

HEALTHY INVESTMENT

As the aging population spurs development of medical office buildings, real estate managers seize opportunities to diversify portfolios *by Darnell Little*

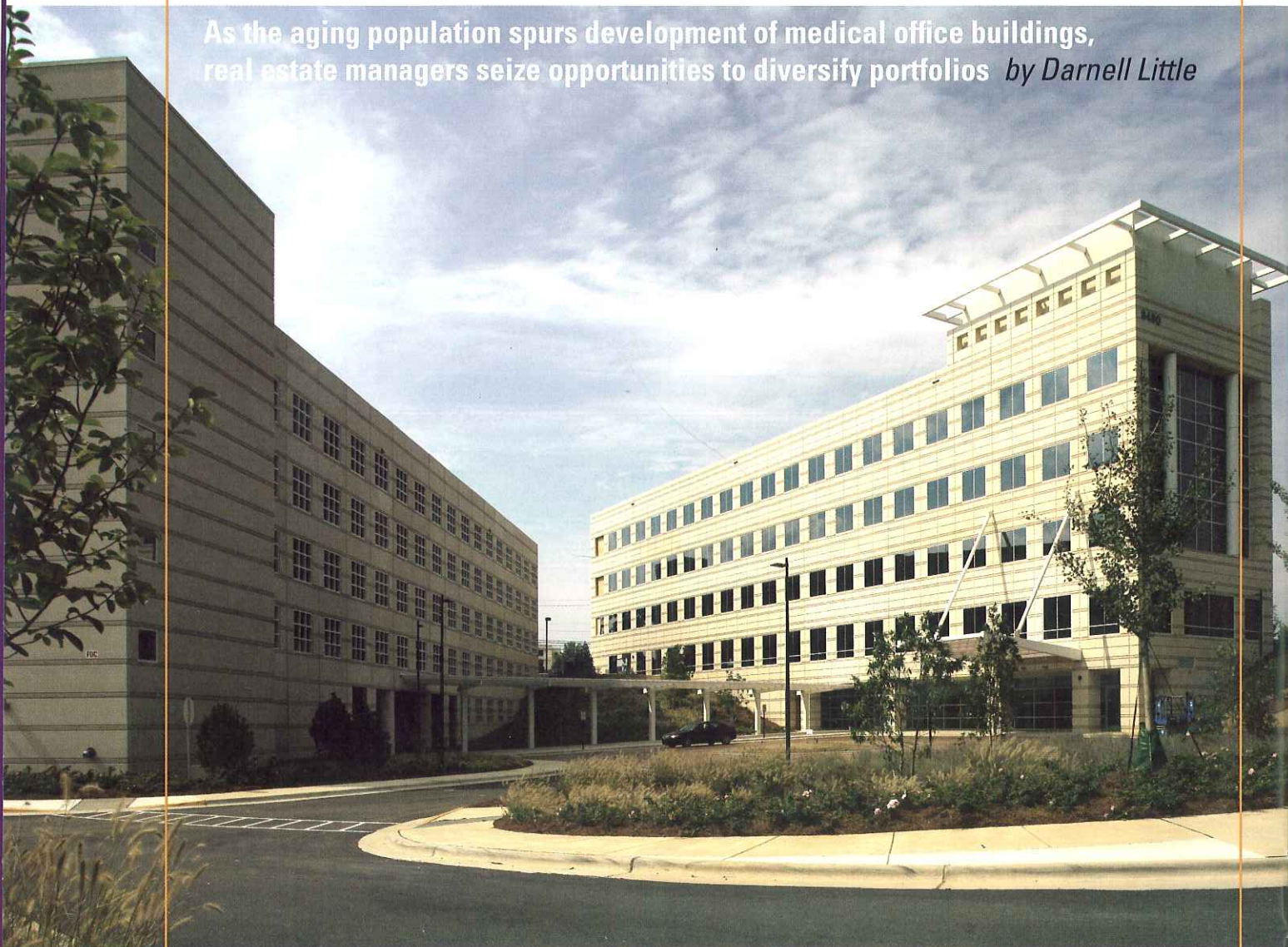


Photo: Trammell Crow Company

Duke Raleigh Medical Plaza is an 84,000-square-foot medical office building located on the campus of Raleigh Community Hospital in Raleigh, N.C.

America is getting older. The first wave of Baby Boomers—numerically the largest generation in U.S. history—has reached the age of 60.

Many business sectors are gearing up to capitalize on the graying of the population—especially the healthcare industry. For real estate managers, that creates new opportunities in the rapidly growing area of medical office buildings.

“There’s a focus on healthcare in general as a growing industry,” said Jeff Cooper, senior managing director for real estate at Granite Partners, an investment banking firm. “You’ve got more people living to an older age. There’s more demand for doctors. Those doctors will need office buildings and that creates opportunity for us.”

GOLDEN YEARS, GOLDEN INVESTMENT

Around 35 million people age 65 and over were living in the year 2000, according to U.S. Census Bureau information. That number will more than double by 2030, the bureau estimates. Such statistics are driving heavy investment in all types of medical office buildings.

Some medical office buildings simply provide office space for physicians to meet and consult with patients, while a few units may have some heavy medical and diagnostic equipment like X-ray or other imaging machines. Other medical office buildings are like mini hospitals, housing operating rooms where doctors perform surgical procedures.

Complicated buildings or not, the attractive financial

return on all medical office buildings is raising interest in the market. Medical office sales have grown from \$857 million in 2002 to \$2.1 billion in 2005, according to information from Real Capital Analytics, a real estate research firm.

In the second quarter of 2006, Real Capital Analytics tracked \$3.5 billion in medical office building sales during the prior 12 months. Medical office space now averages \$211 per square foot, compared with \$203 for all other office buildings. In 2002, medical office rents averaged \$142 per square foot.

“The returns on medical office are much better than in office, retail and residential,” Cooper said. “It provides you with an attractive margin on your property.”

LONGER LIVES, LONGER LEASES

As with all real estate, getting a decent return on a medical office building greatly depends on its location. A medical office building located near a major hospital carries a high premium. Even better is a medical office building located directly on a hospital’s campus.

Physicians like to be housed as close to a major medical facility as possible. They do not want to spend a lot of time commuting back and forth between their offices and their primary hospital—nor do their patients.

“The closer you get to that hospital campus, the higher your rates can be,” said Keith Kaiser, co-chair of GVA Worldwide’s management services practice group. The company manages more than 800,000 square feet of medical



The London Real Estate Group is currently building Northcare, a \$15 million, 80,000-square-foot medical office building in Colorado Springs, Colo.

Photo: RTA Architects, Colorado Springs, Colo.

office space. "That generally translates into stronger fees for the management service provider."

Prime locations often translate into longer leases as well. Leases for medical office buildings tend to be several years longer than leases for traditional office spaces. While the standard office lease is three to five years, medical office leases are routinely in the eight- to 10-year range because doctors form strong bonds with the nearby hospital and are reluctant to move. Changing locations can also be difficult for physicians with expensive, heavy medical equipment in their units.

Because of the longer-term leases, Wall Street tends to look at medical office buildings as secure investments, said Mike Heritage of the London Real Estate Group. The group is building a \$15 million, 80,000-square-foot medical office building called Northcare in Colorado Springs, Colo. Scheduled to be completed in 2008, Northcare will be adjacent to the St. Francis Medical Center. Heritage estimates the building is 65 percent presold.

"The safety and security of the investment is higher than your typical office building where you have tenants that can move to a different location in the city if they get a better deal," Heritage said. "Physicians can't really go anywhere else, so you really have a captive audience."

CRITICAL CONDITIONS

Although managing medical office buildings is proving to be lucrative, it brings its share of challenges.

Medical office buildings routinely have greater cleaning and power demands. More insurance issues might arise if some tenants house expensive medical equipment. An understanding of government regulations and ordinances—like Occupational Safety and Health Administration (OSHA) requirements—is necessary if a building has actual patients walking in the door, said James Lennox, CPM, a director at real estate firm Trammell Crow Co.

"You really need to understand the legal requirements for the generation and proper disposal for hazardous wastes,"

Lennox said. "It adds another layer of complexity to how you resolve issues and operate your building."

The technical aspects of managing a medical office can provide an intense challenge for the property manager. Some tenants may have complex medical equipment requiring extra power to operate; if the doctors treat patients in the building, the operation of this equipment is critical.

If the building contains a surgery center, uninterrupted air conditioning is crucial. Continuous elevator service is essential if the operating room is on another floor. A constant supply of power to operate diagnostic and patient monitoring equipment is vital. All this means the property manager must have expert knowledge of the building's infrastructure and engineering requirements.

"The day-to-day engineering operations of the building are critical when you are in a medical environment," said Tim McNally, director of real estate for Overlake Hospital, a regional medical center in Bellevue, Wash. "The property manager must have more than a passing knowledge of medi-

cal equipment and of the importance and significance of the infrastructure workings."

A medical office located on the same campus as a hospital involves other challenges. While having a convenient location pays off with higher premiums and lower vacancy rates, it comes at a price—bureaucratic nightmares for the property manager.

The hospital may want to maintain control of certain uses and operations of any building located on its campus. It may want the final say on who can and cannot move into the building. Cooper of Granite Partners said hospitals want doctors with practices that generate income for the hospital, and they may specify they don't want tenants with nonmedical uses.

He also said a hospital might not want a tenant with competing services on campus. For example, the hospital may not want a third-party medical imaging group in the building because it will compete with the hospital's imaging practice, Cooper said. That makes the

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Photo: Trammell Crow Company

Baylor Medical Plaza at Garland is a 44,731-square-foot, two-story medical office building in Garland, Texas.

property manager's job of attracting tenants to the building more difficult.

"What makes medical office buildings harder to manage is that you have tenants in the building you have to satisfy and you also have a hospital you have to accommodate," Cooper said. "You have to rely on the hospital and have a good relationship so they continue to send you tenants."

MANAGEMENT PRESCRIPTION

To handle all these greater challenges, a medical office property manager must possess a wide range of skills. Kaiser of GVA Worldwide said education is essential to obtaining these skills.

He said the field of medical office management has grown so quickly that companies and real estate industry organizations have not been able to create training programs fast enough to prepare workers for the challenges.

"Real estate developers and real estate investors have had to be on a very steep learning curve about what to deliver to the market, about how to design it and how to deliver it," Kaiser said. "And I'm not sure that the real estate management disciplines have kept pace in their training programs."

Education aside, successfully managing medical office buildings requires patience and listening skills. Physicians often have complex needs. No matter how well trained the property manager may be, he or she can never fully anticipate all of a medical professional's demands.

"There's a tremendous amount of listening required to understand what the needs are on the part of the tenants in those buildings," Kaiser said. "And so the company that's providing those property management services has to be prepared to make that investment of time, talent and energy, which all translates into money."

Lennox of Trammell Crow said despite all the challenges, he enjoys working with a sophisticated, technologically savvy group of tenants, and he believes he is making a significant contribution to society.

"I just like the nature of the beast," he said. "Being able to help people who are hurt or need help, and being active in the community—as these organizations are—is very fulfilling." □

Darnell Little is a contributing writer for *JPM*. Questions regarding this article can be sent to kgunderson@irem.org.