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A Case for *Rational* Asset Allocations of Hospital Sale Transactions

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Abstract: This article address the need to effectively identify real estate, personal property and intangible business component values that are part of hospital sale transaction. The article reviews prior related articles on the component allocation of healthcare properties, and proposes a method to check the reasonableness of component allocations as part of hospital sale transactions.

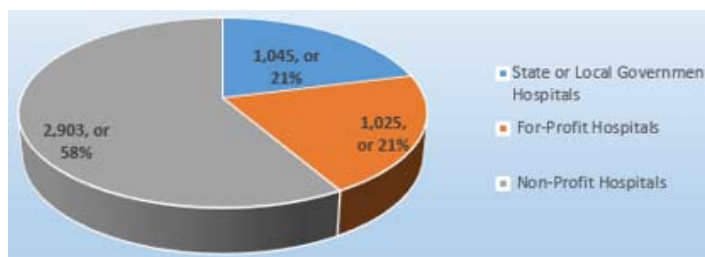
A Case for *Rational* Asset Allocations of Hospital Sale Transactions

The commercial appraisal professional continues to attempt to increase awareness about sales of going concern business enterprises, and the need to separate component asset values. There are many property types that regularly change ownership where more than real estate assets are typically conveyed. When the total assets of a business enterprise change ownership, and are to be valued, another term coined in 2002 (by Wolverton, Lennhoff & Vernor) was *Market Value of Total Assets of a Business (MVTAB)*. For the purpose of this paper, the terms *business enterprises*, *going concern businesses* and *MVTAB* are used interchangeably. Examples of property types that typically sell as business enterprises include healthcare properties (retirement homes, nursing home, hospitals), hotels, casinos, convenient stores and gas stations, restaurants, regional malls, and others.

Need For Allocations:

When hospitals are profitable and change ownership, the transaction usually includes real estate, personal property (furniture and equipment), and intangible personal and business value. Market prices for the sale of the entire businesses are often reported in local papers, trade publications or annual reports. However, the market sale transactions of these property types rarely include a negotiated component allocations between buyer's and seller's. Often, sellers will use one allocation in their accounting while buyers will use an altogether different allocation among component assets for their accounting purposes.

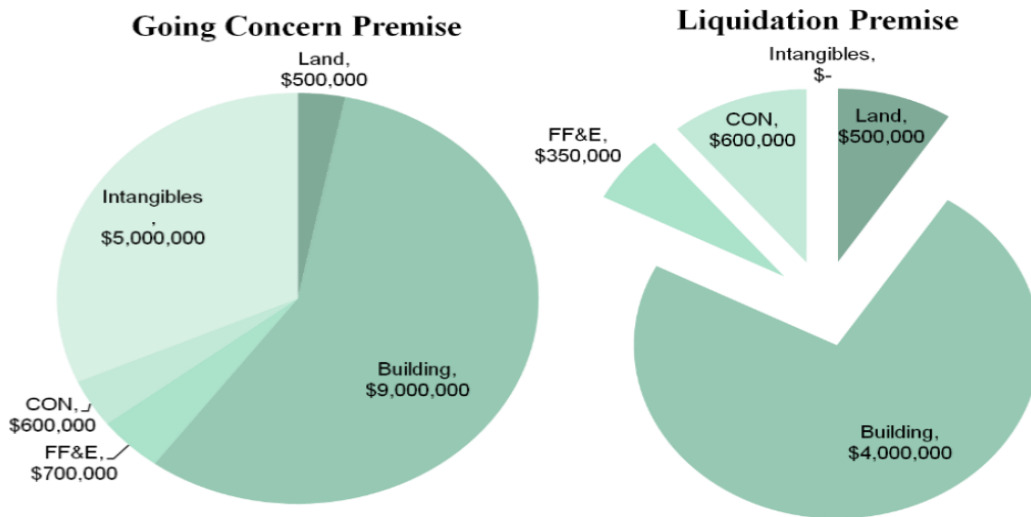
As shown in the following graph 21% of hospitals are for-profit entities, 21% are government hospitals and 58% are private non-profit entities.



Source of Statistics: *AHA Hospital Statistics 2013*, as reported in [Becker Hospital Review](#), *50 Things to Know About the Hospital Industry*, July 2013

In most cases, when a hospital is acquired as a total business enterprise, the sale will, at minimum, include real estate, personal property and business value. *Theoretically*, the estimated value of the real estate, that is part of a hospital business enterprise sale transaction, should be the same if the buyer is a for-profit hospital company or a non-profit hospital company. In the case where a hospital has not been profitable, the amount of intangible or business value may be lower; but, if the highest and best use is for the facility to continue as a going concern hospital, then there is some intangible or business value. In an ongoing hospital sale, there is an established workforce, there are service-provider contracts in place, there are hospital contracts with insurers and physicians in place. In many states, there are certificates of need (CON) that limit competition. *If the hospital is going to continue as a hospital, it would be very hard to support a premise that a sale price did not include any intangible or business value.*

The following is an example of a nursing home allocation taken from an *Appraisal Institute* forum given at the annual Appraisal Institute Conference in 2011:



Source of Graphs and Numbers: *Appraisal Institute Going Concern Forum: Valuation Issues in Appraising Realty and Non-Realty Components, Las Vegas, 2011, Page 70.*

Going Concern Premise			Liquidation Premise		
	Asset Values	% of Total		Asset Values	% of Total
Land Value	\$500,000	3.2%	Land Value	\$500,000	9.2%
Buildings Value	\$9,000,000	57.0%	Buildings Value	\$4,000,000	73.4%
FF&E Value	\$700,000	4.4%	FF&E Value	\$350,000	6.4%
CON Value	\$600,000	3.8%	CON Value (a)	\$600,000	11.0%
Intangibles	\$5,000,000	31.6%	Intangibles	\$0	0.0%
Total Transaction Assets	\$15,800,000	100.0%	Total Transaction Assets	\$5,450,000	100.0%

(a) Apparently assumes CON could be moved to another location.

According to *this* example from the Appraisal Institute seminar, the value of the real estate for a profitable nursing going concern is approximately 60% of the total value, with a personal property and intangible value of approximately 40%. Also in this example, the value of the intangibles would be zero in a liquidation scenario.

Component asset allocations are needed for accounting purposes, for financing purposes, or for other reasons. The level of appraiser experience in hospital appraisals varies widely. Hospitals are a complicated asset type, but many communities have one or more, and there are a large number of appraisers that have prepared appraisals of hospitals in the past, for one purpose or another. There are examples where the real estate value is estimated by one appraiser at the time of a transaction at one number, then is estimated at a much higher number by another appraiser engaged for a bond financing transaction that follows shortly thereafter. There are examples of particular for-profit hospital company executives wanting much higher real estate values allocated with a hospital purchase, because “they have made representations to our investors that the real estate value should be higher.” There are examples of hospitals selling as a business enterprise to another hospital company, then “the hospital real estate” being flipped shortly thereafter to a real estate investment trust (REIT) for double the price; the REIT buyer then recorded the full price as real estate value. *In the absence of clear support for reasonable ranges of real estate component values from the accounting profession, the following is a case study that establishes a quantitative method of providing reasonable asset allocations for hospital sales transactions.*

Common Purchase Allocation Methodologies:

The most common methodology used to allocate the real estate, personal property and intangible value for a hospital transaction is the Cost Approach. This was the method recommended by this author in the 1992 published article “*Estimating Hospital Real Property Values for Ad Valorem Tax Purposes*” (Bates). According to a 2013 article, “*Separating The Real Property From The Tangible And Intangible Personalty in Appraisals*” (Lennhoff), the Cost Approach “is the most straight forward approach, as it completely eliminates the need to address the tangible and intangible personalty.” In a senior housing article published in 2011, “*Valuation of Real Estate Within Senior Living Facilities*” (Beazley, Sparks, Bates), “the Cost Approach is more reliable with sufficient data to support land value and the replacement cost of the improvements.”

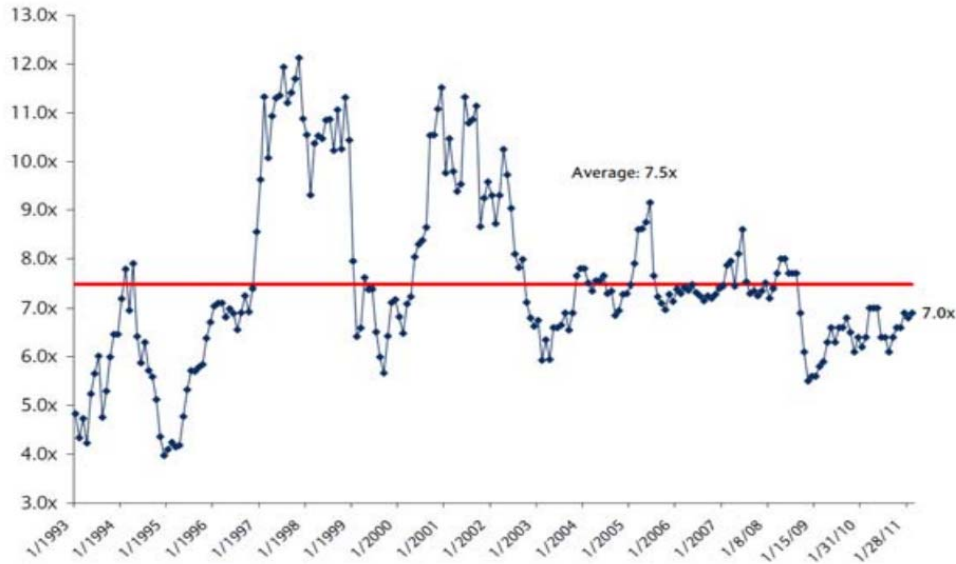
The Sales Comparison Approach can be a good method to be used in a hospital purchase allocation if the buyers and sellers have agreed upon component allocations, if that information is readily available, which is often not the case. Also, comparative sales should have similar ages, conditions, functionality, and the entire going concern sales must reflect a similar hospital market and profitability structure.

An Income Approach is also a very common methodology for separating values within the purchase price that are non-real estate components. This residual methodology begins with the total business income, then deducts income associated with business operations, intangibles, personal property. The remaining income is then capitalized at market rates to estimate real estate value. This method, or derivatives of this method, are the most common used in ad valorem valuations of hotels and regional malls. This approach has also been used for hospital tax appeals, but it is not very reliable for hospitals that have high or low profitability levels. It is generally relatively reliable only for average profit hospitals.

Test of Reasonableness for Hospital Allocations:

The 2011 senior housing article referenced earlier discusses general business enterprise capitalization rates for Independent Living Facilities (ILFs), Assisting Living Facilities (ALFs) and Skilled Nursing Facilities (SNFs). Typical capitalization rates for these three healthcare properties were listed in Table 4 of that article at 8.8%, 9.5% and 12.5%, respectively. That article, which cited other articles and court cases, concluded ranges of real estate value of 35% - 70% for ILFs, 30% - 65% for ALFs and 20% - 55% for SNFs. As discussed in that article, the lower the business enterprise capitalization rate the higher the real estate component value. Conversely, the higher the business enterprise capitalization rate, the lower the real estate component and the higher the person property and intangible value components.

Hospitals are generally considered to be more special-purpose than the above senior housing property types. Hospitals have historically been bought and sold on net revenue and EBITDA (Earnings Before Interest, Taxes, Depreciation, Amortization) multiples. According to Barclays Capital, and shown on the next page, average hospital EBITDA purchase multiples for hospitals have traded in a fairly tight range around 6.0 to 9.0 time EBITDA in the last eight to nine years, with an average multiple of 7.5 times EBITDA:



Note: As of March 8, 2011.
Source: Barclays Capital, Reuters, FactSet.

This equates to comparative capitalization rates of 12.5% to 16.7%. Given this market evidence, we would expect weighted average asset component yields for most stabilized hospital business enterprise transactions to be around 12% to 16%. The following ratio analysis is an attempt to allocated component asset ratios that would prove that the market evidence is correct:

Hospital Ratio Analysis 1: Higher Real Estate Value & Lower Overall Yield						
	Footnote Source	Returns on Component Values	Times	% of Asset to Total	Equals	Weighted Component Yield
Land Value	1	7.5%	X	3.0%	=	0.225%
Improvement Value	2	10.0%	X	55.0%	=	5.500%
Combined Real Estate Value				58.0%		
Personal Property Value	3	10.5%	X	15.0%	=	1.575%
Intangible / Business Value	4	20.0%	X	27.0%	=	5.400%
Weighted Average Hospital Yield				100.0%	=	12.7%
¹ Yields on ground rent comparables ² Healthcare REIT yields ³ Equipment leasing yields ⁴ Cost of Equity						
Hospital Ratio Analysis 2: Lower Real Estate Value & Lower Overall Yield						
	Footnote Source	Returns on Component Values	Times	% of Asset to Total	Equals	Weighted Component Yield
Land Value	1	7.5%	X	3.0%	=	0.225%
Improvement Value	2	10.0%	X	40.0%	=	4.000%
Combined Real Estate Value				43.0%		
Personal Property Value	3	10.5%	X	10.0%	=	1.050%
Intangible / Business Value		20.0%	X	47.0%	=	9.400%
Weighted Average Hospital Yield				100.0%	=	14.7%

The returns on the various components are taken from sources verifiable in the hospital and healthcare markets. In **Hospital Ratio Analysis 1**, the combined real estate value is 58% of the total, with the personal property ratio being 15% and the intangible value being 27%. The weighted average yield under this scenario is 12.7%, or the lower end of the anticipated weighted yield from the EBITDA Multiple market data. In **Hospital Ratio Analysis 2**, the combined real estate value is 43% of the total, with the personal property ratio being 10% and the intangible value being 47% of the total. The weighted average yield under this scenario is 14.7%, which is near the middle of the anticipated weighted yield from the EBITDA Multiple market data.

Hospital Ratio Analysis 1 is an example of a hospital with newer real estate improvements, and buyers would probably be willing to accept a lower overall yield, or a lower EBITDA multiple, in this case because of the newer real estate. In **Hospital Ratio Analysis 2**, the hospital improvements and personal property are a little older, with more depreciation, so the anticipated overall business enterprise yield would need to be greater for this reason.

The reader and appraiser should be aware that anticipated hospital business enterprise yields can vary significantly based on local hospital competition, managed care penetration rates, age and condition of real estate and equipment assets, and other factors. Purchase yields can also vary based upon the number of prospective buyers for a particular hospital.

Summary Conclusions:

A combination of primary valuation allocation methods discussed earlier in this article can be used to estimate realty and non-realty component values in a hospital transactions. *Anticipated purchase multiples from the hospital marketplace can and should also be used as a test of reasonableness when final component values are being estimated for hospital allocations.*

Allocations of hospital business enterprise purchase prices should be rational, supporting a reasonable range of weighted average anticipated business value returns. There will be cases when hospitals are acquired without consideration for market returns; sales of non-profitable or critical-access hospitals could be *non-market driven* examples. **The ratio analysis discussed in this article is another tool to determine if final component allocations are reasonable or rational.**

Reference Summary

Wolverton, Lennhoff & Vernor (2002)

Appraisal Institute Seminar (2011)

Bates (1992)

Lennhoff (2013)

Beazley, Sparks, Bates (2011)