FINANCE

RESOURCE ALLOCATION
TO BUILD OR NOT TO BUILD

By Gary S. Schwartz, MD, MHA, and Daniel K. Zismer, PhD

In this article...

To own or rent? Several factors — financial and practical — play into the final decision.

MOST PHYSICIANS WHO OWN THEIR OWN practices will at one time or another have to decide whether to build and own their next office or ambulatory surgery center or to rent space in a building that someone else owns.

THE PROBLEM

When physician owners build a new building, they typically finance it with a significant amount of their own money. In doing so, they tie up a lot of personal and corporate capital in this non-liquid entity and take on a large personal financial risk. In addition, as primary owners of the building, they are responsible for the building's maintenance and upkeep.

This loss of liquidity, combined with added financial risk and responsibility, discourages many physician owners from taking on a project that otherwise may have many advantages.

Physician owners who decide to build often under-build in an attempt to save money. They may scrimp on the number of exam rooms, the amount of administrative office space, the size of waiting rooms, or any number of areas that are necessary for both revenue production and employee morale.

Some physician owners will try to save money by cutting back on the quality of the finish work, creating an office ambiance that may not be in line with the image that the practice is trying to convey. Cheap finishings, such as hollow-core doors and ineffective sound-mitigation systems, can threaten patient privacy and comfort as sounds carry from room to room.

THE SOLUTION

Partnering with a commercial real estate firm is an excellent alternative for physician owners who want to build a building of the appropriate size and aesthetic while minimizing opportunity cost, personal financial risk, and responsibility. Many physician owners have experience working with commercial real estate firms for planning and construction, but few realize that these firms are often willing to partner with them in the financing and ownership of the new building.

CASE STUDY

A private group owned by 10 physicians rents space in five office buildings in five towns. Three of these offices are adequate, but one is too small for the group's current needs and one is located in a building with poor visibility that is difficult for patients to find. There are no good options available in either of these towns for the group to relocate their clinic so providing adequate clinic space will require new construction.

The physician owners work with a local commercial real estate firm to identify appropriate building sites and create preliminary plans. They predict that each building will cost about $6 million. If the doctors put down 20% upfront, they will need to contribute $240,000 apiece and finance the rest. Once the building is built, they will have to find and pay a management company to maintain and manage it.

After the building costs are laid out, the physician owners decide that they do not want to take on the expense and financial risk of building two new clinic buildings simultaneously. They believe they could manage building one clinic, but cannot decide which of the two is more important, how big it should be, and how much to spend on it. A schism has developed in the boardroom because some partners do not want to be "on the hook" to pay to build clinics that they will not personally use.

DISCUSSION

Many physician owners of private medical groups have faced similar problems at one point or another. It is a sticky problem and one that has caused its fair share of boardroom angst.

One solution is for the physician owners to partner with the commercial real estate firm they have already been working with by creating a separate legal entity (usually a limited liability corporation) that will own the new building.

In our experience, such a partnership is most effective when the commercial real estate firm stays on as a *general partner*, owning 51% of the building company, thus taking on most of the cost and risk. The physician owners are then invited to buy into the building as individuals at investment levels of their own choosing.

Each physician owner can opt-out of investing if they believe it is not a good venture for them personally. The physician owners who invest are each limited partners, meaning that their financial exposure is limited to their initial investment.

The general partner retains control of the partnership and is responsible for property management directly or through a contract with a third party. The commercial real estate firm we have worked with has its own property management division, which manages and maintains the buildings once they are up and running.

The general partner is also responsible for financial distributions made to limited partners. Generally speaking, the average annualized cash-on-cash return should be about 10%, but it could be more or less and could increase or decrease over time. When the facility is sold, the investors typically see a final return that is positive to the initial amount, but there are no guarantees. After the sale, the physician owners can remain in the facility with long-term leases and term renewal options.

SUMMARY

Physician owners do not need to take on the entire cost and financial risk of a new clinic or surgery building themselves. They can rely on commercial real estate firms for the development and construction of the building and often can partner with them in the building itself. Having the commercial real estate firm serve as the general partner allows interested physician owners to invest as limited partners at levels they are comfortable with and with minimal risk of personal financial loss. The commercial real estate firm may have a property management division that can manage and maintain the building. Investing in this way also frees up more capital for the physician owners to invest directly into the medical practice.

Finally, some physicians may ask, "If owning buildings is good for the commercial real estate professional, then why not for me?" The fundamental answer is that physicians have a license to practice medicine, and commercial real estate professionals do not. The returns that physicians can see by investing their capital directly into medical services such as ambulatory surgery, procedure, and diagnostic centers; development and expansion of specialized clinical programming; and the addition of employed providers will almost always exceed that of real estate investments. Moreover, effective management of real estate requires experience and specialized competencies.

Our experience has taught us that physician owners are most successful when they can focus their attention and capital on the performance of the practice rather than on the buildings that they practice in.

Gary S. Schwartz, MD, MHA, is co-chair and executive medical director of Associated Eye Care Partners, LLC, in Stillwater, Minnesota.
gsschwartz@associatedeyecare.com

Daniel K. Zismer, PhD, is co-chair and CEO of Associated Eye Care Partners, LLC, in Stillwater, Minnesota.
dzismer@aecpmso.com