Valuation of the Leased Fee and Leasehold Interests of Senior Housing and Health Care Enterprises

by James K. Tellatin, MAI, Vic Cremeens, MAI, Bradley J. Schopp, MAI, and Hollis Crosby Taggart Jr.

Abstract

Often, appraisal assignments for senior housing, nursing home, and hospital properties will involve valuing only the real estate or a partial interest, such as a leased fee or leasehold interest. Such assignments present challenges around allocating the market value of the going concern between real estate and personal property, and leased fee and leasehold interests. The ownership of the senior housing and health care enterprises is often fragmented. In appraisal assignments where the parties to the ownership of the fee interest in the real estate are different than the ownership of the operating entity (the lease), the value of the leased fee interest is generally needed. There are occasions where an appraiser may need to provide a value opinion for the leasehold interest, and that leasehold interest is likely to have considerable non-realty value. The income capitalization approach is generally applied to the valuation of the leased fee interest, and both direct capitalization and discounted cash flow methods are very useful. The value of the leasehold interest is developed by capitalizing or discounting the tenant's profit. Capitalization rates derived from leased fee transactions, rather than capitalization rates from going-concern transactions involving fee simple interests, are applied to leased fee valuation. The capitalization rate or earnings multipliers for a leasehold interest should be derived from leasehold transactions. Fee simple going-concern capitalization rates do not match the investment risks of a leased fee or a leasehold interest.

Introduction

The ownership of senior housing and health care enterprises is often fragmented, with an operating entity (OpCo or operating company) controlling the licenses and operations while a separate and sometimes unrelated party holds title to the real estate (PropCo or entity owning the real estate interest). In this legally complex and litigious business environment, the division of control and ownership can minimize some types of liabilities that the asset-rich realty entity or PropCo is exposed to through a landlord-tenant structure, while the OpCo, which is the lightning rod for litigation claims, can hold little net worth. Appraisers must properly identify the interest appraised and identify the entity or entities that control the assets of the going concern. There may be other entities, related or not, that contribute to the market value of the going concern, such as a management company, therapy, pharmacy businesses, physician practices, and other entities that may provide services to the property, yet siphon off profits from the property and operations ownership platforms. In a sale or lease of a senior housing or hospital going concern, the market will fold back the value of these other entities into the going-concern price, often without allocating price to the various assets of the purchase. Often in an asset sale involving the going concern, the

The material in this article was originally published as chapter 18 in *The Appraisal of Senior Housing, Nursing Home, and Hospital Properties* (Chicago: Appraisal Institute, 2023).

PropCo receives 100% of the purchase price consideration, and separately there is an operations transfer agreement (OTA) that separately conveys the operating rights and functions and specified intangible assets without price consideration.

Real estate appraisers are typically involved in asset valuation rather than stock or business appraisals. Asset appraisals typically exclude the consideration of financial and other assets and liabilities on a seller's balance sheet that will not transfer to a new ownership upon the sale of the property assets. Note that most appraisal engagements and sales transactions exclude current assets (working capital, cash, accounts receivable, etc.) from the purchase price consideration. Similarly, seller liabilities stay with the seller, and the buyer or successor in the business typically gains indemnity from seller liabilities. It is important for appraisers to confirm what current assets and liabilities, if any, are included in the consideration specified in a sale transaction and what assets are to be included in the appraisal assignment.

Leasehold Interests

Typically, when the PropCo and OpCo entities are owned by the same parties, an appraiser's assignment will be to value the going concern, with a fee simple premise. In appraisal assignments where the parties to the ownership of the fee interest in the real estate are different than the ownership of the operating entity (the lease), the value of the leased fee interest is generally needed. There are occasions where an appraiser may need to provide a value opinion for the leasehold interest. That leasehold interest is likely to have considerable non-realty value. The income capitalization approach is generally applied to the valuation of the leased fee interest, and both direct capitalization and discounted cash flow methods are very useful. To assess the landlord's risk, the net operating income (*NOI*) and contract rent are compared. Most lease rents are set at a level that allows the operators to earn some profit for their efforts, skills, and invested capital.

The value of the leasehold interest is developed by capitalizing or discounting the tenant's profit. Capitalization rates derived from leased fee transactions, rather than capitalization rates from going-concern transactions involving fee simple interests, are applied to leased fee valuation. Similarly, the capitalization rate or earnings multipliers for a leasehold interest should be derived from leasehold transactions. The use of fee simple going-concern capitalization rates does not match the investment risks of a leased fee or a leasehold interest. In a leasehold interest valuation, discounting the anticipated profits (tenant *NOI* less contract rent) to present value is considered more reliable than capitalizing a single year's profit because the lease term is finite.

Most senior housing property[1] and hospital leases involve absolute net terms and extend from five to more than 20 years. Typically, the entire facility is leased to a single tenant. In fact, in many cases multiple properties are contained in a single master lease. In exchange for rent, a typical lease contract conveys the right to occupy the real estate, the right to use any lessor-owned equipment at the property, and the use of transferable operating rights that were under the control of the landlord prior to the lease, to the extent that the landlord controls these intangible assets. Generally, the intangible assets that pass from one operator to the next include the requisite licenses, permits, and certifications, assembled workforce, patient and resident records, and other operational assets.

The transfer of the intangible assets is typically conveyed through the directions within the lease or a separate operations transfer agreement (OTA). Upon termination, most leases require the cooperation of the terminating tenant to convey the necessary operating rights to a succeeding operator. The absence of an OTA or instructions in the lease regarding tenant responsibilities upon the lease termination can lead to a wide range of disputes with economic consequences for the landlord and the tenant with risk considerations in the valuation of a leased fee or leasehold interest.

When compared to the going-concern value under a fee simple premise, a leased fee value of the same property is likely to have a larger percentage of its value attributed to tangible assets. A leasehold value in the same property is likely to have a greater proportion of its value attributable to intangible assets. The leaseholder is responsible to the employees, management, and obligations under licensure and certification agreements, and these business operational responsibilities align more closely with intangible value.

1. The appendix at the end of this article lists terms and acronyms for related property types.

Typical leases for the health care and senior housing properties covered here are long term and absolute net, meaning the tenant is responsible for all operating expenses and capital replacement. Also, the tenant is typically required to carry a significant amount of general and professional liability insurance. The tenant must maintain all licenses and certifications during the lease term. Most contemporary leases will require the tenant to provide the landlord with financial and operating statements regularly. Moreover, many leases require minimum *EBITDAR*[2]-to-rent-coverage ratios and may provide specific definitions for revenue and expense items, in addition to lease guaranties, balance sheet covenants, and rent deposits.

Lease terms are often for 10 years or more. This allows tenants more time to recapture their investment in the business operations.

For conventional real estate, the values of the leased fee and leasehold interests are typically subsets of the fee simple value. While this is not necessarily true in all cases, the sum of the leased fee and leasehold values often, but not always, approximates the hypothetical fee simple value of the property. More discussion on leasehold value issues is presented later in this article.

The cost approach and, if there are enough sales of reasonable comparable leased fee properties, the sales comparison approach are optional in appraising the leased fee interest of hospitals, nursing facilities, and senior housing properties. The income capitalization approach is often the singular approach used to appraise the market value of the leased fee interest. Direct capitalization and discounted cash flow analysis techniques can be applied. The direct capitalization approach uses the current contract rent and an overall capitalization rate derived from market evidence. Yield and value change are implied but not identified in direct capitalization, unless yield capitalization techniques are applied.

In discounted cash flow analysis, the expected rents over the anticipated term of the lease (or the holding period) and the value of the property at the termination of the lease (or holding period) are discounted to present value using a market-derived discount or yield rate. Generally, the market will rely heavily on direct capitalization for leases that have steady rental increases. Discounted cash flow analysis may be better employed when there is irregular or flat rent in the lease, a large, determinable rental change, or a short remaining lease term.

To perform a leased fee valuation using the income capitalization approach, the following steps are applied:

1. Analyze salient issues within the lease agreement
2. Compare market rent to contract rent, and measure these rents to the tenant's net operating income (*EBITDAR*)
3. Determine the likelihood of lease extensions or renewals, or the exercising of a purchase option, per terms and conditions of the lease
4. Capitalize contract rent by applying the appropriate rate developed from the analysis of comparable sales and other market data
5. Develop an internal rate of return through forecasts of lease term, rent, and reversionary value

Lease Contracts

Lease contracts can be more involved than purchase and sale agreements for the same property because the parties will "live" with each other over the lease term for better or worse, whereas with a sale transaction the parties go their separate ways after the sale closes. For many leases that have been in effect for years, it is likely that lease amendments have occurred. Appraisers should request and review the original lease and all lease amendments. It is important to read and understand the lease beyond the rent and lease terms. The following is a list of critical issues to glean from the subject lease when valuing a leased fee interest of a hospital, nursing home, or senior housing property:

- Lessee
- Lease term
- Rental rate
- Rental increases
- Landlord expenses
- Lease deposit
- Lease guaranty
- Financial requirements or restrictions placed on the tenant
- Lease termination clarity
- Tenant purchase option
- Master lease or cross defaults

2. Earnings before interest, taxes, depreciation, amortization, and rent.

Lessee

Important issues regarding the tenant include

- Credit quality: For hospitals, they often have a credit rating, and that is very useful information. That information should be requested.
- Name recognition: Well-branded operators tend to sell "better."
- Quantifiable delivery of care, overall star rating, and care issues across a company's coverage area.
- Issues with Medicare Recovery Audit Contractor (RAC) risks and regulatory transgressions.

Lease Term

Initial lease terms will often run five to 20 years with extensions. The tenant needs years to establish its business and recover its investment. Shorter remaining lease terms require greater speculation from appraisers regarding tenant transition issues, possible substantial change in rent (move to a market rent), and meaningful changes in lease terms of a new lease that tie down loose ends from a prior lease.

Rental Rate

Does the contract rent match market rent? Appraisers should confirm the actual, in-place rent, rather than rely on the stated rent amount in the lease document. Rental payments may have changed through separate lease amendments or other causes that are not apparent in the lease material provided to an appraiser.

Rental Increases

Annual rental increases are the norm, but some leases call for occasional rent step-up, say, every five years. Leases may have rent reset provisions moving rent to market levels, which will require appraisers to speculate about future rent. Rent resets often require an appraisal process should the parties not agree on the new rent. Rent reset language providing instruction to appraisers may be vague, causing two or more appraisers involved in the reset process to make different interpretations, resulting in very different rent conclusions. Some leases have provisions for additional rent based on the tenant's *EBITDAR* or *EBITDARM* (*EBITDAR* plus management expenses).

Landlord Expenses

Typically, the lessee is responsible for all expenses and costs associated with the leased property through the term of the lease. Generally, real estate investment trusts and some more sophisticated landlords will require tenants to maintain a reserve for replacement of short-lived items and require tenants to fund this reserve from operations in some manner.

Lease Deposit

The amount of the deposit is a key element of the lease agreement. Does the deposit change (e.g., increase or get partially or fully refunded) over time or when certain operational or financial thresholds are achieved?

Lease Guaranty

Is there a guaranty, and does that extend to the parent company? Often a tenant is a single-asset entity, and a guaranty with just that entity is considered weak.

Usually, appraisers will not have clear insights into the strength of a lease guaranty. Discussions with the client regarding the lease guaranty can add better insight.

Financial Requirements or Restrictions Placed on the Tenant

In many leases, tenants are required to maintain a minimum *EBITDAR*-to-rent-coverage ratio, a positive net worth in the leasing entity, or other thresholds prior to being able to take distributions. Failure to achieve these minimums may result in a tenant contributing a greater cash deposit, letters of credit, or other forms of security in escrow in favor of the landlord. The absence of such a financial covenant is noteworthy. Without these structures, a tenant could take large distributions, leaving the leasehold operating entity in poor financial condition. In theory, the absence of operating covenants should translate into higher rent.

Lease Termination Clarity

Is there an operations transfer agreement or requirements in the lease that provide for a smooth transition relating to the operation of the facility upon termination of the lease? Is the tenant required to cooperate with transferring Medicare, Medicaid, and managed care provider

agreements and certifications? Licensing? Patient records? Employee matters? Vendor agreements? Noncompete agreements? Often there is a separate agreement to the lease known as the operations transfer agreement. Either through the lease or an OTA, most landlords want to be fully protected from the tenant as it is nearing lease termination from damaging the business for the next operator by requiring the tenant to cooperate with transfer operations and prohibiting the tenant from encouraging employees and residents or patients to move to other properties operated by the tenant.

Tenant Purchase Option

The existence of a purchase option is often impactful on the value of the leased fee interest. The purchase option period might extend over a number of years, and judgment is necessary in determining when the purchase will occur. Purchase options may involve an appraisal process that uses an average of a few appraisals. The lease instructions for appraisers can be vague relative to critical valuation points, like property rights to be valued (leased fee, subject to the lease, or fee simple), or the lease may be unclear regarding the valuation of intangible assets. Having the parties in agreement regarding property rights and assets to be appraised before starting the appraisal process is ideal.

.

Master Lease or Cross-Defaults

Generally, a master lease with multiple properties or a lease with a cross-default structure provides diversification that reduces risk. An assumption may be necessary that keeps the cross-default in place if only one property in the master lease or otherwise cross-defaulted lease is being appraised. Elevated risk consideration will need to be considered should the leased fee interest be somehow separated from the cross-defaulted properties.

While these comments pertain to the subject property lease, they also stress vital facts to know about lease comparable data. Comparable lease data for hospitals and nursing facilities, and possibly assisted living facilities, can be researched through nearly the same sources as those used to gather comparable sales data, although lease data will not show up in most recorder of deeds offices. A change in tenant usually involves a change of operator, which is recognized as a change in ownership (CHOW) that typically requires a review and approval by the state's health department or other licensing agency. Most states provide varying levels of information regarding their review of the change of license application. This could include making available, under the Freedom of Information Act, a copy of the actual lease and operation information. Property transactions that are subject to a lease when the lease and operator remain in place may or may not be reviewed. Of course, the appraiser will have access to Medicaid and Medicare cost reports for nursing facilities and hospitals. That cost report data provides detailed operating data, and, if the cost report covers a period after the lease commenced, it is likely that the cost report will contain useful lease information.

License Ownership Issues

Licensure ownership issues can arise during the lease termination. Increasingly, more contemporary long-term net leases will have an operations transfer agreement within the lease. Alternatively, the lease may include a separate agreement that requires the tenant terminating the lease to cooperate with the landlord and the next operator. The next operator may be taking over in a variety of ways:

- Via another lease
- Via a purchase of the fee simple estate of the real property
- Through a management company acting on behalf of the landlord or another party
- Through the transfer of business operations, which include the transfer of licenses, certifications, employees, patient and resident records, and other elements of the business

The presence or lack of an operations transfer agreement or similar set of agreements presents risks to the landlord's interest. Its absence should result in higher rent to cover the additional backend risk, everything else being equal. Many leases—particularly older leases—are silent or vague regarding the transfer of operations issues.

Subordination

A tenant may need to provide consent to subordinate its rights over a property to the rights of a lender, usually the senior mortgagee. Most lenders forbid the real property (and possibly personal property assets of a going concern) to serve as security for a loan unless their mortgage interest is

in a higher position than any leasehold interests of tenants. Typically, a lender will have the option to terminate a tenant's lease in the event of commercial foreclosure. Most leases will also have a nondisturbance clause so that the lender will not disturb the tenant's possession in the event of a foreclosure.

Estimating Market Rent

A comparison of the estimated net operating income to rent provides insight into the potential duration of the lease, the ability of the lessee to pay rent (risk to the leased fee position), and the reversionary value.

A market rent estimate can be developed using several methods, with each method borrowing from one of the three approaches to value. Techniques for estimating market rent include the following:

- Cost approach
- Market comparison
- Income capitalization

The cost approach technique involves estimating the depreciated cost of the leased assets and land value and multiplying the cost by a market rent factor. The market rent factor is derived by dividing the initial full-first-year absolute net rent by the contracted development cost when the tenant, often a hospital, contracts with a real estate developer to deliver a completed ready-to-license-and-certify building. This rent is generally not used for valuation proposes, for many of the same reasons that the cost approach is not heavily relied upon in appraising the fee simple interest of health care properties, but the technique is useful when more market-oriented approaches are not available. This approach cannot be totally disregarded because rent on newly developed properties is often based on actual costs. The use of cost to established rent does tie the cost approach with the income capitalization approach.

The market comparison technique involves comparing the rent per unit/bed or building square footage (for hospitals) of comparable leases in a process that is similar to the sales comparison approach and that considers the same elements of comparison. Another method involves (a) applying the sales comparison approach to develop a value of the fee simple estate and then (b) applying a market rent factor derived from sale-leaseback transactions. Rent comparable data can be obtained through news releases and Securities and Exchange Commission reporting by real estate investment trusts in the hospital and senior housing sectors announcing their recent lease transactions. Through EMMA[3] (Electronic Municipal Market Access), the Municipal Securities Rulemaking Board publishes information that provides in-depth details for transactions using bond financing. Change of ownership applications filed and reviewed by state licensing departments are another source of comparable lease data.

The income capitalization technique involves developing *EBITDAR* or *NOI* in the same way that it would be developed in a direct capitalization or discounted cash flow analysis for a fee simple valuation. In leased fee and leasehold valuation, the data and analysis to reach the operator's *EBITDAR* are identical to the fee simple going concern. Next, the first-year or stabilized *EBITDAR* is divided by a market lease- or market rent-coverage ratio. This reciprocal of the ratio is the percentage of *EBITDAR* allocated to rent. The market expresses this relation as a ratio; for example, a nursing facility might have a 1.5:1.0 coverage ratio, which would be the same as 66.7% of *EBITDAR* equaling market rent.

The coverage ratio or rent percentage is derived from recent lease transactions for comparable property.

The rent-per-unit process is similar to estimating market rent for other commercial real estate. Units of comparison may include beds, dwelling units, and square feet. For hospitals, other units of comparison may be considered, such as rent per discharge and adjusted discharge, and patient day and adjusted patient day. The degree of adjusting a rent comparable for an element of comparison may differ from the same property being used as a sale comparable because the rent comparable is for a finite period while ownership takes a long-term perspective. Elements of rental comparison include typical lease factors:

- Type of lease (gross to absolute net)
- Physical qualities
- Location
- Rent increases
- Capital expenditure contributions

3. See https://emma.msrb.org/.

Specific considerations for health care and senior housing properties include rent coverage and other financial covenants, operations transfer agreements, and very importantly, census levels, payor mixes, reimbursement and rate levels, and other factors that ultimately drive *NOI*.

These techniques are the most used approaches for estimating market rent. Appraisers are often engaged to appraise market rent per terms in a rent reset provision of a lease, to establish rent for a new lease, and for other reasons. In the development of an estimate of market rent, it is critical to understand and accommodate all the provisions of the lease. Market rent can differ for the same property for the different lease provisions discussed earlier in this article. For example, rent will be affected by the amount of deposit or the presence of operating covenants that restrict cash distributions until net worth and rent coverage ratios are attained or a capital expenditures account is funded. Rent would be expected to be less when the lease requires a minimum rent coverage and regular contribution to a cap-ex account, as compared to the lack of those provisions. If the market rent assignment does not provide a lease, an appraiser should reach an agreement with the client or clients to define the key valuation terms of the lease.

Comparing Market Rent and *EBITDAR* to Contract Rent

The market does not necessarily develop an estimate of market rent when assessing an opportunity to invest in senior housing or a hospital leased fee interest with a lengthy remaining lease term. For a shorter lease term, the market rent is more important because investors will be facing a possible different rent. In long-term leases, a key valuation factor is the anticipated *EBITDAR* coverage. The coverage ratio provides risk assessments—including the likelihood that the tenant will be profitable, pay rent timely and fully, and exercise lease extensions—and predicts rent levels after rent reset events.

An *EBITDAR*-to-rent coverage ratio that equals or exceeds initial market ratios provides the landlord with greater certainty that the tenant will perform under the terms of the lease because the tenant has a sufficient economic incentive to comply with the lease. If the *EBITDAR* is less than market, there is a greater risk that the tenant will not adhere to the terms of the lease. The selection of the leased fee capitalization rate or internal rate of return places substantial emphasis on the *EBITDAR*-to-rent coverage ratios across the anticipated lease term. Other factors influencing the rate selection include property and competitive market qualities, guarantees, and the creditworthiness of the lessee.

The estimation of the tenant's *EBITDAR* is an essential exercise for most leased fee assignments unless the tenant quality is extremely strong. Usually, the operating tenant will be leasing the property through a single-asset entity to minimize liabilities. The landlord might have personal and or corporate guaranties from the tenant, but one of the greatest assurances for the landlord receiving full rent is to see that the tenant, a single-asset entity, is achieving enough cash flow so that the business will continue to operate with sound financial management and that it will comfortably cover contract rent.

Market *EBITDAR*-to-rent-coverage ratios vary with property type. Coverage ratios increase with the amount of human endeavor employed to achieve the *EBITDAR*. Research performed by the investment banking firm Stifel Nicolaus on lease coverage ratios for health care real estate investment trusts (REITs) illustrates this point in Exhibits 18.1 and 18.2. The analysis uses First Quarter 2019 information. Coverage analysis from the pandemic period is less reliable because many REIT tenants experienced significant drops in occupancy and increases in operating expenses caused by labor shortages. The coverage ratios reflect actual trailing *EBITDAR* and *EBITDARM* results.

REITs focus on two operating coverage ratios: before and after management fees. Because many REIT leases have provisions that will prohibit their tenants/operators from paying a management fee to their related-party management entities if coverages fall below prescribed minimums, the *EBITDARM* coverage becomes an important measure. Having this type of management fee provision increases the landlord's ability to receive full rent. Health care REITs will typically publicly report aggregate coverage information on a quarterly basis.

However, in recent years, REITs have been increasingly holding back lease coverage information for their announced property transactions for several reasons, including keeping their deals confidential for competitive reasons and avoiding issues that come with providing more granular details.

Exhibit 18.1 Health Care REIT Coverage Ratios by Asset Type

		EBITDAR Coverage		
Company	**Symbol**	**SNF**	**AL / IL**	**Hospitals**
CareTrust REIT	CTRE	1.80	1.22	–
Physicians Realty Trust	DOC	–	–	4.10
Welltower, Inc.	WELL	1.24	1.05	–
HCP, Inc.*	HCP	1.68	1.02	3.15
LTC Properties	LTC	1.28	1.21	–
Medical Properties Trust†	MPW	–	–	2.25
National Health Investors	NHI	2.07	0.99	1.52
Omega Health Investors	OHI	1.31		–
Sabra Health Care REIT	SBRA	1.24	1.07	2.89
Senior Housing Properties Trust	SNH	1.46		–
New Senior Investment Group	SNR	–	1.23	–
Ventas	VTR	1.20	0.96	1.64
Median		1.31	1.14	2.57
		***EBITDARM* Coverage**		
Company	**Symbol**	**SNF**	**AL / IL**	**Hospitals**
CareTrust REIT	CTRE	2.34	1.44	–
Physicians Realty Trust	DOC	–	–	5.47
Welltower, Inc.	WELL	1.55	1.21	–
HCP, Inc.*	HCP	2.06	1.19	3.49
LTC Properties	LTC	1.77	1.43	–
Medical Properties Trust†	MPW	–	–	3.00
National Health Investors	NHI	2.76	1.15	2.02
Omega Health Investors	OHI	1.67		–
Sabra Health Care REIT	SBRA	1.72	1.25	3.18
Senior Housing Properties Trust	SNH	1.52		–
New Senior Investment Group	SNR	–	1.40	–
Ventas	VTR	1.50	1.10	2.19
Median		1.72	1.33	3.09
Data as of March 31, 2019, lags by a quarter				

* Same-store for senior housing assets

† Estimate: assumes a 5.0% management fee: 35% operating margin for AL/IL, 20% for SNF, 15% for hospitals

Source: Stifel Nicolaus, estimates from company SEC filing

Exhibit 18.2 Typical Lease-Coverage- or Rent-Coverage-Ratio Minimum Targets

Property Type	***NOI*-to-Rent Coverage**
Senior housing	1.1:1.0 – 1.25:1.0
SNFs	1.25:1.0 – 1.50:1.0
Hospitals	Not enough data

Exhibit 18.3 Comparison of Senior Housing Rent and *EBITDAR/EBITDARM*

Year	Contract Rent	*EBITDAR*	*EBITDAR* Coverage	*EBITDARM*	*EBITDARM* Coverage
1	$1,250,000	$1,562,500	1.25	$1,785,714	1.43
2	$1,281,250	$1,620,000	1.26	$1,851,429	1.45
3	$1,313,281	$1,685,000	1.28	$1,925,714	1.47
4	$1,346,113	$1,700,000	1.26	$1,942,857	1.44
5	$1,379,766	$1,750,000	1.27	$2,000,000	1.45
6	$1,414,260	$1,625,000	1.15	$1,857,143	1.31
7	$1,449,617	$1,745,000	1.20	$1,994,286	1.38

REITs investing in senior housing have been migrating to deals where they take ownership of the going concern and retain the seller under a management agreement. These RIDEA-type deals[4] generally transact at lower going-in capitalization rates than net lease deals, but REITs feel that they have greater upside in the long run. They also are getting competition from other institutional investors for senior housing who are willing to accept lower returns.

A comparison of senior housing rent and *EBITDAR(M)* is simply presented in Exhibit 18.3. In this case, the *EBITDAR*-to-rent coverage is initially at market levels and remains within the market range through the remaining forecast. In this example, there is economic incentive for both parties to extend or renew the lease at the same rent level. A new lease might be desired to "modernize" the lease.

Remaining Term of the Lease Including Option Periods and Purchase Options

Most senior housing and health care facility leases extend over many years to allow the tenant time to establish a business and recover investments in personal property assets, including FF&E, working capital, the assembled work force, and management skills. Most leases grant one or more multiple-year lease extensions or renewal options, provided all terms and conditions are being met to the satisfaction of the landlord.

Renewals and purchase options are critical considerations in valuing a leased fee interest. If the contract rent is significantly above or below market, potential leased fee investors adjust their valuation modeling to account for rent bumps. Also, investors need to predict when a tenant will exercise a purchase option.

From the tenant's perspective, the purchase options should be examined closely when purchase points arise. As an example illustrating the considerations that tenants make in assessing a purchase opportunity, consider a tenant who has an option to purchase the leased fee interest at the end of year seven for $20 million. Based on that price and using the in-place *EBITDAR*, the overall capitalization rate is 8.7%. If the market capitalization rate is 7.0%, the tenant has real incentive to purchase because there is significant equity present. The examination of the purchase option will follow the basic steps shown in Exhibit 18.4.

In this example, the tenant has nearly $5 million in potential equity and can realize that by borrowing 70% of the $20 million purchase option and producing $2,799,000 in cash. The debt service would be $339,073 less than the contract rent. That capital cost savings of $339,073 annu-

4. RIDEA (typically pronounced Rye-Dee-Uh, or Rye-Day-Uh) is an acronym that stands for the REIT Investment Diversification and Empowerment Act. This legislation was enacted in a REIT reform act of 2007 and allowed REITs to change the way they accounted for health care real estate income. Prior to this act, health care real estate investments had to be structured as leases (typically triple-net leases) with annual rent payments and escalations. The RIDEA act allowed REITs to participate in the actual net operating income, as long as there was an involved third-party manager. The legal structuring includes creating Taxable REIT Subsidiaries (TRS), with an in-place lease between the landlord and tenant entities (both owned by the REIT). See Scott McCorvie (CEO of Vita Senior Living), "What Is the RIDEA Structure?" Senior Living Growth Advisors (May 3, 2017), www.srgrowth.com/news/2017/5/3/what-is-the-ridea-structure-2.

Exhibit 18.4 Analyzing a Purchase Option from the Tenant's Perspective

EBITDAR	$1,745,000
Fee simple going-concern capitalization rate	7.0%
Market value, fee simple	$24,930,000
Less purchase option price	(20,000,000)
Tenant's equity as fee simple owner	$4,930,000
Mortgage financing available to tenant (70% loan-to-value)	$17,451,000
Amount of cash required by tenant to purchase ($20,000,000 – $17,451,000), plus $250,000 cost to purchase & finance	$2,799,000
Annual debt service, using a 4.25%, 25-year amortizing loan	(1,146,784)
Contract rent in final lease rent, plus 2.5%	$1,485,857
Difference between new rent and mortgage payment	$339,073
First year cash-on-cash return if purchase option is exercised	12.1%

Exhibit 18.5 Leased Fee Cash Flow Forecast

Lease Year	Rent/Sale
1	$1,250,000
2	$1,281,250
3	$1,313,281
4	$1,346,113
5	$1,379,766
6	$1,414,260
7	$1,449,617
Year-7 Purchase	$20,000,000

ally equates to a cash-on-cash return of 12.1%. The purchase opportunity appears attractive and becomes even more attractive if the tenant can raise the equity from investors that accept less than the cash-on-cash yield of 12.1%, which might be possible if the market is indicating equity capitalization rates of around 10% for property similar to the subject.

If *EBITDAR* is expected to fall below the typical market rent-coverage ratio, the prospect that the purchase option declines, and a new lease at a lower amount seems likely. This will be considered in the overall capitalization and discount rate selections.

Staying with this example, the leased fee cash flow forecast is shown in Exhibit 18.5. With this analysis, the leased fee valuation can proceed through direct income capitalization or discounted cash flow analysis. The market generally considers direct capitalization to be reliable when the rent is expected to be steady and will be received for many years. The discounted cash flow analysis becomes more important when there is an expected purchase event or a foreseeable, substantial rent change (up or down).

Direct Capitalization of a Leased Fee Interest

As with any direct capitalization procedure, sales of the leased fee interests involving similar properties are preferred. Investor surveys for leased fee capitalization for senior housing, nursing facilities, and hospitals are not widely available. Capitalization rate surveys for net leased commercial real estate are available through several sources, such as the popular *PwC Investor Survey* published quarterly, and can be used as proxies. Sales for absolute net-leased properties covered in this book are scarce, and the search may necessitate casting a wide geographic net to gather a meaningful number of comparables. Leased fee capitalization rates are typically lower than going-concern rates for similar property because the landlord's income is insulated from the operational and business risks.

Sale-leaseback transactions by health care REITs provide accessible capitalization rate evidence. In sale-leaseback transactions, the capitalization rate is effectively the lease rate. In most cases, the lease rate is the first-year net lease divided by the purchase price. An argument can be made that a sale-leaseback transaction that

involves the seller remaining in the property as the tenant and operator is a financial transaction, not a third-party sale. But there is substantial evidence that the REIT's rent and lease rate would be the same whether the purchase kept the seller in place as the tenant/operator or a new, unrelated party became the lessee and operator.

REITs generally express their rates without making deductions for vacancy or operating expenses. It is important to treat the market data used to derive capitalization rates in a manner that is consistent with the treatment of the *NOI* of the subject property. If the subject property and the comparable sales involve absolute net leases, then deducting for vacancies and operating expenses from the rent of a comparable sale but not from the rent of the subject property will produce an inaccurate value. Most REITs will report capitalization rates based on full rent when the lease is absolute net, without deductions for vacancy risk, management fees, or other potential expenses. For absolute net leases, the possibility of vacancy and expenses associated with the property in a premature tenant transition can be incorporated into the capitalization rate.

A simple technique used to ballpark a leased fee capitalization is to work with better-known facts such as going-concern capitalization rates and *EBITDAR*-to-rent-coverage ratios. Knowing those two, the leased fee capitalization rate can be approximated with this formula:

$$\frac{\text{Going-concern Overall Capitalization Rate}}{\text{Market } EBITDAR \text{ Rent Coverage Ratio}} = \text{Leased Fee Capitalization Rate}$$

Examples for skilled nursing (SN) and assisted living (AL) properties are as follows:

$$\text{SNF:} \quad \frac{12.5\% \text{ (going-concern } R_o)}{1.5} = 8.33\%$$

$$\text{ALF:} \quad \frac{7.5\% \text{ (going-concern } R_o)}{1.2} = 6.25\%$$

The indicated capitalization rates from this formula represent rate floors. If the *EBITDAR* were capitalized at the going-concern capitalization rate, that value would equal the rent capitalized at the leased fee capitalization, leaving no value to the operator. Certainly, the tenant will have some intangible value resulting from the cash flow from the *EBITDAR* above the 1.0:1.0 coverage. Therefore, it is reasonable to expect that leased fee capitalization should be slightly higher than expressed in this formula.

One interesting observation to note when rent is being set between a developer and the operating tenant is that the rent is typically based on the developer's total costs to deliver a completed project. The cost basis for the rent usually excludes the entrepreneurial incentive to the delivery point. The rent is set at a negotiated "rent" rate. Often the rent rate or rent factor is greater than the ultimate leased fee capitalization rate when the developer elects to sell the leased fee interest. If there has been no change in interest rate, capitalization rate, and other economic factors between the time the lease and development agreements are set and the developer sells the leased fee interest, the developer intends to earn a profit by selling the leased fee interest at a capitalization rate that is less than the cost-based rent rate. For example, if a developer delivers a new orthopedic hospital to the tenant with a 20-year lease and a rent based on 9.0% of total cost and then sells the leased fee interest to real property investors at an 8.0% capitalization rate, the developer's entrepreneurial profit is 12.5% of the cost [(9.0/8.0) – 1].

While REIT transactions offer considerable insight into leased fee capitalization rates, more desirable rate evidence comes from sales that involve leased fee transactions in which the lease was in place prior to the most recent sale, where the leased fee seller had an established leased fee interest. These transactions are difficult to identify.

Exhibit 18.6 presents typical relationships of lease rates, *EBITDAR*-to-rent coverages, and going-concern capitalization rates for senior housing and skilled nursing properties. Hospitals have a different set of rate considerations that tie closely to their credit quality.

Exhibit 18.7 illustrates issues that warrant consideration in the selection of an appropriate lease rate or internal rate of return. Many leases will lack items in the lease level factors.

Leased Fee Capitalization Rate Data from Surveys

Several popular surveys that publish information on triple net lease capitalization rates can be used as a starting point for developing senior housing and health care property rates. The quarterly *PwC*

Exhibit 18.6 Rate Relationships

Property Type	Lease Rate	*NOI*-to-Rent Coverage	Implied Going-Concern Capitalization Rate
Senior housing	5.5% to 7.0%	1.05:1.0 – 1.30:1.0	6.0% to 8.75%
SNFs	8.0% to 10.0%	1.25:1.0 – 1.50:1.0	10.0% to 15.0%

Exhibit 18.7 Factors in the Selection of a Leased Fee Capitalization Rate

Factors at the Lease Level

- Amount and frequency of scheduled rental increases
- Minimum *EBITDAR*-to-rent coverage, operator net worth requirements, management fee holdbacks, and other provisions to ensure that positive coverage is achieved
- Cross-defaulting multiple property leases between the same tenant and landlord
- Remaining term of the lease and prospects and cost of transitioning the property to the next operator
- Credit quality of the tenant and guarantees
- Atypical lease terms or unconventional leases that are unacceptable to investors (equity and lenders)
- Tenant's ability or inability to compete with the existing leased facility after the termination of the lease, assuming the tenant might develop a replacement facility in the same market area
- Clearly define responsibility at lease termination or well-defined operations transfer agreement, etc.
- Operator transparency (i.e., the lease should make operating and financial statements available to the tenant)

Factors at the Property (Asset) Level

- Building condition
- Remaining economic life
- Location
- Anticipated reversion value, relative to the current value
- *EBITDAR*-to-rent-coverage ratio (i.e., high rent coverage reduces risks and rates)
- Barriers to entry (e.g., high land costs, difficult regulatory environment for new developments, and strong certificate of need rules)

Investor Survey includes a triple net capitalization rate and internal rate of return (*IRR*) survey. The spread between the overall rate and the *IRR* offers interesting insights for *IRR* development too. The Fourth Quarter 2021 report showed a 101-basis point spread between the average *IRR* and overall rate for the "national net lease market." The report showed that the spread was consistent for several years. A distinction should be made between internal rates of return and discount rates. While these two rates can be the same, the internal rate of return generally refers to looking back historically to calculate an actual yield rate, whereas the discount rate is a prospective rate, involving future cash flow treatment.

The Boulder Group publishes net lease capitalization rates (not *IRR*s) for a number of property types, including medical properties. Their medical properties include dialysis centers, urgent care properties, and physician offices, not the property types included in this article.

With any rate survey, many critical points that drive the rates are not disclosed, and differences are somehow averaged. For example, are capitalization rates based on pro forma or trailing *NOI*? Maybe more important for leased fee capitalization rates is that the data used to develop rate averages probably includes leases with irregular rent increases (from flat to annual increases), lease terminations, and other inconsistencies with the general terms of the subject property lease.

According to the National Association of Real Estate Investment Trusts (NAREIT), the average dividend yield for health care REITs as of September 30, 2021, was 4.22% or 130 basis points greater than NAREIT's "All Equity REITs" category for the same period. Historical dividend yield rates for health care properties have run 100 to 150 basis points greater than the "All Equity" grouping. NAREIT's health care companies essentially include all those profiled in the Stifel Nicolaus lease coverage survey shown in Exhibit 18.1. The health care grouping includes senior housing, skilled nursing, hospital, medical office, medical research, and other related properties.

Overall, these REITs have a greater concentration in senior housing and skilled nursing than other health care assets.

Exhibit 18.8 shows a way to bridge national real estate investment data with leased fee capitalization rates for health care properties in general. The steps undertaken to arrive at this are summarized in the exhibit.

This analysis produces an average health care leased rate of 7.52%. From this point, the analysis should consider the property type being appraised and the relative risks for the leased fee interest of the subject property. As with fee simple going-concern capitalization rates, senior housing rates are less than skilled nursing facility rates. In this type of analysis, it is reasonable to conclude that skilled nursing facility capitalization rates will be greater than the implied rate shown above and that senior housing would be less.

Part of the going-concern capitalization rate spread between these two property types is the fact that senior housing receives the bulk of its revenues monthly, in advance, whereas nursing facilities often see a 30- to 90-day lag in payments and thus require the use of more working capital. If the average working capital were added to the purchase price investment, the capitalization spread between the two property types would tighten between 50 and 100 basis points. That difference does not exist for leased fee interests, so the spread between skilled nursing and senior housing rates tightens up somewhat.

If the capitalization rate is being measured through sales comparables, surveys, and rate build-up methods, then a reconciliation process that weights the accuracy of each technique should be performed. Direct capitalization is most appropriate when there is a lengthy remaining lease term and rental increases are similar to the comparable transactions used to establish the capitalization rate. The effectiveness of direct capitalization breaks down with a short remaining lease and likely changes in rent or with an impending purchase option.

Developing a leased fee capitalization rate using a band-of-investment or yield capitalization technique is certainly another option. Supporting the equity yield rate may prove challenging because of the scarcity of leased fee market data. But with explicit, linear period rent changes, yield capitalization can produce reliable value indications.

Exhibit 18.8 Steps Used to Develop a Leased Rate or Rent Factor from National Rate Data

Step 1:
- Health care REIT annual dividend yield rate
- Less all equity REIT dividend yield rate
- Equals health care REIT dividend yield premium

Step 2:
- Health care REIT dividend yield premium
- Plus PwC triple net lease capitalization rate
- Equals implied leased rate for health care property, overall

Step 1: NAREIT dividend yields	
Health care REIT annual dividend yield rate (September 2021)	4.22%
All equity REIT dividend yield rate (September 2021)	– 2.92%
Health care REIT dividend yield premium	1.30%
Step 2: Next add the average PwC triple net capitalization rate to the average health care REIT premium.	
Health care REIT dividend yield premium	1.30%
Plus PwC triple net lease capitalization rate (Fourth Quarter 2021)	6.22%
Implied leased rate for health care property, generally	7.52%

Leased Fee Discounted Cash Flow (DCF) Analysis

As an adjunct to direct capitalization or as the primary method of capitalization, discounted cash flow is a viable method. It is the preferred technique when rent will be irregular, the lease will expire in less than, say, 10 years, and a sale of fee interest (either leased fee or fee simple) is within that 10-year horizon.

Judgment calls may be necessary to set the cash flow forecast for the following events:

- What is the probability that the tenant will exercise an extension or renewal?
- What is the likely rent in a rent reset event, including rent involving a lease with a new tenant/operator or a reset triggered by the existing lease?
- When and at what price will the tenant exercise a purchase option?
- Will the existing lease be canceled, and will a new lease, and rent, or a sale of a fee interest occur as a result?
- What are other predictable events?

The discount rate often has a close relationship with the overall capitalization rate. According to

PwC Investor Survey, the spread between national net lease overall capitalization rates and internal rates of return run about 100 basis points. Terminal values in national net lease commercial real estate may have turnover vacancy, whereas senior housing and nursing facilities will not experience vacancy, but maybe some period of collection losses. With hospitals, there is a greater likelihood that the vacancy will be experienced after the lease expiration. The prospects of greater vacancy risk at lease termination will have the effect of lowering the spread between the overall rate and the discount rate, all other things equal, as shown in Exhibit 18.9. The lower terminal value in the vacancy after lease termination suggests that a higher overall capitalization should be applied in a direct capitalization of first-year rent.

If the leased fee capitalization rate is well evidenced and supported—say, 7.0%—and the change in rent and value is expected to be, say, 2.0% annually, then the approximate discount rate would be 9.0% (7.0% + 2.0%), or slightly less, accounting for depreciation. This concept is based on the formula that $Y = R + A$, where Y is the yield rate, R is the overall capitalization rate, and A is the adjustment rate reflecting changes in income and value. This rate development can be a starting point for estimating a market discount rate when cash flows and terminal value will not follow a steady line of change.

Since discount rates comprise a combination of risks and some components of a leased fee cash flow can be predicted more accurately than others, different discount rates can be applied. For example, suppose a lease has five remaining years at a below-market rent, followed by an automatic rent reset to market year for five additional years before terminating. In this case, the first five years are known and certain and are considered low risk. The rent for the next five years (the rent reset period) involves more speculation, but the existence of the lease is still certain. There is considerable uncertainty that in 10 years the property might be released or it might sell. Using different discount rates is referred to as a *split-rate method* or a *bifurcated rate method*.

As an example of split-rate discounting, consider an inpatient rehabilitation hospital that has five years remaining on the initial lease with an annual absolute net lease of $1.2 million. The market rent based on lease comparable data, market lease rate applied to depreciation cost, and lease coverage all suggest that the contract rent is substantially below market. In Year 6, the rent is increased to market through a rent reset process involving the average of two or three appraised values. At that point, rent increases 2.0% annually. The required $100,000 in annual capital expenditures should return the improvements to the landlord in good condition at lease termination. After 10 years, there is considerable uncertainty regarding the property. It will either be released or sold, with the present value at that time resulting in the same terminal value at that point in time. Exhibit 18.10 profiles the calculations and value indication. (Consult chapter 26 of *The Appraisal of Real Estate*, 15th edition, to learn more about discounted cash flow methods.)

Exhibit 18.9 Calculation of Discount Rate Spread

Lease Year	No Vacancy at Termination	Vacancy after Expiration
1	$1,250,000	$1,250,000
2	$1,281,250	$1,281,250
3	$1,313,281	$1,313,281
4	$1,346,113	$1,346,113
5	$1,379,766	$1,379,766
6	$1,414,260	$1,414,260
7	$1,449,617	$1,449,617
Year 7 Purchase	$20,000,000	$16,500,000
NPV @ 10.0% discount rate	$14,694,055	$13,061,279
Indicate capitalization rate	8.51%	9.57%
Capitalization and discount rate spread	149	43

An interesting appraisal problem arises when contract rent is significantly higher than *EBITDAR* and the prospect for the existing tenant or another operator to improve cash flows is bleak because of fundamental changes in the market, such as new dominating competition or a major change in reimbursement. One way to treat this leased fee valuation problem would be to value the "as is" fee simple interest, estimate the market rent, and subtract the market rent from the contract rent. The difference between the contract and market rent could be discounted over the estimated period that the contract rent is expected to be received. In many cases, the contract rent will be paid because (1) personal and corporate guaranties are in place with funds to pay the contract rent saved

Exhibit 18.10 Split Discount Rate in Leased Fee Valuation

Year	Cash Flow	Discount Rate	*PV* Factor	Present Value
1	$1,200,000	6.5%	0.93897	$1,126,761
2	1,200,000	6.5%	0.88166	1,057,991
3	1,200,000	6.5%	0.82785	993,419
4	1,200,000	6.5%	0.77732	932,788
5	1,200,000	6.5%	0.72988	875,857
6 (reset year)	1,800,000	8.5%	0.61295	1,103,301
7	1,836,000	8.5%	0.56493	1,037,205
8	1,872,720	8.5%	0.52067	975,068
9	1,910,174	8.5%	0.47988	916,654
10	1,948,378	8.5%	0.44229	861,739
10 (terminal)	20,000,000	10.0%	0.38554	7,710,866
Total value				$17,591,648
Indicated overall capitalization rate				6.82%
Implied *IRR* or discount rate				8.64%

through the security deposit and other operating covenants and (2) the tenant will experience greater economic harm by forfeiting substantial deposits than by paying the contract rent. The discount rate for the excess rent will be very substantial in many cases, and finding market evidence will be difficult.

Leasehold Interest

A leasehold interest may exist when the contract rent is less than market rent and the lease has provisions that permit the tenant to transfer its interest to another. Since market rent is often set by using an *EBITDAR*- or *EBITDARM*-to-rent-coverage ratio, the rent is set at a level that permits the tenant to earn a profit or experience positive *EBITDA*. There is an argument that the cash flow between *EBITDA* and *EBITDA+MR* (market rent) represents intangible value because that portion of the earnings is not achieved through a positive rental advantage.

Exhibit 18.11 displays an example as to when a leasehold interest has positive value. In this example, there are three situations, with each having the same tenant *EBITDAR* and the same market rent. The significant difference involves the contract rent. In Premise 1, the contract rent exceeds market rent, and thus there is no leasehold interest. However, in Premise 1, the tenant is experiencing positive cash flow, so it probably has business value. In Premise 2, market and contract rent are the same, thus there is no leasehold value by the traditional measure, but there is business value. Premise 3 has both leasehold and business value. The leasehold value exists because contract rent is less than market rent.

In the example in Exhibit 18.11, the discount rate used to estimate the business value is 25% for each scenario. However, the discount rate is likely higher in Premise 1 because the "profit" or *EBITDA* margin is thin. As this margin increases, the discount rate probably decreases because the margin improves. Even with an exhaustive search for leasehold discount rates, it is likely that no direct market data or rate comparable data will be found. Leasehold sales are typically private transactions with little public knowledge or no recording with county or town deed recorders. A leasehold transaction can be picked up in Medicaid and Medicare cost reports filed by a new tenant and identified as a change in ownership at the state licensing office only if the party participates in Medicaid or is licensed.

The following example illustrates a technique to extract a discount rate from information used in Premise 2 in Exhibit 18.11. Under the premise that the fee simple value is being appraised, the value of the going concern is estimated using the facility *EBITDAR* and market capitalization rate. Then the market value of the leased fee interest is estimated using the contract rent, which in this example is also the market rent. The leased fee

Exhibit 18.11 Calculating Leasehold and Business Values

Premise	1	2	3
EBITDAR	$1,200,000	$1,200,000	$1,200,002
Market rent coverage ratio	1.20	1.20	1.20
Market rent	$1,000,000	$1,000,000	$1,000,000
Contract rent	$1,120,000	$1,000,000	$900,000
Tenant *EBITDA*	$80,000	$200,000	$300,000
EBITDAR-to-contract-rent coverage	1.07	1.20	1.33
Rental advantage (market rent minus contract rent)	($120,000)	$0	$100,002
Remaining lease term (years)	6.0	6.0	6.0
Leasehold value (market - contract rent)	Negative?	$0	$295,147
Tenant's going-concern or business value	$236,114	$590,285	$885,433

Assumptions:

Rent remains unchanged over duration of lease

EBITDAR remains unchanged over duration of lease

Market discount rate of leasehold value: 25.0%

Market discount rate of tenant's going-concern value: 25.0%

capitalization applied to the contract rent is based on research into leased fee transactions involving comparable property. There is no "rental advantage" (i.e., market and contract rent are the same), so the difference between the fee simple and the leased fee value is assumed to be the business value. The tenant's after-rent cash flow for the remaining six years of the lease ($200,000 annually) and the business value of $550,000 are then used to calculate the *IRR*. The *IRR* is calculated through an iterative process, as shown in Exhibit 18.12.

The resulting *IRR* of 28.0% is a proxy for the discount rate used to calculate the business value. This technique is simplified because rents are likely to increase on an annual basis and *EBTIDAR* will likely change too. The estimated business value is not complete until current assets and liabilities are considered. It should be mentioned that, assuming the tenant owns the management company providing those services to the property, the profits and perks associated with this property have value. That value is likely value in use. There are other facets in appraising the value of this business and management company. This type of valuation is steering away from the type of valuation assignments most real estate appraisers will encounter or have the competency to accept. Using this process of deducting the leased fee value from the fee simple value to arrive at a leasehold value is not widely accepted and certainly does not fit all leasehold valuation situations.

Exhibit 18.12 Calculation of *IRR*

EBITDAR	$1,200,000
Going-concern capitalization rate, fee simple	7.250%
Market value of the going concern, fee simple	$16,550,000
Market rent (also contract rent)	$1,000,000
Leased fee capitalization rate	6.250%
Leased fee value	$16,000,000
Difference between fee simple and leased fee value – Value of the tenant's business value	$550,000
Tenant's annual *EBITDA*, for 6 years	$200,000
Implied *IRR* for the tenant's business value	28.0%

Allocation of Leased Fee and Leasehold Value

Depending on the definition of leased premises and the operations transfer agreement, the leased fee value for hospital, nursing facility, and senior housing property may also include tangible assets and some of the intangible assets. Therefore, it may be improper to claim that the entire rent and value

are attributable to the real property furniture, fixtures, and equipment (FF&E). Likewise, it is possible that the value of the leasehold interest includes both tangible and intangible components.

It is extremely unlikely that the market will provide any meaningful evidence regarding the allocation of value to these partial interests. The cost approach may provide some insight into the value of the real property and FF&E for the leased fee interest, provided that the leased fee value exceeds the land value and the depreciated costs of the improvements and FF&E. If the leasehold value is represented as the capitalized difference between *EBITDAR* and market rent, then an argument can be made that this value has a significant intangible component. The capitalized difference between the market rent and contract rent may have a greater proportion of value allocated to real property and FF&E. In fact, as the tenant continues to add and replace FF&E over the term of the lease, this asset group could represent increasing proportions of the leasehold value.

About the Authors

James K. Tellatin, MAI, serves as senior managing director of Integra Realty Resources—Healthcare & Senior Housing. He has been an MAI since 1984 and specializes in appraising senior housing, nursing homes, and hospital property, performing appraisals on these properties in every US state and beyond. He has testified as an expert witness on valuation matters concerning these property types in over twenty states, ranging from municipal, county, state, and federal courts. He is the author of *The Appraisal of Nursing Facilities*, published by the Appraisal Institute in 2009. He developed and presented a seven-hour Appraisal Institute seminar covering nursing homes in 1995. He provided significant assistance with developing HUD's "lean" appraisal and market study guidelines. He was a codeveloper, owner, and operator of a group of Arizona post-acute short-stay rehabilitation facilities (Sante). His clients include over 100 US and international banks, several public health care REITs, property ownerships of all sizes and locations, and numerous law firms and government entities. He was the chair of the Missouri Health Facilities Planning Committee, which issued certificates of need for hospitals, nursing homes, and assisted living communities. **Contact: jtellatin@irr.com**

Vic Cremeens, MAI, serves as managing director for hospital valuation services of Integra Realty Resources—Healthcare & Senior Housing. He has exclusively appraised health care and senior housing properties since 2000 and has directed the hospital valuation service segment since 2009. He has performed more than 175 hospital valuation assignments. Those appraisals are a mix of real estate–only and going-concern valuations. Clients include traditional and agency lenders (USDA and HUD programs), operators, assessors, and consultants. He recently participated as a consultant to the American Hospital Association for their *Estimated Useful Lives of Depreciable Hospital Assets*, 2023 edition, and to the General Accounting Office on its study exploring the expansion of the Federal Housing Administration Hospital Mortgage Insurance Program to types of hospitals that are not presently allowed to participate. He also has extensive experience appraising nursing homes and senior housing properties.

Bradley J. Schopp, MAI, is a highly experienced national practice leader of Integra's Healthcare & Senior Housing group, with over two decades of expertise in the appraisal and consultation of senior housing and health care assets. Schopp has valued senior living communities, skilled nursing facilities, hospitals, and medical offices across thirty-seven states with nearly $100 billion in property value. Schopp has testified as an expert witness and is quoted in publications such as *The Wall Street Journal*, *Senior Housing News*, and *McKnight's Senior Living* on senior housing and skilled nursing topics. Schopp serves as treasurer for the Greater St. Louis Chapter of the Appraisal Institute. His clientele includes large and small banks, law firms, property owners, health care providers, and government entities.

Hollis C. Taggart has been employed by the Integra Realty Resources—Healthcare & Senior Housing specialty practice since 2018. He has been involved in valuing skilled nursing, independent living, assisted living, memory care, and life plan communities and hospitals. He also performs market studies for developers of senior housing properties. He has performed valuations in nearly every US state for various clients, including regional and national lenders, law firms, assessors, property owners, and developers. He is a certified general real estate appraiser working toward his MAI designation.

SEE NEXT PAGE FOR APPENDIX AND ADDITIONAL RESOURCES >

Appendix Health Care Industry Property Type Terms and Acronyms

AA Active adult communities

AL Assisted living residences or assisted living facilities (may include other nomenclature, such as personal care, residential care, or supportive care)

CCRC Continuing care retirement communities

IL Independent living communities or independent living facilities

IPF Inpatient psychiatric facilities

IRF Inpatient rehabilitation facilities

LPC Life plan communities

LTAC Long-term acute care facilities

MC Memory care residences or memory care facilities

SNF Skilled nursing facilities, more commonly known as nursing homes

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

American Hospital Association (AHA)—*Estimated Useful Lives of Depreciable Hospital Assets*
https://bit.ly/3NlGxbI

Appraisal Institute
Lum Library, Knowledge Base Information Files [Login required]
Special Use Properties/Healthcare Facilities
https://www.appraisalinstitute.org/insights-and-resources/resources/lum-library

American Seniors Housing Association (ASHA)—Publications
https://www.ashaliving.org/bookstore/view-all-publications/

Barnes Reports—Industry Reports
https://www.barnesreports.com/

National Investment Center for Seniors Housing & Care (NIC)—Research and Analytics
https://www.nic.org/assisted-living-industry-analysis-research/