Enhancing the Health Care Bottom Line With Leased Facilities

Irgens developed Mercy Medical Commons, a NAIOP Medical Office Development of the Year award winner, in Gilbert, Arizona, by implementing the lease model.

Photo courtesy of Irgens
New health care delivery and revenue models are having significant impacts on how and where new health care facilities are planned, developed, owned and operated.

By Dan Cowell and Rob Sult

As the long-range implications of the Affordable Care Act (ACA) settle in, health care systems nationwide must make complex decisions about their real estate growth strategies. Facing a reduction in reimbursement for many medical procedures, based on Medicare and Medicaid benchmarks, as well as cost containment efforts by private insurers, health care systems are adopting a new delivery model centered around the outpatient or ambulatory facility.

What has historically been a physician’s fee-for-service revenue model has become a model based on patient outcomes. For example, if a patient hospitalized for surgery or an illness experiences a complication that causes him or her to be prematurely readmitted, that could result in financial penalties to the health care system. “Wellness,” which takes into account the overall well-being of the patient and focuses on preventative rather than acute care, is now more than ever part of the lexicon. So, too, is convenience of access for the patient.

While a new health care real estate continuum is emerging, health care systems also are confronted with a growing number of outdated, operationally inefficient hospitals and other facilities. In addition, new players like one-stop “quick-care centers” in retail settings (think CVS Health) have emerged, creating competition for the traditional health care system’s “hub-and-spoke” patient care delivery model.

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Federally mandated implementation of expensive electronic health records is driving the need for interdisciplinary collaboration and operational efficiency. Market share expansion, speed to market, cost of capital, physician alignment, and bottom-line revenue results are becoming increasingly important as health care executives map out their strategic visions.

A New Era for Developers

Keen health care real estate developers are embracing this new era. As health care systems modernize and right-size hospitals (and even close some) to offer highly specialized and acute services, they are simultaneously expanding their ambulatory networks outward, closer to where their patients live and work. The results are modern, efficient buildings in more convenient locations. These facilities incorporate careful patient treatment programming, space planning and project cost management, all of which are critical to their long-term success as real estate assets.

Health care system executives traditionally have believed that direct ownership of real estate assets provides more control. In recent years, however, they have been channeling balance sheet capital toward core service line expansion and acquisition of physician practices, resulting in increased profitability. This has led to the emergence of the developer-owned and -leased financing model as the most cost-efficient use of a hospital’s on-hand cash resources to develop contemporary health care facilities.

The Lease Financing Model

Health care systems typically execute real estate transactions using one of three financial models: the lease model, the investment model or the ownership model. Since the adoption of the ACA, the lease model has emerged as a leading financial method for developing medical buildings.

With the lease model, the developer owns the real estate asset and leases the property to a health care system. The health care system, in turn, gains short- or long-term leasehold rights to that asset. The real estate asset may be an existing building, or it may be a new facility that will be developed and built specifically for the system’s use.

The lease model provides substantial advantages to the health care system. The real estate development partner fully capitalizes the real estate portion of the project — typically the land and the building — and is accountable for development and construction risk. In exchange for such a capital-intensive commitment, the health care system signs a long-term lease, typically 15 to 20 years. In this scenario, the health care system preserves precious capital and significantly reduces its risk by not be-
ing engaged in the time-consuming efforts of obtaining entitlements, design, construction and commissioning of the asset. Its occupancy and contractual obligations to pay rent are predicated on the delivery of the premises according to plans and specifications.

**Capital Considerations**

Every health care system chief financial officer must consider capital structure as a key factor in all new development projects. Implementing a specific capital structure — self-funding, lease financing or investment/partnership — greatly affects cash flow. Cash is king in health care system financial strength, and cash balances play into credit ratings and the cost of borrowing across the organization. Accordingly, health care systems today are focused on utilizing cash and traditional capital sources to expand their core business lines.

The opportunity cost of capital is not limited to the rate at which the organization can borrow. Other elements include the cost of human capital, required return on equity and additional financing implications, including the impact on the health care system’s debt capacity and loan covenants. Health care systems report that their true, weighted-average cost of capital is close to the low- to mid-teens (on a percentage basis). This is substantially greater than the interest rate at which development funds can be borrowed.

Speed to market is another significant advantage of the lease model for health care systems. By leveraging third-party capital sources, health care systems can introduce more service lines, expand alignment with specialized physicians and extend market presence more quickly and efficiently.

**Modernizing Regional Hospitals**

St. Clare Hospital, a community hospital in Baraboo, Wisconsin, has long served residents of the surrounding rural area seeking convenient access to health care. In recent years, however, many patients had begun driving to the capital city of Madison, nearly an hour away, for specialty care. The hospital’s owner and operator, SSM Healthcare, and Dean Health System strategically aligned to plan an on-campus
A new medical office building attached to St. Clare Hospital in Baraboo, Wisconsin, has transformed the hospital into a modern facility providing a wider range of specialty services to residents of the surrounding rural area. Photos courtesy of Irgens

medical office building that would provide access to a broader range of specialists in the small town.

The subsequent development of an attached, $6.5 million, 30,000-square-foot medical office building created a striking new “front door” to St. Clare Hospital. It transformed the hospital into a modern facility that aligns with the progressive services being offered inside, while also providing greater connectivity between St. Clare Hospital and Dean Clinic services.

“Our patients can enter at one access point for either hospital services or clinic services,” said Sandy Anderson, president of St. Clare Hospital. “They don’t have to go out in inclement weather anymore and, in fact, are able to have their cars parked for them by a valet.”

The new facility has allowed the hospital to expand its service lines in conjunction with its health care system partners, including existing services such as dermatology, oncology and infusion, while adding a wide range of additional specialty services, including allergy treatment, cardiology, neurology and urology.

Using the lease financing model, developer Irgens oversaw all facets of the project, including procurement of financing, site selection, entitlements and design/construction. The new medical office building was 100 percent leased when it opened in March 2014. This allowed the two health care systems to focus on their core mission: better serving the health care needs of rural south-central Wisconsin residents by keeping care local.

Extending Care With Community-Based Comprehensive Care Centers

Ever-expanding suburban communities are also spurring health care systems to rethink their models for delivering specialized ambulatory care. Rather than requiring their patients to travel to large, centralized facilities, health care systems are now developing smaller, community-based outpatient centers closer to where those patients live and work.

As Newland Communities was developing Estrella, a master-planned community in booming Goodyear, Arizona, a suburb of Phoenix, research on the local health care market determined that a convenient outpatient medical facility was needed. The growing, family-oriented community offered clear opportunities for a local pediatrician as well as primary and specialized ambulatory care services.

The developer, local health care system Banner Health and community leaders worked together to determine which operational model would most benefit Estrella residents. The result: Banner Health is
leasing a built-to-suit facility for the first time in over five years.

“Providing convenient access to medical services to the already successful commercial gateway of the Estrella community is a tremendous addition for our residents,” said Rita Brandin, Newland senior vice president and development director. “A true partnership has been created with all entities involved in the transaction, with the biggest beneficiaries being Estrella’s residents.”

The 13,500-square-foot Mountain Ranch Medical Commons, completed in May 2013, is a state-of-the-art, Class A medical office facility at which Banner Health now offers primary care services to a previously underserved and growing community. The facility is part of a continuum of health care offerings provided by Banner Health that includes urgent care facilities, surgery centers, laboratories and even senior centers and residences.

Providing Services at Neighborhood Clinics

Edward Health Ventures sought to extend its services into the expanding western Chicago suburbs. The health care system’s strategic growth plans called for offering low acuity and primary care services from Edward Medical Group physicians, including walk-in/urgent care, physical and occupational therapy, mammography, ultrasound, x-ray and other specialty services in an easily accessible and cost-efficient format.

After a comprehensive search along a high-traffic route in Plainfield, Illinois, the developer identified and purchased an ideal site. After leading the execution of a land subdivision and procurement of all entitlements, the developer then oversaw the design and construction of the $6.3 million, 22,000-square-foot Edward Healthcare Center. The fully leased, build-to-suit project was built within a tight time frame, moving from groundbreaking in January 2012 to occupancy that August.

“Edward Hospital is committed to providing patients with convenient access to high-quality medical services,” said Bill Kottman, president of Edward Health Ventures. “Our new facility on Route 59 in Plainfield will allow us to serve the medical needs of this growing community.”

An Evolving Landscape

Under the Affordable Care Act, both capital considerations and operational efficiency have become key drivers in health care systems’ bottom-line profitability. Older outpatient facilities built in an era focused on different delivery models are unable to meet the needs of today’s patients and health care systems. Today’s optimal health care facility is right-sized to maximize the delivery of medical services. Cost-effective delivery of the most profitable service lines is best achieved in well-located, modern facilities. An experienced developer specializing in medical office buildings will align strategically with health system partners to deliver real estate solutions that fully leverage the opportunities offered by this new era — and maximize the health care systems’ bottom line.

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