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Financing Healthcare Facilities: Credit Tenant Lease Financing

For construction financing of single- or dual-tenant medical office buildings, credit tenant lease (CTL) offers an intriguing option for developers. A healthcare system or a large healthcare-related company would fit the criteria for consideration.

With CTL financing, the lease rental income is leveraged as the basis for repayment of the loan. In fact, the rental payments are assigned and paid directly to the lender. Because the CTL structure more closely resembles a bond rather than a real estate loan, the interest rate on the note will be determined by the creditworthiness of the tenant(s) rather than the value of the underlying real estate and creditworthiness of, or credit enhancement from, the borrower. The higher the creditworthiness of the tenant(s), the lower the interest rate on the loan.

Under the CTL financing model, the property owner and each tenant enter into a triple net (otherwise known as NNN) lease. Under the lease, the tenant has the responsibility for payment of building operating expenses, real estate taxes and insurance. In some cases, the tenant is responsible for repair, maintenance and replacement of capital items, such as repaving the parking areas, repairing the roof and replacing HVAC systems. The property owner has minimal expense and responsibility.

However, because CTL financing uses the rental stream as the primary source for repayment of the loan, the rental stream must be virtually guaranteed as uninterruptable. To accommodate such requirement, the NNN lease will often have "hell or high water" clauses that require the tenant to continue to pay rent regardless of what happens to the property – no setoff rights or rent abatements. Also typical is a payment guaranty from the corporate parent of the tenant.

Common CTL Financing Terms

CTL financings generally have the following features:

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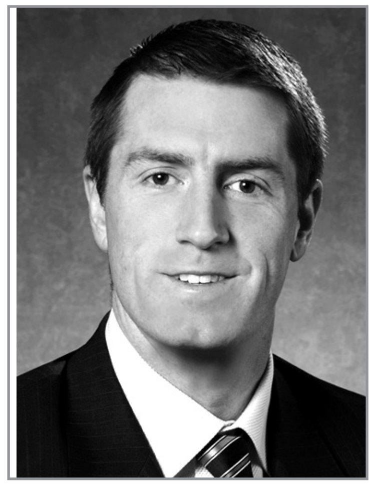

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- Non-recourse
- Self-amortizing over the term of the CTL loan
- Debt coverage ratio as low 1.0 to 1.0
- 100% construction financing available
- No loan-to-value constraints
- Forward commitments with rate locks
- Fixed-rate payments, with lock-step increases
- First lien on property, with assignment of lease payments
- Terms generally between 10 and 30 years

Is an Investment-Grade Tenant Required?

Traditionally, CTL financings have required the tenant be rated investment-grade or higher (i.e., Standard & Poor's (BBB-), Moody's (Baa3), or Fitch (BBB-), or higher). Examples of investment-grade tenants include governmental entities, big box retailers like Walmart, drug stores like Walgreens, and large chain restaurants like McDonald's and Starbucks. Investment-grade tenants remain the gold standard for CTL financings. Some government-owned and other healthcare systems fall into this category. However, as the economy improves and investor appetite for higher returns grows, the number of CTL financings is expanding to encompass tenants with below-investment-grade debt, including those in the healthcare industry. Thirty-six percent of respondents in CBRE's 2014 Healthcare Real Estate Investor/Developer Survey Results stated the minimum hospital credit rating they would consider for investment was BB+ (less than investment grade) or below (the question did not specifically address CTL investments).

Indeed, the CTL deal activity in traditional CTL industry sectors with investment-grade tenants, such as automotive parts retailers, drug stores and fast-food chains, decreased by roughly 20 percent to 25 percent in 2013. However, overall volume of CTL investments increased in 2013.

Development of Healthcare Facilities is on the Rise

Of respondents to the 2014 CBRE survey, 84 percent stated that their planned investment activity in 2014 was to be a "net buyer," while 56 percent responded that demand for medical office products will be higher in 2014 than in 2013. In Colorado a number of new hospitals have recently opened or will soon open along the Front Range, including the new St. Joseph's Hospital in Denver, the expansion of University Hospital in Aurora, the Parkview Medical Center in Pueblo, and the new Children's Hospital South Campus in Highlands Ranch. In 2013, Colorado Public News' report on the Colorado hospital construction boom noted approximately 50 hospital projects ongoing in Colorado at an estimated cost of approximately $3.4 billion. That $3.4 billion price tag accounts only for hospitals. It does not include medical office buildings (or MOBs) and other ancillary healthcare space. In some cases, doctor groups can partner with hospital systems in the development of MOBs on hospital campuses and qualify for CTL financing.

Colorado is currently rated the eighth healthiest state in the country, according to a recent report published by the United Health Foundation, American Public Health Association and the Partnership for Prevention. The report measures four areas: behaviors, community and environment, policy, and clinical care. CTL financing and Colorado's healthcare construction boom could vault Colorado to the top spot in the coming years by increasing access to care. The growth of the healthcare sector in Colorado combined with more relaxed tenant qualification standards for CTL financing are providing more and better opportunities for developing healthcare facilities across Colorado.