Nursing Facilities: Assets, Interests, and Ownership Structures

by James K. Tellatin, MAI

Most appraisal assignments relate to the sale or financing of nursing facilities. Typically, a combination of the fee simple interest in the real estate, tangible personal property or furniture, fixtures, and equipment, and intangible assets are included in the purchase price or as security for the mortgage or loan agreement. However, there are many instances in which the appraiser will be requested to estimate only the value of a specific interest in the real estate or intangible personal property assets. For instance, property tax assessments should exclude the value of the intangible assets. FHA-insured mortgages obtained through HUD are underwritten on the value of the tangible assets (real estate and major movable equipment), but this agency also requires the appraiser to estimate the value of the total assets of the business. The valuation of nursing facilities with a leased fee or leasehold interest may or may not include the tangible or intangible personal property.

A nursing facility’s assets include:
• Real estate—fee simple, leased fee, or leasehold
• Tangible personal property—furniture, fixtures, and equipment
• Intangible personal property—including assembled work forces, licenses, certifications, approvals such as certificates of need (CON), patient records, goodwill, and management

Note that most appraisal engagements and sales transactions exclude current assets (working capital, cash, accounts receivable, etc.) from the purchase price consideration. Similarly, seller liabilities stay with the seller, and the buyer or successor in the business typically gains indemnity for the seller’s liabilities. It is

The material in this article originally was published as chapter 4 in James K. Tellatin, The Appraisal of Nursing Facilities (Chicago: Appraisal Institute, 2009).
important to confirm what current assets and liabilities, if any, were included in the consideration.

Definitions of going-concern and total assets of a business follow:

1. **Going-concern.** A going concern is an established and operating business with an indefinite future life.¹

2. **Total assets of a business.** The tangible property (real property and personal property, including inventory and furniture, fixtures and equipment) and intangible property (cash, work force, contracts, name, patents, copyrights, and other residual intangible assets, to include capitalized economic profit) of a business.²

Several terms are used to describe this value and will be used interchangeably in this discussion.

3. **Business enterprise value** is defined as: Business enterprise value (BEV). A term applied to the concept of the value contribution of the total intangible assets of the continuing business enterprise such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements.³

4. **Real Estate Assets**

Real estate interests may include fee simple, leased fee, and leasehold interests.

A fee simple interest is found when the ownership of the real estate and the operating rights for the facility are controlled by the same party or closely related parties, whereby agreements between related parties can or will collapse into a single entity for purposes of conveyance to a new party. Fee simple estate is defined as:

Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.⁴

The leased fee interest is the interest held by the lessor or landlord. The interests of the landlord include the right to receive rent during the term of the lease plus the right to receive the leased assets back at the lease termination. Typically, nursing facilities are leased on an absolute net basis, whereby the tenant is responsible for expenses associated with the leased premises and the landlord has little or no responsibilities. The assets leased may include the real estate, tangible personal property, and intangible assets. Note that many nursing facility leases are vague or silent regarding successor rights to licenses, certifications, and other necessary intangible assets for the continuation of the business. In leases in which the tenant is required to cooperate with the landlord in transitioning the facility to the next operator, the landlord may be required to compensate the tenant for the tangible personal property. Leased fee interest is defined as:

An ownership interest held by a landlord with the rights of use and occupancy conveyed by lease to others. The rights of the lessor (the leased fee owner) and the lessee are specified by contract terms contained within the lease.⁵

The leasehold interest provides the tenant with the rights to use the property to operate the facility, hopefully for a profit. The tenant may have the right to sublease the facility, changing this interest to a “sandwich” leasehold. The tenant, acting as the operator, will be the licensed entity and will possess the certifications, provider agreements, and other formal responsibilities in operating the nursing facility. Since most facilities are leased on an absolute net basis, the tenant is typically responsible for all maintenance and capital expenses during the lease term. The tenant will typically invest fairly substantial capital (working capital, replacement funds, and additions of building and equipment assets) in the enterprise over the lease term, so the lease should be long enough to fully recover the capital investment. Most leases include renewal or extension options, and some grant the tenant purchase options and first rights of refusal. Leasehold interest is defined as:

The interest held by the lessee (the tenant or renter) through a lease transferring the rights of use and occupancy for a stated term under certain conditions.⁶

5. **Tangible Personal Property—Furniture, Fixtures, and Equipment**

Personal property is defined as:

Identifiable tangible objects that are considered by the general public as being “personal,” e.g., furnishings,
artwork, antiques, gems and jewelry, collectibles, machinery and equipment; all tangible property that is not classified as real estate... movable without damage to itself or the real estate.\footnote{Ibid.}

Nursing facilities require furniture and equipment in nearly every area of the building(s). Patients typically bring only some of their personal items with them; beds and room furniture is typically provided by the facility. The operator may lease some equipment and fixtures such as vehicles, computer systems, dishwashers, and perishable décor items (plants and aquariums) that require frequent, specialized servicing. Outside providers, such as therapy companies and pharmacies, may provide their own exercise equipment and medicine carts.

\textbf{Intangible Personal Property}

Several definitions are fundamental to any discussion of intangible personal property.

*Business enterprise* is defined by the Uniform Standards of Professional Appraisal Practice (USPAP) of The Appraisal Foundation as “an entity pursuing an economic activity.”

*Business assets* are “tangible and intangible resources other than personal property and real estate that are employed by a business enterprise in its operations.”

The intangible assets of a nursing facility typically include:

- Licenses, certifications, and approvals (such as certificates of need) from government agencies and regulators
- Assembled workforces, including licensed, certified, and trained employees
- Patient records
- Goodwill
- Management
- Vendor contracts
- Trade names

Nursing facility operators enter into a series of agreements with government authorities. These agreements include a licensure agreement with the state agency responsible for licensure (typically within the state department of health) and provider agreements with the state agency that administers the Medicaid program (often contained within the state department of social services) and with Medicare. Other licensing and certifications are required at the facility level. Staff and consultants may need certifications issued at local, state, and federal levels. Local licensing and other regulations may be required for fire and safety, food services, and zoning compliance. Verification that the facility remains in compliance with various licenses, certifications, and other regulations is essential for the operator, investors, major creditors (mortgagee or landlord), and those underwriting and evaluating the assets of the business. The appraiser typically does not confirm or verify that all necessary licenses and certifications to operate the facility are current, but the appraisal report should include a stated assumption that those items are current and complete.

While licensed or certified staff and outside consultants (administrators, nurses, nurse aides, therapists, physician consultants, social workers, dieticians, etc.) are directly or indirectly employed by the operator of the facility, they also must adhere to the licensing laws and standards of their respective professional licensing agencies and professional organizations. Violations of laws and standards can result in disciplinary action against the facility and/or individuals, which will often have an adverse impact on the value of the assets of the going concern.

\textbf{Allocation of the Assets of the Business or Going Concern}

USPAP does not specifically require that an allocation of assets be made, but it does require the appraiser to analyze the effect on value of non-real property items.\footnote{Uniform Standards of Professional Appraisal Practice, 2008-2009 Edition, Appraisal Standards Board, The Appraisal Foundation, Standards Rule 1-4(g).} As required by Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the market value of the real estate must be identified and valued separately. Methods for allocating the going-concern value of a nursing facility or any other real estate-intensive business continue to be debated. Under typical circumstances, the going-concern value for a highly profitable nursing facility will exceed the depreciated cost of the tangible assets, which suggests that there is intangible value.

In most cases, the whole is greater than the sum of its parts. The business could not operate if any one of its major assets were absent. If a facility loses its license because of inadequate care or a tenant termi-
nates a lease taking the license (sometimes referred to as the certificate of need) and/or the patients and staff to a replacement facility, the value of the whole and the individual assets are suddenly and severely diminished. In fact, the value is often reduced to a small fraction of the physically depreciated cost if a new license for the building cannot be obtained.

Ownership Structure Issues
The ownership of a nursing facility enterprise is often fragmented, with an operating entity in possession of the license(s), certifications, and business operations, while the ownership of the tangible assets (real estate and personal property) and the management are controlled by other related or unrelated parties.

In 2005, 66.0% of Medicare- and/or Medicaid-certified nursing facilities were owned by for-profit concerns; 27.9% were owned by private non-profits; and the other 6.1% were government-owned.9

In this legally complex and litigious business, the division of control and ownership can minimize some types of liability. The appraiser must properly identify the interest being appraised and identify the entity or entities that control that interest.

Figure 1 illustrates a basic ownership structure for a nursing facility. Note that ownership structures will vary considerably and are often restricted by state laws.

Figure 1 Nursing Home Ownership Diagram

The typical structure for a multi-facility nursing home company will place each facility “owned” or leased from a third-party landlord into a separate real estate company and operating company. Each operating company will then contract for services with related or third-party management, therapy, pharmacy, and other service providers. The flow chart in Figure 2 illustrates a typical structure.

The operator is the licensed entity responsible for conducting all necessary and required activities of the nursing facility. These functions are managed at the facility level by a licensed administrator, who oversees the overall operations of the facility, and a licensed registered nurse, designated as the Director of Nursing (DON), who supervises the nursing staff. The licensed operator will be the entity certified for Medicaid and Medicare and will enter “provider agreements” with Medicare, Medicaid, private insurance companies, and other government agencies. Agreements are also reached with each patient directly. The staff is employed by the licensed operator although the operator may rely on third-party services to satisfy certain functions.

The operating entity may contract to lease the property from a related or unrelated owner. Likewise, it may contract with related or unrelated parties for management and ancillary (therapy and pharmacy) services. Note that leases and management and ancillary service agreements may or may not contain rates, escalator clauses, terms, or other conditions consistent with prevailing levels and terms in the market.

If the operating entity differs from the owner of the real estate, a lease probably exists. Related-party leases typically collapse into the operating entity when these interests are being conveyed to a third party through a sale and lease. Loans secured by property mortgages should somehow bind together the ownership interests in the tangible assets (real estate and furniture, fixtures, and equipment, or FF&E) and the operating rights that are associated with licenses, provider agreements, Medicare and Medicaid certification, certificates of need, and other valuable agreements. Also, landlords should have the ability to regain the operating rights at the termination of the lease. Foreclosure on the real estate interest is of limited value to the owner of the mortgage if the operator discontinues or transfers

the business to a different location, rendering the existing building hollow and empty or without a license, staff, or patients.

The management of a nursing facility is often conducted off site through a management agreement with a related or third-party company.

Therapy services and prescription drugs are significant expenses for most skilled nursing facilities that provide for the dispensing of these services and products through licensed professionals. Since economics often prohibits full-time employment of these professionals at any given facility, operators typically contract with outside concerns to provide these services on an as-needed basis. The ownership of these providers may or may not be related to the operator. Many nursing home companies with many beds within a concentrated geographic area find it feasible to establish and operate therapy companies that not only provide therapy to patients in their facilities, but also to other nursing facilities on an inpatient basis or through outpatient programs at various venues. Some companies view their ancillary businesses as profit centers and will divert earnings from the facility’s operating level by charging amounts that exceed the market rates. When analyzing the operations of a nursing facility, the appraiser should carefully compare third-party ancillary expenses with market levels. Excessive payments for ancillary services to related parties can misrepresent the financial condition of a facility; this practice can also reduce the debt service and rent coverage ratios required by operating covenants in mortgages and leases. Moreover, failure to adjust excessive charges from related parties will result in the underestimation of the market value of various property interests and rental value. Further discussion of ancillary expenses is presented later.

In a typical appraisal of the fee simple interest, the combined entities will be appraised as one. If the analyst is not careful, lenders, third-party landlords, and other creditors who have based their investment decisions on the “whole” will have an investment that is actually secured by something less than the whole and be exposed to elevated, and maybe unknown, risks.

Most sale transactions and financing structures will incorporate the assets of all the entities that control portions of the business enterprise into a single transaction. Considerable care should be taken by appraisers, analysts, and others who apply transaction prices to evaluate nursing facilities (and other going concerns) for investment decisions.

When examining related party, or even third-party, relationships, care should be exercised to determine if the party contracts are set at market levels. Some operators will shift profits from the facility level to real estate, management, or ancillary businesses. Accepting the operating statements without measuring the expenses reported against market levels may result in an inaccurate valuation.

For example, if a rent reset agreed to by an unrelated landlord and tenant requires the new rent to be based on a calculation using a market level of earnings, adjusting the tenant’s related-party management fees and ancillary services contract to market levels is critical. A clever tenant may attempt to divert some of the earnings at the facility level to related parties to have a lower rent calculation.

In many instances, a landlord and tenant will dispute the ownership of the certificate of need or the right to the operating rights (license) at the termination of a lease or when exercising a purchase option. The value of a profitable facility without a license or certificate of need is often dramatically less than the value of that same facility with the license intact.

Landlords, lenders, and other creditors should carefully write their lease and loan agreements so that, in the event of lease termination or a creditor’s action against the debtor, the operating entity will cooperate to facilitate a seamless transition that transfers the facility’s license(s), certification(s), workforce, patient records, and other intangible assets to a succeeding operator.
Well-operated facilities with significant service revenue (income from therapies, the sale of medical supplies, etc.) can produce value that substantially exceeds the replacement costs of real and tangible personal property and the expense of obtaining licenses, approvals, a workforce, and management.

Valuing For-Profit and Non-Profit Nursing Facilities

As Tables 1, 2, and 3 show, 66.0% of all Medicare- and/or Medicaid-certified nursing facilities in the United States are controlled by for-profit concerns. For-profit entities control 68.0% of all certified beds and 67.1% of all occupied beds, based on survey data collected by the Centers for Medicare & Medicaid Services (CMS) in 2005.

Many studies suggest that non-profit nursing facilities experience fewer survey deficiencies and have higher nursing staff ratios and operating expenses. As Table 4 shows, government-controlled facilities have the highest percentage of Medicaid-only certified facilities. Non-profits have the greatest percentage of Medicare-only certified facilities. There is a net migration of patients from non-profit to for-profit nursing facilities.

Non-profit facilities tend to operate at higher expense levels, are less aggressive in their private-pay rate structures, and are often less profitable than otherwise similar for-profit facilities. Non-profit facilities have several operating advantages in that they are often exempt from local property tax, pay no income tax, and have access to lower-cost debt available through tax-exempt bond financing.

In appraising non-profit facilities, one of the first questions to resolve is how to treat the ownership. It may be necessary to appraise the facility under two assumptions. First, it can be appraised assuming it remains a non profit and will have certain tax and financing advantages, offset to some degree with higher operating expenses. Second, an assumption can be made that the facility is converted to for-profit ownership. In this case, the valuer will need to adjust the operating forecast to include taxes, higher interest rates, and lower operating costs, consistent with expense levels for comparable for-profit facilities in the same or similar market areas. Adjustments for occupancy characteristics and rates will also be needed. Converting from a non-profit to a for-profit facility, or vice versa, will impact a facility’s Medicaid reimbursement in most states that apply facility-specific, cost-based reimbursement schemes. The valuation approach for a non profit ownership should be discussed and agreed on by the appraiser and the client when the appraiser is engaged.

Exposure and Marketing Time

News of an impending change in ownership often causes fear among nursing home staff and patients. For this reason, nursing facilities are often marketed quietly. Broadcasting the sale may cause some staff

<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>Facilities</th>
<th>Licensed Beds</th>
<th>Occupied Beds</th>
<th>Occupancy</th>
</tr>
</thead>
<tbody>
<tr>
<td>For profit</td>
<td>66.0%</td>
<td>68.0%</td>
<td>67.1%</td>
<td>84.4%</td>
</tr>
<tr>
<td>Government</td>
<td>6.1%</td>
<td>6.7%</td>
<td>6.6%</td>
<td>84.7%</td>
</tr>
<tr>
<td>Non profit</td>
<td>27.9%</td>
<td>25.3%</td>
<td>26.3%</td>
<td>88.8%</td>
</tr>
<tr>
<td>Totals</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>85.5%</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>No. of Facilities</th>
<th>Licensed Beds</th>
<th>Occupied Beds</th>
</tr>
</thead>
<tbody>
<tr>
<td>For profit</td>
<td>10,563</td>
<td>1,141,635</td>
<td>963,699</td>
</tr>
<tr>
<td>Government</td>
<td>971</td>
<td>112,257</td>
<td>95,096</td>
</tr>
<tr>
<td>Non profit</td>
<td>4,469</td>
<td>425,086</td>
<td>377,359</td>
</tr>
<tr>
<td>Totals</td>
<td>16,003</td>
<td>1,678,978</td>
<td>1,436,154</td>
</tr>
</tbody>
</table>

Source: Centers for Medicare & Medicaid Services.
and patients to leave, thus impacting value. States must approve all changes of ownership (ChOWs) for licensed nursing facilities. The process varies by state, and in some states it can be quite lengthy. States must assure the public that the new ownership (licensed operator) is morally, ethically, and financially capable of meeting the obligations required. Because of the secrecy that surrounds the marketing of nursing care facilities, exposure and marketing time are difficult to measure objectively. In addition to actual sales data, interviews with operators who are active in the market or brokers who specialize in selling long-term care facilities can provide sufficient information to address these subjects in the appraisal report.

Summary

The appraisal of a nursing facility typically involves the valuation of the total assets of the business, including the real estate interest and the tangible and intangible personal property assets. Real estate interests may include fee simple, leased fee, and/or

### Table 3  Hospital-Based and Chain-Owned Nursing Facilities by Type of Control in the U.S. in 2005

<table>
<thead>
<tr>
<th>Ownership Type</th>
<th>No. of Facilities</th>
<th>Facilities Within Hospital</th>
<th>Total NFs by Control</th>
<th>Part of Type That Are a chain</th>
<th>Total NFs by Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>For profit</td>
<td>10,563</td>
<td>176</td>
<td>1.7%</td>
<td>6,468</td>
<td>61.2%</td>
</tr>
<tr>
<td>Government</td>
<td>971</td>
<td>343</td>
<td>35.3%</td>
<td>78</td>
<td>8.0%</td>
</tr>
<tr>
<td>Non profit</td>
<td>4,469</td>
<td>888</td>
<td>19.9%</td>
<td>1,825</td>
<td>40.8%</td>
</tr>
<tr>
<td>Totals</td>
<td>16,003</td>
<td>1,407</td>
<td>8.8%</td>
<td>8,371</td>
<td>52.3%</td>
</tr>
</tbody>
</table>

Source: Centers for Medicare & Medicaid Services.

### Table 4  Breakdown of Medicare- and Medicaid-Certified Facilities by Type of Ownership

<table>
<thead>
<tr>
<th>By Facility</th>
<th>Number of Facilities</th>
<th>Medicaid-only</th>
<th>Medicare-only</th>
<th>Dual certification</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicaid-only</td>
<td>458</td>
<td>226</td>
<td>306</td>
<td>912</td>
<td>990</td>
</tr>
<tr>
<td>Medicare-only</td>
<td>293</td>
<td>57</td>
<td>507</td>
<td>3,656</td>
<td>857</td>
</tr>
<tr>
<td>Dual certification</td>
<td>9,812</td>
<td>688</td>
<td>3,656</td>
<td>14,156</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>10,563</td>
<td>971</td>
<td>4,469</td>
<td>16,003</td>
<td></td>
</tr>
</tbody>
</table>

Percentage of totals:

- Medicaid-only: 4.3% Medicaid-only: 23.3% Non profit: 6.8%
- Medicare-only: 2.8% Medicare-only: 5.9% Non profit: 11.3%
- Dual certification: 92.9% Dual certification: 70.9% Non profit: 81.8%
- Totals: 100.0% Medicaid-only: 100.0% Medicare-only: 100.0% Dual certification: 88.5%

Source: Centers for Medicare & Medicaid Services.

James K. Tellatin, MAI, has appraised several thousand nursing facilities and various types of senior housing and hospital properties in nearly every state in the United States. Tellatin has contributed two articles to The Appraisal Journal on nursing facility valuation topics and developed the “Appraisal of Nursing Facilities” seminar for the Appraisal Institute. He has also lectured and instructed governmental, financial, and professional association groups on healthcare valuation issues throughout the nation. He has spoken at national conferences for the National Investment Center for the Seniors Housing & Care Industry (NIC), Robert Morris Associates (RMA-The Risk Management Association), the International Association of Assessing Officers (IAAO), and the World Research Group. Tellatin has also been instrumental in the development of appraisal guidelines for healthcare properties for the U.S. Department of Housing and Urban Development (HUD). He is the founding partner in Tellatin, Short & Hansen, Inc.

Contact: T 636-530-0009; jim@tellatin.com
leasehold rights. Tangible personal property includes furniture, fixtures, and equipment. Intangible personal property usually includes assembled workforces, various local and state licenses, certifications, approvals, patient records, goodwill, and management know-how. These assets may be held by a single entity or the ownership may be fragmented between various related and unrelated parties.

The assets are generally divided for economic and legal reasons. In performing an appraisal or, for that matter, underwriting a financial transaction, it is important to identify, understand, and properly treat the assets being appraised. While the assets may be controlled by separate entities, the combining of these interests may be necessary for valuation purposes. Lenders often secure their loans by binding the assets of related parties to a single loan; real estate tax assessments are typically based on the fee simple interest, despite the presence of existing leased fee and leasehold interests. The reversion rights to personal property assets at the expiration of a lease are often disputed by the parties when the lease agreement is unclear as to the ownership rights. Current assets (working capital, cash, accounts receivable, etc.) and all liabilities are typically excluded from an appraisal assignment. For consistency purposes, the appraiser should verify the assets and liabilities that are included in the transactions that are used to develop comparable sale and lease data.