The Case for Medical Office in a Core Real Estate Portfolio

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Executive Summary

Institutional investors have long included core, private real estate in mixed asset portfolios because of:

- **Income** streams that are relatively high and stable
- **Diversification** – a low correlation to other financial assets
- **Inflation Protection** – the ability to mitigate inflationary pressures through increases in rents and the inherent value of the physical property, and a
- **Total Return** that is typically better than fixed income and less volatile than equities.

Medical office assets provide these benefits and are 11%[1] of the U.S. commercial real estate market but are generally under-represented in private, institutional portfolios. Investors looking to improve the efficiency of their real estate portfolio should consider a healthy allocation to medical office. In this paper we examine medical office, its demand drivers and how it fares against preferred institutional sectors (industrial and multifamily) on its ability to deliver the benefits of core real estate in a mixed asset portfolio. Let's start with a look at the drivers of demand for healthcare space.

Healthcare Real Estate Demand Drivers

Healthcare is a fundamental societal need and a substantial portion of the U.S. economy. Over the past five years, healthcare expenditures have represented over 18%[2] of gross domestic product (GDP) and are projected to grow from $4.5 trillion in 2022 to $6.8 trillion by 2030[3]. Where is this expected increase coming from? Not surprisingly, an aging population is one of the primary drivers behind it. An older population requires more healthcare services, which spurs demand for more healthcare space. Another major factor bolstering the demand for healthcare space is the ongoing shift from inpatient to outpatient care. Let's take a closer look at each of these:

The Demographics

Currently, the 65 and older age cohort represents 17% of the U.S. population and accounts for 35% of healthcare spending[4]. Between 2012 and 2022 this group grew 20[5] times faster than all other age cohorts and is projected to grow at a 2.6%[6] annual rate in the coming years, compared to near zero growth for all other age cohorts. Figure 1 shows how U.S. seniors have grown relative to the rest of the population. Notwithstanding a recent drop in life expectancy, which can be attributed to COVID-19 and observed in the shaded period of Figure 1, the steady march of seniors continues with the 50 to 64 age cohort (19% of the population[7]) transitioning into senior ranks over the coming years.

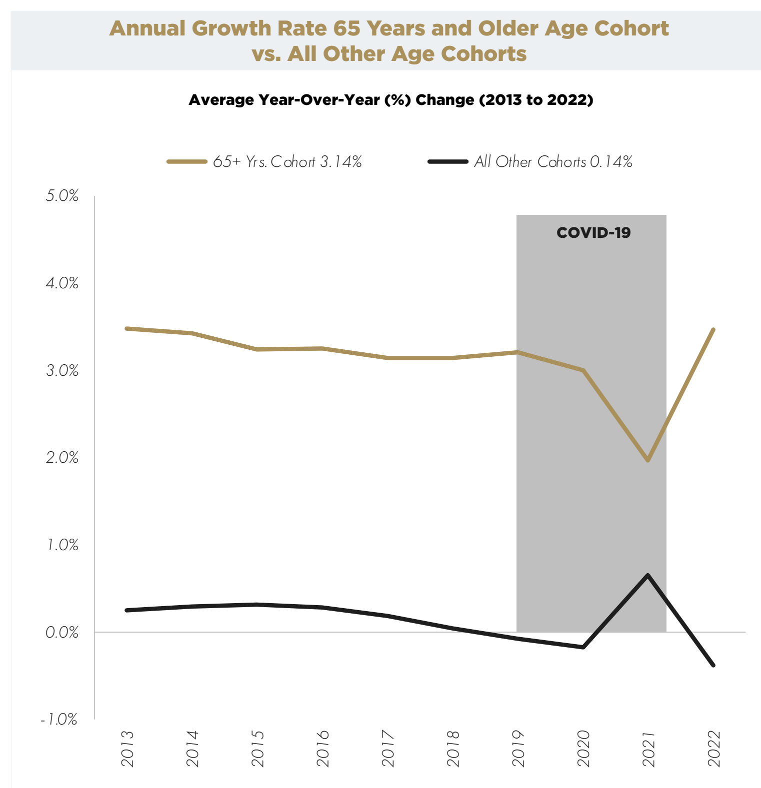

Figure 1. Source: Census Bureau, Upshot Capital Advisors

The Secular Shift in Healthcare Delivery

The demographic trends are strong, but they only tell part of the story. A look at the fundamental change in how healthcare is delivered brings the fuller picture into view. This can be observed in Figure 2, which shows a rise in outpatient admissions over the past 20 years coinciding with a decline in inpatient admissions. The shift to outpatient care is the result of technological advances such as minimally invasive surgical procedures, growing pressure from payers to adopt value-based payment models that incentivize treating patients in lower-cost settings, and consumers' desire for convenience. The trend towards outpatient should continue with projected annual growth of 6.2% through 2028[8] in global ambulatory services, a $3.5 trillion dollar market in 2022[9].

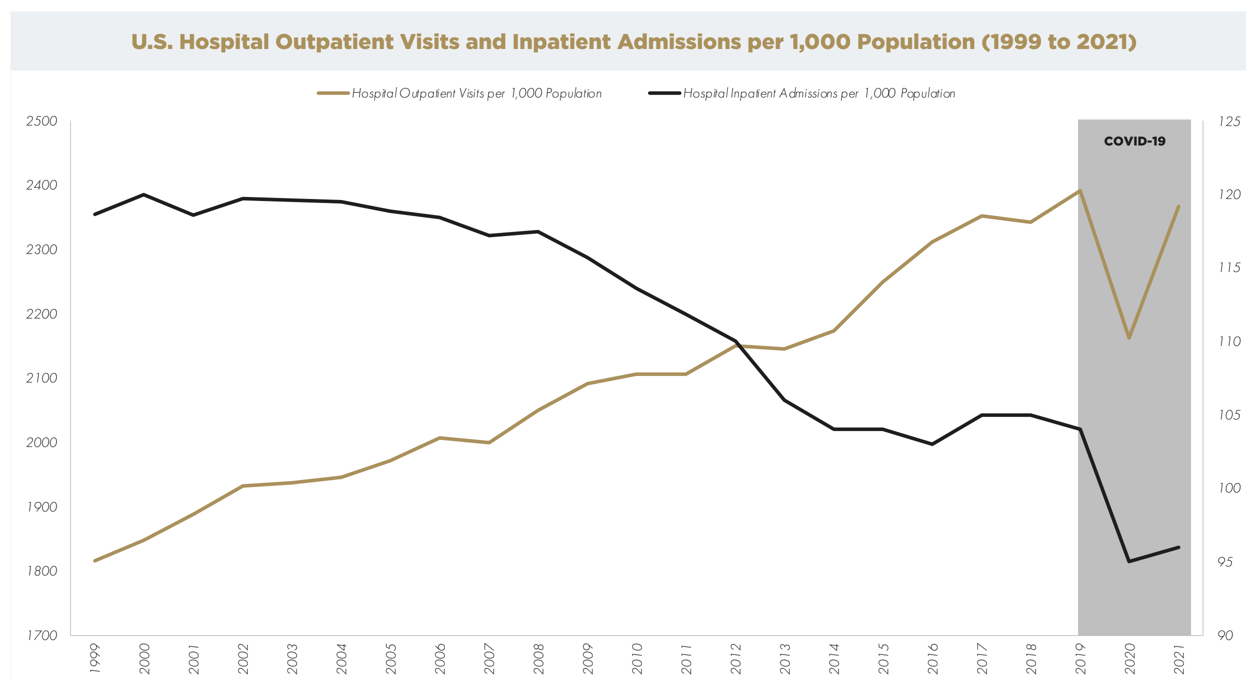

Figure 2. Source: Kaiser Family Foundation, Advisory Board, Upshot Capital Advisors

The combination of these powerful forces (an aging population and shift towards outpatient care) provides for a steady, long-term tailwind for medical office demand. However, can institutions efficiently access this sector and will it provide the real estate benefits they seek? Ideally, we could look to the NCREIF Property Index or the NFI ODCE for clues, but the history of these indices and criteria for inclusion are such that medical office data is sparse. In the absence of a robust private market performance data series, we could look to fill the gaps with a combination of sources including the REIT market, U.S. GDP, transactional cap rate information, and a look at the healthcare industry, its tenants and their leases. Let's now re-examine the reasons institutions invest in core real estate under a medical office lens.

Income Streams That Are Relatively High and Stable

Medical office properties have historically traded at a yield premium relative to the four core property types. This premium was roughly 200 bps just ahead of the Fed tightening cycle with cap rates for medical office and the NFI ODCE at 5.9%[10] and 3.9%[11], respectively, as of December 2021. It persists today with medical office cap rates remaining stable at a 5.9%[9] and the NFI ODCE clicking in at 4.0%[11]. Admittedly, transactions underpinning this data have been limited and we believe medical office cap rates have increased by 50 to 100 bps since mid-2022. No sector is immune to the significant changes we have seen in interest rates, borrowing costs, and financing availability. However, the high level of income in medical office, relative to traditional core sectors

provides for better insulation from rising rates and the potential for some spread compression as the sector garners more investment.

Medical office cash flows should also be more stable than traditional sectors for the following reasons:

- The essential nature of healthcare services (see analysis in Figure 5)
- Higher tenant credit quality than other sectors (technology, financials, energy, others)
- Long leases with 10-to-15-year terms
- "Sticky" tenancy – healthcare tenants renew at a rate of over 80%[12] because they need to remain proximate to patients and affiliated hospitals. They also tend to have a high level of investment in their own space.

Figure 3 compares medical office transaction cap rates to preferred institutional sectors (industrial and apartments). Upshot believes the market is mispricing the risks associated with medical office.

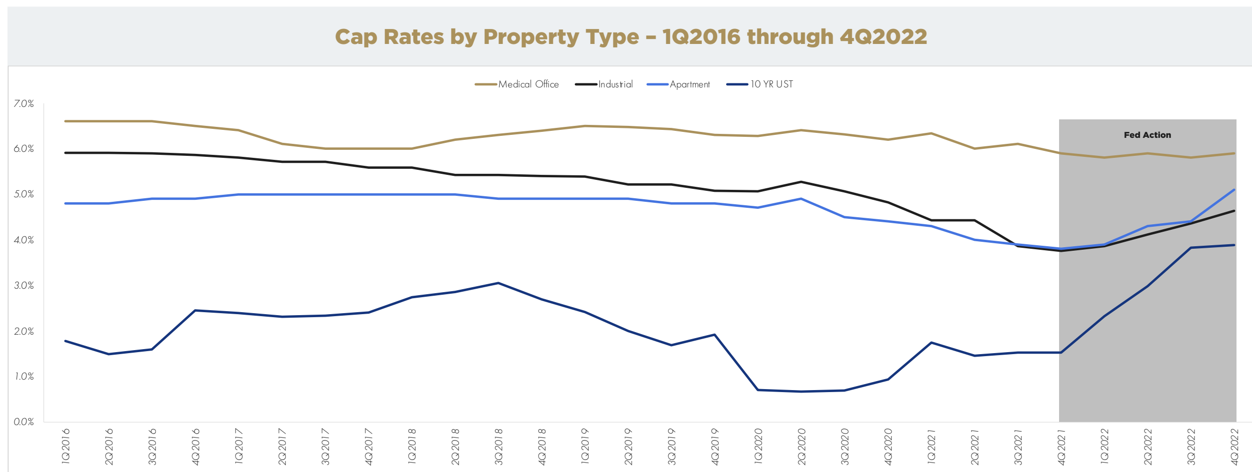

Figure 3. Source: Revista, Green Street, Bloomberg Finance L.P., IDR, NCREIF-Altus, Upshot Capital Advisors

Another way to assess the stability of cash flows in medical office relative to other sectors is to look at absorption trends. Figure 4 shows year over year absorption for medical office, apartments, and industrial. Medical office and industrial look more stable than apartments from this perspective.

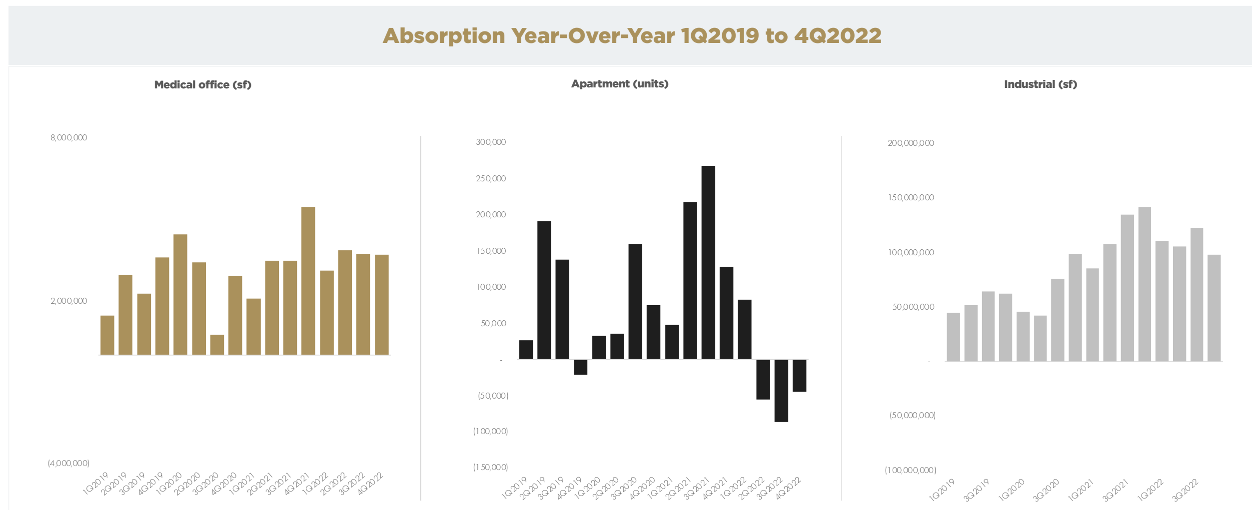

Figure 4. Source: Revista (Top 50 Markets), Axiometrics, Upshot Capital Advisors

Diversification, Inflation Protection and Total Return Benefits

One of the strongest arguments for real estate in a mixed asset portfolio is its low correlation to other financial assets. In the absence of a robust private market performance dataset for medical office, we can look at healthcare spending growth versus GDP growth to get a sense for how medical office might behave relative to other more economically sensitive sectors. This is where medical office really stands apart. Figure 5, which compares healthcare expenditure to GDP growth over time, speaks to the stability of the sector, its total return potential and diversification benefits. Some noteworthy facts:

- Since 1980, healthcare expenditure has grown at a 7.1%[13] annual rate versus GDP at 5.3%[12]. This speaks to the total return opportunity.
- Healthcare expenditure has never experienced negative growth. There are of course periods when growth decelerates, for example between 2020 and 2021. However, it has never turned negative, unlike GDP.
- When GDP decelerates dramatically (dot com bust, great recession, and most recently with the pandemic), healthcare outperforms GDP by a wide margin providing for diversification when you need it the most.

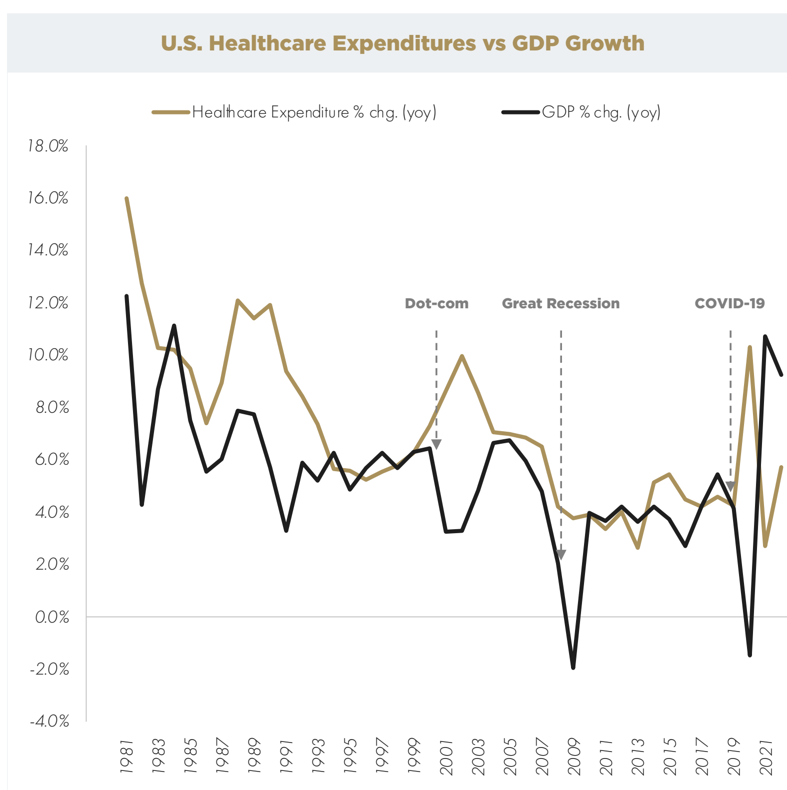

Figure 5. Source: Centers for Medicare & Medicaid Services, Bureau of Economic Analysis, Upshot Capital Advisors

During economic shocks you often hear about portfolio diversification not working. Last year was a classic example with equities and fixed income both posting negative returns. Private real estate was a bright spot, but that had more to do with the appraisal lag than any real insulation from the impact of rising rates. During the second half of 2022, transaction activity came to a grinding halt and liquidity became scarce. Even the mighty Blackstone had to limit withdrawals from BREIT as most, if not all, open-ended real estate funds developed, and likely still have, redemption queues. It takes longer for price discovery to occur in private markets, but it does happen. No asset type is immune to the capital market repricing that has played out over the past 15 months and medical office is no exception. However, it can be said that **during economic shocks medical office cash flows will be more stable**. The behavior of healthcare expenditure, which we are using as a proxy for medical office cash flows during difficult economic periods, is simply remarkable, as shown in Figure 5. The first 12 months of the pandemic were a challenge for many real estate owners. Rent relief, rent freezes, and eviction moratoriums were commonplace. Many stores and businesses succumbed to the pandemic while others thrived. Office, retail, apartments, and hotels all suffered to varying degrees. While other sectors have recovered, office continues to struggle as what appears to be a permanent shift to hybrid work creates a

glut of supply at a time when financing is more expensive, less available, and a recession looms on the horizon. Medical office tenants did not call for rent relief and collections remained above 95% during the depths of the pandemic. If a recession indeed materializes, we expect the sector to be resilient as it has been during previous downturns.

The REIT market also supports the diversification benefits of medical office during times of equity market stress. For instance, the S&P 500 has produced negative returns six out of the last 30 calendar years. Healthcare REITs have outperformed the S&P five out of those six years by an average margin of 2,640 bps[14]. They also outperformed industrial and apartment REITs by wide margins, four and five out of those years, respectively. Figure 6 shows the excess total return of healthcare REITs over the S&P 500, industrial, and apartment REITs during these time periods. **Investors looking for a stabilizing real estate sector during periods of market stress should consider a significant allocation to medical office.**

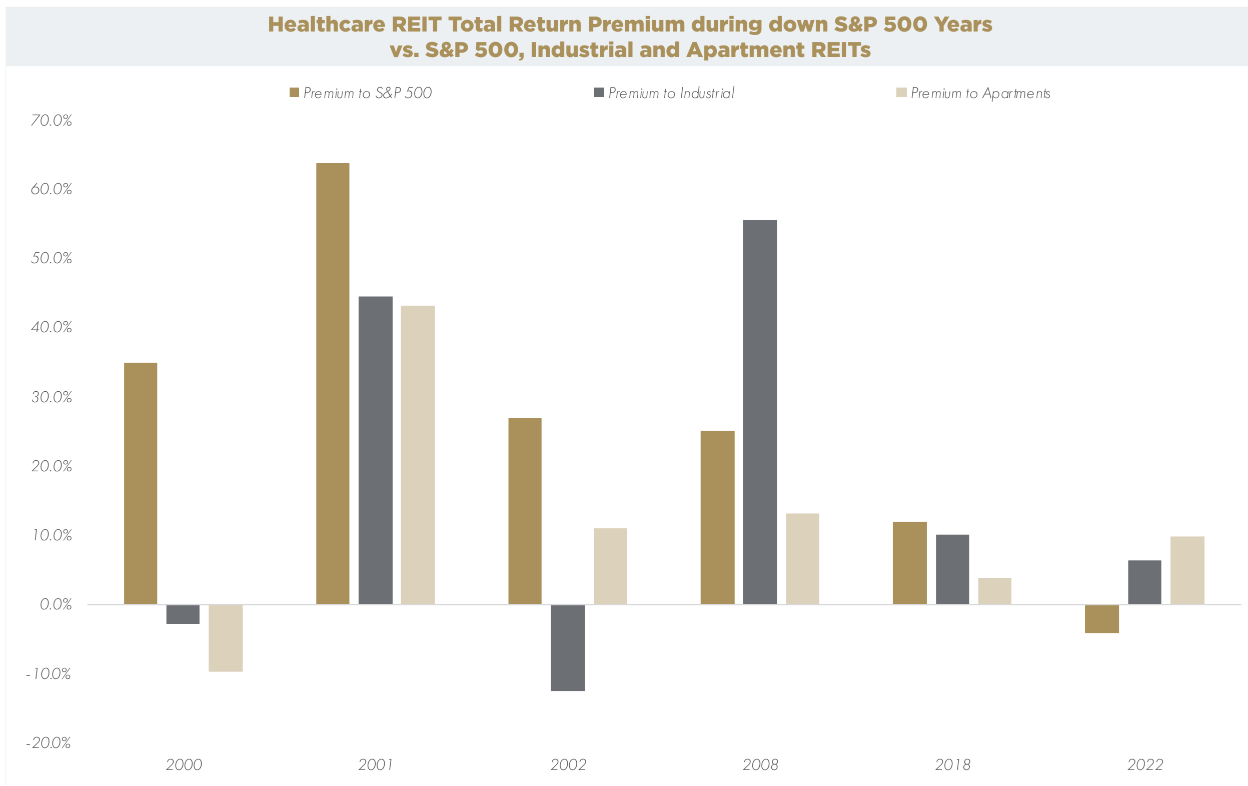

Figure 6. Source: NAREIT, Bloomberg Finance LP, Upshot Capital Advisors

In terms of inflation protection, triple net leases have become the norm in the medical office sector. Rent bumps are either fixed or tied to CPI. Rising costs of operations (insurance, taxes, and other operating expenses) are passed through to the tenants. Medical office clearly delivers the benefits of real estate in a mixed asset portfolio, but it does come with its own unique risks and challenges. Let's look at those next.

Medical Office Risks and Challenges

We see four primary risks and challenges for institutional investors to consider before diving into the sector:

Regulatory risk – adverse policy changes such as changes to Medicare reimbursement rates could impact the profitability of medical tenants and hurt their ability to pay rent. While this risk is ever-present and it cannot be managed, there are a number of mitigating factors that make

this an acceptable risk. Among them, the essential nature of healthcare services, the general stability of healthcare expenditures, and the real political and societal impacts of adverse policy changes perceived to lower the availability and quality of care.

Technology, high tenant improvement costs and specialized build-outs – medical office tenants have specialized build-out, design, and technology needs that must be met precisely to land and keep them. Specialized healthcare real estate operators understand these risks and requirements and know how to manage them. General office players do not. Tenant improvement costs are relatively high at $100 to $200 psf, and space is customized, but these risks are mitigated by several factors including significant tenant investment in their space, proximity requirements to patients and affiliated hospitals, and long lease terms with a high probability of renewal.

Tenant concentration risk – is generally higher in medical office. Buildings are often leased to a single tenant. This risk can be managed and mitigated through:

- Tenant quality bias in terms of their credit and operating history
- Smaller building sizes. For example, a large medical office building might have multiple floors and 60,000 to 80,000 square feet. This could be the size of a single office floor in any of our big cities and would be smaller than the average apartment building with 150 units.
- Portfolio construction (multiple investments with a diversified tenant base)

Smaller transaction sizes – this is a challenge for investors looking to deploy larger sums of capital into a sector in which transactions typically range from $10 to $50 million in total cost. The challenge can be overcome by focusing on larger transactions, relationship-based investing, and portfolio transactions. Investors should also consider working with managers that have the right expertise and discretion to build up portfolio exposures on an asset-by-asset basis.

Another risk worth mentioning here is the overall strain on healthcare systems which was evident before and exacerbated by COVID-19. The profitability of the sector is suffering through a combination of issues including high fixed costs, lower availability and higher cost of labor (nursing in particular), decreasing reimbursements, supply chain issues, and increasing competition from outpatient services. This is both a risk and an opportunity for investors as they can step in with capital and be a real estate solutions provider to high quality healthcare systems. The strain on health systems is also leading to industry consolidation with 17 M&A transactions announced in the fourth quarter of 2022, followed by 15 in the first quarter of 2023 for total transacted revenue of $12.4 billion[15].

Conclusion

Healthcare is a large, stable, and growing sector of the U.S. economy. Healthcare real estate is a substantial portion of the total U.S. real estate market and is underrepresented in institutional investor portfolios. Medical office can deliver enhanced real estate benefits to a mixed asset portfolio; high and stable income, diversification, inflation protection, and a total return that provides a premium to bonds with less volatility than equities. The weight of demographics (an aging population) and the continued shift towards outpatient care will power medical office demand for years to come. The sector comes with added risks, which can be mitigated, but requires specialized expertise. Medical office compares favorably to multifamily and industrial, providing a yield premium to both and offering a more stable return profile, particularly during economic downturns. **Institutions looking to improve the risk/return profile of their real estate portfolio should consider a healthy allocation to medical office.** It's what the doctor ordered.

References:

Note 1. Healthcare REITs represent 11% of NAREIT equity as of Feb. 2023
Note 2. Centers for Medicare & Medicaid Services, CMS Office of the Actuary, National Health Expenditures; Aggregate and Per Capita Amounts, Annual Percent Change and Percent Distribution: Calendar Years 1960-2021
Note 3. Center for Medicare & Medicaid Services (CMS Office of the Actuary Releases 2021-2030 Projections of National Health Expenditures, March 28, 2022)
Note 4. Kaiser Family Foundation analysis of Medical Expenditure Panel Survey
Note 5. Upshot Capital Advisors
Note 6. Census Bureau
Note 7. Census Bureau
Note 8. and 9. International Market Analysis Research and Consulting Group (IMARC Group) – "Ambulatory Services Market: Global Industry Trends, Share, Size, Growth, Opportunity and Forecast 2023-2028".
Note 10. Revista
Note 11. NFI ODCE
Note 12. Revista
Note 13. Centers for Medicare Services, Bureau of Economic Analysis, Upshot Capital Advisors
Note 14. Upshot Capital Advisors
Note 15. Kaufman Hall – M&A Quarterly Activity Report: Q1 2023

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To make a lasting and positive impact on the lives of our people and communities through our actions.