

ANNUAL INVESTMENT OUTLOOK ISSUE

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Healthcare's Pulse Is Strong & Steady

DESPITE UNCERTAINTY WITH THE AFFORDABLE CARE ACT, HEALTHCARE-RELATED INVESTMENT IS ALIVE AND WELL

BY NATALIE DOLCE

In late September, DLA Piper released its "State of the Market Survey" at the firm's 14th Global Real Estate Summit in Chicago. The majority of the 222 respondents—a diverse group of CEOs, COOs, CFOs and others—felt healthcare properties were among some of the most attractive for investors, amid uncertainty over the status of the Affordable Care Act.

"We've got an aging population," John Sullivan, US chair of the firm's real estate practice, told *REAL ESTATE FORUM*'s sister publication, GlobeSt.com, at the time. And coupled with new developments in technology and treatments, "demand for the delivery of healthcare services will be sustained."

Marcus & Millichap's Alan Pontius, SVP and national director of specialty divisions, explains that ongoing uncertainty about changes to healthcare law will likely persist for an extended period, but positive demographic factors continue to support the investment climate for the growing medical office segment. "With the 75-plus age group expected to increase by nearly 14% over the next five years, this aging population will require more medical services," he says. "This is a principal driver behind medical office investment

activity, and regardless of what changes occur to the ACA, this factor remains."

Jay Epstien, co-chair of DLA Piper's global real estate practice, says that "regulatory changes in the past few years, especially Obamacare, have fueled the need for more medical office buildings." Healthcare providers increasingly felt pressure to provide more services and cut costs. Typically, this means developing outpatient facilities, which can provide services more efficiently and across a wider geographic area. "These properties, which usually have high occupancy and great tenants, have become especially popular with investors."

As an example, Epstien points to Ventas Inc., which has opened the eyes of many investors to the possibilities in the sector. The Chicago-based healthcare REIT has put together many quarters of impressive growth, including several high-profile acquisitions, and most analysts say it still has a lot of potential.

The numbers seem to back Ventas' strategy. Investment in the US medical office sector has increased substantially over the past seven years, with total investment volume in MOBs of at least 10,000 square feet rising from just under \$4 bil-

lion in 2010 to \$10.2 billion in 2016, according to numbers from CBRE. Moreover, total investment in 2016 exceeded the prior annual peak of \$7.3 billion in 2006, the firm says.

A growing number of groups are beginning to aggregate portfolios of medical office buildings in secondary and tertiary markets throughout the country. "Larger groups especially are taking advantage of capital resources to purchase assets in non-primary markets in the \$10-million to \$30-million range with initial yields 75 to 150 basis points higher than core markets," relates Marcus & Millichap's Pontius. "These investors are creating arbitrage when packaging individual properties into portfolios, and then selling to investors who may not have the resources or relationships required to build portfolios of medical office properties on their own."

The Affordable Care Act—and the movement away from a fee-for-service model toward outcome-based payment methods that shift risk to providers—have been driving and accelerating mergers and acquisitions between health systems, insurers and healthcare providers, explains Christopher Stai, managing director at Brown Gibbons Lang & Co.



The people developing these sites are looking to see if there is demand for the services. Most believe that the healthcare system is not going to change radically.



Andrew Fogg

Cox, Castle & Nicholson

The current political narrative around healthcare, and the many efforts to repeal the ACA, could diminish that new demand, however. Andrew Fogg, a partner at Cox, Castle & Nicholson, says that landlords and developers aren't concerned for now, but that could change if healthcare repeal efforts succeed.

Fogg relates that none of his clients have seemed hesitant to sign on urgent care tenants due to the possibility of ACA being repealed. "The people developing these sites are looking to see if there is demand for the services. Most people believe that the healthcare system is not going to change radically, particularly in California, but it's an open question."

It's difficult to envision what will happen to the ACA at this point in time. The current system is not working, notes Stuart M. Saft, a partner with Holland & Knight, and the prospect of a single-payer system being enacted is unlikely for at least several decades. "There are nowhere nearly enough healthcare providers—and particularly doctors—to meet the needs of 340 million Americans, which is quickly increasing to 400 million by 2030.

"The likelihood is that the gap in the system will be filled by standalone facilities, which cater to the needs of local communities at reasonable costs, and large medical centers will focus on major diseases and critical injuries," Saft goes on. This, he opines, would likely entail a reimagining of healthcare by requiring employers to provide health insurance, and having the federal government provide major medical insurance for those who cannot afford it. These moves "will spur the use of retail facilities for non-life-threatening situations."

Yet nothing is occurring in the real estate world specifically in response to the ACA situation, since none of the bills considered by Congress over the past

eight months have had any detail as to potential solutions to the perceived problem. "As soon as a decision is made," Saft says, "the money sitting on the sidelines will find ways to invest in the new system."

Not that capital isn't flowing into the sector now—the demand is clearly there. "The steep increase in the 65-plus population and anticipated greater need for in-office physician services by this group signals a continued increase in demand for healthcare services and medical office space in the years ahead," explains Andrea Cross, Americas head of office



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Stuart M. Saft

Holland & Knight

research for CBRE, in a recent report.

Healthcare providers are facing increasing pressure to reduce costs in the face of uncertain reimbursement rates from both Medicare, Medicaid and private insurance companies and improve patient outcomes, according to the study. One method being used is the adoption of new technologies, but the upfront capital required means that costs must either increase or be trimmed elsewhere, according to the report. Among the cost-cutting measures healthcare providers are taking are relocating services closer to where patients live,

utilizing video technology to meet with patients remotely and moving more patient volume away from hospitals—the highest-cost facilities—and into lower-cost outpatient centers.

"The evolution of medical technologies is boosting demand for newer product with the infrastructure capable of handling cutting-edge devices and systems," says Jim Hayden, executive managing director of healthcare and global workplace solutions at CBRE. "Medical office space that helps providers minimize costs and maximize outcomes, including buildings that support collaboration and can accommodate new technologies, will likely remain in favor."

Likewise, Stai observes that in order to remain competitive and extend market share, development has increased in health system-sponsored multi-specialty outpatient facilities and micro-hospitals that offer a wide array of services under one roof.

As investor appetite for healthcare real estate has grown, medical office buildings have emerged as the most popular property type within the sector. "As yields for traditional real estate asset classes have

compressed in recent years, new capital sources—including foreign capital—have entered the medical office sector in search of stability to hedge against any potential correction in the global markets," points out Chris Bodnar, EVP of healthcare for CBRE Capital Markets.

Medical office cap rates have consistently decreased from a high of 8.3% in mid-2010 to 6.8% as of Q1 2017. On a regional basis, average cap rates have been lowest in the West over the past seven years, below the US average by about 60 bps. However, the spread between the highest and the lowest regional cap rates

remained relatively tight during this period, as industrywide trends have a similar impact across the various markets, according to CBRE research.

"Comparatively moderate regional differences are an attractive feature of medical office," says Lee Asher, EVP of healthcare at CBRE Capital Markets. "Because there is demand for healthcare everywhere, investors are generally more willing to look outside the primary markets compared with traditional office investment, and this is apparent in pricing metrics."

Related to these trends, both institutional and private capital is increasingly entering the sector in a more direct manner. "Investors are deviating from healthcare-focused REITs and instead aligning themselves with local or regional operators with proven track records and high quality standards," says Phil Krispin, a director of Eastern Union's Healthcare Group. "The mindset seems to be that the local/regional operators aren't disconnected and have a better feel for their facilities and territory, as well as the ability to be more nimble and quick to respond to changes in their market."

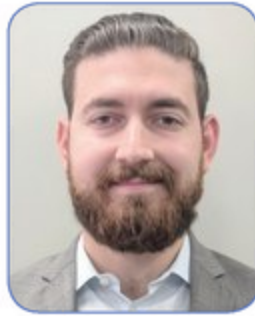


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Christopher Stai
Brown Gibbons Lang & Co.

Eastern Union Funding vice president Nachum Soroka adds that "investors who have previously not dealt with healthcare are now recognizing that with the right operator, they can achieve returns far greater than typical real estate investments have provided in the past."

But over the past year or so, he notes, a number of larger institutional healthcare real estate funds have gone completely by the wayside, "either because their interests were not aligned with those of their tenants—Manorcare and QCP are two examples—or because they were leasing to larger operators who



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were unable to navigate a changing business environment." These situations, Soroka says, are creating great opportunities for a smaller, regional player to step in and pick up properties across one or two states and turn them around. "This has become the norm and lenders are very much aware of the strength a local player brings to a property."

Retail is also seeing a boost from the growth in healthcare. Brown Gibbons Lang's Stai points out that former high-visibility retail space is being repurposed into clinical facilities, and health systems are

drive occupancy at some retail centers that have seen significant vacancies due to store closures in recent years.

The need to have 24/7 access to basic medical and dental care is another influencing factor. "We will see more unused showing centers filled up with medical and healthcare facilities, as well as offices and retail," relates Saft. "When the retail market was more robust, the owners of the malls and strip centers only wanted to focus on retail. That's changing as more people shop online, but they still need to leave their homes for other needs."

These trends will continue and will create opportunistic plays for both sides. A lot of issues have come into play as things have realigned, says Fogg. "This is a tremendous opportunity both for filling vacant retail space and drawing people to the property," he relates. "If you have an urgent care facility on one side of the center and a pharmacy on the other, I see a lot of potential for synergy. They will continue to peruse those opportunities."

The simple reality, he notes, is that the growth of insurance coverage has opened up a world of opportunities in general. "There are a lot of people at the marginal ends of our society who tended previously to rely on emergency rooms as their primary care physicians because they did not have access to insurance or funds to get into an urgent care facility," he explains. "As insurance coverage has increased, there's been a corresponding impact on the need for additional medical care providers and additional facilities."

As such, developers of urgent care facilities are looking for opportunities in underserved markets, he adds. "When they find one, they are going to go after it. The ACA, and candidly any insurance program that makes healthcare more accessible to a larger number of people, is going to help spur that kind of development." ♦