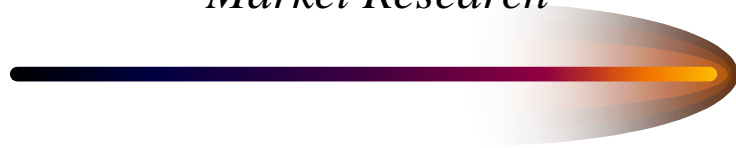


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*The Competitive Environment:
Market Research*



**Using Data and Understanding Supply
The Cyclical Nature of Supply and Demand
Financial Feasibility**

This module reviews the feasibility and research process: how does one determine whether a proposed facility or addition is likely to be profitable? How does one keep an existing property profitable?

We will address the following areas:

- Market feasibility
- Financial feasibility
- Types of marketing research for existing projects

NOTES:

The Johns Hopkins Bloomberg School of Public Health
“Managing Long-Term Care Services for Aging Populations”

Types of Research:



- Market Feasibility
- Financial Feasibility
- Feasibility Research

Market feasibility research is the process of collecting the appropriate information and analyzing it to make an informed business decision about the marketplace. Such research attempts to determine what customers want and the price they are willing to pay.

Financial feasibility research determines if demand for a product or service at the price the customer is willing to pay will translate into a profit that will justify the risk, time, effort, and capital involved.

Feasibility research combines the first two types to assess whether the existing demand creates a reasonable likelihood of profit, given the risk.

NOTES:

Market Research in a Seniors’ Housing and Care Project



Feasibility studies in the seniors’ housing and care industry are similar to the processes used in other businesses:

- Collecting appropriate information
- Analyzing the information
- Using this information to determine the most likely absorption rate for a project—what the marketplace wants and the price it is willing to pay

The goal of financial feasibility research is to determine whether the most likely absorption rate will cover project costs

and produce a profit (or, in the case of a non-profit project, cover debt service by a sufficient margin).

Several critical costs of a seniors’ housing and care project are tied directly to the absorption rate:

- Operating deficit
- Construction and move-in period interest expense
- Marketing costs

Therefore, the goal of feasibility research must be to predict the most likely absorption rate for a project through market feasibility research then determine if that absorption rate will enable the project to be financially feasible.

NOTES:

Historical Feasibility Research



The seniors’ housing and care industry has traditionally failed to take advantage of sophisticated research techniques. The traditional approach (which typically analyzes capture rates and sometimes penetration rates) has several flaws:

- The seniors’ housing and care industry is constantly changing and has a complex set of characteristics, such as services and amenities, price, and competition. Such factors cannot be adequately measured by a single, unchanging number.

- The many ways analysts can use to calculate capture rates lead to an inconsistency that make it impossible to compare rates of different projects over different times.
- Meaningful capture rates must relate to a specified period of time, but many analysts provide rates as if there were no time constant.

As a result, capture rates can not be compared except in the very rare event that analysts have used identical methodologies to develop them.

Additional limitations of capture rates as historically calculated center on two assumptions:

- All of the necessary research on the range of capture rates for a representative sample of prior successful projects has been completed.
- The project under consideration will have the same key criteria or attributes of all past successful projects of that type.

These questionable assumptions have historically guided the calculation of many capture rates.

Who is the Customer?

Why Does the Customer Buy?



“Who is the Customer?” This critical question—the kind of person most likely to be attracted to a facility—has often been neglected. Assessment of this variable can provide significant information to support feasibility research. For example, consider age: Customers are older than had been believed. Early investors in CCRCs believed that the target population started at age 65. Evaluation showed, however, that the average age of new residents in Corks was 78 and 80 in congregate communities 80. Only 9% of CCRC residents and 6% of congregate community residents were in their 60s.

We find similar surprises when we assess the number of married couples at a new CCRC—54%—and new congregate communities—24%. The percentages are much lower in mature facilities.

“Why Does the Customer Buy?” Are they *needs*-driven or *wants*-driven?

Current research suggests that people move primarily because they are needs-driven or influenced. The major reason people move into Corks or congregate communities is access to care and services to maintain their independence.

An important factor affecting seniors’ needs is health care; developers must take provision of these services into account, or their turnover from independent units will be significant and they will limit their potential market.

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Focus Groups... Why Not?



Focus groups (more formally known as “group depth interviews”) are a qualitative research technique that can have value if used properly. However, focus groups are almost by definition contrary to sound research principles:

- Samples are small and not scientifically selected.
- Varying phrasing of questions among groups can result in significantly different answers.
- Responses are not independent, since some members may push their views on others while some members may not voice any opinions at all.

- Finally, because the analyst must interpret the results, his or her views can bias the results.

Many seniors do not understand the various types of seniors’ housing and care facilities, and are unlikely to receive adequate information before or during the group. They can therefore provide little information or feedback about the project.

Unfortunately, some new projects rely almost exclusively on focus groups for their feasibility research—meaning that they have performed little, if any, real market research.

NOTES:

Four Steps in Market Feasibility:



1. Quantitative Techniques
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

The first goal of quantitative research in market feasibility is to identify those markets that are too small to support a traditional project or are currently overbuilt.

That established, qualitative techniques have seven goals:

- Preliminarily define the primary market area (PMA)
- Understand the quality of the PMAs demographics, both current and future
- Thoroughly evaluate the competition, including what has worked in the marketplace and why

- Assess the competition’s historical absorption rates and the key factors affecting them. such as marketing costs per unit, cost per lead, and lead-to-sale ratio.
- Identify any proposed or future competition that could affect the PMA supply/demand balance.
- Understand the site’s initial desirability for a senior living project.
- Determine the quality of the real estate market in the PMA.
- Assess the current and future economy of the PMA and how it might affect the quality of the demographics and real estate market.

NOTES:

Four Steps in Market Feasibility:

1. Quantitative Techniques:
 Quality of Demographics
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

Most researchers fail to understand the *quality* of the demographics. In particular, many fail to recognize the make-up of the five-year age cohorts above 65. For example, those from 65-69 are 42% of the entire 65+ population with incomes above \$25,000. However, this group represents a very small portion of residents at newer communities.

The following figures reflect the number of households with more than \$25,000 plus the percentage of new retirement community residents.

<u>Age</u>	<u>Percentage of U.S. Households</u>	<u>Ind. Living Residents</u>
65-69	42%	8%
70-74	28%	12%
75-79	16%	24%
80+	14%	56%

These are national averages; the numbers vary among locations. For example, areas of Florida are home to very high percentages of seniors 75 and above, while other parts of the country have unusually higher percentages of residents from 65-69 or 70-74.

Clearly, developers must pay close attention to the seniors in the upper age ranges when evaluating a project’s potential. They must be careful, though, to avoid the opposite mistake: using only older (e.g., 75+) households in the demographic analysis. Such a focus ignores the fact that seniors from 65-74 can be a significant part of the market (20—25%).

Four Steps in Market Feasibility:



1. Quantitative Techniques:
Existing Competitor Analysis
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

While most researchers obtain basic competitive information, they do not obtain the data that could be most valuable:

- Date marketing began
- Date first application received
- Date project reached 90% occupancy
- Date project reached full occupancy (if greater)
- Total marketing costs to reach current occupancy level
- Components of promotional plan
- Total leads to current occupancy

- Monthly move-in analysis to current occupancy level
- Size of Sales Department staff


Most executive directors can provide such information. If not, the researcher must rely on public documents, other competitors, and/or having someone pose as a prospect.

A key indicator is the failure of one or more projects in the PMA to achieve stabilized occupancy. Also, a PMA having an overall occupancy rate below 90% should be viewed very cautiously.

It is natural to assume that an unsuccessful project failed because of poor management, project flaws, etc. The developer should investigate the project to determine whether that was, in fact, the case. Even if it was, the developer must consider the possibility that someone will buy the project and take action that could result in its becoming a competitive threat.

Finally, a thorough competitor analysis evaluates any planned or formally proposed (legal processes underway) competition. Any potential project that is in or has completed the approval process in the last two years must be evaluated as thoroughly as an existing competitor.

Four Steps in Market Feasibility:

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1. Quantitative Techniques:
Real Estate Market Analysis
 2. Empirically-based Demand Prediction
 3. Qualitative Techniques
 4. Predicting the Most Likely Absorption Rate

Most seniors can only move into retirement communities if they sell their homes, so the quantitative process must include a comprehensive evaluation of the PMA's real estate market.

This process involves four steps:

1. Measuring the mean (or median) selling price of a single-family home over the last three years
2. Measuring the median (or mean) number of days the homes were on the market for the last three years

3. Comparing these statistics for each zip code in the PMA to gauge the quality of that zip code
4. Comparing each zip code's average selling price with the number of age- and income-qualified households in that zip code

The developer may find that large concentrations of age- and income-qualified households are actually in zip codes with low average selling prices.

If two or three zip codes with low home sales prices account for a substantial number of the potential customers, the developer must carefully consider the quality of the demographics. Residents might have the necessary income but not the home equity needed to pay for a project that requires an entrance fee.

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Four Steps in Market Feasibility:



1. Quantitative Techniques:
Now What?
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

Once the quantitative stage has been completed, the developer will be able (or forced!) to rule out the project. For example, a PMA with average demographics, an 85% occupancy rate for existing projects, one proposed project, a bad location, falling real estate prices, and a non-diversified economy should probably be ruled out at this point.

Most cases, however, are not so clear-cut. Often, four or five of the key criteria appear to be positive or neutral. At this point, the real work begins and the developer moves on to the next step.

Four Steps in Market Feasibility:



- Quantitative Techniques
- Empirically-based Demand Prediction
- Qualitative Techniques
- Predicting the Most Likely Absorption Rate

“Empirically-based demand prediction” describes research that uses the laws of statistical science to predict demand for a particular project at a particular price and sponsored by a given organization. Such predictions are “empirically-based” because developers can’t develop a true random sample of qualified senior households—a requirement of truly scientific sampling.

The typical approach involves a direct-mail survey of qualified senior houses in the PMA. The envelope—personalized when possible—contains a three-page letter that describes the purpose of the mailing. After this introduction, the mailing

describes the community being planned, its location, amenities, services, and health care. It should also include unit types and tentative prices.

Finally, the letter asks readers to return a postage-paid reply card if they are interested in the community, plus a statement that failure to return the card will be construed as a lack of interest.

Often, the card presents two check-off alternatives:

1. “Would seriously consider being a resident as soon as units are available.”
2. “Would serious consider a unit in two to three years.”

Finally, the card asks for the household type (couple, single female, single male, etc.); name; and address. The card should *not* request the telephone number.

NOTES:

Four Steps in Market Feasibility:



1. Quantitative Techniques
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

Qualitative techniques attempt to meet four goals:

- Obtaining information from senior households regarding what they would want in a community
- Testing the demand prediction on a real project
- Finalizing the definition of the PMA
- Creating the first several hundred leads for the project

One approach is to purchase several thousand randomly selected names that meet age and income criteria. The developer can then mail an invitation to a seminar on “Lifestyle Alternatives in Your Senior Years.”

The seminar addresses lifestyles alternatives and the advantages and disadvantages of each. The developer then gives a presentation on the project.

An advantage of this technique is that it can measure the site’s desirability and the PMAs real size. Having the seminar close to the proposed site provides valuable information regarding the population—including those areas (typically by zip code) that should be excluded from the definition of the PMA.

At the end of the seminar, the developer can ask the participants to complete questionnaires regarding their personal circumstances, what they would want in a retirement community, and what they thought of the project.

The statistical bias in this approach is a positive one: those who choose to attend are those who are most interested in retirement community living. Therefore, their responses deserve close scrutiny to determine what aspects of the project are most likely to attract other interested seniors.

Four Steps in Market Feasibility:



1. Quantitative Techniques
2. Empirically-based Demand Prediction
3. Qualitative Techniques
4. Predicting the Most Likely Absorption Rate

To predict the project’s absorption rate, the developer must obtain current, reliable information:

- National absorption rate statistics
- Historical absorption rates for the PMA
- Historical absorption of the developer’s similar projects, if any

In addition to assessing the information, the developer must take proposed or planned competition very seriously. Projects can fail if the developer makes some common but inaccurate assumptions:

- Our project is better; more residents will move there.
- We’ll beat the competitors to the market and thus have a head start.

Failure to uncover planned, competitive projects is the greatest reason for project failure.

NOTES:

Financial Feasibility Process:



1. Market Pricing vs. Construction Costs
2. Operating and Total Deficits
3. Variability of Interest Rates

Having predicted the likely absorption rate, the developer must then determine whether the project’s costs will enable it to be financially feasible.

The absorption rate directly affects the move-in rate; between them, these rates determine the most critical aspects of financial feasibility:

- Marketing costs
- Operating deficit (operating expenses before debt service exceeds operating income)
- Construction- and occupancy-period interest expense

The financial feasibility process starts with a fully integrated financial model, which typically balances more than 100 key assumptions. The model must integrate development and operational phases so that any change in project costs can be immediately reflected in the debt service-coverage ratio in the first full year of stabilized occupancy.

NOTES:

Financial Feasibility Process:



1. Market Pricing vs. Construction Costs
2. Operating and Total Deficits
3. Variability of Interest Rates

The findings of the market research process (particularly as they relate to unit pricing) is critical to the financial feasibility process. Whether in the form of entrance fees or condo fees with monthly service charges or rents, the price the market is willing to pay must drive construction costs and total project costs.

Construction costs, the single greatest item in total project costs, can vary dramatically—as much as a \$30/sq.ft. difference between two essentially identical projects.

If construction prices are excessive, unit pricing must increase. The result—unit costs driving market pricing—is contrary to the entire feasibility process

NOTES:

Financial Feasibility Process:



1. Market Pricing vs. Construction Costs
2. Operating and Total Deficits
3. Variability of Interest Rates

Probably the least understood but most important element of the financial feasibility process, an **operating deficit** occurs when fixed and variable operating expenses exceed operating income.

Such a deficit occurs in virtually every project. The break-even point on operations typically occurs at about 50% occupancy. Break-even on operations plus debt service probably won't occur until occupancy equals 85% (depending largely on the amount of leverage used).

The total deficit can then be calculated as follows:

$$\text{Total deficit} = \text{operating deficit} + \text{debt service deficit}$$

From another perspective, the total deficit is the amount of negative cash flow from the time of start-up operations (typically four-to-twelve months before project opening) until operating income covers both operating expenses and debt service. It is as much a project cost as construction or “soft costs,” such as architecture and engineering fees.

The total deficit is directly affected by three factors:

- The percentage of pre-sales
- The strength of the real estate market in the PMA
- The variability of interest rates.

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Financial Feasibility Process:



1. Market Pricing vs. Construction Costs
2. Operating and Total Deficits
3. Variability of Interest Rates

Virtually all conventional construction and mini-permanent loans have floating interest rates tied to the prime interest rate. Therefore, if interest rates increase during the fill-up period, interest expense will, of course, increase accordingly.

The move-in assumption will have a dramatic impact on the total deficit. Missing the move-in assumption by just one unit per month can add at least \$500,000 to the total deficit, sometimes \$1,000,000.

The analysis must start with a monthly spread sheet that ties *average* monthly occupancy to fixed and variable expenses

as well as the monthly debt service payments. Sensitivity analyses must also vary the interest-rate assumption if the debt is not a fixed-interest-rate obligation.

The analyses is largely based on the following corollaries:

- The greater the pre-opening commitments, the smaller the total deficit.
- The greater the reliance on entrance-fees the higher the brokered margin will be.
- The greater the interest rate risk, the greater the risk of financial failure (particularly if the project experiences a long fill-up period).

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