IRR - Healthcare & Senior Housing

Appraising Skilled Nursing Facilities and Senior Housing Properties

IAAO Regional Conference – June 2021, La Crosse, Wisconsin

INTEGRA REALTY RESOURCES

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provides world-class commercial real estate valuation and counseling services to the nation's top financial institutions, developers, corporations, law firms, and government agencies. As one of the largest independent property valuation and counseling firms in the United States, we provide our diverse array of clients the highly informed opinions and trusted expert advice needed to understand the value, use and feasibility of their real estate. ***IRR. Local expertise. Nationally.***

James K. Tellatin, MAI

- Senior Managing Director, IRR, Healthcare & Senior Housing since merging with IRR in 2018; previously founded Tellatin, Inc. in 1984
- Founder of Santé Partners, a developer, operator and property owner of a group of post-acute rehabilitation centers
- Former chair of the Missouri Health Facilities Committee - certificate of need
- Author, Appraisal of Nursing Facilities
- Consultant to HUD for their Healthcare lending program known as LEAN
- Given seminars on senior housing and nursing facilities in over 20 states, plus on-line seminar development to Appraisal Institute, IAAO, RMA, and NIC
- Testified in various courts in 18 states, many cases involve property tax assessment

Topics Covered in Appraising Senior Housing and Long-term Care Facilities

- Ownership structures, property rights appraised, Going-concern concepts and allocation of value, focusing on the fee simple interest of the real estate
- Regulatory issues – Medicaid, Medicare, Certificate of of Need and Licensing issues impacting value
- Market analyses, supply and demand factors impacting occupancy, payor mix, rental levels, absorption and risk considerations
- Cost approach issues – importance of considering indirect costs – absorption and entrepreneurial incentives
- Sales comparison issues --- sales comparables will be mostly going-concern transaction
- Income capitalization – revenue and expense forecasting, issues with capitalization rates
- Reconciliation of final going-concern value, and allocation of value

Data Sources

- The largest association representing nursing facilities is the **American Health Care Association:** – **www.ahca.org**
- The largest association for senior housing is the **American Senior Housing Association**: ***https://www.seniorshousing.org***
- ***National Investment Center for Long-term Care Financing (NIC), offering a huge amount of supply data, sales, capitalization rate and debt financing and other materials: www.nic.org***
- ***Irving Levin Reports (monthly and annual reports -- excellent sale data, subscription service): http://www.levinassociates.com/scidescription***
- ***Senior Housing News (sale data, announced development projects, daily email): www.seniorhousingnews.com***
- ***Medicare (CMS) Web Site Providing Healthcare Survey Data: http://www.medicare.gov/nursinghomecompare/search.html***

Assets of the Going Concern

- These property types are **real-estate-intensive businesses or going concerns**, requiring considerable and continued human endeavor to generate income
- For most assignments, the appraiser will value the going concern.
- The assets include:
  - real estate,
  - tangible personal property or furniture, fixtures, and equipment, and
  - intangible personal property
- These assets are inextricably entwined.

Property Rights Being Appraised

- Going concern valuations will typically involve a fee simple or a leasehold interest
- Leased fee valuations are often associated with properties that are under long-term absolute net lease agreements. Health care REITs typically invest in and create leased fee estates -- we will discuss this in more depth later.

Asset or Stock Valuation

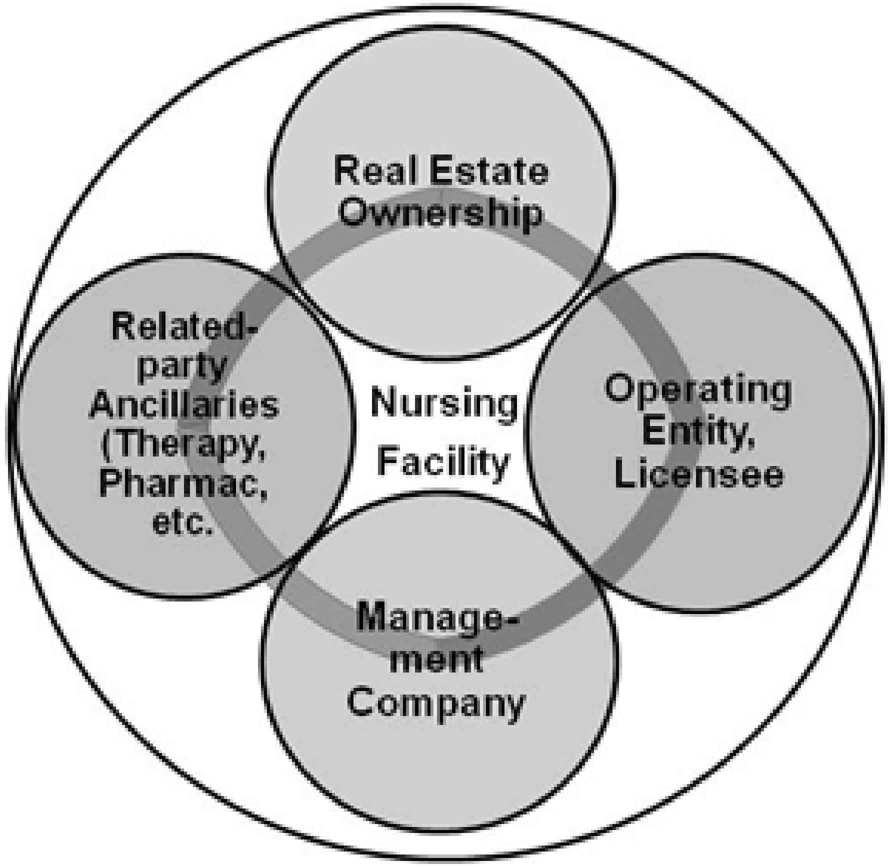
- Typical appraisal engagements are asset appraisals – not stock valuations
- Stock valuations will also include the valuation and monetary assets (cash, receivables, etc.) as well as the treatment of liabilities.
- Be sure to identify the assets being valued and state the assets not being value with the client in the engagement process and in the report.
- Asset sales typically excluded
  - Cash and equivalents
  - Accounts receivable
  - Inventory(?)
- Are there successor liabilities or liabilities that the buyer assumes (specific or implied)?

Asset or Stock Valuation, Continued

- For assessors, it is important to know what is included and excluded in a reported sale price, recorded in local public records.
- Some transactions will report entire going-concern price.
- While others will report a low real estate price to minimized transfer tax and future assessment increases. This is an issue!
- Can can the assessor validate the reported real estate transaction price? Often buyers will report one price to assessors and a higher price (allocation) will be reported for setting depreciation basis, and yet another price (or value) will be used by lenders.

Senior Housing and Nursing Facility Ownership Structures

- Multiple entities often control the assets of a single-property going concern.
- Ownership structures often are set up with a real estate company owning the tangible property, leasing it to an operating entity, that operating entity contracts with management, therapy, and pharmacy companies to provide services into the facility.



Senior Housing and Nursing Facility Ownership Structures, Continued

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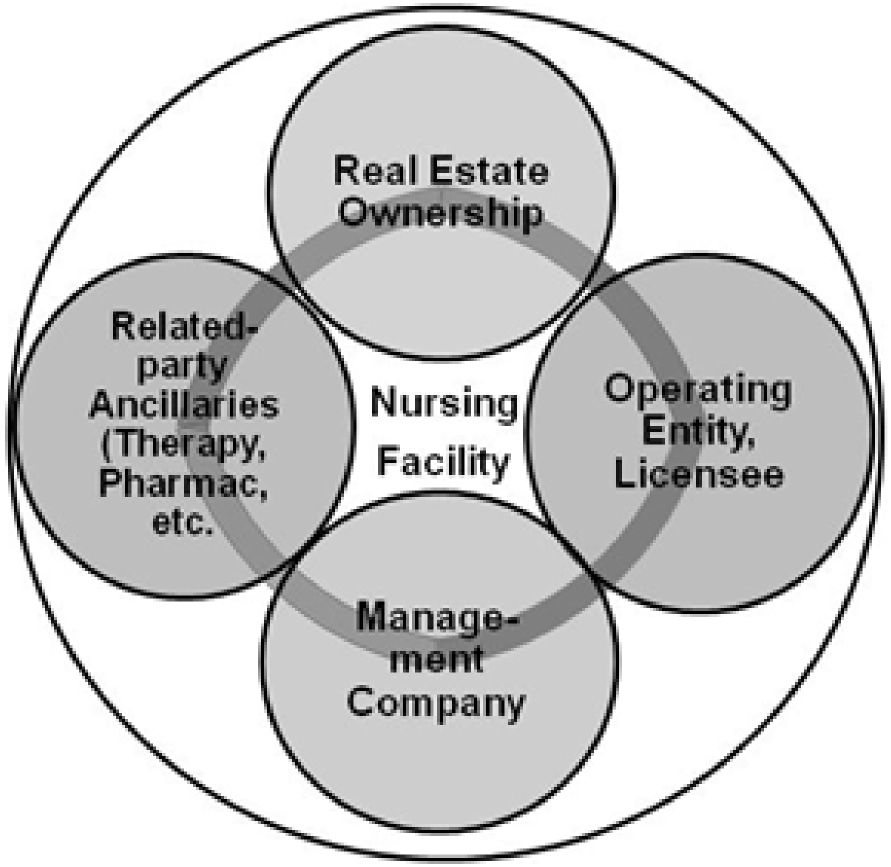


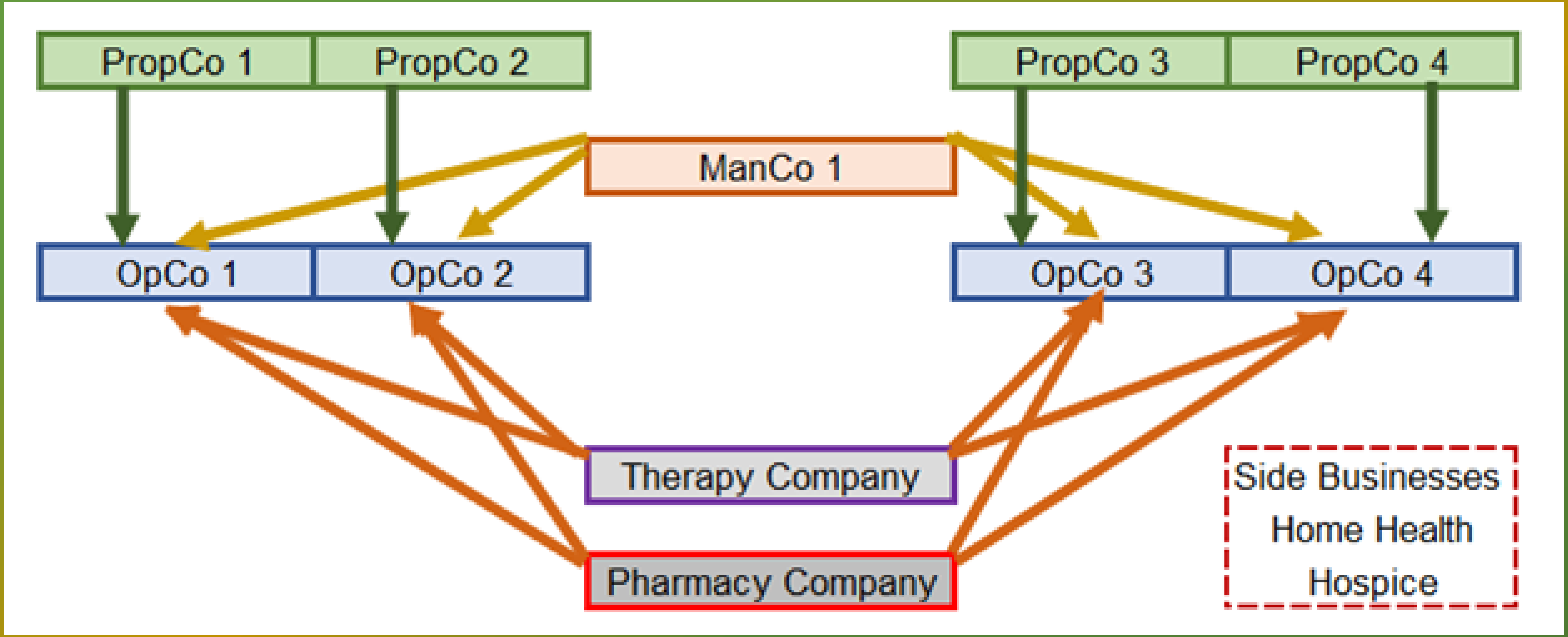
Typical Ownership Structure Diagramed

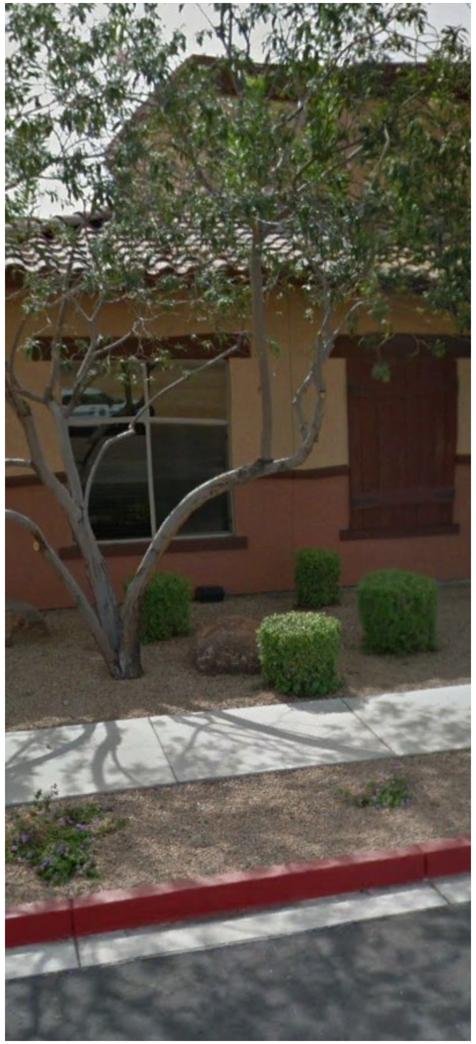
- Reasons to split the ownership include
  - Minimize liability to the ***asset-rich real estate*** entity,
  - Shift liabilities to an ***improvised operating entity***
  - distributing ownership by monetary contribution and expertise to the various entities
- Sometimes the partners or shareholders ownership percentages will differ among the various ownership entities.
- Appraisal Assumptions may be necessary to match the assets appraised with the actual or intended ownership in the appraisal.

Don’t Double Count

- How does the management company fit into value?
- Are the **expenses between related parties** set at market or actual cost or are some expenses shifting profits to or from the entity being valued?
- Be prepared to discuss with the ownership or their management the operations and the various entities with an interest in the subject going concern.
- As an example, in a SNF, is the facility contracting with a related-party therapy business and the expense such that the therapy company is losing money to the property’s benefit, or is the therapy pricing such that profits are being siphoned from the PropCo and/or OpCo (and their creditors).

Multiple Property Ownership Structure





For Real Estate Tax Assessment -- Most States Require Fee Simple Value - Using In-place Rent Presents Issues

- Senior housing and nursing facilities often lease on absolute-net, long-term basis. Such leases can be an indication of real estate value.
- Using actual, ***in-place lease rent*** for real estate tax assessment is problematic, unless the rent is squared against market rent.
- Many leased facilities are part of ***master leases***, involving multiple properties, and rent allocations may be set in some arbitrary fashion which is not necessarily market rent for any individual property in the master lease.



Regulatory, and Government Reimbursements

Regulatory Issues Involving Assisted Living and Independent Living

- Independent living facilities typically require no licensure through a state healthcare regulator and are often no more regulated than apartments and restaurants.
- Assisted living and memory care facilities require licensure. Some states have a variety of licensure levels, and/or recognize special care needs, such as memory care or mental health. Some states also extend Medicaid benefits to assisted living resulting in the beginning of more government partnership and regulation.

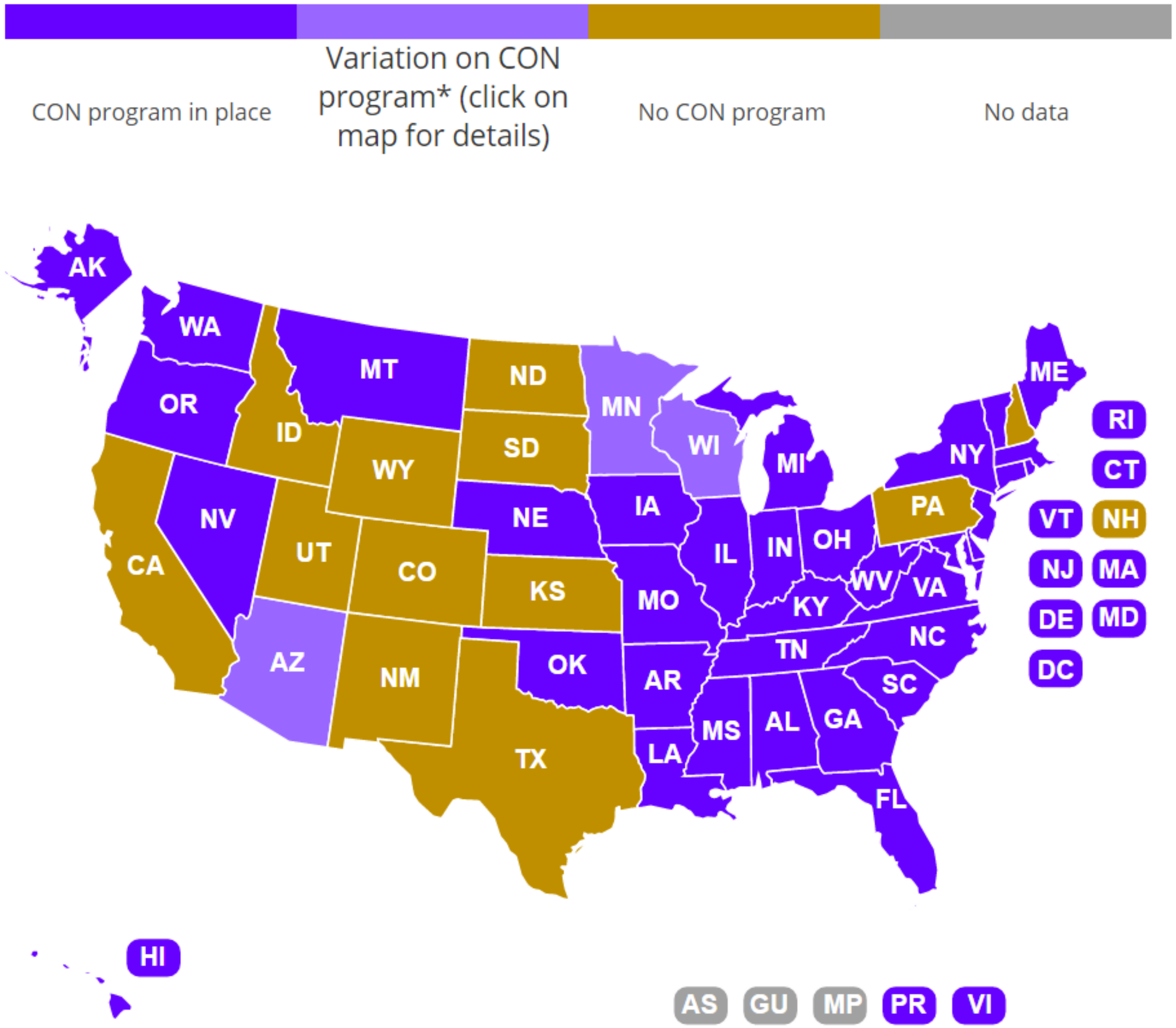
SNF – Regulatory

- **Licensure**: Nursing facilities are typically licensed state health departments.
- **Medicaid and Medicare Certification**: In order to be reimbursed by either of these programs, a facility must obtain certification and comply with the extensive rules for the programs. USPAP is nothing by comparison.
- **Health Surveys**: Licensing and certification are typically renewed annually, after the state conducts a comprehensive annual survey of the healthcare and physical plant. Resolution of deficiencies are required as a condition of renewal.

Skilled Nursing Regulatory, Continued

- **Certificate of Need (CON)**: Most, but not all states regulate nursing facility bed supply by requiring new facilities to receive a CON prior to application for licensure.
  - This program intends to maintain an equilibrium between supply and demand, and limit capital spending which should result in lower costs.
  - CON is developed and administrated by the states, and there is no federal oversight
- Federal CON mandate, along with federal funding was lifted in 1987 and since then more than 15 states have eliminated CON as it pertains to SNFs.

CERTIFICATE OF NEED STATE LAWS



Source: NCSL, Feb. 2019

SNF – Certificate of Need

- A facility's certifications, licenses, and other approvals are usually considered components of intangible value.
- In some states where bed licensure may be transferred to a different ownership and location, it is possible to value the bed licensure separately.
- Some states without CON will regulate the supply of Medicaid-certified beds, and often those bed certifications may be sold and/or transferred
- Many argue that CON is anti-competitive and protects the existing owners from further competition, while it does nothing to hold down costs.

Highest and Best Use Issues With Senior Housing

- Senior housing development will compete with other uses for land, but generally the highest and best of the land, as vacant, will be senior housing, once improved.
- Generally senior housing developers will compete for sites with high-density residential, and healthcare use.
- As-improved with senior housing, the highest and best use is likely to be the continued use, however there are circumstances that might warrant a tweak in the building functions – maybe converting portion of the building from assisted living to memory care, skilled to assisted living, etc.

Cost Approach

- **Is the cost approach relevant? Yes and no! YES!**

- Cost approach may be very relevant in the allocation of going concern value, especially when there is little obsolescence.
- Many buyers and investors tether their pricing to costs
- Leases for new construction are typically based on development costs
- Very useful in determining the economic feasibility for proposed development, as total costs are compared to value and/or return on costs

Land Value Issues

- Question: Where should the value of the entitlements permitting the proposed or existing use be recognized? In the land value, or as part of the improvement value?
- Land purchases for senior housing are typically contingent upon developer receiving zoning and other entitlements.
- Question: As a seller of land, would you take a lower price from a developer that doesn't requiring a successful rezoning and can close in short order, or would you take a higher price, subject to the buyer obtaining zoning, with a longer close date?
- Land prices for senior housing development typically range from $10,000 to $50,000 per proposed unit, or roughly 10% of the total value of the stabilized property, in in mid-sized and larger Midwest cities.
- If available, land sales purchased for other senior housing development might be better than land sales purchased for development of other use. You'll need to weigh the relative factors.

Beyond Commercially Published Construction Cost Sources

- While using a specific cost data source, like Marshall and R.S. Means may be the best route to estimating direct costs, across all property types, for equalization purposes, these cost services don’t always square up with actual costs.
- Alternative cost sources include:
  - ❖ Cost reported in certificate of need application
  - ❖ Actual project costs, as reported to lenders and investors for the development project
  - ❖ Cost surveys conducted by construction companies and real estate service firms involved in this space
- Cost reported in building permits often exclude cost associated with design, construction interest, taxes and insurance. These reported cost may not be reliable, and are generally not relied upon for any purchase or financing decision.

SENIOR LIVING CONSTRUCTION COSTS

(Per Gross Square Foot)

WEITZ

SUMMER 2020	CITY INDEX OF 100 MID-LEVEL LOW	CITY INDEX OF 100 MID-LEVEL HIGH	CITY INDEX OF 100 HIGH-LEVEL LOW	CITY INDEX OF 100 HIGH-LEVEL HIGH	INDIANAPOLIS, IN MID-LEVEL CITY INDEX 93.4 LOW	INDIANAPOLIS, IN MID-LEVEL CITY INDEX 93.4 HIGH
Independent Living	$158	$186	$194	$261	$147	$174
Cottages	$125	$147	$189	$234	$117	$138
Assisted Living	$183	$234	$267	$315	$170	$218
Skilled Nursing	$210	$245	$289	$368	$196	$229
IL Commons	$258	$326	$365	$448	$241	$304
Under Building Parking	$91	$123	$135	$171	$85	$115
Sitework	Excluded		Excluded		Excluded	

Mid-Level: *Generally are of wood-framed construction with standard amenities and finishes, targeting the more moderate income senior.*
High-Level: *Generally are of steel or concrete construction with high-end luxury amenities and finishes, targeting the higher income senior.*

https://www.weitz.com/senior-living-construction-costs-brief-summer-2020/

Improvement Replacement Cost Considerations

The market recognizes the following soft cost in purchasing and financing senior housing:

- **Absorption, operating deficits, lease up cost to reach stabilization**
- **Entrepreneurial incents/profits**
- **Developer fees**
- **Pre-opening expenses such as pre-marketing, advertising, personal recruiting**

Recognizing these costs is consistent with the market, despite what a taxpayer may want an assessor to believe.

Indirect and/or Soft Costs

Indirect Costs

- Architectural and engineering fees for plans, plan checks, surveys to establish building lines and grades, and environmental studies
- Appraisal, consulting, accounting, and legal fees
- All-risk insurance expense and ad valorem taxes during construction
- The cost of carrying the investment in land and contract payments during construction*
- The cost of carrying the investment in the property after construction is complete but before stabilization is achieved
- Supplemental capital investment in tenant improvements and leasing commissions
- Marketing costs, sales commissions, and any applicable holding costs to achieve stabilized occupancy in a normal market
- Administrative expenses of the developer
- Local government development levies

* If construction financing is required, the points, fees or service charges, and interest on construction loans are indirect costs.

Cost Approach Allocation – Indirect and/or Soft Costs

- Developer fees – covering:
  - Time and travel spent performing internal market and site analysis and selection
  - Attending and coordinating entitlement applications and meetings
  - Time spend working with planners, architects, engineers and general contractors
  - Time and travel spent seeking financing – both equity and debt
  - Administrative expenses during the pre-development and construction phases
  - Other costs – what do you think?
- Developer profits or incentives
  - Developers take considerable financial and opportunity cost risks for any single project and the cost of failure in other projects is attempted to be absorbed into profits on future developments

Typical Soft and Indirect Cost Not Included in Marshall and Swift

- ***Developer fees: 3.0 to 5.0 percent*** of total direct costs, may or may not include land purchase.
  - ❑ This is the cost that the developer incurs in conducting all the off-site facets of development including feasibility studies (inhouse and external, site selection, land entitlements, coordinating design, finance and legal efforts, prior to and during the construction.
- ***Absorption, operating deficits, and lease-up expenses: 5 to 20 percent*** of total direct costs (land improvements & FF&E)
  - ❑ This expense can vary widely based on anticipate lease up time frame. It covers the cash flow deficits experienced before reaching operational break even or stabilized NOI.
- ***Entrepreneurial incentive: 10 to 20 percent of all direct costs***
  - ❑ This expense covers the incentive that the developer needs to take on the financial risk and opportunity costs. This is often measure by comparing a recently stabilized property that is sold, and deducting all direct and all other indirect costs. The remainder represents the developer's profit or incentive. The incentive is the anticipate profit, while profit will be the actual result.

Cost Approach Allocation –Soft and Indirect Costs

- Question – Should soft cost be included as real estate assets?
- Next generation buyers will typically incorporate soft costs into depreciable asset basis.
- Lenders may include those cost into the loan-to-value ratio.
- Many leases on new developments set rent using costs, and often those costs include some of these soft cost directly in the recognized costs, or get folded into the lease rate.
- Costs that are not included in the rent should eventually equate to additional leasehold value for the tenant.
- Question: Can soft cost can be somehow allocated between the tangible and intangible assets?

Depreciation Issues in the Cost Approach

- Standard depreciation methods are equally applicable for senior housing and nursing facilities.
- Age-life depreciation methods are widely accepted
- Extracting depreciation from comparable sales requires additional step to remove FF&E and intangible asset contributions.
- Inadequate Medicaid reimbursements may cause external obsolescence in SNFs.

Sales Comparison Approach

For Sale

Azure Cielo Brokers

345.543.9876

Identifying and Researching Sales

- Potential sources for sale data include, but are not limited to, the following:
- State health planning, licensing and certificate of need divisions
- Medicaid offices, which list changes in provider numbers, suggesting that ownership of the operation has changed
- State healthcare associations, which provide general knowledge
- Active owner/operators in the market (It's a small world.)
- Brokers specializing in healthcare properties, who typically work in one region of the country or nationally
- Public disclosures from press releases and quarterly or annual financial statements from public companies and healthcare REITs.
- Assessors and deed recorders
- Publications such as *Senior Care Investor*, *Senior Housing News* and *Contemporary Long-term Care*
- Private, fee-based comparable sale data services
- Other appraisers

Sorting Through Potential Sale Comparables

- Is the sales an asset or stock transaction?
- Real estate appraisers typical use asset sales – the transfer of the real estate asset
- A stock sale involves a buyer acquiring all the assets and liabilities of a business – probably not a good transaction to use for real estate appraisals
- What property rights transacted – leased fee, see simple, possibly leasehold?
- Did the seller transfer the operating rights?
- Was the sale part of a portfolio transaction? And, if so, can the allocated price to one property be trusted, or should the entire portfolio be the comparable sale?

Sale Price Adjusting

- Type of adjusting is best?
- Quantitative adjusting --- specific dollar or percentage adjustments
- Qualitative adjusting --- non-specific, directional adjustment
- Why not both?
- Units of comparison may include:
  - Price per unit (best for independent living and assisted living)
  - Price per bed (typical best for nursing and maybe memory care facilities)
  - Price per square foot

Property Rights and Assets Conveyed

Asset or stock sale

- Best to avoid using stock sales when valuing assets
- Even if the sale is an asset sale, the buyer may assume certain monetary assets or liabilities typically not transferred or valued.

Real estate interest – fee simple, leased fee or leasehold

- Best to avoid leased fee sales when property rights appraised are fee simple.

Elements of Comparison

- Property rights and assets conveyed
- Financing terms
- Conditions of sale
- Capital expenditures made immediately after purchase
- Market conditions
- Location
- Physical characteristics
- Economic characteristics
- Use (zoning)
- Non-realty components of value (used for real-estate-only valuations)

Financing Adjustments

- Typically involves assumption of existing financing – can be favorable but might be punitive
- Note: HUD financing while attractive, given the non-recourse and fixed interest rate, can be punitive in the early year of the mortgage because of pre-payment restrictions may require a buyer to assume the existing debt, causing an under-leverage situation – more cash involved in the sale price, and since equity is more costly, some price discounting may occur. Buyers using high debt leverage would be eliminated from the buyer pool.

Condition of Sale

- A seller facing imminent Medicaid and Medicare decertification, or revocation of licensure create distressed sale conditions.
- Also, non-profit and government-owned properties typical sell to for profit ownerships and often require the buyer to incur short-term additional expense and risk to transition the operations.

Portfolio and Bulk Sales

- Portfolio sales often sell at a significant premium in bull markets and discounts in a bear market. Adjustments may be necessary and critical.
- Portfolio transactions may involve price allocations that are arbitrary or to serve various tax, reimbursement, and other purposes -- the moral of the story – avoid using an allocated price of a single property -- instead, try to make the most of the totality of sale.
- If a portfolio sale represents one of the best indicators of value among the available sales, then it may be best to analyze the aggregated data (--e.g., overall price per bed, price per square foot, combined overall capitalization rate, net revenue multiplier) and attempt to support a quantifiable adjustment for the portfolio price.

Market Condition Adjustments

- This adjustment is often referred to as a *time adjustment,* but the passage of time does not cause value changes. It is market conditions, which change over time, that cause value fluctuations.
- Simply adjusting a sale price to reflect the difference in the cost of capital (interest rates) between the date of the comparable sale and the effective date of the appraisal may not accurately characterize the change in value.
- Changes in reimbursements or other regulatory factors (CON for example) can cause value change over time.
- Matched pair sales are often unavailable
- Published price studies are often quoted, such as the *Senior Care Acquisition Report*; however, the data from this report may be disproportionately weighted from year to year with higher or lower quality sales.

Market Condition Adjusting, Continued

- Equity share prices and earnings multipliers for public senior housing, nursing facility companies and healthcare REITs may provide some general guidance on the direction of value change.
- However, stock prices represent equity-only positions and, therefore, these values will display greater volatility, unless the debt is computed into the pricing to arrive at an enterprise value.
- Note that many of the facilities controlled by public companies are either leased or managed, in which case the real estate interest is minimized.
- Moreover, operating companies are usually not purely engaged in a single property type and they operate other types of long-term care properties and service businesses.
- REITs are likely landlords to all types of senior housing, nursing facility and hospitals, and thus a pure price trend from one property type is not easily indicated.

Location, Physical and Economic Adjustment Quantitative or Qualitative Adjusting May Be Used

Generally, the market is more attuned to thinking about valuation problems through a matrix of economic factors rather than isolated difference based almost exclusively on location and physical plant factors.

Location

- Location has a profound impact on economic drivers of value --- occupancy, payor mix and rates, also remaining economic life
- Can home values and household income levels in the vicinity of the subject and sales be used as a creditable basis for adjusting for location?
- **Avoid double adjusting for location if economic adjustments are also utilized**

Physical Characteristics

- Differences in age, physical condition, and functional design directly impact rates, payor mix, the Medicaid capital reimbursement rate, the occupancy rate, and the overall economic performance.

Economic Adjustment Considerations
Quantitative or Qualitative Adjusting May Be Used

- Care should be taken to avoid double adjusting using economic adjustments that might already by covered in location and physical adjusting
- Economic adjusting can consider average rent/rate, occupancy (both the individual property and its market), expense margins, and NOI.
- **By relying heavily on a single, all encompassing NOI-per-unit adjustment, isn't that technique income capitalization? This technique can be highly misleading**

Other Sales Comparison Techniques

- Multiple regression analysis – only works well with a large set of sales, and even then, results may lack statistical significance.
- Revenue multiplier techniques – Essentially a very simplistic income approach, so why not just capitalized NOI?

Name that Tune?

When **logic and proportion**

Have fallen sloppy dead,

And the White Knight is talking backwards

And the Red Queen's "off with her head!“

Income Approach

- Income capitalization is typically the most relied upon approach, but when actual operating information is limited or not available, as often occurs for tax assessment valuation work, the approach may take a back seat to the sales comparison and cost approach.

Income Approach as Applied to Senior Housing and Nursing Facilities

We will examine:

- Supply and demand forces – current and future for the market, and specifically as it impacts the subject
- Forecast occupancy, payor mix, and rates (rents) and other revenue using market analyses and current and historic levels at the property
- Forecast operating expenses and NOI
- Apply direct capitalization

Supply and Demand Analysis and Estimating Occupancy and Payor Mix

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Supply and Demand Analysis and Estimating Occupancy and Payor Mix

- Supply and demand
  - Identifying, selecting and measuring existing and new supply
  - Measuring demand, usually through occupancy counts among existing supply
  - Estimating future demand using population forecasts and market saturation analysis
- Occupancy forecasting
- Payor mix forecasting

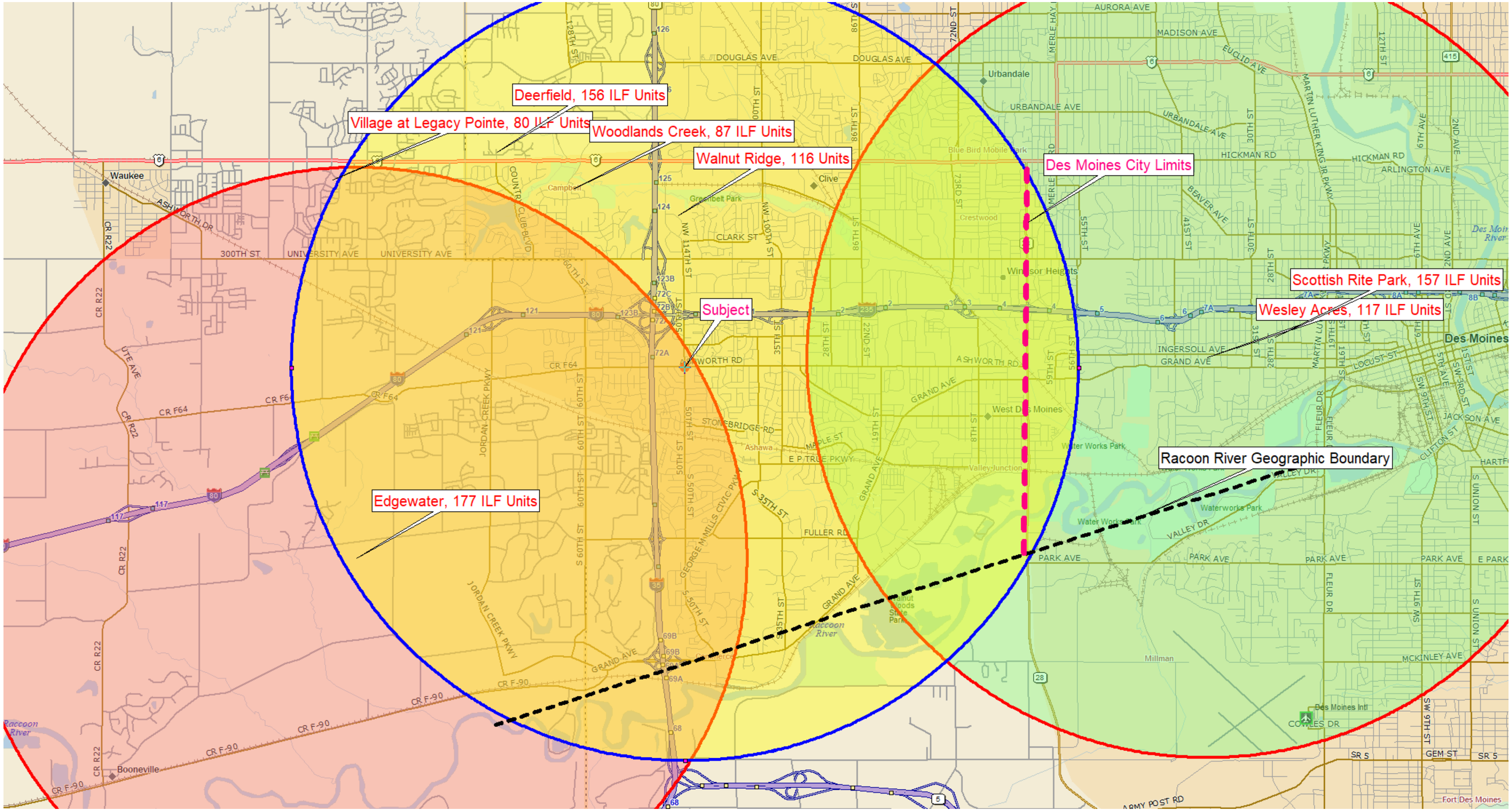
Establish the Competitive Market Area

- Market boundaries are set by a host of geographic considerations, including:
  - Distances from competitive properties,
  - Political boundaries (state and county lines),
  - Physical features (large bodies of water, mountains, road systems) that create lengthy drive times,
  - Commercial, healthcare and cultural draws

Identifying Existing Supply

- State licensing departments provide a comprehensive list of nursing and assisted living properties, and often will have census and other useful information.
- SNF supply can be identified through www.hnhcompare.gov
- State certificate of need web sites and state Medicaid sites may be a good source
- For senior housing, various subscription and free senior housing internet search site can be comprehensive,
- Management of the subject and competitors may offer insights into their competitive set of properties.
- But simply relying of their information should be avoided; they may be motivated to skew the information – but never once happened, not once.

Identifying Market Area Boundaries – Distances, Natural and Political Boundaries



Supply Analysis, Step One - Indentify Supply in Primary Market

Property	ILF Units	Distance From Subject	Direct From Subject	Estimated Market Overlap	Competitive Units
Edgewater	117	4.0	SW	80.0%	93.6
Legacy Point	80	4.0	NW	65.0%	52.0
Deerfield	156	2.9	NW	70.0%	109.2
Woodlands Creek	87	2.1	NW	75.0%	65.3
Walnut Ridge	116	1.5	NW	85.0%	98.6
Wesley Acres	117	5.4	E	20.0%	23.4
Scottish Rite	157	6.0	E	20.0%	31.4
Subject	830				473.5

Supply Analysis -- Current Occupancy Data

Property	ILF Units	Estimated Market Overlap	Competitive Units	Current Occupancy	Occupied Units From Subject Primary Market Area
Edgewater	117	80.0%	93.6	85.0%	79.6
Legacy Point	80	65.0%	52.0	90.0%	46.8
Deerfield	156	70.0%	109.2	85.0%	92.8
Woodlands Creek	87	75.0%	65.3	92.5%	60.4
Walnut Ridge	116	85.0%	98.6	85.0%	83.8
Wesley Acres	117	20.0%	23.4	92.5%	21.6
Scottish Rite	157	20.0%	31.4	82.5%	25.9
Totals (Without Subject)	830		473.5	86.8%	410.9

Demand Analysis

- Measure existing demand by determining occupancy levels at competitive facilities
- Determine if the market has unmet need (demand) currently
  - If occupancy rates are high in existing competitive properties, there are waiting lists, and/or existing supply is inferior to current needs, then demand forecasting will need to measure that unmet need
  - If occupancy levels are low, then the market may be oversaturated, and the existing supply satisfied current demand
- Apply market saturation rate to population in the market to determine demand

Demand Forecast When Market is Oversaturated (the market has more supply or inventory, than demand, as suggest by lower occupancy rates)

Demand Forecast

		Current	In 1 Year	In 2 Years	In 3 Years
Existing Demand From Primary Market		410.9			
Annual Demand Growth (75+ Population Change Forecast)	3.5%				
Forecast Demand		410.9	425.3	440.2	455.6
Existing Supply in Primary Market		473.5			
Subject, Adding New Properties (Subject)	60	473.5	533.5	533.5	533.5
Market Occupancy		86.8%	79.7%	82.5%	85.4%

Occupancy Forecast – Subject Opens Today, Absorbs to Stabilized Occupancy in 12 Months, Stabilized

Subject Occupancy Forecast

		Current	In 1 Year	In 2 Years	In 3 Years
Forecast Demand	a	410.9	425.3	440.2	455.6
Existing Supply in Primary Market	b	473.5			
New Units Added to Market - Subject 60 Units	c		60.0	0.0	0.0
Total Units in Competitive Market b + c)	d	473.5	533.5	533.5	533.5
Subject as % of Total Supply (c / d)	e		11.2%	11.2%	11.2%
Subject As % Of Competitive Properties (1 / 8 total facilities)	f		12.5%	12.5%	12.5%
Subject's Estimated Fair Market Share (considers e & f)	g	12.0%	12.0%	12.0%	12.0%
Absorption Factor	h		50.0%	100.0%	100.0%
Subject Capture Rate, % of Fair Mark Share	i		102.5%	102.5%	102.5%
Forecasted Occupied Units At Subject (a x g x h x i)	j		26.2	54.1	56.0
Subject Forecasted Occupancy Rate (j / cj)	j		43.6%	90.2%	93.4%
Overall Market Occupancy Rate	k		79.7%	82.5%	85.4%

Developing Empirical Market Saturation Data

Developing Market-supported Saturation Rates

		Market One	Market Two	Market Three	Market Four
Age- and Income-Qualifed Population	a	4,750	7,500	3,750	4,250
Total ILF Units In Market	b	455	725	375	500
Total Market Occupancy	c	87.5%	90.0%	88.5%	95.0%
Number of Occupied Untis (b x c)	d	398	653	332	475
Market Saturation Rate (d / a)	**e**	**8.4%**	**8.7%**	**8.9%**	**11.2%**

Comments:
Market Four is 95% occupied suggesting the demand may be greater than suppy, and therefore, the indicated market saturation rate is not reflected of a saturated market, or the market size is greater than

Estimating Occupancy for a Proposed Facility Using Market Saturation Analysis

Subject is expected to out-perform the market occupancy because of newer construction.

	Year One	Year Two	Year Three
Age- and Income-Qualifed Population	4,725	4,891	5,062
Market Saturation Rate	9.0%	9.0%	9.0%
Estimated Market Demand	425	440	456
Existing Supply	473		
New Supply	60		
Total Supply	533	533	533
Implied Market Occupancy With New Supply	79.8%	82.6%	85.5%
Subject Stabilizeed Capture Rate (105% of fair market share)		105.0%	105.0%
Estimated Stabilized Occuapncy for Subject		86.7%	89.7%

Payor Mix Analysis

- Skilled nursing patients will us private funds and/or Medicare and Medicaid to pay for skilled nursing.
- This payor mix is a critical value driver as there is usually very different NOI or EBTDAR achievement with each payor.
- Profitability rankings -- most to least profitable -- generally

  1) Medicare
  2) Private, or self pay
  3) Medicaid

- Some states offer Medicaid programs available for assisted living and residential care through Medicaid waivers.

SNF Payor Mix Importance

- Medicare-occupied SNF beds may be valued at more than $300,000 per bed for new state-of-the art SNFs
- Medicaid-occupied beds in older buildings often command less than $30,000 per bed
- Getting the payor mix correct is singularly the most important estimate made in appraising a skilled nursing facility – as it has huge bearing on the NOI and could trigger large price adjusting in the sales comparison approach.
- The 2018 national average SNF payor mix was:
  - Medicare 10.3%
  - Medicaid 62.0%
  - Private and Other 27.7%
- Medicaid mix has been increasing and private-pay decreasing over time, as healthcare costs are increasing more rapidly than income.

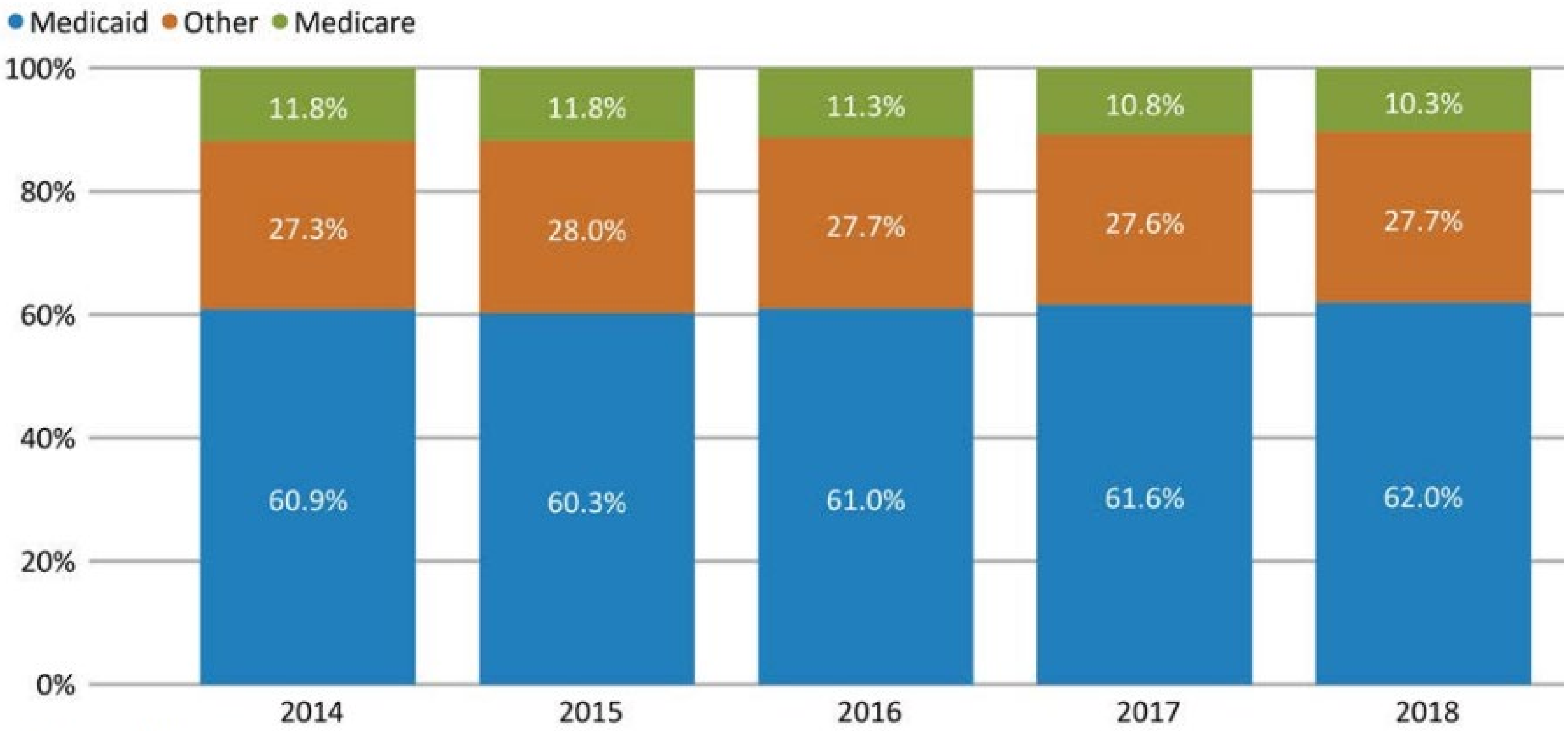
Government Reimbursement Program Descriptions -- Independent and Assisted Living Does Not Participate In Medicare

- **Medicaid** will pay for qualifying long-term care for persons that are indigent or become indigent once they spend down their assets during a long-term care stay.
- Medicaid represents more than 60% of SNF census, nationally
- Medicaid waivers, used in some states, will cover assisted living and memory care.
- **Medicare** is the federal health insurance for persons aged 65 and over and for persons with disabilities.
- Medicare Part A covers hospital and short rehab stays in SNFs.
- Medicare Part B covers certain non-hospital expenses, such as doctor charges, outpatient therapy, etc..
- Medicare Part D coverages drug expenses
- Part B & D are optional, and additional premiums are required.
- Medicare Part C is known as Medicare Advantage, whereby a person opts into a private-insurance arrangement that provides similar benefit to Medicare. Payments to providers and services to patient can be different than same case under Medicare.

Revenue Forecasting

- Skilled nursing and senior housing revenue forecasting have very different processes
  - ➢ SNF's involve estimating
  - ➢ Payor Mix (private, Medicare, Medicaid, managed care & other)
  - ➢ Rates for each payor source:
    - ❖ Medicare, rates are set at a federal level
    - ❖ Medicaid, rates are set at state level
    - ❖ Managed care, rate are negotiated between private insurance companies and the provider
    - ❖ Private-pay mix, based on historic and market analyses
  - ➢ Independent living and assisted often involve only private pay – market-set rates, and their rates are based on competitive market forces.

Skilled Nursing Payor (Census) Mix Trends



Source: CMS

SNF Payor Mix Comments

- Medicare is generally consider the most profitable payor source, with NOIs potentially exceeding $100.00 per patient days.
- Medicare Advantage (Medicare Part C) covers the same patients, but rates are typically 60% to 80% of the same rate that Medicare Part A pays the SNF. However, managed care will typical require less to be spend on therapy (possible $50/day saving) and will not make the SNF pay for the cost of drugs, another saving averaging $25 to $50 per patient day.
- Medicaid is typical least profitable, often paying less than the operators actual expenses
- Private-pay profitability depends how high the market allows those rates to be set.

Skilled Nursing Facility Mix Forecasting

- Actual historical mix of the subject is often the best guide provided that the supply and demand conditions are expected to be steady.
- Comparison to competitive facilities is important measurement
- A reassessment of the subject's payor mix becomes paramount when new supply enters the market.
    - Any new SNF development will be focused on capturing Medicare and private-pay demand, as Medicaid rarely supports financial feasibility.
- When new supply is entering the market, an analysis that redistributes market demand for each payor component should be performed.

Hospital Relationship to SNF Demand

- Hospitals are very important demand generators, especially for skilled nursing facilities.
  - Hospital discharge data can be useful in developing demand estimates for short-term rehabilitation demand (Medicare and managed care)
  - A relocation of a hospital can have huge consequence on nursing facilities, especially if they are located near the hospital being closed or replaced elsewhere.

What Drives SNF Quality Mix – Medicare and Private Pay?

Location	Physical plant	Reputation
access	building age	Family perspective
proximity to medical services	cleanliness	Medical perspective
neighborhood economic and reputation factors	amenities	staff perspective
Staff consideration	private rooms	
other	private bathrooms	
	therapy space	
	site improvements	
	other	

The Medicare and private-pay patients are increasingly demanding private patient rooms with full bathrooms.

Three and four-bed wards are rapidly becoming obsolete, even for Medicaid patients. The pandemic has accelerated this trend.

Private-pay Rates – SNF

- For most states, private-pay rates are set by market forces.
- Minnesota and North Dakota generally prohibit private-pay rates to exceed Medicaid rates.
- Historic levels are a good starting point for forecasting private-pay rates.
- Increasing private-pay rates could result in lower private-pay census by patients spending down to Medicaid more rapidly and prospective patients seeking better value elsewhere.
- Rate comparison to competitors is a useful measure to set “market” private-pay rates,

Medicare SNF Rates

- Part A: This is the hospital coverage portion of the program which also covers up to 100 days in a skilled nursing facility (SNF). For the first 20 days, Medicare covers the entire cost; for the remaining 80 days of potential coverage, a co-payment is required.
- Part B: This is optional medical insurance known as the Supplementary Medical Insurance (SMI) program. It pays a portion of doctors' bills and other outpatient expenses. Nursing facilities achieve limited Part B revenues through their patients not covered by Part A, mostly as reimbursement for covered therapy.
- Part C: Known as the Medicare Advantage (managed care) alternative, whereby a person elects to substitute Medicare coverage for private health insurance coverage that mirrors or enriches the benefits that are offered by Medicare (Parts A and B).
- Part D: This is the recently added prescription drug benefit program, which is actually administered by private health insurance companies. Part D does not have a significant impact on nursing facilities.

Medicare SNF Rates

- Prospective Payment System – actual allowable costs are not considered.
- All operators receive the same rate, adjusted for local wage difference and care needs (resource utilization groups – RUGs)
- Medicare uses a Patient Driven Payment Model (PDPM) for setting rates, the rates are scaled to location and patient needs for:
  - ❖ Nursing and direct patient care
  - ❖ Therapy, drugs and ancillary services
- Payment for administrative, management, dietary, housekeeping, laundry, plant, maintenance, utilities, and insurance are based on a flat rate regardless of care needs.
- Capital cost (interest, depreciation, rent) rates are the same, regardless
- Non-capital cost are adjusted for local wage indexing

Medicare SNF Rates

- For the most part, the current reimbursement level, or average daily Medicare rate is a good basis for forecasting future rates
- Rates in place prior to the PDPM reimbursement (before October 2019) involved a different reimbursement system and is less reliable than forecasting rates under PDPM
- PDPM is an extremely complex set of calculations, and generally beyond the scope or expertise for a real estate appraiser to calculate.
- Like many parts of Medicare reimbursements, some operators will ”push” medical charts to receive higher reimbursement – a dangerous game.
- Medicare Advantage (managed care) rates are typically expressed as a percentage of Medicare rates – often only 65 to 80 percent of corresponding Medicare reimbursement.

Medicaid Reimbursements - SNF

- Medicaid reimbursements are set on a state level
- Medicaid is a jointly funded by federal and state, with the federal side requiring general program guidelines, and states setting their own specifics
- Federal Medical Assistance Matching Funds pay cover 56 to over 80 percent of the total state Medicaid spending. The state picks up the balance.
- Many states used provider tax schemes to enhance the contribution from the funds. The state taxes the providers (SNF and hospitals) and use those tax dollars to receive more federal matching fund to return to providers.

Two Types of SNF Medicaid Reimbursements

1. Prospective rates – rates are set in advance of payments and are not subject to change
2. Retrospective rate - rates are estimated in advance with final settlement after actual cost are reviewed

Most states use prospective reimbursements

Types of Medicaid Reimbursement

- Facility specific:
  - Rates are based on actual expense levels incurred at the property.
  - Retrospective payments and some prospective systems are facility specific.
- Pricing system:
  - Rates are predetermined for a group of facilities, depending on bed capacity, and/or geography, and all facilities within the grouping receive the same reimbursement.
  - Pricing systems are only prospective.
- Some states use a combination of the two.

Facility Specific Reimbursement

- Actual expenses at a specific property are used to set reimbursements.
- The expenses are reported to the state through a cost reporting system (each state is different).
- Non-allowable expenses are removed
- Allowable expenses ($/resident day) are compared to reimbursement ceiling set by peer averages, state budget limits, etc.
- Reimbursement is set at the lesser of a ceiling or actual allowable expenses.
- Cost-saving and quality care incentive can be incorporated into the reimbursement.

Medicaid Reimbursement Rate Example – Facility Specific

	Current Rate	Forecasted Expense	Rate Ceiling	Forecasted Rate
Patient Care (nursing, social services)	$100.00	$90.00	$101.00	$90.00
Indirect (dietary, housekeeping, utilities & maintenance)	50.00	45.00	52.00	45.00
Administration & Management	25.00	27.00	25.00	25.00
Property Taxes	5.00	5.00	5.00	5.00
Interest, Depreciation and Rent	15.00	25.00	15.00	15.00
Total	$195.00	$192.00	$198.00	$180.00
Total Medicaid Days, Annual	29,200	29,200		29,200
Total Medicaid Reimbursement	$5,694,000 (a)			$5,256,000 (b)
Difference Between Current Total Reimbursement (a) and Reimbursement With Forecasted Expenses (b)				$438,000

Other Important SNF Reimbursement Issues Contractual Allowance & Provider Tax

Contractual Allowance Calculations

Annual Total Figures		Medicare	Medicaid
Charge (Rack Rate)	a	900	250
Patient Days	b	3,500	29,200
Billed Amount (a x b)	c	$3,150,000	$7,300,000
Actual Reimbursing Rate	d	$550.00	$195.00
Actual Reimbursement (b x d)	e	$1,925,000	$5,694,000
Contractual Allowance c - e)		$1,225,000	$1,606,000

Provider Tax

Tax Per Non-Medicare Patient Day	$10.00
Patient Days Being Taxes	30000
Tax Amount	$300,000
State's Share of Federal Match	40.0%
Provider Tax Rate Enhancement	$750,000
Net Amount Return to Facility	$450,000

SNF - Other Revenue: Medicare Part B Ancillary Services (therapy -- typically $500 to $15.00 per patient day), Miscellanous (tyically less than 1%)

Example of Forecasting SNF Revenue

Calculations For SNF Revenue

Calculation of Annual Resident Days:				
Number of Beds	120			
Potential Resident Days	43,800			
Occupancy Rate	85.0%			
Estimated Resident Days	37,230			

Revenue Source	Resident Days	Census Mix	Daily Rates	Revenues
Private Pay	7,446	20.0%	$250.00	$1,861,500
Medicare	3,723	10.0%	550.00	2,047,650
Managed Care	1,862	5.0%	425.00	791,138
Medicaid	24,200	65.0%	195.00	4,718,903
Totals	37,230	100.0%	$394.32	$9,833,096
Ancillary (Medicare Part B and Other)	37,230		$10.00	$372,300
Other Revenues	37,230		2.00	74,460
Bad Debt	37,230		(2.00)	(74,460)
Total Effective Gross Revenue			$274.12	$10,205,396

Forecasting Senior Housing Revenue (ILF, ALF & MC)

- Occupancy forecasting supply and demand analysis from the competitive market -- much the same way occupancy rates are developed for other income property
- Rent and service revenue is developed in a manner that one would develop for apartments, however, there are service components to consider – meals, personal care, etc.
- Rent forecasting relies on historic and in-place rents at the subject, and through market comparisons to comparable senior housing in the market.
- Following a process similar to apartment rent comparison is an excellent starting platform, with further adjustment consideration for meals, care included in the rate, social services, amenities, etc.

Example of Forecasting Senior Housing Revenue

Calculations For Senior Housing Revenue

Calculation of Annual Resident Days:	ILF	ALF	MC
Number of Beds	60	40	20
Potential Resident Days	21,900	14,600	7,300
Occupancy Rate	85.0%	90.0%	80.0%
Average Occupied Units	51.0	36.0	16.0

Level of Care/Service	Average Occupied Units	Average Monthly Rate per Occupied Unit	Revenues
Independent Living	51.0	$3,250.00	$1,989,000
Assisted Living	36.0	4,750.00	2,052,000
Memory Care	16.0	5,750.00	1,104,000
Medicaid Waivers	0.0	195.00	0
Totals	103.0	$394.32	$5,145,000
Other Revenue			
Second Occupant Fee (ILF)	10.2	$900.00	$110,160
Second Occupant Fee (ALF)	3.6	1,500.00	64,800
Additional Care Revenue (ALF)	39.6	1,200.00	47,520
Other Revenues (meals, parking, etc.)			25,000
Bad Debt	0.50%		(26,962)
Total Effective Gross Revenue		$52,092.40	$5,365,518

Operating Expense Topics

- For existing, stabilized properties, the actual expenses may deserve the greatest weight in forecasting expenses going forward.
- Operating expenses are typically measured on a per-patient-day or per-occupied room basis. This is especially important when developing variable expenses.
- Expenses, as a percent of revenue is simplistic and not relied upon in a serious manner by the market.
- Expenses comparable data for nursing facilities can be obtained from Medicaid and Medicare cost reports.

SNF Operating Expense Comments

- Expenses are best measured on a per-patient day basis
- Ancillary expenses relate to the therapy component of the Medicare reimbursement, and typical run between $140 to $175 per Medicare/managed care day, and cover therapy, drug and other minor items. Therapy is roughly $100 to $125 PPD.
- Does the facility use contract the therapy and pharmacy functions to a related party which charges above or below market costs – i.e. – are SNF profits being transferred to a related party or is the related party losing money painting higher NOI than can be otherwise realized.
- Remember to include provider tax expense.
- Cap-ex – replacement reserves typically $500 per bed -- be consistent with cap-ex treatment for sales used to develop capitalization rate NOI.
- In cost-based Medicaid systems, are forecast expenses reconciled to the Medicaid rate?

Operating Expense Comments

- Like revenue, operating expenses should be based on forecasted stabilized levels.
- Capitalization rates should be based on anticipated revenue and expenses, with consistent treatment of revenue and expenses between subject and sales used to develop capitalization rate data.
- Trailing expense experience for property that has been stabilized is a good measure for future expenses
- Non-stabilized properties may require greater reliance on expense comparable data to make forecasts.
- Non-profit facilities might run expenses at higher levels than if the same property were owned/operated by a for-profit concern.

Operating Expense Categories and Typical Expense Ranges

Typical Expense Ranges for SNF, ILF and ALF Property

	SNF ($/Patient Day)		ILF ($/Occupied Unit)		ILF ($/Occupied Unit)	
Category	Low	High	Low	High	Low	High
Administrative	$20.00	$40.00	$3,500	$8,000	$12	$20
Marketing/Advertising	0.00	5.00	500	2,500	500	2,500
Personal Care/Nursing	60.00	125.00	0	0	9,000	18,000
Ancillaries (Medicare Part B therapy, drugs, etc.)	5.00	12.00	0	0	0	0
Social Services	2.50	7.50	500	1,500	750	1,750
Dietary	12.50	25.00	1,500	12,500	4,500	10,000
Housekeeping & Laundry	8.00	15.00	1,500	3,000	1,500	3,000
Plant Operations (maintenance & utilities)	5.00	9.00	3,200	7,200	3,200	7,200
Insurance (property and liability)	0.50	5.00	400	900	500	1,000
Real Estate & Other Property Tax	0.50	3.00	1,000	5,000	1,000	5,000
Cap-ex (replacement reserves) Per Unit	300.00	1,000.00	500.00	1,500.00	500.00	1,500.00
Management -- Percentage of EGR	4.0%	6.0%	5.0%	6.5%	5.0%	6.5%

Salaries and employee benefit expenses is distributed through the various expense departments

Issues in Valuing Non-Profits

- Who is the likely buyer? For- or non- profit?
- Considerations for non-profits?

1. Possible exemption from property taxes? May need to forecast property tax as an expense. Will this affect the Medicaid rate?
2. Possible exemption from sale tax and lower expenses?
3. Marketing advantage, being able to say they are non-profit benevolent, vs. greed for profit competitors?
4. Operating expenses that are excessive as care is a greater part of the mission than profit?
5. If faith base, does the property draw from a larger market area, and would that draw be able to continue under a different ownership that doesn't align to that faith?
6. Any other ideas?

Consistency in NOI and Capitalization Rate Use – Applies to All Property Types

<u>Do unto your sales as you do to your subject</u>

<u>Be consistent</u>

Capitalize anticipated stabilized NOI using capitalization rates derived from forecasted stabilized NOI from sale data and surveyed data

Not all surveyed capitalized rates are on the same page relative to trialing/anticipated NOI, or treatment of management and cap-ex expenses.

Income Capitalization Rate Issues

- Individual comparable sales
- Industry rate surveys
- Interviews with market participants
- Band-of-investment capitalizations rates are only as good as the development of the equity capitalization rates and mortgage rate and ratio from the market
- Care should be made to avoid using a cap rate for one type of senior housing with another, i.e. independent living rates are not applicable to assisted living or memory care.
- Capitalization rates increase with the amount of labor necessary to generate NOI and increase as the expense margin increases (higher expense margins translated to higher earnings volatility).

Senior Housing Cap Rate Survey & Rate Spread by Property Type

Overall Capitalization Rate

	2019 All Responses		2019 Adjusted Responses (1)		Basis Point Change from 2018
	Range	Average	Range	Average	
Age Restricted Apartments	5%-7.5%	6.0%	5%-7%	6.0%	0
Unlicensed Congregate Living	5.5%-7.8%	6.7%	6%-7.5%	6.6%	+10
Licensed Assisted Living	6%-9%	7.4%	6.3%-8.5%	7.4%	-10
Licensed Memory Care	6.3%-9%	7.9%	6.8%-9%	7.9%	-10
Licensed Skilled Nursing-Long Term Care	7.3%-13.3%	11.7%	11%-13%	11.9%	+10
Licensed Skilled Nursing-Subacute Care	7.3%-14.5%	12.0%	10.5%-13%	12.2%	-10
Continuing Care Retirement Community	7.3%-11%	8.9%	7.5%-10%	8.9%	+20

This survey is published by fellow appraiser, San Francisco-based Michael Boehm, MAI. While surveys may attempt to have respondents consider the NOI in a consistent fashion -- using pro forma figures, with market levels of management fees and cap-ex, the answers are not always received in this manner. Therefore, the surveys may be suspect. Similarly, a small sample of individual sales may skew the data

Needle Movers on the Capitalization Rate Meter

Location

- Adverse environmental encroaches
- Life cycle of the neighborhood, growth, stable, declining
- Regional and/or state consideration
- Market area demographic, economic and physical trends

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Needle Movers on the Capitalization Rate Meter

<u>Economic and business operational</u>

- Mortgage interest rate trends over the survey and sale data time span
- Available mortgage terms for the subject, considering physical, location, political and operational factors (largely covered elsewhere in this analysis – but emphasis added here)
- NOI or EBITDAR margin (narrower has greater volatility)
- Anticipated change in NOI or EBITDAR (higher growth = lower rate)
- General outlook of the state's Medicaid reimbursement
- Barriers to entry – stringent certificate of need policies, difficulties meeting state regulatory requirements, local entitlement and land shortages
- Vulnerability to additional competitive supply, not considered within barriers to entry
- Risk of obtaining the forecasted NOI if forecast includes significant turn-around assumptions, such as transitioning a property from non-profit to for profit, replacing under-performing management and/or /ownership
- Perceived intangible asset value relative to overall value – higher intangible value tends to warrant higher capitalization.

More Thoughts on Capitalization Rates

- SNF rates are higher in part since the operator will need multiple months of working capital since Medicaid and Medicare are paid in arears, whereas private-pay pays in advance.
- Bank of Investment (Capital Stack) – financing and interest rates will depend on non-property factors:
  - Credit worthiness of the borrower/operator
  - Properties ability to obtain low-interest, fixed rate financing from HUD (SNF/ALF) and Fannie Mae/ Freddie Mac – ILF and ALF, or via bonds
  - How does property and/or income tax exemption paly into the capitalization rate?

Trailing or Pro Forma Cap Rate

	Seller/Trailing	Buyer/Forecast
Revenues		
Gross potential revenue	$6,000,000	$6,300,000
Vacancy rate	10.0%	7.9%
Net revenue	$5,400,000	$5,800,000
Operating Expenses, Including Reserves & Management	- 4,920,000	- 5,135,000
NOI or EBITDAR	$ 480,000	$ 665,000
Sale price	$5,000,000	$5,000,000
Capitalization rate (NOI after management -- EBITDAR)	9.6%	13.3%

When Real-estate-only Value Is Needed

- Real estate tax assessment
- As instructed by a purchase option in a lease, whereby the purchase only covers the real estate and/or tangible personal property
- Condemnation assignments where law prohibits the purchase of business or intangible assets

- Since the real estate assets are ***inextricably entwined*** with the total assets of the business or going concern, the appraiser will typically approach valuing the entire going concern first, and then move to separate value of the various assets (top-down approach). Further discussion on allocation will be address later.

Allocation of Value

- The methods for allocating seem to be a subject of on-going debate.
- Generally, appraisers will apply a **top-down approach** to allocation, whereby the going-concern value is developed first.
- **Buyers and sellers do not contemplate** the value by adding the value of the real estate to the separate values of the tangible and intangible personal property; they focus on the overall value.
- A bottom-up approach essentially implies that the value of the intangible assets, FF&E, and real estate can be developed in some independent manner and then added together to arrive at the total value of the business or going concern. The difficulty with this approach is that there is little market evidence to support the value of any single asset component. Moreover, the value of the whole may be different from the sum of the individual values.

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Exploring Some Allocation Techniques

Several techniques are available and, when the allocation is a critical component of the appraisal, using several techniques, just like using more than one valuation approach, will produce a more convincing allocation.

- Cost Approach
- Market Rent Residual Methods
- Other Methods
    - Management Fee
    - Different Use, but Similar Constructed Real-estate Only Sales/Leases
    - Parsing the revenue between services and real estate Functions
    - Extracting marginal rent differences
- Others?

Cost Approach Allocation

- **When the depreciated cost of the tangible assets and the land are less than the overall business enterprise value, the cost approach can be a proxy for real estate value. After all, the old adage that the cost approach sets the upper limit of value does have some truth. This is a top-down, residual technique that begins with the best known and supported values and works back to the unknown.**

Total Going-concern Value	$11,000,000
Less Land Value	-1,500,000
Less Depreciated Total Improvement Cost	- 7,000,000
Less Depreciated FF&E Value (Value in Use)	- 1,000,000
Residual Value – Intangible Assets	$1,500,000

Cost Approach Allocation – Improvement and Other Costs

- Replacement versus reproduction cost
- Replacement cost is generally preferred since costs are easier to obtain and some forms of obsolescence are eliminated.
- Replacement cost is problematic with many older buildings that have deficiencies; this is especially true with older nursing facilities.
- Today's SNF designs require more building area per bed to meet market demands and increased regulatory requirements. For example an SNF in 1970 would have typically required less than 300 square feet per bed, whereas new SNFs are often more than 600 square feet per bed and have considerably greater electrical, plumbing, HVAC and life-safety elements.

Cost Approach Allocation – Soft Costs

- Cost of entitlements – CON, Medicaid and Medicare certification – are these entitlement cost related to real estate or intangible asset value?
- Pre-opening expenses, marketing and advertising, staff recruitment and training
- Operating deficits during the initial absorption and stabilization period
- Can you think of other soft costs?

Market Rent Allocation Approach

- Entrepreneurial profit or proprietary earnings is deducted from the *NOI* or *EBITDAR* and it is capitalized to arrive at an indication of the intangible value.

Or

- Market rent can be capitalized into real estate (and FF&E), with the remaining value (residual) being intangible value.

Market Rent Allocation – Rent or Entrepreneurial Profit Residual

Going-concern EBITDAR

Less Market Rent of Leased Assets

Equals Entrepreneurial Profit or Proprietary Earnings

EBITDAR	$1,200,000
Market Rent	(900,000)
Profit to Business	$300,000

Market Rent Allocation – Market Rent Coverage Ratios

- The market clearly demonstrates that rent for existing properties is established as a percentage of EBITDAR, or expressed as a rent-coverage ratio.
- The residual (EBITDA) represents entrepreneurial profit or proprietary earnings
- Typically market EBITDAR-to-rent-coverage ratios vary by property type:
  - Independent Living: 1.1:1.0
  - Assisted Living: 1.2:1.0
  - Skilled Nursing: 1.4:1
  - Hospitals: 1.75-plus
- Coverage ratios will vary depending on quality of the real estate asset, terms and conditions in the lease, and tenant credit.

Market Rent Allocation – Capitalization of Market Rent

- Residual Value Represents Intangible Asset Value

- Going-concern Value $12,000,000
- Less Capitalized Value of Market Rent - Realty and FF&E
  - Assumed Coverage Ratio 1.33:1.0,
  - or $1,200,000 (NOI) ÷ 1.33 (coverage ratio)= $900,000
  - **$900,000 (**NOI attributable to RE) **÷ 8.5% (leased fee CR)** - 10,900,000
- Intangible Asset Value (Residual) $ 1,100,000

Market Rent Allocation
Capitalization of Proprietary Income or Return to Intangible Assets

- Residual Value Represents Real Estate Value

Going-concern Value		$12,000,000
EBITDAR		$ 1,200,000
Less Market Rent		
(Coverage Ratio 1.33:1.0, or $1,200,000 ÷ 1.33) -		$ 900,000
Return to Intangible Assets	$ 300,000	
Less Capitalized Value of Intangibles		
($300,000 ÷ 20.0% -- Business Capitalization Rate)	- $1,500,000	
Tangible Asset Value (Residual)	$ 10,500,000	

Reconciliation of Two Market Rent Allocations

Values	Tangible Property Value	Intangible Asset Value	Going-concern Value
Rent Capitalization	$10,900,000	$1,100,000	$12,000,000
Proprietary Earning	$10,500,000	$1,500,000	$12,000,000
Reconciled Value Conclusion	**$10,750,000**	**$1,250,000**	**$12,000,000**

Implied Capitalization Rates From Allocation

Asset	Value	NOI/EBITDA/ EBITDAR	Implied Capitalization Rate
Real Estate & FF&E	$10,750,000	$900,000	8.37%
Intangible Assets	$1,250,000	$300,000	24.00%
Total Going Concern	$12,000,000	$1,200,000	10.00%

Separating Real Estate and FF&E Value and Implied Capitalization Rates

Real Estate and FF&E Value			**$10,750,000**
Less FF&E Value	Cost New $1,250,000	Depreciation 40.0%	- 750,000
Real Estate Value			$10,000,000
NOI Attributable to RE & FF&E	$900,000		
Less Return On and Of FF&E	12 year Average Life & 8.0% Return	(1 / 12) + 8.0% = 16.33% $1,250,000 x 16.33%	- 204,125
NOI Attributable to Real Estate	($900,000 - $204,125)		$695,875
Implied Real Estate Capitalization Rate	**($695,875 ÷ $10,000,000)**		**6.95%**

Market Rent Allocation – Proprietary Earnings Separations Problems

- Value of the identifiable and quantifiable intangible assets could be greater than the total intangible value – example CON may have a market-demonstrated value greater than indicated intangible value.
- Does the rent include payment for non-realty assets (FF&E), CON, assumption of inherited assembled work force?
- Use of two or more allocation methods often results in huge differences of intangible value, creating credibility issues. However, multiple method that produce similar intangible value allocation create confidence.

- **Best to begin with "best knowns" or more supportable values and then proceed to least provable components.**

Interesting Characteristics of Senior Housing and SNF Leases

- **Long-term, absolute net, with predictable annual rental increases**
- **Tenant required to maintain minimum rent coverage ratio and net worth, before taking distributions**
- **If minimum coverage ratios are not achieved, then tenant is in default, and may be required to make additional rent deposit, withhold paying themselves their management fee, etc.**
- **End of lease terms that require tenant to:**
  - **Transfer operation to new operator (tenant), including workforce, certifications, licenses, patient records -- Operating Transfer Agreement – might be a separate agreement from the lease**
  - **Non compete agreement – restricting tenant from competing for residents, staff and referrals within a geographic (market) area, for a few years after termination.**
- **Do these operating restrictions suggest that the landlord may have intangible asset value, and might some of the rent actually represent payment for use of intangibles?**

Other Allocation Techniques – Implied Rent – Capitalize Marginal Rent Difference

	Unit SF	Monthly Rate	Annual
One Bedroom	600	$5,000	
Studio	400	$4,000	
Differences	200	$1,000	$12,000
Real Estate Operating Expenses ($10.00/SF x 200 SF)			- 2,000
Marginal NOI Difference			$10,000
Capitalized Marginal NOI ($10,000 ÷ 8.0%)			$125,000
Indicated Real Estate Value per Square Foot ($125,000 ÷ 8.0%)			$625.00

- The difference in monthly fees are entirely attributable to real estate and FF&E, since the resident will receive the same nursing and personal care, meals and use of amenities, regardless of the unit type occupied.
- How does the implied marginal, per-square-foot value compare to depreciated replacement costs, and various values indicated by sales comparison and income capitalization?

Other Allocation Techniques – Management Fee Methods

- While management fee methods are often applied to lodging properties, it is generally not used for hospitals, nursing facilities or senior housing.
- When used, the intangible value indication may be extremely different than more commonly used methods.
- Management fees in health care and senior housing properties have real expenses associated with the fee revenue. Thus, if management fees are capitalized, then only the profit portion should be considered.

Other Allocation Techniques

- Using sales of similarly constructed real estate as a proxy for realty value
- Start-up and operating deficits prior to stabilization and CON and license value segregated from the going-concern value – The problem arise when buyers and lenders often consider the startup costs as real estate value, which can be is mortgaged and can be incorporated in a new Ownership's depreciation basis. Some states allow CON sales, and that value can be "comp'd" and separated.
- For nursing facilities, the Medicaid capital rate can be used as a value proxy for the tangible assets, but is limited in use to just the Medicaid portion of the census mix, and is only valid when the state uses a facility-specific, cost-base reimbursement structure with frequent rate rebasing.

Other Allocation Techniques, Continued

- Cost accounting might be able to segregate revenues and operating expenses associated with activities relating to resident care and services which drive intangible value
- The income associated with the non-property activities could be converted to value
- There are many problems with this type of analysis, including:
  - How accurate is the cost accounting?
  - If the appraiser is performing the cost accounting, is this beyond competency?
  - If ownership provides this accounting, are there motivations associated with the cost accounting? Was it performed professionally, and attested.
  - The market doesn't use such techniques
  - Subject to considerable manipulation
  - There are much superior method available that should be considered first

Sales Comparison Approaches in Allocation

- Sale comparison typically involves sales where the going-concern was transacted, not just the real estate.
- Sale comparison can be an excellent approach to estimating the going concern, but as related to real estate, some reasonable steps are necessary to identify the real estate price. Often buyer and seller give no consideration of the separate asset value or price allocation, until tax considerations enter the scene, after the price is set.
- Reported, real-estate-only purchase prices to assessing authorities can understate the actual allocation used by the buyer for financing and for setting depreciation basis …. i.e. unless the price allocation is the same for all purposes, and agreed upon by all parties, there is some likelihood that the amount reported to the assessor is inconsistent with amounts used for financing and depreciation.

Allocation Conclusions

- It’s art – not science but impersonating a white-coat scientist might add more credibility.
- Be logical and proportionate
- Use methods that have best market support
- Use tests of reasonableness
  - How does the allocated real estate value compare to depreciated costs? Value per square foot, relative to general experience for the property type? Is there an implied capitalization for the real estate, and how does that look to general expectations?
- What may be used for property tax allocations in certain jurisdictions, may not be appropriate for non-property-tax assignments.