The Influence of Healthcare Reform on Commercial Real Estate
**Research:** Our primary data includes closed transactions for direct property acquisitions for medical office buildings. Data reflected through December 9, 2013.

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**Acknowledgment:** We gratefully acknowledge the assistance of Real Capital Analytics Inc. in collecting and providing data. Please refer to www.rcanalytics.com for more information regarding its methodology and sources. Although the data is believed to be accurate, its accuracy is not guaranteed and may be subject to future revision.
Executive Summary

The Patient Protection & Affordable Care Act (PPACA), commonly referred to as the Affordable Care Act and otherwise known as “Obamacare” or healthcare reform, was signed into law by President Barack Obama on March 23, 2010 and became effective January 1, 2014. This legislation represents the most significant overhaul of the U.S. healthcare system since the passage of Medicare and Medicaid in 1965. PPACA provisions have been the subject of both controversy and litigation challenging the act’s constitutionality. In due course, the Supreme Court upheld the act in June 2012, thereby also making the tax provisions of the act a reality.¹

When the Affordable Care Act takes full effect in 2014, it will prohibit discrimination due to preexisting conditions or gender; eliminate an annual limit on insurance coverage; provide coverage for individuals participating in clinical trials; provide tax credits for many, including small businesses; establish health insurance exchanges, increase access to Medicaid; and promote individual responsibility and free choice.²

For real estate investors, the big question is what, if any, impact this regulatory overhaul of mandates, subsidies and insurance exchanges will have on commercial real estate (CRE). Historically, growth in real estate demand has primarily been driven by population density, wealth accumulation, price appreciation, household formation, employment growth, and other economic factors. As a result of healthcare reform, can we also now expect to see an accelerated demand for commercial real estate? What winning strategies are investors adopting in response to this healthcare reform?

The Changing Landscape

Healthcare is a business and, in the United States, it is a multi-trillion dollar economy ($2.5 trillion plus). As a consequence of the new healthcare legislation, it is estimated that an additional 30 to 32 million people will receive coverage and subsidies, which when using an industry multiplier, suggests that there will be a need for 64 million additional square feet of space to accommodate those being served (1.9 square feet per patient).³ It is expected that we will see an increase in both the demand for healthcare-related space and services as consumer preferences for medical insurance evolve. As the industry is forced to innovate, growth in employment of healthcare industry personnel, from physician assistants and technicians to other servicers, is also expected. The need to accommodate those employees will directly impact healthcare industry real estate requirements.

Disruptive healthcare megatrends are fueling the industry’s performance and driving its growth.⁴ In terms of demographics, the aging population means greater medical needs and an increasing demand for services. The U.S. Census Survey predicts there will be 86.7 million people 65 and older by 2050, comprising 21% of the population.⁵ Added to this are the millions of previously uninsured and those who have aged out of their parents’ coverage signing on for coverage under Obamacare. The following are among the other trends we expect to see:

- The global healthcare market is forecast to reach $3 trillion in 2015.⁶
- Investment in sectors such as health information technologies (HIT), telehealth (virtual healthcare delivery), bio pharmaceuticals and biosciences will drive market expansion.
- The Affordable Care Act will spur growth.
- Consumers will continue to use increased purchasing power and information access to drive healthcare decisions.
- Changing models of market access to healthcare will result in a revised delivery system in accordance with a hub and spokes network.

¹ Beginning in 2013, taxpayers will start to feel the effect of the Affordable Care Act in the form of two new taxes: an additional 0.9% payroll tax assessed on certain taxpayers’ earned income, and a 3.8% surtax on the “net investment income” of certain high earners under Section 1411 of the Internal Revenue Code.
² Investor Survey - Medical Office Building (Cushman & Wakefield, Inc. 2013).
Healthcare Trends Impact on Commercial Real Estate

Among the unintended consequences of healthcare reform and its associated cost structures may be the geographic footprint of many of the uninsured and the disruption of the typical operating models for healthcare delivery. This disruption may be in the form of the newly insured seeking “preventative medical care” rather than strictly “reactive medical care.” Low reimbursement rates and an increased regulatory environment are expected to result in many physicians consolidating or merging into, or aligning their practices with, the hospital system or larger healthcare organizations, while forcing others to operate as physician concierge service providers strictly for the affluent. We are already witnessing the creation of synergistic relationships and joint ventures in the industry as a result of healthcare-related reform. For-profit (FP) and not-for-profit (NFP) health systems have begun to form partnerships, including the Cleveland Clinic (NFP) and Community Health Systems, Inc. (FP); Duke University (NFP) and LifePoint Hospitals (FP), as well as Tufts Medical Center (NFP) and Vanguard Health Systems (FP), to name a few.7

Real estate often constitutes the single largest balance sheet asset for healthcare providers, and this, too, is an area where we anticipate seeing much of the amalgamation expected to transpire in the industry. Stark Law and other reporting obligations have become a primary focus for health systems as they consider requirements to execute real estate transactions involving physicians and medical care facilities.

Healthcare Trust of America’s Director of Acquisitions Ann Atkinson states, “On a national level, information is the number one capital expenditure for most hospitals, followed closely by the acquisition of physician practices. Much of these capital requirements are being funded through the monetization of the hospitals system’s real estate.”8

Healthcare real estate is a niche market, commonly referred to as medical office buildings, or MOBs. Demand for real estate to support varied healthcare-related businesses is expected to increase, and an accelerated trend for investment in medical office buildings may be a significant byproduct. MOB investment continues to outperform other sectors in the commercial real estate market. CAP rates for class A and class B MOBs have continued to decrease over the prior 12 months as a result of increasing property values, validating these asset classes as favored by many investors.

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The Investors

Healthcare REITs have gained value in the real estate sector. This is due primarily to their portfolio diversification, strong tenants and varied income sources such as insurance companies, assisted-living facilities, pharmaceutical companies and biotechnology companies. Investment managers are also looking at medical office space as a growth sector.

In light of the new law, some investors are also beginning to dispose of assets in the medical office sector. For example, in November 2013, Seavest Healthcare Properties, LLC, a real estate investment firm specializing in this sector, sold 13 properties to Duke Realty for $342 million. The exit strategy for real estate assets by many smaller and independent physician groups may also be a likely consequence of the changing regulatory environment and cost structures of the Affordable Care Act. Owners of MOBs may well anticipate an increase in value of their real estate assets over the next three to five years, and disposition as well as acquisition strategies will come into play.

Lucrative investment opportunities may exist in healthcare real estate with a heightened demand for efficient, outpatient facilities, many from ground-up development projects. One such development site is the March LifeCare Campus in Riverside, Calif., which is expected to be 3.5 million square feet. March Healthcare Development, LLC is developing this 236-acre “health and wellness city” on surplus land of the former March Air Reserve Base, with an estimated cost of more than $3 billion. This model will provide a “continuum of care” in one location and will include a leading-edge medical research facility; a hospital; medical office space; retail space; restaurants; senior care, skilled nursing, short- and long-term acute care and hospice facilities; outpatient and ambulatory surgery centers; and a hotel in a single master-planned community. Essentially, it will be “a health-care city within a city.” Doctors, pharmacists and practitioners all provide medical care from some type of medical office building, and this is the primary sub-sector in the real estate sector that we track (in addition to senior housing). One of the primary drivers of the new reform may likely be the shift of healthcare delivery from hospitals to medical office buildings. The result will be an evolution in “patient-centered healthcare” from “doctor-centered healthcare” as a model for delivery. The demand for primary and urgent healthcare facilities is already strong, and we are also seeing expanded roles for pharmacists and nurses with enhanced credentials, resulting in a new model for the medical office building.

The Influence of Healthcare Reform on Commercial Real Estate

As a result of many of the changes outlined above, the MOB model will be forced to change. Some ways in which these changes will occur is through the shifting of these buildings to more digitally, aesthetic appealing and “greener” developments.\(^{10}\) There will be significant opportunities for enhanced utilization of MOB space. We anticipate seeing a growth in insurance claims processing centers, expansion of hospital satellite facilities, electronic medical records and high-tech information data facilities, as well telemedicine centers with videoconferencing and high-technology imaging. In addition, we expect to see ambulatory care and surgical care centers pooling their resources under aligned umbrella organizations as a single provider, a result of the Affordable Care Act’s new reimbursement model of Medicare Accountable Organizations. Multi-specialty suites, where specialists can share resources and costs, franchised entities and joint ventures will all play a part in the new MOB environment.

The Medical Retail Model

Medical retail space will be a relatively newer and faster growing sub-sector in the retail asset class. The National Center for Policy Analysis (NCPA) estimates that there will be more than 3,200 such clinics in 2014, and that they will operate as high-visibility retail walk-in locations for medical care. We expect to see the rapid expansion of hospital-connected clinics, which typically operate at lower costs than primary-care doctors’ offices or emergency rooms. These types of facilities will include wellness centers, urgent care centers, preventative care centers, outpatient care centers, hospital retail clinics, and medical institution education facilities. Mayo Clinic announced in January 2013 that it expects to spend $3 billion to expand its facilities, including retail centers. Kaiser Permanente is opening a 32,000-square-foot medical facility in Portland, Ore., in the now-defunct store site of Circuit City. This site, known as Gateway Medical Office, will provide medical imaging, pharmacy and laboratory services, all in one location. Walgreen’s, CVS and Rite-Aid have all implemented routine exams and annual checkups through these retail models, allowing their facilities to ultimately compete with hospitals as neighborhood outpatient centers.

Top Buyers & Sellers (prior 24 months) by Volume

<table>
<thead>
<tr>
<th>Buyers</th>
<th>Sellers</th>
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<tr>
<td>Ventas, Inc.</td>
<td>Cogdell Spencer Inc.</td>
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<tr>
<td>Griffin-American Healthcare REIT II</td>
<td>Washington Real Investment Trust</td>
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<tr>
<td>American Realty Capital</td>
<td>American Realty Capital Trust</td>
</tr>
<tr>
<td>Harrison Street Real Estate Capital LLC</td>
<td>Seavest, Inc.</td>
</tr>
<tr>
<td>Duke Realty Corp.</td>
<td>LaSalle Investment Management</td>
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<tr>
<td>Realty Income Corp.</td>
<td>The Boyer Company</td>
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<tr>
<td>Healthcare Trust of America</td>
<td>Harrison Street Real Estate Capital LLC</td>
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<tr>
<td>HCP, Inc.</td>
<td>Montecito Medical</td>
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<tr>
<td>CNL Financial Group</td>
<td>Kilroy Realty Corporation</td>
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<tr>
<td>Health Care REIT</td>
<td>Duke Realty Corporation</td>
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<tr>
<td>Healthcare Realty Trust</td>
<td>Columbia Development Companies</td>
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Using Real Capital Analytics data, we estimate that the majority of principals engaged in MOB transactions are private entities. For the years 2010 through 2013, nearly 50% of deals were done by private players (49.32%), followed by public players (29.37%), institutional players (10.09%) and equity funds (6.49%). CMBS represented less than .60% of this volume during this timeframe; however, that volume is expected to increase.

While transactional volume for medical office buildings appeared to be rather substantial in 2012, estimated at more than $6.7 billion and the largest year on record since 2001, early December 2013 figures indicate that we may approach this volume, but likely will not surpass it. Closed MOB deals for 2013 are estimated at $6.7 billion, with approximately $290 million additional in the pipeline. The majority of MOB properties are in the western part of the United States, with Los Angeles being the largest metro with MOB properties.

Notable Deals

- Pending (as of December 2013): Washington Real Estate Investment Trust (WRIT), a public REIT, is selling a three-property portfolio to Harrison Street Real Estate Capital, a real estate private equity firm. The total sale is rumored to be around $193.6 million.

- November 2013: Seavest, LLC (SHP) a leading investor in the MOB sector sold 13 properties to Duke Realty for $342 million. September 2013: Seavest, LLC (SHP), in partnership with Ciminelli Real Estate Corp., broke ground on a $300 million, 300,000-square-foot (plus) Conventus medical office building on the Buffalo Niagara Medical Campus.

- July 2013: Ventas, Inc., a publicly traded REIT, acquired from LaSalle Investment Management a seven-property MOB portfolio in Illinois for approximately $81.7 million.

- April 2012: Ventas, Inc. a publicly traded REIT, acquired from Godgell Spencer Inc. (NYSE: CSA), its 68-MOB portfolio of high-quality medical office buildings (92% occupied), including two lease-ups and two developments, and was made part of the Lillbridge Healthcare Services, Inc. subsidiary platform. This transaction closed for $760 million.

CMBS Medical Office Maturity

Conclusion

The velocity at which the healthcare industry is changing cannot be overestimated. While we are already experiencing disruption and change resulting from healthcare reform, technology, big data, regulatory and other impactful forces in the healthcare industry, it is simply too soon to accurately predict the full impact these changes will have on the commercial real estate industry. Despite the uncertainty, we are seeing a number of trends such as an increasing demand for MOBs and heightened activity in this asset class, both of which reflect the healthcare industry's changing real estate needs. The demand for primary and urgent care facilities is already strong, with so many changes underway and record-breaking medical practice consolidations and mergers, as well as acquisitions of medical practices by large facilities also taking place. While many changes may reflect the cyclical nature of real estate, the questions remain to what extent the cycle will be guided by outside forces and how investors will respond.