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## Valuation of Real Estate Within Senior Living Facilities

William "Trey" Beazley III, MAI; Steven Sparks, MAI; Michael Bates, MAI, ASA

### ABSTRACT

To properly establish the value of a specialized health care facility such as seniors housing, an analyst must understand the underlying elements that create value in the business entity. It may be difficult to separate the market value of the land and the building from the total value of the business, but such division of realty and non-realty components of value is often required. Estimating the value of any complex property, where the income and expenses are driven by both the real estate and business, one must rely on a recognized methodology supported with market data to properly account for the components of land and buildings, along with tangible and intangible personal property. This article builds on growing market knowledge and provides a quantitative analysis to support reasonable allocations of the real estate component of various seniors housing facilities.

## INTRODUCTION

Is senior living considered an operating business, real estate, or both? The answer has important implications, since real estate assets are different from business assets. Investors, lenders, and specifically appraisers should be knowledgeable in component allocation to properly understand seniors housing transactions. Appraisers are required by Standard Rule 1-2 of the Uniform Standards of Professional Appraisal Practice (USPAP) to separately identify any assets being valued that are not real estate.

Independent living facilities (ILFs) and assisted living facilities (ALFs) provide primarily room and board and limited care services, and the funding for these facilities is mostly private pay. Skilled nursing facilities (SNFs) are more special-purpose institutional structures due to governmental controls and health care regulations. In recent years, most of the funding for SNFs is via public programs, including Medicaid and Medicare. Medicaid and Medicare payments for skilled nursing services do not consider the quality of real estate improvements, but there is a cost factor for real estate as part of the overall cost reimbursement process underlying the payment formulas. Under real estate theory, the age of an SNF should be a more important factor in determining value than the revenue generated by Medicaid or Medicare program rate reimbursements.

Real estate appraisal literature includes a bounty of articles (Lennhoff, 1999; Mullen, 1999; Wallery, 1991) citing the existence of intangible value in seniors housing properties, which include ILFs, ALFs, and SNFs. A going concern is an established and operating business with an indefinite future life. For certain types of properties, the physical real estate assets are integral parts of an ongoing business. Accounting regulations require this allocation between the real estate and the business personal property (BPP), which is both tangible and intangible. Seniors housing and care is correctly defined as a "real estate-based business," and real estate is a depreciable asset while intangible business value

is not depreciable. A proper allocation of the real estate value is also important for real estate lending, accounting integrity, or property tax valuations.

According to the *Dictionary of Real Estate Appraisal* (2010), the term market analysis is "a process for examining the demand for and supply of a property type and the geographic market area for that property type." This term is used more broadly in economics but has a more specific meaning within the real estate discipline. Market analysis investigates the relationship between the demand for and competitive supply of real estate in a defined market. Seniors housing market analysis requires extensive examination to properly support the value of the going concern and to estimate the portion of the going concern that is real estate.

## Proposition

Is there a mechanism that gives supportable allocations? Market evidence indicates that there is quantitative support for reasonable real estate allocation ranges for seniors housing properties. The analytical framework begins with the Principle of Substitution. This article provides a methodology to support a reasonable allocation range for the real estate component and BPP component out of the total going concern value.

## OVERVIEW

The task facing most analysts is that seniors housing properties are bought and sold as going concerns with residents in-place. The going concern includes all tangible and intangible personal property in the sales transaction. Tangible personal property encompasses office equipment, kitchen equipment, and resident furniture. Intangible personal property includes accounting systems, workforce, personnel manuals, medical records, insurance contracts, reputation and goodwill, working capital, and in most cases, corporate marketing and management expertise necessary to attract and maintain market occupancy.

One factor complicating the analysis of sales is that most transactions involve multifacility (or portfolio) transactions, which may include a significant premium in price compared to individual facility sales. According to *The Senior Care Acquisition Report* (2008), the average price per unit for portfolio sales was 20.3% higher in 2007 and 26.4% higher in 2008 than single-unit sales. The second factor is many of these multifacility transactions involve real estate investment trusts (REITs). Under historical tax codes, REITs are not allowed to have more than 10% of their portfolio in non-realty items (recent legislation appears to be easing this requirement). As a result, there may be legal pressure to allocate a lower ratio to intangible or business value, so that real property is at least 90% of the acquisition price.

In a comprehensive article on sale-leasebacks, Sirmans and Slade (2010) provided documentation that sale-leasebacks occur at average price premiums that were 13.86% higher than non-sale-leasebacks: "The findings reveal that transactions structured as sale-leasebacks occur at significantly higher prices than market transactions." Based on this research, sale-leaseback transactions should not be used to estimate the market value of the fee simple real estate without further analysis to recognize the component allocation of real and personal property.

Sale-leasebacks are an investment vehicle commonly used by various investors to invest in health care properties. In some cases, the investor acquires the real estate and the same independent operator continues to operate the facility. The investor is partnering with the operator. Sale-leasebacks are considered financing transactions because of corporate tenant guarantees, buy-back options, joint ventures, income from the operating business determining the rental payments, and investor lease structures, which often include working capital as well as tangible and intangible personal property. Working capital (or short-term assets minus short-term liabilities) is the money that is needed to fund day-to-day business operations. Tangible personal property is furniture and equipment, while

intangible personal property may be the value of the workforce or goodwill or other non-physical assets. The intangible personal property assets are also commonly referred to as business enterprise value. An investor lease structure will often include ownership or control of some of these non-real estate assets. This makes the process of separately identifying real estate value more difficult.

In most states, property taxes are assessed based on a fee simple real estate value, and courts have ruled that values derived from above-market leases reflect intangible or contract value rather than real estate value. According to Karvel and Patchin (2001), "Lease premiums that result in rental payments above market rental are a source of business value." This was further confirmed by a July 8, 2008, The Wisconsin Supreme Court case called *Walgreen & Co. vs. City of Madison*. In Section 96 of that case, the court stated (*The Appraisal of Real Estate*, 12th ed.), "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."

Another court ruled that there is significant intangible value in nursing homes. In a New Britain, Connecticut, superior court case in 2006, *Avon Realty, LLC vs. Town of Avon*, on page 14 of the ruling, "the court finds that a nursing home's intangibles, not its real estate, are its major components of value." The nursing home had an average physical age of approximately 30 years. In that case, an appraiser had observed, "the real estate is worth little without the intangibles." ILFs and ALFs also clearly have significant BPP components.

In *The Journal of Property Tax Management*, Wallery (1991) states, "There are businesses housed within congregate care facilities, including food service, housekeeping, and activity. Services are provided for a fee that usually includes business profit. These services are labor intensive, and the profit earned is attributable to the business, not to the tangible

real property." Over the past 20 years, these services have expanded multifold and now also include vans for transportation to events in the community, as well as shopping, activities, salons, exercise classes, and other programs. This has expanded the overall going concern.

According to Lennhoff (1999), "senior housing is another good example of the type of property in which business enterprise value plays a major role." This was reinforced by Lennhoff, quoting the CEO of a senior living company: "Assisted living is not a real estate business. It's an operating business that happens to take place in real estate." According to Lennhoff, "When asked to value just the real estate, using the Cost Approach is relatively straightforward." (The Cost Approach is discussed in detail in a later section.)

Mullen (1999) estimated real estate ratios at 73.5% for congregate care facilities, 53.1% for assisted living facilities, and 36.7% for nursing homes. Mullen's calculations support the real estate allocation ranges derived in this article.

### **Income Approach**

The Income Approach is a common appraisal methodology that capitalizes real estate income into an estimate of property value. This approach becomes complicated because a seniors housing property's actual revenue and expense statement represents a going concern operation rather than an income statement based on real property only (land and building). Supporting a going concern value for the entire business operation is fairly straightforward using the Income Approach. The biggest difficulty valuing a senior living facility by the Income Approach is allocating the total going concern between 1) real estate; 2) personal property; and 3) business enterprise.

There are published seniors housing industry operating and acquisition data that can be used to test the reasonableness of facility financials and operating data to estimate the going concern value, which is the value of all facility component assets. National

occupancy data, loan data, new construction and capitalization rates are available by seniors housing property type from the National Investment Center (NIC). Another source providing average occupancy rates, purchase price data, gross income multiples and capitalization rates is the annual *Senior Care Acquisition Report* (Irvin Levin Associates, Inc.). *The State of Senior Housing* (American Senior Housing Association, ASHA) is an annual report that provides average income and expenses and ratios by seniors housing property type. This published and subject financial data can be used to estimate the net operating income (NOI), which is capitalized at a market overall rate that is readily available in the marketplace to estimate the going concern value. Additional sources are available from brokerage and consulting firms.

The sources in **Table 1** provide market overall capitalization rates that reflect the return investors are paying to acquire going concern interests for operating seniors housing properties:

All reported surveys reflect distinct differences in capitalization rates for ILFs, ALFs, and SNFs. The market is recognizing the difference in risk and required returns associated with each property type. There are fewer alternative uses for the more institutional SNF structures, which creates higher risks for potential buyers. As government controls, regulations, and potential insurance liabilities increase from ILFs to ALFs to SNFs, there are fewer prospective buyers. This creates higher risks and thus higher required returns; e.g., most pension funds and many other large investors will not buy SNFs because of government regulations and the associated higher liability risks. As a result of the increase in perceived risk, the market-indicated required returns also increase from ILFs to ALFs to SNFs.

When developing a methodology to separate the going concern value between the real estate and BPP, the starting point is to estimate the going concern value using revenues and expenses (market averages and actual), and market capitalization rates for the going concern. The Income Approach is

the most applicable approach to support the going concern value.

**Table 2** is a detailed analysis of the revenues and operating expenses of ILFs, ALFs, and SNFs.

Data on Lines 1, 2, and 4 come from data sources cited previously, including *The State of Senior Housing* (2010), *The Senior Care Acquisition Report* (2010), and the *NIC Investment Guide* (2010). The most common formula for Value is Income (NOI) divided by Rate (or  $V=I/R$ ). Line 3 shows the net operating income (NOI) of the going concern, or expenses subtracted from total revenue. Total Going Concern is a calculation dividing NOI by the Overall Rate,

resulting in average going concern values by property type. Next, this analysis looks at the principle of substitution via the Cost Approach to estimate the real estate component value and to separate the real estate value from the going concern value. This was implied previously by Lennhoff (1999) and stated explicitly by Bates (1997), which supports the Cost Approach as the preferred method to estimate component values for the total going concern value.

**Cost Approach**

A frequent misconception when valuing a senior living facility is that cost always equals value. The

	Independent Living	Assisted Living	Nursing Home
NIC	8.8	9.9	13.3
Slysinc Study	8.5	9.1	12.8
Marcus & Millichap	8.5	8.9	12.5
Senior Acq Report	8.1	9.9	12.8
Concluded	8.8	9.5	12.5

Line	Income Approach	Ind. Living	Assisted Living	Nursing
1	Total Revenue	\$35.03	\$57.79	\$283.31
2	Expenses	\$21.86 62.4%	\$41.13 71.2%	\$239.66 84.6%
3	NOI / SF	\$13.17 37.6%	\$16.65 28.8%	\$43.65 15.4%
4	Overall Rate	8.8%	9.5%	12.5%
5	Total Value Going Concern via Income	\$149.70	\$175.31	\$349.20

*All dollar amounts are on a per square foot (SF) basis.*

fact is that the cost may, under certain circumstances, be a reliable indicator of value. Reported improvement values may also reflect their "value in use" when they comprise an integral part of a business enterprise. Some factors determining the relevance of the Cost Approach: the Cost Approach is more reliable with sufficient data to support land value and replacement cost of the improvements; the Cost Approach is more relevant for properties where actual rents reflect going concern operating cash flows; the Cost Approach is typically more relevant when comparable sales include more than just real estate assets; and the Cost Approach has a great advantage in that it is not tainted with tangible and

intangible personal property issues.

**Table 3** is a quantification of the Cost Approach allocation process. It is assumed that anyone performing these calculations has a knowledge and understanding of current market conditions affecting the various health care industries (ILFs, ALFs, SNFs).

Going Concern Value in Table 3 comes from Table 2. "Replacement Cost New" estimates on a national basis from multiple sources, including but not limited to Marshall & Swift, RS Means, Design Cost Data,<sup>1</sup> and project managers who build these types of facilities. Land value is supported and estimated from the analysis of seniors housing properties using

Line		Ind. Living	Assisted Living	Nursing
1	Going Concern via Income	\$149.70	\$175.51	\$349.20
2	Replacement Cost New/SF	\$86.92	\$92.22	\$138.75
3	<u>Plus Land</u>	<u>\$25.00</u> 28.8%	<u>\$35.00</u> 38.0%	<u>\$60.00</u> 43.2%
4	Total Cost	\$111.92	\$127.22	\$198.75
5	Average Effective Age	15 <sup>1</sup>	16 <sup>2</sup>	32 <sup>3</sup>
6	Depreciation	30.00% 50	35.56% 45	80.00% 40
7	Market Value of Land & Improvements	\$85.84	\$94.43	\$87.75
8	Implied BPP Market Value	\$63.82	\$80.83	\$261.45
9	Percentage to BPP	42.6%	46.1%	74.9%
10	Percentage Real Estate	57.4%	53.9%	25.1%

<sup>1</sup> IL Average Age Per National Investment Center for the Senior Housing & Care Industry is 15.4 years  
<sup>2</sup> AL Average Age Per National Investment Center for the Senior Housing & Care Industry is 15.8 years  
<sup>3</sup> Nursing Home Average Age Per The Senior Care Acquisition Report, 15th Edition, 2010 is 32.1 years

<sup>1</sup> Marshall & Swift, RS Means, and Design Cost Data are subscription-based cost services used frequently in the appraisal and construction industries.

ratios of land-to-replacement cost.

This analysis only considers physical depreciation, assuming there is no economic or functional depreciation present. Physical depreciation is a reflection of the age of the improvements. There could be economic depreciation present if the property being valued was located in an area of low demand or oversupply. There could be functional depreciation, for instance, if there was a structural problem that negatively impacted occupancy or rental rate levels. For the purpose of this analysis, the authors have not considered any economic or functional depreciation.

Line 5 shows the average effective ages of each facility type. According to NIC, the average ages for ILFs and ALFs were 15.4 years and 15.8 years, respectively. The average age of SNFs was 32.1 years, according to *The Senior Care Acquisition Report* (2010). The average economic life for each facility type in Line 6 was derived from several sources, including Marshall & Swift and the American Hospital Association.

Line 7 represents the market value of the land and improvements of each facility type by the Cost Approach. This is the depreciated value of Line 2 plus Line 3. When compared to the going concern value (Line 1), Line 8 shows the implied premium paid for the business personal property (BPP), the non-realty component. Finally, in Line 9 and Line 10, the ratio between the BPP and real estate is calculated.

## Case Study

This case study expands upon a previous methodology and demonstrates that it produces a reasonable allocation for the various interests in seniors housing transactions. The methodology follows USPAP in properly addressing non-realty component values that are part of the going concern. The reader is cautioned that in applying the Cost Approach, a qualified practitioner should use market-supported costs to support or complement any replacement cost estimates derived from costing services.

**Table 4** uses the market data from Table 3 to show

what ratios would be for various facilities of different ages. These ranges are quantitative results from data commonly available in the market, and the results of this analysis are reflective of the market. The reader is cautioned that these ratios are calculations based on market averages. The experienced analyst needs to make adjustments for particular property and market characteristics. Some of the main factors that would require potentially major comparative adjustments are:

- Superior location and high demand and occupancy rates
- Inferior location and low demand and occupancy rates
- A significant difference in the number of units and economies of scale compared to transaction averages
- Areas with limited demand and low land values
- Very new or very old facilities with or without functional issues

Table 4 includes a sensitivity analysis using the Cost Approach to calculate the real estate component ratio for the following building ages: 10 years, 15 years, 20 years, 25 years, 30 years, and 35 years. It is clear that as seniors housing facilities age, the ratio of real estate value declines and the ratio of BPP values rise. In reality, as the real estate ages the tangible personal property value usually also declines, while the intangible value increases. This makes sense because established businesses typically become more profitable as they mature (Advertising Beacon, 2011).

The bottom of Table 4 and the following graphs reflect changing real estate allocations as the facilities age.

The sensitivity analysis is a graphic representation of real estate ratios using simple age-life depreciation without consideration for functional or economic issues. The table and graphs indicate that the real estate ratio declines and the BPP ratio rises as a facility gets older, given the same level of total going concern value. In actuality, the ratio trend lines would not be linear, particularly in the earlier and

Table 4						
Inputs	Independent Living		Assisted Living		Nursing Home	
Going Concern Cap Rate	8.8%		9.5%		12.5%	
Subject NOI/SF	\$13.17		\$16.65		\$43.65	
Going Concern Value	\$149.66		\$175.26		\$349.20	
RCN	\$86.92		\$92.22		\$138.75	
Land Value/SF Improve	\$25.00		\$35.00		\$60.00	
Ratio of Land to RCN	28.8%		38.0%		43.2%	
	IL - Econ Life 50		AL - Econ Life 45		NH - Econ Life 40	
Age	RE %	BPP%	RE %	BPP%	RE %	BPP%
10	63.2%	36.8%	60.9%	39.1%	47.0%	53.0%
15	57.4%	42.6%	55.0%	45.0%	42.0%	58.0%
20	51.6%	48.4%	49.2%	50.8%	37.0%	63.0%
25	45.7%	54.3%	43.4%	56.6%	32.1%	67.9%
30	39.9%	60.1%	37.5%	62.5%	27.1%	72.9%
35	34.1%	65.9%	31.7%	68.3%	22.1%	77.9%

late years of a building's life. In the early few years of a building's life, there is typically very little physical depreciation, while in the later years the remaining building is usually depreciating very rapidly.

**Table 5** is a summary of component allocations derived in this Cost Approach compared to previous allocations discussed by Mullen (1999). The authors have reconciled the results of these studies into ranges of real estate to going concern values for average-aged ILFs, ALFs, and nursing homes. A 15-year-old ILF should have a real estate component ratio of 35% to 70% of the going concern. A

32-year-old nursing home should have a real estate component ratio that ranges from 20% to 55%.

As long as there is a profitable operating business in the real estate, there is intangible business value that needs to be recognized. Just like there could never be 100% real estate value, there also could never be zero real estate value as long as an operating business continues to function profitably in the real estate. Hence, an appraiser would have to understand the seniors housing facility business to accurately opine about real estate component allocations.

The Income Approach is not considered reliable in

estimating the real estate values or real estate ratios of seniors housing properties because revenues and expenses represent going concern operations rather than income and expense solely applicable to real property (land and building).

A Sales Comparison Approach to separately estimate the real estate of seniors housing facilities is hindered by the fact that most market transactions are going concerns and are often part of multifacility acquisitions. The lack of availability of clearly

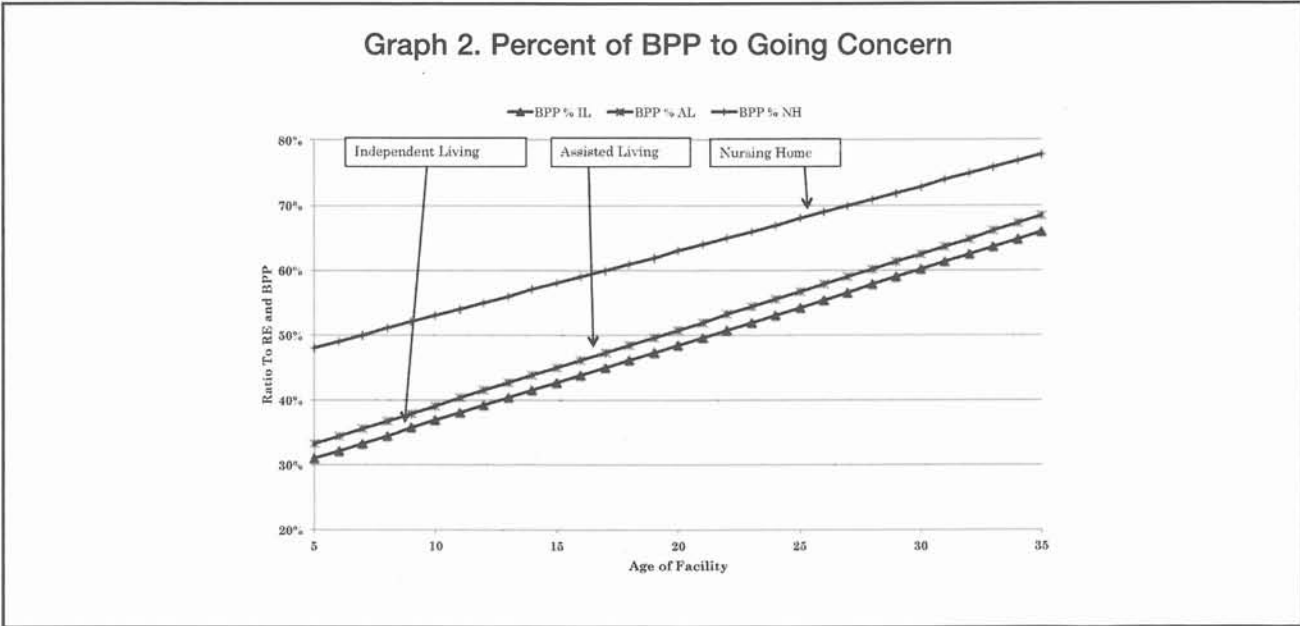
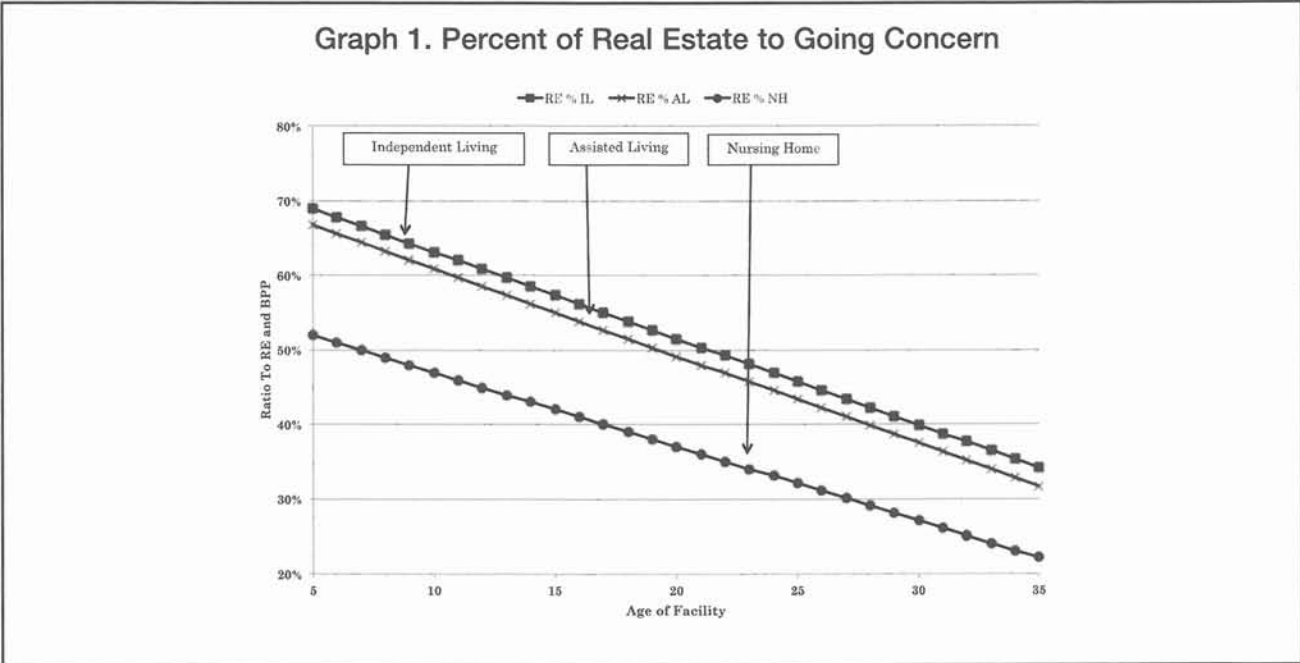


Table 5			
Allocation of Going Concern to Real Estate			
	ILFs	ALFs	Nursing Home
1999 Mullen's Article	73.50%	53.10%	36.70%
2011 Cost Approach Method	57.36%	53.88%	25.13%
Age	15	16	32
Range based on Age of facility	35% - 70%	30% - 65%	20% - 55%
Age Range for all facilities	5 to 35 years		

supported real estate-only sales makes the use of the Sales Comparison Approach difficult for this process. According to Unland (1993), "the sales comparison approach can provide a 'frame of reference,' but that is the extent of its usefulness..."

## CONCLUSION

As with any analysis of a complex property, the availability of relevant market data is a critical factor in producing a reliable and supported conclusion. This analysis includes a market-supported methodology to allocate the real estate and BPP components within the going concern. The process is more difficult and time-consuming because both standard real estate due diligence and the business/management due diligence must be completed. The BPP and real estate allocations percentages change over time as facilities age. A combination of the Cost Approach and the Income Approach provides the market support for the allocation between the real estate and BPP.

Understanding the market forces that impact the seniors housing industry is the key to valuing a senior living facility. Again, according to Unland (1993): "To properly establish the value of a specialized health care organization or facility, one must

understand the underlying elements that create value in the business entity."

Failure to perform a detailed market analysis of the industry and to understand the market forces that face the industry would preclude the possibility of a credible and market-supported analysis. According to *The Appraisal of Real Estate*, "It may be difficult to separate the market value of the land and the building from the total value of the business, but such division of realty and non-realty components of value is often required by federal regulations. Only qualified practitioners should undertake these kinds of assignments, which must be performed in compliance with appropriate USPAP standards" (Appraisal Institute, 1996). Employing nationally recognized market data sources and quantitative methods as described here with a detailed knowledge of the seniors housing industry, the allocation between BPP and real estate can be reasonably supported. This analysis confirms there are definable and supportable value ranges for the real estate component within going concern senior living facilities.

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