USAA Real Estate Company

MEDICAL OFFICE MARKET REACHES FEVER PITCH

RESEARCH ARTICLE

SEPTEMBER 2014

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Medical Office Building (MOB) transactions exceeded $7 billion in 2013 for the first time ever, and cap rates reached a six-year low of 7.3 over the same period, according to Real Capital Analytics. A recent IREI/Kingsley survey indicates the MOB market is in favor among institutional investors, which is difficult to argue given the recent market performance. However, strong demand and limited supply has caused growing pains.

Specifically, existing barriers to entry have constrained supply levels. Developers constructed only 15 million square feet of healthcare properties from 2011 to 2013 compared with 41 million square feet from 2008 to 2009, according to CCIM. Hospital systems are now primary drivers of MOB developments and historically their real estate expansions were limited to organic growth over long time horizons.

Therefore, most hospital systems are not equipped to handle a fast-paced expansion, which has resulted in construction delays. Meanwhile, developers are cautious regarding speculative construction, as MOB tenants often have complex life/safety requirements that can lead to costly changes if not included in the original project. As Cushman & Wakefield expressed regarding the increased demand for institutional-quality properties in the MOB market, "at some point the product supply will run out."

On the other hand, investor demand is strong for MOB as federal laws and secular demographic trends favor the sector. The U.S government estimates the Affordable Care Act (ACA) will add over 25 million new patients and drive healthcare costs to 20% of GDP by 2021, up 3% from 2012 levels. The impact of the ACA is evident, as MOB vacancy fell below 10% in 2013 for the first time in five years and continues to decline. Meanwhile, the 65+ age group will spend 20% to 100% more on annual healthcare costs when compared to other age cohorts, while also having the largest population growth over the next 15 years.

Indeed, the MOB market seems under-built at a time when demand is increasing. Yet we are optimistic that this issue will dissipate as hospital systems streamline their decision-making processes following further clarity regarding the ACA, advancements in healthcare technology renders aging stock obsolete, and an abundance of investor capital supports new construction. Furthermore, hospital systems tend to be high-credit tenants with a low risk of default and medical providers, similar to retailers, prefer longer-term occupancy, which reduces investor rollover expenses and makes this sector even more appealing.

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