

MedicalOffice

RESEARCH REPORT

Marcus & Millichap

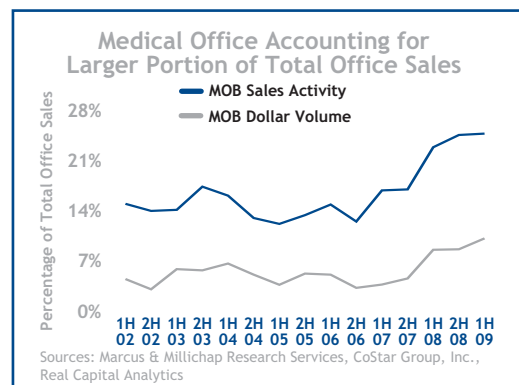
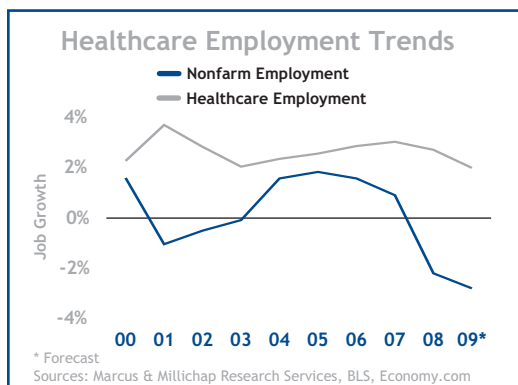
Second Half 2009

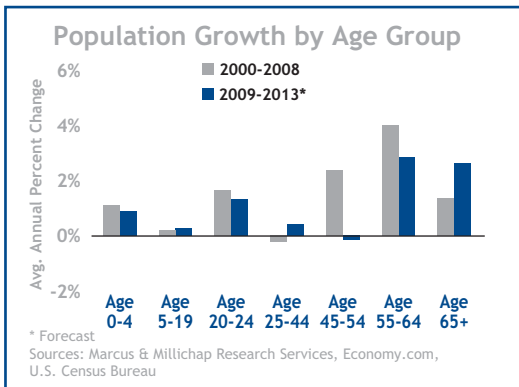
MEDICAL OFFICE SECTOR AVOIDING ILLS OF TRADITIONAL OFFICE MARKET

With healthcare remaining the strongest sector of the economy, adding 222,000 workers so far this year for growth of 1.4 percent, medical office building (MOB) assets have been much more stable than traditional office properties. Only 1 percent of MOB assets are currently distressed, equating to just \$200 million in troubled loans, compared with almost \$20 billion for the 3 percent of traditional office assets now at risk. While its performance is clearly stronger than other property sectors, the MOB segment remains under pressure. Recessionary stresses and rising medical costs have kept a portion of the U.S. population on the sidelines for elective outpatient care, easing demand for physicians' services and, in turn, medical space. As a result, deliveries have recently outpaced absorption and vacancy has ticked up, forcing operators to lower rents in an effort to keep occupancy levels in check.

The heated topic of healthcare reform is especially relevant to the MOB market, as any measures passed by Congress could further bolster the sector. It is estimated that if 50 percent of the 46 million individuals currently uninsured gained coverage, the added demand would require nearly 45 million square feet of MOB space beyond what is needed to satisfy normal demand trends. While this alone would be a boon to MOB demand, changes in healthcare technology and data center needs also are expected to drive a need for space proximate to medical buildings in the near term. Specifically, the American Recovery and Reinvestment Act of 2009 has allocated approximately \$19 billion to facilitate the development of electronic medical records, potentially creating a new tenant group for existing MOB space.

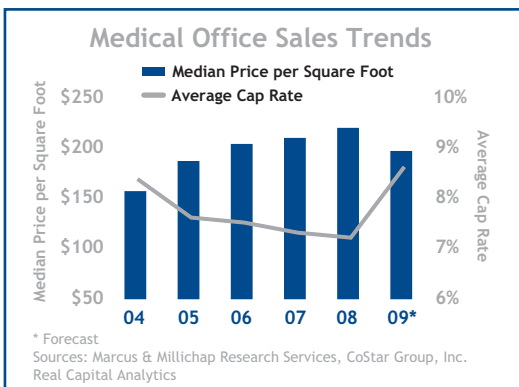
Although lenders are favoring MOB assets, transaction velocity has been stymied by the capital markets crisis and subsequent lack of available credit. Increased equity requirements have put a damper on purchases, as LTVs have dropped from 90 percent, inclusive of mezzanine debt, to 60 percent. While deal flow has slowed, MOB sales as a share of total office activity have risen from 14 percent to 25 percent over the past seven years. This clearly demonstrates the continued draw of MOB product, which provides higher risk-adjusted returns and more stability than traditional office assets. For investors seeking upside opportunities, some distressed assets are surfacing, although troubled properties are very limited in most of the country. In the once high-growth Southwest and Southeast regions, many struggling markets have excellent prognoses for long-term health, which could make MOB assets in these locales attractive to investors searching for assets that are currently underperforming. Medical facilities in suburban and rural locations where hospital systems are having difficulties remaining viable also may offer potential investment prospects. Pressure from insurers to change more procedures to outpatient status has increased demand for private practices in these areas and the MOB space to house them.





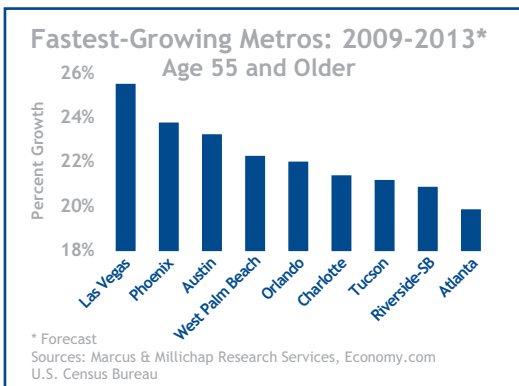
NATIONAL TRENDS

- ◆ **Demographic Trends:** Notwithstanding any proposed healthcare reform, the ongoing maturation of the U.S. population will continue to support the need for MOB space. Population growth in the 55-plus age cohort alone will necessitate an additional 25 million square feet of MOB space by the end of 2013, above and beyond normal absorption trends.
- ◆ **Construction Trends:** Lagging demand generated by economic uncertainty, together with tightened development capital, have resulted in a slower pace of medical office construction. Completions are on track to decline more than 30 percent in 2009 to 10.1 million square feet. Currently, only 7 million square feet of MOB space is scheduled for delivery next year.
- ◆ **Rent/Vacancy Trends:** Lower patient loads are challenging the performance of some outpatient practices, subsequently effecting business scale backs, consolidations and even early retirement for some doctors. As such, vacancy has risen 130 basis points to 12 percent since the third quarter of 2008, and owners have trimmed rents 4 percent to \$23.90 per square foot. Although rents are expected to fall 4.8 percent this year to \$23.42 per square foot and vacancy is forecast to climb to 12.3 percent, medical office assets will continue to outperform traditional office properties.
- ◆ **Investment Trends:** With the exception of the \$164 million Healthcare Trust of America purchase in South Carolina, institutions and REITs represent the bulk of a pullback in transaction velocity, as MOB sales over \$10 million fell more than 60 percent in the first half of 2009 when compared to the same period last year. Transaction volume for assets under \$10 million declined less than 30 percent during the same span. Cap rates continue to rise in response to market pressure for higher returns and tighter lending scrutiny. Over the past year, average cap rates have increased more than 100 basis points to the mid- to high-8 percent range. Prices have retreated approximately 5 percent since the end of 2008, with the median currently at \$195 per square foot.



NORTHEAST

- ◆ **Construction Trends:** Despite solid demand, developers are scaling back MOB construction in the Northeast, helping to combat a larger uptick in vacancy. Approximately 1.7 million square feet of medical office space is scheduled for completion this year, down 30 percent from deliveries in 2008. Expanding areas in Northern New Jersey and suburban New York continue to receive the majority of new product.
- ◆ **Rent/Vacancy Trends:** While vacancy is expected to rise slightly through the end of the year, the region remains among the tightest in the nation, recording a vacancy increase of just 70 basis points to 10.4 percent over the past 12 months. Vacancy is forecast to tick up to 10.6 percent by year end, with just over 1 million square feet of space absorbed. Rent declines persist, but they appear to have moderated in recent months. Rents are expected to fall 1 percent for the year to \$24.75 per square foot.
- ◆ **Investment Trends:** Transaction activity in the Northeast stalled in the first half of the year. The exception was Northern New Jersey, where both transaction velocity and dollar volume increased slightly, powered by private investors' interest in growing suburban markets. Regionwide, the median price is currently \$180 per square foot, while cap rates are averaging in the mid-7 percent range.



Regional definitions are available on page 4.

SOUTHEAST

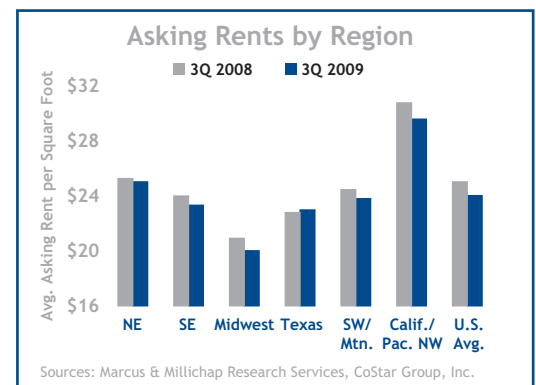
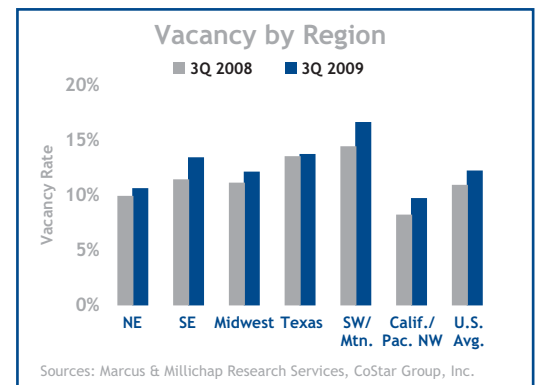
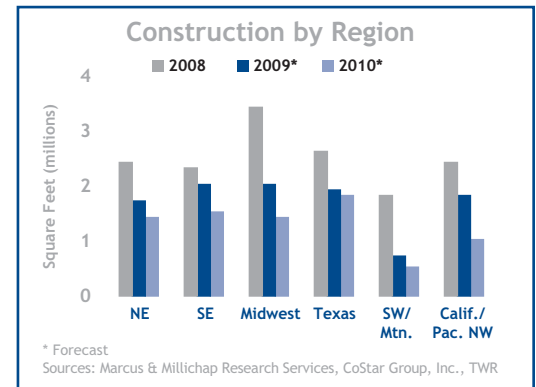
- ◆ **Construction Trends:** After completing 2.3 million square feet of MOB space in the Southeast last year, builders are expected to bring 2 million square feet online by the end of 2009. Nearly half of the construction is taking place in central Florida, while just under 500,000 square feet of space is scheduled for Atlanta, less than half of the metro's deliveries in 2008.
- ◆ **Rent/Vacancy Trends:** Elevated development levels in Florida continue to weigh on occupancy regionwide. Vacancy in the Southeast is currently 13.2 percent, up 200 basis points year over year, driven by a 250 basis point surge in Florida. Nonetheless, at 11.2 percent, vacancy in Florida remains well below the current rate of 18 percent in Atlanta, where construction has outpaced demand over the past few years. Owners in the region have trimmed rents by 2.8 percent in the past year to \$23.20 per square foot. So far in 2009, negative net absorption in the Southeast has totaled 300,000 square feet.
- ◆ **Investment Trends:** Although investors' interest in well-located, high-quality assets will continue to be supported by positive long-term fundamentals, activity has declined significantly due to tighter operational scrutiny. With transaction velocity slowing by more than 65 percent during the first half, prices pulled back almost 15 percent to \$175 per square foot. Cap rates are now up 100 basis points year to date in the low- to mid-8 percent range.

MIDWEST

- ◆ **Construction Trends:** Following the completion of 3.4 million square feet in the Midwest last year, developers are on track to add 2 million square feet of MOB space in 2009, a 1.5 percent increase in inventory. Deliveries have averaged close to 3 percent of stock annually for the past five years.
- ◆ **Rent/Vacancy Trends:** Slowing development activity and solid demand will drive up vacancy 50 basis points this year to 12 percent. Vacancy in Minneapolis will remain tight in the low-6 percent range, sustained by steady demand and modest construction activity. Rents in the Midwest are expected to finish 2009 at \$19.70 per square foot, down 2.1 percent from last year and the lowest point in more than two years.
- ◆ **Investment Trends:** Sales have waned in the region, with transaction velocity during the first half of the year declining just over 20 percent from the corresponding period in 2008. Prices have receded slightly to a median of \$140 per square foot, while cap rates are in the low- to mid-8 percent range.

TEXAS

- ◆ **Construction Trends:** MOB completions will decrease in 2009 to just under 2 million square feet, adding 3.5 percent to inventory; stock expanded by 4.7 percent last year. Dallas/Fort Worth is projected to receive nearly half of the new construction.
- ◆ **Rent/Vacancy Trends:** Vacancy has ticked up 20 basis points over the past 12 months to 13.5 percent but is expected to remain flat through the end of 2009. As such, rents are forecast to rise 0.8 percent to \$22.90 per square foot. Despite increased completions, vacancy in Dallas/Fort Worth is down 20 basis points year over year at 14.2 percent, in line with the metro's historical average.
- ◆ **Investment Trends:** Transaction activity increased slightly during the first half of the year compared to the corresponding period in 2008. As a result, the median price is up modestly from the end of last year at \$220 per square foot, while cap rates are averaging in the high-7 percent range.



Regional definitions are available on page 4.

Marcus & Millichap

HEALTHCARE REAL ESTATE GROUP

Marcus & Millichap's Healthcare Real Estate Group is comprised of real estate investment professionals who specialize in healthcare properties nationwide. In addition to offering specialized market knowledge, members of the Healthcare Real Estate Group are able to leverage the firm's network of more than 1,300 investment professionals to help clients meet their investment objectives.

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SOUTHWEST/MOUNTAIN

- ◆ **Construction Trends:** MOB completions in the Southwest/Mountain region will decrease significantly this year to just 700,000 square feet, or an 0.8 percent rise in stock, following a 2.3 percent increase in 2008. There are no completions due in Las Vegas, while only 300,000 square feet is expected to come online in Phoenix. Developers will maintain their pace of activity in Denver, which is scheduled to receive 300,000 square feet of new MOB space by year end.
- ◆ **Rent/Vacancy Trends:** Vacancy has increased 220 basis points to 16.4 percent over the past year, with rents falling 2.7 percent to \$23.68 per square foot during that period. Vacancy in the struggling Phoenix metro has already surpassed 20 percent in 2009, while the rate in Las Vegas is above 22 percent and forecast to rise further through the rest of the year. With regionwide vacancy expected to finish this year at 16.8 percent, rents are projected to fall 4.4 percent to \$23.20 per square foot.
- ◆ **Investment Trends:** Transaction velocity in the Southwest/Mountain region decelerated by 35 percent in the first half of 2009 compared to the same period last year, as buyers were met with a lack of for-sale product and more challenging fundamentals. The median price is currently down 10 percent from the end of 2008 at \$194 per square foot, while cap rates average in the mid- to high-8 percent range.

CALIFORNIA/PACIFIC NORTHWEST

- ◆ **Construction Trends:** After building approximately 2.5 million square feet of MOB space in each of the past three years, developers are on track to deliver just 1.6 million square feet in the California/Pacific Northwest region by year end. The bulk of activity will take place in Riverside-San Bernardino, where the addition of more than 500,000 square feet of MOB product will push vacancy above 17 percent this year. Builders are expected to complete 400,000 square feet in Portland, although solid demand will keep vacancy in check.
- ◆ **Rent/Vacancy Trends:** At 9.5 percent, vacancy is up 110 basis points from the end of 2008, with the average rent falling 3.3 percent in that stretch to \$29.45 per square foot. Vacancy is expected to finish the year at just under 10 percent, while rents are forecast to ease to \$29.40 per square foot. Portland and the Puget Sound continue to outperform other West Coast markets, with vacancy between the two areas averaging 6.5 percent, one of the lowest rates in the nation. Southern California remains the region's rent leader, with rents of \$31.00 per square foot.
- ◆ **Investment Trends:** Both transaction velocity and dollar volume have dropped considerably in the region, as investors continue to struggle with financing assets where operations are unsettled. The one exception to this trend is the East Bay, where private investors have stepped up their activity as REITs and institutions have scaled back. Consequently, sales in the area held flat in the first half of 2009 compared to one year earlier. Regionwide, the median price has fallen 10 percent since the end of 2008 to \$272 per square foot, while cap rates are currently in the mid-7 percent range.

Regional Definitions:

California/Pacific Northwest: Los Angeles, Oakland, Orange County, Portland, Riverside-San Bernardino, Sacramento, San Diego, San Francisco, San Jose, Seattle

Midwest: Chicago, Cincinnati, Cleveland, Columbus, Detroit, Indianapolis, Milwaukee, Minneapolis, St. Louis

Northeast: Boston, New York City, Northern New Jersey, Philadelphia, Washington, D.C.

Southeast: Atlanta, Charlotte, Orlando, South Florida, Tampa

Southwest/Mountain: Denver, Las Vegas, Phoenix, Salt Lake City, Tucson

Texas: Austin, Dallas/Fort Worth, Houston, San Antonio

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