

Subject: Long Position--Brookdale Senior Living (BKD)

To: McIntire Investment Institute Managers

From: Harrison B. Freund, College of Arts and Sciences, Class of 2013

Date: November 27, 2009



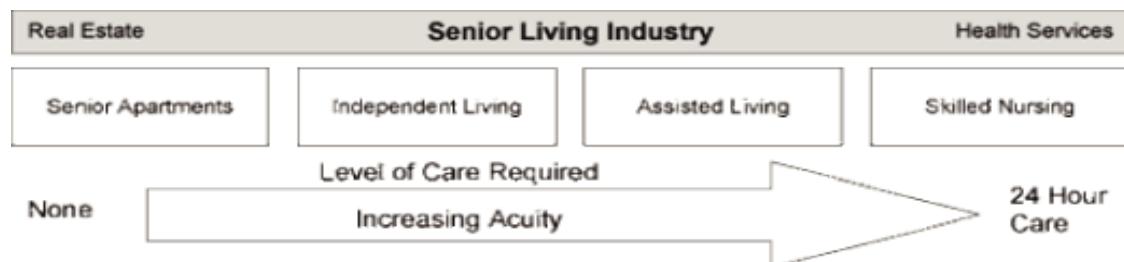
Business description:

Sector: Healthcare/Health services

Summary:

Brookdale owns and operates senior living facilities throughout the United States. Founded in 1978, it has 550 communities in 35 states and the ability to serve over 52,000 residents from suburban areas to major cities. The states where Brookdale has the most retirement homes are Florida, Texas, North Carolina, California, Colorado, Ohio and Arizona. Brookdale is the largest provider of "senior related services" in the nation. Specifically it offers a wide range of services to residents with various needs and stages of health.

The least intensive stage of healthcare services is independent living where residents lead their own lives but eat and live in a retirement home. Next comes assisted living involving further assistance for those who need help with dressing, bathing, and other needs. Finally they offer skilled nursing for critical patients. The following breakdown will give a more in-depth approach of understanding the company by focusing on what specific housing models Brookdale offers, its revenue breakdown, the services, and finally what their strategic objectives and business models are.



The Housing Models:

Retirement Centers consist of both independent and assisted living. On average, approximately 80% of the rooms are for independent living and 20% are for assisted living. They contain an average of 184 beds and 30% of Brookdale's total residents live in these apartment-style buildings. In addition to the housing, residents receive meals and participate in social activities—the “optimum life program” all included in the monthly cost. Skilled nursing and additional medical services are extra. The advantage of these buildings is that as patients get older, they don't have to transition into another retirement home; they simply change from independent into assisted living that offers more care for residents. Brookdale calls this the “age-in-place” concept.

Assisted Living communities are only for assisted living and 40% of Brookdale's residents live in them. Those in the assisted living communities have access to health assessments along with meals and other communal activates. Like at the Retirement Centers, specific medical assistance is extra. Some of these assisted living communities have memory care communities specifically catering to the niche market of people suffering from Alzheimer's disease, dementia and other conditions that impair memory. Because of the increased demands of these memory care units, Brookdale is able to charge higher prices.

Continuing Care retirement communities (CCRCs) offer the largest physical plant of Brookdale's communities. They offer independent and assisted living along with memory care and skilled nursing. About 27% of Brookdale's residents live in these CCRCs which are “campus” style apartments that offer full range, “age-in-place” care.

Revenue Breakdown:

Brookdale generates its revenue in three ways:

- First, customers pay an entrance fee when they sign the contract for their living situation. In some cases, residents can pay a higher entrance fee in exchange for lower monthly payments.
- Second, residents are billed monthly maintenance—it is like paying rent.
 - Specifically, some locations have what is called **Life Care**. Basically the resident enters into a contract where the more they pay, the more their family gets back when they die. Also, if they have to upgrade to assisted living, their rent does not increase. This plan is extremely attractive to people who realize the company will not jack up rents if their health declines.
- Finally, extra services such as nursing are tacked onto the monthly bill.

It is important to note that over 90% of Brookdale's residents are “self-pay” with less than 10% who use Medicaid. Because retirement homes can get over 30% more if the patient pays out of pocket, the small proportion of Medicaid patients benefits Brookdale. In a conference call, the CEO stated that they are looking to further expand to units where they can receive 100% private pay. Because

Brookdale's clients are almost all self pay, the government health care bill will not impact the company very much, if at all. Mr. Bohlen, an analyst at Goldman Sachs covering Brookdale, confirmed this opinion.

The Services:

Brookdale offers health services such as gymnasiums and swimming pools for their residents. By keeping residents healthier, they will be happier and live longer, so they will be able to pay the dues for a longer amount of time. Brookdale has special features unlike other retirement homes such as the "optimum life" program which emphasizes six key wellness points. Fundamentally this involves supplying cultural activities such as watercolor classes, field trips to local attractions, special dinners for holidays, book clubs and other positive group activities. Many seniors move in as widows or widowers; Brookdale's wide array of activities gives the elderly, who would otherwise be lonely, a brighter outlook on life by keeping them mentally and physically active. Their "Culinary Arts Institute" is the name given for Brookdale's industry-leading dining services that offers healthy, high quality meals. Brookdale prepared 50 million meals (in 2007); it can take key advantage of economies of scale. The quality of the meals is also important to recognize. Many seniors have health needs such as hypertension, diabetes, or allergies that require appropriate diets. They look for retirement homes that will provide meals that are healthy—thus they will choose Brookdale.

Business model/Strategic objectives:

Brookdale has three strategic objectives for growth that constitutes their business model. The first objective is to grow in their existing core business and to critically take advantage of economies of scale that their competitors simply cannot match. Brookdale will increase the monthly service fee as occupancy grows due to demographic demand. They make efforts to hold on to current residents and to attract new ones. Brookdale specifically targets middle to upper class persons over 70 years old.

The second cornerstone in the plan for growth is the expansion of services. Brookdale is actively seeking to expand their services to provide more home therapy, health, nursing, wellness and cultural programs. This holistic 'Senior Care Program' puts them ahead of their competitors because Brookdale has the experience and the infrastructure to supply these services. Ultimately, this array of services increases current customer satisfaction while attracting new customers, allowing Brookdale to charge a higher price and generate more revenue.

The third strategic objective of Brookdale is to develop already existing communities and to look at segments of the market in which to deploy and develop new senior living facilities. Communities that face high demand will be developed more and Brookdale either plans to acquire existing senior living facilities or construct new ones in areas where there is demand but not enough supply of senior living. Because of the soft economy, Brookdale is taking an especially critical perspective of which markets to put capital into for expansion. This careful analysis is sure to generate profits in the near future.

Their mission is to enrich “*the lives of those we serve with compassion, respect, excellence and integrity.*”

Competition:

The main competitors are Sunrise Senior Living, Emeritus, and Assisted Living Concepts. They are discussed throughout this memo. Sunrise and Emeritus do not pose risks due to the fact that they are markedly inferior companies as will be explained later on. Their biggest threat is Assisted Living Concepts. They have decent financials in comparison with the industry and are prudently managed, but are smaller and thus cannot take advantage of economies of scale.

Metrics

Market Cap	1.84 billion
P/E	5.26
Price/Book	1.7X
Current Ratio	.6
Debt/Equity	3.63
Interest coverage	2.3
EBITDA	12.03%
ROIC	.77%
52 Week range	2.50 to 20.69

Thesis points (includes VAR)

Value Added Research: **Survey of senior living in the greater Roanoke, VA area.**

Pheasant Ridge--Problems include: Only has assisted living and some memory care (no independent living). Also, their location is poor as they have a very steep road which is hard to access in inclement weather. Also their food is very unhealthy and extremely salty. The soup was “like saline” and is not good for seniors with hypertension, heart problems or other conditions requiring a healthy diet.

Park Oak Grove--Problems include: Though it can offer assisted living services, it is primarily an independent living unit. It has no nursing care, so you would have to move out when you are most sick (after assisted living). There are also very few services.

Roanoke United Methodist Home—You do not buy into and pay a moderate monthly fee like at Brookdale—you only rent. There is a huge price jump between the different levels of care. This turns many clients off as they will face huge price increases from independent to assisted to skilled nursing. Also their independent living building is separate from the main building, so seniors have to drive (even in bad weather) to do simple things such as eat meals and participate in activities. Brookdale's retirement centers and CCRCs are in one building so the elderly can easily access the services.

Richfield—There are no services, no activities and no meals for independent living! Seniors do not want to move into this facility because they would be lonely and isolated. The primary services used are memory care and convalescent care.

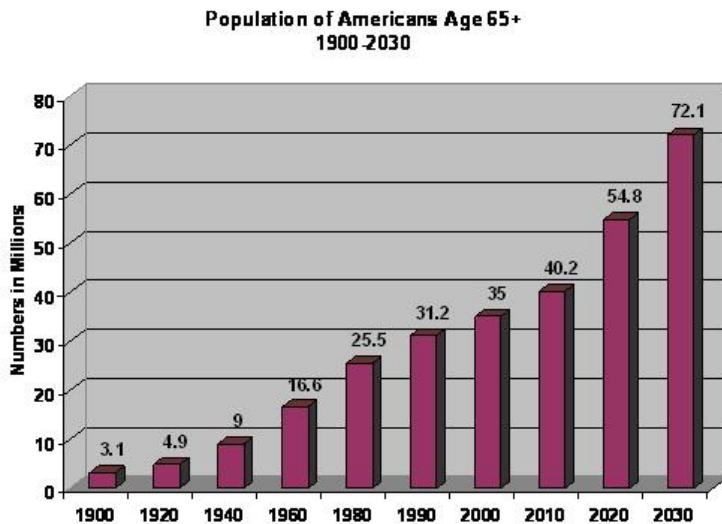
Brandon Oaks--This is the Brookdale of the Roanoke area. Just like Brookdale, it offers all three stages of care—Independent and assisted living in the same building and skilled nursing. Also like Brookdale, it offers special features such as a version of the Culinary Arts Program. The food there is healthy, and I must say, delicious. The holistic approach to living, called the “Optimum Life Program” at Brookdale, is duplicated at Brandon Oaks and offers similar services that provide maximum opportunities for an active lifestyle. My grandfather takes part in a lot of field trips, watercolor classes, attends lectures, Bible study, visits the library and participates in the World War II roundtable. Finally, the payment structure is the same as Brookdale. For all intents and purposes, this is the Brookdale of the Roanoke area. The facility received the highest 5 star rating from ourparents.com, a website dedicated to supplying information to children who are looking for senior care for their parents. *The Roanoker* magazine consistently gives it the “Best Retirement Community” award.

Based on the above comparison of senior living in the Roanoke Valley, it is not surprising that my grandfather chose Brandon Oaks (“Brookdale”). Many other seniors will choose Brookdale for their twilight years as well.

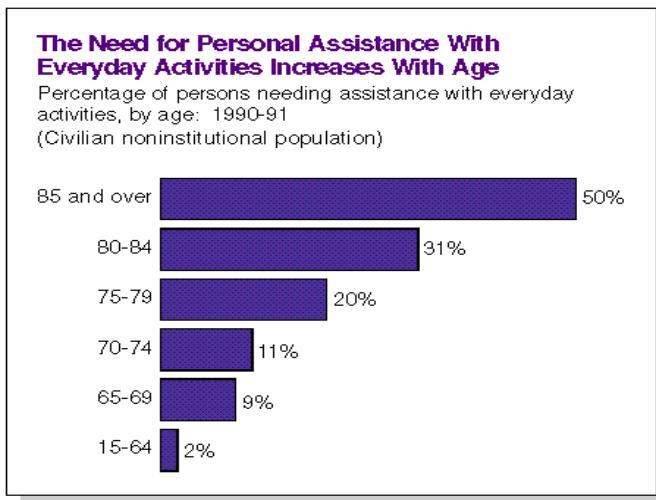
Growth of the senior population. Perhaps this is most convincing reason to invest in Brookdale. Brookdale is positioning itself well, tapping into its target market that is experiencing “unprecedented growth.” Drawing from the United States census report this is clear:

“The elderly population **increased elevenfold** between 1900 and 1994; the nonelderly increased only threefold. The oldest old is the **fastest growing** segment of the elderly population....The oldest old (persons 85 years old and over) from 1960 to 1994, **increased 274 percent**...the oldest old are projected to be the fastest growing part of the elderly population into the next century.”

Because it is the oldest old (85 and older) who take advantage of senior living the most and have to pay the highest prices due to their increased demands, Brookdale stands to benefit from this secular trend for years to come.



It is also important to note that demand for senior living is *highly inelastic*. As a CEO in the industry mentioned, the business of senior living is “need driven” and is “more impacted by demographic trends in population than cyclical economic trends.” As mentioned above in my VAR, my grandfather, a retired doctor, experienced deteriorating health *forcing* him to seek some type of retirement care as he sought the assurance that his future needs would be accommodated. This graph illustrates this point



Changing Family Demographics. Dr. Boggs explained how the change in family dynamics benefits senior living companies. In the past, family members looked after their relatives. Often the wife would look out for the father and mother-in-law of her husband. Children lived close to their parents and could take care of them in their old age. Now, with children moving far from their parents, senior homes took over the responsibility that families once had.

Wide range of housing models and services. Brookdale offers an extensive range of housing models that differentiate it from other retirement facilities. It also offers the “age-in-place” security. Most residents who are not already infirmed enter the Retirement Centers or CCRCs. Because all of Brookdale’s retirement homes and CCRCs offer the “age-in-place” services, seniors will want to move into these homes because they realize as they age they will not have to move out. Unlike other retirement homes that scatter their assisted living homes, Brookdale tries to have “Brookdale clusters” so even though there will be an Assisted Living community, there will also be CCRCs or Retirement Centers in the area that offer independent living and skilled nursing as well.

To make this point more clear about the wide range of housing models, let’s contrast Brookdale to a rival Emeritus which is not as diversified as Brookdale. Emeritus’ focus is in smaller cities and suburbs whereas Brookdale also targets larger urban areas. However, Emeritus’ goal is to create a niche market for Alzheimer’s and dementia care. They have some assisted care and some independent living, but their focus is not the age-in-place model that captures people and holds on to them for the rest of their lives. Only 7 out of their 306 communities are for independent living and though there is transition from assisted living to skilled nursing/Alzheimer’s, there does not seem to be the transition from independent to assisted. Because of this strategic blunder, they have incurred losses except for 2005. Here is a graph showing the lack of diversity in Emeritus’ properties.

Service Offering	Number of Communities
Independent Living	7
Assisted Living	90
Alzheimer's / Dementia Care	29
Assisted Living & Independent Living	9
Assisted Living & Alzheimer's / Dementia Care	152
Assisted Living & Alzheimer's / Dementia Care & Skilled Nursing	4
Independent Living & Assisted Living & Alzheimer's / Dementia Care	12
Alzheimer's / Dementia Care & Skilled Nursing	2
Skilled Nursing	1
Total Communities	306

Some smaller, local companies have few housing models and lack life-improving services. For example, these smaller retirement homes which may only offer independent living, assisted living or skilled nursing care in separate places are less attractive to seniors because they realize they will have to move as time passes. Also smaller companies cannot offer the range of services Brookdale has to offer such as the Optimum Life Program. Considering that most senior live alone, having engaging activities (the Optimum Life Program) is particularly attractive and a key factor in most decisions to “buy in”.

The Villages. Brookdale has a monopoly in providing senior services to The Villages in Florida. The Villages is a massive retirement community an hour from Orlando. Depending on the season, 60,000 to 80,000 people live in the Villages which offers attractive services such as golf, boating, and

tennis. As these older people age, they will need retirement services. The CEO on the conference call stated that Brookdale has the exclusive right to be the only retirement community within that town. The fact that there is a hospital across the street makes it a very attractive location to retire. Wanting to learn more, I called Mr. Ross Roadman, head of Investor Relations. He stated that the family who developed and owns The Villages knew the board of Brookdale well and entered into a joint venture to let Brookdale provide exclusive access within The Villages. People who live in The Villages are not required to chose Brookdale's retirement home, but the fact that it is so close and the hospital is across the street, why wouldn't they?

There is another benefit that comes with the exclusive access to The Villages. Apparently, because of Florida legislation, Brookdale cannot state the revenue generated from the entrance fees until occupation reaches over 70% in Brookdale's senior living units at The Villages. Currently, the CEO in the November 2009 conference call stated that 60% of the units are already signed to buyers and with current growth; they will reach 85-100% capacity by the end of the year. This is crucial because there is a whole stream of revenue that cannot be included until next year on their cash flow statement. When it is included in early 2010, the stock price will jump. However, their "projects in The Villages incur great start up costs" which might weaken financials. Seeing this, investors will be hesitant to buy the stock. But since Brookdale has a monopoly position, it will quickly recover these losses, causing share prices to rise.

Brookdale has positive cash flow and can cover costs. Unlike some rival companies such as Sunrise Senior Living that operate with a negative cash flow, Brookdale has positive cash flow, "158 million dollars in unrestricted cash and no borrowings on the line," said the CFO on the conference call. Mr. Ross Roadman (head of Investor Relations) sees this number reaching 180 million in the future. Over the third quarter of 2008, CCRC revenue increased 4.4 % while expenses grew at .9%. This is a similar story for most of the housing models such as the retirement centers and assisted living communities. Across the board, net losses have decreased quarterly as this graph from the SEC filing reveals:

(21,290)	\$	(35,877)	\$	(45,456)	\$	(94,455)
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Speaking of financials, Mr. Roadman of Investor Relations stated that due to accounting rules, they have to depreciate their buildings so that by the 30th year, they are worth nothing. However, in reality, the market value of their properties does not fall as fast as they have to depreciate, thus there is hidden value.

Far-sighted leadership. Strong leadership is another strength of the company. Brookdale's CEO, Mr. Sheriff, has been in the senior care business for over 25 years and was the CEO of the American Retirement Cooperation before joining Brookdale in 2006. The CFO, Mr. Ohlendorf, also served for over 25 years in health services industry with Vitas Healthcare Corporation and Horizon/CMS Healthcare Corporation. Currently "He is a member of the board of directors of the Assisted Living Federation of America." Other key leaders in the company have extensive time serving in this

industry. The CEO is “proud of the management team…[they have] put us in a strong position for the future.” It is reassuring to know that this is not only an experienced team but also one who can work together.

Compared to the leadership of one of its rivals, Sunrise Senior Living, Brookdale’s is far superior. Other competitors have poor leadership. Major recent reshuffling in Sunrise Senior Living’s management has hurt their company and they have/are skirting bankruptcy. For example, although their CEO was in commercial real-estate, he mainly worked on the boards of gourmet food companies such as Whole Foods and Balducci’s, industries that do not have much to do with senior care.

Unlike Brookdale’s stable and senior board who manages the company, Emeritus has many shareholders such as the Apollo Sartoga shareholders who are on the board of directors. Sometimes they conflict with the board who is trying to run the company. The board has trouble making strategic decisions because the shareholders and the management on the board sometimes clash.

Economies of Scale. Finally, because Brookdale is the largest supplier of retirement homes in the nation, they can take advantages of great economies of scale that their smaller competitors cannot match. This allows them to purchase such goods as food and medical products in bulk which lowers their long run average total costs.

Risks

Lawsuits. The first risk is the threat of litigation. It is important to note that claims brought against Brookdale are “comparable to other companies in the senior living industry,” as reported in the SEC filings. However, lawsuits are never a good thing. An example of a specific threat of litigation that may occur would be the improper disposal of medical waste that does not comply with the standards set forth by the EPA. This waste would be generated from the nursing side of the business. Other factors that would be grounds for lawsuits are if buildings contain asbestos, the drinking water was somehow polluted or some factor affecting the safety of the employees or the residents.

Though Brookdale has not been involved in significant lawsuits, a competitor, Sunrise Senior Living has been. HCP (A REIT that deals with senior living companies) filed complaints stating Sunrise “systematically breached various contractual and fiduciary duties.”¹ In fact, if you go on to google and start typing in Sunrise Senior Living, the 2nd suggested result says “Sunrise Senior Living Bankruptcy” and the fifth says “Sunrise Senior Living Bankruptcy 2009.”

Other competitors such as Emeritus, like Sunrise are not as fortunate as Brookdale. Emeritus manages their homes in a truly appalling and atrocious manner that invites lawsuits, not to mention

¹ Seniorhousingnews.com

violates the basic standards of decency. Negligence in an Emeritus operated home in Florida caused the state to halt all new admissions within the state for Emeritus. Details follow:

"A patient...died of heart failure after staff members failed **for four days to give her the heart medicine** she had been prescribed. --Another patient who was given a blood thinner -- a medicine she had not been prescribed -- ...made her so sick, she went to the hospital for an emergency blood transfusion. --An employee who had **falsified medication** and nurse's orders. --Three Alzheimer's patients with toenails so long they curled around their toes. --Managers who, over several days, **could not give an accurate resident count**. One day, they were off by more than 30 people. The 185-bed facility reports it has brought in a new on-site executive."

Just to clarify, this statement applies to Emeritus NOT Brookdale.

Obviously, this company does not follow Brookdale's mission statement to enrich "*the lives of those we serve with compassion, respect, excellence and integrity.*" It is important to know that Brookdale has not been involved with significant litigation like its competitors. It is an industry-wide risk and Brookdale does have insurance against claims.

The weak housing market. The CEO's report stated that because of instability in the housing markets, some seniors are putting off selling their homes. They also may be unable to sell them due to the poor housing market. To move into a retirement home, you usually have to sell your house first. But because of the soft real estate market, some people could be putting off selling their houses to wait for market conditions to improve. Despite this, Brookdale has 200 communities with over 95% occupancy. In a call with a retirement center in Massachusetts, the marketing director said they have over 90% stable occupancy.

Occupancy Percent—3 months ended	September 30, 2008	September 30, 2009
Retirement Centers	89.1%	90.6%
Assisted Living	90.7%	90.2%
CCRCs	85.7%	87.4%

Weather. Some homes, especially located in the southeast, might be prone to hurricane damages. This is pertinent to retirement centers in Florida and Texas. According to SEC filings, in 2008 there was 3.6 million in hurricane and tropical storm damage.

Little to no barriers to entry. Any entrepreneur who is able to organize the factors of production can open and operate some kind of retirement home.

Debt. This is probably the most significant and realistic risk facing Brookdale. Expansions, such as acquiring 21 units from Sunrise Senior Living, are financed mostly through debt. However prudent and researched expansion may be, growth requires Brookdale to take on debt which over time might harm the company. Currently, Brookdale does have a fair amount of debt and lease obligations. In the present, Brookdale is able to extend their debt. For example, they just extended 131 million dollars of long term mortgages until 2011. However, if the pattern keeps up, they might find it

difficult to acquire credit lines to fund expansion. It is important to mention that Brookdale has mortgage, not corporate debt.

Additional risks related to debt include property foreclosure. Combined with the fact that some financing is by cross-collateralization provisions, one foreclosure would have the potential to affect other properties. Another consideration is that if they maintain their debt, they might have to cut dividend payments which might concern shareholders. Sunrise is having more issues with debt and has had constantly disappointing quarterly losses. In fact, it has twice come very close to bankruptcy.

Summary

In the broader strategic outlook, as McIntire Investment Institute is structured as a hedge fund, Brookdale Senior Living would add critical and necessary exposure to the healthcare sector market, something MII does not yet have. The S&P 500, our benchmark, is made up of 13.4% healthcare stocks. With our large cash holdings, we could prudently diversify MII which now has 0% in healthcare.

Specifically, because of this risk of debt (which all retirement homes are facing) the street is perhaps hesitant about the stock. However, due to Brookdale's première position in the industry, they actually operated in positive cash flow, in their "third consecutive quarter of producing \$50 million or more of recurring CFFO." Additionally, the street sees Brookdale and other senior living options as housing. In fact, an anchor from the Street.com in an interview asked the CEO of Emeritus,² "Senior living is still a form of housing?" Indeed, across the board, investors think in this similar manner, that senior living stocks are a housing play, albeit for people with more money. In 2007, due to fears of real-estate, a knee-jerk reaction by investors drove the stock down to about 3 dollars a share. The analysts felt that occupancy would drop to the upper 70% range, putting Brookdale at risk of negative cash flow. Instead, the lowest average occupancy was 88.5%--much higher than the investors thought it to be. This is a solid company that is not valued where it should be because of lingering fears of the current housing and economic situation. However this market misperception is where MII can take advantage. Don't take my word for it:

"Insiders own an above average percent of this company relative to other companies in the Healthcare Providers and Services industry...This is in stark contrast to the 2-year quarterly average where insiders are net sellers and provides some indication that insiders are more bullish about BKD's prospects for the next 6-12 months."³

² Remember, this is the bad company that mismanaged their homes in Florida, cannot expand there and will face litigation.

³ <http://investing.businessweek.com/research/stocks/ownership/ownership.asp?ric=BKD>

In this memo I have argued that investing in Brookdale, because it is a company with great leaders, positive cash flow, and many services is an astute decision. It is taking maximum advantage of secular growth in an industry facing a growing inelastic demand.

VAR Contacts

Dr. Charles Boggs—grandfather and resident of a retirement home

Marketing Director (unnamed) of River Bay Club independent and assisted living in Massachusetts

Sloan Bohlen—Goldman Sachs analyst who covers Brookdale

Many calls to investor relations to Brookdale and call to investor relations of Assisted Living Concepts

Note: Due to the fact that many seniors want privacy in their retirement homes, it was impossible to actually talk with a senior in a Brookdale community via phone.

Ideas for MII

McIntire could have more social events. From the perspective of first years, it is a bit daunting to talk to fourth years. Meeting in more informal settings might foster more dialogue between the junior and veteran members. Secondly, mentoring the first years by the third and fourth years who have gone through the internships/job hunt would be quite helpful. Similarly, discussing how to prepare for interviews (and how to market involvement in MII) and maybe talking about the types of careers McIntire alumnae go into would be helpful as well. Also, maybe interspersed with the stock pitches, we could have pitches that propose commodities. Finally, perhaps McIntire could encourage members to open up a paper money account with thinkorswim.com. These accounts let you trade stocks, options and fx. After each month, the members would submit their results and the member with the greatest returns would get some type of prize.