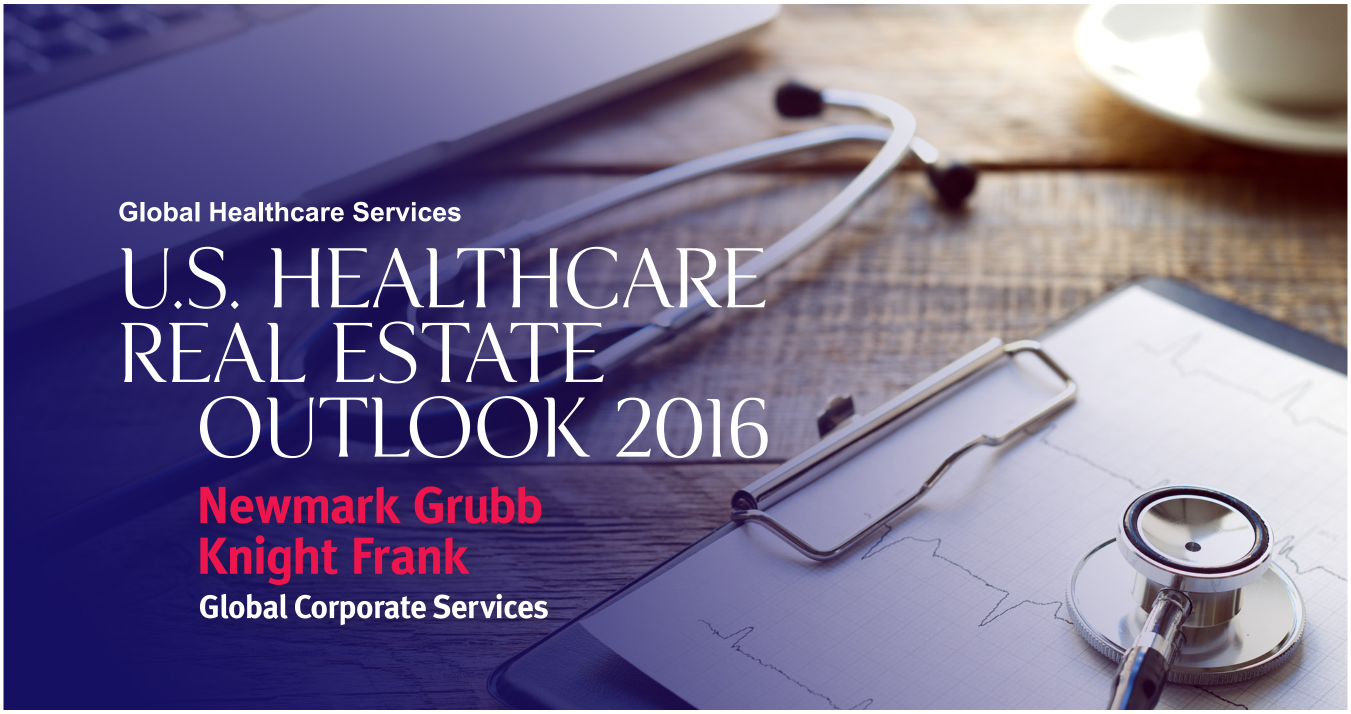


Global Healthcare Services

U.S. HEALTHCARE REAL ESTATE OUTLOOK 2016

Newmark Grubb Knight Frank

Global Corporate Services

Key Takeaways

- Four key trends are defining the evolution of the U.S. healthcare industry: an increasing patient load, increasing demand from tenants and occupiers, pressure to reduce costs and the growing impact of telemedicine.
- Leasing market conditions will tighten further in 2016, particularly if the downward blip of construction activity in the first quarter proves to be a sustained trend.
- Investor demand is expected to remain strong but perhaps below the record level set in 2015, as the market deals with heightened lender caution across all property types and greater scrutiny from bank regulators.

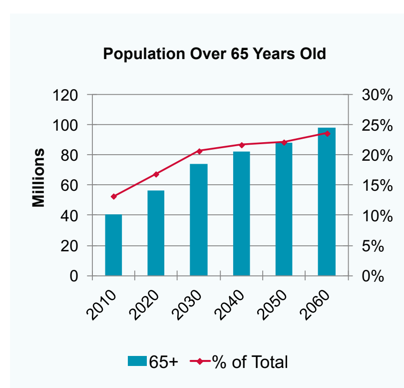
Industry Overview

The healthcare industry continues to evolve, as it responds to the twin mandates of serving a growing patient population while controlling the rapid increase in the price of the services it delivers. Four key trends are defining the industry's evolution:

Increasing Patient Load

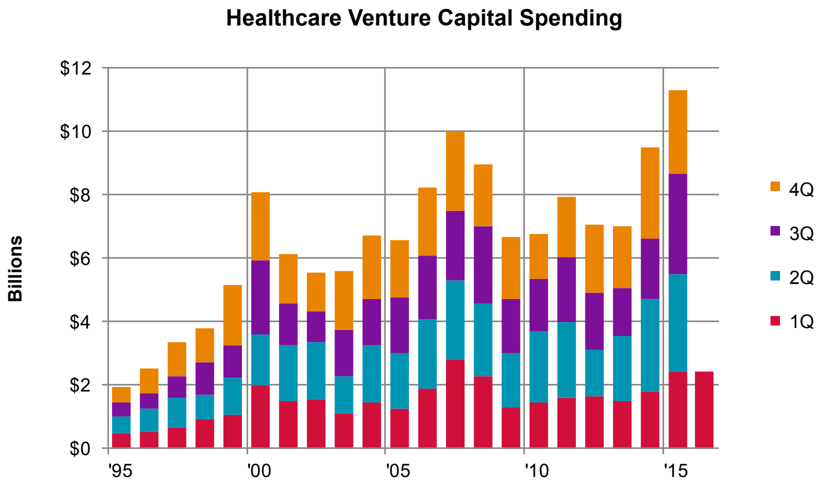
The U.S. Department of Health and Human Services recently announced that 20 million people have gained health insurance coverage through the Affordable Care Act (ACA) since the law was passed in 2010. The law has increased coverage by expanding Medicaid, introducing a Health Insurance Marketplace, permitting young adults to remain covered by their parents' health insurance plans and requiring plans to cover people with pre-existing health conditions. The newly insured include 6.1 million young adults aged 19 to 25, a demographic that was particularly likely to be uninsured before the law was passed. The Gallup-Healthways Well-Being Index reported that the rate of uninsured adults aged 18 to 64 was 11.9% at the end of 2015, down 5.2 percentage points since key provisions of the ACA took effect.

The aging population is another key driver of demand, given that doctor visits tend to increase with age. Seniors aged 65 to 74 averaged 5.3 annual doctor visits in 2013, while the 75-and-older age group averaged 6.7 visits, compared with the overall average of 3.0 visits. Seniors 65 years old and older comprised 13.1% of the population in 2010, but will account for 23.6% by 2060, with the absolute number more than doubling from 40.1 million to 98.2 million.



Source: U.S. Census Bureau, NGKF

Another factor contributing to the rise in doctor visits is the proliferation of new and better treatment protocols for a wide range of conditions. Once-fatal diseases

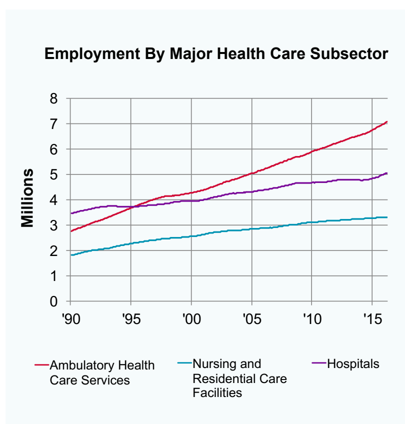


Source: PwC, NVCA: MoneyTree Report, NGKF

have become manageable, extending the lives of patients. This correlates with the increase in venture capital spending for biotech, medical devices and healthcare services, which reached $11.3 billion in 2015, eclipsing the previous record of $10.0 billion in 2007. First-quarter 2016 expenditures of $2.4 billion are slightly ahead of last year's first quarter, suggesting that 2016 could be on pace to set another record.

Increasing Need for Space

The growth in patient loads is generating a rapid increase in healthcare-related employment, which translates into increasing tenant and owner-user demand for healthcare real estate. Since 1990, healthcare employment, seasonally adjusted, has increased 92%, growing in 310 of the 314 months during this time span, which included three recessions. This was three times faster than the increase in both total nonfarm employment and the total U.S. population. Of the three major categories of healthcare employment tracked by the U.S. Bureau of Labor Statistics, ambulatory healthcare services grew the fastest, increasing by 157%, while employment in nursing home and residential care facilities grew by 84%, and employment in hospitals expanded by 46%. Ambulatory care also was the fastest growing segment over the past 12 months, adding 281,600 jobs for a gain of 4.1%, far outpacing the 1.9% increase in total payroll employment. Nursing home and residential care facilities gained 38,300 new jobs during this period, an increase of 1.2%, while hospital employment increased by 183,400, up 3.8%. The gain in hospital employment is likely overstated, because some in this group are located in outpatient facilities owned by hospitals, such as clinics and medical office buildings, but the BLS counts them as hospital employees if the outpatient facility uses the same billing code as the parent hospital.

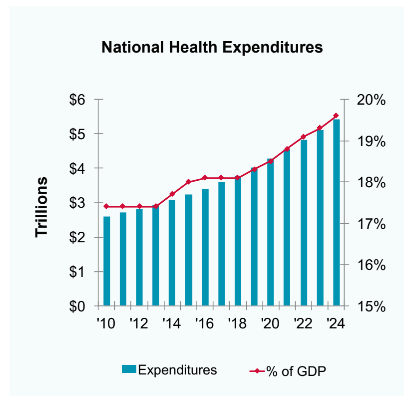


Source: U.S. Bureau of Labor Statistics, NGKF

The rapid growth of employment in the healthcare sector will continue. The BLS projects that the two fastest growing occupations from 2014 to 2024 will be healthcare/tech practitioners and healthcare support, together adding 2.3 million new jobs. These two sectors will account for nearly one in four of all jobs created over this 10-year span.

Pressure to Reduce Costs

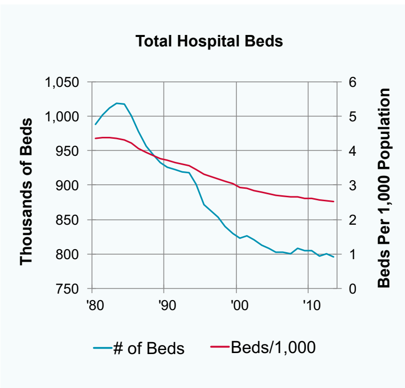
The rate of increase in healthcare expenditures has receded in recent years. After rising by 7.6% annually from 2000 to 2007, total expenditures rose by just 4.0% per year from 2007 to 2013, the last year in which the Centers for Medicare & Medicaid Services (CMS) tabulated historical data. The moderation in healthcare expenditures since 2007 could be related to the 2007-2009 recession, when millions of people lost their insurance along with their jobs, and also to efforts by insurers and healthcare providers to rein in costs. The CMS projects total healthcare expenditures will rise by 5.8% annually from 2013 to 2024—below the rapid increases before the recession, but above the subdued post-recession rate. The CMS forecasts that expenditures will rise from 17.4% of GDP in 2013 to 19.6% in 2024.



Source: Centers for Medicare & Medicaid Services, NGKF

To serve more patients at lower costs, healthcare providers are pursuing multiple strategies, including mergers and acquisitions to cut overhead and boost credit ratings, joint ventures with other providers, collaborating with insurers, health plan ownership, diversifying into related business lines and investments in information technology.

One of the strategies most relevant to the commercial real estate industry is that providers are shifting care from hospitals to more affordable outpatient facilities, including physician offices, emergency care clinics, diagnostic laboratories and surgical centers. These operations can be located in stand-alone facilities, medical office buildings (both on and off campus) and, increasingly, shopping centers and freestanding retail space, as providers seek to locate closer to where their patients live, in areas with greater visibility, convenient parking and more foot traffic. Some retailers, including Walgreens, CVS, Walmart and Target, have taken this a step further by opening clinics in their stores. As the delivery of services has migrated to outpatient facilities, the number of hospital beds in the U.S. has been declining on an absolute and per capita basis for the past 33 years, from 4.36 beds per 1,000 U.S. residents in 1980 to 2.52 beds in 2013, according to the most recent data available from the American Hospital Association.



Source: American Hospital Association, NGKF

Telemedicine

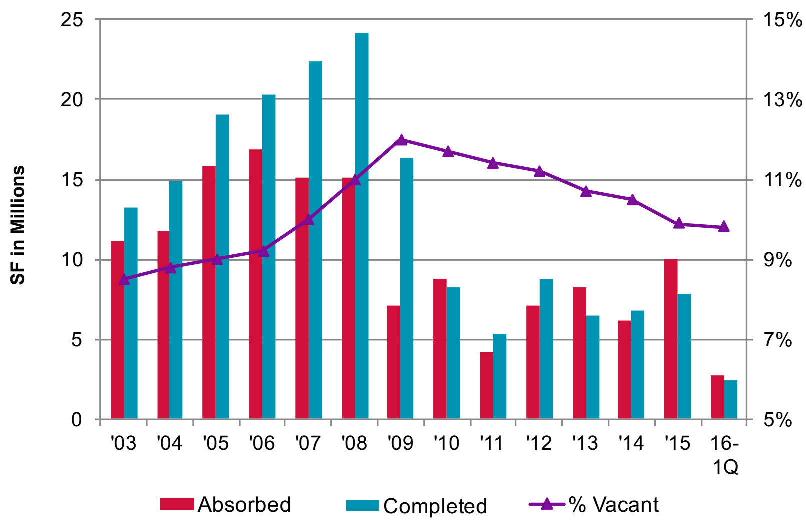
Telemedicine is a rapidly growing component of healthcare in the U.S. and globally. The American Telemedicine Association defines telemedicine as the remote delivery of healthcare services and clinical information using telecommunications technology. Over half of all U.S. hospitals now use some form of telemedicine, while consumers and physicians download health and wellness applications for use on their cell phones.

A recent study by Mordor Intelligence reports that the global market for telemedicine is expected to be worth more than $34 billion by the end of 2020. North America is the largest market, accounting for more than 40% of the global total.

Several forces are driving the growth of telemedicine: the aging population, the need to control costs, increasing use of remote monitoring, especially of patients with chronic diseases, the rapid rise in the software market and rapidly growing populations in developing countries.

While the growing use of telemedicine is unlikely to reduce demand for healthcare real estate, it is likely to bend the growth curve over the next few years and decades. Its adoption can be compared to the growth of online retailing, which has been around since the mid-1990s but has only recently begun to affect construction of new shopping centers to a noticeable degree. In a recent blog post, principals at research firm Revista noted that telemedicine "…will only be adapted so quickly, and there are only so many types of situations where it can be used. For example, you can reduce the number of doctors in a space because telecommunication allows them to video conference, but nurses are still necessary to carry out basic medical tests and procedures… It will be a while before we see telemedicine actively impact space needs across the board."

U.S. Medical Office Market Key Statistics*



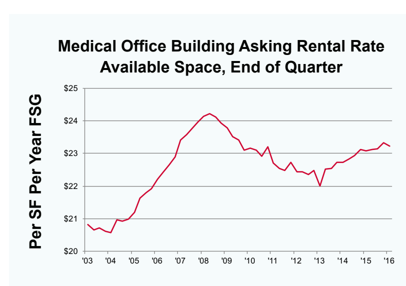
Source: CoStar, NGKF

Medical Office Leasing Market

The strength of the leasing market, as measured by absorption, construction, vacancy rates and rents, has not returned to pre-recession levels. This is likely because the rapid transformation of the industry, including the elevated number of mergers and acquisitions, is clouding the ability of providers to forecast their future space requirements.

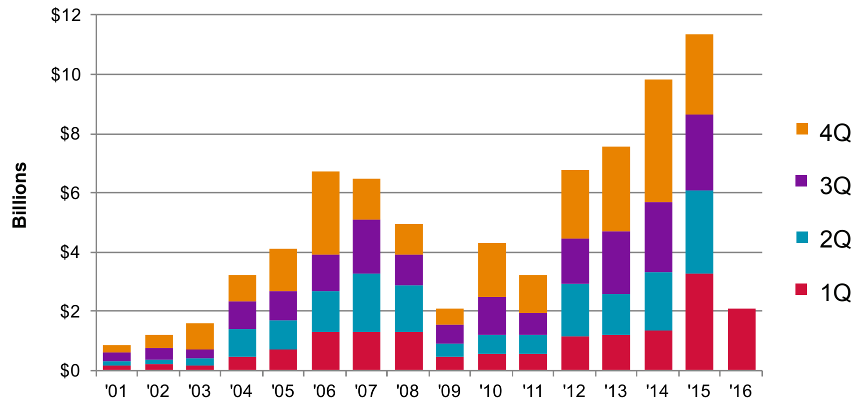
Vacancy: After peaking at 12.0% in fourth-quarter 2009, vacancy has retreated slowly, ending the first quarter of 2016 at 9.8%. This is the lowest level since the recession. Vacancy for space added in 2010 or later is higher at 14.7%, likely because rental rates are higher for newer space and because some newly delivered buildings remain in their initial lease-up phase.

Absorption: Tenants and owner-users absorbed 2.8 million square feet of medical office space in the first quarter of 2016, outpacing new space completions of 2.4 million square feet. This puts the market on pace to beat total 2015 absorption of 10.0 million square feet, which was the highest level of absorption since 2008. Annual absorption from 2009 through 2015 averaged 7.4 million square feet, or about half the average of 14.3 million square feet absorbed from 2003 through 2008. Newer buildings—those completed in 2010 and later—captured 57% of total absorption in the first quarter despite their higher rental rates. Post-2010 buildings have an average asking rent of $29.84/SF gross compared with the overall average of $23.22, but tenants often are willing to pay for a premium product, with state-of-the-art design standards and a location that serves fast-growing markets.



Source: CoStar, NGKF

Medical Office Sales Volume



Source: Real Capital Analytics, NGKF

Medical Office Investment Market

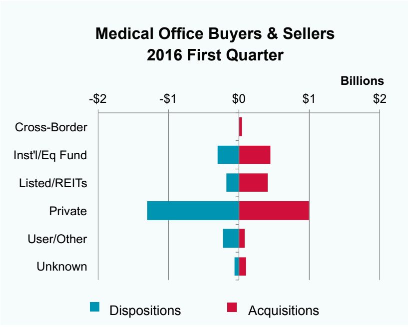
Investor demand for MOBs, in contrast with the moderate leasing market, has been very strong, with several metrics approaching pre-recession levels. Like other property types, investor demand has been driven by plentiful financing and the search for yield in a low-interest-rate environment. Yet investment activity for all property types, including MOBs, softened at the start of 2016, restrained by tighter lending conditions and the rapid run-up in prices since 2009.

Sales Volume: During the first quarter of 2016, medical office properties valued at almost $2.1 billion changed ownership, down 36% from the $3.3 billion exchanged during the year-ago period, when several entity-level and portfolio sales juiced the total. However, the first quarter of this year represents the strongest start to any year except 2015, suggesting that investors, while exercising more caution, remain interested in medical office buildings.

Pricing: Prices for medical office properties remain under upward pressure even as prices for some other commercial properties have flattened or softened since late last year. The average capitalization rate for medical office buildings sold in the U.S. in the first quarter of 2016 was 6.7%, down 10 basis points from the first quarter of 2015. Another pricing metric, the Moody's/REAL Commercial Property Price Index (CPPI)

Construction: After peaking at 27.4 million square feet just before the recession, the volume of medical office space under construction plummeted to a low of 6.0 million square feet in 2010. Construction gradually rose to 10.5 million square feet in the fall of 2015 but then sank back to 7.4 million square feet in the first quarter of this year, possibly because regulators are more closely scrutinizing construction lending for all property types to reduce the potential for overbuilding. The decline in construction, if it can be sustained, is a positive sign for existing properties, giving them some breathing room to boost occupancies.

Rental Rates: Asking rents have not yet returned to their pre-recession peak, ending the first quarter at $23.22/SF gross. This was an increase of 0.6% from a year ago and 5.5% from the recent nadir in the first quarter of 2013. Over the past year, rent gains were spread fairly evenly across all building age categories, ranging from 1.0% for properties built between 2000 and 2009, to 0.2% for properties built in the 1990s.



Source: Real Capital Analytics, NGKF

Medical Office Portfolio Sales Transactions of Note 2015/Early 2016

Portfolio/Property Name	Size	Location	Buyer	Seller	Sales Price (millions)
ARC Healthcare	115 property portfolio	Multiple markets	Ventas	ARC Healthcare Trust	$2,600.0
Catholic Health Initiatives US MOB Portfolio*	52 property portfolio	Multiple markets	Physicians Realty Trust	Catholic Health Initiatives	$724.9
G&L Office Portfolio	7 property portfolio	Southern California	Health Care REIT	G&L Realty	$449.0
Memorial Hermann Medical Office Portfolio	11 property portfolio	Houston	HCP Inc	Memorial Hermann Hospital System	$225.0
First Hill Medical Pavilion	228,000 SF	Seattle	Heitman JV NexCore Group	Trammell Crow JV Washington Capital Mgmt.	$192.3
833 Chestnut East	705,000 SF	Philadelphia	HCP Inc	Digital Realty Trust	$160.9
Integrated Medical AZ Office Portfolio	4 property portfolio	Phoenix	Physicians Realty Trust	Integrated Medical Services	$141.0
North Shore-LIJ	438,766 SF	New Hyde Park, NY	Long Island Jewish Health System	Ares Management	$137.0
Independence MOB Portfolio	5 property portfolio	Multiple markets	Griffin-American Healthcare REIT III	Kalmon Dolgin	$135.0
Baptist Health System Portfolio	4 property portfolio	Alabama	Tenet Healthcare Corp	Baptist Health System Inc	$132.5

* Pending

shows that repeat-sale prices of medical office properties rose by 3.0% in the first quarter and a robust 14.2% over the past four quarters. By comparison, the aggregate price index for all commercial properties slipped 0.8% in the first quarter but increased by 6.5% year-over-year.

Investor Profile: Private investors were the largest buyers and the largest sellers of medical office assets in the first quarter of 2016, accounting for 48% of acquisitions and 63% of dispositions by dollar volume. On a net basis, private investors were the largest sellers, with net dispositions totalling $314.4 million in the first quarter. The users/other category, which includes healthcare systems and other providers, also were net sellers, accounting for net dispositions totalling $142.0 million. This highlights two trends: The increased level of mergers and acquisitions in the healthcare industry is prompting the merged entities to right-size their occupancy footprint; and the desire by many providers to monetize their real estate assets, preferring to focus their capital on their core mission of service delivery. Publicly traded REITs were by far the largest net buyers of medical office assets in the first quarter, accounting for net acquisitions of $232.6 million, followed by institutions and equity funds at $143.7 million and cross border investors at $44.0 million.

Capital Markets: Publicly traded healthcare REITs have remained a leading capital raiser in the debt and equity markets. These REITs collectively raised $12.86 billion, a 27% year-over-year increase, ranking as the second-largest capital raiser by property sector in 2015. While public healthcare REITs have outpaced most property sectors, non-traded healthcare REITs have decelerated funding and face regulatory headwinds. In 2015, fundraising for non-traded REITs declined more than $5 billion from the previous year. While there are signs that the real estate cycle has matured, there remains a significant amount of capital and demand for quality healthcare assets.

Conclusions

The combination of low—and possibly declining—construction activity along with the continued growth of demand for services will result in further, gradual tightening of leasing market conditions in 2016. At the same time, investor demand should remain strong, but likely not as strong as the peak year of 2015, as debt and equity markets take a breather following the rapid, post-recession run-up in prices across all property types. Over the long term, the industry will continue to grow and evolve, creating increased occupier and investor demand for space even as it seeks to cut costs.

** The survey includes multi- or single-tenant office buildings with at least 5,000 square feet, where more than 50% of the demised space is suitable for medical uses. Office space in hospitals and specialty medical facilities is excluded. The survey includes the following markets: Atlanta; Austin; Baltimore; Boston; Charlotte; Chicago; Cincinnati/Dayton; Cleveland; Columbus; Dallas/Ft Worth; Denver; Detroit; East Bay/Oakland; Houston; Indianapolis; Inland Empire (California); Jacksonville (Florida); Kansas City; Long Island (New York); Los Angeles; Memphis; Nashville; New York City; Northern New Jersey; Orange County (California); Orlando; Philadelphia; Phoenix; Pittsburgh; Portland; Raleigh/Durham; Sacramento; San Diego; San Francisco; Seattle/Puget Sound; South Bay/San Jose; South Florida; St. Louis; Tampa/St Petersburg; Washington, DC; Westchester/So Connecticut.*

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