HEALTHCARE REAL ESTATE TRENDS OF 2011

By Beth Young and Henry Hagendorf

A recent survey of 125 investors, developers, appraisers, brokers and architects from across 25 states provided plenty of information about what the users of healthcare real estate see happening in the market. Numerous subjects were covered, and following is a summary.

Expansion Plans

When asked, "Is your healthcare system actively pursing the development of Outpatient Controlled Cost Clinics, "Accountable Care Organizations (ACO's)" or "Federally Qualified (FQ's)" Clinics, 64.4 percent said yes, with almost half of those projecting the square footage (SF) of the clinics to be 15,000 SF or more. Nearly 90 percent are currently working on acquiring other healthcare systems with most seeking to close down the existing hospitals of the acquired healthcare system and relocate the patient volume to the existing campuses of the acquiring healthcare system.

Acquistions – Market Observations

Two thirds of those surveyed see the market as a great time to buy healthcare real estate in the next year, while others plan to hold what they've got or sell some properties. Those that plan to buy are divided about the dollar amounts of transaction volume they expect to see: 35 percent project their transaction volume to be below $10 million and another 35 percent expect it to be between $10 and $50 million. The rest expect to spend at least $50 to $150 million. A large percentage of owners, 45 percent, believe their properties' values will stabilize this year, while 34 percent believe they will still lose value, and 22 percent believe the values will increase.

On-Campus Stability

When a healthcare system sells a medical property but continues to lease and occupy the space from the new owner, the lease term is typically 10-15 years. Medical office buildings (MOB's) that are located on the campus of the hospital are top choices for investors because the buildings typically benefit from the highest occupancies and very stable tenants. Over half of on-campus MOB's are full or nearly fully leased, and another 36 percent are somewhere between 76 and 90 percent occupied.

Prospect Management

Organizations that own healthcare real estate usually choose to manage the portfolio of properties "in-house". Occasionally an owner may let third-party managers watch over a few select properties. Two thirds of the owners have already made or are in the process of making electronic medical records a factor in their medical office portfolio.

Financing Property Purchases

For those investors who will purchase properties this year, 40.2 percent will use bank debt as a way of structuring the new acquisitions. Cash from funds on their balance sheets will be used by 22 percent; and 14 percent will use a revolving line of credit. Some other sources of financing include private equity, life companies, capital partnering, reserves, insurance companies, pension funds, tax exempt bonds, and institutional lenders.

Office Space Construction

Tenant-improvement allowances for new leases vary widely from new construction to second generation space for MOB's. For on-campus (on the hospital campus) medical office buildings, on average, for leases in new construction or core and shell space, 32 percent of respondents offered between $40-$50 per square foot for tenant improvements for the leased office space. Interestingly, more than half of the owners of similar buildings that are off-campus will also provide between $40 and $50 per square foot for tenant improvement

High-Demand Uses
Currently most demand for medical office space is coming from General/Family Practice, followed by Oncology, Urgent Care, Cardiology, Women's Care, Surgeons, Pediatrics, Dental/Orthodontists, Urology and Dermatology, in that order.

Medical Property Cap Rates
Regarding both on-campus and off-campus MOB assets with single-tenant lessee scenarios, respondents to the survey perceive the current national healthcare real estate market cap rate values to be between 7.0 and 7.5 percent if the tenant is a stronger-than-average healthcare system. If there are multiple tenants, but still stronger-than-average healthcare systems as tenants, the cap rate range increases to between 6.5 and 8.5 percent, with the lower rates applying to the on-campus buildings with the strongest tenants.

For buildings that are off-campus in secondary markets with stronger-than-average multi-tenant physician lessees, cap rates are typically between 8.0 and 8.5 percent.

When looking at asset types, the current national healthcare real estate market cap rate values are mostly between 8.0 and 8.5 percent for long term acute care hospitals, specialty hospitals, rehab hospitals, assisted living, skilled nursing, and memory care. Only acute care hospitals are seeing lower cap rates.

New Development Pre-Leasing Requirements
For new developments, 42 percent of respondents said they require, along with their lender or joint venture partner, at least 60-80 percent pre-leasing before a building can be opened for business. Only 35 percent required 40-60 percent pre-leasing.

Influences on Healthcare Real Estate
The Healthcare Reform Bill ranked #1 as having the largest impact on the Healthcare Real Estate Investment Market in 2011. Unaffiliated physicians trending towards affiliation has had the second largest impact on the healthcare real estate investment market this year. Acquisition activity of healthcare REITs came in at third; and the lack of effective development financing was ranked fourth.

Other Factors included:
• Functional change of MOB's & suite configurations
• State budget cutbacks
• Over supply of investors and developers
• Acquisition activity from many types of buyers
• Demand for additional mixed use multi-purpose adult healthcare facilities
• Health System mergers and acquisitions
• Overall reimbursement rates from both Medicare/Medicaid and Commercial Payers

With Baby Boomers providing a whole new patient population at the rate of 10,000 patients turning 65 each day, and all age groups increasing the number of times they visit a doctor each year, the demand drivers for healthcare properties are very favorable over the next decade. Also boding well for the healthcare sector is the fact that the 65 and older Americans of the future are likely to be better educated and wealthier than the current population of senior citizens. As a result, they are more likely to access medical services and to do so even more frequently.
Survey Source: Grubb & Ellis Healthcare Properties Group