

GENERAL SURGERY NEWS

ISSUE: APRIL, 2010 | VOLUME: 37:04

Is Medical Office Real Estate Investment for You?

By Denny Freudeman and Bhagwan Satiani, MD, MBA, FACHE

Many physicians now view what was once considered a cost of doing business as a hedge against decreased income due to reimbursement cuts and as an opportunity to increase personal wealth. Medical office space and medical office buildings have become the real estate investment of choice for physicians as well as sophisticated institutional investors. Even in current times, when investment portfolios have been quite challenged in many cases, medical office real estate has held value and continues to produce very satisfying annual cash returns and appreciated value. The investment markets have identified the health care industry as having longevity, along with significant potential growth, based on the aging of our population and the continued demand for health care services.

A Historical Look

Ten to 20 years ago, physician offices were not viewed in the same light as they are today. Many physicians were solo practitioners or in two-physician practices, so the average medical office tenant required 1,000 to 2,000 square feet of office space. Most developers avoided medical building development because physician tenant improvements were costly and leases were limited to two- to five-year terms with custom individual tenant space needs. Also, hospitals developed and owned campus-based medical buildings that were in high convenience to physicians who could make hospital visits with ease. Off-campus fragmented and occupied by several medical practices with smaller spaces and



A Current Look

Fast forward to 2010. Today, most physicians have merged with other practices for economic reasons, which has led to larger practices that, in turn, require much more space. In a recent survey, the proportion of physicians in groups of six to 50 has increased from 13.1% in 1996-1997 to 17.6% in 2004-2005.¹

It is not uncommon today for a typical medium to large practice to need anywhere from 5,000 to 30,000 square feet. With government regulations becoming stricter relating to hospital-owned medical buildings and physician tenants, hospitals owning medical offices must continually increase rents to meet Fair Market Value tests in accordance with Medicare regulations. Add to this the current economic climate, which has led to the following: landlords are demanding longer term leases (10-15 years) in order to pay for costly physician tenant improvements; there has been a shift from "all-inclusive leases" to "triple net leases" in which the burden of operating expenses are shifted to the physician tenant; and physicians are limiting visits to the hospital in order to see more patients. As a result, the perfect scenario is created for physicians to explore ownership versus conventional leasing for their practice space. After all, the success of a physicians' practice is

directly related to the success of the building that houses the practice. Why? Because successful, stable practices can pay their rent, creating positive cash flow, and will remain in the space for longer periods of time, creating long-term value.

Investing in Medical Office Buildings

Physicians who are interested in investing in medical buildings need to answer several questions in order to determine if ownership is right for them.

1. Should the practice own the building alone or should a joint venture with other practices be considered?
2. Should partnering with a hospital be considered?
3. Should a third-party developer partner be considered to help guide the practice through the development process?
4. What are the front-end cash requirements?
5. What is the physician's tolerance for debt guarantees?
6. How does ownership align with long-term practice strategies and goals?
7. What is a viable exit strategy?

The answers to these questions will help guide the physician to the right decision regarding investing in a medical office project. Typically, investment includes borrowing funds from a lender that could represent anywhere from 60% to 80% of the project cost (or acquisition cost), and requires investing the difference in cash (20% to 40%). In today's tight lending environment, the more cash invested, the better the borrowing terms available. Although borrowing today has become more challenging, lenders look at owner-occupied medical buildings with a favorable eye. Continuing to build business relationships with lenders will enhance the opportunity to finance a medical office investment.

Rents are based on the cost of the project and the cost of borrowed funds along with the return on cash investment desired. In today's medical real estate investment climate, the typical cash on annual return ranges from 9% to 15% per year based on a fully occupied building. As the years go by and rents increase, two favorable investment events happen: The cash return increases on an annual basis, and the market value of the property increases. Both of these events create increased value and wealth for the physician owners. The obvious risk in this investment is the inability to maintain building occupancy with rent-paying tenants. Empty buildings rarely increase in value (except for maybe the land on which it sits).

Project Value

The value of a medical office building is determined by various factors, including the following:

- Location;
- Strength of tenants;
- Length of leases; and
- Annual cash flow.

These factors allow a buyer to assess the long-term risk associated with ownership. So, if these factors are favorable and the value increases, when is the best time to exit the investment?

This becomes an interesting and sometimes tricky question. A good rule of thumb is to sell the building at a time when there is enough space leased on a long-term basis to assure a buyer of future cash flow with enough time remaining on the leases to support a purchaser's desire to invest.

Case Study

A large physician group builds a 45,000-square foot building to be used exclusively for their own practice. They receive 80% financing on the project and secure a 10-year loan with the bank. The practice signs a 15-year lease with renewal options for an additional 15 years with a newly formed limited liability company (LLC) that was established to own the building. The physicians are investors in this LLC.

Selling the building in year 4 or 5 assures a new buyer a secure cash-flow position for 10 to 11 years (the remaining term of the initial lease). The physicians sell the building, receive its appreciated value (which is still at the high end of value based on remaining lease term) and remain in the building as a tenant, paying the same rent structure as originally negotiated in their 15-year lease that commenced four to five years before.

From a practice operations viewpoint, they have done nothing to increase their normal rent obligation. From an ownership viewpoint, they have converted the value of their lease to real dollars and capital gains profit. It truly is a win-win scenario. This same case study works in a multi-tenant building as long as the building is occupied with leases that support long-term cash flow.

Current Economic Status: A Cautiously Optimistic Approach

There can be no denying that we are currently living in challenging economic times, including a credit reduction the likes of which have not been seen in the past 50 years. Although credit is tight, good projects with a sound business strategy and a successful business partner can produce projects that can be financed and will produce positive investment results. It should be noted that interest rate spreads (cost of money) are higher today than in the past few years, cash requirements are greater today, as are credit-enhancement requirements (debt guarantees). These factors are not detrimental in completing a project as long as they are considered when preparing the front-end financial analysis.

With tightening credit, slowing sales in the other commercial real estate sectors and growing vacancy rates, is now a good time to consider investing in a medical office building? The fact that the health care industry likely will continue to grow over the next several years because of the aging of the population, a growing shift to outpatient services and consolidation of physician groups, would indicate that the answer is yes.

Conclusion

Physicians and their medical managers need to consider medical office real estate as one of several strategies for financial viability in the face of declining reimbursement. The practice must assess its long-term goals, evaluate the cash requirement and weigh the long-term risk associated with ownership before deciding to diversify investments and increase personal wealth by investing in practice facilities.

References

1. Liebhaber A, Grossman JM. Physicians moving to mid-sized, single-specialty practices. Tracking report no. 18. Washington, DC: Center for Studying Health System Change, August 2007. <http://www.hschange.com/CONTENT/941/?words=physicians+moving+to+mid+ sized>). Accessed November 4, 2009.

Mr. Freudeman is President of Hplex Solutions, Columbus, Ohio. Dr. Satiani is professor of clinical surgery, Division of Vascular Diseases and Surgery, Department of Surgery, The Ohio State Heart & Vascular Center, Columbus. He is president of Savvy-Medicine, also in Columbus.