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Senior Living Business INTERACTIVE

Financial News, Growth Strategies, and Best Practices for Providers and Suppliers

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Senior Living Financing Roadmap: Where To Go For What

Continued access to capital is critical for any business. For senior living, all sources—FHA/HUD, Fannie/Freddie, tax-exempt bonds, bank loans—have their merits, depending on the type of project, the amount of capital being sought, and the type of entity seeking the financing. On the other hand, different lenders have different appetites for the various seniors housing operating models. **KeyBank**, for instance, has portfolio percentage targets for skilled nursing facilities vs. independent living vs. assisted living, because it perceives different risks for the different operating models, according to Grant Saunders, Senior Vice President and Senior Banker, Healthcare/Seniors Housing Finance, at KeyBank Real Estate Capital in Tampa, Florida. So where do you go for financing?

Conventional bank financing, traditionally short-term, is typically used for construction, expansion, and bridge loans—although some banks finance on a longer-term basis and more regularly do stabilized financing.

Agency financing—Fannie Mae, Freddie Mac, and HUD—is traditionally used for longer-term, fixed-rate permanent financing.

Tax-exempt financing is available to not-for-profits.

REITs are having a huge impact on the sector recently. Publicly traded REITs have had unprecedented access to cheap capital, which has spearheaded consolidation; nontraded REITs, which raise capital from retail broker-dealers, have also raised large amounts of equity that then has to be deployed. Owner-operators traditionally go to REITs for sale/leaseback financing.

Private equity firms create joint ventures with owner-operators who contribute their existing assets and, in some cases, additional capital for development and/or acquisition.

Commercial mortgage-backed securities and insurance companies are increasingly providing financing in the sector, especially as Fannie and Freddie rates have increased.

Lender interest also varies based on attributes such as loan tenure, ease of repayment, leverage (loan-to-value and loan-to-cost), credit profile, and purpose (e.g., construction, acquisition, troubled property, permanent financing). An analysis of the sponsor—a general credit profile—is important to most financing institutions operating in the senior living space. Among the items the lenders analyze are:

Experience: How long has the company been in the business, how many properties has it operated, and where are they located?

Track record: Lenders review the

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operator's prior projects, including occupancy levels, debt service coverage, operating margins, and success at filling facilities and keeping them filled.

Marketing ability: How well does the operator promote the facility? Does it have the ability to create a lead database and is the marketing staff well-trained and able to convert leads into move-ins.

Operational excellence: What is the business plan, how large does the organization want to grow, what capacities does it have to grow, and what is the operating philosophy?

Financial wherewithal: What is the borrower's net worth, liquidity, and credit history? Does the organization have both the capacity and the willingness to step in and correct problems when they occur?

Qualitative factors: Overall reputation and visibility within the industry at large are both important; for regulated organizations, state survey results are also reviewed.

Lenders like seniors housing because of the positive demographics going forward and the solid profitability of the sector, according to Saunders. Compared to many other real estate classes, lenders are able to achieve a premium return due to the sector's operational risk component—and loan delinquency is very low. Lenders also view the secondary market take-out financing (Fannie, Freddie, and HUD) as a strength. "Lenders in this space have had—and will continue to have—a good run," he said. "That will lead to new lenders entering the sector and, ultimately, to greater competition among debt capital sources."

Tax-exempt financing structures

Tax-exempt financing using traditional bonds are long-term, fixed-rate loans. And as long as the borrower doesn't default, the covenants negotiated when the deal was struck will continue. There's no interest-rate or refinancing risk; rates are locked in for the term of the loan (e.g., 30 years), and the loan is fully amortizing. Tax-exempt interest rates are lower than taxable financing, and the recourse to owners on bond deals is less onerous.

The drawbacks of tax-exempt financing, however, are greater today than in the past primarily due to trending interest rates and the yield curve, according to Mark Landreville, Executive Vice President at **Herbert J. Sims & Co.** in Bloomington, Minnesota. All the money is borrowed up front and drawn down as needed for construction. A fully-funded debt service reserve fund (typically the lesser of the maximum annual debt service, 125% average annual debt service, or 10% of par) is required along with, for new construction, a capitalized interest fund. Those dollars—6-7%, depending on whether the loan is investment or non-investment grade—are invested but earn nothing.

A bank, on the other hand, will advance funds as needed for the construction project, significantly reducing the negative arbitrage on that construction fund. Also, banks typically don't have the full maximum annual requirement for a debt service reserve fund. Rather, because of today's yield curve, it's an automatic 4-5% draw on whatever money is sitting there—a huge benefit for the borrower, according to Landreville.

Established operators with proven track records—those who have been in the marketplace for some time and have been able to work through any problems—have strong access to the tax-exempt marketplace. Demand from the borrower side has been rather strong in the past 12 months as the single-family home market has come back.

Tax-exempt capital is increasingly driven by credit quality, and rates are low. Refunding transactions with established facilities are still able to access historically low tax-exempt rates, although new construction projects, particularly large CCRCs, are increasingly difficult to finance. "Today, rates for new construction projects are 7.5% to 8% or more for a startup CCRC," Landreville said. Meanwhile, retail investors (including mutual funds) that deal directly with firms such as Sims continue to have an appetite for tax-exempt financing despite the low rates. Year-to-date tax-exempt mutual-fund outflows are estimated at $15 billion.

Tax-exempt interest rates are generally tied to the five- or 10-year U.S. Treasury index, depending on the term/rate resets. The spread ranges from 350 to 500 basis points above the Treasury rate based on the overall loan quality. Loan terms are generally five, 10, or 15 years, with amortizations of 20-25 years.

Prepayment penalties are highly flexible and vary according to the term. A three-year lockout is typical, with the penalty declining 3% in year four and 1% each year thereafter. "We try to avoid the yield maintenance type of prepayment penalty, because that eliminates any way for the borrower to save any money if rates go down," said Landreville. If a bank is using a match-funding technique

Swaps...

A swap is a financial instrument, a derivitave, in which two parties agree to exchange interest rates for the purpose of hedging or speculating. Risks involve the interest rate, your credit, and the counterparty.

If you have a swap, you're usually issuing tax-exempt debt and then paying a fixed rate to a counterparty who, in turn, is paying you a floating rate. When the cost of money changes, the value of the swap goes up or down. With the dislocations evident in recent years, the counterparty could be paying substantially less than the actual floating rate paid by borrower—resulting in a rather nasty surprise for the borrower.

Everybody thought they understood swaps until swaps were "out of the money," or not in their favor. Then, people suddenly discovered they'd have to pay a penalty to get out of the swap and record the liability—rather unappealing to boards of directors. But you can use the proceeds of tax-exempt bonds to get out of swaps.

Landreville nevertheless urges people to move with caution. "In the past," he said, "a lot of the major investment banks pushed swaps, because it was an incredibly profitable business for the swap providers. Today, people are much more careful."

So how should you deal with swaps? "The same way you would clean a piranha fish tank—very slowly and very carefully," said Landreville.

(matching the value of the loan to the bonds funding it), however, it will include a yield maintenance penalty for early payment."

Currently, a minimum debt service of 1.20 or more, debt-to-worth covenants, and an additional debt test are required. Sometimes banks refuse additional debt; other times they'll agree to a formula, according to Landreville. Liquidity covenants are typically 90+ days cash on hand.

"Liquidity should be at the top of your list if you want strong and continued access to the capital markets—whether through banks, mutual funds, or directly to retail investors" he said. Occupancy and some other types of covenants are often negotiated. Occupancy thresholds are more important for a new project or new construction than when refunding an existing property.

Typically, tax-exempt financing includes some recourse. In a situation where a nonprofit has established a subsidiary, for example, there will be a limited guaranty with a burn-off provision after certain thresholds are met. Or when private activity housing bonds are used to finance a project, the developer will need some continued recourse for a period of time. "Whether financing through a bank or the bond markets, you have to have some skin in the game," said Landreville. "105% financing is pretty much a thing of the past."

Collateral packages include a first mortgage and a net revenue pledge. For new construction, that will include a pledge of the construction and architect contracts and a limited guarantee or another type of liquidity support, such as through a letter of credit (LOC).

Fixed-rate financing terms are longer than those for variable-rate demand bonds (VRDBs), with no refinance risk and no liquidity provider risk. With VRDBs, banks can pull the LOC and/or demand onerous fees and covenants at the end of the LOC term. Today, that type of credit enhancement is virtually nonexistent, according to Landreville. "Almost universally, banks want out—unless you're an A+ credit with a lot of days cash on hand." Plus, it's almost impossible to find a financial institution willing to write an LOC without having a broader relationship with the borrower. Banks just aren't interested."

Then, when comparing private placement to retail placement, having just one or two large institutional holders makes it easier to adjust or change covenants than trying to deal with a large number of retail investors. Things do change, after all, or difficulties unexpectedly arise.

The FHA/HUD financing option

FHA mortgage insurance programs, administered by **HUD**, have become an increasingly prominent part of the senior living finance landscape over the past five years. In FY2012, HUD's mortgage commitment volume was $6.0 billion—three or four times its historical volumes up to 2008. For 2013, HUD's programs are on pace to exceed the 2012 volume by about 20%.

Why so popular? The financial crisis of 2008 and subsequent recession disrupted the more traditional lending to the senior living space, and a lot of providers successfully went to HUD as a backstop to refinance their indebtedness, explained T. Brian Pollard, Senior Managing Director of **Lancaster Pollard & Co.** in Columbus, Ohio. HUD efforts to streamline and standardize its programs also led to more predictable—and more timely—outcomes. “HUD is probably the longest, most permanent funding source available,” he noted. Terms can be up to 35 or 40 years, depending on the program. For senior living, HUD offers two construction and two refinance programs:

- *HUD Section 232* is for ground-up new construction or substantial rehabilitation of an existing building.
- *HUD Section 241* is a second-mortgage program used for projects that are currently HUD-insured and looking to renovate or expand the facilities.
- *HUD Section 223(f)*, which refinances properties into the program, is also used to fund moderate repairs and improvements or, less often because of the timeframes, to fund acquisitions.
- *HUD Section 223(a)(7)* is an expedited program that allows existing HUD-insured properties to refinance in order to lower their interest rate.

Properties eligible for HUD programs include licensed assisted living, skilled nursing, and memory care. A limited number of unlicensed independent living, typically between 25% and 30%, may be included as part of the project; HUD does not include entry-fee communities in its programs. Over the last two years, skilled nursing properties consumed about two-thirds of the volume; assisted living properties, about one-third. Most of those transactions involved refinancings. Only 4% of the volume was tied to the construction programs.

For-profit, not-for-profit, and governmental entities are all eligible for these HUD programs, but the ownership must be a single-purpose entity. If multiple properties are owned prior to closing, the HUD-insured property must be transferred into a single-purpose entity.

HUD programs are mortgage insurance programs—basically, loan guarantees from the federal government. Post-closing, the lender will securitize the FHA loan into a Ginnie Mae mortgage-backed security, which provides an additional form of credit, guarantees timely payment of monthly principal and interest, and, most importantly, substantially enhances the liquidity of the guaranteed loan. That improved liquidity allows the lender to offer a lower interest rate. “For not-for-profit borrowers, the Ginnie Mae security may also be used to secure a tax-exempt bond offering, which can result in a rating on the bonds of up to triple-A,” said Pollard. “Historically, that’s been a common way of funding deals for not-for-profit owners; but in recent years, with rates going so low, we’ve gotten better

Future Outlook For Fannie Mae/Freddie Mac

After five years of conservatorship, several ideas have begun to circulate about how to modify or replace Fannie Mae and Freddie Mac. Several pieces of legislation have been (or are likely to be) proposed.

Most importantly: the *Housing Finance Reform and Taxpayer Protection Act*, also referred to as the Corker-Warner bill, was proposed in June 2013 and probably warrants the closest following, according to Sherman. It has broad-based, bipartisan support—quite a feat in the current Congress—and several proposed parts are beneficial to both the industry and the financial community. The bill calls for winding down government-sponsored enterprises (GSEs) but also for creating the Federal Mortgage Insurance Corporation (FMIC), a new organization modeled after the **FDIC**.

"While the bill was widely reported in the press as dismantling Freddie and Fannie, it will, in fact, do quite the opposite," Sherman said. "It will still provide an explicit federal guarantee for qualified single-family and multifamily loans, including seniors housing, but it also requires private risk-share in an amount equal to at least a 10% first-loss position—expected to be executed through a combination of private mortgage insurance, subordinated securitization structures, and credit-linked notes. "That's a key change," he said.

The bill's broad support stems from the fact that: a) It retains both the Fannie Mae DUS Program and the Freddie Mac Program Plus lender models, which have been very successful and profitable; b) It maintains an explicit government guarantee; and c) It allows the agency to hire qualified individuals and, within reason, pay salaries beyond the federal caps—thus reversing the "brain drain" that has plagued the agencies in the past.

execution on these deals in the taxable markets. That will likely change as rates rise and the spread between taxable and tax-exempt starts to normalize."

HUD-insured loans are nonrecourse except in certain cases such as for the parent organization of a not-for-profit. With that in mind, many CCRCs carve out their health-care operations and push them into the HUD programs. That lowers their overall cost of capital and reduces risk to the mothership entity. Also, these loans can be assumed, which can be a considerable driver to the value of the property. For a 35-year loan, for example, each 1% increase in rates theoretically raises the value of the property by about 10% of the amount of the mortgage.

In terms of operating covenants, HUD requires no debt service coverage, no liquidity covenant (although positive working capital must be maintained), and no leverage covenants. Certain changes to the building, to the collateral, or to operations do require HUD permission or approval.

Most loans are limited by a loan-to-value set at the lower of 80% of value or the cost to refinance. HUD also focuses very closely on trailing 12-month performance. A borrower that has had a hiccup may want to time its application well after the hiccup period has passed; otherwise, it could impact the valuation of the property and the amount of the loan for which the borrower would otherwise qualify.

HUD is authorized to issue only a certain amount of mortgage commitments each year. In FY2013, that amount was $25 billion (the same as the prior year) to serve both the senior living and multifamily programs. In both years, HUD began to reach the limit of its commitment authority at the end of its Q3.

Fannie Mae/Freddie Mac Financing

In 2012, **Fannie Mae**'s $1.2 billion in seniors housing financing was just 3.5% of its multifamily portfolio; **Freddie Mac**'s $650 million of seniors housing financing that year was just 2.25% of its $28.8 billion multifamily portfolio. Yet, Fannie and Freddie are premier financing options for large seniors housing organizations, according to James Sherman, Executive Vice President— Seniors Housing for **Beech Street Capital** in Bethesda, Maryland.

Freestanding independent living, assisted living, or memory care properties—or any combination thereof—are eligible for Fannie Mae/Freddie Mac financing as long as they don't accept more than 20% Medicaid-eligible residents (without a waiver from the state). In addition to housing, eligible properties must provide care, meals, and assistance with daily living needs. Skilled nursing facilities are not eligible.

Sponsors must have a minimum five years' experience owning/operating a minimum of five seniors housing properties, although those requirements are sometimes waived. Borrowers must exhibit financial strength commensurate with the size of the loan and the overall risk level of the transaction. Both the sponsor and the manager of the property must demonstrate profitability at levels that indicate long-term viability, including sufficient liquidity and reserves beyond those required by covenants.

The typical agency borrower is a single-asset, single-purpose entity. Loan amounts, which start at $2 million, average about $10–12 million and have a maximum loan-to-value rate of 75%. Maturities vary from five to 30 years. Fannie also has a competitively priced 12-year loan program. Debt-service coverage ratios vary by the type of property; the lowest is for independent living (min. 1.30x). Borrowers can choose a fixed-rate or an adjustable-rate program, taxable or tax-exempt. The adjustable rate structures have conversion rights with no penalties. “When the markets are fairly stable, a lot of borrowers use the adjustable-rate program with the idea of converting to a fixed rate at some time in the future,” Sherman said. Escrow is required at closing for insurance, real estate, special assessments, and repairs. Any repairs must be completed within 12 months of closing.

Individual loans are funded by the lender with a Fannie or Freddie guarantee. And compared to HUD, the execution of the transaction can be much quicker—typically closing within 75 to 90 days.

> *“REITs are the X factor. With their capital availability, REITs ultimately will be the big driver of cap rates for everyone.”*
>
> *—Imran Javaid*

“Fannie Mae and Freddie Mac programs are viable,” said Sherman. “The two agencies are committed to the industry and are not slowing down despite a 10% mandated reduction—some of which is occurring through general market conditions such as insurance companies stepping in.” In recent months, too, Fannie and Freddie have paid back quite a bit of money to the government. While those funds weren’t used to reduce outstanding debt, they were considered a dividend payment.

The question now is whether those high earnings from the multifamily and seniors housing programs will expedite or slow down reform. “It’s not clear which will be the case,” he said. “The government would like to continue to receive those funds. And given the other issues pending in Congress, proposed legislative changes *(see box, p. 6)* may be several years off.”

Conventional bank financing
Like agency financing, banks operate within a regulatory box. But banks have more flexibility to step outside the box for borrowers with whom the bank has had a longstanding relationship or track record, according to Imran Javaid, Managing Director for Healthcare Real Estate at **Capital One Bank** in Chevy Chase, Maryland.

"Banks today have money to lend—almost at 2008 levels—and most are looking to increase their exposure within the senior living sector," he said. Along with that increased interest, however, bank lenders are paying greater attention to borrower credit quality—both the quantitative aspects and, increasingly, the qualitative factors (e.g., clinical survey history compared to other operators). For the most part, too, banks still lend within their banking footprint.

Conventional bank financing currently requires a loan-to-value ratio of about 75% and occasionally 70%; the typical amortization is 25 years or less. Although uncommon, terms of seven to 10 years are increasing for newer, high-quality assets.

Construction lending is the most capital-constrained, particularly for independent living properties. Javaid views that as good news for borrowers, because it prevents overbuilding. When comparing inventory growth and absorption, the trends so far are positive. Construction dollars are most consistently available in the needs-based sectors—assisted living and freestanding memory care—and in metro markets where banking is fragmented. Banks also recognize that fill-up is slower than borrowers project or expect; so in order to avoid problems down the road, lenders are increasingly comfortable giving a four-year, rather than a three-year, term for construction loans.

Finally, banks don't like surprises. In fact, no lenders like surprises. If there are issues or there is negative news of any kind, borrowers should share that with lenders up front, Javaid advised. They always find out anyway and will respect the borrower who comes forward with issues sooner rather than later. And since borrowers need banks to step up and help when times are challenging, it's important to build good relationships during the good times.

"Manage those relationships, keep the lines of communication open, share the good and the bad, and don't be modest," he said. "Also, let lenders know what you're doing in terms of open houses, community events, and so forth. Quite frankly, bankers like that kind of stuff, too."

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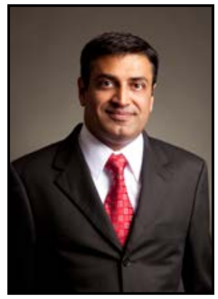

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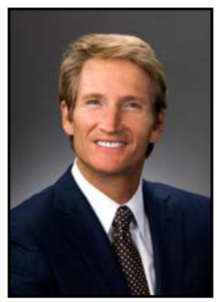

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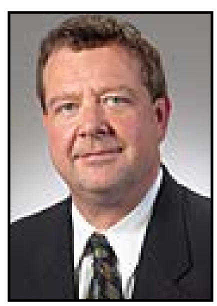

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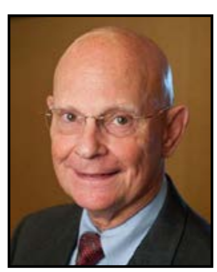

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