

How much is your building worth?

Most doctors think their medical office building (MOB) are like their home when it comes to valuation, believing that MOB values go up over time because they are well-located and boast nice interiors. Nothing could be further from reality.

A commercial income property (like an MOB) gets its value from the net annual income generated from the leases. The sale price for any income property is calculated by using a cap rate, or capitalization rate, formula. The cap rate is equal to the net annual rent divided by sales price.

The sales price or value is simply a multiple of the net annual rent produced by the property. The higher the rent, the higher the value created. The best way to think of a cap rate is to compare it to a yield on a CD. If the local bank were offering 10% CDs, we know if we invested \$100,000 then we would get \$10,000 of interest back at the end of the year.

The cap rate is just like this CD yield. If your MOB were putting out \$10,000 per year net income from rent (after paying annual real estate taxes, insurance and maintenance)...and the market cap rate for MOB's with minimum five-year term leases were still trading at 10% like they were for so many MOB's that I sold from 1988 thru 2002...then your MOB would be worth \$100,000.

The longer the lease term, the more investors are willing to pay for the property. So longer term leases always create higher sales prices or lower cap rates. This is how you manipulate the cap rate by making sure whenever you sell the property; you have the longest term lease in place.

If your MOB is smaller than 10,000 square feet, you can get away with a minimum term of a five-year lease to get a good price (i.e. cap rate). If your building is larger than 10,000 square feet, your lease term needs to be seven or 10 years. A five-year term lease will get you a very good market cap rate (i.e. good price). A seven-year lease term will get you a little bit higher sales price (i.e. lower cap rate) and a 10-Year lease term will get an even higher sales price than a seven-year term lease.

The beauty of this system is that you can tailor your lease to fit your needs when you decide to cash out the equity in your MOB. There are many different ways to use this sale/leaseback tool depending upon: how old or young the partners are; whether all partners in practice hold equity in the building or only some do; whether the practice plans to expand, contract or remain the same in the future. At what point in your career will you be prepared to personally guarantee a five, seven or 10-year term lease to create a top of market sales price?

The stronger the tenant, the more assurance the buyer has that the tenant will stay in business for a long time, the higher the price (or lower the cap rate) he will pay for this property. The longer the lease term, the higher the sales price (as we discussed before). That is why a Walgreen's store with a 25-year term NNN lease will sell at a lower cap rate (i.e. higher price) than an MOB will sell with a five year term lease that is guaranteed by two MDs.

The average annual cap rates for my sales from 1988 thru 2002 averaged around 10%. From 2003 thru 2009, they have bumped between 8% and 9%. This means that doctors who sold their MOB after 2002 got roughly 15% higher sales prices than doctors who sold their MOB over the previous decade and a half.

Cap Rates for MOB are heading back towards 10% where they used to be so stable for so long...before we had these crazy days of easy credit that helped drive cap rates down (or sale prices up). The medical business is perceived to be more recession resistant than most other businesses in the country. That is the main reason why NNN leased MOB have not dramatically softened on prices like all the other segments of commercial real estate has to date. All commercial values are sliding downward because of the economy and commercial foreclosures that are just getting started.

I expect you will get higher sale prices (i.e. lower cap rates) for MOB sold in 2009 compared to those sold in 2010 and 2011. Plus if you sell before President Obama raises capital gains taxes next year, you get to keep more of your hard earned profits...profits that you manipulated higher by making sure you had a nice long lease in place when you sold.

Source: Article posted on Medical Office Today newsletter, by Mark Alexander, senior medical office advisor with Sperry Van Ness, which has sold more than 70 medical office buildings throughout his 17-year career. Many of his MOB sales hold the record for the highest sales prices on a per square foot basis. You can reach him at 239-826-4174 or marka@svn.com.

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