Medical Office

RESEARCH REPORT

Marcus & Millichap

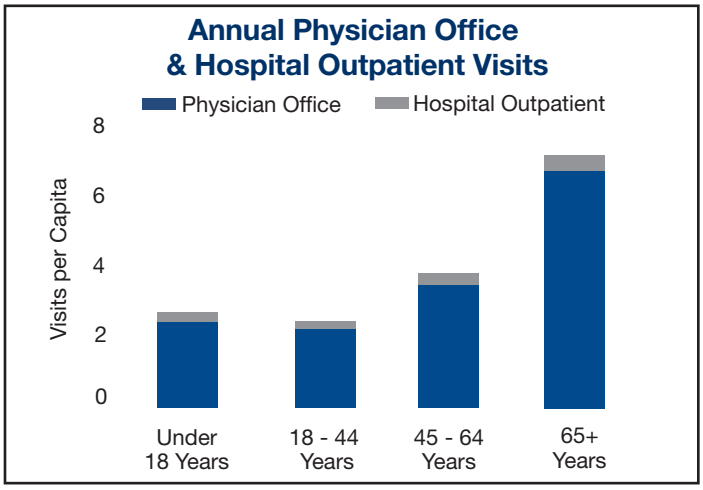
Second Half 2014

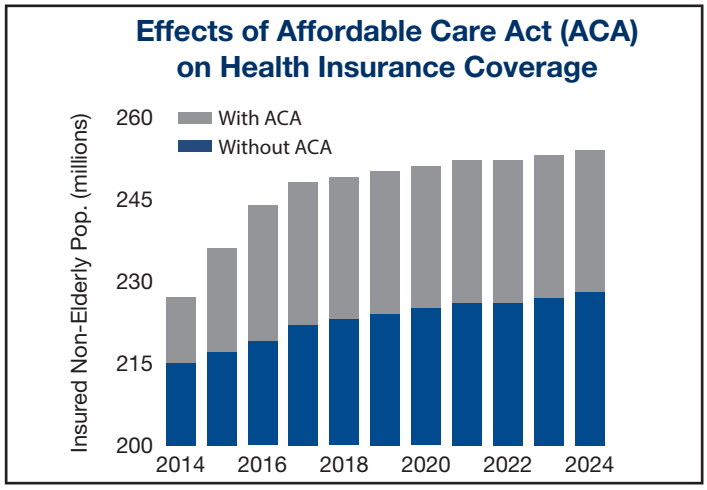
Healthcare Consolidation Bifurcating Medical Office Market

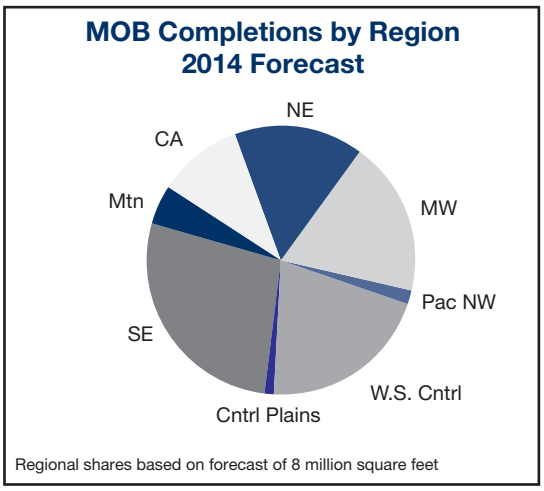
Expanded health insurance coverage and the overall aging of the U.S. population bode well for the medical office sector and continue to attract investors to the marketplace. During the next 10 years, the 65-plus age cohort, who average 2.5 times the number of physician-office visits than the rest of the population, will grow by 17 million individuals. The non-elderly populace will expand at a more measured pace during the same 10-year span; however, greater utilization of insurance exchanges, along with Medicaid expansion, will help provide coverage to an additional 27 million people in this segment. While implementation of the Affordable Care Act (ACA) and favorable demographic trends will undoubtedly boost demand for medical services, quantifying the impact on future medical office space needs has become increasingly difficult. Multiple trends muddy the forecasts, including a growing physician shortage, the proliferation of in-store clinics, telemedicine, evolution of the care delivery model and overall healthcare-industry consolidation. While these variables introduce more unknowns into the long-term outlook for the medical office sector, they have begun to factor into property-level performance and values.

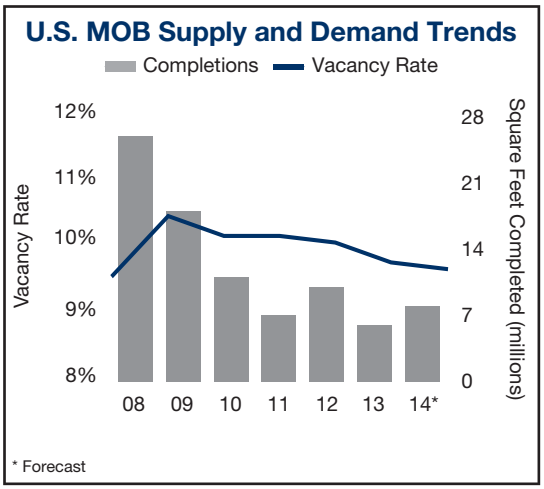
The shift toward a more consumer-centric delivery model, for example, has encouraged hospitals and health systems to bring more care into communities, mostly by way of outpatient facilities and satellite offices. These large providers tend to favor newer medical office properties, which typically offer flexible designs and incorporate features that promote efficiency and maximize space utility. Aesthetics and visibility also carry more weight in major providers' real estate decisions, as outpatient expansion brings with it tremendous opportunities for marketing and branding. To this end, the lion's share of new space demand is now being funneled into modern buildings, driving down vacancy rates and supporting above-average rents for later-vintage assets. That said, the growing involvement of hospitals and health systems in lease negotiations likely will inhibit future rent growth, as major providers often have both scale and credit working in their favor. For owners, however, landing a sizable tenant can not only reduce management costs but may also elevate property value. During the past year, medical office buildings with major hospital tenants traded for an average of nearly $270 per square foot, which reflects a roughly 40 percent premium to the overall market.

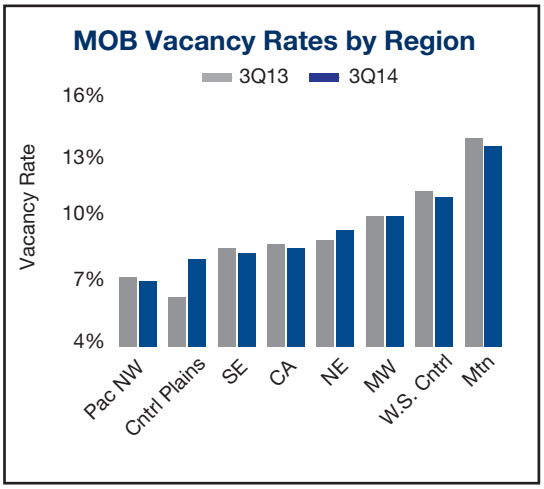
Based on the changing dynamics of the healthcare industry, early-vintage medical office properties, at least those housing multiple independent practices, appear likely to bear the brunt of tenant attrition due to industry consolidation and physician retirement. While many older multi-tenant buildings currently boast below-average vacancy, the tide may turn in the not-so-distant future. Nationwide, an estimated 45 percent of office-based physicians are over 55 years old, and many doctors who postponed retirement through the recession have started to reconsider amid recent stock market gains and looming penalties for non-compliance with meaningful use standards. An approaching wave of retirements, coupled with the growing dominance of health systems in leasing decisions, elevates rollover and re-tenanting risk for many older buildings, which likely will drive further divergence in prices and cap rate trends by property vintage.











Sources: Costar Group, Inc.

Regional definitions are available on page 4.

Construction Trends

Medical office development has become a highly specialized field. Shifts in the healthcare delivery model, public policy and technology, along with a host of other variables, will factor into the success of new buildings. With change a certainty in the healthcare sector, flexibility has emerged as a critical component of building design. New projects often feature modular layouts and furnishings that can be reconfigured to accommodate a variety of specialists or evolving space needs among existing tenants.

Aside from the form and function of medical office space, providers increasingly rely on real estate to enhance their visibility within communities and to create recognizable brands. From a marketing perspective, healthcare tenants are also favoring properties that improve the overall patient experience, be it through aesthetics, convenient parking or on-site diagnostic services. Catering to consumer preferences will only become more critical in years to come as providers compete for a share of the newly insured population.

Nationwide, developers will complete an estimated 8 million square feet of medical office space in 2014, up from approximately 6 million square feet in 2013. Similar to last year, hospitals and health systems remain the driving force behind new development — both on and off hospital campuses. Nationally, off-campus buildings account for more than three-quarters of the medical office space coming online in 2014, though multiple large on-campus projects are slated for delivery by year end. Northwestern Memorial, for example, is nearing completion on a 24-story outpatient pavilion adjacent to its downtown Chicago hospital, while University of Florida Health will soon open a 210,000-square foot facility on the campus of its North Jacksonville hospital, which is also underway.

Vacancy Trends

U.S. medical office vacancy dipped to 9.9 percent in the third quarter, which reflects a 10-basis point reduction from 12 months earlier. The tightest conditions can be found in the Pacific Northwest, where vacancy averages 7.2 percent, followed by the Central Plains, Southeast and California regions, which post vacancy rates in the low- to high-8 percent range. Mountain states report the softest conditions, with vacancy in the region averaging 13.8 percent.

At the national level, newer medical office buildings continue to capture the vast majority of new tenant demand, with expanding hospitals and health systems leading the charge. While some major providers are transforming vacant retail spaces and regional malls into clinics and one-stop healthcare shops, others are turning to late-vintage medical office properties and build-to-suit ambulatory facilities for expansion. For perspective, net absorption among properties built since 2009 reached 6.6 million square feet during the most recent 12-month period, which equates to 96 percent of the marketwide total.

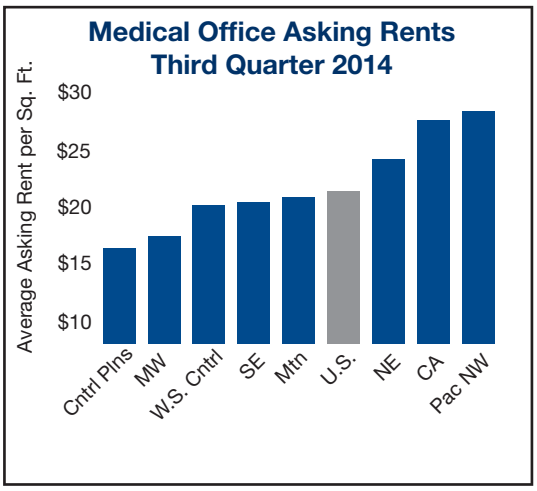
While newer medical office properties maintain a clear advantage with regard to capturing new tenant demand, there is still plenty of room in the market for earlier-vintage buildings, particularly those that are well managed and maintained. In fact, the tightest conditions, by vintage, can be found among 1990s buildings, which collectively report vacancy of 8.7 percent. That said, properties built in earlier decades generally post significantly higher vacancy rates and are more likely to soften further in years to come amid ongoing healthcare-industry consolidation and accelerating physician retirements.

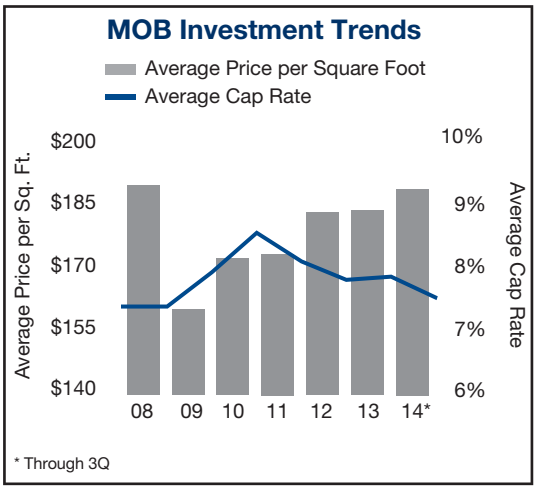
Rent Trends

Nationwide, asking rents for available medical office space averaged $22.47 per square foot in the third quarter, slightly above the year-earlier level. By region, market rents span a broad spectrum, starting at $17.80 per square foot in the Central Plains and topping out at approximately $28.95 per square foot in the Pacific Northwest. At the metro level, San Francisco, New York and Seattle boast the highest rents, with averages between $33.60 and $39.70 per square foot. Aside from Austin, where asking rates average $31.55 per square foot, most of the other higher-rent metros are located on the East and West Coasts. The most affordable rents, on the other hand, can be found in Milwaukee, Pittsburgh and Salt Lake City, where averages range from $15.35 to $17.15 per square foot.

Even within individual metros, rents run the gamut based on location, property quality and vintage. While the age of a building, in and of itself, may not be central to tenants' leasing decisions, it has become a relatively reliable indicator of an asset's desirability. Newer medical buildings, for example, tend to offer features most coveted by today's healthcare providers, such as flexible floorplans, energy-saving designs and systems, and the digital infrastructure necessary to fully integrate technology into their operations. Not surprisingly, later-vintage assets generally command premiums. Rents for properties constructed within the past five years average $27.00 per square foot, which is 35 percent above the average for 1970s-vintage buildings.

Several variables unique to healthcare play into medical office rent trends. When an insurer eliminates coverage for a specific medical treatment, for example, patient demand tends to slide, thereby reducing providers' revenues and affecting their ability to make rent. Third-party payer reimbursements also factor into the equation. In addition, health systems, which can often leverage credit-quality and outsized space needs in rent negotiations, are involved in a growing share of leasing decisions. From an owner's perspective, leasing a sizable share of a building to a single high-credit tenant versus multiple small providers not only lowers management costs but can also elevate the value of a property itself.



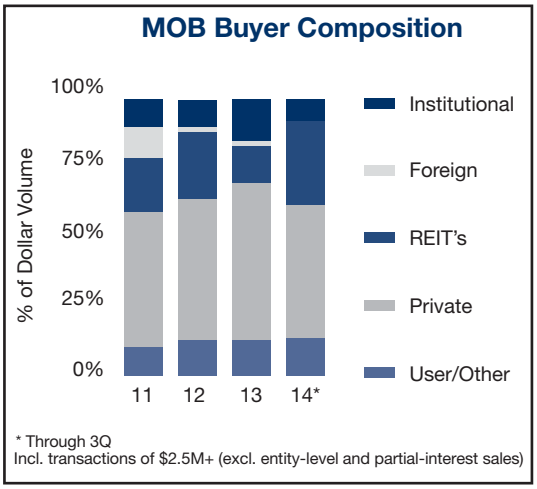


Investment Trends

Through the first nine months of 2014, sales velocity was up 15 percent when compared with the same period of 2013. By region, the Southeast and Midwest continue to account for the most sales, though California and Texas remain the most active states. Overall, property prices increased 4.5 percent through the third quarter to an average of $192 per square foot, which aligns closely to the 2007 level.

Year to date, cap rates have slipped to approximately 7.6 percent, which is within 20 basis points of the pre-recession average. Cap rate compression in recent quarters can be attributed in part to the favorable lending climate and more crowded buyer pool, but also reflects healthcare industry consolidation. Hospital and health system mergers and acquisitions, and overall expansion, have effectively raised the credit characteristics of the U.S. medical office sector, drawing more REIT and institutional capital into the space. Year to date, REITs accounted for 30 percent of total dollar volume, more than twice their share in 2013.

In recent quarters, cap rates for on-campus properties with credit tenants hovered in the mid-6 to mid-7 percent range, while similar-credit off-campus assets traded roughly 30 to 40 basis points higher. Cap rates for buildings lacking credit tenants, on the other hand, were concentrated between 7.0 and 8.5 percent.



Sources: Costar Group, Inc. Real Capital Analytics.

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Capital Markets

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

- According to the minutes of the most recent FOMC meeting, the Fed will cease asset purchases associated with the third round of quantitative easing in October this year. The tapering was announced in late 2013 and commenced in January. Healthy economic indicators encouraged the Fed to pare $10 billion in asset purchases during each meeting thus far in 2014. Employment reached pre-recession levels in the second quarter and the unemployment rate has fallen into the low-6 percent range.

- Lenders are aggressively pursuing medical office deals, encouraged by expectations for sizable growth in healthcare demand. In addition to favorable demographics and expanded insurance coverage, optimism also stems from healthcare-industry consolidation, as hospital system mergers and acquisitions are effectively elevating the credit characteristics of the property sector itself.

- Mortgage originations by portfolio lenders were up 95 percent in the second quarter when compared with the same period in 2013. On average, portfolio lenders are quoting 10-year medical office loans at all-in rates between 4.4 to 5.25 percent, depending on the strength of borrower, property location and tenants' credit quality. LTVs generally fall between 70 and 75 percent.

- In the CMBS sector, the number of medical office loans originated to date in 2014 already exceeds the overall 2013 total by 50 percent. Elevated competition among conduit lenders has compressed long-term spreads, which are down an estimated 45 basis points from a year ago. Depending on strength of the sponsor and credit quality of a deal, conduit lenders are originating loans at all-in rates between 4.5 and 5.25 percent, with LTVs topping out at 75 percent.

Recent Marcus & Millichap Transactions

Property Name	City, State	Sq. Ft.	Sales Price	$/Sq. Ft.
Dermatology Assoc. of Wis. Portfolio	Northeast WI	88,114	$28,339,280	$322
Arrowhead Health Center	Scottsdale, AZ	11,272	$4,500,000	$399
Brentwood Medical Plaza	Brentwood, CA	51,599	$16,000,000	$310
Latham Professional Office Plaza	Riverside, CA	31,201	$6,150,000	$197
Central PA Medical Portfolio	Carlisle, PA	125,685	$21,750,000	$173
Mill Valley Medical Office Building	Marysville, OH	10,000	$2,640,000	$264
Somerset Park	Las Vegas, NV	51,646	$7,800,000	$151
Lakeshore 20th Street Medical	Milwaukee, WI	25,466	$5,953,000	$234
Brookshire Medical Building	Downey, CA	56,121	$11,300,000	$201
Berwyn Medical Center	Berwyn, IL	42,779	$11,000,000	$257
Fridley Medical Center	Fridley, MN	60,476	$19,845,000	$328
The Renaissance Surgery Center	Oshkosh, WI	24,622	$8,500,000	$345
Alvarado Medical Plaza I & II	San Diego, CA	107,330	$14,250,000	$133

Rent, Vacancy and Construction averages/totals based on properties of 20,000 square feet or more. Sales figures based on properties with a minimum of 10,000 square feet that traded for $1 million or more. Comparisons to previous reports may not align due to data revisions and periodic re-benchmarking.

Regional Definitions:
U.S.: 50 states, D.C. | *California: CA* | *Central Plains (Cntrl Plains): KS, ND, NE, SD* |
Midwest (MW): IA, IL, IN, MI, MN, MO, OH, WI | *Mountain (Mtn): AZ, CO, ID, MT, NM, NV, UT, WY*
Pacific Northwest (Pac NW): OR, WA | *Southeast (SE): AL, FL, GA, KY, MS, NC, SC, TN, VA, WV*
West South Central (W.S. Cntrl): AR, LA, OK, TX | *Northeast (NE): CT, DC, DE, MA, MD, ME, NH, NJ, NY, PA, RI, VT*

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Sources: Marcus & Millichap Research Services, AAMC, Bureau of Labor Statistics, CBO, CoStar Group, Inc., Economy.com, Real Capital Analytics, U.S. Census Bureau.

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