

# Fewer medical office buildings selling

## Health care reform creates uncertainty

Ninety percent of the doctors in the U.S. work in medical practices comprised of one to three doctors. These doctors own medical office buildings totaling hundreds of millions of dollars.

Health care reform has caused intense uncertainty among doctors today, which has led to lower medical building transaction volume. This is a timely misfortune for doctors who own the buildings because fully rented medical buildings are trading at remarkably high values today relative to other commercial real estate sectors. Medical office buildings are deemed a safe haven in today's stormy real estate market.

## Public health care

President Johnson signed Medicare into law in 1965. The program was initially designed only to be minimally adequate. Numerous changes occurred every decade to allow more and more people access to free and sub-

sized health care.

Today's Medicare appears relatively generous as it now serves 41 million people and bears little resemblance to LBJ's Medicare of 1966, when it served just 19 million people. This has forced us to make a change since we no longer have enough money to pay for the current system. But which Medicare do we now save?

## Rising care costs

Similar to health care, the food, electronics and computer industries showed the same remarkable growth over the past 40 years. But we witnessed the real cost of agricultural commodities, TVs and computers fall over this time as health care costs rose with seemingly reckless abandon. The difference is "supply and demand" free market dynamics are missing from today's health care system.

## Good old days

There was a time in the 1960s and early 1970s when patients were responsible for paying their doctor in full for med-

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ical services.

This former system accomplished two things that are lacking in today's system:

- It helped keep physician fees more competitive within the market by maintaining accountability between patient and health care provider.

- It helped keep more reasonable health insurance rates since patients held their insurance companies more accountable since they had to chase the insurance companies for reimbursement.

## Game over

In the mid-1970s, the insurance industry was able to convince doctors and hospitals to stop seeking full payment from their patients and instead collect only nominal co-pays or deductibles from their patients up front while seeking the majority of their fees from private

insurance companies at a later date, just as Medicare operates.

Can you imagine Home Depot suddenly agreeing to allow every customer to purchase their goods with only a small deposit and then having to collect the balances due 30 to 90 days later from an insurance company?

In this one swift move, financial leverage over health care providers shifted from patients to the insurance industry. Patients readily embraced this change since they would only have to pay small co-pays or deductibles upfront instead of being responsible for the whole bill. This is where the public unknowingly sold its soul to the insurance industry for smaller payments up front in exchange for runaway health care costs in the future.

The present health care system guarantees escalating health care costs. We can't turn things around without changing the system first.

## Potential outcome

Cuts to Medicare/Medicaid are anticipated. Doc-

tors could face lower incomes. Some could stop seeing Medicare patients all together. Doctors who built or refinanced their medical office buildings at the top of the market a few years ago are now saddled with high debt and may have a tough time. We could see practice bankruptcies in a few highly leveraged cases.

Concern is deep over doctors' mandated lower income adjustments set for January 2012 unless they get rescinded once again.

Some doctors will use medical office building sale/leaseback transactions to pay off mortgages and replace with lower lease-back payments in an effort to lower overhead. Defaulting on a commercial lease is much less onerous than defaulting on a property mortgage, so that should also lead to more medical office building sale/leaseback transactions as a defensive strategy.

If doctors have less future income to pay their rent or mortgage, their lower property payments will lead to lower medical office building values. So we could see a softening of medical office building values over time as the buildings' net incomes trend down.

However, since demand

for medical care is only going up due to demographics (i.e., baby boomer retirements), investor demand for medical office buildings should remain strong, leading to some cap rate compression.

Doctors who stand to benefit most have low medical office building property debt or have leases due to expire soon so they can renegotiate for lower rent or relocate to more affordable spaces.

The insurance industry has helped bring the health care industry to its knees. The main mantra for the health care industry is now "reduce overhead." Early retirement by some senior physicians is likely.

Regardless of how Medicare and our tax rates may change, we need to find a way to let supply and demand work its natural magic to help keep future costs of health care services in check, like it does for every other type of business in America.

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