ACA a boost for medical offices

Regardless of how you feel about the Affordable Care Act, the cloud of uncertainty has been removed. The ACA was passed by Congress and signed into law by the President on March 23, 2010 and upheld by the Supreme Court on June 28, 2012. This new direction for health care will ensure dramatic change in demand for real estate used by hospitals and doctors. This is especially true locally given the large number of elderly Americans who retire in Florida, combined with our large proportion of poor, uninsured and under-insured who will soon be added to the ranks of medically insured.

There are two main segments of medical office real estate: hospital-controlled buildings and doctor-controlled buildings. The problem over the past three uncertain years during health care reform debate was that neither hospitals nor doctors knew how health care reform was going to wind up. Well, now we know.

Hospitals

Health care systems have been more proactive regarding their real estate needs than doctors over the past three years while the debate raged. While not knowing for sure how reform was going to shake out, most hospitals felt change was inevitable in one form or another, which would lead to more Americans becoming medically insured. Many HC systems have already taken steps to expand their real estate needs to accommodate this anticipated increased demand for care. Now that the Presidential election is over, eliminating any reasonable speculation about ACA repeal, many hospital systems across the U.S. are accelerating their expansion plans. Health care systems are partnering with developers to construct new projects while others are using sale/leaseback transactions involving existing facilities to self-fund their expansion.

Doctors

Most private practice physicians adopted a "maintain the status quo" attitude over the past three years . This uncertainty fueled today's pent-up demand for medical real estate that is now being released. This is a new environment for doctors and is causing them to change the way they manage their businesses. I find that doctors

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focus on the bottom line today more than ever before.

For example, over the past twenty years it had become common for doctors that owned their own medical buildings to have their medical practices pay themselves (as landlord) rent that often exceeded fair-market rental rates. This was a popular way for doctors to create exceptional "in-house investments" where their medical office building investment returns where often quite remarkable. But this meant their practices often paid very high rental rates that sometimes exceeded fair market rental rates by as much as 200%. When many of these doctor/owners decided to sell their buildings before retirement, they quickly learned that a sale/leaseback to an investor created much higher sale prices than selling to another doctor or even to their own practice.

The reason for this phenomenon is that owner occupied office buildings get appraised as though vacant because the appraiser is not allowed to use the existing lease (that would normally drive value higher) because the lease is between related parties and not deemed "arm's length". This is great for the acquiring practice but it causes the seller to leave a lot of money on the table.

On the flip side, when the office is sold in an arm's length transaction to an investor and the building is then leased back by the medical practice, the appraiser must use the lease to calculate value. The market rent lease steers prices much higher and in some cases by as much as 40 percent higher compared to selling the same office to another doctor.

Consequently, over the past 20 years, doctors who understood these advantages employed the sale/leaseback approach, often choosing the highest rental rate possible to set the highest possible sales price. This "pushing the envelope to the top" of fair market rental rates created some eye-popping sale prices and saddled medical practice tenants with very high future rents. While this was not a significant issue under the old way of doing business for doctors over the past twenty years, it is today. Now that ACA is anticipated to bring lower reimbursement rates to doctors in the future, doctors are very concerned and look to keep overhead as low as possible.

Today, I see doctors doing the opposite of the past two decades and are either choosing a moderate rental rate for their lease back future; or they pick a below market rent sufficient to retire debt so they can lock in the lowest possible rent to maximize future practice profitability. This is a sound business move as doctors' incomes are expected to be reduced. This is the fiscally responsible approach, in my view, and it is one example where ACA is helping to reduce the overall cost of health care in America.

Since ACA rewards doctors who work in bigger groups or alliances, there is a trend for single practice doctors to merge with larger medical practices or switch employment to hospital systems. Since stronger tenants are preferred by MOB investors, this trend of smaller groups merging into bigger medical groups is helping the single practice MD get a better price for his MOB than he would have when he was a solo practitioner.

Some forward thinking medical groups were ahead of this curve and started alliances years ago. Others are just getting started. But the trend is clear. Large medical groups are becoming more prevalent.

The Affordable Care Act is not perfect, and most doctors don't like it because it reduces their future income. But ACA will add millions of individuals to the roles of the medically insured, and this will create higher future demand for health care services. This, in turn, will create higher future demand for medical office space for doctors to treat patients. There are strong, long-term, underlying business fundamentals for medical office building investments.

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