REITs: A Growing Healthcare Financing Option

By

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Introduction

Real estate investment trusts are a growing source of financing for the healthcare industry. In order to monetize assets, hospitals and health systems increasingly turn to third-party ownership alternatives, such as real estate investment trusts (REITs). Health-care companies, particularly hospitals, can run more efficiently if their available capital is devoted to operations rather than tied up in real estate.

Until the early 1980s, hospitals were reimbursed on a cost-plus basis, meaning that efficiency was not rewarded. But when the industry switched to the "Prospective Payment System," hospitals were now reimbursed on a flat fee, per discharge bases, known as diagnostic-related groupings (DRGs).

The result is that hospitals suddenly had to become efficient and judicious stewards of their capital, leaving only two avenues for managing that capital: traditional bank financing or a health-care REIT that purchases the real estate and leases it back to operators on a long-term lease.

The Creation of REITs

REITs were created by Congress in 1960. For more than three decades, they played a very limited role in real estate investment. Since 1992, however, the REIT marketplace has exploded.

Congress created REITs to enable small investors to make investments in large-scale, income-producing real estate. Congress decided that the only way for the average investor to access investments in significant commercial properties was through pooling arrangements. As a result, Congress designed REITs to unite the capital of many into a single economic enterprise. That enterprise is geared to the production of income through commercial real estate ownership and finance. REITs played a limited role in real estate investment for more than 30 years.

In the beginning, REITs were constrained because they were permitted only to own real estate, not operate or manage it. This meant that REITs needed to find third parties, whose economic interests might diverge from those of the REITs' owners, to operate and manage the properties. The investment marketplace did not readily accept this arrangement.

During these years, provisions of the tax code also distorted the real estate marketplace by making real estate investment tax shelter-oriented. By using high debt levels and aggressive depreciation schedules, a taxpayer could take interest and depreciation deductions that significantly reduced his or her taxable income. In many cases these deductions led to so-called "paper losses" that were used to shelter a taxpayer's other income.

By contrast, Congress designed REITs specifically to create taxable income on a regular basis, and did not permit REITs to pass losses through to shareholders. Therefore, for many years the REIT industry could not compete effectively for capital against tax shelters.

The Evolution of the REIT

The Tax Reform Act of 1986 radically changed the real estate investment landscape in two important ways. First, the Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. It did so by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses." This meant that real estate investment had to be economic and income-oriented.

Second, as part of the Act, Congress empowered REITs. The Act permitted REITs not only to own, but also to operate and manage, most types of income-producing commercial properties. They could do so by providing "customary" services associated with real estate ownership. Finally, for most types of real estate (other than hotels, health care facilities and some other activities that require a higher degree of personal services relative to rent), the economic interests of the REIT's owners could be merged with those of the REIT's operators and managers.

Even with these changes, REITs did not immediately flourish. During the late 1980s, banks, insurance companies and pension funds kept a fast pace of real estate financing. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990, the combined impact of the savings and loan crisis, the Tax Reform Act of 1986, overbuilding during the 1980s and regulatory pressures on bank and insurance leaders, led to a depression in the real estate industry. During the early 1990s, commercial property values dropped between 30 and 50 percent. Credit and capital for commercial real estate became largely unavailable.

Against this backdrop, many private real estate companies decided that the best and most efficient way to access capital was through the public marketplace using REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate on terms favorable to them.

Use of REITs in Healthcare

Many healthcare specific REITs are partnering with physician groups and other healthcare providers across the country to selectively develop and manage medical properties such as medical office buildings, specialty hospitals, outpatient treatment and diagnostic facilities, and ambulatory surgery centers.

These REITS are focused on meeting the real estate needs of the medical provider community nationwide. The REITS provide capital through the purchase of healthcare properties and realize investment return through the subsequent property lease.

REITS are best suited for healthcare organizations with large amounts of property and facilities and organizations with underutilized facilities. Hospitals are most likely to sell medical office buildings or outpatient centers to REITs. The sale of property to a REIT typically results in a large cash infusion to the healthcare organization.

REIT investments are highly dependent on real estate market rates. Selling property to a REIT results in a healthcare organization giving up control over a primary asset and forgoing any benefits from the future appreciation of the sold asset. Unless contractually structured, hospitals may lose the ability to determine appropriate tenants for the buildings. REIT terms are individually negotiated between the parties. Some property sales are structured to leave some control with the healthcare organization through retention of the “ground” rights.

Current Healthcare REIT Developments

On June 2, 2006 Baptist Health System physicians sold five properties for almost $30 million to a real estate investment trust that specializes in specialty medical properties. This sale should provide financial savings for the health system.

Ultimately, monetizing assets, such as medical office buildings and ambulatory care facilities, is not just a means to generate cash, but also to enhance debt capacity, both of which can help hospitals fund “core” acute care projects. Moving medical office buildings, ambulatory care facilities and small boutique specialty hospitals off the balance sheet means less debt maintenance for the hospital, which can improve its rating. Often, lenders discount the earnings from non-core assets because they lie outside the hospital’s key mission and purpose.

Hospitals often find they can increase their borrowing power by converting the asset to cash. To monetize assets, hospitals increasingly turn to third-party ownership alternatives, such as real estate investment trusts (REITs). Currently, there are thirteen publicly traded REITs that specialize in health care and a handful of private firms.

In addition to hospital systems, the strategic decision to utilize specialized medical property is also being utilized by physician groups across the nation as a source of financing for the development of physician owned health care facilities and hospitals. This process is about strategic direction and fiscal management rather than savings. Physicians are making the decision to focus on developing and running quality venues for the patients they serve.

The physician ownership hospital model is one that several medical REITs embrace. For example, Medical Properties Trust of Birmingham, Alabama, a leader in hospital investments, has stated that physician investment is a critical element when deciding to buy, build or finance a hospital. While many REITs have traditionally invested in large hospital and medical campus developments, there is a trend toward focusing on physician owned health care properties or hospital / physician partnerships due to the rise in these properties. REITs are increasingly focusing attention on the real estate occupied by physician owned surgery centers, imaging centers, medical office buildings, and acute care hospitals.

Conclusion

In today's healthcare industry, it is important to properly manage financial assets, including capital. Real estate investment trusts that specialize in healthcare properties allow healthcare providers to focus monetary assets on patient care, rather than lofty real estate costs. Therefore, REITs are a growing healthcare financing option.

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