unit independent living facility on FD's campus.

The 'BBB-' rating is supported by FD's strong revenue defensibility highlighted by solid historical occupancy and robust pre-sales for the Terraces expansion project. The Terraces represents the second phase of FD's current capital improvement plan. Phase I, which was funded by the series 2021 bonds, was the construction of a new 90-bed small-house model health center. The phase II Terraces project will be built on the site of the old health center building.

Fitch expects FD to be able to successfully integrate the new Terraces ILUs provided the project is completed on time and on budget which is likely given the project team is the same team used for the recently completed healthcare facility, which was completed within the project contingencies.

The rating is supported by strong historical and projected operating performance along with FD's adequate, but increasingly leveraged balance sheet. FD's leverage materially increased following its series 2021 bond issuance, leading to the previous rating downgrade in 2021. The additional debt for Phase II leaves FD highly leveraged. Additionally, Phase II project costs are approximately $10 million higher than previously anticipated due to escalating costs from inflation.

The $95.6 million of new debt for The Terraces is unrated and was issued as a bank direct purchase by Truist Commercial Equity, Inc. on Nov. 16, 2022. Of the total new debt, $29.5 million was issued as temporary debt (series 2022A-2) and will be repaid from initial entrance fees; $66.07 million was issued as permanent debt (series 2022 A-1) with a Sept. 1, 2052 maturity date.

The series 2022 debt further constrains FD's balance sheet with pro forma cash to adjusted debt averaging 33% and 28% respectively through Fitch's forward-looking base and stress case scenarios. Although the forward-looking financial profile is weak for the rating level, solely due to the increase in leverage, Fitch believes that there remains an adequate, but very limited, financial cushion to support the total debt, particularly since FD has a demonstrated history of capable management, and because presales for the new IL units suggest that demand is robust. However, FD has no additional debt capacity at the current rating level.

KEY RATING DRIVERS

Revenue Defensibility: 'a'

Strong market position and demand for existing and new units

FD's revenue defensibility is assessed at 'strong'. This primarily reflects the community's strong historical census levels, with independent living unit (ILU) occupancy that has averaged above 95% over the last four years. The community's focus on lifelong learning supported by its relationship with Duke University, attractive facilities and programs, and multi-channel marketing strategy, has helped FD maintain a strong overall market position and stable demand even in the presence of several competitors.

The health center project, funded by the series 2021 bonds, replaces the current health center with a 110,000-sf five-story building. The new 90-unit health center is based on a 'small house' format where clusters of rooms are supported by a common space and dining facility that is shared by the household. The new health facility replaces 14 IL cottages. The old health center will remain occupied until health center residents are moved to their new facility in early January and then decommissioning, demolition, and site preparation for The Terraces will begin with construction expected to be completed by March 2025.

The Terraces project representing phase II of FD's capital improvement plan will be a 71-unit ILU expansion project on the old health center site. As of Dec. 21, 2022 100% of the new ILUs have been pre-sold (with 10% deposits). There are 130 individuals who have signed non-binding $1,000 reservation agreements for the new units.

Fitch views the Terraces project favorably, given the community's strong demand. Over time, Fitch expects this project will be accretive to operations; however, in the short term will constrain FD's financial profile.

FD's historical occupancy trends have been fairly stable over the last five fiscal years, with an average of approximately 95% of ILUs, 68% of ALUs, and 81% of SNF beds occupied from fiscal 2018 to fiscal 2022. ILU occupancy remained high through the coronavirus pandemic, at 96% in fiscal 2020 and 2021 (Sept. 30 FYE). FD has a waitlist totaling 400 individuals for its existing ILUs.

AL units experienced a decline in occupancy during the pandemic which has yet to rebound, but that also reflects the closing of an eight-room AL neighborhood from March 2020 until April 2021 for pandemic reasons. The SNF, which has maintained its occupancy, operates under a closed certificate of need as such it cannot accept outside admits. The AL may accept direct admits and rebuilding of AL occupancy is expected. Outside admits to the AL pay a moderate entrance fee, and pay a monthly fee that is up to double what an IL resident pays who is transitioning to a higher level of care.

FD's historically robust demand is supported by a solid market position in a growing and favorable service area. Durham County has a median household income level above the state average and has benefitted from a five-year population growth of over 7%. The community faces competition, with four primary competitors in the service area, but occupancy remains high across all competitors which indicates sufficient demand.

Local real estate data also indicates a very strong local housing market, which should support continued high ILU demand going forward. Additionally, the business community remains robust with Apple, Google, and JP Morgan Chase all planning to expand their presence in the area.

FD has applied consistent rate increases for both average entrance fees and monthly service fees of historically 3%-4% each year. For fiscal 2023 FD increased the IL entrance fee by 3% and monthly fee by 4.5% and the monthly service fee for AL and SNF per diem by 5%. Single occupancy entrance fees for FD range from $98,000 to just under $620,000 for the largest units. Entrance fees for the new Terraces ILUs are expected to be $416,000 to $590,000. Entrance fees remain in-line with local home values, which continue to see strong demand and quick sales.

Operating Risk: 'bbb'

Solid core operations, Predominantly Type-B community offering fully amortizing contracts

Historically, FD has been a strong operator, with an operating ratio, net operating margin (NOM), and NOM-adjusted (NOMA) that have averaged 87.2%, 12.3%, and 25.4%, respectively, over the last four fiscal years, which Fitch attributes to strong census levels, good expense management, and favorable contract pricing. Operating performance remained solid in fiscal 2021 even after taking off-line 14 ILUs in conjunction with the health center project and favorable operating performance for fiscal 2022 was sustained.

With the new project and current inflationary pressures, Fitch expects some contraction of operating metrics resulting in the operating ratio, NOM, and NOMA averaging 98%, 11%, and 26% over the five-year forward looking base case. While somewhat more constrained relative to historical performance, operating metrics should remain comfortably within the midrange thresholds.

Inclusive of spending for the healthcare project capex to depreciation averaged 239% over the last four years, with the bulk of that spending falling in 2022. Capital spending will remain robust over the next three fiscal years with construction of The Terraces project. Routine capital spending needs over the next few years are expected to be modest, averaging under $3 million annually.

Financial Profile: 'bb'

Materially Elevated Leverage

The rating reflects the significant fiscal 2021 increase in leverage following FD's issuance of $44 million series 2021 bonds and the $96 million unrated series 2022 bank placed bonds. FD's financial profile weakened with fiscal 2022 cash-to-adjusted debt falling to around 56%. With the issuance of the series 2022 bonds, proforma cash to adjusted debt is expected to decline to 41% in 2023, and with the additional construction draws will dip further to 28% in 2025 before building back over time, particularly once the temporary debt is repaid through the Terraces initial entrance fee pool.

In fiscal 2022, FD's $36 million in unrestricted cash and investments and $64 million in debt translated to 650 days cash on hand (DCOH) under Fitch's calculation methodology, and 56% cash-to-adjusted debt. Fitch believes that FD's strong demand and solid operating profile will allow the community absorb the new project debt but with limited financial flexibility to address a stressed scenario at the current rating level.

Fitch's stress scenario incorporates both an investment portfolio and cash flow stress that are in line with current economic conditions and expectations. Under these assumptions, FD's key leverage metrics and coverage levels remain more consistent with a 'bb' financial profile assessment.

Asymmetric Additional Risk Considerations

There are no asymmetric additional risk considerations associated with this rating.

Total outstanding, and pro forma debt is approximately $158 million. The unrated bonds associated with The Terraces project are structured as drawdown bonds and were issued as $29.5 million of (series 2022A-2) short-term debt maturing Sept. 1, 2027-to be repaid from the initial entrance fee pool-and $66.07 million (series 2022A-1) of long-term debt maturing Sept. 1, 2052, but with an initial bank term of Nov. 16, 2037.

The series 2022 bonds were placed with Truist Commercial Equity, Inc. and issued as variable rate obligations. FD entered into a forward starting fixed payer swap on the series 2022A-1 with an increasing notional principal based on the expected series 2022A-1 draws. The swap becomes effective on Mar. 1, 2023 and terminates on Nov. 1, 2037.

FD remains in compliance with its annually tested 1.2x rate covenant and minimum 250 days cash on hand (DCOH). DCOH is tested semi-annually at March 31 and Sept. 30. Subject to certain conditions being met DCOH may be subject to a lower threshold.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Any increase in leverage above the recently issued debt;

--A sustained decline in average cash-to-adjusted debt below 30% after all construction draws, or should cash to adjusted debt levels be materially weaker than what is currently expected under the forward- looking base case scenario;

--Project execution issues that materially disrupt current operations or deteriorate liquidity levels.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-- A positive rating action is not expected until after completion of construction and stabilization of The Terraces project.

--Over the longer term, balance sheet improvement where cash-to-adjusted debt is sustained above 80%.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

FD operates a Type-B life plan community located in Durham, NC. The community currently consists of 242 ILUs, 34 assisted living units (ALUs) and 58 skilled nursing facility (SNF) beds (seven of the 14 ILUs being demolished were taken off-line before the project commenced). Once After the health center project has been completed FD will have 235 ILUs, 32 ALUs and 58 SNF beds. The planned ILU expansion will increase the community's ILUS to 306. FD is CCAC-CARF accredited and Medicare certified. In fiscal 2022 (year-end Sept. 30), FD had total operating revenues of $27.9 million.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

FITCH RATINGS ANALYSTS

Karl Propst
Director
Primary Rating Analyst
+1 512 215 3727
karl.propst@fitchratings.com
Fitch Ratings, Inc.
2600 Via Fortuna, Suite 330 Austin, TX 78746

Margaret Johnson, CFA
Senior Director
Secondary Rating Analyst
+1 212 908 0545
margaret.johnson@fitchratings.com

Eva Thein
Senior Director
Committee Chairperson
+1 212 908 0674
eva.thein@fitchratings.com

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

U.S. Public Finance Not-For-Profit Life Plan Community Rating Criteria (pub. 05 Apr 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Portfolio Analysis Model (PAM), v2.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

North Carolina Medical Care Commission (NC)	EU Endorsed, UK Endorsed

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