

## Medicine For An Ailing Office Property Market Medical Office and Healthcare Properties

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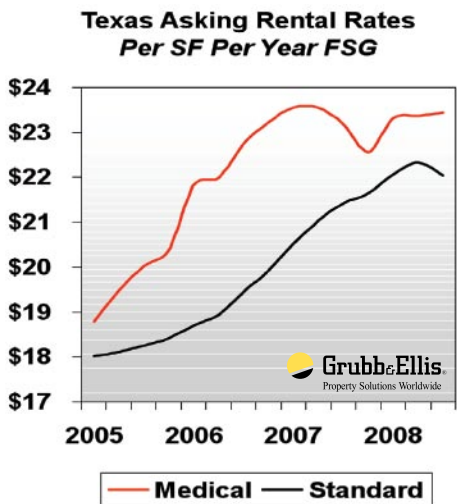
As we plot our course for 2009 and ponder the uncertainty of local, national and international economic woes, it is very difficult to find the bright spot that signals a safe harbor for commercial real estate investments. The sure bets of the past are not so sure today because the businesses that created rent roll and cash flow value are plagued by the trickle-down effects that we all feel, both in our business and personal arenas. One can certainly identify with, and personally experience, the feeling that "the sky is falling" as did Chicken Little in the famed children's fable. At least we now know that the "bubble" that we constantly heard about and questioned did have a breaking point and has officially burst.

Although very few healthy areas are apparent in the near chronic real estate market, the healthcare industry and its underlying commercial real estate offer a seemingly strong, fundamentally sound investment vehicle for many investors. We have all heard references to the Medical Office Building (MOB) segment of commercial real estate; however, the medical property market includes other aspects of the medical industry. In addition to the investment opportunities in the MOB segment, other medical properties for investment consideration include surgery centers, specialty diagnostic facilities, research facilities, rehab and skilled nursing facilities, hospitals and assisted living/senior housing. If there is a recession-proof commercial real estate investment, it may be healthcare related, mainly because of the current, and more profound, future demand for medical services because of the aging of the American population. The 65 and over age group will grow by 36 percent between 2010 and 2020 compared with nine percent for the general population. The size of the healthcare properties is estimated at between \$700 and \$750 billion, about half the size of the U.S. office market. Traditionally, vacancy in medical office is lower than standard office vacancies. This gap will likely get wider with what we now know about the slippage in the economy. This has also been the case in capitalization rates as well - lower cap rates for medical vs. standard office space. In Houston cap rates had declined since 2004 (9% to a 7% average) until recently when, like other commercial real estate investments, they have increased to a current average of approximately 8%. The popular opinion seems to be that MOB cap rates will continue to rise; however, they should remain lower than non-medical office space.

In Houston we are all witnesses to the continued new medical developments in the Texas Medical Center (TMC) and along our major freeways. The rapid growth in the suburban areas has been created in response to strong demands for close-by medical services spurring large scale MOB, hospital and other healthcare property development. In addition to the suburban population growth, advancements in patient care allowing more in-office procedures have driven demand for MOB construction.

According to published materials from the Texas Medical Center, the complex is experiencing the largest amount of construction in TMC history. There is more construction at TMC than the rest of Houston combined. Over half the construction cranes in Houston are within the boundaries of the TMC. From the end of 2007, the TMC reports that current and planned development through

2014 will add approximately 18 million gross square feet (over 20 million sq. ft. including parking), growing the TMC to 40 million square feet. That is a city in itself. The projected cost of all new construction and infrastructure is approximately \$7 billion. When you add in the other new medical development



in the greater Houston area, you can be assured that the construction industry has a huge pipeline of work for the next several years. If there is a recession proof industry, it may be the construction related to the medical healthcare industry. With job losses in the millions throughout the United States, the healthcare industry is expected to have positive job growth throughout 2009.

The foundation and fundamentals for healthcare properties seems rock solid, at least compared to other commercial real estate investments. The demand drives for healthcare properties seem sustainable and include:

- **Aging Americans:** According to the U.S. Census Bureau every 11 seconds another American turns 60. The first baby boomers will turn 65 in 2011 beginning the swell of the senior population. Currently there are approximately 37 million Americans over the age of 65. This is expected to increase to 55 million by 2020. The over-65 population as a percentage of the total population is also expected to grow faster than the total population in every state. The math is simple - more aged Americans, more doctors visits. More doctors' visits,

the need for more doctors. More doctors, the need for more facilities. Seems to be a self fulfilling, and sure fire strategy.

- **Where Do Seniors Live:** Three states, Texas, Florida and California, will account for nearly 45% of the total U.S. population between 2000 and 2030. These three states will have the largest senior citizen populations also as they grow. This trend in itself gives tremendous credibility to the sustained healthcare growth requirements in our state and in every major metro-area. Texas, Florida and Illinois accounted for one-third of all U.S. healthcare construction starts in 2007.

- **Life Expectancy:** Up and climbing. The U.S. Census Bureau reports that average life expectancy is 77, up from 47 in 1900. By 2010 they project that there will be over six million people over 85, an increase of 43% since 2000. If all else fails, this trend alone feeds the doctor visit, treatment and hospital-stay pipeline.

- **Wealthier Aging Group:** The future senior citizen population is going to be wealthier and more educated than the current senior citizen population. As a result they are more likely to seek medical services more frequently.

- **Increased Physician Visits:** The youngest and the oldest age groups have the highest annual rates of physician visits according to National Ambulatory Medical Care Survey.

- **Decentralization:** The trend has shifted from centralized inpatient hospital services to a more decentralized model where treatment and outpatient surgery is done in the doctor's office or non-hospital medical centers. Tenants of medical office buildings now include diagnostic imaging centers, ambulatory surgery centers and urgent care centers.

Medical office is one of the most popular investment vehicles for investors. This asset class offers several advantages over traditional office buildings, including higher occupancies, lower tenant turnover and longer term leases. Typically medical office building vacancy and rental rates do not fluctuate up and down as much with fluctuations as the economy. Rental rates are generally higher also because of the higher cost of medical-tenant improvements.

In conclusion, based on the current office building market conditions and the inherent stabilizing forces of the medical property market, medical office buildings and other types of medical properties are in a position to better weather soft economic conditions due to the recession-resistant, non-cyclical nature of demand for healthcare services. The healthcare property sector will surely be negatively affected by current economic conditions. How bad and how deep is yet to be determined. Lack of financing options, increased equity requirements and tighter credit terms will have a big impact; however, one cannot deny the huge pipeline of current and future customers for medical providers. If there is a sure thing, this business model is it.



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