Hammond Hanlon Camp LLC

+The Elements of Capital and Strategy

ATLANTA | CHICAGO | NEW YORK | SAN DIEGO

2Q17

Medical Office Building Quarterly Update

Medical Office Building Appeal Growing and Cap Rates Compressing As Flight To Quality Takes Place

Introduction

Despite the economy continuing to show consistency in expansion and pricing trending up, certain real estate asset classes such as retail and traditional office have been rattled by well-funded disruptors. Year to date, the DJIA Retail REIT Index is down 26.1 percent as a direct result of Amazon's delivery presence. The traditional office sector is being targeted by co-working space providers such as WeWork, which recently closed its eleventh round of funding valuing the company at $20 billion. The entrants have yet to pose a serious threat in tertiary markets, where they aren't located and/or have yet to gain a footprint, but in New York, their largest footprints, sales volume is down 55% year-over-year for the respective asset classes showing tremendous investor weariness.

Once seen as an alternative real estate investment, the medical office building (MOB) segment has grown in deal volume and presence to establish itself as a target asset class. The publicity of Healthcare Trust of America's (NYSE: HTA) $2.75 billion acquisition of Duke Realty's (NYSE: DRE) MOB portfolio has increased the interest of new entrants and foreign capital. Because the sector's tenancy is fueled by demographic trends of the aging population, increasing utilization of healthcare, and growing integration of hospitals and health systems, the MOBs have grown in popularity as a flight to quality takes place for investors seeking stable yield as other real estate asset classes have come under attack.

We expect traditional investors and foreign capital to allocate a greater proportion of their real estate investments toward the medical office sector as they seek yield backed by investment-grade health system tenants. Additionally, a change in the Foreign Investment in Real Property Tax Act (FIRPTA) allowing foreign funds to avoid paying taxes upon exit in U.S. based investments may further grow the global appeal of the asset class. For example, in the second quarter, Mercy Health Partner's sold its headquarters in Cincinnati to 90 North, a London-based firm in a joint-venture with Sidra Capital, a Saudi Arabia-based fund.

According to Revista, private equity investment in healthcare real estate jumped to $5 billion in 2016 from an average of $1 billion annually in previous years. New entrants into the market are another positive sign for the sector. Starwood Capital acquired 34 medical office buildings in their first acquisition within the sector earlier this year. Since May 2013, Kayne Anderson, historically an energy focused fund, has acquired 10 million square feet of medical office space across 30 states.

Supporting the "safe" asset title, it appears that a full-scale repeal of the Affordable Care Act (ACA) is unlikely to pass but may eventually

be modified. The gridlock in Washington and cross party "agreement" that some form of healthcare insurance is a necessity keeps the sector stable moving forward as the number of insured individuals will only diminish minimally if at all. In the second quarter alone, the sector saw 84,300 jobs created as hiring managers anticipate consistent growth in services rendered. Since 1990, health care employment has grown 95 percent, nearly three times U.S. overall job growth, driving the need for medical office and patient care facilities.

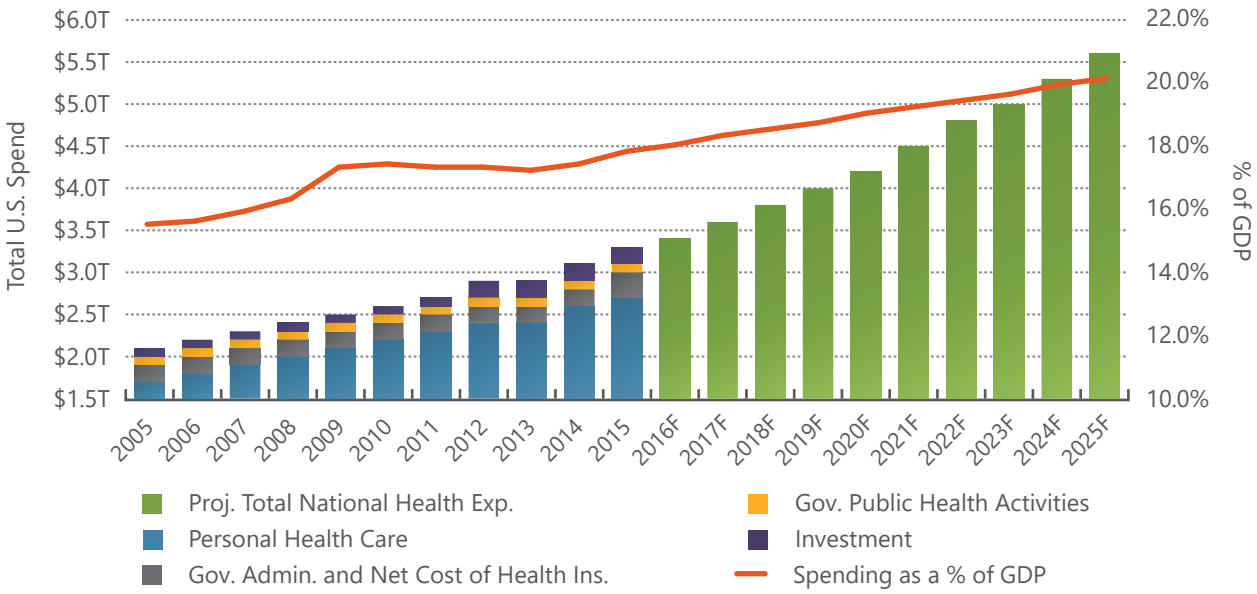
The healthcare services industry continues to see marked consolidation activity in 2017, including mergers between health systems and practice groups in order to create economies of scale and cut costs to offset declining reimbursement rates. The mergers and acquisitions trends will have a positive impact on valuations in the medical office sector as the credit profiles of the tenants are strengthened by their size and diversity.

The data is a positive indicator for the medical office building sector as well. While we expect health systems to continue their investment in strategies to provide greater value to patients, their footprint and patient presence isn't under significant technological threat in comparison to other industries. One technology that poses a potential threat is the growth of Telemedicine, which implements the use of electronic communication to exchange medical information.

While telemedicine is growing rapidly, it is typically a factor only for diagnostics, not for the physical treatment which will require space for the foreseeable future. Furthermore, the largest demographic served by health systems is over 65 years old, a population that has historically been the last to adapt to new technologies. Additionally, the demographic bucks some macro concerns of an inflationary environment in the future as social security benefits are inflation adjusted.

Lastly, elevated spending trends are expected to continue in the foreseeable future (Figure 1). Expected total healthcare spend from 2017 to 2025 is projected to grow annually by 5.8 percent, reaching 20.1 percent of total GDP.

Figure 1: Total National Healthcare Expenditures • *2005-2025F*

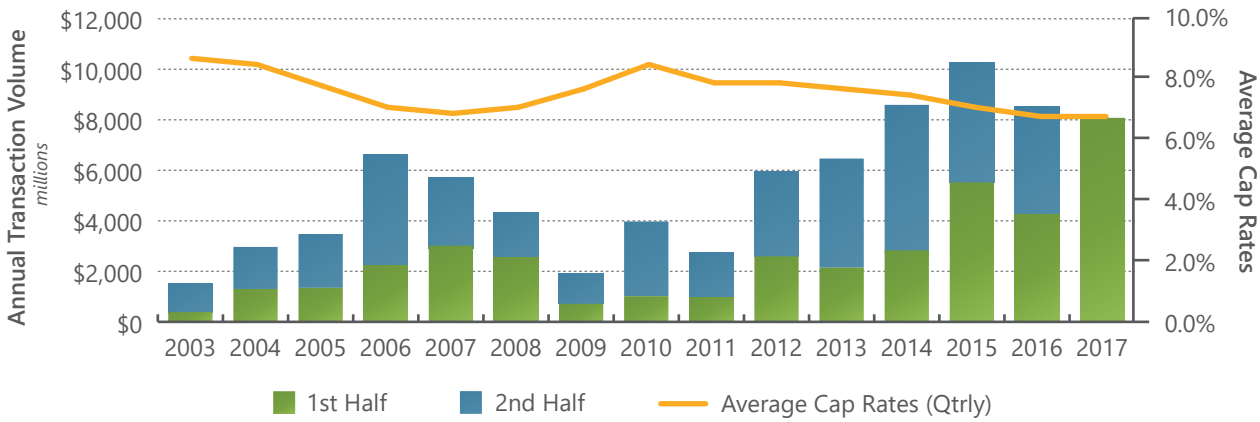


Source: U.S. Centers for Medicare and Medicare Services

Investment Sale Volumes and Pricing Trends

The medical office building market saw explosive growth in the second quarter, up 109% year-over-year with deal volume of $5.3 billion, driven in large part by the closing of a majority ($2.2 billion) of Duke Realty's (NYSE: DRE) $2.31 billion, 69-property portfolio sale to Healthcare Trust of America (NYSE: HTA). Even without the $2.2 billion transaction, $2.99 billion worth of assets exchanged hands, a 28 percent premium to the first quarter of the year and 57 percent uptick in comparison to the second quarter of 2016. The $7.6 billion in year-to-date activity is expected to far exceed 2016's total dollar volume of $8.5 billion (Figure 2), with several large portfolio transactions expected to hit the market later this year.

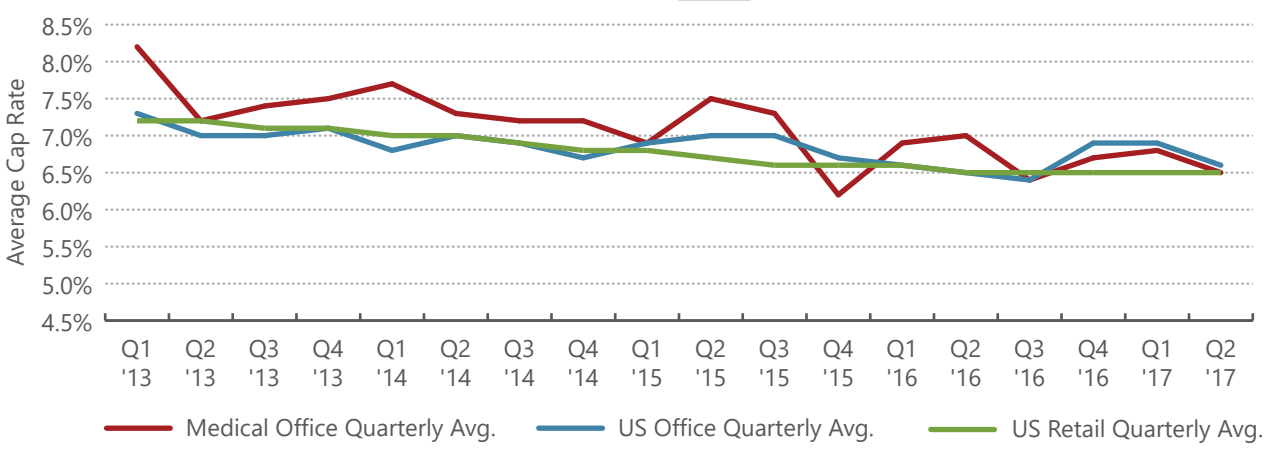
Figure 2: MOB Sales Volume in Thousands and Cap Rate Trends



As can be seen in Figure 3, cap rates have been trending downward since 2012 for medical office while traditional office and retail cap rates have been trending upward or leveling off. Pricing on an average price per square foot basis for medical office has now surpassed traditional U.S. office in the last three quarters as can be seen in Figure 4. The appeal and stability of the asset class have converged the sector's return metrics and placed a premium on medical pricing since the first quarter of 2013 as investors seeking investment credit tenancy under long term leases feel less confident in the traditional office and retail spaces.

Broken down by location, the Northeast, West, and Mid-Atlantic regions show significant premiums paid on a cap rate basis (Figure 5) in comparison to others. As portfolios are excluded from this graphical representation, the West saw the greatest transaction volume with $1.1 billion in deals for the quarter.

Figure 3: Cap Rate Trends



Source: RC Analytics

Figure 4: Price per Square Foot Trends[1]

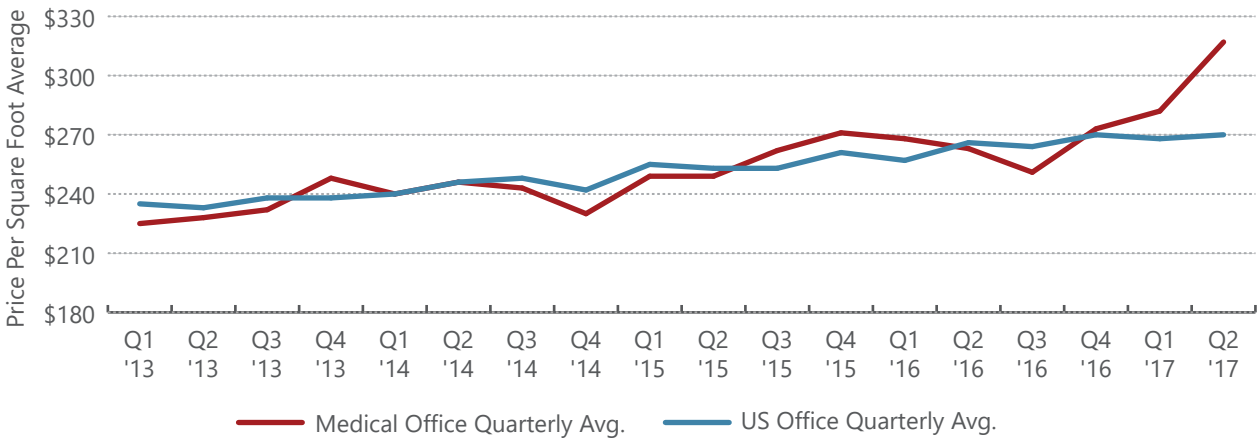
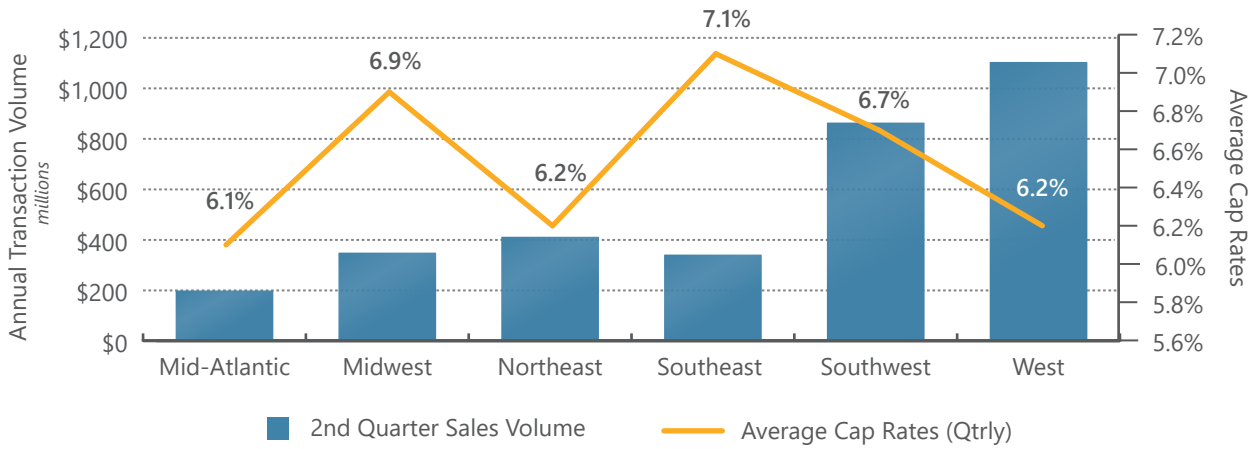


Figure 5: Cap Rates and Sales Volume by Region[1]



[1]*Source: RC Analytics*

Regional Review

West Region

In addition to their $2.31 billion acquisition, HTA purchased Antelope Care Center, a 76,000 square foot single-story medical office building in Lancaster, California from United Casualty Insurance. The property is NNN leased through 2026 to High Desert Medical Group, a multi-specialty group that is an affiliate of Heritage Provider Network. The $12.5 million acquisition price represented a 6.7 percent cap rate.

Public non-traded real estate investment trust, Griffin-American Healthcare REIT continued their 2017 buying spree by acquiring the Roseburg Medical Office Building in Roseburg, Oregon from HTA. Located 70 miles south of Eugene, the asset traded for $23.2 million, or approximately $374 per square foot. It is net leased to Mercy Medical Center, an affiliate of Catholic Health Services.

Anchor Health Properties, in a joint-venture with the Carlyle Group, purchased Fletcher Parkway Medical Center, a mission-critical, 82,024 square foot medical office building in La Mesa, California from The Abbey Company. The Class B, value-add asset is currently 81% occupied and anchored by Sharp Healthcare and Surgical Care Affiliates, who occupy approximately 43% of the building on a net basis. The property sold for $33 million, or $402 per square foot.

Southwest Region

In June, New York-based Everest Medical Properties tripled the size of their portfolio with the purchase of four medical office buildings in Houston, Texas for $58 million. The package includes Memorial Hermann Surgical Hospital, Physicians Pavilion, and two University of Texas Physicians facilities in Sugar Land and Richmond.

Montecito Medical purchased the Thunderbird Square Medical Center, a 35,420 square foot medical office building in Sun City, Arizona for $9.25 million, or $261 per square foot. Developed in 2012, the single-story property was purchased from the original developer for a 6.7 percent cap rate. The fully leased building is occupied by four tenants ranging in practice from digestive diseases, endoscopy, urology, and internal medicine.

Southeast Region

Keystone Property Group acquired Dadeland Towers South in Kendall, a suburb of Miami, by executing a sale-leaseback transaction with AvMed. The towers total 228,136 square feet of which 102,000 square feet is leased to AvMed on a long-term basis. The acquisition price of $36 million equates to $158 per square foot. The buildings are currently operating at 89 percent occupancy.

In June, Charlotte-based Flagship Healthcare Properties ("FHP") acquired the Covington Medical Arts Pavilion to establish a presence within the New Orleans MSA. Located on Hospital Corporation of America's ("HCA") Lakeview Hospital Campus, the building has a diverse medical roster with 37 percent of the space net leased to HCA. The purchase price of $16.5 million, or $306 per square foot, represented an entry cap rate of 4.5 percent based on the 72 percent occupancy with a projected stabilized cap just over six percent.

Midwest Region

A joint-venture between London-based 90 North and Saudi Arabia-based Sidra Capital purchased the newly developed Mercy Health Headquarters in Cincinnati, Ohio for $84.5 million, or $229 per square foot. The newly developed single tenant building was acquired from Verus Partners, the original developer, and is net leased to Mercy Health through May 2032. The transaction highlights the attractiveness of healthcare backed assets to foreign capital as it traded in a tier-two market at a 6.2 percent cap rate.

Indiana-based Cornerstone Companies closed on a package of three net leased medical office buildings in Indiana, Kentucky, and Colorado totaling 82,000 square feet. The acquisitions include The Medical Centre at Lone Tree, The Muhlenberg Medical Center, and Indiana University Health Clinic. The $22.6 million acquisition equated to a price per square foot of $276 with a weighted average acquisition cap rate of 6.4 percent.

Mid-Atlantic

The Sanders Trust, a Birmingham, Alabama-based healthcare real estate firm completed a $21 million acquisition of the Parkway Professional Center in Hagerstown, Maryland. The Class A, 71,000 square foot medical center was developed in 2012 and is leased to premier area medical providers including Parkway Neuroscience & Spine Institute and the Center for Joint Surgery. The building is 85 percent leased with asking rents for the remaining vacant space at $22 per square foot.

In July, Potomac, Maryland based developer Foulger-Pratt sold an on-campus 62,379 square foot medical office building for $24 million to HTA. The building is located on the campus of Holy Cross Hospital in Silver Spring, MD, less than a mile from the Forest Glen Metro station.

Northeast Region

Anchor Health Properties, in another joint-venture with Carlyle Group, acquired the Oxford Valley Medical Plaza in Langhorne, Pennsylvania from a private developer. Developed in 2007, the 66,000 square foot building is anchored by Jefferson Health System and St. Mary's Healthcare. At $21.75 million, the acquisition equated to a 6.7 percent cap rate and $330 per square foot.

New York-based Spector Group sold a 24,600 square foot medical office building North Hills, New York for $14.7 million, approximately $598 per square foot. The three tenants who occupied 100% of the building were Integrated Medical Professionals, Northern OBGYN, and Aesthetic Dermatology. The acquisition cap rate was 6.43 percent with leases in-place through 2022.

NEW YORK
623 Fifth Avenue, *29th Floor*
New York, NY 10022
212 **257 4500**

CHICAGO
311 S. Wacker Drive, *Suite 5425*
Chicago, IL 60606
312 **508 4200**

ATLANTA
3333 Piedmont Road, *Suite 700*
Atlanta, GA 30305
402 **937 1350**

SAN DIEGO
4655 Executive Drive, *Suite 280*
San Diego, CA 92121
858 **242 4800**

About Hammond Hanlon Camp LLC

HAMMOND HANLON CAMP LLC ("H2C") is a healthcare-focused strategic advisory and investment banking firm with a dedicated real estate advisory and transaction practice.

With offices across the country in New York, Chicago, Atlanta, and San Diego, H2C is uniquely positioned to help your company meet its financial goals. The firm's principals have been lead advisors on billions of dollars of transactions in the healthcare industry, offering the experience and industry knowledge to achieve the most favorable results.

The H2C approach has resulted in loyal clients and longstanding relationships. Please contact one of our senior professionals today to find out how we can help your company.

Real Estate Investment Banking Practice

The real estate investment banking professionals at H2C have successfully served as advisor for over 20 years on real estate transactions in excess of $11 billion nationwide. For more information on our real estate advisory group, please contact one of the following H2C professionals or visit our website at h2c.com.

Philip J. Camp
Principal
212 257 4505
pcamp@h2c.com

Jay J. Miele
Managing Director
212 257 4515
jmiele@h2c.com

John P. Nero
Vice President
212 257 4502
jnero@h2c.com

Matthew T. Tarpley
Associate
212 257 4516
mtarpley@h2c.com

Hammond Hanlon Camp LLC offers securities through its wholly-owned subsidiary, H2C Securities Inc., a member of the Financial Industry Regulatory Authority (FINRA) and the Securities Investors Protection Corporation (SIPC) and registered with the Securities and Exchange Commission (SEC), the Municipal Securities Rulemaking Board (MSRB) and the National Futures Association (NFA).