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2022: Healthcare Real Estate Trends in a Pandemic

By: Beth Young

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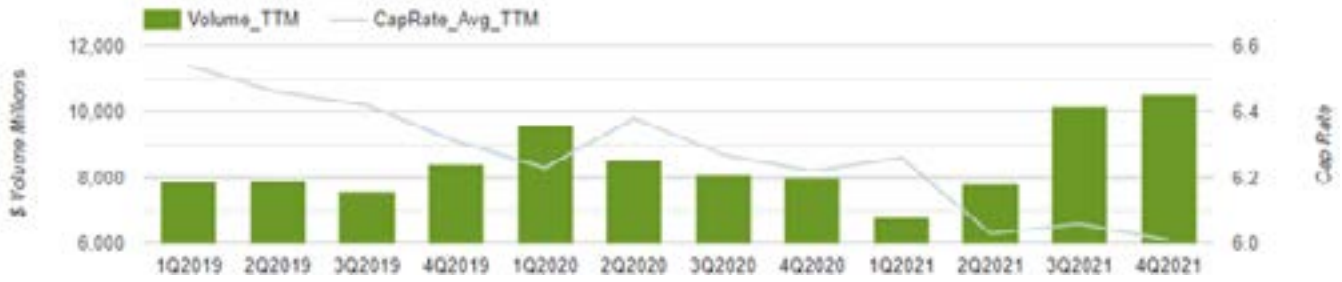
Two years after the beginning of the Covid-19 pandemic, healthcare real estate investments and developments are providing some evidence of trends that appear to be here for a while.

Medical Office Buildings – Snapshot

The top 50 metropolitan markets ended 2021 with 863,761,351 total square feet of medical office space, which is 0.5% higher than it was in September 2021, as reported by Revista, a national database/website with healthcare real estate information. Another 8.4 percent is under construction in an environment that has a 91.6 percent occupancy with average NNN lease rates at $23.29, up 9.9 percent in the last quarter. The sales volume for the last twelve months was $10.55 billion.

Aggressive Cap Rates

The healthcare real estate ("HCRE") market is small compared to other sectors, yet there is a continuous flow of capital coming into it. The pandemic provided an environment that highlighted the best factors of healthcare real estate investments: higher consumption of healthcare services resulting in demand for medical space, stability of medical tenants, long-term leases, low vacancy rates. The capital chasing deals in the market is particularly coming from private equity and private buyers. Yet the flow of institutional capital has a big impact on where cap rates are headed.



Cap Rates Provided by Revista

Cap rates in the top 50 markets are still averaging below 6.5 percent. But overall cap rates for medical office buildings (MOBs) are higher nationally - closer to seven (7.0%) percent.

Signs appear positive. MOB investors have a high rate of rent collection. Many tenants reached out for help early in the pandemic and then realized they didn't need it. Tenants became very focused on their cost structure which contributed to helping providers determine where they can find lower cost settings, what they can move off campus, what service lines can be grown while keeping costs down. They became more efficient and cost safe than they had been previously.

At the start of the pandemic, the market wanted to know about rent collections from REITs. Several REITs provided consultants to their tenants/providers to guide them through applying for loans which offset deferred rent payments. It was a surprise that some REITs have maintained 99% of collections.

Overall, the percentage of rent collection was in the high 90's. Lenders expect cash flow to stay positive. There will be plenty of loans. People spend money when it's inexpensive to borrow. Interest rates are still low, although increases are expected a few times in 2022.

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New Development

Healthcare providers have had capital plans for a long time, and they have had a chance to look at it closely to make sure they are spending money in areas that are most important to them. Sometimes that may mean spending money on things other than real estate, such as medical equipment, personnel, etc. Although providers have a need for capital projects, they also have capital constraints. Some solutions follow.

The graph below shows completions, absorption, and occupancy over the last four years. The development market is slightly lower than where it was last year.

Completions in future quarters based on construction pipeline

Some non-traditional developers are looking to REITs for capital and expertise to help them deliver medical property projects at lower delivery costs. Other developers are partnering with health systems and medical providers. The alignment looks like this: physicians want to be partners before even starting a development, but when it comes to writing checks, it is more challenging. The trend (looking at new assets) is that more physicians are getting out of real estate by doing sale-leasebacks.

REITs are making physician involvement available if they want it; but that interest goes up and down. Much will depend on what happens with the economy and how physicians view it. The ability to be entrepreneurial is most important to providers. Physicians and developers must be aligned on their strategy, direction and long-term plan for it to have a great outcome. The partnership must understand what the physician group needs to translate it into something that economically makes sense.

Health systems have always looked to offer physicians the ability to have a long-term alignment with the system by investing in the real estate. With hospital involvement, the union must also deal with regulatory aspects like Stark Law compliance. Flexibility is key with physician ownership.

Often co-investment in a project helps a health system attract physicians to align with them. It also helps to bring the right mix of services to a building. Ultimately, the most important aspect is the cohesiveness of the building and the asset as a whole, delivery of modern healthcare, leveraging operational efficiencies, and synergistic relationships inside the building vs. just the investment piece.

New Development

The partnership percentage is still a minority position for physicians. It is more of a tax discussion with physicians rather than how long the investment will be held. Physicians own typically 15-30 percent of the asset, although occasionally with a very strong tenant, there may be a 50/50 split. Also, some physicians want to invest who are not tenants in the building. This is often seen as a negative by some developers.

When developing new projects, not-for-profit hospitals are expecting minimal spread between takeout cap rates and development yield, which is a challenge for developers. They went from 200 basis point spreads to 25 or 50. (Available private capital has different expectations.) Hospitals will find that it is important to look for value. They will benefit from avoiding the lowest cost of capital vs searching for the highest quality of development.

Disruptors that Impact Investment Strategies

Covid has definitely been a disruptor, and in some cases, it has accelerated providers' cost structure, forcing them to go off-campus and closer to their patients' homes more rapidly than was occurring before this event. Working on social distancing and curbing the spread of disease, most have set up waiting rooms that provide spacing between patients, and some providers are using apps while patients are in parking lots five-to-ten minutes before going to an exam room.

Physicians and health systems are trying to determine how the common layout of a clinic or hospital that we've used for the last ten years can become more efficient and safer. It has been suggested that retail similar to IKEA stores may have a good idea – providing a one-way path in and another way out. New technology is being implemented in new ambulatory layouts.

It's important that providers buy in and continue to do things in the safer ways that were created and achieved during the pandemic. The healthcare consumer wants to see people cleaning the space, not just signs that it was cleaned.

Telehealth is a great addition to healthcare. It's not seamless yet, but it's being figured out. It opens a whole other avenue for seeing patients that wouldn't normally be seen. Assets may shift to more specialized buildings including surgery centers, ENT clinics, orthopedic facilities, and primary care offices. No physician will do only zoom calls. Physicians like to spend time with patients and have in-person interaction. Some exam rooms will be set up for both in-person and telehealth.

Overall, trends point to better conditions for patients, and creative opportunities for providers. Investors continue to see healthcare real estate as a safe harbor and strategic investment, particularly when interest rates will stay low for the foreseeable future.

About the Author

Beth H. Young, CCIM, LEED AP

Senior Vice President, Colliers International - Houston
+1 713 830 2166
Beth.Young@Colliers.com

Beth Young is a real estate advisor to health systems, private and institutional investors, and users of medical facilities. She specializes in dispositions, acquisitions, marketing, asset valuation, contract negotiations, and leases of medical and investment properties.

Prior to joining Colliers, Beth was Vice President of the Investment Services Group of the former Grubb & Ellis Company where she specialized in the sale of investment properties including office, medical, retail and industrial buildings, and was a member of the Healthcare Practice Group. From 1996 to 2002, she served as Vice President of Corporate Services for The Staubach Company, now JLL.

Beth has served in numerous executive positions on the Boards of the Houston/Gulf Coast Chapter of CCIM, the National Board of the CCIM Institute, CREW, CoreNet Global, and the Greater Houston Women's Chamber of Commerce. In 2002, she was the first female to be elected President of the Houston/Gulf Coast Chapter of CCIM. In 2003, she was presented with the Presidents' Cup Award, the international award for outstanding achievement and leadership by a chapter president. In 2003 and 2004 she was elected Regional Vice President of CCIM's Region Four over Texas, Louisiana and Oklahoma.

Beth is a Director of the Greater Houston Women's Chamber of Commerce and has served since 2011. She is the Chamber Liaison with the Texas Medical Center; and has been recognized and presented with many awards including the Chamber's Volunteer of the Year, President's Key Supporter Award, the first Role Model Award and the Committee Chair Award. Beth is a Trustee and Assistant Secretary on the Harris County Hospital District Foundation Board and is Chairman of the Small Grants Committee. She has also served on the boards of the American Heart Association and the War Against Drugs. In addition to being an industry speaker at conferences, she regularly writes healthcare property articles that have been published by GlobeSt.com, Knowledge Leader, the Houston Medical Journal, Texas Real Estate Business, REDNews, Commercial Investment Real Estate magazine for the CCIM Institute, CREW White Papers, the Houston Chronicle, and the RCA Report for the National Association of Realtors.