A Proposal that smoothes the way for hospitals to get bank loans

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(Introduction)

The figure of Japanese medical corporations' bankruptcy is very small even under the present depression. Its figure is around 100 after 1990, which has been gathered from the data announced in public (see attached sheet I-1). This is only around 1% of the total number of hospitals (it was around 10,000 in 1990). When a bank lends money to a medical corporation in term of 20 years, probability of bankruptcy during the term is only around 2%.

Originally, the medical corporations must be low risk borrowers for financial institutions. However, in Japan, most loans for medical corporations are mortgage loans, and at the screenings of the loan application, collateral property value is thought as quite important. And the screenings are not carried out so smoothly for hospitals.

Financial institutions examine the business performance and the collateral property value, at the screenings of loan application. And even if they could get beliefs on the near future management, long-term anticipation is quite difficult.

There are criticisms that examinations are inclining toward the valuation of collateral properties. But, from the financial institutions side, when a medical corporation goes bankrupt, the last warranty for the collection of their claim is the collateral property.

Then, when they went bankrupt, how were the collateral hospitals disposed, and at what price levels were hospitals sold? These problems have large influence on the screenings of loan application from medical corporations, because their price levels had been quite low.

On the other hand, there are some cases that the medical corporation which bought the bankrupt hospital went bankrupt again. So, the sale price of a hospital at the time of bankruptcy is also a large problem for the transferee medical corporation.

In this report, I collected and analyzed many hospital bankruptcy examples. And I will make a proposal that would create reasonable sale price level of hospitals.

(Terminological meanings)

There are three approaches to appraise real estates. They are Cost approach, Sales comparison approach, and Income capitalization approach.

1. Cost approach is a method which indicates the value by paying attention to the reproduction cost. And indicated value is called the "Value indicated by the Cost approach".
2. Sales comparison approach is the method which indicates the value by paying attention to the sales data of real estates. And indicated value is called the "Value indicated by the Sales comparison approach".
3. Income capitalization approach is the method which indicates the value by paying attention to the income generated from the subject property. And indicated value is called the "Value indicated by the Income approach".

Generally, financial institutions set up the credit line by estimating the "Value indicated by the Cost approach" and multiplying this by loan-to-value ratio.

On the other hand, in recent years the importance of “Income capitalization approach" is increasing on actual sales.

1. Examples of hospital bankruptcy

In Japan, the increase of hospital sickbeds and medical expenses had continued after the World War 2. It was supported by high economic growth and the universal health insurance system.

But the number of hospital sickbeds had reached the ceiling in 1992, and it is decreasing slightly or remaining level after that. On the other hand, medical expense increase is expected in the future aging society, and its control is a political problem now.

(Annual transition of the number of hospital sickbeds)

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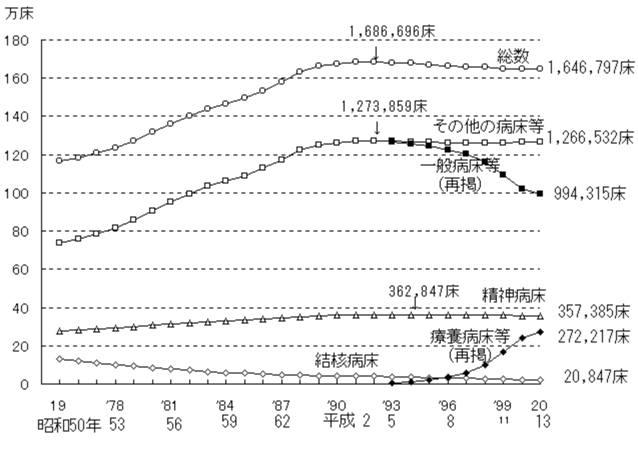
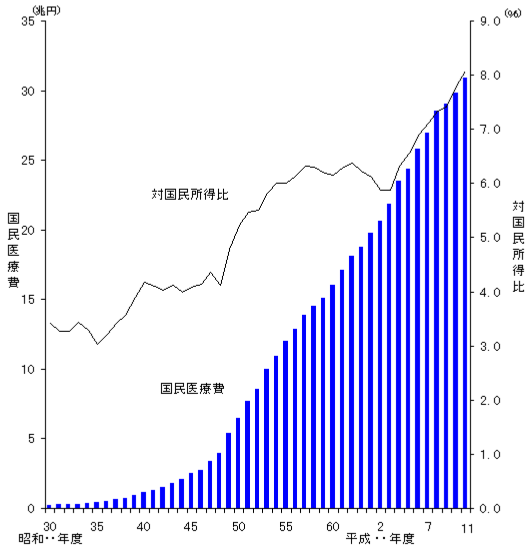


(Annual transition of national medical expenditures

(Trillion yen) ↓ and the ratio for national income)



In Japan, the number of hospitals is regulated by the hospital sickbed figure regulation of local governments, etc. And there are also many other regulations related to hospital managements.

So, hospital dealing market is not a free market in Japan.

Although it seems strange that medical corporations go bankrupt under such public protection, but bankruptcies had come to be conspicuous with various factors after 1990.

As for the number, there were about 100 hospital bankruptcies after the 1990s, according to my inspection.

There are two types of bankruptcies. One is a usual type of bankruptcy. Another is a bankruptcy caused by the discharge of designation for the medical insurance institution that is carried out because of the unjust receipt of medical insurance payment. But the latter, in fact in many cases, management got worse and they were led to the unjust claim.

Attached sheet I-1 shows what progress was followed after their bankruptcy. Attached sheet I-2 shows, from the financial institutions side, how much claims were collected from the collateral hospital.

Many of bankrupt hospitals were taken over to another medical institution. But, in the worst cases, there was no buyer, and building demolition cost exceeded vacant lot price, so they became dilapidated buildings or ruins.

I classified the bankrupt examples roughly as follows.

(Group A)

The cases that hospitals were taken over to another medical corporation after bankruptcy and hospital management have been continuing.

(Group B)

The cases that hospitals were bought by developer, etc., after bankruptcy under the premise of building demolition (for condominium sites, detached housing development sites, etc.). Many of these cases were seen in urban areas.

(Group C)

The cases that hospitals were bought by another entity after bankruptcy for other uses that are similar to hospital (for elderly related facilities, medical schools, etc.).

(Group D)

The cases that buyer was not found over a long time after bankruptcy, and hospital buildings became dilapidated buildings or ruins.

(Other cases)

For example,… integration and abolition of public hospitals, abolition of National Railroad hospitals, composition of creditors, application of the Civil Rehabilitation Law, management reconstruction with support of other medical institutions, etc.

The level of each sale price is considered as below.

(Group A)

Even under voluntary sales, their prices are much lower than the "Value indicated by the Cost approach" which financial institutions usually assess them as collateral properties. Also under public auctions, their prices are quite low, or, there are many cases that they could not get any bidders.

(Group B)

In this case, disposal of collateral hospital is easy. When the building is old and there are no short term selling factors, the difference may be not so large between the value assessed by the financial institution and the sale price. But, when building is not old, the difference may be larger. (In these cases, there occurs another problem of dismissal.)

(Group C)

Since building repair cost is needed, the sale price usually becomes lower than that of group A

(Group D)

In Group D, there are some typical cases like below.

1. Location of the hospital is special, or, the site is not permitted to use for various objects under the local regulations, e.g., the hospital exists in the "urbanization control area" far from urban areas.
2. There are severe arguments over ownership or management of the hospital.
3. Owner's inheritor does not exist.
4. During the public auction period, the hospital building was damaged and it had become a dilapidated building or ruin.

Group D has serious problems from the viewpoint of collateral value. There are some better cases which, after becoming a dilapidated building during some period, another medical corporation bought it at low price. But there are also worse cases which they are left as a dilapidated buildings or ruins with no hope of sale (the building demolition cost exceeds land price and even vacant lot dealing could not be expected).

(Other cases)

In the near future, it is expected that application of the Civil Rehabilitation Law increases. In these cases, the value of the hospital would be assessed by paying attentions to the reproduction cost, and the cash flow that hospital would generate in the future, bearing in mind above-mentioned Group A-D sale price levels.

2. Sale price and Successful bid price of hospitals

(1) Sale price of hospital

On the accounting, in Japan, not newly built hospital buildings are usually depreciated by declining balance method. On the other hand, financial institutions usually depreciate building value by straight-line method.

In many sales, unreasonable prices were set up by setting the building price at the book-value and the land price at voluntary price. In such cases, the transfer prices become quite lower than the collateral property value assessed by the financial institutions.

In certain example, a building and medical apparatus were transferred at the book-value and land was transferred at around half price of market value. Total transfer price was around 30 % of the collateral property value assessed by the financial institution.

Conversely speaking, if most sale prices of hospitals were so low, financial institutions must set up the loan-to-value ratio at around 30%. If not, the collection loss may break out.

(2) Successful bid price of hospital

When a medical corporation went bankrupt, how much claim could be collected by public auction? Some auction examples are below.

A. [redacted] Hospital (mental hospital in the "urbanization control area")

Value indicated by the Cost approach ¥[redacted].

It was knocked down to another medical corporation.

Successful bid price ¥[redacted].

(About [redacted]% of the "Value indicated by the Cost approach")

B. [redacted] Hospital (4 stories hospital in a 13 stories condominium)

Value indicated by the Cost approach ¥[redacted].

It was knocked down to a nursing-services corporation.

Successful bid price ¥[redacted].

(About [redacted]% of the "Value indicated by the Cost approach")

C. [redacted] Hospital (mental hospital in the "urbanization control area")

Value indicated by the Cost approach ¥[redacted].

There was no bidder even at the 3rd auction.

Upset price ¥[redacted].

(About [redacted]% of the "Value indicated by the Cost approach")

Japanese public auction system has many institutional defects, I think. Successful bid prices of real estates other than hospitals in Japanese public auction are usually lower than the voluntary sale prices.

But above-mentioned successful bid prices of hospital were not so lower than the price set up in the voluntary sale. There are also many defects in the voluntary sales of hospitals in Japan, I think. One of them is that the hospital dealings are not performed in the open market.

("C" is a comparatively new mental hospital built in 12 years ago. Since the location is special, even at the 3rd auction there was no bidder, and it has become a dilapidated building.)

3. Income capitalization approach and Hospital

Income capitalization approach (DCF method) is the method which indicates principal value by analyzing the future income, expense, capital expenditure, etc., and anticipating the future cash flow which the hospital could generate.

When management state is not bad, large difference usually does not occur between the "Value indicated by the Cost approach" and the "Value indicated by the Income approach".

However, when management gets worse, anticipation of future cash flow decreases, and the "Value indicated by the Income approach" becomes lower. Then large difference might arise between the value assessed at the loan time and the value assessed at the time of bankruptcy.

This problem is quite serious nowadays for not only hospitals but also other special business use real estates. The price at the time of bankruptcy of hotels, golf courses, ski resorts, resort institutions, etc., are quite low. It could not be explained by the cost concerning factors, such as the depreciation of land price, the fall down of building construction cost, the short term selling factors, etc. It could be explained only by the fall of the "Value indicated by the Income approach".

However, in the case of hospitals, there is a decisive difference. Hotels, golf courses, ski resorts, resort institutions, etc. had become oversupply by new entries at the "Bubble period", and, in addition, the number of visitors is decreasing under the following recession. But as for the hospital, the number of sickbeds is regulated publicly and demand-and-supply balance is adjusted. Originally, the price of hospital at the time of bankruptcy should be higher if the market were open, I think.

4. Disposal price and the "Value indicated by the Cost approach"

In the screenings of loan applications, the lowness of the price of the real estates for special business use at the time of bankruptcy appears in financial institutes as insufficient collateral value.

Comparison of the disposal price and "Value indicated by the Cost approach" at the collateral property disposal time is illustrated below (disposal price / Value indicated by the Cost approach). Under the present market condition, they are about following degrees in general.

<Case of marketable real estates>

(1) Condominium....... By public auction, it is about an average of 80%.

(2) Detached house..... By public auction, it is about an average of 70 - 80%.

(3) Office building...... By public auction, it is about an average of 60 - 70%.

By voluntary sale, there are cases exceeding these figures. But, when demand-and-supply does not suit locally under depression, there are also cases under these figures.

<Case of real estates for special business use >

(4) Hotel in urban area..... It is better if the price were a half of the "Value indicated by the Cost approach". By public auction, it is quite difficult to get bidders under the

premise of hotel management. It sometimes gets bidders under the premise of building demolition.

(5) Hotel in resort area..... Onerous sale of the hotels in resort area of which management got worse are sometimes difficult. Even in the major resort areas, prices are quite low.

(6) Large-scale supermarket....There is such an example as “construction cost was ¥7,000,000,000 ten years ago, but the present disposal price is ¥300,000,000".

(7) Golf course ..... There is such an example as "development cost was ¥20,000,000,000 at the “Bubble period”, but the present disposal price is ¥1,000,000,000".

(8) Ski resort .....Onerous sale of ski resort of which management got worse is quite difficult. There is such an example as “development cost was ¥100,000,000,000 at the “Bubble period”, but the present disposal price is ¥6,000,000,000".

(9) Hospital ..... (It is above mentioned).

Why the disposal price of the real estates for special business use is so quite low? It is because the price is set up by paying attention to the profitability of the property.

Even if the “Value indicated by the Cost approach” could be a "listing price" of the transferors side, it exceeds the price at which the transferee’s management could go well under this depression. Since if the property is not sold transferor’s deficit accumulates, the seller is under severe situation that property must be sold. From the buyer’s side, the reasonable value is the "Value indicated by the Income approach". Then the price is set up by attaching great importance to the "Value indicated by the Income approach".

In financial institutions, credit line is usually set up by multiplying the "Value indicated by the Cost approach" by loan-to-value ratio. In these cases, the collection of claim from the collateral properties may be much lesser than the assessed value of collateral properties.

On the other hand, if screenings of loan applications are performed by paying attention on the price level at the time of bankruptcy, loan for the real estates for special business use would be impossible in many cases.

I think that the mortgage loans should be performed by taking into consideration synthetically following items, other than the collateral property value. That is ….the business performance, the bankruptcy probability, the collection possibility from the future cash flow, the interest rates corresponding to the risks, etc.

However, in many financial institutions in Japan, the screenings of loan application are not in such style still now.

5. "Value indicated by the Income approach" of Hospital

To evaluate the "Value indicated by the Income approach" of hospitals in Japan, there are some important issues particular to Japan. I make reference about them in below (2).

(There are “Direct capitalization method” and “DCF method” in Income capitalization approach.)

(1) Direct capitalization method

It is the method to indicate the capital value by capitalizing the net operating income (by the capitalization rate) of the specific period which generated from subject real estate.

It has been performed in Japan for decades. It is suitable for the real estate of which the net operating income is comparatively stable. (It is not suitable for hospital valuation.)

(2) DCF method

DCF method occupies the mainstream in US real estate appraisal. And also in Japan, in recent years, valuations that apply this method are increasing rapidly.

When we apply DCF method to evaluate the hospitals in Japan, we need to pay attention to the following matters.

A. Specificity of Japanese hospital

The hospital management for the profit purpose is accepted in US. Therefore, it is possible to purchase and resale the hospital for the purpose of investment. DCF method is suitable for such a scheme.

On the other hand, in Japan, there are many mandatory controls related to the hospital management.

a. Establishment of the hospital for profit purpose is not permitted (Medical Law 7-5).
b. As for medical corporations, dividend of surplus is forbidden (Medical Law 54).
c. Chief director of Medical corporations must be a doctor or a dentist in principle (Medical Law 46-3).
d. There are hospital sickbed figure regulations based on the local medical plans (Medical Law 30-3).

Therefore, in present Japan, it is hard to consider the purchase and resale of hospitals for the purpose of investment.

In Japan, buyers of the hospitals at the time of bankruptcy are limited, and the marketability of the hospitals is naturally very weak.

However, also in Japan, in case that another medical corporation purchase the hospital of which management got worse, conveyance should be performed at the price at which the transferee’s management could go well.

It is the minimum requirements that the future cash flow must be a plus figure. DCF method, which indicates the capital value based on the future cash flow, has persuasive power at this point.

B. Anticipation of the future cash flow

Anticipation of the future cash flow of a medical corporation is influenced by various factors, such as, change of the economic situation, change of the medical administration, new medicine development, management trends of other hospitals, etc.

Moreover, in the medical corporation of which management got worse, unjust claim of medical insurance payment has been done in many cases. So, due diligence on the hospital accounting is needed. The analysis of the transferor's financial statement could not be performed correctly, if not by the expert of medical accounting.

Therefore, in order to evaluate the "Value indicated by the Income approach" by DCF method appropriately, the real estate appraiser must have fine knowledge about medical management.

However, until now, there might be only a few hospitals (which went bankrupt) of which appraisal was performed by real estate appraiser at voluntary sales.

On the other hand, since medical corporation bankruptcy is not so frequent and their hospitals are dotted all over the country, real estate appraisers cannot experience many valuations of bankrupt hospitals.

C. Difference between the values indicated by Cost approach and Income approach

The "Value indicated by the Income approach" of the hospital of which management got worse, is usually much less than the "Value indicated by the Cost approach".

However, in a hospital of which management is going well, difference between two values would not be so large, or sometimes the "Value indicated by the Income approach" may exceeds the "Value indicated by the Cost approach".

In Japanese building-related public regulations, hospital construction is dealt with as an exception. Hospital construction is possible even in the "urbanization control area" where common building construction is strictly restricted.

Inside of the "urbanization control area", land price is remarkably low. In such cases, the "Value indicated by the Income approach" of the hospital of which management is going well would exceeds the "Value indicated by the Cost approach" in some cases. This is because, the land use ability of a hospital is higher than that of prevailing land use in such areas, or the "business value" of the hospital might contains "goodwill value".

In addition, if the management gets worse in the future, the "Value indicated by the Income approach" would depreciates, because anticipation of future cash flow decreases. Even if it is the same hospital, the value is always changing.

D. Capitalization rate

When we evaluate the "Value indicated by the Income approach" of a hospital, it becomes a difficult issue how much risk rate should be put into the capitalization rate. We could finally obtain it appropriately after engaged in many hospital bankrupt processes.

As a future subject, I feel deeply the necessity of bringing up real estate appraisers well skilled in the hospital valuation.

6. A proposal that smoothes the way for hospitals to get bank loans

Japanese hospital dealing market is not a free market. The issue of deregulation of hospital management, and the issue of hospital management by joint stock companies, has been discussed in Japan, in recent years. But doctors are strongly opposing to them. It will take long time (decades) until the issues would be adjusted properly.

On the other hand, in the US where hospital management is liberalized, the weak nonprofit hospitals have been purchased one after another by large medical institutions.

Reasonable price formation process is needed. As an urgent problem, in order to smooth the way for hospitals to get bank loans, hospital value must be more reasonable.

From the financial institutes' side, problems are such as below.

(1) The disposal price of the bankrupt hospital is quite low.

(2) Bankrupt hospital in the "urbanization control area" is often difficult to sold, and they often become dilapidated building, without ability to convert into money.

(3) The collateral value of hospitals is taken lower by the financial institutions, according as the past disposal examples. Etc.

Therefore, I think it is effective to take following measures in JABCD.

(1) To establish the guarantee organization special for medical corporations that guarantees when hospitals will borrow money from financial institutions.

(2) Prepare the conditions where the financial statement of the hospitals of which management got worse can be watched, and prevent the price down according to the risks.

(3) Prepare the conditions where they can convey hospitals smoothly at the time of bankruptcy among medical corporations, and prevent the price down according to the short term selling factors.

(4) To collect and analyze many hospital bankrupt examples and their disposal prices, and contribute to establish the reasonable hospital price formation process.

In addition, special knowledge is required in order to know the management state of a hospital. If the appraiser has not fine knowledge, appropriate hospital valuation is impossible. If appropriate hospital valuation is not performed, reasonable hospital price level would not be formed. If reasonable hospital price level is not formed, screenings of loan application by financial institutions would not become reasonable. If screenings of loan application of financial institutions would not become reasonable, financial institutions become reluctant to lend money to medical institutions. If financial institutions become reluctant to lend money to medical institutions, hospital price would depreciate…... These are in a vicious circle.

In order to solve these problems, in addition to the above-mentioned proposal, I think it is necessary to bring up real estate appraisers well skilled in the hospital valuation, who have fine knowledge about hospital management, and continuously engage in hospital bankrupt process, and can lead appropriate hospital price formation.

Hospital Bankruptcy cases（Examples）

I - 1

No.	Year	Name	Address	Inspected by T.Yamaguchi in 8/2002
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108	2002			
[redacted]				

Hospital Disposal Cases（In Kanto area）

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Inspected by T.Yamaguchi in 11/2002.				