Global Healthcare Services

2017 HEALTHCARE OUTLOOK

Newmark Knight Frank
Industry Overview

Of all the economic sectors, health care is arguably experiencing the most disruption, and it is coming from all directions: intense cost pressures, groundbreaking advances in treatments and technology, changing client expectations, new delivery systems and, perhaps most visible, the changing legislative framework in which the industry operates. The American Health Care Act (AHCA), touted by House Speaker Paul Ryan as a replacement for the Affordable Care Act (commonly referred to as Obamacare), recently was voted down in Congress and may or may not resurface in a different form later this year.

Lost in the high-decibel debate are other disruptors changing the healthcare industry and, by extension, the outlook for medical office buildings and other health care properties. A recent series of reports from HFMA, the Healthcare Financial Management Association, groups these disruptors into four categories:

- **Transition to value**: Payers (insurers, employers, individuals) will compensate health care providers for quality (successful outcomes), not quantity (specific procedures). In industry parlance, this is an outcomes-based payment model, as opposed to the traditional fee-for-service model. The primary mechanism for this transition will be improved data flow between health care service providers, insurers and patients, enabling them to focus on the treatments that deliver the best results at a cost-effective price. Technology investment is the means of making this data flow and its necessary analysis a reality, creating a real-time feedback loop that helps providers and insurers improve outcomes while cutting costs. This favors providers—physician groups and hospital systems—which have the resources to invest in this transition.

- **Consumerism**: Consumers will gain bargaining power as they get more information on costs, success rates and other factors to help them make intelligent choices on how to spend their health care dollars. The growing prevalence of high-deductible health plans (HDHPs) is turning health care consumers into shoppers, incenting them to focus on the cost as well as the quality of the care they receive. HFMA notes that high-deductible policies “have the potential to move volume from high-cost to low-cost sites of service,” which would include outpatient facilities such as medical office buildings. At the same time, insurers are making “transparency tools” available to their members, encouraging them to become informed consumers of care, and they are using surveys and analytics from retailers and other consumer-facing sectors to tailor their programs and offerings.

- **Consolidation**: Has increased demand for capital and cost reduction, while consumer demand for improved access and better patient outcomes has increased the need for innovation.

- **Regardless of uncertainty, demand**: For healthcare real estate investment remains at an all-time high. Interest rates have increased, and CAP rates on quality assets and larger portfolios have had little adjustment and remain compressed, while assets in question have had difficulty trading. As we continue to move into a more inflationary period, we may see a rise in cap rates depending on the other legislative factors.

- **Construction**: Rental rates and absorption have been going through a transition, which is in alignment with consumer demands and trends. Rental rates continue to rise, primarily as a result of the cost of new construction.

**Key Takeaways and Challenges**

- **Uncertainty regarding healthcare legislation**, the reimbursement model, the insured population, governmental control... One thing is certain: There will be change.

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- **The Healthcare Financial Management Association** (HFMA) has identified four key trends: transition to value, consumerism, consolidation and transformation innovation. All of them will impact the need for capital, demand for change in healthcare real estate and renovation/new construction.

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• **Consolidation**: Although federal judges blocked the high-profile insurance industry mergers of Aetna-Humana and Anthem-Cigna, the steady drumbeat of consolidations will continue among insurers and providers if they can show that the mergers will benefit consumers through better products and services and not just result in higher prices. The transition to an outcomes-based payment model will require capital investments and sophisticated management expertise, which is likely to drive M&A activity within health care systems, physician practices, insurers and post-acute providers (skilled nursing facilities). There may also be some cross-sector mergers, notably smaller physician practices into health care systems, as outcomes-based payments put pressure on compensation while driving demand for more sophisticated analytics to evaluate treatment costs versus success.

• **Transformative innovation**: Change is coming from three directions: advances in technology; demand for improved outcomes at lower prices; and venture capital spending, which surged in the past three years, averaging $11.1 billion compared with an annual average of $7.3 billion in the previous 10 years. The growth in venture capital spending and technology are resulting in new and better treatment protocols for a wide range of conditions. Once-fatal diseases have become manageable, extending the lives of patients. However, cutting-edge treatments are often costly, working at cross purposes with the need to reduce costs.

**Pressure to Reduce Costs**

The first two disruptors, transition to value and consumerism, focus on the pressing need to restrain the increase in health care expenditures, which is an overarching disruptor in the health care industry. After rising by 7.7% annually from 2000 to 2007,
total expenditures rose by just 3.8% per year from 2007 to 2013, according to data from the Centers for Medicare & Medicaid Services (CMS). This could be a result of the 2007-2009 recession, when millions of people lost their insurance along with their jobs, and to mandates in the Affordable Care Act, passed in 2010, pushing insurers and health care providers to rein in costs. The moderation was temporary, however, with annual cost increases averaging 5.5% in 2014 and 2015, the last year for which CMS has data. Over the next 10 years, CMS expects an average annual increase of 5.6%, which would likely be about twice the rate of general inflation. CMS forecasts that expenditures will rise from 17.8% of GDP in 2015 to 19.9% in 2025. On a per capita basis, expenditures will increase from $9,990 in 2015 to $15,800 in 2025.

One of the cost-cutting strategies most relevant to commercial real estate is the shift by providers from hospitals to more affordable outpatient facilities, including physician offices, emergency care clinics, diagnostic laboratories and surgical centers. As the delivery of services has migrated to outpatient facilities, the number of hospital beds in the U.S. has been declining on an absolute and per capita basis for the past 34 years, from 4.36 beds per 1,000 U.S. residents in 1980 to 2.47 beds in 2014, according to the most recent data available from the American Hospital Association.

Increasing Need for Space

Despite the heightened level of disruption and the pressing need to control costs, employment growth in the health care sector has scarcely missed a beat. Since 1990, health care employment has increased 95%, growing in 310 of the 314 months during this time span, which included three recessions. This was almost three times faster than the increase in both total nonfarm employment and the total U.S. population. Of the three major categories of health care employment tracked by the U.S. Bureau of Labor Statistics, ambulatory health care services grew the fastest, increasing 162%, while employment in nursing home and residential care facilities grew by 84%, and employment in hospitals expanded by 47%. Ambulatory care also was the fastest-growing segment over the past 12 months, adding 230,800 jobs for a gain
of 3.3%, far outpacing the 1.6% increase in total payroll employment. Nursing home and residential care facilities gained 21,800 new jobs during this period, an increase of 0.7%, while hospital employment increased by 104,000, up 2.1%. These numbers likely overstate the gain in hospital employment, because some in this group are located in outpatient facilities owned by hospitals, but the BLS counts them as hospital employees if the outpatient facility uses the same billing code as the parent hospital.

The rapid growth of employment in the health care sector will continue. In its latest occupational forecast, the BLS projects that the two fastest growing occupations from 2014 to 2024 will be health care/tech practitioners and health care support, together adding 2.3 million new jobs. These two sectors will account for nearly one in four of all jobs created over this 10-year span.

Demographics Is Destiny

The aging of the U.S. population is the primary driver of demand for health care products and services, which generates rapid employment growth and occupier demand for health care real estate. Seniors aged 65 to 74 averaged 5.7 annual doctor visits in 2013, the latest year for which most recent data available from the Centers for Disease Control and Prevention (CDC), while the 75-and-older age group averaged 6.7 visits, compared with the overall average of 3.0 visits. Seniors aged 65 and older comprised 14.9% of the population in 2015, but will account for 19.0% by 2025, with the absolute number increasing from 47.8 million to 65.9 million.

The 65-plus age group is growing everywhere, but it is more heavily concentrated in some areas than in others, as the adjacent maps illustrate. The first map shows the 65-plus population in 2016 with the nation’s 917 core-based statistical areas (CBSAs) divided into quintiles, while the second map shows the 65-plus population in 2021 using the same breaking points as in 2016. Six of 10 areas with the largest shares of 65-plus residents in 2021 will be in Florida, led by The Villages, a large retirement community where 48.4% of residents will be 65 and older. At the other end of the spectrum, Provo-Orem,
Utah, will have the smallest share of 65-plus residents at just 7.6%. Considering areas with populations of at least 1 million in 2021, Pittsburgh will have the largest share of 65-plus residents at 19.5%, followed by Tampa, Buffalo, Tucson and Miami. Austin will have the smallest share of 65-plus residents among large areas at 9.9%, followed by Salt Lake City, Houston, Dallas and Raleigh. All of the 917 CBSAs will have more 65-plus residents in 2021 than in 2016.

**Telemedicine: The Next Trend in Healthcare?**

The American Telemedicine Association (ATA) defines telemedicine as the use of medical information exchanged from one site to another via electronic communications to improve a patient’s clinical health status. Health care providers and insurers are rapidly adopting telemedicine to make the delivery of services to consumers easier and more cost-effective. Just a few examples:

- Cell phone apps such as Teladoc and Doctor on Demand link consumers with doctors by video, email or text more quickly and at prices typically lower than in-person visits.
- Electronic health records can improve communications between the patient and multiple providers, saving time and potentially improving diagnoses and outcomes.
- Doctors can monitor intensive care patients remotely, working with onsite professionals to improve the quality of care for patients in distant locations.

The use of telemedicine is expanding rapidly. Virtual doctor visits in the U.S. were expected to reach 1.2 million last year, up from 1.0 million in 2015 according to the ATA. Nearly three-quarters of hospitals and more than half of all physician groups have telemedicine programs, according to a survey by Avizia as reported in the Wall Street Journal, while the percentage of large employers offering telemedicine benefits increased from 48% in 2015 to 74% in 2016, based on a survey by the National Business Group on Health.

Over the next decade or so, the massive wave of aging baby boomers is likely to obscure any impact of telemedicine on the aggregate demand for health care facilities. Beyond that, the continued adoption of telemedicine coupled with slower growth of the aging population, as Gen-Xers enter their golden years, may slow the growth in demand for new facilities. Rather than the shopping center market, a better analogy for health care may be the market for conventional office space. Technology combined with the changing design of office space—the open-office concept—has significantly reduced the required space per employee. Yet the overall demand for space has
Medical Office Leasing Market

Medical office buildings (MOBs) are benefitting from moderate occupier demand coupled with moderate levels of new supply.

- **Vacancy:** After peaking at 12.0% in fourth-quarter 2009, vacancy retreated slowly, ending 2016 at 8.7%. This was the lowest level since 2004. Vacancy for space added in 2010 or later was higher at 12.4%, likely because rental rates are higher for newer space, and because recently delivered buildings remain in their lease-up phase.

- **Absorption:** Occupiers absorbed 13.2 million square feet of medical office space in 2016, the highest level since 2008. Annual absorption from 2009 through 2015 averaged 7.9 million square feet, or a little over half the average of 14.3 million square feet absorbed from 2003 through 2008. Newer buildings—those completed in 2010 and later—captured 55% of total absorption despite their higher rental rates, a sign of occupier demand for well-located space offering up-to-date design and features.

- **Construction:** Both completions and space under construction have crept up slowly since the recession, but they are nowhere near the pre-recession peak. After topping out at 26.8 million square feet just before the recession, the volume of medical office space under construction plummeted to a low of 6.0 million square feet in 2010. Construction rebounded to 9.3 million square feet at year-end 2016, about on par with the 9.1 million square feet in the pipeline at the end of 2015. Space completed in 2016 totalled 7.7 million square feet, within the tight range that has prevailed since the end of the last construction cycle in 2010.

- **Rental Rates:** The average asking rent ended 2016 at $23.58/SF gross, an increase of 0.6% from the prior quarter and 1.3% from the year-ago quarter. Rent was highest among newer buildings—those completed in 2010 or later, averaging $29.80/SF. Higher rents and strong absorption in these newer properties indicate that providers are cognizant of the trend toward consumerism within the industry and value having state-of-the-art facilities to serve their patients.

- **First Quarter Update:** First-quarter market data showed some levelling in supply/demand indicators, although pricing was firm. The average MOB vacancy rate was 8.7%, unchanged from the fourth quarter, as completions of 1.5 million square feet outpaced absorption of 1.1 million square feet during the quarter. Both completions and absorption were down substantially from the year-ago quarter, although it is too soon to tell if this was a one-quarter blip or a longer-lasting moderation in the rate of growth. Rental rates continued to increase at a deliberate pace, partially due to the addition of new, top-of-the-line space to the inventory. The average asking rent ended the first quarter at $23.70, up by 0.5% quarter-over-quarter and by 2.2% year-over-year. Since bottoming in the first quarter of 2013, the average rent has risen by 7.7%.

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Medical Office Investment Market

**Sales Volume:** During 2016, medical office properties valued at $11.4 billion changed ownership, just shy of the record $11.6 billion traded in 2015. While no major portfolios traded in 2016, a blockbuster sale closed in January 2017: NorthStar Realty Finance Corp., a major senior housing owner, sold a joint venture interest in its health care property portfolio for $1 billion to Chinese insurance giant Taikang Insurance Group.

**Pricing:** The trailing four-quarter cap rate ticked up by a mere 10 basis points in the fourth quarter, while the average price per square foot ended the year at $245.53, within the range that has prevailed since mid-2015. Another pricing metric, the Moody’s/REAL Commercial Property Price Index (CPPI), showed that repeat-sale prices of medical office properties rose by 6.0% in 2016 compared with an increase of 13.6% in 2015, indicating that prices continued to rise last year but at a slower pace. With the Federal Reserve expected to raise short-term rates by another 50 basis points in 2017, 10-year yields are likely to increase as well, meaning that the days of cap rate compression are likely over. Expect cap rates and pricing to remain stable in 2017 despite the expected increase in interest rates, thanks to abundant capital and buyer enthusiasm for health care assets.

**Investor Profile:** Private investors were the largest buyers of medical office assets in 2016, accounting for 41% of acquisitions and 5% of dispositions by dollar volume. On a net basis, private investors were also the largest sellers, with net dispositions totalling $1.4 billion. Users/others, including health care systems and other providers, also were net sellers, accounting...
for net dispositions totalling $1.0 billion. This highlights two trends: The increased level of mergers and acquisitions in the industry is prompting the merged entities to right-size their occupancy footprint; and some providers are looking to monetize their real estate assets, preferring to focus their capital on their core mission of service delivery. Publicly traded REITs were by far the largest net buyers of medical office assets in 2016, accounting for net acquisitions of $1.5 billion, followed by institutions and equity funds at $814.8 million and cross-border investors at $156.1 million.

On-Campus Versus Off-Campus: All things being equal, on-campus MOBs command slightly better pricing than off-campus MOBs, with cap rates 25 to 50 basis points lower. Yet the spread has narrowed in recent years, as hospital systems and developers have chosen locations that are more convenient for their patients, a development consistent with the aforementioned trend toward consumerism in the health care industry. Equally important are the tenant financials: A 10-year lease to a credit tenant in a state-of-the-art facility in an off-campus location could erase the gap with an on-campus facility. CMS recently finalized the site-neutral payment rule, which stops paying hospital off-campus facilities the same as hospital-based outpatient departments if they started billing Medicare after November 2, 2015. The rule, which went into effect on January 1, 2017, may force hospital systems to reconsider the costs and benefits of on-versus off-campus facilities.

First Quarter Update: Quarterly transaction volume dipped below $2.0 billion for the first time since first-quarter 2014. We believe this was due to the uncertainty surrounding the interest rate environment after the 2016 election. In the first quarter of 2017, sellers that had previously held off brought a high volume of opportunities to market. There is still strong demand for the best opportunities, and pricing fundamentals remain at or near their historically strongest levels.

While the Fed increased interest rates once during the quarter and signaled the possibility of additional increases, we anticipate strong investment activity in the near term.
Conclusions

Despite the legislative and organizational change roiling the health care industry, the health care property market has been resilient on both the occupier and investment sides. Market fundamentals indicate that absorption, occupancy and rent are at multi-year highs, while construction activity has been appropriate to the level of demand. Investor demand has been solid, just shy of the record sales volume of 2015, despite modest upward pressure on interest rates.

There are three likely reasons why health care property markets have been able to shrug off industry disruption:

• **Demographics is destiny**, and in the case of the health care industry, the aging of the U.S. population is creating overriding demand for products, services—and real estate.

• **Consumerism has not yet reached the disruptive stage** for the health care industry that it has for traditional retailers, many of which are struggling as sales migrate online. Location and functionality in many older and obsolete health care properties is spurring demand for new properties offering state-of-the-art design and better access to consumers.

Expect demand for health care properties to remain solid as the industry continues to evolve.
Sources
American Hospital Association
American Telemedicine Association
Bureau of Labor Statistics
Census Bureau
Centers for Disease Control and Prevention
Centers for Medicare & Medicaid Services
CoStar
ESRI
MoneyTree Report from PwC and CB Insights
Real Capital Analytics
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Newmark Knight Frank research reports are also available at www.ngkf.com/research.

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