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A warm reception

Physicians welcome $141 million sale-leaseback

Medical group tenant was big driver in six-building MOB portfolio deal

Since its founding 17 years ago, a physicians' group in the mid-Hudson Valley area of New York has built itself into one of the leading independent, multi-specialty physician practices in the United States.

"As (one healthcare real estate consultant) always tells me, a provider's market share in its respective area is the key to its success over the long term," says Danny Prosky, president and chief operating officer of Newport Beach, Calif.-based Griffin-American Healthcare REIT II, a prolific investor in healthcare real estate (HRE).

"And this group owns the market there."

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Griffin-American adds six MOBs

Mr. Prosky was talking about Crystal Run Healthcare, the seller and only tenant in a portfolio of six medical office buildings (MOBs) that Griffin-American, an unlisted real estate investment trust (REIT), recently acquired for $141 million.

Although the REIT closed on the acquisition of most of the buildings in the third quarter (Q3), the last tranche was finalized shortly before the end of the year. The buildings are in the New York cities of Middletown and Rock Hill – an area of the Hudson Valley about 60 miles northwest of Manhattan.

With 360,000 square feet of space in the portfolio, the price per square foot (PSF) worked out to $392.

"We are definitely investing in the strength of the tenant, but we also like the real estate as well, as the portfolio includes newer Class A MOBs. They're very nice buildings in good locations," adds Mr. Prosky.

The REIT looks positively upon the deal for several reasons, Mr. Prosky notes. For instance, Crystal Run occupies the space in the portfolio on "an absolutely bondable net lease (through 2033), so they pay the taxes, insurance, maintenance, utilities and janitorial, and we monitor all of that but really do not get involved in the day-to-day operation of the buildings."

"The deal was at a 7.1 percent going-in cap (capitalization) rate with fixed annual bumps," Mr. Prosky adds. Those bumps, or annual rental rate escalations, are 3 percent, he notes.

As part of the negotiations, Griffin-American gained ownership of the buildings on a fee simple basis, meaning there are no ground leases involved. In most cases, ground leases are only necessary, as far as Mr. Prosky and his company are concerned, when a hospital, health system or group needs assurances that competitors will not be allowed into a certain property.

"Because they have a 20-year bondable net lease, they have the controls they want," Mr. Prosky says. "We said we'd stand by our price but didn't want it on a ground lease, and we did as promised and closed on the transaction in six weeks."

For Crystal Run, the monetization provides it with capital to continue growing operations and recruit more physicians to serve its increasing patient base. The 300-plus provider, 40-plus specialty group, which has more than 15 locations, is one of just six accredited physician-hospital network accountable care organizations (ACOs) in the country.

It provides ambulatory health services and physician inpatient care to more than 200,000 patients annually. Throughout its history, Crystal Run officials say their tenet has been to deliver "high quality and cost-effective care to patients in (our) market. This philosophy has ideally positioned Crystal Run for the changes anticipated under healthcare reform, which could include closer relationships between managed care organizations and providers."

Raymond James' role

Marketing the portfolio and brokering the deal for Crystal Run was the New York-based HRE practice of Raymond James, whose investment bankers landed the assignment following a competitive process to provide advisory services.

Laca Wong-Hammond, a senior VP who heads the firm's HRE efforts, led the marketing of the portfolio along with the firm's Peter H. Delaney, a VP.

As far as Ms. Wong-Hammond is concerned, the seller, Crystal Run, and its founder, Dr. Hal Teitelbaum, the managing principal and CEO who has a degree in law as well as an MBA, are "very impressive leaders that continuously innovate and are always looking ahead."

"As the group peered into their future, it became clear additional capital was needed to fully realize the company's ambitious, long-term strategy," says Ms. Wong-Hammond. "We undertook a strategic options assessment with Crystal Run to determine the course of action that would best meet their needs for growth. During the course of this consultative phase, we came to understand Crystal Run's primary objectives, which were to enhance their ACO infrastructure, originally launched in 2011; unlock capital for opportunistic expansion including for facilities and operations; and further enhance the company's ability to provide quality and cost-efficient medicine in a new accountable care environment."

When it comes to real estate, the group practice has a history of moving into new markets in either newly developed MOBs or leased spaces, and it has plans for future expansions as well, she adds.

"They've plotted to broaden the patient base, so that includes new capital and the expending of time and resources in order to assess what the right schematic is."

For Griffin-American, the transaction could lead to more deals with Crystal Run, including, perhaps, financial investments in future development projects.

"This was a successful transaction because Crystal Run was able to secure a stable agreement that will complement their current operations while at the same time increasing liquidity that can be used for margin-increasing endeavors."

The marketing strategy

According to Ms. Wong-Hammond, Raymond James landed the assignment based on "the breadth of capabilities the firm was able to bring to the table."

"Within our Healthcare Finance department, not only do we have a strong real estate practice, but our investment bankers are also very experienced advising physician practices on capital raising and M&A activities," she says. "Crystal Run has a very dynamic and progressive long-term strategy where real estate assets are just one factor along with a number of other considerations, such as changing market dynamics, reviewing

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The six-building Crystal Run MOB portfolio includes the 127,000 square foot 95 Crystal Run Road in Middletown, N.Y.
Photo courtesy of Raymond James

potential affiliation and partnership options, and optimizing the group's capital structure. So they really wanted an advisor to think about this in a holistic, bigger picture scheme, not just in terms of the real estate."

Upon landing the advisory assignment, Ms. Wong-Hammond, Mr. Delaney and others at Raymond James looked at the provider's financial picture, its current capital structure and its long-term plans in determining a course of action.

"We spent a lot of time on the front end being thoughtful and structuring the real estate transaction in the context of all that was going on with their strategic and corporate initiatives and all of these proposed alignments," she says.

The Raymond James group attended a number of the Crystal Run Healthcare board and subcommittee meetings. "We had to build consensus for this particular real estate process – it was thoroughly vetted."

To finance the continued build out of Crystal Run's ACO, enhancement of the health network and potential geographic expansion, alternatives considered included not only monetizing Crystal Run's owned real estate but also finding an equity partner and/or borrowing more capital.

"They have great relationships with some local and regional banks that have extended them credit for decades," according to Ms. Wong-Hammond. "And we called on some national and international lenders from the debt side so that we could run that analysis, too."

Crystal Run and Raymond James also considered approaching private equity firms for capital, as it was clear there would be significant interest given the company's dominant market share and other strengths.

"We analyzed these scenarios from a number of fronts, and we did it concurrently with looking at the monetization of the real estate," Ms. Wong-Hammond says. "But it came down to trade-offs between cost of capital, credit implications and qualitative considerations affecting cultural fit. "

A sale-leaseback of the provider's owned properties made the most sense to the leadership, she says.

Competition was strong

Competition was strong among bidders, "in large part because of the Crystal Run brand," notes Ms. Wong-Hammond.

"We cast a wide net, including a number of net lease investors. And because of future development possibilities, it made sense to include opportunity fund investors, developers, REITs – private and public – and private equity groups," she recalls. "And then we got inquiries from buyers that we never contacted but who heard about the portfolio and were familiar with the Crystal Run name."

For the most part, because of the uncertain healthcare environment, many top investors remain cautious and when it comes to acquiring real estate. Ms. Wong-Hammond says they want to be sure they are partnering with "the accountable care thrivers and survivors."

"Many providers – hospital systems or physician groups – have gone out of business" she says. "But the Crystal Run platform is different and investors saw that. We're talking about a group that is financially stronger than many hospitals, is always on the cutting edge of providing services as well on the business end of the equation. They rolled out their electronic medical record systems back in 1999. And they are so well-diversified, even beyond many regional health systems."

"All of that just gives the investor comfort that this is the right group to be aligned with now as well as in the future," Ms. Wong-Hammond says.

In the end, Crystal Run received about a dozen written offers from a wide range of investors as well as numerous verbal proposals during the months leading up to the closing.

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Gaining a partner

While Ms. Wong-Hammond would not confirm whether Griffin-American was the highest bidder, she did add that Crystal Run was looking for a long-term partner with experience in healthcare real estate that might want to, at some point, invest in new developments.

"They were *a* high bidder, there were several that were very competitive and it was a competitive process," she says. "We brought in the top bidders to several on-site meetings that involved executive management hosting very in-depth discussions. The potential buyers were vetted thoroughly. Then we had to get the 100 physician partners to vote, and they chose Griffin unanimously."

In a statement, Douglas Sansted, Crystal Run's chief legal officer, said: "As important as total (price) consideration was, (so was) Crystal Run's requirement to structure a long-term partnership with the buyer to allow Crystal Run to retain an ownership type perspective toward its single-tenant office buildings.

"This partnership with the buyer will allow Crystal Run the necessary latitude to timely maintain and enhance the real estate assets as needed to best serve our patients."

"Best serving its patients" could entail adding new facilities that Griffin-American, which has an overall HRE portfolio of more than $2.2 billion, will likely get a chance to finance or partner in, according to Ms. Wong-Hammond.

"Crystal Run could end up partnering with somebody else on new development," she notes.

"But they really like Griffin-American, who they see as a long-term partner. So, sure, if someone makes them a great offer in a market that they are focused on, who knows? But I do know that they are ecstatic about the relationship with Griffin-American and really vetted them thoroughly before awarding this transaction to them."

From a proceeds distribution standpoint, the final transaction was rather complicated, Ms. Wong-Hammond adds, because numerous doctors were involved in the ownership of the facilities, making their investments at different points in time.

"We did a lot of analysis on that end to determine allocation of proceeds, tax ramifications, unwinding loans and there was a swap involved," she says. "Crystal Run will self-manage the properties, as they have a group that will continue to do that internally."

Dr. Teitelbaum, Crystal Run's CEO, noted that the group was pleased with how the transaction turned out, including Raymond James' efforts.

The transaction, he said, provides the organization with flexibility "as we continue to expand in geography, scope and scale, taking a leading role in healthcare transformation for the benefit of the patients and communities we serve."

He added: "Crystal Run Healthcare is uniquely qualified and positioned to thrive in the new era of healthcare where compensation is outcomes-driven.

"Accountable care and the development of our own health plans reward us financially for the successful management of performance risk – the achievement of better health outcomes for our patients."

Mr. Prosky and other officers at Griffin-American Healthcare REIT II agree.

"We're always looking to partner with the people and organizations who we think will be the winners in the new healthcare paradigm, and we think Crystal Run is certainly one of those groups that will continue to be one of the winners," he says. ❑

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