The RiverWoods Company at Exeter, NH (RiverWoods Exeter)
Philosophy of Financial Budgeting & Performance- Updated as of Fiscal Year 2018

As an obligation of being recognized by the State of New Hampshire as a charitable corporate entity, the Trustees of RiverWoods agree to fulfill the Mission established under the Articles of Agreement. The duty to further the Mission of the corporation is the most fundamental fiduciary duty of a Trustee.
Because we offer a Type A "All Inclusive" contract, RiverWoods is both a housing/health care organization and an insurance provider. We have a perpetual commitment to our ongoing flow of residents. To meet that commitment, we need to act in a way that provides us the best opportunity for ongoing financial strength. To do that we have established certain basic financial tenets and goals that guide the budgeting and pricing process. It is RiverWoods intent to charge the lowest rates possible that will allow us to attain our financial goals in support of our Mission.

Financial Goals – Basic Tenets – the most basic financial tenet is that due to the ever changing population and the long term commitment (for housing, health care, insurance and return of capital) that RiverWoods provides, all financial decisions will be made with a long term horizon. This is with the understanding that the Trustee's primary fiduciary duty is to protect and further the Mission of the organization in perpetuity. Additionally, as most RiverWoods contracts allow for a 90% refund upon death/move out and resale, to fully keep its commitment to residents and their estates RiverWoods must maintain a level of service quality, physical appearance and financial health that continues a reasonable flow of move ins and encourages high occupancy levels.

On an annual basis, general, basic financial goals will be as follows:

- RiverWoods will generate total cash revenue that is sufficient, at a minimum, to pay all cash operating expenses and the current year debt principal payment (i.e. DSCR-Rev >1.0). Non-cash items such as earned entrance fee revenue, depreciation and amortization expense are excluded.
- In a normal year, we will expect cash from net entrance fees to cover cash needed for capital expenditures.
- If cash operating expenses rise in any given year, there will likely be an associated increase in resident monthly service fees.
- RiverWoods will use industry accepted financial ratios and actuarial calculations to be the practical measure of its basic financial goals.

On a long term basis, RiverWoods commissions an actuarial study on at least a bi-annual basis to ensure that it has sufficiently planned to meet all of its obligations for each resident.

- RiverWoods uses "funded status" as the appropriate actuarially based target. The funded status indicates that the combination of net actuarial assets and the present value of projected

monthly fees for the residents as of the fiscal year end will exceed the present value of the contractual liabilities of these residents over the course of their lifetimes.
- CCRC Actuaries, our actuary, targets a Funded Status of 110% to allow for an appropriate buffer should adverse situations arise.
- RiverWoods will target a range of Funded Status of 108% - 112%.

Financial Goals- Ratios – RiverWoods has identified seven key ratios from CARF International that are pertinent to its business, and expects to perform in the 50th to 75th %ile of accredited single site communities with Type A (all- inclusive) contracts. Establishing performance in the 50th to 75th percentile range provides a confidence level that RiverWoods is performing in a manner that will ensure long term existence and the ability to meet the contractual obligations it has made and will continue to make to current and future residents. To eliminate annual fluctuations and allow for more consistent expected performance, RiverWoods utilizes a five year rolling average of the CARF International reported performance to set the targets. As a secondary measure, RiverWoods also evaluates Fitch investment grade rated communities that have Type A contracts for ratio conformance. The ratios and the associated goals are detailed in Appendix A. It is important to note that these ratios are interdependent and should be evaluated as a group. The five most critical are:

- **Net Operating Margin (NOM**) - which measures the core, sustainable business and excludes interest expense, investment earnings, contributions and all non-cash items. NOM defines our ability to pay core, controllable expenses with core, controllable revenue. When NOM is sufficiently positive it provides a level of comfort that the community can continue on as an operating entity based on its current financial trajectory. Positive NOM performance is important as it reflects the organization's ability to run the business without being overly reliant on investment markets (which are not in our control).
- **Operating Ratio (OR) –** which compares cash operating expenses to cash operating revenues. The operating ratio is more robust than NOM, as it also includes net assets released from restriction revenue, investment interest and dividends, and interest expense. Over its history RiverWoods has paid careful attention to its balance sheet, specifically managing its cash/investments and debt positions, and the income statement benefits from this diligence are reflected in the OR.
- **Debt Service Coverage Ratio- Revenue Basis (DSCR-RB)** – which shows the ability to fund annual debt service (principal and interest) with cash flow from net cash revenues (cash revenues less cash expenses). When this ratio is > 1.0 it provides comfort that the community can pay all of its cash outflows (expenses + mortgage principal) with no reliance on entrance fee cash. This is important as entrance fee cash can be uneven year to year as it is heavily reliant on items outside of the organizations control, like turnover and the real estate market.
- **Debt Service Coverage Ratio (DSCR)** – which shows the ability to fund annual debt service (principal and interest) with cash flow from net cash revenues (cash revenues less cash expense) <u>AND</u> net cash from entrance fees (new entrance fees less refunds). This is a ratio required to reach a minimum of 1.20 in the bond documents.

- **Cash to Debt Ratio (C to D)**- Shows the relationship between unrestricted cash/investments and total debt. With a Type A, 90% refundable contract RiverWoods has high entrance fees, leading to higher cash balances than communities with other types of refunds/contract styles. Therefore strength in this ratio shows that the entrance fee cash has not been eroded by funding excess operating losses or capital expenses.

NOM, OR, DSCR-RB, DSCR and Cash to Debt calculation methodology can also be found in Appendix A.

Budget Process – below is a general description of the budget process which is reviewed annually in conjunction with the Summary of Significant Assumptions in the Budget presentation.

Upon the establishment of its financial goals, RiverWoods will evaluate external market conditions to determine the potential impact on the following year's budget. Major assumptions include:

- Occupancy at all of levels of care. This is an important consideration as it not only impacts operating revenue but also entrance fee cash flow (and related investment earnings). While the industry considers 95% independent living (IL) occupancy full capacity, RiverWoods will consider budgeting at a higher level after carefully evaluating current occupancy levels, the size of its wait list, real estate market conditions and projected move-in activity.
- Health center utilization – this includes the number of direct admits expected to be in the census (as direct admits pay market-rate fees), the number of spousal transfers, the number of temporary transfers and the number of permanent single person transfers which will then require a unit resale.
- RiverWoods budgets 100% of the expected long-term yield as interest and dividend income (available to partially offset monthly service fee increases).
- With respect to capital gains, we budget for the long-term portfolio average return with the expectation that 20% of these capital gains will be realized to the income statement as a non-operating gain (and thus available to partially offset monthly service fee increases). In the five year plan we project an increase in realizing gains to the income statement (from 20% to 25%).
- On the expense side, we zero-base budget. Each department head is instructed to evaluate all line items in his/her department and evaluate how to deliver the same quality service in the coming year as inexpensively as possible. The department heads meet with the Director of Finance to discuss their submissions and any appropriate adjustments are made. Periodically RiverWoods will engage an external study of its operating expenses (an "Operating Audit" to determine costs in conjunction with industry norms for like kind communities).
- Annual pricing changes are a product of the major revenue assumptions (occupancy, health center utilization, and investment income) and major expense inflation assumptions (salary, benefits, insurances, food, property taxes, utilities).
- Capital Expenditures are evaluated on a rolling ten year basis. Significant reinvestments are forecast in addition to normal replacement of equipment, furniture, fixtures, and vehicles. Periodically RiverWoods will engage an external study of its facilities (a "Facilities Audit" to

provide an independent opinion on the current state of the campuses as well as the future plans of reinvestment).

FY 2018 Budget Details and FAQ

In the FY18 budget the expectation is that there will be approximately $518k of positive cash flow from the income statement, after retiring the required debt service. FY18's NOM of 4.4% sits RiverWoods slightly below the 50th%ile of accredited CCRCs as well as Fitch-rated organizations with Type A contracts. However, with an OR performing in the 75th%ile the organization is comfortable with the overall financial projections.

As the communities age, reinvestment is important to maintain high occupancy rates. There will be "milestone" years where additional reinvestment is needed In these years reserves from the balance sheet will be utilized to cover the short fall. In the ten year capital plan we project significant capital reinvestment at each of our three campuses.

It is important to highlight important changes made during the FY18 budget process. These changes were largely a result of discussions between the board finance committee and members of the resident finance committee. The underlying theme was to find a prudent way to better utilize the strengths of the RiverWoods, most notably the balance sheet and high level of IL occupancy, for its current residents. As a result, the FY18 budget reflects an increased reliance on realized capital gains, less emphasis on NOM (with more emphasis on OR) and budgeting 96% IL occupancy (higher than what the industry consider full occupancy). These changes helped mitigate the FY18 monthly service fee increase and all three have been incorporated into our revised financial philosophy.

"Why not use the cash on the balance sheet in lieu of a monthly service fee increase?"

> In any given year a financially solid organization could provide a 0% increase with no major impact to its short term financial health. The impact, however, would be felt in the future by allowing expenses to grow at a faster rate than revenues. This has an adverse compounding effect on cash margin. Additionally, forgoing cash flow from new monthly service fees results in a drawdown of cash reserves which can also have a long-term adverse effect (fewer reserves as well as reduced investment earnings).

"Why do you budget conservatively?

> RiverWoods attempts to strike a balance in its financial business model approach. Serving our mission for today's and tomorrow's residents and staff is something we think about every day. We utilize a prudent approach because we are always engaged in long-range planning. With this approach, we have the ability to be proactive should difficult situations arise. Should prosperous situations arise, such as higher occupancy than budget or lower operating costs, we have a mechanism, the MSF Rebate Policy ("Spring Break Credit"), for returning a portion of the monthly service fee back to our residents. Additionally, the Staff Discretionary Bonus Plan Policy provides the option of additional retirement funding to our staff.

Appendix A- Ratio Calculations

Net Operating Margin

$$\frac{\text{(Cash from Resident Revenues – Cash from Resident Operating Expenses)}}{\text{(Cash from Resident Revenues)}}$$

Operating Ratio

$$\frac{\text{(Total Cash Operating Expenses)}}{\text{(Cash from Resident Revenues + Interest \& Dividends + Net Assets Released from Restriction)}}$$

Debt Service Coverage Ratio- Revenue Basis

$$\frac{\text{(Total Cash Margin + Interest Expense)}}{\text{(Interest Expense + Principal Repayment)}}$$

Debt Service Coverage Ratio

$$\frac{\text{(Total Cash Margin + Interest Expense+ Net Cash from Entrance Fees)}}{\text{(Interest Expense + Principal Repayment)}}$$

Cash to Debt Ratio

$$\frac{\text{Total Unrestricted Cash and Investments}}{\text{Total Debt Outstanding}}$$

The RiverWoods Company- Key Ratios Summary

Ratio	Goal %ile	What is Better?	FY18 Goal	Budget FY18 Final	Fitch Type "A"
Days Cash on Hand	75th	Higher	598	**800**	**494**
Cushion Ratio	50th/75th	Higher	10.1	**21.3**	**8.1**
Net Operating Margin	50th	Higher	4.6%	**4.4%**	**5.5%**
Operating Ratio	75th	Lower	95.5%	**95.2%**	**98.6%**
Debt Service Coverage	50th	Higher	2.33	**2.50**	**2.17**
DSCR- Revenue Basis	75th	Higher	1.00	**1.15**	**0.77**
Cash to Debt Ratio	50th/75th	Higher	84.3%	**128.3%**	**69.5%**

Goals based upon CCAC-CARF accredited single site Type A CCRCs- 5 year avg.
Fitch ratios are median values- 3 year avg.

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