Medical Office Research

National Report

First Half 2018

Institutional Property Advisors
A Division of Marcus & Millichap

Tax Reform Raises Healthcare Market Ambiguity; Intact Affordable Care Act Keeps Investors Optimistic

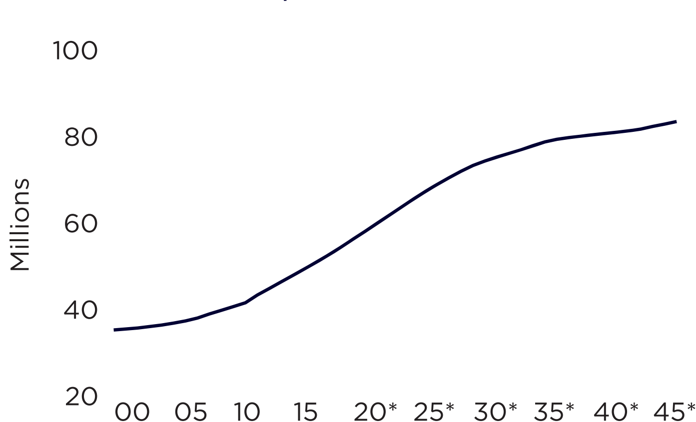
Strong demographics keep demand strong despite continued uncertainty. The new tax law passed in December 2017 will remove a critical piece of the Affordable Care Act (ACA), the individual mandate, but the impact on healthcare coverage will be smaller than originally anticipated, according to current Congressional Budget Office (CBO) estimates. While some decline in coverage rates could impact medical office demand as patient visits fall due to fewer covered individuals, especially for preventative care, many other demand factors remain in place. An aging population, the federal government subsidizing premiums for those with low to moderate income, and other key pieces of the original legislation remain intact. While uncertainty over future changes to the healthcare law will likely remain for an extended period, consolidation and expansion in the industry continues signaling confidence among providers in the segment.

Vacancy tumbles again this year. Medical office property operations are sound, with overall vacancy falling for an eighth consecutive year during 2017 and average rent continuing to rise at a steady but moderate pace. These trends will persist in 2018 as medical office deliveries remain below the 10-year average and consistent demand pushes vacancy to the lowest level since mid-2006. Rent growth will continue to trek along at a modest pace as large groups dominate leasing activity.

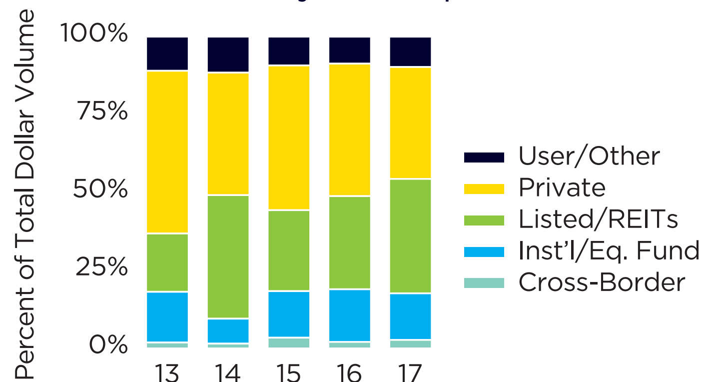
Investment Highlights

- Consolidation within the industry has resulted in major medical providers owning a number of medical office properties. When marketed, these assets are being packaged into portfolios that typically attract attention from REITs and private equity funds. First-year returns for these portfolios have compressed amid strong investor demand, often below 5.5 percent.
- Private physician groups are considering sale-leaseback opportunities of medical office assets, cashing in on increased equity as property values have risen over the past few years. A competitive bidding environment also helps these physicians obtain favorable pricing. They are then able to lock in lease terms that help them better plan for future real estate-related expenses.
- Stabilized medical office assets in prime markets are in high demand, and on-campus buildings fetch initial returns in the mid-5 percent to 6 percent span. Comparable off-campus assets trade at cap rates approximately 50 basis points higher, while buildings in secondary or tertiary locations typically garner first-year yields up to 200 basis points higher.

65+ Population Growth



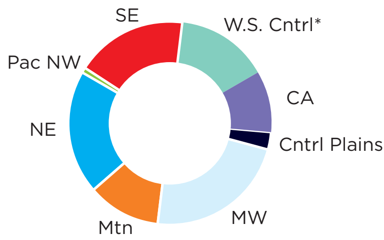
MOB Buyer Composition



Based on trans. of $2.5M+ (excludes entity-level and partial-interest sales)

* Forecast
Sources: Real Capital Analytics; U.S. Census Bureau

2017 Annual MOB Completions by U.S. Region

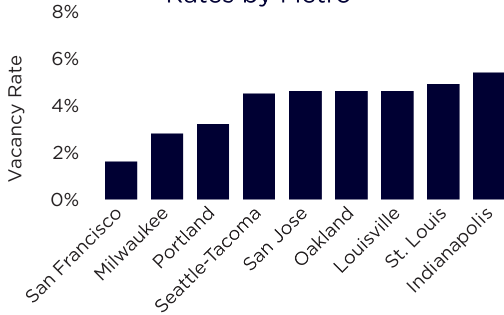


Regional shares based on U.S. total of 9.5 million square feet.
* West South Central

Construction Trends

- Large healthcare companies continue to expand outpatient services in medical office buildings on hospital campuses as well as closer to patients in residential areas. As a result, medical office developers completed 9.5 million square feet of space during 2017, matching deliveries in 2016 and on par with the previous five-year average.
- Providers are updating or adding onto existing facilities at many hospital campuses across the country by developing specialty buildings or renovating emergency departments, among other activities. However, the majority of medical office development is occurring in off-campus settings as providers move into communities and underserved areas.
- The Midwest region received the bulk of deliveries during 2017 as nearly 2.2 million square feet of medical office space was brought online. Deliveries in the region remain robust this year, as another 1.9 million square feet is slated for completion; however, the Southeast region will lead development during 2018 as more than 2.9 million square feet of medical office space comes online.

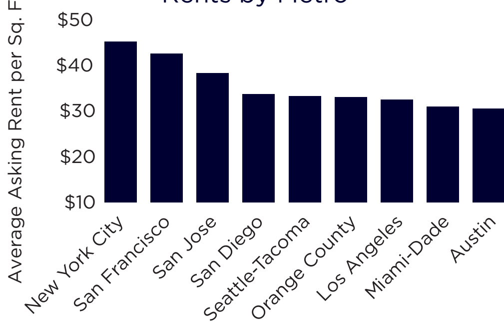
2017 Lowest Vacancy Rates by Metro



Vacancy Trends

- Medical office deliveries remain at less than half of peak levels achieved before 2010 when more than 20 million square feet was added to stock in a single year. Compared with these robust additions, a slower, albeit steady, pace of new supply has come online over the past few years and has been met with strong demand as absorption is concentrated in recently completed properties. This has pushed down overall vacancy, with the rate declining 50 basis points during 2017 to 8.0 percent, a decade low.
- Providers are expanding or moving practices into recently completed or updated buildings in search of high-tech and modern amenities. Technology is playing a greater role in healthcare today as many offices move to paperless systems, or move toward providing telehealth services. Other medical office users may be seeking flexible floor plans to accommodate future growth and changes in the healthcare industry.
- Several markets are maintaining tight vacancy rates, especially in areas where new development is restrained. The Las Vegas, Phoenix and Tucson metros continue to boast some of the highest medical office vacancy rates in the country, however, ranging from 13 percent to 17 percent, keeping the Mountain region's overall vacancy rate above 11 percent.

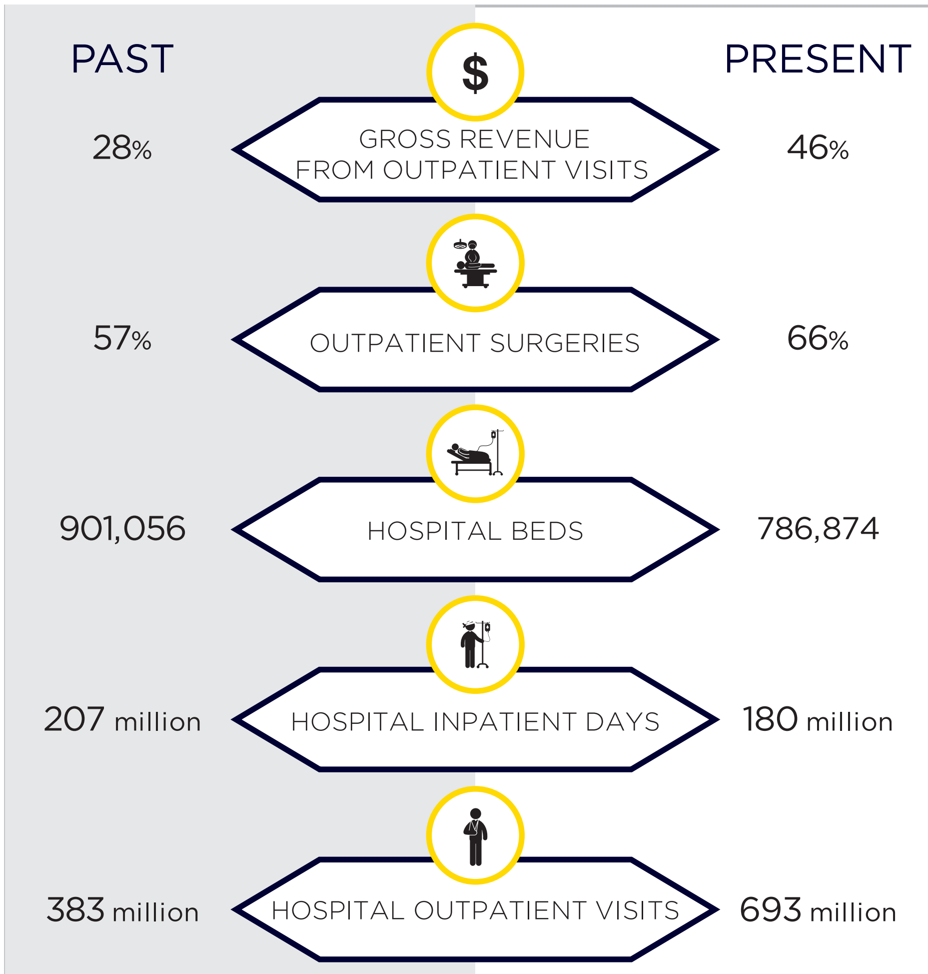
2017 Highest Asking Rents by Metro



Rent Trends

- Consolidation in the healthcare industry is placing major medical providers in the driver's seat of lease signings, keeping rent growth from gaining much traction despite continued tightening in the vacancy rate. In 2017, the average gross rate was flat from the prior year at $22.88 per square foot.
- Ten markets boast an average rent above $30 per square foot, from $30.36 per square foot in Miami-Dade to $45.33 per square foot in New York City. With the exception of Austin, all of these markets are located along the East and West coasts, with five California metros in the top 10.
- Average gross rent at medical office properties constructed since 2010 reached nearly $29 per square foot at the end of 2017, approximately $8 per square foot more than the average for properties built before 1980.

Healthcare Dynamics Shift in Favor of Outpatient Care Over Last Two Decades



2018

OFF-CAMPUS* MEDICAL OFFICE

development represents 68% of total space underway

property sales represent more than 2/3 of transaction volume for the past four years

cap rates average near 7% compressing 100 bps over the last five years

* Off-campus development includes, but is not limited to, ambulatory care centers, outpatient surgery centers, multi-specialty buildings, and single-tenant medical providers in buildings with 20,000 square feet or more.

Sources: American Hospital Association Trendwatch Chartbook 2016: Trends Affecting Hospitals and Health Systems, 1994 to 2014; CoStar Group, Inc.

2018 Medical Office Building Forecast

8.8 million square feet

Construction:

Medical office construction tapers during 2018 as 8.8 million square feet of space is scheduled for completion. The Southeast and Midwest regions lead deliveries again this year, each adding approximately 2 million square feet or more in new stock. The state of Texas gains nearly 1 million square feet of medical office space this year.

40 basis point decrease

Vacancy:

Medical office vacancy continues to fall this year, tightening 40 basis points to 7.6 percent. The Pacific Northwest continues to boast the tightest rate in the country, hovering near 4 percent throughout the year. High vacancy in select Mountain region markets keeps vacancy elevated and the region boasts the highest vacancy rate in the country.

0.6% increase

Asking Rent:

Average rent for medical office properties rises at a modest pace again this year, ticking up 0.6 percent to $23.03 per square foot. The highest medical office rents are on the East and West coasts, while the Central Plains and Midwest regions boast the most affordable rental rates in the country, staying below $20 per square foot this year.

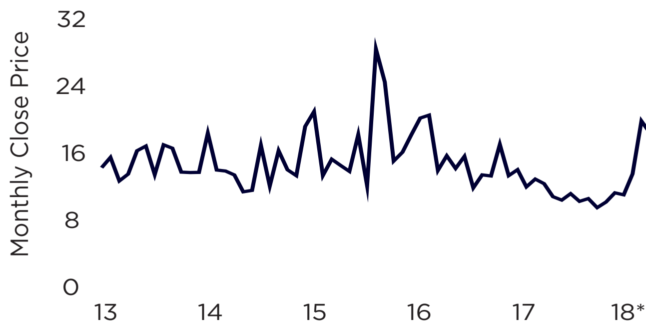
Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

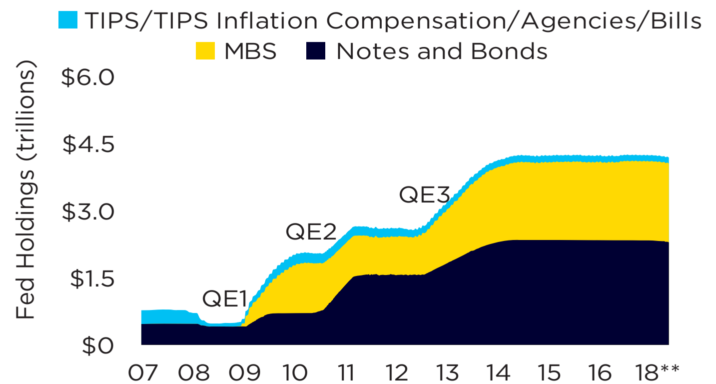
Fed carefully considers tighter policies as new chairman takes the helm. The Federal Reserve has hinted at three to four increases of the fed funds rate during 2018 as it hedges against inflation risk amid accelerated economic growth. The potential for higher inflation could prompt a more aggressive approach; however, the Fed will be cautious about pushing rates up too quickly as it does not want to stall the economy. Inflationary concerns and higher interest rates have driven a recent surge of volatility in the equity markets. Investors are worried that rising interest rates will reduce their stock market returns as elevated costs of borrowing could cut into corporate profits. Additional uncertainty regarding the new untested leadership of Fed Chairman Jerome Powell contributed to the volatility. His policies have yet to be clarified, though he will likely continue reducing the balance sheet in an effort to move long-term rates higher. Despite increased concerns, the economy remains on strong footing and after several years of steady growth in equity markets, a correction was likely. Investors will remain cautious, however, realigning their strategies as necessary to meet their needs. Commercial real estate will offer some of these investors a compelling alternative with relatively less volatility and competitive yields.

Tighter yield spreads in other asset types benefit medical office demand. The average medical office cap rate has remained relatively steady in the mid- to high-6 percent area over the last three years, keeping the yield spread above the 10-year Treasury by 400 basis points to 450 basis points. While many investors believe cap rates will rise in tandem with interest rates, this has not always been the case historically. Tightening yields in several other property types could entice investors to seek the higher returns offered by medical office assets.

S&P Volatility Index



Fed to Begin Balance Sheet Normalization



* Through March 1

** Through February 28

Healthcare Real Estate Group

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Sources: Marcus & Millichap Research Services; American Hospital Association Trendwatch Chartbook 2016: Trends Affecting Hospitals and Health Systems, 1994 to 2014; AAMC; Bureau of Labor Statistics; CBO; CoStar Group, Inc.; Moody Analytics; Real Capital Analytics, U.S. Census Bureau.