Retiring doctors hope to counter low property values

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Doctors who plan to retire over the next several years are expected to leave a lot of money on the table as they sell their interests in medical practices and medical office buildings (MOBs) to their remaining partners or incoming new partners.

There is, however, one ace that they have up their sleeve as an alternative to counter this unfortunate trend.

Retirement

Doctors have retired the same way for decades. When it's time to put their scalpel or stethoscope down, they say goodbye to their partners and ask to be bought out for their share of the business and building.

The most equitable way to establish property value is to order an appraisal of their MOB. Unfortunately, for outgoing doctors today, this will lead to low property values due to depressed market conditions. These conditions should persist and bounce along the bottom for the next five to seven years.

Even if the medical practice (the tenant) is paying a high rent to itself (the landlord), which would ordinarily create a higher value using the income approach to valuation, the appraiser must disregard this rent in determining value. Only leases executed at "arm's length" between nonrelated parties can be used for this purpose.

So this type of arrangement where the left hand pays rent to its right hand cannot be considered for valuation unless the rental rate happens to match current market rates determined by a survey of comparable properties.

There is an important reason for exclusion of leases between related entities to determine value. When doctors act as tenant and landlord in the same lease agreement, there is nothing to stop them from tearing up their "in-house" lease whenever it suits them. So an appraiser cannot depend upon this lease data to determine accurate value. That value could run out the door the moment they decide to terminate the lease to create a new lease or vacate the property.

For this reason, "in-house leases" are treated by appraisers as "month-to-month" term agreements since they could end at the doctor's or practice's discretion. This lease term limitation (to one month) treatment for "in-house leases" significantly reduces appraised MOB values for the medical office owner/occupant.

Longer term leases (like 5- to 10- or even 15-year terms) between nonrelated parties are the cornerstone of creating top valuations that often exceed appraised values. Appraisers that evaluate MOBs rented with month-to-month leases treat them as they would vacant MOBs since they could become vacant at any time with a 30-day notice.

Unfortunately for senior doctors looking to retire soon, this "income approach" to valuation is the best tool appraisers have for establishing top values for commercial income properties such as MOBs and it can't be used with their "in-house lease." This is especially cogent in today's environment where conservatism in lending and valuations is the norm.

Appraisers are then only able to compare market rents of "like kind" properties to determine what the subject MOB would rent for in today's market. Higher vacancies in our market bring about very low asking rents for vacant MOBs, which skew appraised MOB values sharply downward. This is great news for the incoming practice partners or remaining partners who purchase the interest of their retiree at a deep discount in today's dismal market conditions.

But most retiring doctors leave considerable MOB equity on the table due to poor planning if they keep their "in-house lease" intact when they retire. That's the bad news. But there is a more equitable alternative that can be "win-win" for those doctors coming and going.

Sale/leaseback

Sale/leaseback transactions have become the best practice for creating strong MOB values even in today's dispirited market. High values for such MOB sales have been recorded across the country.

The MOB ownership sells the property to an "arm's length" (nonrelated) investor and signs a new lease at the closing. The MOB owners can exert more positive influence over the sales price in this fashion since they get to pick the rental rate and the term of their new lease.

The only potential complication is that property partners (landlord) and practice partners (tenant) must agree to the new sale/leaseback terms to be used at the closing.

Practice value

The value of the medical business, or practice, is also a consideration for the partners. Practice value is generally determined by multiplying the stabilized net annual practice revenue times a factor of anywhere from zero to three. This factor is tied to elements that include the medical specialty, the size of the group, reputation and years in business.

Patient volumes have decreased during this "great recession," causing lower medical practice revenues. This translates to lower practice valuations.

Practice values can be difficult to pin down anyway. This is especially true in today's shifting medical landscape. This leads many doctors to view their practice more as a vehicle where they can earn a living with limited expectations on future business value.

Building value

Circumstances have placed much of the real value of the practice assets in the MOB, since its value is typically much higher than that of the practice value. MOBs using properly structured sale/leaseback transactions are valued by multiplying the net annual rent times a factor of anywhere from nine to 12. The market determines this valuation factor — known as a cap rate — which is tied to strength of tenant and duration of lease. Doctors can steer their MOB values higher by choosing a longer term for their new lease.

Obviously, MOB valuation factors of "nine to 12" are a lot better for value creation than medical practice valuation factors of "zero to three." Prior to retirement, doctors often shift value from their practice (where value is somewhat nebulous) to their building by simply increasing the rent on their building. But this works successfully only if they use a sale/leaseback transaction with a non-related buyer.

The appraiser (hired by the buyer and his lender) in a sale/leaseback transaction must use the actual net rent (chosen by the doctors for their new lease that is due to be signed at closing) as a key factor in determining value. The appraiser will select a market cap rate commensurate with the tenant quality, durability and term of the lease. The longer lease term also factors into the appraiser's calculations to generate a lower cap rate which increases property value using the "income approach" to valuation.

The sale/leaseback transaction is a more transparent approach to maximize asset values for the doctors in any economic environment. But it is particularly appealing today since the price gap has widened considerably between "well-leased MOBs" (created by sale/leaseback transactions between non-related parties) and vacant or "poorly leased MOBs" (created by in-house leases between related parties).

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