

# **MDS** Moore Diversified Services, Inc.

*Serving Senior Living Clients For Over 37 Years  
There Is No Substitute For Experience*

*“You’ve Got Questions . . . We’ve Got Answers”*

2009

## **THE OPPORTUNITY COST OF A VACANT UNIT**

### *Using Objective Thinking to Make Tough Financial Decisions*

The *opportunity cost* concept been taught in business schools for the last 70 years. Simply defined, opportunity cost is the net financial benefit lost by either avoiding or rejecting some alternative course of action. Let’s put this definition into simple real world senior living terms. We often forget how very expensive chronically vacant assisted living units can be to our overall operation. We frequently perceive our vacant unit “lost profit” as being in the range of our current operating profit margin. That is clearly flawed thinking. The solution to excessive vacancies frequently lies in the execution of some alternative strategies that could involve additional one time costs. This “investment opportunity” frequently appears either elusive or too expensive. But by applying simple opportunity cost concepts we can bring a cost-benefit comparison of necessary alternatives into very sharp, quantitative focus.

Let’s look at typical opportunity cost of just one vacant assisted living unit. We’ll start by asking three fundamental questions involving the expenses involved with just one more assisted living unit being occupied at relatively high occupancies:

1. Would you likely have to buy any more raw food? Probably not.
2. Will you have to hire an additional full time equivalent employee? Probably not unless your direct care staff is already stretched delivering hands-on direct care to your existing residents 24/7.
3. What other operating expenses will likely increase?

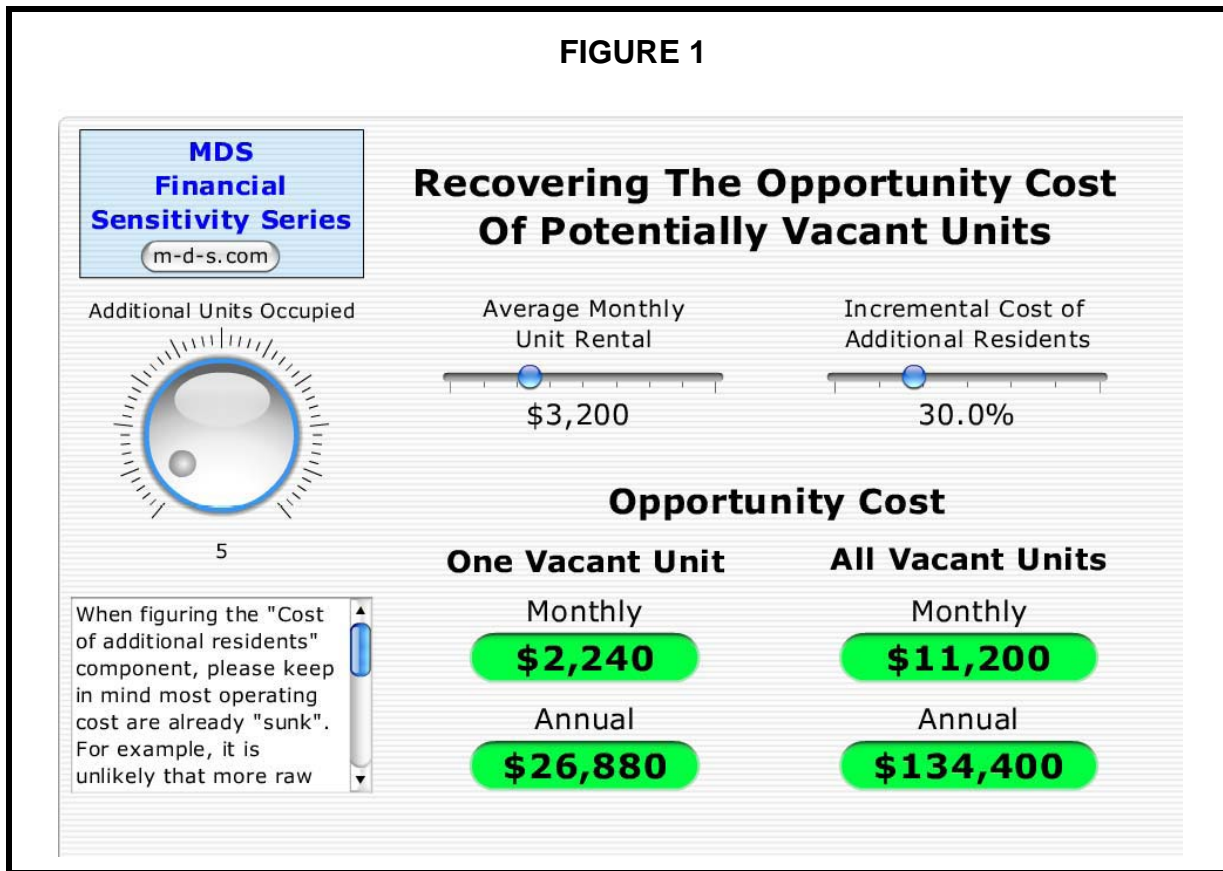
Now let's assume you are charging a very modest *baseline* monthly service fee of \$3,200 per month. That fee is *before* extra charges for higher acuity residents being helped with an above average number of activities of daily living. Considering your previous answers to the three key questions, do you think you could cover all unavoidable additional costs with, say 30% of that additional \$3,200 you will be collecting or \$960 per month? If so, that means most of your operating expenses were already being covered. The fancy economic term for that is "sunk costs." That leaves a new cash flow of \$2,240 per month. Therefore, the "opportunity cost" for not filling just one vacant assisted living unit is \$2,240 per month or almost \$27,000 per year.

The opportunity cost for filling just five vacant assisted living units would be \$135,000 per year. If these units remain chronically vacant, this represents a permanent cash loss each and every year. Looked at another way, if those vacant units were occupied, at least 70 percent of the new incremental monthly service fee revenue would fall right to your bottom line! What do you think - is it time to get creative with various alternatives - even if it requires some additional cash investments?

Vacancy problems affect more than just operating cash flow. Just five vacant units can diminish the overall selling/exit value or potential refinancing capacity of your community by almost \$1.4 million. That's because today buyers and appraisers will value communities by applying about a 10.0 percent capitalization rate on net operating income. That five unit opportunity cost of \$135,000 per year divided by 0.10 equals a \$1.4 million reduction in value.

Figure 1 is a one of about 20 financial sensitivity templates our firm has developed to show our clients both the sensitivity and cost-benefit relationship of implementing action for their unique situation. Using a live, interactive Power Point driven conference call, with the client, we can move the two *sliders* in Figure 1 to emulate their financial situation. The vacant unit *knob* can also be manipulated to observe the sensitivity of various vacant unit scenarios. The *opportunity cost* windows at the bottom of Figure 1 change dynamically; showing the sobering financial impacts.

FIGURE 1



My role in this newsletter is not to sell consulting services. However, I must address for your benefit a frequently asked question, *“What should I do and what might be an expected outcome?”* The answer obviously varies for each situation, but the typical next step is an objective third-party sales, marketing, product positioning and pricing strategy situation analysis. The one-time cost should be in the range of approximately 60 percent of your first year cash flow savings. After this first year investment, 100 percent of the future cash flow benefits are yours and flows right to your bottom line.

The reason opportunity cost is frequently elusive is that it doesn’t specifically show up as a line item in any financial statements. It is an invisible, but extremely important, concept. And there are a number of practical and cost-effective strategies that can significantly reduce these opportunity costs. We’ll cover some of those next month.

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