Medical office buildings top investors' wish lists

- $5.3B in MOB sales closed in 2013, one of the top years historically but down 10% from peak volume in 2012.
- Non-listed REITs and private equity capital were the most aggressive portfolio buyers in 2013, surpassing public REITs for the first time.
- 78% of MOB sellers and buyers in 2013 were investors— not developers or hospitals— compared to 36% in 2012.
- Ten portfolio sales of at least $50M each closed in 2013, for an aggregate $1.8B in portfolio MOB sales.
- No enterprise-level deals closed in 2013, and average portfolio sale was smaller than in 2012 in terms of total price, number of properties and price psf.
- 85% of healthcare real estate remains in the hands of hospitals and healthcare providers, meaning a shallow, yet competitive investment pool persists.
- Outlook for 2014: Prices for MOBs will continue to be high as the supply of product remains constrained, benefitting sellers.

2013 was another strong year for medical office building (MOB) sales, particularly for private investors, the most aggressive portfolio buyers and the primary sellers. Total MOB sales volume of $5.33 billion in buildings greater than 25,000 square feet demonstrated the high sustained level of interest in MOB investment. While 2013 volume represented a 10 percent drop from the peak of $5.94 billion in 2012, and slightly less than the previous cycle’s peak of $5.54 billion in 2006, the volume statistics are primarily a reflection of the constraints on supply of available product in the face of increasing allocation of real estate capital to the healthcare sector.

We see this intense interest in stabilized MOBs continuing through 2014 as both institutional and private equity buyers compete for increasingly constrained supply. Some 85% of the $1 trillion healthcare real estate market, including MOBs, is still owned by hospitals and healthcare providers, most of whom have shown little interest in monetization transactions. Public REITs have been important historical buyers but typically hold for the long term and are not sellers. The wave of new development from 2005-2007 has largely been sold, and the current development pipeline is much smaller.
Due to imbalance of supply and demand for MOBs, pricing for properties is likely to continue at high, if not stronger, levels in 2014. New investment capital available for medical office and new entrants feed the market imbalance. Concerns of investors about the impact of healthcare reform measures are ameliorating. The potential for rising interest rates in 2014 and impact on cap rates is subsiding, particularly since the spread between cap rates and interest rates remains greater than the historical average. Greater acceptance of MOBs as a component of a real estate investment portfolio is growing, resulting in the view that pricing for MOBs has reached equilibrium relative to traditional office product. Strong pricing levels in the current rate environment should encourage owners, including health systems, to crystallize the value of their holdings.

The most notable change in the MOB sales market in 2013 compared to previous years was the dominance of private investors as sellers, as opposed to developers and hospital and physician group monetization deals, and private investors as buyers. Fully 78 percent of sales by volume came from private equity funds, non-listed REITs and other private investors. In 2011 and 2012, by contrast, investors represented only 35-36 percent of the market for MOB transfers. This phenomenon reflects the low level of development starts since the financial crisis and the current robust credit markets for health systems seeking to access capital. Public REITs, historically the largest class of acquirers of MOBs, were less active in 2013 as they adjusted to changes in debt and equity capital markets.

Stabilized product from developers fetched the highest average price per square foot in 2013—about $320—while buildings sold by investors traded for about $260 per square foot. The pricing differential can be attributed to developers’ properties being new-build, state-of-the-art outpatient care facilities with significant health system occupancy and sponsorship.

As in previous years, portfolio MOB sales in 2013 were overshadowed by single-asset sales. Ten portfolio sales over $50 million closed during the year, for an aggregate price of $1.8 billion, or one-third of all MOB sales. Single-asset sales actually outpaced the volume of 2012, when portfolio sales made up a larger percentage.
2013 investment summary

Approximately $5.33 billion of MOBs larger than 25,000 square feet changed hands in 2013, a very strong year historically but a decline of about 10 percent from 2012. Sale-leaseback deals represented 11 percent of volume, down from 27 percent in 2012 after no such transactions in 2010 or 2011. Sales of new construction by developers were just 11 percent of volume, compared to 33 percent in 2012 and the overwhelming majority of sales in 2010 and 2011. As healthcare companies and developers became less of a factor, institutional and private owner sellers came into the market much more aggressively than ever before, accounting for 78 percent of sales by dollar volume in 2013.

Portfolio sales comprised $1.79 billion of the 2013 total, representing 33.6 percent of total volume. The ten portfolio transactions ranged from $81.7 million to $500.7 million and represented nearly 5.7 million square feet in the aggregate.

Both the number and the size of portfolio sales decreased in 2013 compared to 2012, as the last of the major new development pools started in 2006 and 2007 were bought up. In fact, the average size of portfolio sales in 2013 would have been much smaller if not for the largest single sale — the $500 million,17-property transfer from WRIT to Harrison Street Real Estate Capital — which was bigger than the next two largest sales combined.
Investment patterns 2006-2013

Healthcare property, and MOBs in particular, continue to top real estate investors’ wish lists despite steady recovery of core property types in 2013. In the economic downturn, MOBs retained their value better than most property types, and cap rates continue to be lower for MOBs than for most asset classes.

The top MOB portfolio buyers over the past eight years have been public REITs, with 58 percent market share, followed by non-listed REITs, accounting for 27 percent. Even with the strong showing in 2013, private equity players have acquired just 11 percent of portfolios since 2006 and asset managers have accounted for about 4 percent of buyers.

On the sell side, developers have been the most active players over the past eight years, accounting for 47 of all portfolio sales. Investors have accounted for 38 percent, and health systems and physician groups were the source of the other 15 percent of portfolio product.

Developer offerings have also sold for much higher average prices than other product since 2006. Portfolios of new developments have sold for $324 per square foot on average, with the few 2013 sales raising the eight-year average. Investor sales have brought $216 per square foot on average, on par with sale-leaseback deals that traded for about $215 per square foot.

Since 2006, 53 multi-asset sales greater than $50 million have closed, totaling $8.4 billion in aggregate volume. Portfolio sales represented one-quarter of the total $33.7 billion in MOB sales during the period, but portfolio sales have been heavily weighted to the past two years, when combined volume roughly equaled the previous six years.
2014 outlook

Inadequate supply and the resurgence of interest in core asset types in 2013 may set the stage for lower volume of MOB sales in 2014, but demand for well-located product continues to be very strong. Portfolio sales in 2013 were heavier in the first half, suggesting that supply in 2014 will be even tighter. At the same time, new sources of capital are increasingly focused on healthcare real estate investment, and that will keep competition for MOBs high, continuing the seller’s market that has existed for the past few years.

The tug-of-war for MOB portfolios between public REITs and private equity/non-listed REITs will continue in 2014, with private equity sources seemingly willing to outbid public REITs as a way to deploy equity capital that continues to pour in from retail channels. Private investors will also look for opportunities to upgrade existing MOBs, while investors of all types will also look strongly at funding development deals to achieve superior returns.

The larger number of one-off MOB sales to private investors in 2013 suggests a potential aggregation strategy could be in the works. Historically, a well-positioned MOB portfolio will bring a premium price of 10 percent or more over the aggregate prices of the assets sold individually. Private equity buyers in the past two years could become sellers of portfolios over the next two years, realizing the extra profit margin of aggregation as well as market value increases.

Healthcare monetization

Healthcare organizations have mostly avoided monetizing their owned medical office and outpatient facilities, which they view as important to their ability to attract top doctors. As hospitals learn to contend with new pressures brought on by the Affordable Care Act, they may look to capitalize on owned properties that the hospital only partially occupies, with the balance representing physicians, in order to lower their occupancy expense and risk profile.

Hospital networks are more willing to use third-party capital sources for new development, particularly in off-campus locations where outpatient locations are proliferating. An increasing share of medical tests and surgical procedures take place in off-campus facilities due to their lower cost structures and greater convenience for patients. The prospect that ACA may add up to 30 million newly insured patients intensifies the need for cost containment and outpatient facilities, a direction that hospitals have been moving for years regardless of ACA's impact.
About this report

Jones Lang LaSalle monitors and reports on the medical office building investment market via collaboration of the firm's Healthcare Solutions, Capital Markets and Research functions. In addition to proprietary JLL research, this report was compiled with information from Real Capital Analytics and Healthcare Real Estate Insights.

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