

Maximizing Consolidation Value Through Operational & Real Estate Transactions

*Key considerations for collaborative
approaches*

INTRODUCTION

Private equity (PE) and strategic partner opportunities continue to fuel M&A activity in healthcare and [shows no signs of slowing down](#). Investments in physician-owned hospitals and ambulatory surgery centers (ASCs), in particular, have seen an uptick in recent years. In 2022, there were [53 hospital mergers](#) with some representing cross-market transactions. Plus, at least [386 U.S. hospitals](#) are currently owned by private equity firms, representing 30% of all proprietary for-profit hospitals.

Multiple drivers are at play, spurring new opportunities for consolidation and innovative business models. For starters, the growing population of older adults—expected to reach [80.8 million by 2040](#)—coupled with a growing [chronic disease](#) burden are driving the increased need for healthcare services. At the same time, for independent hospitals and ASCs, regulatory changes in the last 10–15 years have made negotiating reimbursement rates with payers nearly impossible.

As a highly fragmented industry, there have been more opportunities for investors to innovate and find ways to improve quality and outcomes, drive efficiency, and reduce costs. In addition, telehealth and remote patient monitoring (RPM) technologies have made consolidation even more attractive.

As a result, physician-owners of surgical hospitals and ASCs are taking a closer look at their assets along with strategies that can unlock value and monetize the businesses they have tirelessly built over the years, while allowing them to maintain long-term control and address

succession planning within the operating and real estate entities.

Oftentimes, when considering a potential partner, whether for the operating entity or the real estate, running the transactions in tandem has been shown to produce the best results. Coordination between the investment bankers and the healthcare real estate specialists can allow for improved alignment on the key deal points and various structure considerations to ensure both transactions have a positive impact on the other.

This approach enables physician-owners to achieve the highest valuation for their businesses and the real estate without compromising future growth. Additionally, when the holder of the operating business is an institutional or a strategic partner, the value of the real estate is often improved.

These joint healthcare transactions, however, are complex, multi-faceted, and nuanced, but can ultimately lead to higher valuations of the operating business and the real estate asset. Many physician-owners think they can manage the process on their own or only with an attorney, yet the reality is there's only one chance to get it right. Without the right advisors, significant aspects of the process can be overlooked, and physician-owners can leave themselves vulnerable to unexpected challenges or liability, and risk a lower valuation—or worse, no deal at all.

THE COLLABORATIVE APPROACH: AREAS OF FOCUS

For physician-owned hospitals and ambulatory surgery centers that are considering a healthcare transaction, engaging with investment banking and real estate partners that take a collaborative approach can ensure optimal financial and non-financial outcomes. A comprehensive understanding of the goals, areas to prioritize, and strategies are key.

VALUATION MAXIMIZATION

Optimizing the value of the operating and real estate entities, creating competition amongst buyers, and ultimately driving up the valuation and addressing other critical components of any healthcare transaction are three core goals for a transaction process.

Valuation maximization is a complicated process that requires an integrated approach and insights into financial, operational, and real estate aspects. Since the real estate ownership post-merger will likely continue to be owned entirely by the physicians, careful consideration and planning are necessary upfront. During this time, a significant amount of value from the real estate in terms of the economics can be created. Value can also be created from various lease items such as long-term control through multiple lease renewal options, as well as the ability to make modifications to the building, expand the building, or make improvements to the overall site.

Working in tandem, the investment banker's priority is to ensure the rental rate is operationally sustainable long-term and within a fair market

value range, while the real estate advisor's goal is to ensure the flexibility of the clinical operations is maintained well after the real estate transaction is completed.

Real estate rental rates must be within fair market value range, otherwise the transaction could be considered a kickback to physicians. It's also important, however, to consider where in the fair market value range it makes the most sense for the operating business. For example, if the rate is very high, it will depress the OpCo profits but drive valuation for the real estate entity. A majority of the time, it's advantageous to have the real estate entity, which trades at a higher multiple, with a higher valuation, without placing undue burden on the OpCo.

When properly planned using a holistic approach, the value for both the operations and the real estate can be maximized.

While many physician-owners of surgical hospitals or ASCs think that having the lowest rental rate possible in the lease is the way to go, the opposite is true. The goal is to have fair market value or fair market rent that nets a higher valuation for the real estate, which generally has a higher valuation multiple than the operating assets. Investors value healthcare real estate assets based on the income approach or the net revenue that the property produces, which is why having a rental rate at fair market value is an important piece in maximizing the value of the real estate.

When evaluating a potential M&A transaction, it's important to have a strategy in place that ensures the value of the real estate will be enhanced. For example, an institutional quality lease should be in place for the

physician-owners and their partner. It's also important to keep in mind that the lease could have a positive or negative impact on the Opco partner during the transaction, so having representation by a healthcare real estate specialist and legal counsel is important. For physician-owners who are looking at a merger in the future, it's also important to evaluate the potential impact the merger may have on the real estate.

CONTROL PROVISIONS

An essential component of healthcare transactions, control provisions are clauses that describe the ability of stakeholders to maintain authority over various aspects including clinical operations, business decisions, and strategic directions that allow the entity to thrive.

When they are established, control provisions must balance the interests of the buyer and seller, ensure the sustainability of the healthcare entity, and ideally allow the physicians-owners to maintain clinical controls.

Incorporating control provisions into the ongoing clinical operations and the real estate relationship is vital to maximizing outcomes for both transactions and ensuring future success and security for the physician-owners and leadership.

CLINICAL CONTROL

The goal of clinical controls for the healthcare entity is to retain autonomy and the resources required to uphold the highest standards of care. Control provisions allow quality of care, clinical

THE STRUCTURED AUCTION PROCESS

Careful consideration of the operational, financial, and real estate aspects is key to the competitive bid process. Here's what to expect.

PREPARATION TIME: 2-3 MONTHS

Collect and organize information and prepare offering materials, such as a Confidential Investment Memorandum. A well-designed pro-forma, which includes projected financial statements and operational plans, is developed to add credibility and attract more favorable terms. Expert market positioning and market analysis create a holistic picture of the potential of the healthcare entity, garnering a higher valuation.

MARKETING AND BIDDING TIME: 2-3 MONTHS

Create awareness and interest among an extensive network of potential bidders. After signing an NDA and reviewing marketing materials, initial bids are evaluated based on operational, financial, and real estate considerations.

LOI NEGOTIATION, EXCLUSIVITY, DUE DILIGENCE, AND CLOSING TIME: 3-4 MONTHS

After a group has been selected as a result of the competitive bid process and interviews with ownership, letter of intent (LOI) negotiations ensure the final terms maximize both the operational and real estate values. The transaction then moves into an exclusive period where the buyer conducts its due diligence and moves forward toward closing.

protocols, and patient outcomes to be prioritized and real estate aspects, such as facility design and layout, to support those clinical objectives.

BUSINESS CONTROL

The goal of business control provisions is to enable financial stability and operational efficiency and make certain that business objectives are aligned with the real estate assets to support business efficiency, flexibility, and growth.

Control provisions include budgeting, financial management and staffing, and other business operations. Although most M&A deals are control transactions, there are certain minority protections that can be secured and optimized. Some include:

GOVERNANCE AND DECISION-MAKING

Governance and decision-making provisions determine how decisions are made, responsibilities are assigned, and conflicts are resolved within the healthcare entity. When establishing governance structures, it's important to balance the interests of all stakeholders and understand real estate issues such as facility management and lease agreements.

Similar to the realignment in ownership on the operations side, there is also a realignment opportunity on the real estate side in which older physicians can capitalize on the value that has been created from a transaction and offer ownership and partnership opportunities to new and future physicians. This is known as the Hybrid Sale-Leaseback (“HybridSLB”).

The HybridSLB transaction also provides an opportunity for younger physicians to maintain or reduce ownership or buy into the ownership. With a recapitalization of the equity, the buy-in is reduced for the younger physicians, creating more affordable physician alignment. For example, if the entity is 100% physician-owned, and a real estate investment trust (REIT) or private equity institutional buyer investment group is brought in to acquire 70% of the real estate, the buy-in for new physicians is reduced by 70%.

What is a Hybrid Sale Leaseback?

For physician-owners that own the real estate, the Hybrid-Sale Leaseback (“HybridSLB”) is an option that provides the benefits of real estate ownership and maintains alignment between the real estate and the physician-ownership of the hospital or ASC.

The ownership monetizes all—or a portion of—the real estate and leases it back, which allows ownership to unlock the majority of their passive equity. The equity can then be invested into the core business to modernize facilities and equipment, build a new facility or expand an existing one, reduce debt, or make partner distributions.

ALIGNMENT OF OPERATIONS AND REAL ESTATE

When evaluating a transaction, maintaining physician ownership and alignment between the operating entity and the real estate holding company is critical.

For example, physician-owners should evaluate financial compatibility, which includes analyzing the financial stability, investment capacity, and expected financial returns of the potential partner, as well as how the real estate assets and strategies may impact the financial stability.

A well-negotiated lease can ensure long-term control of the facility and site. The following important factors should be considered with any lease:

- Address the potential of a future merger or acquisition.
- Include multiple renewal options at Fair Market Rent.
- Safeguard the ability to make modifications to the building and site.
- Provide a capital improvement allowance to be used for future renovations, expansion, and development.
- Eliminate any personal guaranties on the loan and the lease.

RISK MANAGEMENT

Physician-owners who attempt to manage a transaction on their own can open themselves up to a multitude of risks. They're likely to risk a lower valuation, agree to less-than-optimal terms, face unnecessary challenges, or even risk the deal not going through.

If the deal is not properly planned on the propco side, the real estate partner could later sell the asset as part of a portfolio to a larger institutional investor, potentially leaving the physician-ownership vulnerable to capital gain taxes or a change in ownership.

Working with a healthcare real estate specialist and advisor who can collaboratively manage every step of the process on the operations and real estate sides can help physician-owners mitigate risks while they're considering a sale, when they enter the market, and during the post-LOI and integration phase.

CASE STUDY: KANSAS SPINE & SPECIALTY HOSPITAL

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THE CHALLENGE

Kansas Spine & Specialty Hospital, a physician-owned hospital located in Wichita, KS, specializes in disorders of the spine, neck and joint. The hospital was looking to evaluate a strategic partner and monetization strategy for its hospital operations and real estate.

THE SOLUTION

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THE RESULTS*

Kansas Spine & Specialty Hospital received 11 initial offers that ranged between \$51M and \$53M. Through the second round and best and final processes, they received offers that ranged between \$56M and \$58M—a 14% increase over the initial bids and a 41% increase over the appraised value. The client selected a group that wasn't the highest bidder, but one that structured the sale as a Hybrid Sale-Leaseback ("HybridSLB"). Merritt and HREA worked closely to ensure the closing for the sale of the real estate and the completion of the hospital's merger, which ran simultaneously, was a smooth, seamless process. With a collaborative approach, the client was able to generate a larger valuation and create additional value on the operations and real estate sides.

EVALUATING POTENTIAL PARTNERS

Physician-owned hospitals and ASCs that choose to work with investment banking and real estate advisors stand to benefit from a holistic approach and shared decision-making that prioritizes their best interests every step of the way.

For example, advisors can lend industry insights that allow physician-owners to understand the current market value of their assets and navigate the complicated negotiation process. Additionally, the right advisor can introduce other key vendors

for a transaction process, such as lawyers and accountants who specialize in healthcare.

Since these types of transactions are complex, advisors must carefully consider both sides of the deal, employ coordinated strategies that ensure all aspects are represented and effectively negotiated, and work collaboratively to achieve optimal outcomes.

Finding the right partner is paramount to ensure long-term success and sustainability. Before engaging with any partner, however, it's important to understand and evaluate certain key areas.

- **ALIGNMENT OF VALUES AND OBJECTIVES:** A potential partner should demonstrate the ability to identify the healthcare entity's goals and work collaboratively to achieve the best outcomes, leading to a successful and mutually-aligned long-term partnership.
- **CAPABILITY TO SUPPORT GROWTH PROSPECTS:** The partner should be able to assist in the recruitment of new physicians, building out new ancillary service lines, or a new site of service.
- **COST SYNERGIES:** Ideally look for a partner that has the capability to bring stronger payer relationships that will impact the long-term sustainability of the operating assets.
- **OPERATIONAL SYNERGIES:** The partner should be able to identify, assess, and maximize complementary service lines, shared resources, operational efficiencies, and the associated real estate implications.

- **FINANCIAL COMPATIBILITIES:** The partner should analyze the financial stability, investment capacity, and expected financial returns of the investment partner as well as how real estate assets and strategies may impact financial sustainability.
- **HEALTHCARE EXPERTISE:** With no shortage of regulatory and compliance challenges, it's important to work with a partner that has healthcare expertise and proven results. On the Opco side, in particular, look for a partner that has healthcare operational expertise and an extensive relationship network.

ABOUT MERRITT HEALTHCARE ADVISORS

Merritt Healthcare Advisors (“MHA”) is focused exclusively on representing owners of surgical facilities and healthcare practices that are considering strategic options, whether it is selling an interest in their organization, creating a new partnership or growing through acquisition. MHA is unique in that we are the only firm that combines an investment banking background with actual “owners” experience that comes from developing and managing our own healthcare facilities. We have used this experience to successfully complete more than \$5 billion in transactions on behalf of our clients. As the industry’s leading mergers and acquisitions (“M&A”) firm, our proven process and extensive buyer network enables us to help our clients realize the absolute best financial and non-financial outcomes. Principals of Merritt are licensed investment banking agents of Burch & Company, Inc., member FINRA/SIPC. For additional information about Merritt Healthcare Advisors, please visit www.merrittadvisory.com.

ABOUT HEALTHCARE REAL ESTATE ADVISORS

HREA | Healthcare Real Estate Advisors is a national leader in providing real estate advisory services and innovative solutions to healthcare providers and real estate owners with various real estate strategies in the disposition process, including property valuation, marketing and exposure, buyer identification and negotiations, transaction management, timing and market insights, and asset value optimization. HREA also provides healthcare providers with access to equity financing, joint venture (JV) partnerships, and forward commitment buyers that can secure the necessary capital and resources to execute their development project and help mitigate risk with their exit strategy. HREA’s advisory team has completed over \$4 billion in healthcare real estate transactions throughout the U.S. With an exclusive focus on healthcare real estate and simplifying complex transactions, HREA is uniquely capable of providing solutions and outcomes that are tailored to each client. For additional information about HREA, please visit <https://www.healthcarerea.com>.

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