

# MedicalOffice

## RESEARCH REPORT

Marcus & Millichap

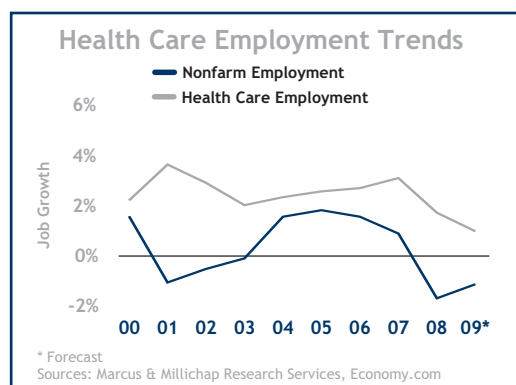
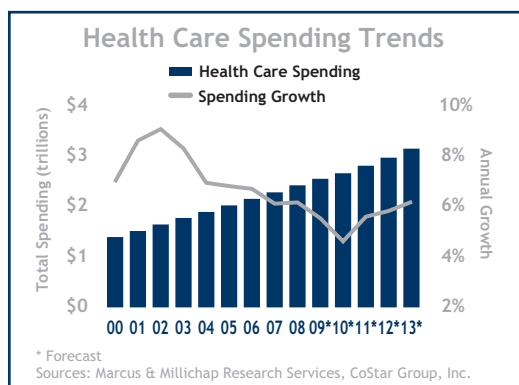
First Half 2009

### MEDICAL OFFICE SECTOR REMAINS HEALTHY IN AILING ECONOMY

Unlike other asset types, medical office properties continue to garner investor demand by exhibiting considerable resistance to the economic downturn. Nonetheless, there are locales across the country where medical office assets are underperforming, and in many instances, there is upward pressure on vacancy. The segment, however, is holding up better than other product types. Much of the economic resilience tempting investors can be attributed to the positive state of the health care industry. The nation spends over \$2 trillion on health care annually, more than double U.S. expenditures on food, and health care spending is projected to exceed \$3 trillion by 2013. In fact, medical outlays have increased by an annual average of 7.7 percent over the past 10 years and now comprise 17 percent of GDP. The rise in spending is facilitated by growth in the number of residents over 55 years old, a group that will expand nearly 20 percent through 2013. Furthermore, people will continue to seek medical care for illness and preventative reasons, despite a recent slowdown in costly elective procedures.

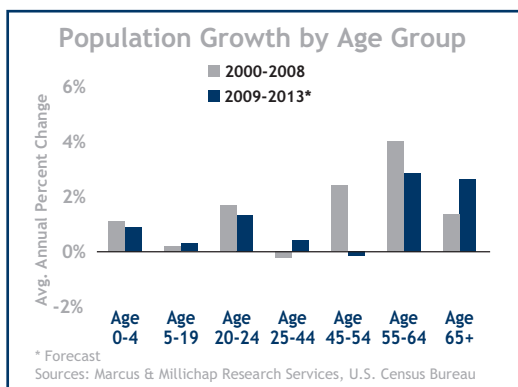
Another demand driver for medical office space has been the shift of medical care from an inpatient to outpatient focus. Hospital construction costs have skyrocketed to an estimated \$1 million per bed, prompting facilities to downsize. In the past, hospitals often supported 800 beds, but many new facilities contain fewer than 100 beds, necessitating more off-site services. As such, care at physicians' offices and visits to ambulatory and diagnostic offices have increased significantly in recent years, generating demand for space. Other construction trends that focus on a property's visibility and ease of accessibility also are becoming popular. Among these are medical malls, or health care offices located in mixed-use projects. Going forward, these trends are expected to gain momentum as hospitals continue to scale back on exportable patient care, further buttressing demand for medical office space.

As a result of forecasts for continued increases in demand, the need for medical workers will remain strong. While almost every other employment sector is contracting, the medical field is adding jobs, albeit at a far more modest pace than the average annual gain of 382,000 employees over the last eight years. The slowdown is due primarily to mild reductions in consumer medical spending. Approximately 52,000 positions have been created in the sector so far this year, and another 200,000 workers are expected by year end. More than 2.4 million health care jobs are forecast to be generated through 2013. The most significant gains are projected for Sun Belt states such as Texas and Florida, where retiring baby boomers are likely to settle. Increased hiring also has facilitated a 17 percent jump in medical school enrollment over the past two years, while the nation continues to undergo a nursing shortage. Nonetheless, of the 420,000 medical positions created in 2008, 168,000 were for registered nurses.





## NATIONAL TRENDS

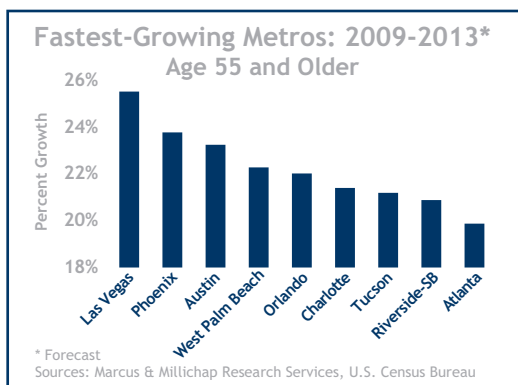


◆ **Demographic Trends:** The aging population continues to support expansion in the medical office market, although the struggling economy has put a damper on recent exuberance. Mounting requirements for expanded health care remain centered on the maturing population, particularly in the nation’s retiree havens. Over the next five years, the population of those between the ages of 65 and 74 will increase 24 percent nationwide and nearly 30 percent in the Southeast and Southwest combined.

◆ **Construction Trends:** In response to increased demand for medical space, developers have ramped up deliveries since 2003. Completions peaked last year at more than 17 million square feet of space. Almost one-third of the new inventory came online in the Southwest, where a once-booming housing market and robust population growth supported demand. Despite the strength of medical office properties, the current economy has prompted developers to cut deliveries for the foreseeable future. Completions are forecast to drop to 14.1 million square feet this year, or an inventory expansion of 2.6 percent.

◆ **Rent/Vacancy Trends:** Uncertainties in the economy, including layoffs and corporate benefit cuts, have prompted many consumers to forgo routine health care and some elective procedures. The resulting decrease in demand will contribute to pushing vacancy up 100 basis points this year to 12.4 percent. Consequently, after finishing 2008 up 1 percent at \$24.60 per square foot, asking rents are expected to dip roughly 2.7 percent by year end.

◆ **Investment Trends:** Demand for medical office assets remains strong, although transaction levels in 2008 were down 15 percent from those recorded a year earlier. Cap rates have climbed over the past year to the high-7 percent to low-8 percent range, fueled by tightening underwriting standards and adjusting buyer expectations. At the close of 2008, the median price was up 1 percent from the previous year at \$210 per square foot.

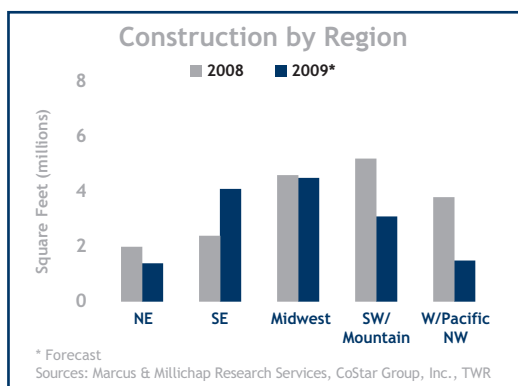


## NORTHEAST

◆ **Construction Trends:** Dense populations within the Northeast region’s large cities help to drive demand for health care; increasingly, however, more hospitals are choosing to expand and office space is springing up in suburban areas where young families are locating. Developers are expected to complete of 1.3 million square feet of medical office space in 2009, the majority of which will be in these growing areas. This year’s deliveries will be down 25 percent from 2008.

◆ **Rent/Vacancy Trends:** Vacancy is forecast to increase again this year as development continues to precede demand. After climbing 40 basis points in 2008 on the heels of a ramp-up in construction, vacancy is projected to rise 50 basis points to 9.8 percent. As such, owners are expected to cut rents, following a 2.7 percent bump last year. Robust development in Northern New Jersey will effect a 50 basis point jump in vacancy, although moderate demand will enable local owners to hold rents relatively firm at slightly less than \$25.00 per square foot.

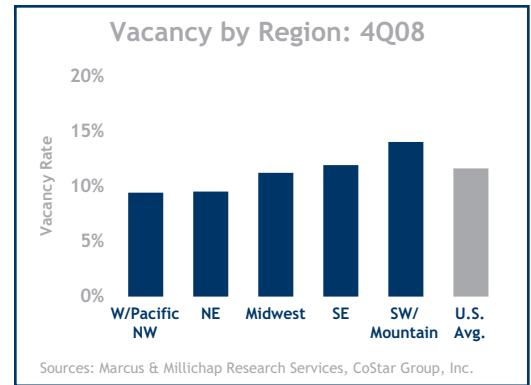
◆ **Investment Trends:** Investors’ interest in the Northeast region remains strong as comparatively healthy fundamentals lure buyers. Investment activity surged last year, with transaction velocity jumping 21 percent. The median price dropped 3 percent to \$195 per square foot, while cap rates averaged in the low-7 percent range.



Regional definitions are available on page 4.

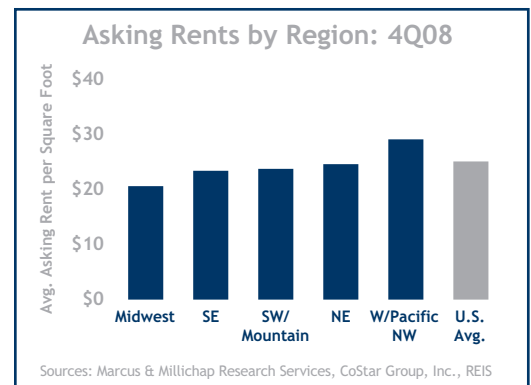
## SOUTHEAST

- ◆ **Construction Trends:** After completing 2.3 million square feet in 2008, developers are forecast to deliver 4 million square feet of space this year. Nearly 40 percent of the projects are located in Florida, slightly above the state's five-year annual average.
- ◆ **Rent/Vacancy Trends:** Robust development resulted in a 150 basis point jump in vacancy last year to 11.6 percent. Vacancy is forecast to rise approximately 100 basis points in 2009 as new product comes online. The long-term outlook for the region's popular retiree locales remains favorable, however, as healthy population gains in older age cohorts will support increased demand for space. Nonetheless, asking rents are expected to fall until vacancy moderates, with the largest corrections projected in central Florida.
- ◆ **Investment Trends:** Expectations for solid long-term fundamentals will continue to support investors' interest in the region. Sales activity rose again in 2008, with both transaction volume and dollar volume growing from the previous year. The median price, however, dropped by about 1 percent to \$202 per square foot, while cap rates increased 40 basis points to 7.9 percent.



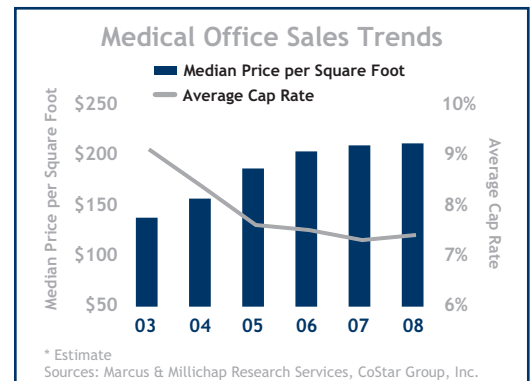
## MIDWEST

- ◆ **Construction Trends:** Medical office developers remain active in the Midwest, fueled by robust demand from growing health care and bio-research facilities in Ohio. Completions in the region continue to average approximately 3 percent of inventory, with roughly 4.4 million square feet of space forecast for delivery this year.
- ◆ **Rent/Vacancy Trends:** New additions to stock will be met with solid demand, keeping vacancy from spiking considerably. After ticking up 20 basis points last year to 11 percent, vacancy is expected to register a similar bump in 2009. As a result, owners in the Midwest are forecast to cut rents this year to keep vacancy in check.
- ◆ **Investment Trends:** Investor demand remains strong in the Midwest, with transaction activity up slightly in 2008. Increased demand put modest upward pressure on prices last year, as the median price inched up 5 percent to \$146 per square foot. Cap rates, meanwhile, compressed 30 basis points to an average of 8.1 percent.



## SOUTHWEST/MOUNTAIN

- ◆ **Construction Trends:** After several years of robust completions in excess of 4 percent of inventory annually, medical office construction is beginning to slow in the Southwest as increasing vacancy and the sour economy dampen builder sentiment. This year, developers are forecast to deliver 3 million square feet of space, adding 2.3 percent to inventory.
- ◆ **Rent/Vacancy Trends:** In 2008, heightened construction activity generated a 180 basis point jump in vacancy to 13.2 percent. Vacancy is forecast to continue rising in 2009 as economic conditions are magnified by the lingering effects of last year's deliveries. After advancing through mid-2008 and then mitigating through the second half, rents are expected to fall this year as owners seek to keep increasing vacancy rates restrained. Phoenix will be especially hard-hit, with vacancy in the metro forecast to approach 20 percent.
- ◆ **Investment Trends:** In 2008, investment activity for medical office product slowed in the region, with dollar volume falling almost 20 percent and the number of sales dropping approximately 30 percent. The median price rose slightly and currently is in the \$200 per square foot range, while cap rates continue to average at the mid-7 percent level.



Regional definitions are available on page 4.

# Marcus & Millichap

## HEALTHCARE REAL ESTATE GROUP

Marcus & Millichap's Healthcare Real Estate Group is comprised of real estate investment professionals who specialize in healthcare properties nationwide. In addition to offering specialized market knowledge, members of the Healthcare Real Estate Group are able to leverage the firm's network of more than 1,300 investment professionals to help clients meet their investment objectives.

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## WEST/PACIFIC NORTHWEST

- ◆ **Construction Trends:** In the West/Pacific Northwest region, developers are pulling back on deliveries, particularly in Riverside-San Bernardino and Las Vegas. Completions in the region will drop by more than 60 percent this year as inventory expands just 1 percent, compared with an average annual stock increase of nearly 4 percent over the past several years.
- ◆ **Rent/Vacancy Trends:** Despite a substantial contingent of retirees and growing populations, the region will continue to record increased vacancy, spurred by recessionary conditions and high development levels in 2008. Nonetheless, vacancy in the region remains the lowest in the nation at 9.2 percent. Rents are not expected to rise this year, hampered by elevated vacancy levels. Las Vegas will be hardest-hit, with vacancy forecast to climb again in 2009 after jumping more than 400 basis points over the past 12 months to approximately 21 percent.
- ◆ **Investment Trends:** Transaction volume fell roughly 20 percent in 2008, following record activity in the preceding year. The median price rose more than 10 percent last year to \$300 per square foot, while cap rates remained in the low-7 percent range, as investors continued on their flight to quality assets. Increasing vacancy and falling revenue streams are expected to dampen activity in 2009, however, with cap rates climbing regionwide.

## SALES HIGHLIGHTS

Property Name	City, State	Sales Price	Square Feet	Price/SF
Palisade Physical Therapy	Palisades Park, NJ	\$3,000,000	4,812	\$623
Valley Medical Day Surgery	Renton, WA	\$3,300,000	7,578	\$435
Valley West Medical	Los Gatos, CA	\$4,300,000	11,005	\$418
University Medical Center	Las Vegas, NV	\$7,000,000	17,874	\$392
Magruder Eye Institute	Orlando, FL	\$12,737,300	34,422	\$370
Medical Office Buildings	Menomonee Falls, WI	\$34,000,000	92,264	\$369
Mills Breast Cancer Institute	Urbana, IL	\$11,246,000	32,290	\$348
Cancer Care Center of Thornton	Thornton, CO	\$6,500,000	18,825	\$345
Southwest Kidney Institute	Phoenix, AZ	\$6,058,000	17,979	\$337
University Medical	Washington, D.C.	\$23,577,952	82,452	\$286
Valley Family Practice Clinic	Renton, WA	\$3,200,000	11,430	\$280
Medical Office Buildings	Las Vegas, NV	\$1,920,000	8,000	\$240
North Hills Professional Plaza	Brea, CA	\$2,615,000	11,800	\$222
Desert Cove Medical Building	Scottsdale, AZ	\$1,575,000	7,269	\$217
Fuller-Ashland Medical Building	Chicago, IL	\$1,540,000	7,855	\$196
Marietta Park	Marietta, GA	\$15,300,000	81,102	\$189
California Cancer & Research Institute	Pleasant Hill, CA	\$11,700,000	62,946	\$186
Taylor Station Medical	Columbus, OH	\$2,350,000	12,792	\$184
Health One	Thornton, CO	\$1,080,000	6,032	\$179
Bacon East & West Medical Center	Concord, CA	\$4,700,000	27,613	\$170
Taft Building	Pembroke Pines, FL	\$3,500,000	20,639	\$170
South Beaches Medical Center	Jacksonville Beach, FL	\$1,200,000	7,169	\$167
Academy Medical Plaza	Philadelphia, PA	\$1,950,000	14,267	\$137

### Regional Definitions:

*Midwest:* Chicago, Cincinnati, Cleveland, Columbus, Detroit, Indianapolis, Milwaukee, Minneapolis  
*Northeast:* Boston, New York City, Northern New Jersey, Philadelphia, Washington, D.C.

*Southeast:* Atlanta, Charlotte, Orlando, South Florida, Tampa

*Mountain/Southwest:* Austin, Dallas/Fort Worth, Denver, Houston, Phoenix, Tucson

*West/Pacific Northwest:* Las Vegas, Los Angeles, Oakland, Orange County, Portland, Riverside-San Bernardino, Sacramento, San Diego, San Francisco, San Jose, Seattle