HealthCare Appraisers
INCORPORATED

WHITE PAPER

Alternative Structures to Physician-Owned Hospitals

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August 20, 2013

Introduction

Due to Section 6001 of the Patient Protection and Affordable Care Act ("PPACA"), there is a moratorium on the future development of physician-owned hospitals that went into effect on March 23, 2010. This moratorium is only applicable to physician-owned hospitals that accept government payors. As a result, there are currently a number of physician-owned hospitals currently under development which will *not* accept government payors. Given the changing payor landscape under PPACA, there is significant risk associated with the ever-increasing percentage of the market that will be considered a government payor with the continued implementation of provisions within PPACA. Alternatively, management/development companies and physicians are still involved in the development of new hospitals (i.e., where physicians do not have an equity ownership). Instead of investing equity capital, physicians may be able to provide debt capital, real estate leasing, equipment leasing, and certain types of management services while still accepting government payors. Though these alternative investment structures may provide an opportunity for physician investment, they still require certain legal and valuation guidance to ensure compliance. This article outlines the necessary valuation considerations associated with each of the aforementioned alternative structures.[1]

Debt Capital

When physicians provide debt capital for the development of new surgical and specialty hospitals, it is typically in the form of subordinated debt. Terms of this subordinated debt typically include unsecured status, interest rates that may be significantly higher than interest rates afforded to secured senior debt holders, terms of 10 to 20 years, payment-in-kind (PIK) interest for the first 1 to 3 years of the term[2], interest-only payments until the surgical hospital reaches a steady state of operations (i.e., usually 2 to 4 years after opening), and repayment of principal and interest through the remaining term of the loan. Lastly, these loans tend to have a conversion or warrant feature, similar to mezzanine debt securities, that is tied to the repeal of or significant adjustment to Section 6001 of PPACA.

These unsecured subordinated debt securities typically involve the valuation and assessment of the appropriate interest rate and terms by an independent valuation analyst. Generally, there is a four step process for analyzing these debt securities.

Step 1 — Determine the *lower* and *upper* interest rate parameters, as mezzanine debt tends to have interest rates between senior debt facilities (lower) and returns on equity (upper).

Determining the *lower* interest rate parameter involves reviewing the actual interest rate or estimating an appropriate interest rate for the senior-level debt

[1] Additional alternative structures, such as public company and employee stock ownership structures, exist and are not discussed in detail within this article.
[2] PIK interest is interest that is not paid and instead is rolled into the principal amount of the debt security.

financing of the subject hospital. If an actual rate is not yet available, then the analyst could review and analyze the annual yields for investment-grade corporate bonds. It is also advised for analysts to call and question commercial loan officers regarding appropriate interest rates for senior debt facilities.

Determining the *upper* interest rate parameter involves estimating an appropriate required rate of return on equity using the modified capital asset pricing model for the subject hospital. To the extent financial projections and equity purchase prices are available, the analyst can solve for the implied required rate of return on equity through calculating the internal rate of return necessary to discount the estimated future cash flows to the price paid in the sale of equity interests.

Step 2 — Review the terms of the subject debt security in order to understand what provisions may lead to higher concluded interest rates, such as a callable feature, or lower interest rates, such as a conversation feature should Section 6001 of PPACA be repealed or significantly modified. Further, it is important for the analyst to analyze the relative magnitude of senior, secured financing relative to the subordinated, unsecured financing. The higher the percentage of senior, secured financing relative to the total financing capital, the more risk and higher required interest rate for holding subordinated, unsecured debt securities (and vice versa).

Step 3 — Review and benchmark the subject debt security to market data, such as yields of mezzanine debt securities or funds and yields on other low-quality debt securities. In addition to reviewing market data, it is advisable to discuss market trends with investment bankers and other professionals working in the mezzanine capital and low-quality debt markets.

Step 4 — Synthesize the information gleaned from the previous three steps and select an appropriate concluded interest rate for the subject debt security.

These unsecured subordinated debt securities tend to have a conversion feature (e.g., embedded call option) attached to them. The conversion is based on the repeal or significant adjustment to Section 6001 of PPACA. This embedded call option is classified as a "real" option, as the conversion is *not* based on the equity value or other financial metric of the underlying subject hospital. Factors impacting the value of the embedded call option include: demonstrated successes of physician-owned hospitals, continued implementation and ultimate effectiveness of PPACA as a whole, changes in this country's political landscape, and other macro and micro economic factors related to the healthcare industry. Needless to say, these securities are complex and care should be taken when constructing and valuing.

Real Estate Capital/Leasing

More often than not, the underlying building and land are held in a separate holding company (i.e., real estate holding company) from the operating company (i.e., surgical hospital). It is common for physicians to be involved with the development of new surgical hospitals and in certain cases for physicians to hold a control or minority interest in associated real estate holding companies. Due to the potential referral relationship[3], the appropriate fair market value lease rate is typically developed by an independent real property appraiser. The real property appraisers develop a fair market lease rate consistent with the structure of the lease, which is typically a triple net lease. These lease structures have the ability to become more complex (e.g., the inclusion of separate block leases, etc.), thus making it critically important that a healthcare attorney ultimately opine on the lease structure from a legal prospective.

Equipment Capital/Leasing

Certain arrangements include separate equipment holding companies with physician ownership. These companies typically own diagnostic imaging equipment that is leased to surgical hospitals, with terms ranging from three to seven years and include money factors of 0.2 to 0.4 (i.e., 5 percent to 10 percent annual market lease rates). Based on the terms of the equipment lease, valuation analysts typically opine on the fair market value money factor and periodic payment made by the surgical hospital to the equipment leasing company.[4] The credit quality of the subject hospital and length of the lease are important factors when benchmarking appropriate money factors. In addition to considering fair market value, it is important the healthcare valuation expert also consider commercial reasonableness for equipment leasing arrangements (e.g., the subject hospital should not lease equipment from physicians if the subject hospital already has sufficient, comparable equipment that is currently underutilized).

Management Services

Management services are provided to surgical hospitals through a separate contract between a management company owned by physicians and the subject surgical hospital. Management services vary significantly in scope for each surgical hospital, with the management fee constructed as either a fixed period payment and assessed on a periodic basis given the potential for fluctuating levels of services, or as a certain percentage of net revenue. These management services can include: pre-opening services, leading and participating in steering committees, facility planning, operational planning and oversight, management oversight, supervise the day-to-day operations,

[3] Referrals of patients from physician owners of a real estate holding company to an associated surgical hospital potentially implicate the Federal Physician Self-Referral Prohibition (more commonly known as the "Stark" law), *42 U.S.C. § 1395nn*, and the Federal Anti-Kickback Statute, *42 U.S.C. § 1320a-7b(b)*. In particular, in the case of a lease arrangement, the Stark law and associated regulations require that the lease rate be consistent with "fair market value" (see *42 CFR § 411.357(a)* related to space leases). The term "fair market value" (or "FMV") is specifically defined in the Stark law and regulations (see *42 CFR § 411.351* and its associated regulatory commentary).

[4] Similar to space leases, the Stark law and regulations also have a specific exception and FMV requirement applicable to equipment leases between physicians and surgical hospitals (see *42 CFR § 411.357(b)*).

accounting and book-keeping services, etc. Management services are typically analyzed by healthcare valuation firms in order to help opine on the fair market value of said services. Analyses performed to assess fair market value payments for management services include: cost analysis, benchmarking to publicly available data for similar arrangements, and proprietary scoring matrices to assess the level of management services included in the subject management agreement.

Summary

In summary, the development stage and corporate structure for these alternatively structured specialty hospitals are complex. Thus, during the development stage management must be prudent in selecting advisors who are well versed in the various structural, legal, and valuation issues that may be present.

If you have any questions about current or future valuations for alternatively structured specialty hospital, you can contact the author at (303) 688-0700 or njaniga@hcfmv.com. Learn more about HealthCare Appraisers, Inc. at http://www.hcfmv.com.