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U.S. RESEARCH REPORT

2020 HEALTHCARE MARKETPLACE

Challenges Ahead Due to COVID-19
2019 in Review | Outlook for 2020

COVID-19: Implications for the U.S. Healthcare Sector

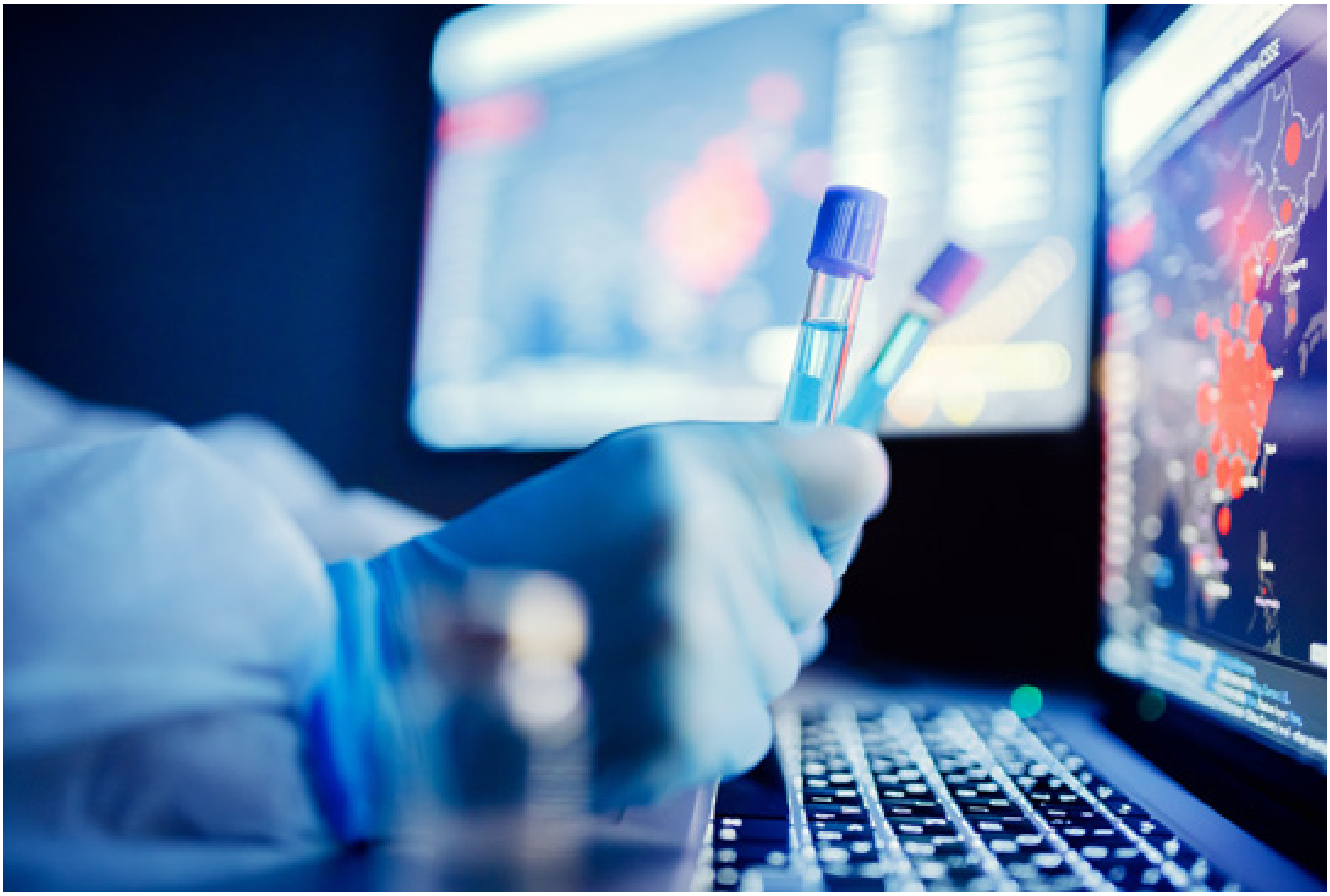
As we publish this report, both the U.S. and the world are facing a tremendous challenge, the scale of which is unprecedented in recent history. The spread of COVID-19 is significantly changing all aspects of day-to-day life and impacting society, the economy and, by extension, commercial real estate.

The extent, length and severity of the COVID-19 pandemic is unknown and continues to evolve at a rapid pace, sometimes changing by the hour. We are already seeing entire states and countries on lockdown, rising fatalities, and widespread layoffs, while the economy has moved into recessionary territory.

Some economists are anticipating a sharp bounce back for the economy that could occur as soon as Q4 2020; others feel that it could take 12 to 18 months for the impact of the COVID-19 pandemic to fully play out.

What are the implications for healthcare real estate? Potential impacts include the following:

- Real estate decision making may largely be put on hold, impacting leasing and acquisition/disposition activity.
- Fewer medical office buildings (MOB) or hospital developments are expected to break ground in the near term. Expect a focus on increasing the availability of options to treat COVID-19 patients through re-designating and converting existing spaces, reopening closed hospitals and the construction of temporary facilities.
- Corporate merger and acquisition activity involving healthcare firms is expected to slow. The current volatility in the capital markets and unfolding impacts on the economy may change the competitive positions and strategies of individual healthcare firms, but the structural changes that have been taking place in the industry should resume in due course.
- Even after the economy and markets stabilize, a period of dislocation and a need for price discovery can be expected.
- Healthcare should be one of the few economic sectors that will gain jobs as a result of the pandemic, with accelerated hiring of medical professionals, administrators, and support staff already underway. Where these positions are located, how long they will exist, and how they will be housed while they are needed are being decided on a real-time basis.
- The healthcare industry's demand curve may be shifted upward as a result of post-crisis policy changes. There is debate over whether the U.S. was sufficiently prepared for a pandemic. Individual states are proving to have different levels of healthcare capacity relative to the size and potential needs of their populations. These factors are being spotlighted by COVID-19's rapid spread.



- One result of the potential post-pandemic changes may be an increase in funding and staffing for healthcare research, facilities and equipment, and preparedness planning. In such a scenario, the impacts for the healthcare and life science industries could be positive.
- The trend toward telehealth should also accelerate, as non-critical visits to hospitals, clinics and physicians' offices move online to minimize exposure of medical staff and limit in-person visits.
- Differences in economic composition could translate into performance variations for individual metro markets. Cities that have major medical centers and/or host biotech, medical device, and pharmaceutical research clusters may well perform the strongest in this environment.
- Initiatives involving medical data storage, analysis and diagnostics could continue to emerge. One example is Google's "Nightingale" venture with Ascension Health Systems, which has given Google access to patient data from the 21 Midwestern states in which Ascension operates. Amazon and Apple are also understood to be expanding their businesses to include electronic health records.

Colliers will continue to track the impact of COVID-19 across economies, markets, and real estate sectors. We are providing insights to help you understand the potential impact on your business and community and recommendations on ways to minimize the impacts, where possible. Please visit our COVID-19 Knowledge Leader page for resources and the latest updates.

Key Takeaways from 2019

Vacancy: Following a cyclical low in 2018, national MOB vacancy increased by 30 basis points during 2019, to 8.4%. The sector's vacancy rate has been less than 10% for seven consecutive years — a sign of tight market conditions.

Absorption: Demand for medical office space remains strong and has broadly kept pace with the volume of new supply.

Rents: National average asking rents for MOB space increased by 3.9% in 2019 to $23.18 per square foot — a 10-year high.

Construction: After delivering 25.1 million square feet of MOB product in 2018, completions declined in 2019, to 21 million square feet. MOB development continues to favor off-campus locations: Almost 75% of current MOB projects — and 62% of total square footage — are off-campus.

Sales: Total investment in MOB assets rose from $12.6 billion in 2018 to $13.2 billion in 2019. Transaction volumes in the sector continue to be constrained by the relatively small universe of investable product. Although pricing fell 6.2% in 2019, this may be due to a shift in the composition and location of the assets that traded. Average MOB cap rates held steady in 2019 at 6.6%.

Top 10 Markets - Vacancy Rate and Asking Rent

MARKET	MOB VACANCY %	DIRECT ASKING RENT PSF
Atlanta	10.0%	$22.94
Boston	5.3%	$24.46
Chicago	12.8%	$21.29
Dallas-Fort Worth	15.2%	$26.18
Houston	14.6%	$24.94
Los Angeles	8.2%	$35.55
Miami	6.2%	$34.94
New York	9.4%	$30.96
Philadelphia	11.3%	$24.04
Washington, D.C.	13.4%	$28.72

Source: CoStar

Vacancy Stays Low and Rents Continue to Rise

Only three of the 10 leading U.S. markets ended 2019 with vacancy rates lower than the U.S. average, but five of the 10 achieved above-average rent growth — likely driven by the delivery of new MOBs. Rent growth in 2019 was strongest in two markets where vacancy remained low (Los Angeles) or contracted (Miami).

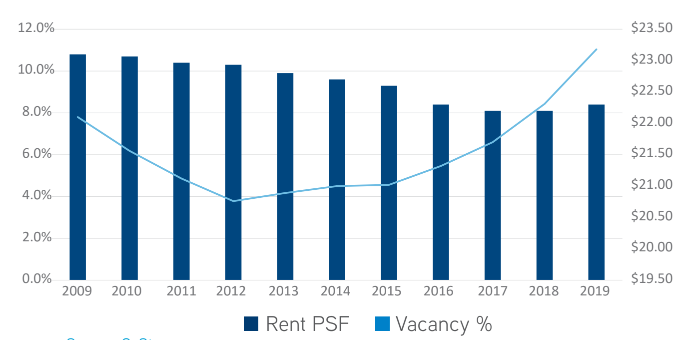
Boston continues to enjoy the lowest MOB vacancy across the major markets, with its vacancy rate falling by another 50 basis points during 2019, to a very tight 5.2%. In Chicago, the vacancy rate held flat but remains elevated (12.8%), while asking rents edged down by 0.7% in 2019.

Miami posted the greatest improvement in fundamentals among the top 10 markets. Its vacancy rate fell 100 basis points to a low 6.2%, supporting a robust 7.2% gain in its average MOB rent. Philadelphia led the top 10 markets for annual MOB rent growth in 2019, at 9.6%.

Dallas and Houston recorded the highest vacancy levels (15.2% and 14.6%, respectively) as significant new supply came on-line in both metros. Despite softening conditions, both metros recorded modest but positive rent growth for the year. Atlanta's MOB rent growth was also positive, but below the national average at 2.9%.

Los Angeles has the highest average MOB rents at $35.66 per square foot, followed closely by Miami's $34.94 per square foot. New York is the only other top 10 metro with an average MOB rent higher than $30, with Washington, D.C. just below that level at $29.72 per square foot. Rents in the remaining six markets range from $21 to $26 per square foot.

Medical Office National Average Vacancy Rates and Asking Rent

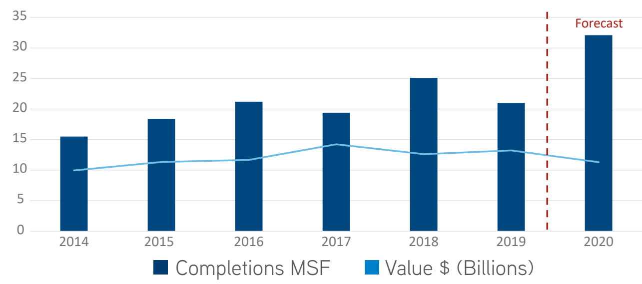


Source: CoStar

MOB Construction Remains Elevated and Focused in Off-Campus Locations

The volume of MOB space being delivered to the market stepped back in 2019, although it continues to be substantial. Completions totaled 21 million square feet, down from 25.1 million square feet in 2018. The total construction value of new MOB projects rose, however, reaching $13.2 billion, up from $12.6 billion in 2018.

Medical Office Recent & Forecast Completions



Source: Revista

There are currently 1,245 projects underway, consisting of 743 MOBs and 502 hospital developments. Median construction value per project stands at $15 million for MOBs and $61.5 million for hospitals. The average MOB project is 45,000 square feet in size, while new hospital projects average 106,500 square feet. Most current hospital development involves expansion or replacement of existing facilities; new facilities comprise only 25% of the pipeline.

All 743 MOB projects under construction — totaling 49 million square feet — are slated to deliver in 2020. MOB construction remains concentrated in off-campus facilities that provide readily accessible locations and out-patient clinics to accommodate the shift away from in-patient hospital care. Off-campus properties — which tend to be considerably smaller than new on-campus facilities — account for 73% of the projects set to come on-line during 2020.

Construction in Progress: Q4 2019

	MOB	HOSPITAL	TOTAL
# of Properties	743	502	1,245
Total	49.0 MSF	86.9 MSF	135.9 MSF
Total Construction Value	$20.5B	$63.3B	$83.8B
Median SF / Project	45.0K SF	106.5K SF	61.2K SF
Median Construction Value / Project	$15M	$61.5M	$25M

Source: Revista

The five states with the most healthcare square footage (either under construction or planned) are California, Texas, Florida, New York and Pennsylvania, reflecting their large and growing populations. Pipeline composition varies significantly: Hospital projects dominate the totals for Pennsylvania (78%) and Texas (72%), while activity in California and New York favors MOBs much more (with 42% and 47% of total square footage, respectively).

Medical Office: Openings Expected in 2020

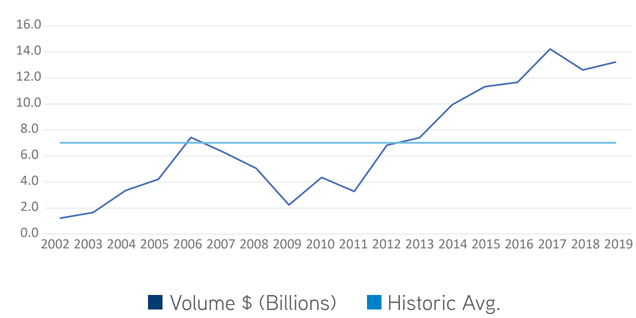
	PROPERTIES	TOTAL VALUE	TOTAL SF
Off-Campus	541	$11.3B	30.3 MSF
On-Campus	202	$9.2B	18.7 MSF
Total	743	$20.5B	49.0 MSF

Source: Revista

Cap Rates and Pricing Hold Firm

Total MOB investment was $13.2 billion in 2019, almost 5% higher than 2018's $12.6 billion level. Activity in the sector has escalated rapidly over the last 10 years as it gained market acceptance, from only $2.2 billion in the recession year of 2009 to $7.4 billion in 2014 and $14.2 billion in 2017, an 18-year peak. 2019's sales total is the second-highest on record. Two-thirds of the year's transactions involved portfolio trades among large industry players.

Medical Office Sales Volume

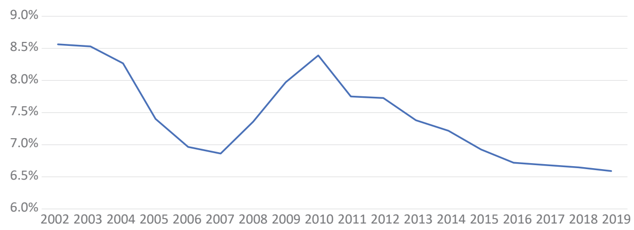


Source: Real Capital Analytics

Average MOB cap rates were unchanged from 2018 at 6.6%, while average pricing declined 6.2%, from $304 to $285 per square foot. It should be noted that this pricing statistic does not control for changes over time in the composition and location of the assets sold.

Apart from new construction, the U.S. MOB market has a relatively limited supply of investable product. More than two-thirds of healthcare real estate is held by healthcare providers and systems.

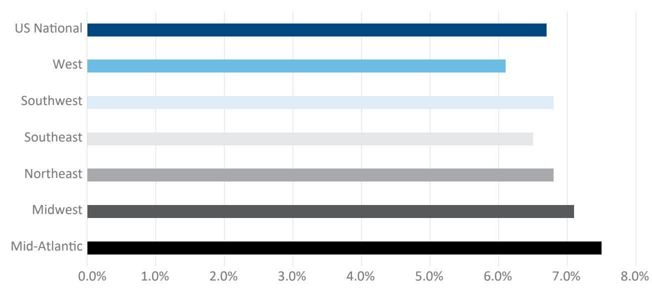
Medical Office Average Cap Rates



Source: Real Capital Analytics

On a regional basis, pricing is highest in the West and Northeast, at $357 and $313 per square foot respectively. The Southeast is third at $289 per square foot, having seen strong appreciation in recent years. Average prices in the remaining three regions (Mid-Atlantic, Midwest and Southwest) are tightly clustered between $230 and $245 per square foot.

Medical Office Cap Rates by Region



Source: Real Capital Analytics (Data as at 4Q 2019)

Regional cap rates are lowest in the West, at 6.1% as of Q4 2019. The range of cap rates has widened out from a year ago. Outside of the West cap rates range from a low of 6.5% in the Southeast to a high of 7.5% in the Mid-Atlantic It should be noted that lower cap rates are being achieved on the best assets, with sub-6% cap rates reported for multiple transactions. One MOB asset in northern San Diego County changed hands in mid-2019 at a quoted cap rate of only 4.8%. Cap rate stability reflects the continued desirability of the healthcare sector. Investors view it as a relatively safe and durable investment even in times of economic uncertainty. Healthcare real estate is now firmly established as a separate asset class within the real estate sector.

Four markets exceeded $100 million in MOB property sales during 2019, led by the New York City metro at $355 million. Los Angeles was a distant second with $204 million, followed by Seattle at $133 million and Dallas at $110 million.

Outlook for 2020: Overshadowed by COVID-19

The healthcare industry and medical real estate should continue to evolve in several ways. These include scrutiny of industry financial models; cost concerns from insurers, consumers and providers; the changing nature of healthcare provision and consumer demand; and the expansion of facilities in retail locations and former retail spaces.

Further reductions in provider income — notably at hospital properties — could impact credit ratings and, for healthcare property owners, the security of rental income. In the near term, however, as addressed at the beginning of this report, all has been eclipsed by the rapid spread of COVID-19.

Beyond the current context, several factors will influence asset performance and investment strategy, including:

Both the design and location of MOB properties must provide the flexibility to respond to ongoing industry changes. New assets in optimal locations are expected to out-perform.

Newer medical office properties and healthcare real estate offering superior accessibility for consumers should generate stronger returns.

MOB assets need to be flexible in order to accommodate change. Capital improvements to reposition older holdings may be necessary.

Competition between providers is driving demand for prominent retail locations, with tenants willing to pay higher rents for prime locations. This may present opportunities for owners of retail properties to repurpose at least some of their space for medical uses. It may be quicker and less expensive to reposition such space rather than to build new healthcare product.

The credit strength of tenants should be closely monitored. Sustained pressure for healthcare operators to lower spending while remaining competitive will further increase their sensitivity to occupancy costs.

The rise of telehealth is impacting both the volume and location of demand for physical real estate. A greater understanding of its impact should emerge over time.

In addition, there are a number of trends impacting the healthcare industry and medical real estate that, once past the COVID-19 pandemic, should reassert themselves. These include continued financial scrutiny and concerns about industry profitability; demographic changes; and a sustained shift to retail locations. Three factors are driving the industry's evolution:

(1) The increased integration of technology into all aspects of the healthcare system as a means of improving outcomes while controlling costs.

(2) Ongoing disruption to the organization and functioning of healthcare systems as major players merge and new companies enter the marketplace. These mergers serve to consolidate bargaining power among fewer, larger firms covering a broad spectrum of costs, including real estate. This trend may also reduce space needs as merging health systems eliminate redundancies and streamline operations.

(3) The unbundling of healthcare service provision — in terms of both setting and staffing — to improve resource allocation, control costs and enhance accessibility for consumers.

The U.S. healthcare system has been a major policy focus at the federal and state levels for some time, centered on the potential repeal of the Affordable Care Act (ACA). The pandemic's primacy, a divided Congress, and the upcoming Presidential election in November make it unlikely that any significant legislative changes will be enacted during 2020.

While investors should closely track these factors, the medical office sector remains attractive for the stability and diversification that it offers. Healthcare needs continue to grow as the U.S. population continues to age. However, greater selectivity and a degree of caution are critical in determining the type and location of assets to target.

HEALTHCARE SERVICES

Shawn Janus
National Director, Healthcare Services
+1 312 612 5927
shawn.janus@colliers.com

RESEARCH

Stephen Newbold
National Director of Office Research | USA
+1 202 534 3630
stephen.newbold@colliers.com

Steig Seaward
National Director of Research | USA
+1 303 283 4561
steig.seaward@colliers.com

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