National Report

Medical Office Research

2016 Outlook

Aging Population, Revitalization of Industry Boost Medical Office Market

The aging U.S. population is contributing to a rise in healthcare needs, supporting a bright outlook for the medical office sector. The age cohort consisting of residents 65 and older will rise by nearly 42 percent over the next 10 years as more than 20 million join this segment. As a result, the 65-plus age cohort will account for 20 percent of the total population. At the same time, hiring in healthcare and related industries will increase 17 percent to meet the growing demands of an older demographic, though a potential physician shortage will remain a concern. A boost in healthcare needs will bode well for medical office assets, though the long-term effect is hard to project due to a rise in in-store clinics, telemedicine, the care delivery model and industry consolidation.

The revitalization of the healthcare industry is placing medical services into the local community, providing a more patient-centered model. The trend toward this level of care has encouraged providers to expand outpatient services into more retail-like settings, providing easier access to patients and capitalizing on strong traffic and demographic trends. Amid consolidation, major medical providers account for a large share of all leasing decisions and tend to favor properties providing more-modern amenities. Newer-vintage assets will continue to fare well; however, vacancy at outdated centers will rise amid physician retirements and hospital acquisitions.

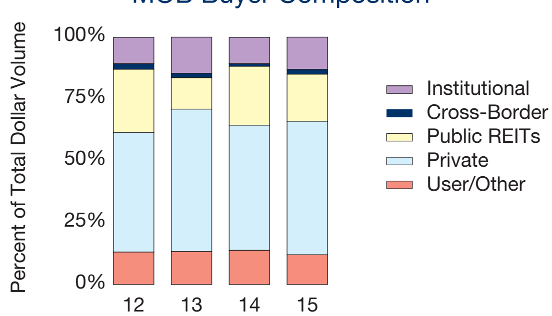
A multitude of buyers are active in medical office investments, with institutions, REITs and private investors raising significant capital to purchase assets. The aging population, credit tenants and positive outlook for our nation's healthcare industry are driving this demand. These factors, coupled with a limited amount of inventory available for sale, are raising values. Migration patterns of those older than 65 years of age are spurring both sales and development, with Southern and Western markets performing strongest.

In 2015, sales activity accelerated amid increased buyer activity while the average price edged up 29 percent to $252 per square foot, surpassing 2007 levels. Prices vary widely, depending on asset quality, property location and tenant credit. Overall, the average cap rate compressed 20 basis points to 7.3 percent, inching closer to pre-recession levels. On-campus assets trade at the lowest initial yields, with single-tenant buildings drawing first-year returns below 6 percent in some instances and multi-tenant assets trading at cap rates in the mid-6 to low-7 percent area. First-year returns for off-campus assets depend on multiple factors and can range from the low-6 percent area to above 8 percent.

Also increasing investment activity is a surge in crossover capital. Many investors in search of single-tenant, net-leased retail opportunities are seeking similar investments in the medical office segment in an effort to chase higher yields. Single-tenant retail cap rates have compressed substantially, and single-tenant medical office can yield 100 to 200 basis points higher, depending on tenant affiliation and location. This trend will persist through the year.

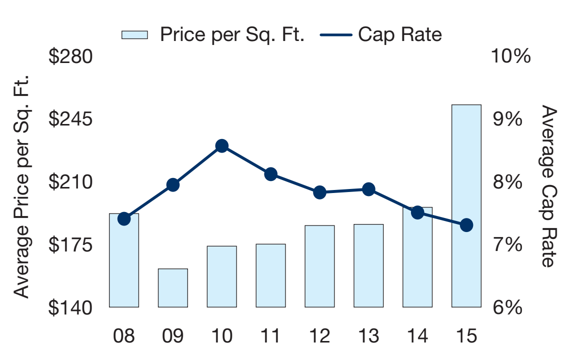
Hospital mergers and acquisitions are increasing tenant quality across the medical office spectrum. As a result of this, REITs and institutions have steadily increased capital flows into the sector, accounting for nearly 30 percent of investment in 2015. Private buyers remained the main player during the year, accounting for over 50 percent of dollar volume.

MOB Buyer Composition



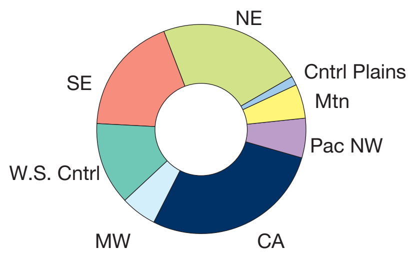
Based on trans. of $2.5M+ (excludes entity-level and partial-interest sales)

Medical Office Sales Trends



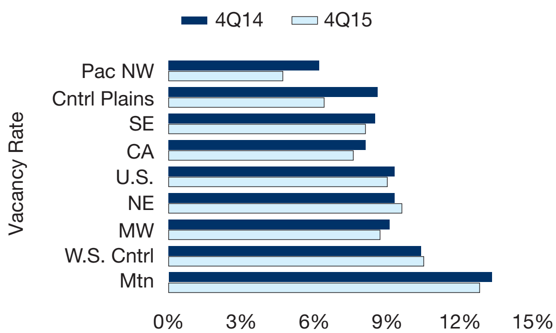
Marcus & Millichap

2015 MOB Completions by U.S. Region

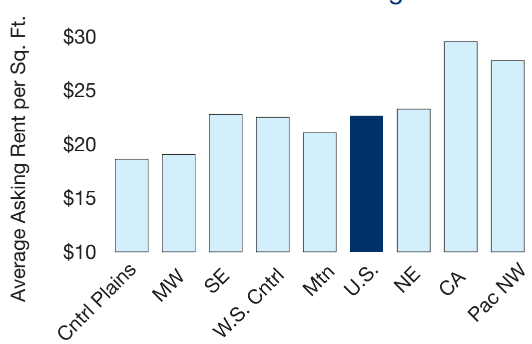


Regional shares based on U.S. total of 8.9 million square feet

Medical Office Vacancy Rates



2015 Medical Office Asking Rents



Off-Campus Building Leads Construction Surge

An estimated 12.2 million square feet of medical office space will come online in 2016 as hospitals and health systems remain the driving force behind new projects. Last year, 8.9 million square feet of new space was delivered. As the healthcare industry moves toward a convenience-oriented and patient-centered model, the layout of doctors' offices is changing. Modern amenities and spaces promoting data sharing and a team-based approach to care are replacing excessive file storage and large areas for administrative staff. Buildings that promote these objectives will remain in high demand. The evolution of the healthcare sector is encouraging off-campus development, which comprises a large share of projects underway. A shift toward a more patient-centric delivery model has major medical providers expanding services into communities, placing ambulatory surgery centers, stand-alone emergency departments and large multitenant medical office buildings closer to residential and retail developments.

Vacancy Tightens as Health Systems Expand

U.S. medical office vacancy dropped 30 basis points in 2015 on net absorption of more than 7.8 million square feet, ending the year at 9.0 percent. The Pacific Northwest region boasts the lowest vacancy in the country, falling 150 basis points year over year to 4.7 percent. The Central Plains, California, Southeast, Midwest and Northeast regions follow, respectively, with vacancy ranging from 6.4 percent to 9.6 percent. Conditions in the Mountain region are softest, and vacancy contracted 50 basis points from last year to 12.8 percent. Conditions will continue to tighten at medical office properties through 2016, despite a surge in completions. The majority of space coming online is mostly pre-leased, and expanding practices will seek space in existing buildings. Earlier-vintage assets will continue to struggle, however, as modern amenities fostering a patient-centered model are in high demand.

Providers Play Larger Role in Rent Advances

Despite tightening conditions at medical office assets across the nation, average rents declined in some areas as health systems dominate the changing healthcare industry. Both credit and scale work in their favor, likely keeping rent growth subdued in the months to come. The average U.S. medical office rent dipped 0.3 percent last year, reaching $22.62 per square foot. In the Central Plains region, the average grew at the fastest pace, rising 3.4 percent to $18.61 per square foot. The California, Southeast and West South Central regions also experienced an uptick, as rents advanced from 1.3 to 1.9 percent. The Midwest, Mountain, Northeast and Pacific Northwest regions all realized declines in average rent last year, ranging from 0.6 percent to 3.8 percent. In addition to health systems comprising a larger share of medical office leases, the push into off-campus properties also contributed to a dip in rents. Space in on-campus buildings rents for a premium when compared with space in off-campus assets, though as conditions tighten for these properties, overall rent growth will resume.

Healthcare Real Estate Group

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