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HEALTHCARE REAL ESTATE OPTIMIZATION

Generating Cost Savings & Creating Value
in a Changing Industry Landscape

Helping Create Places for Healing

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Healthcare Real Estate Optimization – White Paper

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About Realty Trust Group

Since our inception in 1998, Realty Trust Group has become one of the most experienced and knowledgeable real estate advisory firms in the healthcare industry.

With offices in Knoxville, Tennessee and Atlanta, Georgia, we have completed projects for clients in 23 states—serving hospitals, health systems, physician groups and other owners, users and investors of healthcare real estate. Our philosophy is to provide innovative solutions to the complex and challenging issues found in today's healthcare real estate market. These solutions include strategic campus and facility planning, portfolio optimization, portfolio monetization, project development, site analysis and acquisition, asset management, fair market value opinions and many other ideas and services.

Copyright Statement

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Healthcare Real Estate Optimization

Generating Cost Savings and Creating Value in a Changing Industry Landscape

by Scott Evans and Adam Luttrell

As health systems continue to re-shape their businesses and face the challenges of the ever-shifting healthcare industry, finding and achieving cost savings in operations and programs has become critical to maintaining competitiveness. The largest line item on most health systems' balance sheets is Property, Plant & Equipment, yet this asset class is frequently overlooked as a potential source of cost savings. Additionally, there are methods and strategies commonly used in other industries to create value and improve efficiencies through real estate and facilities management that can be effectively utilized by health care organizations.

This Realty Trust Group white paper explores the issues surrounding Healthcare Real Estate Optimization, and provides a framework for health systems to assess their ability to mine cost savings opportunities and create value in their real estate portfolio.

Background

In this era of cost-cutting, most hospitals and health systems (collectively referred to as "health systems") are reviewing clinical business units and community outreach programs, including employed physician practices, to determine where and how costs can be reduced...except, in many cases, these reviews do not include the health systems' real estate portfolios. Due to lower prioritization, incomplete data, outdated systems, lack of sufficient staff or a myriad of other reasons, health systems have often not focused on the potentially extraordinary savings that can be achieved and the value that can be created with the practical, fundamental real estate optimization applications used in many other industries.

Along with the potential "business upside" achieved with optimization applications, health systems can also help mitigate legal and regulatory risk. Without proper lease documentation and fair market value support - and appropriate adherence to the provisions of the Stark Law and Anti-Kickback Statute- health systems can open themselves up to potentially crippling fines and other penalties. The potential economic benefits, along with addressing possible risks of existing, potentially damaging, compliance outcomes, should provide the underlying motivations for health systems to pursue a real estate optimization strategy.

Granted, because of the life-and-death nature of health care, hospital facilities must frequently be operated and managed differently than facilities utilized in many other industries. Therefore, many of the strategies and practices noted here would not necessarily be applicable to hospital buildings themselves, because of the highly- specialized, 24/7 nature of operation for these facilities. However, even with the variety of treatments and procedures that are provided daily in outpatient settings, many of these types of buildings and facilities (urgent care centers, medical office buildings, cancer centers, outpatient surgery centers, etc.) can be developed, financed, operated, managed and maintained utilizing generally the same principles as a portfolio of aerospace properties, or retail malls or automotive plants. Many of the fundamentals of how to most efficiently operate a portfolio of properties in any industry can be translated to healthcare real estate portfolios, and the results can be very positive for the health system's bottom line.

Universally, healthcare industry experts are predicting a continual "shrinking" of acute care facilities and inpatient services as health systems shift more and more services to lower-cost, outpatient settings. As this trend plays out, the opportunities for cost savings and value creation, or conversely, the risk of missing out on these opportunities, will only continue to increase. Having the proper optimization strategies in place has never been more important than it is today.

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Background *(continued)*

> As an example, one of our clients will be able to generate over **$5 million in present value savings on one 60,000 square foot facility** as a result of modifying their ownership and financing strategies for that facility.

Across the industry, incremental progress is being made with respect to real estate opportunities. But there exists structural barriers to aggressively pursuing these initiatives, including:

- Other, more pressing priorities requiring attention;
- Lack of real estate experience in senior management;
- Insufficient internal staff (or trusted outsource partner) to deal with strategic real estate issues;
- Lack of understanding as to the value that can be realized with creative real estate strategies; and
- Insufficient real estate data required for strategic decisions.

Assessing the Opportunities

Most real estate decisions are expensive, long-term propositions and it is incredibly difficult to make these decisions and formulate effective strategies without having the proper data to do so. For all of the reasons noted above (and more), many health systems need help in formulating the appropriate data needed to effectively analyze their real estate portfolios. In order to assess the opportunities to create value for the organization through Real Estate Optimization, there are six major areas which require appropriate data collection and / or data analysis:

1. **Portfolio Inventory**
2. **Portfolio Utilization**
3. **Leasing Strategies**
4. **Capital Strategies**
5. **Development Strategies**
6. **Facilities Management Effectiveness**

1 Portfolio Inventory

This may seem basic, but health systems often do not have a complete inventory of the buildings they own and the space they lease, at least in a manageable format from which decisions can be made. Historically, the real estate portfolios associated with health systems have been relatively stable, but because of today's healthcare reform environment, health systems' real estate portfolios have never been more in flux. Two major trends that are contributing to health systems' fluctuating real estate portfolios are physician acquisitions and health system mergers and acquisitions. Both of these trends can have significant real estate implications as new properties are integrated into the health system, many times by different parts of the organization.

Another trend significantly impacting real estate portfolio inventories relates to health systems' evolving ambulatory care strategies. As health systems continue to creatively seek ways to reach their patients in more convenient, more cost-effective settings, this often results in health systems leasing new space in off-campus medical office buildings or retail settings, or possibly even developing new submarket "hospitals without beds" campuses.

As these trends continue, it is easy to see how a health system's real estate portfolio can dramatically change in a relatively short time period. Therefore, the process of organizing and maintaining an appropriate portfolio inventory can be time-consuming, but is absolutely the foundation for informed decision-making. Portfolio inventory can be tracked in something as simple as an Excel spreadsheet, or in a more-involved software solution, and should at a minimum contain the following data:

(see spreadsheet sample on the following page)

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Portfolio Inventory *(continued)*

This chart contains a sample of data that should be tracked in Excel or software solution:

OWNED PORTFOLIO							
Hospital/ Submarket	**Facility**	**Address**	**Facility Type**	**Total SF**	**Hospital SF**	**3rd-Party SF**	**Vacant SF**

LEASED PORTFOLIO							
Hospital/ Submarket	**Tenant/ Use**	**Address**	**SF**	**Start Date**	**End Date**	**Annual Rent/ SF**	**Expenses**

There is perhaps other data which could be captured in this database, but the above is probably the minimum needed to understand what the portfolio looks like. To truly identify value opportunities and cost savings, a rent roll and operating statement for each owned building should be created. Having an understanding of the competitive properties available for lease and knowledge of current market terms is also essential for optimizing both the owned and leased portfolios. Creating and maintaining a current, workable inventory of the entire real estate portfolio allows the internal Director of Real Estate to formulate strategies that can contain costs and create value in the portfolio.

2 Portfolio Utilization

What is the annual cost to operate your owned buildings? Is this in line with market norms? Are there opportunities to reduce the total rental costs in the space you lease from others? What other benefits are important to you in leased space — and how can you achieve them? What are the strategic uses for the vacant space in owned buildings? How do you measure the cost of occupancy in each building? Do you have opportunities to efficiently consolidate space? Is there vacant land — or entire buildings — that should be sold?

The answers to these (and many other) questions form the basis of how to most effectively utilize the real estate portfolio, at least from a management perspective. Clearly, measuring patient throughput and having flexibility for moving practices and programs around the real estate portfolio are important considerations for health system executives, in addition to understanding the cost structure of the portfolio and making strategic real estate decisions. Analyzing, and then capturing cost savings opportunities, however, can provide near-term, bottom-line results.

Case Study

Take the following example: a three-hospital system with 22 owned properties totaling 620,000 square feet and 28 leases in third-party-owned buildings, totaling 170,000 square feet. We'll call this **Generic Health System (GHS)**. Let's also assume the following: 1) the owned portfolio is 90% occupied by GHS and third-party tenants (meaning 62,000 square feet is vacant); and 2) the leased portfolio consists of leases structured in a number of different ways – full-service (landlord pays all expenses), modified gross (landlord pays some expenses, tenant pays some) and net (tenant pays all expenses), with the average gross rental rate (inclusive of all expenses) for the portfolio being $23 per square foot. We'll also assume that GHS has an investment-grade credit rating and is in a market with over 1 million population, so given current market conditions, the owned portfolio has a current value of over $100 million.

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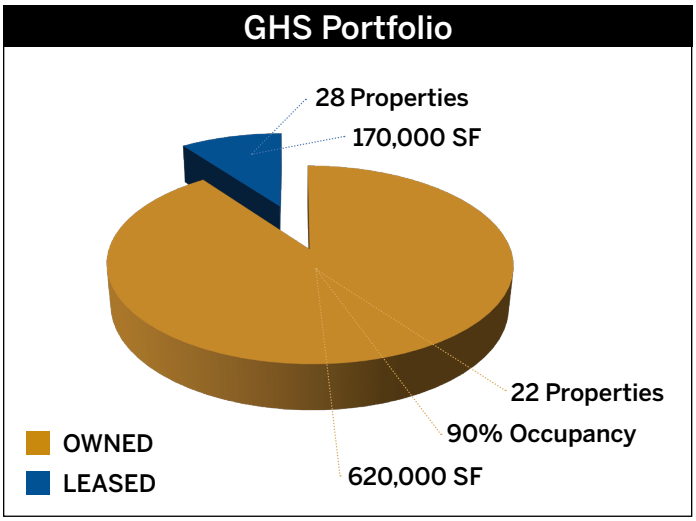
Case Study (continued)



POINTS WORTH CONSIDERING:

There is 62,000 square feet of vacant space in the owned portfolio. If GHS could utilize *just one-half* of that vacant space (by consolidating or relocating physicians or hospital departments from space it leases in third-party buildings) it could save approximately $713,000 per year.

And if, by implementing prudent operating and management practices, the system could reduce its operating expenses by $.50 per square foot (through utility controls, contract negotiations or similar strategies), it would experience an additional savings of approximately $310,000 per year.

These cash savings of over $1 million would drop straight to the bottom line — every year.

3 Leasing Strategies

Once the Portfolio Inventory has been established, this database provides a foundation and framework for making strategic decisions about the leased portfolio. In our example, GHS has 28 separate leases in 170,000 square feet in third-party-owned buildings. If, on average, one-third to one-fourth of those leases roll over every year, then the system faces multiple decisions annually as to whether to renew, terminate, move, transfer or possibly sublet.

Let's say that GHS has 7 leases coming due in the next 12 months, and 8 additional leases coming due in the following 12 months. Should all of those leases be renewed? Depending on the dynamics of the specific third-party buildings and submarkets, there may be opportunities to negotiate lower rental rates or achieve other economic benefits with a focused leasing strategy, which requires both an intimate knowledge of the vision and strategy of the health system and each of the groups leasing space, as well as a complete understanding of the real estate market.

Again, proper data analysis and market knowledge is the key to successfully executing the leasing strategy. Understanding the market rent and other market terms achievable in the competitive landscape is paramount to achieving cost savings in the leased portfolio.

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4 Capital Strategies

Many health systems across the country have utilized monetization, credit tenant lease (CTL) financing and other creative solutions to accommodate financial and strategic goals. Much has been written about these strategies, and there are a series of analyses which should be completed to determine whether or not it is prudent to pursue one or more capital strategies involving the real estate portfolio. At its core, healthcare real estate capitalization strategies are intended to utilize the most effective capital structure for a health system's real estate portfolio while balancing and supporting the organization's overall capital and strategic needs.

In our example, let's assume the owned GHS real estate portfolio is worth somewhere between $110 and $130 million in the current market environment. Depending on the strategic nature and use of each property, different capitalization strategies may be appropriate for different properties. For mission-critical "core" properties, a traditional monetization or sale/leaseback structure may not be most advantageous to GHS when considering its organizational-wide capital and strategic needs. However, CTL financing may better support GHS' overall capital strategies while also providing an extremely cost-effective approach to accessing the capital currently "locked up in the bricks and mortar". Other properties may be "non-core", such as multi-tenant medical office buildings where GHS does not occupy the entire building or where GHS does not see a strategic value in the property beyond the next 10-15 years. Those buildings may be candidates for traditional monetization.

If a health system is considering some form of monetization, a specific analysis should be conducted either internally or on behalf of the system by a third party to provide senior management with the data required to make a proper decision.

At a minimum, management should have a basic understanding of the following items before pursuing a monetization strategy:

- **Likely market pricing for the properties**
- **Issues complicating a proposed transaction**
- **Most effective structure to utilize, given the system's objectives**
- **Impact of the transaction on the system's financial statements and ratios**
- **Appropriate control provisions**
- **Impact on the system's regulatory compliance framework**

The appetite for capital by most health systems is not waning, and utilizing appropriate capital strategies involving the owned real estate portfolio may be beneficial. These types of transactions have been successfully utilized by numerous health systems around the country for many years to increase liquidity, remove future capital expenditure obligations, reduce operating expenses and improve or maintain their credit ratings (ratings agencies have typically been neutral to slightly positive in their comments about these types of transactions). Again, careful study and proper analysis are required before a transaction should occur.

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5 Development Strategies

As with the owned and leased portfolio, there are a variety of paths a health system can take when it decides there is need for a new facility to be developed, whether on- or off-campus. The key decision factor for determining the appropriate development strategy is understanding the health system's anticipated use and/or operational strategy for the development project. For example, if GHS needs a new medical office building on its main campus and plans to fill 100% of the space with its employed physicians and programs, the decision on who should develop that building and how it should be financed may be quite different than the development of an off-campus, multi-tenanted MOB where GHS only needs 20% of the space.

In addition to understanding the anticipated use/ operational strategy for a new building, there are other fundamental location-specific questions that must be addressed, particularly when planning for an off-campus project. Proper application of geospatial analyses can provide the foundation for implementing the system's vision and strategy for a new facility. This analysis will provide the data on where to locate as well as what services to provide, and then the system must decide on whether it will self develop the facility, or use a third party.

There are four basic scenarios for a health system to consider, in terms of ownership/capital strategies for new development:

- **Self Develop – Long-Term Hold**
- **Self Develop – Sell after Stabilization**
- **Third Party Developer – Institutional Capital**
- **Third-Party Developer – Entrepreneurial Capital**

There are also variations on these scenarios, such as a Joint Venture. In each one of these cases, the anticipated use of space for the health system, and the amount of risk that the system is willing to take in the process, provides the foundation for the decisions about which party should develop the building, and how it should be financed. The financing decision can mean the difference in literally millions of dollars to the health system.

Let's say that GHS is looking at various options for a new, off-campus 100,000 square foot MOB in which it plans to take 80,000 square feet. The total occupancy costs (whether in the form of lease payments or debt service payments) for the four scenarios listed above, over a 20-year period, are projected as follows:

	DEVELOPMENT STRATEGIES			
	Self Develop (Long-Term Hold)	**Self Develop (Sell After Stabilization)**	**Third-Party Developer (Institutional Capital)**	**Third-Party Developer (Entrepreneurial Capital)**
GHS OCCUPANCY	100% Master Lease GHS Subleases 20K SF	80% Master Lease GHS Leases 20K SF	80% Master Lease Developer Leases 20K SF	80% Master Lease Developer Leases 20K SF
GHS Debt Service Payments: 20 Years	$38.6M	-	-	-
GHS Lease Payments to Landlord	-	$37.0M	$37.0M	$42.0M
Third-Party Rental Revenue	($9.3M)	-	-	-
Gain on Sale to Investor	-	($3.3M)	-	-
Total GHS Occupancy Cost: 20 Years	**$29.3M**	**$33.7M**	**$37.0M**	**$42.0M**
NPV of Total Occupancy Cost (5.0%)	**$18.4M**	**$19.2M**	**$22.4M**	**$25.3M**

The scenario shown above is just one consideration for GHS. Clearly, the residual value of the MOB, the leasing risk associated with non-GHS space, the internal availability of capital, the variety of available locations and other factors are generally a part of the decision-making process. The graphic above exhibits the potential for cost savings. However, that can also be achieved with the utilization of proper development strategies.

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6 Facilities Management Effectiveness

The real question to be answered here is this:

Does the facilities management organizational structure and personnel support the health system's strategic, financial and operational objectives in the most efficient and effective manner?

This is a very broad question, but points to the nature of the issue – is there a better approach? Frequently, the facilities management organization is viewed by corporate management as a cost center, when it can function as a profit center if organized and operated effectively.

There are essentially **three FM models** utilized by health systems:

- **Internal Model** — virtually all functions and personnel employed by health system
- **Fully-Outsourced Model** — virtually all functions and personnel outsourced
- **Hybrid Model**

In the Fully-Outsourced Model, the system may employ a handful of people with some real estate/ facilities experience, for specific job responsibilities (maintenance engineer, for example) or a Director of Real Estate, who would interface with the outsource partner. But, the property accounting, property management, leasing, construction management and similar personnel would reside with the outsource partner.

There is not necessarily a right or wrong model for a given health system to utilize. The issue is how effectively does the current model fulfill the needs of the organization? Is there proper strategic planning and thinking occurring, such that costs are contained appropriately, sites are acquired at the right price and time, leases are managed/ renewed/ negotiated properly, etc.? If the FM function is not properly structured and operated, it's quite possible that the health system is either losing or leaving millions of dollars on the table on real estate decisions — every year.

Conclusion

Real Estate Optimization is a series of processes that have been used in numerous industries for many years, but have only recently been utilized in the healthcare industry. The primary objectives are to reduce costs and create value across an organization's real estate portfolio, and to create and implement effective strategies that help fulfill the organization's mission. In today's healthcare environment, aggressive cost reductions/savings and creating /maintaining efficiencies are paramount to a health system's survival With the right optimization strategies and framework in place, including sound data gathering and analysis, followed by effective implementation strategies, health systems can now use their real estate portfolios to outpace their competition and achieve tangible financial, operational and strategic benefits.