# Notes on ***Leased Fee*** and ***Fee Simple*** Valuations of Medical Office Buildings (MOBs)

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As part of the initial steps in the appraisal process, the appraiser must understand special nuances of asset values affecting medical office buildings (MOBs), as discussed in the following section.

**Typical Lifecycle and Nuances of Medical Office Buildings (MOBs)**

Physicians in larger physician practice groups tend to prefer to occupy relatively new MOBs. MOBs constructed by hospitals or larger physician practice groups are usually leased triple net (NNN), which means the tenants are also responsible for their share of all operating expenses for the building, including management. When initial leases are signed, many prior to the construction of the building, tenant leases are often grossed-up, meaning tenants are also required under the lease to pay prorata shares of rent and operating expenses for common areas of the building. For instance, if the tenant is renting 4,000 square feet in a building with a 15% load factor, they only occupy or use 3,400 square feet (4,000*.85) The net effect of this structure means the owner of the building receives the rent and may not be obligated to pay any operating or out-of-pocket expenses. Under this structure, there is a strong investment market to resell the asset, particularly if the guarantor is a strong credit.

In the current MOB market environment, the initial leases in the new buildings are typically for ten to fifteen year terms. Tenants that have specialty imaging, surgery center or lab finishes may negotiate with the landlord to construct these more expensive tenant finishes, but they will have to pay higher rent and may have to accept longer lease terms to compensate the landlord for providing those more expensive finishes in the building.

Many medical office buildings today need upscale electrical sources to operate imaging equipment; they need greater access to water for treatments and procedures; they need fiber optic cables for high-speed access and transfer of electronic medical records. As MOBs begin to age, they may no longer have the most modern tenant layouts, and the buildings also may no longer have the most up-to-date electronics and building system infrastructures. Changing technology in MOBs can have an impact on the competitiveness of MOBs as they get older.

A hospital operator, or initial MOB owner, may master-lease all of the MOB space in building to entice a banker to finance the building's construction costs, or to monetize (recapture) the investment (construction cost, land cost, etc.) after the building is completed. A common vehicle to accomplish this, once the building is constructed and occupied, is a sale/leaseback agreement with a real estate investment trust (REIT). A sale/leaseback is a financing vehicle that can allow the prior building owner to recapture 100% or greater of the costs of construction, as opposed to other long-term real estate financing that more typically is limited to 65% to 80% of value. The REIT's tax benefits and lower cost of capital often gives this type of acquiring entity a purchase advantage. The seller in a full sale/leaseback typically signs a 10-15 year master lease term, with annual rent escalations, and multiple renewal option periods. The sale price amount and annual rent are somewhat dependent upon the desires of the seller/tenant and their credit strength. *The REIT buyer will likely record or designate all or most of the Leased Fee purchase price as real estate value, in order to meet REIT accounting and acquisition rules and requirements.*

This financing vehicle can be favorable in the early years of the building, when the building owner wants to collect a profit or recapture that investment for other uses. This vehicle can become very burdensome to the tenant in later years when the escalating rent has risen significantly, while the building is depreciating or showing signs of aging or functional obsolescence. If the seller does not continue to occupy all of most of that space, they may have to sub-lease some of the MOB space to additional physicians or physician groups or other tenants in order to recapture some of the master-leased rent being paid under the sale/leaseback. At that time, the net combined sublet rent can be, and often is, significantly less than the contract sale/leaseback rent that includes all building expenses.

*[Note: A hospital company is required to charge market rent to MOB tenants, under any lease with physicians, or potentially face severe penalties under the Stark II anti-kickback law.]*

The market rent for the sublease tenants may be declining while the master-lease rent continues to escalate under the contractual sale/leaseback agreement. It may also be difficult to sign up new sublease tenants as the building ages and no longer meets modern medical delivery standards. As discussed below, the value derived from master-lease contract would represent a Leased Fee value. Leased Fee in this case is a representation of contract value, not necessarily market value. The value derived from market rent and market occupancy would represent Fee Simple market value.

Also, as MOBs age, the leasing structure often changes. After the first or second leasing cycle for the building, tenants may no longer be willing to pay a NNN lease, or to lease more (grossed-up) space than they physically occupy. As MOBs get older, tenants often will only lease usable suite area. They begin to request modified gross or gross leases, where the landlord takes more responsibility for maintenance, and inefficient or aging utilities systems, management fees or other uncontrollable operating costs. It is not uncommon to see an aging building, constructed and previously occupied as a medical office building, began accepting general office tenants, as current MOB tenants no longer see the benefit of being in this building or location.

The Leased Fee value is a value conclusion based on the contract leases and contractual cash flow terms. The following is a clarification of why above-market rent is inconsistent with Fee Simple real estate value:

- *Leased fee sales and value conclusions for medical office buildings may include more than just real estate value* – Leased Fee sales are acquisitions with leases or contracts in place. *According to appraisal literature, documented here, values derived by above-market rent represents intangible value, not Fee Simple real estate value.* The acquisition of a property with an existing lease in place can include intangible or business value. For example, an investor acquires a property with an annual rent that increases each year based upon the CPI or other index. That lease has years remaining on that lease term, and rents to the buyer will continue to increase based on lease contract escalations and the guarantees in that contract. As the real estate ages and depreciates, the value of the real estate does not continue to increase, although the contract rent continues to rise under the contractual obligation. The buyer is pleased with this investment, because they have the guarantee of the tenant that this rising income will continue. *The value of the investment, however, based on the above-market rent, is intangible value or business value.*

- *Sale/leasebacks on medical properties are often at above-market rent for the real estate* - It is typically the goal of sellers in medical building sale/leaseback arrangements to raise the most capital at the time of the sale; these monies are then used to fund operations or renovations, to pay off existing debt, or to develop other properties presently planned or anticipated in other locations. The sellers in the sale/leaseback transactions are often willing to accept higher rents, secured by the contract lease agreement, with rents increasing annually into the future. These sale/leaseback rents may be based on arms-length negotiations, but they are often at contract terms that include above-market rent solely for the subject real estate. The sale/leaseback buyer sometimes further reduces their potential investment risks by obligating the leaseback seller to cross-default agreements with multiple other properties in other locations. *Again, the value of the investment, based on the above-market rent, is intangible value or business value.*

The following references provide further documentation that above-market rent component represents intangible value:

1) The Uniform Standards of Professional Appraisal Practice (USPAP) FAQ 194 (Pages F-88 and F-89) addresses situations when there is a Leased Fee sale when the *"price*

*was well above replacement costs."* USPAP requires appraisers to analyze the effect of the lease on the value.

2) An above-market lease rent represents intangible value, according to the following quote from P.441 of *The Appraisal of Real Estate, 14th Edition*: *"A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract."*

3) *According to Karvel & Patchin (Appraisal Journal, 1992, P. 454), "Lease premiums that result in rental payments above market rental are a source of business value."*

4) Section 96 of the Wisconsin Supreme Court case *Walgreen & Co. vs. City of Madison* stated *"a lease favorable to the lessor does not increase the fair market value of the real property; any potential increased value in excess of the value of a fee simple interest in the property is attributable to the particular lease and constitutes the value of contract rights rather than real property rights."*

When a recent Leased Fee sale of a property is for a price significantly above the current replacement costs, USPAP states that there may be intangible value associated with the Leased Fee transaction. Further, Standards Rule 1-4(d) states: *"When developing an opinion of value of a leased fee estate or a leasehold estate, an appraiser must analyze the effect on value, if any, of the terms and conditions of the lease(s)."*

Appraisers can perform Leased Fee or Fee Simple value estimates to meet professional practice guidelines and client requirements. Appraisers are frequently asked to value the Leased Fee estate of MOBs. **If real estate value, however, is indicated and required for the purpose of the assignment, then the appraiser may also need to prepare a value of the Fee Simple estate.**