GLOBAL HEALTHCARE SERVICES
& CORPORATE CAPITAL MARKETS

CLINICALS

ALTERNATIVE FINANCING OPTIONS FOR NONPROFIT HEALTHCARE PROVIDERS UNDER THE NEW LEASE ACCOUNTING RULES

HEALTHCARE FINANCING ALTERNATIVES TO REDUCE RENT AND BALANCE SHEET IMPACT

Effective January 1, 2020 non-profit healthcare providers will adopt new lease accounting rules that will fundamentally change the way they look at the cost of occupying their core real estate assets. Under new rules for both FASB and GASB, the present value of all lease obligations and any likely renewals will be added to the Tenant/Lessee's balance sheet as a Right of Use Asset and a corresponding Lease Liability. Under the new FASB rules (ASC 842) leases will still be classified as either an Operating Lease or a Finance Lease, however, no lease will be fully "off balance sheet." Under GASB (Statement 87) all leases will be Finance Leases.

Going forward, this means that long-term lease obligations will look a lot like ownership on the Tenant/Lessee's financial statements. For investment grade non-profit healthcare companies the "Lease vs. Own" analysis will come down to an evaluation of the respective cost of capital, issues relating to property "control", and consideration for the treatment of property taxes. All of these factors will favor "ownership" oriented financings over traditional landlord leases for long term core assets under the new lease accounting guidelines.
Direct ownership financed by debt will continue to have a negative effect on the balance sheet and the income statement. An asset directly owned by a healthcare company will be recorded on the balance sheet at the full value of the property, which is then amortized through the income statement over the book depreciable life (typically 40 years). Interest is also charged against the unamortized portion of the asset resulting in substantial front-loaded costs. Fortunately, there are emerging financing alternatives that can provide the control benefits of ownership along with a more favorable financial reporting profile, resulting in lower rents and a lower balance sheet impact than either traditional landlord leases or direct ownership.

A BETTER SOLUTION: HYBRID LEASE FINANCING

Hybrid Leases are debt-type financing transactions which are viewed as secured financings for federal income tax and property tax purposes. However, they are treated as operating leases or finance leases for the Tenant/Lessee for financial accounting purposes under the new FASB or GASB lease accounting guidelines.

We refer to these structures as "Hybrid Leases" as they utilize the positive attributes of the traditional long term fixed rate Credit Tenant Lease Debt investor market (insurance companies and pension funds) combined with the re-emerging financial accounting structure of a Synthetic Lease.

HYBRID LEASE FINANCING

The Hybrid Lease structure cannot be used for sale/leasebacks of owned properties, but can be used to finance single-tenant properties in the following scenarios:

ACQUISITIONS OF NEW PROPERTY

BUILD-TO-SUIT DEVELOPMENTS

Construction plus permanent term, inclusive of all improvements

TENANT BUYOUTS OF PROPERTIES

Currently under Landlord leases

Hybrid Leases provide 100% financing and are typically structured as non-amortizing, interest-only financings for the Tenant/Lessee. These leases are funded entirely by financial investors (insurance companies and pension funds) and are priced at a slight premium to the Tenant/Lessee's public bond equivalent trading spreads. At the end of the lease the Tenant/Lessee will have three options:

RENEW

The Tenant/Lessee may engage with the existing Lessor or a new Lessor to renew the lease at par (100% of original cost) at prevailing market interest rates as determined by the parties, each within their sole discretion (no automatic renewal).

PURCHASE

Exercise the fixed price purchase option, equal to 100% of the original cost of the asset.

RETURN

Tenant/Lessee must act as the Lessor's remarketing agent and sell the property prior to lease maturity. The sale will be made subject to the Tenant/Lessee's first loss Residual Value Guarantee (RVG) in an amount equal to approximately 80-100% of original cost. For operating lease transactions this first loss RVG along with the interest only rents will present value to less than 90% of the fair value of the property at the start of the lease.

The financial reporting benefits of a Hybrid Lease under the new accounting rules are derived from the fact that only the PV of the interest-only rent is capitalized onto the Tenant/Lessee's balance sheet. The end of term RVG (80-100%) is excluded from the Lease Liability capitalization as long as the property under lease maintains its original value (i.e. no expected shortfall payment from the RVG).

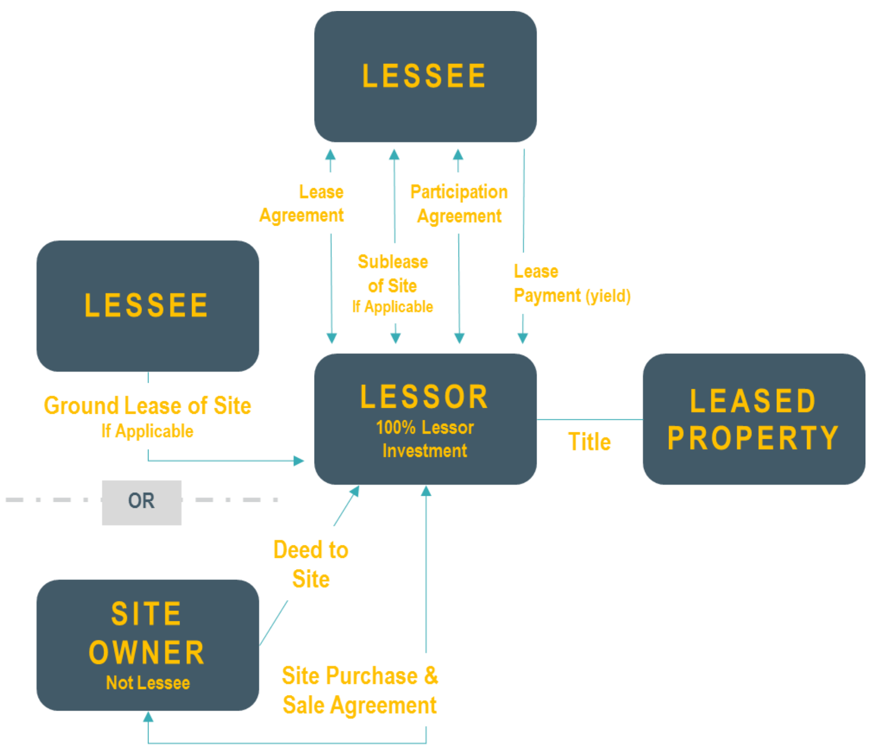
TENANT / LESSEE BENEFITS VS. TRADITIONAL LANDLORD LEASES AND DIRECT OWNERSHIP

- **30-60% REDUCTION IN RENT** – Interest-only profile, pricing based on credit of the Tenant.
- **20-50% REDUCTION IN LEASE LIABILITY** – RVG is not capitalized onto the balance sheet.
- **OWNERSHIP FOR TAX PURPOSES** – Tenant can apply for property tax exemption (same as Direct Ownership).
- **CONTROL OF PROPERTY** – Title to the property is held by the financial Lessor but Tenant has economic control, no exposure to FMV purchase or renewal (same as Direct Ownership).

SUMMARY: BEST OF BOTH WORLDS

Hybrid Leases are the most efficient way to combine the benefits of asset control associated with ownership with the benefits of favorable financial reporting associated with leasing structures.

Hybrid Leases can provide important economic and financial reporting benefits for investment grade non-profit healthcare tenants under the new lease accounting rules. The paradigm shift occurring in this market will favor "ownership" structures like Hybrid Leases which can help healthcare companies squeeze out the higher cost of landlord equity in the funding of their core real estate assets while still achieving a more optimal financial reporting profile than either a landlord lease or direct ownership.



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Newmark Knight Frank’s Global Healthcare Services team is one of the largest and most experienced healthcare real estate teams in the country, advising healthcare clients seeking to maximize value on assets and implement long-term business strategies. The Global Healthcare Services team provides clients with a single-source solution for every phase of acquiring, financing, developing, and disposing healthcare real estate. The team comprises real estate transaction and consulting professionals with more than 25 years of experience serving hospitals, health systems, and medical office building owners throughout the U.S. and across the globe.

Interested in Global Healthcare Services identifying alternative financing options for your organization? Let’s talk.

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