

COOK COUNTY ASSESSOR'S OFFICE

# EXEMPT HOSPITALS

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VALUATION ESTIMATES AND  
APPRAISAL METHODOLOGY

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### PURPOSE OF THE REPORT

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In 2006, the Cook County Board of Commissioners requested that the Cook County Assessor's Office provide them with a report estimating the taxable property value for all Cook County hospitals that are currently exempt from taxation. The Assessor's Office agreed to provide a report after the completion of the 2006 City of Chicago reassessment. This report details the estimated value as well as the methodology employed to arrive at the estimate.

Currently, there are hospitals in Cook County that are listed as taxable entities as well as exempt and partially exempt entities. This report does not address whether those properties' exemptions should or should not be maintained. The exempt status of one not-for-profit hospital is the subject of current litigation, the outcome of which is uncertain at this time. The impact of that litigation on other not-for-profit hospitals is also currently unknown, including a range of effects on the exempt status of other not-for-profit hospitals from continued complete exemption to partial exemption to full taxation. This report is not intended to predict the outcome of the litigation and is beyond the scope of the Assessor's Office review and analysis.

The Board should also recognize that hospitals are highly unique properties and must undergo thorough individual analysis with direct involvement and information from the property owners before any number, which was estimated for an individual hospital and which was utilized to develop an aggregate value, should be discussed or distributed. As is typical of highly unique properties, estimated values for such properties require significant input of usually nonpublic information that is derived from the property owner. Often the information is disclosed through a series of appeals both at the Assessor's Office and higher levels of review such as the Cook County Board of Review, the Illinois Property Tax Appeals Board and through Illinois Circuit Courts.

Also, pursuant to the Board's request this report is limited to Illinois licensed general hospitals and does not address the valuation or tax exemption status of other medical facilities or other properties owned by charitable institutions. Whether the current litigation will impact these other properties relying on the State's charitable exemption is also unknown. The exclusion from this report of these other property types is not intended to indicate that the properties would or would not be treated any differently as a result of current litigation. The list of Illinois licensed general hospitals was obtained from the Illinois Department of Public Health as listed on its website as of January 2007. A list of 54 identified Cook County licensed general hospitals is Attachment 1 of this report.

In accordance with the Board of Commissioners' request, the Assessor's Office has estimated a range of aggregate property value of approximately \$4,300,000,000 to \$4,500,000,000 as of January 2006, under the assumption that real estate of the hospitals is entirely taxable and that no portion is exempt from property taxes. This

represents approximately 0.72% to 0.75% of the property value for all of Cook County, respectively. The range was created using commonly accepted appraisal practices and is the type of value traditionally placed by the Assessor's Office on taxable property.

There are three commonly accepted methods for estimating property value: the Cost Approach, the Sales Comparison Approach, and the Income Capitalization (or Income) Approach. These three approaches to value are industry recognized methods employed by both the appraisal and the assessment industries to determine the market value of nonresidential properties. To estimate the taxable property value for the 54 Cook County hospitals, which are currently exempt or partially exempt from taxation, the Assessor's Office reviewed each of the three approaches for their suitability. In estimating values for assessment purposes of for-profit hospitals as well as other commercial properties, the Assessor's Office uses the same three approaches, though the weight of the individual approaches may differ due to available data.

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### THE COST APPROACH TO VALUE

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*The Appraisal of Real Estate* (12th ed.) by the Appraisal Institute defines the cost approach as the process of deriving the value of a property "by adding the estimated value of the land to the current cost of constructing a reproduction or replacement for the improvements and then subtracting the amount of depreciation (i.e., deterioration and obsolescence) in the structures from all causes." The cost approach is typically utilized to estimate the value of unique or special-purpose properties, like hospitals. Construction cost information is widely available and somewhat standardized, making access to market data easily verifiable in valuing a property's physical attributes. In addition, a property's physical attributes are objective and easily verifiable.

As a first step in estimating values under the cost approach, the Assessor's Office physically inspected each hospital facility and related properties and gathered all relevant data, such as building square footage, building square footage per floor, number of stories, uses of property, exterior construction, construction class and condition. In addition, digital photographs of each property were taken. Typically, the Assessor's Office does not collect this type of information on exempt properties since the information is unnecessary for our assessment process. As a result, the effort in gathering data on each exempt hospital property was extremely time and labor intensive. The process in gathering the data was even more complex and labor intensive than typical commercial structures because hospital sites are large and complex structures and access to information was often difficult. Approximately 9,000 man-hours, or an average of 120 hours per site, were devoted to the data collection portion of this project. Attachment 2 has a copy of each hospital's property record card and the digital photograph taken of the facility.<sup>1</sup>

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<sup>1</sup> Attachment 2 includes property record cards (PRCs) that were not part of the valuation estimate.

Using the data gathered from the physical inspections of the property, the Assessor's staff estimated the cost approach by employing the following steps:

1. Estimated the land value as though vacant,<sup>2</sup>
2. Estimated the current construction costs of existing improvements,
3. Estimated the accrued depreciation from all causes,
4. Deducted the estimated accrued depreciation from the total costs of the improvements to derive the depreciated costs of the improvements,
5. Added the land value to the depreciated costs of the improvements to derive the indicated value of property.

Current construction costs for the hospital improvements were obtained using the Marshall & Swift Commercial Estimator software, which calculates the replacement cost new for commercial buildings, including specific estimates for hospitals. The Marshall & Swift cost system estimates a building's physical and functional depreciation based on the subject's age and condition. Marshall & Swift/Boeckh, LLC is a nationally recognized and leading provider of building cost data in the United States, and its software is widely used by appraisers and assessors to produce reliable, market-derived construction costs.

Although the cost approach brings strong verifiable market evidence to the valuation of a property's physical attributes, it still has elements of subjectivity included in effective age estimates, property condition and depreciation estimates. As a result, it is often a preferred approach for special use properties, although the income approach is often utilized to reconcile estimated property values. Reconciliation and how it was used to derive the estimated range of values is discussed further below.

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#### THE SALES COMPARISON APPROACH TO VALUE

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According to the Appraisal Institute's *The Dictionary of Real Estate Appraisal* (4th ed.), the sales comparison approach is defined as "a set of procedures in which a value indication is derived by comparing the property being appraised to similar properties that have been sold recently, applying appropriate units of comparison, and

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<sup>2</sup> **Valuing Vacant Land:** The sales comparison approach is reliable and given significant consideration in determining the market value of vacant land within Cook County. Vacant land transactions are analyzed within each township and are a source of information used to accurately estimate market value. Adjustments are made to the vacant land sales comparables for variables as discussed in the following pages under the "Sales Comparison Approach". Location is the most significant factor in determining market value. Zoning is also an important factor affecting market value and dictates whether the land is classified as residential, commercial, industrial or agricultural. Other factors affecting market value include parcel size, shape, topography and frontage.

making adjustments to the sales prices of the comparables based on the elements of comparison.” According to *Income Property Valuation* (published by Dearborn Real Estate Education), the sales comparison “approach is best used when an adequate number of sales of similar properties exist and data can be retrieved from accurate sources.” During a typical sales analysis, individual sales are reviewed by appraisers and assessors for appropriateness and some are adjusted appropriately while others are disregarded as inappropriate for the approach. In particular, appraisers and assessors consider both the use of the property before and after the sale and discard sales that are determined to be a change that makes comparison inappropriate. For example, according to *The Appraisal of Real Estate* (12 Ed.):

An apartment complex purchased for conversion to condominiums may reflect a sale price above the market level for apartment properties. This property would not be an appropriate comparable for the “as is” valuation of an apartment complex for which no change in use is intended or one for which the highest and best use remains an apartment use.

To complete its sales comparison analysis, the Assessor’s Office carefully reviewed and evaluated 26 recorded sales transactions classified as hospital sales by CoStar Group, Inc., a nationally recognized and leading provider of sales information. In addition, the Assessor’s Office reviewed data available from the Cook County Recorder of Deeds.

The Assessor’s Office determined that only 17 of the 26 recorded sales of the transactions classified by CoStar as hospital sales actually involved the sale of comparable hospital facilities, including the sale of psychiatric hospital facilities. As a result, nine sales were immediately discarded and only 17 sales were subject to further analysis. To further analyze the sales data, the Assessor’s Office considered use of the property before and after the sale, market conditions and the amount of detailed and accurate available information through public resources and private information services.

Of the 17 sales considered, five properties were sold for conversion or redevelopment purposes. Of the 54 hospitals that are the subject of this report, the Assessor’s Office determined that the highest and best use of all the hospitals was to remain as hospitals. Hospitals converted to alternate uses have a significant impact on the price an investor is willing to pay. Therefore, if an investor buys the hospital property for something other than hospital use, the sale is less useful and less comparable in the valuation of hospitals that continue to operate as hospitals. Thus, in accordance with *The Appraisal of Real Estate* and common assessment practices, the five sales of properties converted to a non-hospital use were eliminated from further consideration and analysis.

Of the remaining sales, only four of the properties were sold in the five years prior to the valuation date of January 2007. Although sales older than five years are often considered stale and inapplicable for further analysis, the Assessor’s Office further analyzed the remaining sales because of the limited number of recent sales available. To attempt to make these older sales into a value useful for comparison purposes, the Assessor’s Office attempted to adjust the sales to reflect changes in market conditions

between the date of the sale and the effective date of the estimation, a process known as time trending. Typically, in a technique known as paired sales analysis, which is recognized by the International Association of Assessing Officers as a valid assessment method for time trending and is a standard method utilized by assessors for commercial properties, the Assessor's Office will compare sales and resales of the same property. However, of the remaining sales, only a single pair of paired sales was discovered. Consequently, for the purpose of mass appraisal, time trending in this case is not a useful analysis technique because there is only one paired sale.<sup>3</sup>

In its analysis, the Assessor's Office further considered the amount of information available regarding all of the 17 hospital sales, such as sale price, terms of the sale including limiting conditions, the amount of non-realty involved in the transaction, etc. The information available for all sales from the Cook County Recorder of Deeds was very limited and deemed unusable. CoStar and other private sales information sources also could not provide necessary detailed information on most of the transactions. After carefully reviewing and analyzing all available information, only one transaction was deemed suitable for complete analysis.

After completing its analysis and determining only one sale was truly suitable for analysis, the Assessor's Office determined that the sales comparison approach for purposes of this report was an unreliable indicator of hospital market value. First, hospital properties are not frequently sold. Typically, the sales comparison approach relies heavily on a large number of recent sales to support a strong predictive value. Appraisal experts widely believe that the sales comparison approach is the strongest approach only when a high number of representative sales have accurate and readily available data for the development of sales adjustments; this is not the case for such a specialized property use as hospitals with significant variance in ownership interests. In addition, the range of value on a gross building area basis for all analyzed 17 sales was extremely large, ranging from \$6.43 per square foot to \$467.44 per square foot. Without further nonpublic information and given the limited number of sales, it is difficult if not impossible to reconcile the values without introducing a high degree of subjectivity into the valuation process.

Second, sales of hospital properties involve personal property value, which cannot be taxed under Illinois law. Theoretically, the value of this personal property should be disclosed and detailed in the real estate transfer declaration. However, an examination of documents filed with the Cook County Recorder of Deeds Office shows that most sales do not provide a description of these items nor a corresponding value. In addition, these sales transactions typically include a significant amount of intangible business value.<sup>4</sup>

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<sup>3</sup> The Paired Sales Analysis technique with limited samples may work for an individual analysis, but not on a mass appraisal report herein.

<sup>4</sup> Illinois statute also prohibits ad valorem personal property taxes levied on any personal property having tax situs in this State. § 35 ILCS 200/24-5. No one may reclassify personal property as real property under any circumstances. See *People ex rel. Bosworth v. Lowen*, 115 Ill. App. 3d 855, 71 Ill. Dec. 554, 451 N.E.2d 269 (3 Dist. 1983). Pursuant to the Illinois constitution, statute and case law, a property's sale must be separated into realty and non-realty, such as personal property, good will, non-complete agreements, or other things. Historically, representations set forth on real estate transfer declarations (green sheets) have been used to make this determination. The courts have found that this is not a preferred practice, but acknowledge that it is not specifically prohibited by the statutes.

The sale of hospitals is not merely the sale of brick and mortar. Hospital sales generally involve the sale of the real estate and the business of the health care entity. Sale prices reflect both the value of the real estate and the value of the business. Separating these two components is topic of much controversy in the real estate appraisal industry. Much of the difficulty in separating real estate value from business value stems from the fact that purchase price allocation is rarely disclosed in real estate transfers declaration by sellers. Further complicating matters, buyers and sellers are not readily available to verify the allocations of purchase prices among real and personal property. In the article *Estimation of Hospital Real Property Values for Ad Valorem Tax Purposes* published by the American Appraisal Associates, Michael P. Bates, MAI, discounts the use of the Sales Comparison Approach. He states “Although the Sales Comparison Approach is strong method of valuing going-concern hospital enterprises, it is not usually a reliable and supportable method of valuing the separate real property assets.” Both personalty and the intangible business value component within personalty must be defined and removed from the estimate of reality value in order to estimate a value in compliance with Illinois law. The personalty estimate is very difficult without intimate knowledge of the sales transaction and/or additional nonpublic documentation. In contrast, quantification of personalty is more standardized and documented within the income approach.

Third, sales of hospitals frequently involve conversions to alternate non hospital uses, including redevelopment projects, as was evident in the Assessor’s Office analysis of the 17 sales. Attachment 3 is a list of sales that were analyzed for this report with comments added on the investigation conducted on the conditions of the transaction.

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#### THE INCOME CAPITALIZATION APPROACH TO VALUE

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*The Dictionary of Real Estate Appraisal* (4th ed.) defines the income capitalization approach as “a set of procedures through which an appraiser derives a value indication for an income-producing property by converting its anticipated benefits (cash flows and reversion) into property value.” It further states that in the income capitalization approach “one year’s income expectancy can be capitalized at a market-derived capitalization rate or at a capitalization rate that reflects a specified income pattern, return on investment, and change in value of the investment.” In *Income Property Valuation*, by Jeff Fisher and Robert Martin, “[s]pecial-use properties, including health care facilities, recreational facilities and recreational vehicle parks, have unique patterns of income and expense. Frequently, valuation of these properties includes nonrealty interests, as in the case of hotel properties. Care should be taken to support each input of the income and expense forecast as well as the discount rate.”

In *The Analysis and Valuation of Health Care Enterprises*, author Arthur E. Gimmy, MAI, states “[f]rom the viewpoint of an appraiser a hospital is an extremely complex, highly regulated, special purpose property that lacks the normal requisites from marketability and complicates the application of traditional appraisal techniques.” Gimmy states that “[t]heoretically the physical assets of a hospital can be appraised on a capitalized lease basis where there is an existing lease or sufficient evidence is available to estimate the rental value of the facility. Hospitals, however, are rarely leased on an

open-market basis. When they are leased, many complications relative to third-party relationship can materially affect income-producing capabilities over a projected time interval.” Therefore, Gimmy places emphasis on the cost and income approaches in valuing hospitals and that the “income approach should be given the most emphasis to reflect market factors.” Gimmy advises that “the income approach, as applied to the hospital’s NOI or cash flow (net income plus depreciation, amortization, and debt service), results in a valuation of the hospital as a going concern.”

In determining the business value of a hospital, Gimmy provides that “Intangibles may be appraised by . . . techniques such as . . . a percentage from net income to allow for entrepreneurial return.” This involves deriving “a percentage reduction from net income (prior to its capitalization into a value of the physical assets) that represents a fair allowance for the entrepreneurial component of the property.” Furthermore, Gimmy states that “[i]n addition to investment income, profit margins may include philanthropic contributions, endowment revenue, government grants, and other revenue and expense not related to patient care operations.”

Historically, the Assessor’s Office has used the cost and income approaches to assess the market value of for-profit hospitals in Cook County. The valuation of for-profit hospitals using the income approach is based on historic revenue and expense data supplied by the hospitals. The method used to value the for-profit hospital is similar to the method used to value for nursing homes and hotels, which analyzes revenue and expense data of the business rather than rental income generated by a specific property. This methodology has historically produced accurate assessments for the for-profit hospitals, and therefore the Assessor’s Office used this same methodology in valuing the exempt hospitals.

A search of current Illinois court decisions did not yield precedent case law specifically concerning the issue of valuing not-for-profit hospitals. However, other jurisdictions have considered the issue and have found that the income approach to valuation as described in this paper is a valid method for appraising hospitals, see for example Myrtle Beach Hospital, Inc., v. Horry County Assessor, 1998 S.C. Tax LEXIS 52.

Requests by the Assessor’s Office for income information from the exempt hospitals produced very limited results; therefore, rather than relying on hospital supplied income data, the Assessor’s Office used information obtained from various publicly available sources. These sources included the Annual Non-Profit Hospital Community Benefits Plan Reports submitted to the Illinois Attorney General for the fiscal year 2005 and the Medicare Cost Reports from Illinois Department of Public Health for 2000 through 2004, as well as published information from Chicago Department of Public Health – Chicago Health and Health Systems Project (published December 1, 2005), the American Hospital Directory website, U.S. News & World Reports’ *Best Hospitals 2006*, and Crain’s Chicago Business’ *Chicago Largest Hospitals 2005* (published in 2006).

For the income approach, the data collected was used to derive a value estimate employing the following steps:

1. Determined Gross Patient Revenue (the total revenue from patient billing) based on historical revenue,
2. Deducted Contractual Allowances (primarily discounts to Medicare and Medicaid) and Uncompensated Care (all patient bills unpaid by insurance or patients) to yield Net Patient Revenue,
3. Added Other Revenue (i.e., capitation revenue, contributions, grant revenue, net assets released from restrictions, and Medicaid assessment revenue) to Net Patient Revenue to yield Total Operating Revenue,
4. Subtracted Total Operating Expenses (i.e., salaries and wages, employee benefits, physician compensation, Medicaid hospital assessment expense, food, utilities, repairs and maintenance, insurance, and supplies) from Total Operating Revenue to yield Net Operating Revenue,
5. Capitalized Net Operating Revenue using a market-derived capitalization rate (sources: RealtyRates.com's Investor Survey, which reports historical data on capitalization rate trends by property type and the capitalization rate for Health Care & Senior Housing, which includes all health care and senior housing properties, such as acute care facilities and which would be used in the income capitalization approach) to derive the Unadjusted Market Value,
6. Deducted the Return on and Return of Furniture, Fixtures, and Equipment and Business Enterprise Value from the Unadjusted Market Value (BEV, net income attributed to return on business value components), to yield the Market Value by Income Approach.

A critical factor in applying the income capitalization approach using this methodology is the determination of Business Enterprise Value. *The Dictionary of Real Estate Appraisal* (4th Edition) defines Business Value as “a value enhancement that results from items of intangible personal property such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements.” The Assessor's Office has adopted a standard appraisal theory in trying to determine the most accurate values to apply. In the context of valuing exempt hospitals, this particular step in the overall income valuation concept proved to be the most difficult. In general, the most important component of business value for hospitals is the hospital's license. Since all licenses are controlled by the State of Illinois, there are a limited number of approved facilities and each hospital has a set number of licenses, much of each hospital's intangible value is tied to the license itself. Other components that consist of links to business value can be

interpreted as the reputation of the hospital, trade name, patents, trademarks, contracts, and operating agreements. The valuation of these components is extremely difficult and often very specific to an individual hospital.

Since income information was not supplied directly from the property owners and was not verified, individual hospital estimations used to develop an aggregate value are simply that and should not be considered at this time as actual. Only if individual hospitals underwent a true appellant process may an individual hospital's estimate of value be considered as accurate.

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#### RECONCILIATION

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The valuation process of exempt hospitals is a very complex one, due to the unique characteristics of each hospital: age, condition, location, architecture, and hospital specialties vary widely in Cook County. The appropriateness of the approaches to value, the accuracy of the data and computations, and the quantity or adequacy of data presented in relation to the individual appraisal problems are considered to attain a final value estimate. Because the sales comparison approach, as discussed above, is not a strong indicator of value, and using just one approach to value could have the potential of skewing the results in the favor of certain types of properties, both the cost and income approaches provided good estimates of value. However, both the cost and income approaches also require significant subjective input. The cost approach requires subjective analysis in determining among other things effective ages, construction quality, and depreciation assumptions. The income approach requires subjectivity in the valuation and separation of business value from real estate value. Using both approaches aids in reducing that subjectivity and arriving at a more uniform and consistent value. The Assessor's staff analyzed the estimated values produced by both approaches and compared them based on a review of various units of measure (i.e., value per square foot of gross building area (GBA), value per square foot of hospital area, value per licensed bed<sup>5</sup>, or value per staffed bed<sup>6</sup>) to ensure that value estimates were consistent and uniform. The reconciled value analysis will rely upon a value per staffed bed, which reflects a hospital's operating capacity.

Finally, the Board should recognize that the analysis of cost and income information for not-for-profit hospitals was also very time and labor intensive for the

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<sup>5</sup> According to the Chicago Department of Public Health – Chicago Health Systems Project, licensed beds are the number of beds that a hospital is licensed to operate by the Illinois Department of Public Health. Licensed beds are the maximum capacity of the hospital.

<sup>6</sup> Staffed beds are the number of licensed beds that a hospital is currently operating. Staffed beds are also classified as the operating capacity of the hospital, per the Chicago Department of Public Health – Chicago Health System Project.

Assessor's Office's commercial analysts. Valuation reconciliation totaled approximately 800 additional hours of senior staff member's time averaging 15 hours per hospital.

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**AGGREGATE VALUE OF NOT-FOR-PROFIT HOSPITALS**

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The rounded aggregate value for hospitals using the income approach to value was \$4,400,000,000, or an estimated value of \$294,570 per staffed bed. Based on the cost approach alone, the estimated value was approximately \$100 million higher at \$4,500,000,000 or an estimated value of \$301,265 per staffed bed. Estimates for individual hospitals on a staffed bed basis had a substantial range of \$44,686 to \$983,577 per staffed bed. In creating the proposed range of value presented at the beginning of this report, the estimated value using the cost approach was rounded and presented as the high value while the estimate value using the income approach was rounded and presented as the low end of the proposed range.

To estimate the tax impact as requested by the Board, a number of factors were taken into consideration and assumptions were made to calculate the effect of assessing and placing all not-for-profit hospital properties on the tax roll.<sup>7</sup> These factors include the classification of the hospital properties, projected local tax rate and the actual State's multiplier. After applying these factors, the estimated taxes generated from utilizing the income approach were \$238,000,000, while the cost approach generated \$241,000,000 in estimated tax revenue. Although every effort has been made to accurately estimate the projected tax impact, the projected tax impact may not fully take into account the available levels of appeals that may reduce the estimates herein.

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<sup>7</sup> For the purposes of the tax estimate, the hospital properties were assessed as Class 4, with projected tax rates estimated under the assumption that HB664 (as Amended) is in place in 2006, and utilizing the actual multiplier of 2.7076.