Re: BZA Application for 2619-2623 Wisconsin Avenue NW
Square 1935, Lots 44,33,34 – Application for Special Exception

Testimony of John G. Cunningham

1. Experience

Good afternoon, I am John Cunningham, and it's a pleasure to be here today.

I have worked for eight years in seniors housing and multifamily lending. I have analyzed proposed and completed Fannie Mae, FHA, and balance sheet loans for the development, acquisition, and refinancing of multifamily, assisted living, and skilled nursing properties worth hundreds of millions of dollars.

During my time working at two reputable lending firms, I have developed a knowledge of what makes a financially viable transaction, with particular expertise in determining whether a proposed transaction represents a viable debt opportunity.

In order to make these determinations and evaluate each transaction's strengths and risks, my work has included examining market conditions, evaluating the creditworthiness of deal sponsors, reviewing asset quality, underwriting income and expenses, and reviewing the proposed operator's historical performance.

In determining a deal's financial viability there are two, interconnected components. The first is the operational performance of the asset and whether the property can be expected to generate sufficient income to pay expenses, debt service, and other costs of capital. The second is the availability of adequate, affordable financing—are reputable lenders going be willing to provide the debt for the construction and permanent, post-construction financing.

2. Financing Criteria and Relevant Facts

1. What are the financing criteria for a memory care/assisted living care facility?
Specific underwriting procedures may differ from lender to lender, but all ultimately seek to answer the same question: Does the proposed deal present reasonable creditworthiness that falls within the lender's risk threshold: Is the lender confident the loan will not default, if default occurs can the lender be made whole by the sale of the asset, and upon maturity of the loan can the lender be confident the outstanding loan balance can be refinanced.

To answer these questions, lenders will consider:

- First, lenders examine he expected financial and operational performance of the asset--will future income be sufficient to cover principal and interest payments.

- In doing so, the lender will consider the proposed facility operations, experience of the operator and developer, and market conditions.

- The experience of the operator and developer is a key consideration for all lending, but particularly seniors housing. The emphasis on experience and expertise increases with higher care, or acuity, levels. This is because seniors housing is not just real estate—it is also an operating business. The facility is delivering health care and caring for them every day. Memory care is the second highest acuity level of seniors housing, second only to skilled nursing facilities, and requires careful, attentive, specific care. Sponsors and operators without extensive experience specifically in memory care are considered highly likely to fail to maintain functioning operations. A central consideration is name recognition. Referrals of the operator and developer draw a significant portion of future occupants. Properties run by firms without a good name are not trusted. Consider the surveys published annually in the annual State of Seniors Housing publication, which show fewer than 5% of assisted living and memory care facilities are run by operators with fewer than 10 properties under management. Small operators are not as successful as larger, more established, experienced ones.

- Second, lenders look to the creditworthiness of the Sponsor -- can they be confident the sponsor brings the experience, credit history, and financial wherewithal to support the transaction, to complete the development, and to sustain the deal.
  - Again, heavy emphasis is placed on borrower experience
    - I the Fannie Mae and FHA loan underwriting regulations, and standard balance sheet lending practices highlight how key this is in lenders' determinations.,
      - For seniors housing, Fannie Mae explicitly requires previous ownership and operating experience in their published underwriting guide and in their guidance to lenders through memos, training sessions, and regular interactions between Fannie Mae staff and lenders' staff while underwriting deals.
        - See Fannie Mae's published official central underwriting guide, the DUS Guide Part IIIB Section 501.03
        - For FHA loans, extensive experience with memory care assets is required from both the Sponsor AND operator.
          - See the Section 232 Handbook, Section 2, Chapter 2.5 - FF.
          - This paragraph states that "at least three years of experience successfully operating multiple projects with the types of beds proposed will generally qualify for ORCF mortgage insurance"
          - My experience and conversations with those who have worked in FHA seniors housing underwriting for decades say the typical standard is 5 years and 5 facilities.
  - Lenders also investigate the sponsors' credit history -- lenders must have comfort the sponsor has no history of walking away

- Lenders will carefully analyze sponsors' personal financial statements and their existing real estate portfolio.

- Third, the quality of the facility is considered. Lenders will ask "is the loan collateral a quality asset which functions properly?"
  - Lenders want to ensure the building will be built properly and appeal to potential residents and their families.
  - Lenders want to ensure it is operated properly -- full staffing, etc.
    - These items are important to lenders because they affect property occupancy and could expose the project to crippling lawsuits or regulatory action.

- Finally, the refinance potential and an exit strategy are evaluated. The lender must have confidence that another lender would provide financing for the project.

2.What data is required to secure lending?

- To evaluate the operating performance of the building, the following are required:
  - The expected operating revenue and expenses of the property.
  - As part of this is requesting a thorough marketing campaign, which is essential for leasing up the building initially and maintaining new occupants. New construction presents many challenges, particularly in seniors housing and especially in memory care, and among these is drawing new tenants. It often makes seniors housing investors more inclined to purchase existing properties than build new ones.
    - There is especially a risk in providing ONLY memory care; many facilities offer a continuum of care allowing residents to age in place.
      - Families and residents may be disinclined to have to move from place to place, as it can be traumatic for the individual, costly for the resident and her family, and inconvenient for the family.
      - There is no in-house demand source, as there would be with a facility offering standard AL and dementia care. The absence of aging-in-place residents increases the difficulties and costs of attracting tenants.
    - Lenders also need a market research report. These examine existing market supply and demand and determine what net demand, or oversupply, exists in the market.
      - Only those properties with significant demand in the primary market area are eligible for new construction financing.

- To consider the sponsor and operator, lenders require the following
  - First, the current real estate portfolio of the sponsor and operator, and previous assets. Underwriters will carefully examine the portfolio do determine the sponsors' experience in the particular field. They also review the performance of the properties to ensure the development team has maintained high occupancy levels and operate profitably.
  - Second, financial statements are required.

- A full design plan is needed to ensure it is being built to appeal to residents, consistent with modern trends. Technical architectural and engineering documents are also requested to be passed on to the third-party engineering review firm for a specialized analysis of the construction plan.
- Many other documents and third party reports are also required.

3. **What relevant data is on the record so far?**

- Some information lenders require may not be expected to made public at this stage, and some may be confidential, such as the most detailed projected line-by-line income and expenses.
- Other data, however, should be available and should be reviewed by any agency such as the BZA seeking to determine the likely impact of a proposed use of property. None of that information has been provided.
    - Notably, we have not seen a basic cost revenue assessment backed up by a marketing study and marketing plan to ensure the project will not stand half full and then fail.
    - MED and Guest Service also have provided only a limited description of their experience in developing and operating small, urban, single purpose memory care units.

4. Do we have any information about this market?

My experience permits me to estimate a few the factors relevant to assessing the viability of the MED proposal at issue in this case.

- A high-end memory care facility in the area would charge around $9k/month, potentially more.
- Occupancy in Washington DC averages about 92%, considered relatively strong nationally.
- However, supply has gone up, and significant supply is coming online in the next couple years targeting the Bethesda, Chevy Chase, and upper Northwest areas. I would expect this facility to draw upon the Georgetown through Tenley Town area, a relatively narrow band. Significant inroads with this segment will be required.

4. If there any evidence you have seen that would show the facility can be financed, and if financed could succeed?

- The evidence I have seen suggests an absence of developer and operator experience. This absence suggests that financing would be difficult to get.

- As I understand, Mr. Finland has little to no experience in memory care. On this basis, I expect agency, FHA, and balance sheet financing would be difficult, if not impossible to get.
- The same applies to the proposed operator, Guest Services. While Mr. Gonzales appears to have had broad experience that may extend to the details of memory care operations, I understand that GSI has operated only one seniors housing facility. It appears to be an early stage retirement facility, primarily providing independent living, which is housing that provides little care to the residents. This one Guest Services facility has a small assisted living component, but the size of that segment indicates it is not a core business segment. The facility, as I understand it, provides no memory care. To my knowledge, they have not operated a second facility.
- This absence of institutional experience suggests that they would not qualify for construction or permanent financing from a reputable lender offering reasonable interest rates which could be paid out of net income.

- On ongoing operations, nothing provided gives me confidence the development team could establish a sustainable business.
  - I have seen no evidence that MED or Guest Services has established name recognition or a network in the Northwest DC network. As I mentioned, the marketing campaign and referrals are key to generating interest and bringing occupancy levels to those required to generate sufficient income.
    - The facility will face heavy competition from properties run by experienced, well-regarded owners and operators with name recognition. Attracting residents will be a challenge.
  - There is nothing to suggest MED and Guest Services Could put together a successful operation.
    - The staffing plan and care quality are critical, especially for capturing a high-end consumer base. None has been provided.
    - Again, seniors housing, particularly on the higher acuity levels, is not just real estate. It is an operating and health care business. This is a care game, not a developer game. Facilities that do not provide excellent health care will fail.
  - The proposed facility does not seem part of a coherent strategy, but instead a one-off developer play. For investors intending to maintain long term, well run facilities, this will seem odd.
    - For example, owners and operators face heavy fixed cost burdens, which are best spread out among several facilities.
    - Establishing a referral network will also prove to be more challenging.
  - Finally, the debt markets are tightening and interest rates are rising. If the developers are not prepared to face tighter lender standards and more expensive debt, they cannot sustain the property.

5. What would happen if the proposed memory care facility were built and could not succeed?

If the property were constructed and either could not find permanent financing, or if it were financed and failed to sustain itself as an on-going profitable business and could not pay debt service, it would go into default.
The sponsors could pay the loan out of pocket, which would be a highly costly decision and presumably unlikely—if they could not operate a profitable facility before, why would they be able to continue to do so? Alternatively, the sponsors might reorganize their business – formally or informally - and seek to put the building to another use.

If neither effort were successful, the lender would foreclose on the property and sell the asset quickly. Lenders do not like holding assets. These sales are often completed at below standard market prices to expedite the disposition.

In any event, the reorganized sponsor or the buyer would either maintain it as a seniors housing facility, or repurpose it. Having achieved savings on the purchase, the investor might conduct renovations and construct an apartment building, a hotel, or potentially a retail or office building. Depending on zoning rules and building permit availability, they may be tempted to expand, upwards or outwards.

What's the most likely financeable use of the property once re-purposed? As proposed, this building would be a strong candidate for renovations into a high-end apartment building.