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3Q17

Medical Office Building Quarterly Update

Aggregation Strategies Paying Off as Investors Seek Scale in Medical Office Building Space

Introduction

Medical office building (MOB) sales through the first three quarters of 2017 have already broken the annual record for sales volume topping $10.45 billion Year to Date (YTD). Private equity firms of all sizes seeking diversification as well as large exchange traded REITs have been on a buying spree, combining an exceptionally strong middle market with an equally active institutional market.

There are a number of factors that have created such favorable market conditions. As discussed in our second quarter report, as a fear of Amazon has permeated the retail real estate market, new investors continue to enter the healthcare real estate space seeking yield secured by investment-grade, credit-tenant leases that many health systems offer. Additionally, Canadian investors have become the largest cross-border buyers of U.S. real estate assets after increased competition in the Canadian real estate market resulted in a 32 percent increase in Canadian transaction volume last year. Furthermore, the effort to repeal or change the Affordable Care Act ("ACA") appeared to be dead during the third quarter, bringing capital that had been sitting on the sidelines into the healthcare real estate market expecting cap rate compression. Offsetting these factors, however, is the potential elimination of the individual mandate within the Senate tax bill (as we write this report), which could have a negative impact on the perception of the real estate market as foreign investors have viewed the ACA positively as a building block of a "government protected" healthcare system, similar to Canada's, where yields have historically been lower on medical office buildings.

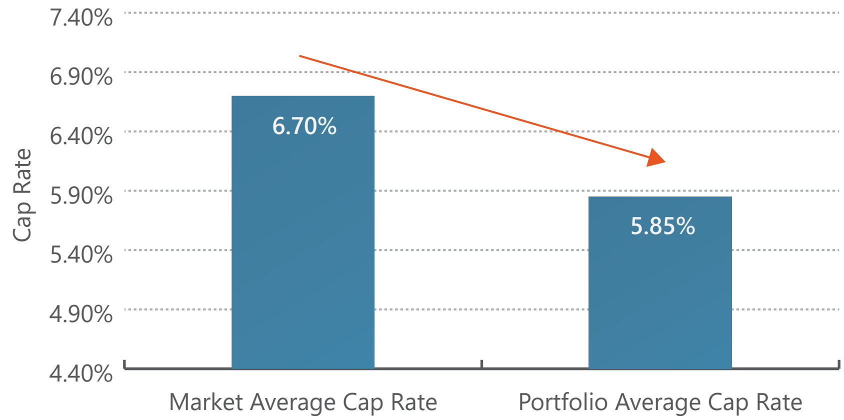
Benefits of an Aggregation Strategy

With established dividend patterns, cap rate compression for five consecutive years, and a lack of institutional level assets up-for-sale, REITs and large funds have been paying up for portfolios made up of smaller assets. The portfolios, which are assembled with varying levels of tenant credits and lease terms, and feature both on-campus and off-campus properties, typically garner a premium to what the properties would sell for individually. While the "portfolio premium" [Figure 1] can vary dramatically depending on the credit rating and lease terms, it has provided a substantial exit opportunity for owners of a collection of smaller assets that previously had not been available at the low cap rates present today. It appears to be an advantageous time to sell portfolios of smaller assets as the market is starved for product and only 12 portfolio sales are projected to take place in 2017 [Figure 2].

The largest transaction of the quarter took place in August, when CBRE Global Investment Partners ("GIP") closed on a 95 percent interest in a 27-building portfolio for $590 million from a joint venture between Kayne Anderson Real Estate Advisors ("KAREA") and MB Real Estate ("MBRE") (collectively "KAREA/MBRE Healthcare") at a 5.5 percent cap rate. Six of the buildings are on, or adjacent to, a health system campus, and eight of the buildings are occupied by a single tenant. The sale represents approximately 16 percent of KAREA's portfolio, which they have built up since entering the MOB space in 2013, and the KAREA/MBRE Healthcare joint venture will continue to operate the facilities. The GIP acquisition provides an example of a portfolio premium from an aggregation strategy as many of the individual assets would likely have sold in the high-six cap range due to the majority of off-campus locations.

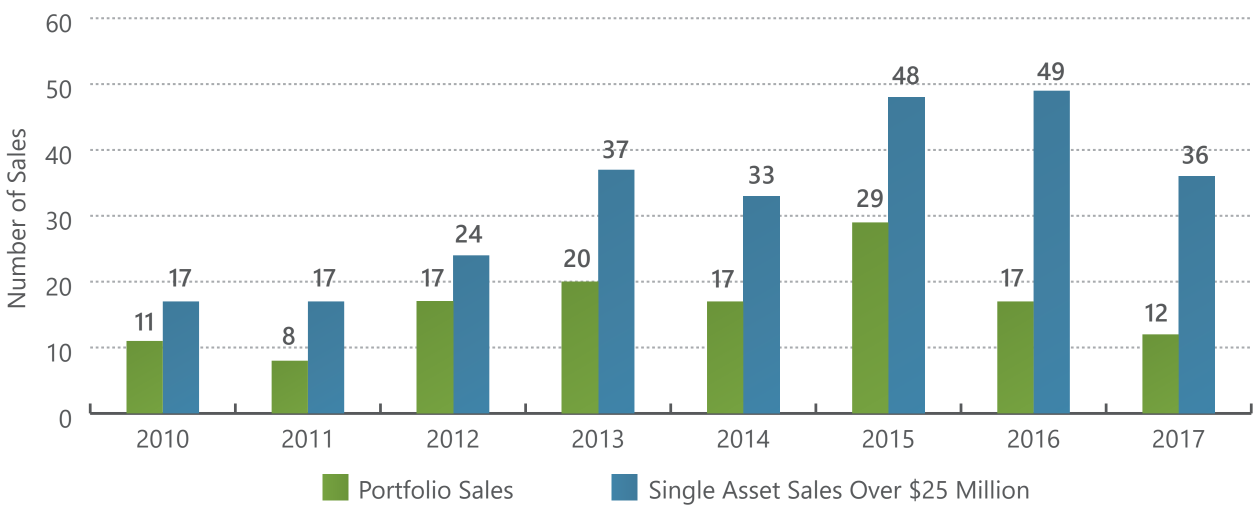
Another example of a portfolio premium realized through an aggregation strategy is the sale of a seven-property portfolio sold by The Sanders Trust and acquired by Dallas-based MedProperties Holdings in September. The $72.5 million trade at a 6.4 percent cap rate consisted of assets ranging in size from 12,000 to 46,000 square feet across six states.

Figure 1: Portfolio Premium



Note: Average portfolio cap rate is for the last two years of transactions

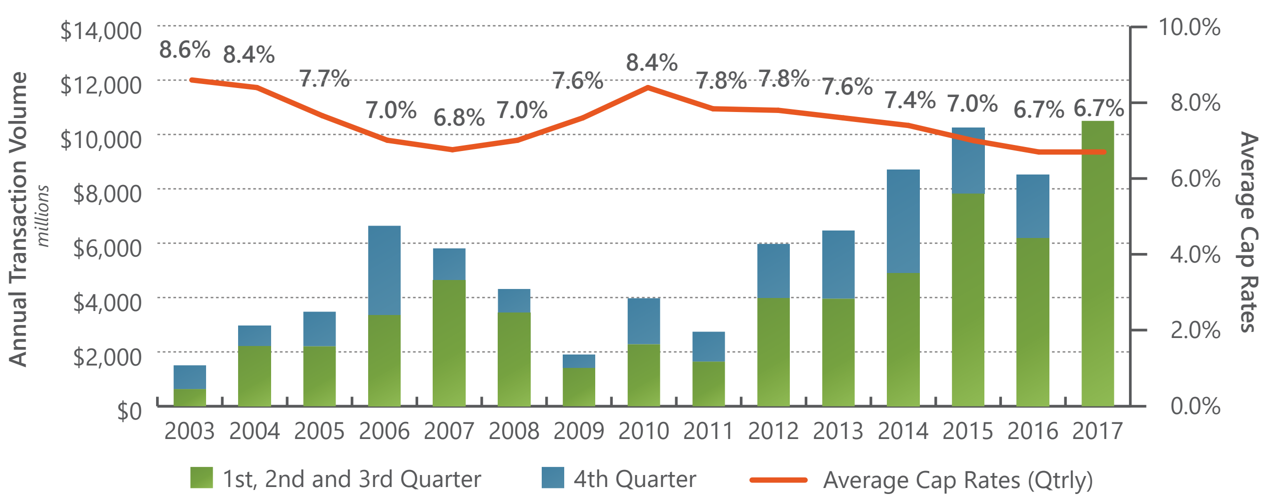
Figure 2: Portfolio and Large Asset Transactions



Investment Sale Volumes and Pricing Trends

Medical office building sales totaled $2.4 billion in the third quarter, down from the $2.99 billion in the second quarter (adjusted to exclude the $2.2 billion Duke Realty sale for comparative purposes). Although this marks the third year in a row that the third quarter has lagged all others in deal volume, total sales for the year have reached $10.45 billion, making it the largest sales volume ever recorded through the first three quarters of a year [Figure 3]. The deal volume for medical office buildings is in stark contrast to the broader office market, which is down 18 percent year-over-year in sales volume, including 49 percent year-over-year in the CBD subsector, and the retail sector, which has experienced a 32 percent year-over-year drop in sales volume. The new data supports the theory described in our Q2 report that capital is expected to transfer from other asset classes into the healthcare-backed real estate space. Listed REITs and private capital both had positive net acquisitions for the first time since Q3 2015, while institutional investors and others sold more than they purchased for a second straight quarter [Figure 4]. The spread between traditional office and medical office continues to decline as cap rates and price per square foot metrics have been close to parity for the last three quarters [Figures 5 and 6].

Figure 3: MOB Sales Volume and Cap Rate Trends • *$ in millions*



Source: RC Analytics

Broken down by region, the Southeast had the largest sales volume with $670 million [Figure 7], driven by the $160 million acquisition of Piedmont West Medical Office Park in Atlanta as part of the KAREA/MBRE Healthcare portfolio. Adding to the Southeast's volume in the quarter, the Northside-Cherokee Towne Lake MOB in Atlanta traded for $37.1 million at a 5.1 percent cap rate, which was one of the few assets Duke Realty did not sell to Healthcare Trust of America (NYSE: HTA) earlier this year. Furthermore, a purchase option was executed on the Emory Proton Center by Invest Atlanta for $32.4 million, or $324 per square foot. Despite lower sales volume in each region from the second quarter to the third quarter, the Northeast, West, and Mid-Atlantic continue to show premiums on a cap rate basis over other regions.

Figure 4: Net Acquisitions by Investor Type • *$ in thousands*[1]

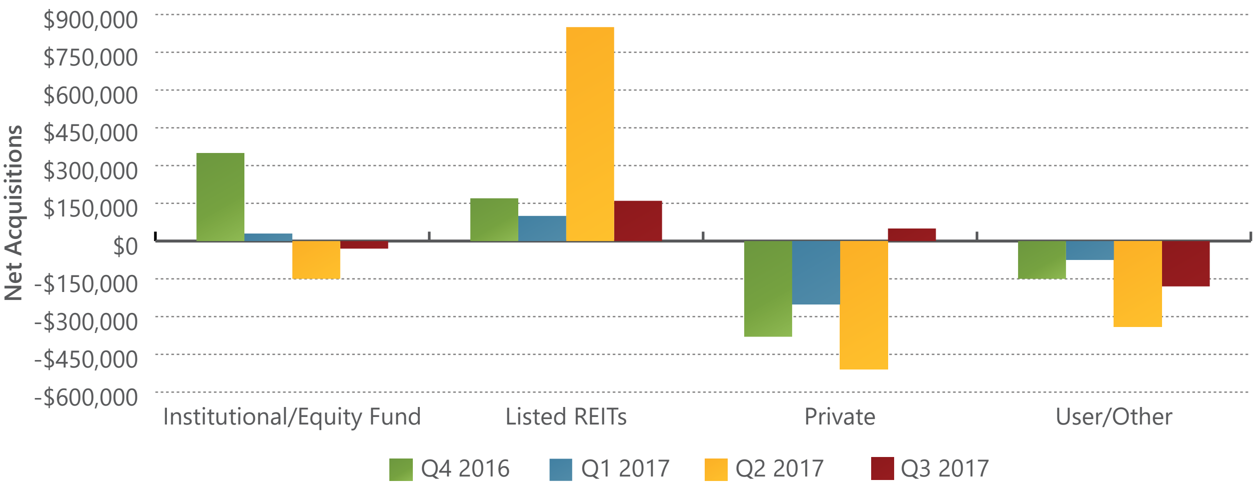


Figure 5: Cap Rate Trends[1]

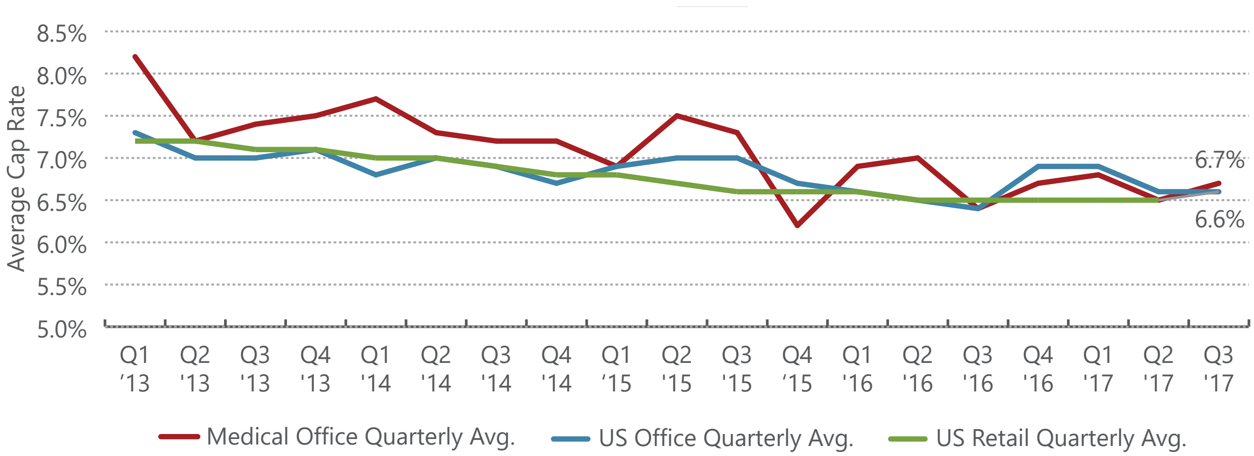
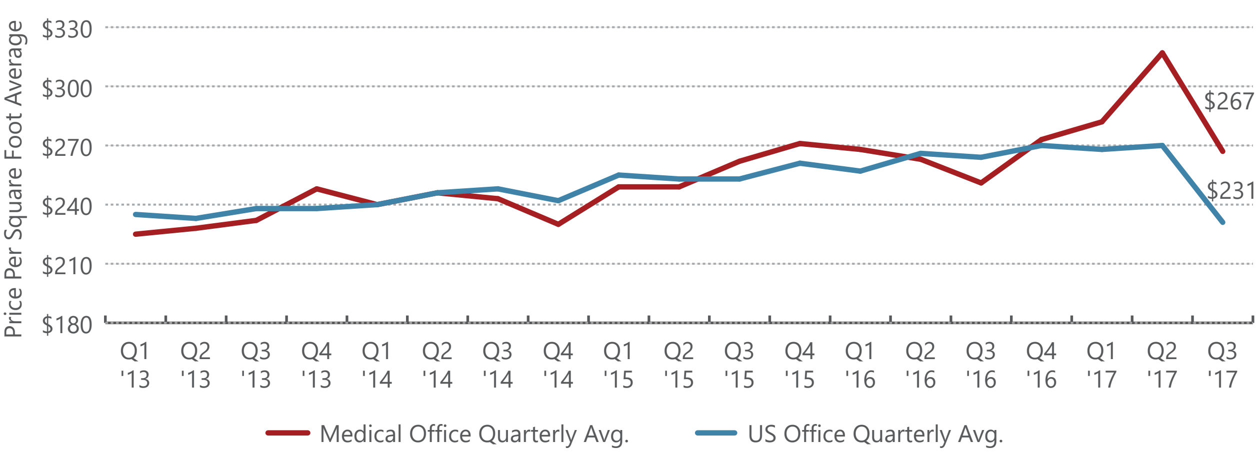
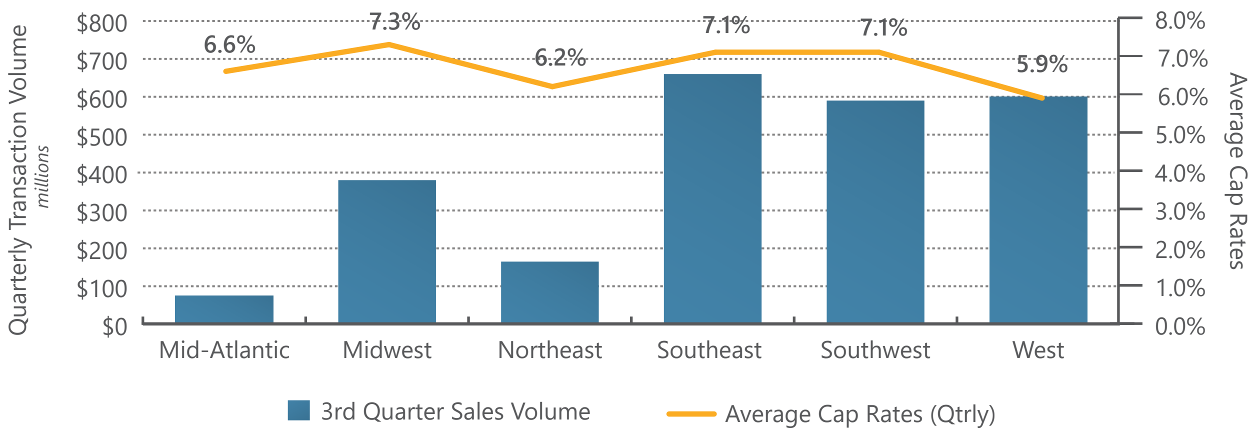


Figure 6: Price per Square Foot Trends[1]



[1]*Source: Real Capital Analytics*

Figure 7: Cap Rates and Sales Volume by Region[1]



[1]*Source: Real Capital Analytics*

Regional Review

West Region

Zion Enterprises, an opportunistic and value-add fund based in Orange County, California, sold Corona Plaza and Professional Park in Corona, California for $18.5 million. The single-story, 72,236 square foot building was acquired by a high-net worth investor from China at a 6 percent cap rate. A majority of the tenants are established local practices with services offered at the facility including urgent care, orthopedics, and physical therapy.

Healthcare Realty Trust (NYSE: HR) purchased Park Hill Medical Center in the West Hills neighborhood of Los Angeles, California for $16.3 million, or $373 per square foot. The medical center is 93 percent occupied by 21 tenants and adjacent to West Hills Hospital. After being marketed at $15.9 million, the asset sold over the asking price, driven by significant competition, at a 5.4 percent acquisition cap rate that is projected to stabilize in the low 6 percent range by late 2018.

Southwest Region

Global Medical REIT (NYSE: GMRE) closed on a 27,280 square foot medical office building in Lubbock, Texas through a sale-leaseback to a cardiology group affiliated with Lubbock Heart Hospital. 52 percent of the lease payments under a 12-year, triple-net lease are guaranteed by Surgery Partners, which has an ownership percentage in the tenant. The $8.2 million purchase equated to $301 per square foot and a 7.3 percent cap rate.

Woodside Health, a Cleveland-based MOB investor, added two properties to their portfolio in Arizona in the third quarter by acquiring Shea Medical Plaza in Scottsdale and Foothills Health Center in Phoenix. The separate transactions total $23.8 million and complement a MOB purchased last year in Glendale as part of their targeted geographic acquisition strategy. The 42,439 square foot Scottsdale asset was purchased for a 6.6 percent cap rate and Foothills Health Center was acquired at a 6.7 percent cap rate. Both multi-tenant properties are operating above 90 percent occupancy and occupied by established local practices.

Southeast Region

Physician's Realty Trust (NYSE: DOC) acquired the Clearview Cancer Institute in Huntsville, Alabama for $53.25 million, or $471 per square foot at a 6.3 percent unlevered yield. The property was built-to-suit in 2006 for Clearview Cancer Institute by Martin Medical Properties, the seller. Clearview Cancer Institute is an established, 14-physician local practice with five locations and strong relationships with premier systems.

In addition to the seven-building portfolio acquired from The Sanders Trust, MedProperties Holdings purchased a single-tenant asset in Jacksonville, Florida for $16 million, or $423 per square foot from Harrison Street Real Estate Capital. The 37,863 square foot property is triple-net leased to the University of Florida Health System whose Women's Specialists Department operates out of the facility. The long-term leased asset was acquired for a 6.4 percent cap rate and represents MedProperties Holding's re-entry into the Florida market after divesting four medical office buildings in 2014.

Midwest Region

Chicago-based, Harrison Street Real Estate Capital picked up the Fox Valley Centre for Health in St. Charles, Illinois for $15.3 million. The off-campus, 45,397 square foot, two-story MOB developed in 2009 is 87.5 percent occupied of which 53.8 percent of the building is leased to Advocate Medical Group and 14.2 percent is leased to DuPage Medical Group. The going-in yield is 5.7 percent and expected to stabilize in the 6 percent range.

The Plymouth City Center Medical Building in Plymouth, Minnesota, a suburb of Minneapolis, was sold to a joint venture between USAA Real Estate and HSA PrimeCare from BTO Development, which built the building in 2014. The multi-tenant asset is majority leased to Institute for Athletic Medicine, an affiliate of North Memorial Health Care and traded for a 6.3 percent cap rate.

Mid-Atlantic

The Atkins Companies, a New Jersey-based family enterprise that invests across a wide-range of asset classes, acquired The Vincent A. Nese Building in Pittsburgh, Pennsylvania. The two-story, class A medical office building is fully leased to Premier Medical Associates ("PMA"), the largest multi-specialty physician practice in Greater Pittsburgh and wholly owned by Highmark Health. The $13.3 million purchase of the 44,000 square foot property equated to $301 per square foot.

Bayrock Investment, a Charlotte, North Carolina based, historically retail focused investor, purchased a newly developed, single-tenant primary care facility in a suburb of Raleigh, North Carolina. The Keith Corporation, the seller, developed the asset in 2015 which is net-leased for 14 years to the Duke University Health System. The property sold above the original asking price of $5.67 million, which represented a 4.97 percent cap rate that will increase by 2.5 percent annually.

Northeast Region

Anchor Health Properties, based in Charlottesville, Virginia, purchased the Cross Street Medical Building in Norwalk, Connecticut from Marcus Partners in September. The $23 million purchase of the 71,401 square foot multi-tenant building equated to $322 per square foot and a 6.9 percent cap rate. Marcus Partners acquired the asset in March 2013 and was able to execute a successful value-add strategy, which involved renovations and re-tenanting, resulting in a $10 million premium to their purchase price.

The Davis Companies, which is under contract to sell three Midwest assets, continued their acquisition strategy of buying properties closer to their primary market by closing on a 137,000 square foot, multi-tenant medical office building in Cambridge, Massachusetts for $44.5 million. The three-story property was gut renovated in 2001 and is leased to Charles River Analytics and Mount Auburn Hospital. The unlevered acquisition yield is 5.2 percent in 2018.

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About Hammond Hanlon Camp LLC

HAMMOND HANLON CAMP LLC ("H2C") is an independent strategic advisory and investment banking firm with a singular focus on healthcare. Our commitment to exceed our clients' expectations begins with senior leadership on every engagement and continues with independent and objective strategic advice. Our belief in the markets and in the power of competition has resulted in loyal clients and long-term relationships.

The experienced professionals at H2C are well positioned to serve as your trusted advisors. We have the expertise to understand the unique complexities of the healthcare industry and an in-depth knowledge of the range of potential alternatives essential to designing and implementing highly successful business and financial strategies. We bring in-depth knowledge and experience across the full continuum of care and across a wide range of healthcare-related businesses.

H2C offers services in the following areas:

- Strategy design, development and execution
- Mergers, acquisitions and divestitures
- Capital planning and management
- Capital markets financial advisory and private placements
- Real estate advisory and execution services
- Bankruptcy and restructuring

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 $12.5 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.

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