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Medical properties hold up amid office weakness

Prices for health-care offices up 13% in Q3, vs. 3% drop in other office space; aging of boomers underpins positive outlook for sector.

By Beth Braverman
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Most office developers have pulled back this year as demand slackened amid corporate layoffs and banks cut off lending for any project with a hint of risk. But not all of them.

C.J. Follini, for one, has closed three deals in the past six months, and he is on the hunt for more. Mr. Follini, managing principal at Noyack Medical Partners, attributed his busy year to a conservative balance sheet and a "recession-proof" niche: medical office space and assisted-living facilities.

"The demand for health-care properties is very inelastic," he said. "And the sector keeps growing."

Though deals for medical office buildings declined 13% during the first three quarters of the year, they have fared much better than the overall office space sector, which plummeted 62% over the same period, according to real estate research firm Real Capital Analytics. As a result, medical office sales more than doubled as a percentage of all office sales year-to-date, to 6.5%.

"You can see some softness here and there in health care and senior housing, but I'd much rather be there than almost any other sector in the economy," George Chapman, chief executive officer of Health Care REIT, said during the company's third-quarter conference call Tuesday. "We're pretty comfortable right now."

Of course, that means there is at least a bit of uneasiness. Health Care REIT pulled out of a planned acquisition of Sunrise Senior Living last month as a result of the market seizures, and Mr. Chapman said the company plans to continue funding developments under construction, but to make fewer property acquisitions.

Health-care real estate investors are finding some upside in the current uncertain economy. Mr. Follini said he has seen increasing interest in sale-leaseback arrangements from hospitals that want to monetize their real estate assets amid the cash crunch.

“Hospital sale-leasebacks have always existed, but the market is accelerating rapidly right now given the credit markets,” he said.

The fundamentals of medical real estate—long-term leases, subsidized consumers and demand in every geographic region—offer the sector more protection from economic ups and downs than other types of commercial real estate. Experts say medical office buildings tend to have low turn-over because doctors risk losing patients if they move. Health-care providers also often invest heavily in office equipment and infrastructure, giving them an added incentive to stay in one place.

The average pricing for medical office properties is trending upward, rising 13% year over year in the third quarter, to \$233.91 per square foot, according to Real Capital Analytics. (Pricing for all office space fell 3% in the quarter, to \$267 per square foot.)

That has surely made medical properties a more attractive investment. Real estate development and investment management firm Bayshore Land Group has turned to medical office investment over the past two years as it watched demand for residential and other commercial properties disappear, said owner Jay Fertig. The company recently completed construction of a 50,000-square-foot medical office building in Port Charlotte, Fla., and has another 25,000-square-foot project in the works in Coral Gables, Fla. Both buildings are minutes away from hospitals, proving easy access for doctors who need to commute.

“We find medical is holding its prices a little bit better,” Mr. Fertig said. “Physician demand is continuing to grow.”

Medical practices are finding it easier than some other businesses to get loans to purchase office space in Bayshore's buildings, he added. “They just pledge their receivables to the bank.”

Capitalization rates for the medical office sector have fluctuated from a low of 6.8% in the second quarter of 2007 to 7.2% in the third quarter, according to Real Capital Analytics.

Health-care real estate investment trusts, which invest in medical offices, assisted-living facilities and other health-care-related real estate, have outperformed the broader REIT sector, although they have also posted losses. According to the FTSE NAREIT index, returns on health-care REITs have fallen 12.6% year to date, compared with a 33.1% year-to-date decline in returns for all equity REITs.

Driving the long-term outlook for the sector is the fact that baby boomers, who comprise about a quarter of the U.S. population, have begun to reach their 60s, and their increased medical needs will escalate demand for outpatient medical services, acute care and assisted living.

Experts say President-elect Obama will likely expand health insurance, which will give the market an additional boost by increasing demand for medical office space.

“There's no question investors view medical office buildings as a flight to safety in this type of environment,” said Dan Fasulo, managing director of Real Capital Analytics. “We saw similar trends [in the last real estate downturn] in 2002 and 2003. It's hard to fight the overwhelming demographics that are driving demand for that niche sector.” FW