PG Briefing
July 14, 2020

Not All Valuation Reports Are Created Equal: A Practical Guide to Reviewing and Applying Real Estate Valuation Reports

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This Briefing is brought to you by the Real Estate Affinity Group of AHLA's Hospitals and Health Systems Practice Group.

To avoid liability under the Stark Law,[1] health systems' real estate arrangements with physicians and other referral sources must, among other requirements, be predicated on terms that are consistent with fair market value. Health systems often rely on internal real estate departments, internal legal teams, or external counsel to ensure these standards. In most instances, these individuals rely heavily on external valuation professionals as the experts to establish fair market value and provide the supporting valuation reports. But obtaining a report is only half the battle. Simply having a third-party valuation report "in the file" does not guarantee compliance. The ultimate responsibility rests on the health system to ensure that the valuation report establishes a sound fair market value opinion and is applied appropriately to the lease in question. Due to the Stark Law's strict liability standard, it is critical for health systems to be diligent in their evaluation and application of real estate valuation reports. This article addresses some of the fundamental elements that should be closely reviewed and highlights common misconceptions about real estate valuation reports.

The Report Should Be Prepared by A Qualified Valuation Consultant

First and foremost, health systems should take care to evaluate and engage only independent, objective, and qualified third-party professionals to perform real estate valuation services. By default, many health systems turn to a local real estate appraiser. In some cases, this is a prudent course of action, but in other cases there may be other alternatives. It is notable to highlight that neither the Stark Law nor the Centers for Medicare and Medicaid Services (CMS) prescribe a specific method of valuation or specific credentials or qualifications necessary for the purposes of determining Fair Market Value, thus leaving a certain degree of discretion to select a method that is appropriate under the given circumstances:

> *To establish the fair market value (and general market value) of a transaction that involves compensation paid for assets or services, we intend to accept any method that is commercially reasonable and provides us with evidence that the compensation is comparable to what is ordinarily paid for an item or service in the location at issue, by parties in arm's length*

transactions who are not in a position to refer to one another . . . For example, a commercially reasonable method for establishing fair market value (and general market value) for the rental of office space can include providing us with a list of comparables. We would also find acceptable an appraisal that the parties have received from a qualified independent expert.[2]

However, CMS has expressed caution regarding internally generated fair market value surveys:

While internally generated surveys can be appropriate as a method of establishing fair market value in some circumstances, due to their susceptibility to manipulation and absent independent verification, such surveys do not have strong evidentiary value and, therefore, may be subject to more intensive scrutiny than an independent survey.[3]

In light of this guidance, health systems should seek independent, third-party consultants to evaluate and document fair market value. In addition to commercial appraisers, other real estate professionals, especially those with specific experience in health care real estate development, management, and brokerage can offer valuable insight into industry-specific market factors, trends, and analytics.

When evaluating the right valuation consultant, it is important to ask a key question: Is the consultant fully qualified to provide the necessary analysis and, if needed, defend it? While credentials and years of experience are important considerations, this assessment should go a step further. Health care real estate transactions can be complex and often vary from other commercial real estate transactions. It is critical to ensure that your valuation consultant is experienced not only in the local real estate market, but also understands the health care real estate market, the applicable laws and regulations, and other factors such as medical space requirements and related construction costs.

One fundamental distinction in health care valuation is the specific fair market value definition under the Stark Law. There are multiple and varying concepts, definitions, and applications of the term "value" with "General Market Value" being the most commonly referenced in real estate valuation. The Stark Law defines fair market value as the following:

Fair market value means the value in arm's-length transactions, consistent with the general market value. "General market value" means the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset *or at the time of the service agreement. Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals. With respect to rentals and leases described in § 411.357(a), (b), and (l) (as to equipment leases only), "fair market value" means the value of rental property for general commercial purposes (not taking into account its intended use). In the case of a lease of space, this value may not be adjusted to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor when the lessor is a potential source of patient referrals to the lessee. For purposes of this definition, a rental payment does not take into account intended use if it takes into account costs incurred by the lessor in developing or upgrading the property or maintaining the property or its improvements.*[4]

While certain other definitions may be acceptable in general real estate valuation, they likely do not meet the standard required by Stark and, therefore, can potentially create unintended exposure for the health system. Most notably, the Stark Law definition of fair market value prescribes that the determination of fair market value must not take into account proximity to the lessor nor the potential volume or value of anticipated or actual referrals. The valuation consultant should be able to demonstrate a thorough understanding of the specific Stark Law fair market value definition, its application in the real estate valuation assignment, and a willingness to include the required definition in the report and reconcile findings appropriately.

Lastly, while health systems hope that they never have to defend any of their arrangements, there is always a possibility for that need to arise. In such a case, the valuation consultant will likely be called upon to defend the analysis and report. In addition to the accuracy of market data, the ability to present a logical analysis and demonstrate sound professional judgement, as well as attest to the required fair market value definition, are all critical to such a defense.

In certain instances, depending on the nature and circumstances of the valuation request, health systems may elect, or attorneys may advise their clients, to engage the valuation consultant through the attorney or law firm. In addition to invoking the attorney client and attorney work product privileges, which protect the confidentiality of communications and work products, this also inserts an objective intermediary in the process and provides an additional level of separation and quality assurance review between the valuation consultant and those on the front lines of the transaction.

The Report Should Accurately Reflect the Facts, Circumstances, and Assumptions

Health systems should ensure that the valuation consultant fully understands the pertinent facts and the report clearly and accurately presents those facts. Fundamental items will include facts about the property itself, the transaction terms, any assumptions or conditions, and the relevant time period for the analysis. It seems all-too-simple, but basic facts are often overlooked, assumed, misstated, or omitted altogether.

***The Property*.** The valuation report should include a clear and precise definition and description of the subject property being evaluated. Reports should specify the property address and include a description of the space – number of floors, square footage, and other relevant facts. If the entire building is being sold or leased, there are critical considerations around the site, zoning, building systems, and other factors. If only a specific space or suite are being evaluated, the report should specify such and provide a thorough description of the space including considerations related to suite conditions, accessibility, common areas, and square footage measurements.

The Transaction. Valuation reports should contain an accurate description of the proposed transaction, the parties to the transaction, the intended use of the space, the basis for square footage measurement, and any required renovations. In a purchase and sale scenario, the analysis will be focused on a single transaction event with heavy emphasis on the sales price. In a lease scenario, the analysis must address a longer term, multi-year arrangement with multiple factors at play. Failure to account for each of the various elements, is a common opportunity for misalignment between the valuation report and the subsequent lease arrangement.

In a leasing scenario, key terms include the term of the lease and general lease structure, most notably which party is responsible for certain operating expenses (e.g., utilities, janitorial, maintenance, taxes, and insurance). Generally speaking, “Triple-Net” or “NNN” leases include a base rent only and, in addition, the tenant is responsible for payment of building operating expenses. Conversely, “Full Service” or “Gross” leases reflect a single rent number including both the base rent and estimated operating expenses. “Modified Gross” leases can represent a myriad of hybrid scenarios where each party may be responsible for certain expense items. Specific terminology and actual operating expense amounts vary widely across markets and individual properties and the various structures can drastically impact the corresponding lease rates. For example, if real estate taxes for a certain property are approximately $2.00 per square foot and the rental rate is $20.00 per square foot, responsibility for payment of property taxes alone could impact the fair market value determination (up or down) by approximately 10%. Understanding which type of lease is being evaluated and which party is ultimately responsible for each expense item is fundamental to an accurate analysis and determination of the fair market value rental rate.

Another key factor is the determination and documentation of the leased square footage. While there are numerous and varied details that cannot be addressed here, “Usable” square footage generally reflects a demised suite area only, whereas “Rentable” square footage generally reflects the usable area plus an allocation of certain building common areas. In certain single-tenant scenarios, “Gross” square footage may be most applicable. It is often outside of the valuator’s scope to measure or confirm the exact square footage of a leased space. Instead, they may rely upon information from public tax records or utilize information provided by the health system client. Regardless, it is important to establish a mutual understanding and clearly document the square footage basis and impact on the overall valuation. An incongruence in leased square footage between the valuation and the lease itself could impact the resulting rental payments by approximately 10% - 15% annually.

Other unique factors in a lease arrangement may include tenant improvement allowances, moving allowances, rent abatement periods, or other leasing concessions.

Assumptions and Conditions. Oftentimes, certain information may not be available at the time of the analysis and it may be necessary for the valuation consultant to make certain assumptions. For example, in the case of new construction, valuators are often asked to provide an “as complete” value. Such an analysis is based on a series of assumptions such as the cost and schedule to construct the project, market conditions at the time of completion, and required timing for leasing and stabilization following completion. A health system may provide the valuation consultant with an initial set of assumptions that are subject to change. When reviewing a valuation report, take care to note any such assumptions or conditions, as they could significantly impact your review and application of the report. The terms “Extraordinary Assumption” and “Hypothetical Condition” are two common terms that warrant additional attention and review. Simply stated, an Extraordinary Assumption is an assumption made for purposes of the report, which if found to be false could alter the resulting opinion or conclusion. A Hypothetical Condition is an assumption made contrary to fact, but which is assumed for the purpose of the analysis. Any such assumption or conditions should be clearly stated and never inferred, implied, nor left to interpretation in the analysis or report.

Time Period. Fair market value reports should also specify both the effective date and time period of validity for the report. It is critical that the time period is reflective of the transaction being evaluated. A one-year time frame is fairly common, but there may be special circumstances that call for a shorter or longer time period. Health systems should be cautious to avoid reports with time periods that are too short, too long, or simply not reflective of the underlying transaction. It is important that the time period allows adequate time to negotiate and memorialize a transaction. Conversely, the time period should not be unnecessarily long as future changes to the macro economy, local market, or specific transaction details could invalidate the report and its findings and recommendations. In unique circumstances, it may be necessary for a valuation report to consider a retroactive time period or an extended future time period, both of which merit special considerations, require evaluation and documentation of relevant assumptions and conditions, and warrant a higher level of overall scrutiny and internal review in the application of the report.

The Report Should Clearly Illustrate the Analysis Performed

We all remember that dreaded "show your work" mandate from high school algebra, but it certainly rings true in this context. Health systems should require valuation consultants to clearly and concisely illustrate the data utilized, cite relevant data sources, and explain the analyses and assumptions. If the report simply states a conclusion but lacks the necessary supporting detail, request additional information to specify the methodology and supporting data.

Depending on the approach(s) utilized—Market,[5] Cost,[6] or Income[7]--the relevant data and analysis will vary. Market data will likely include comparable sale and lease transactions; Cost data will include similar project construction cost metrics or published construction cost indices*;* Income data will include a leasing analysis, typical underwriting adjustments, and debt assumptions to perform a pro forma cash flow analysis, as well as discussion of market capitalization rates. If multiple approaches are evaluated, they will likely produce somewhat different results making it necessary for the valuation consultant to evaluate the relative merits of each approach and reconcile the results to a consolidated recommendation or opinion. This reconciliation exercise is typically based largely on professional judgement; the report should make a statement to this effect and outline relevant considerations for making such judgement.

Health system personnel and attorneys are not expected to be experts on these matters. Yet, the report should contain enough descriptive narrative and explanation that the reader/reviewer can follow the general logic of the analysis, clearly understand any assumptions, and assess whether the information is applicable, and the outcome or recommendation is reasonable for the situation at hand. In the review process, consider other similar transactions and whether the current recommendation is in line with past experiences. If not, consult with the valuation consultant and document differences between the scenarios that may support the variance if the question should arise in the future.

The Report Should Clearly State the Conclusions and Intended Application

Health systems should ensure that the report clearly states the relevant conclusions and addresses the application of those conclusions. An incorrect or misapplied valuation report can be more damaging than not having a report at all. If there is any question or uncertainty about the conclusions or their application, consult the valuation consultant to discuss and obtain the necessary clarification.

A common best practice employed by many health systems and attorneys is to request preliminary feedback, including initial verbal feedback, prior to the preparation of a written report. This early communication allows both parties the opportunity to confirm the facts and assumptions, review initial feedback based on market data and initial analysis, and discuss key variables that may be subject to negotiation or otherwise not yet known. The premise of "early and often" communication can help streamline the flow of information and prevent a potential last-minute surprise or misunderstanding.

Another suggested best practice is to request that the final conclusions and recommendations be presented in a range rather than a single number or value. This serves two key purposes. First, it is representative of the real estate market and the fact that there is no one-size-fits-all in real estate transactions. There are multiple deal terms—base rent, lease term, escalators over the lease term, tenant improvements, and others—that must be considered both individually and as a whole “bundle” of rights and responsibilities. Second, the range allows a defined bandwidth for arms-length negotiations between the parties. A valuation report that provides only a single value likely does not leave room for negotiation and may prevent the parties from being able to reach an agreement. The appropriate range may vary based on the type of transaction. As noted above, the range should provide a reasonable range to allow for negotiation, but not be so large that it becomes irrelevant.

Lastly, as noted above, it is critical to ensure that the final conclusions are accurately applied in the subsequent lease agreement itself. Health systems should ensure that the final facts, circumstances, and assumptions are reconciled between the valuation report and the actual transaction agreements. All deal terms should be reconciled to ensure that the total dollars exchanged in a particular transaction are consistent with the valuation report. Even seemingly minor variances can have significant impacts when compounded over the term of multi-year lease agreements. If there are any questions about how specific deal terms are accounted for in the valuation report, those questions should be addressed before executing an agreement.

Conclusion

The real estate valuation process is a critical component of any health system’s efforts to comply with the Stark Law. While many health systems rightfully rely on external valuation experts, it is also necessary for health system representatives to take an active role in the process of obtaining, reviewing, and applying the valuation reports. From engaging a qualified consultant, verifying the facts and assumptions, confirming an understanding of the analysis performed, and ensuring the correct application of the findings, there are numerous potential pitfalls in the process that must be proactively addressed through communication and quality assurance measures.

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[1] *See* 42 U.S.C. § 1395nn; 42 C.F.R. § 411.350.389.
[2] 66 Fed. Reg. at p. 944 (Jan. 4, 2001).
[3] *Id*. at p. 945.
[4] 42 C.F.R. § 411.351.
[5] The ***Market Approach*** is based on the premise that an informed purchaser would pay no more to acquire a property than the cost of acquiring another comparable property of similar utility. The Market Approach considers the price other purchasers have paid to acquire comparable properties in an active market.
[6] The ***Cost Approach*** is based on the premise that an informed purchaser would pay no more to acquire a property than the cost of reproducing a comparable property of similar utility. The Cost Approach

considers the estimated cost to reproduce the property with adjustments for depreciation to the subject property and development risk.

[7] The ***Income Approach*** is based on the premise that an informed purchaser would pay no more to acquire a property than the cost of another comparable investment with a similar risk / return profile. The Income Approach considers the estimated present value of anticipated future benefits of ownership adjusted to reflect the relative risk associated with the potential to realize those future benefits.