**Victor McConnell** 00:00
As an operator, you look at what sort of return are we achieving through investment in operations. And if we have that money invested in real estate, what's kind of the implicit return that we're receiving in our own real estate? And then there's the compliance thing to think about, if you have physicians who are lessees? What sort of risks do we have? And do we have to hire some outside consultant like Victor or broker or something to help us sort through, you know, our real estate lease compliance issues? So there's kind of, there's kind of a wide array of, I think financial strategic compliance that you think through if you're, if you're a healthcare operator in deciding, do I want to own my real estate? Do I want to lease my real estate? If I want to sell it. What do I want to commit to in terms of a lease term? Do I want it to be in a joint venture, lots of options.

**Trisha Talbot** 00:51
This is the Providers Properties and Performance podcast. The podcast that brings together leaders in healthcare and investment real estate to consider the possibilities in future at the intersection of practicing medicine, and healthcare real estate investment returns.

**Trisha Talbot** 01:06
Welcome to the providers properties and performance podcast I am your host Trisha Talbot. As a healthcare real estate adviser to providers and investors. The best solutions occur when the two collaborate together as partners in delivering better patient care. Providers can deliver care to their patients when and where they need it and investors realize the returns to build and manage facilities. We explore changes in medicine and wellness the future of healthcare and using real estate as a strategic and financial tool.

**Trisha Talbot** 01:33
Welcome to this week's episode of the Providers Properties and Performance podcast where I interview Victor McConnell, managing director and head of real estate services at VMG Health. This is part one of a two part episode and in this episode, we talk about how evaluating health care properties involves the real estate portion plus the operational portion with regard to the health care company or health care companies occupying the property and with the health care companies how important it is to understand the value of your real estate.

**Trisha Talbot** 02:04
And then next week, we dive into trends in healthcare and healthcare real estate industry that were happening, pre pandemic and then are likely to happen post pandemic. And I hope you enjoy both episodes.

**Trisha Talbot** 02:16
Victor, welcome to the Providers Properties and Performance podcast.

**Victor McConnell** 02:19
Thank you, Trisha. I'm happy to be here.

**Trisha Talbot** 02:21
So why don't you start with sharing with the audience what VMG Health does as a whole for the healthcare industry, and then specifically the real estate services that serve the healthcare industry.

**Victor McConnell** 02:30
So VMG is a healthcare M&A advisory valuation firm. We were founded in the early 90s originally doing primarily business valuations, valuations of everything from physician practices up to entire hospital systems. And then over the last 20 or so years, we've added other service lines like PSA, valuation of compensation arrangements, quality of earnings, black box, capital assets equipment, and where I sit real estate we've had for about a decade and our real estate service line works exclusively with healthcare related properties. Sometimes we're engaged by hospital systems or physician groups, or private equity. It could be real estate focused or operationally focused private equity. And then we also do a fair amount of litigation support work and then other consulting work that has often a valuation component.

**Trisha Talbot** 03:22
and VMG helps serve clients nationally, or is there a specific geographic focus?

**Victor McConnell** 03:27
We do nationally, and then occasionally, internationally. We actually valued 1 million square foot hospital in the Middle East a couple years ago.

**Trisha Talbot** 03:35
Interesting. So you began your real estate career as an appraiser. And when did you start to focus on healthcare real estate?

**Victor McConnell** 03:41
I did some healthcare real estate, starting probably around 2008. I had a bit of an atypical path. I was a creative writing major at Dartmouth in undergrad and kind of fell into the real estate world by happenstance. And I've been doing work with VMG since about 2012, or 2013.

**Trisha Talbot** 04:02
That is interesting. It's interesting how our career paths wind.

**Victor McConnell** 04:06
Life never goes as we expect it to.

**Trisha Talbot** 04:09
Exactly. So I'm excited to have this interview because I really want to selfishly pick your brain on some healthcare trends. But before discussing that, healthcare companies are making strategic decisions all the time, either for long term strategic goals or current market conditions that they want to take advantage of, and understanding the value of their real estate, real estate assets under management, fair market value versus book value, or the annual run rate, which is either the cost to operate that real estate or lease cost as well. How important is it for health care companies to understand the value and

cost of their real estate expense? And after that, you know, how they align the cost of the real estate with the operational costs and make strategic decisions and plans.

**Victor McConnell** 04:58
Yeah, I think as I'm sure you've seen and experienced, I think the way real estate is thought of within the healthcare world, whether it's on the the investor side or on the the operator side has changed a lot. You know, real estate is typically the largest item on a hospital balance sheet. So in any sort of hospital transaction, one hospital acquiring another or, you know, a joint venture or anything like that real estate, maybe 20 years ago was more of an afterthought. I think now, hospitals think about it more strategically. And they realize maybe more how real estate fits into strategic plans, both from a geographic footprint perspective and also from a hospital campus perspective as where and how we can provide care changes what's needed on the the actual campus changes.

**Victor McConnell** 05:51
And then there's also more investors who are interested in owning healthcare real estate who understand it better. And so they may be more willing to invest in, say, an orthopedic hospital or a surgery center or a cancer center or property types that again, in the past may have been perceived as highly specialized in only a very small group of investors would be interested. Now, I think that pool is larger. So wherever you kind of sit in the healthcare real estate spectrum, there's a greater understanding of complexity and of strategic importance when it comes to how real estate fits into the the overall kind of healthcare business

**Trisha Talbot** 06:33
For some financial advantages of understanding their real estate, you know, maybe insurance and changing changing that against the value some capital asset valuations, if they're wanting to renegotiate a loan, or put new debt on a property, negotiate some leasing, some ground lease valuations, you know, like you said, per campus, and then, you know, Stark regulations. And so can you touch on a couple things about those that could be advantageous for a hospital or health group to use their valuation to benefit them?

**Victor McConnell** 07:08
Yeah. I mean, if I were a hospital, and I was thinking about my real estate, I'm thinking, what can I do with it, it's a, you know, it's a tool to provide patient care. But it's also it can be a tool for say, physician alignment, I can choose to enter into a joint venture with some physicians in developing a new property that may align with the strategic objectives of both the hospital as well as the physician group, those can be complex, they can require parties to consider, you know, what's the value of say, at least guarantee? Or who's going to be responsible between the parties for which aspects of development.

**Victor McConnell** 07:42
and then some hospitals may prefer to own because maybe they they have kind of nonprofit considerations, where there's a tax exempt status that they have to consider, or they can get money from large donors who can put their name on a cancer center and, you know, that's something that that may not be possible with outside capital.

**Victor McConnell** 08:08
On the other hand, as an operator, you look at what sort of return are we achieving through investment in operations and if we have that money invested in real estate, what's kind of the implicit return that we're receiving in our own real estate? And then there's the compliance thing to think about. If you have physicians who are lessees, what sort of risks do we have? And do we have to hire some outside consultant like Victor or broker or something to help us sort through, you know, our real estate lease compliance issues?

**Victor McConnell** 08:37
So there's kind of a wide array of, I think financial strategic compliance that you think through if you're a healthcare operator in deciding, do I want to own my real estate, do I want to lease my real estate, if I want to sell it, what do I want to commit to in terms of the lease term, do I want it to be in a joint venture, lots of options.

**Victor McConnell** 09:00
Where I would fit in or where VMG would fit in from a kind of third party evaluation perspective. You know, we we help our clients kind of sort through those options. It can be as simple as physician lease renewal or something, and they need a third party opinion on what's a fair market rent renewal for the surgery centers, medical office building, or this specialty hospital. In other cases, it could be a more complex transaction where, like I was mentioning earlier, it's a new project. It's a joint venture on a development, and there's a lot of different pieces to it, one of which includes real estate, and there's also, you know, other operational considerations that they need third party assistance to help sort through and make sure that transactions commercially reasonable and within kind of fair market value parameters,

**Trisha Talbot** 09:50
Do healthcare companies ever come to you and and say, Hey, you know, we want to kind of understand what the value is of our real estate in order to maybe take advantage of some market conditions, like right now and cap rates compressing, or you know, they have a lease coming up didn't want to, would it make more sense to purchase a property. Do they ever come to you with those sorts of questions?

**Victor McConnell** 10:10
They do. I mean, you know, or they may talk to their broker, but obviously that sometimes they think, Well, those are our broker has an incentive for us to sell, you know, but yeah, that's something sometimes we'll have, say with a lease renewal, maybe a company with the sale, we've done analysis where say, if we would commit to a five versus 10 versus 15 year lease term, what does that do to cap rate in a sale? And then if, if you're in a joint venture, how do you distribute the profits between, say, hospital physician, or strategically what are you comfortable committing to from a lease perspective?

**Victor McConnell** 10:45
In terms of assessing market conditions, it's somewhat of a double edged sword, obviously, cap rates are correlated with cost of capital to some extent. So, again, if I'm a healthcare provider, I'm debating do I want to do a sale leaseback or sell this property? Or do I want to borrow money? And so you're, you're kind of looking at those two things, you know, hand in hand, because if you can borrow money at

4%, that may or may not be attractive than doing a sale leaseback at a five and a half or 6% cap rate or whatever it is.

**Trisha Talbot** 11:22
Exactly, but the common denominator between all of those decisions is understanding the value the current value of your real estate, which

**Victor McConnell** 11:29
Yeah, that's absolutely right. And understanding it in the context of both. I think it's important to think about it in the context of both an owner occupant as well as from an investment markets perspective, sometimes those two are aligned. And sometimes there's a difference there. And theoretically, you know, if the investment market is as a stronger kind of valuation that you could make an argument that the owner occupant should more strongly consider looking at, you know, potential investments sale.

**Trisha Talbot** 12:02
Do you have any healthcare companies that like to perform this analysis, like on a quarterly basis? Or do you get a lot that are like, we have a problem to solve? And, and we need your help on this particular situation?

**Victor McConnell** 12:14
Yeah, I mean, you have, you know, there's the REITs that we'll do, you know, quarterly updates and such for, you know, for financial reporting. The hospitals don't have the same requirements to record, say, real estate values. So I generally don't see that I mean, I think this sort of top to bottom system assessment of real estate is done less frequently by hospitals. And it can be done from a strategic angle, what you're getting at, like, understanding, hey, what, what sort of value do we have here? How do we want to use this real estate either as collateral in a dead issue? And so or do we want to sell any of it?

**Victor McConnell** 12:53
Maybe, you know, I was talking with a hospital real estate person who said, Hey, we have 400 sites of care, you know, owned or leased properties, we don't know what the right number is maybe the right numbers 250, maybe numbers 450. But we understand in strategically, what we need from besides a care perspective. And then the second question is, do we want to own or lease those sites of care? You know, both of those are kind of internal questions for system sort through that tie back to your comment about understanding value.

**Victor McConnell** 13:23
The other part, I think it's updated maybe a little more regularly, the hospitals take different approaches on is their rent analysis. Some hospitals will do it on a case by case basis. Others have internal market studies, others hire external firms to do studies on an individual market or, or they have brokers or appraisers do it. And in terms of timing, again, that varies. I've see anywhere from one to two to three years, generally, on how often are we taking a hard look at what I would call FMB, rents or market value rent? So I don't know if that answers your question.

**Trisha Talbot** 14:03
Yeah, no, it does. It does. You know, when I prepared this, I was saying, you know, now that we're heading out of the pandemic, and now, we're having some hiccups, but in general, I mean, what have healthcare companies, what has the pandemic done as far as making decisions for for healthcare companies that they may have not considered pre pandemic that you're seeing? I mean, obviously, there's the basic ones, but are there any new ones that they're that are coming across your desk as a result of the pandemic affecting them?

**Victor McConnell** 14:34
Well, I'll pretend that I perfectly understand all of the short and long term consequences of the pandemic on like, all aspects of social and economic life, including healthcare real estate sector,

**Trisha Talbot** 14:47
no no, just healthcare.

**Victor McConnell** 14:49
Well, I think the story that you read, I think again, and again, is is one of variability across our economy and I think the healthcare sector, the healthcare real estate sector is no exception to that. So another common theme is kind of the large, getting larger, the financially well positioned hospital systems coming out of it doing okay or in some cases have an even stronger market position, and then those who are more vulnerable being in maybe even more dire straits. And so how does that impact real estate?

**Victor McConnell** 15:24
Well, again, it depends, it depends on what's your market looks like from a kind of market fundamentals perspective. And then what sort of, you know, asset class are you in. Are you in skilled nursing or assisted living? Or are you in inpatient rehab hospitals? Are you in medical office buildings, surgery centers, urgent care? for send any Bs, there's a different different reimbursement environment, different payer environment, I guess, saying the same thing a different way. And then geographically, you know, the markets that there's a lot of population growth and kind of things that drive fundamental real estate demand, those are the same markets that generally speaking are doing better. And so the hospitals in those markets are grappling with a different set of decisions versus your tertiary or more rural hospital, which is struggling to keep its doors open, and maybe has excess space. So it's a complicated story.

**Victor McConnell** 16:26
I mean, the things that people have been talking about for a decade, outpatient migration, those things, those are all, of course, still happening. They're manifesting in different ways. The freestanding ED, urgent care, you and I talked about a little bit in our kind of preparation, that's a, I think, a good example of one model that had some serious struggles. And another that's been more consistently had more consistent growth, but both kind of trying to do the same thing, you know, trying to capture patients who would otherwise be going elsewhere into a different outpatient setting.

**Victor McConnell** 17:02
Same thing with surgery centers, which have been on a multi decade growth trend, that hasn't really changed, you know, there's still that flow of surgical procedures that used to be able to be performed in the hospital, or they used to have to be performed at hospital. Now they can be performed in an outpatient setting, what does it mean? Well, if it's a, if it's spinal or hip, you may need a larger OR. You may need, you know, some design changes to your surgery center to be competitive. So that was a long, sprawling answer.

**Victor McConnell** 17:31
But I think it's a complicated question in terms of, I guess, my short answer would be a lot of the trends pre pandemic remain in place, I think some of those maybe have been accelerated, would be what I would say, and that the big have gotten bigger, and the small, are struggling more, would be my soundbite.

**Trisha Talbot** 17:51
Right. And maybe like the hospitals that were already putting their, you know, outpatient services out of the hospital, and really, really having the hospital focus on acute care and higher acuity care, versus those that have thought about it or, you know, not quite developed the strategy. I'm thinking the larger the ones that have already started that process and have the ability to just implement it faster, might have a lot more long term success than trying to do it while they're going through the pandemic and having to deal with that as well.

**Victor McConnell** 18:22
Yeah, I think that's true. If you're, if you are already kind of out in front of some of those trends, then you're probably handling them a little better now. I mean, I think there's still some unanswered questions about, you know, how durable some of the pandemic effects will be, you know, telehealth is the one everybody cites. I talked to a hospital in the West Coast early on, and they had like, in the first two weeks of April of 2020, they did something like three times the total amount of telehealth that they've done in the entire year previously. So you know, that, obviously, that's not going to stay at that level. But some amount of that care will remain, you know, patients, patients still want to see the doctor for a lot of things, but there'll be some things that consumer preference will change and healthcare provider preference and technological abilities will change. And I think, I think that's still all kind of shaking out. I don't think anyone really knows for sure where it's all going to land.

**Trisha Talbot** 19:26
Yeah, I think it's a great addition to use as a additional tool, but it can't replace it, but I think it's great for triage. I think it'd be good for that. And then are you seeing healthcare companies kind of assessing their so if they had some non clinical space that, you know, they want to reallocate and either convert the clinical, I'm sure some of their operational and administrative folks that are non clinical that may be going to more of a hybrid workforce, do you see them kind of trying to analyze that and use their real estate especially, maybe the most expensive real estate for their highest acuity. Clinical youth?

**Victor McConnell** 20:04
Yeah, well, I think the admin space is one of the things that has maybe changed the most and still, I mean I think the healthcare sector, like a lot of the general commercial real estate sector is still doesn't know what ultimately, what they're going to require their employees in terms of how many days a week are we going to come into the office? Are we going to use a hotel in configuration? Are we going to, what's our office footprint going to look like? I think those questions are still somewhat unanswered. And you've seen you see the news every week, some large company announces a policy about people coming back into the office, and then they change the policy when there's feedback in one direction or the other. And I don't think the healthcare sector is an exception to that.

**Victor McConnell** 20:47
So I think your comment about potentially rethinking how the healthcare community is using administrative space, I think it's right. I don't think that there's a clear answer. But you know, I was working with a health system that was considering an acquisition that they were going to use for administrative office space that was near their campus, they moved forward with the acquisition under the same terms as pre COVID. This was a deal that had been discussed before COVID, they closed on it a few months after, but they said, we don't know what we're going to use it for. I said, we're still gonna buy it, we still think we're gonna need it for something. But we don't know, it could, it's by our campus, it was an old building, it was going to be renovated. So I think in their case, they kind of looked at it and said, Well, we don't think our space needs are going to be less, they may be different. We just don't know exactly what they're going to look like yet.

**Trisha Talbot** 21:35
Yeah. No, I think that's fair too. So going back to some growth strategies, you know, some may be able to implement faster, you know, in order to implement them faster, do you see, you know, hospitals, you know, in my opinion, their capital should be used for mostly their operations. And, you know, the real estate, obviously, that needs to house them, some of it, but when it comes down to it, you know, there need to serve, you know, to provide health care services should be where, in my opinion, a lot of their resources go to first.

**Trisha Talbot** 22:06
So do you see that in order for some of these healthcare companies and hospitals to implement some of their plans faster with regard to the real estate, needing the real estate to do it? Are they more open to partnering with Capital Partners, development partners, in order to implement this quicker and maybe share the risk?

**Victor McConnell** 22:24
Yeah, I mean, I think they're still is kind of, not across the board. But a lot of hospitals prefer to own their on campus real estate, some don't, some have changed the outline areas or, to your point, if you're developing a string of outpatient clinics of whether it's I don't know an urgent care, primary care, I see more alternative structures there, whether in some cases, it could be, you have a development partner on the real estate side. And then you also have an operating partner, maybe the hospital's partnering with an entity that specializes in whatever the platform is a primary care clinic or an urgent care clinic.

**Victor McConnell** 23:06
So you may have participation on the real estate landlord physician, from the hospital or the physician or the operator who's partnering with a developer. And then on the lessee side, it could be any combination of those entities as well. And ultimately, I think, what's going to drive what the right structure is, is going to be the strategic objectives of those, the hospital of the physicians of the if there's a platform company that's operating it, how do those overlap? What sort of, you know, growth targets do they have? What's their capital availability? Do they have a development partner that they think has the right combination of geographical and architectural and development expertise to develop what may be a specialty clinic type? And then what sort of debt can they get dependent upon the structure? Dependent upon who the who's going to be the owner? Who's going to be the lessee? How high cost is it? If it's if it's very high cost, then if I'm a lender, I'm going to look at it with greater scrutiny, because I know that if it goes dark, if it fails, the gap between the value of the property as built versus in a vacant scenario could be wider.

**Victor McConnell** 24:22
That means you have to do more diligence around either the lease guarantee or the operational projections or both. So I don't know if there's more if you kind of your original question if a greater percentage of those types of developments are using outside capital than they were before. But I think that there's a wider array of different structuring options and the potential different structures or, or maybe more, there's more to choose from, even just strictly with third party developer. There's the traditional build to suit yield on cost. There's the the fully amortizing kind of CTL structure where it's more of a financing deal. And there's a lot of kind of permutations in between.

**Trisha Talbot** 25:06
You know, I always recommend that they, you can consider several options until the one that becomes the most beneficial kind of appears. So I guess, do they ask you for some help and considering, like evaluating the real estate and maybe giving them a little bit of idea, based on their value of the real estate, and where where it sits on their balance sheet, kind of which direction might be most beneficial for them? Or is that like an additional level?

**Victor McConnell** 25:35
Well, some hospitals, it depends on how large and sophisticated their real estate department is, and what kind of internal capabilities they have. And then generally, the real estate's not the driver, right. It's the, you know, whatever the kind of operational strategic focus is, if so, it's, it's how does the real estate, help them achieve that objective? And that a lot of times, that's, that's kind of self evident, you know, if they have some physician partners that are interested in, in participating in the real estate, then that's the structure that's going to make sense strategically, you know, you probably don't need to do a lot of financial analysis to figure that out. Same thing, if you have a private equity platform company that doesn't want to own real estate, then that kind of eliminates some options right off the bat.

**Victor McConnell** 26:24

For us, it kind of depends on in part who's who's hiring us, or who's asking the question. So you know, sometimes it's a, if it's a real estate investor client, a, you know, a REIT, an individual or private equity, their concern maybe more on the risk side, they're investing in this specialty healthcare property. That's a, it's a surgery center. It's a micro hospital, it's recent AD, they want to know, what's the risk. And sometimes that risk is tied to if it's a purpose build asset, the risk is going to be tied to either who's guaranteeing the lease or the operational projections. And if you're, if you live and breathe the projections in that industry, then you can look at them and benchmark certain projections to help understand how likely is this tenant to pay or to default on their rent, which is the core question you want to ask if you're a landlord. And so how you answer that question, again, depends on who

**Trisha Talbot** 27:22
you're representing,

**Victor McConnell** 27:23
Well, it depends on if it's a lease guaranteed by a parent hospital system, then the risk is probably more associated with that parent system. Whereas if it's a lease that's guaranteed by just the LLC that's specific to that surgery center, your risk is more, it's a in the surgery center cost $700 a foot to build, then your risk is associated with the projections there. So you ideally you want to have someone look at the projections and say, okay, they're projecting x in terms of arthroscopies, knee arthroscopies. Is the volume and the reimbursement reasonable? Are the operating expenses reasonable? Are they going to be able to pay rent? So that that question in that case, is more operationally focused, less about the real estate that's what informs the risk, whereas in other cases, it may be, it may be more of a real estate specific exercise.

**Trisha Talbot** 28:19
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