CAMBRIDGE
Senior Housing & Healthcare Capital
125 SOUTH WACKER DRIVE | SUITE 1800 | CHICAGO, IL 60606 | M 312-357-1601 | F 312-357-1611
WWW.CAMBRIDGECAP.COM

HUD 232 LEAN PROCESSING

Frequently Asked Questions

The Department of Housing and Urban Development recently modified their underwriting and processing of HUD 232 financing for senior housing and long-term care properties. In a historic move, the agency has moved from the Multifamily Accelerated Processing (MAP) and has embraced the LEAN management process. The goal of the "HUD 232 LEAN" program is to simplify the application process and substantially reduce the time it takes qualified borrowers to obtain funding. Cambridge embraces and supports these goals. The following questions were developed to help interested parties better understand this underwriting and loan processing program and explain how the HUD LEAN program and Cambridge can assist them in obtaining their financial goals.

SECTION 1: LEAN BASICS

1. **What is HUD LEAN? How was it developed?**
   LEAN is the processing system for all HUD 232/223(f) loans. The LEAN system was developed when FHA Commissioner Brian Montgomery made the decision to insert the highly touted "LEAN" management concept into the HUD system of processing and approving loan applications. The "LEAN" management process is driven by a few simple rules: all work should be highly specified as to content, sequences, timing and outcome, and every customer-supplier connection must be direct. Also, there needs to be an unambiguous "yes or no" way to send requests and receive responses. The pathway for every product and service must be simple and direct, and any improvements must be made in accordance with the scientific method under the guidance of a teacher at the lowest possible level in the organization. LEAN is aimed to eliminate historical inefficiencies in the processing and approval of HUD applications.

2. **I hear the process is more electronic. What does this mean?**
   HUD LEAN lenders submit applications electronically via Oracle Application Server Portal. This allows the application documents to be more accessible to the HUD underwriting team and for processing to be expedited.

3. **Can I get cash out under LEAN?**
   The same rules still apply under LEAN as they did for MAP: cash-out is not immediately available to borrower. However, borrowers can receive additional funds to make capital improvements to the facility being financed by HUD. Cash-out can be obtained in conjunction with a bridge loan after 24 months of seasoning.

4. **Will my local HUD office still exist?**
   Effective September 1, 2008, Multifamily Hubs and Program Centers no longer accept Section 232/223(f) applications.

5. **What is ORCF?**
   The Office of Residential Care Facilities (ORCF) was created to oversee every HUD-insured healthcare facility financing that is funded. The ORCF is comprised of individuals that are healthcare industry professionals hailing from several discipline backgrounds, i.e. valuation, architectural, mortgage credit, etc.

6. **What property types work for HUD LEAN?**
   Licensed senior housing and long-term care facilities, licensed skilled nursing, assisted living, and board and care facilities are eligible for HUD LEAN 232/223(f) financing. Facilities containing unlicensed independent units are eligible, as long as the number of these types of units is less than 25% of the total units in the facility.

SECTION 2: UNDERWRITING & DUE DILIGENCE

1. **Have the terms of the program changed under the LEAN program? Are any other terms changing (LTV, DSCR, etc)?**
   HUD's loan terms have not changed under the LEAN program. Maximum loan-to-value remains at 80% for for-profit mortgagors and 85% for nonprofit mortgagors. Minimum debt service requirements remain the same at 1.1765 for for-profit mortgagors and 1.11 for nonprofit mortgagors.

2. **Are there any restrictions on the payor mix or vacancy rates?**
   For existing properties, there is no change in the way that a facility's payor mix or vacancy rate is underwritten. Both conclusions must be supported by market data and the subject's operating history. The program still requires a minimum 5% vacancy and collection loss factor.

3. **Do appraisers utilize actual management fee expense or standard market management fee, which is typically 5.0% of revenues?**
   According to the Appraisal Statement of Work, "A management fee must be included in the expenses for determining overall market value. It should be supported by expense comparables with arm's length management agreements." Upward or downward adjustments can be made to the management fee by the lender if they are justified and supported by market data. In cases where a management agent review is required, the management fee approved by the Lender should be consistent with and supported by the market for similar types and sizes of facilities. In these cases, the underwritten net operating income should reflect the higher of market and the contracted fee.

4. **Does every deal get underwritten centrally in Washington D.C.?**
   No, all HUD deals are underwritten by HUD-approved LEAN lenders. The underwriting is submitted to HUD as part of the application.

5. **How has underwriting changed?**
   The two major changes to HUD underwriting are:
   1. Elimination of proprietary earnings adjustment. Lenders and appraisers no longer deduct proprietary earnings from a facility's NOI.
   2. Inclusion of Risk Analysis. The LEAN underwriting is more focused on the operator. If the Risk Factors are identified, the lender must provide sufficient justification / mitigation to support the additional risk associated with the loan. These risk factors are:
      a. If the loan exceeds 80% of the underwritten value.
      b. If the debt service coverage of the loan is less than (a) 1.45 for skilled nursing;

(b) 1.30 for assisted living; or, (c) 1.25 for independent or board and care facilities.

6. **FHA now accepts fair market value appraisals vs. FHA-specific appraisals. This should reduce costs to borrower? Can I use my old appraisal under LEAN?**
   Expenses have not changed for LEAN appraisals. The same appraisal standards that applied under MAP apply under LEAN. Also, a previous appraisal may be used if it is a LEAN-approved appraiser, and the date of valuation may not be more than 180 days prior to the date Lender makes application to HUD/FHA.

7. **Does the same due diligence process still apply (i.e. appraisal, Phase I, PCNA, etc.)?**
   HUD LEAN projects still require the same third-party reports.

SECTION 3: PROCESSING

1. **How are LEAN applications submitted and reviewed?**
   Electronic applications are submitted to the ORCF. Team members will access the applications remotely via Oracle platform. This creates a "virtual" office. All funding decisions are made by the ORCF.

2. **How is the LEAN process different from the former MAP process?**
   The most significant improvements:
   a. Improvements in underwriting. HUD LEAN underwriters are specifically focused on and have experience with senior housing and health care facilities.
   b. Simplified appraisal process. Fair market value appraisals are now acceptable.
   c. Elimination of proprietary earnings adjustment.
      i. Elimination of proprietary earnings adjustment makes HUD lending more user-friendly.
      ii. HUD previously required proprietary earnings adjustment of 15% – 25% for skilled nursing and 10 – 15% for assisted living. This adjustment was deducted from the NOI and could impact valuation.

3. **How does the LEAN process affect construction projects? Is the construction program affected?**
   Effective March 1, 2009, all other Section 232 loans (including new construction, substantial rehabilitation, supplemental loans, operating loss loans, and Section 223(a)(7) loans) are being processed under HUD LEAN.

4. **How are the offices set up for processing? Can I submit a loan directly to HUD?**
   Presently, all LEAN applications are being submitted electronically to the ORCF in Washington, D.C. Applications must be submitted to HUD using a HUD-approved mortgagee such as Cambridge; borrowers cannot submit loans directly to HUD.

5. **Potential closing dates will be identified upon receipt of the FHA firm commitment for mortgage insurance. Does this mean we will know the actual closing date at time of commitment?**
   The legal review begins at the time an application is submitted to HUD, greatly expediting the closing process. This allows for closing dates to be identified and set at the time a firm commitment is issued.

6. **Which processing steps were modified?**

Several steps during the LEAN processing phase significantly improve turnaround time, resulting in a faster closing. A few of these major modifications include:

1. Legal review begins once the application is submitted to HUD. This step of the process historically took place later in the processing, and could significantly increase the time to set a closing date.
2. Many forms and certifications are now being combined as “Super Certifications.” This saves the lender and borrower a significant amount time in filling out forms.

7. What is the process for a loan to be approved? How many committees must sign off?

Each LEAN application must be signed off at three levels: by the LEAN team, by the ORCF, and by Legal. The approval process is as follows:

1. Lender submits application to the ORCF via internet portal and two hard copies. Simultaneously, the legal review begins.
2. The application is reviewed by a LEAN Team, including Valuation; Environmental; Mortgage Credit; and Architectural and Engineering.
3. Members of the LEAN team approve and sign off on the application.
4. ORCF approves and signs off on the application and issues a Firm Commitment.
5. The legal review is finalized.
6. Closing takes place.

SECTION 4: HUD LEAN – THEN & NOW

1. I have heard that LEAN deals are taking up to a year to close. What is HUD doing, if anything, to change this timing issue?

Due to the overwhelming demand for HUD LEAN financing, the ORCF contracted an underwriting firm in July 2011 to help to alleviate the queue buildup at the time, as well as prevent future application backlog. This has significantly shortened the processing time.

2. Is my debt eligible to be refinanced with a HUD loan?

Debt that is eligible to be refinanced by a HUD loan includes:

A. Any outstanding mortgage(s), including debt incurred in connection with the construction of the project, or with capital improvements made to the property.

B. Other recorded indebtedness such as mechanic's liens and tax liens, provided they did not result from personal obligations of the borrower.

C. Unrecorded debt directly connected with the project, supported by documentation from the borrower. In this case, the borrower must provide the lender with documentation that the debt is directly connected to the project. This includes indebtedness incurred from capital improvements or from advances made to cover operating deficits.

D. Must pass the two-year rule. This means that any recorded debt that is less than two years old will need to be investigated by HUD. Existing debt that provided the borrower with any cash-out must be seasoned for two years. No investigation is required for debt that is at least two years old.

3. What is HUD LEAN’s “queue” and how does it affect my deal?

Once a HUD LEAN application is received by the ORCF, it is placed in line behind the applications that were received before it. The applications in queue are waiting to be assigned to an underwriter. The underwriters take on the application in the order in which they are received. Once your HUD LEAN application has been submitted, your HUD lender has no control over the time to close.

4. **How many HUD LEAN deals have been closed? What has been Cambridge's success rate with HUD LEAN?**
   As of November 2012, Cambridge has completed 55 HUD-insured financings, totaling more than $478.6 million. Additionally, Cambridge was once again a leading lender during HUD LEAN's fiscal year that ended September 30, 2012, closing nearly 10% of the total LEAN dollar volume.

5. **Can I refinance my existing HUD mortgage with a lower interest rate? What are the benefits to the HUD 223(a)(7) program and will my deal be processed with all other HUD deals?**
   HUD 223(a)(7) transactions are being processed under the LEAN program, along with all other 232 deals. However, applications for (a)(7) financing are being given priority over all other 232 applications, and are put into their own, separate queue. With interest rates being historically low, the (a)(7) program is ideal for borrowers that are past their lockout period. Your HUD loan can be refinanced in a very short period of time with little to no out-of-pocket cash required from you.

6. **What changes will be taking place under the new HUD LEAN regulations in 2013?**
   1. Sometime in 2013, HUD will begin requiring operating financial statements. Operators will be required to submit quarterly and year-to-date operator-certified financial statements to both their lender, ands HUD. Annual audited financials will continue to be required on the mortgagor.

   2. REAC (Real Estate Assessment Center) inspections will no longer be routinely performed on skilled nursing and assisted living facilities that already have a reliable state or local government inspection system in place.

   3. For transactions which receive a firm commitment on or after April 9, 2013, an operator may not be able to withdraw funds if financial statements are not submitted in a timely manner, or if the financials reflect negative working capital.

   4. Operators of HUD LEAN financed projects are required to immediately provide HUD and the lender with any notification that has placed the licensure, a provider funding source (i.e. Medicare or Medicaid), and/or the ability to admit new residents at risk.

7. **What changes are taking place with HUD LEAN closing documents?**
   1. Effective Dates For New Docs

      a. Must be used if facility gets commitment on or after 4/9/2013
      b. Must be used for all applications on or after 7/12/2013
      c. Applications submitted between now and 7/12/2013 must include either all old documents or all new documents; cannot combine.

   2. Major changes

      a. <u>Inclusion of Operator's license as collateral for Security Agreement, whether or not Operator is an affiliate.</u>
      b. If Owner is also Operator, it must submit quarterly financial reports per Operator Regulatory

Agreement.

c. Non-profit borrowers must abide to special distribution constraints that don't apply to for profit borrowers if the loan is underwritten based on the more conservative numbers required for a for-profit borrower.
d. Owner must submit an annual financial audit within 90 days after the close of its fiscal year; Owners must obtain written cost estimates for work that costs more than 5 percent of the facility's Gross Annual Revenue; Owners must notify HUD and their lender within two days of any notices they receive that are G-Level or higher.
e. <u>All operators are required to create a Risk Management Program.</u>
f. <u>Operator must pledge its assets (rents, leases, government receivables, provider agreements and residential leases) as collateral to the Owner's loan, even if not related.</u>
g. Operator must provide notice of default under operating lease to lender in order to be valid.

FOR FURTHER DETAILS CONTACT:
Financing Information Group
CAMBRIDGE REALTY CAPITAL COMPANIES
125 South Wacker Drive – Suite 1800
Chicago, Illinois 60606
Telephone 312-357-1601 — Fax 312-357-1611
Email: info@cambridgecap.com
http://www.cambridgecap.com

Western Regional Office:
Hymie Barber
CATALYST/CAMBRIDGE HEALTHCARE FINANCE
4929 Wilshire Boulevard, Suite 701
Los Angeles, CA 90010-3824
(818)610-0750 x103
(818)692-0750 Cell
(310)388-9042 Fax
hbarber@crgcorp.com

N:\goldmine\FaxRush\Outfax\execshhc-hudLEANfaqs-Version 3 - DRAFT.doc