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Off the Beaten Path: Finding Value in Medical Office

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Anyone who watches food and travel shows knows that the "best" restaurants are not always the most satisfying experiences. Every city has its overburdened hotspots; meanwhile, there are hidden gems with equally good menus that only the locals know. In Austin, where Virtus is based, it is probably craft barbeque that draws the biggest crowds, with the most famous spots having multiple hour-long lines that often end with the restaurant selling out before the last folks can place their orders. Even if these places are legitimately the best barbeque restaurants, waiting for two hours and leaving without food (or without the dish you wanted) does not leave a good taste in your mouth.

There are similar trends at play within the Medical Office ("MOB") sector in recent years, which have seen a hot streak of rising enthusiasm and valuations. One effect has been that many investors who would historically prefer on-campus assets (located on or beside hospital campuses) have been either crowded out of deals or forced to overpay for them. Historically, on-campus assets have been perceived as being less risky due to the support that a hospital system offers (many times even extending to master leases and significant involvement in tenant screening and operations). By contrast, off-campus assets are seen as riskier from a tenant credit and general demand perspective.

However, in recent years, off-campus product has increasingly matured into a more viable and frequently Core or Core-Plus oriented investment option. The reasons for this include:

- Technological advances and policy shifts making it easier and more possible to conduct complex diagnostic or surgical work in an outpatient setting. This has shifted total care delivery from mainly an inpatient to majority outpatient, with **over 2/3 of all surgical procedures being delivered on an outpatient basis, which will boost total off-campus service demand**.
- **A lack of available land around the most established hospital systems**, which tend to be in dense urban settings, leading to more development in outlying areas.
- A high-intensity buying environment where **prime on-campus deals are often overvalued**.
- Rampant **consolidation of physician practices** as a byproduct of healthcare reform; as a result, larger doctor groups can be more strategic and efficient about which staff are required to travel to the hospital and make patient rounds. Moreover, most doctors prefer convenient access to their office rather than dealing with the pain of traveling to and accessing a more on-campus location, which is often older and lower quality space.
- As healthcare consumers (patients) have become more educated and informed, **they are demanding greater convenience and improved access in a high-quality setting**, ideally with multiple synergistic healthcare service providers in the same accessible location.

Thus, it is clear that off-campus product should be reevaluated to determine whether the relative risks are offset by opportunities for better growth or returns. Are we arguing that off-campus assets are better than on-campus? No. In fact, our analysis quantifies many of the anecdotal advantages that on-campus assets have, and we have invested quite successfully in on-campus MOB opportunities for the last twelve years. But that does not tell the whole story. Much like a local who knows the best spots and can navigate around the tourist traps for equally good or better food, an experienced MOB investor can find assets that provide equally good fundamentals, but at a more attractive basis than the widely marketed on-campus

deals. This is a significant advantage in today's buying environment and offers experienced investors an edge over the newcomers who often gravitate toward the highest profile options. Below, we will provide a brief high-level view of the Medical Office sector, present internal research comparing performance among different kinds of assets, and sketch out a likely trajectory for the sector as current trends continue to rebalance the landscape.

SECTOR OVERVIEW

Top 50 MSAs	Off-Campus	On-Campus
Number of Properties	15,919 (82%)	2,912 (18%)
Total Square Footage	491 Million SF (66%)	249 Million SF (34%)
Average Size	38,731 SF	88,595 SF
Median Vintage Year	1994	1993
Average Rent PSF	$22.00	$24.16

Source: Revista

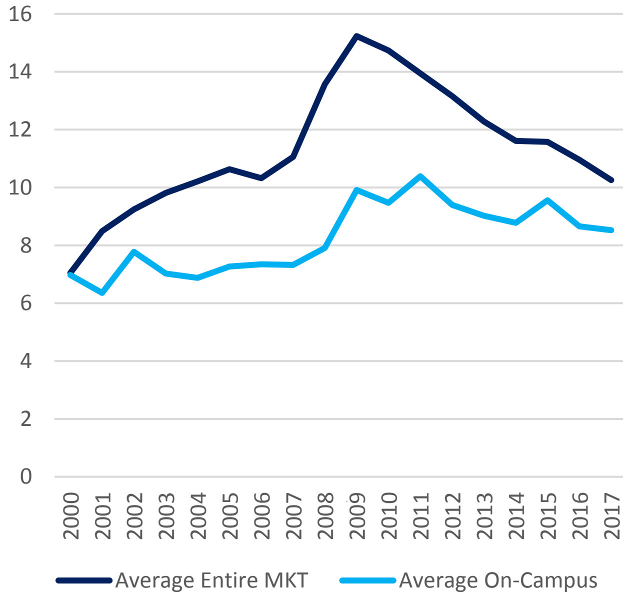
According to Revista's breakdown of the Top 50 Metropolitan Statistical Areas ("MSAs") in the nation, on-campus assets represent only 18% of total Medical Office properties, but 34% of total built MOB space. This is because they tend to be larger than off-campus properties. Further, on-campus assets offer an average of a 9.8% rent premium compared to off-campus product, with most individual markets seeing between a 5% and 15% premium. Finally, while anecdotal evidence suggests a roughly 300 bps occupancy difference between On Campus and Off Campus product, we found few formal studies that measure it with any real precision. Accordingly, we set out to assess the differences ourselves.

FUNDAMENTALS PERFORMANCE

Virtus chose ten markets ranging from Tier I to Tier II sized MSAs, with moderate to high rates of population growth, and low to high current vacancy rates. All were selected as relatively attractive places we would consider for investment given the right deal basis and competitive positioning. We then chose the top ten largest hospital systems in each area and captured a 0.25-mile radius around each hospital (with slightly more for extremely large or low-density sites). After filtering each selection set for institutionally sized properties and weeding out functionally obsolete assets, we compared the on-campus assets to their surrounding markets to see how asset performance compared.

The first thing we noted was that the anecdotal figure of 300 bps difference holds true over the long historical timeline, even if the current spread is much narrower at less than 200 bps. The reason is that on-campus assets tend to hold their occupancies more steadfastly during downturns. This relationship is most apparent in the aggregated data. However, we also found markets where there was a negligible difference or even long periods where on-campus vacancies were higher during major hospital expansions or developments. **It is also arguable that as off-campus locations have become more in demand for patients and healthcare tenants alike, the trend may continue, and it is possible the more recent 200 bps spread will compress further.** Finally, not all individual markets showed the same historical pattern where on-campus occupancies were more resilient than off-campus. Some low barrier markets like Atlanta, GA, and Phoenix, AZ saw modest and shifting differences. Other low barrier markets like Dallas,

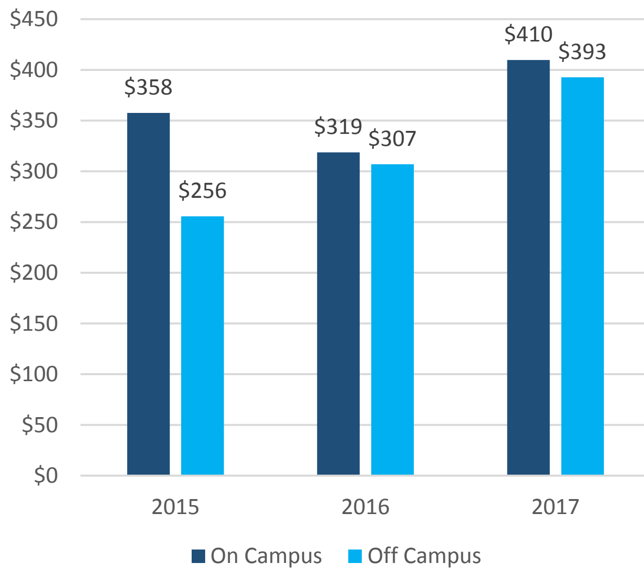
TX saw significant and persistent advantages for on-campus product. And finally, higher barrier markets showed variability as well: in Boston, the spread is quite substantial, whereas in Seattle it is very minor. In other words, as in all real estate, there is no replacement for understanding local conditions. Nonetheless, at the highest level, it is clear that on-campus product generally offers a more defensive market position.



Source: CoStar Analytics

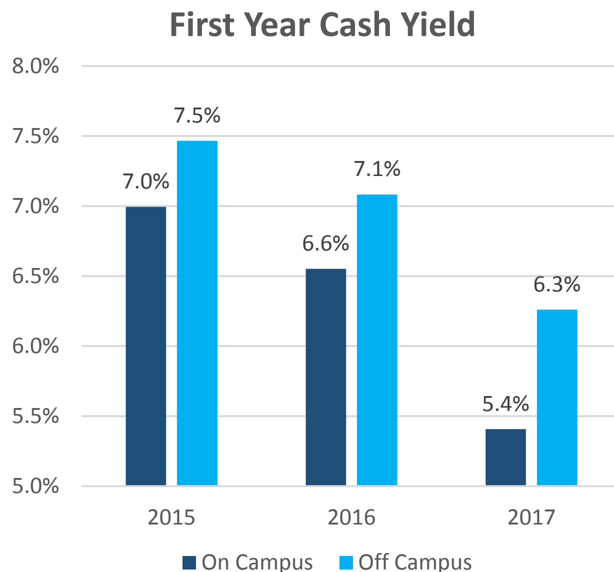
REIT BUYING ACTIVITY

We dug further and looked at recent REIT behavior to establish how major investors perceive these product types. As expected, REITs overall prefer on-campus product to off-campus product. Since 2015, the three most "pure play" MOB REITs have acquired a total of $9.7 Billion in individual acquisitions. We looked at individual trades rather than portfolios so that we could assess the true difference in valuations without the distortion of portfolio premiums or allocated valuations. Of these, roughly 79% of total square feet acquired have been on or adjacent to a hospital system, which is notable given that such product is a minority. In addition, this overall percentage has remained quite consistent over the available time horizon among pure-play REITs. In fact, total on-campus portfolio composition has gone from 76% in 2013 to 79% today. This preference ranges from Healthcare Realty Trust (NYSE: HR) and its rather conservative 87% on-campus breakdown to Healthcare Trust of America (NYSE: HTA) at 70%.



Source: Public filings from Physicians Realty Trust (NYSE:DOC), Healthcare Realty Trust (NYSE: HR), Healthcare Trust of America (NYSE: HTA)

That said, there are also signs that off-campus assets are finding a different place in the current market. While the average price per foot was radically different in 2015, that difference has compressed to the point where REITs are largely paying similar figures on a space basis. We have seen more significant variation in cap rates and implied yields, especially as the market for the most Core assets heats up. However, even this premium may have more to do with correlated factors in each subsector than the merits of the sectors themselves. As Scott Herbold, First Vice President with CBRE's Healthcare Capital Markets Group, stated, *"With all variables being equal, I believe the on-campus premium is largely gone. That being said, on-campus cap rates are often lower because on-campus MOBs often have stronger credit on the rent roll (hospital system) than their off-campus*



Source: Public filings from Physicians Realty Trust (NYSE:DOC), Healthcare Realty Trust (NYSE: HR), Healthcare Trust of America (NYSE: HTA)

counterparts. Often off-campus MOBs have stronger retail qualities (visibility from major highways, convenient and accessible locations)." [Link]

Thus, conservative buyers like REITs accept the lower yield on-campus product offers in exchange for perceived better credit and expectations of better performance. **What are their preferences in off-campus product? Most of their acquisitions tend to be large new centers with a diverse tenant base that act as regional neighborhood health hubs in high demand markets that are not served by a nearby hospital.** Such assets are likely better positioned to take advantage of growing demand areas in outlying parts of a market than core urban infill locations for all but the most complex and demanding care.

FORWARD HEALTHCARE SECTOR OUTLOOK

Finally, we wanted to contextualize the relative performance of the two subsectors given the backdrop of evolving American healthcare policy and business trends. At the highest level, we looked at which procedures and specialties (aside from the maternity ward) tend to provide the most revenue for hospital systems. According to Medicare data, joint replacements, blood infections, and cardiology constitute the largest revenue sources. In addition, we conducted a more granular breakdown of which kinds of specialist tenants are statistically overrepresented or underrepresented in an on-campus setting. We found that Gastroenterology, Neurology, Pulmonary/Blood Diseases, and Oncology tend to be most rooted within hospital or on-campus settings. This makes sense, as most are highly complex procedures requiring significant diagnostics and continual care. However, some of these specialties are already thriving in an outpatient setting. For instance, in 2017, the Centers for Medicare and Medicaid proposed allowing full reimbursement for joint replacement surgeries taking place in Ambulatory Surgery Centers. This shift came after years of medical innovation in which surgeons vastly reduce the post-acute recovery time and the need for skilled nursing care. Such trends, which many hospitals oppose, would remove barriers that have kept the most lucrative procedures confined to hospital campuses. **As such, we believe that there are enough tailwinds for off-campus product, especially high quality buildings with numerous synergistic healthcare practices, such that the right properties can provide very favorable risk-adjusted returns and more significant growth.**

CONCLUSION

Medical Office real estate will have a hot 2018 if investor expectations (and valuations) are any guide. It has become well accepted that healthcare policy and practices will continue to evolve at a meaningful pace, ultimately with a bias toward outcomes-based payment structures rather than the more arcane fee for services model. The industry is getting better at underwriting deals around the existing and potential real estate effects that healthcare evolution has had. But chiefly, the projections on healthcare demand

show robust growth across all policy projections due to a greying population, and this has the attention of an investor community already worried about the prospects of increasingly thin options for income producing assets elsewhere. Whether medical office investments are on-campus or off-campus, the industry as a whole has not only outperformed its traditional office counterpart; it continues to show the resilient nature of the asset class in good times and bad.

To be successful, medical office investors will need to develop an informed viewpoint on their off-campus strategies, given current valuations and the low existing stock of on-campus inventory that is generally swarmed by REITs and other purportedly "conservative" healthcare investors. **With still-persistent (though narrowing) valuation spreads and frequently more significant potential for growth, off-campus investments can be a central and accretive way to invest in the growing and historically recession-resilient medical office space.**

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