Medical Office Market Outlook 2008

By Mark Alexander, CCIM

Long term investment prospects for the MOB (Medical Office Building) market sector look very bright indeed because of demographics. Our population is living longer and we all know that the older one gets the more medical care one needs. Over the next ten years, the segment of our population that is age 55 or older is expected to increase by 25%. Put another way, we are projected to have 15 million more people in this 55 & up group by the year 2017. Chevrolet can look forward to selling lots of black shiny corvettes to some members of this esteemed group who missed their mid-life crisis in their 40's. But most all members of this "55 & Up Club" will have more frequent visits to their doctors office (i.e. MOB). And their frequency of "doctor office visits" will only increase as the patients grow older.

Before my dad passed away at the young age of 72, he used to kid me that it would be cheaper for him to pitch a tent and live in the doctor's waiting room, in order to save a small fortune in gas that it cost him to drive to the doctors' office so much. My dad helped put me and his cardiologist's kid through college. I know he was proud of both of us.

This dramatic growth in the size of the "55 & Up Club" is the core reason why demand will remain strong for the next ten years for medical care and the medical office buildings where this care is provided.

MOB Investor Profiles:

Investors large and small have noticed these favorable demographics that support strong growth in the medical care industry. These demographics look even brighter for states where people are more likely to retire, like Florida, Arizona and the Carolinas. Consequently, investing in medical office buildings have become more main-stream over the past few years. Institutional investors have targeted larger MOB's on hospital campuses in many large markets across the country. Private investors doing 1031 exchanges have had a voracious appetite for MOB's in small to mid-size markets in the $500,000 to $4 million price range.

Having sold over 50 Medical Office Buildings to 1031 exchange investors in my career, I can tell you that 95% of these 1031 Exchange investors all have the same profile. They are at or near retirement. They are conservative in nature and safety of their nest egg is more important than getting the highest return. As they near retirement and sell their investment properties up north where they raised their families and grew their businesses, they are using the sale proceeds to reinvest in properties where they are spending more time in retirement. Regardless of the type of investment property they sold up north, they first try to buy triple net leased income properties to provide "management free" income to match their retirement lifestyle. The triple net (NNN) lease means the tenant pays base rent to the owner plus the tenant pays for the real estate taxes, insurance and maintenance (hence the three N's in NNN lease) in addition to base rent. So if the roof leaks or the AC breaks down, the tenant pays for it and the owner is not bothered at the race track. For these reasons, retiree 1031 investors love triple-net (NNN) leased medical office building investments. The retiree investor does not want to buy a management intensive property with gross leases that could pull him away from such things as the grandkids, the pool, the boat, the golf course, the couch …or even his black shiny corvette.

Location: Where do MOB's thrive?

In small towns with one hospital, just look at streets around the hospital for your MOB market. In bigger towns with two or more hospitals, look around the hospitals and on the streets in between the hospitals to find your MOB market. These MOB markets have a long history of stable occupancy by MD's which investors find so attractive. First time MOB investors always ask the same question, which is, "What happens if the doctors do not renew their lease when it expires in five years or more?" The obvious answer is you would have to find a new tenant but the chances that your medical tenant will not renew his lease are slim. I always ask first time MOB investors, "How often have your own personal doctors moved their office in the past twenty years?" They often blink, pause and respond, "Well never…or maybe one of them once". The reality in the medical care provider business is that it can be the kiss of death for a doctor's business to move his location frequently if at all. Doctors like to show stability to the community they serve. After doctors have been in a particular building for ten or sometimes twenty years, community goodwill has been established in their MOB. Patients in this town have grown to know this building for its particular specialty of medicine. The last thing doctors in this situation want to do is relocate which would allow a competing medical group of the same specialty to move right in and take advantage of this wonderful goodwill for their brand of medicine. Another reason doctors rarely move is because it takes a consensus of the group to actually make the move. It can be difficult sometimes just to get two people to agree on anything. The bigger the group of doctors, the harder it can be to reach a consensus. Doctors tend to be "Type A" personalities with sometimes large egos. Try getting this type of group to agree on something as radical as moving their medical office location, and watch the fun. Historically, doctors rarely move their medical office and if they do, it is normally not more than once in their entire career. There is a trend for doctors to open multiple offices today in an effort to increase patient volume to offset continued cuts in Medicare. In this fashion, the doctors are attempting to use the McDonald's philosophy and make more on volume because their profit margin keeps eroding. This further fuels the demand for future medical office buildings.

Value of MOB's and Capital Market Influence:

Fueled by historic low interest rates over the previous four years, demand increased for MOB investments that caused a "compression of cap rates" as we call it in our industry. This is a fancy way to say that Medical Office Building property values went up since cap rates or the buyer's yields were compressed (i.e. went down). But the state of our capital market today is not what it once was. A friend of mine named Marty is Past President of the San Diego Mortgage Brokers Association and he has owned and operated his own mortgage brokerage business for more than 25 years in California. He told me recently that he has never seen the capital market like it is today. Marty said it was like all the rules have been rewritten and we simply cannot do business like we did in the past. He was referring to tighter lending requirements caused by the fallout from the sub-prime lending market. Lenders are making it more difficult to get financing and charging higher spreads.

As interest rates edge up and collateral requirements become more stringent, the cost of capital is rising. Cap rates always follow interest rates so we are seeing Cap Rates drift up in order to make the contracts close. The seller (on Sale/Leaseback transactions) and the buyer both have to jump through more financial hoops today to get the mortgage approved so the seller can put the cash in his pocket and the buyer can become the new proud owner of the investment property. Even though the short term view may have a few bumps in the road due to the state of the capital market, the long term view over the next ten years for growth and demand in the medical office market is quite good due to favorable demographics.

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