Assessing Senior Housing and Skilled Nursing Facility Real Estate

Presented by James K. Tellatin, MAI

Offices in
Greater Boston, Nashville, St. Louis, Kansas City, Santa Fe and Portland, Oregon
636.534.6919
jim@tellatin.com   www.tellatin.com
James K. Tellatin, MAI

• James K. Tellatin, MAI
• Member of AI since 1984
• More than 10,000 senior housing and nursing facility appraisal and market study engagement
• Author of The Appraisal of Nursing Facilities and several Appraisal Journal articles
• Helped develop appraisal and market study guidelines for HUD’s Lean program
• Considerable REIT, bank and litigation assignment experience
• Former chair of Missouri’s CON program
• Founding principal in a company that develops, owns and operates post-acute rehabilitation centers, skilled nursing, independent living, assisted living and memory care Property, in addition to home healthcare, with more than $125,000,000 in assets and 700 employees.
Going-concern Versus Real Estate Value

- Senior housing properties are real-estate intensive going concerns.
- Assets include real estate, tangible personal property (FF&E) and intangible personal property.
- These assets are inextricably entwined.
- Separating value continues to be controversial, at best.
- The whole (going-concern value) may be greater than the sum of the parts.
- Should the excess value (value in excess of the parts) be considered real estate or intangible or somehow allocated back to the various parts?
Allocation of Value – When Does Price Allocation Really Matter?

• Buyers and sellers typically DO NOT BUILD UP a price from the various components, but rather view **value in totality**.
• Allocations are typical made after price or total value is set
• Allocations are important for the following:
  • Property tax assessing
  • **Distribution of sale proceeds** when the sale involves multiple entities owning proportions of the— ProCo. OpCo, ManCo entities of the going concern.
  • Extraction of real estate value to set **rent** for the real estate
  • **Bank regulators** are beginning to ask lenders to set interest rates and amortization terms according to the assets’ contribution to going-concern value.
  • Establishing **basis for depreciation** and for calculating potential depreciation recapture
  • Others?
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 Appraised

• Going concern valuations will typical 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.

• Question: In New Hampshire, does real estate tax law require valuations to be set under fee simple ownership, or does case law permit valuations to consider leased fee interest?
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.

• Assets 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

- Most appraisal engagements and sales transactions exclude current assets (working capital, cash, accounts receivable, etc.) from the purchase price consideration.
- Seller liabilities typically stay with the seller.
- Buyers or successors typically have indemnity for the seller’s liabilities, to the extent possible.
- If a sale transaction or the assets being appraised vary from these issues, then there’s extra work involved.
- Developing assumptions to cover these possibilities is recommended.
Ownership Structures

• Multiple entities often control the total assets of the business.
• There are a number of solid reasons to split the ownership, including minimizing liability, distributing ownership by contribution monetary and expertise to the various entities are two significant considerations.
• Sometimes the partners or shareholders ownership percentages will differ among the various ownership entities.
• Assumptions may be necessary to match the assets appraised with the actual or intended ownership in the appraisal.
• 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.
Typical Ownership Structure Diagramed
Multiple Property Ownership Structure
Don’t Double Count

• It is possible that assignments might ask that the appraiser value something less or more than the typically considered in the going-concern valuation or a real estate valuation.

• 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 a hand into the business.

• As an example, in an 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 off the property.
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.
• On rare occasions, a real-estate-only value may be required to satisfy the terms of a purchase option during or at the termination of a lease or a long-term management agreement.
“Researchers will discover cures for cancer before appraisers, accountants and attorneys resolve the allocation of a going concern value -- One is science the other is art.” Jim Tellatin

“Let me not hear facts figures and logic, Fain I would hear lore, legend and magic” --Donovan, *Roots of Oak*, 1969
Exploring Popular Allocation Techniques

There are a number of approaches for allocation of the going-concern value for these property types.

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**
• HUD & REIT *(Market Rent)* Earnings Residual Methods
• Different Use, but Similar Constructed Real-estate Only Sales
• Others?
Allocation Methods for Senior Housing and Long-term Care

• Top down – starting with going-concern value – consistent with market pricing
  • **Parse the income** – using market rent or lease coverage ratios, comparing going-concern NOI or EBITDAR to market rent (based on recent lease transactions) the tenant or operator’s earnings (NOI less market rent) is capitalized into a value indication and deducted from the going-concern value, with the residual value being the value of the leased property assets, presumably realty and possible FF&E. Removal of the FF&E value may be a simple deduction, typically using depreciated cost, or even the assessor’s personal property value
  • Separating the “**proprietary earnings** using the former **HUD MAP** (Multifamily Accelerating Processing) Guidelines continue to be cited as a basis for income separation, with assisted living seeing no less than 10% in NOI removed from total NOI and no less than 15% pulled from SNF NOI. (Note – HUD no longer requires separation of NOI or value, as MAP was replaced with Lean more than five years ago, and Lean sets the maximum loan amount to a percentage of going-concern value.)
Cost Approach in Allocation

- Cost approach may prove effective if the state deems this is a viable approach to value, and that the cost new and depreciation are fairly easily measured.
  - Problem: Depreciation is difficult to measure and extracting depreciation from going-concern sales is messy since the first step of extracting non-real estate value is often speculative, and followed by a further set of estimates and calculations on the real estate price.
  - Most assessors and appraisers under estimate the contribution (cost) for indirect and other soft costs.

- **Debate Question**: Should the start-up, absorption cost or initial operating deficits be included as real estate value or are these costs part of intangible value -- or some of each?

- **Tellatin Opinion** – Yes, start-up cost and developer profits are at part of real estate value!
Cost Approach

• What are the real estate costs in developing senior housing property?
• Direct cost (construction contract)
• Design and planning (architects, engineers, zoning and planning, special consultants)
• Financial cost for construction and beyond to stabilization
• All cost incurred directly by developer
• Start-up, absorption and operating deficits incurred to reach stabilization
• Developer profits
• All of these cost are recognized by the market – lenders, equity investors and buyers.
Cost Approach, Continued

• Is the cost approach relevant? Yes and no!

• 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

• Very useful in determining the economic feasibility for proposed development, as total costs are compared to value and/or return on costs
Cost Approach – Direct and Indirect Cost – Per 14th Edition The Appraisal of Real Estate

• **Direct costs** are expenditures for the labor and materials used in the construction of improvements; also called hard costs.

• **Indirect costs** are expenditures or allowances for items other than labor and materials that are necessary for construction, but are not typically part of the construction contract. Indirect costs may include:
  • administrative costs,
  • professional fees, financing
  • costs and the interest
  • paid on construction loans,
  • taxes and the builder’s or developer’s all-risk insurance during construction, and marketing, sales, and lease-up costs incurred to achieve occupancy or sale - not include in Marshall Valuation.
  • Also called soft costs.
Cost Approach – Measuring Value of the Cost of Stabilization and Developer Profit

• How to calculated stabilization and developer profit costs
• Residual process:
• Sale Price of new, just stabilized senior housing property
• Less all direct and indirect costs, adjusted for cost trending and value changes over the development time span
• Remainder equals combined “value” of cost of stabilization and developer profits.
• Typical stabilization cost can run over 10% of direct and indirect costs while developer profits are typically 10 to 20 percent of the total cost to stabilization.
• The buyer will reset the improvement cost basis from the seller’s “hard” cost to the purchase price, less land value, FF&E value (deprecated cost usually), and maybe some intangible value. The buyer’s price allocation will recognize a substantial amount of stabilization and developer profit as real estate and will finance and depreciate these soft costs, and will not identify the seller’s costs as separate allocations.
Contributions of the Entrepreneur, Developer, and Contractor, per 14th Edition of The Appraisal of Real Estate

Reward and compensation received (or anticipated) by an entrepreneur, appraisers may choose to further distinguish between the concepts of project profit, entrepreneurial profit, developer’s profit, and contractor’s profit:

- **Project profit** is the total amount of *reward for entrepreneurial coordination and risk*.
- **Entrepreneurial profit** refers to the portion of project profit attributable to the efforts of the entrepreneur, distinct from the efforts of the developer, if one is present. In projects in which the entrepreneur and the developer are one and the same, the entrepreneurial profit is equivalent to total project profit.
- **Developer’s profit** represents compensation for the time, energy, and expertise of an individual other than the original entrepreneur—usually, in large projects, the person responsible for managing the overall development process.
- **Contractor’s profit** (including subcontractors’ fees) is essentially a portion of the project’s overhead and is not usually reflected in the entrepreneurial reward.

The measure of project profit used in cost approach calculations usually includes both a developer’s profit and an entrepreneurial profit. The profit a contractor receives is often already reflected in the fee a contractor charges and would therefore be included in the direct costs.
## Cost Approach Example – Estimating Costs

<table>
<thead>
<tr>
<th>Cost Component</th>
<th>RCN/SF</th>
<th>Area</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building (Direct Cost - per M&amp;S)</td>
<td>$175.00</td>
<td>40,000</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Site Improvements</td>
<td></td>
<td></td>
<td>400,000</td>
</tr>
<tr>
<td>Subject Total</td>
<td></td>
<td></td>
<td>$7,400,000</td>
</tr>
<tr>
<td>Developer Fee</td>
<td></td>
<td></td>
<td>$370,000</td>
</tr>
<tr>
<td>Other Soft Cost, Not Included in M&amp;S</td>
<td></td>
<td></td>
<td>250,000</td>
</tr>
<tr>
<td>Cost to Achieve Stabilization (Absorption/Lease-up)</td>
<td></td>
<td></td>
<td>750,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
<td></td>
<td>$8,770,000</td>
</tr>
<tr>
<td>Developer Profit/Incentive, Related to Improvement</td>
<td></td>
<td></td>
<td>$1,315,500</td>
</tr>
<tr>
<td>Total RCN (Cost) Attributable to Improvements</td>
<td></td>
<td></td>
<td>$10,085,500</td>
</tr>
<tr>
<td>Description</td>
<td>Value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------------</td>
<td>----------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total RCN (Cost) Attributable to Improvements</td>
<td>$10,085,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less Depreciation -- Age-Life</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effective Age</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Life</td>
<td>50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation, Before Consideration of External Obsolescence</td>
<td>20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indicated Improvement Value, Rounded)</td>
<td>$8,070,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plus Land Value</td>
<td>$430,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Real Estate Value</td>
<td>$8,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciated FF&amp;E RCN (generally acceptable approach for FF&amp;E value)</td>
<td>$500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Tangible Asset Value</td>
<td>$9,000,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## The Cost Approach from the Other Side of the Fence

### Base Costs

<table>
<thead>
<tr>
<th>Unit Type</th>
<th>Cost</th>
<th>Quantity</th>
<th>Multiplier</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Base Cost</td>
<td>$110.37</td>
<td>37,556</td>
<td>1.132</td>
<td>$4,691,765</td>
</tr>
<tr>
<td>Building Sprinklers</td>
<td>$2.50</td>
<td>37,556</td>
<td>1.132</td>
<td>$106,274</td>
</tr>
<tr>
<td><strong>Total Building Improvement Costs</strong></td>
<td></td>
<td></td>
<td></td>
<td>$4,798,039</td>
</tr>
</tbody>
</table>

### SITE COSTS

<table>
<thead>
<tr>
<th>Item</th>
<th>Unit Type</th>
<th>Cost</th>
<th>Quantity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Site Preparation</td>
<td>Sq. Ft.</td>
<td>$0.35</td>
<td>52,933</td>
<td>$18,526</td>
</tr>
<tr>
<td>Landscaping</td>
<td>Sq. Ft.</td>
<td>$1.25</td>
<td>35,826</td>
<td>$44,782</td>
</tr>
<tr>
<td>Signs</td>
<td>Per Unit</td>
<td>$2,500</td>
<td>1</td>
<td>$2,500</td>
</tr>
<tr>
<td>Concrete Walkways</td>
<td>Sq. Ft.</td>
<td>$6.00</td>
<td>17,107</td>
<td>$102,642</td>
</tr>
<tr>
<td>Parking Area</td>
<td>Per Unit</td>
<td>$3,375</td>
<td>30</td>
<td>$101,250</td>
</tr>
<tr>
<td><strong>Total Site Improvement Costs</strong></td>
<td></td>
<td></td>
<td></td>
<td>$269,700</td>
</tr>
</tbody>
</table>

### FF&E

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost Basis</th>
<th>Cost</th>
<th>Quantity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total FF&amp;E Costs</strong></td>
<td>Per Bed</td>
<td>$7,500</td>
<td>74</td>
<td>$555,000</td>
</tr>
</tbody>
</table>

### TOTAL REPLACEMENT COST NEW (RCN)

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost Basis</th>
<th>Cost</th>
<th>Quantity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subtotal: Building, Site Imp., &amp; FF&amp;E</td>
<td></td>
<td></td>
<td></td>
<td>$5,622,739</td>
</tr>
<tr>
<td>Indirect Costs @ 15.0%</td>
<td></td>
<td></td>
<td></td>
<td>$843,411</td>
</tr>
<tr>
<td>Subtotal: Building, Site Imp., FF&amp;E &amp; Indirect Costs</td>
<td></td>
<td></td>
<td></td>
<td>$6,466,150</td>
</tr>
<tr>
<td>Premarketing Costs @ $15,000 Per Bed</td>
<td></td>
<td></td>
<td></td>
<td>$1,110,000</td>
</tr>
<tr>
<td><strong>Total Costs</strong></td>
<td></td>
<td></td>
<td></td>
<td>$7,576,150</td>
</tr>
<tr>
<td>Entrepreneurial Incentive (Including Land) @ 20.0%</td>
<td></td>
<td></td>
<td></td>
<td>$1,741,230</td>
</tr>
<tr>
<td><strong>Replacement Cost New (RCN) Excluding Land</strong></td>
<td></td>
<td></td>
<td></td>
<td>$9,317,380</td>
</tr>
<tr>
<td>Price Per Square Foot GBA</td>
<td></td>
<td></td>
<td></td>
<td>$248.09</td>
</tr>
</tbody>
</table>
## Typical Senior Housing Building Costs

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Mid Level</th>
<th>High Level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Independent Living</td>
<td>$128</td>
<td>$165</td>
</tr>
<tr>
<td>Cottages</td>
<td>$120</td>
<td>$139</td>
</tr>
<tr>
<td>Assisted Living</td>
<td>$156</td>
<td>$207</td>
</tr>
<tr>
<td>Skilled Nursing</td>
<td>$188</td>
<td>$222</td>
</tr>
<tr>
<td>IL Commons</td>
<td>$226</td>
<td>$275</td>
</tr>
<tr>
<td>Under Building Parking</td>
<td>$75</td>
<td>$110</td>
</tr>
<tr>
<td>Sitework</td>
<td>Excluded</td>
<td></td>
</tr>
</tbody>
</table>

### Notes/Definitions
- Component cost include full burden of general conditions, insurance, tax, performance bond & fee, **but do not include site costs.**
- Cost based on a national average with a city index of 1.00; the Means index for a specific city should be used to adjust the data to that particular city.
- Mid-level projects are generally wood-framed construction with standard amenities and finishes, and typically target the more moderate income seniors.
- High-level projects generally are of steel or concrete construction with high-end luxury amenities and finishes and typically target the higher income senior.
Putting the Cost Approach to Allocation to Use – Intangible Residual

• 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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Going Concern Value</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Less Land Value</td>
<td>-430,000</td>
</tr>
<tr>
<td>Less Improvement Value (Depreciated Cost)</td>
<td>-8,070,000</td>
</tr>
<tr>
<td>Less FF&amp;E Value (Depreciated Cost)</td>
<td>-500,000</td>
</tr>
<tr>
<td>Residual Value -- Intangible Value</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>
Sales Comparison Approach in Allocation

• Sale comparison typically involves sales where the going-concern is 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.
Income Approach in Allocation

- Revenues and expenses of senior housing property are generated from real estate and personal property assets.
- Revenues and expense can not be separated between amounts attributable to real estate and amounts associated with personal property – they are inextricably entwined.
- The market does not price or set monthly service fees for senior housing by actually separating the real estate costs and profits from the “service” costs associated with intangible assets.
- Often there is identifiable revenue associated with “additional services” such as therapy and extra care, that is not included in the base monthly fee.
- **Question: Are charges for additional care, meals, etc. exclusively non-real estate?**
- **Tellatin Answer – No**, the real estate improvements are typically designed to accommodate the additional space necessary to provide for the additional staff and physical needs. And, certainly, other than the tax payer telling the assessor that these revenues should be excluded from any measure of real estate value, the tax payer is representing that these additional revenues are tied into the real estate, if that question arises from lenders, investors and the IRS.
Developing Market Rent (and Value) of the Real Estate – Market Rent Allocation Technique

• REITS and other investors may create or acquire senior housing and SNF property through sale-leaseback type transactions

• Many real estate developers will develop a property for a tenant and serve as the landlord – lease rates on new construction typically range from 8.5% to 10.0% for SNFs and 6.5% to 8.0% for senior housing based on development cost. Similar “lease rates” apply to properties involved in sale-leaseback transactions.

• In these long-term leases, tenant will operate the property, typically paying the landlord a fixed rent, with regular, prescribed rental increases.

• These leases are typical set for a minimum of 10 years, and often allow the tenant extensions or renewals, and occasionally purchase options.

• Leases are typically absolute net leases, and increasingly, the leases will require the tenant to fund a capital reserve account to replace worn-out assets.
Market Rent – Value Allocation

• Increasingly, leases require tenants to maintain minimum NOI-to-rent coverage ratios -- typically 1.1 or more for ILF, 1.25 or more for SNF.

• Failure to achieve these minimums may require the tenant to increase their deposit, lease guarantee, and/or reduce their management fee to achieve the prescribed coverage.

• Occasionally a new lease with an existing tenant might include other price or rent considerations that allow the landlord to rework aspects of existing leases with the same tenant. Therefore, pricing of the newest transaction may be skewed and not representative of the market.
Problems with Rent Coverage and HUD Proprietary Earnings Separations

• Value of the identifiable and quantifiable intangible assets could be greater than the total intangible value – example CON may have a market-demonstrated 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.
• Two sides may use different allocation methods, to which most of the value difference can be traced.

• Best to begin with “best knowns” or more supportable values and then proceed to least provable components.
Income Approach as Applied to Senior Housing and SNFs Using Market Rent Allocation

• The appraiser should measure the operators NOI against the rent to determine the operating strength of the tenant.

• Development of a capitalization rate for rented senior housing property can be readily achieved by reviewing recent transactions announced by public REITs as they report their individual transactions after closing or within quarterly reports.

• Note that the published information will often lack the critical details, such as coverage requirements, guarantees, rental increases, etc.

• In addition to the quality of the physical plant, and location, the capitalization rate is significantly impacted by the tenant credit, required coverage ratios, prescribed rental increases, participating or shared excess cash flow, non-compete agreements, operating transfer conditions at the lease termination, requirements for maintaining liability insurance, and other unique conditions.

• DCF and/or IRR analyses may also be employed, but usually doesn’t provide further significance.

• By definition of the NOI-to-rent ratio, capitalization rates for rented senior housing property are lower than going-concern capitalization rates for comparable property.
REIT (Market Rent) Approach – Estimated the Intangible Value in a Top-down Process

\[
\begin{align*}
\text{EBITDAR} & \quad $1,200,000 \\
\text{Market EBITDAR-to-rent Ratio} & \quad 1.40 \\
\text{Market rent} & \quad -\ 857,143 \\
\text{Tenant “Profit”} & \quad 342,857 \\
\text{Capitalized Value of Tenant’s Interest (25.0%)} & \quad $1,370,000
\end{align*}
\]

Is the tenant’s interest, a leasehold interest?
Top-down Allocation Using REIT – Market Rent Approach

• Going Concern Value:
  • Total NOI $ 1,200,000
  • Going-concern Capitalization Rate 12.0%
  • Indicated Going-concern Value $10,000,000
  • Less FF&E Value (Depreciated Cost) - 500,000
  • Less Intangible Value (Previous Slide) - 1,370,000
  • Real Estate Value $ 8,130,000
Residual Analysis - Intangible Asset Value and Implied Capitalization Rate for Intangible Assets

<table>
<thead>
<tr>
<th>Allocated Value</th>
<th>Return</th>
<th>NOI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Value of the Going Concern</td>
<td>$10,000,000</td>
<td></td>
</tr>
<tr>
<td>Total NOI</td>
<td>12.00%</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Less Return to Real Estate Improvements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocated Improvement Value</td>
<td>8,070,000</td>
<td></td>
</tr>
<tr>
<td>Return on the Real Estate Improvements</td>
<td>7.75%</td>
<td></td>
</tr>
<tr>
<td>Recapture of the Improvements (50-year Life)</td>
<td>2.00%</td>
<td></td>
</tr>
<tr>
<td>Total Return on and of the Improvements</td>
<td>9.75%</td>
<td>786,825</td>
</tr>
<tr>
<td>Land Value</td>
<td>430,000</td>
<td></td>
</tr>
<tr>
<td>Less Return on the Land Value</td>
<td>7.75%</td>
<td>33,325</td>
</tr>
<tr>
<td>Less Return On and Of the FF&amp;E</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FF&amp;E Value</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Return On the FF&amp;E</td>
<td>7.75%</td>
<td></td>
</tr>
<tr>
<td>Recapture of the FF&amp;E 10-year Life</td>
<td>10.00%</td>
<td></td>
</tr>
<tr>
<td>Total Return to FF&amp;E</td>
<td>17.75%</td>
<td>88,750</td>
</tr>
<tr>
<td>Allocated Value to the Intangible Assets</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Return to Intangible Assets</td>
<td>29.11%</td>
<td>$291,100</td>
</tr>
</tbody>
</table>
Bottom Up Allocation

- Capitalized value of the real estate rent – requires use of comparable property, real estate-only lease data and rent estimation, and the difference between the going concern value and the real estate value represents personal property value.

- Problems:
  - Realty value could exceed going-concern value?
  - Rent could include payments for the use of non-real estate assets.

- Apply cost approach to tangible assets and the quantifiable personal property assets -- remainder equals intangibles.

- Other top-down and top-up methods or approaches are used occasionally.
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 the a new ownership’s depreciation basis. Some states allow CON sales, and that value can be comp’ed 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.
Skilled Nursing Facility Unique Issues

• Medicare and Medicaid reimbursements and impact on value
• Supply controls – Certificate of Need and bed licensure moratoriums
  • Until July 2016, New Hampshire had a certificate of need (CON) law controlling supply of skilled nursing facilities, hospitals, other medical facility and costly medical equipment.
  • With the elimination of CON, expect to see more supply (development) of medical and long-term care properties.
Skilled Nursing (SNF) -- Medicaid Property Tax Reimbursement Pass Through

- State Medicaid reimbursements schemes often allow property taxes to be directly passed through, i.e. if the real estate taxes are $100,000 annually, and the SNF census is comprised of entirely Medicaid, then the state may reimburse the SNF the entire $100,000. If the taxes go up, so does the reimbursement and likewise if tax go down, so does reimbursement for taxes. Is such reimbursement structures, taxes have no impact on NOI. However, taxes will directly impact NOI derived from Medicare and private-pay patients.

- Should property tax refunds resulting from prior-year over-payment settlements be returned to the state’s Medicaid program?
SNF Medicaid Capital Reimbursement

- Medicaid capital reimbursement pays for cost of the use of capital – interest, depreciation, rent and return on equity for the use of the real estate and FF&E.
- Each state has developed its own capital reimbursement scheme.
- Many use a fair rental system, using flat per-diem amounts, or vary the rent according to building age or depreciated costs.
- Other states pay interest and depreciation using the original cost of the land, improvements and FF&E.
- The allowable capital cost basis or the rent could be an indicator of the property assessed value – at least for the Medicaid portion of the SNF census.

**Debate:** Should the Medicaid portion of the nursing facility have parity between the recognized capital cost basis and the real estate assessment?
Assessing CCRC (Continuing Care Retirement Communities) Real Estate with Entrance Fee

• There are generally two types of entrance fees within CCRC structures:
  • Refundable entrance fees
  • Non-refundable, which part or all of the entrance fee is amortized over a specified period

• Entrance fees are essentially pre-paid rent or function as interest fee loans from the residents

• Substantial portions of the entrance fees are used to pay down mortgage debt or bond financing.

• Essentially the ownership is transferring debt from a commercial source to private individuals through the residency agreements
Step to Developing an Income Approach

• Supply and Demand
  • Identifying new supply
  • Market saturation – demand estimate tool

• Develop Occupancy Forecast
  • Use historical, consider new supply, compare to competitive properties

• Payor Mix – Develop estimated for Medicare, Medicaid, private-pay and managed care-insured patients

• Revenue – Private-pay and Government Reimbursements

• Operating Expenses

• Capitalization Rate Issues
Steps in Revenue Estimating

• Establish the competitive market area, using common sense, opinions of the management of the subject and competitors, and, if available, resident origin data.

• Inventory current and future supply and demand

• Estimate future supply and demand and the impact on occupancy, payor mix and rates

• Use of market saturation analysis to measure imbalances between supply and demand – impacting occupancy, mix, rates and if necessary absorption

• Comparing subject to “rent comparables” in developing market rates, occupancy and mix for the subject
Demand Analysis

• Demand becomes more inelastic as care needs increase – Independent living is more optional and suffers more census deterioration during recessions than skilled nursing.

• Forecasted population change in the 75-plus-age cohort should be given particular attention in estimating future demand, but consideration to the other age cohort also warrants consideration.

• Refinements to population data may include looking at household income levels, home ownership and values, activities in daily living
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.
Identifying Existing Supply

• Existing supply should be easy to identify
• State licensing departments provide a comprehensive list of nursing and assisted living properties, and often will have census and other useful information.
• 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 and Considering Future Supply - Competition

• Changes in supply have profound impact on occupancy levels, rates and payor mix for existing properties.

• This even more critical with the elimination of New Hampshire’s Certificate of Need Program – Expect to see development of more skilled nursing, and possibly specialty hospitals

• New supply can identified from:
  • Interviews with the subject’s management and the competitors – don’t be afraid to ask – it might be a nice opening question when interviewing competitors
  • Researching local building permits and zoning -- remember that those interviewed may not understand the importance of being complete and/or simply recall all the project that come through their offices
  • Published construction surveys such as CBRE Pipeline
  • Industry newsletters
  • State certificate of need applications and recent approvals (SNF and ALF in a few states)
  • Licensing application made to state departments of health – typically the licensing process begins with the state approving building plans prior to construction
  • Can you think of other sources? Please share your ideas.
Example: How Supply and Demand Are Used to Forecast Occupancy When Supply and Demand Are Changing

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Next Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Supply</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>New Supply</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Total Supply</td>
<td>800</td>
<td>900</td>
</tr>
<tr>
<td>Current Demand</td>
<td>775</td>
<td>775</td>
</tr>
<tr>
<td>New Demand Capture in Market</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>(from demand growth and displaced and unmet demand)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Demand</td>
<td>775</td>
<td>825</td>
</tr>
<tr>
<td>Market Occupancy Rate</td>
<td>96.9%</td>
<td>91.7%</td>
</tr>
<tr>
<td>Subject Capacity</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Subject Fair Market Share (subject capacity / total market capacity)</td>
<td>12.5%</td>
<td>11.1%</td>
</tr>
<tr>
<td>Subject Occupancy</td>
<td>90.0%</td>
<td>???</td>
</tr>
</tbody>
</table>
Revenue Forecasting

• Skilled nursing and senior housing revenue forecasting have very different processes
• SNF involve government reimbursements
• Independent living and assisted often involve only private pay – market-set rates

• We start with SNF revenue forecasting – this is complex
Payor Mix in SNFs and Assisted Living

- Skilled nursing and assisted living facility revenues, earnings and value are especially sensitive to payor mix. In the pecking order, nursing facilities achieve the highest earnings from Medicare patients, followed by private-pay patients. Medicaid patients, which typically represent the majority of SNF patients are significantly less profitable.

- Given that Medicare-occupied beds may be valued at more than $300,000 per bed for new state-of-the art SNFs, while 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.

- According to the American Health Care Association, the 2011 national SNF payor mix was:
  - Medicare 14.2%
  - Medicaid 63.6%
  - Private and Other 22.2%
Estimating Payor Mix - SNF

- Actual historical mix of the subject is often the best guide provided the supply and demand conditions are expected to be fairly steady.
- Comparison to competitive facilities is important measurement
- A reassessment of the subject’s payor mix become 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.
- The Medicare and private-pay patients are increasingly demanding private patient rooms with full bathroom.
- Three and four-bed wards are rapidly becoming obsolete, even for Medicaid patients.
SNF Revenue Forecasting

• Briefly Medicaid and Medicare rate development can be highly complex.

• Generally for Medicare, the historical average rate can be relied upon for a stable, well managed SNF.

• Medicaid rate forecasting is more complex, especially in states where reimbursements are facility-specific, cost-based, and subject to frequent rebasing.

• Private-pay rates can be developed by comparing the historical rates and current rates of the subject to current rates for the competition.
### SNF Revenue Forecast Example

**Table P-1 Estimated Income and Expenses of the Subject -- Year One of the Forecast**

**Calculation of Annual Resident Days:**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Beds</td>
<td>120</td>
</tr>
<tr>
<td>Potential Resident Days</td>
<td>43,800</td>
</tr>
<tr>
<td>Occupancy Rate</td>
<td>77.7%</td>
</tr>
<tr>
<td>Estimated Resident Days</td>
<td>34,014</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>Days</th>
<th>Census Mix</th>
<th>Daily Rates</th>
<th>Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private, VA &amp; Other</td>
<td>2,762</td>
<td>8.1%</td>
<td>$171.00</td>
<td>$472,236</td>
</tr>
<tr>
<td>Medicare</td>
<td>1,920</td>
<td>5.6%</td>
<td>503.79</td>
<td>967,146</td>
</tr>
<tr>
<td>Managed Care</td>
<td>1,361</td>
<td>4.0%</td>
<td>375.00</td>
<td>510,205</td>
</tr>
<tr>
<td>Medicaid</td>
<td>27,972</td>
<td>82.2%</td>
<td>127.53</td>
<td>3,567,145</td>
</tr>
<tr>
<td>Assisted Living</td>
<td>0</td>
<td>0.0%</td>
<td>0.00</td>
<td>-</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>34,014</td>
<td>100.0%</td>
<td><strong>$162.19</strong></td>
<td><strong>$5,516,733</strong></td>
</tr>
</tbody>
</table>

| Ancillary (Medicare Part B and Other) | 34,014 | $7.00 | $238,096 |
| Other Revenues                | 34,014 | 0.25  | 8,503    |
| Bad Debt                      | 34,014 | (1.00)| (34,014) |

**Total Effective Gross Revenue**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$168.44</td>
</tr>
</tbody>
</table>
Medicare Insurance – High Level of Coverage

• Medicare is a federal entitlement program that provides medical insurance coverage to most U.S. citizens age 65 or older.

• Medicare is also available to some people with certain disabilities, and diseases.

• Medicare is not a revenue source for assisted living and independent living, but is essential for skilled nursing

• The program has four benefit components (Parts A, B, C, and D).
Medicare Program Description

• 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.
SNF – Medicare Reimbursement

• Prospective Payment System
• All operators receive the same rate, adjusted for local wage difference and care needs (resource utilization groups – RUGs)
• The rate is made up of three of the four components below, 1, 4 and either 2 or 3.

Federal/PPS Components
Rates Effective October 1, 2015 to September 30, 2016

<table>
<thead>
<tr>
<th>Component</th>
<th>Urban</th>
<th>Rural</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Nursing @ 1.0 Index</td>
<td>$171.17</td>
<td>$163.53</td>
</tr>
<tr>
<td>2. Therapy @ 1.0 Index</td>
<td>$128.94</td>
<td>$148.67</td>
</tr>
<tr>
<td>3. Therapy, non-case-mix</td>
<td>$16.98</td>
<td>$18.14</td>
</tr>
<tr>
<td>4. Non-case-mix</td>
<td>$87.36</td>
<td>$88.97</td>
</tr>
</tbody>
</table>
SNF Profiting from Medicare

• Ancillary service reimbursement often is greater than the cost to provide the therapy and drugs that are covered in this component.

• Typical therapy expenses runs about $100 to $125 per Medicare patient day, but typical reimbursement for therapy often exceeds $200 PPD, allowing a gross profit margin of $75 to $100 PPD. Translated to NOI, that’s over $25,000 annually per bed!
SNF Medicare Advantage Reimbursement

- Medicare Advantage is the substitute for standard, government-direct pay Medicare
- Coverage for SNF is theoretically the same – but actually, coverage tends to be less.
- SNF operators receive lower rates generally
- Patients general receive short lengths of stay – Under Medicare the stay averages 25 days, but under managed care the stay is typically 25% to 50% shorter.
- Reimbursement rates to SNF providers are generally negotiated, and the rates are generally only 75% to 90% of amounts that Medicare would pay for the identical patient. So for the SNF, these are less profitable patients than Medicare
New Hampshire Medicaid

- A facility-specific prospective per diem rate is calculated by summing the five rate components.
  1. **Patient Care** costs are attributed to the direct care of resident nursing salaries, nursing supplies and ancillary services. Rate is specific to each property.
  2. **Administrative** costs are attributed to the general management and support of the facility, including owner’s compensation, administrator’s salary, consultant fees, management fees, accounting, legal fees and travel.
  3. **Other Support** costs include housekeeping, laundry, dietary, central supply, pharmacy, medical records, social service and recreation.
  4. **Plant Maintenance** costs include plant maintenance costs, salaries and benefits, supplies, utilities and property taxes.
  5. **Capital** costs include allowable depreciation and interest.

Items 2, 3, and 4 are flat rates, i.e., all SNFs receive the same rates for these three areas.
New Hampshire SNF Medicaid Reimbursements

• The per diem rates established for a nursing facility are calculated by dividing allowable costs by the greater of the facility’s actual resident days (including reserved bed days) or the total available resident days multiplied by 85.0%.

• The DHHS reviews and rebases nursing facility rates at least every five years (currently 2013 Medicaid cost reports are used) subject to the following limitations:
  • Costs are only inflated when rates are rebased.
  • The total reimbursement rate is subject to budget neutrality, which is the adjustment to rates made by the DHHS to the amount that the state has budgeted in order to fund that care.
Medicaid Capital Cost – Interest and Depreciation

• *The capital component of the rate* - is facility specific and includes the interest and depreciation payments based on the lesser of the current owner’s actual cost basis or the original cost of assets, subject to a ceiling set at the 85\textsuperscript{th} percentile.

• In most change in ownership situations, the new owner assumes the previous owner’s original cost basis, and the state will pay reasonable (actual) interest and depreciation from the original basis.

• In the event of a change in ownership, the seller is subjected to depreciation recapture. The seller must pay back to the state any difference between the depreciated (net) book value, that is, the historical cost less accumulated depreciation and the selling price, up to the total amount of depreciation previously reimbursed by the state.

• The new ownership basis would return to the original cost and depreciation would begin again.
Medicaid Provider Tax - SNFs

• New Hampshire has a Medicaid Provider Tax known as a quality assessment fee “QAF” that is a flat tax charged on all SNF revenue at a rate of 5.5%.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provider tax (paid by facility, state’s share)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Federal match (72% or 3:1)</td>
<td>$3,571</td>
</tr>
<tr>
<td>Total provider tax revenue</td>
<td>$4,571</td>
</tr>
<tr>
<td>Redistributed provider payment for 75% statewide Medicaid mix (divided by 75%)</td>
<td>$6,094</td>
</tr>
<tr>
<td>Less bed tax</td>
<td>-1,000</td>
</tr>
<tr>
<td>Provider tax net gain (100% Medicaid)</td>
<td>$5,094</td>
</tr>
</tbody>
</table>
Revenue Forecasting Senior Housing – Independent Living and Assisted Living

• In most cases, independent living will be entirely private pay and rates are set by competitive market forces.
• Assisted living facilities may accept Medicaid waiver residents, but only as a way to keep beds full.
• Market rental rates should be developed in a manner similar to apartments, hotels and office buildings.
• The current rent roll should be used as a starting point for developing private-pay revenues.
• The current contracted and asking rents should be compared to determine if concessions are necessary or can be eliminated.
• Keep in mind that most occupancies are short-term (month-to-month), although there are often limitations on the frequency that rates and additional service fees can be increased.
Operating Expense Topics

• For existing, stabilized properties, the actual expenses may deserve the greatest weight in forecasting expenses going forward.

• **Staffing analysis**, using full-time equivalencies (FTE), staffing ratios and market labor rates can be used to develop employee expenses.

• Operating expenses are typically measured on a per-patient-day or per-occupied room basis. This is especially important when developing variable expenses.

• Simply using expenses, as a **percent of revenue**, is far too 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

• The **American Senior Housing Association** publishes reasonable good operating expense averages, similar to BOMA, but not as market specific.
## SNF Operating Expense Example

<table>
<thead>
<tr>
<th>Departmental Expenses</th>
<th>% of Rev</th>
<th>$ PRD</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>General &amp; Administrative</td>
<td>8.1%</td>
<td>$13.70</td>
<td>$465,987</td>
</tr>
<tr>
<td>Central Office / Management Fee</td>
<td>3.9%</td>
<td>6.60</td>
<td>224,490</td>
</tr>
<tr>
<td>Provider Tax</td>
<td>4.5%</td>
<td>7.66</td>
<td>260,511</td>
</tr>
<tr>
<td>Social Services &amp; Activities</td>
<td>2.2%</td>
<td>3.70</td>
<td>125,851</td>
</tr>
<tr>
<td>Nursing</td>
<td>28.9%</td>
<td>48.65</td>
<td>1,654,765</td>
</tr>
<tr>
<td>Ancillary, Relates to Medicare &amp; Managed Care</td>
<td>12.6%</td>
<td>21.20</td>
<td>721,006</td>
</tr>
<tr>
<td>Employee Benefits, Taxes &amp; Workers' Comp</td>
<td>8.6%</td>
<td>14.50</td>
<td>493,198</td>
</tr>
<tr>
<td>Dietary</td>
<td>7.5%</td>
<td>12.60</td>
<td>428,572</td>
</tr>
<tr>
<td>Laundry &amp; Housekeeping</td>
<td>3.7%</td>
<td>6.20</td>
<td>210,885</td>
</tr>
<tr>
<td>Plant Operations</td>
<td>4.3%</td>
<td>7.30</td>
<td>248,300</td>
</tr>
<tr>
<td>Property and Liability Insurance</td>
<td>2.1%</td>
<td>3.55</td>
<td>120,749</td>
</tr>
<tr>
<td>Property Taxes</td>
<td>1.6%</td>
<td>2.67</td>
<td>90,958</td>
</tr>
<tr>
<td>Reserves for Replacements</td>
<td>0.6%</td>
<td>1.06</td>
<td>36,000</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td><strong>88.7%</strong></td>
<td><strong>149.39</strong></td>
<td><strong>5,081,270</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Operating Income</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>11.3%</td>
<td>$19.05</td>
<td>$648,048</td>
</tr>
</tbody>
</table>
• Expenses are best measured on a per-patient or resident day basis

• Ancillary expenses relate to 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

• Cap-ex – replacement reserves typically $500 per bed

• In cost-based Medicaid systems, are forecast expenses reconciled to the Medicaid rate?
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 for one type of senior housing type 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).
Consistency in Developing NOI is Critical

• **Do unto your sales as you do unto your subject**”

• Generally, the market looks to pro forma NOI as the basis for setting price

• Generally, appraisers capitalized a subject’s pro forma or forecasted NOI

• Therefore, capitalization rates from the market should be derived on the same basis

• Also, treatment of management fees and reserves for replacement should be consistent
<table>
<thead>
<tr>
<th>Revenues</th>
<th>Seller/Trailing</th>
<th>Buyer/Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross potential revenue</td>
<td>$6,000,000</td>
<td>$6,300,000</td>
</tr>
<tr>
<td>Vacancy rate</td>
<td>10.0%</td>
<td>7.9%</td>
</tr>
<tr>
<td>Net revenue</td>
<td>$5,400,000</td>
<td>$5,800,000</td>
</tr>
<tr>
<td>Operating Expenses, Including Reserves &amp;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td>- 4,920,000</td>
<td>- 5,135,000</td>
</tr>
<tr>
<td>NOI or EBITDAR</td>
<td>$ 480,000</td>
<td>$ 665,000</td>
</tr>
<tr>
<td>Sale price</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Capitalization rate (NOI after management -- EBITDAR)</td>
<td>9.6%</td>
<td>13.3%</td>
</tr>
</tbody>
</table>
Senior Housing Cap Rate Survey & Rate Spread by Property Type

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

**Physical**
- Building age
- Construction quality
- Overall condition, relative to age
- Remaining economic life
- Quality of therapy and common area amenities space
- Adequacy of back-of-the-house functions
- Ratio of private rooms (SNF)
- Ratio of three and/or four-bed wards (SNF)
- Immediately curable physical and functional issue not adjusted in sale price
- Probable need for near-term major capital expenditures and/or building repositioning
- Site features
- Underlying land value relative to total value/price (higher land value percentage generally reduces downside risks)
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
Needle Movers on the Capitalization Rate Meter

**Economic and business operational**

- 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.
DCF - Generally Not Vital for Stabilized Properties

• The DCF is typically not used on properties that are expected to operate under stable conditions. In fact, HUD, the largest lender to assisted living and skilled nursing facilities doesn’t require the use of the DCF.

• DCF is important when changing NOI, for whatever cause or causes, is expected and can be reasonably forecasted.

• A truncated DCF may be useful in developing a value upon completion, where there is expected to be a short-run operating deficit resulting from the absorption process.
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 – subscription services mostly – and costly: http://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
Entrance-fee CCRCs – Fee Simple Property Rights?

• Given that real estate assessments are generally based on fee simple ownership, the assessors should capture the hypothetical fee simple interest in entrance-fee-structure senior housing properties.

• Often the tax payer will argue that the entrance fees should be excluded from the valuation, given that the property title holder does not have the ability to transfer those entrance fees (unamortized entrance fees and refundable entrance fees) to a subsequent ownership in an asset sale.
SNF Operating Statement with Contractual Allowances - Tricky Business – Rack Rate Vs. Actual Rate

<table>
<thead>
<tr>
<th>Service</th>
<th>Total</th>
<th>$/Per Diem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicare Part A revenue</td>
<td>$1,578,453</td>
<td>$315.69</td>
</tr>
<tr>
<td>Medicare Part A routine</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less routine contractual</td>
<td>-178,593</td>
<td>-35.72</td>
</tr>
<tr>
<td>Part A physical therapy</td>
<td>287,542</td>
<td>57.51</td>
</tr>
<tr>
<td>Less physical therapy contractual</td>
<td>-35,875</td>
<td>-7.18</td>
</tr>
<tr>
<td>Part A speech therapy</td>
<td>65,875</td>
<td>13.18</td>
</tr>
<tr>
<td>Less speech therapy contractual</td>
<td>-25,478</td>
<td>-5.10</td>
</tr>
<tr>
<td>Part A occupational therapy</td>
<td>74,852</td>
<td>14.97</td>
</tr>
<tr>
<td>Less occupational therapy contractual</td>
<td>-35,879</td>
<td>-7.18</td>
</tr>
<tr>
<td>Part A prescription drugs</td>
<td>78,589</td>
<td>15.72</td>
</tr>
<tr>
<td>Less drug contractual</td>
<td>-47,835</td>
<td>-9.57</td>
</tr>
<tr>
<td>Part A medical supplies</td>
<td>25,789</td>
<td>5.16</td>
</tr>
<tr>
<td>Less medical supply contractual</td>
<td>-17,589</td>
<td>-3.52</td>
</tr>
<tr>
<td>Net Medicare Part A revenue</td>
<td>$1,769,851</td>
<td>$353.97</td>
</tr>
</tbody>
</table>
Medicaid Payments

• Medicaid is a federal-state partnership administered at the state level, which provides health care benefits to low-income individuals and families who fit into various eligibility groups.

• Federal Medical Assistance Percentage (FMAP), based on a state’s average per capita income level compared to the national average income level. FMAPs range from 50% in the wealthier states to almost 77% in the poorest state.

<table>
<thead>
<tr>
<th>Service Category</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital, inpatient and outpatient</td>
<td>22.60%</td>
</tr>
<tr>
<td>Nursing facilities</td>
<td>19.60%</td>
</tr>
<tr>
<td>Mental health facility services</td>
<td>2.70%</td>
</tr>
<tr>
<td>Physicians' services</td>
<td>3.40%</td>
</tr>
<tr>
<td>Prescribed drugs</td>
<td>10.20%</td>
</tr>
<tr>
<td>Medicaid - MCO</td>
<td>13.80%</td>
</tr>
<tr>
<td>Home and community</td>
<td>7.60%</td>
</tr>
<tr>
<td>Personal care services</td>
<td>3.10%</td>
</tr>
<tr>
<td>Medicare part A &amp; B premiums</td>
<td>2.60%</td>
</tr>
<tr>
<td>All other medical assistance programs</td>
<td>14.40%</td>
</tr>
</tbody>
</table>
Types of Medicaid Reimbursement to SNFs

• Payment systems have a variety of rate-calculation methods but generally are flat-rate systems or facility-specific systems.

• **Flat rates** pay all SNFs in a group the same rate, regardless of actual allowable cost. Rate may vary based on Case mix (similar to Medicare)

• **Facility-specific** rates are based on actual ”allowable” expenses of an SNF, and limited by rate ceiling for various expense groupings – nursing, administrative, dietary, capital, etc. This type system can be complex and very impactful on value.
How should the entrance fees be treated in the income approach?

• Should *imputed interest* on the entrance fees be added into the revenue development? Case law from Massachusetts clearly require imputed interest to be income as operating revenue.

• How is the imputed interest rate developed and support?
  • **Owner perspective** -- Could the interest rate of the mortgage or the bond financing equal an appropriate imputed interest?
  • **Resident perspective** -- What are the investment yield rate expectations for the CCRC residents if the entrance fee were instead, invested in securities of comparable duration, liquidity and security?
  • Can the imputed rate be derived from comparing differences in monthly service fees and entrance fees for a particular unit with different financing options (rent-only vs. partial and complete refunding or non-refundable)
CCRCs and Sales Comparison

• Sale comparison is generally not reliable in valuing the fee owner’s fractional interest because entrance-fee CCRC rarely sell under normal sale conditions and sorting out the influences of the entrance fee liabilities relative to pricing is extremely difficult.

• For valuing the hypothetical fee simple interest for real estate assessment purposes, sale comparison is useful, when the sales involve rent-only properties, with property qualities similar enough to the subject to be useful in comparison.
Senior Housing 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.seniorhousing.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 – subscription 
  services mostly – and costly: http://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
Comparable Data Sources

• Sale Comp Lead:
  • State licensing and CON offices will track change of ownerships, and these offices represent an excellent source for leads on sales and lease for assisted living and nursing facilities. FOI (Freedom of Information) request may lead you to actually reviewing purchase and sale and/or lease agreements and buyer financial feasibility analyses.

• Expense and Occupancy Data Sources:
  • Medicaid cost reports are an excellent source for occupancy and operating expense data for subject and comparables. These reports are filed annually and available under FOI. These reports are also likely to reveal sale and lease pricing.