



BUCKS *for* Bricks

Whether you remodel or build your practice's facilities, it's not cheap, and unless you're rolling in dough, you'll need to finance at least part of the project. A how-to guide for landing the best deal and avoiding common pitfalls.

BY CHRISTINE A. HINZ

WHEN PETER DAYTON, MD, AND HIS THREE partners set out to construct a satellite office in St. Lucie West, Florida, they knew they'd face some lean times.

After all, they didn't want outside investors, even though each of them had to kick in \$75,000 plus the \$1.8 million loan.

But no one could have predicted how a force of nature would turn this group's building plan on its head. When a spate of hurricanes—Frances, Jean, and Wilma—swept over Florida in 2004 and '05, their ob/gyn practice took a financial hit, though not a physical one. The partners had already signed their construction loan, but the hurricane caused innumerable delays. In the meantime, the clock kept ticking on loan payments, which meant the practice had to carry the debt.

The physicians took smaller paychecks to carry the project during the 18-month delay, which meant actually

increasing their investments another \$15,000. Moreover,

the doctors encountered numerous cost overruns and hurdles, including redrawing the designs to meet new building codes.

But Dayton, who had learned a thing or two about constructing buildings since he'd done it in the past, kept focused on the prize—a functional 15,666 square-foot facility that would meet their space needs now and their investment goals for the future.

"I'm not a super land investor kind of guy," Dayton says. "But I know it's better to own your property and lease [to other tenants] than it is to rent from somebody else. That might not be true in other situations, but I think it's certainly true for us."

The basics of borrowing

Few decisions pose bigger challenges for a medical prac-

“If you are a good lending risk, people with money will loan you the money,” says William Edsel, Pinehurst Surgical’s CEO. “We didn’t have a problem getting financing. In fact, lenders were competing for the privilege. The fact that our practice is a community standard and a highly successful business stood us well for our prospects.”



tice than financing and constructing an office building. On the plus side, there’s the lure of building equity as your structure appreciates. On the down side, committing millions of dollars to your own bricks, steel, and mortar is an entrepreneurial risk.

With a few make-or-break basics, you can sail smoothly through the process. In general, you want to:

- **Make sure you’re a high quality borrower.**
- **Shop around with your proposal to multiple lenders.**
- **Plan upfront to get accurate project estimates.**
- **Consider tenants for your building.**
- **Think twice about outside investors.**
- **Bring your accountant and attorney to the table to strategize your tax and legal options before you spend one dollar.**

“One of the biggest mistakes physicians can make is entering into a financial transaction, especially constructing a medical office building, without talking to a CPA first,” says Joe Scutellaro, a CPA with Jump Scutellaro and Company in

Toms River, New Jersey. “There’s always so much more we can do to help structure the deal up front to maximize potential tax benefits. But those benefits can be lost if we’re brought in too late,” he says

Your advisers, for instance, will no doubt suggest spinning the building into its own Limited Liability Company, or LLC, so it’s separate from the practice. Obviously, state law will govern your options (you may see Limited Liability Partnerships instead), but the idea is that you don’t commingle the two entities for tax and liability reasons.

“If you can get your attorneys involved in the beginning, they can save you a lot of headaches down the road,” says Aasia Mustakeem, an attorney and real estate partner for the law firm of Powell Goldstein in Atlanta. “Sometimes people will say, ‘I’ve negotiated this and I just need you to do X, Y and Z.’ But when you look at what they’ve done, your hands are tied because they did A, B, and C.”

Banks...mortgage brokers...corporate financing groups...institutional investors...even the Small Business

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Administration. With a plethora of lenders in the market, there's never been a better time to finance a medical office building. But what's the best way to do it? And how do you create the kind of leverage that will earn you the most favorable terms?

First, you want to come into the marketplace with capital (usually 20 percent of the total amount needed). While the goal is to spend as little of your own money as possible, in order to compete, you must show that you're willing and able to invest.

Second, you want to court lenders. Even before you're ready to make your pitch, it's smart to know what the local bankers want from you. Usually eager for such business, they'll work with you on the kind of financing that you'll need. This financing typically includes a short-term adjustable-rate construction loan to cover the creation of the building and a longer fixed-rate mortgage to pay it off.

Obviously, there are many nuances to this process—you may have to involve a regional institution or even Wall Street if your project is big. But in every case, you'll want to comparison shop things like interest rates, down payments, and "recourse" or the debt level you or the group must guarantee.

"We typically tell our clients, 'All money is green,'" says Hugh DuBose, Jr., a principal with HealthCare Facilities Associates in Columbia, South Carolina. "We recommend that they pick three to four commercial banks in the area with good relationships and then basically bid it."

When Helen Torok, MD, and Leonard Torok, MD, decided to merge her dermatology office and his holistic medicine practice into one integrated Medina, Ohio campus, their daughter and CEO, Heather Funk, wanted to

✓ **Few decisions pose bigger challenges for a practice than financing and constructing an office. There's the lure of building equity as your structure appreciates, but committing millions of dollars to bricks, steel, and mortar is an entrepreneurial risk.**

keep things local.

After crafting a business plan proving that the market indeed could support the 23,000 square-foot venture—a two-building facility called Trillium Creek—she took her package to several banks that had worked with her parents or simply knew them and their solid reputations.

Funk secured the money at rates—the fixed, just above six percent, and the variable, often floating between three and five percent—she still considers "phenomenal." What's more, since the total was under \$5 million, First Merit Bank didn't have to farm anything out to branch or regional lenders, which saved on costs.

"Because we used a local bank, they could be flexible," says Funk. "To this day our lender still works with our attorneys and accountants to make sure that our loan and our tax obligations all mesh. That's pretty important."

Create a winning business plan

Like Funk, you'll have to demonstrate that you're a serious suitor to woo any financial institution, much less attract several to compete for your business. Lenders will want to know as much as possible about you, your partners, your practice, and the project to determine

whether you can support a new level of debt. That means showing that you're not only credit worthy and business savvy, but that you're also proposing a building that will succeed in the market.

Your practice business plan will be an important element of any package. By putting details to your vision and showing how you will make your business dreams a reality, you show lenders that you're committed to and have a roadmap for achieving your goals.

In terms of a new office, a business plan begets a building plan, which is simply the where, when, why, and how you intend to turn your designs into a real street address. By laying out in great detail the specifics of your project, such a document can help you—and your lender—understand the potential return on investment as well as the financial resources necessary to make this work. Most importantly, it shows that you're a serious, disciplined, player in the real estate market and probably a good risk.

"Lenders are looking for stability, preparation, and substance," says Christopher Bowen, the senior vice president and managing director of Marshall Erdman Development in Madison, Wisconsin. "The worst thing you can do is to give them information that's not well-prepared. That sends a message that maybe you're not a good risk."

Jack Boudler, a vice president of Key Bank Real Estate Capital Healthcare in Cleveland, agrees. "First and foremost, we want to see the historical strength of a practice. We want to know that it's clearly a strong player in the market and that it has the ability to sustain revenues and grow. That's how we gauge a practice's capability to pay the rent, which eventually will pay the mort-

gage.”

With a 60-year reputation as a successful medical practice, Pinehurst Surgical hardly needed an introduction to North Carolina’s banking community. In fact, when it came to financing the group’s three-story, \$26 million facility, administrators parlayed their good reputation—and a decade’s worth of annual reports and business plans demonstrating solid growth—into a bidding competition on their terms.

In the end, a “feisty” local bank put together a deal the group couldn’t refuse. In exchange for Pinehurst Surgical’s overall business, the bank offered a 3.7 percent fixed-rate loan (including a two-year construction phase) to be refinanced at five years. There’s also limited liability for each doctor: The total physician guarantee is restricted to 25 percent of the outstanding note balance, prorated for each doctor and reduced as the principal amortizes and new physicians are added to the group.

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The construction plan

Your advisers may use other analyses to demonstrate your venture’s prospects for success. But the most important numbers to the lender will likely be what this is going to cost.

Bidding a construction project is an intricate process—many variables come into play. But the way you get estimates on your project will be dictated by the way it’s designed and built. You’ll have to decide whether you want:

- **DESIGN-BID-BUILD.** You retain an architect who develops the building schematics and, based on those drawings, also solicits and ranks general contractor bids for you to compare and contrast.
- **DESIGN-BUILD.** You forge an alliance with an

Involve Your Attorney Early

When should you involve a lawyer? As with your accountant, you want a legal professional in the beginning and at every juncture. An attorney can help you:

- Craft an initial operating agreement with your partners - to establish each physician’s financial commitments and responsibilities.
- Review the land purchase - to point out any zoning, environment, easement, or other issues that would prohibit construction of a medical facility.
- Assess any health-care regulatory issues - to ensure that if you’re going to have tenants, for instance, you’re aware of federal and state anti-kickback statutes governing compensation for referrals (the so-called Stark amendments). If you’re going to add imaging or ambulatory surgery centers, you also may have certificate-of-need hurdles to overcome in your state.
- Structure the building ownership - to guarantee that you and your partners have the best tax and legal protections under your state law and that you’ve made provisions for when a co-owner leaves the group.
- Negotiate contracts - to double-check that any document with the architect and contractor protects your interests by setting specific performance standards and deadlines in addition to the right price.
- Secure a bank loan - to ascertain that the terms are reasonable and that, if possible, your liability isn’t “joint and several,” meaning that you’d be responsible for everything should your partner(s) default.
- Bring on tenants - to make certain that you’ve not only charged market value for your square footage but also have included rent escalation clauses so that your building produces the growing income stream that appraisers and the bank love.

Since much of what you’re doing involves contracts, you probably can tap your personal or practice attorney. But, there are advantages in using someone who understands the particulars of real estate finance and the regulatory nuances of health care. A lawyer schooled in both fields not only can walk you through the specific minefields but also help you cut the best deals. “If you don’t involve people with the right skills at the onset,” says Sydney Welch, a partner and health-care lawyer with Powell Goldstein in Atlanta, “it could end up costing you.”

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integrated entity to provide complete architectural, engineering, and construction services for a guaranteed maximum price or a fee plus the cost of the work. You choose the firm based on a request-for-proposal (RFP), rather than individual bids.

- **CONSTRUCTION MANAGEMENT.**

You hire someone to act on your behalf either as a consultant on the entire project or as a development/design adviser and later, general contractor. In either case, he/she solicits bids for your approval.

Design-bid-build gives the physician/group the most control but also demands the most time and attention. By comparison, the construction management option requires the least time on the doctor's part but requires faith in your developer/contractor.

With the right team, any of these approaches can work. A consultant can explain the ins and outs of competitive bidding and RFPs. Whatever you choose, consider the common caveat: To get an estimate that comes close to your final construction cost, you must plan up front. There's usually some contingency built into the project (nothing goes exactly as planned) but if your plan is ill-conceived or lacks proper definition, you can be sure of pricy change-orders down the line.

In fact, while rule-of-thumb estimates will guide you initially, you'll eventually undergo a functional and space assessment to nail down your configuration needs. Your design/construction team will translate that analysis—along with their experience and other information—into a design and price.

"It really comes down to the up-front work that we do with physicians," says Stephen Dobias, a CPA with Somerset CPAs in Indianapolis. "We think it's crit-

ical to detail what they're going to get for a certain price, and what they're not going to get. The better job we do in defining those expectations, the less likely they are to have changes."

Since your structure's size will bear directly on your investment, you don't want to build too big for the market. But then again, you don't want to build too small for your own growth. In fact, many experts say you should shy away from 2,000- to 4,000-square-foot buildings because they're so single purpose that you'll be looking at more construction soon.

Within two years after moving into their current 8,000-square-foot Stewart, Florida, facility in the late 1990s, Dayton and his partners were bursting at the proverbial practice seams. When a zip code analysis revealed that many patients were already coming from nearby St. Lucie West, locating a second building in one of the country's fastest growing communities just seemed like a smart move. The doctors would have 4,000 square feet for their own practice, with 12,000 square feet reserved for outside tenants.

"What I learned from my first building experience," Dayton says, "is that the best way to finance a project like this is to build as big a facility as you can carry and then lease out any additional space."

Indeed, tenants can affect the long-term valuation and marketability of your building. If you don't mind being a landlord, having other practices and services—especially those that support your specialty—can create an income stream that helps secure your financing initially and boosts your return on investment later. (See "To Landlord or Not to Landlord," page 15.)

"Anytime you can do an ancillary income stream, whether it's for your busi-

ness or not, it can help your practice," says Richard Haines, Jr., the president of Medical Design International in Atlanta. "If we can get patients to come to our client's building for reasons other than seeing our client, it just improves that practice's visibility and marketability. That's a strong asset."

Another important asset is your own formal rental agreement with the corporation that owns your building to pay at least the market rate per square foot. Such an arrangement may sound a bit like robbing Peter to pay Paul, but you're really contributing to the appreciation of your property by helping cover the mortgage, taxes, and expenses.

Since Mark Smith, MD, an Austin, Texas, general pediatric surgeon and his 39 owner-colleagues moved into their 127,000 square foot office building earlier this year, they've become more than landlords—they're paying tenants.

The physicians—from six pediatric specialty groups—had already invested their personal capital, matched by favorable bank financing, to guarantee the biggest share, \$26.5 million, of this \$31 million venture.

So it was just good business to charge everyone the \$24-per-square-foot market rate. Before the building even opened, it was nearly 100 percent occupied, not just with the owner groups but other practices and ancillary services that signed on for 10 years.

"Doctors make the mistake of trying to charge themselves a low rent," says Smith. "But they should charge whatever the market will bear for a couple of reasons: One, all you're doing is taking money out of your left pocket and putting it in your right pocket. Two, the value of your building is contingent on its income or rental stream. So if you charge low, you're hurting yourself in both the financing and the return."

You also may hurt yourself if you involve private, nonprofessional investors. Experts encourage practices to own 100 percent of their real estate ventures, rather than tapping friends and family since these individuals often see such projects as tradeable assets rather than long-term deals.

As to real estate developers, they're often brought in on larger, complicated projects with multiple players and heavy-duty risk. The advantage is that they put up most of the capital by tapping a wide range of investors. The disadvantage is that the developer typically expects to be the managing partner since he has contributed the lion's share of equity and assumes the fiduciary responsibility and risk.

You may be able to strike a different relationship; developers sometimes serve as advisers or even lesser investment partners. You may also want to employ an owner's representative, someone who knows his way around medical office building projects and can guide you from A to Z.

Just keep in mind that anytime you work with a third party, you can expect to pay a fee or percentage of the action in return for that backing and/or expertise. On the other hand, the money might be worth the investment, especially if you're skittish about the risk.

"What a lot of doctors have to realize is that people are in business to make money," says Dayton. "Doctors like to think that every time they pay somebody to do something, they're getting hosed. But it's not a sin for someone to want to make a profit."

Dobias, the accountant, adds that "Too often, physicians are scared into believing that they can't afford the project. They can't live with the risk, meaning the debt guarantees or the fact that the building could go dark. But it's our belief that if

they have the right advisers, they can own 100 percent of their project and should do so in every situation."

But when?

Truth is, there's not one best time to put your toe into the real estate water. You probably don't want to wait until you're near retirement unless you have a succession plan firmly in place. Then again, borrowing more money while you're carrying school loans and start-up expenses is tenuous at best.

"Ownership presents great opportunities," says Haines. "It can produce many rewards down the line. But you need to consider whether this is a good thing to do now or whether you should just wait until later. You may end up saying, 'Owning a building is step two in the evolution of my practice—not step one.'"

Whatever the moment, you want to strut your best stuff. By showing bankers that you're a good financial citizen and that you have a project worth their money, you also take control.

While Dayton didn't organize one giant document, he and his partners delivered the kind of detailed financial and project information that prompted their long-time lender, Gulf Stream Business Bank, to extend the loans. Although the doctors bid the project to two other financial institutions, Dayton liked the idea of collaborating with "forward, progressive-thinking guys" who had serviced their accounts well in the past. "I really wanted to work with them."

Similarly, he put construction in the hands of a trusted collaborator from past projects. In fact, Dayton suggests that due diligence—finding the right people and costing out the venture as carefully as possible—has to come before everything else. Then expect some delays and overruns. It's the nature of

human commerce, not to mention a product of natural events.

Even when the weather played havoc with the schedule, his builder was upfront about skyrocketing material costs, offering new estimates to make sure that it worked. Dayton admits a dedicated project manager and a tighter construction schedule would have saved the practice money. (Overruns came in 10 percent higher than budgeted.)

Since taking possession in May 2006, however, the physicians are confident in the decision to build. Dayton is also convinced that they'll eventually have 100 percent occupancy, even though the storms delayed tenant leasing and they're still filling the bays. In fact, he and his partners expect a handsome return on their investment in the future, given the area's explosive growth.

In the meantime, Dayton is looking ahead to the next potential market. "Once we get St. Lucie West up and running, we're probably going to Okeechobee. We have patients there too."

Chris Hinz, a free-lance writer and a regular contributor to *Unique Opportunities*, lives in Milwaukee, Wisconsin.