



## SENIOR LIVING

### Perceptions and Effects

# The Five-Star Rating System for Skilled Nursing

The Centers for Medicare & Medicaid Services (CMS) introduced its Nursing Home Compare five-star system for skilled nursing facilities in December of 2008 to assist the public in identifying meaningful distinctions among skilled nursing providers. The skilled nursing facility (SNF) five-star rating is based on health surveys, staffing numbers and quality measures and has become a frequently referenced metric in the industry nine years after its introduction.

### Why the Rating Matters

The system is designed to be an objective measure of operators and facility quality. This allows consumers, lenders, providers and management to recognize performance issues and advantages. The ratings affect the reputations of operators and facilities and can have significant impact. Poor ratings can lead to lower occupancy and make operations suffer and vice-versa. Likewise, improving scores can signal improving operations and declining scores can be a potential red flag for operational inefficiencies, losses, and claims. Further, capital and financing partners consider the star ratings when determining credit eligibility. Poor ratings could lead to difficulty in obtaining financing for capital improvements and/or higher interest rates, which could also affect the overall cash flow of the facility.

### Breakdown of the Five-Star Rating

The Nursing Home Compare five-star system gives each nursing home a score between one and five stars, with a five being well above average quality and a 1 being well below average. The five-star rating is comprised of three parts:

- **Health inspection rating.** This rating is based on the three most current survey cycles, with each cycle containing one standard survey and 12 months of complaint surveys. The rating is based on the relative performance of facilities within a state, which helps control for variation among states. The top 10% (with the lowest health inspection weighted scores) in each state receive a health inspection rating of five stars; the middle 70% receive a rating of four, three, or two stars; and the bottom 20% receive a one-star rating.
- **Staffing rating.** The staffing rating has information about the number of hours of care provided on average to each

resident each day by nursing staff. This rating considers differences in the levels of residents' care need in each nursing home. For example, a nursing home with residents who had more severe needs would be expected to have more nursing staff than a nursing home where the resident needs were not as high.

- **Quality Measure (QM) rating.** This rating has information on 16 different physical and clinical measures for nursing home residents. The QMs offer information about how well nursing homes are caring for their residents' physical and clinical needs. More than 12 million assessments of the conditions of nursing home residents are used in the five-star rating system.

### Things to Consider

No rating system can address all of the important considerations that go into a decision about which nursing home may be best for a particular person. Examples include the extent to which specialty care is provided (such as specialized rehabilitation or dementia care) or how easy it will be for family members to visit the nursing home resident. Visits can improve both the residents' quality of life and quality of care, thus it may be better to select a nursing home that is in close proximity over one that is farther away but has a higher star rating. Ideally, consumers should use the Nursing Home Compare website together with other sources of information, such as local advocacy groups and the state ombudsman program, as well as visits to nursing homes.

### How Finance Agencies View the Rating

The U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration's (FHA) Lean mortgage insurance program is a popular and valuable financing option for seniors housing properties, closing 287 loans totaling \$2.84 billion in fiscal year (FY) 2016 alone. The five-star ratings have recently become a greater point of emphasis with lenders because they can impact FHA financing. HUD's Lean Handbook requires lenders to review star ratings and provide additional information and explanations for facilities with one- or two-star ratings. The Handbook also requires operators to implement and maintain a risk management program.

A one-star facility would face significant hurdles to obtain approval and to close an FHA-insured loan. For instance, HUD may require facilities with a low star rating and poor survey history to enter into an agreement with a third-party management company to assess the risks associated with the facility. Further, if a facility had a recent survey with several deficiencies, it may be required to achieve a score with fewer deficiencies than its state's average on its next annual survey. Lastly, HUD may also require restricted cash distributions during this period.

### How Buyers Perceive the Rating

Per bed values for SNFs have been at an all-time high during the last three years. This is driven by a trend where providers have migrated towards higher acuity levels, such as rehabilitation services, to achieve more lucrative reimbursement levels. In turn, this has helped increase cash flow and decrease cap rates to below 12.0%. As prospective buyers look to acquire SNFs, they will evaluate several factors such as the location, asset quality and size, census mix and occupancy, quality of staff and retention, and ultimately the cash flow of the facility. Facilities that are well operated through retaining high quality staff, maintain the asset quality of their facility, are located in high demand markets, and achieve strong occupancy will always drive higher per bed valuations. In addition, as quality of care metrics further impact hospital and health systems, these groups will likely look to higher star-rated SNFs to contract with regarding referrals. As hospitals further narrow their networks, the facility's star rating is likely to have an even larger impact in the future, especially in metropolitan areas where hospitals have the ability to choose from numerous competing SNFs.

A buyer may perceive a facility's five-star rating as a strength or weakness, especially when compared to competing facilities in its market. A five-star rating could signal that the quality of care and staff is strong. In addition, it could signal that the facility has strong marketability to potential residents. This could be representative of the facility's ability to maintain occupancy and drive operating margins.

It is important to note that those buyers intimately familiar with the five-star rating system will thoroughly examine a lower-rated facility to determine its cause. Specifically, these buyers understand that all one-star facilities are not created equal. For example, a one- or two-star facility in a state with a very competitive health inspection score may actually be comparable in their number of deficiencies to a four- or five-star facility in another state. Further, a facility with a recent poor survey is worse off than a facility that had a poor survey three years ago since the health inspection score is based on the three most recent surveys. Lastly, an issue with staffing is much easier to control and improve than an issue with the health inspection survey component. These factors, along with those previously mentioned, will be considered in a buyer's evaluation of a facility and the ultimate purchase

price that is offered.

### How Facility Referral Sources Use the Rating for Patient Placement

In regards to facility referral sources, the following patient outcome metrics will be used to qualify a facility as a network member:

- Rate of functional improvement (FI)
- Length of stay (LOS) by diagnosis
- 7/30/60/90 day readmission rates
- Emergency room transfer rate
- Rate at which patients are discharged to the community
- Appropriate level of ancillary services delivered per diagnosis

Most of the metrics above are contained within the first four quality measures of the five-star rating system: improvements in physical function, re-hospitalized after a nursing home admission, outpatient emergency department visit and successfully discharged to the community.

In addition, the Comprehensive Care for Joint Replacement (CJR) bundled payment initiative requires that a facility have a minimum three-star rating in order to participate in the program. Under CMS's final bundled payment model, a waiver to the three-day stay rule will only be granted if a patient is discharged to a SNF with a star rating of three or higher for at least seven of the previous 12 months.

Clearly, the star rating is of great importance to the future of SNFs across the nation. Providers that are knowledgeable about the program and well-prepared will be poised to have a star rating that is a strength and not a weakness.



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