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HEALTHCARE PRACTICE GROUP

How Do Landlords & Developers Decide Rental Rates to Quote?

Authors Trey Holsten & John Stubbs are with the Healthcare Practice Group of Davis Moore. Davis Moore's Healthcare Practice Group works exclusively with health systems and physician practice groups on ambulatory real estate strategies and needs.

Outline

Introduction, Executive Summary & Healthcare Real Estate (HRE)

Whether a ground-up development, an acquisition, or a long-term owned asset, how do owners and developers decide what rental rates to charge?

While no two owners are alike, and there are more variables than can be covered in a single paper, there are common practices for the development of rental rates and ownership returns in all forms of real estate, including healthcare real estate ("HRE"). The topic could cover volumes of books surrounding finance, economics, and real estate; this is by no means a comprehensive review of the subject matter. The goal of the HRE Practice Group at Davis Moore with this paper is to outline the most substantive considerations and contextual thoughts when owners and developers calculate rental rates for tenants. While we are solely focused on HRE, most thoughts and principles herein can be applied to almost any commercial real estate that is owned and rented to a third party.

Whether an owner pays all cash, borrows 100% of funds for an investment, or some variation, investors are constantly comparing possible returns to alternative investments. Long-term investors usually begin any comparison of possible investment returns with what most consider the safest, long-term investment in the world: a ten-year loan to the US government, also known as a ten-year treasury bond (10 YT). From the 10 YT, risk grows and the returns that investors require for such risk, increase. Most investors will use some form of floating or fixed-rate debt. Considerations related to a real estate investment's risk, prevailing short and long-term interest rates, and other macro and micro factors, all work together to influence the needed return and resulting rental rate owners and developers require.

Yet, most all rental rates are derived from one basic formula:

Total Investment × Desired Unlevered Return = Rental Rate

One of the more intriguing – and challenging – aspects of real estate is that market forces are dynamic and thus create ever-changing variables and quoted rental rates from owners. While there are common methodologies reviewed in this paper, all owners are different. One never knows when the owner of a property is going to tell a Davis Moore client, "Well, you know… Ronald Reagan met here in this building during his presidential campaign, so the rent should be a little higher." True story!

Placing HRE in the Investing World

It is often said there are only four places to invest: currency, real estate, debt, or equity. HRE has developed over the past 20 years into its own asset class within the broader commercial real estate space. Within HRE there are three main categories of property types: acute/outpatient facilities, senior living, and life sciences. Real estate investors in the HRE space are generally trying to develop, acquire, or own properties in these categories that they then lease to end users. Rents from end users create a return – positive or negative – for investors providing capital. As the United States has aged and healthcare delivery has transitioned more to the ambulatory setting, an industry servicing investors and end-users of HRE has evolved.

Rental Rates & Interest Rates

Rental rates of all buildings, including HRE, are largely affected by interest rates. Interest rates are the percentage of interest paid to borrow money, often affected by the current state of the economy and what the Federal Reserve sets as their exchange rate for banks to borrow from one another. As the cost to borrow money increases (i.e. interest rates go up), it becomes more expensive to pay for projects through loans. An owner borrowing project funds at higher rates will need to increase rents charged to tenants. In contrast, lower rates equal lower rents.

While this is all logical, changes in interest rates can also impact what returns investors may achieve from other investments. This is why real estate values reached a peak a few years ago when the rate investors could achieve from owning 10 YTs was below 1%. Investors were willing to take lower returns from real estate, in turn pushing values higher, because owners could borrow funds for less, and the comparable potential returns from alternative investments were less.

An Owner's Yield or Required Unlevered Return on Investment

In the introduction to this paper, we outlined that most rental rate calculations come down to an owner's required yield multiplied by a property's cost or value. Sometimes this "yield" is called a capitalization "cap" rate (year one, unlevered return) of a property. They are the same figure. An owner needs to achieve a yield that is more than they could secure investing in the world's safest investment (10 YT) and is reflective of an investment's risk. For example, an investor pricing a rental rate for a lower-quality building with a shorter-term lease from a financially unstable tenant will often require a much higher "yield" than the opposite situation of a long-term lease from a financially strong client in a newer property.

Of course, macroeconomic factors can influence each of these variables.

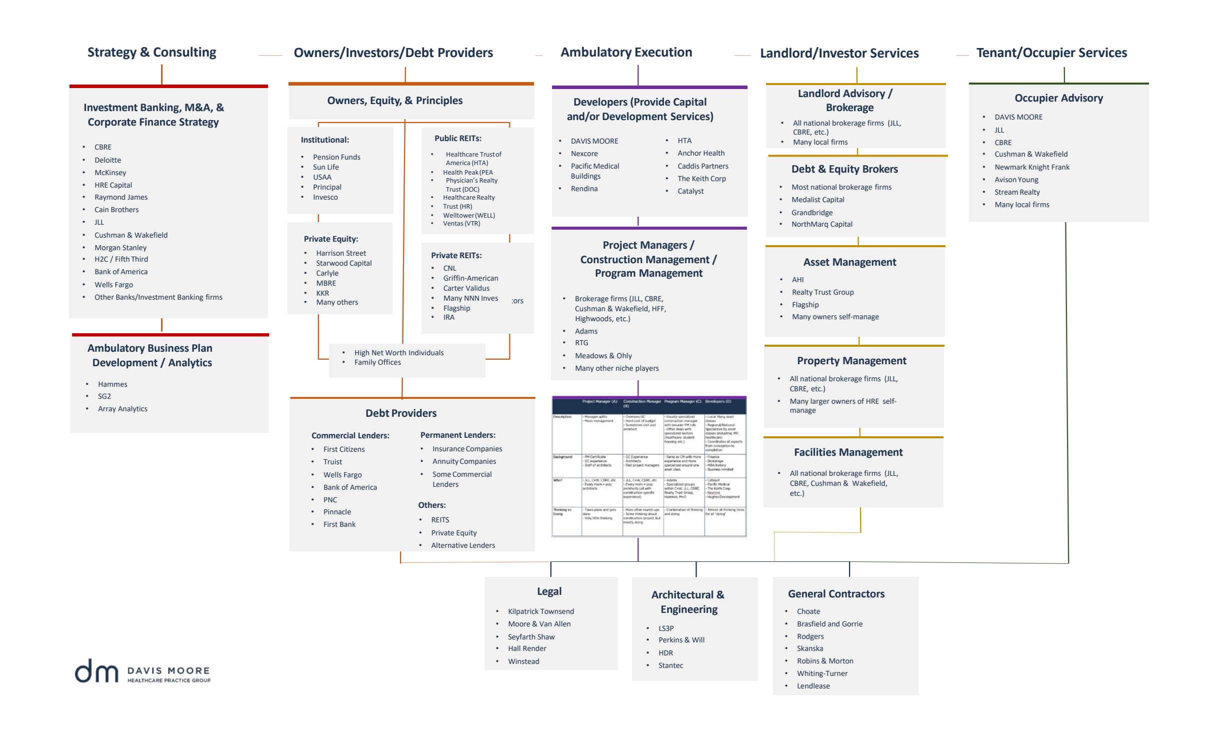
Various Types of Owners & Investors = Different Rental Rates & Lease Terms

- Public and Private REITS: Real Estate Investment Trusts raise funds, publicly or privately, to invest strictly in real estate. REITs can invest in different types of real estate or sometimes just one type. Similarly to stocks, their investing goals are to pool a large amount of capital to invest in real estate and produce **steady income for their shareholders.**

- Institutional (Pension Funds/Insurance Companies/Endowments): Pension Funds are retirement funds for different professions. They will invest money throughout a person's career and invest it to **produce revenues to pay a worker after they retire.** Insurance companies will invest in real estate to ensure they are profitable and **diversify their assets.** Endowments invest to meet the future needs of what it endows. Most of these investors are typically looking for a **long-term, safe return on their investments.**

- Local/Regional/National Developers: Developers are the people who coordinate projects and new buildings of real estate. They are typically investing capital to start a project from the ground to delivery. They do the work of organizing all the parties crucial to delivering a building that can then be leased. Developers have many different investment goals; some simply want to lease their development and achieve returns through renting to tenants. Some **will develop a property, lease it up and sell to realize gains more quickly.** Developers can be very flexible on how they obtain their returns.

Who are the Players in HRE?



Types of Owners & Investors Cont.

Some owners are **long-term, cash-flow investors** while others are the **“fix and flip” types.** These owners secure capital from different sources and promise different expectations of annual returns from 6% to 20%+. Often you hear the terms core, core plus, value add, or opportunity to describe the scale of low-to-high returns each investor expects (see link to more detailed explanation from Origin Investments here). An insurance company, pension fund, endowment, or REIT looking to achieve long-term, core, or core plus investment results may provide different rental rates or lease terms that meet the desires of its constituents/owners.

Shorter-term investors focused on the value add or opportunity-associated returns may price rental rates and lease terms with the property sale in mind.

These owners factor in all goals & market conditions, and expectations to come up with a “yield” required.

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	Cost $	Cost PSF
Land Cost	$2,600,000	$104.00
Offsite Improvements/Monument Sign	$10,000	$0.40
Due Diligence & Planning		
Civil Planning	$31,250	$1.25
Architectural Planning	$50,000	$2.00
Soil Borings	$15,000	$0.60
Survey	$7,500	$0.30
Phase I Environmental Survey	$3,500	$0.14
Legal / JV Due Diligence	$15,000	$0.60
Document Prep, Miscellaneous	$1,500	$0.06
City Fees-Property Subdivision	$25,000	$1.00
Due Diligence & Planning Total	$148,750	$5.95
Construction		
Shell & Parking Structure	$3,750,000	$150.00
Site Work	$875,000	$35.00
Landscaping	$50,000	$2.00
Tenant Upfit	$1,250,000	$50.00
Construction Total	$5,925,000	$237.00
Design		
Architecture	$200,000	$8.00
Civil Engineering	$87,500	$3.50
Material Testing / Monitoring	$50,000	$2.00
Permitting	$50,000	$2.00
Design Total	$387,500	$15.50
Financing		
Lender Appraisal	$4,500	$0.18
Lender Legal	$20,000	$0.80
Borrower Legal	$20,000	$0.80
Loan Fees	$40,000	$1.60
Interest Carry	$285,000	$11.40
OPEX Carry	$75,000	$3.00
Insurance	$5,000	$0.20
Real Estate Taxes	$20,000	$0.80
Financing Total	$469,500	$18.78
Marketing		
Leasing Commission	$315,000	$12.60
Land Commission	$0	$0.00
Marketing Total	$315,000	$12.60
Development / Administration		
Development Fee	$250,000	$10.00
TPI CM	$85,000	$3.40
Loan Guaranty Fee	$0	$0.00

Rental Rates: How?

Once a yield or owner’s required return is developed, and the cost of a future development or a property value and associated costs of a transaction are known, the rental rate derivation is simple:

Total Investment × Desired Unlevered Return = Rental Rate

Any operating expenses an owner wants to include in a rental rate (such as in-office leases) are then added to the NNN Rental Rate.

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Summary

While there are many varying macro and micro factors in how owners derive rental rates, and although everyone may use different vernacular for the formula, it doesn't change much from owner to owner:

Total Investment × Desired Unlevered Return = Rental Rate

Finally, we can never forget the unknown of human behavior and emotion that comes with real estate. Many owners have future thoughts/predictions about inflation, end times, the future of automobile usage, borrowing money, or simply philosophies that make every owner unique.

So at Davis Moore, where our firm only works with the end users of real estate, we always advise a bit of caution when trying to determine exactly how owners derive rental rates. It can be quite mysterious – even to those of us who spend all our working hours on the subject matter.

	Total Investment					
Desired Unlevered Return	$250	$300	$350	$400	$450	$500
6.50%	$16.25	$19.50	$22.75	$26.00	$29.25	$32.50
7.00%	$17.50	$21.00	$24.50	$28.00	$31.50	$35.00
7.50%	$18.75	$22.50	$26.25	$30.00	$33.75	$37.50
8.00%	$20.00	$24.00	$28.00	$32.00	$36.00	$40.00
8.50%	$21.25	$25.50	$29.75	$34.00	$38.25	$42.50

About Davis Moore

Physician practice groups and health systems turn to Davis Moore to solve their most critical ambulatory real estate needs. Over the past twenty years, Davis Moore principals have participated in more than 1,500 healthcare transactions that total to more than 18 million square feet all from the providers perspective. We understand the issues and opportunities that affect today's healthcare providers, since we only work for providers.

Trey Holsten

804.690.3957
tholsten@davismoorehealthcare.com

John Stubbs

919.417.8800
jstubbs@davismoorehealthcare.com