Sector Spotlight

Strong VITAL SIGNS

Appraisers focused on health care real estate say the sector is in good shape and full of opportunity — but there can be complications

by Deborah R. Huso


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Health care is one of the hottest real estate sectors right now, but in terms of valuation, it's also one of the most complex. As going concerns, health care properties require appraisers to consider property rights; non–real estate assets; salaries; and Medicaid, Medicare and insurance reimbursements that are paramount to revenue development, among other issues.

"It's not just about comps," says James Graber, MAI, vice president and national health care specialty practice leader at CBRE in New York. "If you don't understand the underlying operations, your underwriting won't be correct."

Health care properties can be grouped into two basic categories: medical office space and senior housing. Medical office space includes everything from hospitals and outpatient surgery centers to behavioral health facilities and walk-in clinics. Senior housing includes assisted living, independent living, active adult communities and nursing homes.

The sector as a whole has been on an upward trajectory for several years and is expected to continue on that track. Between 2010 and 2017, the population of those age 65 and older in the U.S. grew by 26 percent, according to the 2018 U.S. Medical Office Buildings report from CBRE. Economists project that population to increase another 32 percent by 2025, and nearly double by 2060.

The CBRE report also notes that the number of insured individuals nearly doubled between 2010 and

2017, meaning some 36 million new patients have access to health care.

"Health care real estate as a sector has become an increasingly recognized asset class and has attracted more institutional investment and foreign capital," says Victor McConnell, MAI, director of real estate services for VMG Health in Denver. "We have an aging demographic and a tremendous amount of demand."

Hot properties

The market for medical office buildings is strong. The national average rental rate for MOBs is $22.90 per square foot, according to the CBRE report. That's the highest on record. What's more, rental rates grew in two-thirds of the nation's markets, with the biggest increases in cities already experiencing low vacancy, including Indianapolis; Louisville, Kentucky; Nashville, Tennessee; New York City; and Seattle.

The same report notes that the total number of outpatient care centers grew more than 50 percent between 2005 and 2016, largely due to efforts by health care providers to reduce costs and patients looking to reduce their personal health care expenditures.

Graber describes outpatient centers affiliated with a major hospital system as the "gold standard" in the real estate sector because the properties have long-term leases with only one or two tenants.

Development of new health care facilities is rapidly expanding in metro areas with heavy population growth, including Atlanta, Dallas/Fort Worth, Houston and Phoenix, CBRE reports. Other markets seeing strong health care construction activity are Boston, Chicago, Minneapolis/St. Paul and California's Inland Empire. However, construction activity and net absorption slowed last year, largely due to heavy consolidation that occurred during the past several years. Merger and acquisition activity almost doubled between 2009 and 2017, with 115 M&A transactions in the health care sector in 2017 alone — the most on record.

Last year, medical office vacancies were up slightly, but the market remains tight, particularly compared with the traditional office market. Cap rates for class A on-campus medical office properties are below 5.5 percent and around 6 percent for off-campus properties, similar to cap rates for traditional office space.

Graber says he doesn't think heavy M&A activity is over. "The M&A side is really working to drive down costs associated with the Affordable Care Act. Smaller guys just can't absorb the cost or deal with the hassle," he says. "Rising costs and electronic medical records have basically done away with the solo practitioner."

McConnell agrees. "The fundamentals driving M&A activity within the health care sector aren't going to change in the immediate future," he says. "The state of the health care real estate market should continue to attract an increasing amount of investor attention, with a larger buyer pool."

Supply and demand

Investment in housing and care for seniors has increased dramatically in recent years, driving growth in independent- and assisted-living properties. Given the fact that the 75 million-strong baby boomer population has already started to reach retirement age, senior housing and care is a market with explosive long-term growth potential. Another CBRE report, 2018 U.S. Seniors Housing & Care Investors Survey and Trends, showed investment volume in those two sectors up 27.3 percent in July 2018 compared with the same point a year earlier.

However, the senior housing market is incredibly fragmented, according to Zach Bowyer, MAI, senior managing director and seniors housing and health care practice leader at CBRE in Boston. Bowyer says the fragmentation signals the possibility of significant growth, noting, "There are a lot of potential disruptors, such as interest in in-home care and technological advances."

Bowyer also sees the likelihood of temporary backward pressure on vacancy rates in the senior housing market. "The leading edge of the baby boomers have 12 to 14 years before they reach the point of needing this type of housing," he says, adding that investors with patience should be rewarded because the market eventually will be "severely underserved."

Interestingly, one area of senior housing and care is cool: nursing care. Nursing care saw a 44.5 percent drop in investment volume in the second quarter of 2018 compared with a year earlier, the CBRE report noted. The chill largely comes from a regulation-heavy environment and challenging Medicare reimbursement models. "Margins are pretty low in nursing care," Graber says, noting that "there is a lot of angst about what's going to happen" as the government begins to roll out a new reimbursement model within the next year or two.

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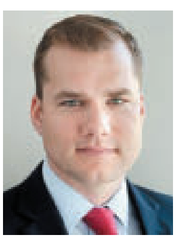

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Walk-in urgent care clinics and other medical office buildings have been commanding the highest rental rates on record — an average of $22.90 per square foot nationally, according to CBRE's 2018 U.S. Medical Office Buildings report.

When CBRE excludes nursing care from its senior housing tabulations, the report reveals a stable sector that's ripe for growth, noting that senior housing investments "outpaced all core asset classes on a quarterly and trailing four-quarter basis."

Graber says he also sees significant potential in the behavioral health care market because it, too, is fragmented and has very few institutional players. "I think that's going to change over the next several years," he says.

Bowyer agrees, noting that behavioral health is one of the fastest-growing health care segments. "It's a very young asset class,'" he says, which means future opportunities will abound.

"The sheer demand for behavioral health care is unlimited, considering things like the escalating opioid crisis," Graber says. But, he adds, "It's not just substance abuse anymore." The Affordable Care Act has driven market expansion in behavioral health because it extended insurance coverage to such conditions as eating disorders, post-traumatic stress disorder and autism. Graber believes behavioral health will join other health care sectors in the coming years in scaling to reduce costs, and says he's working to establish standardization in appraisals for the sector.

Challenges and opportunities

The things that make the health care sector a challenging one in which to generate appraisals are the same things that create opportunities for valuation professionals who are willing to educate themselves about the health care environment.

"The challenges narrow down the playing field," Graber says. "For example, how many people want to work to understand the regulatory environment in senior housing? You have to know the health systems and the M&A activity nationally." He adds, "I enjoy it because of the complexity and the engagement it requires."

James Tellatin, MAI, senior managing director of the health care and senior housing division at Integra Realty Resources in St. Louis, notes, "For hospitals, nursing facilities and senior housing, appraisers should understand that buyers are often regional or national. They will rely upon sale and expense comparables from other states, often many hundreds of miles away from the subject property."

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Appraisers should also consider the value of MOBs in relation to the hospitals or health care systems with which they are affiliated. "Medical office buildings are inextricably connected to the performance of their host hospital," McConnell says. "If you're appraising an MOB, you have to consider the host hospital."

At the same time, it is possible for a market to be dominated by one health asset, which could give it a lower risk profile than one might think, McConnell explains. "You want your building affiliated with the No. 1 or 2 [health care] players in the market," he says.

"Health care is almost 20 percent of GDP, but it's still a fragmented industry," McConnell says. "You have players looking to consolidate and create efficiencies in order to adapt to a value-based reimbursement model, and you need scale to do that."

Additionally, McConnell says, "Appraisers need to understand the legislative climate and regulatory risks within the health care vertical. You can't view this sector in a vacuum." ◀

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