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## Investors Bullish on Health Care Real Estate as Reform Showdown Draws Closer

*Hospitals Especially Could Thrive Under Proposed Universal Health Care Winding Through Congress. But The Medical Office Sector Should Remain Healthy Regardless of What Lawmakers Decide*

With the mammoth health care reform package hanging in the balance, medical real estate companies will enter 2010 in the throes of debate over the legislation's potential impact on their business, especially those owning and occupying hospitals and hospital campus office space.

Some key questions remain unanswered about the legislation, which will cost anywhere between \$849 billion and \$3 trillion, depending on who's making the estimates. How will the final legislation affect hospitals and physicians? What companies, niches or sub-niches will be the winners and losers? How much new demand for space, if any, will the sweeping legislation generate -- and will it knock certain classes of medical property out of favor?

The answers may start coming into focus if Congress and President Obama meet their goal of passing a reform package by the end of the year. The House of Representatives passed a bill on Nov. 7 with a price tag that could range from just under \$900 billion to \$1.2 trillion. Senate Majority Leader Harry Reid moved the needle considerably late Wednesday, introducing a bill that covers 94% of Americans and costs \$849 billion over 10 years. Both bills contain some form of "public option," a government-sponsored insurance plan, and the legislation is sure to bring intense debate in the Senate before both houses can hammer out a compromise for the president's signature.

The stock market seems to be mixed on the question so far. Citigroup reports that shares of publicly traded healthcare real estate investment trusts are priced closely in line with the broader REIT sector, which has enjoyed a rally since early March. Healthcare REITs are up 11% year to date, which is about even with the benchmark MSCI US REIT index.

Clearly, though, hospital and medical office building (MOB) owners and developers are looking at the government's investment in health care as a key future driver for one of the few pockets of commercial real estate growth in 2010.

Medical real estate specialists have long made the case that a steadily aging population will create more demand for physicians, therapists and hospitals along with the spaces they occupy, especially in major cities and regions where retired folks settle down.

Analysts believe that health care reform will be a tremendous potential boost to for-profit hospital providers such as Tenet Healthcare Corp., with as many as 30-36 million formerly uninsured patients who will enter (or be dragged into) the health-care system.

Medical service providers will need technologically advanced space and systems to deal with this onslaught of new patients from universal health care. Hospitals and medical buildings will be in demand regardless of the fate of reform, particularly in areas with large retirement populations like Arizona, California, Florida, the Carolinas and Texas.

**MOB: More Growth, Less Distress**

Even before reform became an issue, medical office assets were deemed much more stable than

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traditional office properties. Health care remains the strongest sector of the economy, adding 222,000 workers as of midyear for a growth rate of 1.4%. Lenders are more favorable to health care deals, and only 1% of MOB were classified as distressed at midyear, equating to \$200 million in troubled loans, according to a 2010 medical office outlook by Marcus & Millichap. Traditional office, by comparison, had almost \$20 billion, or 3%, of assets at risk of default or foreclosure.

Make no mistake, the MOB segment is under pressure like the rest of commercial real estate. The recession and rising medical costs are causing many Americans to defer elective outpatient care, diminishing demand for doctors, hospitals and the spaces they occupy. Deliveries have outpaced absorption and vacancy has ticked up, forcing operators to cut rents, according to Marcus & Millichap.

But universal health care could change the game. If even half the 46 million people who are currently uninsured gain coverage under health care reform, the added demand would require nearly 45 million square feet of MOB space beyond what is needed to satisfy normal demand, the M&M report cited. What's more, advances in health care technology and higher data and bandwidth needs will also drive space requirements at or near MOB levels. The American Recovery and Reinvestment Act of 2009 has allocated about \$19 billion to for development of electronic medical record systems, "potentially creating a new tenant group for existing MOB space," the Marcus & Millichap report said.

While deal flow has slowed like every other building type, MOB sales as a share of total office sales activity have actually risen from 14% to 25% over the past seven years, Marcus & Millichap observed. And despite recent expansion of capitalization rates, returns have been remarkably stable since the mid-1990s.

"We're finally seeing some stabilization of caps rates," Kevin Roy, health-care property specialist with Jones Lang LaSalle, tells CoStar Group. Roy noted that MOB levels which were selling at a 6.5% cap rate 18 months ago may now trade in the high 8%'s or 9% today. That's at or near the 9% historical average calculated by JLL researchers for medical offices over a 15-year period.

Most buyers today are interested in hospital campus space. Hospital facilities in major city centers with a high percentage of Medicaid and Medicare patients stand to benefit the most from newly captured patient revenue under health care reform. If and when reform passes, however, leasing growth will initially be more constrained because the supply of new doctors who occupy of medical space will rise more slowly than the number of new patients, Roy said.

Real estate companies affiliated with hospital groups are clearly enthused about reform-fueled opportunities.

"The reopening of the capital markets coupled with the expected near-term passage of health care reform "has set in motion an unprecedented volume of strategic and capital market activity" that will likely result in health care deal volumes for the first six months of 2010 that will exceed the previous three years combined, said Jay Flaherty, chairman and CEO of HCP Corp., which specializes in hospital real estate. "The fabled impact of this activity on HCP cuts across our entire portfolio and is likely to redefine our company in the period ahead. These opportunities will manifest themselves in several ways as market valuations of HCP-owned investments increase in value," Flaherty said in an earning call earlier this month.

Others remain on the fence about the prospect of universal health care, or downplay its potential impact.

"No one knows exactly what that's going to look like now. There are too many versions of it," said Edward K. Aldag Jr., chairman, president and CEO of Medical Properties Trust, Inc., which specializes in providing financing for health-care development and acquisitions. "However, one thing throughout all of the versions that we believe is that the hospitals will do fairly well."

In any case, analysts say health care property companies with strong capital positions like HCP, Nationwide Healthcare Properties (NYSE: NHP) and Ventas Inc. (NYSE: VTR) are poised to expand their portfolios through external growth -- a claim not many CRE companies can make in the current market.

Nationwide Health reported last week that it has agreed in principal to resurrect a long dormant deal to buy seven medical office buildings from Pacific Medical Buildings LLC in a deal valued at between \$275 million and \$300 million - an \$80 million discount to the pre-credit crunch purchase price. NHP, with one of the strongest balance sheets in the REIT universe, has holdings in senior housing, skilled nursing and medical office properties. The company has sold \$190 million of equity, which it will likely deploy for the Pacific Medical deal.

#### Funds Raising Dry Powder

At least 15 funds targeting healthcare, life science, assisted living and senior living acquisitions have announced in recent months they intend to raise more than \$6.3 billion and have actually raised at least \$1.3 billion as of early November, according to information compiled by CoStar. The bulk of the targeted fundraising is by two funds, Grubb & Ellis Healthcare REIT II Inc. (targeting \$3.29 billion) and Healthcare Trust of America, Inc. (targeting \$2 billion).

The biggest player, non-publicly traded REIT Healthcare Trust, has so far raised at least \$1.26 billion -- nearly two-thirds of its funding goal -- and accounts for 97% of the total raised by all the funds so far.

Also this week, Scottsdale, AZ-based Healthcare Trust announced an agreement to acquire a 62,000-square-foot medical office building on the campus of Good Samaritan Hospital in Baltimore, MD, for \$11.2 million. As of Oct. 31, its portfolio included 154 buildings totaling 6.4 million square feet, including 137 MOB, four hospitals, nine skilled-nursing and assisted-living facilities and four other office buildings across 19 states.

In another deal this week, Hunt Valley, MD-based Omega Healthcare Investors said it has reached a \$565 million agreement with Chevy Chase, MD-based CapitalSource to acquire 80 net lease long-term-care facilities. The transaction is expected to close in two parts and includes an option through 2011 to acquire 63 more CapitalSource facilities in 19 states for \$295 million in cash. Omega Healthcare expects to close the first part of the deal, 40 long-term-care facilities in 12 states along with an option on an additional 63 facilities. In the second part, Omega will acquire another 40 long-term-care facilities in two states for \$65.1 million in cash and \$205.3 million in debt by April 1, 2010.

Other large investment transactions recorded by CoStar since the beginning of the fourth quarter include the following:

Capital Solutions acquired three medical facilities from Crozer-Keystone Health System for \$38 million or about \$148 per square foot. The sale included a 40,000-square-foot medical building located at 100 W Sproul Road, a 176,000-square-foot hospital and 40,000-square medical building located at 190 W Sproul Rd, in Springfield PA. Crozer-Keystone Health System will lease back all three medical facilities for 20 years located in Delaware County. Both parties handled the transaction in-house. (CoStar COMP# 1810780)

Healthcare Trust of America Inc. signed an agreement to acquire the 108,500-square-foot Mary Black Medical Office Building, at 1650 Skylyn Drive, on the campus of the Mary Black Memorial Hospital in Spartanburg, SC. The sale price is set at \$16.25 million, or about \$150 per square foot, and the closing is subject to a number of conditions. Mary Black Health System LLC, an entity of Cogdell Spencer Advisors, is the seller. Mary Black Health System leases 65% of the three-year old medical office building, and its operation includes about 209 acute licensed beds and 386 active physicians. "This acquisition allows us to continue the growth we started in the South Carolina marketplace in September with a strategically located on-campus property that has significant tenant occupancy", said Mark D. Engstrom, the REIT's executive vice president of acquisitions.

Legacy Real Estate Ventures LLC purchased a medical office building at 111 Plain St. in Providence RI, from Corsetti Properties LLC for \$3.32 million, or about \$260 per square foot. The three-story, 12,792-square-foot structure was built in 1900. University Medical Foundation occupies the entire building. (CoStar COMPS #1796681)

#### Developments

Seavest Inc. and its joint venture partner, Aardex LLC, announced that they are developing two medical

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office buildings on the new campus of St. Anthony Hospital in Lakewood, CO. Seavest will be the majority owner of the buildings, which will total 250,000 square feet, in its first project in the Denver area. The first building, a four-story, 100,000 square foot facility, will start construction in the first quarter of 2010. The second building will be five or six stories and between 125,000 and 150,000 square feet.

Ensemble Real Estate has completed construction of Auburn Medical Plaza II, a \$12.9 million medical/office development in Auburn, WA. The three-story, 41,311-square-foot building at 121 N. Division St. is part of the Auburn Regional Medical Center campus and includes a four-story, 304-space parking garage. The property is already 75% leased. Capital Oncology plans to occupy more than half of the facility in April 2010. The medical provider signed a 12-year lease for the entire ground floor and part of the second, totaling 24,957 square feet. Additionally, Auburn Neurological Institute has signed a seven-year lease for 3,792 square feet, and Auburn Regional Medical Center has reserved 4,056 square feet for a sleep center. Tracy Altemus with Ensemble is currently leasing the remainder of space.

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KIRCO completed construction on the Mount Clemens Regional Medical Center at 8180 26 Mile Road in Shelby Township, MI. The three-story medical office building is on five acres and totals 58,719 square feet. The project, developed by KIRCO, was about 66% preleased. The new tenants, set to take occupancy early next month, are Mount Clemens Regional Medical Center, which will occupy the entire first floor, and Allure Medical Spa, which will occupy the entire third floor. KIRCO will stay on as property manager. Neumann/Smith & Associates was the architect for the building. Paul Choukourian of KIRCO represents the lessor, MCMRC Health Building Partners. (CoStar Property ID #7258549)

The Matan Cos., in collaboration with Federal Capital Partners, secured a \$52 million construction loan for its planned development of the National Cancer Institute's 330,000-square-foot facility on Gas House Pike in Frederick, MD. Paul Collins and David Webb of Cassidy & Pinkard Colliers arranged the financing on behalf of Matan. Both Wells Fargo Bank and US Bank provided the financing. Construction on the new NCI facility will begin immediately. The \$200 million lab facility will be completed in mid-2011. The building is a part of the Riverside Research Park.

Pacific Medical Buildings will break ground in November on an 88,000-square-foot medical office building for the St. Jude Heritage Medical Group in Yorba Linda, CA. Additional MOB's are scheduled to break ground in San Diego and Castro Valley in 2011. In addition to primary care and multi-specialty medical offices, the Yorba Linda facility, which will be jointly owned by physician investors and St. Jude, will house imaging and urgent care centers. The building is one of three new MOB's and a parking structure the San Diego-based company will build in California over the next couple years.

The other two projects are a 60,000-square-foot building and 320-space parking structure developed with the Sharp Rees-Stealy Medical Group in San Diego, and an 80,000-square-foot medical office building in the San Francisco Bay Area community of Castro Valley on the campus of Sutter Health System's Eden Medical Center.

Ridgeview Medical Center has broken ground on Two Twelve Medical Center, a \$17 million, 163,000-square-foot outpatient center in Chaska, MN. The new facility at 111 Hundertmark Road is slated for completion in February 2011 in Chaska, the seat of Carver County, MN, about 26 miles from Minneapolis. The Economic Development Authority of the City of Arlington, TX is planning the construction of a 70,000-square-foot medical office complex in south Arlington. Texas Clinic at Arlington will cost an estimated \$12 million and will be located at 400 W. Arbrog Brook Blvd. The three-story medical office building will break ground in December with completion slated for summer 2011. Arlington MOB Partners, L.P. is the developer.

MOB/Healthcare Leasing

Laser & Skin Surgery Center of New York (LSSCNY) signed a 25,940-square-foot lease with Adams & Co. Real Estate at The Medical Arts Center in Manhattan. The cosmetic skin surgery center has renewed its lease for the sixth and 11th floors, and has expanded onto the second and ninth floors. The 12-story,

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120,000-square-foot medical office building 317 E. 34th St. was built in 1910 in the Murray Hill submarket. David Levy of Adams & Co. represented both parties in the deal.

Six tenants leased a total of 19,500 square feet at 3886 Princeton Lakes Way in Atlanta, GA. Orthopaedics of Atlanta, Southern Pain Institute, Geetha Manchireddy MD, Providence Foot & Ankle, Sofia Farah MD and Tenet South Fulton signed leases ranging from 1,500 square feet to 5,000 square feet. The two-story, 30,000-square-foot medical office building starts construction late October and is due to deliver in March 2010. The proposed building is the 3rd building within the Camp Creek Medical Center, a 110,000-square-foot medical office park. Kevin Ehringer of Ackerman & Co represented the landlord in each deal. Bryant Cornett of Ackerman & Co represented Tenet South Fulton. The other tenants did not have representation.

Santa Barbara-based Montecito Medical Investment Corp. awarded CB Richard Ellis a tri-state leasing assignment totaling 367,000 square feet. The leasing team of Kim Penny and Laura Westervelt will handle the 158,420-square-foot Knoll I and II projects in Columbia, MD. Brandon Wallace will lease the 59,238-square-foot Cartersville Physician Center in Atlanta, GA. Lars Eisenhower will head the San Diego County leasing of three properties totaling 149,810 square feet. The San Diego portfolio includes the 30,450-square-foot Hillcrest Medical Center, the 70,058-square-foot Valley Parkway Medical Office and the 49,302-square-foot Escondido Medical Arts Building. Montecito Medical Investment Corp. specializes in the acquisition and development of a variety of medical facilities, including hospitals, medical office buildings, surgery centers, and skilled nursing facilities.

Premier Inc., a leading healthcare alliance of hospitals and other medical providers, is moving its corporate headquarters from San Diego, CA, to Charlotte, NC, signing a 15-year lease at the Boyle Building in the Ballantyne Corporate Park. Occupancy is slated for February 2011. Premier is taking the entire 10-story, 262,000-square-foot office building at 13034 Ballantyne Corporate Place. Bissell Development delivered the Class A property at the end of last year. Blair Bryan, Jeff Harper and Eric Parris represented Premier in the transaction. Barry Fabyan, Charley Leavitt, Jenny Dykstra and Edward Curran with Bissell Cos. represented the landlord in-house. The organization already has a large presence in Charlotte, occupying the 175,000-square-foot Corporate Center One in the Lakepointe Corporate Center. Premier also has offices in Philadelphia and Washington, D.C.

Omniflight Helicopters Inc. signed a deal totaling 26,882 square feet at 16415 Addison Road in Addison, TX. The air medical services company renewed 16,560 square feet on the fourth floor and leased an additional 10,322 square feet. Addison Tower is a nine-story, 145,886-square-foot office building. Ryan Collier and Ryan Evanich of Stream Realty Partners LP represented the landlord, Aque Investment Group. John Beach and Santee Hathaway of Jackson Cooksey represented Omniflight.

**Skilled Nursing/Senior/Assisted Living**

The largest MOB developers and owners such as Health Care REIT, Inc. are increasingly diversified with senior care, skilled nursing, continuing care retirement communities and other residential sub-niches. Like the single-family home and multifamily markets, these assets have been negatively affected to varying degree by the weak housing market.

Diversification comes with other risks, as HCP Inc. found. Sunrise Senior Living Inc., which has battled liquidity and balance-sheet problems, recently agreed to sell 21 wholly owned assisted-living communities in 11 states to an affiliate of Brookdale Senior Living Inc. for \$204 million.

The portfolio has a total of 1,389 units, comprised of 92 independent-living units, 876 assisted-living units and 421 Alzheimer's units in 11 states. Sunrise is expected to receive approximately \$60 million in proceeds, to be used in part to pay off its credit facility.

Sunrise's issues led to breach-of-contract allegations by HCP Inc., which terminated dozens of management agreements with the senior care operator.

In other selected assisted-living, skilled-nursing and senior-living leases, sales and development activity tracked by CoStar news and research:

Elmwood Centers purchased the St. Francis Health Care Centre investment property at 401 N. Broadway in Green Springs, OH, for \$10 million or \$500 per square foot from Franciscan Sisters of Our Lady of Our Lady of Perpetual Help, a nonprofit organization. The transaction was deemed a distress sale/high vacancy property.

The Covenant Group acquired the Aberdeen Heights Assisted Living building at 7220 S. Yale Ave. in Tulsa, OK, from Turnaround Professionals LLC for \$5.75 million, or about \$68 per square foot. The CB Richard Ellis/San Diego team of David Rothschild and Mary Christian represented the buyer and seller. (CoStar COMPS #1798151)

New York-based equity firm MCAP Sabine Pointe acquired the Cocomo Residential Center at 1556 Saybrook Road in Haddam, CT, from local investors for \$7.15 million. Oren Klein and Joshua Olshin of Tranzon handled the auction sale for the seller. (CoStar COMPS #1798518)

The Ensign Group signed a 10-year, 29,829-square-foot lease for the top floor of 27101 Puerta Real in Mission Viejo, CA. The skilled-nursing and assisted-living services provider is expanding, taking an additional 9,632 square feet. Leland Bruce and Mitch Lundquist of Jones Lang LaSalle represented The Ensign Group. Scott Johnstone and Greg Puccinelli of Grubb & Ellis represented the landlord, Mission Ridge Associates.

Bridgewood Property Co. and Harrison Street Real Estate Capital have begun construction of a 207-unit in The Woodlands, TX, master-planned senior living community north of Houston. The project is scheduled for late-2011 delivery.

Welsh Construction and Genesis Architecture completed Highview Hills by Walker, a 242,000-square-foot senior-living community center in Lakeville, MN. A grand opening ceremony was held Oct. 24. The 153 units include independent living, assisted living, memory care, and assisted-living care. Highview Hills by Walker is owned and operated by Minneapolis-based Walker Methodist, which operates nine other senior living facilities in Minnesota.