

Does It Still Make Sense for Doctors to Own Medical Office Buildings?

How Physicians Can Invest in MOB Real Estate - Two Case Studies

By Robert Rosenthal, Pacific Medical Buildings, Executive Chairman, and Barry Weinbaum, Pacific Medical Buildings, Director of Business Development

Introduction

With fees declining and future reimbursement rates in doubt, many physicians are exploring alternative sources of income. If they can do that through familiar, relatively safe investments, so much the better. Fortunately, many physicians need look no further than their own medical office buildings.

The reasons for physicians to consider ownership of medical office buildings are more compelling today than they have been for several years. Medical office buildings deliver both stability and consistent returns, unlike most investments in today's market. Recently, even large institutional investors have come to recognize the desirability of these properties, as evidenced by the growing number of medical office buildings in their portfolios.



Bob Rosenthal



Barry Weinbaum

Pros and Cons of Medical Outpatient Real Estate

Every investment has risks and rewards. Real estate has the benefit of leverage-investing only a portion of the property cost and borrowing the remainder (today, lenders require about 30 percent cash). Medical real estate, if properly located and structured, has an additional advantage. As part of an economic environment with the proximity of inpatient, outpatient, diagnostic and other ancillary services, a synergy is created that enhances the value of what would otherwise have been a stand-alone investment.

Some of the advantages of medical office building ownership are:

- Leveraged ownership with third-party real estate lenders
- Appreciation in value and gradual retirement of debt
- Relatively secure tenancy over time
- Ability to achieve full occupancy in a relatively short period of time
- Mid-teen cash-on-cash return
- Commonality of purpose and business strategy with developers, physician owners and hospital
- Cash flow partially sheltered by depreciation during the early years
- If the ownership or partial ownership in the building is held by a medical practice, it can be used as an effective recruiting tool
- Refinancing and/or buy-in by new physicians can create liquidity for retiring physicians



As with all real estate, there can also be potential disadvantages in medical office building investments:

- Exposure to loan guarantees (if not assumed by the developer)
- Lack of liquidity, if no exit mechanism has been planned into the investment

Case Studies

Two case studies are presented below which illustrate how physicians or hospitals can participate in an ownership arrangement. In both instances, the developer provides loan guarantees, obtains entitlements and permits, construction loan and permanent financing, and supplies equity needed to satisfy lender requirements. The developer also provides construction and property management services. The first is an actual case study and the second, is a hypothetical scenario.

Case Study # 1 – St. Joseph Medical Tower

St. Joseph Medical Tower is a 130,000 square foot, seven-story medical office building and a six-level 1,100 space parking structure located on the campus of St. Joseph Medical Center, a 525-bed tertiary care facility in Orange, California. The tower was completed in 2008 by Pacific Medical Buildings (PMB) as the developer. It is attached to a three-story, 87,000 square foot cancer center which was constructed simultaneously and is owned by the hospital. The tower includes two major oncology groups, several cancer-related surgical specialists, and 64,000 square feet of hospital ancillary and office space. The hospital's cancer center includes four linear accelerators, a PET CT scanner and infusion therapy services.



St. Joseph Medical Tower, Orange, Calif.

The tower's equity requirement of about \$10.9 million was funded by 30 individual physician investors who contributed \$4.5 million, an institutional investor that contributed \$3.7 million and PMB, which contributed \$2.7 million. The parties formed a limited liability company to own the project. The hospital leased land for the project to the LLC for a 55-year term with two 10-year options.

Equity investors received a 10 percent cumulative return on their investment, in addition to 50 percent of the remaining cash flow. Before the building opened in 2007, the tower was 100 percent leased and has been providing investors with a 10 to 12 percent return since its opening.



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In February 2010, the building was recapitalized at full market value by Nationwide Health Properties (NYSE: NHP) and placed into a tax-deferred partnership (a "DownREIT") where those investors wanting to take advantage of the current capital gains environment were able to sell outright, and those wishing to exchange elected to take operating units in the newly formed DownREIT. A portion of the physicians remained as investors and were given the opportunity to continue their current ownership as partners with the new entity.

The unique nature of this transaction fulfilled the expectations of everyone involved. Total returns to investors, including the equity gain, were 19 percent per year.

Some of the physician owners took cash, some exchanged on a tax-deferred basis into operating partnership units in the DownREIT and others continued to own their respective interests in the medical tower itself. Any investors who took operating partnership units in the NHP/PMB DownREIT now own an investment that pays a yield on their increased value which was developed during the lease up of the tower. This transaction is tax-deferred and is readily convertible to a highly liquid NYSE-traded stock.

"In addition to the operational benefits of a new medical office building – including a more patient-friendly environment, better working conditions and increased staff productivity – there can also be significant ownership benefits, as we found with St. Joseph Medical Tower," says Dr. James Padova, of Hematology-Oncology Medical Group of Orange County, Inc. "The additional income that is generated by the real estate partnership is particularly attractive in today's uncertain economic climate."

Case Study #2 – Hospital/ Physician/Developer Ownership Model

In this case, a single-asset LLC is formed, which is jointly owned by individual physicians in a medical group, the hospital and the developer in proportion to their respective capital contributions. The hospital contributes a ground lease with \$1 per year ground rent and receives capital account credit equal to the value of the land. The developer and the physician-tenants contribute cash. The developer is the managing partner and delivers to the LLC a turnkey building contract, including a tenant improvement (TI) allowance and all of the services required to finance and construct the building. The developer supplies any additional equity needed to satisfy lender requirements, provides all of the required guarantees, including the construction loan, and covers any construction shortfalls by increasing its cash investment.

In this scenario, the medical group could be an existing or newly formed foundation model. That entity could lease space in the building from the LLC, fund excess tenant improvement costs, and sub-lease to the medical group. The rent paid by the foundation and other tenants (non-competing physicians, ancillary service providers, hospital services) is set at market rates which should be sufficient to provide a mid-teen return on investment from building operations once the building reaches stabilized occupancy. Proceeds from capital events (sale or refinancing) are allocated to the members of the LLC in proportion to their respective capital accounts.

This structure allows individual physicians in the medical group to invest in their building. This strategy will also work where physicians are employed by a hospital or health system.

If there is no hospital land ownership involved, the developer can acquire land and include it as a project cost to the LLC. Key elements of the two case studies are summarized below.



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An option worth exploring

As these two case studies illustrate, there are viable opportunities for physicians to invest in their medical building and create significant value from the ownership of medical office space – whether they are employed by a hospital or health system, in a group practice, or in private practice. The willingness to allow opportunities for hospitals’ affiliated or employed physicians to profit from owning their own medical office space enables hospitals and health systems to offer an added incentive for physician recruitment and retention.

Whether employed by a healthcare system, member of a foundation model or a large integrated medical group, or in private practice, investment in a new medical office building is still one of the best investments a physician can make.

Pacific Medical Buildings is a developer of medical office buildings and outpatient facilities that specializes exclusively in developing, owning, managing and acquiring medical buildings throughout the western United States. For additional information about PMB, please visit its website at www.pacificmedicalbuildings.com or call Barry Weinbaum, Director of Business Development, at (800) 495-1700.

	Case Study 1	Case Study 2
Hospital	St. Joseph Medical Center, Orange, CA	Hypothetical Hospital w/Foundation Model
Building Area	130,000 SF	75,000 SF
Parking	1,100 in structure	375 surface
Total Project Cost	\$57,000,000	\$22,500,000
Debt	\$46,100,000	\$15,750,000
Equity		
*Physicians	\$4,500,000	\$2,925,000
*Institutional Investor or Hospital	\$3,700,000	\$900,000
*PMB	\$2,700,000	\$2,925,000
Land Ownership	Hospital	Hospital
Pro Forma Allocations:		
Preferred return on investment	10.0%	10.0%
% of Cash Flow after preferred return	50.0%	50%
Structure of Recapitalization	NHP/PMB DownREIT	NHP/PMB DownREIT

