Colliers INTERNATIONAL

Accelerating success.

U.S. Research Report

2019 HEALTHCARE MARKETPLACE

Investors Remain Bullish as Technology, Consumerization and Mergers Further Transform the Healthcare Landscape

Context & Outlook

- Healthcare real estate fundamentals remain healthy
- Construction is increasingly focused off-campus
- Sales volume and investor interest continue to be strong
- Healthcare assets offer stability and portfolio diversification
- Major policy changes are unlikely ahead of the 2020 election
- Profitability and costs remain a central concern for healthcare providers, including real estate overheads
- The drive to retail locations reflects the rising competition between operators
- Consumers seek convenience and flexibility as illustrated by the rise of telehealth
- Mega-mergers are a key disruptor to health systems and are set to continue
- New assets in optimal locations and expected to out-perform
- MOB properties need to be flexible to respond to the pace of change in the healthcare industry
- The credit strength of healthcare tenants should be closely monitored
- Health facilities in low-population rural areas are declining

Market fundamentals show that the U.S. Healthcare real estate sector remains on solid footing. The national vacancy rate for medical office buildings (MOBs) held virtually flat after 2017's all-time low, even though 20.9 million square feet of new medical office space was delivered in 2018. Pricing and capitalization rates (cap rates) held firm in 2018, while MOB rental growth in 2018 was the highest on record.

Construction and investor demand remain weighted toward off-campus assets. This is partly due to lower availability of on-campus assets plus the growing trend of health systems expanding their reach to strategic off-campus locations.

There are persistent challenges confronting the healthcare industry and medical real estate that are likely to continue in to 2019, including financial scrutiny and profitability; demographic changes; and the drive to retail locations. However, there are two factors that are set to dominate the year ahead. First, the range and impact of technology, telehealth and consumer devices is becoming wider and deeper. Secondly, there is increased disruption to the nature of healthcare systems led by mega-mergers of health systems and new investment players entering the marketplace. These mergers serve to consolidate bargaining power among fewer, larger firms covering a broad spectrum of costs, including real estate. It may also reduce space needs as merging health systems consolidate redundancies.

Although concerns over healthcare policy persist, the issue could recede over the short-term. With a divided House following the mid-term elections, it is unlikely that any significant legislative changes will be passed during the remaining term of the current administration.

Two other factors will continue to play out in 2019: Rising competition among healthcare providers, which is impacting locational choice, and the decline of health facilities in low-population rural areas.

While investors should take note of these factors, the medical office sector remains attractive in terms of both stability and diversification. Healthcare needs are growing as the U.S. population continues to age. However, greater selectivity and a degree of caution are critical in determining the nature, type and location of assets to target.

Consumer demand for flexibility and convenience suggest that newer, better-located medical office and healthcare real estate should continue to generate stronger returns than older properties, particularly hospitals. Technology is driving the increase in, and demand for, lower cost outpatient centers focusing on surgical procedures that formerly required a hospital stay.

Security of income due to low insurance reimbursements remains a key challenge facing owners of healthcare assets, and the credit strength of tenants should be closely monitored. Sustained pressure for healthcare operators to lower spending while remaining competitive should increase sensitivity to real estate overheads.

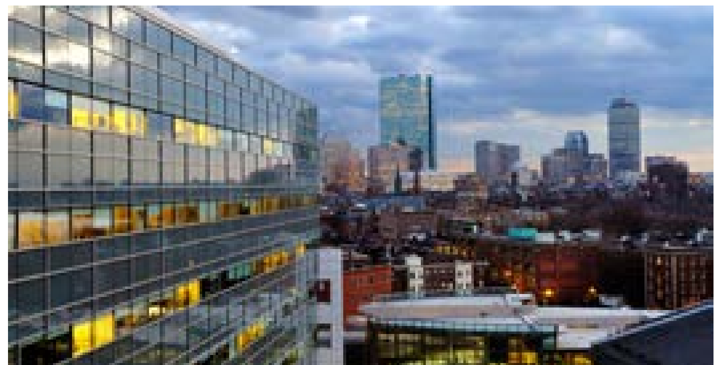
The healthcare industry continues to evolve at a rapid pace, and health systems are facing disruption. MOB assets need to be flexible in order to embrace change. Capital improvements to reposition older holdings may be necessary.

The rise of telehealth has the potential to influence physical real estate, and a greater understanding of its impact should emerge over the medium-term. However, while telehealth can provide convenient alternatives to some clinical visits, there will still be strong demand for in-person visits for initial consultations or procedures.

Competition between providers is driving increased demand for prominent retail locations, with tenants showing a willingness to pay higher rents for in-demand locations. Opportunities exist for owners of retail properties to repurpose them for medical use. It may be quicker and less expensive to reposition such space rather than build anew.

Key Takeaways

- **Vacancy:** Following 2017's cyclical low, national MOB vacancy essentially remained flat in 2018, with a marginal increase of 10 basis points to 8.2%.
- **Absorption:** Demand for medical office space remains strong and is keeping pace with new supply being added.
- **Rents:** National full-service gross MOB rents increased by 3.6% in 2018, significantly higher than the historic annual average of 0.2%.
- **Construction:** Following 18.8 million square feet of MOB deliveries in 2017, the 2018 total rose to 20.9 million square feet. MOB construction remains heavily weighted toward off-campus projects.
- **Sales:** Total investment in MOBs fell from $14.5 billion in 2017 to $12.7 billion in 2018, though transaction volumes continue to be restrained by the small universe of investable product. Meanwhile, average cap rates held steady at 6.7%.



Vacancy Stays Low as Rents Continue to Rise

Among the 10 leading U.S. markets, rent growth in 2018 was strongest in three markets where vacancy remained low or contracted. MOB vacancy in Boston is the lowest across the major markets and fell further to 5.7% in 2018, driving outsized annual rent growth of 20.7%. Two other markets witnessed double-digit rent growth: New York, where rents rose by 19.4% and vacancy stayed tight at 7.6%, and Atlanta, where an 80 basis-point contraction in the vacancy rate to 10.3%, fueled a 12.2% rise in rents.

Philadelphia was the only market in the leading 10 to witness a fall in rents in 2018 at negative 2.1%. Three other markets saw rent growth below the national average—Washington, D.C. (0.9%), Miami (1%) and Chicago (2.3%).

New York has by far the highest MOB rents at $75.62 per square foot, followed by three markets where rents are in the $30s per square foot. Miami leads at $34.16 per square foot, closely followed by Los Angeles at $33.94 per square foot and Boston at $30.17 per square foot. Rents in the remaining six markets are banded in a five-dollar range from $22 to $27 per square foot.

Top 10 Markets - Vacancy Rate & Asking Rent

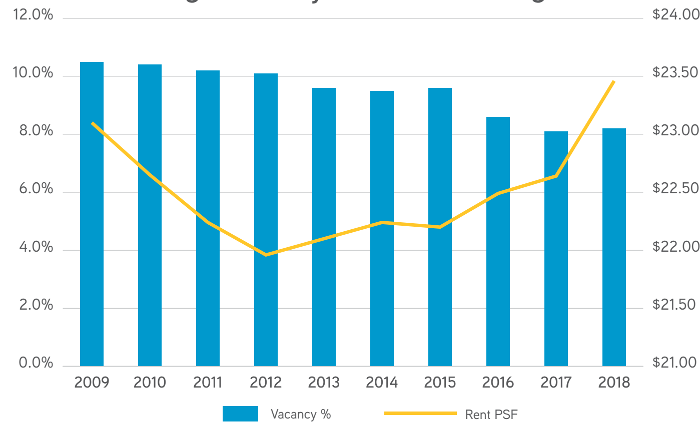
MARKET	MOB VACANCY %	DIRECT GROSS ASKING RENT PSF
Atlanta	10.3%	$24.03
Boston	5.7%	$30.71
Chicago	12.4%	$22.45
Dallas-Fort Worth	14.8%	$25.90
Houston	12.2%	$25.31
Los Angeles	8.2%	$33.94
Miami	8.6%	$34.16
New York	7.6%	$75.62
Philadelphia	9.1%	$22.43
Washington, D.C.	10.4%	$27.83

Source: CoStar

Demand for MOB space remains strong and is keeping pace with new supply being added. The U.S. MOB vacancy rate remained essentially flat in 2018, rising by 10 basis points to 8.2% from 2017's cyclical low.

MEDICAL OFFICE:

National Average Vacancy Rates and Asking Rents



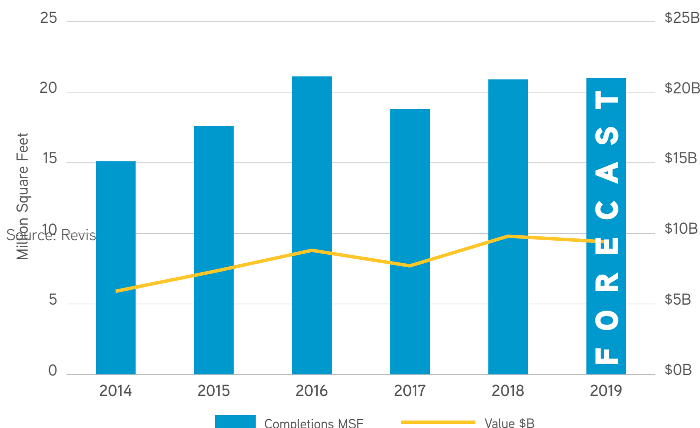
Source: CoStar

MOB Construction Remains Elevated and Focused on Off-Campus Locations

The volume of MOB space being delivered to the market continues to rise. Completions totaled 20.9 million square feet in 2018, up from 18.8 million square feet in 2017. The construction value of MOB space being added is rising and reached $9.8 billion in 2018, up from $7.7 billion in 2017.

MEDICAL OFFICE:

Recent & Forecasted Completions



Source: Revista

With regard to current construction, there are 874 projects underway comprised of 388 MOBs and 486 hospital developments. Median construction value per project stands at $17 million for MOBs and $52.4 million for hospitals. Project sizes average 51,600 square feet for MOBs and 95,500 square feet for hospitals.

Construction in Progress: Year-End 2018

	MOB	HOSPITAL	TOTAL
# of Properties	388	486	874
Total MSF	28.2	79.6	108
Construction vs. Inventory	2.2%	5.3%	3.9%
Total Construction Value	$12.6B	$56.9B	$69.5B
Median SF / Project	51.6	95.5	65.0
Median Construction Value / Project	$17.0M	$52.4M	$30.0M

Source: Revista

A further 21 million square feet of MOB space is expected to deliver in 2019 in 336 projects. MOB construction remains focused on off-campus facilities, underpinned by the continued demand for readily accessible locations and the shift away from inpatient hospital care. Off-campus properties account for 71% of projects set to deliver in 2018. Health systems continue to expand their base as consumers seek close and convenient facilities.

Medical Office: Openings Expected in 2019

	PROPERTIES	TOTAL VALUE	TOTAL SF
Off-campus	240	5.0	12.4
On-campus	96	4.4	8.6
Total	336	9.4	21

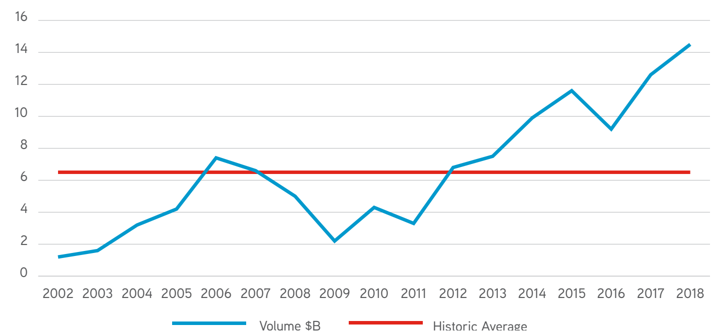
Source: Revista

Cap Rates and Pricing Hold Firm

Total investment in MOBs fell from an all-time high of $14.5 billion in 2017 to $12.7 billion in 2018. Despite this decrease, the 2018 total was the second-highest on record. The reduction was attributable to a fall in the dollar volume of portfolio sales which dropped by 40.8%, while single-asset sales rose by 4.7%. Average cap rates were unchanged at 6.7%, and average pricing remained at $286 per square foot.

MEDICAL OFFICE:

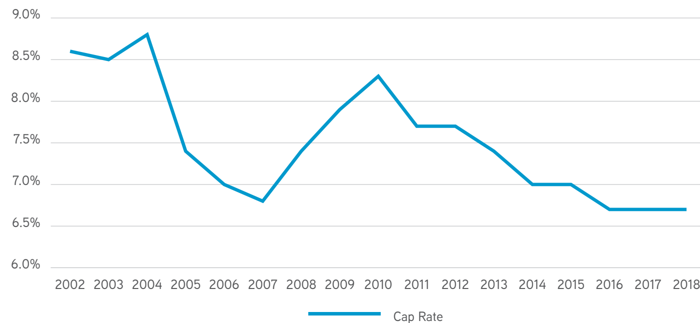
Sales Volume



Source: Real Capital Analytics

When considering MOB sales volume, it should be noted that, barring new construction, there is a relatively limited supply of investable product. Over two-thirds of healthcare real estate remains in the hands of healthcare providers and systems, led by Kaiser Permanente's $37 billion portfolio in California, and assets rarely change hands.

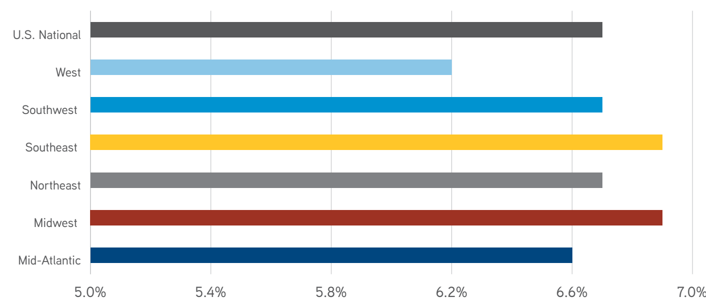
MEDICAL OFFICE:
Cap Rates



Source: Real Capital Analytics

Regional pricing is highest in the Northeast and West at $343.60 per square foot and $316.80 per square foot respectively. Pricing in the remaining four regions (Mid-Atlantic, Midwest, Southeast and Southwest) is tightly banded between $250 to $270 per square foot. Regional cap rates are tightest in the West at 6.2% but show little variation elsewhere ranging from 6.7% in the Northeast to 6.9% in the Midwest and Southeast. It should be noted that lower cap rates are being achieved on the best assets. Sub 6% cap rates have been seen on multiple transactions with some trading even lower at 5% cap rates.

MEDICAL OFFICE:
Cap Rates by Region



Source: Real Capital Analytics

Cap rate compression reflects the continued desirability of the healthcare sector and its view as a safe and durable investment even during times of economic uncertainty. Healthcare real estate is now firmly established as its own separate asset class within the real estate sector.

Four markets recorded more than half-a-billion dollars in MOB sales volume in 2018, led by the New York City metro at $1.2 billion, followed by Houston with $0.8 billion. The strength of the Boston market, noted earlier, drove transactions totaling $0.7 billion in sales volume followed by $0.6 billion in Chicago.

2019 Outlook: Leading Factors Impacting Healthcare Real Estate

There are persistent challenges that the healthcare industry and medical real estate will continue to face in 2019. These include financial scrutiny; cost concerns from consumers and providers alike; the changing nature of healthcare provision and consumer demand; the rising cost of health insurance; and the growth of facilities in retail locations and former retail space. Further reductions in provider income, notably in hospital properties, could impact credit ratings and the security of income.

As these factors continue to play out, two key issues bear close watching in the year ahead: the impact of technology and the transformation of healthcare systems. These topics are discussed below, along with other pertinent issues for the year ahead.

Technology, Telehealth and Consumerization

Technological advances and the rise of telehealth are impacting healthcare at an increasing pace and across the board, from how and where surgery is delivered to how consumers interact with providers.

Medical procedures that formerly required a hospital stay are becoming viable outside of the hospital as a result of improved technology and are increasingly being undertaken in a lower cost same-day, outpatient basis. The number of on-call specialists in hospitals is being reduced by providing video consultations where, dependent upon the nature of the condition being treated, patients from multiple hospitals can interact with a doctor in an off-site location.

The growth in personal diagnostic devices, such as Fitbits, cellphone apps and blood pressure and heart monitoring cuffs, reflects both growing consumer awareness of, and desire for, basic health information but also can monitor health conditions remotely reducing the need for in-person visits to a physician.

In a similar manner, tests that formerly required an overnight stay, such as a sleep study, can now be conducted at home using a simple device provided to the patient. Once a condition is diagnosed, Bluetooth and wireless communications enable automatic reporting, from devices such as CPAP machines and heart monitors, thereby only requiring a patient visit if something of concern is noted.

The success of Teladoc.com is a leading example of web-enabled healthcare services, connecting consumers with doctors for consultations that are undertaken by phone or video, both on demand and at a time convenient for the individual. Leading insurers, including Aetna and United Healthcare, are partnering with Teladoc and have developed their own apps for consumers use.

The adoption of, and resistance to, this technology varies by age. Research by the Advisory Board shows that people in the age

bands of 18 to 29 years old and 30 to 49 years old are the most receptive to virtual visits while the older population (65 years old and above) has the greatest resistance.

Transformation and Disruption of Healthcare Systems

Mega-mergers were front and center in the $3.5 trillion healthcare industry in 2018. These moves are transforming the nature of service delivery and providing the largest companies with increased market share. At the same time, we are witnessing greater collaboration between healthcare systems, the further growth of employer-sponsored insurance and the emergence of independent providers.

The $69 billion merger between CVS and Aetna closed in late 2018. CVS Chief Executive Officer Larry Merlo commented that the merger will "transform the consumer health experience by making care more localized, less expensive and more accessible." CVS has 9,700 pharmacy locations across the U.S. generating more than $40 billion in specialty drug revenue. CVS is estimated to have the largest number of clinics in the country, and plans to further expand their network of "MinuteClinics", while also seeking to provide more localized care plus health screenings and chronic care management. Aetna will continue to operate as a standalone company within CVS and has over 23 million medical members.

Also, in late 2018, Cigna and Express Scripts closed their $67 billion merger pairing another health insurance giant with the nation's largest pharmacy benefit manager. In a smaller but significant deal, Humana Inc., in conjunction with a private equity consortium, acquired Kindred Healthcare Inc. for $4.1 billion in July 2018. Kindred operates long-term acute care hospitals and inpatient rehabilitation facilities.

UnitedHealth Group continues to grow its health services subsidiary, Optum, through the acquisition of DaVita Medical Group to its care delivery network, along with its pharmacy benefit management business and its data and analytics company.

Further merger and acquisition activity is expected as 2019 progresses. While mergers such as the one between CVS and Aetna arguably provide the proximity, pricing and convenience that today's healthcare consumer demands, their wider impact on healthcare systems is untested.

Collaboration is also on the rise. Intermountain Healthcare is leading a group of health systems, including Ascension, SSM Health and Trinity Health, to form a new, not-for-profit drug company in consultation with the U.S. Department of Veterans Affairs.

The impact of the combined move by Amazon, Berkshire Hathaway and J.P. Morgan to create their own independent health insurance company for their 1.2 million employees continues to attract speculation. As with its prior forays into other industries such as online retail, cloud computing and groceries, Amazon's vision for healthcare is typically ambitious.

Advances made by Amazon in 2018, included the acquisition of the internet pharmacy start-up PillPack, examining the retail potential of home diagnostics, the introduction of more health products to its marketplace, and filing a patent for its voice assistant, Alexa, to diagnose (or identify) a cold or cough. Looking ahead, there are other potential areas of interest including bringing more companies into the Amazon insurance network, leveraging its extensive global logistics platform, and perhaps, moving into primary care.

Other Key Factors for 2019

INCREASED COMPETITION AMONG PROVIDERS

Competition among healthcare providers continues to intensify, especially for primary and urgent care services. Location is increasingly determined by proximity to both consumers and a critical mass of complementary healthcare services.

Two ways in which this is manifesting itself are greater demand for downtown and high-street locations and an increase in the number of smaller space requirements in the market. It is increasingly common to see two or three doctors coming together and leasing around 5,000 square feet in street-level retail locations, despite the higher rents incurred.

Balancing costs and pricing remain front and center for such providers. Price sensitivity among some consumers is on the rise as deductibles continue to escalate and providers need to remain cost competitive.

RURAL CLOSURES

Demographic and cost concerns are placing pressure on the viability of some hospitals in rural locations. Low incomes and a higher rate of uninsured patients in rural areas result in an inability to pay hospital bills, particularly in states that chose not to expand Medicaid.

In its June 2018 report to Congress, the Medicaid Payment Advisory Commission found that almost 70 rural hospitals had closed since 2013, one-third of which were more that 20 miles from the nearest alternative hospital. Hundreds more rural hospitals are thought to be at similar risk.

Such closures impact healthcare provision and the economy in several ways. Core services such as obstetrics can be closed, thereby increasing the distance that pregnant women must travel for delivery. Trauma centers can be similarly impacted.

There is also a concomitant impact on wider medical services and the local economy. Specialists tend to cluster around hospitals and may leave when a hospital closes. On the economic front, in addition to loss of jobs for hospital workers, further jobs are lost in supporting services.

While telehealth may help to bridge the gap for routine services, the consolidation of services in larger but more distant facilities looks set to continue. There is also an opportunity for smaller urgent and primary facilities to set up practices in rural locations or for micro-hospitals or free-standing emergency departments to fill the void and help meet the healthcare needs of the local population.

HEALTHCARE SERVICES CONTACT

Mary Beth Kuzmanovich
National Director, Healthcare | USA
+1 704 619 3931
marybeth.kuzmanovich@colliers.com

RESEARCH CONTACT

Stephen Newbold
National Director of Office Research | USA
+1 202 534 3630
stephen.newbold@colliers.com

Copyright © 2019 Colliers International.
The information contained herein has been obtained from sources deemed reliable. While every reasonable effort has been made to ensure its accuracy, we cannot guarantee it. No responsibility is assumed for any inaccuracies. Readers are encouraged to consult their professional advisors prior to acting on any of the material contained in this report.