

GREATER PHOENIX | MEDICAL OFFICE

4Q 2017

Accelerating success.

Medical Office Vacancy Dips to a 10-Year Low

Key Takeaways

- > The Greater Phoenix medical office market improved at the end of 2017, posting robust levels of net absorption during the fourth quarter. This drove the local vacancy rate to a 10-year low and resulted in modest rent growth.
- > Vacancy in medical office buildings fell by more than 100 basis points in the fourth quarter, ending the year at 14.7 percent. Vacancy in medical office buildings has been on the decline in each of the past eight years.
- > Rents inched higher to close the year, reaching \$23.00 per square foot. Asking rents ticked up 1.3 percent in 2017, similar to annual gains that have been recorded each year since 2014.
- > The improvement in property fundamentals has been slow to translate to investment activity. Sales prices have been rising even as the number of properties changing hands cooled in 2017. Cap rates for investment properties compressed to about 7 percent in the past year.

Greater Phoenix Medical Office Market

The Greater Phoenix medical office market closed 2017 in strong form, with the local vacancy rate reaching a 10-year low. Vacancy in local medical office buildings dipped below 15 percent in the fourth quarter, ending the year at 14.7 percent, identical to the rate at year-end 2007. The vacancy rate was driven lower by healthy levels of tenant demand. Net absorption during the fourth quarter topped 245,000 square feet, the strongest single quarter since 2007.

While market fundamentals are improving, fewer medical office properties sold in 2017 than in the preceding year. This is likely a short-term dip in activity levels, and it is likely that sales velocity could gain momentum in the year ahead, particularly if the tenant demand recorded in the second half of 2017 is repeated in the coming quarters.

Market Indicators Relative to prior period	Market Q4 2017	Market Q4 2016
Vacancy	↓	↓
On-Campus Vacancy	↓	↓
Completions	↑	↑
Net Absorption	↑	↑
On-Campus Net Absorption	↑	↑
Asking Rents	↑	↑

Fourth Quarter Employment Trends*

Total Nonfarm Phoenix Metro	↓	↓
Healthcare Employment Phoenix Metro	↑	↔
Total Nonfarm United States	↑	↓
Healthcare Employment United States	↑	↓

*Source: Bureau of Labor Statistics

Summary Statistics	Phoenix MOB Market	On-Campus MOB	Off-Campus MOB
Vacancy Rate	14.7%	16.8%	13.9%
Change from Q4 2016 (bps)	-80	-110	-70
Net Absorption (thousands SF)	245.4	24.0	221.4
New Construction (thousands SF)	59.4	-	59.4
Under Construction (thousands SF)	125	125	-
Asking Rents Per Square Foot Per Year	\$23.00	\$24.90	\$22.10
Change from Q4 2016	1.3%	-2.1%	2.6%

Vacancy:

- > The vacancy rate in Greater Phoenix medical office buildings fell 110 basis points from the third quarter to the fourth quarter, ending the year at 14.7 percent. This is the greatest quarterly vacancy decline in more than five years. For the year, vacancy dropped 80 basis points, the eighth consecutive year where medical office vacancy has improved.
- > Vacancy in on-campus buildings ended 2017 at 16.8 percent, 110 basis points lower than one year ago. The rate declined by 40 basis points during the fourth quarter, the third straight quarter of improvement.
- > The vacancy rate in off-campus medical office buildings fell 130 basis points during the fourth quarter, dipping to 13.9 percent. The rate fell by 70 basis points in 2017, following a decline of 230 basis points in 2016. This is the lowest vacancy rate in off-campus buildings since 2007.

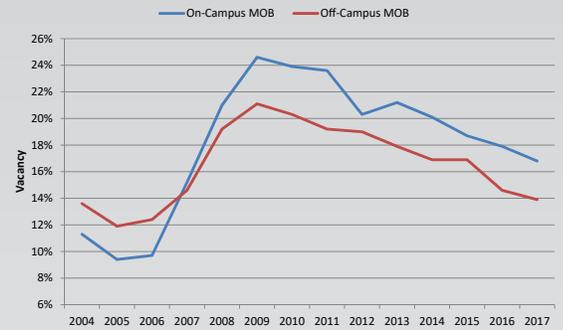
Rents:

- > After a dip during the third quarter, medical office rents rose to close the year. Asking rents ended 2017 at \$23.00 per square foot, 1.3 percent higher than one year ago. Rents have increased in each of the past four years, although gains have averaged just 1.2 percent per year.
- > Asking rents in on-campus buildings dropped in the fourth quarter, ending the year at \$24.90 per square foot. Rents in on-campus buildings retreated by 2.1 percent in 2017, following slight upticks in both 2015 and 2016.
- > Rents in off-campus medical buildings rose in the fourth quarter, reaching \$22.10 per square foot, up 2.6 percent in 2017. While rent growth was modest throughout much of the Greater Phoenix area, off-campus buildings in the Midtown submarket, where vacancy rates are low, posted strong rent increases in 2017.

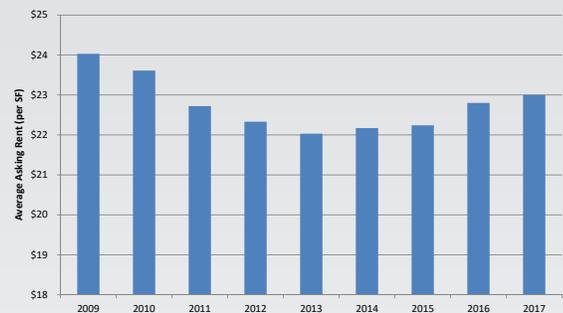
Investment Trends:

- > Sales of medical office condos were flat from the third quarter to the fourth quarter. The pace of sales velocity slowed during the second half of the year, and total transaction activity in 2017 lagged 2016 levels by more than 25 percent.
- > While fewer medical office condos are selling, prices are still trending higher. The median price during the fourth quarter topped \$200 per square foot, and for the year, the median price was \$181 per square foot, up 8 percent from the 2016 median price.
- > In 2017, there was a general slowing in the sales of traditional, non-condo medical office buildings. Sales of these properties slowed by nearly 30 percent from 2016 to 2017, including a decline of more than 20 percent from the third quarter to the fourth quarter.
- > Prices rose in the fourth quarter, with the median price spiking to \$225 per square foot. The median price in 2017 advanced 17 percent, reaching \$153 per square foot. Cap rates compressed to an average of approximately 7 percent in 2017, 100 basis points lower than one year earlier.

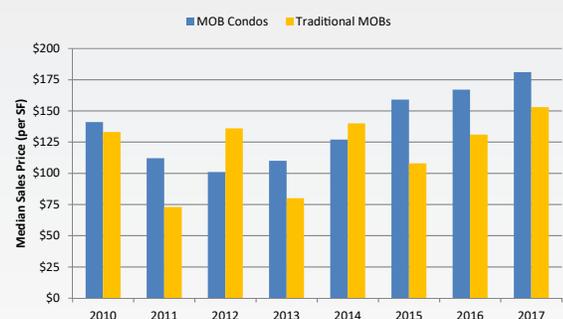
Vacancy Trends



Asking Rents Trends



Investment Trends

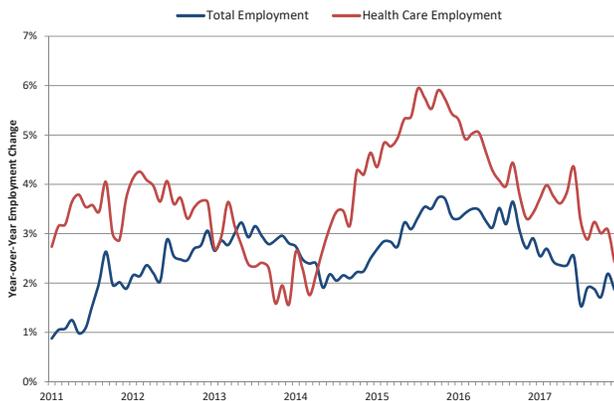


Outlook:

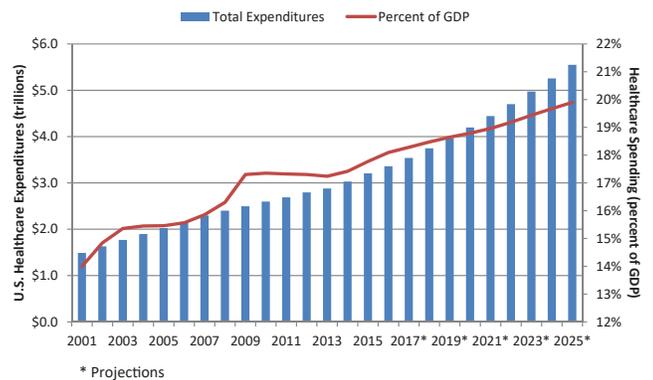
The strong net absorption displayed at the end of 2017 brightens the outlook for the Greater Phoenix medical office market in the year ahead. While the market has experienced strong tenant demand during the past two years, new development has been modest, and this trend is forecast to continue in 2018. While there are a number of proposed medical office projects in the development pipeline, deliveries for 2018 will be minimal, which should allow for at least one more year of vacancy tightening in the local medical office market. With vacancies tightening, rents should edge higher for a fifth consecutive year.

To this point in the cycle, rent growth has been very slow to gain momentum. Historically, the strongest rent growth in the local medical office market has occurred when vacancy was in the 12-15 percent range and when development was active. The combined impact of lower vacancies and the introduction of newer, more expensive buildings fueled annual rent growth in the 5-7 percent range during the last expansion cycle. In the year ahead, the vacancy rate will be in the range that has traditionally sparked rent growth, but new construction will be limited. Current forecasts call for rent growth in the medical office sector of approximately 3 percent in 2018.

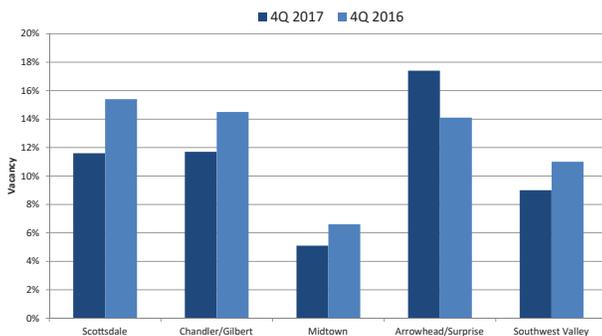
Greater Phoenix Employment Trends



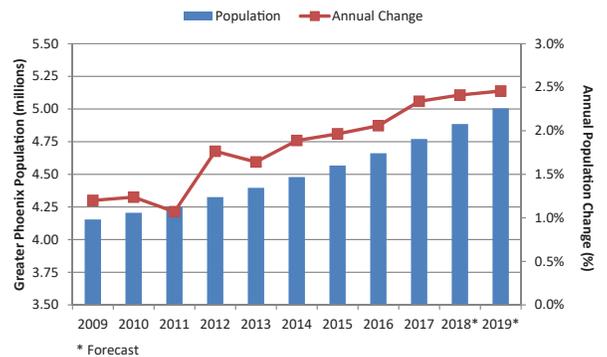
U.S. Healthcare Expenditures



Greater Phoenix MOB Vacancy by Submarket



Greater Phoenix Population Trends



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