United States | 2018

JLL Research Report

Healthcare Real Estate Outlook

The race is on to meet patients where they are

What's inside?

Top 2018 healthcare real estate *trends*

Interest in healthcare real estate is increasing as fast as the industry itself is growing. Rising patient numbers and real estate spending point to long-term demand and cycle resilience for investment in healthcare-related buildings.

1 The shifting healthcare landscape is continuing to push real estate strategies outside traditional settings.

Healthcare providers are getting creative with real estate strategy to capture growing patient demand—and that's delivering more settings for care. The race is on to meet patients where they are and the growing number of medical office buildings (MOBs), healthcare-anchored retail centers, surgery centers and other healthcare specialty buildings is capturing that demand.

2 The appeal of the "durable-income" MOB.

Investors are doubling down on this growing asset class. Stable, long-term occupancy is expected to continue as off-campus locations gain stature as locations of choice for patients and providers alike.

3 More patience for inpatient

Hospitals remain a crucial piece of the healthcare delivery puzzle, serving the growing needs of an aging population, and the anchors to a continuum of care outside their campus. The key word here is "puzzle," as the retailization of healthcare continues. Hospital campuses and outpatient care remain an anchor of the healthcare real estate ecosystem, with construction of new and expanded hospitals rising across the United States.

Trend 1

The shifting healthcare landscape is continuing to push real estate strategies outside traditional settings

Real estate is a key lever to capture demand in the war for patients

As we look at the landscape of patient-care facilities across the United States, one thing is clear: the hospital-centric image of traditional healthcare is shattering. A growing and aging population is placing new demands on the nation's healthcare system, while technology advances and shifting consumer preferences are increasing demand for easier access to care in lower-cost settings in communities.

Meanwhile, healthcare providers face ever-mounting pressure to expand care and quality of service while containing costs, in part because health insurers are slashing spending. Hospitals are not the only healthcare providers in town; while total patient numbers are rising, many hospitals face mounting risks of volume decline and margin erosion in their specific geographies.

Now more than ever, healthcare providers of all sizes are responding to the challenge and using real estate to serve patients more efficiently *and* effectively. The manifold benefits of more diverse offerings for care are fueling a swell in off-campus locations that, together with future-friendly healthcare delivery, help boost revenue and trim costs.

More seniors, more care

Healthcare is the fastest growing sector in the U.S. economy. Spending has jumped 33 percent since 2000 alone and today accounts for 17.9 percent of the gross domestic product (GDP). More growth is on the horizon, too—from now through 2025, we expect spending to continue to grow by another 5 percent or more annually. The job force is also surging, with healthcare employment enjoying faster growth than any other sector in the U.S. workforce. Today, it comprises 12.2 percent of the nation's workforce—with another 18 percent increase on tap over the next decade.

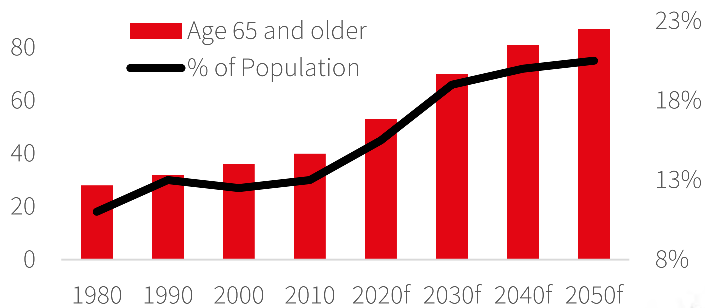
This momentum points to an overwhelming hunger for more modern, intelligent locations, as rapidly as possible.

Add in our aging population, and long-term stability of this demand is all but ensured. Roughly three-quarters (73 percent) of the nation's healthcare spending now comes from the 50-plus population. More than 10,000 baby boomers are turning 65 this year, which makes them Medicare-ready.

And many more are on the way, considering estimates that **the number of people 65 years old and up will nearly double by 2050**, 80-and-up will triple, and 90s and 100s will quadruple between 2010 and 2050 alone.

A growing, aging U.S. population

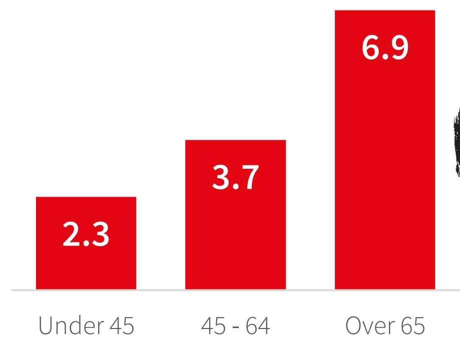
65+ population (millions) and percentage of population



Source: U.S. Census

By 2050, the U.S. population over 65 years is projected to nearly double from 48 million to almost 88 million. Doctor visits and medical expenses dramatically increase with age.

Annual doctor office visits by age



Source: U.S. Centers for Disease Control and Prevention

As senior care needs grow, it follows that the need will also grow for more effective space, in more locations, to serve older adults.

Healthcare providers face higher expectations, shrinking reimbursement

In an environment of increasing demand, the opportunities are indeed promising. At the same time, pressure to perform is at a fever pitch, with healthcare leaders under immense pressure to reduce costs while improving care and the patient experience. That means offering the right location for the right care—no more, no less. Rising to this occasion isn't particularly easy in an era of **decreasing reimbursement-per-patient models** and operating income pressure.

A Kaiser Family Foundation analysis of Medicare spending shows average annual growth in Medicare spending per beneficiary was just 1.3 percent between 2010 and 2016, down from 7.4 percent between 2000 and 2010. Meanwhile, the aging of the baby boom generation will increase Medicare enrollment by 3 percent annually through 2025.

Traditional approaches to real estate are proving too costly to keep up with both rising demand and compressed reimbursements. What's more, cultural preferences are also changing. The younger generations of patients have grown up accustomed to on-demand service and authentic experiences, and they increasingly expect the same from their healthcare providers too.

Millennials are redefining healthcare today. They don't want a one-size-fits-all hospital campus. They want more convenient locations, with smaller, more concentrated offerings, at convenient times and self-directed—and when they find the right fit, this brand-loyal generation is likely to keep the faith.

These preferences hold significant weight in an industry where young people are quickly becoming the dominant healthcare consumers, both for themselves and for their families as caregivers. The majority of babies born in the United States this year (82 percent) were born to millennial parents, and many are looking to establish a relationship with a healthcare system for the first time.

Intergenerational dynamics, rising patient numbers in general and intense cost pressure all point to the need for new types of real estate, in new and more locations.

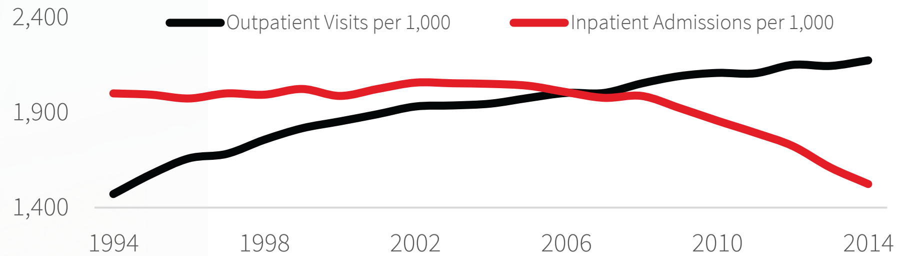
Setting of care is changing

Healthcare leaders are making major strides in meeting patients where they are, while supporting financial health. Value-based care with a focus on population health and the rise of consumerism have altered healthcare delivery, leading to new real estate strategies that include urgent care and building outpatient centers or smaller-scale micro-hospitals and health-system sponsored wellness centers. The migration from inpatient to outpatient care, which has been taking place over the past 20 years, has contributed to a decrease in the national occupancy rate for hospitals from 77 percent to 61 percent since 1980, according to data from the Medicare Payment Advisory Commission.

As offerings become more diverse and more strategically structured, investor communities are taking note—and action.

Location of care is moving to outpatient

Inpatient admissions vs. outpatient visits



Source: American Hospital Association Annual Survey Data, 2014

In response, healthcare organizations have developed locations that are easier for patients to access. Sites with varied services, including physician services and ancillary services that are necessary to manage populations in one location, provide an advantage when you care for patients—patients want convenience.

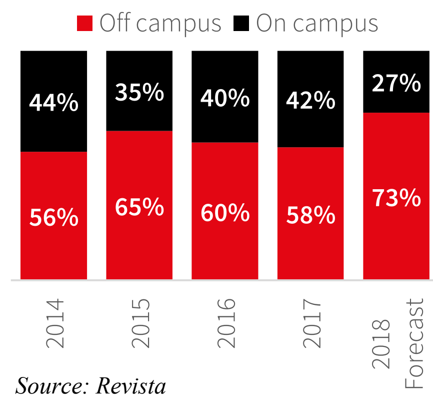
The transition to value is a key driver, with healthcare organizations exploring ways to keep populations healthier and control costs by reducing unnecessary utilization such as hospital admissions and readmissions. This approach has influenced efforts to define the most appropriate care setting while aligning inpatient and outpatient services.

How are real estate strategies enabling them to accomplish these goals?

Consider the following trends:

- **Demand for remote care locations is growing quickly.** By year-end 2018, a full 73 percent of MOB construction projects underway will be in off-campus locations.
- **Outpatient centers often are less expensive** to construct and operate than traditional hospitals
- **More diverse facilities improve the patient experience—and win brand loyalty.** A mix of outpatient facilities or multispecialty centers enables patients to get the care they need for the specific issue they're having. That can save patient wait time, limit risk of infection and streamline medical costs.

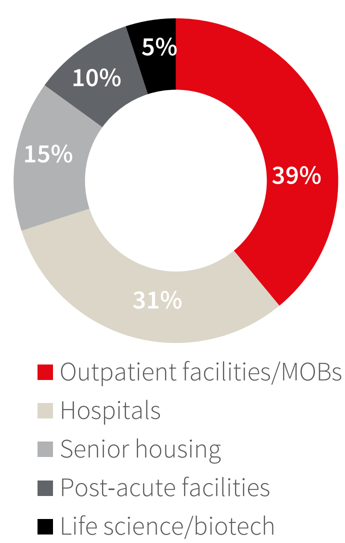
MOB construction is trending toward off campus



Source: Revista

Healthcare real estate is being transformed as we speak. Today, the $1 trillion healthcare real estate market is more diverse than ever.

U.S. healthcare real estate market value



Source: JLL Research

Trend 2

The growing appeal of the "durable-income" MOB

Four reasons investors are placing their bets on this growing asset class

Real estate capital is increasingly flowing to MOBs. With fundamentals that are more cycle-resistant than other, more traditional property sectors, investors are doubling down on this class of buildings for its stability and bright prospects for continuing strong performance.

There's a compelling case for continued capital interest. These four key indicators demonstrate that confidence in the sector is warranted:

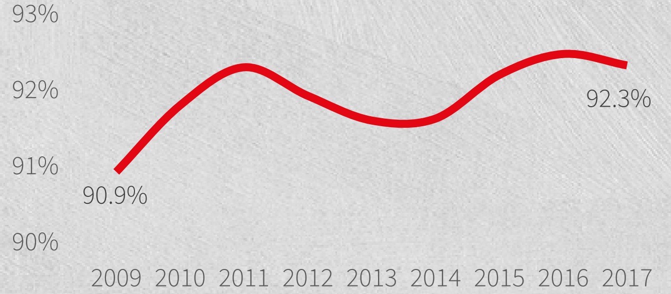
1.

Compelling fundamentals speak for themselves

MOBs boast uniquely stable long-term occupancy rates. Indeed, from 2009 on, this sector has been the picture of stability. The quarterly weighted average occupancy ranged between a low of 90.4 percent in Q1 2009 and a peak of 92.6 percent in Q4 2016—a mere 200-basis-point spread from recent peak to trough. Occupancy rates are expected to remain stable for the near future, with limited room for growth given the presently high rates.

Medical occupancy stable long-term

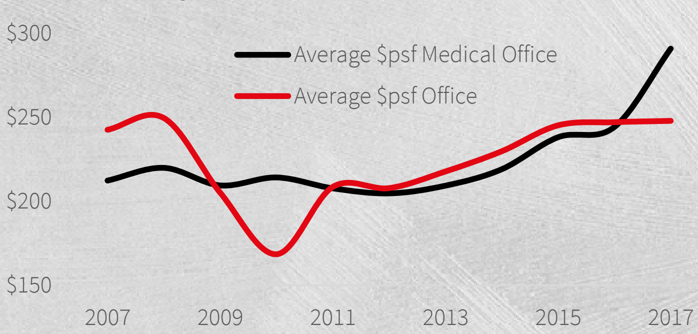
Medical office average annual occupancy



Source: Revista

We're seeing exceptional pricing performance, too, with dollar-value-per-square-foot currently at peak levels. Pricing has been steadily trending up, by an average of 49.8 percent over the last five years, with overall steady growth over the last decade despite the Great Recession. All told, MOB average sales price numbers bear out this sector's appeal and relative resistance to downturns in the real estate market.

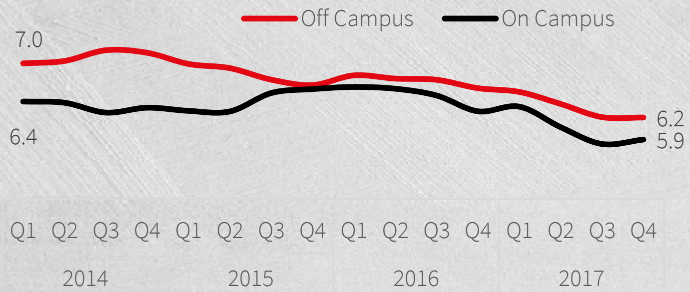
Steady, strong price performance with less volatility



Source: JLL Research

Meanwhile, cap rates are following the services moving closer to patient communities and on- and off-campus cap rates are converging.

On- and off-campus cap rates converging



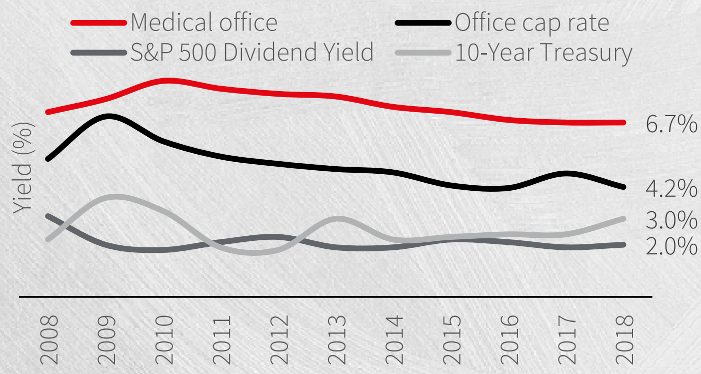
Source: Revista

2.

As other property sectors have tightened, MOBs offer high returns

As competition for Core product in gateway markets has resulted in several years of cap rate compression, investors are moving into new sectors, with a greater focus on alternative property sectors. As low yields for commercial office and other traditional real estate persist, institutional and foreign investors are increasingly turning to alternatives offering attractive returns. Medical office has consistently offered a 2 percent spread in cap rate or greater over similar benchmarks for the last five years, making it a desirable prospect given its consistent performance over a longtime horizon.

Medical office relative to other yields



Source: JLL Research, Bloomberg, NCREIF, RCA Analytics

3.

MOBs attract a high-quality tenant base

As more physician practices move to hospital ownership, an MOB's hospital affiliation, or lack thereof, is increasingly important. From the perspective of MOB investors, hospital affiliation may provide greater overall tenant stability and credit ratings as the hospitals themselves become the lessees. Hospital ownership of physician practices is on the rise. As of mid-2015, one in four medical practices was hospital-owned, according to a study by Avalere Health. Further, hospitals acquired 31,000 physician practices, a 50 percent increase, from 2012 to 2015, according to the report. According to an American Medical Association (AMA) study the newest generation of doctors is shifting from owning their medical practice to joining larger multispecialty practices to leverage administrative and payer partnerships as well as lifestyle choices.

Medical office space users and physician practices are "stickier" and don't typically relocate to new buildings as often as general office tenants. Medical users tend to sign space leases with longer terms than your typical office tenant. The higher longevity of tenants stems from a higher cost of buildout for the typical medical user, which often greatly exceeds that of a general office tenant. From a tenant's pocket, a healthcare fitout will cost $259 p.s.f. on average, nearly $100 p.s.f. more than a tenant will pay for a typical office fitout. The extensive plumbing, electrical, equipment and compliance issues create additional cost as well as specific lease and transaction issues.

> In 2016, for the first time, less than **1/2** of physician practices were independent.

4.

Strong pipeline of new construction is keeping pace with demand

Despite strong demand, MOB inventory crept up only slightly in 2017. While 2018 expects to see higher completions and starts, with virtually no speculative development unlike other property types, these deliveries are in step with absorption, and overall, steady occupancies and increasing rental rates are on the short- and long-term outlook.

New development is increasing MOB inventory in line with demand

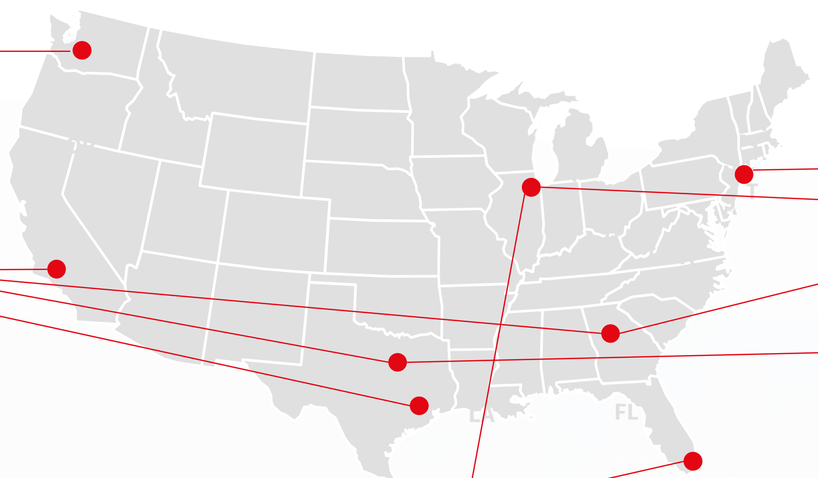
Medical office construction completions

Source: Revista

Zeroing in on local *markets*

In some ways, healthcare real estate trends are universal across the United States. After all, young and old patients alike live in cities and towns in every state. Still, a few regions are experiencing more momentum for change than others due to transformational transactions.

The West Coast and South led the way in 2017 in MOB sales growth. With some of the fastest-growing populations, most of the action—and volume—is focused in cities like Atlanta, Dallas, Houston, Los Angeles and Seattle.



New York takes top prize for MOB construction volume. The Big Apple is home to more MOB construction than any other city, with a strapping 3.7 million square feet of new space in the pipeline. Atlanta, Chicago and Dallas are next in line, with 1.3 million, 944,000 and 906,000 square feet respectively.

Chicago is winning in number of MOB construction starts; Miami, in hospitals. Chicago saw the highest volume of MOB starts in 2017, with almost triple the amount of its 2016 activity. Meanwhile, on the opposite end of the spectrum, Miami nearly doubled its number of new hospital starts.

Source: Revista

Trend 3

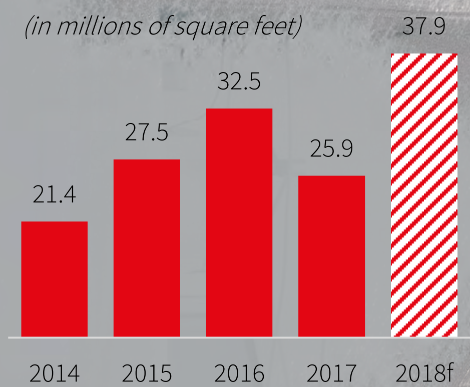
More patience for inpatient

Healthcare real estate will continue to evolve in many shapes and sizes
Despite the momentum around MOBs, the need for acute care real estate—hospitals and hospital campus properties—is also growing, and for good reason. While healthcare services are trending from inpatient to outpatient facilities, hospitals will also see growth in total patient-day numbers. As baby boomers age—10,000 Americans will turn 65 every day for the next 20 years—the volume of inpatient services will only grow regardless of declining inpatient utilization rates. Inpatient facilities will increasingly be focused on the sickest and most acute care needs, often requiring longer stays.

And we're seeing a relatively active hospital pipeline, with more hospital starts under way as health systems race to expand and replace obsolete facilities. Roughly 75 percent of these hospital project starts are expansions or replacements, although entirely new hospitals are also being built, too, with 92 under way at the end of 2017.

There are a handful of related drivers fueling this demand for new hospital facilities, including local requirements like seismic replacements in California, as well as the push for more micro-hospitals and licensed post-acute and sub-acute facilities. Ultimately, however, the $21.4 billion of new hospital construction under way now is helping meet patient demand.

Hospital construction on the rise
Hospital construction starts



Source: Revista

Looking ahead

What's next for healthcare real estate?

Stable and sustainable demand will provide continued momentum for this evolving asset class. We anticipate the following trends to emerge as key drivers of healthcare real estate decision-making over the next year and beyond:

1.

The "retailization" of healthcare is on—and more is on the way

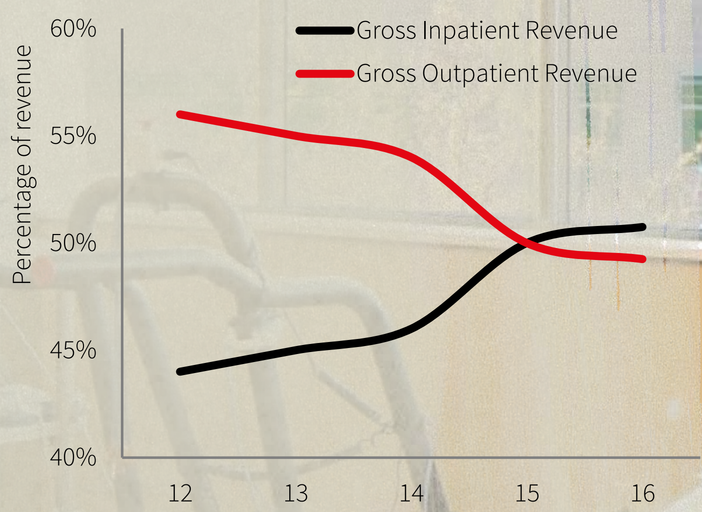
As healthcare moves away from the hospital-as-hub model, healthcare will roll even further out of the hospital doors and into community settings. Freestanding emergency rooms, urgent care and walk-in clinics are already proliferating in valuable retail locations, and we're also beginning to see interesting new partnerships being formed to bring integrated wellness and preventative themes into established retail locations.

A decade ago, retailization was driven by the recession and the value healthcare companies saw in scooping up vacant big-box spaces. Now, this approach is becoming more of a strategic move, with developers considering healthcare tenants for new mixed-use developments from the beginning. No longer an afterthought, healthcare will increasingly become a key piece in the future retail puzzle.

One reason we can be so confident about the future trajectory is recent, mold-breaking momentum in outpatient revenue compared with inpatient. Gone are the days of the inpatient-facility monopoly. In its place, we see a more balanced mix of sprawling hospitals as well as lower-cost settings of care.

Outpatient revenue driving healthcare growth

Distribution of outpatient vs. inpatient revenue



Source: Moody's Investor Service (data based on audited financial statements for 323 Moody's-rated not-for-profit hospitals and health systems)

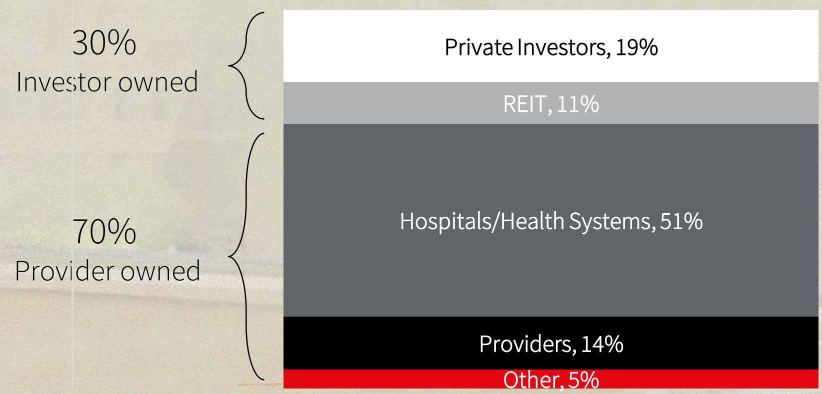
2.

Growing sources of capital

All this opportunity has not escaped the attention of shrewd real estate investors and the buyer landscape is healthy and growing. Healthcare real estate ownership is already no longer dominated by specialty healthcare real estate investment trusts (REITs). In 2014, REITs drove 60 percent of medical real estate transactions compared to 16 percent by hospitals and health systems. Today's buyer pool is better distributed. New investors are coming in—and it is probable that this trend will only continue as more parties see the tremendous, yet stable, growth in this newly dynamic sector.

Historically, hospitals and health systems held the lion's share of the MOB market. But hospital operators are finding that opening up their real estate to investors frees up capital for patient care and quality improvements. Revista data shows they own only around half of medical office buildings (MOBs), with REITs, private investors, individual providers, government and other entities accounting for the other half.

MOB ownership by type, total square feet



Source: Revista

There is also growing diversity in how many healthcare locations a given ownership group holds in its portfolio. Forty percent of MOBs today are owned by single-asset owners. At the other end of the spectrum, a full 19 percent of investors own at least 25 properties.

3.

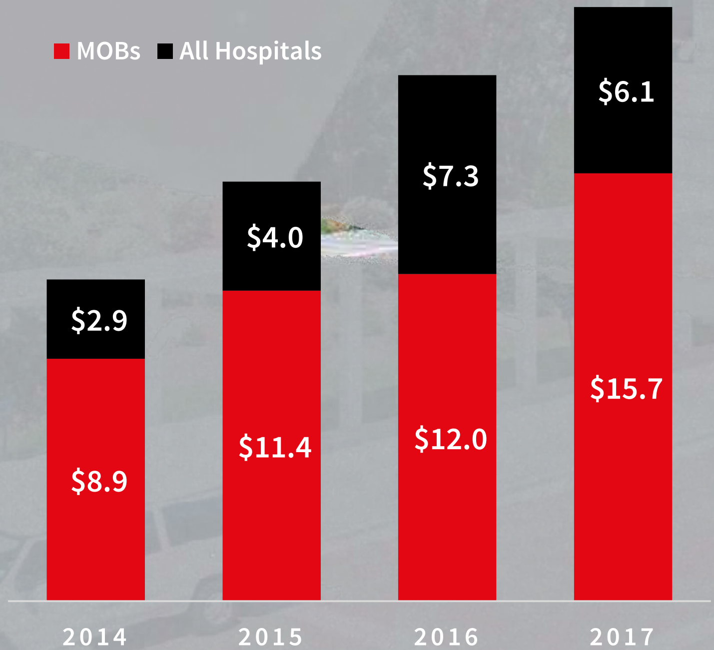
Healthcare real estate will continue to grow into a Core asset type

Healthcare real estate stability will continue to attract investment. Consistency over the last five years is fueling confidence in the sector. Among traditional investors, MOBs continue to be the most popular property type in the healthcare niche. The strong prospect of stable, growing demand in this sector is attracting a new mix of owners and prospective investors—and as a result 2017 set new records for investment.

Healthcare transaction volumes have been on the rise over the last four years, up 13.6 percent year-over-year, and demonstrating the characteristics of a Core asset class. Besides growing interest from institutional investors, notable transformational dispositions and M&A punctuated the landscape in 2017 and provide clear evidence of the vibrancy of the healthcare sector overall.

The vital signs for healthcare real estate are strong, but investors need to stay sharp in today's rapidly evolving market. As the destinations where patients go for care continue to shift, investors need to constantly stay apprised of industry trends to identify the real estate assets that are likely to thrive now and into the future.

All healthcare real estate annual transactions
Volumes in billions



Source: Revista

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