Raymond J. Lewis

Putting Your Real Estate In Trust

Partnering with a REIT can free up capital by removing real estate investments from an owner's balance sheet.

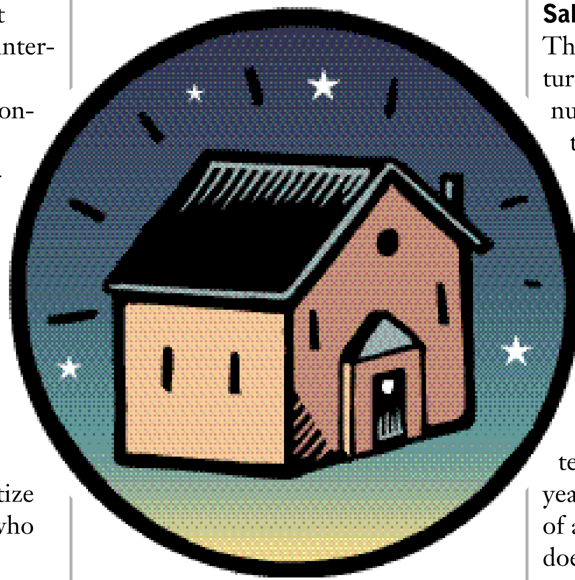
Nursing facilities are traditionally financed with a combination of equity and first mortgages secured by a lien on the real estate. But this approach has certain drawbacks. For example, floating rate loans of between three and five years may be extremely attractive in today's low-interest-rate environment, but they carry future refinancing and interest-rate risk.

One alternative to this conventional approach that nursing facility operators may consider is partnering with a health care real estate investment trust (REIT). REITs can offer long-term, fixed-rate financing and provide a way for owners to free up some of their capital by removing the real estate investments from their balance sheets. This approach can be particularly attractive to nursing facility operators looking to monetize equity in stabilized properties or who may be investigating family estate planning issues.

REITs Defined

REITs are corporate entities designed specifically to own—and sometimes operate—a wide variety of real estate assets, including retail space; apartments; office buildings; lodging; industrial space; and, increasingly, health care facilities such as nursing facilities, hospitals, clinics, and medical office buildings. Created under the U.S. tax code about 40 years ago, REITs were designed to allow smaller investors the opportunity to invest in diversified real estate assets without owning properties directly and bearing all of the management and operating costs.

In exchange for distributing at least 90 percent of their net taxable income as dividends to shareholders (a requirement for REIT status), they pay no corporate taxes. REITs must also invest



at least 75 percent of their total assets in real estate and derive at least 75 percent of their gross income from rents from real estate property or interest on mortgages on real property. The vast majority of REITs own property directly and are known as equity REITs. Some REITs, though, known as mortgage REITs, make or hold loans that are backed by real estate collateral. Finally, hybrid REITs own both property and mortgages. Because of their steady, attractive dividends, in recent years REITs have become an important investment vehicle and have enjoyed steady and favorable access to capital. Over the past three years, the Healthcare REIT Index (of the National Association of Real Estate Investment Trusts) had a compound annual total shareholder return of 25 percent.

Sale-Leaseback Transactions

The typical REIT transaction is structured as a sale-leaseback, in which the nursing facility properties are sold to the REIT, which then leases the properties back to the operator. This can be an especially suitable option for small or medium-sized nursing facility operators with stabilized properties, as it enables them to monetize their equity in the real estate while maintaining the steady cash flow from operations. In today's market, the lease term is typically between 10 and 15 years and carries an average lease rate of about 11 percent. The operator does not need to fund any additional equity to complete the transaction and, in fact, is able to cash out some or all of the equity value that has been created in the nursing facility properties.

In today's marketplace, a REIT typically will purchase a facility from the operator at a multiple of between 6.0x to 7.0x cash flow. While each agreement and transaction varies between the two parties involved, a lease may contain certain provisions such as annual rent escalators and an option to

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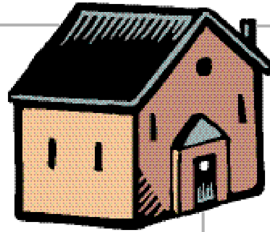
repurchase the property at some point in the future. The most common lease structure is a triple net lease, in which the tenant pays all operating expenses, property taxes, and capital improvements on the properties. Additionally, if there are multiple facilities involved, the transaction may be subject to a master lease, whereby one lease governs multiple properties.



The Pros And Cons

There are many benefits to a sale-leaseback transaction. The all-in cost of any transaction is always the cost of capital, blended between the debt and equity financing involved. While the lease rate may seem high when considered in isolation, REIT financing involves no equity so the blended cost of capital is often as competitive and attractive as traditional mortgage financing. And because no equity is required, REIT financing becomes a one-stop financing solution for the operator.

Additionally, a REIT transaction provides the financial advantages of long-term, fixed-rate financing with no additional capital commitment at the end of the lease term. Finally, the operator has the ability to unlock the equity in its real estate and redeploy it for growth or distribute it while still maintaining a steady cash flow from operations going forward.

REIT financing, however, is not appropriate in every situation. If an operator has a property with significant upside, such as a nonstabilized, turnaround, or lease-up facility, a REIT solution would not be the appropriate path. The operator would have no pre-payment option, and any upside appreciation in the value of the real estate is lost upon the sale to the REIT.

It's important to compare these pros and cons with the conventional financing approach. First, with a mortgage loan the owner retains the real estate and all of the value that accompanies it. Interest costs are lower, the terms are more flexible, and the owner retains the depreciation tax advantage. On the negative side, conventional financing ties up a significant amount of equity that might better be used in other investment opportunities. And, future interest-rate risk and refinancing risk are realities that are particularly amplified in today's low-interest-rate environments.

REIT financing offers the greatest advantage to those nursing facility owners who already have significant equity built up in their real estate as it allows them to redeploy that equity

while retaining the cash flow from the facility's operations.

Conversely, REIT financing is not a particularly good option for those who own properties in which the value has not been fully realized; the operator would lose any opportunity to realize significant upside as the turnaround is completed.

In addition to their ability to unlock

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equity, many smaller, family-owned operators are looking to REIT sale-leaseback financing for estate planning purposes. The typical structure used for these situations is that of the UPREIT.

The UPREIT Advantage

Some equity REITs employ umbrella partnership (UPREIT) structures in which all properties are actually owned by a partnership of the REIT, and the REIT in turn owns interest in the operating partnership. There are several advantages to nursing facility owners and operators who enter into an agreement to sell their real estate in exchange for UPREIT units or a combination of UPREIT units and cash. Among these advantages:

- Units may be converted into REIT common stock at the seller's option;
- Tax gains are deferred until units are converted to stock;
- Seller can generally recognize gains in share values as earnings;
- Seller receives dividend distribution;
- Seller can borrow against the units;
- Seller participates in upside through stock appreciation; and
- Seller receives benefit of REIT's portfolio diversification.

The UPREIT structure creates many of the same advantages as owning REIT shares directly. Because of the unique nature of the instruments, the UPREIT shares can be transferred to heirs tax-free in certain circumstances. For these reasons, UPREITs are often particularly attractive to

smaller operators or family-owned businesses that may be dealing with estate-planning issues. As a pass-through owner of the REIT shares, the units enjoy the benefits of the

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REIT's portfolio diversification as well as upside in the REIT's underlying portfolio through the share price.

What To Look For

In the current challenging financial markets nursing facility operators may want to focus on REITs that are willing to take a more creative approach to financing and access multiple capital markets to achieve the desired financial structure and capitals costs.

In addition to creativity, a number of key issues need to be considered when choosing a REIT partner. These include:

- How strong is the REIT's access to capital?
- How sound is the REIT's balance sheet?
- Does the REIT have the expertise to understand the provider's business?
- Does the REIT have the products and resources to execute creative transactions and solve unique or complex business problems? ■

For More Information

- The author can be reached by contacting Ventas at (312) 765-0394.
- Additional information about REITs can be found on the Internet at www.reitnet.com.