NATIONAL REPORT

Marcus & Millichap

MEDICAL OFFICE

1H/24

Construction Slows and Healthcare Retailers Shutter, Mitigating Emerging Vacancy Pressures

New supply is limited outside of Texas. While most medical office construction projects are less than 50,000 square feet, Houston has several large builds slated for 2024, leading to a nationally prominent pipeline. The metro will host nearly 22 percent of medical office space delivering nationally this year. While this creates short-term pressure for Houston, the metro will note the third largest increase in the 65 and over population by 2034, tempering the long-run impact. A well-dispersed pipeline outside of Houston will help limit the national vacancy increase to only 30 basis points this year as overall completions step down from 12.5 million square feet in 2023 to about 10 million this year. Going forward, construction may ease further, given rising material and labor costs. To contend with higher expenses, more future projects may involve traditional office conversions.

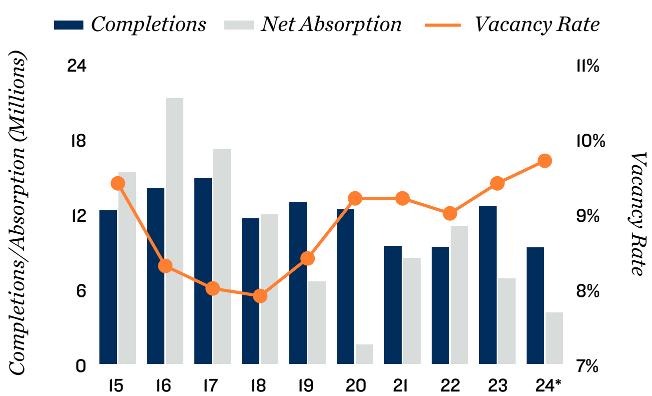
Retailers stepping back from healthcare could offer opportunities. The decision from some pharmacy retailers to offer limited, on-site medical care has emerged as a potential competitor for medical office operators in recent years. These companies aimed to offer patients more convenient medical care in retail locations they already visit, but in practice this strategy has produced mixed success. Companies like Walmart and Walgreens have elected to shutter medical offerings in stores, pointing to an inability to make the business profitable. This has alleviated some healthcare competition and demonstrated that retailers still have hurdles to jump over near-term to provide health services. As these operations downsize, providers could see opportunities to fill demand gaps and open offices in multi-tenant spaces.

Medical Office Investment Highlights

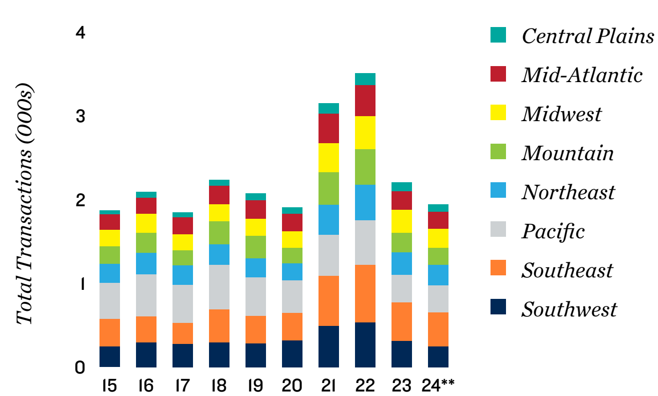
Deal flow falls, but private buyers find alternative financing. Medical office investment continued to trend down in the first quarter as interest rates remain elevated relative to recent years. During the trailing 12 months ended in March, transaction velocity was down by nearly 40 percent year-over-year. The bulk of trades that took place, however, were in the $1 to $10 million price tranche as private buyers stayed active. Deals with lower price tags also have the advantage of utilizing alternative means of financing. As lenders limited their exposure to office properties — even low-vacancy medical office assets — avenues like seller financing and 1031 exchanges have gained traction. Trades taking place in a lower price tranche have impacted the average sale price. During the trailing yearlong span ended in March, the mean price per square foot for medical office space was $292, with a corresponding average cap rate of 7.2 percent.

Regional differences emerge compared to pre-2020. While deal flow has declined from the highs recorded in 2021 and 2022, trades were more closely aligned with pre-pandemic trends. During the trailing 12 months ended in March, half of the eight regions recorded transaction velocity above their pre-pandemic five-year average. These included the Central Plains, Midwest, Northeast and Southeast. Meanwhile, the mid-Atlantic, Mountain and Southwest regions were 3 to 12 percent lower than the 2015-2019 period. The Pacific region was the only area to note a significant drop in transactions, falling by nearly one-third. Metros with limited development and lower vacancy rates will likely continue to be sought out.

National Supply and Demand Trends



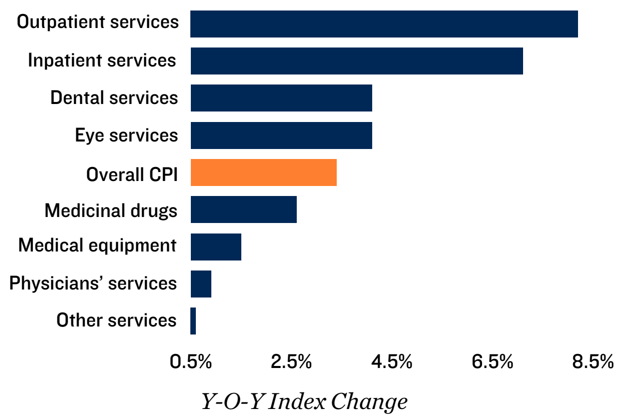
Medical Office Trades by Region



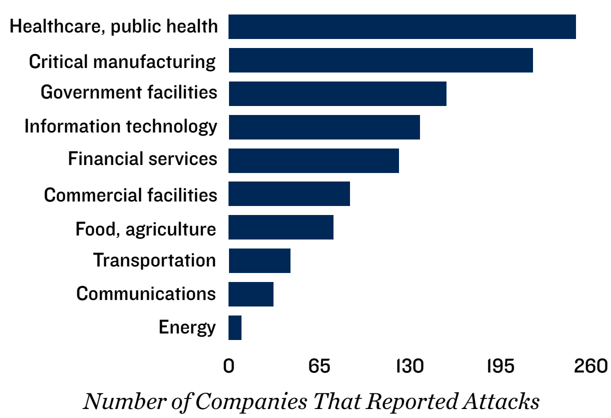
** Forecast; ** Trailing 12-months through 1Q*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Centers for Medicare & Medicaid Services

Healthcare Year-Over-Year Change in CPI



Ransomware Attacks by Industry in 2023



Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; Federal Reserve; Centers for Medicare & Medicaid Services; Moody's; Federal Bureau of Investigation

Operating Costs, Increasing Patient Premiums and Ransomware Attacks Present Headwinds

Physicians contend with rising operating costs. Medical office space demand will grow long term. The need for healthcare is closely tied with the aging population, and the 75-plus category is projected to be one of the fastest-growing age groups over the next 10 years. While this bodes well for medical office buildings, there are macro barriers to expansion that operators face and must be resolved before widespread expansions take place. For instance, reports from the American Medical Group Association show that operational costs for medical groups are outpacing revenue gains. The cost and supply of healthcare labor has been a hindrance for years, an issue further exacerbated by pandemic burn-out. Additionally, cost increases have some patients opting to delay non-essential medical care, even as the national uninsured rate is decreasing. In April, the cost of medical services rose 2.7 percent year-over-year, propelled by an 8.2 percent increase in outpatient services. While providers may want to expand private practices, these mid-term roadblocks pose challenges.

Cyber security concerns loom over the health system. Outside of direct medical office operators, other healthcare-related companies have faced cost issues, like UnitedHealthcare, the nation's largest private health insurer and employer of physicians. After a cyberattack in February that was aimed at the company's subsidiary Change Healthcare cost the company $870 million, there is increasing scrutiny among lawmakers for the size of some firms across the country's health system. According to the American Hospital Association, 94 percent of hospitals reported being financially impacted by the February cyberattack. If some of the nation's largest healthcare firms are divided into smaller pieces, it could have a trickle down effect on the overall demand for medical office space. The added expense of cyber security could also prompt cost cutting in other areas, including real estate holdings. Following the cyberattack fallout, UnitedHealthcare moved to shrink its traditional office real estate footprint. Other large companies may face similar attacks, which could impact their buy/sell/lease decisions of commercial real estate, including medical office.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Real Capital Analytics; U.S. Census Bureau; American Medical Group Association; Federal Bureau of Investigation; America Hospital Association

Price: $500