U.S. Research Report

2018 HEALTHCARE MARKETPLACE

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Strong Investor Demand but Policy Concerns Persist. The Nature of Health Insurance is Shifting.

Overview

The U.S. healthcare real estate sector remains on solid footing. The national vacancy rate for medical office buildings (MOBs) fell to an all-time low in 2017. Sales volumes rose and capitalization (cap) rates fell. Net absorption slid, though leasing remained comfortably above its long-term historic average and rents increased marginally at a national level. Over 16 million square feet of new medical office space was delivered in 2017. Driven by rising labor and materials costs, median cost per project rose by around 20% for both MOBs and hospitals in 2017.

As noted in our prior annual reports, there are consistent challenges confronting the healthcare industry and medical real estate which continue in to 2018: financial scrutiny and profitability, demographic changes, advances in technology, co-location with retail uses and a lack of clarity over policy changes to Medicare, Medicaid and the Affordable Care Act (ACA).

The cost and nature of health insurance remains front and center as the future of healthcare policy is still unclear. Our view is that the number of people with health insurance will fall, further heightening cost pressures for healthcare providers, as the new federal income tax code removes the individual insurance coverage mandate under the ACA. At the same time, employers that provide health insurance are encouraging employees to sign up for plans with higher deductibles, thereby placing more cost pressure on consumers.

While investors should be cognizant of these factors, the medical office sector remains attractive in terms of both stability and diversification. Healthcare needs are a constant and the U.S. population continues to age.

Consumer demand for both flexibility and convenience suggest that newer medical office and urgent care facilities should generate stronger returns than older properties, particularly hospitals. This could lead to a degree of obsolescence in healthcare inventory unless capital investment can be justified.

Key challenges facing owners of healthcare assets are the expected drop in provider income, which could weaken the credit strength of some tenants, and the ability to remain competitive on rents. A reduction in the number of people insured, some of whom will be unable to afford private insurance, combined with firms providing direct insurance and healthcare for their employees, could negatively impact revenues.

Additionally, sustained pressure for healthcare operators to lower spending should heighten their focus on reducing real estate overheads. The continued stream of mergers between healthcare systems will reduce the number of players in the market and increase their negotiating power. This could drive a downturn in rents.

Key Takeaways

- **Vacancy:** National MOB vacancy fell for the sixth successive year in 2017 to an all-time low of 7.3%.
- **Absorption:** MOB net absorption fell by 25% in 2017 to 17.2 million square feet, after a record year in 2016, but remained above its long-term average.
- **Rents:** National full-service gross MOB rents increased by 1% in 2017. Boston, San Diego and Seattle saw the strongest rent growth among the major markets.
- **Construction:** Following 16.2 million square feet of MOB deliveries in 2017, down 15% from the prior year, the 2018 total is set to rise to 20.5 million square feet. Median cost per project rose by 19% for MOBs and 23% for hospitals in 2017.
- **Sales:** Total investment in MOBs rose from $9.2 billion in 2016 to $11.3 billion in 2017, while cap rates compressed to an average of 6.4%.

Vacancy Remains Historically Low. Rents are Still Rising in Most Leading Markets.

Looking at 10 U.S. markets that are popular with investors, these markets fall into two distinct categories. Four markets—Boston, Los Angeles, San Diego and Seattle—all have vacancy rates well below 10%, with Seattle ranking the lowest at 4.9%, which is the same level as a year ago at the end of 2016.

Conversely, vacancy rates in the less supply-constrained markets of Atlanta, Chicago, Dallas, Houston, Phoenix and Washington, D.C. are all above 10%, peaking at 13.3% in Phoenix, down from 14.3% one year earlier.

Key Markets: Vacancy Rates and Asking Rent

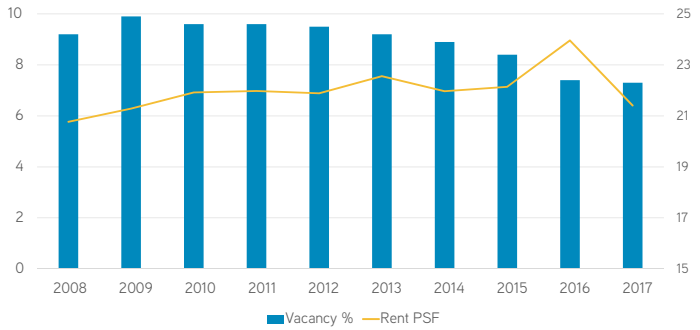
MARKET	MOB VACANCY	GROSS RENT PSF
Atlanta	11.1%	$21.41
Boston	6.1%	$25.44
Chicago	10.9%	$21.94
Dallas / Fort Worth	11.1%	$24.59
Houston	11.4%	$25.42
Los Angeles	7.4%	$31.32
Phoenix	13.3%	$22.16
San Diego	7%	$32.89
Seattle	4.9%	$30.01
Washington, DC	11.3%	$27.58

Note: Data as of Q4 2017
Source: CoStar

Over half of the 10 markets have rents in a narrow range of around $21.50 to $25.50 per square foot FSG. The principal exceptions are on the west coast, most notably in Southern California with rents in San Diego and Los Angeles at $32.89 and $31.32 per square foot FSG respectively.

Rent growth during 2017 was by far the strongest in Boston at 17.1%, followed by the west coast markets of San Diego (6.0%) and Seattle (5.7%).

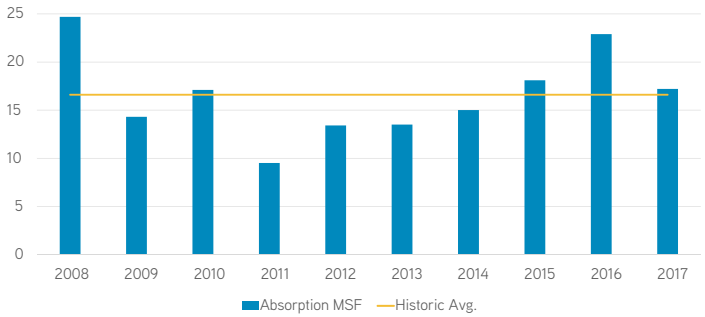
Medical Office: National Average Vacancy Rates and Asking Rent



Source: CoStar

Demand for MOB space fell at a national level in 2017. Total U.S. MOB net absorption was 17.2 million square feet in 2017, down from an all-time high of 22.9 million square feet in 2016 but slightly above the 10-year historic average of 16.6 million square feet per year. The U.S. MOB vacancy rate fell marginally to 7.3%, down by 10 basis points over the year from 7.4%, which is a 10-year low.

Medical Office: National Average Net Absorption

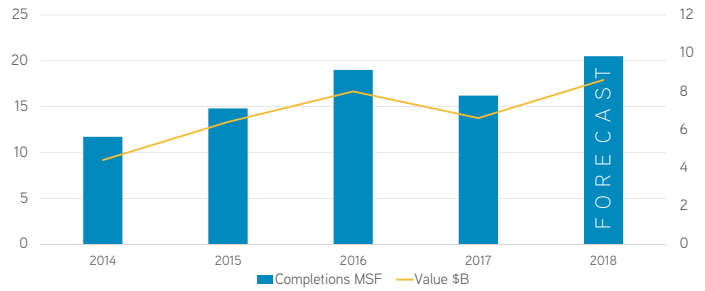


Source: CoStar

Construction Remains Elevated

The volume of MOB space being delivered to the market continues to rise. Completions are forecast to total 20.5 million square feet in 2017, up from 16.2 million square feet in 2017. The construction value of MOB space being added is rising and is estimated at $8.6 billion for 2018, up from $6.6 billion in 2017 and $8 billion in 2016.

Medical Office: Recent & Forecast Supply



Source: Revista

There are almost 860 healthcare properties under construction in approximately 360 MOBs and 490 hospital projects. Median construction value per project stands at $17.8 million for MOBs and $42.5 million for hospitals. Driven by rising labor and materials costs, median cost per project rose by 19% for MOBs and 23% for hospitals in 2017. Project sizes average 77,000 square feet for hospitals and 50,000 square feet for MOBs.

Construction in Progress | Year-end 2017			
	MOB	HOSPITAL	TOTAL
Number of Properties	366	490	856
Total Square Feet	29.7M	77.5M	107.2M
Construction vs. Inventory	2.1%	4.9%	3.6%
Total Construction Value	$13.3B	$56.4B	$69.7B
Median SF/Project	50,000	76,700	60,000
Median Construction Value/Project	$17.8M	$42.5M	$26.7M

Source: Revista

With with an additional 21.2 million square feet at the planning stage, the delivery of MOB space looks set to remain elevated for the immediate future. However, the combined pipeline remains weighted to hospitals which account for 69% of potential new square footage and 80% of total construction value.

MOB construction remains focused on off-campus facilities underpinned by the continued demand for readily accessible location and the shift away from inpatient hospital care. Off-campus properties account for 72% of projects opened in 2017 and 70% of those set to deliver in 2018.

Medical Office Openings Expected in 2018			
	PROPERTIES	TOTAL VALUE	TOTAL SF
Off Campus	231	$4.4B	12.6M
On Campus	97	$3.8B	7.9M
Total	328	$8.2B	20.5M

Note: Forecast as of Q4 2017
Source: Revista

Five states—California, Florida, New York, Pennsylvania and Texas—dominate the construction pipeline with a combined total of 63.8 million square feet in current and planned projects. Led by California at 17.2 million square feet, these states account for 37% of the total U.S. total pipeline.

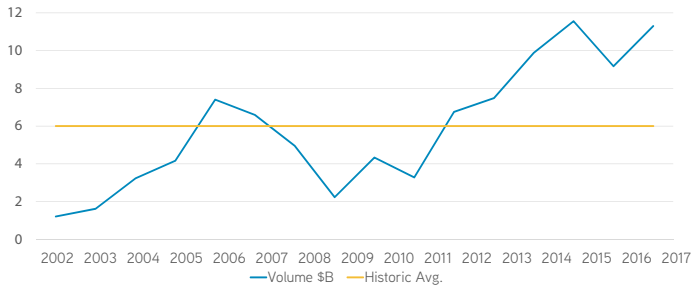
Total Construction Pipeline | Leading States			
	MOB MSF	HOSPITAL MSF	TOTAL MSF
California	11.8	5.4	17.2
Texas	11.8	3.1	14.9
Florida	10.1	2.6	12.7
New York	5.5	4.8	10.3
Pennsylvania	6.8	1.9	8.7

Source: Revista

Sales

Total investment in MOBs rose from $9.2 billion in 2016 to $11.3 billion in 2017, while average cap rates compressed from 6.7% in 2016 to 6.4% in 2017. Pricing remained steady, with a marginal increase from $259 per square foot in 2016 to $263 per square foot in 2017.

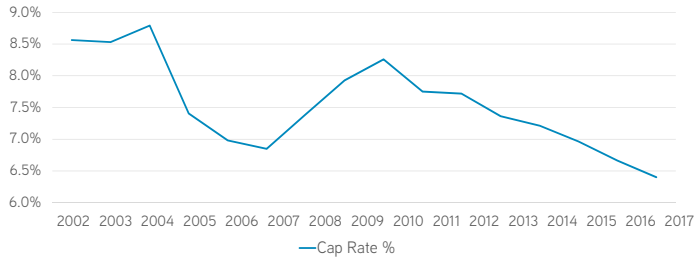
Medical Office: Sales Volume



Source: Real Capital Analytics

Cap rates ranged between 6% to 6.5% for the majority of transactions. While sub-5% cap rates have been achieved on sales of trophy assets, the yield-gap is expected to narrow which may deter some investors. The credit rating of the operator and remaining length of lease term remain the core criteria by which investors are measuring the attractiveness of acquisitions. There is no discernable investor preference between on- and off-campus assets. Properties that mix healthcare with other uses (predominantly retail) are perceived by some as more intensive to manage.

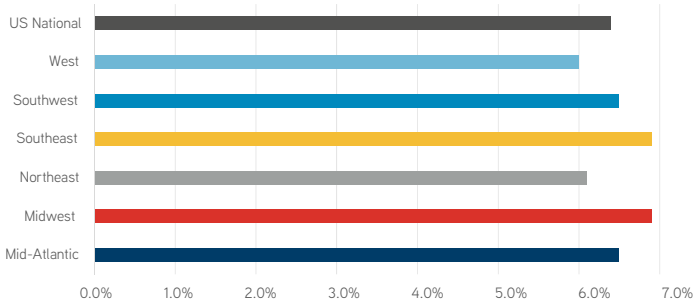
Medical Office Cap Rates



Source: Real Capital Analytics

Within the overall MOB investment framework there are marked differentials by location. Cap rates are the tightest in the West at 6.0% followed by the Northeast at 6.1%. Only two regions—the Midwest and Southeast—have cap rates that are noticeably higher than the national average with both at 6.9%.

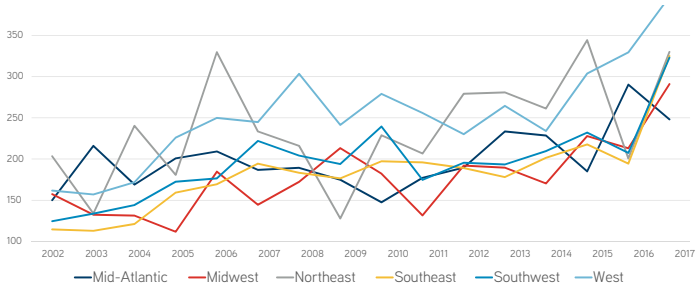
Medical Office: Cap Rates by Regions



Source: Real Capital Analytics (Data as of 4Q 2017)

In terms of pricing, assets in the West remain by far the most expensive at $397 per square foot. With the exception of the Mid-Atlantic, all six U.S. regions saw an increase in pricing in 2017. Pricing across the Northeast, Southeast and Southwest is virtually in tandem with all three regions generating average sales values of around $325 per square foot.

Medical Office: Sales Price by Region ($/SF)



Source: Real Capital Analytics

In terms of sales volume per market, the three most active markets in 2017 were Atlanta ($1.1 billion), Los Angeles ($973 million) and Dallas ($893 million). Houston and Chicago round out the top five at $495 million and $409 million respectively.

Most Active Investment Markets in 2017

MARKET	VOLUME $M
Atlanta	1,115
Los Angeles Metro	973
Dallas	893
Houston	495
Chicago	409
New York City Metro	385
San Francisco Metro	381
Minneapolis	344
San Diego	315
Tampa	287

Source: Real Capital Analytics

REITs and publicly listed real estate companies remain the dominant presence in terms of buyer type, accounting for 41% of acquisitions by sales volume in 2017 up from 33% in 2016. Reflecting this commitment to the healthcare sector, acquisitions by REITs tend to exhibit the most aggressive pricing.

Institutional investor interest in MOBs remains healthy but fell from 37% of sales volume in 2016 to 30% in 2017. Cross-border investors have yet to make a sizeable foray into the MOB sector accounting for just 3% of total sales volume in 2017.

2018 Outlook

Before considering the year ahead of us, let's reflect on the trends and outlooks from the past three years. In this annual market report, we have reported on the consistently favorable real estate trends for vacancy, rents and investment. Each year, we have noted the consistent challenges confronting the healthcare industry: financial scrutiny and profitability, demographic changes, advances in technology, co-location with retail uses and a lack of clarity on policy regarding Medicare, Medicaid and the ACA. All of these, along with the two issues below, remain front and center.

- **Costs:** Cost-containment remains a major issue for healthcare providers and competes with pressure for improvement and innovation in services. Staying ahead requires investment. Healthcare tenants will continue to look for ways to reduce their real estate occupancy costs. Capital raising through the sale and leaseback of assets by healthcare operators is set to continue. Developers are also facing cost challenges. Driven by rising labor and materials costs, median cost per project rose by around 20% for both MOBs and hospitals in 2017.
- **Healthcare Policy:** One year out from our previous report, the future of healthcare policy is still unclear. While the repeal of the ACA and policies that will replace it remain under debate, the overarching view is that the number of people with health insurance will fall with the end of the individual insurance coverage mandate, further heightening cost pressures for healthcare. However, it will take time for the policy changes to fully play out which, to a degree, tempers immediate worries. Starting in June of this year, insurance carriers can opt out of offering coverage through the ACA marketplace which could negatively impact health insurance affordability. Reduced income due to a drop in the number of people insured could impact the credit strength of some operators.

Additional factors that are increasingly coming in to play include:

- **Employer-Sponsored Insurance:** Employers that provide health insurance are encouraging employees to sign up for plans with higher deductibles, thereby placing more cost pressure on consumers. The cost of health insurance is already outpacing earnings, rising by 19% and 12% respectively from 2012 to 2017. According to the Kaiser Family Foundation, the employer-sponsored health insurance market provides coverage to an estimated 160 million Americans.
- **Independent Insurance Provision:** In an attempt to curtail employee healthcare costs, Amazon, Berkshire Hathaway and JP Morgan recently announced an unprecedented move to create their own independent health insurance company. Details of the proposal, which could apply to one million workers, will emerge in 2018. Additionally, Apple plans to roll out its own onsite clinics for employees this spring through a subsidiary called AC Wellness. Initially these new primary care facilities will be located at two sites in Santa Clara County, California where Apple is headquartered.
- **Mergers and Acquisitions:** Further blurring the lines between healthcare players, CVS announced a $69 billion acquisition of Aetna in December 2017. CVS operates 10,000 pharmacy and clinic locations which could become community-based healthcare operations, with medical professionals and services on site, as a response to consumer demands for proximity and one-stop shopping in their healthcare needs. Within the realm of healthcare providers, further consolidation is expected driven by cost and efficiency concerns involving both healthcare systems and physician practices.
- **Taxes:** The recently enacted federal tax reform has mixed messages for health insurers. For-profit firms are expected to see a significant short-term rise in earnings. Margins could be impacted over time by the need to keep rates competitive but lower enrollment in ACA plans, particularly by people who don't receive federal subsidies, could put upward pressure on premiums and lower operator income which could put downward pressure on rents. Non-profits, such as most Blue Cross and Blue Shield insurers, will see a more limited drop in taxes as, for the most part, they already have a lower federal tax rate than for-profits. On the plus side, deregulation and reduced business taxes for pharmaceutical firms should drive down medication costs and increase the development of new drugs.

Implications for Investors:

- While investors should be cognizant of the issues noted above, the medical office sector remains attractive in terms of both stability and diversification. Healthcare needs are a constant and the U.S. population continues to age.
- Key challenges facing owners of healthcare assets are the expected drop in provider income, which could weaken the credit strength of some tenants, and the ability to remain competitive on rents. A reduction in the number of people insured, some of whom will be unable to afford private insurance, combined with firms providing direct insurance and healthcare for their employees could negatively impact revenues.
- In addition, sustained pressure for healthcare operators to lower spending should heighten their focus on reducing real estate overheads. The continued stream of mergers between healthcare systems will reduce the number of players in the market and increase their negotiating power. This could drive a downturn in rents.
- Continued consumer demand for both flexibility and convenience suggest that newer medical office and urgent care facilities should generate stronger returns than older properties, particularly hospitals as inpatient numbers continue to decline despite population growth. This could lead to a degree of obsolescence in healthcare inventory unless capital investment can be justified.
- While an inflationary environment and rising finance costs may reduce margins on core assets, the healthcare sector is still expanding as other asset classes such as multifamily and office look to have peaked. When combined with solid fundamentals and demographics it may prove more acceptable to take on some degree of risk for medical office acquisitions. Look for the attraction of smaller, niche markets to increase as pricing remains high in major cities.

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Despite Record Occupancy, Areas of Uncertainty Remain for Health Care

Overall, 2016 was a year of expansion for health care real estate in the United States. The national vacancy rate for medical office buildings (MOB) hit an all-time low. Net absorption of MOB space was the highest since 2008 while average rents grew. Investment activity—while down slightly from 2015—remained strong and compressed capitalization rates slightly.

Yet as 2017 gets underway, health care providers and health system owners are facing a variety of considerations that could impact their businesses and real estate strategies. While every change in administration ushers in some level of uncertainty, the industry is facing many questions surrounding the repeal of the Affordable Care Act (ACA) and the details of coverage to replace it. As a result, decision-making in this dynamic sector is likely to be delayed for a time, especially if these policy changes evolve over a protracted and contentious process.

Health care providers are also grappling with the implementation of the final terms for the site-neutral payment rule—which limits the way off-campus facilities are reimbursed by Medicare. This will likely challenge the financial viability of future off-campus real estate projects and cause health care providers to reevaluate relocation or expansion opportunities.

The health care industry is also facing a continued wave of rising costs—from services to construction materials to labor. The U.S. population is aging, which heightens the demand for health care. Health care expenditures per capita exceeded $10,000 in 2016 and are forecast to grow at an average annual rate of 5.8% through 2025. However, providers are increasingly receiving less insurance income and are under constant pressure to protect operating margins while still innovating, improving and enhancing services.

In the face of these challenges, health care real estate fundamentals remain solid and the industry will likely remain buoyed by consumer demand. It will continue to be as important as ever for providers to base real estate decisions in a nuanced understanding of the consumer landscape, the real estate environment and investment opportunities.

Key Takeaways

- **Vacancy:** Strong demand for MOBs pushed the national vacancy rate to an all-time low of 7.4% at year-end 2016.
- **Absorption:** MOB net absorption increased by 25% in 2016 from 18.1 million square feet to 22.7 million square feet—the highest annual total since 2008.
- **Rents:** Full service gross (FSG) MOB rents rose by 8% in 2016 to a national average of $24 per square foot.
- **Construction:** Following 14.6 million square feet of deliveries in 2015, the 2016 delivery total is set to exceed 22 million square feet—just below the 2008 peak of 24.9 million square feet. Nonetheless, this new supply is still modest in inventory terms, representing only 1.7% of the total MOB universe.
- **Sales:** Total investment in MOBs fell from $11.6 billion in 2015 to a still-respectable $9.3 billion in 2016. At 6.7%, average MOB cap rates are in line with the office sector average cap rate of 6.5%.

Vacancy Falls to All-Time Low as Rents Rise

In looking at the 10 U.S. markets that garnered the most investor interest in 2016, MOB vacancy rates and rents vary significantly. Five markets—Boston, Houston, Los Angeles, San Diego and Seattle—have vacancy rates well below 10%, with Seattle ranking the lowest at 4.9%. In contrast, vacancy rates in over-supplied markets are much higher, such as Phoenix at 14.3%.

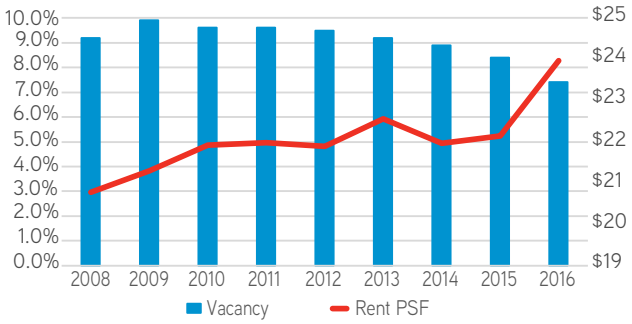
Key Markets: Vacancy Rates and Asking Rent

MARKET	VACANCY	GROSS RENT PSF
Atlanta	10.8%	$20.95
Boston	5.7%	$21.05
Chicago	10.2%	$21.84
Dallas-Ft. Worth	10.2%	$24.01
Houston	7.9%	$21.55
Los Angeles	6.7%	$29.72
Phoenix	14.3%	$22.47
San Diego	6.9%	$31.02
Seattle	4.9%	$27.66
Washington, D.C.	11.3%	$29.59

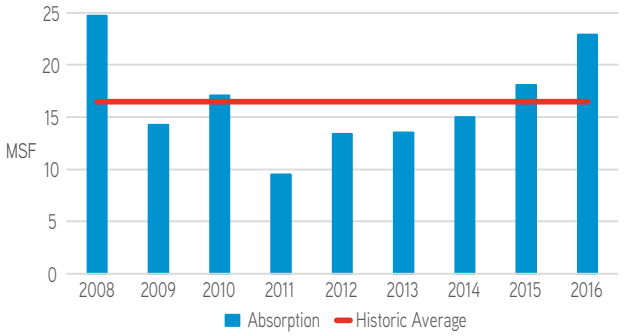
Note: Data as of Q4 2016
Source: CoStar

The majority of the 10 leading markets have rents in a narrow range from $21 to $24 per square foot FSG. However, Southern California markets are achieving the highest rents at $31.02 per square foot FSG in San Diego and $29.72 in Los Angeles. Though not a top 10 market, it's interesting to note that New York exhibits an enormous differential between MOB rents in New York City ($72.07 per square foot FSG) and across the entire New York metropolitan statistical area ($22.93 per square foot FSG).

National Average Vacancy Rates and Asking Rent



National Average Net Absorption

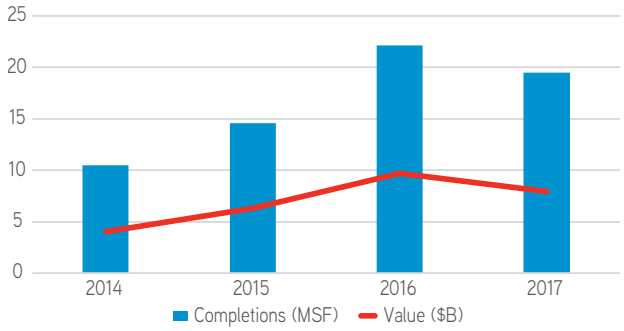


Source: CoStar

Construction Ramps Up After Several Modest Years

Following 14.6 million square feet of deliveries in 2015, the 2016 delivery total is set to slightly exceed 22 million square feet—second only to the 2008 peak of 24.9 million square feet and nearly double the level in 2014. While this resulted in a 54% increase in MOB construction spending in 2016 over 2015, this level is still modest in inventory terms and represents only 1.7% of the total MOB universe. MOB deliveries are expected to remain elevated with around 20 million square feet of completions projected in 2017.

Recent and Forecasted Completions



Source: Revista

The construction pipeline (combining properties already under construction and those at the proposed/planning stages) has the potential to generate more than 1,400 new health care properties, 46% of which are MOBs. Median construction value per project stands at $33 million for hospitals and $15 million for MOBs. Project sizes average 60,000 square feet for hospitals and 45,000 square feet for MOBs.

Total Construction Pipeline

	MOB	HOSPITAL	TOTAL
Number of Properties	648	767	1,415
Total Square Feet	45.8M	111.5M	157.2 M
Construction vs. Inventory	3.5%	7.3%	5.6%
Total Construction Value	$20.3B	$81.8B	$102.1B
Median SF/Project	45K	60K	50K
Median Construction Value/Project	$15M	$33M	$23M

Source: Revista

Analysis of 2015 and 2016 deliveries shows a significant shift away from hospital construction and toward MOBs during this time period. In 2015, the total amount of hospital space delivered (mostly existing facility expansion) was almost double the amount of MOB space delivered. This differential disappeared in 2016, with both property types forecast to account for an equal share of the 44.8 million square feet of health care real estate set to deliver.

Going forward, the total pipeline of future construction is still very much weighted to hospitals, which are slated to account for 71% of the health care space and more than 80% of the construction value in health care space deliveries in the coming years. However, new hospital development is becoming less prevalent. Out of 283 hospital projects set to deliver in 2016, 235 (83%) involve the expansion of existing facilities.

Reflecting the trends of providing care near population centers and reducing hospital beds for inpatient care, the number of off-campus MOB projects expected to deliver in 2016 (300) is nearly three times the on-campus total (115). This reflects the continued shift to off-campus, readily accessible locations to expand reach beyond inpatient market areas.

In terms of value, the four most-populated states dominate the health care construction pipeline. In the lead is California with $15.6 billion in existing and potential construction expenditures, followed by Texas ($9.5 billion), New York ($7.8 billion) and Florida ($6.5 billion). These states account for 40% of the U.S. total by construction value and also lead in terms of expenditures for projects set to deliver in 2016. The totals for California and New York are, in part, driven by high land and construction costs.

Pipeline and Construction Value

	PIPELINE	2016 DELIVERIES
California	$15.6B	$4.3B
Texas	$9.5B	$3.5B
Florida	$6.5B	$2.0B
New York	$7.8B	$1.7B

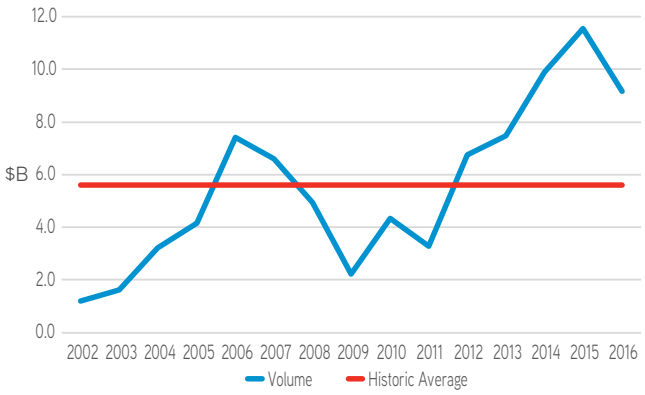
Source: Revista

Rising costs for materials and labor may hold back new construction and lead to more repurposing of existing properties. Yet from an investment standpoint, the rising cost of construction should support rising rent growth in existing properties. However, with health care providers intent on reducing their expenses, securing such increases in rent will be a challenge for landlords.

Transaction Volume Dips but Investor Interest Holds Strong

Total investment in MOBs fell from $11.6 billion in 2015 to a still-respectable $9.3 billion in 2016. Excluding large-scale portfolio trades, the nature and composition of investment activity was similar in both years.

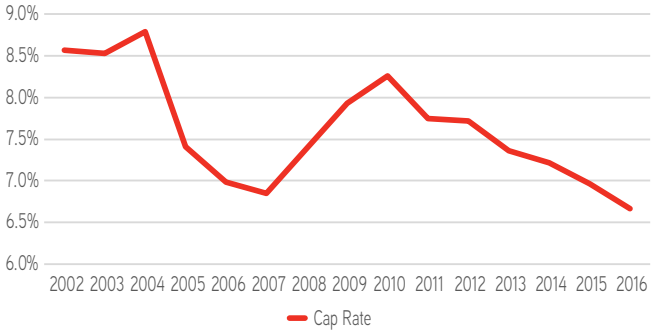
Medical Office Sales Volume



Source: Real Capital Analytics

Average MOB cap rates compressed slightly from 7% in 2015 to 6.7% in 2016, while values decreased marginally with an average price per square foot of $239 in 2016 compared to $252 the prior year. Despite the slight drop in average price, the lower cap rate suggests the dip in transaction volume is likely the result of a slightly lower supply of investment-quality product available for purchase, rather than a lack of interest in the sector.

Medical Office Cap Rates



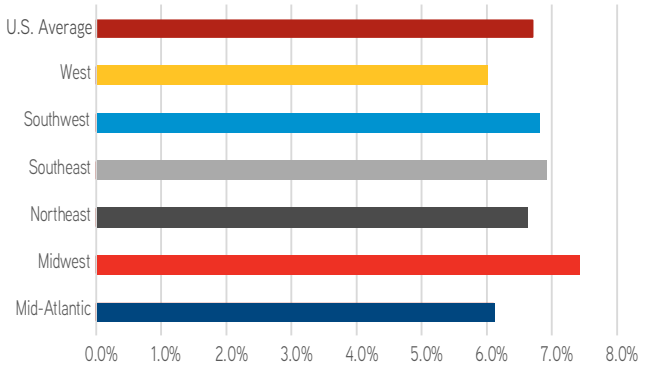
Source: Real Capital Analytics

MOB assets are increasingly being viewed as long-term holds, with investors appreciating their generally stable, long-term tenant bases. The fact that MOB cap rates are now on a par with those in the office sector demonstrates this fact.

In addition to the standard considerations of building class, occupancy and location, buyers must dig into tenants' future income streams. The nature of health care is subject to constant change and innovation. Thus, tenants must be evaluated in terms of their financial strength and outlook as well as their service strategies. Properties that align with the changing nature of health care provision should attract the greatest interest. One example is the "one-stop-shop" approach that combines multiple outpatient specialties and ambulatory services under one roof.

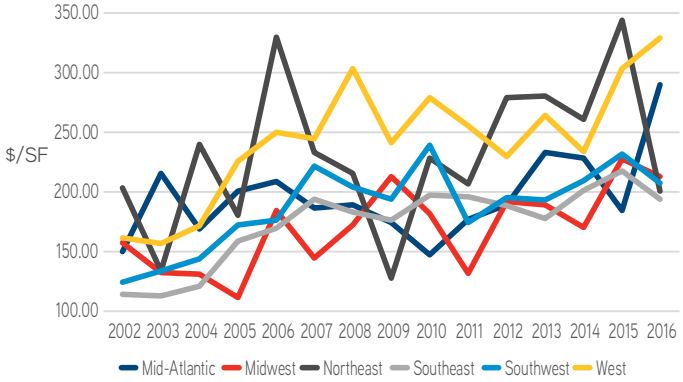
Within the current MOB investment framework, there are marked differences in terms of quality, occupancy and location. The western region of the U.S. remains ahead of the pack with an average sale price of $329 per square foot—$90 per square foot above the national average. Seattle and Los Angeles saw the most MOB investment activity among major U.S. cities in 2016 with a combined total of $1.1 billion in transactions across 82 properties. Along with New York, these two markets also saw trades in excess of $1,000 per square foot, with several around $1,500 per square foot and one above $1,750 per square foot. Cap rates for well-located and fully-leased prime assets remain compressed at around 4.5% in these markets with high barriers to entry—a substantial premium over national averages.

Medical Office Cap Rates by Region



Note: Data as of Q4 2016
Source: Real Capital Analytics

Medical Office Sales Price by Region



Source: Real Capital Analytics

Investor composition only shifted at the margins in 2016. Private investors accounted for the largest share of transactions by value (41%) but this is down from 47% in 2015, making this group net dis-investors. REITS and listed real estate companies were the primary net investors, accounting for 29% of transactions by value in 2016 compared to 26% the prior year. Institutions held steady at around 15% while cross-border investment rose from 3% to 6%. Chinese investors dominated the latter group, accounting for more than 50% of cross-border acquisitions by value.

2017 Outlook: Initially Cloudy but Clearer Skies Ahead

There can be no doubt that the repeal of the ACA and the uncertainty around what lies ahead will cast a shadow over the health care sector for some time. In spite of this, health care real estate fundamentals remain solid and the scale of consumer demand for health care services should continue to increase thanks to the country's aging population. The stability this provides will continue to garner investor interest in health care real estate.

Setting aside speculation on the ACA, there are several other regulatory and market changes that we expect to affect health care real estate in 2017 and beyond.

› Health Care Systems Grapple with the Site-Neutral Payment Rule

As of January 1, 2017, the Centers for Medicare & Medicaid Services (CMS) stopped paying for services provided at hospitals' off-campus sites at the same rate as hospital-based outpatient sites (if they started billing Medicare after November 2, 2015). For affected locations, payments from Medicare for services included under the new rules may be reduced by half. While this rule applies specifically to 2017, CMS has left the door open for subsequent years, listing various ways that it could expand site-neutral payments in the future.

The impact of this change on health care providers and their real estate decisions is potentially significant. For new and planned off-campus sites, providers will need to assess whether they can operate profitably with the lower payments from Medicare, likely delaying some new projects or cancelling some real estate deals altogether. For existing sites, health care providers need to evaluate any relocation or expansion opportunities because a move or even a change in suite number could revoke their excepted status.

› Consumers Take on More Financial Responsibility for Health Care

Beyond the government-sponsored changes to reduce costs, employers continue to drive down their costs by shifting more financial responsibility for health care benefits to employees. The continued expansion of high-deductible health plans is also causing individuals to take on more of the costs for their care.

This shift is making health care purchases a more consumer-driven decision based on cost, quality and convenience. A recent study by The Advisory Board Company showed that primary care customers prioritize convenience over the credentials of their provider or continuity in seeing the same provider. The same study showed that short travel distance was the most-cited consideration when choosing a specialist.

There's no doubt that health care providers' increased mandate to offer care in lower-cost, easily accessible settings will drive changes in property markets. While this trend has been active for years, the intersection with demographic and technology forces will continue to push care into more mainstream settings, like urgent-care centers and retail environments.

› Patient Experience Becomes More Measurable and More Visible

As health care has increasingly moved into outpatient settings, the federal government has implemented reporting to monitor patient experience across a range of metrics. Specific to real estate, these measures include rating facilities and staff. This reporting will become mandatory in 2018, and public reports will be issued starting in 2020.

Many health care tenants are likely to begin assessing their facilities immediately in order to prepare for these reporting requirements. These results will no doubt influence decisions regarding the role outpatient spaces play in providers' patient experiences.

Despite these shifts, the uncertainty surrounding the ACA and rising costs in every facet of the industry, the prospects remain strong for the health care real estate industry. Fueled by the momentum of 2016 and strategic decision-making in the face of market changes, we expect 2017 to bring valuable opportunities for investors and providers alike.

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HEALTH CARE TRENDS IN ACTION

Every day, the trends highlighted in this report are brought to life by Colliers' clients. Learn more about some of our recent transactions.

Maury Regional Health Complex
Spring Hill, TN
64,999 SF
Client: Confidential developer
Price: Confidential

The build-to-suit Maury Regional Health Complex attracted strong demand from private equity investors and REITs, reflecting the value generated when a health system anchors a development. In the transaction with a publicly-traded REIT that invested in the asset, the developer retained an investment in the building and was able to continue their long-term relationship with the health system.

Terrace Park Professional Center
Bettendorf, IA
59,615 SF
Client: Lockard Development, Inc.
Price: $16,800,000

Despite its location in a tertiary market, the Terrace Park Professional Center was met with strong interest from institutional and private equity investors. This transaction showcased the classic profile for medical office investment: located on a hospital campus, connected by a walkway to the hospital and more than 80% leased to a credit-rated health system or affiliate. This transaction also demonstrates that due to limited supply, investors are exploring smaller markets to find high-quality, hospital-affiliated assets.

Holston Medical Group
Kingsport, TN
311,945 SF
Client: Holston Medical Group
Price: $74,000,000

Holston Medical Group (HMG) occupies six office buildings with the trophy asset, HMG Medical Plaza, adjacent to the 505-bed Holston Valley Medical Center. HMG wanted to sell and lease back the six-building portfolio to a private equity firm, but delay closing on three of the buildings. A private equity firm agreed to the delayed closing, lowered rents on the building and created an investment vehicle through which HMG physicians could re-invest back into the assets.

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United States
Research Report

2016 HEALTHCARE MARKETPLACE

Colliers INTERNATIONAL
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Healthcare Real Estate Continues Strong Performance

Michael Roessle Director of Office Research | USA

Colliers' analysis of the healthcare industry and its effect on commercial real estate in the U.S. points to a soaring healthcare landscape with expected increases in investment and further "retailization." In 2016 and beyond, there will continue to be strong demand for medical office space as healthcare spending rises and demand from an aging population grows.

Investor appetite is driven by higher yields compared to other asset classes, low interest rates and a stable tenant base with strong credit. The solid fundamentals of this asset class, combined with the projected aging population growth, are attracting investors not accustomed to investing in medical office buildings. Strong demand should continue into 2016, with the recent interest rate rise having minimal effect.

The retail sector is also expected to benefit as medical clinics, urgent care centers and other outpatient facilities lease space in shopping centers where retailers have left vacancies. There are often favorable lease terms in centers with several vacancies and these areas offer greater visibility and more convenient locations to their patients.

We expect healthcare costs will continue to rise as the Affordable Care Act (ACA) has enrolled millions of Americans who are actively using the coverage they are now paying for. This, combined with the projections in growth of the population 65 years and older, leads to the estimate of a near doubling of healthcare spending - from $3 trillion in 2014 to $5.5 in 2024.

As hospitals and healthcare systems are under pressure to reduce costs while increasing the quality of care, there has been a wave of merger and acquisition activity that is expected to continue into 2016. These hospitals and healthcare systems are seeking to improve efficiencies, reduce duplicate facilities and gain greater negotiating leverage with insurance companies.

Key Takeaways

- **Vacancy Rates: Demand for Medical Office Buildings (MOBs) continues to be strong across the country.** Through three quarters of 2015, the vacancy rate stood at 9.5% nationally, which is a drop of 30 basis points (bps) from the same period in 2014, 130 basis points down from the peak in 2010. The last time the national vacancy rate was this low was in the second quarter of 2008.
- **Absorption: While absorption has slowed, it has remained positive in 2015; totaling 5.8 million square feet through the third quarter of 2015.** That leasing represents a decline of 15.1% over the same period in 2014 and a 58.6% drop from the high of 14 million square feet absorbed in the first three quarters of 2008. As employment growth in the hospital and healthcare systems continues, absorption should remain positive throughout 2016.
- **Rent: Average asking rents for medical office buildings were generally flat in 2015, reaching $22.95 per square foot in the third quarter.** That represents a 0.3% gain from this time last year and a 4.1% gain from the low of $22.16 per square foot seen in the beginning of 2013.
- **Sales: At the end of the third quarter of 2015, the rolling 12 month sales volume ($12.9 billion) hit a new peak, which has contributed to downward pressure on cap rates.** After three quarters of 2015, the rolling 12 month cap rate stood at 7.2% and continues the downward trend seen since yields hovered over 8.0% in 2010. Availability of capital combined with low interest rates, an aging demographic and the effects of the Affordable Care Act (ACA) have been heating up the demand and competition for medical office properties.
- **Technology: Consumers have embraced technology to take a more active role in their care while providing caregivers with crucial information that can lead to more personalized courses of treatment, earlier diagnoses, prevention of unnecessary costs and easier direct communication.**
- **Retail Effect: The "retailization" of healthcare has continued to take leaps forward as providers look for lower-costs and locations that are easily accessible to customers.** As the ACA boosts the number of people with insurance and consumers adopt more responsibility for payment, they are moving from the historical payment model to treating healthcare as any other retail product in terms of choice and cost.
- **Mergers & Acquisitions: Merger and acquisition activity continued to roll in 2015 as the pressures to cut costs and reduce spending while increasing the quality of care have**

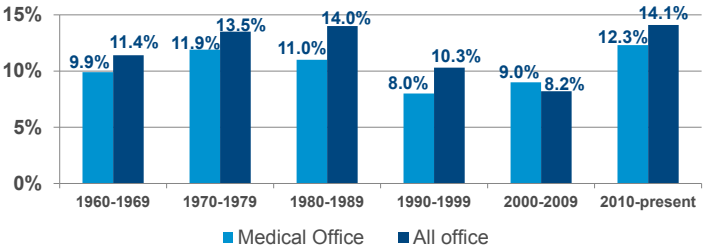
led physician practices, hospitals and healthcare systems to combine for greater negotiating leverage and improved efficiencies.

- **Financial Health: U.S. health expenditures topped $3 trillion in 2014 and are projected to grow by another 5.3% when the totals for 2015 are finalized.** A combination of millions of newly insured people and an aging population have led to this growth in spending.

Vacancy Rates Continued Their Descent in 2015

Medical office building vacancy rates continued their downward trajectory in 2015, reaching 9.5% at the end of the third quarter of 2015, fully 320 basis points below the rate for all office space nationally. This 30 bps drop from 2014 emphasizes the sustained demand for space as health systems continue to expand their footprints. For some historical context, 2015's vacancy rate is a full 130 bps drop from the 10.8% rate at the peak registered in 2010. Vacancies have declined steadily each year since, and we are not far from reaching the 9.1% rate seen at the height of the economic boom in 2007. While the market is experiencing solid vacancy declines overall, the recovery has been bifurcated, with higher vacancies typically seen in older buildings that are more difficult to adjust to changing clinical service needs and new technologies.

Vacancy Rates by Building Age

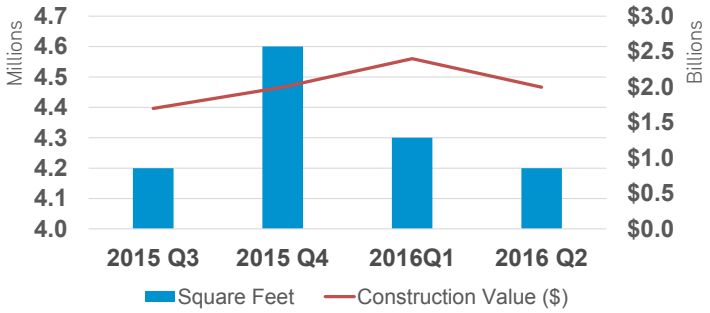


Sources: CoStar, Colliers International

This trend of declining vacancies can been seen in markets as diverse as the Los Angeles Basin, Phoenix and Las Vegas–all of which registered year-on-year drops of at least 50 bps. The Las Vegas market saw a particularly strong decrease of 150 bps to 17.8% from 19.3% in Q3 2014. Phoenix was nearly as strong, registering a 120 bp annual dip to 16.7% from 17.9%. This was the fifth decline in the last six quarters in the market. The L.A. Basin medical office vacancy rate dropped 60 bps over the past year, reaching 8.0% in the third quarter of 2015. Though demand for medical office space in Houston has weathered the plunge in energy prices better than many sectors, vacancy rates rose by 90 basis points in Q3 to 11.5% (from 10.6% in the corresponding period one year ago).

The stable and restrained pace of new construction during the recovery has helped reduce the backlog of vacancies in existing space. After a high of 24.9 million square feet of new supply delivered in the U.S. in 2008, the pace of deliveries has fallen significantly, hovering near 4.0 million square feet per quarter in 2015. According to data from Revista, the MOB deliveries in 2015 are expected to total 16.7 million square feet in 283 properties. Including the expected deliveries of hospital construction, total new supply in 2015 will amount to 28.1 million square feet in 245 properties. The amount of space under construction has also been restrained in recent years following the boom in 2007. The current pipeline of MOBs under construction totals 38.7 million square feet with a value of $18.3 billion, while 84.4 million square feet of hospital construction has a value of $68.3 billion.

MOB - Forecasted Completions



Source: Revista

Total Construction Pipeline			
	MOB	HOSPITAL	TOTAL
# of Properties	542	647	1,189
Total SF	38.7M	84.4M	123.1M
Total Construction Value	$18.3B	$68.3B	$86.7B
Median SF/Project	45.0K	50.0K	46.0K
Median Construction Value/Project	$14.0M	$37.5M	$21.0M

Source: Revista

Medical Office Absorption Remains Positive

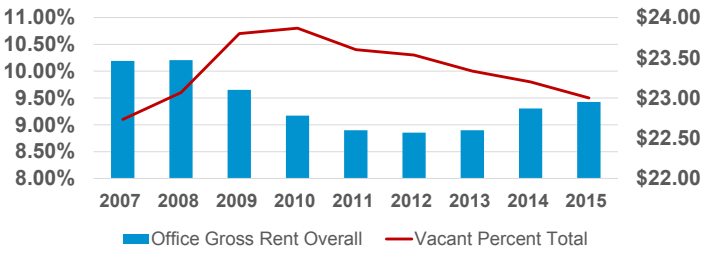
Absorption registered gains of 5.8 million square feet nationally through the first three quarters of 2015, which is a 15.1% decline from the same 6.8 million square feet a year ago. Several years of strong positive absorption–including the period between 2012-2014 when annual totals were between 8.5 and 10.2 million square feet–combined with the limited new supply of the last few years has fueled the steady drop in vacancies and rises in asking rents across the country. Barring any unanticipated shocks to the U.S. economy, strong absorption should continue for at least the short term as the measured pace of strengthening in this sector suggests this is not part of a bubble typically signified by abnormally rapid growth. Still, the dynamic and complicated changes facing the healthcare industry as a whole could alter these variables in the long-term and should be monitored.

Medical Office Rental Rates Hold Steady

Asking rents for medical office space posted an annual gain of 4.1% in Q3, reaching $22.95 per square foot. This is the third consecutive year of asking rent increases for the sector and the highest figure since the $23.10 per square foot seen in 2009. Even with these recent increases, asking rents have remained relatively stable, fluctuating less than $1.00 since 2007. As a comparison, asking rents in the general office market have also seen positive growth,

with Class A properties in CBDs rising 6.8% annually to $48.62 and Suburban Class A properties increasing 3.5% to $28.59. CBD Class A office properties have seen five straight years of rent increases while suburban properties have registered four consecutive years of rent growth.

Medical Office Vacancy Rate & Asking Rent



Source: Revista

Medical Office Sales Continue Strong Performance

2015 was a banner year for medical office sales as capital continued to flow into the sector and strong pricing continued to drive down cap rates. Demand for this asset class should remain healthy throughout 2016, and the modest interest rate rises anticipated this year are unlikely to alter the investment landscape significantly. Vast amounts of capital continue to compete for available investment opportunities, which has led to yields declining to near 7% nationally, with the Northeast and West regions of the country generating yields in the low to mid 6% range. Prices per square foot have reached record levels, pushing above $240 per square foot nationally and above $330 per square foot in the Northeast.

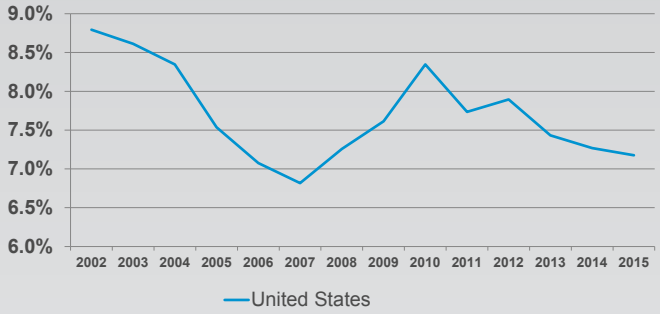
Sales volume continued its record pace in 2015: by the end of the third quarter the rolling 12-month total reached $12.9 billion, far surpassing the trough of $2.2 billion at the end of 2009. As another measure of market strength, that $12.9 billion figure represents 8.7% of all office sales, a sizeable jump from the sub-6% total seen in much of 2014.

The positive market dynamics have drawn investors not traditionally accustomed to investing in medical office properties. Factors include the availability of debt, shrinking yields in other asset classes (particularly in gateway markets) and demographics that point to continued growth in the demand for healthcare services. Projections by the Centers for Medicare & Medicaid Services (CMS) forecast total, national health expenditures climbing from a forecasted 2015 total of $3.2 trillion to nearly $5.5 trillion in 2024.

2016: A Positive Outlook

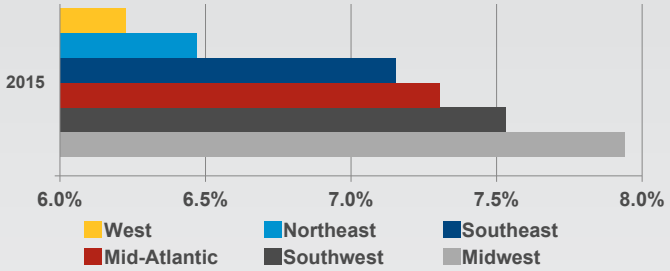
The MOB sector should continue its strong and steady performance through 2016 as healthcare industry employment growth and demographic trends all line up favorably. Now that some of the uncertainty around the ACA has passed and a clearer understanding of its regulations are in place, many barriers to further development and leasing performance are coming down (with a caveat to keep an eye on the political debate surrounding

Medical Office Cap Rates - United States



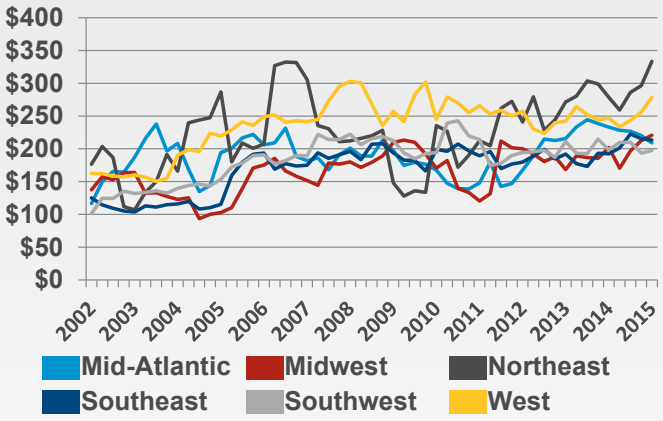
Source: Real Capital Analytics

Medical Office Cap Rates by Region



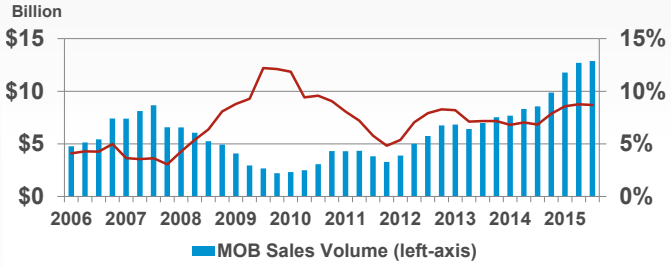
Source: Real Capital Analytics

Medical Office $/SF by Region



Source: Real Capital Analytics

Medical Office Sales Volume



Note: All data are 12 month trailing

Source: Real Capital Analytics

the ACA and results from the elections in 2016). With millions of newly-insured people and a continuing recovery in the more general economy, we should see the positive trends of 2015 carry forward.

This combination of the high numbers of newly-insured people (nearly 17 million according to a study by the RAND Corporation), clarity surrounding the ACA, steady demand from aging Baby Boomers, and economic growth should keep investors attracted to this sector. Still, changing models in the provision of health care can upend the dynamics of medical real estate in the longer term, which is our next topic.

2016 Healthcare Industry Trends: Opportunity or Threat to Real Estate?

With strong demand and favorable growth indicators for medical office real estate from 2015, the outlook for 2016 should be one of continued, steady and positive financial performance. But much of that depends on the healthcare industry overall. Even with the encouraging shifts in reimbursement and steady demand for services, the industry continues to face unprecedented uncertainty and change driven by multitudes of converging trends: complex demographic forces, revolutionary clinical treatments, population health management, provider shortages, and a myriad of other challenges. The outlook for and subsequent performance of healthcare real estate is inextricably tied to the interaction and impact of these changes. This report identifies four key health care trends that will directly impact medical real estate and explores how these four areas will offer opportunities or pose threats in 2016 and beyond.

1. Technological Transformation

Healthcare technology continues to advance to meet demands from patients, providers and payers. The emergence of wearable and shareable technology has enabled consumers to take a more active role in their care. At the same time, it can provide caregivers with crucial information that can lead to more personalized courses of treatment, earlier diagnoses and easier direct communication which can aid in avoiding unnecessary costs. On the consumer front, the proliferation of wearable devices, such as FitBit and Jawbone, are rapidly advancing beyond merely tracking the number of steps taken each day to providing information on sleep, heart rate and body temperature. Also, more advanced monitoring devices are consistently being developed. This data is invaluable for care providers to continuously track and record vital signs rather than relying on a point-in-time snapshot of a patient's condition. Monitoring blood sugar more accurately for diabetic patients, constant monitoring of heart function in cardiac patients, more customized medication adjustments, and tracking medication compliance are all emerging standards of care enabled by advances in technology.

An InMedica study predicted that the number of patients with chronic illnesses who are being remotely monitored will increase from 308,000 in 2012 to 1.8 million by 2017. Remote monitoring can be effective in preventing highly expensive hospitalizations, readmissions after discharge and emergency department visits through proactive early identification and response to symptoms of a worsening condition. All of this reduces the need for direct patient care and thus medical real estate.

As technologies expand and data capabilities become more robust, it is transforming not only how and what care to provide but when and where to provide that care. The traditional business model of patients traveling to their physician's office for routine treatment is being replaced by telemedicine. From providing care online, over the phone, or with remote monitoring, these forms of virtual care reduce the time and cost of recurring office visits. As part of this movement, one of the largest U.S. healthcare chain, Community Health Systems (CHS), announced it was launching a major telehealth program to allow patients access to urgent care services 24 hours a day. According to figures from analytics firm IHS, the market for telehealth in the U.S. is predicted to explode from $240 million in 2013 to $1.9 billion in 2018. With the changes in reimbursement for bundled payments and the push for population health management, telemedicine offers a lower cost approach to direct patient care.

Still, given the risk to patients, there are concerns about the technology changes in healthcare. While smart phones apps proliferate and their usage soars (64% of American adults own a smartphone and 62% of smartphone owners have used their phone to look up information on health conditions, according to a study by Pew Research), the reliability and integrity of the healthcare information provided lacks the robust regulatory controls on direct care provided by licensed professionals. For example, in a 2013 report by the House Ways & Means Committee it was estimated that the 109 new regulations (13,000 pages) imposed under the ACA would translate to an estimated 190 million hours of paperwork per year for businesses and the healthcare industry – regulations that don't apply to the information on many healthcare websites. The safety of remote devices used by untrained, often unwell, consumers along with the reliability of the data reported raises questions of liability to the healthcare provider who provides treatment based on that information. With cyber threats and breaches rampant, the security and privacy of vital health information is under constant attack (massive healthcare data breaches occurred in 2015, including the nearly 80 million records compromised at Anthem, Inc., 11 million records hacked at Premera Blue Cross and 10 million records exposed at Excellus Health Plan). While not as measurable, there is the concern over a less personal relationship between patient and healthcare provider as technology enables distant and data driven care. Nonetheless, healthcare systems continue to invest billions in their information systems and platforms to drive and support these technologies. Many prominent healthcare systems such as Providence Health & Services, Kaiser Permanente and Cleveland Clinic, had or have recently started venture funds to invest in technology being developed by startups. According to a report by Rock Health, venture funding of digital health companies in 2015 is on pace to match or exceed 2014's record-breaking total of $4.3 billion; $2.1 billion has been invested through the first half of 2015.

Opportunity: This rise of technology in healthcare requires

space to accommodate the related changes to how patient care is delivered. As self-service check-in kiosks and patient-location tracking systems become more common, floor plans need to change to enhance patient flow and to maximize space for patient/provider consultations. In addition, healthcare systems that offer shared medical appointments need strong audio/visual capabilities so off-site providers can join the consultations. The demand for technologically-advanced medical office buildings is helped by the shift in procedures to outpatient facilities from the costlier hospital settings where many of those services were performed in the past. With the costs and interruption to retrofit existing space, it can be less expensive to simply build anew. These factors could drive development for new medical office real estate.

Threat: As telehealth services and remote monitoring take hold, the need for direct patient care could plummet. Virtual office visits for minor, urgent and follow-up care require no real estate and could spur providers to reduce the number of exam rooms in their offices. The size of diagnostic equipment is decreasing (handheld ultrasound devices) making them more portable and reducing the need for storage space. As other technologies emerge and drive care into the consumer's hands or home, the need for medical office space could decline.

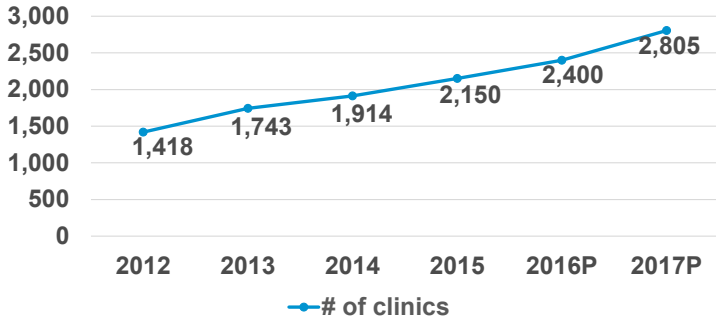
2. Healthcare as a Retail Market

As the Affordable Care Act (ACA) boosts the number of people with insurance and consumers adopt more responsibility for payment, we are shifting from the historical reimbursement model to treating healthcare as any other retail product in terms of choice and cost. This rise of patient consumerism plays a large role in the rise of retail settings for health care use.

- The retail building: Many medical providers, including physicians, dentists, and physical therapists, are being drawn to shopping center locations to leverage the enormous volume of foot traffic. This serves a dual need as landlords seek to fill vacant retail spaces and medical providers want to be visible and easily accessible to existing and potential patients. Prominent signage and the visibility of shopping center locations offer a form of built-in marketing as these facilities aren't tucked away on a hospital campus or in a traditional medical office building. The aging population is in particular need of the convenience and ample parking offered by many of these locations. In addition, the retail setting offers lower occupancy costs compared to traditional medical office settings, particularly if a landlord has high vacancies that push them to consider nontraditional retail space tenants and offer generous free rent and tenant improvement packages.
- The retail health clinic: As millions of new people get health insurance under the ACA, both hospitals and primary care providers struggle to keep up with demand. This has created the opportunity for retail health clinics to ease some of that burden. Patients as consumers are attracted to the convenience and cost of retail clinics as they offer longer hours, shorter wait times and on-site pharmacies. The shift in philosophy from hospital systems and retail clinics as adversaries to partners is also driving the expansion of this approach to care. Healthcare systems are attracted to the lower costs associated with operating in existing real estate footprints and keeping minor medical issues out of expensive emergency departments. The main drawback so far has been winning over consumer confidence in the quality of care provided in these more casual, retail settings, particularly as the seriousness of the health problem increases.

A study by Accenture illustrates the proliferation of retail clinics in the U.S. According to the study, the number of retail clinics is projected to nearly double from 1,418 in 2012 to 2,805 in 2017.

Retail Clinic Growth



Source: Accenture

A study by Manatt Health shows that CVS MinuteClinic and Walgreens Healthcare Clinic are the dominant players–accounting for nearly 75% of market share in the category–with CVS racking up the largest number of health system affiliations (further emphasizing the shift from competitor to partner).

Major Retailers With Health Clinics

CLINIC NAME	# OF LOCATIONS	MARKET SHARE	HEALTH SYSTEM AFFILIATIONS
CVS MinuteClinic	901	50%	47
Walgreens Healthcare Clinic	437	24%	6
Kroger Little Clinic	140	8%	4
Walmart Retail Clinics	103	6%	46
Target Clinic	80	4%	2
RiteAid RediClinic	30	2%	3

Source: Manatt Health

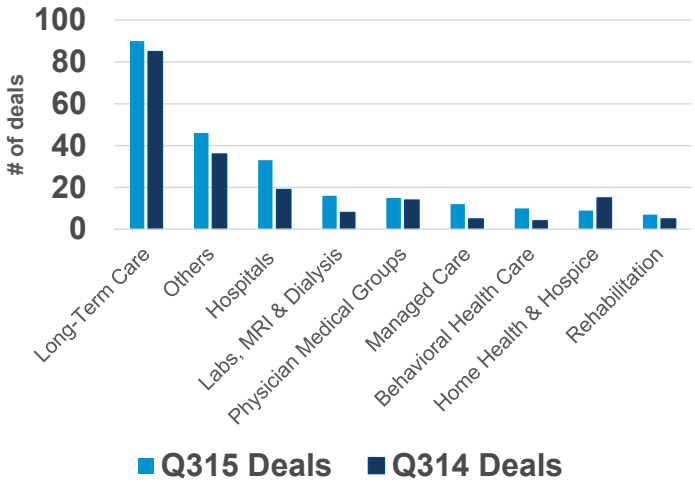
Opportunity: The long-term effect of this retail trend on real estate could be positive if these clinics continue to take space in vacant shopping centers, repurpose vacated big-box stores or build new stand-alone facilities in existing retail centers. As the retail landscape has been shifting toward e-commerce, the growth in demand for healthcare services in convenient locations can be a large driver in filling that void and driving vacancies down, particularly for neighborhood and community retail centers. Long-term leases with favorable terms are often available as landlords are recognizing the benefits of the additional foot traffic these clinics can bring to a retail center. Suburban health care villages are an example of a growing healthcare/retail partnership as a hospital anchors the center and the site includes a host of other medical services as well as retail and restaurant sites. This benefits both the healthcare and the retail real estate markets.

Threat: However, the explosion in growth of clinics located within existing footprints (CVS, Walgreens, Target etc.) does little to spur demand for more real estate in the sector. The cost benefits for both the retail chains and their health system affiliates are significant. It takes only about 300 square feet for a clinic within an existing structure, with immediate exposure to steady foot traffic bringing in many potential healthcare consumers. There is no net demand for real estate, for either retail or healthcare markets.

3. Merger and Acquisition Movement

The trend of mergers and acquisitions in the healthcare industry has continued its momentum in 2015, in terms of payers (Anthem's $54.2 billion acquisition of Cigna and Aetna's $37 billion acquisition of Humana), providers (the merger of Baptist Health South Florida and Bethesda Health) pharmaceuticals (the Pfizer-Allergan merger worth approximately $160 billion) and physicians (AmSurg's acquisition of Valley Anesthesiology & Pain Consultants in Phoenix which has roughly $160 million in annual revenue). The landscape has changed for all sectors of the industry, led by the low cost of capital and interest rates.

Healthcare M&A Volume



Source: Health Care M&A News

The appetite for mergers in 2016 is uncertain. While providers feel the need to scale up to have better negotiating positions with each other and to provide better quality, lower cost care, the Federal Trade Commission is challenging recent merger efforts. It has blocked three proposed mergers recently, in Huntington, West Virginia (Cabell Huntington Hospital and St. Mary's Medical Center), Harrisburg, PA (Penn State Milton S. Hershey Medical Center and PinnacleHealth) and in Chicago (Advocate Health Care and NorthShore University HealthSystem). The FTC claims these mergers would harm consumers with higher prices driven by these larger system's combined bargaining power with health plans.

Thanks to the REIT Investment Diversification and Empowerment Act of 2007, which allows REITs to be involved in the business side of healthcare rather than solely generating revenue by managing real estate, there have been heavy REIT-led acquisitions in 2015. Many of the top deals of the year involved REITs purchasing healthcare systems and their associated real estate, both inpatient and outpatient. The increased cost sensitivity of health systems has led them to explore monetizing their large real estate portfolios to access that capital for upgrades in technology, acquiring independent physician groups and other inpatient facility investments.

Largest Deals of 2015

BUYER	SELLER	SALE PRICE*
Ventas REIT	Ardent Health Services	$1,600,000,000
Ventas REIT	ARC Healthcare REIT (HCT)	$1,286,465,414
Medical Properties Trust (MPW)	Capella Healthcare	$600,000,000
SNH REIT	Cole Properties Trust	$539,000,000
Health Care REIT	G&L Realty	$443,041,633
HCP, Inc.	Memorial Hermann Health System	$225,000,000
St. Louis University	Tenet Healthcare	$200,000,000
HCP, Inc.	Digital Realty Trust	$161,000,000
GA Healthcare REIT III	Kadima Medical Properties	$135,000,000
MBA Real Estate	Illinois Bone & Joint	$131,000,000
*Sale price of real estate only		

Source: Revistamed.com

As mergers bring together hospitals and physician practices into large, financially solid healthcare systems, they aggregate significant real estate portfolios. The full implications of this M&A activity on real estate demand have yet to be fully realized.

Opportunity: Having wider geographic coverage and larger headcounts can lead to increased space demand in existing medical office facilities, as well as those currently under development. These mergers allow healthcare systems to repurpose some inpatient areas as outpatient facilities and open more specialized hospitals and care centers. Investors in these assets enjoy the security of steady income generation projections and higher yields than some other assets, as spaces are typically leased on a long-term basis to tenants backed by healthcare systems with strong credit ratings.

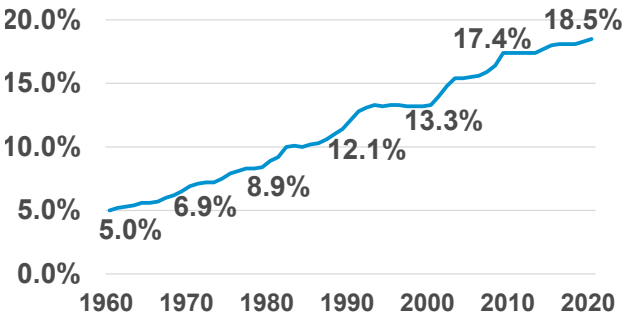
Threat: With these consolidations comes the potential for overlapping markets and redundant facilities. This can fuel the need to shed real estate where demand does not justify the operating costs of duplicate facilities. While these consolidations may ultimately benefit the consumer through improved operating efficiencies and increased capital to invest in upgrading facilities and technology, it could leave many of these facilities dark in the years ahead, with far less need for medical office real estate.

4. Healthcare's Financial Health

Despite the extensive efforts by government, employers and providers to reduce costs, healthcare costs continue to rise, albeit with slower but still steady increases.

- U.S. health expenditures topped $3 trillion in 2014 and are projected to grow by another 5.3% when the totals for 2015 are finalized.
- According to the latest figures from the Office of the Actuary in the Centers for Medicare & Medicaid Services (CMS) published in Health Affairs in early December, national health expenditures rose to $3.0 trillion in 2014, which was a 5.3% increase over 2013.
- Per capita spending on health care was $9,523 in 2014, representing a 4.5% boost from 2013.
- As a percent of gross domestic product, health expenditures amount to 17.5%, 20 bps higher than the prior year.

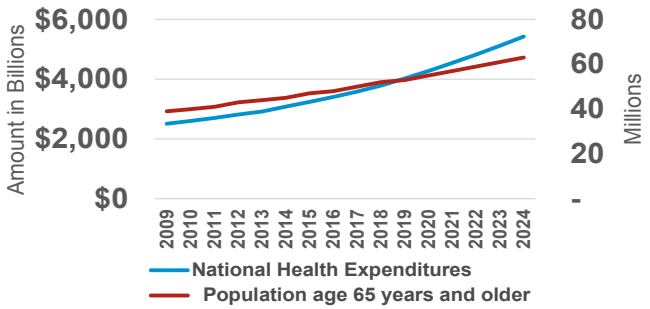
Healthcare Spending as a Percent of GDP



Sources: Centers for Medicare & Medicaid Services, Office of the Actuary

The projections for 2015 look just as strong, with the same 5.3% annual growth forecasted for health expenditures. Looking ahead, we see annual growth in spending rising above the 6.0% mark from 2019-2024. It is no coincidence that between 2015 and 2024, the U.S. population age 65 and older is projected to grow by 34.0% to 63 million people.

Health Expenditures & Population Growth Projections



Sources: Centers for Medicare & Medicaid Services, Office of the Actuary

The rise in spending is largely attributed to the expansion of coverage under the ACA, as there was strong growth in both private health insurance, as well as Medicaid. This rise in spending follows years of much slower growth, as the millions of people who enrolled in coverage under the ACA are using the services for which they are now covered. Fitch, the bond rating agency, maintained a negative outlook for U.S. nonprofit hospitals and healthcare systems in their 2016 forecast. They believe that this sector will continue to be challenged by the rise of healthcare consumerism, minimal insurance rate increases, labor cost pressures and a shift of risk from payers to providers by the growth of value/risk-based contracting. Nonprofit hospitals are generally less equipped to cut costs and contain spending than major for-profit hospital systems. With few expectations that expanded insurance coverage will take the pressure off of operating margins, the healthcare industry faces continued scrutiny to reduce costs.

Opportunity: The core business of healthcare is inherently driven by demand for patient care, providing a stable foundation to support investment in the sector. The population is steadily aging, with data from the U.S. Census Bureau estimating that there were 43.1 million age 65 and older in 2012. That number is projected balloon to 83.7 million people by 2050, translating into a sizeable bump in revenue streams as demand increases for health care. The need for more facilities and services to manage the chronic illnesses of this aging population will be a major driver for growth. The financial structure to pay for healthcare services has evolved since the first 'sickness insurance' was introduced in 1847, through the creation of Medicare in 1965, to the launch of the ACA in 2010. Despite the controversy around these and future changes to reimbursement, healthcare is a required service that will continue to need real estate assets and investments.

Threat: Healthcare providers have three main expense categories: staffing, supplies and space. They have taken difficult steps to reduce staffing levels, trim offered benefits and limit pay increases. They have squeezed operating expenses through supply chain and revenue cycle management. With around 60% of their balance sheet invested in facilities, healthcare systems are confronting the need to reduce their occupancy costs. For investors in medical office real estate who built their financial models on regular rental rate increases and long lease terms, the reality is far less certain as tenants look to reduce their rent expense, with little certainty on

lease renewal. For investors in hospital real estate, the questions around financial performance of the core healthcare business add greater uncertainty to the significant investment into these assets.

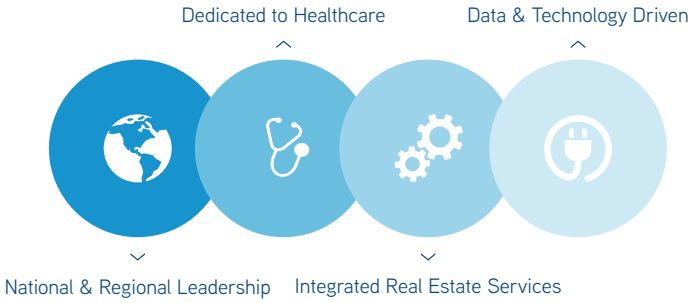
Conclusion

The positive trends in vacancy rates, asking rents and cap rates point to a continued healthy performance of the MOB sector through 2016. In a push to lower costs, health care providers are shifting care away from hospitals to outpatient facilities, further increasing demand. Investor appetite should remain robust as strong valuations and availability of capital will continue to drive activity. Demographic trends pointing to increasing demand for medical services and the credit-worthiness of hospital tenants will add to the positive long-term view of this asset class. Pursuits of mergers and acquisitions will remain strong as hospital systems continue to seek growth of market share and changes under the Affordable Care Act lead physicians to be employed by hospital systems rather than remain independent.

Healthcare facilities will have to adapt to the rapid changes in technology. Hospitals, ambulatory centers and MOBs are becoming fully digitally integrated. Therefore, existing facilities will have to be renovated and new buildings will need flexible designs to keep up with future technology. The need for these new and newly renovated structures will continue as we move forward and technology advances.

The impacts of technology, retailization, mergers and acquisitions, and financial uncertainty will all have an effect on healthcare real estate. The rapid pace of these changes in the industry makes it difficult to assess the exact impact they will have in the long-term. Monitoring whether at least some of these shifts are here for the long haul and will result in softening future demand for space or whether different models can continue to coexist and see demand grow is a topic worthy of debate in the coming years.

Our Commitments



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