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## Hospital Sale Leaseback Markups are Financing Transactions

By Michael Bates, MAI, ASA

Hospital sale/leaseback transactions (SLBs) are financing vehicles that are often designed to raise significantly more capital than traditional commercial real estate loans. According to a March 13, 2017, article by *Kahler Financial Group* titled *Real Estate Sale/Leaseback Can Be a Win-Win*:

*“The seller ends up with cash and gets to stay in the building for the term of the lease. The tradeoff is that the seller now becomes a tenant. The buyer ends up with a building, a tenant (typically a long-term tenant), and income in the form of rent payments... While the details of a particular sale/leaseback may be complex, the basic purpose is straight forward. It’s a way to use a real estate asset to provide business benefits to both parties.”*

The large amounts of raised capital is used to provide needed capital replacements or renovations at the subject hospital or to fund owner capital developments in other locations.

The amount of capital raised with a sale/leaseback (SLB) transaction is often based on capital needed, the amount of annual contract rent, and the quality of the guarantee. The quality of the guarantee is determined by the financial strength of the tenant, and any other credit enhancements such as triple net assurances, annual rent escalations and cross-default provisions with other real estate assets. Accepting a cross-default provision with other real estate will enable the SLB lessee to obtain a higher sale price or a lower rent yield.

According to International Accounting Standards documentation, *“Entities often enter into sale and leaseback transactions in order to obtain cash financing. Many sale and leaseback transactions are essentially financing arrangements that enable the seller-lessee to borrow money without classifying it as debt on the balance sheet.”*<sup>1</sup> As further reported on Page 5 of the *Irvin Levin Hospital Acquisition Report 2017*, and presented on the next page, REIT (real estate investment trust) acquisitions are financing vehicles rather than fee simple sales of hospital real estate:

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<sup>1</sup> IAS 17: <http://annualreporting.info/ias-17-leases-2/sale-and-leaseback-transactions/sale-and-leaseback-transactions>

REIT deals with hospitals are technically a financing vehicle, according to Josh Nemzoff, head of Nemzoff & Co. On the February 2017 webinar on hospital M&A, he explained the strategies behind these deals. "REITs are typically the lender of last resort, maybe just ahead of the FHA 242 program," he said. "But if you can't find the money and you're looking for capital, and you can't do it any other way, then sometimes hospitals resort to a REIT."

This tactic is a very expensive way to raise capital, however. But for private equity firms looking to cash out, it's worth it. Nemzoff noted that Prime Healthcare, Ardent Health Services and Cerberus, which owned the nine-hospital Steward Healthcare system, sold their hard assets to a REIT "with a lot of tax issues involved. The REIT then becomes the landlord, and the operating company becomes the tenant. It's a way to raise substantial amounts of cash," he added.

**A REIT often pays a total acquisition price that is above the total fair value of the tangible assets. Goodwill is not recognized in an asset acquisition, so the excess price over the tangible assets must be allocated by buyer accounting representatives to the identifiable tangible assets. The following is an example of the steps in this kind of allocation, as provided by an accounting representative of a large US REIT:**

#### Real Estate Investment Trust Allocations of Hospital Purchase Price Assets

- Step 1: Appraisals of all tangible assets including land, building improvements and FF&E (Furniture Fixtures and Equipment).
- Step 2: Deduction total appraised tangible assets from Going Concern Purchase Price to Derive *Excess Purchase Price*. Goodwill is not recognized in an asset acquisition.
- Step 3: Allocate the *Excess Purchase Price Over Fair Value of Tangible Assets* Proportionally to Tangible Assets for Schedule 3 10K acquisition reporting.

#### Example of REIT Accounting Allocation

Appraised Fair Value of Tangible Assets	Building			Total	
	Land	Improvements	FF&E		
	\$2,000,000	\$12,000,000	\$2,500,000	\$16,500,000	Step 1
<i>Percent of Total</i>	12.1%	72.7%	15.2%	100.0%	
Going Concern Purchase Price				\$25,000,000	
<i>Excess Purchase Price Over Derived Identifiable Asset Values</i>				\$8,500,000	Step 2
Excess Purchase Price Prorata Allocations to Tangibles	\$1,030,303	\$6,181,818	\$1,287,879	\$8,500,000	
Total Allocated Tangible Assets For 10K Schedule III (Real Estate and Accumulated Depreciation)	\$3,030,303	\$18,181,818	\$3,787,879	\$25,000,000	Step 3

**It is clear from this methodology that reported real estate prices from sale/leaseback and other REIT acquisitions often include significantly more than real estate values.**

The amount of rent that is above market represents intangible value rather than real estate rent. For example, if market rent for a single real estate property is \$20 per square foot. The owner enters into a new SLB and becomes a Lessee paying \$30 per square foot. As documented in literature and courts below, the \$10 per square foot in rent above the real estate market rent creates intangible or business value not real estate value.

*According to Karvel & Patchin (Appraisal Journal, 1992, P. 454), "Lease premiums that result in rental payments above market rental are a source of business value."*

*Section 96 of the Wisconsin Supreme Court case Walgreen & Co. vs. City of Madison stated "a lease favorable to the lessor does not increase the fair market value of the real property; any potential increased value in excess of the value of a fee simple interest in the property is attributable to the particular lease and constitutes the value of contract rights rather than real property rights."*

*In his Spring 2016 article in The Appraisal Journal, titled "Is Excess Rent Intangible", Stephen D. Roach, MAI, concludes "Based on longstanding and generally accepted definitions used in the real estate industry and the appraisal profession, the value created by excess rent is intangible."*

Leases that cover personal property or any business assets will include rent that creates intangible business value rather than just real estate rent.

FAQ 193 of USPAP (Uniform Standards of Professional Appraisal Practice), addresses situations when there is a Leased Fee sale when the "price was well above replacement costs", and that this may have resulted from "other sales that also have above-market leases that were also created by the same type of sale-leaseback arrangement." FAQ 193 goes on to conclude "In this situation you are required to analyze the effect on value of the above-market lease." For this reason, according to USPAP, appraisers should not use SLB rents to establish market rent for solely real estate, unless it can be clearly documented that the lease rate is not above market.

**The following pages include cases where hospital SLBs transacted well above construction costs or where it is clear the transaction included non-real estate assets:**

## Case One

### Select Medical Rehabilitation Hospital in Augusta, GA

**In December 2005, 3.11 acres of land was acquired for \$1.7 million for the construction of a new, four-story, 71,900 square foot, LTAC (long-term acute care) specialty hospital in Augusta, Georgia. The operator of the hospital was Select Medical Corporation. Total construction costs were approximately \$16 million, excluding personal property, and the new hospital opened in 2007. On December 17, 2010, HealthCare Trust (HTA), a real estate investment trust (REIT), acquired the property in a new sale-leaseback transaction for \$25.7 million [Deed Book 1287, Page 516], shown from local deed records below:**

Sale Date	Deed Book / Page	Plat Book / Page	Sale Price	Reason	Grantor	Grantee
12/17/2010	1287 516	298 1674	\$25,700,000	Fair Market Value	SM PARTNERS AUGUSTA ONE LLC	HTA - AUGUSTA SS HOSPITAL LLC
12/29/2005	1031 978	298 1674	\$1,700,000	DNU Non Fair Market Value_Retired 4.29.16	PASCARELLA NORA	SM PARTNERS AUGUSTA ONE LLC

**The property changed ownership via a SLB at a price *significantly* above construction costs. As indicated before in FAQ 193 and the Appraisal Journal references, this transaction occurred at above market rent, which includes intangible business value. Select Medical Corporation was undergoing notable new hospital development since it was founded in 1996, and this and other transactions were designed to provide capital for new hospital developments in other locations.**

## Case Two

### Landmark LTAC Hospital in Athens, GA

**Landmark Hospital of Athens (Athens, Georgia) was a specialty long-term acute care (LTAC) hospital constructed in 2008 for approximately \$8.7 million according to construction loan and state CON (certificate of need) data. The land had been acquired for \$1,614,720 in July 2007. On October 29, 2010, an entity of Griffin-American Healthcare REIT acquired the constructed hospital in a sale-leaseback transaction for \$12,141,555, as shown below:**

Sale Date	Deed Book / Page	Plat Book / Page	Sale Price	Reason	Grantor	Grantee
10/29/2010	3778 548		\$0	Quit-Claim	Landmark Hospital Of Athens, Llc	G&E HC REIT II ATHENS LTACH, LLC
10/29/2010	3778 542		\$12,141,556	Fair Market - Improved	WHITE OAKS REAL ESTATE INVESTM	G&E HC REIT II ATHENS LTACH, LLC
7/19/2007	3363 185		\$1,614,720	Fair Market - Improved	V F W POST 2872	WHITE OAKS REAL ESTATE INVESTMENTS OF GE

At the time of this new SLB transaction, Landmark was operating the hospital. The property changed ownership via a SLB at a price *significantly* above construction costs. As indicated before in FAQ 193 and the Appraisal Journal references, this transaction occurred at above market rent, which indicates the presence of intangible business value.

### Case Three

#### Prime Healthcare Hospital in Reno, NV

On July 2, 2012, Prime Healthcare acquired St. Mary’s Regional Medical Center in Reno, Nevada, from Dignity Health for a total of \$50 million for all assets (including personal property and intangible business assets). They then recorded a real estate price of \$32,538,104 (which was \$79.44 per square foot for the large, long-established hospital). On September 20, 2012, Prime Healthcare resold the real estate component to MPT (Medical Properties Trust) of Reno, LLC, for \$80 million, a 245% mark-up for the real estate. This SLB became part of a multi-property security agreement with a master lease and cross-defaults (involving many other properties operated by Prime Healthcare) governing that agreement. As part of that transaction, the parties agreed, in Section 3.3 of that agreement, under the heading *“Sale-Leaseback To Be Treated as a Financing Transaction:…the parties intend and agree that the transactions described in this Agreement, the Master Lease II and the Lease Amendment are part of one, independent and indivisible transaction and that for federal, state and local income tax purposes, the sale-leaseback transaction described herein is a secured financing, and not a true sale or true lease.”*

Valuation Information			Sales/Transfer Information/Recorded Document					
Valuation History	2017/18 FV	2018/19 FV	Sales/Transfer History					
			V-Code	DOR	Doc Date	Value/Sale Price	Grantor	Grantee
Taxable Land Value	3,327,980	3,494,379						
Taxable Improvement Value	35,093,814	36,505,621	1MGA	400	09-20-2012	80,000,000	PRIME HEALTHCARE SERVICES RENO,	MPT OF RENO LLC
			0	400	09-05-2012	0	PRIME HEALTHCARE SERVICES RENO,	PRIME HEALTHCARE SERVICES
Taxable Total	38,421,794	40,000,000	2QC	400	07-02-2012	32,538,104	DIGNITY HEALTH,	PRIME HEALTHCARE SERVICES

**This sale-leaseback transaction clearly *included assets far in excess of fee simple real estate value*, as confirmed in Section 3.3 of the sales agreement language.**

It is our understanding that the hospital, which was built in stages from 1935 forward, was in need of significant capital renovations. The

SLB price was very high transaction price to provide the hospital operator with monies (financing) to complete those renovations. SLBs are typically for higher than documented real estate values. This transaction included stock investor documentation making it very clear this was a “*secured financing and not a true sale or true lease.*” As also indicated from Washoe County records, the 2018 tax-appraised value was \$40 million, meaning the County agreed that the documented September 2012 transaction included much more than just real estate assets.

Hospitals are special-purpose assets than include real estate, personal property and intangible business components. They are complicated, capital intensive assets, and the operations of those facilities are heavily regulated due to government funding sources. The largest hospital operators have cheaper sources of capital and will not typically initiate new sale/ leasebacks because of the higher cost of this form of capital as well as the loss of control. Readers are cautioned to understand hospital uses of SLBs, and to understand that *hospital sale/leaseback transactions are financing vehicles* that are typically designed to raise more capital than other forms of real estate financing. Appraisers should thus not report these transactions as if true sales or true leases.