2010 Valuations for Medical Office

By Mark Alexander, CCIM

We saw a slow steady climb in values for medical office buildings (hereafter "MOB's") from 1980 thru 2003. During this same time, income for doctors continued to rise as their brief concern over Health Care reform never made it past the desk of Hillary Rodham Clinton. We witnessed a steep climb in values for MOB's from 2004 through 2008 as the rising tide of values for all property types got swept higher and higher in our crazed real estate bubble period in America. But the bubble burst in 2007 for residential real estate followed by another bubble burst in 2009 for commercial real estate. Our high flying Saturday night dance with escalating property values is finally over. It feels like the market has a "day after" hang-over on a cold rainy Sunday morning…and it is time to pay the band and clean up the mess.

The only glimmer of light peaking through the clouds to shine on commercial real estate values these past two years has been the fully leased medical office property market segment. Investors that buy well leased medical buildings noticed that people didn't stop getting sick just because the economy was lousy. Yes, business for doctors has fallen off…but not as much as just about every other sector in the economy. So the lesser of all the property market evils…has been the well leased medical office market where values have fallen a little...but not a lot like everything else.

But now enter the Sandman…named Health Care Reform. 2009 was a very unsettling year for doctors as they anxiously watched the debate on Capital Hill while waiting with "lottery-like baited breadth" for Medicare Reimbursement cuts to get extended…just one more time. This uncertainty among doctors in 2009 caused a big "Pause" button to be pushed somewhere…as doctors put off making decisions on their medical office building expansions, relocations, sale/leasebacks, new equipment acquisitions, staffing and retirement plans. It is hard to make long term financial commitments when you don't really know how much money you will be making next year…or the year after.

Since Health Care reform legislation has been enacted, it is still clear as mud…except for the cold expectation that doctors will be making less money going forward. This realization has caused a new trend among doctors and their plans & expectations on their medical office buildings. In today's environment, it is no longer prudent for doctors to arbitrarily pick the highest rental rate possible for their Sale/Leaseback just because they prefer a real high sales price. Their practice may not be able to afford this high rent option comfortably any more. But a lower rent option...if possible…will certainly help their practice bottom line going forward.

The doctors who are really benefiting today are the ones who have been renting their offices with leases due to expire shortly. This soft "Tenant's Market" has made it possible for doctors to renegotiate lower rents to stay where they are or relocate for much lower rents. I have seen some doctors with low credit scores caused by bad investments in residential real estate…simply walk away from existing MOB leases to secure lower rents nearby. This trend of doctors seeking more affordable space should continue. I have also witnessed many doctors who have always rented, chose to buy their new office as vacant medical space has also seen a big drop in values. It is only the well leased medical buildings that are still doing reasonably well on holding value. But since top prices are tied to leases…as more and more new medical leases get restructured thru 2010 and 2011 at lower rental rates…this is causing appraised values to diminish proportionately for leased medical buildings.

There are many doctors that own their MOB's that refinanced their mortgages at real high values within the past few years. In many cases, the best choice for doctors in this position is to do a sale/leaseback to pay off their high balance mortgages. Their new lease payments can often be set at lower levels than their current mortgage payments to help their practice bottom. Plus a personal guarantee on a new lease is much less onerous than a personal guarantee on their current mortgage. Soon-to-be retired doctors really like this lower liability benefit that Sale/Leasebacks can provide them. Plus tax benefits abound if they can close their sale/leaseback in 2010 before capital gains tax rate gets increased in 2011. Many expect the capital gains tax rate to keep bumping higher each year over the following years to pay for the unprecedented spending done by our US government.

I expect values for medical office buildings to reverse their course of the past three decades and slowly taper downward over the following decade now that doctors must find ways to reduce overhead to maintain profitability. Lower rent creates lower sale prices when valuing income properties.

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