



MEMORANDUM FOR: Minnesota MF Hub Lenders

SUBJECT: Underwriting Issues Clarification- Circular 03-06

Date: Drafted December 23, 2002; Issued April 10, 2003

After reading our December 19th Memorandum a few lenders requested clarification regarding how these Requirements relate to "Entry Care" (EC) segments of Section 232 proposals and the past review practices of this office.

First of all, EC units are not considered to be retirement service centers (ReSC's) by this office because the owner *must offer* a full meals program and minimal level of assistance with activities of daily living (3+ ADL's to qualify for admission as "frail elderly), including continuous protective oversight. Full staffing overhead is necessary in order to offer a full array of services and accommodate whatever ala carte choices are made at the EC levels. Also, because EC residents must need assistance with at least 3 ADL's, by definition, and are aging in place, it is not tenable that less professional health care staff (a large portion of the overhead) is necessary, on a stabilized basis, to meet the hypothetical average demand depicted in the stabilized revenue projection.

Finally, "continuous protective oversight" and "available services" means 3 shifts of administration around the clock must be staffed, and a full kitchen complement, regardless of the lowest acuity component's average meals and services intake. Initial Operating Deficit calculations may be affected (absorption rate increased) by a large segment of EC units, but little else in the underwriting is affected since FHA focuses on "stabilized" operations for the duration of the loan.

We require that lenders underwrite on the basis of average estimated consumption within *both* the revenue and expense projections, based on a snapshot of average resident acuity and management and staffing personnel to meet that future stabilized need. We believe that this provides a more accurate picture than to attempt the analysis or review of EC revenues and expenses ramp-up and maturation, patterns that are difficult to accurately predict. In other words, EC levels of charges on the revenue side can be misleading, since we know through experience that seasoned projects contain a much higher "typical" resident and user of services, and it is that hypothetical average resident's needs we underwrite toward for the life of the ALF loan.

In our experience, this means that total operating expenses (excluding debt service) divided by effective gross income typically produces operating expense ratios (OER's) in the 60%-70% range for freestanding assisted living facilities (ALF's). While EC segments, if proportionally significant and analyzed in isolation, could theoretically produce OER's similar to congregate care in the 50%-55% range, it is also true that this must be offset where equally significant proportions of greater levels of care are included under the same roof in the same ALF, such as Memory Care wings (MC, say, 65%-95% OER when analyzed independently, depending on the level of Alzheimers patients served).

Thus, where continuums are developed, and EC units and MC units are both included, it is likely that the overall OER of the entire ALF may still hover in the 60%-70% range described. Unless the lender and/or the appraiser identify expense comparables achieving stronger efficiencies, or the Hub portfolio contains a project of similar composition achieving lower OER's, then we anticipate more realistic estimates of OER's and corresponding estimates of net operating income (NOI) available to provide business returns, and to service mortgage debt, than we have recently reviewed in both MAP and TAP underwriting support.