

MEDICAL OFFICE SPECTRUM

A look at core and non-core medical properties: demand, growth and financing.

By Daniel Mee

The medical office market has always held a fascinating role as a unique real estate subsector, and is largely characterized by its barbell nature. On one end you have virtual core assets while on the other you have highly speculative assets, and in this polar environment there tends to be limited middle ground.

INDUSTRY DYNAMICS

The core medical office market is typically characterized by newer space located on or adjacent to the campus of its major tenant — a hospital. The major tenant — or preferably sole tenant — for a core medical office asset will be a major hospital. Defining a “major hospital” is always subject to some discussion; however, the consensus in the industry is that to qualify as a prime, core asset tenant, the major hospital must meet two critical criteria. First, it needs to be profitable. Interestingly, the level of profit at a given time is not always critical, but it certainly cannot be losing money. The other major criterion is that the hospital must be the

office real estate class is that location is less relevant. Imagine that, real estate where property location does not drive interest! Unlike most other asset classes, core medical office attraction revolves more around the tenant and less on whether or not the property is located in an infill, major market, secondary or even tertiary market. Such assets have large followings in the institutional lender world.



Mee

At the other end of the spectrum is “non-core” medical office. These properties are characterized by off-campus properties usually with little or no major hospital leases. Sometimes properties drop to this category due to heavy rollover risk. These assets are rented by various doctors or doctor groups and some support industries. The irony for some is that many of these non-core medical office facilities are state-of-the-art and

medical office tend to be very entrepreneurial. They often are local real estate players with low basis in some land that can deliver the high cost of such properties without undue risk. Ultimately, many of these assets are owned by doctor/dentist/physical therapy groups that are user-owners. There are also many non-core medical office condos that have worked.

INDUSTRY OUTLOOK

Healthcare has always been somewhat recession-proof since the advent of Medicare/Medicaid. The double-digit inflation in insurance premiums over the past decade has moved many people to the uninsured roles and created stress for weaker hospitals.

The recent U.S. healthcare legislation will certainly create new changes to the industry. Some are citing figures attributed to Jeffrey Cooper of Savills US, a respected real estate services firm. According to Cooper, 1.9 square feet of medical office space will be required for every patient. Based on the President Obama’s recent enrollment of 30 million new users of healthcare, it would appear the U.S. is 60 million square feet short of medical office space requirements.

However, some believe this 60 million square foot requirement is grossly overstated. Using the same linear logic, if we truly need this space, we need occupants. Using a rule of thumb that it takes about 10,000 medical office square feet for a four-physician practice, we need 24,000 net new physicians to fill this space. While

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first or second dominant hospital in a given market. (Super-major markets such as New York or Los Angeles will have multiple dominant hospitals).

Another interesting and contradictory aspect of the core medical

may even be superior in quality to their nearby cousins with major hospital leases. This is just another example of why real estate investing is such a microeconomic exercise. Know your market! The investors in non-core

anticipated retirement acceleration and increasing healthcare users will create demand for many new doctors very quickly, most experts agree medical school and resident programs cannot possibly fill this need for several decades. In reality, we will likely see even longer lines at medical offices and smart owners are preparing for larger, more entertainment-friendly waiting rooms and larger parking facilities. All said, demand for this space should certainly not decline, but be wary if a rash of new development occurs.

FINANCING TODAY

Not surprisingly, given the foregoing description of this subset of real estate and the knowledge that all real estate debt is under pressure today, we have a story of haves and have-nots when it comes to medical office space. With non-core medical office, as well as skilled and un-skilled nursing facilities, debt is extremely scarce. Some financing is available for strong borrowers through local banks that possess local knowledge, but even strong borrowers should expect to provide recourse. Pricing and leverage is all over the lot and often dependent on the relationship with the guarantor. Expect L+300 basis points with 6 to 7 percent floors. In addition to bank financing, HUD financing is available for skilled nursing.

For core medical office, life companies are offering 5- to 10-year non-recourse loans to 65 percent on book and with some structure (read: external, internal mezzanine or b-note) leverage can rise to as high as 80 percent. All in, pricing for a full loan can be in the low 6 percent neighborhood. If the borrower does not require full leverage, pricing can drop to the 5s easily for 50 percent funding.

In summary, medical office continues to be a fascinating field. New entrants simply need to do their homework and be comfortable with the binary aspects of this real estate asset sub-class.

Daniel Mee is executive director with Boston-based Tremont Realty Capital.