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Healthcare Public Finance Update

It's Time to Consider New Financing Solutions for Leased Facilities

Executive Summary

Over the last 20+ years, healthcare providers have often engaged third party developers to build outpatient or support facilities or have sold these assets to third party investors and development entities like healthcare real estate investment trusts. Today, several factors ought to compel hospitals to rethink the traditional lease v. own solutions: 1) changes to lease accounting rules; 2) continued increase in physician and hospital consolidation; and 3) long-term facility control and site control of key ambulatory care locations.

Lease Accounting Changes Finally Becoming Effective

In 2016, the Financial Accounting Standards Board (FASB) issued a new lease accounting standard (ASC 842) which significantly impacts how healthcare providers account for and report nearly all leases, including equipment and real estate. Private companies are required to adopt ASC 842 in fiscal year 2022 for calendar year-end companies and 2023 if the fiscal year-end is June 30 or another quarter-end date.

Given the passage of time since ASC 842 was introduced, a refresher might be useful. ASC 842 requires organizations who lease assets (lessees) to recognize, on their balance sheet, the assets and liabilities for the rights and obligations created by those leases with terms greater than one year, regardless of the lease classification.

Under ASC 842 for non-profit healthcare providers, there are two types of leases: *financing leases* and *operating leases*. The requirements for each of these leases, under ASC 842 are:

Financing Leases	Operating Leases
• Recognition of a finance lease asset and a corresponding finance lease liability upon lease commencement. • The lessee recognizes both amortization expense & interest expense, with higher expense in the initial years.	• Recognition of a right of use (ROU) asset and a corresponding lease liability upon lease commencement. • The lessee recognizes lease expense, with the expense straight-lined over the lease term.

How These Lease Accounting Changes May Impact Provider Covenants

Within most healthcare provider debt documents, capital leases (now called financing leases) are typically included in definitions of indebtedness for purposes of calculating debt service coverage ratios, while operating leases are typically excluded from this calculation. Some healthcare providers have anticipated this lease accounting change by amending their financing documents to exclude operating leases under ASC 842 (and in some cases the prior accounting standard) from their covenant calculations.

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How These Lease Accounting Changes May Impact Provider Covenants (continued)

Healthcare providers that have yet to amend their financing documents to address the new lease accounting standard, there is a potential that operating leases executed before the accounting change may be included as debt service, which would then lower providers' debt service coverage ratios. There is also the potential that new leases, which would formerly qualify as operating leases, will now be treated as financing leases (formerly capital leases) and potentially impact covenant calculations.

What Lease Accounting Changes Mean for Healthcare Providers Going Forward

As providers look to renew or extend leases for fully occupied buildings or joint-venture facilities, they will need to:

1) Assess the balance sheet and covenant impacts of renewing these leases as capital/financing leases.

2) Review their "fully-leased" real-estate portfolios and look for opportunities to purchase buildings outright or facilitate a non-profit charitable foundation purchase and lease back (CFL) to potentially generate occupancy cost savings.

3) Providers should consider the long-term costs associated with occupying these assets to ensure they are not paying for them 2 or 3 times over.

Providers have a wide variety of financing structures to consider, including direct debt, leasing, and tax-exempt charitable foundation leases for their administration, support buildings, and joint-venture facilities. These structures can be used to lower the ownership cost on existing leased facilities.

To understand the benefits of each of these options, providers should complete a financial analysis of their real estate portfolio, including an assessment of the covenant impacts, to determine if an on-balance sheet acquisition (via direct debt) or a CFL acquisition and leaseback creates value relative to leasing from a developer.

Charitable Foundation Lease Transactions

In Charitable Foundation Lease (CFL) Transactions, independent 501c3 organizations, serve as project owners and source the capital to develop or acquire the facility.

The facility is master-leased by the hospital (the "Tenant") for use in furtherance of its charitable purpose. After amortization of project capital, the property will revert to the Tenant.

Tenants can work with a landlord whose charitable objectives are aligned with the hospital and not motivated by profit.

Benefits and considerations of a non-profit CFL transaction include:

Benefits

- Lower occupancy cost as compared to any other 3rd party for-profit financing structure
- Potential avoidance of property taxes vs. developer-owned
- Escalation of real-estate value accrues to provider
- Financial ratio impact on the balance sheet is more modest for operating leases with change in accounting standards

Considerations

- Covenant and financial ratio impact based on whether the lease is treated as an operating lease or financing lease.

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Considerations for the Acquisition of Outpatient Care and Support Facilities

Steps to determine the viability of acquiring leased healthcare and support facilities include:

- ✓ Determine what properties in your portfolio are "core assets" you would like to control in the future
- ✓ Review your portfolio of leases to see what purchase options you hold and when the options are available
- ✓ Determine market purchase rates (or negotiated purchase prices) to see if an on-balance sheet acquisition or CFL acquisition with leaseback is value creating relative to your future stream of payments
- ✓ Assess the covenant impacts of the various acquisition financing models
- ✓ Determine the value-creating opportunities and the preferred financing structure
- ✓ Work with a commercial real estate consultant to approach the property owner with an offer to purchase

How to Assess the Potential Opportunity

1) Contact to your Piper Sandler banker to examine your operating leases and covenants to determine what current and future risks and opportunities exist.
2) Explore an analysis of the full set of financing solutions involved in continuing to lease or acquire (either directly or through a CFL structure) these leased facilities.
3) Consider retaining an outside real estate consultant, such as Hall Render Advisory Services, to review your portfolio of leased real estate buildings to explore the ability to potentially acquire these buildings.

The authors thank John Marshall of Hall Render Advisory Services (jmarshall@HallrenderAS.com) for his insights in the creation of this article.

We encourage you to reach out to the banking professionals below to learn more about potential opportunities:

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