

Medical Office Building Quarterly Update

Transaction Volume Dips Dramatically, While Cap Rates and Pricing Remain Flat

Are we in a “pocket” within the market—or is this a sign of something larger?

Introduction

Following a strong year for the medical office building (“MOB”) sector, 223 properties transacted in the first quarter of 2019, for a total dollar volume of \$1.7 billion—the lowest quarterly dollar volume since the first quarter of 2014 across the lowest number of properties since

the first quarter of 2016. The steep drop in transaction volume (down 32 percent compared with Q1 2018) is noteworthy; however, it is also in line with the year-over-year volume declines for other asset types. The broader commercial office market, of which medical offices comprise approximately 19 percent, is down 35 percent year over year. Not all

data coming out of Q1 is negative, however. Average price per square foot for MOB’s hit an all-time high of \$303 per square foot, and average MOB cap rates crept up just 12 basis points in the first quarter, barely affecting the trailing 12-month average cap rate, which totaled 6.68 percent.

Figure 1: MOB Sales Volume and Cap Rate Trends¹ • \$ in millions



¹Source: Real Capital Analytics

Coming off the relative “market equilibrium” exhibited in the fourth quarter of 2018, this quarter’s data can be interpreted in several ways. It is important to note that the closings of a 55-property MOB portfolio (CNL) and an entity-level transaction encompassing approximately 34 properties (Omega Healthcare Investors acquiring MedEquities Realty Trust) are expected in the second quarter.

These large pending transactions should propel an active second and third quarter and help stabilize volume. Because there hasn’t been movement in cap rates and price-per-square-foot metrics—which typically accompanies downward trends in transaction volume as sellers and buyers’ expectations align—we believe the dip in MOB activity that occurred in Q1 2019 is more a “pocket” in the market rather than something larger. There

Figure 2: Quarterly Transaction Volume Percentage Increases Following Decline in Previous Quarter¹



are two factors supporting this stance. First is the trend of historical quarterly transaction volume following quarters of double-digit, year-over-year declines. When this phenomenon has occurred in the past, we’ve seen an increase in transaction volume following seven quarters of double-digit decreases.

Second is a stable interest rate environment, as rates are expected to remain unchanged through Q2 and Q3.

Investment Sales and Trends

The first quarter saw just a handful of new entrants in the MOB space. Activity was dominated by transactions involving investors that have been active in the healthcare sector over the past 24 months.

The most active buyer this year is Chicago-based MB Real Estate (“MBRE”). In addition to a five-property portfolio acquired in New York, MBRE purchased an additional five assets during the first quarter in Illinois, South Carolina, and Arizona.

Welltower Inc. (NYSE: WELL) continued its acquisition streak by closing on an eight-property portfolio totaling 337,437 square feet that was sold by Charlotte-based Flagship Healthcare Properties. The properties are located throughout the Carolinas and Norfolk, Va., with a concentration in the Greater Charlotte area. The \$75 million purchase equated to \$222 per square foot.

Anchor Health Properties (“Anchor”) acquired five properties in the first

quarter. Notably, Wilmington, Del.-based Anchor has rapidly expanded its portfolio in the Western states, having been very active in acquiring properties in California, Arizona, and Washington over the past 12 months.

¹Source: Real Capital Analytics

Figure 3: Cap Rate Trends¹

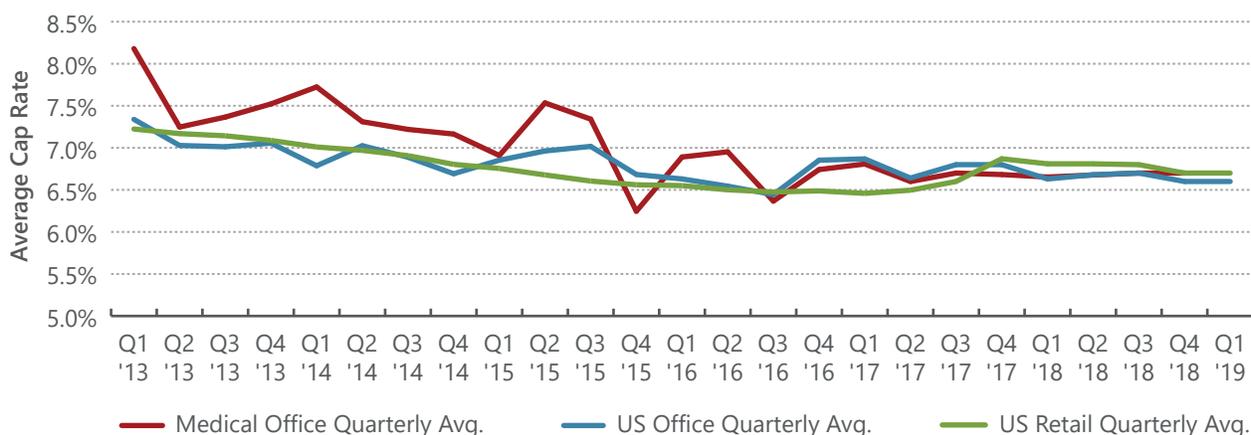


Figure 4: Price per Square Foot Trends¹



Regional Review

Transaction volume—based on dollar volume and number of properties sold—was greatest in the Southeast region for the sixth straight quarter. Notably, the Southeast region is the only region that hasn't seen a material change and/or any fluctuation in cap rates over the past 12 months.

As pointed out in our Q4 2018 report, average cap rates for

the Northeast and West regions have seen notable increases. The increases are believed to be driven by investor hesitation as to how the cap on property-tax deductions in high-tax states will affect the cash flow associated with deduction limitations as well as increases in transaction volume within those regions. The data seen in Q1 supports the increases previously exhibited, as shown by minimal movement in cap rates. Other

regions, such as the Southeast, have been trending downward over the past six quarters.

Overall, transaction volume was down across the board. The largest decline on a year-over-year percentage basis took place in the Southwest, where transaction volume is down 44 percent.

¹Source: Real Capital Analytics

Figure 5: Changes in Cap Rates by Region¹ • Trailing 12-Month Average

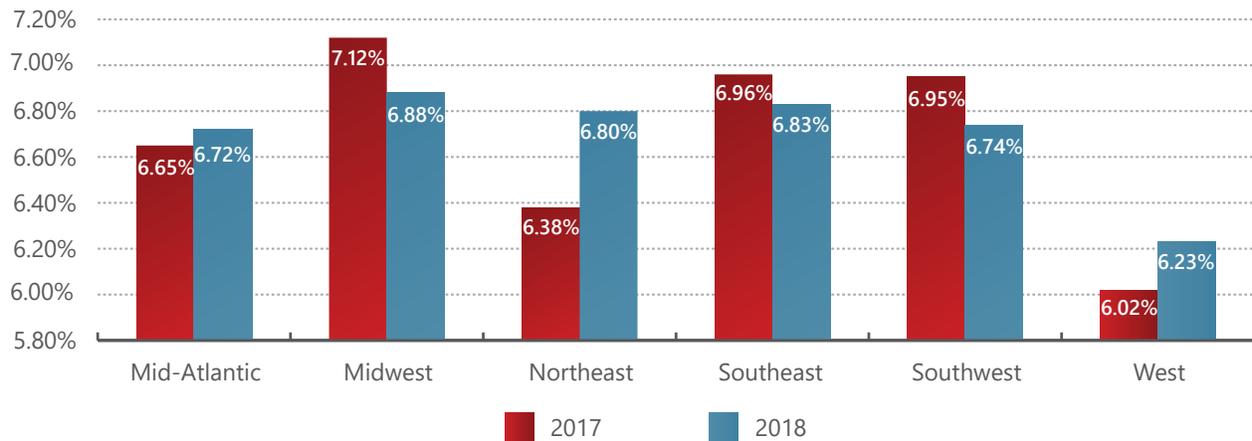
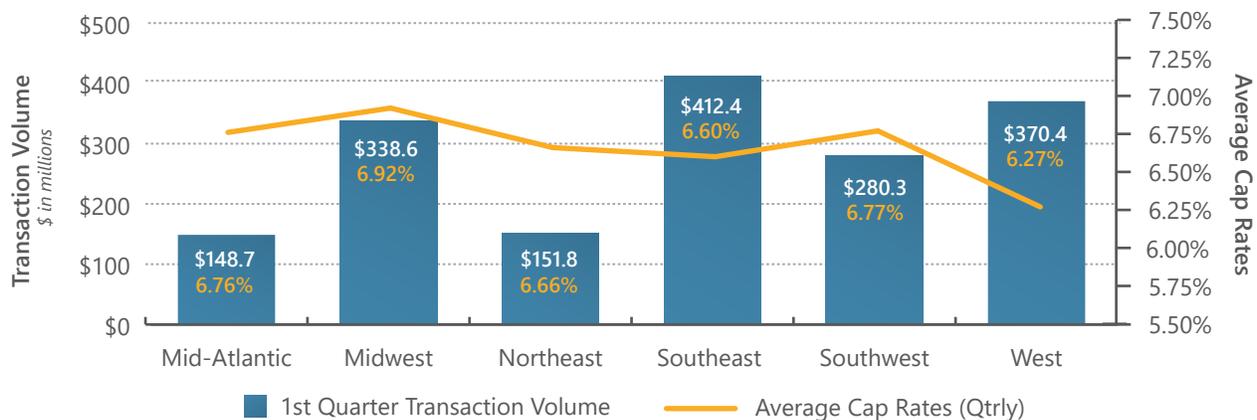


Figure 6: Cap Rates and Sales Volume by Region¹ • \$ in millions



Northeast Region

MBRE acquired a five-property portfolio for \$45 million in New York. Four of the five properties are located near Albany, with the fifth located in Newburgh. The buildings range in size from 24,835 to 47,696 square feet for a total of 208,728 square feet, representing a price per square foot of \$216. Tenants that occupy space at the properties include Hudson Valley Imaging (affiliate of Montefiore

St. Luke's Cornwall) (A2/NA/BBB), Medco Health Solutions (affiliate of Express Scripts), Ellis Medicine (NA/NA/AA+), and Seton Health System (A3/NA/A-). Services offered at the properties include ophthalmology, audiology, imaging, family medicine, and rehabilitation. The acquisition by MBRE was its first purchase in New York since acquiring a portfolio in the Greater Buffalo area in 2015.

Caddis Healthcare Real Estate purchased 2605 Keiser Boulevard

in Reading, Pa., from New York-based Laub Realty. The two-story, 36,126-square-foot MOB was developed in 2002 and is triple-net leased to Berks Cardiology, an affiliate of Penn State Health (Aa1/NA/AA). Eleven physicians provide services at the full-service outpatient cardiovascular center, their primary location. The \$11.5 million purchase price equated to \$319 per square foot.

¹Source: Real Capital Analytics

West Region

Anchor Health Properties, in a joint-venture with Carlyle Group, one of its equity partners, purchased a pair of MOBs in Silverdale, Wash., a western suburb of Seattle, in a sale-leaseback transaction. The two properties, totaling 52,306 square feet, are both majority-leased to The Doctors Clinic, an affiliate of Catholic Health Initiatives Franciscan (A2/A/A+). The \$17.6 million purchase equated to \$336 per square foot and a 6.2 percent cap rate.

M.C. Strauss Company, a San Diego-based private real estate investment company, acquired 29645 Rancho California Road in Temecula, Calif. Developed in 1984 and known as Rancho California Medical Plaza, the two-story, 36,728-square-foot MOB is approximately 75 percent leased to eight tenants. Services at the property include physical therapy, pulmonology, dental, orthodontic, chiropractic, and internal medicine. The \$5.8 million acquisition price equated to \$159 per square foot and an in-place 7.4 percent cap rate.

Southwest Region

Bertram Partners Inc., a privately held real estate investment company based in Irvine, Calif., utilized a 1031 Exchange to acquire 5125 South Rural Road in Tempe, Ariz., in January. The 8,500-square-foot building was built-to-suit for Dignity Health ("Dignity") (A3/A/A+), which uses it as a 24/7 freestanding emergency care center. The property is absolute triple-net leased to Dignity until June 2037, with six five-year options

to extend beyond. The \$13.4 million purchase price equated to \$1,589 per square foot and a 5.3 percent cap rate.

In March, Chicago-based Harrison Street Real Estate Capital acquired The Children's Hospital of San Antonio Health Pavilion from New York-based Seavest Investment Group for an undisclosed amount. Located in the Stone Oak area of San Antonio and adjacent to Methodist Stone Oak Hospital (242 beds), the newly built, 57,250-square-foot hospital and MOB is fully occupied by an affiliate of Christus Health. Services offered at the facility include pediatric orthopedics, audiology, neurology, cardiology, gastroenterology, nephrology, and pulmonology.

Midwest Region

H2C advised Mercy Iowa City on the sale of a six-property clinic portfolio structured as a sale-leaseback that closed in February. The six properties, located in and around Iowa City, totaled 41,764 square feet, with assets ranging in size from 2,828 to 11,298 square feet. All of the clinics were leased for 10 years on a triple-net basis, with services including urology, orthopedics, and otolaryngology. The buyer, Block & Co., acquired the portfolio for \$10.5 million.

In January, Nashville-based Montecito Medical acquired a three-property portfolio from Irgens Development. Two of the properties are located in suburbs of Milwaukee, and the third is located in Mokena, Ill., a southern suburb of Chicago. All of the buildings were developed after 2011 and

total 156,900 square feet. The 100,000-square-foot Tosa Health Center and the 24,000-square-foot Calhoun Health Center are majority-leased to Froedtert & the Medical College of Wisconsin (NA/AA-/AA). The 32,900-square-foot Mokena Medical Commons is leased to Women's Healthcare of Illinois and Heart Care Centers of Illinois. The \$75.3 million price equated to \$480 per square foot and a 6.7 percent cap rate.

Mid-Atlantic

In March, Welltower purchased a standalone, 50,128-square-foot MOB located in Winston Salem, N.C., from a joint venture between Flagship Healthcare Properties and First Colony. Known as the Greystone Medical Center, the four-story, Class A building was developed in 1998 and is located less than one mile south of Novant Health's Forsyth Medical Center. The property is leased to four tenants, three of which are affiliates of Novant Health (A1/AA-/A+). The \$9.7 million purchase price equated to \$227 per square foot and a cap rate of 7.1 percent.

Through its strategic joint venture with Kayne Anderson, MBRE acquired 8 Medical Drive in Asheville, N.C., in a sale-leaseback transaction. The 44,402-square-foot MOB was built-to-suit in 2002 for the current tenant, Asheville Eye Associates, a 20-physician ophthalmology practice. The property serves as the practice's flagship location and includes a surgery center. The \$18.2 million purchase price equated to \$409 per square foot. The acquisition by MBRE is the fourth property it

has purchased within the Asheville Medical District, having acquired 5 Medical Park Drive, 7 Vanderbilt Park, and 14 Medical Park Drive in 2018.

Southeast

American Healthcare Investors purchased 1670 Scott Boulevard in Decatur, Ga. The \$11.6 million purchase equated to \$357 per square foot. Known as the Regional Medical Group Professional

Building, the property is fully occupied, with the majority leased to members of Emory Health Network (Aa2/AA+/AA). Services offered at the property include dermatology, imaging, and family medicine.

Chicago-based Stage Equity Partners purchased 202 Inverness Center Drive in Hoover, Ala., for \$6.5 million. Known as Inverness Dental and Medical Plaza, the

20,019-square-foot MOB is 100 percent occupied by three tenants that have been occupants since the building was developed in 2001. Under the terms of the transaction, the well-known area dental practices executed 12-year triple-net leases with 1.5 percent annual increases. The cap rate was reported to be 7.2 percent.

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