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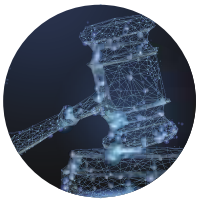


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Ambulatory Real Estate Development: Converging Perspectives and Objectives Between Health Systems, Physicians, and Developers

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For the past ten years, delivering healthcare to communities in non-acute care settings has become a central strategic objective for most health systems. The impetuses for shifting the delivery of healthcare to non-acute settings have been technology improvements in patient care, reimbursement and policy changes, and efforts to create lower-cost settings as part of the drive towards value-based healthcare. The importance of delivering healthcare in this setting has been magnified during the COVID-19 pandemic as the need for conservation of acute care space to provide emergency-based care has been amplified.

Successfully completing a large-scale ambulatory real estate development project requires aligning the strategic goals, concerns, and values of three primary stakeholders: a sponsoring hospital or health system, physicians and other providers, and a real estate developer. This article provides insight into the perspectives and objectives that each of these stakeholders brings into a development project and dissects the areas in which each stakeholder's priorities align and differ. Understanding the objectives and concerns of the three stakeholders and finding ways to bridge the gaps when they have conflicting interests is critically important to ensuring that the development project is ultimately a success. Healthcare real estate advisory and development firms are uniquely qualified to help efficiently and effectively bridge these gaps because of their experience working with each type of stakeholder.

Realty Trust Group, LLC (RTG) is a healthcare real estate advisory and development firm with significant experience spanning the course of over 20 years working with health systems and physicians to craft and implement real estate strategies and develop medical office buildings and other ambulatory care facilities—RTG actively manages over 14.5 million square feet of healthcare real estate, has completed over $2.2 billion of healthcare real estate transactions, and has delivered over $736 million in development projects.

To more effectively illustrate the key steps in developing an ambulatory real estate project and to discuss how health systems, physicians, and developers can align their perspectives and objectives on any given development, this article walks through a hypothetical scenario where a multi-hospital health system (the "Hospital") and a healthcare-focused real estate developer (the "Developer") are working together on an ambulatory medical office building development, with the anticipation of recruiting physicians to participate in the development. While the hypothetical will present certain stages of the development process in a linear fashion, it is important to note that many of these stages will happen concurrently during development.

The Hypothetical

After an extensive period of strategic planning, the Hospital has identified a geographic submarket desirable to expand their delivery of care through the development of a medical office building focused on ambulatory services. The project would comprise approximately 150,000 square feet of space for both hospital services and third-party physicians. The Hospital evaluated various project delivery options and elected to utilize the expertise of a healthcare-focused real estate developer. To preserve the integrity of the medical services to the patient population and maintain a certain level of control over the project, the Hospital requires owning the land that would be developed so that it can impose certain restrictions and controls on the use of the building through a long-term (>50 years) ground lease. The Hospital will also enter into a master lease with the Developer to lease a large portion of the space in the building and may sublease portions of the space to third-party tenants. The estimated project costs are $45,000,000.

The Developer will source the requisite financing and own the building. Additionally, to accelerate the leasing effort prior to the completion of the development, the Developer will offer equity participation in the ownership of the project to physicians who are willing to enter into leases at the building for a term of at least ten years. The Developer will source construction financing that will consist of 70% debt and 30% equity and, upon completion and subsequent stabilization at 95% occupancy of the development, the Developer will source permanent financing, thereby creating an equity event for the investors.

In this hypothetical, and in most healthcare real estate projects, the primary considerations are:

1. Site Selection;
2. Entitlements;
3. Planning and Design;
4. Ownership Structure;
5. Restrictions;
6. Capital and Financing;
7. Leasing; and
8. Operations.

1. Site Selection

After the Hospital completes its internal analysis regarding the desired delivery of services and the general location where these services are needed (typically driven by internal data related to patients and services and external data related to demographics and consumer demand), the site selection process begins. During site selection, the Hospital's objective is to identify a site that will support the delivery of patient services needed in the community. The Hospital might engage a consultant or work directly with the Developer to establish and prioritize key criteria to help guide the search for potential sites. Examples of common criteria include size (acreage), availability (on or off market), visibility, accessibility, topography, and configuration to name a few. Additionally, the Hospital might consider the pros and cons of a particular site's proximity to competitive services. Once all sites have been identified, the Hospital and Developer (or consultant) compare the sites based on the defined criteria, utilizing a weighted-average scoring methodology, to narrow the list to one specific site.

Once the site has been selected, the Developer, on behalf of the Hospital, will negotiate an inspection period into the purchase and sale agreement (the "PSA") for the site that provides enough time for robust due diligence that should include, among other things, land use and zoning evaluations, an environmental assessment, a title study and ALTA survey, a geotechnical assessment, preliminary civil schematic planning, a traffic analysis, a vibration analysis, and an electromagnetic frequency evaluation. This due diligence period should allow the Developer to terminate the PSA in the event any inspections or findings during the due diligence period reveal that the site will not support the planned development. Although the Hospital will likely invest a substantial amount of capital during its assessment of the site, effective due diligence helps protect against the undesirable outcome of the Hospital owning a property that is inadequate for its needs.

At this stage, because more work still needs to be accomplished before the Hospital is willing to commit to the project, the Developer is usually going to look to protect its time, energy, and capital by requiring some form of predevelopment agreement with the Hospital providing reimbursement of a negotiated amount of the Developer's capital outlay and services. This agreement protects the Developer from overcommitting resources for a project that never materializes. Market factors and the Hospital's track record on other projects and demonstrated commitment to the current project should all factor into how flexible the Developer is when negotiating the predevelopment agreement.

Lastly, although the physicians will be critical for the long-term success of the project, the Hospital is typically the driver in the site selection process, working hand-in-hand with the Developer.

2. Entitlements

Site entitlement is the legal process the Developer will undertake to gain the necessary approvals for a real estate development plan. This process starts concurrently with the site selection process. Key aspects of the entitlement process will include obtaining changes in zoning or zoning variances, determining allowed density, identifying allowable uses, ensuring necessary access to public roads, identifying allowable parking ratios, and acquiring any other necessary permits. The Developer can save both time and money at this stage of the process by excluding potential sites that would not be approved for the Hospital's development plan.

The entitlement process does not end at site selection; final approval of the development plan will come in the form of a site plan permit and building permit, which requires the completion of the next stage in the process: planning and design. The Hospital and Developer will most likely be aligned at this stage of development in their shared objective of obtaining development plan approval. Certain aspects (e.g., parking ratios) may be of more importance to the Hospital if those aspects impact the overall use of the site and affect patient experience. These issues, however, will also be important to the Developer because they are important for the long-term satisfaction of the Hospital's stakeholders.

3. Planning and Design

The project starts to take conceptual form in the planning and design phase. With ever-changing needs in healthcare, long-term flexibility will be critical to the success of the development for all stakeholders.

Generally, healthcare providers often have different design philosophies. Some believe in designing from the inside out—programming for certain planned uses will drive the sizing and configuration of the facility layout. Others believe in designing from the outside in, allowing site conditions to influence or drive the size and configuration of the building before determining the interior uses.

Developers may also take different approaches to design based on the characteristics of a particular site. As outpatient services shift more and more to a convenience model, developers are increasingly programming medical services into larger, mixed-use developments. For example, when developing an urgent care center, a developer would design the project based on the services that will be provided, anticipating the standard needs for the services (parking, size, basic configuration, etc.) and then marketing the space to a variety of local, regional, and national providers. In contrast to the predictability of end-uses for urgent care center development projects, the project development needs for particular specialty groups are often unique, making it difficult for a developer to "pre-plan" for specific program needs. Typically, developers will want to design a building that allows for adaptability as provider and market needs change. One of

the Developer's goals here will be to minimize the risk of the facility reaching functional obsolescence in order to protect its exit strategy.

For this project, a group of employed primary care physicians and multiple third-party medical and surgical specialty physicians (the "Physicians") and the Hospital will collectively approach designing the project with specific healthcare services in mind. More specialized services will require more specialized design, which will subsequently impact lease terms (as discussed further in the Leasing section). The Hospital and the Physicians, however, may have dissimilar viewpoints regarding certain aspects of the design. The two stakeholders may, for example, have competing preferences surrounding branding and signage. Either stakeholder may already have a unique architectural brand implemented at other facilities in the market. The Hospital may require a higher level of building systems and materials to provide certain services in a hospital-based setting for reimbursement purposes. Or the Hospital's needs might impact site design to accommodate physical plant needs, generators, or similar items. Another common misalignment between the Hospital and the Physicians may relate to which services should be offered on the ground floor versus higher floors. The Hospital may want the highest acuity services with the most expensive (and sometimes heaviest) equipment on the ground floor (e.g., imaging centers or ambulatory surgery centers) with direct egress for surgical discharges. The Physicians, on the other hand, may argue that their services generate the most foot-traffic, as may be the case with primary care, or that they require space on the ground floor for easy access by patients, as may be the case with orthopedics, rehab/therapy, or pulmonology. All these considerations must be weighed and evaluated as the building design starts to take shape, but the guiding principle should always be providing the best possible patient experience.

4. Ownership Structure

The Hospital and Developer will need to consider how to structure ownership during four distinct time periods:

1. Planning Phase;
2. Lease-Up Phase;
3. Construction Phase; and
4. Stabilized Phase.

Ownership participation may vary across each of these periods in the project timeline. The Hospital and Physicians may join together in a joint venture to create synergies from medical services in the building, but they do not necessarily need to be partners from day one.

One possible scenario is that the Developer and Hospital have agreed that the Developer will own and control the project during the development/planning phase, as is typical on these types of projects. Following that phase, the Developer can either enter into a joint venture with the Hospital and the Physicians during construction or wait until the project is completed. Another consideration for the Developer is whether it wants to maintain a long-term interest in the project or sell its interest at some point after stabilization, either to the Hospital and Physicians or to an investor.

When it comes to ownership vehicles, limited liability companies (LLCs) and limited partnerships (LPs) are the two legal entity structures most commonly used in these types of projects. A significant issue to agree upon at this stage involves which stakeholder will hold the majority ownership interest in the LLC or LP. Regardless of which structure the stakeholders choose and which stakeholder holds the majority ownership interest, it is important to understand, and agree upon, who serves as the managing member in the LLC or who serves as the managing general partner for the LP.

5. Restrictions

As previously discussed, ground leases are a common real estate strategy deployed by hospitals for medical office building projects. Historically, and mainly for on-campus projects, ground leases have become more prevalent for off-campus projects and these facilities have grown larger and more complex with additional hospital-based services. Assuming the Hospital owns the land, the Developer will enter into a long-term (>50 years) ground lease. By carefully drafting certain control provisions into the ground lease, the Hospital can control the uses at the location and ensure the quality of services provided at the location are in alignment with its delivery of healthcare to the community. The long-term nature of the ground lease allows the Developer to source financing for both a construction loan and permanent financing. As described below, several control provisions that might be included in the ground lease create a natural tension, leading to the possibility of misalignment, between the Hospital and the Developer as well as between the Hospital and the Physicians. A few examples of these control provisions that the stakeholders might have different perspectives and objectives on include:

Permitted Uses and Use Restrictions

The Hospital will seek to control the uses in the building to ensure that they support its overall strategy of healthcare delivery to the community and avoid duplication of services. It will also be important for the Hospital to put in place controls that will maintain the quality of care at the location. Common examples of these restrictions include imaging services and certain types of procedures and therapy services.

The Developer should generally be supportive of the Hospital's efforts to control uses and maintain quality of care, but the Developer will also be focused on the leasing velocity of the building and efforts to reach stabilized occupancy (typically 95% occupancy) as quickly as possible in order to secure permanent financing. To accelerate leasing, the Developer may be incentivized to pursue tenants that are incompatible with the Hospital's strategy. Potential lenders will want to see a balance between the Hospital's desire to preserve the integrity of the building's occupants and the Developer's ability to quickly reach stabilized occupancy for the building.

Assignment of Third Party's Ownership Interest

The Hospital will want to control the Developer's ability to assign or sell its interests in the building to another party that is not proficient in owning and managing ambulatory medical office buildings. Depending on the Developer's motivations and ownership goals, it may

attempt to sell the asset soon after building occupancy has reached stabilization in hopes of creating an equity event for the investors. These competing interests create a situation ripe for misalignment of objectives between the Hospital and the Developer, or the new owner, especially if the new owner is not an experienced owner of medical real estate. Potential lenders will typically prefer the Developer to have liberal rights to sell, allowing the Developer to determine who to sell to and to sell for the highest price, which may not support the Hospital's overall strategy.

Ground Lessor's Right to Purchase and Rights of First Refusal

Given the substantial investment the Hospital is making, it may want a right to acquire the property in the future along with a right to first negotiate and a right of first refusal in the event the Developer elects to sell the asset. On the other hand, the Developer will want to give the Hospital as few rights as possible so that the Developer can pursue an exit strategy without being encumbered by any rights that the Hospital may have. This issue is typically heavily negotiated and can get detailed all the way down to specific valuation methodologies that must be utilized in future transaction events.

Minimum Thresholds

As is common in these types of projects, the Hospital may enter into a master lease with the Developer whereby the Hospital will lease a large percentage of the building and then potentially sublease other portions of the building to third-party Physicians. The master lease will outline the Hospital uses and third-party physician practices, and the Developer will typically be responsible for leasing the remaining portion of the building. The Hospital will want to commit to leasing only the space that is needed while the Developer and the lender will want the Hospital to commit to leasing as much space as possible.

6. Capital and Financing

All real estate development projects are funded by two forms of capital: equity and debt. The Developer will likely fund a portion of the required capital with its own equity or cash and will borrow the remaining capital as debt from a lender. As healthcare real estate has evolved and more sophisticated developers have entered the market, complicated capital structures have become the norm. Developers might maintain multiple capital partner relationships that look to invest in different parts of the capital stack, and each type of investment will carry different risks and possibility for return. In addition, capital investments might be for just the construction period with a defined payoff at completion or stabilization, or capital can be positioned to participate in the project for the long term.

Traditional "first position" debt is typically sourced from financial institutions, with local, regional, and national banks all active in healthcare real estate lending, as well as insurance companies and pension funds. The two most common types of debt are construction loans (these loans are shorter term in nature and designed to fund the construction and stabilization of the project before maturing) and permanent loans. A third hybrid product, referred to as a "construction/mini-perm" loan (these loans act like construction loans, but transition to act more like traditional permanent financing once the project is completed), is also common. Mezzanine debt ("mez debt") is another common type of debt utilized in healthcare real estate developments. Mez debt has a higher risk profile than traditional debt because it takes a second position to the traditional debt in the event of a default by the borrower. It is common when there is a shortfall in total capital required after the traditional debt and equity raised for the project, and it is typically issued for a shorter time period. Mez debt is often paid off when the project is completed and/or stabilized and permanent financing has been put in place.

Certain types of equity investments can be for a defined or short period of time as well. The Developer may offer preferred equity investment options that provide "guaranteed" returns with lower risk profiles, versus common equity positions with higher risk/higher return opportunities. Alternatively, the Developer may offer common equity investment opportunities but provide different pricing structures depending on the status of the project at the time of investment. For example, equity pricing would be least expensive in the predevelopment phase; it becomes more expensive as key development milestones are achieved and risks are reduced.

The Hospital and the Physicians are typically going to be closely aligned on capital and financing objectives. The Hospital may consider funding healthcare real estate projects with equity through internally generated funds (i.e., cash), but with all the competing capital initiatives hospitals face, accessing debt financing can be an attractive option to fund new projects. Physicians, on the other hand, rarely look to fund new projects with cash. Although there are several types of private practice compensation models, generally these models share one thing in common: cash is flushed out of the organization on a regular basis to its physician shareholders. With minimal liquid working capital, physicians often look to debt financing to fund as much of the required project capital as possible. Physicians also typically prefer to avoid or minimize personal guarantees related to project debt. The two most common approaches to avoiding personal guarantees for physicians are (1) practice corporate guarantees or (2) shifting guarantees to the developer in exchange for certain fees and/or equity positions.

A Developer's financing objectives will vary more significantly depending on its size and capital resources. Many developers look to fund 5-15% of a project with their equity while seeking additional equity from physician and hospital stakeholders or by leveraging private equity or debt to meet remaining equity needs. Whether the Developer's strategy is to hold or sell will typically be the driving factor in how it structures debt for the project.

7. Leasing

At this point, the Hospital has probably identified service lines and specialties that it intends to offer the community based on a thorough market assessment. The Hospital may want to make sure the practices the Developer pursues will support the identified healthcare needs in the community. A balance between the Hospital and the Developer is needed to allow the Hospital to have input into determining which services will be leased in the building while allowing the Developer to achieve stabile occupancy. Areas that can cause misalignment in the leasing process are:

Building Rental Rate

The Developer will seek an annual return on the building's project cost, known as the rent constant, based on a negotiated percentage return in the form of rent payment. In the Hypothetical, the project costs are $45,000,000. If the Developer is looking for an annual return of 7.5%, the resulting annual rent, excluding operating expenses, will be $3,375,000 or $22.50 per square foot ($45,000,000 x 7.5%). The rent constant is a heavily negotiated point that may also implicate regulatory compliance laws such as the Stark Law; if third-party Physicians are entering into leases in the building, the rent they pay must be consistent with fair market value. If the fair market value rate is not sufficient for the Developer to meet its desired annual returns, misalignment can occur.

Hospital Alignment with Tenants

The Hospital will want to maintain control over the types of occupants in the building so that the occupants support and/or add to the Hospital's services in the community. The Developer will likely support the Hospital's practice strategy but will also need to accelerate leasing of the building to find appropriate financing. This can lead to misalignment of objectives between the Hospital and Developer.

Sizing

Due to the scope of investment the Hospital will be making in the project and in the community, it will want a building that allows them to expand and grow operations over time. At this point, the Developer might conduct a feasibility study to determine market data such as supply and demand, occupancy of competitive buildings, uses, and rental rate growth. If the results of the study are inconsistent with the Hospital's desired scale, misalignment between the parties can occur. The Developer's lender will also be concerned with financing a project that is not consistent with current market demands. A balance will be necessary between the Hospital's long-term strategy and the Developer's ability to reach and maintain stabilized occupancy.

8. Operations

Once the medical office building is complete, it will be critical for the Developer to either provide management services or retain property management services from a third party to support the operations of the building, including patient experience and delivery of care. The Hospital may have direct oversight as to who is hired to provide property management services to protect the quality of management. All stakeholders are likely to be aligned at this point. Unique challenges presented by ambulatory medical office buildings require a property manager with substantial experience in managing not just commercial office buildings but specifically medical office buildings. A few areas of concern regarding property management are:

Standard of Care

The medical office building was developed with the ultimate goal of delivering quality healthcare to the community. Close management of patient experience from the time they arrive on the site through arrival at their physician's office is important to maintain a high standard of care. Baseline elements that help ensure a positive patient experience include branding, wayfinding, providing easy access for patient drop-off, sufficient and easily identifiable tenant listings, parking, seating areas for patients in building lobbies, clear signage in elevators, and patient-friendly key panels. More advanced expertise in medical office building operations will help to address the additional impact on mechanical, electrical, and plumbing systems, particularly when specialty services are provided (e.g., imaging, surgery centers, and radiation oncology). Concentrated management oversight will ensure effective and efficient clinical operations while preserving the building's value as an investment.

Communication

As previously mentioned, the Hospital may master lease a substantial portion of the building that will include both hospital services and hospital-physician suites. The Hospital will sometimes communicate operational issues that are relevant to the users of the master space that may also impact third-party occupants in the building. It is important for the property manager to understand the desires of the different clinical users and navigate the overlapping impact on all occupants of the building.

Conclusion

Developing any ambulatory real estate project will present various opportunities for misalignment between the health system, the physicians, and the developer. But common ground can be reached if each party works to understand the others' perspectives and long-term objectives for the project. With decades of experience in the healthcare real estate industry, RTG can help ensure alignment between key stakeholders, enabling successful healthcare ambulatory real estate development projects.

To learn more about RTG's full spectrum of healthcare real estate advisory services, see http://www.realtytrustgroup.com.

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Many of our clients find it an ongoing challenge to balance the tactical nature of healthcare real estate transactions, or the "how", with the overall strategy set by the organization, or the "why", a transaction should be considered. Each of these elements must be addressed, while also balancing healthcare compliance considerations. We believe careful, precise management of transactions can align existing real estate assets and future real estate investments with the crucial strategic, operational, and financial goals of the organization.

RTG acts as an extension of healthcare leadership teams and their counsel and provides a full spectrum of healthcare real estate transaction support services. Whether evaluating the structure for a new transaction, conducting a feasibility analysis, or helping with real estate due diligence efforts, our team has you covered.

Leveraging our deep healthcare experience, we have the right team of experienced healthcare real estate advisors to assist with these physical, legal and financial aspects of due diligence processes; helping you mitigate risk and close a successful transaction. We provide highly experienced, independent, and objective representation for transactions related to acquisition or disposition of properties, and landlord and tenant representation. After all, your healthcare real estate should be a strategic asset, not just a cost of doing business.

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Printed in the U.S.A.