Modern Healthcare

The REIT Way to Finance Growth for Not-for-Profit Hospitals

October 22, 2016

Real estate investment trusts are moving to the forefront in financing expansions of for-profit hospital chains.

Medical Properties Trust, one of the few REITs that specialize in hospital real-estate investment, is helping launch the national expansion of nine-hospital Steward Health Care System of Boston through a planned $1.2 billion purchase of Steward's hospital real estate. The firm will lease the property back to Steward.

As part of the deal announced in September, Birmingham, Ala.-based Medical Properties Trust, or MPT, also invested $50 million in Steward equity and committed to spending up to another $1 billion for the real estate of hospitals that Steward acquires nationally, said MPT CEO Ed Aldag.

Steward CEO Dr. Ralph de la Torre said his organization will look to acquire health systems outside of Boston. It is looking for hospitals that sit at the center of a fully developed delivery network of ambulatory, diagnostic and physician facilities, or where that continuum of care can be built out by Steward.

That's the approach that Steward has used in Massachusetts. Just buying hospitals is a recipe for trouble, de la Torre said. “You need to be able to develop an integrated model” to deliver the best care for patients and the lowest costs for payers.

REITs—or companies that own and maintain income-producing real estate—are an alternative way to finance growth. It unlocks accumulated capital in hospital and outpatient center real estate. More than 50% of all U.S. hotels, for instance, are now owned by REITs.

Instead of selling bonds for expansion or diluting stock with secondary equity offerings, the cash can be put to immediate use. Hospitals pay rent in long-term leases with the facilities.

Many healthcare companies have gotten over-extended in the past three years by using debt to finance large acquisitions. Many of those deals are now being unwound.

Notably, Community Health Systems of Franklin, Tenn., is selling hospitals and other assets to reduce its $15 billion debt burden, which included the $7.6 billion borrowed for the disastrous 2014 acquisition of Health Management Associates. Englewood, Colo.-based Catholic Health Initiatives is trying to sell its health plan business after increasing its debt to buy plans beginning in 2013.

MPT isn't the only REIT seeing opportunities in the healthcare sector. REIT industry giant Ventas is providing the bulk of the financing for Ardent Health Services' $850 million acquisition of LHP Hospital Group announced earlier this month.

Ventas is loaning Ardent $700 million to buy five-hospital LHP, a deal that will make Nashville-based Ardent the nation's second-largest privately held for-profit hospital company by revenue, with a total of 19 hospitals and annual revenue of about $3 billion. Ventas already owns the real estate of 10 of the 14 hospitals that Ardent brings to the merger as well as most of the health system's ancillary medical facilities.

Chicago-based Equity Group Investments, an affiliate of billionaire Sam Zell that is already a majority owner of Ardent's operating side, is putting the additional equity into the deal to buy LHP. It is scheduled to close in the fourth quarter, said Ardent CEO David Vandewater.

Most active subsectors in Q3 2016

Subsector	Deals
Drugs and biologics	31
Medical devices	24
IT	15
Physician practice	10
Medical offices	4

Source: Modern Healthcare Mergers & Acquisitions premium database

These deals are breaking new ground for the healthcare industry. Major provider groups have been comfortable with REITs owning medical office buildings and ambulatory centers, but only recently have they been willing to work with REITS to unlock the value in hospital real estate.

MPT's Aldag said just 1% of acute-care hospitals are owned by REITs, well below the 15% of all commercial healthcare real estate owned by the investment vehicles. The universe of healthcare real estate assets is about $1 trillion, with about $300 billion of that value in acute-care hospitals, according to Debra Cafaro, CEO of Ventas.

MPT is the established leader in hospital REIT ownership with 240 facilities in its portfolio. Most of its properties are in the U.S., but it also owns hospitals in Germany, Italy, Spain and the United Kingdom, Aldag said.

Hospital systems, especially the not-for-profits, have traditionally been shy about selling hospital assets because most have been owned for generations and a system's identity is tied up with them, Aldag said.

But selling the real estate frees up capital for expansion and quality improvements, the REITs argue. “We're nothing more than a financing mechanism.” Aldag said.

The hospital operator maintains control of all operations, including providing charity care that is crucial to their missions.

REITs are stepping forward at a time that capital is getting scarcer for providers. Healthcare merger and acquisition activity through the first nine months is down about 50% from a historically busy 2015.

Top 10 largest M&A deals in Q3 2016

Announced	Acquirer	Seller or target	Target location	Deal value	Deal type	Subsector
7/5/16	Ventas	Wexford Science & Technology	Maryland	$1,500,000,000	Acquisition	Healthcare REITs
7/28/16	Fosun Pharma	Gland Pharma (KKR)	India	$1,260,000,000	Acquisition	Drugs and biologics
9/26/16	Medical Properties Trust	Steward Health Care System	Massachusetts	$1,250,000,000	Acquisition	Healthcare REITs
7/11/16	Nichi-Iko Pharmaceutical Co.	Sagent Pharmaceuticals	Illinois	$736,000,000	Acquisition	Drugs and biologics
7/11/16	Pantheon	NA	NA	$579,000,000	IPO	Drugs and biologics
7/13/16	Thoma Bravo	Imprivata	California	$544,000,000	Acquisition	IT
8/3/16	Teva Pharmaceuticals	Anda distribution (Allergan)	Ireland	$500,000,000	Acquisition	Drugs and biologics
7/27/16	Laboratory Corporation of America	Sequenom	California	$302,000,000	Acquisition	Medical devices
7/6/16	Bio-Techne	Advanced Cell Diagnostics	California	$250,000,000	Acquisition	Drugs and biologics
8/1/16	Pfizer	Bamboo Therapeutics	North Carolina	$150,000,000	Acquisition	Drugs and biologics

Note: Includes only deals with announced value; parent company in parentheses.
Source: Modern Healthcare Mergers & Acquisitions premium database

Buyers and financiers have been taking a breather from frantic activity last year, and capital markets tightened some in the early part of 2016, said Gregory Hagood, senior managing director and head of investment banking at SOLIC Capital.

Antitrust challenges to several hospital mergers also dampened the enthusiasm for mergers, Hagood said. This month, Penn State Milton S. Hershey (Pa.) Medical Center and PinnacleHealth System called off a merger after the Federal Trade Commission fought the tie-up as creating an anti-competitive environment.

Hagood, however, said he expects regional hospital systems to continue looking to combine where it makes sense. "There are still a lot of hospitals that need to pair up," Hagood said.

Chicago-based Ventas, which owns $37 billion in real-estate assets, bought its first acute-care hospitals in 2015 with $1.3 billion deal for 10 of Ardent's 14 hospitals and and all of its ambulatory-care assets, including a 10% equity stake in the operating company, said Ventas' Cafaro.

She said the diversification made sense based on Ardent's strong financial performance and management's commitment to continue growing. To facilitate the LHP acquisition, Ventas is providing a five-year loan guaranteed by Ardent's parent company that has an initial interest rate of about 8%. If more opportunities at Ardent or other hospital companies present themselves, Ventas would look at doing additional deals. "It's a long game, but we're committed to it," Cafaro said.

Top 10 largest life sciences deals in Q3 2016

Announced	Acquirer	Seller or target	Target location	Deal value	Deal type	Subsector
7/28/16	Fosun Pharma	Gland Pharma (KKR)	India	$1,260,000,000	Acquisition	Drugs and biologics
7/11/16	Nichi-Iko Pharmaceutical Co.	Sagent Pharmaceuticals	Illinois	$736,000,000	Acquisition	Drugs and biologics
7/11/16	Pantheon		NA	$579,000,000	IPO	Drugs and biologics
8/3/16	Teva Pharmaceuticals	Anda (Allergan)	Ireland	$500,000,000	Acquisition	Drugs and biologics
7/6/16	Bio-Techne	Advanced Cell Diagnostics	California	$250,000,000	Acquisition	Drugs and biologics
8/1/16	Pfizer	Bamboo Therapeutics	North Carolina	$150,000,000	Acquisition	Drugs and biologics
7/5/16	Bristol-Myers Squibb	Cormorant Pharmaceuticals	International	$95,000,000	Acquisition	Drugs and biologics
9/28/16	Charles River Laboratories	Agilux Laboratories	Massachusetts	$64,000,000	Acquisition	Drugs and biologics
8/18/16	Mayne Pharma	GlaxoSmithKline, dermatology foam assets	United Kingdom	$50,100,000	Acquisition	Drugs and biologics
9/20/16	Allergan	Akarna Therapeutics	California	$50,000,000	Acquisition	Drugs and biologics

Note: Includes only deals with announced value; parent company in parentheses.
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Hospitals represent a new thrust for Ventas' penetration into healthcare. Its 1,300 healthcare properties include 375 medical office buildings, 750 senior-living, private pay facilities, 39 long-term care and rehabilitation hospitals and 50 skilled-nursing homes.

Cafaro said when Ventas buys hospital real estate, it also is open to investing in the real estate of medical offices and ambulatory centers that support the system.

In September, Ventas sold $450 million of senior notes with a 3.25% interest rate in an hour's time in a demonstration of the access to capital that Ventas has earned with investors, she said.

Aldag, who founded MPT in 2003 and took it public in 2005, said it was lonely being the only prominent acute-care hospital REIT until Ventas joined the action in 2015. He said a player of Ventas' caliber is raising awareness of how REITs are relevant to the acute-care sector and that investors need not fear getting involved with such REITs.

Aldag said hospital reimbursement will change and fee-for-service will eventually give way to value-based payments. But REIT operators understand communities will always need hospitals. When MPT buys the real estate, it closely monitors the performance, including quality, of hospital operations to ensure that its 7.5% to 9.75% annual lease gets paid on time, he said.

MPT's senior management team consists of former hospital administrators and operators who can step in to run a hospital if needed. But that rarely happens. MPT had to switch hospital operators to improve performance just six times since its founding, Aldag said. Hospitals with strong market share are a safe bet for REITs, he said, “because they can't just close and move down the street.”

MPT saw great growth potential in the Steward team, Aldag said. MPT owns hospital real estate in seven of the top 10 privately owned for-profit chains, including RCCH HealthCare Partners, Iasis Healthcare and LHP.

Aldag said that as hospitals, including not-for-profits, see how REITs can help them access capital yet stay out of day-to-day operations, they will eventually look at that option for financing.

But it will take education to help them get past an aversion to parting with the brick-and-mortar structures that they've owned for generations. It's “taken a lot longer than I thought it would,” Aldag said.

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