2018 MEDICAL OFFICE BUILDING FUNDAMENTALS REPORT

HealthCare Appraisers

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HealthCare Appraisers, Inc. ("HAI") is pleased to present its inaugural medical office fundamentals report. In compiling this report, HAI communicated with lenders, real estate brokers, investment bankers and various other investors of medical office product, asking questions on subjects such as industry drivers, financial markets, capitalization rates, internal rates of return (IRR), as well as current trends and overall market conditions.

Overall, our findings indicate that the national medical office market has remained robust over the last 12 months, with most respondents indicating that demand drivers for medical office pricing continues to remain favorable. A low interest rate environment (but moving higher), coupled with strong physician and health system fundamentals, continue to be the driving forces behind sustained strong pricing levels.

As the medical office product has moved from niche status to a favored asset class, a common theme amongst investors is the general lack of available, good-quality product, which continues to drive strong pricing for institutional-quality assets that come to market. Given the substantial size of the larger REITs, and the inability to move the investment needle with one-off, smaller asset acquisitions, the larger players are seeking to grow via the M&A route, or through joint venture partnerships with operating entities. 2017 and the first half of 2018 witnessed numerous portfolio sales.

This survey looks to explore and illustrate various real-estate related highlights for medical office product, including: timeshare usage, rental rates, development trends, product type, and pricing parameters.

STARK LAW – CONTINUED EMPHASIS

By now, most health systems have developed meaningful strategies to address and avoid Stark Law violations and associated self-reporting requirements. However, the increasing scope and complexity of these issues have required the use of more hospital personnel and resulted in bloated budgets, forcing numerous health systems to outsource large components of their real estate portfolios as cost saving measures. Outsourcing of services typically includes: property management, lease administration, leasing, and various accounting responsibilities.

A majority of the recent penalties for Stark violations have occurred from what outsiders would describe as "seemingly minor" issues (e.g., expired leases, storing files in unleased basement space, verbal lease agreements, timeshare physicians storing equipment in non-designated spaces, etc.). But unlike JCAHO, Stark does not differentiate between minor or major violations. Every violation is considered a violation of potential significant consequence. Given the minutiae involved in dealing with these issues, numerous health systems have sought third-party assistance in lease administration, property management, and compliance issues to help maintain compliance, as well as to shift away some of the liability. When third parties (non-physicians) own the medical office real estate, many of the potential Stark Law requirements are removed, as the hospitals no longer have to worry about directly leasing the space to physicians or other referral sources.

Timeshare Usages

Timeshare space demand and usage continues to be a driving force in the market, and a thorn in the side for compliance staff and real estate personnel. 2016 ushered in new regulations that allowed for "drop-in" usage of space (and services) known as the Timeshare Exception.

While the Timeshare Exception primarily deals with evaluation and management (E/M) services, it does provide for space usage under several conditions, including: the arrangement is set out in writing, no referrals, compensation must be consistent with FMV, commercially reasonable, no AKS or other violations, and not a possessory leasehold interest in the real estate.

Because of the structured nature of RE timeshares (e.g., 4-hour block on every other Tuesday), the Timeshare Exception rule is difficult to adopt in real-world situations. As a result, most health systems are not applying the Timeshare Exception to real estate transactions. One caveat is that for short-term transactions under 12 months, the “license” structure is being utilized on a consistent basis.

Timeshare rate calculations are based primarily on prevailing rental rates for similar space in the marketplace as the baseline for determining the session lease rate. The base rate is broken down into an hourly rate based on full-time usage of the suite. Adjustments are then made that account for a variety of items including: number of block usages per month, standard medical office FF&E, standard medical office supplies, size of the suite, etc., and are commonly referred to as the Administrative Surcharge. Typical surcharge percentages generally range from 25 to 200 percent, depending on the previously mentioned factors.

Furthermore, the actual usage of space within the timeshare suite must be accounted for in a proper manner. This includes the exclusive use of the timeshare space, as well the allocation of common area space within the suite. Typically, a pro rata share allocation of common area space is accounted for when totaling the square feet utilized in the lease rate calculations, based on the exclusive use of space within the suite.

As health systems and healthcare real estate owners become savvier and have begun to view their hospital real estate as an income-producing asset, we are seeing more timeshare and full-time leases of underutilized space within hospitals and other specialized healthcare real estate. Examples include: sleep labs within hospitals, medical office leases within rehab facilities, etc. The usage of non-acuity space within higher-acuity facilities has created a bifurcation of rental rates within facilities and warrants diligence on RE personnel to clearly define space and time usages within these facilities to avoid Stark violations.

REITS – FACING PRICING PRESSURE

Healthcare REITs have declined approximately 10 to 15 percent over the last 12 months but have recently trended upward. The table below illustrates the 52-week highs and lows for several of the larger publicly traded REITs.

STOCK	CURRENT PRICE	52 WEEK HIGH	52 WEEK LOW	MARKET CAPITALIZATION	ENTERPRISE VALUE	FORWARD ANNUAL DIVIDEND YIELD
HR	$28.60	$33.98	$26.09	$3.63B	$4.9B	4.21%
WELL	$63.05	$70.96	$49.24	$23..81B	$36.22B	5.53%
VTR	$53.96	$65.72	$46.55	$19.4B	$29.65B	5.89%
HCP	$25.65	$27.98	$21.48	$12.5B	$19.88B	5.79%
SNH	$17.31	$19.98	$14.86	$4.16B	$7.87B	9.11%
HTA	$26.04	$31.69	$24.06	$5.62M	$8.13B	4.78%
DOC	$16.57	$19.03	$14.13	$3.14B	$4.6B	5.54%
MPW	$14.46	$15.24	$11.82	$5.4B	$9.98B	6.95%

** All data as of September 27, 2018 – Yahoo Finance*

As indicated, the publicly traded Healthcare REITs are generally trading near the midpoint of their respective 52-week high/low points. This centering movement is largely a response to the recent upticks in the interest rate environment in 2018, as well as projections for future interest rate hikes as we move through 2018 and into 2019. The movement in share prices has been partially offset by increases in the forward annual dividend yield in comparison to historical figures. The decrease in stock prices has led to an "increased cost of capital" according to several REIT acquisition personnel, and they have adjusted their acquisition underwriting in response.

Given that interest rates are projected to continue to rise, many equity investors have begun to adjust pricing parameters downward, as the cost of capital has increased. Currently, 10-year Treasury bonds are pricing around the 3.00 percent mark. One investor succinctly opined, "When 10-year rates approach or exceed the 3.00 percent mark, the stock market tends to dip lower, pricing fears become material, and cap rates tend to rise. A sustained level above 3.00 percent is projected to result in cap rates increasing by 25 to 50 basis points." Another investor was more optimistic and expected "a weird reality where interest rates rise yet treasuries fall," but further cautioned, "The inversion in yields has signaled a recession more often than not." Most respondents to the survey projected stable to slightly increasing cap rates for the remainder of 2018, with further cap rate increases projected for 2019 in correlation to upticks in the interest rate.

Strong pricing assumptions for Core+ and On-Campus Class A product continue to grab investment headlines for medical office investments. Combined with a lack of product, high barriers to entry (cost and locations), the focal coastal markets continue to see the majority of sub 5.0 percent capitalization rates. These investments have a high percentage of the key investment drivers that initially drove medical office investors to the sector (stable cashflow, strong demand, credit tenancy, etc.).

Portfolio acquisitions continue to fuel the market, as pricing premiums reportedly come into play in excess of the $100 million threshold. Heitman's 2018 acquisition of the PHT portfolio approximated a 4.75 percent cap rate, while HTA's 2017 acquisition of Duke Realty approximated a 4.70 percent cap rate (inclusive of development deals—reportedly closer to 5.10 percent on existing assets). Several investors have reported that pricing premiums for portfolios would range up to 25 to 50 basis points depending on size and credit quality of tenants within the portfolio.

MOB DEVELOPMENT TRENDS

In discussions with several of the larger, national medical office development firms, there appears to be continued, strong demand for medical office developments across the country. New product is generally in the 25,000 to 75,000 square foot range, but some developments are approaching the 200,000 square foot size. Across all facility sizes, development capitalization rates or yields have continued to tighten, with spreads approaching 75 to 100 basis points for the most sought-after creditworthy deals. Core and Class A deals are generally seeing development cap rates ranging from 6.50 to 7.50 percent, which is approximately 50 to 100 basis points above sales cap rates. The tightening of the spread between sales and development capitalization rates have many developers on edge given the rising interest rate environment. HAI has seen several development contracts in 2018 that have language adjusting the development cap rate if interest rates move upward. Most language is on a basis point to basis point movement, while others have an approximate 50 percent adjustment factor (e.g., a 25-basis point move in interest rate equals a 12.5 basis point development cap rate movement).

We have also witnessed large increases in construction costs over the last 12–24 months. In certain areas of California, costs have increased 25 to 50 percent, while most markets are witnessing increases of 15 to 30 percent. The increased construction costs are having an impact on rental rates as well, as new construction is pricing substantially higher than existing product.

An emerging trend in servicing higher acuity patients in ambulatory setting has been the emergence of micro-hospitals. These facilities are often 8–10 beds in total with a large medical office presence also located in the facility. Facility sizes generally approximate 30,000 to 50,000 square feet, and generally have longer-term master leases for the entire facility. In several cases, the micro-hospitals are located on future hospital campuses, while in other scenarios, the micro-hospitals are located in retail ambulatory settings that are located in proximity to patients. Micro-hospitals fall under the larger mothership hospital from an admissions/overnight stay requirement, as well as from a reimbursement standpoint, if they are located within 35 miles of the main hospital.

The micro-hospital portion is typically located on the main floor of the facility, along with a radiology component, and the medical office portion, which often includes a physical therapy component, is located on the second floor. The medical office portion is generally utilized by physicians who also see patients on the main floor of the facility. Given the higher acuity levels of the main floor, the master lease rental rates for these facilities are generally in the $30.00 to $40.00 per square foot range, on a net basis.

Health systems and independent physician networks continue to develop urgent care centers to provide efficient low-cost service for patients that do not require specialization. Health systems have actively pursued the independent development of urgent care networks and offsite urgent care facilities and commonly partner with physicians and physician groups via joint ventures and other affiliations to establish offsite locations for urgent care delivery. Questions about long-term reimbursement rates for the freestanding EDs versus urgent care facilities have led some experts to question the long-term viability of freestanding EDs, given the reimbursement review and other review items by CMS.

MEDICAL OFFICE ECONOMICS

Rental rates have shown increases over the last 12–24 months, as construction costs have risen, along with a strengthening economy. A majority of Tier One markets appear to have witnessed a 10 to 20 percent increase in rates since 2015, with certain coastal markets and other high-growth markets witnessing rental rate increases of more than 25 percent for new construction.

Labor costs have consistently been the number one driver of increasing costs; however, material costs have ramped up recently in unison with increasing commodity prices, such as oil. New medical office developments in California that were forced to compete with Apple and Google (new headquarter facilities) for labor witnessed some of the largest construction costs increases. Some health systems delayed or entirely scrapped new projects as construction cost budgets were coming in approximately 50 percent higher than initial estimates.

On a national basis, new construction, Class A medical office space is generally achieving rental rates ranging from $22.50 to $27.50 per square foot, net—which is an approximate $1.00 to $3.00/PSF increase to the higher end of the range (all rental rate ranges exclude the higher priced coastal markets such as NYC, LA, San Francisco, Boston, etc.) as compared to 2015 levels.
As space build-out becomes more specialized, radiology suites are generally pricing from $25.00 to $32.50 per square foot, net; cancer centers generally exhibit rates ranging from $25.00 to $40.00 per square foot,

net (rate is highly dependent on medical oncology versus radiation oncology—specifically the number of vault rooms); and ambulatory surgery centers generally are witnessing rates from $35.00 to $50.00 per square foot, net. At all acuity levels, tenants are generally spending an additional $10.00 to $50.00 per square foot of their own money to enhance their space. Core & shell tenant improvement allowances are generally approximating $60.00 to $80.00 per square foot (new Class A space).

Guarantees from physicians or managing members of larger physician groups continue to be included on most lease terms for good-quality medical office space. We have seen a renewed interest in longer term leases from health systems for strategic on- and off-campus medical office space. Lease terms generally range from 7–15 years in length for larger spaces with 10 years being most prevalent.

The low interest rate environment for commercial real estate, healthcare real estate in particular, continues to be one of the primary drivers of value in the current market. Investors are able to obtain mortgage financing for well sponsored MOBs at rates generally ranging from a low of 4.0 to 4.5 percent for owner occupied properties to approximately 4.0 to 6.5 percent for typical medical office properties. Currently, loan- to-value ratios for well sponsored MOBs with strong operating characteristics approximate 65 to 90 percent, with the upper end of the range occurring with more frequency as the market continues to improve.

The market continues to remain bifurcated between Class A on-campus and Class B off-campus product, with Class A on-campus and Core product being heavily favored. Given the somewhat limited supply of this asset class, many investors have looked to the Class B, or higher acuity product in an effort to obtain yield.

2018 MEDICAL OFFICE BUILDING INVESTOR SURVEY RESULTS

The following table illustrates the results of HAI's inaugural MOB Investor survey.

2018 MEDICAL OFFICE BUILDING INVESTOR MATRIX SURVEY

2018	Core On-Campus	Core Off-Campus	Class A On-Campus	Class A Off-Campus	Class B On-Campus	Class B Off-Campus
Capitalization Rates - Going-In						
Range	4.25% to 7.00%	4.75% to 7.00%	4.25% to 8.00%	5.25% to 8.00%	4.75% to 8.50%	5.50% to 8.50%
Average	**5.48%**	**5.95%**	**5.59%**	**6.31%**	**6.36%**	**6.82%**
Capitalization Rates - Terminal						
Range	5.00% to 7.50%	5.50% to 7.50%	5.00% to 7.50%	5.25% to 8.00%	4.75% to 8.50%	6.00% to 8.50%
Average	**5.92%**	**6.23%**	**5.96%**	**6.38%**	**6.48%**	**6.98%**
Internal Rates of Return						
Range	5.50% to 9.25%	6.00% to 10.25%	5.50% to 9.00%	7.00% to 10.00%	6.50% to 10.00%	7.50% to 10.00%
Average	**7.43%**	**8.33%**	**7.58%**	**8.53%**	**8.20%**	**8.73%**

Source: HealthCare Appraisers, Inc. 2018 Medical Office Survey

Core+ Product

Capitalization rates for Core and Core+ medical office buildings situated on campus ranged from 4.25 to 7.00 percent and averaged 5.48 percent. It is noted that numerous respondents indicated a much lower upper end of the range for Core and Core+ product, from 4.50 to 5.50 percent, suggesting a much lower median rate than the overall average of 5.48 percent. This seems to correlate with actual transactions for Core and Core+ product that HAI has been associated with in 2017 and 2018.

Class A Product

Capitalization rates for Class A medical office buildings situated on campus ranged from 4.25 to 8.00 percent and averaged 5.59 percent for on-campus product and 6.31 percent for off-campus product, which is consistent with investor respondents indicating their strong desire for well leased, high quality on-campus healthcare product.

Class B Product

Capitalization rates for Class B medical office buildings situated on campus ranged from 4.75 to 8.50 percent and averaged 6.36 percent for on-campus product and 6.82 percent for off-campus product, which is consistent with investor respondents indicating lesser demand for Class B healthcare product.

CONCLUSION

In 2018, strong market fundamentals continue for medical office buildings. The strength in market conditions is a continuation of a low interest rate environment, the ability of the private REITS to raise massive levels of new investment dollars, as well as a limited supply of good-quality product that is available for sale. Average capitalization rates for Class A and B MOBs remained stable to a slight decrease over the last 12 months. Investors continue to view MOBs as a favored asset class, given the sustained strong fundamentals of medical office leasing and healthcare demographics in general. However, as pricing levels surpassed historical highs, investors have begun to wonder how long the market can continue this momentum, and are placing added scrutiny on new acquisition underwriting, given the anticipated uptick in interest rates over the next 12 months.

REAL ESTATE VALUATION

The Real Estate Professionals at HealthCare Appraisers provide expertise and insight into the complex and unique considerations required for healthcare real estate transactions. Whatever your particular valuation needs may be, you can trust the real estate valuation team for strategic support, guidance, and reliable, defensible valuation conclusions.

Healthcare Real Estate Valuation

Our professionals have an in-depth understanding of the numerous types of healthcare facilities and a multitude of various compensation relationships between landlord and tenant. Many appraisers simply do not understand the interplay of healthcare operations and healthcare real estate, as well as the relevant value drivers, terminology, reporting metrics, etc.

Our real estate valuation services include:

Fair Market Value Purchase Price Valuations & FMV Lease/Rental Rate Opinions

For large and/or complex real property transactions, a member of our real estate valuation team will conduct an on-site inspection as a key aspect of the valuation process.

“Desktop” Fair Market Value Opinions

Whether for a FMV lease opinion or purchase price valuation, HealthCare Appraisers can oftentimes complete an analysis without the need for an onsite inspection, thereby saving time and money.

Commercial Reasonableness Opinions (CRO)

Oftentimes, healthcare entities will enter into joint venture (JV) arrangements with real estate developers for new construction projects, or more nuanced arrangements including: cross access agreements, swapping ingress/egress for a ROFR, early termination agreements, and a host of various other arrangements that warrant a CRO opinion that falls outside the scope of a traditional valuation. HealthCare Appraisers has the experience and expertise to advise Clients on similar unique transactions.

Focused on Details

Our due diligence involves review of real estate-related documents, investigating the acuity level of the space, discussions with owners and business administrators, research of industry trends and local conditions affecting the market, and a thorough financial analysis of the facility as applicable. Generally, financial analysis will include a review of lease documents, historical financial statements, a review of financial projections, capital expenditures and benchmarking to industry norms.

We provide real estate valuations and services for the following healthcare facilities:

- Acute care hospitals
- Cancer centers
- Diagnostic facilities
- LTACH (Hospital in Hospital)
- Medical office buildings (MOB)
- Rural health clinics
- Teaching hospitals
- ASCs
- Community hospitals
- Laboratory and R&D facilities
- Academic medical centers
- Physician practices
- Rehabilitation centers
- Specialty hospitals

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HealthCare Appraisers

CORPORATE PROFILE

THE RECOGNIZED LEADER IN FAIR MARKET VALUE ANALYSIS

HealthCare Appraisers is the nation's premier full-service valuation and consulting firm specializing in defensible expert FMV analysis for all types of healthcare compensation arrangements, businesses and assets.

- Full-service valuation firm
- Approximately 80 valuation professionals
- Thousands of FMV reports prepared annually
- An industry thought leader
- Clients in every state

AUTOMATED FMV SOLUTIONS™

HealthCare Appraisers is the leader in providing automated FMV solutions. Our Physician Employment Calculator™ and our On-Call Calculator™ have been in use for years by hundreds of hospitals across the country, providing fast, cost effective and defensible FMV opinions.

BUSINESS VALUATION

HealthCare Appraisers provides valuations for all types of healthcare organizations.

- Investments / Divestitures
- Joint Ventures
- Mergers & Acquisitions
- Corporate Restructuring
- Financial Reporting
- Appraisal Review

CAPITAL EQUIPMENT VALUATION

- Purchase / Sale of Medical Equipment
- Leasing and Financing
- Insurable Value
- Financial Reporting
- On-Site Inventory & Inspection
- Personal Property Tax

LITIGATION SUPPORT

HealthCare Appraisers provides expert analysis and testimony related to fraud and abuse claims and commercial disputes.

COMPENSATION VALUATION

We provide FMV analysis for all types of physician compensation arrangements.

- Physician / Midlevel Employment
- Call Coverage
- Collection Guarantees / Subsidies
- Professional Services Arrangements
- Medical Directorships
- Pay-for-Performance
- Clinically Integrated Networks
- Co-Management Arrangements
- Telemedicine Arrangements

INTANGIBLE ASSET VALUATION

- Certificates of Need (CON)
- Licensing Arrangements
- Option Valuation
- EMR & Paper Charts
- Royalty Rate Valuation
- Trademarks and Trade Names
- Workforce in Place
- Programs / Processes / Procedures

REAL ESTATE VALUATION

- Rental Rate Analysis
- "Desktop" FMV Opinions
- Timeshare Analysis
- Financial Reporting
- Real Estate Portfolio Valuations
- Commercial Reasonableness Opinions

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