Health System Strategy: Lease Versus Buy

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Lease Versus Buy

Health systems in today's operating environment face many challenges. With costs rapidly rising and margins becoming slimmer, systems must more frequently operate in an ambulatory setting to retain market share from competitors This modern shift in healthcare, from mostly on-campus facilities to a mix of ambulatory and on-campus facilities, puts additional pressure on executives to manage the balance sheet effectively and get the most out of their capital.

One of the biggest questions health systems encounter when securing new facilities is whether it would be more advantageous to lease or own their real estate.

Additionally, many health systems seek to maintain investment grade credit and often consider other alternative financing such as: synthetic lease, credit tenant lease, private REIT or other structured finance methods. This whitepaper primarily focuses on the discussion around leasing and buying real estate, but recognizes that other alternative financing methods exist.

What factors should be considered to choose the most appropriate form of occupancy?

The "Lease versus Buy" decision can be sorted into two primary considerations, operational and financial. Specific operational considerations include, but aren't limited to, flexibility and length of occupancy, desired control and level of building acuity, and location of the asset. Whereas cost of capital, cash position, and total cost of occupancy/reversion price of the asset are common financial considerations in any lease versus buy decision.

Operational	Financial
Flexibility and Length of Occupancy	Cost of Capital/Alternative Investment
Desired Control of Building/ Level of Acuity	Cash Position
Location of Asset	Total Cost of Occupancy/ Reversion of Asset

Operational Considerations

Flexibility and Length of Occupancy

The ability or need to maintain flexibility when establishing locations or practices can heavily influence a health systems' decision to lease or buy real estate.

The flexibility of leasing allows health systems to decide if a practice or service line will succeed in a new market. Naturally, a healthcare provider is only committed to the leased space for the duration of the lease term which typically requires a lower entry cost than an outright purchase or ground-up development.

At the end of a lease term, should a health system want to vacate, less capital is tied up in the building. When leaving an owned building there is significant time required to market and sell an asset, which increases the time required to recoup capital and reinvest it into more profitable services.

With more opportunity to exit or expand in leased space, provider networks can grow, shrink, and shift as patient needs change and evolve.

Desired Control of the Building/Level of Acuity

Control of a building or site is one of the biggest factors in choosing between leasing or ownership. Ownership ensures a health system has control over physical aspects of the building and site such as parking, ingress and egress, the building façade, signage, and more.

From an operational perspective, it is generally preferred to own a hospital or acute care facility. When considering the capital requirements to construct these facilities, licensing requirements, and alternative locations to move or relocate, having a third -party own these facilities can become problematic in the event of a lease renegotiation.

Additionally, health systems are unique businesses with distinct regulatory challenges. The intense regulatory environment around health systems further complicates these decisions, especially when considering hospital outpatient department (HOPD) billing and certificate of need (CON) requirements. In the case of a HOPD billing or CON licensing, more consideration should be given to ownership as these facilities are typically more critical to the operations of a health system.

As demonstrated below, there is typically a strong positive correlation between the level of acuity of a building and the desire or need for control of a building. Typically, control is not required for a medical office building or urgent care. As a health system moves “up” the acuity chain (towards hospital-grade construction) more control is both desired, and in many cases required, to operate the facility in a way that is best for the health system and patients.

Location of Asset/Newly Established Market

Typically, on-campus assets should be owned by a health system, regardless of what type of service lines are within. In many instances, on-campus facilities are critical to the overall business strategy of a health system.

As mentioned previously, if the location of the asset is in a new market or outside a hospital campus, leasing may offer the flexibility needed. The decision to lease or buy becomes most complicated when there is a large concentration of clinics or a “mini-campus” environment, but many of them are not critical in nature to the health systems strategy.

Most of the operational considerations for health systems have been addressed, although there are certainly others. As already discussed, there is a spectrum of operational benefits to each form of occupancy. However, when discussing the following financial implications leasing and owning are simply two different methods of financing real estate costs.

Financial Considerations

Cost of Capital/Alternative Investment

When considering the lease versus buy analysis a health system must compare their cost of capital versus the cost of capital of any third party owner or developer.

To fairly compare all potential capital projects a health system will evaluate the potential investment versus any associated return or profit. To best evaluate each option or investment a health system will proportionally weight their unique cost of debt and equity to calculate a system-wide weighted average cost of capital (WACC). This analysis helps to clearly identify which investments a health system should make with its limited capital.

This same evaluation method should be applied to the lease versus buy decision and ideally would be evaluated alongside all possible health system investments. When considering cost of capital alone, health systems frequently have a lower cost of capital than a third-party owner, which creates a strong bias towards ownership. However, when considered alongside new imaging equipment, new service lines, or other profitable investments leasing becomes more appealing. In many cases leasing can be a better outcome as it allows a health system to pursue other capital intensive yet more profitable ventures.

Health systems will often assume cash to purchase an asset (instead of property-specific debt) and will then apply the cost of capital or WACC. This helps to best evaluate the true cost of each form of occupancy.

Cash Position

In some ways, a system's cash position is the most straight forward financial consideration. Either the health system has cash, or it doesn't.

Of course, this becomes much more complicated when you consider:

- ◊ What is the current bond rating?
- ◊ Is this the appropriate bond rating for future capital needs?
- ◊ What is our forecast for capital and cash needs?
- ◊ Will there be big expenditures in the next year? 2 years? 5 years?
- ◊ How many days cash-on-hand are required to maintain the appropriate bond rating?
- ◊ How does capital budgeting or forecasting affect days cash on hand?

The previous financial considerations ultimately lead to the crux of the lease versus buy decision which is:

What is the total cost of occupancy and which pathway provides the lowest cost?

Health systems often rely on various finance tools to evaluate each opportunity against one another. The most common of these tools being: payback period, internal rate of return (IRR), net present value (NPV). Most often systems will compare the net present value of leasing against the net present value of owning over the same predetermined time period, be that five, ten, or fifteen years.

Total Cost of Occupancy/Reversion of Asset

Several factors influencing total costs of occupancy are detailed below. One cost, or benefit, that tends to be overlooked is the reversion price of the asset. Much of this is due to the difficulty, or impossibility, to predict the reversion or sale price when forecasting for ten or more years.

Common Questions to Ask when Considering Reversion Price:

- ◊ Will the health system sell the building with a lease in place or vacant?
    - ◊ If leased:
        - How long is the lease duration?
        - Are rents within market?
        - What specialty buildout is included?
    - ◊ If vacant:
        - What is the condition of the building or building systems?
        - What is the demand for this type of building?
        - How expensive is it to convert to a new use?

Common Valuation Methods:

- ◊ Reversion is equal to the book value of the building.
- ◊ Assume appreciation of asset throughout evaluation period (Example: 2% appreciation over term).
- ◊ Sell for original purchase price.
- ◊ Apply a capitalization (cap) rate to rent.

As discussed, there are many operational and financial considerations to account for when deciding whether to lease or buy a facility.

Often, this relatively simple question of “should we lease or buy this facility?” can lead to a much more complex discussion that requires alignment from many different departments within a health system.

About Davis Moore

Physician practice groups and healthcare systems turn to Davis Moore to provide ambulatory real estate advising and development services. Over the past twenty years, Davis Moore principals has provided leadership in more than 300 medical facility transactions totaling more than 4 million square feet. We understand the issues and opportunities that affect today's healthcare providers and can tailor ambulatory real estate solutions to meet each provider's specific goals.

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