



Using Healthcare Appraisals

*Health Care Lending Forum
Houston, Texas – March 20-21, 2018*

AGENDA



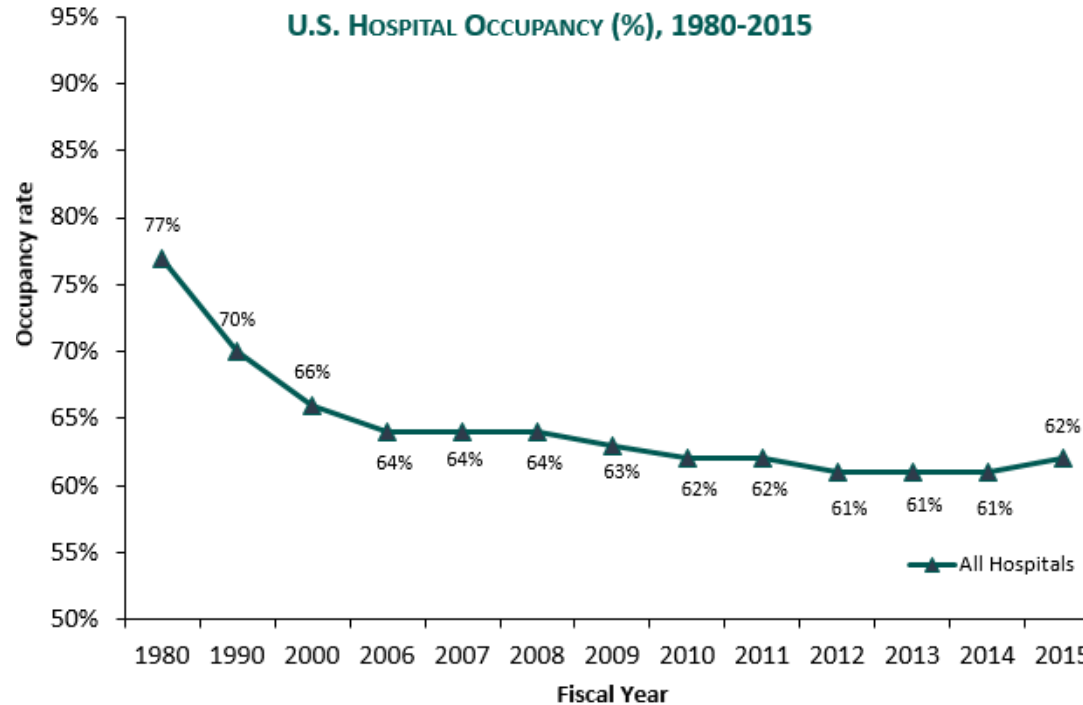
- **Healthcare Real Estate Market Overview**
- **Current Regulations that Impact Healthcare Appraisals**
- **Going Concern vs. Liquidation Value**
- **How to Find a Good Appraiser**
- **What Goes into a Good Appraisal?**



Healthcare Real Estate Market Trends & Overview

Shift to Outpatient Settings

- From 1975 to 2014, # of beds decreased from ~1.5M to 900k, a ~40% decline
- Over same period, U.S. population grew ~50% and OP visits doubled
- Hospital occupancy fell from 77% in 1980 to in the low-60s (%) post-2010.



Source: Medicare Payment Advisory Commission



Healthcare Real Estate: *What is it & how has it changed?*



Healthcare real estate has expanded to encompass more than a dozen property types.

Healthcare Real Estate Property Types

Circa 1960

vs.

Circa 2017

Nursing Home

Medical Office Building

Hospital

Seniors Housing

Independent Living Facility (ILF)

Assisted Living Facility (ALF)

Continuing Care Retirement Community (CCRC)

Skilled Nursing Facility (SNF)

Outpatient Buildings

Medical Office Building (MOB)

Urgent Care Center

Free Standing Emergency Department (FSED)

Ambulatory Surgery Center (ASC)

Cancer Clinic

Diagnostic Imaging Center

Hospitals

Inpatient Rehabilitation Facility (IRF)

Long Term Acute Care Hospital (LTACH)

Surgical / Specialty Hospital

Critical Access Hospital

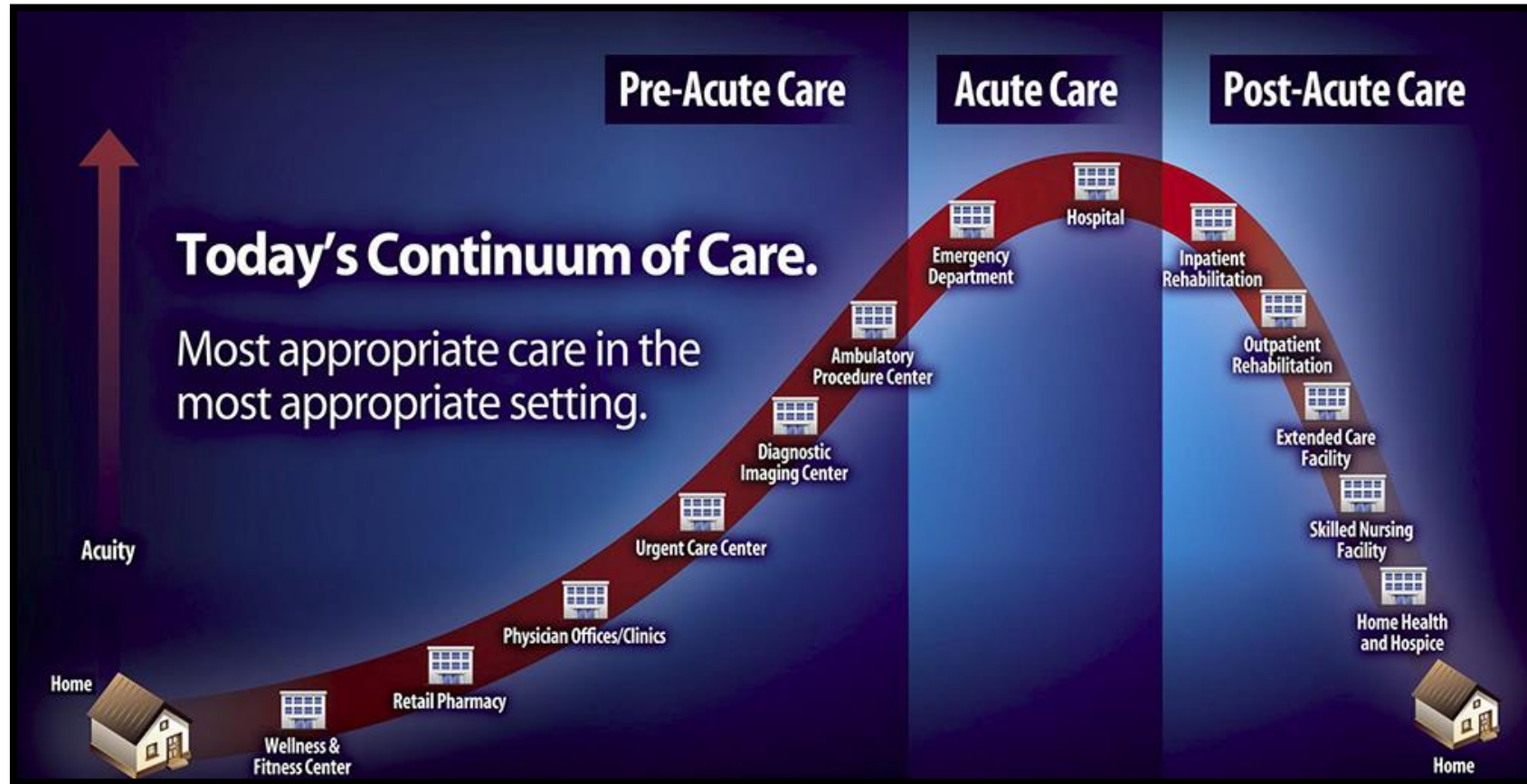
Micro Hospital

Psychiatric Hospital

Acute Care Hospital



Continuum of Care



Source: HGA and Western Maryland Health System



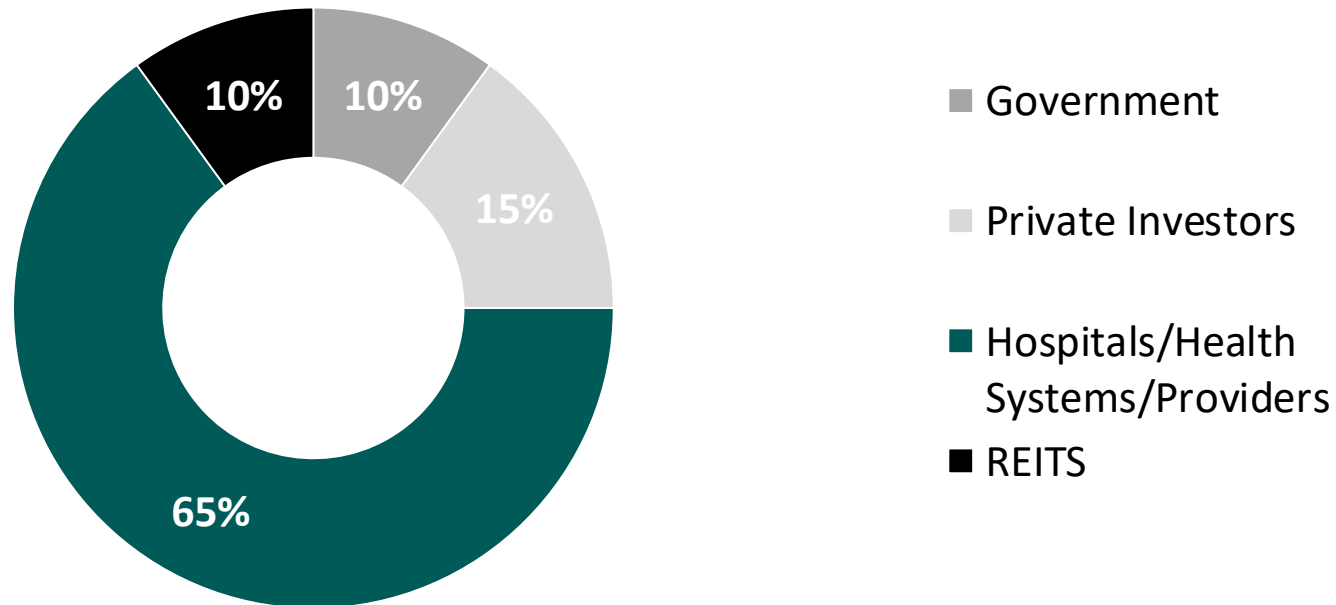
Healthcare Real Estate: *Who owns it?*



Ownership of Healthcare Real Estate (*Outpatient Sector*)

- Approximately 2/3 is still owned by health systems or other providers.

Estimated Ownership % Share by Investor Type (by Sq. Ft.) - as of January 2017



Source: *Revista's 2017 Outlook for Medical Real Estate*



Investment & Market Trends – Healthcare Real Estate

- **Total Sales Volume Is Up (MOB Sector)**
 - \$14.7B in MOB sales, mid-2016 to mid-2017 (vs. \$10.3B in prior 12 mo.)
- **Average Sales Price PSF Is Up**
 - 9.8% over same period
- **Price Remains Higher than Replacement Cost (116.3%)**
 - Impacts buying vs. building vs. leasing decisions for users & influences investment decisions
- **Increased Investor Attention, Domestic & International**
 - Domestic funds focused on healthcare, new international capital willing to invest in inpatient or outpatient real estate. \$2.6B in Chinese capital invested in U.S. HRE in 2016.
- **Portfolios & Monetizations, & Reverse Monetizations**
 - 2016 – Single Largest Health System MOB Monetization: Catholic Health Initiatives – Physicians Realty Trust (\$703.5M for 52 properties)
 - 2017 – Sale of all of Duke Realty’s 6.6 million sq. ft. of MOBs to HTA for \$2.8B
 - 2018 – Welltower-Aurora \$433 million transaction (“Reverse Monetization”)
- **Rising Construction Costs**
 - Labor costs have increased in many markets; continued cost pressure expected
 - Build-to-suit terms changing

Sources: PwC Medical Office Building Investor Survey 3Q 2017, Hammond Hanlon Camp (H2C), MVS, Turner Construction



Healthcare Real Estate: *Trends & Regulatory Environment*

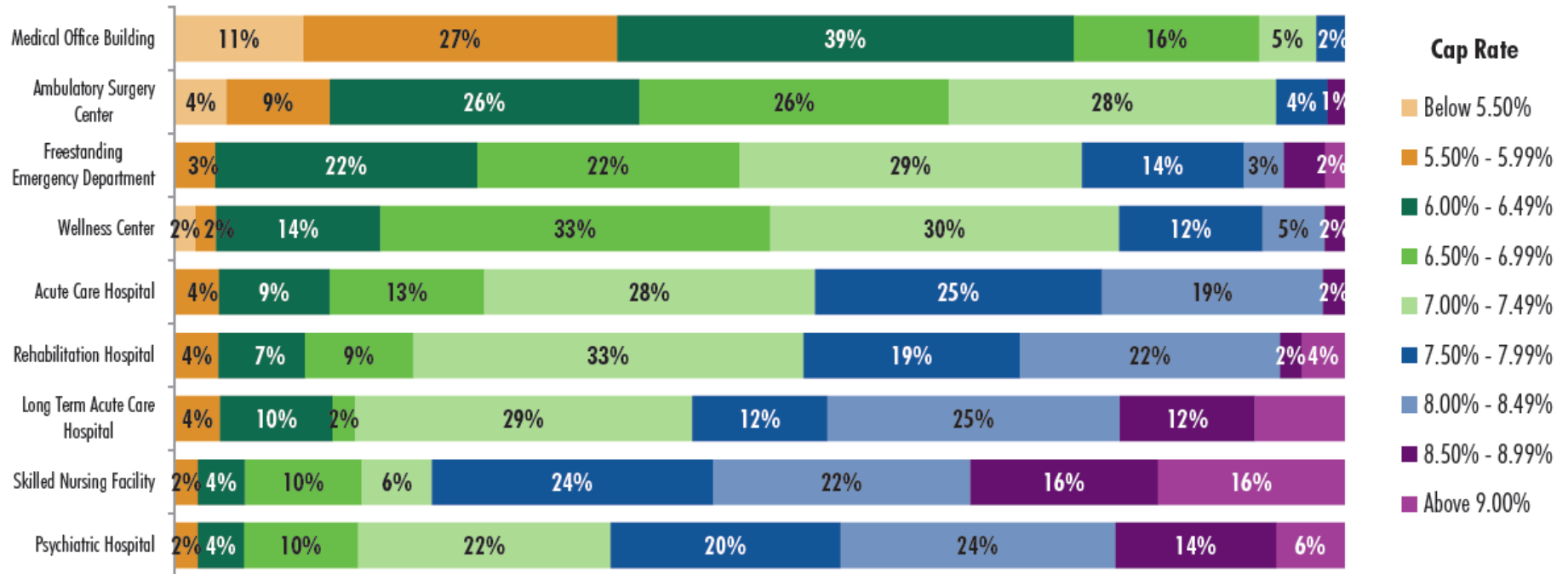


Within the healthcare real estate sector, risk profile varies significantly across healthcare verticals.

- Perceived risk differences in MOBs vs. other outpatient assets (such as ASCs) have changed.
- More investors willing to buy inpatient assets.
- Aging facilities require more capital expenditures to continue to operate.
- Acute care sector facing headwinds in 2018 (*both for-profits and non-profits*).



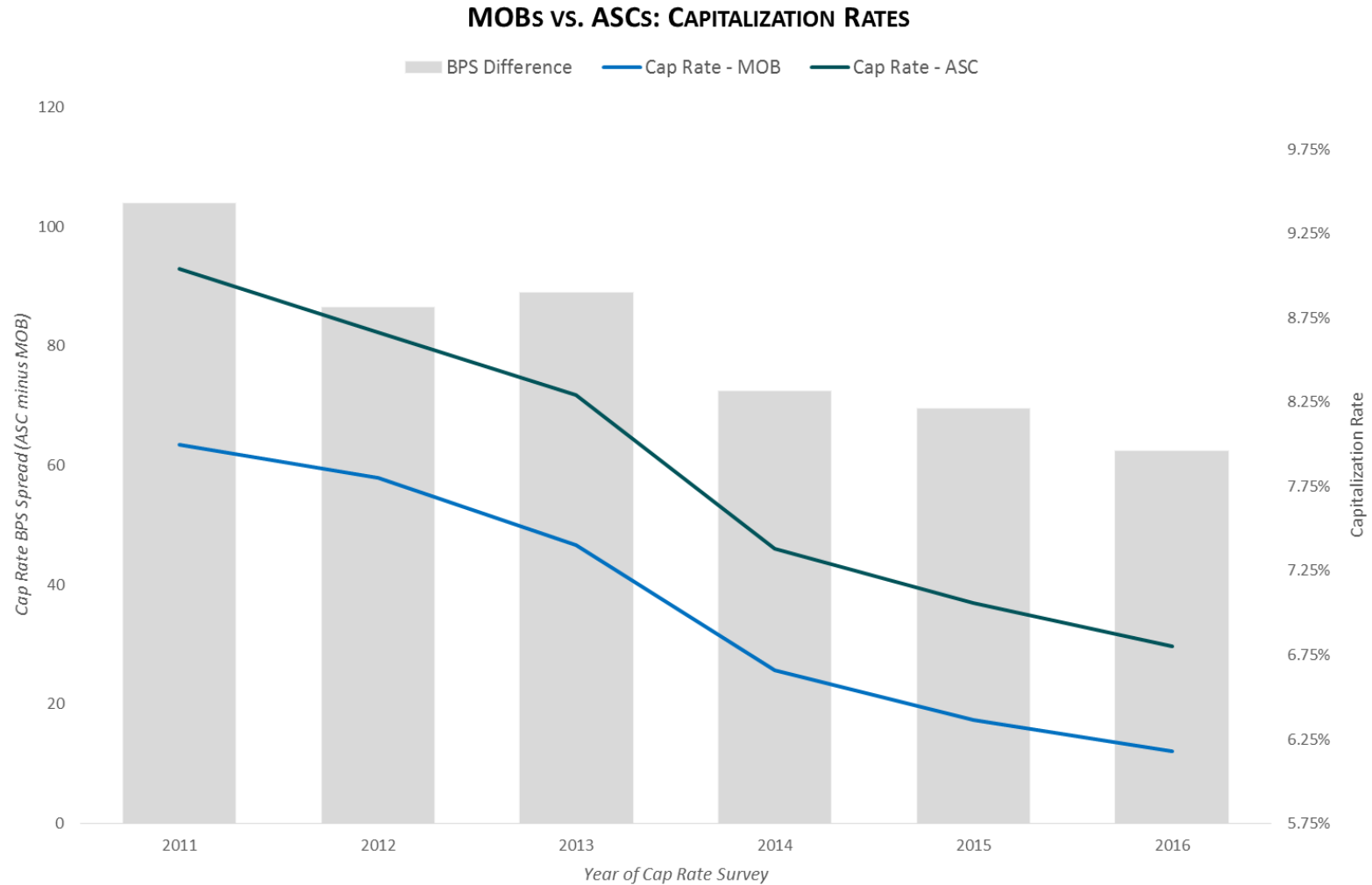
2017 Cap Rate Expectations for Various Healthcare Asset Classes (Single-Tenant, Net Lease)



Source: CBRE 2017 Healthcare Real Estate Investor & Developer Survey



Changes in Perceived Risk: MOB vs. ASCs

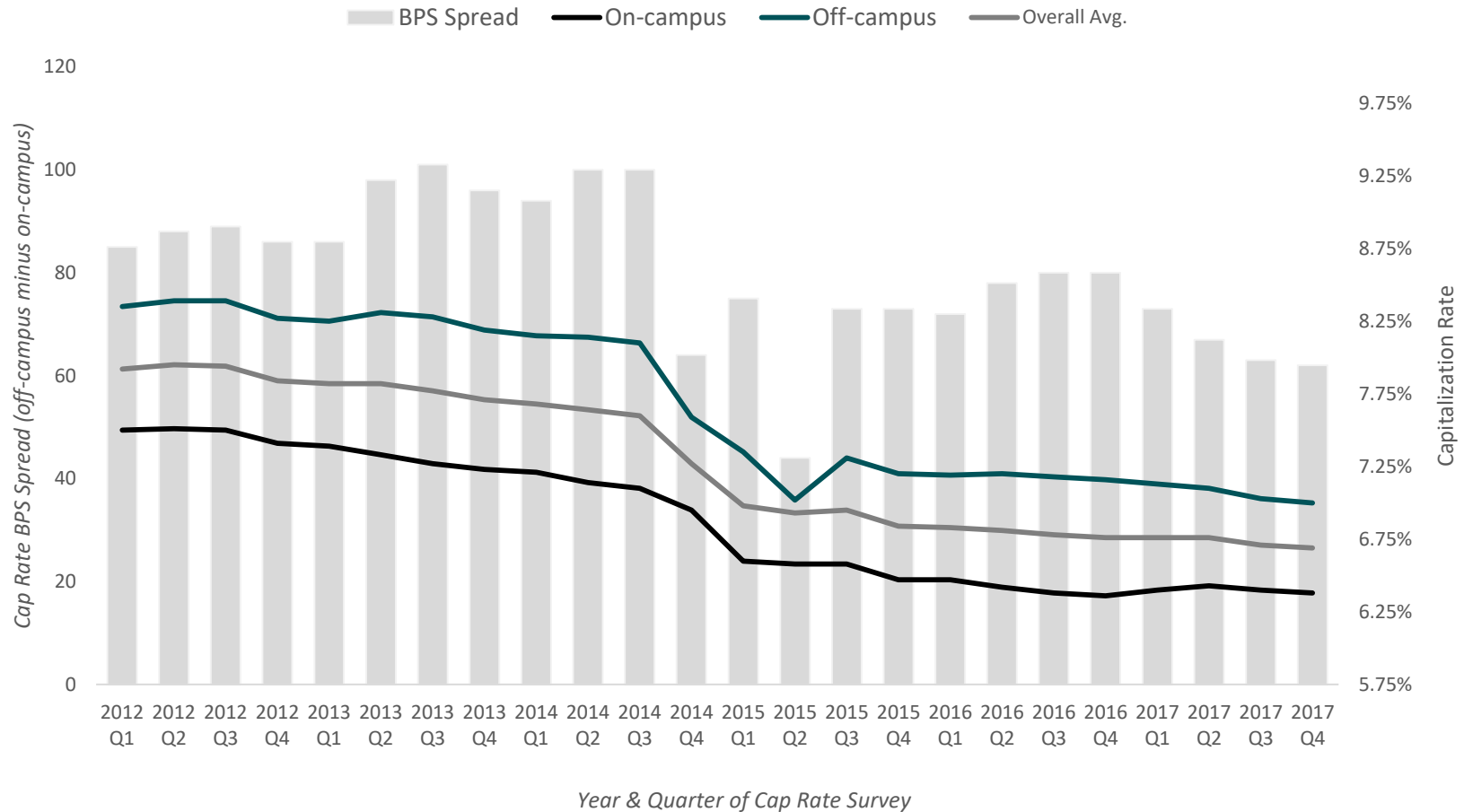


Sources: Healthcare real estate investor surveys from CBRE, H2C, Cushman & Wakefield, & PwC



Changes in Perceived Risk: On- vs. Off- Campus Medical Office Buildings

ON- VS OFF-CAMPUS MOB CAPITALIZATION RATES



Source: PwC National Medical Office Buildings Market Investor Survey



Healthcare Real Estate: Regulatory Considerations

The regulatory environment can shift rapidly, affecting real estate values.

- ***RELEVANT REGULATORY ENTITIES: CMS, OIG, DOJ, PAYERS, FBI, STATE ATTORNEY GENERALS, LICENSING, HHS, IRS, JOINT COMMISSION, ETC.***
- ***STARK LAW***
- ***ANTI-KICKBACK STATUTE (AKS)***
- ***FALSE CLAIMS ACT (FCA)***
- ***SAFE HARBOR PROVISIONS***
- ***SITE NEUTRAL PAYMENT LEGISLATION – JANUARY 2017***
- ***CERTIFICATES OF NEED (CONS)***
- ***TIMESHARES***
- ***S&C MEMO 17-44 (MICRO-HOSPITALS) – SEPTEMBER 2017***
- ***HIGH VOLATILITY COMMERCIAL REAL ESTATE (HVCRE)***



Healthcare Real Estate: Regulatory Considerations

STARK LAW

- The Stark Law (42 U.S.C. §§1395nn et seq.) is the federal physician self-referral statute.
- If a **physician** (or an **immediate family member**) has a **financial relationship** with an entity:
- The physician may not make a **referral** to the **entity** for the furnishing of **designated health services** for which payment otherwise may be made by the Medicare program; and
- The entity may not bill any individual, third-party payor, or other entity for designated health services furnished pursuant to a prohibited referral.
- *Exceptions are found in 42 C.F.R. §§ 411.351, et seq.*
 - *Real estate exceptions: office space leasing (compensation); timeshare arrangement*
- ***Underlined/bolded words have specific definitions in the context of Stark Law***
- *Stark penalties: \$15,000 per prohibited claim plus refund; potential exclusion, and \$100,000 per circumvention scheme*



Healthcare Real Estate: Regulatory Considerations

ANTI-KICKBACK STATUTE (AKS)

- AKS prohibits offer, payment, solicitation or receipt of remunerations to induce or reward referrals of services reimbursable by a federal healthcare program
- Violations of AKS are criminal and civil offenses and are punishable by:
 - a) Five years imprisonment and a fine of up to \$25,000
 - b) Civil monetary penalty of up to \$50,000
 - c) Exclusion from participation in the Medicare and Medicaid programs.



Guidance on Healthcare Real Estate Compliance for Health Systems

OVERVIEW OF GENERAL GUIDANCE OFFERED TO HEALTH SYSTEMS

- **Education, Risk Assessment, Process Implementation, Monitoring/Auditing**
- **Property Identification & Inventory**
 - **Organization, Property Management, Expense Tracking**
 - **Standard leasing practices**
- **Fair Market Value & Commercial Reasonableness**
 - **Understand FMV, safe harbors**
 - **Understand BOVs and Appraisal Reports – assumptions, methodology, limitations**
 - **Best practices and red flags**
 - **Guidelines for what every valuation report should contain**



Due Diligence: Risk Associated with Leasing Practices

TOP TEN OBSERVED LEASING DEFICIENCIES

1. No lease exists between landlord and tenant.
2. Expired lease.
3. Lease is not signed by both parties.
4. Space is not properly identified in lease agreement.
5. Rental rate is not within the determined Fair Market Rent range.
6. The rate includes concessions not typical of the marketplace. These can include items such as tenant improvements, rental abatements, and parking concessions.
7. Lease rate has market escalators that are outside of market parameters.
8. Holdover rent is not addressed.
9. The lease provides additional services not provided in the market (hazardous waste disposal). Or services are provided which are not identified in lease.
10. Early termination provisions outside of market parameters.



High Volatility Commercial Real Estate (HVCRE)

Sources: FDIC, American Bankers Association, Gibson Dunn

HIGH VOLATILITY COMMERCIAL REAL ESTATE (HVCRE)

Definition: A credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- 1 One-to-four family residential properties
- 2 Community Development real estate loans.
- 3 The purchase or development of agricultural land, provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of land for non-agricultural commercial development or residential development, or
- 4 Commercial real estate loans that meet **all** of the following:
 - a. A LTV ratio < applicable regulatory requirements (ie - Supervisory LTV)
 - Raw land: 65%
 - Land development: 75%
 - Construction (commercial, multifamily, other non-residential): 80%
 - Improved property - 85%
 - b. The borrower has contributed at least 15% of the "as completed" appraised value in cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) prior to advancement of loan funds;
and
 - c. The capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project until the credit facility is converted to permanent financing, sold or paid in full.

Sources:

FDIC

American Bankers Association

Gibson Dunn - "High Volatility Commercial Real Estate": U.S. Federal Banking Agencies Release Answers to Frequently Asked Questions



Healthcare Real Estate: *Going Concern vs. Liquidation Value*



Value of Real Estate within a Going Concern

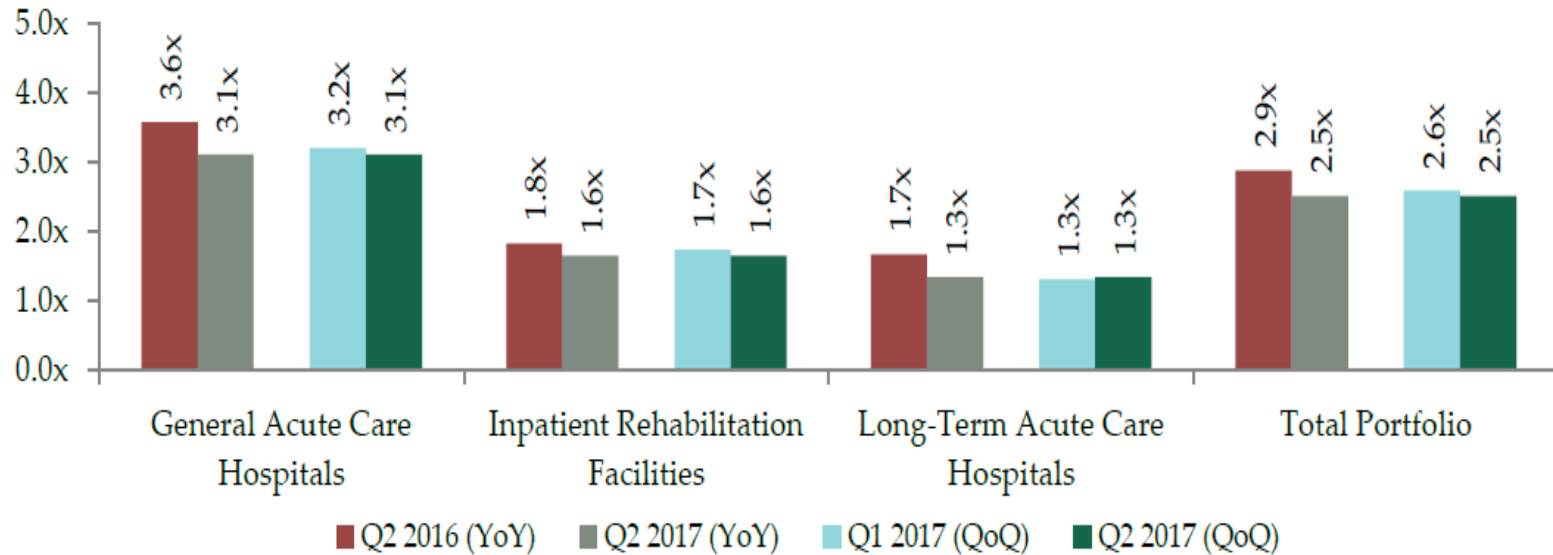
- **Contentious topic with long history of debate in appraisal theory**
- **Appraisal Institute & American Society of Appraisers have both offered classes on allocation of value within a going concern (or business enterprise)**
- **Hotels, c-stores, car washes, shopping malls, etc**
- **Healthcare Sector: hospitals, nursing homes**
- **Rent coverage ratio (and other approaches to isolating real estate value)**



Rent Coverage Ratio Data - Hospital Sector

Medical Properties Trust

YOY and Sequential Quarter Comparisons by Property Type



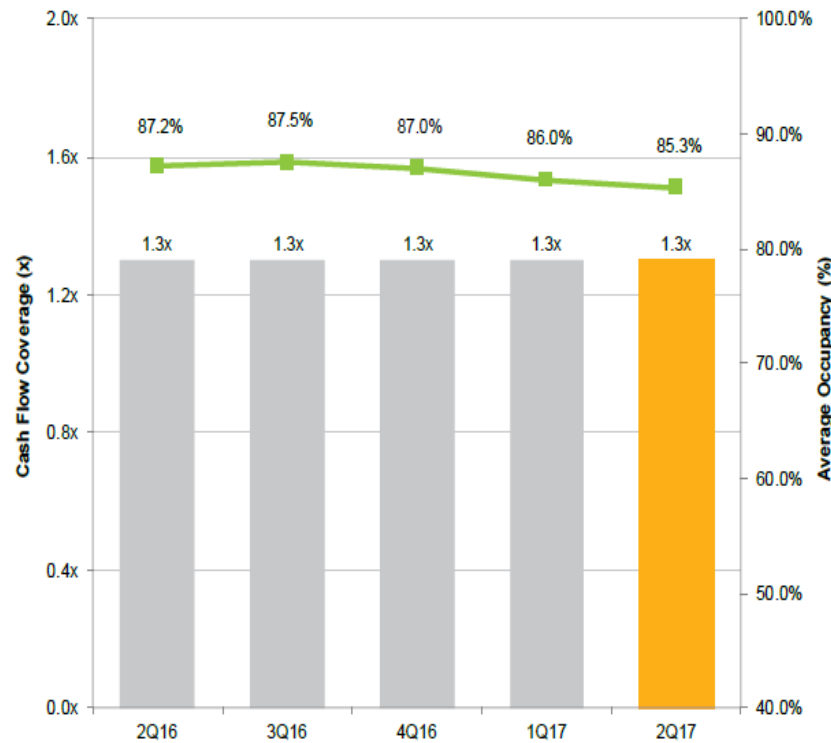
Source: Medical Properties Trust (NYSE: MPW) SEC Filings



Rent Coverage Ratio Data – Post-Acute & Senior Housing

Ventas, Inc.

Seniors Housing Portfolio



334 Properties

Post-Acute Care Portfolio



53 Properties

Source: Ventas, Inc. (NYSE: VTR) SEC Filings



Liquidation Value

- **How does it differ from market value?**
- The most notable difference relates to the motivation of the seller. Under market value, the seller would be acting in his or her own best interests. The seller would be acting prudently and knowledgeably, assuming the price is not affected by undue stimulus or atypical motivation. In the case of liquidation value, the seller would be acting under extreme compulsion within a severely limited future marketing period.



Healthcare Real Estate:

*How to find a good appraiser
&
What goes in a good appraisal?*



Selecting an Appraiser

How to find a Good Appraiser

- Healthcare real estate is a unique market sector
- Within healthcare real estate, diverse array of property types
- Geographic competency vs. property type competency
- National commercial firms, local appraisal firms, healthcare specialty firms
- USPAP compliance
- Compliance with lender's requirements
- State licensed (Appraisal Subcommittee)
- Review of Sample Report
- MAI Designated (Appraisal Institute)
- Proper E&O Insurance



Evaluating an Appraisal

What goes into a good appraisal?

- **USPAP compliant** - *The Uniform Standards of Professional Appraisal Practice (USPAP) is the generally recognized ethical and performance standards for the appraisal profession in the United States. USPAP was adopted by Congress in 1989, and contains standards for all types of appraisal services, including real estate, personal property, business and mass appraisal. Compliance is required for state-licensed and state-certified appraisers involved in federally-related real estate transactions.*
- **Follow Interagency Appraisal and Evaluation Guidelines, Federal Register, 75 FR 77449, December 10, 2010, page 77472**
- **Follow bank guidelines**
- Not commit any substantial **errors of omission or commission** that significantly affect the appraisal
- Adequately disclose extraordinary assumptions or hypothetical conditions. Hypothetical conditions are not permissible in association with the As Is value of the property
- **Include Certifications and Qualifications**
- **Appropriate methodology**
- **Appropriate data selection**
- **Clarity of analysis and presentation**



MEET THE PRESENTERS



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