Medical Properties: A Profitable Investment Opportunity

The demand for medical office properties has steadily risen over the past few years. These properties have become popular among investors, due to their generally lower vacancy rates, relatively stable cap rates, and the strength of the health services sector. As the baby boomers age in the coming years, the demand for health care services will increase, making these properties even more appealing investment opportunities.

Figure 1	**Medical Office Sales vs. All Office Sales, 3Q2005 to 3Q2006**			
	Medical Office	**Change**	**Other Office**	**Change**
Volume ($millions)	$3,637	43%	$113,852	21%
Properties Sold	288	45%	3,228	22%
Wtd Ave Cap Rate	7.0%	-11%	6.4%	-46%
Top Quartile	6.5%	-34%	6.5%	-33%
Median	7.0%	-32%	7.1%	-34%
Bottom Quartile	7.6%	-22%	7.7%	-36%

According to Real Capital Analytics, the volume of medical office properties sold has increased 43% since the third quarter of 2005, compared to an increase of only 22% in the volume of office properties sold. Compared to other office properties, medical office buildings across the country possess higher median prices, more noticeable increases in prices, and slightly higher and more stable cap rates.
The Midwest region is the third largest medical office market in terms of both the number of properties sold and the total volume of sales (ranked below the West and Southeast, see Fig.2).

Figure 2	**Medical Office Sales by Region, 3Q2005 to 3Q2006**							
	Volume		**$/SF**			**Cap Rate**		
Regions	**$millions**	**#**	**Max**	**Ave**	**Min**	**Max**	**Ave**	**Min**
West	$955.2	86	$644	$258	$96	9.3%	6.7%	4.7%
Southeast	$934.2	69	$422	$196	$69	9.0%	7.2%	6.1%
Midwest	$489.0	42	$427	$172	$91	11.4%	7.6%	6.2%
Southwest	$454.8	40	$356	$201	$82	9.4%	7.5%	5.8%
Northeast	$406.6	23	$1,717	$220	$34	9.6%	7.2%	4.8%
Mid-Atlantic	$336.3	22	$439	$223	$90	9.4%	7.1%	5.5%
US Total	$3,576.1	282	$1,717	$212	$34	11.4%	7.1%	4.7%

Both buyers and sellers of these properties are mostly private companies. Two trends have emerged in the private ownership of these properties: an increase in doctor-owned medical buildings and an increase in third party development of office properties, mainly in the form of real estate investment trusts.

One reason for the popularity of doctor-owned medical properties is the perception of a solid investment opportunity. Another reason is the opportunity to provide better quality medical care. Some feel that better care can be provided when doctors and support staff are able to provide direct input into the development and management of a property.

Figure 3	**Investor Composition, 3Q2005 to 3Q2006**			
	Buyers		**Sellers**	
	Medical Office	**All Others**	**Medical Office**	**All Others**
Private In-State	28%	15%	62%	25%
Private Out-of-State	18%	11%	13%	8%
Fund	6%	21%	2%	11%
Syndicator	4%	5%	1%	1%
Condo Converter	7%	1%	0%	0%
User/Other	7%	4%	16%	8%
REIT/Public	18%	11%	0%	20%
Foreign	5%	11%	0%	11%
Institutional	8%	21%	6%	17%

Data provided by Real Capital Analytics, based on independent reports of properties $5 million and greater.

Third party ownership of these properties is also increasing, mainly in the form of Healthcare real estate investment trusts (REITs). Healthcare REITs first emerged in the 1980s when new regulations allowed health care companies to begin spinning off their real estate. This appeals to hospitals and health care systems as it enables them to preserve capital for acute care, to minimize any conflicts that surface in landlord/tenant relations between hospitals and referring physicians, and to minimize legal challenges that might arise when leasing space to referring physicians. One advantage of these REITs for investors is that, like other REITS, they must pay at least 90% of taxable income out as dividend, which guarantees a healthy yield for investors. Most health care companies are interested in long-term leases that include annual increases, thus guaranteeing the REIT's revenue for the length of the lease. In general, because the medical office market is tighter than the regular office market, third party investors are more willing to rent to doctors, with the promise of these longer leases, lower vacancy rates, and the continued strength of the health-care sector.

With lower vacancy rates, less volatile cap rates, and the strong health services sector in its favor, this niche market is likely to continue to be a good opportunity for investors in commercial real estate, both in the Midwest and across the nation.

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