BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT MEDICAL OFFICE THIRD QUARTER 2020

Medical Office Poised for Strong Return as Patient Care Adapts and Healthcare Needs Climb

Virus upends the healthcare industry. The medical office sector is being tested as operators navigate new challenges created by COVID-19. Medical office was once perceived to be a more resilient asset class during a downturn, but the unique uphill battle faced by healthcare providers due to the pandemic has choked revenue streams and considerably shrunk margins. Restrictions on elective surgeries and the voluntary delay of non-emergency visits to doctors' offices, dentists, and dermatologists have weighed on operations, contributing to job losses and furloughs. Despite the short-term costs, the healthcare industry will be one of the quickest to bounce back from the pandemic since the care needs of a growing and aging population continue to increase. Medical services are returning as states move through reopening phases, and pent-up demand from postponed procedures and office visits provide a positive outlook.

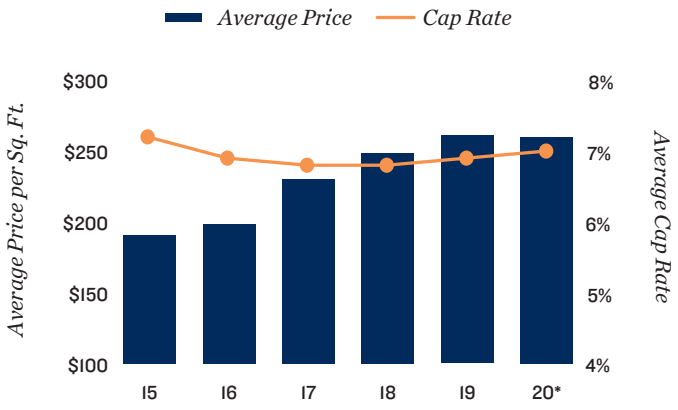
Pandemic accelerates use of tech. Medical service providers have taken steps to manage the safety of both patients and staff, particularly with a rapid adoption of telehealth options. Relaxed regulatory barriers have been critical in boosting the use of virtual care options, and proposed policies aim to make permanent the availability of these services to patients long after the health crisis. With a physician shortage looming on the horizon, telehealth serves as a strong alternative to increase throughput of patients for minor care needs. Current capabilities are not a replacement for the majority of office visits, however, sustaining demand for medical office space.

Increased spending and coverage shape the industry. A compelling demographic shift and strong growth of healthcare spending support long-term tenant demand for the medical office sector. Between 2008 and 2018, spending on clinical services grew by an annual average of 6.3 percent, outpacing expenditures on hospital services, which rose 5.1 percent per year over the same span. Expansion of private and public health insurance has played a role with less than 9 percent of Americans now without coverage, half the level of 2010. The high cost of care has led to a consolidation of providers in recent years as healthcare systems seek greater efficiencies and wider margins through mergers and acquisitions. This trend has contributed to higher-quality care at off-campus locations with more assets under a major network, generating strong investor interest among midsize funds and private buyers.

Investment Highlights

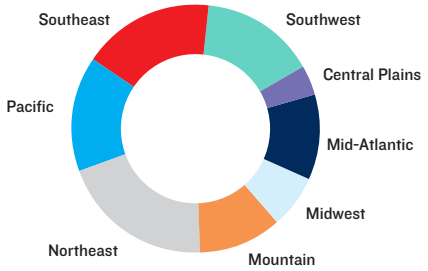
- Medical office sales remained comparatively stable over the 12-month period in June with transactions dipping just 2 percent. Strong investor interest led medical offices to account for 19 percent of overall office volume in the second quarter, up considerably from the 7 percent average.
- Transaction velocity was headlined by the Southeast region, an area of greater in-migration among the older cohorts in recent years. The average cap rate rested in the low-7 percent band.
- Medical office cap rates are flattening with the pandemic impacting sales activity, averaging nearly 7 percent over the past 12 months.
- Pricing averaged just above $259 per square foot over the past four quarters, a modest 1.9 percent increase from the prior yearlong stretch.
- Medical campus and hospital expansions continue to draw REITs and institutional buyers to proximate office assets. Cap rates for newer buildings in these districts begin in the mid-4 percent range.

Attractive Yield Profile Motivates Investors



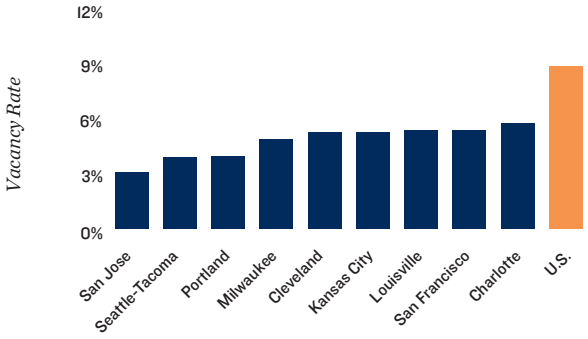
*Trailing 12 months through 2Q
Sources: CoStar Group, Inc.; Real Capital Analytics

Trailing 12-Month 2Q 2020 MOB Completions By U.S. Region

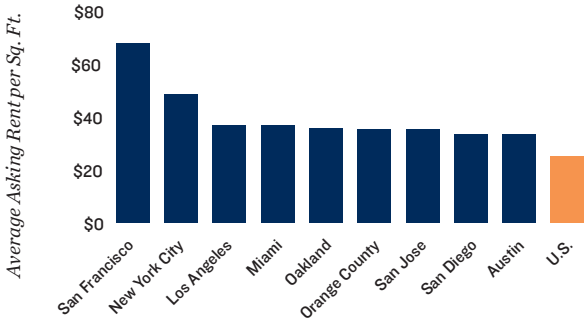


Regional shares based on U.S. total of 10 million square feet

2Q 2020 Lowest Vacancy by Metro



2Q 2020 Highest Asking Rent by Metro



Source: CoStar Group, Inc.

Construction Trends

- Despite a major pullback in projects underway in the second quarter, more than 2.8 million square feet was delivered, bringing the yearlong total to just above 10 million square feet. Deliveries were down by almost 1 million square feet from the prior period. Moving forward, more projects will be shelved, which should help to stabilize the sector and prevent oversupply risks.
- Philadelphia and Washington, D.C., recorded the strongest supply increases over the past year, each adding just over 530,000 square feet. One project totaled nearly all of the new space in D.C.: the 508,000-square-foot Medical Pavilion at White Oak. The largest delivery on the West Coast was in California, the Kaiser Dublin Medical Center at 220,000 square feet.

Vacancy Trends

- The economic challenges and elimination of major revenue streams experienced by care providers have placed pressure on tenants to reduce expenses and reconsider space requirements. Some health systems may allow a greater share of administrative staff to work remotely going forward, which could bring more sublet space onto the market. Underlying demand factors, including the growing need for healthcare services, overshadow the immediate impacts of the pandemic.
- On a national basis, vacancy climbed to 8.9 percent in the second quarter, a 40-basis-point climb from the same time last year. Net absorption fell by roughly half over the past 12 months in contrast with the prior period, in large part due to limited availability and the shortage of modern and upgraded facilities.
- Operations were exceedingly tight in some West Coast markets in the second quarter, led by San Jose with a vacancy rate of 3.1 percent. Seattle-Tacoma and Portland were close behind with vacancy of 3.9 percent and 4.0 percent, respectively. Strong job growth prior to the crisis and stable economies have contributed to the health of the medical office sector and point to a robust bounce back as activity slowly resumes.

Rent Trends

- A hit to revenue for many tenants has led some to seek deferrals and rent relief, though most REITs have reported strong rent collections, an indication that many operators have been able to weather the worst of the crisis. Small businesses in the healthcare sector often have greater cash reserves than those impacted in other industries, preventing a wave of business closures.
- Amid the current turmoil, rent growth maintained an upward trajectory over the past four quarters, reaching an average of $25.22 per square foot. The Mountain and Central Plains regions posted some of the steepest gains, climbing to $23.75 per square foot and $24.35 per square foot, respectively.

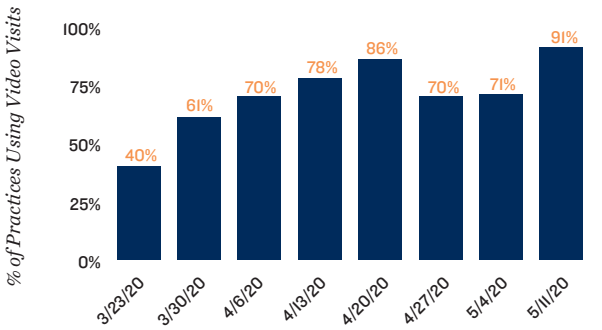
Decentralized Healthcare Model Connects More Patients And Boosts Demand for Medical Office Buildings

Access to care expands through telehealth platforms. Virtual care use has skyrocketed as the pandemic shuttered doctors' offices and hospitals moved to free up resources. Telehealth has proved to be an integral channel to ensure access to healthcare while also acting as an alternate revenue stream for care providers. After the easing of restrictions, 43.5 percent of primary care visits for Medicare beneficiaries were via telehealth services in April, up from nearly zero in February. Telehealth and digital monitoring tools enable providers to better manage patients with chronic conditions, while also serving to grow their market reach and attract new patients. More consumers are anticipated to increase the use of virtual care options over the coming years, though hurdles and limitations remain. Many medications cannot be prescribed online, and inconsistent federal and state regulatory issues hinder health insurers' abilities. Some types of care are more adaptable to online settings, including behavioral health services, though the need for in-person visits, labs and imaging will sustain demand for medical office space.

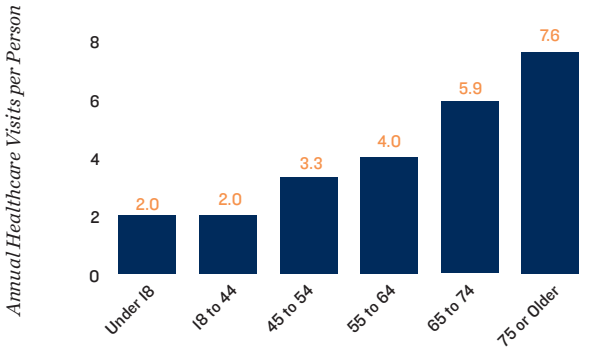
Top-tier medical care extends moves off-campus. The decentralization of the healthcare industry has moved more visits outside of hospital settings and toward outpatient facilities in a cost-savings measure, boosting health services away from consolidated campuses. The expansion of many healthcare systems over the past decade has considerably increased the care capabilities of providers at off-campus facilities. Excluding some major surgeries, off-campus properties now offer the highest quality of care and complex procedures, driven by the need to provide equal levels of service across a metro. New hospital and expansion projects continue to target suburban areas as a demographic shift has caught the attention of health systems, placing more modern facilities and specialized care closer to patients' homes. As these medical districts expand, the need for nearby outpatient clinics and supportive services generates demand for medical office space. Competition is on the rise though with Walgreens partnering with VillageMD to bring primary care services to as many as 700 of their stores. This is on the heels of the roughly 1,100 MinuteClinic locations operated by CVS and a recent plan by the drugstore chain to expand services with a new HealthHUB model that places a greater focus on chronic disease management and family medicine.

Evolving care model benefits MOB sector. A growing population and the aging of the baby boomer generation support long-term demand for medical office properties. Over the next 10 years, the 65 and older cohort will expand 30 percent, steadily boosting the need for medical services. Americans in this cohort account for a greater share of visits to the physician's office at more than five per year. Examinations, lab tests, imaging services, and procedures are some of the more common services provided, which today can be more readily met in house. Prior to the pandemic, expanded medical coverage and new treatment options drove space demand in the sector with more patient services moving away from hospitals and to outpatient care facilities. The structural shift in demand has benefited owners of medical office properties with vacancy moderately above all-time lows, supporting strong investment activity.

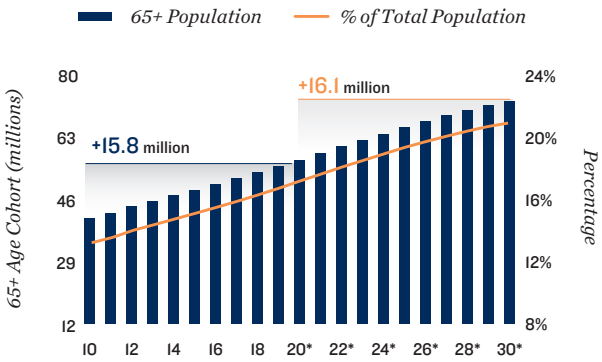
Primary Care Offices Rapidly Go Virtual



Office Visits Increase With Age



Growth of U.S. Population Over the Age 65



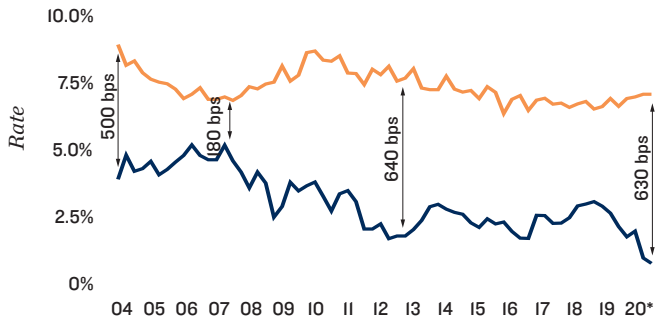
** Forecast*
Sources: CDC; Moody's Analytics; NCHS; Primary Care Collaborative; U.S. Census Bureau; The Larry A. Green Center

Abundance of Sidelined Capital Ready to Target MOB Assets

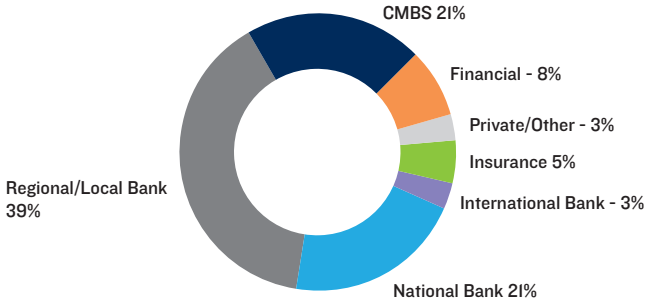
Attractive yields sustain investor sentiment. Sales activity in the second quarter was cut nearly in half as it was harder to obtain financing and bring deals to the finish line. Strong transaction velocity in the quarters leading up to the health crisis held the yearlong total nearly in line with the prior four-quarter stretch, however. New deal sourcing has been curbed alongside other asset classes, while strong demand drivers provide a bright outlook for the sector. Deal flow over the 12-month period ended at midyear was headlined by Dallas/Fort Worth, where investors targeted the rapidly growing Mid-Cities and Plano areas. Initial yields in the Texas markets rest in the mid-6 to upper-7 percent band. Tighter cap rates are found in the West Coast markets; they can dip under 5 percent in the San Francisco area, while Portland and Orange County registered an average closer to 6 percent. Investors targeting higher yields have found attractive cap rates in the Central Plains and Midwest. Initial yields in many of these markets fall in the low-7 to upper-8 percent territory. Many Mid-Atlantic and Southeast markets also fell in this range.

Banks more conservative as they assess the new climate. Lenders quickly adjusted underwriting criteria as the pandemic set in, and as the crisis advances, they are increasingly conservative as they await greater clarity. An abundance of capital is ready to deploy from a range of sources, and some smaller regional banks have been quicker to fill the gap than others. Cautious lending despite ample liquidity has kept loan-to-value (LTV) ratios typically in the 50 to 70 percent range, dependent on the borrower, asset and location. The current interest rate environment is exceptionally attractive, though banks have been inundated with refinancing requests, adding extra hurdles to obtain cheap debt financing. The stability and resilience of the medical office sector during this downturn should keep buyer-seller expectations better aligned than for more impacted asset classes. Assumptions surrounding operating expenses, rental rate increases and tenant turnover are proving more durable due to strong demand for medical services, bolstering net operating income.

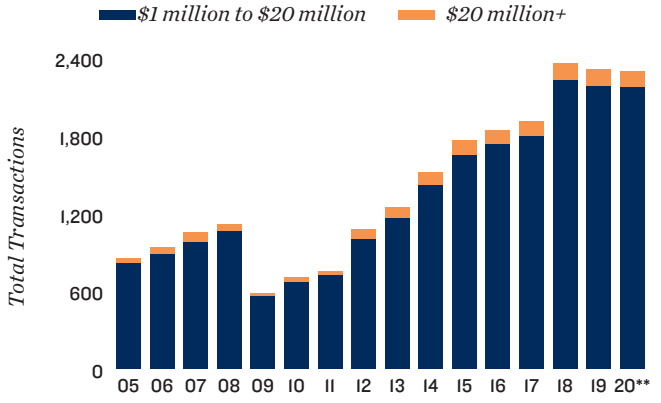
Medical Office Cap Rate Trends



Medical Office Mortgage Originations By Lender (2019)



Transaction Activity



** Through second quarter*
*** Trailing 12 months through second quarter*

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Sources: Marcus & Millichap Research Services; CDC; CMS; CoStar Group, Inc.; The Larry A. Green Center; Moody's Analytics; NCHS; Primary Care Collaborative; Real Capital Analytics; U.S. Census Bureau.