

Valuation of Healthcare Real Estate & Real Property

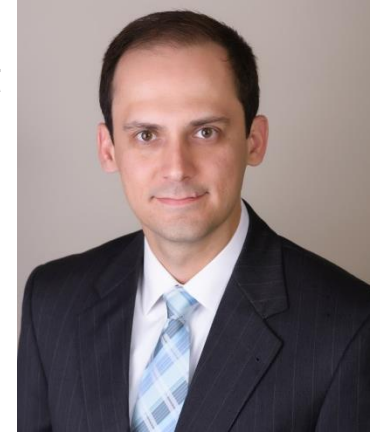
Presenters

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Presenter Bio

Michael Baldwin, ASA, MAI, has specialized in the valuation and market analysis of seniors housing and healthcare properties since 2005. Mr. Baldwin stays directly in touch with the senior housing and nursing care market by visiting hundreds of properties each year to interview on-site management and has personally toured over 2,000 senior housing and long-term care properties across almost every state in the U.S. He has led the development of over 1,500 appraisals and market studies nationwide for lenders, developers, investors, and operators. Prior to forming Oracle Healthcare Advisors, he held leadership roles in several national healthcare real estate valuation firms.



Mr. Baldwin is a national speaker on the seniors housing and long term care industry and has participated as both guest and lead speaker in front of national audiences in person at industry conferences and via webinars. He is consulted by board members for the seniors housing industry's largest trade association, the National Investment Center for the Seniors Housing & Care Industry (NIC).

Presenter Bio



Todd A. Zigrang, MBA, MHA, FACHE, ASA is the President of **HEALTH CAPITAL CONSULTANTS (HCC)**, where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 20 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 1,000 transactions and joint ventures involving acute care hospitals and health systems; physician practices; ambulatory surgery centers; diagnostic imaging centers; accountable care organizations, managed care organizations, and other third-party payors; dialysis centers; home health agencies; long-term care facilities; and, numerous other ancillary healthcare service businesses. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the co-author of the soon-to-be released “*Adviser’s Guide to Healthcare – 2nd Edition*” (AICPA, 2015), numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Accountant’s Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies; Business Appraisal Practice*; and, *NACVA QuickRead*. Additionally, Mr. Zigrang has served as faculty before professional and trade associations such as the American Bar Association (ABA); the National Association of Certified Valuators and Analysts (NACVA); the Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

About the American Society of Appraisers

The American Society of Appraisers, is an international organization of appraisal professionals, founded in 1952 to provide a comprehensive, profession-wide organization for appraisers and valuation engineers.

As a comprehensive body, the ASA pursues accurate valuation for all classes of property and hence examines multiple levels of economic activity. As such, the ASA seeks to foster cooperation between professionals of several valuation disciplines, and this spirit of cooperation may help engender multidisciplinary approaches to the art and science of valuation.

Mission of the Healthcare Special Interest Group (HSiG)

The *Healthcare Special Interest Group* (HSiG) is a Subcommittee of the ASA's International Education Committee and dedicated to the advancement of multidisciplinary education in healthcare valuation.

HSiG views the field of healthcare valuation as a complex area affecting multiple disciplines and requiring unique approaches for study and solutions. At the same time, the field also holds much promise for those willing to pursue new, multidisciplinary answers in this ever-changing healthcare market environment.

ASA HSIG Subcommittee Members

Robert James Cimasi (Chair Emeritus)
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Chief Executive Officer
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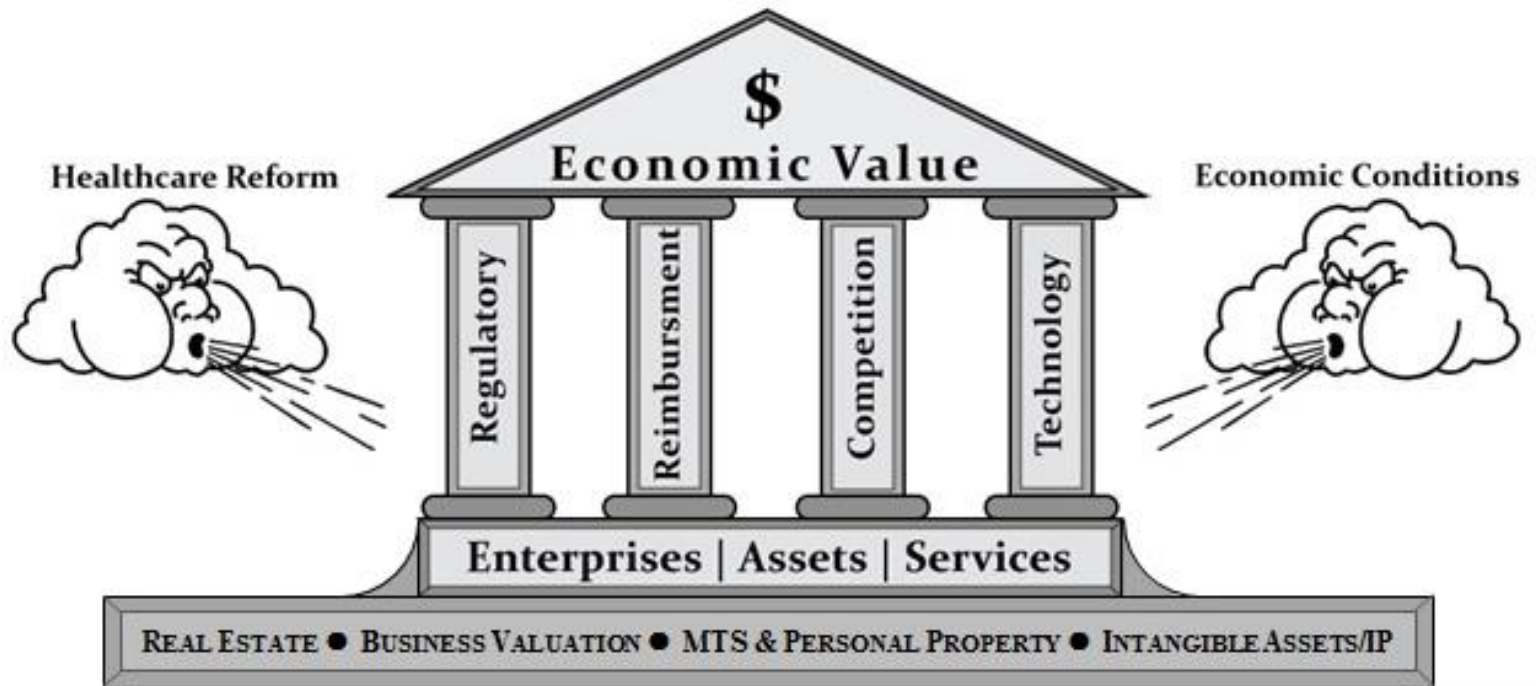


Additional sponsorship opportunities are available
Please visit the ASA HSIG webpage, or call (800) 272-8258

Overview of the Presentation

- Healthcare Trends Related to Real Estate & Real Property
- Need for an Appraisal Process
- Appraisal Principles
- Healthcare Real Estate Market
- Classification and Valuation of Tangible and Intangible Real Estate and Real Property Assets
- Real Estate Forecasting
- Concluding Remarks

Healthcare Trends Related to Real Estate and Real Property: *The Four Pillars*



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Regulatory

Healthcare transactions are subject to regulatory scrutiny, including:

- False Claims Act / qui tam action
 - Stark Law
 - Anti-Kickback Statute
- State fraud and abuse laws
- *IRS regulations pertaining to excess benefit and inurement of private benefit*

Regulatory scrutiny has caused many healthcare providers to:

- Become increasingly uneasy in their role as landlord to their referring physicians
- Remove themselves from a landlord position by monetizing real property assets

Reimbursement

Healthcare entities are reimbursed for the cost of the use of real property through several channels:

Service	Reimbursement Channel
Hospital Inpatient	Diagnostic Related Groups (DRGs)
Hospital Outpatient	Ambulatory Payment Classifications (APCs)
Ambulatory Surgery Center	ASC Payment Rate
Skilled Nursing Facilities	Medicare: Resource Utilization Groups (RUGs) Medicaid: Explicit capital component in Medicaid rate-setting methodologies
Independent Diagnostic Testing	Physician Fee Schedule
End Stage Renal Disease	Composite Rate (CR)
Physician Practices	Practice Expense Relative Value Unit (PE RVU)

Competition

- Increasing focus on ownership of *tangible assets* such as new, high quality, technologically advanced services provided in part via buildings and facilities
- However, *capital demand* for information and medical technology, physician alignment and other initiatives have increased, forcing healthcare organizations to unlock equity from existing, non-core real estate assets

Technology

Rapidly changing technology *drives the need and creation of newer, updated facilities*, while also often *diminishing the value of those already in place*

- Digital requirements for data driven hospitals
- Energy use/efficiencies
- Heating, ventilation, and air conditioning (HVAC) systems with infection control
- Aging patient population
- Accommodations in caring for obese patients

Need for an Appraisal Process

Real property value depends on:

- Physical Attributes
- Legal Substantiation and Constraint
- Social Dynamics
- Economic/Demographic Characteristics

An appraisal must reflect:

- Complexity of real property interest
- Availability (or scarcity) of market information

Purposes of Valuation

Rendering an Opinion as to the Value of Real Property:

- Determining a fair purchase price
- Lenders determining a loan amount or for portfolio management
- An operating entity to reflect the real property value in its capital structure
- Physical assets for reimbursement (e.g., Medicare Cost Reports), tax, or insurance purposes
- Support of expert testimony in litigation

Typical Users of Valuation Services

An appraiser's independent value opinion is relied upon by:

- Buyers/Sellers
- Investors
- Lenders/Mortgage or Commercial Bankers/Leasing Companies
- Government Agencies & Taxing Authorities
- C-Suite Executives
- Medicare or Medicaid Auditors
- Professional Advisors
 - Certified Public Accountants
 - Attorneys
- Insurance Companies/ Risk Management Parties

Licenses and Certifications of Real Property Appraisers

- State Licensure Authorities
 - Certified General Appraiser
 - Registered Trainee Appraiser
- Professional Accreditations
 - Accredited Senior Appraiser (ASA)
 - Designated Member of The Appraisal Institute (MAI)

Statutory, Regulatory, and Professional Standards Governance

- Statutory
 - Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) – 1989
 - Sarbanes-Oxley Act – 2002
 - Dodd-Frank Act – 2010
- The Appraisal Subcommittee (ASC)
 - Federal agency charged with oversight of the state appraisal regulatory programs
 - Monitors activities of The Appraisal Foundation, ASB, & AQB
 - Provides federal grants to assist in the operations of ASB & AQB

Statutory, Regulatory, and Professional Standards Governance

- The Appraisal Foundation
 - Appraisal Standards Board (ASB)
 - Uniform Standards of Professional Appraisal Practice (USPAP)
 - Standards and Standards Rules
 - Statements on Appraisal Standards (SMT)
 - Other Communications
 - USPAP Advisory Opinions (AOs)
 - USPAP Frequently Asked Questions (FAQs)
 - USPAP Questions and Answers (Q&A)
 - Appraiser Qualifications Board (AQB)
 - Appraisal Practices Board (APB)

Types of Tangible and Intangible Assets

From an *economic perspective* it may be useful to consider assets, or *property*, within the context of four principal categories:

	Tangible Assets	Intangible Assets
Real Property	Land, Buildings, Leasehold Improvements	Easements, Permits, Leasehold Interests, Zoning Waivers, Use Rights
Personal Property	Furniture Fixtures and Equipment, Cash, Accounts Receivable, Supplies, Inventory	Trained and Assembled Workforce, Custodial Rights to the Patient Charts, Patient Care Protocols, Patents, Trademarks

Classification of Tangible Assets

Physical Assets

- Inventory
- Land
- Land Improvements
- Leasehold Improvements
- Buildings
- Equipment

Financial Assets

- Cash
- Accounts Receivables
- Pre-paid Expenses
- Intercorporate Investments
- Securities
- Tax-loss Carry Forward

Classification of Intangible Assets

Intangible assets should:

- Be subject to specific identification and should have a recognizable description
- Be subject to legal existence and legal protection
- Be subject to the right of private ownership, and the private ownership should be legally transferable
- Have some tangible evidence or manifestation of their existence
- Have been created or have come into existence at an identifiable time or as the result of an identifiable event
- Be subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event

Real Property in Contrast to Real Estate

Real estate encompasses the *land, buildings, and any permanent fixture* related to the land and buildings

Real property is “...*the bundle of legal rights which people have in...the very objects, particularly the tangible [and intangible] objects to which these rights attach.*”

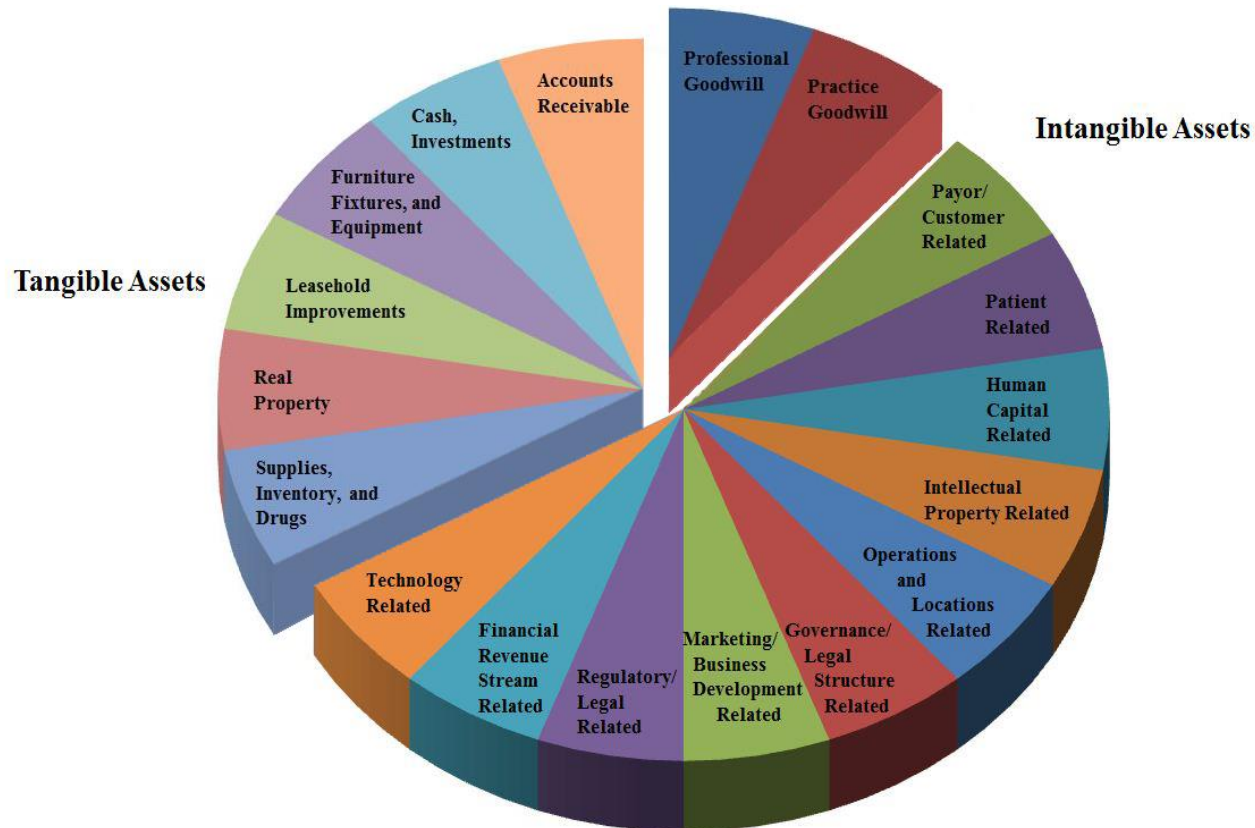
Assuming the premise that any given *legal right* is *intangible*, it is a logical deduction that *real property* is an *intangible asset*

Rights of Real Property Ownership:

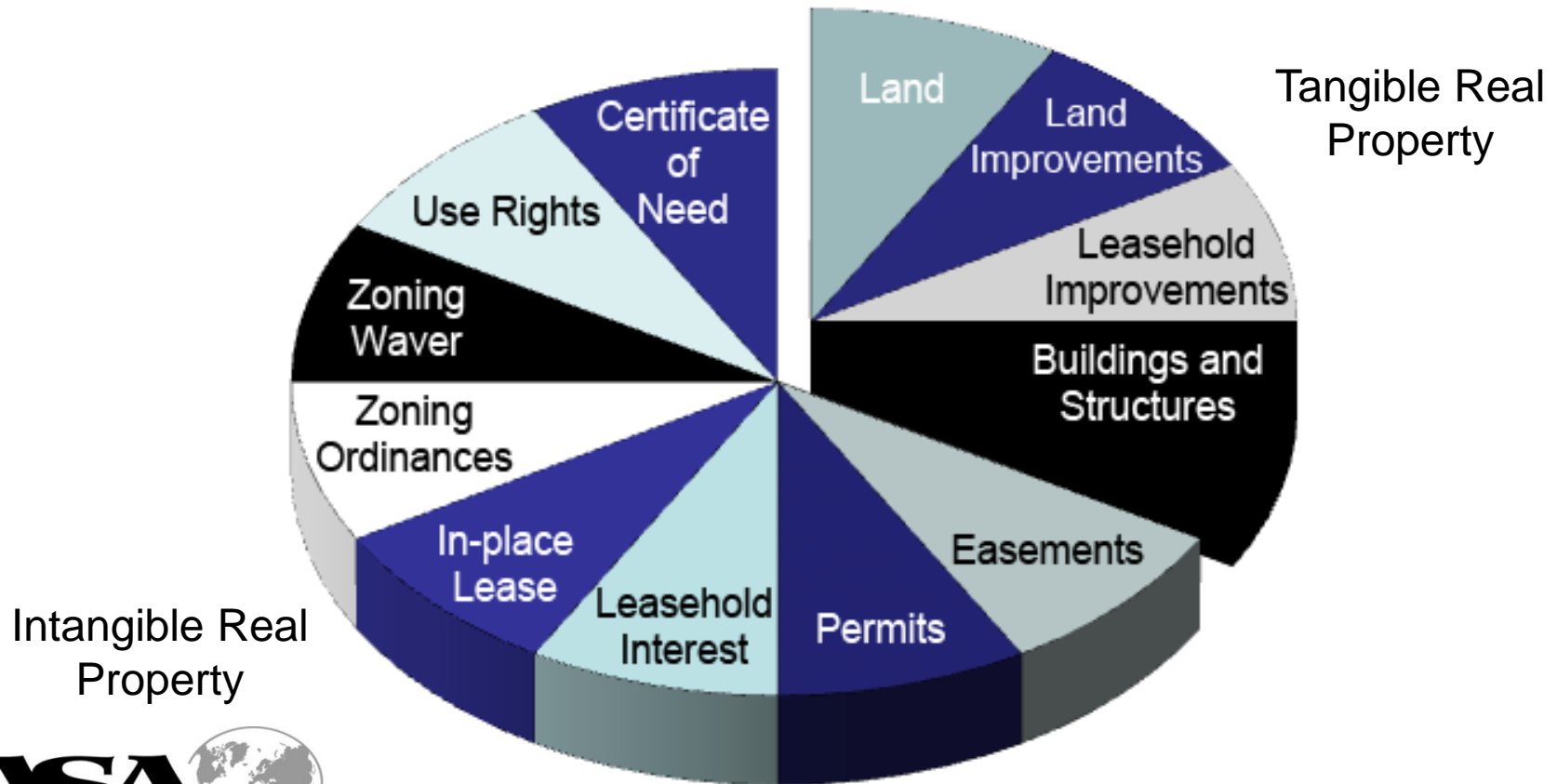
- Sell, Lease, or Trade Real Estate
- Use or Occupy Real Estate
- Mortgage or Encumber Real Estate
- Do Nothing

Polling Question 1

Types of Tangible and Intangible Assets in Healthcare Enterprises



Types of Tangible and Intangible Real Property in Healthcare



Contrasting Real Property Appraisal to Other Valuation Disciplines

Historical distinctions between real property appraisals and other appraisal disciplines:

- Statutes and regulatory pronouncements
- Professional standards for real estate appraisals (nationally and internationally)
 - USPAP
 - Individual appraisal society standards
- Individual licensure requirements for each state
- Appraisal definitions in legal venues (e.g., courts, agency hearings)
- Conflicting definitions and concepts in valuation society standards, glossaries, and educational materials

Contrasting Real Property Appraisal to Other Valuation Disciplines

- Despite challenges, there is overlap between the appraisal disciplines
- ***“Several otherwise diverse disciplines have or use certain principles in common. The general principles and methods apply for the most part to all appraisal disciplines.” – Richard Rickert, PhD***
- All appraisers draw from the same *“body of interdisciplinary principles, concepts and methods ... then apply them to diverse types of property”*
- This holds true for all types of property being valued
- The definitions and sources of data used may exhibit differences

Contrasting Real Property Appraisal to Business Valuation Methodology

Contrast in terms related to similar valuation principles

	Real Estate Appraisal Methods	Business Valuation Methods
Income Approach	Discounted Cash Flow (DCF)/ Yield Capitalization	Discounted Future Economic Income Method
	Direct Capitalization	Single Period Capitalized Economic Income Method
Market Approach	Sales Comparison	Merged and Acquired Company Method
	Effective Gross Income Multiplier	Guideline Publicly Traded Company Method
Asset-Based Approach	Cost Approach	Discrete Asset Accumulation Method
		Capitalized Excess Earnings Method

- Each approach requires market data observations
- All methods are interrelated and based on the principals of substitution and/or anticipation

Variance in Characteristics of Securities Transaction Exchange & Real Property Exchange Markets

Operating Real Property Transactions Markets	Securities Transactions Markets
Substantially heterogeneous properties competing for investment funds.	Generally homogeneous properties competing for investment funds.
Few buyers and sellers in any one price range at any one location (particularly for special purpose assets).	Large number of buyers and sellers.
Relatively high and fluctuating transaction prices.	Relatively uniform, stable, and low transaction prices.
High cost of individual transactions (including brokerage, information, and title-transfer fees).	Low cost of individual transactions (including brokerage, information, and title-transfer fees).
Secondary market transactions subject to regulations, registration, and legislation at all levels.	Relatively few government restrictions on secondary market transactions.
Volatile demand for and sluggish supply of properties.	Supply and demand of properties never far out of balance.
Potentially uninformed buyers and sellers who interact infrequently.	Reasonably knowledgeable and generally informed buyers and sellers.
Restricted disclosure of limited information (if any disclosure at all) regarding properties.	Public disclosure of substantial financial and operational information regarding properties.
Small, fragmented, overlapping market segments causing delayed consummation of transaction.	Organized market mechanism, allowing for rapid consummation and confirmation of transaction.
Durable, relatively immobile, and illiquid properties.	Readily " <i>consumed</i> ," quickly supplied, and easily transported properties.

Contrasting Real Estate to Business Appraisal

Selection of Risk Premia

Whether valuing real estate or a going concern business enterprise, both disciplines utilize risk premia to determine the indicated risk adjusted required rate of return

The derivation of the risk premia will differ between real estate & business appraisal disciplines

Real Estate Appraisal

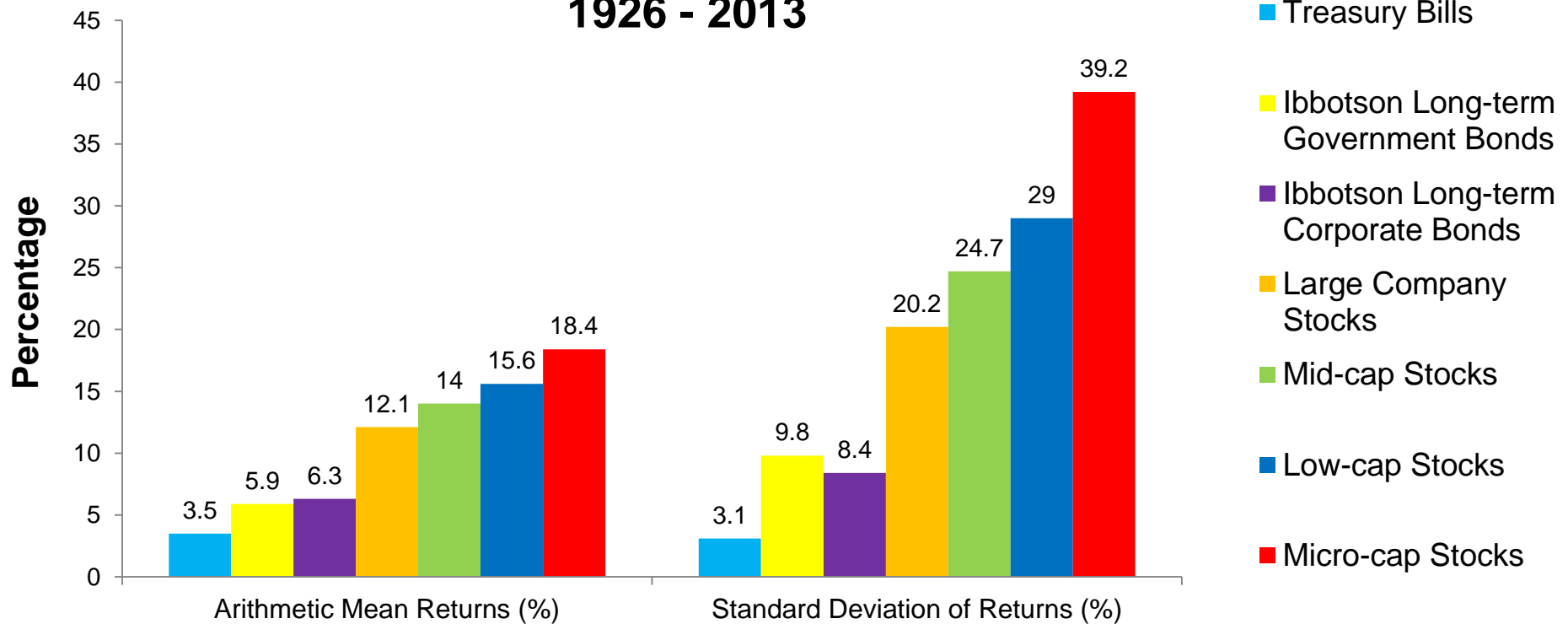
Risk premia measures difference between government treasury bonds and implied capitalization rates

Business Valuation

Risk premia measures difference between government treasury bonds and various equity market indices (e.g., S&P 500; Dow Jones Industrial Average; or, Wilshire 5,000)

Contrasting Real Estate to Business Appraisal Selection of Risk Premia

Average Annual Returns and Standard Deviation 1926 - 2013



Basic Appraisal Principles

Principle	Description
Anticipation	Value determined by the anticipated future benefits accruing from the property
Change	Property and its environment are always in transition
Supply & Demand	Supply of competitive space versus demand for space by users
Substitution	Value determined by the cost of an equally desirable alternative property of equal utility
Balance	Value is maximized when contrasting market forces are in a state of equilibrium
Conformity	Relationship between property and surroundings
Contribution	The value of a particular component is measured by the marginal increase in value attributable to its existence
Opportunity Cost	Costs associated with sacrificing opportunities not taken
Utility	Ability of a good to satisfy a need, want or desire

Healthcare Real Estate Market

Overview of Real Estate Market Characteristics

Characteristic	Description
Availability (or scarcity) of market information	Confidential sale prices, lease terms, financing
Relative lack of discourse and transparency	In contrast to stock, bond, or commodity markets
Segmented markets	Type property, location use type, investor type
Infrequent trades of property	May have to use older sales or sales from other neighborhoods
Immobility of real estate	Affected by happenings and trends in the general and immediate geographic area
Each parcel unique	No two parcels of real estate ever exactly alike

Healthcare Real Property Interests in Contrast to Healthcare Enterprises

Difficult to separate and allocate the value of real property elements from the value of the on-going enterprise because:

- Specialized real property characteristics
 - Difficult to convert to alternative use
 - Mostly single-use facilities
 - Value intrinsically tied to operation as healthcare businesses
- These specialized characteristics are of limited non-healthcare market use
- *Highest and best use* accrues only when real property is considered within its inclusion in or utilization by a healthcare enterprise

Healthcare Real Estate Market

Unique Aspects of Healthcare Real Estate

Limited Number and Restricted Nature of Market Comparables

- Larger healthcare facilities change hands infrequently
- The number of healthcare facilities in a given market area is limited – specialized in nature
- Healthcare facilities often change hands as operating businesses
 - The buyer purchases on a *value in use as a going concern* enterprise
 - Finding comparable sales of similar health facilities in a specific market pose a challenge

Healthcare Real Estate Market

Unique Aspects of Healthcare Real Estate

Capital and Labor Intensive/Specialized

- Specialized buildings cannot function without an adequate supply of skilled professionals
- Require a correct combination of capital and labor before a healthcare facility can operate as a healthcare business
- Healthcare businesses are capital and labor intensive
- Entry by new competitors into a market can be difficult

Healthcare Real Estate Market

Unique Aspects of Healthcare Real Estate

Limitations of the “*Highest and Best Use*” Concept

- The valuation of land associated with *healthcare projects* is different from valuing land for more general uses
- Real property associated with an existing healthcare facility or a healthcare facility to be constructed is *special-purpose facility* with:
 - Value of the real property tied to the value of the healthcare facility itself
 - *Highest and best use* analysis more complex than with *general use* real property:
 - Determining the value of the land as vacant
 - The real property as improved is difficult because of the unique, specialized nature of the assemblage

Healthcare Real Estate Market

Unique Aspects of Healthcare Real Estate

High Degree of Regulation

	Safety/ Health	Licensing	Environ- mental	Zoning	Fire/ Building Codes
Federal	X	X	X		
State	X	X			X
Local	X			X	X

Healthcare Real Estate Market

Unique Aspects of Healthcare Real Estate

Cash Flow Driven

- The economic contribution of real property is less dominant in the overall value of healthcare enterprises
- The *specialized, limited* use of healthcare facilities results in:
 - Healthcare real property investment tends to be *cash flow driven*
 - Less driven by *appreciation* of real property at disposal
- A separate appraisal *must* be made for the real property interest of an entity

Polling Question 2

Recent Economic Trends

Movement from inpatient care to outpatient care:

- Consolidation of the healthcare industry
- Increasing demand for outpatient care facilities
- Decreasing demand for free standing acute care hospitals
- Renewed interest by healthcare enterprises in “*monetizing*” the value of their real property
- *Uncertainty* surrounding the *impact of certain provisions* of the *Affordable Care Act (ACA)*
 - 32 million Americans expected to receive new insurance coverage
 - Resulting in need for 64 million additional sq. ft. of healthcare real estate space

Recent Economic Trends

- Retail clinics becoming increasingly important:
 - Increased ability to meet high demand at low cost
 - Convenience for patients
- Rise of *value-based reimbursement*
- Aging *baby boomers*' need for healthcare services
- Medical providers looking to increase visibility for preventative care and health education through:
 - Use and creation of retail outlets
 - Retail strategy for healthcare – “*Wal-martization*” of healthcare
 - Expanded use of more diverse real estate ventures

Recent Economic Trends

Change in demand for healthcare real estate driven by:

- Consolidation in hospital systems
- Expanding concierge practices
- Expanding and changing delivery models
- Health Insurance Exchanges (HIE)
- Potential utilization of technology centers for specialty hubs (e.g., telemedicine) as a *hub-and-spoke* delivery system

Recent Economic Trends

Increasing conversion of existing structures related to:

- Proximity to a hospital and surrounding demographics
- Amount of contiguous space and efficient throughput of patients
- Relative technological functionality and environmental compliance
- Overall feasibility of conversion

Healthcare real estate market indicators:

- Long-term, stable leases
- Diversity of income sources
- Diversity of tenants within healthcare industry
- Increase in utilization demand for healthcare services

Monetization of Healthcare Real Property Assets

- **Sale/Leaseback** – Part of real property interest
- **Sale/Master Leaseback** – Entirety of real property interest
- **Joint Venture** – Joint ownership a separate legal entity
- **Credit Tenant Lease** - Single purpose entity maintains control of the property during the lease term

Types of Healthcare Facilities

Short-Term Acute Care Hospital

- 5,723 registered hospitals in the United States
- 4,999 community hospitals - nonfederal, short-term general & specialty hospitals whose facilities and services are available to the public
- 724 federal, military and private hospitals

Community Hospital Ownership

- 58% owned by religious orders or other nongovernment, non-profit entities
- 21% owned by for-profit companies
- 21% owned by state and local governments

Types of Healthcare Facilities

Short-Term Acute Care Hospital

Specialized Real Estate Requirements

- Medical/Surgical Gas/Liquid Lines
- Toxic/Other Waste Handling Facilities
- Emergency Controls
- Electronic Monitoring and Sensing Systems
- Internal Conveying Systems
- High Speed Internet and Digital Bandwidth
- Internal Communication and Recording Systems
- Specialized Storage Capabilities
- Specialized Insulation Requirements
- Seismic Stressing
- Specialized Wall, Floor, and Other Coverings
- HVAC with Infection Control

Types of Healthcare Facilities

Specialty Hospital

Uniquely designed to treat a *specialized category of patients* often characterizing the patient population

- 4,054 Surgical Hospitals in the United States
 - Includes Orthopedic and Cardiac Surgical Hospitals
- 413 Psychiatric Hospitals in the United States
- 200 Children's Hospitals in the United States

Types of Healthcare Facilities

Long-Term Acute Care Hospital (LTACH)

- A hospital which has an average inpatient length of stay of greater than 25 days
- Provide care to patients that are too ill for skilled nursing facilities, but who no longer need short-term acute care
- LTACH patients typically require *medically complex* and *coordinated services* from various types of providers, including *nurses, therapists, and physicians*

Types of Healthcare Facilities

Skilled Nursing Facilities (SNFs)

- Over 15,000 Skilled Nursing Facilities in the United States
- State licensed to provide *nursing care* on a 24-hour basis as well as:
 - Dietary Services
 - Housekeeping & Laundry Services
 - Range of rehab/therapy services
 - Physical, occupational, speech, etc.
 - Social & Recreational Services
- May have additional state licenses for:
 - Alzheimer's Care
 - Mental Health
 - Developmental Disability
 - Hospice & Palliative Care
 - Traumatic Brain Injury

Types of Healthcare Facilities

Rehabilitation Centers

Offer an *interdisciplinary approach* to treatment using:

- Psychiatrists
- Surgeons
- Physical therapists
- Occupational therapists
- Rehabilitation nurses
- Rehabilitation counselors
- Respiratory therapists
- Recreation therapists
- Social workers
- Psychologists
- Speech-language pathologists

Types of Healthcare Facilities

Assisted Living Facilities (ALFs)

- Over 38,000 ALFs in the United States
- Provide personal care to residents who need assistance with the activities of daily living such as
 - Toileting
 - Walking
 - Eating
 - Medication
 - Bathing
 - Dressing
- Trend toward more intensive service components

Types of Healthcare Facilities

Independent Living Communities

- Age restricted multifamily properties with central dining facilities
- Typically offer:
 - Housekeeping
 - Linen services
 - Meals
 - Transportation
 - Social & recreational activities
- Designed for residents who *can live without* significant healthcare support

Types of Healthcare Facilities

Medical Office Buildings (MOBs)

- 478,000,000 sq. ft. of medical office space in the U.S.
- Primarily occupied by professional medical practices (e.g., physician practices, cosmetic and aesthetic medicine centers)
- Generally 30,000 to 60,000 square feet, low to mid-rise buildings
- Designed for multiple tenants
- Entire buildings may be converted to single, specialized uses

Polling Question 3

Types of Healthcare Facilities

Ambulatory Surgery Centers (ASCs)

- Outpatient facilities where surgeries that *do not require inpatient hospital admission, or a length of stay lasting more than 24 hours*, may be performed
- 5,359 Medicare Certified ASCs in the United States as of October 2012
- 65% of ASCs owned solely by physicians as of 2011 (and 17% owned jointly by hospitals and physicians)

Types of Healthcare Facilities

Diagnostic Imaging Centers

- 6,514 Diagnostic Imaging Centers in the U.S.
 - 66% are owned by an imaging center chain
 - 34% are single sites
- Provide:
 - Computed tomography (CT) scans
 - Positron emission tomography (PET) scans
 - Magnetic resonance imaging (MRI)

Types of Healthcare Facilities

Cancer Treatment Centers

Provide cancer patients with non-surgical cancer treatment modalities

- Chemotherapy therapy
- Radiation therapy
- Ancillary diagnostic imaging technologies

Types of Healthcare Facilities

Dialysis Centers

Care for *End Stage Renal Disease* (ESRD) patients:

- In-center
 - *Hemodialysis*
 - *Hemofiltration*
 - *Peritoneal dialysis*
 - *Pharmacy*
 - *Lab services*
- *Home hemodialysis and peritoneal dialysis training*

Types of Healthcare Facilities

Walk-in Clinics: Urgent Care Centers and Retail Clinics

Urgent care

- 9,300 walk-in, stand-alone urgent care centers in U.S.
- Treat an *acute* illness or episode on a *walk-in basis*
- May be certified & accredited
- Historically owned & operated by a group of physicians

Retail clinics

- 1,418 retail medical clinics in U.S.
- Treat *non-acute* illnesses & conditions on *walk-in basis* in contrast to appointment based physician practices
- Recently developed by retailers and pharmacies
 - Wal-Mart
 - Walgreens
 - Grocery Stores

Types of Healthcare Facilities

Adult Day Centers

- Adult Day Centers (ADCs) offer long-term care for the elderly and adults with diminished capacity; services typically include:
 - Health
 - Personal Care
 - Supportive Services
- Currently, Medicare does not reimburse for ADC services, but Medicaid does
 - Bill introduced to have Medicare cover services in 2013 failed to pass

Types of Healthcare Facilities

Wound Treatment Centers

- Treat chronic wounds
 - Resistant to therapy
 - Provide additional risk of mortality/morbidity to the patient
 - Diminish the patient's quality of life
- Encompass a wide range of etiologies from diabetes to trauma
- Require a different set of skills or expertise than caring for other types of injuries or ailments

Types of Healthcare Facilities

Pain Management Centers

Multidisciplinary oriented

- Focus on the *diagnosis* and *management* of *chronic pain*
- Use of *team* of physicians, psychologists, nurses, and physical and occupational therapists

Modality oriented

- Offer specific treatment options
 - Nerve block clinics
 - Transcutaneous nerve stimulation clinics
 - Acupuncture clinics
 - Biofeedback clinics

Types of Healthcare Facilities

Medical Laboratories

Provide an isolated setting where samples of tissues, fluids, and other bodily substances can be tested and/or stored

Clinical laboratories

- *Collection and examination* of bodily materials for: *diagnosing, preventing, treating, or assessing* an illness or condition

Reference laboratories

- Biobank or biorepository
 - Collects, catalogs, and stores samples of bodily substances and reference materials in furtherance of scientific research and development
- Independent laboratory
 - Receives samples from a hospital or physician practice for *diagnostic* or *pathologic* testing
 - Do not collect specimens from patients directly
 - Receive specimens from other labs or healthcare providers

Polling Question 4

Real Estate Investment Trust (REIT)

- Manage portfolio of real estate holdings for capital appreciation, income, or both
- REITs often purchase and bundle healthcare related real properties which generate rents and revenue streams:
 - Hospitals
 - Senior Housing and SNFs
 - Medical Office Buildings
- Distribute at least 90% of their taxable income as dividends to shareholders

Real Estate Investment Trust (REIT)

Derive at least 75% of their *gross* income from the following:

- (1) Interest on obligations secured by mortgages on real property (or on interests in real property)
- (2) Gain from the sale or other disposition of real property (including interests in real property and interests in mortgages), which is not "*dealer property*" under Section 1221(1)
- (3) Dividends or other distributions on, and gain from the sale of, shares (other than prohibited transactions) in other qualified REITs
- (4) Abatements and refunds of real property taxes
- (5) Income and gain from foreclosure property

Real Estate Investment Trust (REIT)

Derive at least 75% of their *gross* income from the following (cont'd.):

- (6) Certain amounts received as consideration to enter agreements to:
 - (a) Make mortgages
 - (b) Purchase or lease property
- (7) Gains from sales of real property that are included within the prohibited *transaction safe harbor*
- (8) Qualified temporary investment income

Healthcare REITs: Volatility & Returns

As of 5-30-2014

	A	B	C	D	
	REIT (1)	Annual TTM Returns (2)	3 Year CAGR (3)	5 Year CAGR (3)	
1	Health Care REIT, Inc. (HCN)	-4.15%	11.46%	19.38%	1
2	HCP, Inc. (HCP)	-8.20%	8.36%	18.50%	2
3	Ventas, Inc. (VTR)	-4.02%	10.40%	22.47%	3
4	Universal Health Realty Income Trust (UHT)	1.17%	6.05%	13.17%	4
5	Medical Properties Trust, Inc. (MPW)	-4.99%	10.61%	25.75%	5
6	Healthcare Realty Trust, Inc. (HR)	-1.46%	9.98%	14.90%	6
7	National Health Investors, Inc. (NHI)	4.99%	16.17%	25.94%	7
8	Cogdell Spencer Inc. (CSA) (4)	N/A	N/A	N/A	8
9	Omega Healthcare Investors, Inc. (OHI)	18.39%	28.74%	26.61%	9
10	Sabra Health Care REIT, Inc. (SBRA)	11.25%	27.55%	8.97%	10
11	LTC Properties, Inc. (LTC)	-1.76%	16.55%	20.47%	11
12	Senior Housing Properties Trust (SNH)	-2.80%	6.59%	14.95%	12
13	Average	0.76%	13.86%	19.19%	13

Definition of Value and Conditions of Sale

Standard of Value

(answers question ***Value to Whom?***)

- Fair Market Value (FMV)
- Fair Value
- Investment Value

Conditions of Sale

(answers question ***Value Under What Further Defining Circumstances?***)

- Typical Exposure to Market
- Quick Liquidation
- Forced Sale

Tangible Real Property Valuation Methods

- The *real property* utilized by the subject enterprise being acquired in a healthcare transaction is often:
 - *Not owned* by the subject enterprise
 - *Leased* by the subject enterprise
- When owner of real property holding company is also owner of the subject healthcare enterprise, a *separate appraisal* of the *lease rate* being paid by the subject enterprise may be warranted *to ensure that payment is at FMV*
- *Separate appraisal of real property interest* often warranted to ensure entity's *capital structure* reflects the economic FMV of underlying asset
- Real property valuation requires *specific knowledge & skill sets*
- A licensed, certified real estate appraiser is often engaged to complete the real property appraisal component of overall healthcare valuation

Income Approach for Valuing Tangible Real Property

- Involves the analysis of the *income producing capabilities* of the subject property
- Includes the projection of the related *revenue streams* and the *economic cost burdens* necessary to support those *revenue streams*
- The *net economic benefit* derived from these revenue streams and expenses is then *capitalized* to derive an indication of value

Sales Comparison Approach for Valuing Tangible Real Property

- Indication of value can be derived from *valuation metrics* reported in *transactions* of *properties* deemed to be *comparable* to the subject property
 - Homogenous badges of comparability
- Define the subject asset's *categories of market attributes*
 - *Ownership Interest*
 - *Nonmarket Financing*
 - *Locational Characteristics*
 - *Physical Characteristics*
 - *Economic Characteristics*
 - *Use of Property*
 - *Non-Realty Components of Value*

Sales Comparison Approach for Valuing Tangible Real Property

- *Market derived value opinion* must be adjusted for:
 - All expenses necessary to deliver the land in an *undeveloped state*, including:
 - *Demolition*
 - *Any remediation necessary*
- For example, an *aging hospital facility* appraisal may consider the following:
 - *Presence of toxic, radioactive medical waste* on facility
 - *Use of hazardous building materials*
 - *Architectural designs* that are *inefficient* for use in contemporary healthcare service delivery models
 - *Engineering specifications* that are *too costly to retro-fit* with new technologies

Market Approach for Valuing Tangible Real Property

- Healthcare facilities are often *special-use buildings* that may **limit** the market of comparable buildings from which to derive an indication of value
- If the current or prospective use of the property is *functionally or technologically obsolete* due to its *purpose-specific design*, the **highest and best use of the property may be as undeveloped land... or possibly a less intensive use**

Asset/Cost Approach for Valuing Tangible Real Property

- Involves two distinct property interests:
 - The land
 - Any and all land improvements (including the buildings)
- Separate valuation of the buildings and other land improvements may be performed under
 - *Reproduction Cost Method*
 - *Replacement Cost Method*
 - Estimation of **all** costs related to the replacement of the land improvements, less all depreciation, including:
 - Physical deterioration
 - Functional and technological obsolescence
 - External (economic) obsolescence

Classification and Valuation of Land & Land Improvements

- Each parcel of land is *unique* in its location & composition:
 - Land is physically immobile
 - Land is durable
 - Land is often useful to people
- Land can be used for many purposes
- Most important factor related to land is its *location*
- Second most important factor is the property rights such as zoning and use restrictions

Classification and Valuation of Land & Land Improvements

- Due to the nature of healthcare services and the environmental waste they may generate, many sites upon which healthcare entities reside *may require remediation* in some form should the land be *sold* or *repurposed*
- This requirement serves as a *negative reversion* to the value of that *real property interest*
- For example, a *cancer treatment center* or a *diagnostic imaging center* may be constructed to include lead shielding for the purpose of blocking radiographic exposure

Polling Question 5

Classification and Valuation of Intangible Real Property

- Future *net economic benefit* from each interest *not homogenous*
- Some revenue streams are *directly* related a specific interest
- Some interests won't *directly* produce a *revenue stream*
 - Allow owner ability to *reduce or avoid* an *economic operating expense* and/or *economic capital expense*
 - *Avoided costs* may be quantified and projected in a similar manner to a *projected revenue stream*
- Certain intangible real property interests **cannot** be *directly* measured as a *revenue stream* or an *avoided cost*
 - Alternative may be *Market Approach* based valuation methods
- *Asset/Cost Approach* may be used assuming **availability** of **relevant data** related to **costs** incurred or required to develop the subject interest

Classification and Valuation of Intangible Real Property

Easement:

- The *right to perform a specific action on a specific parcel* of real estate created by *contract*:
 - Through *government acquisition, i.e., eminent domain*
 - *As a matter of law*
 - *Use right*

Permits:

- *A certification by a governmental entity* (usually a local authority)
- *Authorizes the use or development* of real estate
- Serves as a form of *land-use control*

Classification and Valuation of Intangible Real Property

Leasehold Interest:

- May arise when a *fee simple interest* in real property is divided by a lease agreement between a *lessor* and a *lessee*
 - The *lessor's partial interest* is a *lease fee interest*
 - The *lessee's partial interest* is a *leasehold interest*
- An *intangible real property asset* can be created when the contractually agreed upon lease rate (*contract rate*) is *higher* or *lower* than the *market rate*
 - *Positive leasehold interest* if *market rate* is above the *contract rate*
 - *Negative leasehold interest* if *market rate* is below the *contract rate*

Classification and Valuation of Intangible Real Property

Zoning Ordinances:

- Real estate development is subject to conforming to existing zoning ordinances
- Established by state and local government to regulate land use
- Three broad categories of land zones include:
 - Residential
 - Commercial
 - Industrial
- Zoning restrictions may include:
 - Height & size of buildings
 - Lot coverage
 - Parking requirements
 - Setbacks
 - Number of units

Classification and Valuation of Intangible Real Property

Zoning Waiver

- Typically *applied from and approved by* a land use committee
- Removing a zoning requirement may potentially increase the land value due to a new highest and best use

Economic value of the *zoning waiver* is:

- The value of the highest and best use of the subject property *with* the waiver or variance
- **Less** the value of the highest and best use of the subject property restricted by the zoning ordinance

Classification and Valuation of Intangible Real Property

Use Rights

- Water use rights
- Mineral and drilling rights
- Air rights
- Subterranean rights

Economic value may be *quantified*:

- Directly through generation of certain revenues (e.g., mineral rights)
- Indirectly from change in value of subject property (e.g., water rights)
- Similar to an easement

Classification and Valuation of Intangible Real Property

Certificates of Need

- 36 state governments still enforce some type of CON law regulation
- Determine where, when, and how capital expenditures will be made for healthcare facilities, services, and major equipment
- Valuation of an existing CON
- *Direct* costs associated with the *CON approval process*
- *Indirect* costs associated with the *CON approval process*
- The quantification of the *avoidance* of the time and effort other market participants would be required to *develop and implement* a successful application to achieve a *similar CON* in the same geographic market service area of the *subject CON*

Polling Question 6

Income Approach for Valuing Intangible Real Property

- Forecast revenue streams from ownership or control of property
- Apply *economic operating* and *capital* expense burdens
- Resulting future net economic benefit stream *discounted to present value* using a *risk-adjusted rate of return*
- May be the most pertinent method of valuation for certain assets
 - Leasehold interests
 - Permits
 - Certain use rights

Market Approach for Valuing Intangible Real Property

Utilize comparable transactions

- Search criteria include type, risk profile, location
- Comparable transactions are aggregated and adjusted to derive conclusion and opinion of value

When a market for the subject asset *does exist* and is *established, liquid and transparent*, ensure that:

- Reported transactions are from *reliable sources*
- Market information represents negotiations at *arm's length*
- Selected transactions are based on *homogenous badges of comparability* to the subject property

Asset/Cost Approach for Valuing Intangible Real Property

- May be useful for valuing certain types of intangible real property, e.g., agreements, permits, licenses, and Certificates of Need
- Determination of the requisite input costs necessary to reproduce the subject property
- Costs are aggregated to find a ceiling of value from which applicable economic depreciation is deducted

Forecasting Principles

- Appropriate timeframe based on the most recent data & trends
- Appropriate units (e.g., per sq. ft. or unit) for the forecast decision
- Level of detail appropriate to capture key factors affecting the forecast item(s)
- Clearly state assumptions and limitations

Cash-Flow Forecasting

- Accomplished by:
 - Reviewing historical information
 - Recognizing relationships between influential factors
 - Drawing conclusions about probable future events
- Final conclusions reached by applying:
 - Modeling techniques
 - Informed, professional judgment based on accepted methodology and body of knowledge
 - Time series analysis

Cash-Flow Forecasting

- **Revenue**
 - **Rent** – Revenue generated by charging a tenant to occupy a defined space, usually through execution of a lease
 - **Other** - Revenue generated from laundry facilities, vending machines, parking, etc.
- **Operating Expenses**
 - Fixed expenses (e.g., property taxes, insurance)
 - Variable expenses (e.g., utility costs, janitorial expenses)
 - Items not included in building expenses (e.g., ownership equity management fees, partnership fees)

Cash-Flow Forecasting

Measurements of income

- **Potential gross income (PGI)** – Potential revenue at full occupancy before deducting any expenses
- **Effective gross income (EGI)** – Anticipated revenue after vacancy and collection losses
- **Net operating income (NOI)** – Residual income after deducting all operating expense from EGI
- **Before-tax cash flow (BTCF)** – Residual cash flow that remains after debt service but before depreciation and income taxes are deducted from NOI
- **After-tax cash flow (ATCF)** – Residual cash flow that remain after income taxes are deducted from BTCF
- **Reversion** – Expected cash to be received at sale

Rental Income Forecasting

- **Gross lease** – Landlord pays all operating expenses
- **Net lease** – Tenant pays most operating expenses, except taxes, insurance, management and, sometimes, exterior maintenance
- **Absolute net lease** – Tenant pays all operating expenses
- **Rental rate** is applied to:
 - **Net usable area** – Space that can be occupied by tenants
 - **Net leasable area** – Includes pro-rata share of common area
 - **Gross building area** – Total floor area
- **Rental units** of comparison
 - Per square foot of **building area**
 - Per square foot of **net leasable area**
 - Per unit of **agreed anything**

Operating Expense Forecasting

- **Methods of estimating operating expenses:**
 - Direct dollar estimate
 - Expenses per square foot of gross building area
 - Expenses per square foot of net building area
 - Percent of effective gross income
 - Expenses per unit
- **Key ratios for calculating reasonableness of expense estimate:**
 - Expenses per square foot of gross building area
 - Expenses per square foot of net building area
 - Operating expense ratio
 - Expenses per unit

Resale Proceeds Forecasting

- ***Holding period*** – Time period over which a property is owned before being sold
- ***Marketing period*** – Time required between the decision to sell and the time the sale closes
- ***Absorption period*** – Time required to fully rent a property

Resale Proceeds Forecasting

- **Resale value**
 - ***Direct dollar forecast*** - Making a direct dollar forecast of resale proceeds without basing it on a calculation method
 - ***Estimated percentage change*** - Assume a percent change in value over the holding period
 - ***Terminal capitalization rate*** – Final period of income of projection is capitalized at the rate expected at time of sale
- **Disposition costs**
 - Sales commissions
 - Legal fees

Concluding Remarks

Pursuing Interdisciplinary Collaboration

Healthcare Industry Specific Appraisal Assignments

Real Estate Appraisal • Machinery & Technical Specialties

Personal Property • Business Valuation • Intangible Assets/IP

Separate and Distinct Disciplines in the Same Profession

- Similar Tools to Solve Similar Problems
- Shared Clients
- Interdisciplinary Approach Yields Significant Benefit to Both Clients and Appraisers

We CAN Work Together!

Concluding Remarks

We Can (and should) All Work Together!

- To obtain the requisite background for forecasting the future performance of healthcare enterprises, assets, and services in the current dynamic era of healthcare reform, valuation professionals should develop and maintain an in-depth understanding of the history and the development of healthcare delivery, as well as, the unique dynamics of those often complex business arrangements that comprise newly emerging healthcare organizations and the various elements of property value involved in each.
- A multidisciplinary project team of appraisers has the potential to provide an enhanced scope and diversity of knowledge and breadth of experience to the benefit of both the appraisers and the client.

Concluding Remarks

We Can (and should) All Work Together!

- When developing an understanding of the forces and stakeholders that have the potential to drive healthcare markets, valuation professionals must examine the subject enterprises, assets, and services as they relate to and within the context of:
 - ***“The Four Pillars of the Healthcare Industry”***
 - Reimbursement
 - Regulatory
 - Competition
 - Technology
- These four elements serve as a conceptual framework for analyzing the viability, efficiency, efficacy, and productivity of the subject property interest(s)

Concluding Remarks

We Can All Work Together!

- More informed and uniform valuation practice would benefit the users of healthcare valuations and improve public confidence in appraisers
- To enhance competency, significant specialized education and training is an important benefit for healthcare appraisers and clients
- Given these issues, a multidisciplinary approach toward advanced education related to healthcare industry valuation is an important initiative of the ASA, as the premier multidisciplinary valuation society of professional appraisers