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Financing Seniors Housing for America

Take It To The (Upper Payment) Limit

Supplemental Revenue and Deal Structuring

Moderator: Alison Lemle, VIUM Capital

Panelist: Susan Gosselin, HUD, ORCF

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Panelist: JP LoMonaco, CBRE

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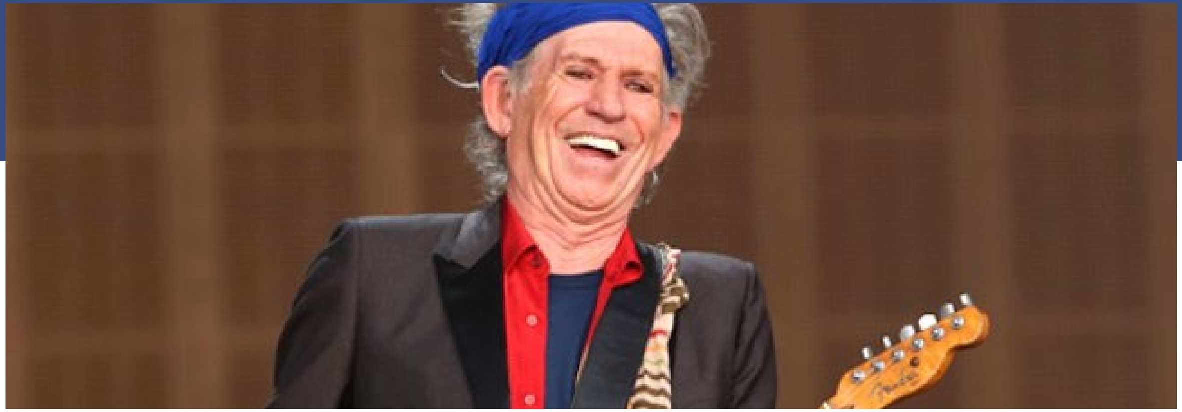
Discussion Topics:

- General Supplemental Revenue Overview (UPL, IGT, QIPP)
- Valuation / Underwriting of Supplemental Revenue (UPL, IGT, QIPP)
- Legal / Credit Risk for Transactions with Supplemental Revenue (UPL, IGT, QIPP)

Upper Payment Limit Program:

- Federal Regulations 447.272 allow states to claim federal matching funds under Medicaid up to what Medicare would pay for a similar service.
- Participation in state UPL programs for Skilled Nursing Facilities requires a partnership with a hospital.
  - In this structure, the hospital becomes the license holder
  - UPL funds are split between the facility operator and hospital
- The UPL Program creates a mutually beneficial relationship between the facility operator and hospital
  - Allows both parties to profit from synergies created and further improve post-acute outcomes.

Upper Payment Limit Program - Continued



- While participation in state UPL programs directly impacts facility level NOI through higher reimbursement, it can add complexities when looking at these transactions for HUD financing:
  - Valuation: How should UPL revenue be valued? How much is too much?
  - Transactions Participants: Who are the parties involved, and what are their roles?
  - Cash Flow: What does the flow of funds look like, and are project accounts appropriately protected?
- Tackling these matters early in the process is key to ensuring a smooth and low risk transaction.

Supplemental Revenue – Valuation

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UPL/IGT Valuation

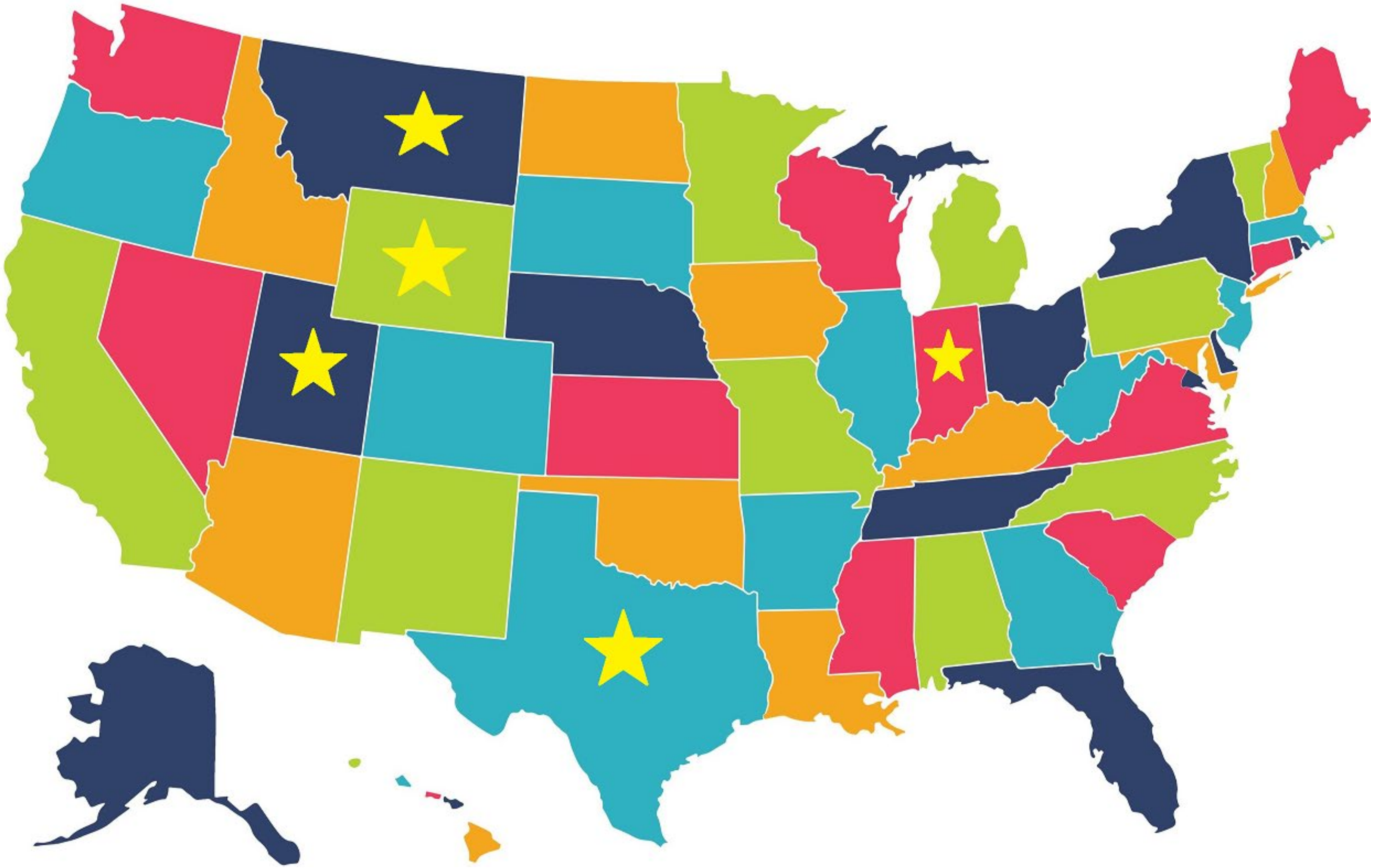
Keys to Understanding Value

- Been dazed and confused for so long it’s not true
- Lots of people talk and few of them know
- Don’t know where you’re going, only know just where you’ve been
- Oh, don’t leave me so confused

Back to Fundamentals

- Duration
- Quality (Risk)
- Amount

UPL/IGT Programs By State



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Texas Quality Incentive Payment Program (QIPP):

- QIPP program was created in 2017
- Approximately 900 facilities currently receive funding through the QIPP program
  - 600± NSGOs
  - 300± privately owned
- Trends: historically a 50/50 split between parties and now 70/30 split is more common
- Lenders influencing value through underwriting
- More value attributed to QIPP as the program ages
- Broker – 50% QIPP cash flow discount at normal cap
  - Equates to 25% effective cap rate or 4x
- Other Participants – 1x to 2x multiplier

Indiana Intergovernmental Transfer (IGT) Program

- The program was created in 2009
- Approximately 490 facilities currently receive funding
- Trends: historically a 50/50 split between parties and now 70/30 or even 80/20 split is more common
- Valuation multiples have decreased over time
  - 5+ years ago multiples were at 5x (20% cap rate)
  - Current multiples range from 1.5x to 3.0x (33% to 67% cap rate)

UPL/IGT State Programs - Continued

- Utah
  - Created in 2016
  - Approximately 65 facilities participate in the program (compared to 90 total facilities in the state)
- Montana
  - Typically, the IGT reimbursement is small ($2.00 to $4.00 per day)
  - No recent Montana cash flow transactions
- Wyoming
  - Created in 2017
  - 13 facilities participate in the program (compared to 26 total facilities in the state)

Supplemental Revenue – Underwriting Considerations

Supplemental Revenue – Underwriting Considerations

- ORCF wants to see a market appraisal/valuation for application submission, but stresses the importance of conservative underwriting and loan sizing with regards to supplemental income sources such as UPL, IGT, QIPP, etc.
- ORCF started to see applications where the supplemental revenue component of value represented 20%-50% of total value, and the transactions were sized at 80% LTV. This was viewed to be a heightened credit risk.
- Supplemental Revenue programs can vary by state, and it is important to evaluate the revenue based on specific ORCF guidance.
- Successful applications have between <u>**10%-15%**</u> of supplemental revenue as a percentage of value for loan sizing.

Supplemental Revenue – ORCF Guidance By State

State	Guidance
Indiana Utah Wyoming Montana	• IGT/UPL Income must be capped separately. • The income cannot be used in debt service calculations. • Successful applications have less than 10%-15% of supplemental revenue as a percentage of value for loan sizing. • The IGT/UPL chart must be included in the Lender Narrative.
Texas	• Quality Incentive Payment Program (QIPP) • QIPP revenue must be capped separately. • The income cannot be used in debt service calculations. • Successful applications have less than 10%-15% of supplemental revenue as a percentage of value for loan sizing. • The IGT/UPL chart must be included in the Lender Narrative.
California	• Quality Accountability Supplemental Payment Program (QASP) • QASP has no association with a hospital and is a quality related income stream. • It does not need to be considered separately for valuation/underwriting and an be included as part of the operating revenue stream for value/debt service. • The IGT/UPL chart is not required.
Michigan	• Quality Measure Incentive (QMI) • QMI is a fund paid by the facilities with Medicaid beds. Funds are redistributed to facilities based on quality measures. o Appraised NOI: QMI revenue and expenses included in NOI. No separate capitalization of revenue required. o DSC NOI: Lender should adjust NOI to remove QMI revenue while maintaining expenses. o Historic NOI: The historic years can reflect actual QMI revenue and expenses. • The IGT/UPL chart is not required.

Supplemental Revenue – Underwriting Considerations

Appraised Value	$ 33,700,000
Appraisal Cap Rate	12.25%
Appraisal LTV	65.3%
Beds	110
Appraisal NOI	$ 3,006,010
Less: IGT/UPL Funds	
Adjusted NOI	$ 3,006,010
Adjusted Cap Rate	12.25%
Adjusted Value before IGT/UPL Payment	$ 24,500,000
IGT/UPL Payment	$ 2,770,000
Adjusted IGT/UPL Cap Rate	30%
Adjusted Value for IG/UPL Payment	9,200,000
Aggregate Value	$ 33,700,000
Per Bed Value	$ 306,364
HUD Underwritten Loan Amount	$ 22,000,000
Adjusted LTV	**65.3%**
IGT/UPL Value as a % of Overall Value	**27.3%**

ORCF IGT/UPL Chart

Example Transaction

- 110-bed facility located in Indiana
- Proposed Loan Amount: $22.0MM
- Core Value (Excluding UPL): $24.5MM
- UPL Value - Appraisal: $9.2MM
- Total Appraised Value: $33.7MM

Is this Acceptable?

No!

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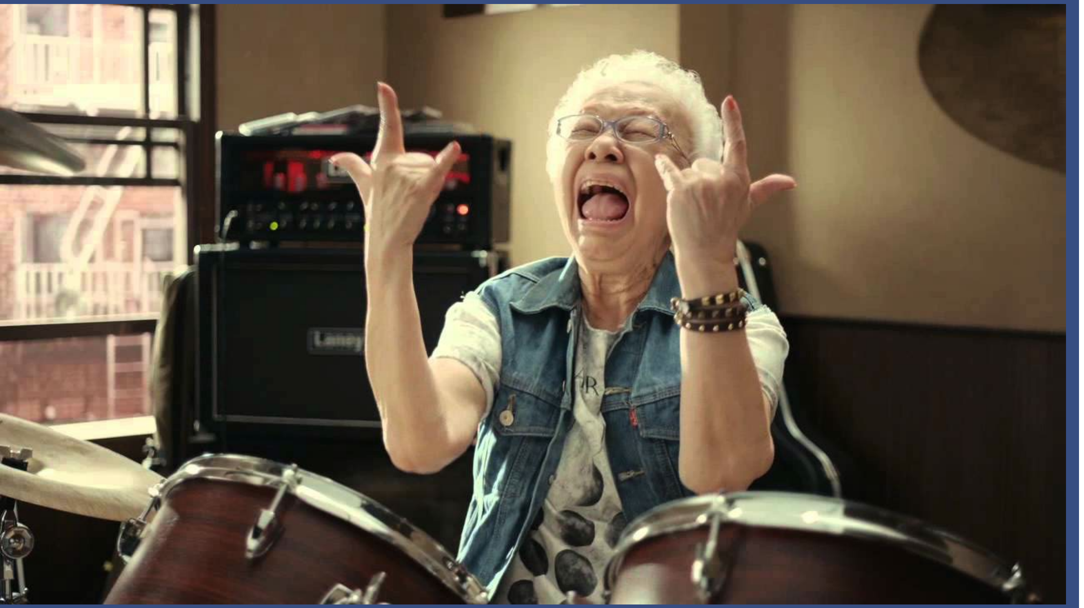
IGT/UPL Payment	$ 2,770,000
Adjusted IGT/UPL Cap Rate	30%
Adjusted Value for IG/UPL Payment	9,200,000
Adjusted IGT / UPL Value (11% of total)	$ 3,028,090
Aggregate Value - Appraisal	$ 33,700,000
Per Bed Value	$ 306,364
Aggregate Value - Adjusted	$ 27,500,000
HUD Underwritten Loan Amount	$ 22,000,000
Adjusted LTV	**80.0%**
IGT/UPL Value as a % of Overall Value	**11.0%**

- Although the value is considered market by the appraiser, the Lender must conservatize UPL valuation to be within ORCF acceptable limits.
  - UPL Value constrained at 11% total valuation
  - Overall Underwritten Valuation reduced to $27.5MM (from $33.7MM)
  - Underwritten LTV 80%
  - Because the subject participates in the Indiana UPL program, the supplemental revenue must be removed for the DSCR constraint:

Overall Revenue	**$ 16,836,004**
IGT/UPL Revenue - TTM	**$ 3,046,126**
IGT/UPL Revenue as a % of overall Revenue	**18.09%**
DSCR Excluding IGT/UPL Funds	
HUD Loan Amount	$ 22,000,000
Loan Term (Years)	35
Market Interest Rate	6.50%
MIP	0.65%
Annual D.S.	$ 1,737,967
D.S. NOI	$ 5,679,675
Less: IGT/UPL Payment	$ (3,046,126)
Adjusted D.S. NOI	$ 2,633,549
DSCR Excluding IGT/UPL Funds	**1.52x**



Supplemental Revenue Underwriting Tools/Guidance:

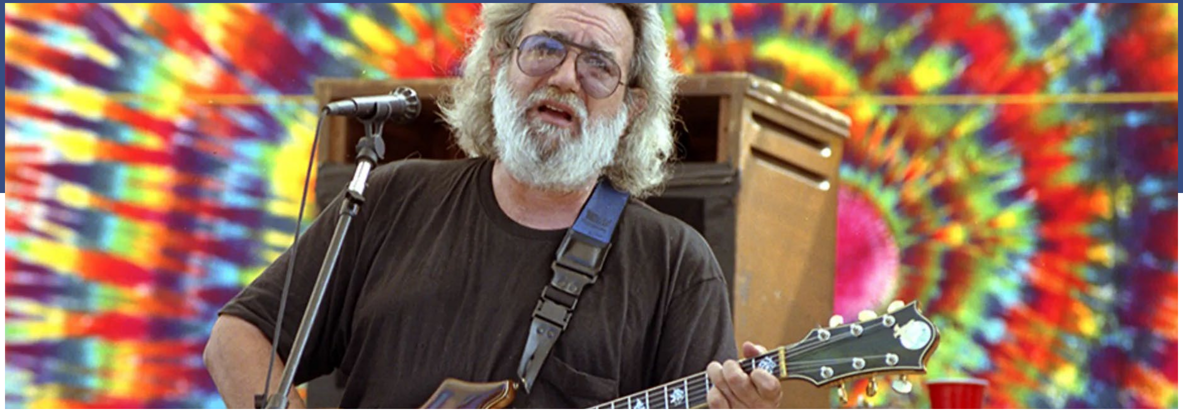
- Supplemental Revenue Chart: IGT_UPL_chart.xlsx (live.com)
- Supplemental Payment Revenue Guidance: SuppRevGuide.docx (live.com)
- Lean Blasts – Supplemental Revenue Guidance:
  - June 27, 2012
  - June 24, 2015
  - February 24, 2021
  - June 30, 2021

Legal Considerations and Risk Mitigation

Discussed in this Section:

- IGT/UPL/QIPP Legal Highlights
- Management Agent Identity and Responsibilities
- Properly Securing Collateral for HUD loans
- Cash Flow Structures and Considerations
- Accounts Receivable Financing

IGT/UPL/QIPP Legal Highlights



Hospital Partner acts as the licensed operator

- The hospital partner will hold the facility's license
- IGT payments are made by the hospital partner
- IGT receipts, including all supplemental IGT payments, are received by the hospital partner in a single comingled account
- The facility's deposit accounts will also be owned by the hospital partner, though separate from the IGT depository accounts
- Typically, the hospital operator does **not** handle the day-to-day operations of the facility

"Facility Operator" handles all or the majority of the day-to-day operations

- The "facility operator" will typically be both an "operator" as HUD defines it, and the facility's management agent under a management agreement
- The "facility operator" is also often the hospital partner's landlord under a sublease or sub-sublease
- The "facility operator" will not typically own the facility's deposit account, but will often maintain operating accounts, payroll accounts, and other accounts utilized in the operation of the facility

Management Agent Identity and Responsibilities

Management Agent as Landlord

- Under this structure:
  - the “facility operator” is the hospital partner’s landlord under a lease, sublease, or sub-sublease, and
  - the “facility operator” is the facility’s management agent under a management agreement
- In some relationships there will be additional documentation such as licensing agreements to move cash from the hospital partner to the Management Agent
- The “facility operator” receives all project revenues under these agreements with the exception of the hospital partner’s portion of the supplemental IGT payments

Management Agent as “True” Management Agent

- Under this structure:
  - the “facility operator” is the facility’s management agent under a management agreement, but
  - The FHA borrower or its tenant will have a lease to the hospital partner.
- The FHA borrower or its tenant receives solely a lease payment from the hospital partner
- The “facility operator” receives all *remaining* project revenues after the lease payment has been made and the hospital partner has taken its portion of the supplemental IGT payments

Properly Securing Collateral for HUD Loan

Securing Hospital Collateral Generally

- The hospital partner will need to enter in the full “suite” of operator HUD loan documents, including but not limited to the operator regulatory agreement, operator security agreement, operator ALR, and lease SNDA
- In some states, securing the assets of hospital authorities is not governed by the UCC
- In states where securing the assets of hospital authorities is not governed by the UCC, the hospital authorizing resolution is critical to properly secure the lien of the FHA loan in the hospital’s records
- UCC-1 Financing Statements are still recorded for notice purposes

Additional Security Considerations

- Hospital partners can not be SPE’s, meaning lien searches will often return many other liens against hospital assets.
- In addition to traditional lien searches, the hospital partner’s opinion counsel should review the hospital’s records to confirm no other liens against the FHA loan collateral.
- In addition to the facility’s non-government receivables accounts, most transactions will have 1 to 3 additional accounts that require control agreements, including 1 on the account where the hospital first transfers the facility funds.

Cash Flow Structures and Considerations

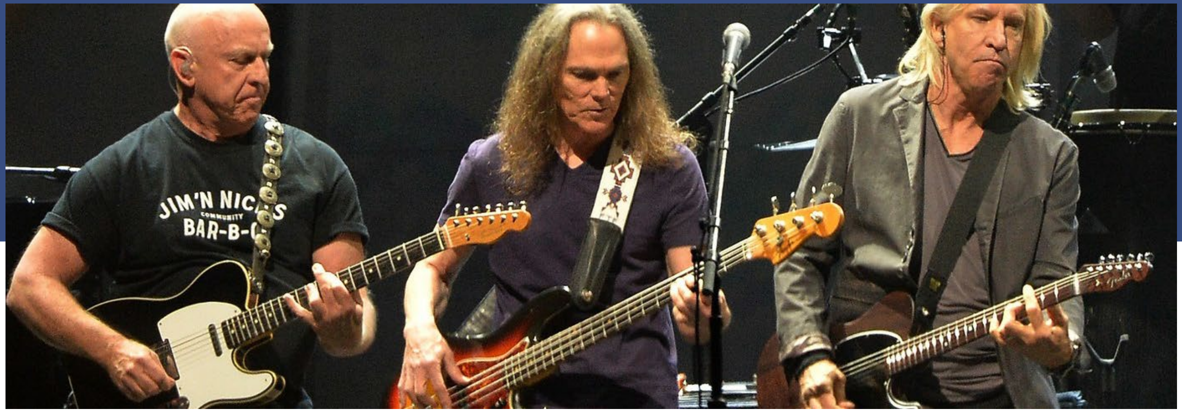
Regulatory Considerations

- All projects' assets must be subject to first lien of FHA loan – including IGT funds.
- HUD has granted regulatory waiver to permit FHA loan closings without a DACA on the hospital's partner commingled IGT account
- However, all facility specific IGT funds must flow through an account subject to a DACA
- The hospital operator security agreement should include a provision that ensures the hospital will transfer the facility's supplemental IGT funds to an account subject to a DACA

Cash Flow Considerations

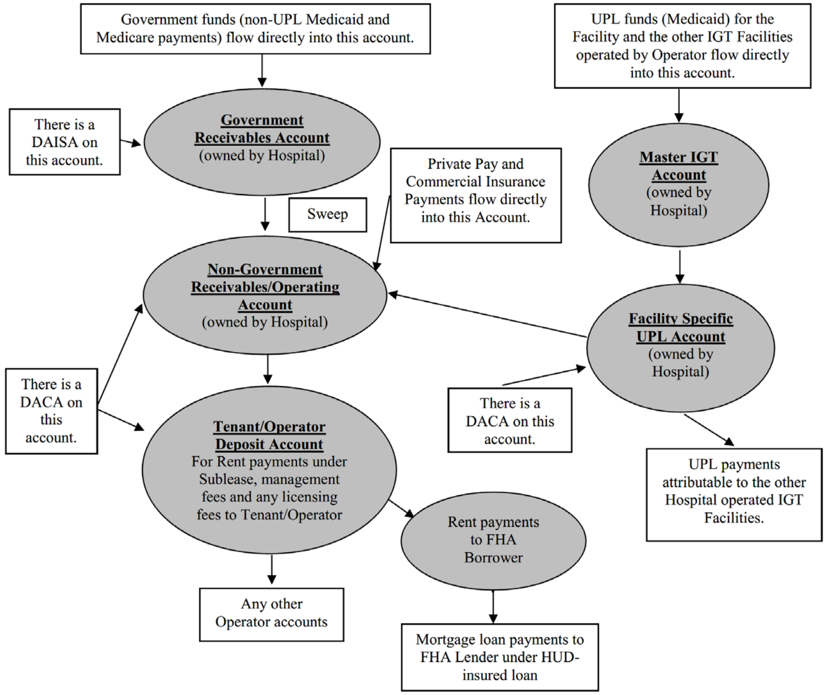
- Some projects set up facility specific IGT account subject a DACA, where they then withdraw their share and transfer the rest to the facility non-government receivables account
- Some projects run all IGT funds through the facility non-government receivables account and then withdraw their share of the supplemental IGT from that account
- The accounts into which the hospital first transfers funds – whether with a landlord/sublandlord or with a management agent – should also be into an account subject to a DACA

Cash Flow Examples



- The FHA Borrower leases the facility to a tenant operator.
- The tenant subleases the facility to the hospital partner. The hospital partner also enters into a management agreement with the tenant.
- All facility deposits are made into hospital partner held accounts, which are subject to a DACA or DAISA.
- The hospital partner pays all lease rents and management fees to the tenant into a single account, which is also subject to a DACA.

Cash Flow Chart



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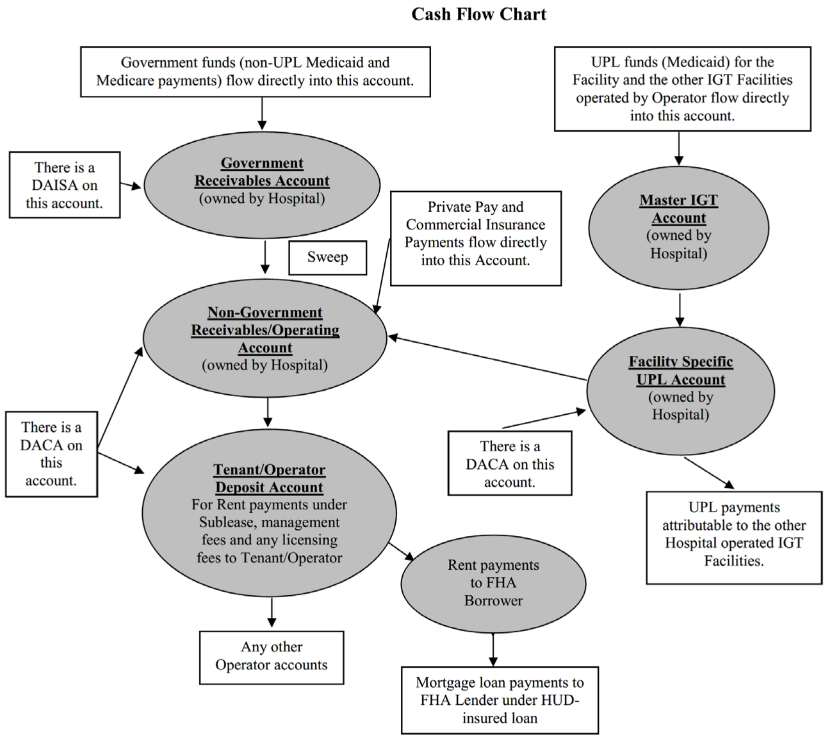
Cash Flow Examples

- The FHA Borrower leases the facility to the hospital partner. The hospital partner enters into a management agreement with the management agent.
- All facility deposits are made into hospital partner held accounts, which are subject to a DACA or DAISA.
- The hospital partner pays all lease rents into an account held by the FHA borrower and all management fees into an account held by the management agent. The management agent account is subject to a DACA.



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Accounts Receivable Financing

- Accounts Receivable Financing lines are less common but not unheard of in IGT transactions
- A HUD-compliant Accounts Receivable Financing line will typically either:
  - Require the hospital partner to pledge its receivables for the accounts receiving financing line, or
  - Have a borrowing base limited to management agreement (and any related document) receivables.
- A modified version of the HUD-form intercreditor is still required under either type of line.

ORCF Perspective – Credit Risks

Supplemental Revenue – ORCF Concerns

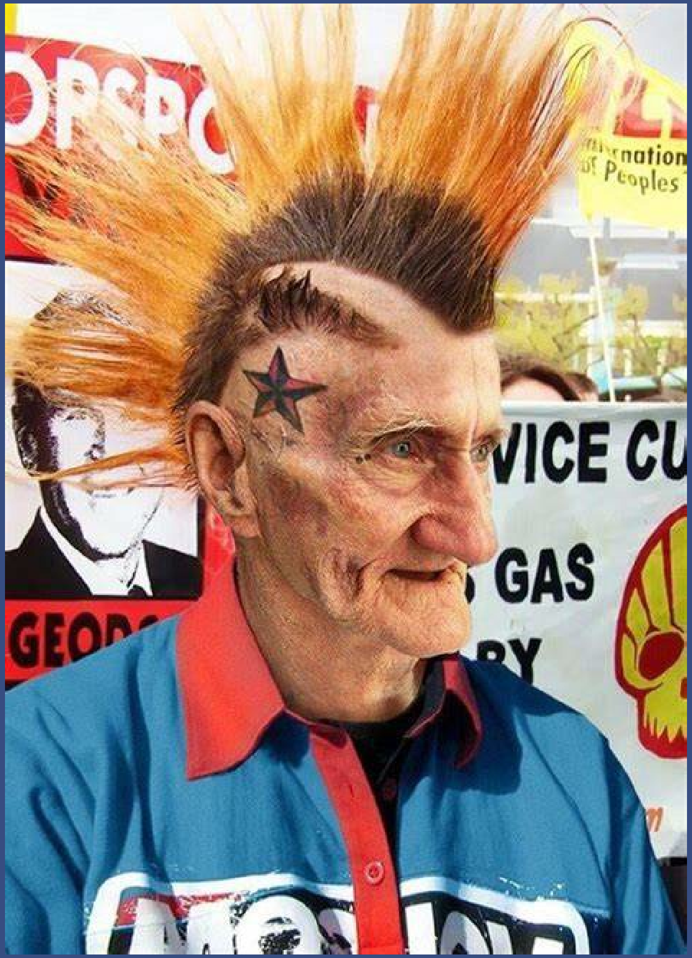
Credit Risks:

- Valuation: Applications submitted with UPL value representing 20%-50% of total value at 80% LTV.
- Dissolution of Hospital Relationship: Although generally a mutually beneficial arrangement, a termination of relationship can result in significant loss of revenue/value.
- Revenue as Credit Enhancement: If the revenue stream is not sufficiently tied to the project, there is a risk it is unavailable for project operations.

Legal Risks:

- Supplemental Revenue as Collateral: Risk that these funds are not sufficiently covered under the Security Agreement (or other relevant documents).
- Flow of Funds Adequately Covered: Risk that loan documents ensure that all funds are directed to debt service payments and other operating expenses as a priority prior to disbursement to sub-Operator / Management Agent.

If Credit and Legal Risks are not sufficiently addressed, there can be issues…



When things go wrong….

- 5-facility 232/223(f) portfolio of SNF's consisting of 611-beds
- Originally closed in 2016 and were all under a Master Lease
- Four of the five facilities participated in the State of Texas Quality Incentive Payment Program (QIPP)
- Underwriting Metrics:
  - Average LTV: 78.8%
  - DSCR: 2.09x
  - QIPP excluded in underwriting and value
- Hospital participant named on the license and served as the Operator.
- Non-IOI sub-Operator / Management Agent

Supplemental Revenue – ORCF Concerns

When things go wrong….continued

- September 2019:
  - Project A closes due to license revocation
  - Project A goes into default and stops operations
  - Non-IOI Operator/Management Agent abandons all five facilities
  - The facilities fall behind on mortgage payments and all loans go into default

- QIPP Revenue was never used to cure the default as no QIPP revenue made it to the borrower

The Workout

- 232/223(a)(7)s were completed in 2022 to restructure the existing debt.
    - $3.9M UPB on Project A was paid off
    - Project B default was cured
    - Three of the four operating projects were able to correct their default, but not resume making full R4R deposits
    - 2 of the 4 operating projects were operating below 1.11x DSCR w/o QIPP
    - Remaining portfolio DSCR w/o QIPP = 1.38x (5.5%)
    - Remaining portfolio DSCR w/ QIPP = 2.09x
    - Required the Management Agent entity to sign the Operator Regulatory Agreement, in addition to the Management Agreement

Supplemental Revenue – ORCF Concerns

The Good:

- Original underwriting was conservative, and QIPP was not utilized for value or debt service.
- The workout ensured new Management Agent entered into the Operator Regulatory Agreement, curing the original issue.

What could have been done better?

- More diligent focus on flow of funds / project accounts.
- Better understanding of the key participants and ensuring those parties executed appropriate loan documents.

Questions?