Virtus Outlook on the Medical Office Space

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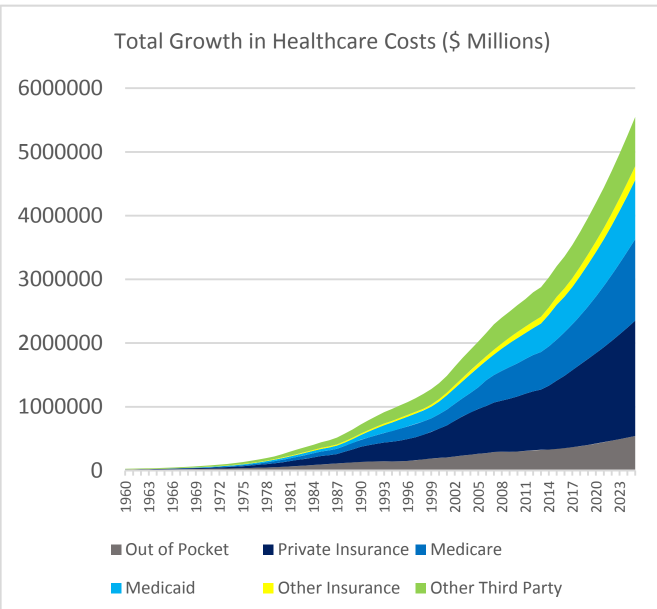
Total healthcare spending in the United States has been headed in one direction for the past 50 years—up, up, and up. *Since 1960, there has not been a single year in which total healthcare spending was less than the prior year.*[1] In a way, one could amend the age-old saying: the only things certain in life are actually death, taxes, and that the U.S. will spend more on healthcare next year.



Think about most of the doctors' visits you have had. Was it tough to get an appointment? Was the waiting room packed? After waiting, were you rushed in and out like you were picking up dry cleaning? If so, your experience was not an uncommon one--doctors today are busier than ever. It is an unfortunate reality for patients, and it is not getting better, and won't be for a long time. Between now and 2050, the 65+ age cohort in the U.S. will nearly double in size, from 47 million up to 84 million[2]. Individuals over 65 visit the doctor at nearly three times the rate of everyone else (6.9 visits per year versus 2.5 for the population under 65). If waiting rooms are packed now, wait to see them in 10 years.

The U.S. economy spent a total of $3.4 trillion on healthcare last year. And while it often goes unnoticed, there is an enormous amount of real estate dedicated solely to this sector—1.4 billion square feet of real estate ***not including hospitals***, just medical office buildings acquirable by private investors[3]. At an average price of $250 per square foot, that would value the healthcare real estate market in the U.S. at roughly $350 billion[4].

In the current world of ultra-low yields, stagnant growth, inflated valuations and the persistent fear of the next economic downturn, medical office continues to offer a compelling investment opportunity. Medical office provides owners with an income stream that has proven to be recession resilient, while also offering growth potential. This piece is not meant to be a comprehensive review or deep dive into the medical office investment

[1] Source: Center for Medicare and Medicaid
[2] Source: Census Department
[3] Source: Revista. There is an additional 1.6 B sq ft of hospital space, but differences in ownership, management, and profitability make it a different asset class.
[4] Source: CoStar Analytics

opportunity. Rather it is merely intended to demonstrate why now is a compelling time to invest in medical office, while also shedding some light on the nuances of investing in the space.

Long Term Demand Drivers

As previously mentioned, healthcare spending has risen steadily over the last 50+ years. This is due to four main demand drivers: demographics, spread of chronic disease, increase in access to healthcare, and advances in technology and innovation.

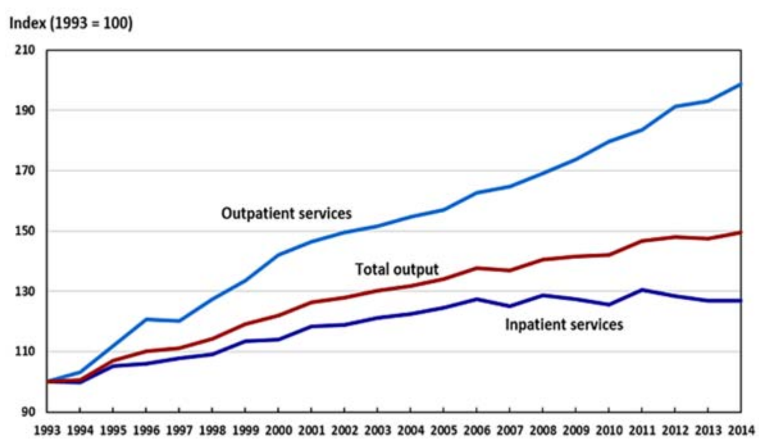
First—demographics. Every day another 4000 people turn 65 years old—the age at which health issues begin to surface. The 65+ population is currently outpacing general population growth at a staggering 3.0% per year[2], and will continue to do so for at least the next 15 years. This rate of growth is almost hard to comprehend for a group of such size and scale. It is a growth rate in line with the general population increases experienced by places like Austin (grew 3.1% per year since 2000) or Denver (grew 2% per year from the Recession until today). Yet this growth applies to over 47 million people, is occurring in every market of the country, and will continue practically unabated for a few decades.

The second driver is the spread of chronic disease, including diabetes, obesity, and hypertension. In the U.S., 86% of total healthcare costs are attributed to patients with at least one chronic disease. Because of an aging population and social factors associated with chronic disease, the number of patients with such ailments is expected to grow by 2.5x the national rate of population growth through 2025.[5]

Thirdly, the reduction in the uninsured population portends resilient demand. This is candidly the least clear driver, since it depends on political policy rather than demographic trends. Despite the vastly differing positions on healthcare policy across political aisles, we believe the Affordable Care Act's ("ACA") lasting legacy will be the enshrinement of certain protections (such as bans on rejection for pre-existing conditions), no matter what the actual legislation's fate proves to be. Furthermore, the coverage debate largely concerns a population that consumes less healthcare than older individual covered by Medicare. People with health insurance are more likely to see a doctor at the onset of symptoms, rather than wait until their condition is severe enough to warrant a trip straight to the hospital. As a result, there is a correlation between access to health insurance and medical office demand. At the start of 2017, the U.S. uninsured rate among all persons is roughly 11.7%, down from 18% before the ACA. While progress has been made since passage of the ACA in 2010, the U.S. still lags other developed countries, and policy makers on both sides of the aisle see additional room for improvement.

Lastly, technology and innovation will continue to contribute to rising healthcare costs. New surgical procedures, drugs, medical devices, and treatment techniques are constantly being developed. While some of these technological advances may lower costs for specific treatments, the overarching impact historically has been a

Figure 2. Index of total output, inpatient services, and outpatient services for private community hospitals

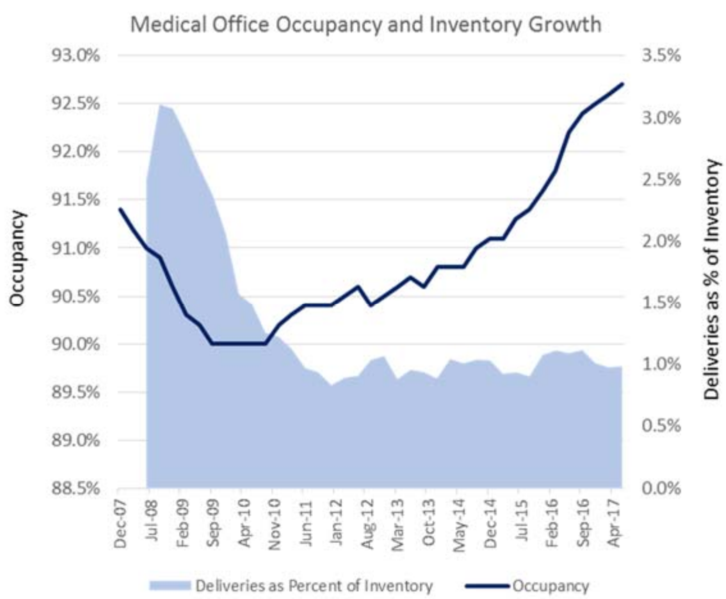


Source: U.S. Bureau of Labor Statistics, Office of Productivity and Technology

[5] Dall, Gallo, Chakrabarti, West, Semilli, and StormAn. "Aging Population and Growing Disease Burden Will Require a Large and Specialized Health Care Workforce by 2025".

broadening of the universe of care that can be offered, and has thus contributed to the continuous expansion of the healthcare industry. This trend shows no signs of reversing. In addition, technology and innovation are allowing more procedures to be performed on an outpatient basis, which can be done in a medical office building. This is reflected in less than 30% growth in total output for inpatient services since 1993, versus 100% growth in outpatient services over the same time period.

Recession Resilient



In addition to exhibiting the long-term growth factors mentioned above, medical office is arguably more *recession resilient* than any other form of real estate.

First, healthcare has always proved to be a less cyclical industry. It doesn't matter how far the S&P has fallen that year, or how high the unemployment rate is, people will still get sick, and they will need to see a doctor. Healthcare services are predominantly needs-based, and are therefore less tied to economic cycles.

Second, medical office buildings receive their cash flow from leases, oftentimes with 7-10+ years of term. Leases insulate owners from short term market swings and provide a stable, predictable cash flow stream. The leases are also usually structured as triple net, which allows medical office owners to avoid the risk of operating expenses increasing over time. Medical office also has high operating margins of 50-70%+.

Third, medical office tends to stay occupied, largely because medical tenants are resistant to relocate. Relocating is not only inconvenient and expensive, it can significantly damage a healthcare provider's referral patterns, leading to significant loss of business and having to "start from scratch." In addition, tenant improvement requirements are much higher for medical office, averaging at least $80 PSF in a typical shell scenario where $40 PSF would be generous for a standard office tenant. Highly specialized practices may require even more, and their share of the total cost borne increases as the space becomes more idiosyncratic. This means medical office owners see a high frequency of renewals—typically 80-90%--which helps keep occupancy high, downtime minimal, and capital expenditures on tenant improvements and leasing commissions lower than what is usually experienced in higher tenant turnover property types.

All these resilient characteristics are confirmed by the historical data on medical office market fundamentals. Medical office vacancy peaked in 2010 at 10.7%, which is incredible, especially when compared to traditional office, which saw vacancy peak at 16%. And since 2010, the vacancy rate has steadily fallen, now at a mere 8.0%, giving landlords the upper hand in most markets. In addition, since 2010, the annual growth of medical office supply has never been more than 1.5% of total supply [3]. Since medical office is a niche sector, with specialized buildouts and a smaller pool of prospective tenants, spec development is too risky. As a result, there is a firm governor on the growth of medical office supply.

Investment Challenges

Despite the overarching demand drivers and proven resiliency, investing in the medical office sector has its challenges. These challenges come out to two interrelated facts: healthcare is complicated, and healthcare is ever-changing.

It is an obvious observation that healthcare has grown into a monstrously complex industry. Nowadays, simple questions like “Can I go to a particular doctor?” or “What are these charges on my medical bill?” or “How much of this will my insurance cover?” almost never come with a straightforward answer. These complications permeate every corner of the healthcare industry, and as such, in-depth knowledge and life-long focus are necessary to successfully invest in medical office over the long-term.

The other main challenge of investing in medical office is that healthcare is ever changing. At Virtus, we see three major sources driving this constant evolution: politics, technology, and consumer/payor trends.

At the forefront is political uncertainty, which has the unique ability to swiftly impact everything from policies on surgical procedures and treatment plans, to insurance markets, to provider compliance regulations, to reimbursement rates. The latest focus of politicians has been centered on the fate of the Affordable Care Act. While it appears the latest efforts to repeal and replace the ACA are on the back burner, it is unlikely that the conversation regarding healthcare reform is going to subside anytime in the next several years. Healthcare will remain far from a perfect system, and political control will continue to change hands, so uncertainty and the constant threat of change will persist. Luckily, changing legislation does not negate the long-term healthcare demand drivers, but it does cause ripple effects throughout the industry, always creating winners and losers. Having a pulse on political trends and knowing which sectors will be affected is essential to successfully investing in healthcare.

Healthcare delivery is also constantly evolving as a result of technology and innovation. New procedures, devices, drugs, and treatment programs are constantly under development, as are new methods of collaboration, medical record keeping, data analysis, and personalized medicine techniques. Healthcare providers are constantly trying to assimilate these technological advances to say ahead of the curve and outperform their competition. A physician group today performing a surgical procedure utilizing a long-standing technique may be forced to adapt or go extinct when less invasive or lower cost techniques are developed. These types of innovations are constantly altering the landscape of healthcare providers.

Lastly, consumer/payor trends are evolving. Consumers have long complained about ballooning healthcare costs in the U.S., which has led to increased pressure on healthcare providers to improve efficiency. In addition, consumers want a better patient experience, with easier access and higher quality care. As a result, healthcare delivery is evolving by experimenting with new strategies and concepts. As one example, there is a shift away from the historical fee-for-service reimbursement model in favor of new models based on value and outcomes. The result is a shift of accountability and risk onto healthcare providers, while also motivating them to become more efficient. Another example is the “retailization” of healthcare, which is the result of providers competing for customers and looking to enhance accessibility and patient experience. Lastly, providers are also facing increased administrative burdens mandated by new legislation, including the ACA. New legislation typically aims to improve quality, reduce fraud, and lower costs, but has forced providers to hire additional administrative staff to keep up with the burden. All of these trends are altering the types of real estate that work best for different healthcare providers.

The fact that healthcare is ever-changing is the primary source of risk when investing in medical office. The growth drivers are undeniable, but there will still be winners and losers, despite the theory that a rising tide lifts all boats. At Virtus, we recognize this risk, and we work tirelessly to mitigate it for our investors. We have been investing in healthcare real estate for over 12 years, which has armed us with a depth of experience and knowledge, including lessons learned along the way that is uncommon in the alternative real estate investment arena. We are constantly focused on getting better and refining our strategy, which includes staying up to date on the latest trends and evolutions within the healthcare industry. Our deep-rooted healthcare relationships and experience help us stay ahead of the curve and mitigate the risks of investing in a rapidly changing industry.

We are currently in the 9th year of the economic recovery. With prices for traditional investment assets at all-time highs, and the lingering unease that at some point the music will stop, there has never been a better time to seek the safety, consistency, resiliency, and growth potential provided by medical office. It is a $350 billion market that has typically outperformed nearly every real estate sector historically, and is poised to deliver a defensive income stream and continued asset appreciation for years to come[6].

[6] Relative outperformance on the basis of total revenue growth. For instance, during the GFC the MOB sector had a 2.3% decline in total revenue (encompassing both occupancy and rate growth) while conventional properties saw a 16% decline.