

Washington State Healthcare Real Estate: A View of the Forest *and* the Trees

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My game for this quarter's article about healthcare real estate is Oversimplification vs. Nuance. It may not be as exciting as this year's NFC Championship game (I am writing this article before the Super Bowl), but it is important in the healthcare real estate field to see both the forest and the trees. Sometimes it makes sense to summarize but this can lead to deceptive oversimplification.

The first year of the Patient Protection and Affordable Care Act (ACA) implementation concluded

with a flurry of Puget Sound healthcare real estate activity, both sales and leasing. Steadfast investor and user interest in acquiring medical office buildings (MOBs) as well as continued health system growth contributed to a wave of fourth quarter investment sale and leasing transactions. I can oversimplify the real estate landscape (Oversimplification #1) by saying that increased demand is good for landlords and sellers and tough for tenants and buyers. However, a more nuanced reaction (Nuance #1) is that most tenants and buyers are also pleased with continued demand for healthcare services and will also ultimately profit from the positive trends.

Oversimplification #2: The number of insured Americans will continue to grow. The Gallup Poll released 1/7/15: "In U.S., Uninsured Rate Sinks to 12.9%" indicates that the uninsured rate among adults in the U.S. for the fourth quarter of 2014 averaged 12.9 percent, which is a significant drop from the uninsured rate for the same period one year ago of 17.1 percent. In Washington State, there are about 700,000 newly

insured. However (Nuance #2), closing the health insurance gap may be more challenging in 2015 than in 2014, as those who did not sign up last year may be harder to reach or more reluctant to get health insurance.

In support of the newly insured (whose ranks may not rise so quickly in 2015) the healthcare industry has been staffing up: the 1/9/15 Bureau of Labor Statistics "Current Employment Statistics Highlights: December 2014" reports that in December, the healthcare industry as a whole added 34,000 jobs. Hospitals added jobs for the fifth consecutive month (7,000 in December). Nursing added 33,000 jobs in 2014 compared to 26,000 in 2013. Healthcare employment growth averaged 26,000 per month in 2014 versus 17,000 per month in 2013.

Oversimplification #3: These growing employment numbers will increase the value of healthcare real estate. Nuance #3: It depends on where the property is located. Quality on-campus properties are appreciating but off-campus

properties are more tenuous. The trend towards locating clinics in retail settings continues, changing the nature of retail centers and off campus medical buildings alike. In addition, there are predicted shortages of physicians, so it may be hard to find the required employees.

Puget Sound Area Real Estate Activity

Leasing News

For the first time in recent memory, the data that our research team gathers for the Puget Sound region shows a positive absorption for both on-campus and off-campus medical office properties. This is tangible evidence that healthcare leasing is strong in this area. Often, our numbers show a shift back and forth between on and off campus properties; this time (Q4 2014 data), the vacancy numbers are strong all over, with a commensurate uptick in rental rates. Oversimplification #4: this is good news for landlords and bad news for tenants. Nuance #4: Compared to other tenant types, healthcare organizations spend a smaller percentage of their budget on real estate, so are at times more location-sensitive than rent-sensitive. Higher rental rates may drive new construction that provides location opportunities for expanding or upgrading clinics. Migration to quality buildings can in turn create opportunities for segments of the industry that have slim margins requiring higher sensitivity to all expense line items, including rent.

Seattle's First Hill submarket recorded a number of lease transactions, decreasing the total vacancy rate for the third straight quarter to 6.84%. On-campus,

Providence Health & Services pre-leased 24,000 SF in the 1st Hill Medical Pavilion currently under construction at Boren and Columbia and slated to be completed in July 2015. Providence also completed 10,000 SF of new leases in 1101 Madison, 600 Broadway and Nordstrom Medical Tower and completed a major renewal of 36,000 SF in 1101 Madison. Off-campus, SVS leased 13,000 SF in M Street's ground floor space at 8th and Madison.

Looking into 2015, the Puget Sound's healthcare real estate market remains active with vitals pointing toward a tighter market. The region's total vacancy for the quarter decreased from 10.32% in Q3 2014 to 9.53% in Q4. Average asking lease rates in the region increased in both on-campus and off-campus MOBs to \$32.01 and \$21.80, respectively (\$/SF/YR, NNN).

Sales and Construction News

Multiple medical office buildings traded in the region in Q4 2014. National pricing for MOBs is hovering at a plateau of about a 7.1% capitalization rate, down from above 8% a few years ago. (Note the "cap rate", while providing a useful estimate of value in many cases, is itself an oversimplification of real estate pricing.)

Near Swedish Edmonds, the Warren Medical Building traded for \$5.4 million to Osberg Construction Company who plans to hold the building as an investment. On Highline Medical Center's campus, the 60,000 SF Three Tree Medical Arts Building was purchased by Healthcare Realty for \$377/SF in an

off-market transaction. It was one of 11 properties that HR purchased throughout the United States in 2014. In Bellevue, 17,397 SF Overlake Medical Park sold for \$6.7 million or \$385/SF to NIU Enterprises LLC and an owner/user. In Redmond, Overlake Office (medical) Center sold to NIU Enterprises as well for \$11.2 million or \$230/SF.

In development news, the owners of First Hill's 1001 Broadway announced that the building would be demolished in 2017 to make way for a 16-story apartment building with a 40,000 SF Whole Foods in 2018. 1001 Broadway is a 62,000 SF off-campus medical office building built in 1928. In Federal Way, construction is underway on Seattle Children's new 35,000 SF clinic at West Campus Square in former Circuit City space, expected to be finished mid-2015.

Conclusion

While it is true that the outlook for healthcare real estate fundamentals in the Puget Sound region is positive, in today's dynamic healthcare world, the details are important. Oversimplifying, the "forest" of medical office buildings in this state appears to be healthy. But the nuances of the location, type and condition of each of the "trees" are, more than ever, what drive the value of any individual asset.

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