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Rightsizing Your Lease Agreements: Options for Healthcare Boards

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Even before the pandemic, many hospitals and health systems found themselves in unfavorable lease arrangements. These agreements, often 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 boards must consider: Should we renew or renegotiate our lease agreements? Or, is now the time to purchase the properties we lease?

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 have 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

While health systems own $1 trillion in real estate—most of it in inpatient facilities (42 percent) and clinical care facilities—H2C Securities, Inc. estimates that 35 percent

of health-system occupied space is leased nationwide.[1] Real estate occupancy and lease agreements account for 8 to 12 percent of hospital costs annually.[2]

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. Other trends driving interest in MOBs include 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.[3] Real estate investment trusts (REITs) had been net acquirers of MOBs for four years, accounting for 22 percent of MOB dollar volume in 2019.[4] 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.

➜ Key Board Takeaways:

Rightsizing a hospital or health system's lease agreements could benefit the organization by reducing rent/lease liability, achieving real estate tax savings, or restricting competitive tenancy in the same building. There are four questions board members should ask in determining whether the time is right to restructure lease agreements:

- Does our organization own or lease the majority of its real estate?
- If we lease, how do our lease rates compare to the market?
- Why do we own certain assets versus leasing them (and vice versa)?
- Is there an opportunity to achieve tax savings by restructuring lease agreements?

1 Based on H2C's review of the Top 100 largest health systems in the United States.
2 "Investors Remain Bullish as Technology, Consumerization, and Mergers Further Transform the Healthcare Landscape," Colliers International, 2019.
3 "REITs Cap Off Active Year for MOB Acquisitions," H2C, February 4, 2020.
4 *Ibid.*

Top 10 Markets: Vacancy Rate and 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.

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.[5] Historically, the annual average rent increase for MOBs had totaled 0.2 percent.[6]

One common—and expensive—issue for healthcare organizations: above-market rental rates, driven by preset 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)

5 Colliers International, 2019.
6 *Ibid.*

- 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. Conducting a thorough review with the help of a qualified healthcare real estate firm will enable boards to understand their options and make the right moves for their organization.

This process—typically led by the CFO—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 board should examine 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 should be taken into consideration.

Typically, healthcare boards find that they have a number of options at their disposal, even in a COVID-19 environment. Options commonly fall into four categories. The CFO will review the pros and cons of each option and make a recommendation to the board.

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.

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.

Acquiring and repurposing non-medical buildings. Health systems may find themselves acquiring assets and land and then redeveloping properties for their use. In 2020, several health systems acquired former retail stores to repurpose them for clinical use to capitalize on the visibility of retail locations. Often, there is a large spread between the costs expended and the potential market value.

Developing new property. Consolidating space into a newly constructed MOB can lead to reduced long-term costs and more efficient care delivery. For example, in 2020, one 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.[7]

There is no one-size-fits-all approach to rightsizing a health system's lease agreements. That's why it's important to carefully consider your options from a number of perspectives—including the impact of COVID-19 on landlords. For example, some landlords may be more amenable to lease restructuring or renegotiation of terms during the pandemic to keep healthcare tenants in place long term.

By carefully considering the options from a number of angles, healthcare boards can better position their organization to navigate negotiations with landlords and determine the right path forward.

The Governance Institute thanks Matthew Tarpley, a Vice President for the real estate division of H2C Securities, Inc., for contributing this article. He can be reached at mtarpley@h2c.com.

7 "Health Systems Make Strategic Moves in Second Full COVID-19-Impacted Quarter," H2C, October 29, 2020.