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## **Medical Developers, Hospitals Early Winners as Health Care Overhaul Becomes Law**

**Non-Affiliated Doctors Who Own Medical Property Could Ultimately Be Most Exposed to Provisions of the 2,000-Page-Plus Health Care Overhaul**

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The uncertainty over the nation's mammoth health-care overhaul has at least partially lifted for medical office developers, investors and hospital systems, who are now gauging the possible impacts of the legislation approved by the House and signed into law Tuesday by President Obama.

By a 219-212 vote, the House of Representatives on Sunday approved the landmark Patient Protection and Affordable Care Act of 2010, the most sweeping overhaul of the nation's health-care system since President Lyndon Johnson signed the Social Security Act of 1965, which implemented Medicare and Medicaid.

More than a dozen states have sued to block the law as unconstitutional at last count and Republicans, who unanimously opposed the legislation, have vowed to repeal the law. However, the bill, widely viewed as dead two months ago, would now extend coverage to 32 million uninsured Americans and prohibit insurance companies from denying or canceling policies due to pre-existing medical conditions or annual or lifetime caps on coverage, according to the Congressional Budget Office. The overhaul will cost \$938 billion over 10 years, with health-insurance exchanges beginning to operate in 2014, eventually raising the percentage of eligible insured Americans from today's 83% to 94%.

Passage of the bill removes another bottleneck in the deal-making process for investors, developers, landlords and tenants and allows the CRE industry to drill down into the details of the massive legislative package, according to experts in the medical office sub-sector contacted by CoStar Advisor.

Health-care real estate players unanimously agreed that the new law would sooner or later result in increased demand for both on- and off-campus outpatient medical office buildings (MOBs).

The year-long wait for Congress to enact the legislation hasn't curbed the appetite for institutional grade MOB product, and "I suspect passage of the bill will likely only make it more attractive," said Jud Jacobs, managing director of Trammell Crow Company's Healthcare Development Initiative, which recently broke ground on a second medical building for CHRISTUS Santa Rosa Health System near San Antonio. "Certainty is always better than uncertainty. The contents of the bill, for better or worse, are now known and I believe this gives lenders and investors one less thing to worry about." Al Pontius, senior vice president and managing director of Marcus & Millichap's National

Office and Industrial Properties Group and director of the firm's health care real estate group, agreed.

"It will be a while before the real impact is more clearly understood and begins to affect supply-demand characteristics," Pontius said. "But I don't think there's any doubt that if health care insurance is made more broadly available, to 32 million more insured, there will be significantly increased demand."

Like other property types, MOB occupancy has suffered in recent quarters. The direct vacancy rate for Class A and B medical office space stood at just over 13% at the end of the fourth quarter, up about 50 basis points from a year earlier, according to CoStar data.

Other potential impacts mentioned by health-care property professionals include the following:

- The bill places limits on new or expanded physician-owned hospitals, a major source of health care development in some parts of the country, including the fast-growing Texas market.
- New Medicare taxes on investment income and capital gains, including rental income, will financially pressure landlords, doctors and other high-income earners.
- Charitable hospitals face more verification and accountability for the "community benefit" they provide in exchange for their tax-exempt status, possibly translating into demand for off-campus facilities. Not-for-profits, which account for nine out of 10 U.S. hospitals, have traditionally met the requirement by writing down the cost of providing care to uninsured patients.
- The investment portfolios of nonprofits have taken a beating in the market. Meanwhile, demand for capital to fund new projects will compel, perhaps require, hospitals to look beyond the weakened public bond market to deals with private real estate investors to monetize their non-core health-care properties through sale-leasebacks and other transactions.

## **Keen Demand Expected**

Nearly 60 million square feet of new medical office supply could eventually be built to meet the demand, based on a standard industry multiplier of 1.9 square feet of new MOB space for each new outpatient brought into the system, according to Jeffrey H. Cooper, executive managing director with global real estate services firm Savills LLC in New York. While not everyone completely agrees with that formula, virtually all said that developers are among the likely winners. Most of them also agreed that hospital systems will benefit, at least in the short run, as more insured patients come into the system and help offset the costs of treating uninsured people who lack the means to pay.

Tens of millions will be added to the insurance rolls, but the central question is how much the legislation will actually drive increased utilization of medical services, said John Montgomery, executive vice president and head of facility development for Chicago-based Lillibridge, one of the nation's largest private health-care development firms. "There will not be 30 million people who suddenly show up and say, 'now that I'm

sick, I can go see a doctor.' They're already doing that anyway."

It's hard to precisely pinpoint how much space will get built, but it's already clear that health care facility dollars will have to be spent more wisely, Montgomery said.

"Hospitals will have to build smaller and more efficiently, with an eye toward keeping patients out of [inpatient] beds, and treating them in the most economical method possible. There will be a need to expand the roles of nurses, nurse practitioners, division assistants, because there aren't enough physicians to see all those new people.

"We think [reform] will continue to drive the need for outpatient facilities, ambulatory care, medical office buildings, and that's good for us," added Montgomery, who said managed-care systems like Kaiser Permanente in California are the likely care delivery models of the future.

Over the medium and long term, hospital systems and doctors will see declining government reimbursements for certain medical procedures. Most of the newly insured will seek out family physicians, but fewer doctors may enter that field because they will need to see up to 50% more patients to maintain the same income, Cooper said.

Shrinking profits could make it difficult for doctors who don't belong to a group to afford occupancy costs, which could negatively impact occupancy and rents, said Cooper, a veteran in investment banking and other aspects of medical office and health-related facilities.

## **Ownership Restrictions Could Hurt Doctors**

In another key element, the Senate version of the bill would effectively halt the expansion or construction of new physician-owned specialty hospitals by denying them Medicare reimbursements. Hospitals owned by doctors have become increasingly popular over the past 20 years. But critics, including Democratic lawmakers and major hospital groups like the American Hospital Association, have long said the practice of doctors referring patients to their own facilities drives up medical costs and amounts to a financial and ethical conflict of interest.

The ban would start on Aug. 1 - or Dec. 31 if the Senate approves "fixes" in the reconciliation bill. The Dallas Morning News has reported that North Texas has the largest concentration of physician-owned hospitals in the nation, particularly rehabilitation facilities, and as many as 32 projects to build such hospitals statewide wouldn't meet the August deadline.

In a statement released Wednesday morning by Physician Hospitals of America (PHA), the industry trade group warned that the reform bill "will have a devastating impact on physician owned hospitals, the patients they treat and the communities they serve."

"The legislation virtually destroys over 60 hospitals that are currently under development, and leaves little room for the future growth of the industry," said Molly Sandvig, executive director of the group. "In total, over 25,000 jobs are at risk in 37 states. Billions of dollars already invested in hospitals stand to be lost. And, rural and inner-city hospitals being rescued and kept open by physician investment will now close."

Large acute-care hospital systems have been co-developing facilities jointly with physicians "to keep doctors from going off on their own and building their own hospital," Cooper said. "With physician-owned hospitals out of the picture, they now become less of a competitive challenge for some of these hospital systems. Doctors won't be able to build an ambulatory care facility that's going to compete with the main hospital because they may not get reimbursed by [Medicare]."

On the other hand, the effect of health-care reform on individual doctors and other smaller tenants is less clear. Because of rising costs and declining revenue, many doctors not connected with physicians groups or hospital may have to join up with practices owned by hospital systems and become tenants of their hospital campuses and MOBs. As those investment-grade properties fill up with good-credit long-term tenants, "there will be more opportunity for institutional investors to invest in this asset class," Cooper said.

After a period of inactivity due to the weak economy, hospitals are beginning to again make expansion decisions. Passage of the legislation will help that process along, Cooper said.

"I think we'll see a boost in activity because the hospitals now know what the landscape is going to look like and can finalize and execute their capital and strategic plans for the next five years," he said. "That will generate a lot more development activity, especially of medical office and other ambulatory type facilities."

## **Long-Term Outlook Cloudy For Hospitals**

Despite the short-term boost, however, Cooper said hospital executives are concerned about the longer-term ramifications of the legislation on their bottom line.

Hospitals, striving for efficiency to cope with the new environment and raise growth capital, will be compelled to review their existing portfolios for possibly sale/leasebacks of non-core MOBs and other non-acute facilities. Possible buyers include cash-flush REITs, which are striving to bolster their MOB portfolios, with private investors, offshore capital and possibly pension funds also likely to look for a piece of the action.

"You'll see new satellite hospital campuses, which may not have an acute-care facility, and emergency care facilities developed by the hospital where the populations move," Cooper said. "Development is going to accelerate because the person who has to get hip surgery who lives on the outskirts of Indianapolis may not want to go all the way downtown for treatment. They'd rather go to an ambulatory surgery facility closer to their home."

The smaller 50- to 100-bed community hospitals are going to be the most economical and efficient way to get care to people, said Montgomery, whose Lillibridge owns 95 MOBs totaling approximately 5.7 million square feet in 37 markets across 16 states and Washington, D.C. The firm serves as third-party manager for 41 MOBs totaling 1.4 million square feet and has developed health care real estate in 36 states.

Real estate ownership of inpatient facilities by REITs may very well increase.

Developers of MOB and outpatient facilities in off-campus hospital satellites will need a strong sponsor for their projects, Montgomery said.

"Patients are going to find points of access where they need to be, not where they are now. In the near term there will be more money flowing in, which is good for us. But hospitals are going to have to start cutting back on the dollars spent. Again, that's very good for us because it pushing folks out of the big expensive hospitals into outpatient facilities. Providers will need more square footage. All of that is very good on the real estate side."

Another component of the legislation, the new Medicare tax on investment income, including capital gains and rental income, is drawing the ire of landlords. To raise more than \$200 billion to help fund the overhaul plan, the House hiked the proposed new tax from the 2.9% proposed by President Obama in February to 3.8%. This first-ever Medicare tax, which would start in 2013, would extend beyond wages to include income from interest, dividends, annuities, royalties, capital gains and rents for individuals who earn more than \$200,000 annually and joint filers reporting more than \$250,000.

### **Implementation Timetable Unclear**

How sooner will the law begin affecting commercial real estate practitioners? Estimates vary.

Trisha A. Talbot, senior vice president with Phoenix-based GPE Medical Office Partners, said investors looking to buy or health care providers looking to lease medical properties "should start looking yesterday." Tenants with good credit that can aggressively negotiate a lease should stop waiting and move forward before the demand for space increases, probably in six to 12 months, she said.

Increased volume of patients could drive medical tenants to not only MOB, but even retail spaces that could accommodate a medical clinic or practice, added Julie Johnson, executive vice president with GPE.

"Our advice to tenants is to secure a good long-term lease at today's market rates," Johnson added.

Health care real estate has felt the downturn in the capital markets, but not to the same degree as other sectors, said GPE executive Kathleen Morgan. "Even in this market, there are physicians that receive financing for tenant improvements, hospitals expanding and medical buildings developed." Planned hospital expansions and medical facilities that were put on hold will likely move forward as implementation of the health care bill unfolds.

Trammell Crow's Jacobs' said now may be good window for investors to sell, not because of the health care overhaul but because there is plenty of equity capital chasing high-quality MOB right now.

Meanwhile, tenants should evaluate the likely impact of the legislation on their individual practices.

"Make sure you are comfortable with the terms before signing a long-term lease commitment. If you can demonstrate a quantifiable hardship resulting from the legislation, this information might be a good lease negotiating position," Jacobs said.

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