WHITE PAPER

# ACCESSING CAPITAL THROUGH HEALTHCARE REAL ESTATE

RTG

Complex Challenges, Smart Solutions

*For Healthcare Real Estate*

RealtyTrustGroup.com

Complex Challenges, Smart Solutions
For Healthcare Real Estate

# ACCESSING CAPITAL THROUGH HEALTHCARE REAL ESTATE

by **Michael Honeycutt, CRE, CCIM**, *Senior Vice President* and **Forrest Gardner, CPA**, *Vice President*

## Table of Contents

1. A Look Back
2. The New Normal
3. Key Considerations
4. Real Estate Strategies
5. Conclusion

*Now more than ever, healthcare providers face growing demands for financial capital. Whether to fund ongoing operations, expansion initiatives, alignment opportunities, or technology investments, hospitals and physician groups must evaluate various capital sources to meet these needs. When properly structured, a strategic real estate recapitalization can provide significant capital to fund key initiatives, improve liquidity and financial ratios, and support broader organizational goals.*

*In this white paper, Realty Trust Group (RTG) explores common strategies that healthcare providers use to unlock capital through real estate.*

Complex Challenges, Smart Solutions
For Healthcare Real Estate

# A Look Back

**For most hospitals and health systems, real estate has drastically evolved from a "must own" physical asset to a valuable strategic asset and capital resource.**

## A NEW ASSET CLASS

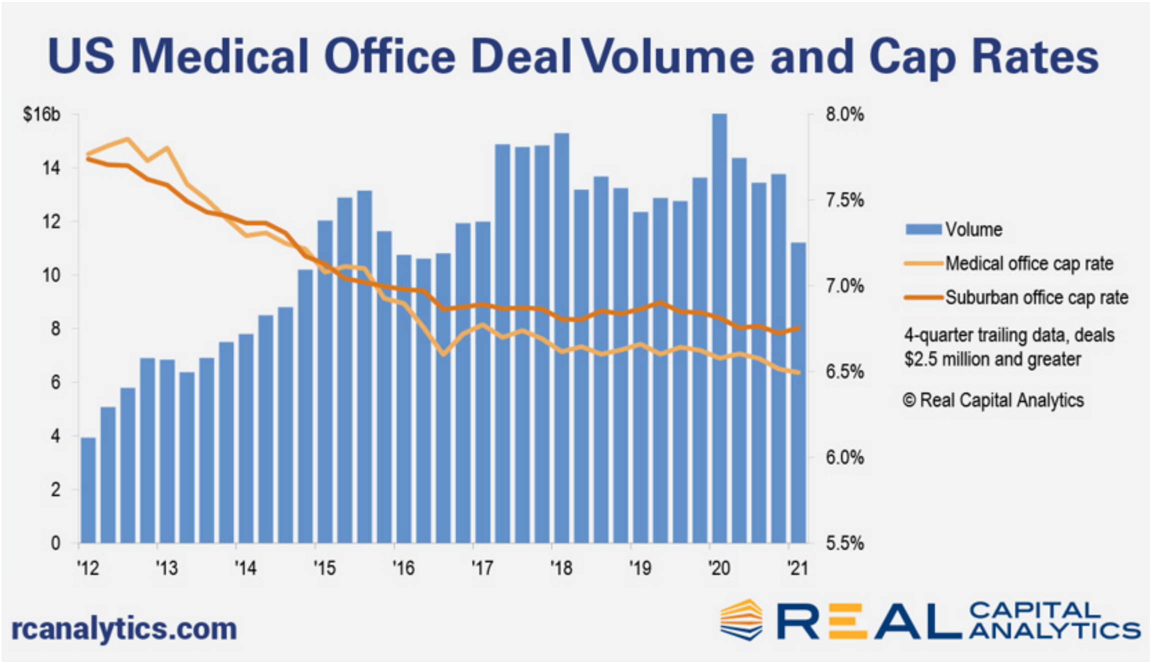
Before 1997, most hospitals and health systems owned their facilities "by default" as Medicare's cost-based reimbursement program provided little incentive to pursue alternative structures.

With the introduction of the Prospective Payment System and the eventual elimination of cost-based reimbursements, many health systems monetized billions of dollars of existing medical office buildings (MOBs) between 1997 and 2008. These organizations adopted a new financial theory: re-direct low-yielding capital tied up in bricks and mortar toward high-return investments in medical equipment, service expansion, and strategic alignment. Institutional investors, including pension funds, insurance companies, and real estate investment trusts (REITs), became enamored with the attractive fundamentals of healthcare real estate and increasingly invested in the new asset class. Transaction volume grew year over year.

Despite the 2008 Financial Market Crisis, when health systems faced unprecedented financial and operational challenges causing them to temporarily shelve healthcare real estate monetization and new development plans, the market demand for healthcare real estate assets remained.

With the passing of the Affordable Care Act (generally known as "ObamaCare") in 2010 and more extensive overall economic recovery from 2012 through 2020, health systems worked diligently to reposition themselves for value-based care and population health management initiatives, driving the need for new, modern ambulatory facilities. New federal lease accounting standards threatened to reshape hospital balance sheets, and health system-backed monetization activity remained low. Yet, low-interest rates fueled the fire for healthcare real estate investments, while competition for premium assets drove down cap rates and elevated prices. Investors, troubled by high investment demand and a low supply of available assets, turned to non-hospital owners and sellers, including physician practices, urgent care clinics, and dialysis providers. Despite this shift, asset pricing grew to peak levels.

*In response to larger healthcare industry trends, the use of third-party capital for facility development and monetization has increased dramatically over the past ten years.*



## The New Normal

In March 2020, the World Health Organization declared a global pandemic. The effects of the pandemic were far-reaching, but perhaps no industry was impacted as severely as healthcare. As hospitals scrambled to respond to peaking COVID volumes, elective procedures halted, emergency department visits vanished, and staffing challenges mounted. The federal government responded with a massive economic stimulus package, including Provider Relief funding, broader economic support programs like the Paycheck Protection Program, and sustained record-low interest rates. Providers "weathered the storm," but the underlying economic fundamentals were unstable, and the future remained uncertain. Although broader healthcare real estate investment activity remained strong, large health system-backed monetization activity was non-existent.

> "As providers emerge from the COVID-19 era and the sun sets on federal government stimulus programs, the need for cost-effective capital is as great as ever."

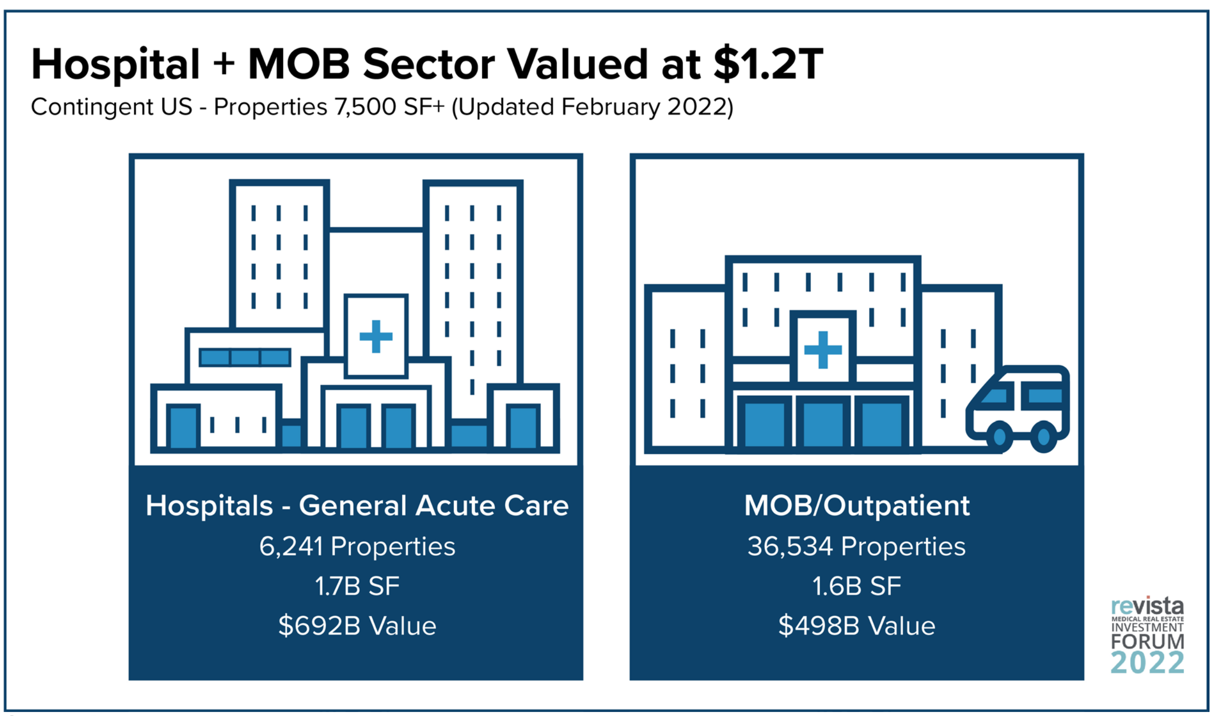
As providers emerge from the COVID-19 era and the sun sets on federal government stimulus programs, the need for cost-effective capital is as great as ever.

Multiple national publications project negative median hospital operating margins. Inflationary pressures in the form of rising interest rates and soaring construction costs, coupled with ongoing labor and supply chain challenges and steadily declining investment portfolios, further compound the already challenging financial environment for hospital operators.

**Many health systems find themselves challenged to identify alternative capital structures to support future funding for operational needs and strategic investments.**

Through it all, the healthcare real estate sector rose to all-time highs. In April 2022, Revista valued the Hospital & Outpatient/Medical-Office Building sector at $1.2 trillion, the highest ever seen.

**The ever-growing financial challenges leave many hospital executives seeking to better understand their real estate portfolios, identify opportunities to recapitalize their real estate assets, and strengthen their overall balance sheet while supporting long-term organizational objectives.**




*Source: Revista*

RTG
Complex Challenges, Smart Solutions
*For Healthcare Real Estate*

# Key Considerations

For any healthcare organization or physician practice considering a real estate recapitalization, it is important to first consider the fundamental strategic, economic, and operational considerations, and then determine which strategy best aligns with their long-term objectives.

## STRATEGY FIRST

A healthcare organization should first evaluate its financial position relative to its larger strategic initiatives, then quantify the potential capital need or “gap.” With this information, leadership can evaluate and prioritize capital needs and timing. This exercise ensures a “strategy first” approach and helps develop a frame of reference to best evaluate and prioritize potential assets for recapitalization. For example, the shifting healthcare environment has led many providers to reconsider the traditional “core vs. non-core” asset discussion, as off-campus assets grow in size, scope, and strategic importance.

As providers shift their focus to strategically located ambulatory care centers, inpatient facilities and on-campus MOBs may be considered for new debt placement, monetization, or third-party investment opportunities. A judicious process (rather than a real or perceived “fire sale”) will allow the organization to evaluate options and timing, select an approach that best aligns with broader objectives, and be positioned to strategically redeploy capital at a higher rate of return to support strategic initiatives elsewhere in the organization.

## ECONOMICS

So, what’s the real estate worth? It is an obvious first question, but the answer requires careful evaluation. While bricks and mortar carry a certain value, from an investment perspective, the true value lies in the underlying lease and resulting revenue stream. The organization should assess its long-term interest in each property and determine an appropriate level of control. If applicable, the terms of a space lease (e.g., lease rate and term) and ground lease will be the most significant determinants in the valuation equation, followed closely by the underlying credit of the tenant responsible for making the lease payments, as well as the location and mix of services offered at the property. Many variables, including accounting treatment (FASB – ASC 842 and GASB 87) and potential property tax exposure, must be analyzed to fully evaluate the trade-offs between the initial valuation and the long-term costs and benefits of ownership to the organization.

## OPERATIONS

In addition to strategic and economic factors, healthcare providers must consider the potential operational impacts of a recapitalization transaction. Depending on the transaction structure, the organization may be able to shift certain operational responsibilities to third parties while other duties may remain with the healthcare provider. Significant operational real estate responsibilities include:

**Management** – Personnel costs associated with property management, leasing, lease administration, and accounting functions.

**Maintenance** – Recurring operating expenses for taxes, insurance, utilities, janitorial and related items, as well as capital expenditures for facility maintenance and upgrades.

**Compliance** – Potential regulatory compliance risk exposure where there are landlord/tenant relationships between health systems and referring physicians.

RTG
Complex Challenges, Smart Solutions
*For Healthcare Real Estate*

# Real Estate Strategies

Once the key considerations related to strategy, economics, and operations have been evaluated, healthcare providers may consider multiple potential real estate capital strategies and should evaluate the relative pros/cons of each approach relative to broader organizational objectives.

| | PROS | CONS |
|---|---|---|
| **HOLD AS-IS** | | |
| Organization continues to hold real estate | • Maintain Status Quo<br>• No Additional Resources or Transaction Risk<br>• Maintain Full Control | • No Additional Capital Generated<br>• Responsibility for Ongoing Maintenance and Capital Costs<br>• Ongoing Management Responsibilities |
| **HOLD AND REFINANCE** | | |
| Organization maintains current ownership and seeks additional financing through bank or bond financing | • Maintain Ownership and Control<br>• Monetize Accumulated Equity (Cash Out)<br>• Maintain Existing Rental Expense and Third-Party Rental Income Stream | • Debt Proceeds Likely Limited to 80-90% of Value<br>• May Require Lease Extension<br>• Ongoing Maintenance and Management Responsibilities<br>• May Reduce Future Strategic or Operational Flexibility |
| **SALE/LEASEBACK** | | |
| Organization receives upfront capital infusion and transfers full or partial (JV) ownership to an investor and enters new long-term lease | • Monetize Full Property Value – Equity Cash Out<br>• Transfer Certain Maintenance and Management Responsibilities to New Owner (Likely)<br>• Potential Third-Party Rental Income to Offset Primary Lease Commitment | • Introduces New Third-Party Real Estate Owner (REIT or Private Investor)<br>• Do Not Maintain Full Control<br>• Requires Long-Term Lease Commitment<br>• Organization May Retain Certain Maintenance Responsibilities via Lease<br>• Potential Property Tax Implications |
| **CREDIT TENANT LEASE** | | |
| Organization receives upfront capital infusion and transfers ownership to institutional lender/investor and enters long-term lease to amortize purchase price | • Up To 100% of Full Property Value for Existing and To-Be-Developed Projects<br>• Long-Term Fixed Rates; Typically Lower than Sale/Leaseback<br>• Non-Recourse Options for Borrower<br>• End-of-Term Ownership Reversion | • Requires Long-Term Lease Commitment<br>• Extensive Underwriting Process<br>• Best Suited for Single-Tenant, Master-Leased Properties |
| **DISPOSITION** | | |
| Organization receives capital through outright sale of non-strategic or underutilized assets | • Provides for exit strategy for unneeded assets<br>• Reduce real estate footprint and costs of ownership<br>• Opportunity to redeploy capital elsewhere in organization | • May not maximize value of asset without a long-term commitment<br>• No longer control property |

# Conclusion

Healthcare organizations will continue to require capital to re-invest in their core business of providing patient care. With strong market pricing and a growing pool of buyers, investors, and lenders, attractive monetization opportunities should remain available for the foreseeable future.

Health systems and physician groups considering a recapitalization transaction should carefully assess organizational objectives and evaluate various real estate strategies to determine the appropriate course of action. The professionals at RTG have successfully advised our hospital, health system, and physician practice clients on multiple real estate capital strategies. We are committed to ensuring an objective evaluation of various monetization opportunities on our clients' behalf.

## Select RTG Recapitalization Transaction Experience

**Hospital MOB Development with Take-Out Partner**

- 169,000 SF building with parking deck
- Approximately $83 million transaction
- Strategic control via ground lease

**Physician Group Portfolio Monetization**

- 334,000 SF six-building portfolio
- Approximately $90 million transaction
- Long-term master lease

**Inpatient Facility Repositioning**

- 160,000 SF acute care hospital
- Approximately $60 million transaction
- Strategic disposition

## About Realty Trust Group

Realty Trust Group, LLC (RTG) is a nationally recognized real estate advisory and services firm serving the healthcare and life science industry since 1998. With objective, accountable, and trusted expertise, RTG provides innovative healthcare real estate solutions through a full platform of advisory, development, transactions, operations, and regulatory compliance services.

RTG acts as an extension of healthcare leadership teams, working to leverage real estate as a strategic asset to support broader organizational objectives. In a rapidly changing healthcare industry, RTG provides real estate strategies that gain market share, enhance patient experience, and increase speed to market. These solutions include strategic planning, portfolio optimization, capital strategies, facility feasibility and development, transaction support, portfolio management, regulatory compliance, and other tailored client solutions.

For more information about RTG, visit www.realtytrustgroup.com, Facebook, LinkedIn, or call 865.521.0630.

## Writers and Contributors

**Michael Honeycutt, CRE, CCIM,** *Senior Vice President* and **Forrest Gardner, CPA,** *Vice President*

## For More Information:

**Michael Honeycutt**, *Senior Vice President*
mhoneycutt@realtytrustgroup.com

**Forrest Gardner,** *Vice President*
fgardner@realtytrustgroup.com

**865.521.0630**
**RealtyTrustGroup.com**

## Copyright Statement