

Strategies in Healthcare

# Guide to Physician Real Estate Ownership Options

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## Introduction: Guide to Physician Real Estate Ownership Options

Over the past decade, many physicians in independent practices have seen declines in profitability caused by factors including changes in reimbursement and increases in business costs. In this environment, physicians increasingly have considered alternative sources of revenue and different options in wealth creation, including joint ventures with non-profit or for-profit healthcare providers or direct investment opportunities.

The increase in real estate values over the past decade, fueled by low interest rates and historically high levels of capital seeking real estate investment, has motivated many physician practices to consider real estate ownership as a key component of their overall business strategy. Physicians all across the country are approaching hospitals and healthcare systems (collectively “hospitals”) regarding their desire to own the “bricks and sticks” of the medical office buildings, clinics, ambulatory surgery centers and other forms of real estate they occupy. In response, hospitals are evaluating the advantages and disadvantages of establishing these new relationships with their affiliated physicians and seeking financial and operating structures that will fairly enhance the business objectives of all parties.

If structured properly, physician investment in a hospital’s non-core real estate assets can prove to be a strategic and financial success for the sponsoring hospital, as well as for medical practices and their physicians. These transactions can create closer bonds between hospitals and physicians that yield mutual long-term positive benefits. The keys to success in this arena are (a) identifying the optimal real estate investment option to maximize benefit for both parties and (b) assembling an experienced team of professionals to assist in the development and implementation of the optimal transaction.

## What Options Are Available to Your Hospital?

The most widely available options in real estate ownership for physicians are:

- a) joint venture;
- b) condominium; and
- c) direct physician ownership.

When considering these options, hospital executives should realize that many factors will be common to all structures, including ground leases (for on-campus or strategic assets), mortgage debt and others. These are used to develop an ownership structure that positions all parties to achieve their business goals and objectives.

Negotiation of a ground lease is frequently a key component of physician real estate transactions. The property that is to be the subject of the proposed investment transaction is frequently located on the hospital’s campus, or, if not on the campus, may have been acquired by the hospital as part of its long-term strategic plan. Accordingly, hospitals often will not wish to sell the underlying land outright, as part of the transaction, preferring to hold a long-term interest in the land on which the real estate asset is located. A “ground lease” is the legal structure by which this is accomplished, and a ground lease can be incorporated into any of the physician ownership options described in this Report. Further discussion regarding this important feature of physician real estate transactions is contained later in this Report.

Similarly, the investing parties may wish to retain a third-party real estate developer or company (such as a REIT or private healthcare real estate developer) to participate in the creation or operation of the real estate venture, operating as the “managing partner.” This entity may acquire a financial interest in the property, or simply act as a manager of the real estate assets on a fee basis. The desirability of involving a real estate company will depend on the actual features of the proposed investment, including its size, since there will likely be added costs from this activity.

### Joint Venture Structure

Joint venture ownership structures result in a new entity where both the hospital and the physician investors maintain an ownership stake in a real estate asset. Joint venture entities can be developed directly by the hospital and physicians. In a joint venture, mortgage debt is often used to leverage the property to achieve the optimal capital structure. Common structures for joint venture real estate entities include limited liability partnerships, trust structures, preferred equity and/or mezzanine debt structures.

In many joint ventures, a third-party real estate developer/owner is positioned as the “managing partner” particularly where additional capital or expertise is required to acquire or develop the project. Further, a company of this type can also add value in providing independent management of the asset, thereby reducing potential friction between the hospital and the physician-investors over day-to-day aspects of property management. A joint venture structure is often considered the optimal structure for large multi-tenant assets or portfolios of assets because it can accommodate both small and large investors, allow for professional real estate owner/developer investment and management, and maintain the overall value and operational economies associated with a larger asset or portfolio.

Hospitals should consider the following advantages and disadvantages in joint venture ownership:

<i>Pros</i>	<i>Cons</i>
<ul style="list-style-type: none"><li>• Positions physician for real estate investment</li></ul>	<ul style="list-style-type: none"><li>• Represents a relatively illiquid investment</li></ul>
<ul style="list-style-type: none"><li>• Allows for professional real estate oversight related to management, capital improvements, leasing and financing</li></ul>	<ul style="list-style-type: none"><li>• Potential conflicts if hospitals are positioned as managing partners and physicians are non-managing partners</li></ul>
<ul style="list-style-type: none"><li>• Achieves market value for hospital real estate assets</li></ul>	<ul style="list-style-type: none"><li>• May require consensus for most real estate decisions including rent levels and vacancy management</li></ul>
<ul style="list-style-type: none"><li>• Aligns physician and hospital interests more closely</li></ul>	
<ul style="list-style-type: none"><li>• Easily financed and structured in today’s market</li></ul>	
<ul style="list-style-type: none"><li>• Preserves asset value</li></ul>	

### Condominium Structure

Like a residential condominium, a physician office condominium structure allows for direct ownership by the tenant in a specific portion of a real estate asset. With this option, the hospital would establish a legally recognized condominium structure that would allow physician tenants to own the real estate space they occupy. In most cases, real estate assets can either be developed as or converted into condominium structures. A condominium board, consisting of representatives of the unit owners (presumably the hospital and physician-investors) would oversee the building's management and capital improvement program. In addition, the hospital could use a ground lease to maintain the appropriate amount of control for on-campus and strategic off-campus assets.

The condominium structure has the following advantages and disadvantages:

<i>Pros</i>	<i>Cons</i>
<ul style="list-style-type: none"><li>• Positions physicians for real estate investment with greater autonomy than joint-venture structure</li><li>• Provides “tangible” asset ownership</li></ul>	<ul style="list-style-type: none"><li>• Dilutes overall asset value by subtracting condominiumized sites from the building</li><li>• Condo board decision-making can lead to conflict</li><li>• Commercial condo typically an illiquid investment</li><li>• Condominium real estate structures are typically complex and costly to set-up</li><li>• Fraud and Abuse Laws should be considered in the value attributed to condo for sale</li><li>• External financing difficult, due to division of the assets ownership</li><li>• Does not allow for professional real estate investment and oversight</li></ul>

This structure is best suited for assets that have several large tenants and for assets that a hospital does not plan to own or occupy on an ongoing basis. One common challenge with this structure is that it can be difficult to monetize units that are not sold to physicians. This illiquidity is primarily due to the specific use and the size of the particular office space, as well as the market demand by physician tenants to own the space they occupy. This can create tension for hospital executives should an owner not be able to sell the unit they purchased from the hospital.

### Direct Physician Ownership

This option positions physician as the direct owners of available or planned real estate assets, and consequently, the hospital does not have an ownership interest in the real estate improvements (but may still have a ground lease). This option may be better suited for smaller single-occupant assets where a

physician tenant buys the asset outright from the hospital or develops a building on hospital land using a ground lease. This form of ownership can be executed with a single tenant or a partnership involving several tenants. Hospitals will typically use a competitive sales process for these real estate transactions that results in a fair market transaction.

Important advantages and disadvantages that apply to direct physician ownership opportunities are as follows:

<i>Pros</i>	<i>Cons</i>
<ul style="list-style-type: none"><li>• Positions physicians to take advantage of real estate investment opportunities with a relatively high level of independence</li><li>• Provides “tangible” asset ownership for physicians</li></ul>	<ul style="list-style-type: none"><li>• Fluctuating real estate values could cause friction if physicians purchase an asset at the height of the market and are trying to sell at the bottom of the market</li><li>• Negotiation of terms and ground lease can strain physician-hospital relationship</li><li>• If physician/hospital relationship changes, asset ownership could become a problem</li><li>• Fraud and Abuse Law considerations apply</li><li>• Physician interest (desire to offer competing services) may not always align with Hospital’s interest</li></ul>

This structure is generally best suited for a smaller, single-user occupied building. When one tenant is owner in a multi-tenant building, conflict can affect building operations and can also impair future physician recruitment.

### **Protecting Core Hospital Interests: Ground Leases and Other Control Mechanisms**

For on-campus buildings or buildings located on parcels that may be strategic to the hospital, any of these ownership structures should typically be combined with a ground lease from the hospital. This lease arrangement positions the hospital to maintain the desired level of control over the reasonable use and operations of the real estate improvements on the site.

Under the terms of a ground lease, a hospital typically:

- a) retains ownership of its land;
- b) generates revenue through lease payments;
- c) assumes no-cost ownership of the building at the termination of the ground lease; and
- d) has in place a legal agreement with control provisions designed to protect the hospital system and its relationship with the occupants of the building.

Ground leases are typically long term, usually 65 years or more. The lease structure allows the buyer to pursue fee-simple financing options used for traditional full-ownership transactions. The ground lease also allows the hospital to realize an annual return on the land to which it will continue to hold title.

The ground lease is an important mechanism for a hospital in these transactions and can provide for the following controls, among others, if desired:

- All tenants must be non-competing, on-staff physicians
- Hospitals retain right of first refusal to lease space as it becomes available and to repurchase a property
- Hospital has right to cure defaults under financing agreements
- Hospitals can demand reversion of improvements at conclusion of ground lease
- Building owner must comply with hospital system directives pertaining to clinical practices
- Building owner must maintain satisfactory management
- All tenant work must be consistent with the hospital mission

## What Option is Best for Your Hospital?

### How Should a Hospital Analyze Assets/Projects and Potential Transaction Alternatives

#### *Goal Establishment*

For hospitals that are considering different real estate ownership options for physicians, or any third-party owner, the first step is to gain a clear understanding of the hospital's goals related to either a currently owned asset or a planned development project. Hospitals can approach these opportunities with many different goals and objectives in mind, including:

- Maximize cash (for monetization) or limit cash contribution (for development project)
- Remove debt or avoid the addition of new debt to the balance sheet
- Maintain reasonable building expense (operating expenses, property taxes etc.)
- Maintain desired levels of control in key areas including:
  - Owner/tenant profiles and space utilization
  - Space leasing and management
  - Ability to cure defaults
  - Ability to repurchase property under certain conditions
  - Cooperative relationship with new owner
  - Buildings maintain or gain status as well run, best-in-class assets in the community
  - Experienced healthcare real estate manager involvement

### *Core or Non-Core Assets*

When the hospitals' goals in a real estate transaction are clear, the next step is to complete a careful analysis of the asset itself. A key consideration here is whether an asset is considered core or non-core to the hospital. Core assets are generally defined as assets that are 100 percent occupied by a hospital and are part of its acute care delivery business, though many other assets can also be considered as core holdings. Hospitals should take all necessary steps to understand the significance of a real estate property or development to its mission. In most cases, hospitals should consider physician ownership options involving only non-core real estate assets that are at least partially occupied by third-party physicians.

### *Compile and Review Property Data*

Before making any decisions related to transactions involving non-core assets, it is important to compile and review data in several key areas, including:

- a) gross and rentable square footage;
- b) occupancy (both hospital and third-party);
- c) income and expenses (actual and projected) associated with the asset(s); and
- d) physical condition of the properties, including planned capital expenditures.

For new development projects, the hospital should complete an analysis based on the size of the project, location, occupancy projections (hospital and third-party), construction costs and income and expense estimates.

### *Estimate Asset Value(s)*

The property data is then used to develop a value estimate of the property. This estimate should take into consideration the current income and expenses of the asset and any anticipated changes to future cash flow that will be introduced by new or expiring leases or extraordinary capital expenditures. The income assessment can then be used to assess the investment value of the asset. That valuation also serves as the benchmark from which to estimate the potential financial benefit in the event of the sale of an asset.

### *Analyze Ownership Structures*

Once the valuation is completed, the next step is to review the ownership structures that are available for the asset(s). As discussed above, these structures can include a direct sale to physicians or a joint venture between the hospital and the physicians. The hospital may also wish to maintain a level of ongoing control within the terms of a ground lease. The hospital should make clear its preferences regarding any on-going occupancy and ownership in an asset. If the asset is surplus or does not fit into the hospital's current or future healthcare delivery model, the hospital might consider selling that asset with no conditions related to future occupancy or control.

### *Determine Optimal Transaction(s)*

The hospital should compare different transaction structures to identify the one option that best achieves the hospital's goals. Prior to any transaction, the hospital should also complete a credit and

accounting analysis for each asset. This final step should include a recreation of post-transaction financial statements and financial ratios to outline the potential financial benefit of the transaction to the hospital.

### *Constituency Buy-In*

Following this analysis, if it is determined that a transaction makes quantitative and qualitative sense for the hospital, the next step is to build constituency buy-in. The hospital team working to facilitate the transaction must make sure that all constituents, including finance committees, boards of directors, administrators, physician tenants, community officials and others are informed about relevant aspects of the transaction and that they support it.

### *Transaction Implementation*

Following the analysis of transaction alternatives and the identification of the optimal structure, the hospital should proceed with the execution phase. For any transaction, especially an outright sale to a third-party, a crucial step is to establish market pricing. Typically this involves a competitive process designed to ensure that the market values the asset at the highest value possible in light of prevailing market conditions.

The establishment of a market price estimate is a multi-step process:

- A. Step I
  - 1) Re-evaluate the properties, campuses and market dynamics
  - 2) Re-confirm hospital-related goals and objectives in considering the transaction
  - 3) Create marketing plan
- B. Step II
  - 1) Prepare transaction materials including:
    - a. Executive Summary
    - b. Asset Description
    - c. Hospital Description
    - d. Regional Economic Overview
    - e. Financial Information on Asset
    - f. Desired Response from Interested Parties
  - 2) Develop and execute outreach effort to potential buyers
  - 3) Guide interested parties through the review process
- C. Step III
  - 1) Complete investor due diligence
  - 2) Conduct negotiations
  - 3) Assist with due diligence and closing

In the event that a hospital chooses a controlled joint venture structure without a competitive bidding process to establish market value, an appraisal and a fairness opinion from your financial advisor are recommended.

## Conclusion

Hospitals have the potential to derive substantial benefits from having physicians participate in the ownership of non-core real estate assets. However, each opportunity is unique and requires careful analysis and planning to maximize the benefit for both the physician-investors and the hospital. In some cases, hospital sponsored entities might be the most appropriate ownership vehicle. In others, a condominium might be the best option. The key element of a successful transaction is to clarify the goals of each participant at the beginning of the process and to refine that understanding continually throughout all negotiations. The review and assessment process must work to identify all of the transaction options that might be considered. From there, the review should help all participants to recognize the most appropriate option and execute that option in a market-driven approach representing an arm's-length transaction process. The involvement of experienced and independent advisors positioned to offer unbiased advice can help to ensure that interests are aligned and conflicts are avoided. Properly planned and executed, a real estate transaction including physician investment can introduce many long-term benefits for both hospitals and physician-owners.

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