Despite uncertainty over healthcare reform, healthcare real estate remains an attractive investment

_JLL believes the overall investment thesis for healthcare real estate remains largely intact in spite of ongoing uncertainty over the future of the Patient Protection and Affordable Care Act of 2010 (ACA), also known as “Obamacare.” While we anticipate changes to the healthcare sector under the new Administration and Congress, legislative and regulation actions are unlikely to undermine the prevailing migration to lower cost outpatient settings and post-acute care. With new investors in healthcare real estate, solid overall fundamentals and a limited supply of institutional properties available, the competitive investment environment for high-quality healthcare real estate remains strong throughout 2017._

**Executive and legislative changes to the Affordable Care Act are challenging**

As President Trump said, “it’s complicated.” But the executive order on healthcare and the initial GOP plan made it loud and clear that this is not business as usual and represents a new paradigm for individual coverage.

Enactment of legislation for changes to healthcare reform and its full implementation are likely to play out over multiple years. The ultimate bill is anyone’s guess at this point and its short-term impact with a delayed implementation date is a wild card.

Proposals in Congress will eliminate the individual and employer mandate; legislation is aimed at greater local determination over allocation of healthcare funding and more choice for the individual.

Changes to Medicare and Medicaid funding, not originally intended to be part of healthcare reform, are being discussed by lawmakers as part of a replacement plan. Modification to long-accepted benefits would further alter access and funding for healthcare, affecting both individuals and providers as stakeholders.

**What’s in the Affordable Care Act of 2010?**

- Individual and employer mandate for insurance
- Coverage: pre-existing conditions, dependents to age 26
- Medicaid expansion up to 133% of federal poverty level, 100% federally funded through 2016, state exchanges optional
- Tax credits for insurance purchased via exchange for households with incomes between 100% and 400% of federal poverty level
- Insurance standards – ban on coverage caps, no loss of coverage if sick, premiums for gender and pre-existing conditions, no co-pay for preventative care, contraceptive services
- Accountable care organizations
- Bundled payments for Medicare
- Medicare payment reduction for hospital readmission
- Healthcare cost / quality incentives
- Taxes –for high-income earners, devices
- Ban on new physician-owned hospitals
- Medicare Part D drug enhancements
Long-term market fundamentals remain favorable for real estate investors

Projections for population growth and aging demographics are strong, supporting continued steady demand for healthcare services.

Today’s U.S. population of 325 million people is projected to grow 23 percent by 2050 and the over-65 population, the greatest draw on health services, will account for one out of every five individuals, nearly doubling in absolute numbers.

U.S. population growth, 2016–2050 (in millions)

![U.S. Population Over 65 graph]

Source: U.S. Census Bureau

The catalysts for health system consolidation and physician group acquisition are largely independent of the ACA and part of a longer-term M&A trend. Deloitte estimates that only half of the 1,833 non-government health systems operating in 2014 will exist by 2024 and virtually none of the survivors will be independent systems.

Projected consolidation: Number of health systems

![Projected consolidation chart]

Source: Deloitte Center for Health Solutions

The trend toward outpatient care enjoys uninterrupted growth. In 1975, there were nearly 1.5 million hospital beds. By 2014, the bed count shrank to almost 900,000, a decline of nearly 40 percent (Statista 2016), while the U.S. population grew by nearly 50 percent. Outpatient visits during this time more than doubled.

Total hospital outpatient visits (in millions)

![Total hospital outpatient visits graph]

Source: American Hospital Association

Certain healthcare trends are here to stay, regardless of the ACA. The movement to value-based reimbursement, population health management, site-neutral payments for post-acute care, bundled payments and further penetration of Medicare Advantage is propelled by improving patient outcomes at a lower effective cost.

The macroeconomic outlook appears positive

A strong economy is good for healthcare – jobs provide valuable access to health insurance by employers.

Proposed tax cuts and economic stimulus bode well for job growth and the employed population, as well as the disposable income that sustains healthcare utilization.

Inflationary pressures from higher spending/lower taxes and the potential for higher interest rates will likely be modest in the short run, minimizing the impact on cap rates and availability of capital.

Deregulation in sectors affecting healthcare, including pharmaceuticals and financial services, will lead to faster drug discovery and, approvals and stronger capital flows for lending.
Changes to ACA could impact credit quality for some hospital systems

Hospitals are at cyclical highs in revenue growth and operating cash flow margins. Coverage under the ACA was a major factor fueling higher inpatient volumes and outpatient visits. But hospitals were more diligent about expense management. Separately, cash and investment reserves enjoyed a nice bounce from equity and bond market appreciation since the November election.

Any significant decline in insured lives could potentially reduce overall health system credit quality and financial flexibility. Restoration of disproportionate share hospital (DSH) payments cut under the ACA is unclear. Freezes on capital spending are a likely outcome. Acceleration of system consolidation and the closure of marginal community hospitals is also possible.

Erosion of margins at health systems due to reduced coverage under the ACA could affect the credit quality of tenants in outpatient buildings. Physicians focused on the commercial payer population are less apt to be affected.

One bright spot: negative effects on credit quality could bode well for the use of third-party capital for development and medical office monetization.

In an uncertain landscape, decision making may slow

Lack of clarity regarding replacement of the ACA and precise timing for full legislative efforts may cast doubt on the future state of healthcare coverage, as well as volumes and reimbursement. Uncertainty may cause some hospitals to hit the pause button for capital and leasing decisions, as many did when the ACA was enacted in 2010. Following successive years of outsized growth, new development could be affected by a slowdown in decision-making, although the trend to outpatient care as well as retail-oriented healthcare will continue unabated. Outpatient projects already in the pipeline, totaling an estimated 17 million square feet of deliveries (Revista), should sustain the industry over the next two years.

Summary

While the underlying fundamentals for healthcare, from a real estate investment perspective, are solid in the short run, smart investors will closely monitor legislative and regulatory proceedings. Decisions today will define healthcare strategies, programs and reimbursement for providers for the next period of time. These decisions will shape the required services for provider groups and the resultant demand for the types, locations and scale of outpatient facilities that real estate investors will need to provide.
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