Unlocking potential value and savings:

How best to coordinate real estate and Facility transactions

Monetizing passive healthcare real estate assets helps physician-owners and creates opportunities to maximize their Practice's value

Merritt Healthcare Advisors
INVESTMENT BANKING

HREA HEALTHCARE REAL ESTATE ADVISORS

While in the process of working with a healthcare investment bank to seek a partner for their physician owned surgical hospital ("Hospital"), the Hospital was approached by a national healthcare real estate investor with an unsolicited offer to acquire the hospital real estate ("Property"). The physician-owners were initially pleased with the $50 million offer. After all, they never considered their facility's underlying real estate to be a stand-alone investment, and the price offered was many times more than the recent appraisal they received.

As reality began to sink in, the physician-owners realized there were many factors to consider that could impact both the Hospital and the Property. The concern was that they could be leaving considerable money on the table and failing to account for long-term operational control considerations that can impact the sale of both entities. To determine the Property's value, they asked the Hospital's banker to coordinate with a healthcare real estate specialist to discretely navigate a four-week marketing campaign to ensure they were maximizing the value of the Hospital. This process involved evaluating the various real estate options to better understand the impact that selling the Property would have on a potential sale of the Hospital's operations.

Engaging both advisors was well worth it - In the end, the physician-partners received several offers from a variety of private equity firms and REITs (Real Estate Investment Trusts), including a Hybrid SLB (hybrid sale-leaseback) option that allowed them to monetize the majority of the Property while continuing to own a minority ownership interest for long-term physician alignment. Through a coordinated process, the healthcare real estate specialists and investment bankers were able to better align the key deal points and various structure considerations to ensure that neither transaction would have the potential to undermine the other.

Ultimately, through a competitive bid process, the REIT that was originally offered on the Property was selected for $8 million more than their initial offer. In addition to garnering a price that was 16% higher, the Property's owners were also able to leverage the controlled marketing and bid process to obtain favorable terms that were not included in the original offer: For example, the transaction included (1) continued physician ownership in the Property for long-term practice alignment, (2) several options to extend the lease at fair market value, (3) the ability to renovate and expand the Hospital for future growth, and (4) addressed tax deferral through a reinvestment in the REIT's real estate portfolio known as an UPREIT — providing monthly dividends, diversification, and estate tax planning opportunities.

On the operations side of the Transaction, the Hospital's owners were able to secure a growth partner and professional manager who would help drive the Hospital's success moving forward. Importantly, the complexities of the Property's transaction were managed by the bankers and healthcare real estate specialists in a manner that only enhanced both transactions.

For physician-owners nationwide, this transaction underscores the importance of understanding the current marketplace and types of creative transaction structures that are unique to healthcare providers. In a world of uncertainty, ASCs, Hospitals, and MOBs (Medical Office Buildings) are proving to be an attractive investment where investors see stability, positive demographic fundamentals, and a lower correlation between healthcare expenditures and the broader economy. On the flip side, physician-owners of their medical practice or hospital operations are increasingly looking into how they can incorporate their real estate assets when considering a capital event or strategic partner for their healthcare operations. This evolution and mindset enables physicians to achieve the highest valuation of their businesses — and real estate — without compromising future growth.

CONTRIBUTING FACTORS: WHY ARE INVESTMENTS OCCURRING?

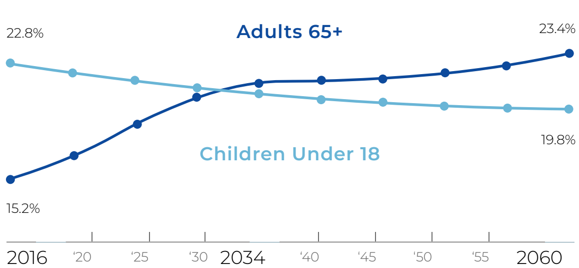
1. POPULATION DEMOGRAPHICS: AN AGING U.S. POPULATION

The population in the United States is aging rapidly, forcing changes in housing, the workplace, healthcare, and virtually every other aspect of the economy.[1] In fact, within the next two decades, Americans 65 years and older will outnumber children in this country for the first time since the U.S. Census Bureau began counting.[2]

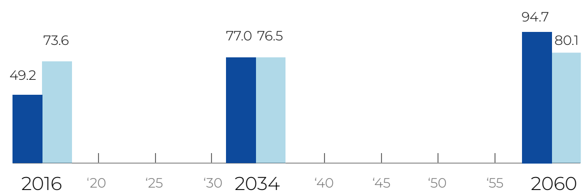
AN AGING AMERICA[3]

Seniors expected to outnumber minors by mid-2030s

PROJECTED PERCENTAGE OF POPULATION

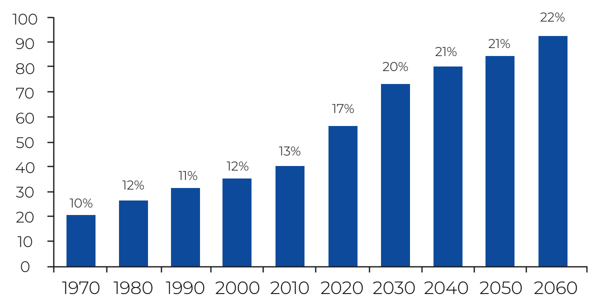


PROJECTED NUMBER (MILLIONS)



SILVER TSUNAMI[4]

Seniors' share of overall population expected to grow through 2060



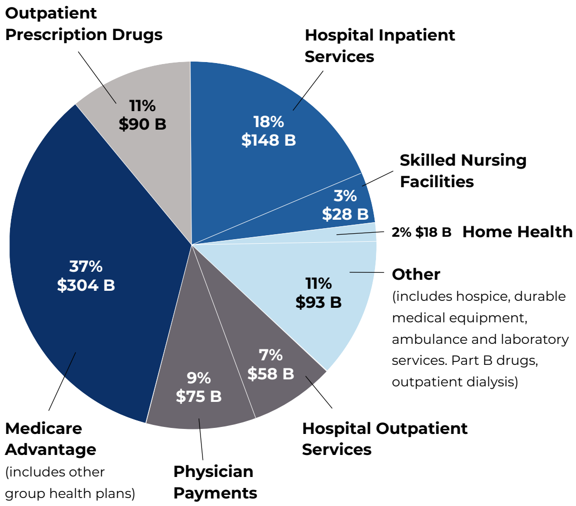
As the nation grows older in the coming decades, the demand for healthcare services is expected to increase dramatically, according to the U.S. Centers for Medicare & Medicaid Services (CMS). In particular, spending on Medicare is expected to peak — both as a share of the overall economy and the nation's total healthcare bill — within the next two decades, CMS data shows. The federal program currently insures about 54 million Americans and covers the costs of inpatient stays, outpatient care, prescriptions drugs and other common healthcare services, according to the Congressional Research Service.[5]

[1] https://www.census.gov/newsroom/stories/senior-citizens-day.html
[2] Ibid.
[3] Ibid.
[4] http://www.medpac.gov/docs/default-source/reports/chapter-2-the-next-generation-of-medicare-beneficiaries-june-2015-report-.pdf
[5] https://crsreports.congress.gov/product/pdf/IF/IF10885

MEDICARE SPENDING[6]

Federal program covers a wide range of healthcare services for seniors

TOTAL BENEFIT SPENDING = $814 BILLION



- **Part A:** Inpatient hospital services, skilled nursing care, hospice care and some home health services
- **Part A and/or B**
- **Part B:** Physician, laboratory, outpatient hospital and some home health services, physician-administered drugs, and durable medical equipment
- **Part C:** Medicare Advantage
- **Part D:** Optional outpatient prescription drug benefit

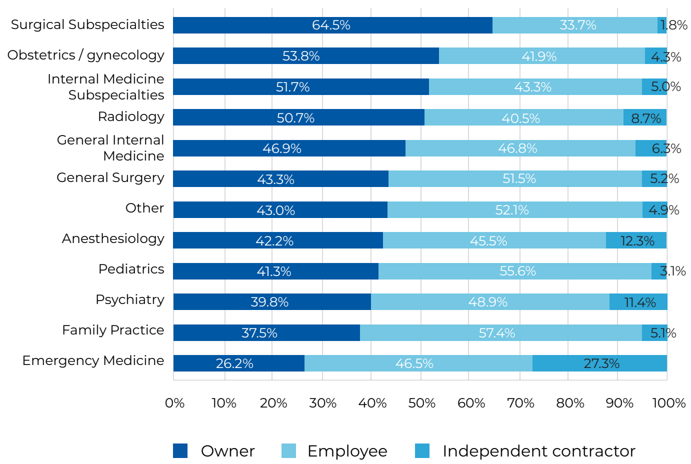
2. PRACTICE CONSOLIDATION: THE SHIFT TO PHYSICIAN EMPLOYMENT

Another macro trend impacting the healthcare industry, which is being driven by America's demographic shift towards an aged population amongst other factors, is the drive towards consolidation in healthcare services. Mergers and acquisitions are one of the primary ways this consolidation is achieved, though there are others. For example, in 2018, the percentage of physicians who were employed (47.4%) surpassed those who owned their Practices (45.9%). This is a startling statistic considering that as recently as 2012, 53.2% of physicians owned their Practices compared with 41.8% who were employed. In under a decade, the shift towards physicians being employed en masse — and further consolidation — has continued and accelerated. This trend is more pronounced in some specialties (e.g. psychiatry) when compared to others (e.g. surgical subspecialties like cardiovascular or orthopedic surgery). Furthermore, according to the AMA, this trend is even more pronounced amongst the youngest generation of physicians — aged 40 and younger — where the percentage of employed physicians was estimated at 69.8%. This shift in physician Practice ownership is another way consolidation is occurring without direct mergers or acquisitions activity taking place. This trend is not surprising, as the benefits of consolidation can be significant, including superior economies of scale, improved patient care and experience, and enhanced negotiating power with insurers and regulators.

[6] https://crsreports.congress.gov/product/pdf/IF/IF10885

A SHIFT IN PHYSICIAN PRACTICE OWNERSHIP[7]

For the first time, fewer physicians are owners than employees

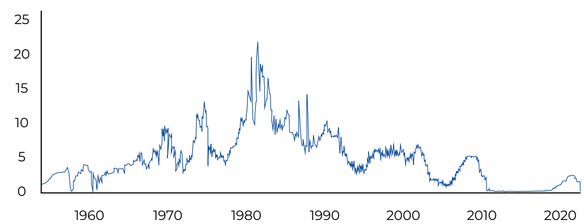


3. INEXPENSIVE CAPITAL AND THE SEARCH FOR HIGH-YIELD INVESTMENTS

Along with an aging population and a rapidly consolidating physician workforce, inexpensive capital — a direct byproduct of short-term borrowing rates set by the U.S. Federal Reserve Board — has pushed yield-hungry institutional investors into once obscure healthcare real estate and business investments over the past decade, generating unprecedented valuations for these properties and Practices. With many other types of investment opportunities drying up or leaving investors searching for higher yield, investors are willing to pay a premium for assets widely considered to be recession proof given the shifting demographics: For example, in many markets, MOBs and other healthcare real estate assets are now selling for as high as 17 times earnings.[8] This has been especially true during the COVID-19 pandemic where healthcare (along with tech) has emerged as a beacon of returns and a relatively safe space for investors to place their capital.

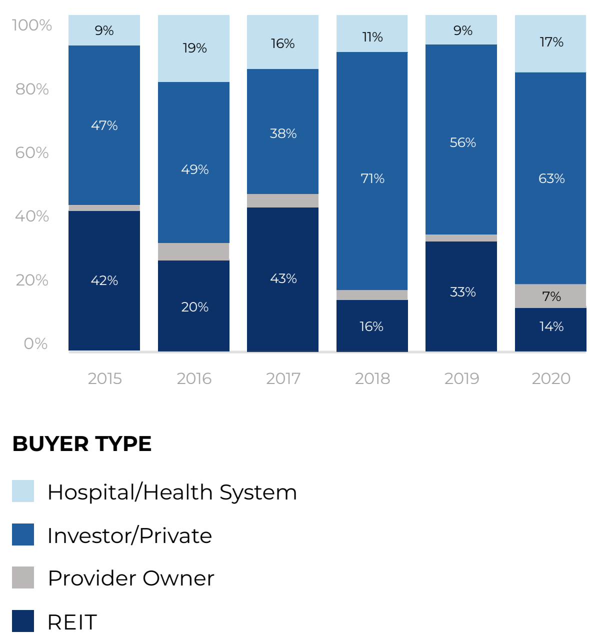
CHEAP MONEY[9]

Historically low federal funds rate is driving shift to healthcare-focused real estate



FEEDING FRENZY[10]

Private equity, REITs now involved in more than 3/4s of all MOB sales



[7] https://www.ama-assn.org/system/files/2019-07/prp-fewer-owners-benchmark-survey-2018.pdf
[8] https://www.healthcarerea.com
[9] https://fred.stlouisfed.org/series/DFF
[10] Revista

SLB: HAVING CAKE, EATING IT TOO

In many cases, a Sale-Leaseback ("SLB") offers the best of both worlds for physician MOB owners. The arrangement, in which physician-owners sell the majority of the property and retain continued physician-ownership in a tax-deferred manner, allows physician partners to monetize all or a portion of their real estate while leasing it back. In doing so, ownership can unlock up to 100% of their passive equity to invest in their core business, modernize facilities and equipment, expand an existing facility, build a new facility, reduce debt, make partner distributions, and maintain stability for their Practice in the future.

In a seller's market, owners can take chips off the table, retain control through a long-term lease with multiple renewal options, retain the ability to reinvest proceeds tax-deferred into a larger diversified medical office portfolio, and maintain physician alignment between the real estate and the Practice. This last point is paramount to the success of any transaction being considered by physicians for their Practice's operations. Real estate is a key factor healthcare operations investors consider when evaluating a potential investment opportunity. The real estate-practice relationship is most attractive when (1) there is a long-term lease in place (e.g. 12 year lease term with four 5-year options to extend), (2) the ownership is stable, and (3) there is common ownership between the healthcare operating business and the real estate entity. By pursuing a SLB strategy and ensuring an investment banker and healthcare real estate specialist coordinate their marketing strategies, physicians can have the best of both worlds when monetizing their assets.

SLB BENEFITS

Practice focus: Free up time to focus more on the practice of medicine and less on real estate ownership and management issues.

Improved economics: Unlike traditional debt financing with a loan-to-value ratio of 65 to 75%, a sale-leaseback unlocks 100% of the value.

Practice alignment: A SLB offers creative transaction structures that allow for continued physician-ownership in the real estate, providing lower buy-in for physician recruitment.

Portfolio reinvestment: SLBs also offer the ability to structure a tax-deferred transaction and diversified income through an UPREIT transaction.

Improved financial statements: The lease can be structured as an operating lease to reduce any impact on the balance sheet and loan covenants.

Operational control: Maintain long-term full operating control over the facility with the ability to modify the space as the business evolves.

Tax benefits: Rental payments are fully deductible, whereas a fully depreciated asset does not offer any tax benefits.

Reduce conflict: Eliminate challenges of having future physicians as owners in the practice but not in the real estate.

Interested in learning more about the healthcare real estate landscape? Let's talk.

Merritt Healthcare Advisors is the industry's leading advisory firm focused exclusively on representing owners of healthcare businesses, surgical facilities and practices that are considering a strategic transaction, whether it is partnering with another group, selling an interest in their business or growing their business through acquisitions. We offer:

- **M&A EXPERTISE:** We leverage our investment banking background, and as registered securities brokers, we have both the experience and qualifications required to manage this extremely complex process.
- **PRACTICE AND OUTPATIENT MEDICAL FACILITY FOCUS:** As the only investment bank with experience owning, developing and managing medical facilities, we add value to your business in ways others cannot. This insight enables us to effectively present your business to the market.
- **UNMATCHED EXPERIENCE:** Our leadership team has more than a century of combined experience working in healthcare and has successfully completed over $2b in transactions on behalf of our clients.
- **PROVEN PROCESS:** Positive outcomes are the result of a deep understanding of your business, transactional expertise, knowledge of the Seller and Buyer communities and the ability to most effectively package, market and manage the sales process.
- **EXCEPTIONAL RESULTS:** By eliminating risk for the owners, effectively positioning your organization, creating the most effective marketing piece, validating our projections and the integrity of the offering, creating the most competitive environment for your business and then understanding how to push potential buyers to agree to the terms of the deal we want, we make a significant impact on the financial and non-financial outcomes of your sale.

HREA | Healthcare Real Estate Advisors (HREA) is a national leader in advising healthcare providers and real estate investors with various monetization strategies, including disposition, debt & equity recapitalization, and tax-deferred structures, such as the §1031 Exchange or UPREIT. In addition, HREA's capabilities also include providing health systems and physician groups with 100% non-recourse financing for new development and expansion, as well as monetizing surplus and non-essential real estate assets. We offer:

- **SPECIALIZATION:** Our relationships in the healthcare industry consistently garner 20%+ additional sale proceeds over fair market value and prevent costly mistakes through a well-negotiated lease.
- **EXPERIENCE:** Our expertise ensures that our client maintains long-term control of the building with numerous control provisions that allow for growth, including no personal guaranties, multiple lease extension options, and the ability to modify or expand the building.
- **FIDUCIARY RESPONSIBILITY:** We are fierce advocates for our client, the owner of the property. Many investment groups will attempt to approach owners directly in order to take advantage of a lack of market knowledge.
- **MARKET INSIGHTS:** HREA is a member of Revista, the leading healthcare real estate data platform that provides information on local area dynamics, including supply/demand for various healthcare provider specialties, as well as admissions and revenue for all ASCs and hospitals.

Contact Merritt

Matt Searles
Partner
msearles@merrittadvisory.com
(914) 262-1217

Connecticut Office
63 Copps Hill, 22A
Ridgefield, CT 06877
(914) 556-6266

West Coast Office
521 Bachman Ave
Los Gatos, CA 95030

merrittadvisory.com

Contact HREA

Christopher Stai
Managing Director, Raleigh
cstai@healthcareREA.com

Joshua Rees
Director, San Diego
jrees@healthcareREA.com

Steve Reeves
Director, Cape Coral
sreeves@healthcareREA.com

San Diego, CA Office
(858) 312-0657

Cape Coral, FL Office
(717) 856-4496

Raleigh, NC Office
(480) 433-3494

healthcareREA.com

Merritt Healthcare Advisors
INVESTMENT BANKING

HREA HEALTHCARE
REAL ESTATE ADVISORS