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Realty Trust Group
Healthcare Real Estate

THE "LEASE VS. OWN" ANALYSIS FOR HEALTHCARE ORGANIZATIONS

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Table of Contents

About Realty Trust Group

Since our inception in 1998, Realty Trust Group has become one of the most experienced and knowledgeable real estate advisory firms in the healthcare industry.

With offices in Knoxville, Tennessee and Atlanta, Georgia, we have completed projects for clients in 30 states—serving hospitals, health systems, physician groups and other owners, users and investors of healthcare real estate. Our philosophy is to provide innovative solutions to the complex and challenging issues found in today's healthcare real estate market. These solutions include strategic campus and facility planning, portfolio optimization, portfolio monetization, project development, site analysis and acquisition, asset management, fair market value opinions and many other ideas and services.

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The "Lease vs. Own" Analysis for Healthcare Organizations

by Kevin Baker, CFA

Healthcare providers, whether it be a health system, a hospital, or a physician group, need real estate in order to provide medical care to their patients. Medicine is practiced in a wide spectrum of settings including ambulatory surgery centers, freestanding emergency departments, medical office buildings, and hospitals. Regardless of provider and location, the question of whether to lease or own real estate is one of importance—and healthcare organizations should understand the pros and cons of real estate ownership.

In this Realty Trust Group white paper, we will share how to best approach the "Lease vs. Own" analysis, explain the typical pros and cons of owning and leasing healthcare real estate, and discuss what "Lease vs. Own" means for an organization's strategy.

Introduction

There are several factors that are causing healthcare executives to take another look at their health systems' real estate portfolios, which typically account for about one-third of most health systems' balance sheets. In 2017 and the coming years, interest rates are expected to increase, which will ultimately make purchasing real estate more expensive for many healthcare organizations. With the election of President Trump and Republican control of both houses of Congress, the Patient Protection and Affordable Care Act faces massive overhaul, if not total repeal. Changes in healthcare legislation and regulation may have significant financial impacts on healthcare organizations. In addition, healthcare systems face competing capital demands, such as aligning with physicians, purchasing new medical equipment, and implementing new electronic medical record systems. With so much uncertainty and potential for negative impacts on health systems' finances, many health system leaders are reviewing the fundamentals of their real estate portfolios to determine which type of real estate strategy will be most beneficial to their organization. A common question leaders ask is whether their health systems should lease or own their real estate.

The Pros and Cons of Owning

As with any choice, there are pros and cons to owning and leasing real estate. Typically, the pros and cons of owning include the following:

PROS OF OWNING

- **Lower Occupancy Cost:** Today's interest rates are still near historical lows. Owners usually enjoy a lower cost of occupancy than lessors.
- **Offsetting Revenue:** There is the potential for additional rental revenue from third-party tenants, which lowers overall cost to ownership.
- **Control:** Owners can control the tenant mix of their buildings. Additionally, owners control which spaces to occupy in their buildings and how long to stay in those spaces.
- **Potential Tax Benefits:** Some municipalities do not assess property taxes against not-for-profit healthcare entities who own their real estate, which ultimately lowers the cost of ownership. However, this is becoming less common for cash-strapped municipalities. Additionally, real estate depreciation expenses could potentially be used to lower for-profit health systems' taxable income.
- **Terminal Value and Potential for Appreciation***:* The biggest benefit to owning real estate is that after it has been paid off, the health system retains a marketable asset from which it can continue to generate revenue or which it can use to reduce its operating expenses by not having to pay for space it needs to conduct its operations. Additionally, the property value of the asset may appreciate over time, providing owners with additional financial benefits.

CONS OF OWNING

- **Higher Up-Front Costs:** The up-front costs to own usually consist of an equity investment in the property and tenant improvement costs. However, in some cases, creditworthy physician groups and hospitals can receive 100% financing.
- **Long-Term Commitment:** Because of higher up-front costs, higher disposition costs, and risk in the sale price, ownership is a long-term commitment.
- **Refinance Risk:** Owners who have financed with a loan that does not fully amortize are subject to interest rate risk at time of refinance. Because interest rates are currently near historical lows and are set to increase in the future, refinancing will likely result in higher financing costs and translate to higher ownership costs for real estate.
- **Disposition Risk:** Owners face risk of the real estate markets when they buy or sell real estate. Today's real estate market remains at historic high prices, which increases the risk that the property value may be less when it is sold.
- **Economic / Functional Obsolescence:** As medicine changes, the requirements for medical equipment and building construction change. Consequently, while health systems would ultimately retain their real estate assets after they have been paid off, the value of those assets could be significantly impaired as a result of that economic / functional obsolescence.
- **Management / Capital Expenses:** When health systems own real estate, they have to manage and upkeep those assets, which most healthcare organizations are not in the business of doing. Proper management of real estate requires time, expertise and resources, including property managers, accounting professionals, maintenance staff, and legal counsel. All of this adds to the cost of owning real estate.
- **Unexpected Expenses:** Not all expenses are typically passed through to a tenant. The owner takes on the risk of major ownership expenses, such as structural deficiencies or major building system replacement.

The Pros and Cons of Leasing

Typically, the pros and cons of leasing include the following:

PROS OF LEASING

- **Flexibility:** The tenant's commitment to a location is more flexible. This can be prudent if expanding into a new location.
- **Less Up-Front Capital:** Traditionally, leasing has required less up-front capital. As stated above, however, this benefit has been muted due to recent aggressive lending practices for medical real estate, which allow some creditworthy owners to obtain 100% financing at historically low interest rates. Additionally, tenants may be required to fund tenant improvement costs, which, in some cases, could be high and, thus, minimize this benefit.
- **Optionality:** If negotiated correctly, leasing can provide tenants with benefits of ownership by way of a future purchase option, right of first refusal / or offer, or some other provision that is specifically targeted to provide tenants with some of the benefits of ownership mentioned above.
- **Ease of Disposition:** There are less costs associated with disposition. The tenant can simply end the lease and move out at the end of the lease term.

CONS OF LEASING

- **Lack of Control:** A landlord could refuse to renew the tenant's lease or could lease a nearby space to tenant's business competitors.
- **Higher Occupancy Cost:** Tenants typically have a higher on-going cost of occupancy than owners. At the end of the lease, tenants can face higher rental rates and less lucrative concession packages.
- **Inability to Dispose Early:** If the tenant desires to move prior to the end of the lease term, there could be costly penalties or even worse, the inability to terminate the lease.
- **Lack of Terminal Value:** Tenants do not own an asset with value at the end of the lease. As a result, the value of tenant's lease payments and tenant improvement investments cannot be recaptured once the lease ends.

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Strategic Implications

Based upon the various considerations listed above, healthcare administrators can begin to piece together how owning and leasing fit into the real estate strategy. The healthcare industry has a unique set of factors when analyzing how real estate fits into its strategy. Often times, healthcare organizations require knowledge of the following in order to make sound real estate decisions:

- **Location of current patients**
- **Neighborhood demographics**
- **Target areas for growth or market penetration**
- **Payor Mixes**
- **Large employers that may impact demand for health services**
- **Existing healthcare providers in the area**
- **Ancillary medical providers, such as express clinics, pharmacies, and urgent care clinics**
- **Future land use plans and municipal zoning codes**

Regardless of whether the organization owns or leases, the real estate must place the right provider in the right place, at the right time. The decision to own or lease should heavily weigh changing market demographics, existing and projected patient bases, payor mixes, and other characteristics of the location. Too often real estate works against the entity's strategies; only after understanding the business goals can healthcare executives begin to make sound real estate decisions.

For example, for an organization that has a long-standing presence in a community with no plans to exit the market, the "lease vs. own" analysis may lean towards owning. On the other hand, a provider who is expanding services into a new, untested market may conclude the prudent choice would be to lease until the long-term outlook is more clear.

Some health systems prefer to own "core" real estate, assets which are critical to major operations and usually offer higher acuity services, and lease 'non-core' assets, such as off-campus clinics and administrative support spaces. Control is a key factor for these real estate users.

Still, financial analyses can weigh heavily in the decision to own or lease. Systems with strong cash flows and balance sheets may opt to use some of their cash or borrowing capacity to own. Entities that have strong demands to spend capital on other investments, such as alignment with key physicians or purchasing new medical equipment may incline administrators to implement a leasing strategy to protect capital and borrowing capacity.

In addition, the 'lease vs. own" analysis must take into account a number of quantitative factors. For each property a health system may be interested in purchasing or leasing, a quantitative analysis should be undertaken to determine the financial implications of both choices. Health systems should carefully evaluate up-front equity / investment, rental payments, operating expenses, debt service, tax savings and a terminal event. Other key factors include the healthcare organization's cost of capital, hurdle rate, anticipated lease terms, and local real estate market conditions. Qualified real estate advisors can provide invaluable insight into these critical decisions.

Finally, regulatory compliance issues must be considered when developing a real estate strategy or performing a "rent vs. own" analysis. Although it is beyond the scope of this paper, health systems must always remember that entry into lease arrangements with referring physicians triggers the Stark Law and, as a result, exposes those health systems to regulatory risk.

Conclusion

Unprecedented changes in healthcare are underway, which are causing today's healthcare leaders to look again at their real estate portfolios. Healthcare real estate must follow healthcare strategy, and the financial analysis of the real estate should reinforce a strategic decision. Benefits and risks of leasing and owning should be discussed in relation to health systems' overall goals. The professionals at RTG understand both healthcare industry trends and real estate fundamentals, and are experienced in advising physician groups and health systems on these and other real estate strategies to support their strategic objectives.

For more information on how your healthcare organization can benefit from a "Lease vs. Own" analysis, contact us at 865.521.0630.

