

GREATER PHOENIX | MEDICAL OFFICE

Q1 2017

Accelerating success.

A Slow Start to 2017 in Medical Office

Key Takeaways

- There was negative net absorption of nearly 50,000 square feet in Greater Phoenix medical office market during the first quarter, driving the vacancy rate higher. Additional vacancy increases could occur in the coming quarters as new spec buildings come online.
- Rents inched lower to start 2017, but gains have been registered over the past 12 months. The robust rent growth that has been realized in the traditional office market has not been duplicated in the medical office segment.
- Fewer medical office properties changed hands in the first quarter than during the final three months of last year. Pricing trends were mixed.

Greater Phoenix Medical Office Market

The Greater Phoenix medical office market got off to a bit of a slow start to 2017. Vacancy ticked higher and rents dipped, but these trends are expected to be short-term disruptions in an overall improvement cycle rather than a change in market direction. The underlying drivers of demand for medical office space remain strong. The total population in Maricopa County expanded by more than 80,000 residents in 2016, the largest increase of any county in the United States. This population growth should fuel demand for healthcare as well as tenant demand for medical office space. The industry continues to add staff to meet this new demand. Healthcare employment has been one of the fastest-growing segments of the local economy, expanding by more than 3.5 percent in the past year with the addition of 8,700 jobs.

The local investment market for medical office buildings recorded some slowing during the first quarter, which is a fairly common occurrence in the early months of the year. While sales activity was unable to maintain the volume that was recorded to close 2016, it is generally even with or outpacing the levels recorded in the first quarter of 2016. With uncertainty in the healthcare industry increasing, there could be some greater volatility in the investment market in the near term. In addition, potential interest rate increases may put some upward pressure on cap rates between now and the end of this year.

Market Indicators Relative to prior period	Market Q1 2017	Market Q1 2016
Vacancy	↑	↓
On-Campus Vacancy	↔	↑
Completions	↓	↓
Net Absorption	↓	↑
On-Campus Net Absorption	↓	↓
Asking Rents	↓	↓

First Quarter Employment Trends*

Total Nonfarm Phoenix Metro	↑	↓
Healthcare Employment Phoenix Metro	↓	↓
Total Nonfarm United States	↑	↓
Healthcare Employment United States	↓	↓

*Source: Bureau of Labor Statistics

Summary Statistics	Phoenix Market	On-Campus MOB	Off-Campus MOB
Vacancy Rate	16.0%	17.9%	15.2%
Change from Q1 2016 (bps)	-120	-70	-150
Net Absorption (thousands SF)	(49.5)	(1.6)	(47.9)
New Construction (thousands SF)	10,500	0	10,500
Under Construction (thousands SF)	225.7	0	225.7
Asking Rents Per Square Foot Per Year	\$22.66	\$24.80	\$21.66
Change from Q1 2016	1.6%	-2.1%	3.9%

Vacancy:

- > Vacancy in medical office buildings in Greater Phoenix ticked higher in the first quarter, reaching 16 percent, up from 15.7 percent at the end of last year. The bulk of the increase was recorded in the Arrowhead/Surprise submarket. Despite the modest uptick, vacancy is 120 basis points lower than one year ago and the rate has been improving over the past several years.
- > Vacancy in on-campus properties was flat in the first quarter, holding steady at 17.9 percent. Vacancy in on-campus buildings is down 70 basis points year over year, but has shown little movement in either direction over the past few quarters.
- > In the off-campus medical office buildings that account for the bulk of the market inventory, vacancy crept higher for the first time in nearly two years during the first quarter. The rate edged up 40 basis points from the end of last year to 15.2 percent. Vacancy in off-campus buildings is 150 basis points lower than it was one year ago.

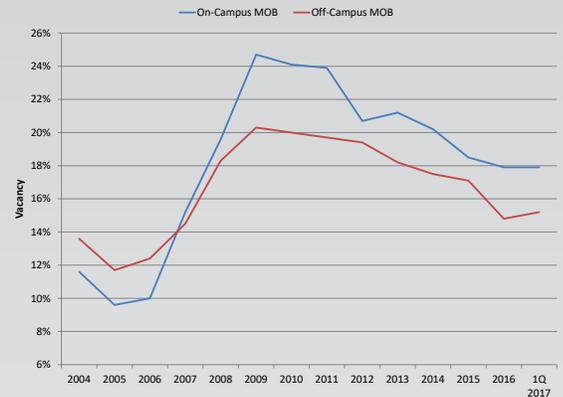
Rents:

- > Medical office asking rents have been slow to gain traction. Rents dipped 1.1 percent in the first quarter, reaching \$22.66 per square foot. Asking rents for medical office buildings are up 1.6 percent from one year ago, after recording modest increases in 2016.
- > Rents in off-campus buildings inched lower during the first quarter, but have recorded healthy annual gains. Off-campus asking rents ended the first quarter at \$21.66 per square foot, up 3.9 percent from one year ago.
- > Asking rents in on-campus buildings have declined in each of the past four quarters, falling 2.1 percent in that time. Asking rents in on-campus buildings ended the first quarter at \$24.80 per square foot.

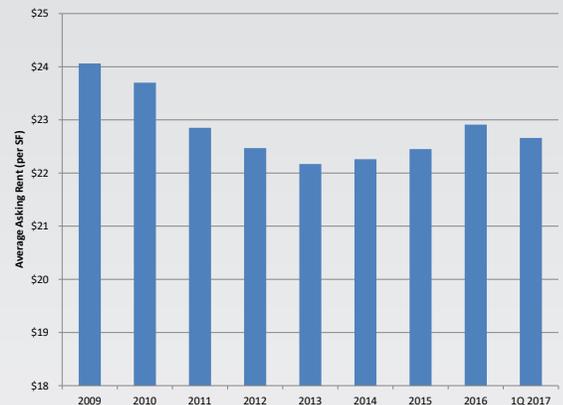
Investment Trends:

- > Following a spike of more than 40 percent in 2016, sales activity of medical office condos slowed in the first quarter of this year. Transaction activity in the first three months of this year lagged levels from the preceding quarter by 43 percent. Sales in the first quarter of 2016 were 30 percent above levels from the same period this year.
- > The median price for medical office condos ticked up slightly in the first quarter, reaching \$170 per square foot. In 2016, the median price was also \$170 per square foot, although the figure in the fourth quarter was only \$160 per square foot.
- > Sales of traditional, non-condo medical office buildings retreated slightly, falling 9 percent from levels from the fourth quarter of last year. Sales velocity in the past three months matched the volume recorded in the first quarter of 2016.
- > The median price in traditional medical office buildings dipped to \$107 per square foot in the first quarter, nearly 20 percent lower than the median price in 2016. The median price from the first quarter was a bit misleading, as more than one-third of the properties that sold during the first quarter traded for more than \$200 per square foot. Cap rates averaged in the mid- to high-7 percent range.

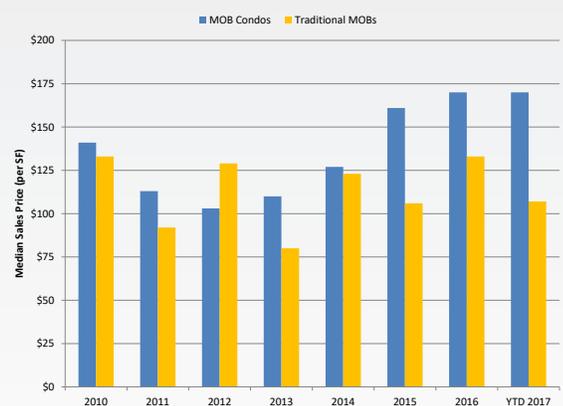
Vacancy Trends



Asking Rents Trends



Investment Trends

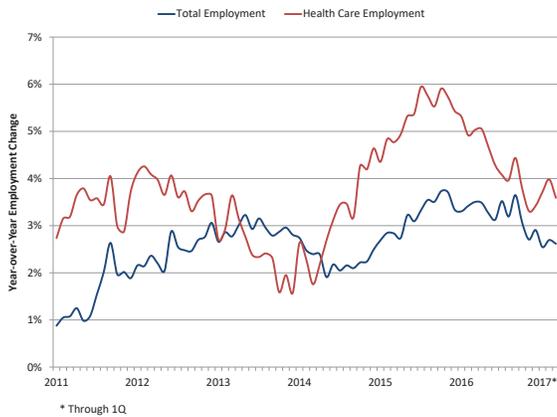


Outlook:

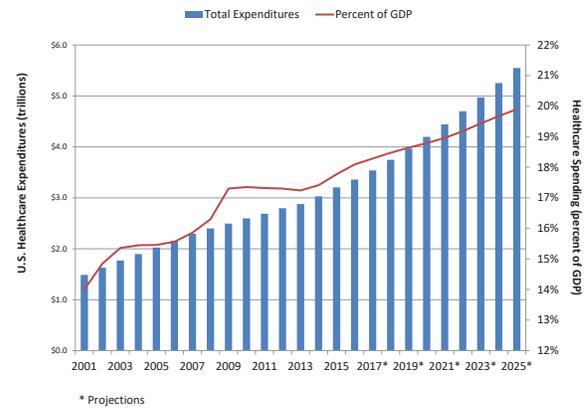
After seven consecutive years of declines, vacancy in the Greater Phoenix medical office market will likely tick higher in 2017. While tenant demand for space is forecast to remain fairly strong, this year is forecast to mark the most new construction since 2009, and the projects that are being delivered are spec developments. The total new square footage that is slated for delivery in 2017 would account for approximately 1.5 percent of the total medical office inventory, meaning the local vacancy rate could rise by as much as 100 basis points this year in response to the delivery of new space.

Aside from a short-term uptick in new development, the greatest uncertainty in the local medical office market continues to be the ongoing national healthcare debate. While the specifics of what will eventually be signed into law are still unclear, there is a potential for fewer insured people, which would likely result in fewer visits to medical offices and more treatment in emergency rooms and urgent care facilities. It will take at least a few more months before a final bill makes it through the legislative process, making analyzing the potential impact on healthcare real estate a very inexact exercise.

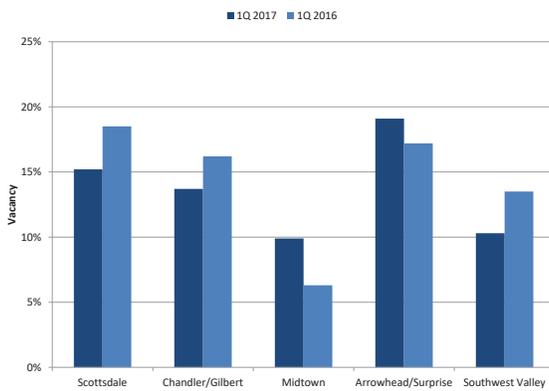
Greater Phoenix Employment Trends



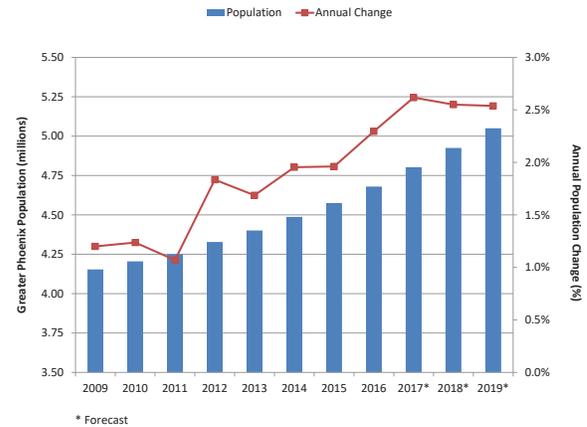
U.S. Healthcare Expenditures



Greater Phoenix MOB Vacancy by Submarket



Greater Phoenix Population Trends



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