


Nursing Facility Property Payment

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Care Providers of Minnesota and Minnesota
Health and Housing

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Property/Capital Component Reimbursement Model Options

- Historical Cost
 - Leases/rentals
 - Depreciation
 - Mortgage interest
- Fair Rental Value System (FRVS)
 - Gross fair rental
 - Net fair rental
 - Market appraisal
 - Proxy appraisal
- Hybrid



Historical Cost - Issues

- Leases/Rentals
 - Related party concerns
 - Capital lease concerns (virtual purchase)
 - Fair market value of lease



Historical Cost – Issues Contd.

□ Depreciation

- No uniformity with tax and business accounting
- Validation problems
 - Original purchase price (DEFRA and COBRA)
 - Renovation and upgrades vs. repairs
 - Allocations between allowable and non-allowable space
 - Determination of useful life
- Lack of any reimbursement if building is owned, no mortgage, and fully depreciated



Historical Cost – Issues Contd.

- Mortgage interest
 - No uniformity of costs
 - Market issues
 - Generally higher cost than other business
 - New capital not necessarily readily available
 - Allowable cost determinations
 - DEFRA and COBRA interest calculation
 - DEFRA and COBRA mortgage amount
 - Refinancing
 - No incentive for equity financing



Historical Cost Issues - Summary

- A process used to determine value for financial accounting purposes, not for economic purposes
- Lacks uniformity in costs that are used to determine reimbursement
- Allowable cost determination validation problems
 - Availability and adequacy of historical records
 - DEFRA and COBRA determinations
 - Non-allowable space issues
- No incentives to generate equity capital



Fair Rental Value System (FRVS) Fundamentals

- Price for use of space irrespective of actual accounting cost
 - Economic value vs. financial accounting value
- Price = Facility value which increases over time based on replacement cost and proper upkeep times a rental rate
- Value based upon professional standards
 - Professional market appraisal
 - Proxy appraisal – Simulated appraisal value using commercial valuation systems such as Marshall Swift/Boeckh or RS Means



Why FRVS?

- A well designed fair rental value system will:
 - Differentiate reimbursement based upon age/condition
 - Provide incentives to generate capital resources for renovation, improvement and replacement
 - Encourage investment in physical plant upgrades and renovations
 - Impact the physical environment that can result in improvement of resident quality of life
 - Simplify administration and allow the State to exert reasonable budget predictability and control



Why FRVS Continued?

- Distinguishes economic value over financial accounting value
- Eliminates concerns for system gaming:
 - DEFRA and COBRA
 - Capital lease issues
 - Related party transactions
- Promotes equity investment



Fair Rental Approaches

- Gross fair rental
 - Fair rental value times rental rate
 - No interest or depreciation component
- Net fair rental
 - Interest expense is a pass-through or subject to certain limitations
 - Rental rate is paid on difference between fair rental value and allowable debt
 - Sometimes reimbursement of depreciation component as well
- Hybrid
 - Fair rental value is used to set maximum level of capital reimbursement



Gross Fair Rental Example

Assumptions

- ❑ 100 bed facility
- ❑ RS Means new bed value of \$60,000
- ❑ Land value at 10%
- ❑ Equipment value at \$5,000/bed
- ❑ 25 years old
- ❑ Depreciation rate of 1.5%/year
- ❑ Rental rate of 9.0%
- ❑ 33,000 annual patient days

Gross Fair Rental Example - Continued

Gross Fair Rental Example		
New Bed Value	\$	6,000,000
Equipment	\$	500,000
Subtotal	\$	<u>6,500,000</u>
Depreciation	0.375 \$	(2,437,500)
Subtotal	\$	<u>4,062,500</u>
Land	\$	600,000
Rental Value	\$	<u>4,662,500</u>
Rental Rate		9%
Fair Rental	\$	<u>419,625</u>
Patient Days		33,000
Fair Rental Rate	\$	<u><u>12.72</u></u>

Net Fair Rental Computation

Net Fair Rental Computation		
New Bed Value	\$	6,000,000
Equipment	\$	500,000
Subtotal	\$	6,500,000
Depreciation	0.375 \$	(2,437,500)
Subtotal	\$	4,062,500
Land	\$	600,000
Rental Value	\$	4,662,500
Less Mortgage	\$	(3,000,000)
Subtotal	\$	1,662,500
Rate of Return		6%
Return on Equity	\$	99,750
Mortgage Interest	\$	225,000
Subtotal	\$	324,750
Patient Days		33,000
Fair Rental Rate	\$	9.84

Hybrid Example

Hybrid Example		
New Bed Value	\$	6,000,000
Equipment	\$	500,000
Subtotal	\$	6,500,000
Depreciation	0.375 \$	(2,437,500)
Subtotal	\$	4,062,500
Land	\$	600,000
Rental Value	\$	4,662,500
Target Rate		0.09
Maximum Property Payment	\$	419,625
Depreciation	\$	160,000
Mortgage Interest	\$	225,000
Subtotal	\$	385,000
Lower of Actual Cost or Ceiling	\$	385,000
Patient Days		33,000
Capital Rate	\$	11.67



States Reimbursed by FRVS

Alabama²

Arkansas²

California²

Colorado¹

Connecticut

Florida¹

Georgia

Idaho

Illinois

Kentucky¹

Louisiana¹

Maryland²

Michigan^{2 3}

Minnesota

Mississippi¹

Missouri²

Nevada¹

Pennsylvania¹

Rhode Island¹

South Carolina¹

Utah¹

West Virginia

Wisconsin³

Virginia¹

¹ Gross, ² Net, ³ Hybrid



FRVS

Commercial Appraisal

- Commercial Appraisal – Requires the services of a professional real estate appraiser to complete a commercial market appraisal of the facility
- Considerations
 - Significant additional costs for initial (base value) and periodic (re-basing)
 - Establishment of initial base values can present problems
 - Timing to complete individual appraisals
 - Inconsistency in valuation because of human factor
 - States using actual appraisals
 - Colorado
 - Kentucky
 - Pennsylvania
 - Wisconsin



FRVS

Proxy Appraisal

- Proxy Appraisal = Creation of an appraisal model simulation using standardized values and depreciation factors consistent with commercial valuation systems
 - Facility base value established using a standard or actual facility square footage (per bed) and construction cost (RS Means or other)
 - Adjusted to include land value and equipment, and sometimes soft costs
 - Further adjusted for age and condition using depreciation factor
 - Periodically rebased for improvements and replacement cost inflation



FRVS Proxy Appraisal - Contd.

□ Considerations

- Minimal cost to establish base value and periodic rebasing
- No timing concern
- No inconsistency in valuation because the human element is removed
- Establishing initial age

Gross Fair Rental Example

Gross Fair Rental Example		
New Bed Value	\$	6,000,000
Equipment	\$	500,000
Subtotal	\$	<u>6,500,000</u>
Depreciation	0.375 \$	(2,437,500)
Subtotal	\$	<u>4,062,500</u>
Land	\$	600,000
Rental Value	\$	<u>4,662,500</u>
Rental Rate		9%
Fair Rental	\$	<u>419,625</u>
Patient Days		33,000
Fair Rental Rate	\$	<u><u>12.72</u></u>



Property Component Example after Renovation

Property Component Example after Renovation

New Bed Value		\$	6,000,000
Equipment		\$	500,000
Subtotal		\$	6,500,000
Depreciation	0.360	\$	(2,340,000)
Subtotal		\$	4,160,000
Land		\$	600,000
Rental Value		\$	4,760,000
Rental Rate			9%
Fair Rental		\$	428,400
Patient Days			33,000
Fair Rental Rate		\$	12.98
Increase in Rental Value		\$	97,500



Renovation Example – Option 2

Renovation Example Option 2

Cost of Renovation \$ 240,000

Accumulated Depreciation/Bed \$ 24,375

New Bed Equivalent 10

	Number of Beds	Age	New Average Age
Existing Beds	90	25	2250
New Beds	10	0	0
Sum	100		2250
New Average Age			22.5

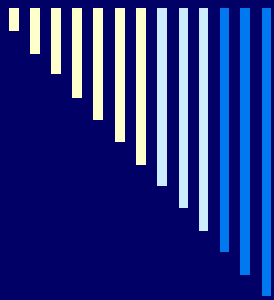
Property Component Example after Renovation (Option 2)

Property Component Example after Renovation		
New Bed Value		\$ 6,000,000
Equipment		\$ 500,000
Subtotal		\$ 6,500,000
Depreciation	0.338	\$ (2,193,750)
Subtotal		\$ 4,306,250
Land		\$ 600,000
Rental Value		\$ 4,906,250
Rental Rate		9%
Fair Rental		\$ 441,563
Patient Days		33,000
Fair Rental Rate		\$ 13.38
Increase in Rental Value		\$ 243,750



Per Bed Values for New Construction in States Recently Implementing FRV

State	Per Bed Value
California	\$58,400 Excl. land and equipment
Louisiana	\$47,000 Excl. land and equipment
Nevada	\$85,600 All inclusive
Rhode Island	\$65,800 Excl. land and equipment
Utah	\$54,000 Excl. land and equipment
Virginia	\$82,000 Excl. equipment (Richmond)



Rental Factors in States using FRV

State	Rental Factors
California	7.35% 20 yr. Treasury Bond (5.35% + 2.0%) (7.0% Floor, 10.0% Ceiling)
Colorado	8.25%
Kentucky	9.0% 20 yr. Treasury Bond (5.35% + 2.0%) (9.0% Floor, 12.0% Ceiling)
Louisiana	9.25% 20 yr. Treasury Bond (5.35% + 2.5%) (9.25% Floor, 10.75% Ceiling)
Maryland	8.37% 20 yr. Treasury Constant Maturities (6.37% + 2.0%)
Mississippi	9.5% (30 yr. Treasury Bond (5.20% + 2.0%) (9.5% Floor, 12.0% Ceiling)
Nevada	9.0%
Pennsylvania	5.68% (AAA Corporate Bond – 5 yr.)
Rhode Island	9.0% 20 yr. Treasury Bond (5.35% + 3.0%) (9.0% Floor, 12.0% Ceiling)
Utah	9.0% 20 yr. Treasury Bond (5.35% + 3.0%) (9.0% Floor, 10.75% Ceiling)
Virginia	9.0% 20 yr. Treasury Bond (5.35% + 2.0%) (9.0% Floor, 11.0% Ceiling)



Issues in Establishing Per Bed Value (New)

- Square footage
- Land value
- Soft costs
- Equipment value
- Location multiplier



Fair Rental Rate Issues

- Nursing home interest rates and debt service constants
- Blend of debt plus equity rates
- Risk factors



Depreciation Issues

- Depreciation rate
 - Too low does not promote renovation
 - Too high moves FRV closer to accounting value rather than economic value
- Maximum deprecation rate



Renovation Issues

- Promote renovation
 - Higher depreciation rates
 - Higher maximum depreciation
 - Favorable treatment of renovation costs
- What is a renovation project?
- Is major moveable equipment included?