

LEAN 232 UNDERWRITING 101

Mortgage Credit Analysis: Identifying and Determining Acceptability of Key Participants

Presented by:



Talel Aïssi
VP, Lean Underwriter
Lument



Kelly Cush
SVP, Chief Underwriter
Walker & Dunlop



Sam Love
VP, Deputy Chief Underwriter
Walker & Dunlop

Agenda:



- Mortgage Credit Overview
- Organizational Structures and Identifying the Principals
- The Credit Investigation
- Experience of Participants
- Participant Financial Review
- Q & A

Mortgage Credit Overview

Purpose and Overall Requirements

A key component of the underwriting process is to assess the Borrower's and/or Operator's ability to own and operate the HUD-Insured project. This involves evaluating the experience and financial condition of the Borrower and its principals, the Operator, the Management Agent, and other participants, as applicable. As such, the Lender is responsible for:

- Identifying the Borrower, Operator, Parent of the Operator, Management Agent, General Contractor, (as applicable), and each of their respective principals
- Analyzing the creditworthiness of all applicable parties
- Review the experience and qualifications of all applicable parties
- Determine the financial capability of the HUD Borrower entity and the General Contractor (if applicable)

Key Components of a Mortgage Credit Review

- Review of Organizational Documents and Organizational Structures:
 - To determine Principal Ownership Interest / Entity type
 - To Identify the Key Principals / Controlling Participants in a transaction for underwriting purposes and for previous participation review
- Credit Investigation
- Participant Experience
- Participant Financial Review

Review of Organizational Structures/Documents

Identifying the Key Principals

Requirements for HUD Borrower Entities:

- Must be a single-asset entity (SAE)
- Acceptable types of entities:
 - General Partnership (GP)
 - Limited Partnership (LP)
 - Corporation, C Corporation, or S Corporation
 - Limited Liability Company (LLC)
 - Trust
 - Non-Profit Corporation
 - Any other public or private single-asset entity
 - Any combination of the above ownership forms used to establish a joint venture
- Must be registered in the United States, and at least one principal w/ decision-making authority must be a U.S. citizen



PROHIBITED STRUCTURES:

A healthcare facility may not be directly owned by:

- Natural persons/individuals
- REITs
- Tenants-in-common (TIC)
- Delaware Statutory Trusts

Requirements for HUD Borrower Entities:

- Entity's org. docs must contain certain HUD-required provisions
- Entity must be in existence for at least as long as the term of the proposed HUD loan
- Entity must have the authority to complete the loan transaction
- Once the HUD loan closes, HUD's approval is required for:
 - Any amendments to the org. docs
 - The addition of any partners/members/investors
- Org. docs cannot conflict with HUD's loan documents
- Entity cannot distribute funds out of the HUD-insured project until after all project and loan obligations have been met

Requirements for HUD Operator Entities:

- Must be a single-purpose entity (SPE) unless under certain circumstances pursuant to Lean Handbook Section II, Ch. 2.5-C
- Acceptable types of entities – same as those listed for Borrower
- Entity's org. docs must contain HUD-required provisions
- Once the HUD loan closes, HUD's approval is required for:
 - Any amendments to the org. docs
 - The addition of any partners/members/investors
- Org. docs cannot conflict with HUD's loan documents

Identifying Principals:

HUD defines Principals as individual(s) and entity(ies) who exercise operational and/or financial control over a project.

1. Operational Control = Any entity or person with decision-making authority on behalf of the entity (such as a Manager, Managing Member, Board Member, etc.); has a controlling interest (majority vote) in the entity; Member that is heavily involved in oversight of the day-to-day operations of the residential care facility (key decision-maker)
2. Financial Control = Any entity or person providing financial sponsorship for the project; has majority ownership/shareholder interest in the HUD Borrowing entity:
 - Greater than 10.00% ownership interest in a corporation
 - Greater than 25.00% ownership interest in an LLC or LP

Identifying Principals (Cont.):

- Lenders must consider Principals in the following contexts:
 1. Individuals or entities who possess financial and/or legal control of the Borrower, thereby requiring financial and credit analysis.
 2. Individuals or entities who will execute Section 38 of the HUD Regulatory Agreement (also requiring financial and credit analysis).
 3. Individuals or entities who must disclose for HUD Previous Participation Certification review.
- Two types of participants:
 1. Principal (Active/Controlling Participant)
 2. Non-Principal (Passive Participant)

Determining Active vs. Passive Participants:

- Identify how the property is owned and understand all layers of the ownership structure
- Identify the Principal's experience and qualifications in owning, operating, and/or managing healthcare properties
- Identify who has decision-making authority/operational control – Examples might include principals who:
 - Develop and approve the annual budget
 - Has approval authority for significant expenses, financing decisions, dissolution of the entity
 - Has authority to engage in/execute contracts with vendors, suppliers, management agents, etc.
 - Appoints staff or delegates decision-making authority
- Identify who is providing financial sponsorship **SL1** the HUD Borrowing entity

SL1 And has financial control
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The Credit Investigation

Mortgage Credit Reports (Entities):

- Entities (Borrower, Operator, Management Agent, Principals, GC, etc.)
 - Shows the credit risk of the entity through providing a record of financial history with creditors
 - Shows creditworthiness and financial trends of entity participants in the transaction
 - Can help compare financial history with provided facility financials as well as legal history (suits/claims/judgments) listed on the loss runs or answered in the Certifications
 - A commercial credit report must be ordered (Dun & Bradstreet, etc.)
 - Cannot exceed 60 days by the date of application submission
 - The Sponsor does not have to have previous HUD experience
 - Projects are NA if the Borrower, Operator, or affiliates have had a bankruptcy in the past 5 years (filed or emerged from bankruptcy)
 - Underwriter should investigate any adverse findings of the credit search results
 - Credit reports for 10% of the entity's Other Business Concerns must be pulled and analyzed
 - Look for federal debt defaults, suits, liens, judgements, etc.

Mortgage Credit Reports (Individuals):

- Principal Individuals
 - Shows creditworthiness and credit history of individual participants in the transaction
 - A residential mortgage credit report must be ordered (Xactus, etc.) that pulls credit scores from the three large credit bureaus (TransUnion, Experian, Equifax)
 - Cannot exceed 60 days by the date of application submission
 - The Sponsor does not have to have previous HUD experience
 - Projects are NA if the Borrower, Operator, or affiliates have had a bankruptcy in the past 5 years (filed or emerged from bankruptcy)
 - Underwriter should investigate any adverse findings of the credit search results
 - Credit reports for 10% of the individual's Other Business Concerns must be pulled and analyzed
 - Look for federal debt defaults, suits, liens, judgments, etc.

Additional Diligence

- Additional Mortgage Credit Searches to include in the Lender Narrative
- Internet Searches (Google, Yahoo, etc.):
 - Search: Facility Name, Borrower, Operator, Management Agent, Principals of the Borrower, Parent of the Operator and Management Agent, GC, Parent Organizations
 - Use search terms (suits, abuse, claim, judgment, accident, death, etc.)
- Department of Justice (DOJ) Website:
 - Search the DOJ website for controlling principals and the facility name. Investigate any adverse findings.
- OFAC Terrorism Check, HUD Limited Denial of Participation List (LDP), and System for Award Management (SAM) searches must also be completed for Active/Controlling Principals/Section 38 Signors.

Experience of the Participants

Experience of Participants:

- For Borrower, Principals of the Borrower, Operator, Parent of the Operator, Management Agent and GC entities:
 - HUD experience is typically a strength to the transaction (check REAC scores, Management Reviews and APPS flags) along with the 2530/APPS/Previous Participation provided
 - The Sponsor does not have to have previous HUD experience
 - Type and size of previous residential care facilities for previous participation
 - Review the geographic area of facility of portfolios
 - Length of time particularly under operations - also check development and ownership experience
 - The Principals' resumes should list out roles and time periods in the residential healthcare industry
 - Some Principals will have a more passive role in the transaction with minimal experience, which is acceptable as long as there are Principals with the requisite experience
 - Operator/Management Agent Principals must have at least 3 years of experience participating in multiple properties that are similar to the subject property.

Participant Financial Review

Financial Statement Analysis:

- Generally, an analysis of the Borrower and Operator Financial Statement history for 4 periods (ex. last three fiscal years and one T-12 period or as far back as the entity has existed). Can also include Parent of Operator and General Contractor Financials.
- Personal financial statements of individual Principals are typically not required unless the transaction is a 232 new construction or sub rehab project (includes 241a's). The Lender would review the following:
 - Net Worth (Total Assets – Total Liabilities = Net Worth)
 - Liquidity/Working Capital (Current Assets – Current Liabilities = Working Capital)
 - Capacity to Meet Cash Requirements
 - Ability to support the project financially over the long term.
- The financial statement should be no more than 90 days old by the time HUD is ready to go to Loan Committee (especially for OpCo financials)
- Financial Statement Certifications for each entity submitting financials must be provided for the project.
- Financial Statements must be certified along with providing a statement of changes if financials are audited.

Borrower Financial Statements:

- Typically Balance Sheets and Income Statements are provided for the Lender's analysis. Accounts Receivable and Accounts Payable schedules can be provided but are generally relevant for the Operator entity.
- Balance Sheet Review:
 - Working Capital/Liquidity
 - Owners' Equity
 - Capacity to Meet Cash Requirements
 - Ability to support the project financially over the long term.
 - Any line items not tied to the subject facility?
- Income Statement Review:
 - Net Operating Income (before depreciation/amortization) – check for a loss prior depreciation/amortization.
 - Check for any line items (typically under expenses) that are tied to the operations of the facility (insurance, real estate taxes, etc.)
 - Any negative or declining NOI trends over the periods provided?

Operator Financial Statements:

- Balance Sheets and Income Statements are typically provided for the Lender's analysis along with Accounts Receivable (AR) and Accounts Payable (AP) schedules.
- Typically NA for SNFs, but are there any issues or discrepancies related to tenant deposit accounts (e.g., not fully funded)?
- AR and AP Review
 - AP – any material accounts payables (in excess of 5% of EGI) over 90 days?
 - AR – any material accounts receivables (in excess of 2% of EGI) over 120 days?
- Balance Sheet Review:
 - Working Capital/Liquidity
 - Owners' Equity
 - Capacity to Meet Cash Requirements
 - Ability to support the project financially over the long term.
- Income Statement Review:
 - Net Operating Income (before depreciation/amortization) – check for a loss prior to depreciation/amortization
 - Any negative or declining NOI trends over the periods provided?

Parent of the Operator and GC Financial Statements:

- Similar Financial Analysis Lender Narrative questions to the Borrower and Operator entities
- Parent of the Operator Financials
 - Should be a roll up of the operations of the facilities that flow up to the Parent of the Operator entity (ex. Balance Sheets and Income Statements can have each property broken out with a total roll up column of all facilities)
- General Contractor Financials
 - Working Capital is a large component of the financial analysis. Does the GC have less than 5% adjusted working capital of the estimated contract of the project? Detail out any adjustments made to the analysis.
 - Work-in-Progress Schedule must also be provided to demonstrate the 5% adjusted working capital for all contract balances that are less than 90% complete.
 - 5% of Working Capital for Other Work in Progress and 5% of Working Capital for the subject is reduced from the GC's Balance Sheet Working Capital (Current Assets – Current Liabilities) to get to the adjusted WC amount.
 - For HUD's comfort, if the adjusted working capital is below the threshold, an assurance of completion in the form of a performance surety bond can be presented as well as presenting proof of lines of credit that the GC can access.

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QUESTIONS