H2C INDUSTRY INSIGHTS • REAL ESTATE

Rightsizing Your Lease Agreements: Options for Healthcare Leaders

February 2, 2021

Even before the pandemic, many hospitals and health systems found themselves in unfavorable lease arrangements. These agreements, which often were structured several years ago, have exceeded market rental rates, prevented healthcare organizations from leaving undesirable space, and allowed competitors to move in nearby.

Now, as the impact of COVID-19 on hospital volumes and expenses strains healthcare organizations' finances—and as medical office buildings continue to show remarkable resilience in pricing and cost of capital remains low—healthcare leaders must consider: "Should we renew or renegotiate our lease agreements? Or, is now the time to purchase the properties we lease?"

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It's also important to evaluate the impact of new lease accounting standards—which require hospitals to report leases longer than 12 months on their balance sheets—on the organization's leverage position. Recently, we've seen instances where the operating lease liability reported by health systems is much higher than what the rating agencies' projection of the debt equivalent of the health system's leases had been. In one instance, a health system's outlook was revised from "stable" to "negative" in part because the health system's leverage metrics weakened when lease liability was added to the balance sheet.

Understanding the Healthcare Lease Landscape

One common—and expensive—issue for healthcare organizations: above-market rental rates, driven by pre-set annual lease payment increases that exceed the consumer price index.

While health systems own $1 trillion in real estate—most of it in inpatient facilities (42 percent) and clinical care facilities—H2C estimates that 35 percent of health-system occupied space is leased nationwide. Real estate occupancy and lease agreements account for 8 to 12 percent of hospital costs annually[(1)].

Real estate investors view medical office buildings ("MOBs") as a "safe haven." These assets have long-term leases, attract investment-grade tenants with big balance sheets, and are recession resistant. Further, people will always need healthcare. Other trends driving interest in MOBs: the "retailization" of medical office space, the steady rise of Baby Boomers aging into Medicare and the accelerated move toward "off-campus" MOB locations, with MOBs situated away from the immediate surrounding areas of large hospitals.

In 2019, private equity investors accounted for the majority of MOB investment volume, with $7 billion in transaction volume. Real estate investment trusts ("REITs") had been net acquirers of MOBs for four years, accounting for 22 percent of MOB dollar volume in 2019. Demand for MOBs was so high that small assets and small individual properties increased in appeal due to the shortage of portfolios or larger MOBs to meet acquisition goals. Some of the largest landlords to hospitals and health systems include REITs such as Welltower, Healthcare Realty Trust Inc., and Healthcare Trust of America and private equity investors such as Remedy Medical Properties, Anchor Health Properties, and Hammes Partners.

Over the past four years, MOB vacancy was low—and rents began to rise. Nationally, MOB vacancy totaled 8.2 percent in 2019, while rents climbed 3.6 percent. Historically, the annual average rent increase for MOBs had totaled 0.2 percent.

Top 10 Markets • Vacancy Rate & Asking Rent

Market	MOB Vacancy %	Direct Gross Asking Rent PSF
Atlanta	10.3%	$24.03
Boston	5.7%	$30.71
Chicago	12.4%	$22.45
Dallas-Fort Worth	14.8%	$25.90
Houston	12.2%	$25.31
Los Angeles	8.2%	$33.94
Miami	8.6%	$34.16
New York	7.6%	$75.62
Philadelphia	9.1%	$22.43
Washington, D.C.	10.4%	$27.83

Source: U.S. Research Report, 2019 Healthcare Marketplace, Colliers International.
(1) Based on H2C's review of Top 100 largest health systems in the United States.

One common—and expensive—issue for healthcare organizations: above-market rental rates, driven by pre-set annual lease payment increases that exceed the consumer price index. One Southwest surgery center discovered it was paying rent that was 20 percent higher than the market rate. A not-for-profit healthcare provider that entered into a master lease agreement for several properties in 2008 saw its rent rise at 3 percent per year, a rate that was significantly above market. A factor that may contribute to the lease rates being over market is that many healthcare providers have improved their financial position and "credit" since leases were originally signed, and in today's marketplace could justify lower yield-to-costs on new developments.

Other issues commonly faced by hospitals and health systems that entered into lease agreements years ago include:

- Unfavorable control provisions (e.g., no competitive leasing restrictions)
- Lease obligations coming onto the balance sheet as liabilities in excess of expected obligations
- Escalating real estate tax pass-throughs

Evaluating Your Organization's Options

Every lease is different. A thorough review by a qualified healthcare real estate firm will enable leaders to understand their options and make the right moves for their organization. This process starts by understanding the status of current lease obligations compared with "market rent" and the ways in which the utility of select assets has increased or decreased since the organization entered into the lease agreement. It also includes an examination of control provisions that have negatively affected the hospital or system. From there, the firm outlines the organization's options as well as the costs and potential savings associated with each option, with careful evaluation of asset locations, long-term utility, and value. The sensitivities related to a potential purchase of an asset or restructuring of a lease also are taken into consideration.

Typically, hospitals and health systems find that they have a number of options at their disposal, even in a COVID-19 environment. For example, since the pandemic began in March 2020, the number of health systems buying and selling MOBs has significantly increased, with health system-based activity comprising more than 25 percent of MOB transaction volume in Q3 2020 alone. Meanwhile, publicly traded REITs have emerged as net sellers during the pandemic, reversing their four-year trend as net acquirers of MOBs due to depressed stock prices during the pandemic. The largest class of buyers: institutional private equity firms and select REITs.

Options for hospitals and health systems commonly fall into four categories.

Purchasing leased facilities. During the pandemic, some health systems are acquiring real estate they have leased, taking advantage of low interest rates and investor demand in the bond market to finance the acquisitions. Health systems often have purchase options within lease agreements that allow them to acquire leased real estate at favorable pricing. By acquiring MOBs in which health systems lease the majority of space and/or look to expand, in some instances, these systems can realize savings by avoiding paying rent and real estate taxes because the cost of the debt issued to acquire the MOBs is less than the rent they pay to occupy. For example, in Q3 2020, a health system advised by H2C acquired a 164,309-square-foot MOB in a Midwest suburb that it had leased from a privately held investor at a purchase price of $54 million. In doing so, the health system is expected to save $50 million in rent costs and $10 million in real estate taxes over a 10-year period.

Restructuring lease agreements. Restructuring a lease agreement and renegotiating lease terms can help hospitals and health systems reduce rent as well as operating expense. At a time when organizations may be considering a partnership with a larger system due to the financial impact of COVID-19, this approach may also increase the pool of potential buyers. By restructuring its lease agreement and renegotiating lease terms, one Midwest health system achieved $2.3 million in rent savings and secured an expense-cap on future occupancy costs.

Acquiring and repurposing non-medical buildings. Health systems may find themselves acquiring assets and land, then redeveloping properties for their use. In 2020, several health systems acquired former retail stores in order to repurpose them for clinical use to capitalize on the visibility of retail locations. Through the health system's acquisition and utilization of a facility, there is tremendous value and oftentimes a large spread between the costs expended and the potential market value. In most cases, the health system can capitalize on the value creation by monetizing the properties at a premium, due to the value the system's tenancy brings, and keep the spread.

Developing new property. Consolidating space into a newly constructed medical office building can lead to reduced long-term costs and more efficient care delivery. For example, a large, not-for-profit system with multiple leases across 26 facilities discovered it could save $20 million in rent by consolidating spaces into a new, single facility built by the system. In 2019, hospitals and health systems built 14 million square feet of MOB space. Today, most MOB construction is concentrated in off-campus projects.

Determining the Right Approach

Rightsizing your hospital or health system's lease agreements can benefit your organization in numerous ways, such as by:

- Reducing rent/lease liability
- Achieving real estate tax savings
- Restricting competitive tenancy in the same building

There is no one-size-fits-all approach to rightsizing. That's why it's important to carefully consider your options from a number of perspectives. Understanding the impact of COVID-19 on landlords also is critical in navigating negotiations. Revista conducted a survey at the height of the pandemic in April 2020 that found 90 percent of landlords experiencing a slowdown or pause in leasing. One-in-four landlords said renewals had decreased, and 32 percent said medical tenants had inquired about rent relief. As a result, some landlords may be more amenable to lease restructuring or renegotiation of terms during the pandemic to keep tenants in place long term.

Contact Us

Care to continue the conversation? H2C can help you better understand your organization's options for rightsizing your organization's lease agreements. Contact us.

About Hammond Hanlon Camp LLC ("H2C")

H2C is a strategic advisory and investment banking firm with a singular focus on healthcare. Our commitment to exceed our clients' expectations begins with senior leadership on every engagement and continues with independent and objective strategic advice. Our belief in the markets and in the power of competition has resulted in loyal clients and long-term relationships.

The experienced professionals at H2C are well positioned to serve as your trusted advisors. We have the expertise to understand the unique complexities of the healthcare industry and an in-depth knowledge of the range of potential alternatives essential to designing and implementing highly successful business and financial strategies. We bring in-depth knowledge and experience across the full continuum of care and across a wide range of healthcare-related businesses. H2C offers services in the following areas:

- Strategy design, development, and execution
- Mergers, acquisitions, and divestitures
- Capital planning and management
- Capital markets financial advisory and private placements
- Real estate advisory and transaction execution services

About H2C Real Estate

For more than 20 years, the real estate investment banking professionals at H2C have successfully served as advisors on real estate transactions in excess of $13.4 billion nationwide. For more information on our real estate advisory group, please contact one of the following H2C professionals, or visit our website at h2c.com.

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