



Article by the *National Real Estate Investor*

Medical Office Sector Ramps Up

Mar 22, 2010 3:54 PM, By Sibley Fleming, NREI managing editor

Outpatient facilities provide investors with great opportunities for reliable returns.

Investors aren't waiting for the outcome of the healthcare debate before they inject their capital into the medical real estate sector. After a year of inactivity, hospitals are expanding again and investors are realizing that demand for medical office space, by most measures, is inexhaustible.

Last year, transaction volume for medical office properties valued at \$1 million or more was down by more than half from 2008 totals, both by the number of deals and by dollar amount. In 2008, there were 891 transactions with a total value of \$4.3 billion. In 2009, just 420 medical office deals, valued at \$1.9 billion, closed.

In 2009, you were very challenged to put together transactions in excess of \$10 million, says Alan Pontius, managing director of the healthcare real estate group at Marcus & Millichap Real Estate Investment Services, in the firm's San Francisco office.

Now deals are beginning to accelerate. In December, Marcus & Millichap brokered the \$16.7 million sale of Hampden Place Medical Center, a 66,339 sq. ft. Class-A medical office building in Englewood, Colo.

In mid-2009, the asset couldn't trade even at a generous capitalization rate of 8.5%, Pontius says. But in December, the property comfortably sold at an 8.25% cap rate. That is an example of how the overall market has come back around, says Pontius.

Hampden Place isn't on a medical campus, but it is within a few blocks of the Swedish Medical Center and Porter Adventist Hospital campuses. The property also is an outpatient facility that houses a broad array of services, including an ambulatory surgery center, medical imaging, physiotherapy and medical offices for orthopedic, hematology-oncology and other physicians.

In short, Hampden Place is a great example of the type of asset lenders and investors are targeting these days. Investment-grade medical office has not been necessarily recession-proof, but it has been recession-resistant, says Jeffrey Cooper, executive managing director of Savills US, who works in the London-based company's New York office.

Cooper defines institutional-grade properties as on-campus buildings or properties associated with healthcare systems.

Demand drivers

Outpatient facilities in particular are getting special treatment from investors due to growing demand for alternatives to traditional hospital care. Healthcare systems are under mounting pressure from government and insurance companies to bring down costs. And from a real estate perspective, it costs less to treat a patient on an outpatient basis than an inpatient basis.

Ten years ago medical office buildings really just had physician practices in them, explains Donna Jarmusz, senior vice president of business development for Alter+Care, based in Chicago. Now the hospital would lease some space for outpatient services like digital imaging, diagnostics and specialty clinics as well as physician offices.

Cooper says that most hospital systems today provide 60% of their treatments on an inpatient basis and 40% as ambulatory care, or outpatient treatments. But that ratio is changing. Hospitals believe that over the next five years, those percentages are going to be reversed, he says.

The demand for outpatient services and buildings where those services are offered will mushroom as the large population of Baby Boomers age and require more medical attention and treatments. And if the healthcare system is overhauled, the demand for cost-effective outpatient facilities could increase exponentially.

The real estate formula is that every patient in the system requires about 1.9 sq. ft. of medical office space, according to Cooper. Reforms proposed by President Obama would add 30 million people to the ranks of the insured, which equates to demand for 60 million sq. ft. of additional medical space.

There is existing space but the sheer increase in numbers of newly insured people would mean a lot of new space would need to be built into it, he says.

Even with no decision on health reform, Jarmusz says she's seen an uptick in hospitals moving forward with development projects. Hospital sector leaders now believe that what's on the table in Washington is insurance reform, she contends, rather than an overhaul of how hospitals operate and deliver healthcare services.

Hospital hang-ups

Despite strong demand for their services, many hospitals do have capital and operating issues, according to Chris Bodnar, vice president of the Denver-based healthcare capital markets group at CB Richard Ellis. Their endowments and investments have fallen significantly during the big downturn, he says.

Bodnar cites several common reasons that hospitals are finding themselves cash poor:

- Declining income from operations: Hospital income is down at many locations because patients choose to defer care due to job losses and the loss of insurance coverage.

- Investment losses: Not-for-profit health systems, which make up 90% of all hospitals in the United States, have their own investments, and many of those ventures have suffered losses along with the rest of the market.
- Curtailed philanthropy: Charitable donations historically have been a huge revenue source for health systems, but they're seeing less philanthropy money today. In fact, the Association of Healthcare Philanthropy reports that three out of four hospitals' philanthropy efforts have been squeezed since the start of the recession.
- Bond market troubles: Health systems with investment-grade credit can still have a positive experience in the bond markets. However, non-rated health systems will have much more difficulty pricing their bonds.

Developers ramp up

The typical development process for an outpatient facility begins when a hospital or a healthcare system publishes a request for proposal, or RFP. Developers respond to the RFP with plans that outline the rent and lease terms the hospital can expect.

If the hospital decides to move forward, the developer will generally secure the financing and then wait for preleasing to reach a certain threshold. Developers will require at least 50% preleasing, as a rule of thumb, although some will hold out for 70% to 80% before proceeding with the project, according to Cooper.

With debt on the financial endangered species list over the past two years, a lot of new development has remained on the drawing board. When Savills pulled together \$160 million in funding to build a 460,000 sq. ft. cancer center at the Baylor University Medical Center in Dallas last year, it was an all-equity deal.

Savills brought the deal to market in mid-2008, but was underwhelmed by the debt quotes at the time. The team ended up financing the project with 86% equity from Northwestern Mutual, an institutional investor, and 14% equity from the developer, Duke Realty Corp. The project is now 94% pre-leased and will open in two years.

DASCO Cos., a national medical office developer, owner and manager based in Palm Beach Gardens, Fla., provides all of the funding for its new developments through a combination of debt and equity. The firm's owned and managed portfolio comes to approximately 3.5 million sq. ft. spread across the nation. It also manages an additional 1 million sq. ft. for institutional owners.

A few months ago, for instance, DASCO completed a 100,000 sq. ft., off-campus outpatient building in Greenville, S.C., according to Malcolm Sina, president and CEO of the development company.

Called St. Francis Millennium, the 103,000 sq. ft. project offers a diverse collection of healthcare services including urgent care, diagnostic imaging, sleep lab, cardiac rehabilitation and a full-floor cardiology practice.

The \$20 million center was approximately 65% pre-leased before DASCO broke ground in June 2008. As with most of DASCO's outpatient developments, the company provided the financing, which included 65% debt, Sina says.

St. Francis Millennium was completed in June 2009 and is now 88% leased. The initial return on investment was just under 10% for the first year, based on the ratio of the property's stabilized income to the total development cost.

Alter+Care is another developer that is cranking out new outpatient medical facilities. The Chicago-based company works primarily with non-profit healthcare providers and develops outpatient facilities such as wellness centers, cancer centers and heart institutes. The healthcare real estate arm of the Alter Group, Alter+Care has 85 million sq. ft. in medical development projects currently in progress.

In the first quarter of this year, hospitals are now saying that regardless of healthcare reform, we can't just sit back and wait. We have growing needs within our communities so we really need to meet those needs, says Jarmusz, the company's business development executive. So they're again now thinking about expanding and growing various services.

Like DASCO, Alter+Care plans, develops, owns and manages medical office facilities. It also obtains the financing for its projects, but makes no demands on hospitals to meet certain occupancy levels or sign master leases in order to break ground.

Instead, says Jarmusz, even when a hospital puts out an RFP for a specific amount of space, Alter relies on its own market and financial feasibility studies to cushion the risk. As a result, she says, Alter doesn't over-design or over-build.

Stability matters

Even with 2009's dismal transaction volume, the medical office niche has been attracting a growing number of investors. Since the beginning of the recession in late 2007, we've seen a 323% increase in medical office transactions as a percentage of traditional office deals, says Bodnar of CB Richard Ellis.

After the financial earthquake of the recession and aftershocks in the form of declining fundamentals for most commercial real estate property types, it's no big surprise that investors are gravitating toward the medical subsector. Demand for outpatient facilities is clearly defined and leases are in the 10- to 15-year range, as opposed to the five- to seven-year range for traditional office.

For core product, or institutional-grade assets on or near a medical campus, the tables have turned a little bit from last year. There's a significant amount of debt available for core products in today's market, says Bodnar. Outside of core product, it's much more difficult. Lenders flocking to the sector include mega banks, community banks and small banks. Even conduit lending is staging a modest comeback.

Healthcare real estate investment trusts (REITs) have become net buyers this year, and the top five largest healthcare REITs have raised about \$2.5 billion in equity to fund new acquisitions. That list of heavyweights includes HCP (NYSE: HCP), Healthcare REIT (NYSE: HCN), Nationwide Health Properties (NYSE: NHP), Ventas (NYSE: VTR) and Healthcare Realty Trust (NYSE: HR).

And experts say that these REITs are under pressure to place the money they've raised. What that means for the single investor is that there's a lot of competition for on-campus, Class-A assets.

These institutional REITs will look at large portfolios and they will look at small properties because there's just not enough product on the market right now for them to place all of their capital, Bodnar explains.

Because REITs typically pay in cash, they have an advantage over the investor who must secure debt to close a deal.

Investors are looking for yield and if they're borrowing money, the [interest] rate of those funds and the ability to borrow those funds has a direct bearing on the amount of yield an investor is going to get, notes Toby Scrivner, a director with Stan Johnson Co., a net-lease brokerage firm based in Tulsa, Okla.

Since December, Scrivner says his team has underwritten more than 1 million sq. ft. of medical office space that will come to market in 2010.

Although the healthcare market took a timeout in 2009 due to uncertainty over healthcare reform and the financial crisis, plans are being reinstated that had previously been put on hold, says Scrivner. Healthcare providers recognize that demand for services will continue to increase, and that being inactive does not create opportunities.

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