THE OUTLOOK

MEDICAL OFFICE

IPA INSTITUTIONAL PROPERTY ADVISORS

MIDYEAR 2021

Long-Standing and Recovery-Driven Trends Augment Health Services Demand, Expand Investor Pool

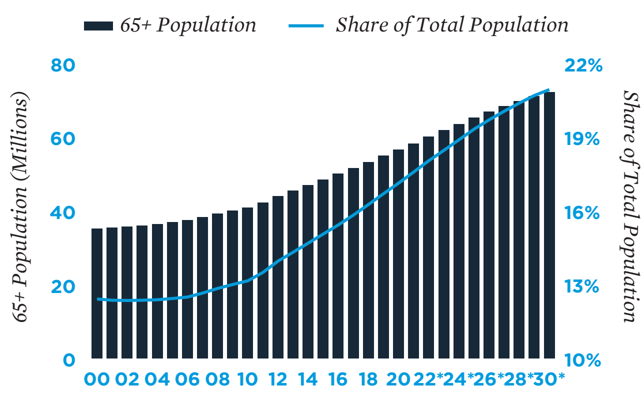
Broader recovery fortifies positive outlook. Resilient during the health crisis, the medical office segment is in a position of strength. Demographic trends and an anticipated boost in health services are positioned to foster long-term tenant demand that will bolster investor confidence in the sector. Shorter term, the full-scale reopening of most states' economies and widespread vaccination efforts have laid the foundation for a broad economic recovery that will fuel continued employment growth in the second half of this year. The expiration of enhanced unemployment benefits in September and many states' plans to terminate the allowance prior to the deadline have the potential to motivate more individuals to obtain work. Furthermore, the reopening of schools this fall should further aid employers when filling open positions during the final third of the year. The resulting employment growth will raise the number of commercially insured households, lifting health spending and the number of medical visits. Together these factors will fuel health-related hiring and supplement demand for medical office space.

Medical office operators the beneficiary of older cohort growth. The transformation of the U.S. population continues in 2021 as the number of persons 65 or older will increase by 3 percent, with the cohort accounting for close to 20 percent of the nation's populace. The unevenly dispersed population will augment overall medical expenditures and demand for health services moving forward. The 65 and older community already accounts for 36 percent of all health spending as they tend to have more routine appointments, preventative screenings and in-patient procedures than younger age groups. Furthermore, an aging population may heighten prescription drug-related spending and long-term demand for nursing home units and nearby medical care facilities.

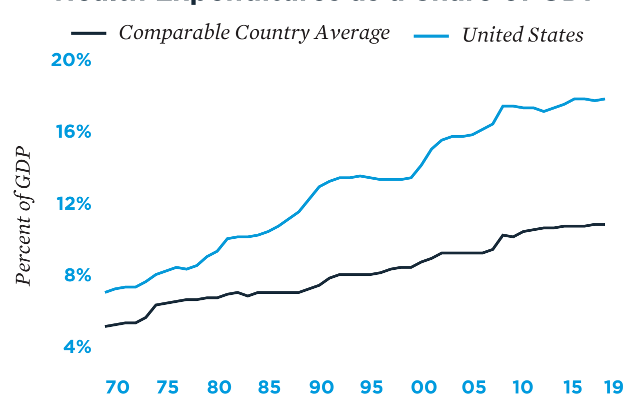
Convenient care accelerates. Prior to the pandemic, a structural shift in patient services away from hospitals and campuses was underway. This trend has been further enhanced by the health crisis as more individuals sought outpatient care and elective procedures in off-campus settings closer to home. A growing preference for convenient health care bodes well for owners of shopping centers and traditional office buildings whose properties feature space with the proper infrastructure to service medical-related tenants. Demand for these floor plans may be strongest in suburban locales that have recently attracted households seeking areas of reduced population density. Austin, Nashville, Phoenix and other cities that are drawing professionals at a leading pace or represent top markets for in-migration also stand to record an increase in medical tenants that are in need of additional or larger off-campus spaces this year.

Potential impacts of telehealth on medical office demand. Virtual appointments skyrocketed last year as patients sought remote outpatient visits during the height of the health crisis. Consumer demand for telehealth has since abated as vaccination efforts and a reduction in COVID-19 cases has revived demand for in-person care. Telehealth visits as a percentage of all medical claims among the commercially insured population fell 5 percent nationally in March 2021 on a month-over-month basis, following a drop of nearly 16 percent from January to February. Still, remote appointments are poised to play a role in future medical care as the technology allows for increased connectivity between patients and physicians, which could stimulate more in-person visits. Additionally, digital health funding hit a record mark during the first quarter of 2021, with companies like Amazon launching their own telehealth services.

65+ Population Growth



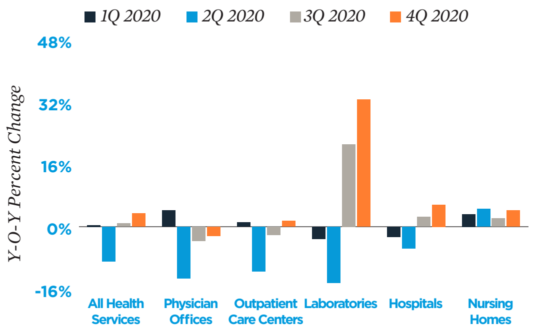
Health Expenditures as a Share of GDP



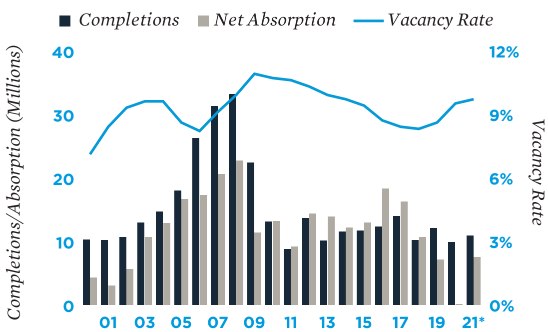
* Forecast

Sources: U.S. Census Bureau; Moody's Analytics; KFF analysis of OECD and National Health Expenditure (NHE) data; Fair Health

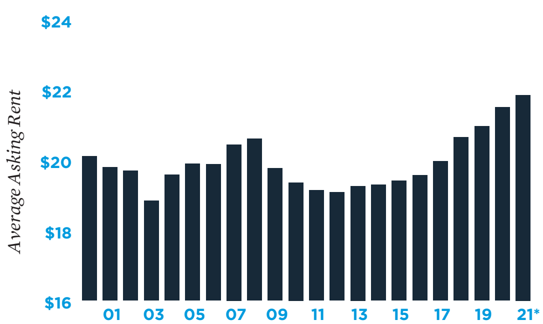
Annual Change in Spending



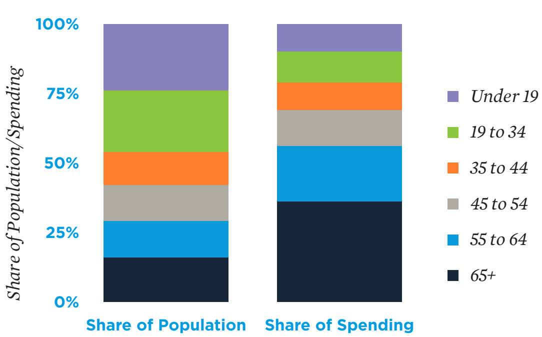
Supply and Demand



Rent Trends



Half of Healthcare Spending by 55+



** Forecast*

Sources: CoStar Group, Inc.; KFF analysis of Quarterly Services and Medical Expenditure Panel Surveys; American Medical Association

Rebound in Health Spending Solidifies Medical Outlook

Backlog of appointments a boon for physician and outpatient centers. After declining on an annual basis during the initial months of the pandemic, spending on health services has improved, rising 3.5 percent on a year-over-year basis during the fourth quarter of 2020. Driven by COVID-19 testing and inpatient care-related expenditures, more pronounced gains in laboratory and hospital spending were registered during the second half of last year. In contrast, physician services and outpatient care center outlays had yet to recover entering 2021. Nevertheless, improvement is on the horizon for these two segments of the healthcare industry. With widespread vaccination achieved, more individuals are likely to schedule routine appointments, elective procedures and preventative screenings that were canceled during the health crisis, supporting an upswing of patient visits and health service spending during the remainder of this year.

Measured Pipeline, Renewed Leasing Aid Fundamentals

Distribution of construction eases supply pressure. Demographic trends and strong fundamentals before the health crisis motivated hospitals and health systems to execute expansion plans, translating to a steady flow of medical office construction. While some ongoing projects were delayed over the past 12 months ending in March, nearly 9.4 million square feet was finalized during the yearlong span. A high percentage of this space was pre-leased, a trend that will continue moving forward as 70 percent of the 14 million square feet underway at the onset of the second quarter was accounted for. Roughly two-thirds of this space is slated for 2021 finalization, yet annual completions will trail the prior five-year mean. A high concentration of pre-leased space and a below-average volume of deliveries will lessen the impact of new supply on vacancy. Additionally, just five major U.S. markets feature active pipelines that exceed 500,000 square feet, led by Houston's 1.5 million square feet. Dallas-Fort Worth, Austin, Philadelphia and St. Louis round out the list of metros where 700,000 to 1.1 million square feet is underway.

Strength of key demand drivers fuels leasing bounce back. Medical properties have proved more resilient from the sharp decline in demand recently registered across the overall office sector. Many medical office tenants were deemed essential at the onset of the health crisis and utilized PPP loans to maintain staff counts. These circumstances enabled independent physicians and practitioners to stay current on rent payments or renew expiring leases, translating to slightly positive absorption over the yearlong span ending in March. Still, medical office vacancy rose 80 basis points to 9.6 percent, the highest rate since late 2015. This jump mainly occurred during the second half of last year as leasing velocity improved in the first quarter of 2021, with roughly 900,000 square feet absorbed. A largely pre-leased pipeline and an expected near-term boost in health services spending suggest demand for medical office floor plans will nearly match new supply this year, translating to a moderate uptick in availability.

Growth markets eclipse national gain. The average marketed rate has climbed on a quarterly basis throughout the health crisis, pushing the mean U.S. asking rent up to an all-time high of $21.53 per square foot in March. Positive absorption and the delivery of nearly 11 million square feet of modern medical facilities this year are slated to further elevate this rate. In Sunbelt markets, expanding cohorts of retirees and strong in-migration may provide operators the impetus to push marketed rents at a pace that exceeds the national average.

Medical Listings Play a Larger Role in Office Marketplace

2021 Forecast

U.S. 65+ POPULATION

3.0% increase Y-O-Y

- The number of residents that are at least 65 years old will climb by more than 1.7 million people in 2021, slightly eclipsing last year's 2.9 percent rate of growth. By the end of this year, the cohort will account for 18 percent of the U.S. population.

U.S. CONSTRUCTION

10.9 million square feet completed

- Supply additions increase the nation's medical office inventory by 1.0 percent in 2021 as delivery volume surpasses the 9.9 million square feet finalized last year. Roughly 70 percent of the space slated for completion this year had lease commitments in place as of mid-May.

U.S. VACANCY

20 basis point increase Y-O-Y

- Positive net absorption is outpaced by new supply, pushing the national vacancy rate up to 9.7 percent. This reading sits 110 basis points above the pre-pandemic mark as availability increased 90 basis points last year.

U.S. RENT

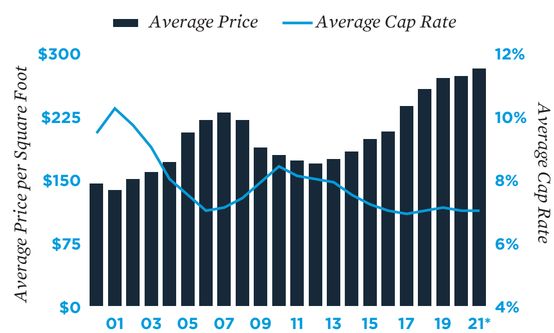
1.6% increase Y-O-Y

- A moderate shift in vacancy and an increase in newly built space will lift the national asking rate to an average of $21.85 per square foot. This gain represents a ninth consecutive year of positive marketed rent growth for the sector.

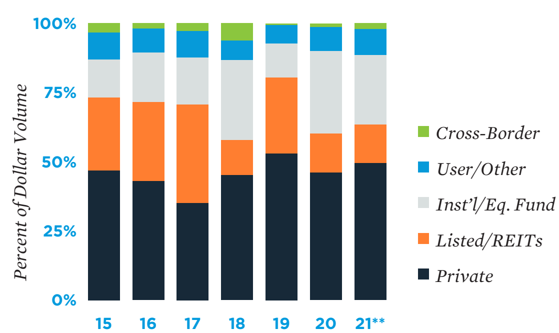
2021 INVESTMENT OUTLOOK

- **Medical office outlook affects buyer count.** Strong fundamentals prior to the pandemic and the relative resiliency of medical office properties during the economic downturn have attracted a broader range of investors to the sector. Population growth among the 65 and older cohort and an expected rise in elective procedures and routine appointments may increase the number of buyers that pursue sub-$10 million on- and off-campus assets this year.
- **Investor confidence in long-term demand translates to record trading.** Medical office closings accounted for nearly 30 percent of all U.S. office sales over the past 12 months ending in March 2021, after comprising 21 percent of all office trades from 2015 to 2019. Buyer activity notably strengthened during the October 2020 through March 2021 span as the number of closings represented the strongest six-month stretch for deal flow in more than 20 years. Recently heightened sales velocity suggests some capital typically allocated for other property types may be funneled into medical office as 2021 progresses.
- **Sunbelt markets shine.** Major metros in the Southwest, Southeast and California that are recording strong in-migration or feature large cohorts of retirees are positioned to drive medical office sales activity in 2021. During the 12-month span ended in March, Riverside-San Bernardino, Miami, Fort Worth, Los Angeles and Orange County each noted year-over-year gains in sales activity. Additionally, Phoenix registered 15 percent of all secondary market trades. Moving forward, tenant quality and income durability will be key to pricing in these locales, with institutional buyers willing to pursue deals at or below $7 million.

Sales Trends



Buyer Composition



** Through 1Q*
*** Trailing 12 months through 1Q*
Buyer composition for sales $2.5 million and greater.
Sources: CoStar Group, Inc.; Real Capital Analytics

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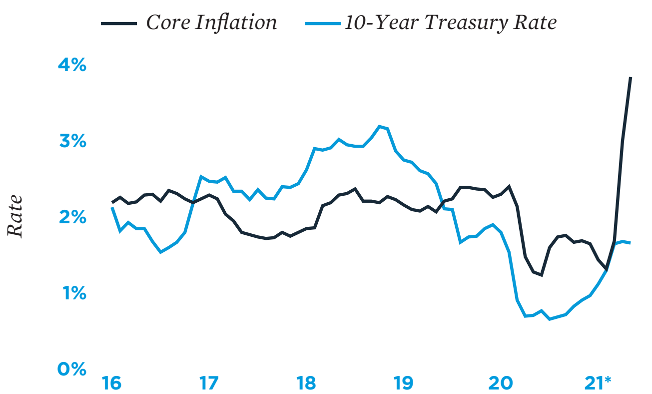
Capital Market Operations Largely Resume; Inflation Concerns Becoming More Apparent

Fed positions for temporary higher inflation period. Applying lessons learned from the global financial crisis, Congress and the Federal Reserve acted swiftly to preserve market liquidity and support borrowers amid the pandemic last year. As U.S. infections recede and the economy reopens, attention is shifting to the potential longer-term ramifications of these actions. The rapid increase in money supply from multiple stimulus provisions paired with low interest rates and disrupted supply chains has led to higher inflation, with core CPI climbing 3.8 percent annually in May. While above earlier expectations, the Federal Open Market Committee (FOMC) still considers this a transitory concern and intends to allow inflation to stay above the traditional 2 percent growth target for longer than it has in the past. The Fed also expects to keep the overnight lending rate low for the near future, citing still-high unemployment as one reason to hold off. More committee members are now open to the prospect of raising rates in 2023, however. Current quantitative easing practices will also remain in effect for the time being. The FOMC will wait for more substantial economic progress before tapering asset purchases, although some pandemic period programs have already expired.

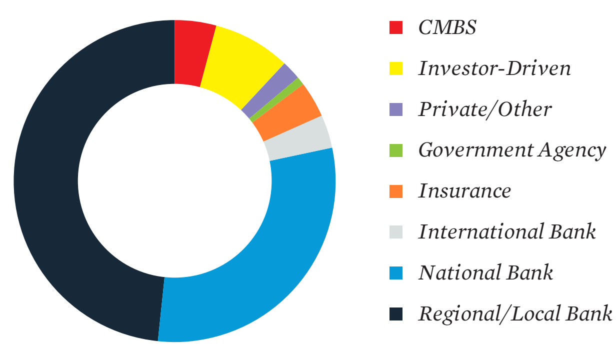
Capital generally available for medical offices as more lenders return to the marketplace. Following significant disruptions last year, the majority of lenders are now active and anticipating larger volume after 2020's slowdown. Sentiment is improving, aided by greater population mobility that will help properties in commercial and travel hubs that were disproportionately affected by lockdowns. Lenders are nevertheless favoring borrowers with whom they have an established and positive relationship. A borrower's credit worthiness and track record bear considerable weight when accessing capital, as does recent property performance, including rent collections. More opportunities are available for assets that demonstrated durability during the pandemic or are now in a strong recovery position. Capital for medical offices is readily available, by virtue of the many necessary services their life science and healthcare tenants provide. Banks, credit unions, life insurance companies are all providing financing on such assets. Medical offices are also a preferred property type for CMBS securitization. Overall, while lending volume is not anticipated to recover to 2019 levels, the impact of the health crisis on capital availability is expected to be less severe than that of the global financial crisis. The external nature of the health problem and critical efforts taken by Congress and the Federal Reserve have maintained and are improving liquidity in the market.

Inflation and Interest Rate Trends



* Through May
Sources: BLS; Federal Reserve; Real Capital Analytics

2020 Medical Office Lender Composition



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