LTC Properties

1Q16 Analyst and Investor Call

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CORPORATE PARTICIPANTS

Wendy Simpson – *Chairman, CEO, and President*

Pam Kessler – *Executive Vice President, CFO, and Secretary*

Clint Malin – *EVP and CIO*

PRESENTATION

Operator
Good morning, and welcome to the LTC Properties First Quarter 2016 Analyst and Investor Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your telephone keypad. To withdraw your question, please press star (*) then two (2). Please note this event is being recorded. I would now like to turn the conference over to Wendy Simpson, CEO and Chairman. Please go ahead.

Wendy Simpson
Thank you. Good morning everyone and thank you for joining us today. Last week we announced our 2 guest speakers for today's call, and I would like to welcome Dr. Craig Flashner, a Principal of Prestige Healthcare, and Mr. Mark Rockwell, a Principal of Anthem Memory Care. They are joining Pam Kessler, LTC's EVP and CFO, Clint Malin, our EVP and CIO and me on this call.

Dr. Flashner's company, Prestige Healthcare, is a privately held operating company providing post-acute care, assisted living, and independent living services and other rehabilitative and healthcare services at 68 facilities in 7 states. Today, Prestige operates 22 properties in LTC's portfolio.

Mr. Rockwell's company, Anthem Memory Care, is privately-held and develops and operates stand-alone private-pay memory care communities. To date, Anthem has developed and opened 6 communities in 3 states, including 5 owned by LTC and has 3 projects in various stages of development, all with LTC. Just last week, LTC purchased 2 memory care properties from another operator in Kansas, and these will be the first already opened and operating properties that we have done with Anthem.

In the first 3 months of 2016, Pam, Clint, and I have had the opportunity to meet one-on-one with investors and analysts, and from these meetings we took away a few recurring questions and possible concerns. Because LTC has a high concentration of nonpublic operators, investors and analysts may perceive they cannot get a good feel for our individual operators and may view those operators as less sophisticated and not able to effectively respond to the always changing reimbursement and competitive environments.

LTC believes the local, regional operator has many advantages over the larger, national operator. These operators are dedicated to the states in which the operate and know the regulators, regulations, legislative proposals, licensing requirements and issues, competition, networks and referral sources, labor environment, just to name a few. Also, the local regional operator usually can make decisions about costs and revenue streams and effectuate needed operational changes more quickly than the large national provider.

Later during today's call, Dr. Flashner will comment on what Prestige Healthcare does to meet operating challenges, how he sees today's post-acute operating environment, and how he views the more immediate future of the post-acute industry. We are of course not in any way denigrating our larger national operators, who we continue to highly value and support. We are opening a discussion of our large investment in the local regional operator and why LTC maintains a very positive view of these operators.

Another discussion point in our industry has been a perceived over-development in the private-pay sector of assisted living and memory care. Mr. Rockwell's company, Anthem Memory Care, has been focused on the need for dementia care-specific properties. Since its inception in 2008, Mark and his team have strategically selected markets and built dementia care facilities. Mark will discuss how Anthem came to be, why they are in the markets they are in, how they select markets, and how he and his team view the competitive environment.

First though, I'll turn the call over to Pam, who will comment on our productive first quarter. We had success in both acquisitions and financing. After Pam's presentation, Clint will discuss our pipeline and operating statistics. Before I ask Craig and Mark to talk about their companies, I will give you updated guidance and then we will take calls related to LTC's remarks. After the question and answer on our remarks is complete we will begin the industry-specific portion of today's call, followed by a chance for you to ask questions of today's guests. Pam?

Pam Kessler
Thank you, Wendy. FFO increased 21.1% year-over-year for the first quarter of 2016 to $28.3 million, or $0.76 on a fully diluted per share basis. Revenues for the quarter increased 22.6% or $7.1 million year-over-year.

The improvement primarily reflects acquisitions, completed development and capital improvement projects, lease amendments, as well as an increase in interest income from mortgage loans resulting from loan originations and the amendment to our Michigan loan. This was partially offset by reduction in revenue from a property sold last December and mortgage loan payoffs.

First quarter interest expense was $6 million, an increase of $2.2 million over the comparable 2015 quarter due primarily to the sale of senior unsecured notes last year, greater utilization of our line of credit to fund investments and development, partially offset by higher capitalized interest. General and administrative expenses were $4.3 million, or $800,000 higher this quarter compared with the year ago. Approximately $600,000 of this increase is due to increased staffing and other costs associated with more investment activity, and the remaining $200,000 is due to the timing of certain expenses.

Turning to the balance sheet. During the quarter we purchased a newly constructed 126-bed skilled nursing center in Texas for $16 million, adding it to a master lease of fundamental at an initial incremental cash yield of 8.5%. We also sold a 48-unit assisted living community located in Florida for $1.8 million. Last quarter we took an impairment change on this property, writing it down to the sales price net of selling costs. Accordingly, no gain or loss is recognized related to the sale of this property.

Additionally, we invested $16.6 million in properties under development and capital improvement projects during the first quarter, funded $6.6 million under existing mortgage loans, and received $1 million in principal payments and mortgage loan payoffs. Subsequent to March 31st, we purchased 2 memory care communities in Kansas, totally 120 units for $25 million. Additionally, we acquired a 16-unit memory care community in Kentucky for $14.3 million and originated a $12.3 million mortgage loan secured by 2 skilled nursing centers in Michigan totaling 216 beds.

During the quarter, we borrowed $40.5 million under our line of credit to fund investments and development. Subsequent to March 31st, we borrowed $37 million on our line and therefore, we currently have borrowings of $198 million outstanding and $402 million available under our

revolver. During the quarter, we repaid $4.2 million of principal on our senior unsecured notes. Subsequent to March 31st, we locked rate under our shelf agreement with Prudential on $37.5 million of senior unsecured notes at 4.15%. These notes will have periodic scheduled principal payments and a 12-year final maturity. We anticipate closing this transaction on or around May 20th.

During the quarter, we received $14.6 million of net proceeds from the sale of 332,619 shares of common stock under our at the market offering program. The weighted average sales price net of commissions was $44 per share. The proceeds were used to fund out investment and development activities.

At the end of the quarter, LTC maintained investment grade metrics with debt-to-annualized normalized EBITDA of 4.4x, a normalized annualized fixed charge coverage ratio of 5.1x, and a debt-to-enterprise value of 26.5%. Additionally, we have one of the most conservative debt maturity ladders in the entire REIT universe with long-term debt maturities carefully matched to our free cash flow thereby virtually eliminating any refinancing risk.

In utilizing debt to fund investments, we have prudently matched our long lived assets with long-term debt with 10-15 year final maturities. We believe our conservative balance sheet management provides us with the best opportunistic approach to financing our Company's future growth and creating long-term shareholder value. I will now turn the call over to Clint.

Clint Malin

Thank you, Pam. Good morning everyone and thank you for joining us today. Year-to-date we have completed $63 million of accretive investments. We continue to execute on our investment strategy on deploying capital to acquire newer and more modern assets. The average age of the four properties acquired year-to-date in 2016 is 2-1/2 years. Two of the transactions closed subsequent to the first quarter were completed with Prestige Healthcare and Anthem. I would like to extend LTC's continued appreciation to both Mark and Craig for their support of LTC as a trusted capital partner.

Currently, we are working on approximately $150 million of off-market transactions, split evenly between skilled nursing and private-pay assets with approximately 90% of the pipeline representing acquisitions. We continue to evaluate selective development opportunities with our existing operating partners and remain disciplined in our underwriting approach while adding these projects to existing master leases for additional credit enhancement.

As I have mentioned on previous earnings calls, in 2015 we began evaluating opportunities to recycle capital assets no longer core to our portfolio. Since that time we have sold two properties, one at the end of 2015 and the other during Q1 of 2016, which Pam just mentioned. In 2016, we will continue to work strategically on recycling capital through selective asset sales to further enhance our portfolio. I will provide updates regarding our capital recycling initiatives on subsequent earnings calls.

Turning to our portfolio, on a same-store basis for the trailing 12-month period ended Q4 in 2015, EBIDARM lease coverage for skilled nursing is 2.19x, assisted living 1.63x, and range of care 1.71x. EBITDAR coverage after an allocated management fee of 5% of revenue is 1.59x for skilled nursing, 1.4x for assisted living, and 1.26x for range of care. Compared with the previous quarter, same-store occupancy remains consistent across all property types.

Occupancy for the trailing 12-month period ended Q4 2015 is as follows: Skilled nursing 79.3, assisted living 86.5, and range of care 85.3.

Income from our portfolio continues to be well-diversified with approximately 52% of our underlying revenue derived from private-pay sources. Although coverage in our skilled nursing portfolio decreased 5 basis points from the previous quarter, LTC's lease coverage metric for this portfolio remains one of the strongest in the industry. Since decreases in coverage is mainly attributable to annual rent escalations and challenges specific to two skilled nursing properties in our portfolio and not related to any specific shift in reimbursement or managed care penetration.

These two properties are included in one of our largest master leases providing us with strong credit and management support. EBIDAR coverage for this portfolio on a trailing 12-month basis for Q3 2015 was 1.5x. One of the properties is on CMS's Special Focus Facility list, resulting from the death of two residents at the facility caused by the actions of another resident, which occurred in mid 2014.

The state has denied renewal of the license for this facility; however, our operator has filed an appeal, which has been pending since the licensure expiration date in November of 2015. The facility continues to be licensed during the appeal process, and although able to admit residents, local media attention has impacted occupancy, dropping from 72% on a trailing 12-month basis in Q4 2014 to 58% on a trailing 12-month basis in Q4 2015. Our net book value for this property is less than $3 million, which is approximately $15,000 per bed. We continue to stay in close contact with our lessee to monitor this situation.

The other properties performance deterioration is a result of challenges relating to implementation of managed Medicaid in 2014 within the state where the property is located. The transition caused a temporary reduction in occupancy relating to a specific Medicaid waiver program operated by this facility. Recently, our operator successfully resolved patient placement issues for this Medicaid waiver program and at the end of March 2016, occupancy has returned to the same level prior to implementation of the managed Medicaid program, so we believe this issue is now behind us. However, since we report coverage one quarter in arrears, we anticipate coverage erosion relating to this property will continue for one more quarter.

And to conclude in our portfolio, combined coverage and occupancy metrics for our 37 assisted living communities leased to Brookdale continues to be strong. For the trailing 12-month period ended Q4 2015, EBITDAR coverage after an allocated management fee of 5% of revenues is 1.78x with an occupancy of 88.2%.

Now I'll turn the call back to Wendy.

Wendy Simpson
Thank you, Clint and Pam. With the inclusion of our transactions in the first quarter and those completed so far in the second quarter, acquisitions, financings and ATM use, I'm increasing our guidance, which was $2.95 to $2.99 and raising it to $3.05 to $3.09 for 2016. At the high end, $3.09 represents a 10% growth from the $2.80 we achieved in 2015. And as Clint discussed, we have opportunities to possibly improve upon that.

In the current guidance, we have made some assumptions regarding timing of certain asset sales this year, but we are not including any assumptions of unannounced additional

acquisitions, financings, or equity issuance. I will now turn the call over for some questions about our performance in the first quarter and our views of the year before we turn the call to the operator. So Austin, if you'd open it up for questions please?

QUESTIONS AND ANSWERS

Operator
Sure. We will now begin the question-and-answer session. To ask a question you may press star (*) then one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) then two (2). At this time we will pause momentarily to assemble our roster.

And our first question comes from Rich Anderson with Mizuho Securities. Please go ahead.

Rich Anderson
Thanks. Congratulations on a good quarter. Pam, can you just tell me what the ATM activity was again for the first quarter? I missed that.

Pam Kessler
Sure. It was, we received proceeds of $14.6 million from the sale of 332,619 shares and that was at a net price of $44 per share.

Rich Anderson
Okay, thank you very much. Now, I know we never got this fully answered but looking at your skilled coverage on the EBITDAR basis of 1.59x, and in that is the Prestige loan, which was originally, call it two-ish, now maybe a little bit lower, but are we thinking about that right, in terms of the rest of the portfolio that's not in a loan format, would it be significantly below 1.59 just to, the weighted average math, or how should we think about the real estate coverage, and the coverage for the real estate that you actually own?

Clint Malin
Sure Rich, this is Clint, good question. One thing regarding the loan of Prestige, that needs to be looked at, it's a 30-year mortgage. So it embodies a lot of elements of the lease or the lease sale. It's obviously a long-term investment for us. Coverage, as we deployed additional capital on that loan, as we mentioned in the last quarter, the coverage has come down a little bit, which we expected with the funding of that incremental payment and interest going up on that, but the coverage right now for the portfolio, we took out the Prestige, although we had around 1.5x coverage within the portfolio, on the skilled portfolio.

Rich Anderson
Okay, so 1.5 excluding Prestige?

Clint Malin
That's correct.

Rich Anderson
Okay, thank you for that. And then Wendy, last we spoke, which wasn't long ago, it didn't sound like the acquisition pipeline was going to be as fruitful this year as it was last year for you, just in terms of volume of opportunities. But now it's a fairly significant increase in guidance based on that and some sense that you might do some more as the year progresses. Would you say that

there has been a change there in that suddenly things are starting to percolate more in the last month or so?

Wendy Simpson
Yes, we've had significant success in converting some of the things that we thought weren't going to be in the pipeline and moved it to the pipeline level where we have an actual LOI. Whether they transition into an actual transaction, I don't predict at this point but yes, it's looking much better for this year than it did the first quarter.

Rich Anderson
Okay, great.

Clint Malin
Rich, let me give me some color on that. These are all off-market transactions that we've been able to source through our relationships. So in general I would say that marketed activity has probably come down a little bit, but again, these are all off-market, which we've used our relationships and contacts to fill out the pipeline we have today.

Rich Anderson
Would you be able to put a dollar figure on this off-market opportunity pipeline?

Clint Malin
I provided it in my prepared remarks as $170 million in total.

Rich Anderson
Okay, so I missed that. Okay. All right, thank you.

Wendy Simpson
Thanks Rich.

Operator
Our next question comes from Paul Morgan with Canaccord. Please go ahead.

Paul Morgan
Hi, good morning. Just in terms of the 3.05 to 3.09 that you just provided, I might have missed this in terms of what you said about this, the balance sheet side of things. So am I right that there is probably around $200 million or so on the line after your April transactions? And if that's about right, is the 3.05 to 3.09 number, assuming that just stays on there? Or is there a kind of terming out or equitization component to the numbers?

Wendy Simpson
It assumes it's on the line and so the line is not termed out in our assumption.

Paul Morgan
Okay. And how do you feel generally about the balance? It's a little bit higher than what you've carried typically in the past. You've given thoughts over the past few quarters about where you want your leverage to be and then maybe in particular about where you'd want the line balance to be, is there any additional color there now?

Wendy Simpson
Well, we're at $400 million of availability and $200 million drawn on the line, we're comfortable with the line balance. But we will remain opportunistic. You saw us pull down on our Pru shelf because the rate that we were offered was a great rate for LTC. Spreads have come in from where they were the last time we talked, I think at the beginning of the year. We were very cautious on possibly terming out the line because not only were rates higher, the spreads were considerably higher than they have been historically as the 10-year crept down and spreads were persistently wide. We did not term out the line and then recently in the past two weeks I would say, spreads have come in significantly, so we took advantage of that. And that's really how we run the balance sheet, is to be opportunistic. So if spreads don't remain low and rates don't move, we possibly could term out more later this year, if rates remain low, where they are right now.

Paul Morgan
Okay, that's helpful, thanks. And then, I think last quarter you talked about looking for some shift in pricing in terms of investments and obviously, all the stocks are in better shape and when as you look at your pipeline now whether any of that improvement in cap rates from your perspective is materializing in what you're looking at or whether that's a less of an urgent focus now and it's more just sort of exploring opportunities with, organically with your partners at kind of cap rates that might be consistent with where you've been in the past?

Clint Malin
Sure. Since these are off-market transactions, we haven't had the cap rates and evaluations work for us on these transactions. But we have seen slowdowns, I mentioned previously, just deal activity in general. So that could be some price discovery, regarding buyers and sellers in the marketplace, given that we've seen a lesser amount of that activity from brokers.

Paul Morgan
Okay. And then just lastly, anything new on the behavioral side, your initiative to explore more investments there?

Clint Malin
So we're still interested and we're having conversations and continue to explore the space and so that we do want to continue to pursue, but we're going to do it slowly and methodically and investing in the space. So it's something we very much continue to be interested in pursuing.

Paul Morgan
Do you think we could see something this year in that, based on what you're looking at now?

Clint Malin
We're having some discussions, it's possible that we could see something later in the year, that’s correct. But that's not in our pipeline right now, but there is something that, later in the year it's possible it could materialize.

Paul Morgan
Okay, great. Thanks.

Clint Malin
But again, it would be probably a single investment and again, we're going to approach this on a methodical and strategic basis and not getting ahead of ourselves. So it would be a small investment, should we be able to do that.

Paul Morgan
Okay. All right, thanks.

Operator
Our next question comes from Jordan Sadler with KeyBanc. Please go ahead.

Jordan Sadler
Thanks, good morning. Did you characterize, Clint, the pipeline in terms of property versus loan opportunity?

Clint Malin
90% was acquisition.

Jordan Sadler
90% is property, okay.

Wendy Simpson
Asking loans, is it one development and the other acquisition or is it one development, one loan?

Clint Malin
There is one development project that would not be a loan, that would be refund on balance sheet.

Wendy Simpson
What Jordan was asking was, I think, was acquisition or development?

Clint Malin
Oh, acquisitions or development, I'm sorry. So in development right now, we have 9% of the pipeline that would be development.

Wendy Simpson
But none of the 150 is loans?

Clint Malin
A small mezz piece, that would be 2%, so very small.

Jordan Sadler
Okay, 2%, small, okay. And then, in terms of obviously, you used the ATM during the quarter. One, I'm curious, the appetite there, if that seems to be the most efficient means to raise capital relative to this acquisition pipeline, if you think you'd continue to use the ATM here. And two, I didn't catch what the year-end leverage would look like if you modeled it out from here based on what's embedded in your guidance?

Wendy Simpson
Our year-end leverage would be, if you used $47 a share, would be approximately 28.72 debt-to-equity. So we still, without assuming any additional ATM shares, so we'd still be below our 30% average target.

Jordan Sadler
Do you have a debt-to-EBITDA number for that?

Pam Kessler
It would be under 5x.

Jordan Sadler
And that’s, and the range there, you want to continue to remain below 5x or is it 4 to 5?

Pam Kessler
We're comfortable at 5x.

Jordan Sadler
But not below? Not above, rather?

Pam Kessler
A little bit above, but certainly not up to 6. I know some of our peers run at 6 but I think that's a little high for us considering we tend to be more conservative.

Jordan Sadler
Okay. And the ATM, the only question there was just you did 337,000 shares during the quarter. Post quarter was how much?

Wendy Simpson
We have actually stopped when we, we're in a blackout period, so we haven't started using the ATM. If we do this quarter, we haven't started. And indeed if we do, the $150 million of acquisitions, it's cheaper to use the ATM but it's not as efficient. So we certainly would be looking at different ways of financing if we do all the $150 million.

Jordan Sadler
Okay, thanks for the color.

Wendy Simpson
You're welcome.

Operator
Our next question comes from Chad Vanacore with Stifel. Please go ahead.

Seth Canetto
Hey, good morning. This is Seth Canetto on for Chad. How are you guys?

Wendy Simpson
Fine, Seth.

Seth Canetto
First question, just on the updated guidance and more specifically on G&A as you've added more headcount, what should we be assuming for a quarter run rate for the remaining of the year?

Pam Kessler
About $4.2 million a quarter.

Seth Canetto
Okay, so where came in this quarter?

Pam Kessler
Yes, I think we're at $4.3 million this quarter or $4.2 million. We have some timing things, first quarter G&A is always a little bit higher. But I think $4.1 million to $4.2 million is probably good for the rest of the year.

Seth Canetto
All right, great. And then, the skilled nursing lease coverage I think, has ticked down for a few quarters consecutively now and I know you guys updated us on 2 isolated incidents with properties, but do you have any view on how that coverage, should we assume this trend persists going into 1Q or any updated thoughts there?

Clint Malin
Right now, as I mentioned in my comments, that the one building we may see some deterioration on that one building for one more quarter, but right now when looking at what we see, we think that is, should stabilize. That’s where we're at right now.

Seth Canetto
All right.

Pam Kessler
And if we continue to buy property, and we underwrite at 1.5 coverage, you would naturally expect the average to trend down as you're adding properties in at 1.5 whereas the legacy portfolio is a little higher than that.

Seth Canetto
Right. And then in the current environment, in looking at the cap rates, where do you guys see the best investment opportunities and do you think you'll see any behavioral health growth opportunity going forward?

Clint Malin
Regarding behavioral health, we talked about that on one of the previous comments that we have been in discussion with somebody and we're looking at a potential opportunity. So it's likely we'll see something on the behavioral health.

Regarding the best opportunities for us, really it's us being proactive. We like to have our resources be out in front of operating companies, we just try to source off-market transactions, because there is some price discovery disconnect on the acquisition side whether it's skilled nursing or assisted living.

So it's really trying to find unique off-market opportunities and position ourselves with strong relationships with our existing operating partner, continue growing relationships with our existing operating partners and forming new relationships, and that's what our pipeline represents and where we're spending our time trying to source investment opportunities.

Seth Canetto
All right, great color. Thanks.

Clint Malin
Thank you.

Operator
This concludes our first question-and-answer session. I'll now turn the call back to Wendy Simpson for the second half of the presentation.

Wendy Simpson
Thank you, Austin. At this time, I'll ask Dr. Flashner to talk a little bit about Prestige.

Craig Flashner
Thanks, Wendy. I appreciate the opportunity to be here. I want to thank LTC for their support. Prestige Healthcare owns and operates 70 facilities in seven states. We focus mostly on skilled nursing but do have a few assisted living and independent living. Our main concentrations are in the states of Tennessee, Ohio, and Michigan; we're currently the second largest provider of skilled nursing in the State of Michigan. Our main office is in Louisville, Kentucky, with a satellite office in the suburbs of Detroit.

I think what makes Prestige a little unique is that I have clinical background, I was a surgeon by training, and our CEO, Bob Norcross, actually started in a skilled nursing facility as a certified nurse's aide when he was 16 years old and worked his way up to be an LPN, RN, and eventually a Director of Nursing.

My background before Prestige Healthcare within skilled nursing dates back to 1994 when I was the Chief Medical Officer and Director of Managed Care for Wingate Healthcare in Massachusetts, outside of Boston, and also was the Director of Development in that company. We grew from four facilities to 22 facilities before I left and formed Prestige, and as I said, we now have 70 facilities in seven states.

Wendy Simpson
Thank you. Mark, would you please talk about Anthem?

Mark Rockwell
Sure. Thank you, Wendy and thank you for the opportunity to be here.

Anthem was established in 2008. Our home office is in Lake Oswego, Oregon. I have two partners, one of whom has extensive experience in operations of 25 years. One of my other partners has in-depth development experience and my career in real estate development and healthcare dates back to the 1980s.

We are focused specifically on freestanding memory care. We currently have a half a dozen communities opened with several more in development. We were attracted to memory care largely because we think it is not only a really large and unmet need but it's one that's growing and we felt as though it was an important enough need that it deserved our complete, undivided focus.

When you say to a family “entrust the care of your mother or father to us”, that's a pretty heavy moral responsibility. And we felt that the only way we could rise to that level of care was to really make it an undivided emphasis.

Wendy Simpson
Thank you. Craig, what have you done to prepare Prestige for the transition to value-based reimbursement? How are the new reimbursement treatment models such as bundled payments, ACOs, Medicare advantage affecting your business?

Craig Flashner
Well, we actually started back in 2012 making a conscious decision to prepare ourselves for bundled payments, ACO's, etcetera, but by way of history, we're really capitated now anyway, back in '94. We've had many, many reimbursement changes over the last 22 years I've been in the industry, dating back to 1998, when I know that a lot of the skilled nursing providers and REITs took a major hit on their stock because everybody though the world was going to end when PPS came into play.

But the reality is that our view on reimbursement changes most of the time is that there is always to take advantage of different reimbursement methodologies and usually there is something that's changing that could be to our advantage, and the main thing about the change to PPS was it really prepared us for what's going on today. Back before 1998, you were guaranteed a profit, fee-for-service guaranteed everybody profit but it did fix your margin. So Medicare margins, pre-PPS, were actually much lower than they were post-PPS and while I know it bothered everybody and everybody thought the world was going to end, we've also realized that, that was a big opportunity. So margins went way, way up.

We've had numerous reimbursement changes over the last 20 years, surely with, obviously, some of the things that have occurred, CMI, Case Mix Index, I don't know how much familiar everybody is with our industry here, but Case Mix Index has come into play. Cost reports have changed over the years, the way the methodology is, and we now have quality add-ons in many states. We have some managed Medicaid in space but really while you hear about managed Medicaid, Medicaid is really not managed in any state except New Jersey because the states still set the rates and anybody can participate.

So back in 2012, the decision we made was that we needed some geographic concentration and coverage. So we actually divested some facilities and we made a conscious effort to acquire within geographic concentrations. So right now if you leave our office in Louisville, Kentucky and you drive north to Ohio and into the middle portion of Michigan, you can't drive within 90 minutes without being at one of our facilities. We have 35 facilities in Southern Michigan and we cover all the way from eastern part of the state to the western part of the state, and we have 19 facilities in Ohio.

We think that demographics are definitely in our favor as far as an industry goes. And while there’s bundling going on and ACOs and yes, they will bring the length of stays down and they will try not to use skilled nursing facilities as best they can, I think that the demographics say that total Medicare beneficiaries were 47 million in 2010 and projected to be 64 million in 2020 and that's 35% increase in potential covered lives. So while there will be a compression of days, there is just that many more, obviously, beneficiaries.

So I think it's actually a necessary change because the reality is if you have 17 million Medicare beneficiaries and we're spending the same amount of money per beneficiary, will put the country out of business. So that doesn't bother us at all.

What we've decided to do, as I said, is go geographic concentration. We also are now the preferred provider for six different systems within the state of Michigan. And what we've really

focused on, myself being a clinician, Bob Norcross, my CEO, being a clinician, is high acuity. If you look back over the history of skilled nursing facilities, since I've been in the industry in '94, you'll see the shift from really basically warehousing elderly to doing what rehab hospitals did when I trained in medicine in the 1980s, which was take care of stroke patients, hips, knees, etcetera, and what I think you're going to see going forward is simply us taking over some of the days that are now seeing in the LPACs, select rehab hospitals, etcetera. They are just going to shift down like they always have. So we have the opportunity there.

So what we've done as a company actually is, we've become a high acuity provider. We actually own 65% of all the ventilator beds in skilled nursing facilities in the state of Michigan. We're one of only 20 buildings in the country that has hemodialysis and ventilator care in the same building and it's one of the buildings that we actually own with LTC.

So what we're seeing is a shift to higher acuity, obviously, and I know everybody is worried about this hip-knee replacement program, and it only really covers about 30% of the country and only in 65 counties, it’s not a big deal and it's a very small volume. But what we're trying to do is position ourselves to be a provider that the preferred provider systems just can't ignore. And I think we're being pretty successful at that. We’re on the Board of a couple of the preferred providers, we have managed care contracts with almost every major managed care in the country. And really that's where we've gone.

Wendy Simpson
Thanks, Craig, and you have a view on how big a company you would like to have?

Craig Flashner
Definitely. I think what's happened over the years is with this shift in acuity, it's become necessary to have staff that can take care of those residents and oversee those residents, surely from a clinical perspective, regional perspective, and of course from a compliance perspective, we have a very large compliance department in our company now that didn't even exist years ago. We have a Chief Compliance Officer, we have another compliance officer. We do triple checks before we bill, etcetera, and I know everybody's heard about all the false claims act, claims, etcetera, etcetera.

Wendy Simpson
RAC audits.

Craig Flashner
RAC audits. And really, everybody makes a big deal about a RAC audit but really, if you’re billing appropriately, it doesn't matter if you have a RAC audit. You didn't bill for anything you weren’t entitled to bill for, so we've done fine on RAC audits.

But I think that what we found is that we think the sweet spot is between 90 and 120 facilities, and you've seen a lot of the actual public companies, including Kindred and some of the other ones pare down from 300 to 350, down to that level. We were involved in Extended Care transaction as one of the operators, and Extended Care had 370 facilities, approximately 160 in United States, they sold 160 in United States and kept their portfolio in Canada, which gets them into that range. So I think that you're seeing a lot of the bigger companies come down to that level as well.

Wendy Simpson
Thank you. Mark, would you talk a bit about how you and your team select markets and how you feel about oversupply currently, or do you see oversupply in your areas?

Mark Rockwell
Well, there is the risk of oversupply. But first of all, let me address your first question about how we select markets.

We are very focused on doing in-depth market studies and we wouldn't, for instance, view a market like Denver as a market, but in fact when we researched that market starting 6, 7 years ago we honeycombed it into probably 25 to 30 submarkets and that's really the way we believe we have to look at any major metropolitan area, because there are supply and need issues in every quadrant of the city and that will vary pretty dramatically.

So we start with an in-depth in-house study to look first at the population, the demographic, the current supply on the ground, and calculate what we believe is an unmet need income-adjusted for private-pay. And if that looks strong enough, then, and we find a site in that quadrant of the town or the city that we like, we will then refer our study to an out of house third party to validate what we have done just to make sure that we're not drinking our own Kool-Aid and then if it's sufficiently strong, we will move forward in in acquiring a site.

We really believe that in-depth market study and research to validate the need is an absolute inviolate first step in any kind of an acquisition or development, and so far that has been good for us and we certainly intend to continue in that line, manner.

In some of the markets that we're in, we're seeing for instance in Denver, there is a continuing supply coming into the market, which is a bit surprising because while I think that we're now pretty close to balanced, it could get out of balance with some of the at least rumored development that's continuing to come. What we anticipate doing is really focusing on our core strengths, which is strong market brand awareness, reaching out to hospitals, conducting community events, and really being recognized in the market as a specialist and an expert in providing top-flight memory care. That is not to say for a moment that we're not concerned about competition, you always have to be, but we will be the one still standing because that is our business and that is what we're committed to.

Wendy Simpson
Great, thank you. Thanks to both of you. I'll now turn the call over to questions from the audience for both Craig and Mark. Austin?

QUESTIONS AND ANSWERS

Operator
We will now begin the second question-and-answer session. To ask a question, you may press star (*) then one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) and then two (2). At this time we will pause momentarily to assemble our roster.

And our first question comes from Michael Carroll with RBC Capital Markets. Please go ahead.

Michael Carroll
Yes, thanks. My first question is to Craig regarding the RAC audits. How many audits are actually taking place in your portfolio right now? Are they just starting, are you receiving more I guess the letters or is anybody actually doing the information search?

Craig Flashner
Actually that was an issue, they didn't even fund the RAC audits for this recent period of time. So there's not a lot of RAC audits is going on right now. I think the last one we had was in '14, so we're not seeing a lot of activity ourselves.

Michael Carroll
Okay. So then, have the audits actually started with the announcement that occurred in March?

Craig Flashner
We don't know. We haven't seen any activity since then.

Michael Carroll
Okay. And then you said you participated in the BPCI starting in 2012, What model did you participate in?

Craig Flashner
We didn't participate in a specific model, but we're a preferred provider for a lot of our systems. We actually have supplied the systems with information that they're using to determine how they're going to bundle and how they're going to contract. So we have two systems that we're jointly supplying information to and working with, and they're actually asking the question of us. They're not part of the bundle yet.

Michael Carroll
Okay, so you're actually participating with the hospital systems that are in the bundles, but you yourself are not in one of the bundle programs?

Craig Flashner
That is correct. They're bundling with SNFs yet.

Michael Carroll
Okay. And have you noticed any changes from those operators as you participate in the bundle? Are they sending more patients to you as you participate in it?

Craig Flashner
Well, we're on the Board of both of those and we're obviously a preferred provider for them for years now, so we haven't really seen any increased activity, but we have large activity with them.

Michael Carroll
Okay, great.

Craig Flashner
I would think, what's really going to happen, I will address this, though. What most people believe, and I was meeting with Mark Parkinson recently at our annual meeting, and Mark is the President of the AHCA, which is the American Health Care Association which represents all of the SNFs throughout the country. And Mark I had this conversation.

What's really going to happen, we believe, him and I, is that anybody, certain companies, and once again, the reason I said, you know, size, it becomes an issue as well. Certain companies are just going to be preferred providers and other companies are going to get shut out. So if I was making a recommendation to an LTC or any healthcare REIT that is in our space, I would tell them to make sure that they're picking the providers that are going to be in this space, that are going to be preferred providers for these guys, because all that’s going to happen is we will see increased volumes, there's no doubt.

We're preferred provider with McLaren, I’m on the Board, same with Saint John, etcetera. So we know that McLaren is going to keep us in their system and McLaren is going to knock out probably a third of the facilities that are in their system today.

And those are going to be the small mom and pops, the ones that just can't handle acuity, the ones that don't have the geographic coverage, and all the things that I talked about earlier as to why we set that up starting in 2012. So we believe that the actual number of days, the covered lives are projected to go up, the number of SNF days are actually projected to go up even with the bundling, even with the ACOs, but what we believe is that there will be a smaller number of providers that will be sharing in those days.

Wendy Simpson
Okay. Another question?

Operator
Our next question is from Rich Anderson with Mizuho Securities.

Rich Anderson
Thanks, and thanks for the interesting color to both of you. So from your business perspective, I think we get the message, but as someone who sees what's going on outside of your specific lines of business, what would you say that the falloff will be and I don't know exactly how to ask this question, but is there some stuff that needed, some companies that needed to be addressed in terms of how they were going about their practices, their Medicare billing or whatever and do you have any opinion about that, about your competition and how it'll play out over the long term?

Craig Flashner
Yes, if you're referring to some of the companies that have been in a little bit of trouble recently.

Rich Anderson
And maybe more that haven't been yet, but may from your perspective, not to name names of course, but, I'm just curious if this is truly a long-term positive, maybe it is for you, but is it for the industry and that's the of perspective…

Craig Flashner
Well, I think it's absolutely a positive for the industry. If you're asking me if I think bundling and if I think that ACOs are positive for the industry. It's not an issue to me of whether it's positive and negative, is it a necessary place to go. We provide healthcare. I know you guys like lend money to buildings and you’re not into our space, but the reality is, guys, is that it's necessary to control the overall costs and I think everybody is so worried about just pulling money out of system, but there is going to be more money in the system, not money pulled out of system.

AHCA published something recently, in 2010, there were 82 million SNF days, Medicare SNF days. In 2020, is projected to be at least 96 million, maybe as high 105 million. So you're talking about anywhere from 6% to a 14% increase in actual SNF days. If we kept paying the same amount of money but we didn't get efficient, we'll put everybody out of business.

So it doesn't bother us from a whole industry perspective, anybody that's bothered is just going to get out of the industry and those are the smaller guys that can negotiate and don't have some leverage and don't understand, and also you have to understand this too, the vendors in our space are not oblivious to what's going on.

Pharmacies. I had dinner the other night with the President of Omnicare Pharmacy, it's owned by CVS. And Rocky understands. He knows that he’s going to have to come down by 8% or 10% to make up its difference. The rehab providers know that, the DME providers know that, and that's what we saw happen back in 1998.

Before 1998, when I joined in Wingate Healthcare in '94, they were totally clueless on what their costs were. They said, go contract with managed care companies, you’re a physician, go contract with managed care companies. I said, that’s great, how much does it cost you to supply services per resident per day? We have no idea. Well, then how much I'm supposed to ask the managed care contract or contractor to pay us? So we had to figure all that out, and that wasn't a bad thing. That was a good thing. That was a necessary thing.

So I thought, you know, our industry is not going anywhere, guys. People are getting old, there's a lot more of them, and they're going to need healthcare and you can't do it at home and what's going to happen is it just keep shifting downhill and we're focusing on some space, and other guys are too, other big companies like ourselves, or mid-sized companies, are focusing on high acuity for a reason. It gives us pricing power.

When we take a ventilator patient from a managed care company that's on dialysis, needs dialysis, I tell them how much they are going to pay us. They don't tell me how much they're going to pay, because they're sitting there in a hospital at $1,600 bucks a day to $2,200, and I know that. Knowledge is valuable, knowledge is power. I know how much it costs them. I can call them up. I did managed care contracting back in 1994 before anybody else was doing it. I know they’re paying $2200 to the hospital and I tell them I’ll take them for $1000. And I know that works for me.

So you’re not going to make the same, obviously margin on every resident, but as long as you have the right population within, you can lose couple of dollars here and make a lot more there. So I think a lot of these companies, they’ve got bright guys there, they’ll be fine. Everybody is going to be fine in this industry, it's not going anywhere.

Rich Anderson
What percentage of your Medicare business is orthopedic?

Craig Flashner
Not that high.

Rich Anderson
Okay.

Craig Flashner
I looked at it, I knew the question would come up, about 3% on knees and hips.

Rich Anderson
Three percent?

Craig Flashner
Yes, because think of it this way. So my CEO just had both his knees replaced in the last year and a half, he's in his 50s. But let's say you're a 68-year-old person, and a buddy of mine is about 58, he just had his knee replaced. He didn't go to skilled nursing facility.

Rich Anderson
Right, right.

Craig Flashner
Of course not. Right, so all the hips and knees of 68, the 72-year-old, the 75-year-old, the guys that are in our buildings are about 80 plus and really 85 plus. So those are much more medically complex individuals, those are the guys that have had congestive heart failure, respiratory problems, emphysema.

We have a big problem now in this country, obviously, with obesity and we have 400-pound residents. The younger-type population are the ones that are killing themselves and they are the big obese diabetic patients.

The orthopedic patients that we see in skilled nursing facility are really just the elderly patients who can't go home right away or can't do outpatient rehab and need to come to our facilities. That's not going to change, because medicine's not going to change. No, I shouldn't say that, medicine will change, obviously technology changes, but in general that's not going to change.

Rich Anderson
Is there any place in your portfolio where you have even just a little bit of concern that you're not connected properly, through relationships or what have you, that you might be one of those that will fall by the wayside as hospitals small-down their relationships?

Craig Flashner
Oh yeah, that's a serious concern, but we've put a huge focus on that. We're making sure that we're in the Humana's of the world and the Aetna's of the world. And, hey, the other thing is a consolidation right now going on within the managed care industry. Aetna, Humana, all those guys, they're merging too. So there is going to be fewer of them. We're in all those networks.

So would you worry about it? There is also a difference, remember, there is a lot of areas in this country still that really don't have high managed care penetration. We have buildings in rural areas, we have buildings in urban areas, and we have buildings in suburbs of urban areas. We love the suburbs because we like to network, but in our rural areas really there is such low managed care penetration that they don't really have a lot of choice.

In a lot of markets and skilled nursing facilities, you and one other person are the only game in town. If you go to Rhinelander, Wisconsin there is us and one of the person, if you look at Ripley, Tennessee there is us and one other person. So, that patient population really isn't just all signing up for managed care because there is not that kind of penetration. So it's really a

mixed bag. And we like to own everything. We like to own rural, we like to own urban, we like to own suburban for that exact reason.

And you've got to hedge your bet, and that's why I think that the companies that are going to do okay at the ones that own 70, 90, 120 buildings. Because you're right, you make a great point. You're going to be an all or none phenomena. If you own 5, 4 facilities and you're in one market, it's very risky. You don't get that managed care. If you're from Massachusetts, and you don't get into Harvard Pilgrim and Tufts, you're out of business. So we're spreading our risk, you get hit right on the head and that was a great question.

But that's why 90 to 120 makes sense, because if we get bumped out of Tennessee, but we're fine in Michigan and Ohio, we're fine. It's the same reason that we believe that we needed that many facilities and we needed to be in these three or four states, because over the years certain states economically are in trouble.

When Tennessee was hurting during the recession, you know what they did? They said, okay, we'll look at our cost report and if you're going to go up, if your rates going to go up $10, then we're going to give you a 20% increase on the upside, if it's can go down $10 a day, then we'll 100% decrease on the downside. So we got hurt in Tennessee for a few years, we just got a huge rate increase this July 1. Same with Ohio. Ohio rates went down, I'm talking about Medicaid now. Ohio rates have gone down and we just got a big bump effective this July 1 again. So that's why I think it's important also to be in multiple states and not one place. But that was a great question.

Rich Anderson
Okay, great. Thank you.

Wendy Simpson
Thanks, Rich.

Operator
Our next question comes from Paul Morgan with Canaccord. Please go ahead.

Paul Morgan
Hi, good morning. And maybe this is for both, but maybe we could start on the Anthem side, there's been a lot of focus on labor costs and the impact of competition for new developments or higher minimum wages, and I'm just curious how your organizations are addressing that challenge, whether it be through retention initiatives or staffing changes or to comp structure, and how the impact been on your margins?

Mark Rockwell
Well, our biggest concern to start with is finding well-qualified caregivers, and while we have seen some upward pressure on wages, it's really not been, at least to date, much more than just inflationary-type pressure, pretty manageable 2% to 3%, but the bigger concern is really finding and hiring and then training and retaining good help.

That is really our number one focus in 2016 is designing an entire program with just a lot of emphasis around recruitment and training and retention and implementing a bonus program. So yes, caregiving, or hiring and retaining good caregivers is probably our biggest single challenge.

Wendy Simpson
Mark, there is a recognized cost of turnover. So as the salary levels go up, if you can reduce turnover, you're still going to be better off.

Mark Rockwell
Well, that's exactly right, and that's why it's really important in the whole process of analysis to make sure that you're hiring the right person to begin with, because if you raise your wages dramatically but you didn't hire the right person, you're still going lose them, they're just not well-suited for the job.

So what we realized is to balance out not only the optimization of quality care and keeping it affordable, we need to do a better job of identifying the right person, then on-boarding them correctly so that they really understand their job, they don't become a demoralized because we've loaded them up with so much information that they can't processes it, and then work to retain them. And you're absolutely right, Wendy, as our turnover costs come down we can then actually reinvest that in higher wages.

Wendy Simpson
Right, right. And then Craig, you…

Craig Flashner
Mark hit right on the head. I think our number one concern is employee retention. Our number one program that we've got, that we've implemented from the last year or year and a half is how to retain our quality employees.

When we took over the 33 facilities that we took over out of the Extended Care portfolio, we actually went through, myself and my CEO, and we implemented actually wage increases in 23 of those facilities, because we just do market studies and we make sure that we're not underpaying people. That's really one of the major problems.

When you're a $12 an hour employee and the building up the street says I'll pay you $12.10, even if you love that building you're tempted to go, so we constantly are looking at that. And you're right, Wendy, there is a huge cost to employee turnover, not just in dollars and cents, but really in quality of care. And our main concern, in our industry at least on the skilled side, is really quality of care. Because I don't care how well you can market a program, if you don't have quality care, the preferred providers are going to know, the hospitals know, the community knows, and you'll never keep your buildings occupied and you'll never keeps staff.

Paul Morgan
Thanks. And then just a comment on new development and I think Mark, maybe you were referring to Denver in terms of the level of competition from new projects with was balanced and then maybe now it could be headed towards sort of more of a lack of balance. Has it affected the lease up of your later stage projects in that market? Does it change at all the way you think about entering new markets and the role, barriers to entry, or the way you think about your geographic expansion?

Mark Rockwell
Yeah, I think it's fair to say that in Denver, it's always concerning when you see announcements of new development, so we would never take that anything other than seriously. We believe that we, well, we have four communities in Denver.

The one community that had a bit of a stall out for a short period of time in January and February, I believe and we'll never know the exact amount, but we had a really horrible car accident happen on New Year's Eve. Even though we sit back from the street about 100 feet, believe it or not, a car at about 60 miles an hour came jumping over the curb and slamming into the front of the building, and thank the good Lord we didn't lose anybody. It took out the entire conference room, which three or four people had just moments before left. So we were celebrating the fact there was no loss of life, but on the other hand, when you have the front building completely under reconstruction, that obviously has an impact on your lease up.

That property, which is Greenridge Place in Westminster is now back on track, we're seeing good lease-up activity. As I said, we had some quiet periods in January and February, how much of that was related to the reconstruction, I don't know for sure, but I suspect a fair amount of it was tied to that.

Our buildings overall in Denver are doing very well. I certainly would never be complacent. We work diligently every day to market ourselves. As one individual in the Colorado market who is a marketing specialist had said, which we take as a compliment, Anthem has been able to establish strong brand identity in the Denver market. We're not real big, but we do have four communities that surround the Denver market.

But yes, I am understandably concerned when I hear about additional announcements. I don't know if we're at the peak and we're just now going to see it start to subside. I know that when I was at NECC conference earlier this year, it appeared that overall that development maybe hitting cresting point and that we may now be seeing things starting to equalize.

We are focusing on a go-forward basis on entering markets where there are higher barriers to entry. One of the other comments has been about the Chicago market and that's where we're also really active. But the way the Chicago market is defined and the way we define it are quite different.

When I look at some maps that define the Chicago market, it takes in a very large portion of Illinois out and including some pretty substantial farming areas which wouldn't strike me as being Chicago. That, in my opinion, is where you're seeing a fair amount of development in the “Chicago market”. We tend to be close-in in higher barriers to entry markets like Glenview, Burr Ridge, Tinley Park, Lincolnwood, Oaklawn, where frankly finding sites are really, really difficult to come across. So, while that's not any guarantee that we won't face competition, it does at least tend to minimize it.

Paul Morgan
Great. Thanks, that’s really helpful.

Wendy Simpson
Thank you.

Operator
Our next question is from Karin Ford with MUFG. Please go ahead.

Karin Ford
Hi, good morning. What are your return hurdles today and what type of same-store NOI growth are you underwriting when you're looking at new deals?

Wendy Simpson
Are you asking the operators when they're looking at new deals or LTC?

Karin Ford
Yes, operators.

Wendy Simpson
Operators, if you're looking to add a facility to your portfolio, what type of returns are you looking for?

Craig Flashner
Well, that's a loaded question in my industry because of the complexity of some of the programs in the buildings and some the operators we acquire from. We try not to do turnaround buildings that need clinical turnaround, that have clinical issues, but surely buildings that have economic issues, we will try and turnaround if we think we can do something different than the operator, especially in a state like Michigan, where we understand cost reports very, very well.

But to answer your question on a specific multiple, our ultimate goal is to be in a facility for a five to five-and-a-half multiple of EBITDAR when we're done with what we're doing and that might include a renovation, that might include a bit of a turnaround, adding a vent unit, whatever. But we try and get into our buildings for around five multiples when we're done.

Karin Ford
Got it.

Wendy Simpson
And Mark?

Mark Rockwell
In our case, this is Mark speaking for Anthem, the way we tend to evaluate markets is primarily driven by lease coverage and bottom line net operating income. We strive to have a debt coverage somewhere in the north of 1.3 range. We want to make sure that we genuinely believe that we can have a net operating income before taxes in that 9% to 11% range. As long as we can meet those two tasks we feel pretty comfortable.

Karin Ford
Thanks, that’s helpful. What are your capital alternatives to the REITs today, and do you see value in doing repeat deals with one capital provider?

Craig Flashner
Sure. Obviously it's advantageous to do multiple deals with one capital provider. I think the most important thing from our perspective is to be with a capital provider that understands our industry. When you're in the skilled nursing facility industry there is a lot of nuances and helps that the provider, if your capital partner understands that. Alternatives to the REITs? There is many banks out there that are lending to skilled nursing facilities today and we do stuff obviously with banks as well as with various REITs.

Karin Ford
And is there any change in appetite from the banks, I'm sorry?

Craig Flashner
Is there a change in appetite? I'd say right now the appetite is reasonably high, but it changes constantly, as you know. If I called up even some of my lenders that I've done eight deals with back in 2010, I probably couldn't have gotten a loan, and I don't take it personally. I just think nobody was really lending. And some of the people on the call are some of the lenders that I deal with. So I think that right now the appetite is reasonably high. I think the hard thing right now for us it is to find deals that make sense. We're very particular, because the last thing we want to do is buy something that’s really not additive, as we talked about earlier, or we can't get to that 5, 5.5 multiple eventually. So I think the toughest thing now is finding a deal that makes sense. I think if we find a deal in our space that makes economic sense, there's lots of lenders that are interested.

Mark Rockwell
This is Mark speaking. From our standpoint, we really appreciate and value the relationship we have with LTC and we think that for us in particular at the stage we're in, a repetitive, an ongoing long-term relationship with a trusted capital partner such as LTC is really optimum and the reason being, what's unique for us in our relationship with LTC is not only its size, which is large enough to be financially robust for our needs, but not so big that we have to deal with multiple levels of management and it's not difficult to get a transaction put together.

And that, as we all know, in a active and growing market being able to analyze and complete transactions in a fast way, and I say fast and I know no transaction is ever fast fast, but in a way that is very straightforward and repetitive where you have your documents agreed to, is I think a strategic advantage for us, and because we see the business as an operating business, not a real estate business, it's all about care. We are focused on creating good buildings, but we are not creating them from the standpoint of seeing it as a capital transaction on the real estate side for a future capital event.

Wendy Simpson
It's an interesting question, Karin, because I recall one of our first meetings with Mark and Isaac in this conference room when we were talking about Anthem and starting to build memory care properties, and we were so impressed with their focus on the care, they had already developed a prototype.

Just looking at numbers, which was the pro forma of what they industry could be doing and Anthem in particular, I told Mark, I said there is going to come a time in your development if this happens when people are going to be throwing money at you like crazy and we understand that we do not finance with one type of financing vehicle. Craig has more properties than are financed by us.

We expect that some time it's appropriate for Anthem maybe to finance in a different way, whether it's to get debt to own their own properties or something, but one of the things that we have with our operators is an understanding of their health is our health. And so if it makes sense for a different capital structure for our operators, we are all in support of that.

Clint Malin
One of the things that Mark has talked about, this relationship we have is really being able to free up your time. Just to focus on development opportunities, construction, operations, and not worry about sourcing capital, which can be a very time consuming process, but it's also taken off the recap risk of the portfolio. Because if we had pursued a joint venture relationship, there's always that monetization recap event, and that's off the table because we’ve provided

permanent financing to Anthem that really allows them and gives them a vehicle they have a business that's ongoing under a lease structure where they can invest their dollars into human capital, technology, really to grow their operating business.

Mark Rockwell
Absolutely.

Karin Ford
Great. And just last one for me, there's been some variation over the years of escalator rates in both skilled nursing and assisted living leases. Do you guys have a view on what the right escalator level is for your business when you partner with a capital provider?

Craig Flashner
Yes, this is Craig. Zero percent.

[Laughter]

Craig Flashner
I tell that to you guys all the time but you just haven't listened.

We have actually been doing fixed rates for the first four or five years on our acquisitions, getting to your point that as we're trying to implement new programs and do some turnarounds or do some capital improvements in these buildings. Right now, in a portfolio that work we did with LTC back in 2013, we're doing $30 million worth of renovations, construction. And that's still 2-1/2 years in, so the first four or five years, we've actually done fixed rates and then we're escalator from there.

But obviously, all kidding aside, we can handle at 1.5% - 2% bump increase, but when it starts getting epic, I think our increases are about 2.25%, when it gets above that it starts really getting out of hand over time. So we've kept those down to 2.25% or 2%.

Mark Rockwell
Well, speaking for Anthem, of course the flatter the increase the better. It's always, I mean it's certainly understandable from a REIT standpoint that they want and need some kind of an annual adjustment. I think the million dollar question is how do you match that up with inflation expectations.

Clearly, if inflation were to remain really, really flat, at some point we might have some real upward pressure on our lease rate. I think we're all expecting that at some point we're going to see some greater increase in inflation than we maybe have in the past five or six years, but we are comfortable with 2% to 2.25% and as long as we have reasonable annual adjustments in our increase in inflation, we should be able to sustain that.

Karin Ford
Thank you very much for the color.

Wendy Simpson
Thanks, Karin.

Operator
Our next question comes from John Kim with BMO. Please go ahead.

John Kim
Thank you, Wendy, for hosting this discussion. I think my first question may be for Dr. Flashner, but I was wondering if your company participates in home health, and do you see a cost advantage of home health versus SNFs for certain episodes?

Craig Flashner
That's one space we've stayed out of. Actually, in my former company when I was with Wingate we did start a home health agency, but we've decided to really hone in and focus on what we do best, and really what we do best is provide skilled nursing care.

That's why we haven't really bought a lot of assisted living and a lot of independent. We've bought independent and assisted when it's kind of come along with our SNF acquisitions, but we don't independently go out and source those and try and acquire those. So to answer to your question, we're not going to do home health, we're going to stay focused on what we're doing and try and grow that.

Do I think the some of our days are going down to home health? Absolutely, absolutely I do, but I think some of our days, some of the days that I mentioned earlier from LPACs and rehab hospitals are coming down to us. There is a finite amount of clinical care that can occur in someone's home.

I know everybody is really worried about home health taking over the world. Never going to happen. It just isn't going to happen, because it's really not an efficient delivery system or a model for true high-acuity individuals. It's great if you need six hours a day for someone to watch your mom or dad who's 85 and has some dementia issues or whatever, because you can hire somebody in at 12 bucks an hour.

And we talked about this earlier too, the cost of lower end home health aides, etcetera, is going up and if these guys keep talking about raising minimum wage to $15 an hour, that's going to real issue for them, no doubt. It's issue for us, as well. But it's not an efficient delivery model, it's not going to be a model that's really going to be taking care of high acuity residents, so we're not too worried about it is, because we're focused on the high acuity side.

John Kim
Got it, okay. And then my second question is on the star ratings by CMS. Do these ratings matter to you? Do you think--

Craig Flashner
Yes, they matter. Well, they don't really matter to me, but they matter to everybody else, so they do.

The star ratings, as you know, change almost weekly now for us, it's been ridiculous. They're adding five new categories that they're looking at and a lot of our buildings, we have building went from five-star down to three-star in the last change and then they changed them again and now they are changing them again. It matters only because the managed care companies are saying it matters. And a lot of the managed care companies are saying, if you don't have a three-star building, we won't contract with you.

So it's a big focus of ours, and all kidding aside, we're definitely focused on it. We break it down as to what we need to do building-by-building to maintain stars. We're above a three-star as a

company. Most of our buildings are above three-stars or above, so we don't have an issue with that. You can't contract with the VA unless you're a three-star now. So it is something to focus on, it is an issue.

But it's hard for the industry, because the government keeps changing what they're measuring and every time they make a change, nobody really knows what the effects going to be until you run your five-star the next day and then you see if you're going up or down or all around. So it's hard for everybody, yes, but it is important.

John Kim
So for your one and two-star facilities, is it just a matter of increased capital or are some facilities ones that you made just sell, or?

Craig Flashner
No, usually John, it's really about, when we take over facilities, we'll take over a number of one and two-stars and it's usually the quality measures and it's usually their surveys that they had, their healthcare surveys from the states that CMS does, their annual surveys. And the reason it takes a little bit of time to raise them up is you have to have the next survey drop off, so you have to have another annual survey and then have the last one drop off and sometimes it might take two good annual surveys for you to really get them up to where you want to go. So it can be a two to three-year process, if you take over one-star buildings.

John Kim
Great. Thank you.

Craig Flashner
Sure.

Operator
Our next question comes from Jordan Sadler with KeyBanc. Please go ahead.

Jordan Sadler
Thank you. Good afternoon, and thanks for everyone taking their time today. Just a follow-up on the CMS star ratings. As a clarification, are you saying, it sounded like in the end of the answer there you were giving, that it does take some time to move a CMS star rating on your portfolio, especially on 1 or 2.

But in general, across a portfolio, you said something about your CMS star ratings moving up and down. Are they more very gradual to move? How long does it take to move a star rating on an individual facility level?

Mark Rockwell
Well, generally what's happened is, they've changed what they're actually looking at to measure to determine how many stars you have. So if they say one day, okay, we're now going to look at how many antidepressants you’re using or antipsychotics in your building, but they weren't using that in the star rating before, you don't know where you're going to fall until you look at all your antipsychotics in your buildings and see if that's going to help your star ratings or hurt your star ratings, so what they have done in the last couple of years is added in many new categories like that.

Sometimes the answer is a little complex, but sometimes you can move a building quickly. Let's say, for example, that one of the measurements is your staffing, your nurse staffing. So if you have a building that doesn't have a lot of RNs and it's well below the average in your area, if you go and hire a bunch of RNs you can move that up fairly quickly.

If you have a facility that had a major clinical issue on its annual survey and got a bunch of high level acuity tags, I, Js, and Gs, then it's going to take a while to move that because you've got to have that survey drop off and that takes a year. So the answer is, it could be anywhere from a quicker fix to a longer term fix, it just depends on the building.

Jordan Sadler
And when you talk to the hospitals now, so where you sit on the on the Board. What are they focused on, are they focused on the star ratings, or are they focused on readmission rates, or are there any hot-buttons that basically affect how you are managing your portfolio?

Craig Flashner
Yes, I think they understand that the star ratings aren't the end of the world, one way or the other because of the variation and fluctuation, but they're definitely focused on readmissions. I can tell you that for sure, because readmissions are costly to them. That's definitely one of their main focuses.

And as they contract and bundle they are going to be focused on how much it's really going to cost for you to take care of these particular DRGs. So when they're discharging somebody, because they're under the DRG system and we're not, we're on RUGs, but we're kind of going to go to the DRG system obviously, which is fine because what they're going to say okay, we're getting paid X and we've got to move him down to here, move him down to here. And they're going to try and skip the next level of acuity obviously, as best they can, so they're focused on that, for sure.

But here's the other thing, there is a finite dollar cost to take care of somebody in a skilled nursing facility. I don't care, you can be the best provider in the world, but you're not hiring a physical therapist or an occupational therapist for a much different cost than anybody else in the marketplace. So if a resident, if a patient comes in and they really need two hours of therapy, it's going to cost you $60 an hour to do it. It doesn't matter who you are.

So what will happen is, you'll probably see, I wouldn't be surprised, Jordan, that you'll see what happened back in the early days of contracting where a lot of providers took contracts on for rates that made no sense whatsoever, and we just sat back and said, all right, we'll let them go out of business and then we'll pick up the debris. So what will happen is someone will contract for something that makes no sense economically because they don't understand what that is, and then they won't be able to do it, and they won't be a provider for that hospital system very long.

Jordan Sadler
That's helpful. And then one other, you talked about folks who might lose share going forward, and moms and pops are often referred to. But at the same time, you're talking about a sweet spot in terms of sizing in the 90 to 120 facilities. So I am curious, who loses more share? Is it the moms and pops out there who may or may not be more versatile or have the ability to sort of change or is it the large corporates?

Craig Flashner
Well, I think

Jordan Sadler
Hello?

Wendy Simpson
Can you hear us now? Hello?

Jordan Sadler
I can hear you now.

Craig Flashner
Sorry about that.

Jordan Sadler
I think you dropped off there. So moms and pops versus large corporates.

Craig Flashner
Yes, I think mom and pops are gone. You will not be able to be in a network if you're mom and pop.

If you have two buildings I just don't think that a hospital system that's bundling or a managed care company is going to want to go through the brain damage of contracting with somebody that can only supply such a specific niche. Unless you're in the rural markets, as we talked about earlier, where you're the only game in town. They can survive, but I'm talking now in the more urban, suburban settings. I just don't think a mom and pop's viable any longer.

I think that when I said 90 to 120 facilities, remember, I also said that it's important to be in multiple states, so you're not going to have 90 facilities in one state. We have 35 facilities in Michigan, we're the second largest operator there. There's 440 buildings, we own about 9% of the buildings in Michigan. So there's a finite amount of buildings that you want in one state, also. But that does give you geographic coverage.

I think what you're seeing is you're seeing the national companies come to our philosophy a little bit, as I said earlier, and they're also paring down. I think Kindred is probably down to 150-170 buildings. I think what they're realizing is it's really more for focus more than anything, Jordan. I think you've got to be able to focus on your buildings and it's hard to focus on 350 buildings. If you're a CEO of a company and you have 350 buildings and 28 million regionals and directors of operations and regional clinicians and all that, it's hard enough for our CEO to focus on 70, and that's why we're thinking 90-100 or 120 will be his max.

Jordan Sadler
Thank you all for the education.

Wendy Simpson
Thank you, Jordan.

Operator
And we have time for one more question. Our last question is from Todd Stender with Wells Fargo. Please go ahead.

Todd Stender
All right, thanks for taking my question. Very unique conference call, Wendy, so thanks for setting it up.

Wendy Simpson
Thank you, Todd.

Todd Stender
Sure thing. This is for either gentleman, whoever wants to give their thoughts, or both, maybe. Can you give your impression of the speed or trajectory of either skilled or senior housing operator consolidation? There's a lot of new regulations, we've been talking about labor costs, new supply, particularly in assisted living. Can you just talk about the ability of maybe smaller operators to navigate on their own, or is there increasing pressure do you think to combine with another operator?

Craig Flashner
There's definitely increasing pressure to combine. We don't see so much combination in our industry. The smaller operators usually just sell out, truthfully. It's hard for a small operator, as we said earlier.

Our compliance department alone is probably as large as some small regional operator's total management company. So, financial services to bill appropriately and make sure you're not making a mistake and do all the things you need to do, is very difficult. We probably have, I don't want to count how many billers I have because I want to shoot myself.

So it's difficult, and even from a clinician perspective, they have to be competitive and they have to compete to hire regionals that can take care of the clinical issues they have, and companies like ourselves can pay more money to those regionals. So there's no doubt that we're seeing a consolidation. I think that if you look at the marketplaces over the last 20 years, that we're in, I'd say already that the vast majority of the mom and pops are gone. I think that there might be some of the mom and pops became regionals and they may have 10, 15, 20 buildings, but guys that have one, two, or three buildings are pretty much out of the business.

Mark Rockwell
Speaking for memory care, I think that there is an advantage to having multiple properties certainly, and in large part due to the whole concept of bringing training and care model to its fullest potential, which if you only have a very small number of one, two, three properties that's pretty difficult to achieve.

However, at least from my vantage point, I don't see that in our segment of the healthcare industry that it's necessary to have to be really big. We would certainly feel as though, given a goal of 25 to 50 properties that that will be a niche that will be really effective for us. We'll be big enough to be able to afford all of the professional staffing at the home office that we need for recruiting, for training, clinical care, etcetera.

And I would think, and this is just speculation on my part, but I would agree with Craig, I think that when you start to get above about a 100 properties, it's going to become pretty unwieldy, but I certainly wouldn't want to be see us get to that 50-ish range and I think that we'll be highly efficient. Even now at closing in on 10 properties, we're starting to see some additional need for corporate staff, which is going to be a little bit rich for us at only 10 properties, it will be a lot

more comfortable when we're at 15 or 20, but we certainly don't see the need to be huge in order to be highly competitive.

Todd Stender
Great. Thank you very much.

CONCLUSION

Wendy Simpson
Thank you and thank you all for attending and I just need to remind you that in order to invest in these two quality operators you have to buy LTC, since they're private. So thank you all for attending this morning and we look forward to talking to you after the second quarter. Thank you.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.