Medical Office Tide Has Turned

By Mark Alexander, CCIM

Once upon a time, in a land outside your front door, there was no health care reform. Doctors were happy. But now that health care reform has passed, doctors face lower incomes. The more immediate cause is due to cuts in Medicare reimbursements. As a result, there has been a dramatic shift in how doctors think about their medical offices now. New trends are emerging for doctors who own their own medical office buildings and how they use them financially.

Before Health-Care-Reform (HCR)

Before HCR, doctors seemed to have just one thing in mind regarding their medical buildings which was…"What is the highest price that I can get?" For doctors that learned how commercial real estate valuation worked (which is much different than residential valuation), the enlightened doctors quickly realized that a Sale/Leaseback could manipulate their medical office values to just about any price they wanted. They simply needed to choose a high rent for their practice to pay…in order to create this high property value…determined from a market cap rate formula per the income approach to valuation. Bankers liked this approach as they got to lend top dollar to their best customers/doctors. This approach worked especially well when senior partners neared retirement and wanted to cash in their building equity at the very top of the market. Before Health Care Reform, the Sale/Leaseback tool helped doctors create record setting high sale prices (per square foot) for their medical buildings all across this country. After Health Care Reform, the Sale/Leaseback tool is now being used in a different way to help medical groups lower their overhead.

After Health-Care-Reform (HCR)

Most medical practices depend upon Medicare reimbursements for anywhere from 30% to as much as 70% of their total practice income. Medicare reimbursements were scheduled to be reduced 21.2% effective April 1st, 2010. But a few days later, Congress extended this date two months to June 1, 2010 when Medicare reimbursements will be reduced by 21.2%. For many medical practices, this cut represents their profit margin. Doctors are no longer happy. Some are downright hostile. Something has to give to maintain their profitability.

Doctors need to either raise income or cut expenses or both. To raise income they need to increase patient volume. Many doctors are not crazy about working a lot longer for a lot less. One doctor friend recently joked to me that he is considering retiring early to buy a retail business to sell T-shirts to tourists since the government has yet to set a limit on the price of T-shirts. This troubling environment for physicians is causing many senior doctors to contemplate early retirement. The quickest path to medical practice solvency is to cut expenses. The two biggest elements of practice overhead are staff labor (i.e. jobs) and their monthly mortgage payments on their medical office buildings.

The Problem
Medical groups that own their own buildings pay themselves rent. Typically the medical practice is the tenant and the landlord (or ownership entity such as a Limited Liability Corporation or partnership) is comprised of doctors from that same medical practice. I call this, “the left hand paying rent to right hand”. But now it suddenly makes a lot of sense to find ways to reduce that rent to maintain practice solvency and profitability in light of the recent seismic shift in physician income caused by health care reform. Doctors in the past (before HCR), typically set their rent payments to exceed their mortgage payments as a way of passing through additional rental income to themselves as the office building owners. During the peak years of 2005 thru 2007, many refinanced their medical buildings and have steep mortgages now. So in some cases, even if they lower their rent to match their mortgage payments, the rent reduction may still not be enough to make a significant impact on profitability. Gone are the days when medical practices can afford to be saddled with above market rental rates. They need to cut business expenses quickly in 2010 to remain solvent and profitable. Swift moves regarding their medical building overhead can yield profitable results and help minimize staff cut-backs.

Solution
The easiest, quickest way to lower overhead and substantially reduce personal liability is to do Sale/Leasebacks on their medical office buildings. Comparable sales prove that long term net leased medical buildings today are trading at close to 100% higher prices (per square foot) than sales of vacant medical buildings. Good value can still be

had for triple net leased medical buildings in this dismal market. In most cases, their new rent payments will be less than their current mortgage payments to help make their medical practices profitable again. They also have a window for favorable tax treatment in 2010. The federal capital gains tax rate on commercial building sales in 2010 is still 15% which is the lowest since the 1940's. The capital gains tax rate is widely expected to increase in future years under President Obama's administration. Thus, doctors will get to keep more of their sale proceeds for their medical office building sale/leasebacks that close in 2010.

Personal Liability

These building ownership doctors normally had to provide personal guarantees (i.e. individually and severably) to the bank on their office property mortgages. This means….if there are three partners in the group…and two partners disappear…. the remaining partner is fully responsible for the entire mortgage. This is one of the reasons why personal liability for doctors who own buildings…. is a very high concern right now…regardless of whether the doctor plans to retire in two months or two decades. Guaranteeing a ten year term lease is much less onerous than guaranteeing 15 to 20 years worth of remaining mortgage payments to a bank. The doctor/owner occupants of medical buildings write their own leases prior to their sale/leaseback closings. Doctors can structure limited personal guarantees on their new leases…equal to their percentage of ownership. This is much better than each doctor being responsible for the whole mortgage balance like most of them have right now!

Emerging Trend

Many doctors today are now looking to change their practice rent to the lowest possible level that will create a sale price just big enough to pay off the mortgage and closing costs. They can always bump the rent higher if they really want to take more cash equity from the sale proceeds…but that is their right.

The Benefits

The Sale/Leaseback has many positive financial benefits for the doctors. At closing, the mortgage gets paid off so they gain increased borrowing power and credit ratings. That is a good thing to have these days. Practice profit margins can be returned to better levels when their new rent payments are set lower than their current mortgage payments. The personal guarantee on a lease is much less onerous than a personal guarantee to a bank on a mortgage, especially when the lease guarantee can be converted to a limited guarantee. When you guarantee a mortgage, it is reported to credit agencies. When you guarantee a lease, it is not normally reported to credit agencies. These are some of the reasons why CPA's call commercial leases: "Off-Balance Sheet Financing Tools". Even hospital systems across the country have been aggressively using Sale/Leaseback transactions for the past two years. But they have used them in a slightly different way…to raise their cash positions instead of lowering overhead.

A Sale/Leaseback is simply a financing tool where the owner/occupant has more control. When you get a loan from a bank, the bank and the market dictate the terms while you have little say in the matter. When you do a sale/leaseback…you pick your own rent to meet your specific needs or desires. It is kind of like picking your own interest rate on a loan when you use a sale/leaseback. You naturally give yourself a better deal when you have this additional control. The Sale/Leaseback is a very handy tool that is helping many doctors today: to lower their overhead, to lower their personal liability and to maximize their medical practice profitability. This in turn helps them to minimize staff reductions in an effort to maintain a high level of care for their patients.

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