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DEEP DIVE

Taking the Pandemic Pulse of Healthcare Real Estate

How COVID-19 changed the landscape for this front-line commercial real estate sector.

By John Salustri

THE OVERVIEW

Nowhere have the transformational effects of the COVID-19 pandemic been more apparent than in the healthcare field itself and, specific to our audience, the medical office building (MOB) sector. Indeed, from virtually all perspectives, be it management and ownership, leasing, investment or development, the pandemic advanced the already aggressive expansion of this market.

This, of course, is not to say that negative effects of the pandemic bypassed healthcare real estate altogether. Just as in the traditional office sector, medical office tenants experienced a period of uncertainty and caution, although the experts interviewed here attest to the shorter lifespan of that hesitation. And, as might be expected, there also were doctors and physician groups who already struggled with bill payments before closing their doors or simply decided it was the proper time to hang up their stethoscopes. Those trends were accelerated as well.

Much of this was due to a dramatic 50-percent decline in patient visits, especially in the early weeks of the pandemic. The causes of this drop-off were two-fold. First came the fear of contact in a period of isolation. The second was regulatory restrictions on elective surgeries and procedures, which were deemed outside the umbrella of essential services.

But any downward impact of the pandemic was absorbed much quicker than in the traditional office market, and the rebound is already well on its way. As just an example, even the 6.4 percent drop in healthcare employment last year "rebounded much more rapidly than the broader job market," according to CBRE. Today, the MOB sector can once again ride the wave that carried it along prior to 2020, a wave that will roll as long as people, from infants to seniors and everyone in between, need medical attention. (Seniors alone currently account for 55 percent of the total U.S. healthcare spend, reports one of our sources.)

The other driver of MOB growth has been the trend, launched well before COVID, to take healthcare off the hospital campus and bring it to the people. While this eases access for current and potential patients, it is not driven by altruism alone. Competition between health systems, cost management and containment and insurance pressures are all drivers of this trend. So, as we wait to see the full impact of the COVID-19 delta variant surge, what follows is the measure of the current healthcare real estate market, as seen by industry practitioners.

DEFINING OUR TERMS: AN MOB PRIMER

As you might imagine, "healthcare" is a vastly broad term, and while all MOBs are healthcare facilities, not all healthcare facilities are MOBs. For property professionals interested in but not yet plying the MOB trade, this section is primarily for you.

At its essence, BOMA International describes MOBs as "buildings that have tenants that are typically doctors or physicians' groups." That straightforward definition also allows for other health-related functions that can be found therein, professionals such as massage therapists or chiropractors.

A good measure of the types of professionals involved in the sector can be drawn from the mix of participants who attend BOMA International's Medical Office Buildings + Healthcare Real Estate Conference each year. Attendees represent a wide-range of assets, including the above-defined MOBs, ambulatory surgery centers, hospitals, urgent-care facilities, outpatient centers, mixed-use retail with healthcare tenants, assisted living facilities and its more independent twin, senior housing. By the way, if you have ever wondered about the difference between a hospital and a medical center, it is largely based on how the specific state defines it. But there are also states that are more casual about their nomenclature, leaving wiggle room for name changes for the sake of marketing.

No matter the asset type, healthcare real estate has been proclaimed recession-resistant, if not fully recession-proof, by more than one expert we spoke with. "The drivers are different from traditional office," says one contributor. Certainly, from an investment standpoint, "Through all of the recessions, including the Great Recession of 2008 and this current pandemic, the MOB market becomes more in favor." (We'll look more closely at investments shortly.)

But that's not the only difference between MOB and traditional office assets. Practitioners state that the sector also carries different responsibilities for property managers than would traditional office, differences worth noting.

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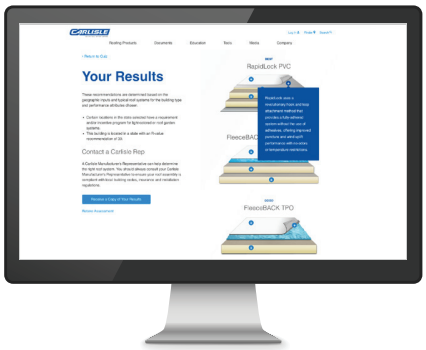

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MOB PROPERTY MANAGEMENT: A BREED APART?

Not surprisingly, there are both parallels and points of differentiation between traditional office management and MOB management. As one professional put it, "It's not just managing a building. It's supporting the goals and objectives of tenants." On the surface, that fits the job description of every proactive property manager, and it would seem to fly in the face of all that was covered in Deep Dive No. 4, which explored the increasingly closer relationships between management, tenant, building and community.

Certainly, there is a lot of crossover work in terms of maintenance, building systems, security and access concerns, but there is a question of degree that is the perceived differentiator. "There's a special obligation there to support the delivery of services," says one contributor. As opposed to most traditional office environments, where a tenant's service-delivery platform is typically "internal to the space."

MOB services are, by definition, based largely on the foot traffic and the health issues patients bring in with them. And, in those cases where MOB and "traditional" tenants commingle, at least one manager sees potential conflicts with office workers and visitors sharing elevators and corridors with those patients.

The configuration of spaces is also a deviation from traditional office layouts. While addressing such concerns as security, access and traffic-control solutions are a part of all managers' concerns—especially since the pandemic—MOB managers also need to be cognizant of such trends as parking access while patients wait to be called in; a reduction in touch points in the current hyper-sensitive sanitation environment; and the one-way flow of patients through waiting rooms, corridors exam rooms and exits.

Also, unlike traditional office environments, work-from-home options rarely exist for physicians. Even telehealth is a service preferred to be delivered from the office. "We haven't seen a lot of downsizing in the medical field," reports one expert. "I do know some of our doctors are using more telemedicine, but they're doing it in their offices," and often seeking dedicated rooms for that function. One practitioner we spoke with estimates telemedicine at roughly 70 percent of the total patient volume during the depths of the pandemic. But the post-vaccine drop in interest has been precipitous, "leveling off at about eight percent." (Depending on the continued spread of new COVID-19 variants, that may very well be a temporary decline.)

What is similar to the traditional office is a movement toward greater patient "experience," and the creation of more comfortable surroundings à la the hospitality sector. According to research from architecture and design firm Gensler, "The new standards for experience will be more like the Four Seasons than a best-in-class hospital. Arrival and check-in will become frictionless, personalized or automated. Digital coordination of doctors, nurses and staff will make clinical environments more efficient and effective but will also change how clinicians organize their time on-site."

"Probably the biggest impact felt by the hospitals was financial impact and the way they're going to change their business going forward. It had remarkably little to do with their real estate."

– Amy Hall,
Physicians Realty Trust

The firm speaks of "digital-first healthcare," to advance the interaction between doctor and patient. "Doctors need specialty workspaces designed for consultation with remote patients, as well as the ability to switch between remote and in-person care."

This, of course, involves the advancement of a slew of already blooming technologies, including diagnostics based in artificial intelligence (AI), as well as both augmented and virtual reality, when "doctor-patient consultation will be digitally enhanced with more immersive and intelligent in-room technology supporting more advanced, real-time diagnosis and richer patient conversations." Better living through technology.

What's more, the MOB of the near future will be designed for maximum flexibility. Digital first means no permanent desks for physicians—another nod to the changes taking place in the traditional office—and patient rooms can be reconfigured regularly. "Designing for this level of flexibility requires better insight into how digital interaction will affect space, patient journeys, workflows and experience," writes Gensler. "Better modeling and analysis for space planning, programming and design will be essential to deliver a better experience."

And it is coming to an MOB near you, probably within the next 20 years. At least, that is what Gensler says. Others are not so sure. "There's a lot of talk about different space configurations," says one expert. "But when the rubber meets the road, very few changes happen." After all is said and done, she says, there is more said than done.

"It will take years for people to change their spaces," she points out, "because leases have to roll in order for them to make the changes . . . unless they're going to make them on their own dime, and these hospital systems and doctors do not want to put their own money into someone else's building. And when COVID is over, we'll still have waiting rooms," and they are likely to be even larger, to keep the social distancing practices in place.

When those leases are set to roll, you can be sure tenant improvement (TI) dollars will be part of the conversation.

"Property managers of both office and medical office buildings are providing wellness offerings within their assets, through healthy living programming and concierge medicine amenities."

— Connie O'Murray, JLL

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COSTS, BOTH RISING AND MITIGATED

As indicated previously, medical centers increasingly are pushing services into the local communities as part of a trend called "retailization" (with healthcare providers moving into vacant big-box stores or other retail locations), giving a major boost to off-campus healthcare facilities. "There's a movement to decrease the number of hospital beds," says one source. "In 1980, you had 5.5 beds per 1,000 people within the population." Today, he says, that has diminished to 3.3 beds per thousand. In addition, outpatient care has grown from 28 to 47 percent of health systems' total revenue over the past two decades. "They've moved about as much out of the hospitals and into ambulatory care as they can," meaning the major decrease in bed counts is pretty much over.

Marcus & Millichap also sees the movement: "Prior to the pandemic, a structural shift in patient services away from hospitals and campuses was underway. This trend has been further enhanced by the health crisis as more individuals sought outpatient care and elective procedures in off-campus settings closer to home."

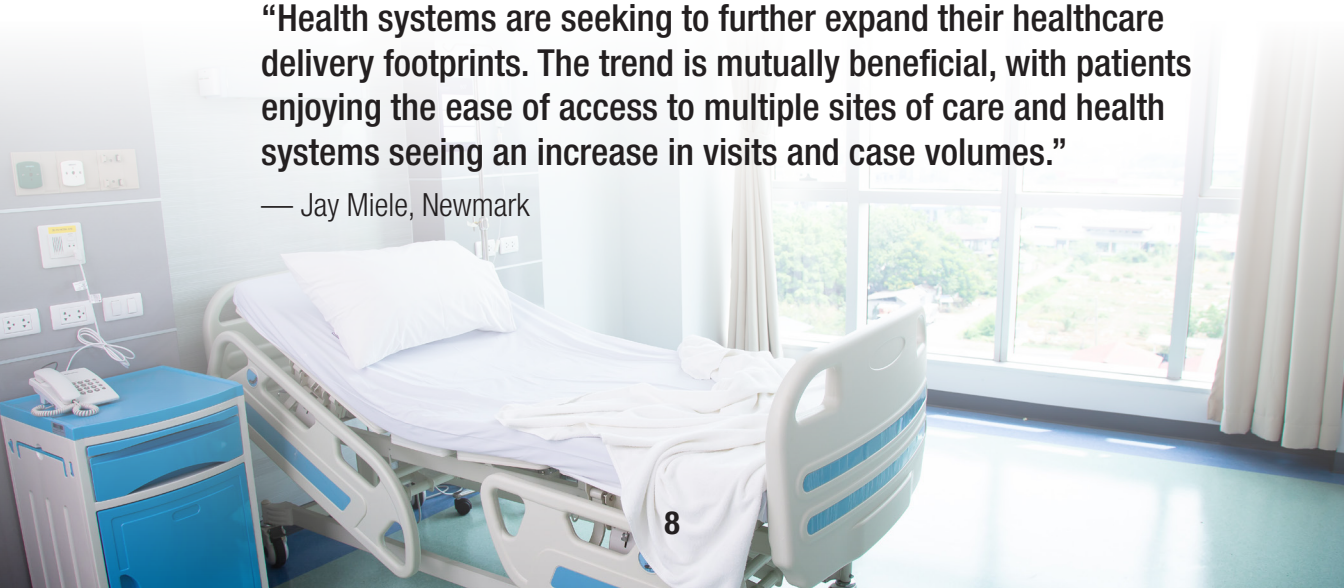
But is it possible to overdo that focus on efficiency and cost savings? As one source points out: "The cost of beds over 20 years has trended down. But then you get into COVID, and we didn't have enough. So, are we now underbuilt?"

Overdone or not, the reduction in beds provides another example of trends not begun, but only supercharged, by the pandemic. Bringing services to the local communities "has been going on for years," says one source. "But thanks to the pandemic, there's been a huge acceleration."

She says that some owners and managers were previously "agnostic" about services either on or off campus, but "we've seen that it makes sense. After all, as a patient, where do you want to go for a doctor? On campus with its hassles of parking and way-finding?"

"Health systems are seeking to further expand their healthcare delivery footprints. The trend is mutually beneficial, with patients enjoying the ease of access to multiple sites of care and health systems seeing an increase in visits and case volumes."

— Jay Miele, Newmark

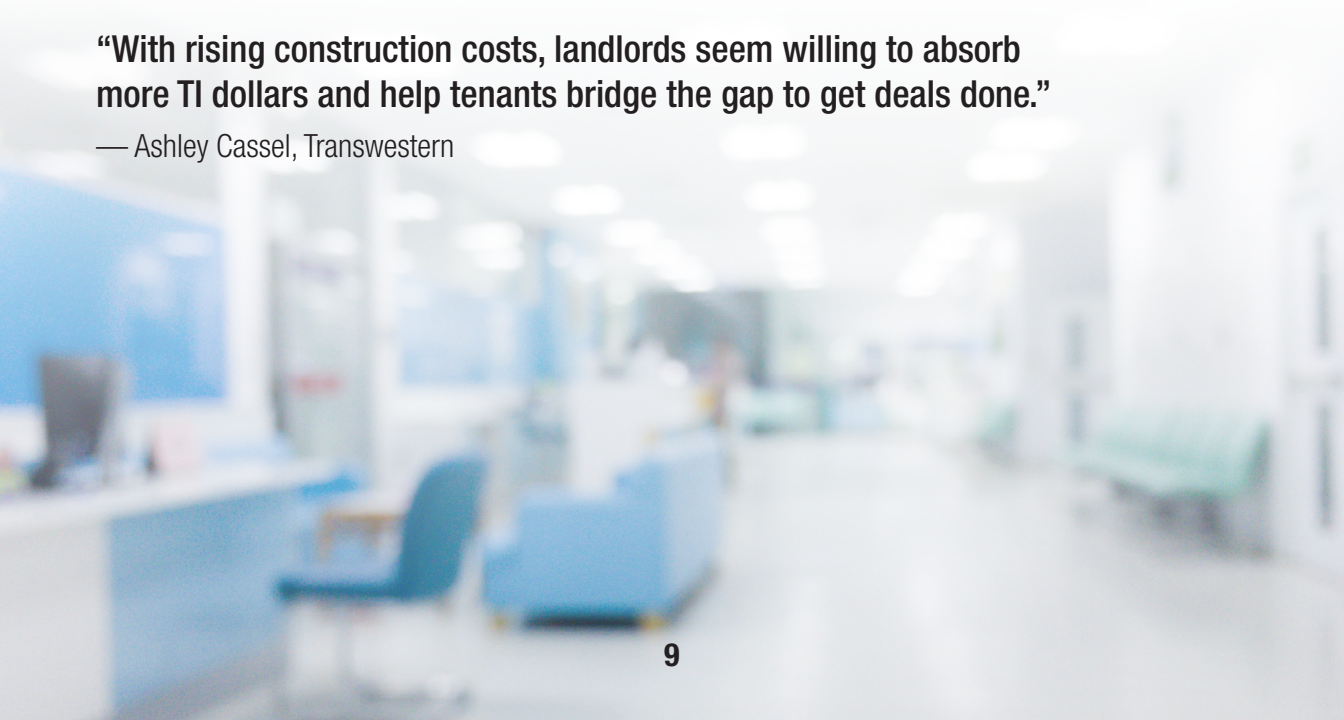


More than convenience, it is about the cost of care, the acuity rate. "Ten years ago, it would have seemed crazy to get a hip replacement at the surgery center down the street. Now you can recover at home, and at one-fourth the cost of a hospital stay." She adds that the insurance companies love the trending alternative.

But outfitting spaces for shifting trends as outlined in the last section is a costly proposition, more so than ever. We can thank the industrial sector in part for that. Ironically, the warehouse and distribution market was, along with healthcare, a relatively strong performer throughout last year's recession. But supply-chain disruptions have not yet normalized, and delays there have helped crank up the pricing of construction. (One contributor with a West Coast office states that he can see the line of cargo ships queued up to the horizon waiting for port entry.)

What does this mean for TIs? "What was $100 a foot all of a sudden is $150 or $175," says one advisor. Backlogs in permitting also exist in municipalities that were shuttered last year, and amid the pile of as-yet untouched red tape, "A doctor sees a space and says, 'I'm ready to move.' But it'll take us six weeks to design, and months to permit it." Potential tenants and, therefore, potential landlords, are then squeezed between leases about to expire and the delays in fitout.

There is also a tug of war in leasing terms—but when is there not? With many smaller physician groups still cautious about the direction of the recovery, they (much like their traditional office counterparts) are gun shy of long-term agreements. But as landlords are quick to point out, TIs amortized over a longer term reduce the size of the pill tenants need to swallow. Or, as JLL points out, "When health systems commit to longer-term occupancy and scale, the cost of capital becomes more affordable."



"With rising construction costs, landlords seem willing to absorb more TI dollars and help tenants bridge the gap to get deals done."

— Ashley Cassel, Transwestern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Sources put the typical health system lease term between 10 and 15 years. "Normally, while an office tenant might pay $30 to $35 a foot for TIs, we'll give as much as $80 due to the infrastructure involved," says one manager, who explains that the annual rent increase now can be as high as four or five dollars. Of course, tenants are likely to push back. "If they're not going to agree to that increase, we'll do a two-year deal, and they can put their own money into it."

But, she adds, after investing what could amount to "hundreds and thousands of dollars, after two years, they'll lose the home they've built." Tenants should go for the long term and the "years of rights that go along with it."

Much like other real estate sectors, there was a detectable shift from enacting strategies to dousing fires, including quickly working to set up both testing and, later, vaccination sites.

As stated, despite the previously mentioned healthcare hardships related to COVID-19, the bulk of the market remained pretty robust, or at least more resilient than traditional office. The essential-service designation and availability of Paycheck Protection Program (PPP) loans were there to help. U.S. healthcare providers received roughly $68 billion in PPP funding, according to the Kaiser Family Foundation, while the CARES Act doled out $454 billion for loans to larger businesses, including hospitals. But how much did that infusion of capital actually help stave off rent delinquency or aid lease renewals? One expert says relatively little of that funding went to rent. "It went primarily for staff," she says. "Maybe it helped with rents here and there, just to help bridge the gap for the two or three months no one could be in a medical office building, but it didn't make a meaningful long-term difference."

"We collected 99.6 percent of our rents," says one manager, noting that this was in line with collections prior to COVID-19. "It was business as usual." This stability was borne out in a survey conducted by CBRE of "influential healthcare real estate" players, of whom 71 percent reported "minimal rent deferrals." (*See "A Rapid Return to Robust Activity for MOBs," page 12.*)

Nevertheless, much like other real estate sectors, there also was a detectable shift from enacting strategies to dousing fires, including quickly working to set up both testing and, later, vaccination sites. Meanwhile, the strategies were "lining up at the light," says one source, using a traffic analogy. "They had to deal with what was coming through the intersection." But, physicians didn't stop practicing, "and residents didn't stop coming out of medical school."

Now, the expansion, the development and the leasing strategies can proceed. "They're doing in 2021 and 2022 the things they couldn't do in 2020," she says. The traffic light has finally changed.

Backlogs and cautionary sentiments aside, the fundamentals attest to a sector that successfully rode out the pandemic storm. While medical office vacancies rose by 80 basis points (bps) to 9.6 percent, it is nearly half of the 17.2 percent that still overshadowed the traditional office market as of Q2 of this year. And the market saw a reversal of that downward spiral as early as Q1, when Marcus & Millichap tracked absorption nearing 900,000 square feet. The firm does expect what it calls a "moderate uptick" in availability, but this is due to an influx of new supply. This will bring the market close to a place other sectors can only hope for right now: equilibrium.

And that is the place where investors clearly want to reside.

A Rapid Return to Robust Activity for MOBs

From a development and investment standpoint, it seems that, whatever headwinds caused by the COVID-19 pandemic, the healthcare real estate market is poised to enhance its frontrunner status among commercial real estate sectors.

"The healthcare industry has long been lauded by economists and industry professionals as being a recession-resistant sector with an inelastic relationship to general economic drivers," states CBRE in a recent survey of some 111 "influential healthcare real estate" players. These included REITs, institutional and private capital investors and developers. "The onset of the COVID-19 pandemic has been just the most recent instance to test that theory, and 80 percent of respondents believe the healthcare real estate industry is recession resistant."

Respondents reportedly plan to allocate some $10.9 billion to healthcare investment and development before the end of the year. Curiously, this is actually less than 2020's $12.3 billion, while just nudging out the $10.3 billion that was earmarked for 2019.

MOBs are the favored investment focus for 96 percent of those respondents, far outpacing other asset types in the sector. These include ambulatory surgery centers (71 percent); life sciences (46 percent); inpatient rehab hospitals (35 percent); and behavioral hospitals (31 percent). Other types each garnered responses under 20 percent.

In terms of development, 43 percent of developers in the space see request-for-proposal (RFP) activity rising from last year, and 67 percent of institutional investors agree. Only 21 percent of developers expect it to decline.

The market for mergers and acquisitions (M&As) was fairly active last year, especially in Q4 2020 when, says the Healthcare Financial Management Association, there was a "marked increase in activity across healthcare. The proliferation of transactions suggests stakeholders' interest in pursuing strategic opportunities, even amid the financial downturn brought on by the COVID-19 pandemic." Q4 saw a 21 percent M&A jump over the same period a year earlier. In all, there were 642 transactions for the year, exceeding the 2019 total by 10.

Listed below are the top five, as provided by Becker's Hospital Review:

1. Teladoc and Livongo ($18.3 billion);
2. Siemens Healthineers' acquisition of Varian Medical Systems ($16.4 billion);
3. Gilead Sciences' purchase of Forty Seven ($4.1 billion);
4. Sanofi's deal with Principia Biosciences ($3.4 billion); and
5. Novo Nordisk's acquisition of Corvidia Therapeutics ($2.1 billion).

Experts agree that COVID-19 has accelerated healthcare real estate's need for innovation and strategies that address both the sector's post-pandemic transformation and new alignment opportunities. Owners and operators who approach this moment with a strategic vision can write themselves a prescription for growth in the years ahead.

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A SAFE HAVEN IN TIMES OF UPHEAVAL

As always happens in times of upheaval, investors, especially those not so far out on the risk scale, seek safe havens in which to place their capital. People need somewhere to live, despite lean times, which buoyed the multifamily market during the recession. The industrial sector more than held its own as e-commerce exploded during quarantines and providers of goods worked overtime to keep grocery shelves stocked. And caution aside—or because of it—people always need healthcare.

Roughly 80 percent of the sector is owned "by hospitals or the healthcare systems," says one source. The rest is divided up among large investment groups, REITs and private capital.

It is a particularly competitive market currently, expanding from "our core healthcare investors that have always been here," says one contributor, to include investors from other sectors, such as retail and hotel. There is also an influx of offshore players, he adds, creating "a perfect storm" of activity, and too much capital outweighs the number of opportunities.

No matter who is doing the buying, it has been a dynamic time, says JLL, "a reflection of investor confidence in the sector's long-term growth fundamentals despite the many challenges faced by the industry itself. The increasing sophistication and clinical acuity of outpatient services, coupled with expanding outpatient delivery models overall, are fueling sustained demand for specialized space."

And historically low interest and capitalization rates certainly do not dampen that enthusiasm. Interest rates remain in the low single digits and in terms of cap rates, professionals we spoke with say, "we are down 50 to 100 bps depending on the asset type, as low as the low fours and into the threes." And since pricing works conversely with cap rates, he says he has seen increases over two years ago in the ballpark range of 10 percent to 20 percent.

"Investors pivot during challenging times to durable income property classes, and medical office buildings proved themselves during COVID."

— Mindy Berman, JLL

Not surprisingly, as he indicated, there are differentials based on asset class. At the core of institutional interest are the large MOBs, ranging upward from 50,000 square feet, both as one-offs and as part of a portfolio.

Single-tenant standalone clinics, those typically found in a retail strip, tend to hold less appeal for the institutions, unless they too are part of a portfolio, "when they become interesting," says one market observer. You will see those trade at cap rates upward of six percent.

But they also tend to hold relatively little interest for building managers. Since they are typically based on triple-net leases, the tenant is responsible for all operations, as well as maintenance, property taxes and insurance. There is little need for third-party management assistance, especially on a retainer basis.

The growing trend of walk-in clinics housed within a larger chain pharmacy are a totally different breed, he says. Those assets "won't get MOB pricing since they're totally dependent on foot traffic into the store. They aren't institutionally favored."

While we are on the subject of different breeds, lab spaces and life science assets, while certainly related to the healthcare sector, are a segment unto themselves. We talked with professionals who considered moving into the lab and life science space, but ultimately passed on opportunities specifically because of the inherent differences. They cited the need for the right demographics, the presence of the right schools and the clusters of like operations to underpin synergies. "It's a totally different dynamic," he says.

If all of the above fundamentals—the vital signs, if you will—remained relatively solid in 2020, even allowing for the temporary caution found in the early days of the pandemic, performance for the now-growing upcycle should be predictably stronger.

But is it perfect? Of course not.

A HEALTHY OUTLOOK, AND HOW TO MAKE IT HEALTHIER

On one hand, "It's never been better," says one source, pretty much capturing the overall sentiment of all participants in this Deep Dive. The aforementioned line of leases piled up "at the intersection" holds a lot of promise for the MOB sector, as does the amount of capital currently chasing deals.

"We've seen a lot of activity," says one contributor. "There are a lot of deals out there." She notes that, by mid-July, her shop already met its annual sales goals. "There's a lot of pent-up demand, and little of it has been released."

The overall growth of the sector also promises new avenues of professional growth for property managers. "It's a unique asset class with unique demands that you might not find in retail or other segments," says one source. "Property managers who specialize in MOBs are in huge demand right now."

But, on the other hand, there's what one professional calls "a long runway" of hospital systems still waiting to monetize in the wake of the pandemic. "They've looked at their balance sheets and realized there's a lot they need to do and ways they can grow. But they need cash."

There is also the ever-present (for decades now) specter of healthcare reform from inside the Beltway. As one practitioner states, "The sector is recession-resistant, but it isn't reform-proof."

Despite the relative strength of the sector, and the promise of more to come, there is one missing element that would accelerate the efficiency of market performance still more. "Shared information, especially between competitors, is still sorely lacking," says one source. Providers don't need to give up their secrets, but "I'm a huge proponent of shared information," she says, adding that there is so much more everyone in the industry can glean from each other's experiences.

"You don't know what you don't know," she says. "Sharing information is a solid way to make us all better professionals." After more than a year of coming together to fight COVID-19, healthcare real estate practitioners are hopeful this spirit of collaboration will continue well after the pandemic ends. ■

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Research work contributing to this paper includes:

- From Becker's Hospital Review: "The Largest Healthcare M&A Deals Announced in 2020."
- From BOMA International:
  - "The Office Building's Role in the Optimized City of the Future."
  - Medical Office Buildings + Healthcare Real Estate Conference
- From CBRE:
  - "2021 US Medical Office Trends: Resilience Amid Historic Change."
  - "2021 Healthcare Real Estate Investor & Developer Survey."
- From Cushman & Wakefield: "U.S. Office Market Remained Soft in Q2, but Green Shoots Are Emerging."
- From Gensler: "Digital Transformation of Healthcare Design," by Scott Latimer and Richard Tyson.
- From Healthcare Finance: "Healthcare M&A's down in 2020 but analysts say COVID-19 is a catalyst for future deals."
- From the Healthcare Financial Management Association: "Healthcare M&A Activity Gained Steam in Q4 2020."
- From JLL: "2021 Healthcare Real Estate Outlook: The Performance Impact of Real Estate on Systemness (and Vice Versa!)."
- From Kaiser Family Foundation: "Funding for Healthcare Providers During the endemic: An Update."
- From Marcus & Millichap: "Medical Office Midyear Outlook."