National Report

Medical Office Research

Second Half 2018

Shifts Toward Outpatient Care Encourage Off-Campus Medical Office Development; Investors Optimistic About Market Outlook

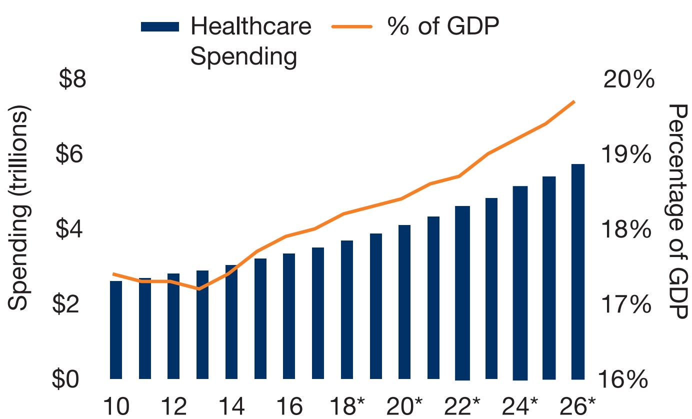
Industry consolidation prompts medical office development. Mergers among healthcare companies and providers has been a driving force behind changes in the industry and how physicians interact with patients. Emerging technologies and a shift in the care delivery model are spilling over into the development of medical offices. A rise in outpatient services and procedures has encouraged medical office development in off-campus locations over the past few years. Hospitals and medical providers seek to place offices in neighborhoods and suburban areas, closer to where people live and work, in order to reduce costs and appeal to patients seeking medical care. While these factors bode well for today's medical office market, the industry still faces numerous challenges as an aging population is met with a physician shortage, rising healthcare costs and insurance reform uncertainty. Despite these challenges, patient demand for services remains strong and will continue to drive further expansion and growth in the medical office building sector.

Advancing healthcare costs. Healthcare expenditures have risen at a hastened pace since 2014 and current projections place annual growth at an average near 5.5 percent through 2026. With expenses rising faster than forecasted GDP growth, healthcare expenditures are expected to make up nearly 20 percent of U.S. GDP by 2026, growing from 13.3 percent in 2000. In 2016, healthcare expenditures surpassed $10,000 per capita.

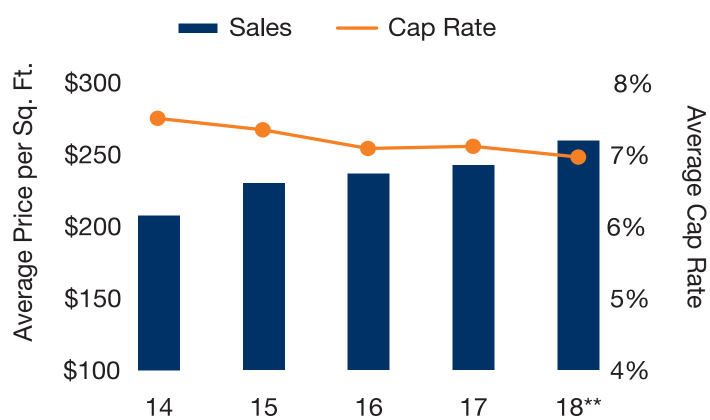
Investment Highlights

- Recently completed single-tenant medical office assets remain in high demand across both private and institutional buyer segments. Properties with major medical providers or hospital systems backing leases trade at a premium, with first-year returns averaging in the high-5 percent to low-6 percent span.
- Sale-leaseback opportunities with private physician groups often require personal guarantees of leases. Many physicians are bringing buildings to market in order to cash in on increased equity as property values have risen over the past few years. Investors will be mindful of lease terms and are scrutinizing these deals closely as many buyers prefer the longer lease guarantees that come with deals tenanted by a major hospital system or healthcare group. Buildings tenanted by a private physician typically trade 100 basis points above properties leased by major groups.
- Investors are seeking stabilized multi-tenant medical office properties in primary and secondary markets. Yield spreads between on-campus and off-campus assets have compressed over the past few years, with private investors and institutions expecting similar returns regardless of assets' proximity to an established hospital.

Total Healthcare Expenditures

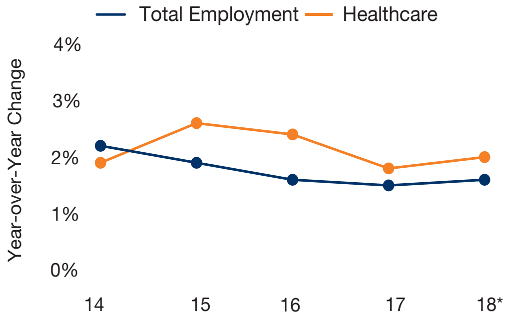


Sales Trends



* Forecast **Trailing 12 months through 2Q
Sources: CoStar Group, Inc.; National Health Expenditure Accounts (NHEA)

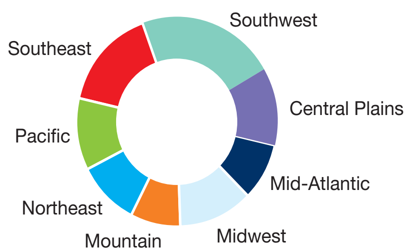
Employment Growth



Economic and Demographic Trends

- Healthcare employment gains have been some of the strongest over the past few years, with approximately 307,000 healthcare services positions added over the past 12 months. While total job growth posted losses during the Great Recession, employment in the healthcare segment remained positive. Hiring among ambulatory care services, which includes a range of physicians and general practitioners, has been the strongest at 27 percent since 2009.
- The 65 and older population has grown at an annual pace greater than 3 percent since 2011. The age group is anticipated to rise by 20 million people by 2028 and will comprise 20 percent of our nation's population base.
- Hiring in healthcare services remains steady this year with the addition of nearly 300,000 positions, or growth of 2.0 percent. Though growth remains healthy this year, the potential for a future physician shortage and steadily rising healthcare costs are facilitating changes and innovations in the healthcare industry that could restrain future medical office space demand.

Annual Deliveries Through 2Q2018

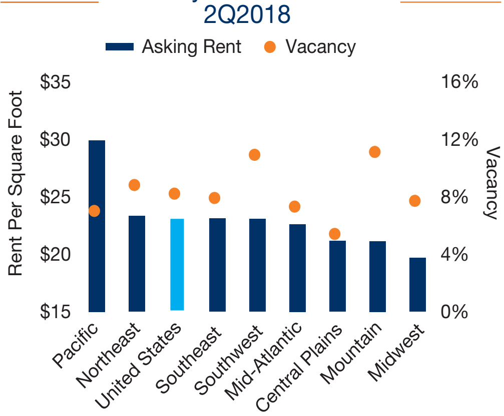


Regional shares based on U.S. total of 9.9 million square feet.

Construction Trends

- Medical office developers completed nearly 4.1 million square feet of space in the first six months of the year, with annual deliveries approaching 9.9 million square feet. The pace of deliveries slowed from the previous annual period when 10.8 million square feet of space was added to stock.
- Developers continue to focus on off-campus locations for new medical office space as medical providers expand services into neighborhoods and locations farther away from hospitals and major medical centers.
- The southern United States remains a target for developers with 3.8 million square feet of space coming online in the Southeast and Southwest regions during the past 12 months. More than 1 million square feet of space also came online in each of the Central Plains, Midwest and Pacific regions.

Vacancy and Rent Trends 2Q2018

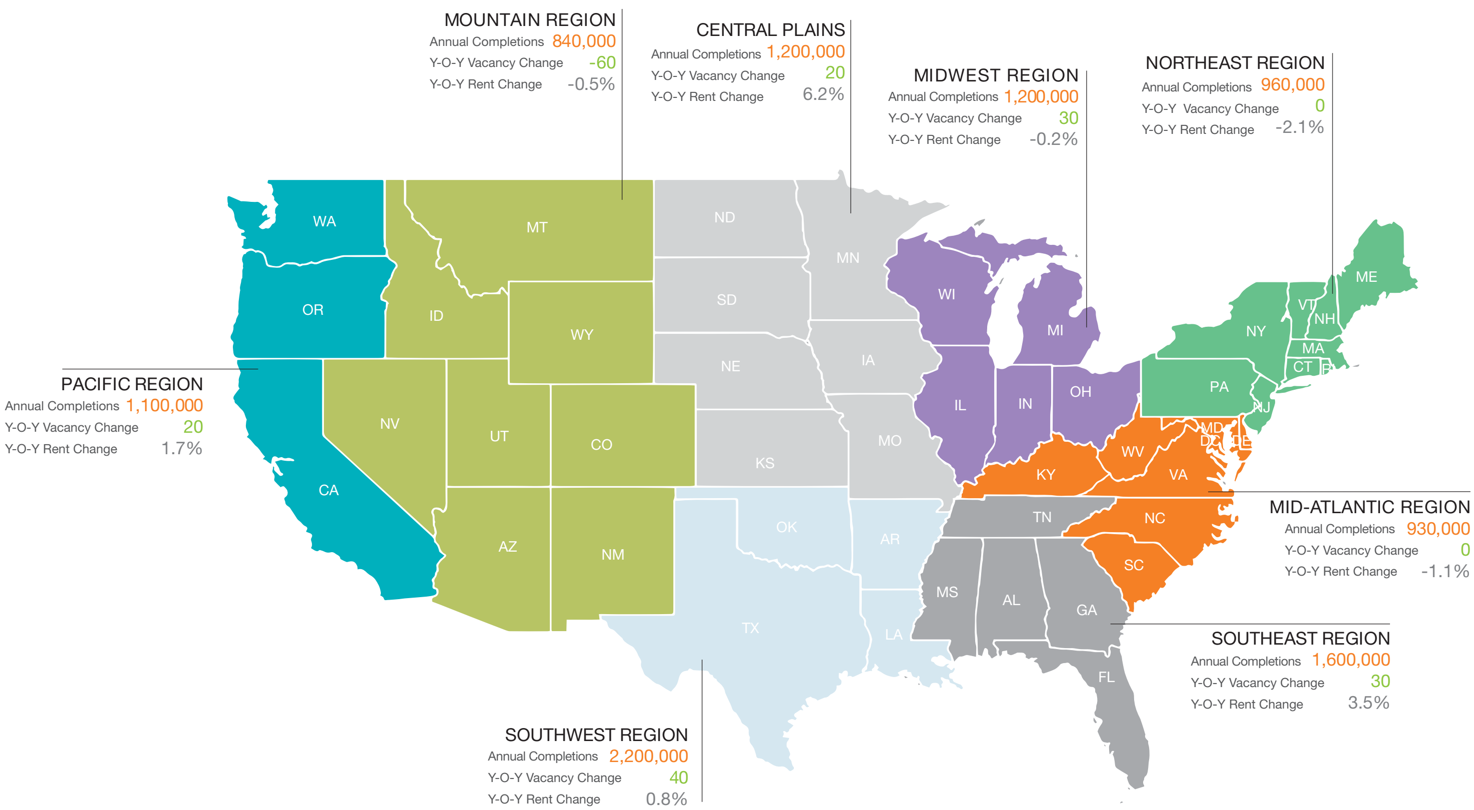


Vacancy and Rent Trends

- Vacancy in the property sector ticked up 10 basis points over the past four quarters to 8.2 percent, remaining near a 10-year low. Nearly every region realized an increase in vacancy during the annual period, with the exception of the Mountain region, where vacancy plummeted 60 basis points year over year to 11.1 percent.
- The average gross rent ticked up 0.9 percent since the middle of 2017, reaching $23.18 per square foot in the second quarter. Consolidation within the healthcare industry is keeping pressure on rental rate growth. Two regions recorded rent advancement of more than 3.0 percent over the past year, the Central Plains and the Southeast.
- While the Central Plains recorded the lowest medical office vacancy rate in the country at 5.4 percent in the second quarter, the highest rents are found in the Pacific. The region's average gross rent reached $29.89 per square foot during the past year, and six of the state's major metropolitan areas boast some of the highest rental rates in the U.S.

* Forecast
Source: CoStar Group, Inc.

Marcus & Millichap Medical Office Building Regions
Trailing 12 Months Through 2Q18



Source: CoStar Group, Inc.

2018 Medical Office Building Forecast

10.7 million
square feet

Construction:
Medical office deliveries totaled nearly 11.3 million square feet during 2017, but completions taper slightly this year. The bulk of new space comes online in the Southwest and Southeast regions, where 980,000 and 950,000 square feet of space is slated for delivery in 2018.

40 basis point
increase

Vacancy:
The vacancy rate ticks up this year to 8.4 percent. The increase will be the first after eight consecutive years of vacancy declines. Despite the uptick, the rate remains near the 10-year low of 8.0 percent achieved during 2017.

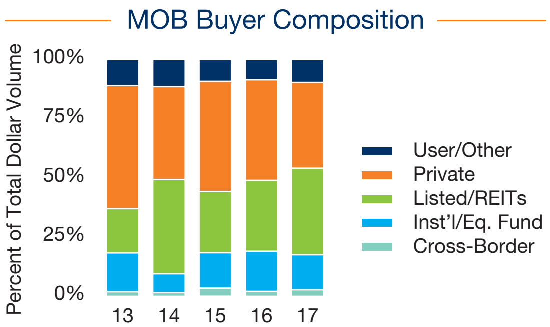
1.0%
increase

Asking Rent:
A slight increase in the average gross rent advances the rate to $23.05 per square foot this year. The average medical office rent has yet to climb back to the peak rate achieved before 2009 but is now within 20 cents of the mean recorded during 2008.

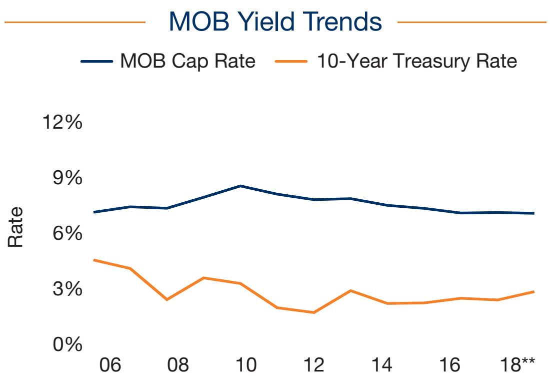
Marcus & Millichap

Medical Office Building Capital Markets

By DAVID G. SHILLINGTON, President, Marcus & Millichap Capital Corporation



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



** Cap rate trailing 12-month average through 2Q; Treasury rate as of June 28.
Sources: CoStar Group, Inc.; Real Capital Analytics

- **Fed watchful as economic surge raises inflationary pressure.** Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. Amid this trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.
- **Lending market remains competitive as interest rates rise.** Though interest rates are rising and cutting into investors leverage objectives, yield spreads for medical office buildings are still favorable. Average medical office cap rates remain more than 400 basis points above the 10-Year Treasury rate, which could prompt additional investors to seek assets in the property sector as they search for higher-yielding alternatives. Medical office interest rates currently reside in the mid-4 percent to mid-5 percent realm with maximum leverage of 70 percent.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.

Healthcare Real Estate Group

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Price: $250

Rent, vacancy and construction averages/totals based on properties of 20,000 square feet or more. Sales figures based on properties with a minimum of 10,000 square feet that traded for $1 million or more.

Sources: Marcus & Millichap Research Services; Association of American Medical Colleges (AAMC); Bureau of Labor Statistics; Congressional Budget Office (CBO); CoStar Group, Inc.; Moody's Analytics; National Health Expenditure Accounts (NHEA); Real Capital Analytics; U.S. Census Bureau.