Medical Office Research

2017 Outlook

Generational Differences Driving Growth, Advancement in Today's Medical Office Market

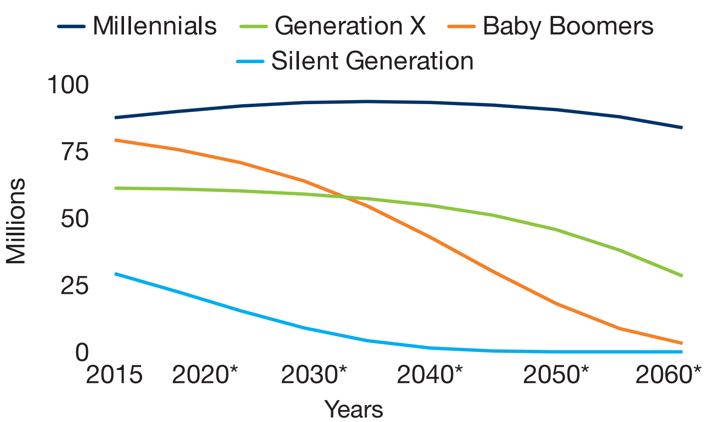
Generational cohorts create diverging trends in healthcare. The aging U.S. population, combined with emerging differences in the way generations process healthcare information, have been significant drivers in the nation's healthcare industry. As the 65-and-older age segment increases by 20 million individuals over the next 10 years, demand for healthcare services will rise. While the baby boomer generation has a huge impact on the current growth of the healthcare industry, the millennial generation, which has surpassed the baby boomers in size, is driving a major shift in the care delivery model and the way they approach, research and resolve issues.

- Technological advances as well as the ability to search online for doctors, research treatment options and use web-based diagnostic and health tracking tools are placing a wealth of knowledge and information about personal healthcare into the hands of the patient.
- Millennial and future generations will further drive an emerging trend in the revitalization of healthcare, preferring quick access to physicians and more transparency from providers and insurance companies regarding coverage and costs.
- Urgent/acute care centers, retail clinics (walk-in centers often located in pharmacies and grocery stores) and stand-alone emergency departments are replacing primary care physicians and hospital emergency rooms as this generation strives for more efficient and affordable healthcare options.

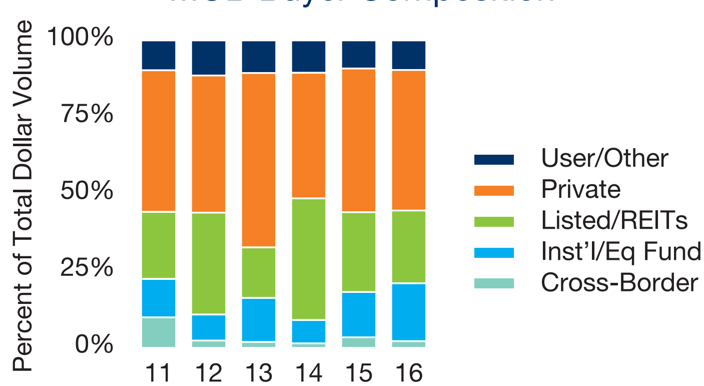
Strong demographic trends support growing industry, remain driver in investment activity this year. Institutional funds and REITs are actively searching for larger deals and portfolios. Private capital is emerging as a major option in the $5 million to $20 million price tranche and could begin to take a larger share of transactions this year. A rise in crossover capital is also increasing competition for medical office properties as single-tenant retail investors target similar investment opportunities in this segment for higher yields. For-sale inventory is limited as medical office assets are in high demand with cap rates compressing over the past several years.

- On-campus medical office buildings command premium cap rates, trading at sub-6 percent initial yields for single-tenant properties, while multi-tenant buildings draw first-year returns in the mid-6 to low-7 percent range.
- Off-campus medical office properties with strong tenancy, which often include a healthcare system and long remaining lease terms, are in high demand. These properties fetch initial returns in the mid-6 percent area.
- Yields on other off-campus medical assets, including those in need of repositioning or located in secondary or tertiary markets, can trade up to 200 basis points higher. Factors such as quality, location, deferred maintenance and tenancy have an impact on returns for these assets.

Population by Generation



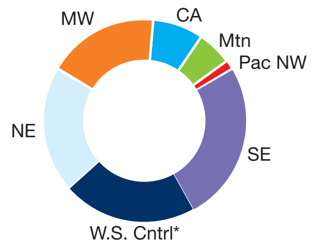
MOB Buyer Composition



Based on trans. of $2.5M+ (excludes entity-level and partial-interest sales)

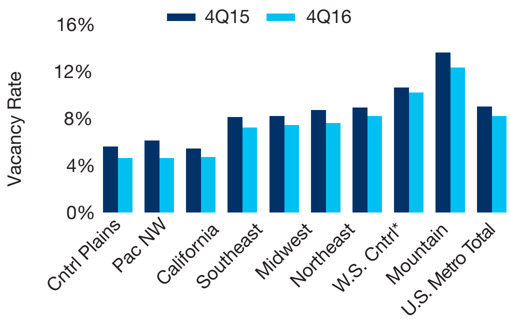
* Forecast
Based on age groups from the U.S. Census Bureau: Millennials (born between 1981 and 2000); Generation X (born between 1966 and 1980); Baby Boomers (born between 1946 and 1965); Silent Generation (born between 1926 and 1945)
Sources: U.S. Census Bureau, Real Capital Analytics

2016 MOB Completions By U.S. Region

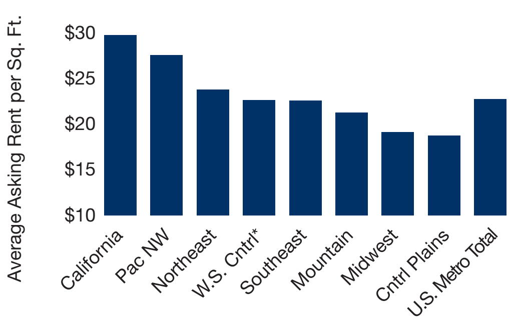


Regional shares based on preliminary U.S. total of 7.5 million square feet. No recorded deliveries in Central Plains.

Medical Office Vacancy Rates



2016 Medical Office Asking Rents



* West South Central

As healthcare industry evolves, so do office design and building amenities. The impact of an aging population and generational drivers on the design of medical office space has been realized in recent years as builders conform to the standards of a patient-centered approach to healthcare and advances in technology. Large healthcare providers are acquiring and expanding services off campus and closer to residential areas, providing patients easier access to care.

- This has prompted the development of ambulatory surgery centers, stand-alone emergency rooms and large multi-tenant medical office buildings.
- As the way people seek medical care and how they approach changes, developers must keep up by offering flexible floorplates, convenient locations and amenities such as lean design, up-to-date technology, and green building features.
- Last year, medical office builders completed 7.5 million square feet of space, concentrating on markets located in the Southeast and West South Central regions. Approximately 50 percent of last year's deliveries were located in the southern United States.

Absorption concentrated in newer properties with modern amenities and flexible design. The combination of reduced deliveries since the recession and strong demand from providers seeking space in recently completed medical office buildings has concentrated absorption in properties constructed since 2000. Vacancy at these properties has fallen more than 500 basis points since 2010, and constricting vacancy in these buildings will drive additional deliveries over the next several years.

- With the majority of space demand channeling into newly built properties, older-vintage assets will bear the brunt of attrition as private physicians retire and private practices are acquired and consolidated into hospital systems preferring newer buildings.
- Vacancy has been flat over the past few years for properties built before the 1980s, but a significant number of assets built during this time are trading as investors seek opportunities to create value. Updated buildings will attract tenants in search of more modern amenities in areas closer to hospitals or medical office campuses.
- Strengthened demand for medical office space during 2016 pushed down vacancy 80 basis points, ending the year at 8.2 percent, the lowest rate in the past 10 years. The Central Plains region realized the strongest decline in vacancy, tumbling 150 basis points to 4.6 percent and boasting the tightest regional vacancy rate in the country.

Rent advances persist, but growth restrained by changes in healthcare landscape. Hospital acquisitions of private practices and the move of outpatient services away from campuses and closer to where patients live and work are placing major medical providers in control of a large share of leasing activity. As a result, overall rent gains are trekking along at a modest and steady pace.

- Despite space demand funneling into newer-vintage buildings, advances in marketed rent for these properties has ticked up just 0.6 percent since 2010.
- Rent for buildings constructed prior to 2000 has produced the strongest gains, rising nearly 3.5 percent over the past six years.
- Overall, medical office rent advanced 0.4 percent during 2016, reaching $22.74 per square foot at the end of the year. The strongest increases recorded during the annual time frame occurred in the California and Mountain regions, advancing 1.3 percent and 1.2 percent, respectively. Just two regions, the Pacific Northwest and West South Central, realized declines over the 12-month period.

Healthcare Delivery Model

Is Shifting From the Primary Care Physician (PCP) to the Patient

1995 PRIMARY CARE

Patient Discovers Issue → Visit PCP → Might be Sent to Hospital or Specialist → Issue Resolution

2015 SPEEDY DELIVERY

Patient Discovers Issue → Online Research → Decision Evaluation → Issue Resolution

Feedback Loop

Consults with one or more providers:
PCP, ER, Masseuse, Retail Clinic, Nurse Practitioner, Physical Therapist Cardiologist, Dermatologist, Gynecologist

Use Online Reviews* (e.g. Yelp, Healthgrades)

48% Millennials
40% Baby Boomers
28% Seniors

Millennials Quickly Embrace Retail & Acute Care Clinics

	Acute Care Clinics**	Retail**	Primary Care Physicians**
Millennials	25%	34%	61%
Boomers	14%	17%	80%
Seniors	11%	15%	85%

* Last time the respondent searched for a provider

** Based on a survey of 5,092 adults.
Participants had option to select one or more providers.
Source: PNC Healthcare, Patients Take the Wheel Strategic Research

2017 Medical Office Building Forecast

8.5 million square feet

Construction:
Completions rise from last year as more than 8.5 million square feet of medical office space is underway and slated for completion in 2017. Developers' focus is shifting from Southern states, and the Midwest will lead deliveries this year as approximately 2.1 million square feet is scheduled to come online in this region.

40 basis point decline

Vacancy:
Strong absorption trends push down the medical office vacancy rate to 7.8 percent this year. Minimal supply additions in the Pacific Northwest and Central Plains regions over 2017 keep vacancy tightest in these areas, ranging from the mid- to high-4 percent area through the year. Vigorous demand facilitated an 80-basis-point decline in overall vacancy last year.

0.3% increase

Asking Rent:
A modest uptick in rent this year will match that of 2016 as the average advances to $22.81 per square foot by year-end. West Coast markets, including those in California and up through the Pacific Northwest, command some of the highest rental rates in the country, with the California region producing low single-digit gains over the past four years.

Capital Markets

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

- Trends that emerged at the end of last year will carry forward into 2017 and impact financing of medical office properties. An increase in the yield on the 10-year U.S. Treasury following the election is encouraging many borrowers to reassess pricing and potential returns. Additional upward pressure on long-term rates could limit the extent of additional price increases and place upward pressure on cap rates. Whether investors are seeking to acquire assets or refinance in the next several months, lenders will likely resist overextending leverage and will maintain debt coverage ratios at a minimum of 1.25X.
- National banks are the most active lenders across the medical office segment, providing financing for both private parties and large institutions. Leverage for medical office assets ranges up to 75 percent with interest rates hovering between 3.75 percent and 4.5 percent depending on terms, strength of borrower, property location and tenancy. Community and regional banks are more flexible, providing creative financing options for local borrowers or familiar assets.
- Financing through life insurance companies will continue to be an option for those investors less concerned about leverage, looking for flexible options and longer terms. CMBS originations, in particular, are lagging behind other capital sources because of rigid structures including borrowing entities, prepayment penalties and warm body carve-outs to name a few. Life insurance companies prefer to lend on high-quality, trophy medical assets to borrowers who intend to hold for extended periods.

2016 Marcus & Millichap Transactions

Property Name	City, State	Sq. Ft.	Sales Price	$/ Sq. Ft.
Baltimore VA Annex	Baltimore, MD	68,121	$12,250,000	$180
Sunset Medical	Miami, FL	35,002	$11,800,000	$337
Forsyth Professional Centre	Forsyth, IL	40,325	$11,148,000	$276
Lake Lurna Professional Center	Orlando, FL	45,000	$10,682,000	$237
Foxhill Medical	Overland Park, KS	52,160	$9,000,000	$173
North Central Federal Clinic	San Antonio, TX	34,500	$8,378,210	$243
Morristown Medical Arts Center	Morristown, NJ	36,317	$8,350,000	$230
UnitedHealth Group Building	Vista, CA	16,486	$7,250,000	$440
Orchard View Medical Complex	Washington, MI	45,207	$6,900,000	$153
Parkway Professional Center	Lakeland, FL	40,000	$6,750,000	$169
Medical Office - Value Add or Development	Reseda, CA	31,085	$6,000,000	$193
Avalon Business Park	Granbury, TX	21,386	$5,692,500	$266

Sources: Marcus & Millichap Research Services, MNet

Healthcare Real Estate Group

Alan Pontius
Senior Vice President | National Director Specialty Divisions
Tel: (415) 963-3000 | al.pontius@marcusmillichap.com

Prepared and edited by

Jessica Hill
Market Analyst | Research Services

For information on national medical office trends, contact:

John Chang
First Vice President | Research Services
Tel: (602) 687-6700 | john.chang@marcusmillichap.com

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