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Senior Living

by Steven W. Kennedy & Chris Blanda

Rediscovering FHA Financing for Senior Living

In this challenging credit environment, senior housing and care providers who have been averse to government financing should revisit the revamped Department of Housing and Urban Development, and historical usage figures suggest that they will.

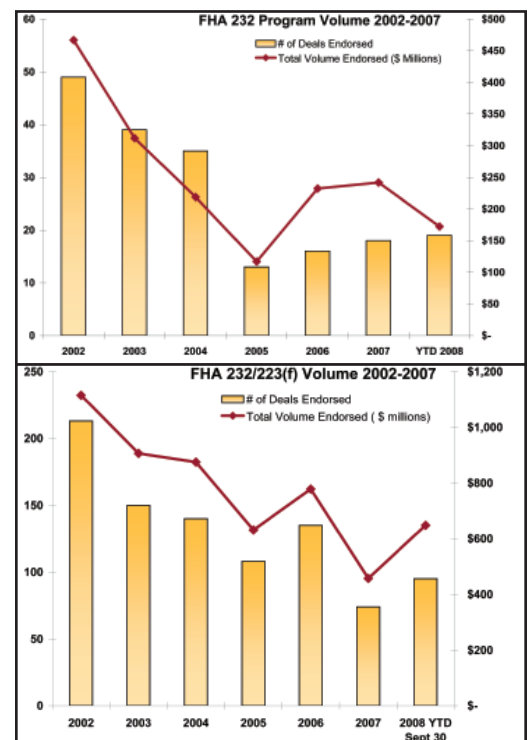
A review of the utilization of HUD mortgage insurance programs offers a glimpse of their future usage in the context of a dynamic economy. In this particular downturn, HUD borrowers will be playing in a new game: HUD has completely overhauled the processing of its Federal Housing Administration Section 232/223(f) mortgage insurance program, which facilitates the refinancing or acquisition of existing senior living projects not requiring substantial rehabilitation. HUD aims to eliminate two universally recognized shortcomings – underwriting consistency and long processing times – that historically have turned off potential borrowers. Similar changes are expected to be rolled-out by Dec. 1 for the Section 232 program for new construction or substantial rehabilitation.

FHA Program Volume Trends

FHA 232 loan volume declined from 2002 to year-to-date 2008, according to HUD volume data by calendar year. Total dollars and deals endorsed reached a high in 2002 (approximately \$450 million endorsed), declined consistently in 2003 and

2004, and experienced a steep drop-off in 2005. However, in the most recent two complete years, total deals endorsed exhibited an upward trend, with nearly \$250 million endorsed in 2007. The number of dollars endorsed per year also appears to be on an upward trend in the two most recent complete years, though 2008 year-to-date data suggest that while more deals are getting done, they are smaller. HUD data show that FHA 232/223(f) loan volume fell over the 2002-2007 calendar years, but may be starting an upward trend based on YTD 2008 numbers.

Market conditions over the past six years provide context that partially



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explains the FHA volume trends. In the early 2000s, a struggling economy limited traditional capital sources, and borrowers reached for government-guaranteed funding. Conversely, the housing and credit boom of the next few years drew borrowers away from government options to the many inexpensive, flexible and quick commercial credit options. A seemingly well-functioning collateralized mortgage-backed securities (CMBS) market provided lenders liquidity, allowing them to make more loans. Thus, FHA 232 and 232/223(f) program volumes dropped. Recently, however, the housing bubble's burst, subsequent credit crisis, and resulting collapse of the CMBS market have again highlighted the attractiveness of government-backed financing options. Some of these more recent dynamics are evident in the upward trend in FHA 232 volume in 2007 and year-to-date 2008.

Trends and Key Indicators

Financing trends in the senior living sector frame these FHA 232 and 232/223(f) observations. The National Investment Center for the Seniors Housing and Care Industry tracks "same store" activity by eight major senior living lenders as a guide to industry debt financing trends. This loan volume reached a peak around the first quarter of 2007 at approximately \$2.3 billion placed. Since that time, however, new debt capital placed in the market has declined. In the most recent quarter reported (1Q08), debt placed was just under \$1 billion, down considerably from the same time last year.

The New FHA LEAN Processing

The Achilles heel of the FHA 232 and 232/223(f) programs has always been processing time. With FHA 232/223(f) average processing times of about 211 days, the programs have historically been far from competitive with traditional funding sources that have closing timeframes of 90 to 120 days. This year, however, HUD launched a new LEAN processing system designed to cut average application processing times for FHA 232/223(f) deals down to as few as 15 days.

With the credit market's current aversion to risk, evidenced by more conservative underwriting standards and widening health care credit spreads, the spectrum of long-term borrowing options has narrowed. If successfully implemented, LEAN processing could support FHA financing options as a competitive alternative to commercial capital sources in any market condition. Key benefits include:

Processing time reduced from 200 to 15 days: HUD moved processing out of local HUD Field Offices to a team of trained health care underwriters who serve as a single point of contact and perform the majority of application review, making processing time comparable to traditional financing methods.

Due diligence procedures similar to those of traditional finance methods: For example, market appraisals now must support facility valuation, rather than the former HUD valuation technique.

Program administrators understand long-term care: The 232 program was moved from HUD's Office of Multifamily Housing to the Office of Insured Healthcare Facilities (OIHCF). This office spearheaded LEAN implementation and operates the successful 242 hospital mortgage insurance program. Its staff have direct private-sector health care experience and understand the characteristics unique to long-term care. They are modernizing the program to meet today's providers' needs, and are pursuing future program improvements.

A key LEAN requirement, and critical element in achieving the reduced processing time, is the "lender's narrative" anchoring the application. This must be completed by a HUD-approved lender and is a comprehensive credit assessment of the borrower, putting additional emphasis on the need to work with a lender that understands and can articulate the organization's health care credit profile.

The 232/223(f) program retains its many favorable features, such as:

- High leverage: Up to 85% of property value
- Terms up to 35 years with matching amortization
- Low interest rates that remain in the 6.0% range
- No personal guarantees: Loans are non-recourse
- Prepayment Flexibility: Prepayment provisions can be negotiated

The Future of FHA 232 and 232/223(f)

The senior living sector is fundamentally strong and in need of capital. Credit market troubles will draw borrowers to government insured options, shedding light on their favorable terms. A successful implementation of the LEAN system should drastically improve borrower experience with FHA. These factors are projected to usher in a new era of increased activity and could mean sustained higher dollar and deal volumes in the future.