John A. Simpson, MAI

How to Review a Nursing Home Appraisal

Nursing homes are intrinsically more difficult to understand than common property types. Reviewers of nursing home appraisals find that the reports can be difficult to analyze and critique because they are so specialized. This article addresses various benchmarks and sensitive areas of which a reviewer must be aware.

Many appraisal reviewers are uncomfortable with nursing home appraisals. To fully understand these assignments, a knowledge of nursing home operations; Medicare and Medicaid incomes; going-concern business value; and furniture, fixtures, and equipment (FF&E) is required. Few reviewers have this knowledge, however; unfortunately many of the reports they review are written by appraisers who also lack a full understanding of the relevant issues. The result may be a cursory review that misses the more common flaws in the appraisal.

PROBLEMS WITH NURSING HOME APPRAISALS

The problems with most nursing home appraisals do not make their review easier or clearer. Some of these problems include:

- No income and expense discussion or analysis; insufficient expense comparable support.
- Incorrect adjustments within the sales comparison approach; incorrect adjustments for financing terms.
- Land sales that do not reflect the additional increase in value caused by the value of the nursing home approvals.
- Insufficient discussion of Medicare, Medicaid, and private-pay incomes.
- Improper analysis of going-concern value or FF&E.
- No discussion of market conditions.

REALITIES OF NURSING HOME APPRAISALS

Because most field appraisers do not have an in-depth understanding of nursing

John A. Simpson, MAI, is an independent fee appraiser in New Jersey. He received a BA in business administration and a BS in management from Rutgers University and an MBA in management and real estate from Temple University. He has previously published in *The Appraisal Journal*.

home operations, the reports that cross the desks of reviewers often take the form of average, standardized appraisals. The unique characteristics of nursing home appraisals, however, are threefold.

1. There is not much expense analysis included in nursing home appraisals. Although they are in a position to do so, even many of the major national firms that specialize in health care do not provide much in-depth operating expense analysis.
2. An in-depth verification of the comparable sales is often necessary to determine the allocation between the real estate, the FF&E, and the going-concern value. The loan-to-value ratio often reflects these items, and an appraiser must verify what these allocations are to make a proper adjustment for above-market financing ratios. Many appraisers do not attempt this verification.
3. Market analysis is seldom found in a nursing home appraisal report.

SOURCES OF NURSING HOME SUPPORT

If most nursing home appraisal reports offer little or no support for their conclusions, how does a reviewer find out if an analysis is valid? There are several sources of support for the various sections of a nursing home appraisal.

- *Market analysis demand estimates*—The major data providers offer various reports with data that form the basis of a demand study. These include population projections for individuals by age cohort[1] and household income by age cohort. These data are used to calculate the per-unit demand for nursing homes in a region. The data can be prepared based on a specified geographic radius, such as 10 miles from the subject, or on a county-wide basis.
- *Market analysis supply estimates*—Data can be acquired from *The Directory of Nursing Homes*, an annual book published by HCIA of Baltimore, Maryland. This book, found in many libraries, lists all of the registered nursing homes in every state. Data such as the address and telephone number of each facility; the number of beds; the type and number of staff; the room usage; the activities for residents; the type of care (e.g., intensive, skilled); the admission requirements; the payer mix; and other items are provided.

  For more details on each nursing home, the U.S. Department of Health and Human Services publishes an annual directory for each state titled, *Medicare/Medicaid Nursing Home Information*. This can also be found at any local library. Other federal sources include the Administration on Aging and the Health Care Financing Administration.
- *Income and expense estimates*—To provide a reviewer with a basis for determining the reasonableness of income and expense estimates, an appraiser should include a per-patient-day analysis. Medicare and Medicaid rates are highly regulated and must be approved by the appropriate state government agency; there is little that can be done about these rates. Private-pay rates are free to fluctuate with the market, however, and a rate survey should be included in a report.

  The operating expense ratio can be a crucial measure for determining the reasonableness of an appraiser's income estimates. According to Arthur Gimmy and Michael Boehm, typical nursing home operating expense ratios range from 70% to 85%.[2] Other key sources are fellow appraisers who may obtain operating data as part of their nursing home assignments.

WHAT REVIEWERS SHOULD LOOK FOR

The major item with which a reviewer should be concerned is the validity of the

1. A cohort is a grouping (e.g., those individuals aged 65–69, 70–74).
2. Arthur Gimmy and Michael Boehm, *Elderly Housing: A Guide to Appraisal, Market Analysis, Development and Financing* (Chicago: American Inst. of Real Estate Appraisers, 1988), 78.

Although nursing homes have a wide range of expenses, making it extremely difficult to compare the subject with other nursing homes line by line, at the very least the appraiser should discuss total operating expense ratios of the subject and other nursing homes.

approach that receives primary weight in the reconciliation. If this approach is weak, there is a good possibility that the value conclusion will also suffer. If primary weight is placed on the sales comparison approach, verification becomes important. If an appraiser states that he or she has verified the sales and no delineation is provided between the real estate, the FF&E, and the business goodwill, the appraiser's verification process is poor. This is especially important when the financing loan-to-value ratio is very high; without this delineation, an improper adjustment for financing is often the result. Further, if possible an appraiser should provide capitalization rates that will support the income capitalization approach; this is a sign that the appraiser has probably performed a proper verification of the sales.

If an appraiser puts primary weight on the income capitalization approach, some type of expense analysis should be presented. Although nursing homes have a wide range of expenses, making it extremely difficult to compare the subject with other nursing homes line by line, at the very least the appraiser should discuss total operating expense ratios of the subject and other nursing homes. This will provide some measure of assurance that the subject is operating according to expected norms, management is competent, and the appraiser has considered this within his or her analysis.

A reviewer should also look at other internal ratios that help to determine whether a facility is competitive.[3] These include the following items.

- *Percentage of continuous occupancy* (i.e., occupancy and vacancy rates)—This is usually derived from a conversation with the manager and is rarely broken out within the operating statements. This is an excellent measure of how much demand exists for this particular facility or location.
- *Waiting list*—Does the project have a waiting list? Many projects have waiting lists and the average wait times can be important in comparing the subject to its competition.
- *Number of rooms per nursing station and distance of the furthest room from the nursing station*—A rule of thumb is that there should be one nursing station for every 50 beds and no more than 55 feet between the nursing station and the furthest room.[4]
- *Number of hours of nursing home care per 24-hour period per patient*—For example, an average of 2.5 hours of nursing-home care per 24-hour period for each patient is required in New Jersey. Nursing homes with a larger percentage of private-pay residents often devote three or four hours per patient to nursing care, while the lower ratios are usually found at facilities heavily dependent on Medicare and Medicaid patients. The higher this ratio, the more likely that the subject is able to attract private-pay residents. This results in more profit since private-pay residents have a higher profit per patient than government-subsidized patients.
- *Ratio of private-pay to government-pay rooms*—This will determine to what degree services are to be offered, how often the facility will have to undergo building and equipment upgrades, and how much profit per resident can be achieved. It is not uncommon for a private-pay profit margin to be two or three times that of a government-subsidized profit margin.
- *Project is Medicare and Medicaid approved*—If it is Medicaid approved (Medicaid is designed for the poor), the project will likely have the reputation and image of a lower market tier facility. It will not be able to compete against the better designed projects in an area. It will also be much harder to acquire private-pay residents who, as noted previously, create a higher profit margin.

Medicare patients are 65 years of

3. This is in addition to the appraiser's site and improvement descriptions as well as any discussion within the report regarding the subject and its competition.
4. Edith Friedman, ed. *Encyclopedia of Real Estate Appraising*, 3d ed. (Englewood Cliffs, New Jersey: Prentice Hall, 1978), 1017.

age or older and require rehabilitation. These patients have a shorter tenure and have a higher turnover than private-pay patients; a larger vacancy factor for turnover is appropriate for these Medicare units.

CONCLUSION

Most nursing home appraisals are deficient in many respects. Unfortunately, most reviewers are not highly trained in reviewing nursing home appraisals, and often the appraiser who wrote the report is unable to educate the reviewer. More than a cursory review is necessary. It is imperative that the appraiser do an in-depth verification for both the sales comparison and income capitalization approaches. Because many, if not most, appraisers put primary weight on the income capitalization approach, some type of expense comparison is in order; at the very least, a total operating expense ratio analysis should be included. Because most appraisers do not provide an in-depth analysis of these factors, however, it is up to a reviewer to ask that the appraiser perform this as part of the assignment. This will ensure that both an acceptably analyzed report and a suitable review will result.

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