Introduction

Change is the only constant, especially in today’s healthcare industry. Declining reimbursements and a heavy regulatory environment are squeezing operating margins, pushing hospitals and other providers to deliver more cost-effective care. This is occurring against a backdrop of perpetually rising costs. Although increases have abated recently, healthcare expenditures, which accounted for 17.9% of U.S. gross domestic product in 2011, are projected to hit 19.6% of GDP by 2021. The 65-plus segment of the population will expand by 39% in the current decade and another 30% in the 2020s as baby boomers, the 76 million Americans born between 1946 and 1964, move into retirement. Typically half of a person’s lifetime medical requirements will occur after age 65. Longer life expectancy, advancements in medical technology and the implementation of the Affordable Care Act, providing health insurance to 32 million uninsured Americans, will add to the velocity of change. All of these trends will impact the footprint of healthcare providers and their real estate requirements. This report includes an update on the leasing and capital markets for medical office buildings (MOBs) and the results of a biannual survey on the industry conducted by Newmark Grubb Knight Frank (NGKF).

Key findings:

- The leasing market recovery in the medical office sector has been sluggish, weighed down by uncertainty over the economy and the Affordable Care Act. The recovery has yet to impact rental rates, which remain compelling for occupiers.
- The recovery in this sector also has been uneven as quality, on-campus MOBs and MOBs affiliated with major hospital systems have outperformed unaffiliated, multi-tenant properties located off-campus. Rental rates for the former are expected to increase at the rate of 2-3% per annum, their historical “cruising speed” in a normal economy.
- Investor demand has been the strongest on record, fueled by the low cost of capital and the recession-resistant reputation of the healthcare industry and related property sector.
- Despite the need for capital to modernize operations, hospital systems have been slow to embrace the concept of selling and leasing back their properties. This could change as the Affordable Care Act is implemented, putting additional pressure on operating margins.

Medical Office Leasing Market

The leasing market for MOBs continued to tighten in the second quarter of 2013 as the vacancy rate dropped another 10 basis points to 11.0%. The rate of recovery has been sluggish due to uncertainty over the economy and healthcare reform. Absorption is running less than half the pace of the past recovery cycle from 2003 to 2008 when it averaged 12.8 million square feet per annum. The average...
from 2009 to 2012 has been 5.7 million square feet, and the 2.2 million square feet absorbed in the first half of 2013 continues the trend of subdued expansion. Rental rates are compelling with the national average asking rent at mid-year falling to a post-recession low of $21.70/sf per year gross, down by 2.9% from a year ago and by 10.4% from the recent peak. Construction and completions remain light, well in line with the lower levels of absorption, which has allowed the vacancy rate to recover slowly.

The aggregate numbers do not tell the whole story, however. As with other property categories, some types of MOBs have been outperforming, specifically quality properties that are hospital-affiliated, located on or adjacent to a hospital campus where sites for future development are scarce. Older, non-affiliated, multi-tenant buildings away from hospital campuses are saddled with high vacancies and in some cases are losing tenants to newer on-campus properties.

The respondents to NGKF’s healthcare survey discussed later in this report expect MOB rental rates to increase in the range of 2-3% over the next 12 months; they most likely are referring to newer space on the radar screen of expanding healthcare systems, not second-generation, off-campus space.

NGKF parsed the latest data by the age and size of buildings to identify trends in demand and supply.

- Net absorption is most clearly related to the age of the building. Since 2010, properties delivered in the current decade have absorbed 14.5 million of the 16.9 million square feet absorbed by all MOBs. The absorption totals decline by decade with buildings delivered in the 2000s absorbing 8.7 million square feet and buildings delivered in the 1990s, 1980s and pre-1980 suffering negative absorption.

- The absorption trend holds true in the first half of 2013, but the recovering economy has lifted all boats. Buildings delivered since 2010 still outperformed, absorbing 1.5 million out of the 2.5 million-square-foot total, but older buildings also absorbed space with the

<table>
<thead>
<tr>
<th>Medical Office Leasing Market Stats First Half 2013</th>
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<tbody>
<tr>
<td><strong>Total Inventory (SF)</strong></td>
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<td>2Q13</td>
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<tr>
<td><strong>Asking Rent (Price/SF)</strong></td>
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<tr>
<td><strong>Vacancy Rate (%)</strong></td>
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<td><strong>Under Construction (SF)</strong></td>
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<td>2Q13</td>
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<tr>
<td><strong>Net Absorption (SF)</strong></td>
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<td><strong>Deliveries (SF)</strong></td>
</tr>
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</table>

Source: CoStar, Newmark Grubb Knight Frank
exception of pre-1980 buildings, in which occupancy dipped slightly.

- Despite their success at attracting tenants, post-2010 vintage buildings still have the highest average vacancy rate at 17.8% compared with the U.S. average of 11.0%, meaning that the newest buildings are still in their initial lease-up phase and are likely pulling tenants from older properties.

- Post-2010 buildings have the highest average asking rental rate at $27.58/sf gross compared with the overall average of $21.70/sf, suggesting that tenants are willing to pay for the space that best meets their needs and in fact view it as a tool for patient attraction and efficient delivery of services.

- While there are clear distinctions in the level of performance among new and old MOBs, the distinctions are less visible among building size ranges. Large (100,000-square-foot-plus) buildings have a slight edge in terms of lower vacancy rates and higher asking rents. But even the smallest buildings are absorbing their fair share of space and are well represented in the construction pipeline. Of the 132 MOBs under construction at mid-year 2013, 57 are between 5,000 and 20,000 square feet, although these represent less than 10% of the total space under way.

**Medical Office Capital Markets**

The dollar volume of MOB sales hit an all-time high of nearly $6.6 billion in 2012, eclipsing the peak bubble year of 2007. By comparison, the sales volume of all commercial property last year remained 48% below the 2007 peak, a sign of the popularity of healthcare real estate among investors. The current year is off to a strong start with a 28% increase in MOB sales volume through April compared with the same period in 2012.

Capitalization rates for MOBs since 2001 have closely followed the trajectory of suburban office cap rates, arguably their closest cousin among other types of commercial property. But the price per square foot has diverged with MOBs generally outperforming suburban office assets in recent years, which implies that MOBs are throwing off more net operating income than their suburban office relatives, resulting in higher pricing at the same cap rate.

Private buyers, boosted by demand from non-traded REITs, have been the biggest buyers and the biggest sellers of MOBs followed by publicly traded REITs. Both types of REITs like MOBs for their stable income streams and their popularity among investors. Demand for healthcare real estate – fueled by the aging population, advances in medical technology, and 32 million people about to become insured through the Affordable Care Act – makes for a compelling story. On a net basis, public REITs far outdistance the other investor groups with net acquisitions in excess of $1.1 billion in 2012 and the first quarter of 2013 thanks to the rapid inflows of capital from investors.
Outlook

All types of commercial real estate are experiencing major changes in their demand drivers, but healthcare real estate arguably is undergoing the biggest transformation. The rollout of the Affordable Care Act, modernization of service delivery, sweeping demographic shifts and looming fiscal obligations by the government have the potential to influence tenant and user demand for space, perhaps drastically so. On the capital markets side, the recent run-up in interest rates, if sustained, will affect mortgage rates, internal rates of return and pricing calculations for all types of commercial real estate. The backlog of empty space in older, Class B and Class C MOBs is akin to the empty malls and strip centers that plague the retail market, and the potential use of these older facilities is a question mark.

In the short term, expect the leasing market to continue to improve slowly. It could be a while before demand trickles down to older, off-campus healthcare real estate. Investor demand for MOBs and other healthcare facilities will remain strong even in the face of rising interest rates, which imply a stronger economy and therefore stronger operating incomes for all types of commercial real estate.

In the long term, demand for space can only strengthen with the addition of 32 million people to insurance rolls and the rapid growth in the 65-plus age group, which as a whole makes more frequent doctor visits than their younger cohorts.
In the medical office market overall, where do you see investment supply or monetization volume for MOBs in 2013 compared to 2012?

- Asked whether the supply of MOBs offered for sale will be higher, lower or the same in 2013 compared with 2012, 44% of advisors and brokers and 44% of REITs said they expect supply to be the same, the most popular response. However, 57% of investors and developers who responded expect the supply of properties on the market to rise this year. This makes sense in two regards. First, developers with access to capital, which is plentiful, can create their own supply. Second, investors are moving out on the risk curve in search of yield, looking at core-plus and value-add properties and secondary markets. Investors who are willing to broaden their acquisition parameters will, by definition, have a wider range of potential target properties in their field of vision.

During the next 12 months, select the top three asset types that you or your clients are targeting for acquisitions:

- Different types of investors are targeting different property types within the health care space. Sixty percent of REITs say they will target on-campus MOBs, while only 30% of other investors and advisors will pursue this asset subtype. REITs also dominate the senior housing category, targeted by 10% of responding REITs compared with 3% of other investors and advisors. Conversely, investors and advisors are more likely than REITs to target off-campus MOBs and specialized assets.
In the medical office market overall, where do you see investment demand for MOBs in 2013 compared to 2012?

- Fifty-three percent of respondents expect investor demand to increase for MOBs in 2013 while 38% expect demand to be stable. Less than 10% say it will decline.
During the next 12 months, where do you project your anticipated acquisition volume?

![Graph showing acquisition volume by REITs and Developers]

- REITs responding to the survey are targeting a broad range of acquisition volumes in 2013. At the low end, 30% expect to invest less than $50 million. Another 30% are looking to place more than $500 million. Developers, by contrast, are focusing on the lower end of the range with 46% expecting to acquire less than $50 million and another 31% expecting to acquire $50-$100 million. Only 23% of developers are looking to place more than $100 million of capital in 2013. Overall, the results point to a strong acquisition pipeline.

Which regions are preferred for new acquisitions or development?

- Healthcare property investors responding to the survey favor the Southeast, selected by 32%, and the Midwest, selected by 23%, over other regions of the U.S. This contrasts with other property categories, where investors are enamored with supply-constrained coastal markets in the Northeast and West. The results, though influenced by the small sample size, do illustrate that healthcare property investors evaluate opportunities differently than other investors, placing less weight on the region and more weight on property-specific features such as hospital affiliation and on-campus location.

What types of financing sources are you or your clients utilizing?

![Graph showing financing sources]

- Asked the type of financing they are using, respondents say they are most likely to utilize either bank debt or no financing (all cash). Advisors and brokers are almost equally likely to use bank debt (73% of respondents) or pay cash (71%) while investors/developers are more likely to use bank debt (66%) compared with an all-cash transaction (40%). Less popular options include bond financing, credit tenant lease financing, insurance companies and lines of credit. The results reflect the wide range of lenders looking for opportunities to place capital.

For a single MOB, what is your preferred medical office transaction size?

![Circle chart showing transaction size preferences]

- In terms of project size, the sweet spot for MOB investors is $10-$20 million, selected by 38% of respondents. Fully 84% of respondents prefer a transaction size below $30 million, while just 16% are targeting transactions above $30 million.
If a hospital or healthcare system were to sell any of its real estate assets, what do you perceive to be the top three reasons?

- REITs, developers, advisors and brokers were asked to rank the top three reasons why a hospital system would consider selling any of its real estate assets. (Note that the hospital systems themselves are presented with the same question later in the survey.) The most popular reason, selected by 26% of respondents, is to create liquidity and improve balance sheets. The second most popular reason, cited by 18%, is to fund growth strategies and protect market share, and 15% say healthy real estate valuations and low cap rates would be a good reason to sell. The evenness of the responses across all the possible answers suggests there are many reasons that healthcare systems might want to sell their real estate assets. But will they? A question later in the survey seeks to provide an answer.

What is the average hold time frame for your or your clients’ medical office investments?

- Asked to indicate the average hold time for their properties, 59% of advisors and brokers and 49% of investors/developers said over seven years. They are bulking up for the long haul. The least cited response was under three years, suggesting that the current market, while strong, has not overheated to the point where buyers expect rapid price appreciation enabling them to flip properties.
For new development, what is the minimum pre-leasing threshold for an on- and off-campus MOB that is required by your typical client or their lender or joint-venture partner?

- A plurality of respondents said that lenders require minimum pre-leasing of 70-80% for new medical office construction. The results indicate that lenders typically have more relaxed pre-leasing thresholds for on-campus versus off-campus development projects.

What is the overall occupancy level of your or your clients’ on-campus MOB portfolio?

- All of the REITs said their on-campus MOBs were above 90% occupied. Seventy-three percent of private investors and advisors cited occupancy levels above 90% while 20% said occupancy levels were between 80-90%.

What is the overall occupancy level of your or your clients’ off-campus MOB portfolio?

- Mirroring the previous question, respondents were asked about the occupancy levels in their off-campus MOBs. The results indicate lower levels of occupancy for the off-campus properties with only 50% of REITs and 61% of private investors and buyers saying their off-campus facilities are more than 90% occupied. Taken together, the results of the two questions about occupancy levels in on-campus and off-campus MOBs indicate that tenants are gravitating to on-campus locations, perhaps due to convenience and perceived value.
In your existing portfolio, which types of users are experiencing an increase in demand for medical office space?

- Respondents indicate that all types of users are expanding and in need of more space, a sign of the breadth of tenant demand. The most oft-cited responses were urgent care providers (17%) and orthopaedic (12%).

Where is the occupancy of your or your clients’ medical office portfolio compared to a year ago?

- Fifty-nine percent of advisors and brokers and 54% of investors and developers report rising occupancies in their portfolios over the past year, while REITs were most likely to report stable occupancies, chosen by 57% of respondents. Given the preference of REITs for premier, on-campus assets, the results suggest that occupancies in REIT portfolios could have been high a year ago and remained stable over the ensuing year.

Where do you perceive capitalization rates for the following off-campus MOB scenarios?

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<th>5.0 - 5.5%</th>
<th>5.5 - 6.0%</th>
<th>6.0 - 6.5%</th>
<th>6.5 - 7.0%</th>
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<td>Single Tenant, Health</td>
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<td>System:</td>
<td>2%</td>
<td>10%</td>
<td>22%</td>
<td>33%</td>
<td>24%</td>
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<td>Single Tenant, Health</td>
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<td>System:</td>
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<td>27%</td>
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<td>Multi Tenant Physician:</td>
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<td>Secondary Market,</td>
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<td>Multi Tenant Physician:</td>
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<td>25%</td>
<td>4%</td>
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</table>

- Cap rates are lowest for properties with single-tenant occupancy by a health system in a primary market, with a third of respondents saying they are in the range of 6.5-7% (the most popular answer). Cap rates rise slightly for the other three tenancy/location combinations: a single-tenant health system in a secondary market, a multi-tenant physician-occupied property in a primary market, and a multi-tenant physician-occupied property in a secondary market.
Which types of MOBs are preferred by your clients?

This question asked respondents to parse the investment value of tenancy (single-versus multi-tenant), location (on campus versus off campus) and hospital affiliation for a MOB. The respondents place more value on an on-campus location whether the MOB is multi-tenant (chosen by 45%) or single-tenant (37%). Investors are less excited by off-campus properties, but they are more attracted to off-campus MOBs with multiple tenants over single-tenant properties, and they prefer a hospital affiliation over no affiliation.

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<tr>
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<th>(1) HIGHEST IMPACT</th>
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<th>5</th>
<th>(6) LOWEST IMPACT</th>
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<tr>
<td>On-Campus Single-Tenant MOBs</td>
<td>37%</td>
<td>26%</td>
<td>5%</td>
<td>12%</td>
<td>7%</td>
<td>14%</td>
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<td>On-Campus Multi-Tenant MOBs</td>
<td>45%</td>
<td>32%</td>
<td>5%</td>
<td>11%</td>
<td>7%</td>
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<td>Off-Campus Multi-Tenant MOBs - Hospital Affiliated</td>
<td>12%</td>
<td>35%</td>
<td>35%</td>
<td>14%</td>
<td>2%</td>
<td>2%</td>
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<tr>
<td>Off-Campus Multi-Tenant MOBs - Non Affiliated</td>
<td>12%</td>
<td>2%</td>
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<td>Off-Campus Single-Tenant MOBs - Hospital Affiliated</td>
<td>5%</td>
<td>23%</td>
<td>32%</td>
<td>18%</td>
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<td>Off-Campus Single-Tenant MOBs - Non Affiliated</td>
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<td>13%</td>
<td>20%</td>
<td>20%</td>
<td>42%</td>
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In the future, when you look back on 2012 to assess the healthcare real estate investment market, how do you think you will rank the factors below from the highest impact (1) to the lowest impact (7)?

- Asked to rank factors that characterized the MOB investment market last year, investors thought the most important was increased buyer competition. The three other factors were only slightly less impactful: lack of available product to buy, healthcare system mergers and acquisitions, and yield compression.

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<th>(7) LOWEST IMPACT</th>
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<tr>
<td>Lack of available product to buy</td>
<td>21%</td>
<td>28%</td>
<td>22%</td>
<td>12%</td>
<td>7%</td>
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<td>4%</td>
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<tr>
<td>Increased buyer competition</td>
<td>33%</td>
<td>31%</td>
<td>23%</td>
<td>7%</td>
<td>2%</td>
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<td>Healthcare system mergers and acquisitions</td>
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<td>30%</td>
<td>29%</td>
<td>17%</td>
<td>7%</td>
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<tr>
<td>Compressing development yields</td>
<td>11%</td>
<td>28%</td>
<td>25%</td>
<td>15%</td>
<td>14%</td>
<td>5%</td>
<td>2%</td>
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What measures are you employing to grow market share?

- Hospital system respondents were asked to rate the importance of four strategies to grow their organizations’ market shares. The most frequently mentioned strategy is renovating existing facilities and developing new medical buildings, cited by 37%, followed by physician recruitment with 25%. A quarter of respondents say they are trying to maintain market share, i.e., they are not looking to increase it, while 13% say their organizations are looking to acquire other systems or hospitals.
How will the following healthcare issues impact your organization in the next three years?

<table>
<thead>
<tr>
<th>Issue</th>
<th>STRONGLY POSITIVE</th>
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<tr>
<td>EMR adoption</td>
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<td>63%</td>
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<td>Patient experience, patient-centric care</td>
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<td>Quality improvement initiatives</td>
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<td>Increase in insured patients</td>
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<td>25%</td>
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<td>38%</td>
<td>38%</td>
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<tr>
<td>Episode of care / bundled payments</td>
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<td>13%</td>
<td>25%</td>
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<td>Physician supply, primary care</td>
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<td>25%</td>
<td>38%</td>
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<td>0%</td>
<td>63%</td>
<td>25%</td>
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<td>Mergers and acquisitions</td>
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<td>50%</td>
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<td>25%</td>
<td>50%</td>
<td>25%</td>
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<td>63%</td>
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<td>25%</td>
<td>13%</td>
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<td>38%</td>
<td>50%</td>
<td>13%</td>
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<td>Nurse supply</td>
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<td>75%</td>
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</tbody>
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- The last four questions were directed specifically at health systems and hospital administrators. Asked to pick from a list of 16 issues impacting the healthcare system over the next three years, respondents indicated that eight would have a net positive impact, six would have a net negative impact and two would have a neutral impact. Issues having a net positive impact in the judgment of the respondents include the adoption of electronic medical records; greater focus on the patient experience and patient-centric care; quality improvement initiatives; the coming increase in insured patients; accountable care organizations; meaningful use criteria; the supply of primary care physicians; and the wave of mergers and acquisitions. Issues with a net negative impact on the respondents’ organizations include episode of care/bundled payments; reimbursement rates for Medicare and Medicaid; reimbursement rates for private payers; the increased use of ICD-10 codes; recovery audit contractors (RACs); and uncompensated care. Interestingly, all six of the issues with a net negative impact relate to compensation and regulatory burdens. The supply of specialty care physicians and nurses were viewed as neutral in their impact.

Generally speaking, is your hospital seeking to own more MOBs or less?

- An overwhelming 87% of hospital system respondents say their hospital system would like to own more MOBs, not fewer. That may change as hospital systems grapple with the cost pressures coming from the Affordable Care Act, the aging of the population and advancements in treatment protocols.

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1This is based on a diffusion index measuring the proportion of responses that contribute positively to the index. Specifically, it is the number of respondents who say the issue will have a positive or strongly positive impact plus one-half the number of respondents who say the impact will be neutral. Index values greater than 50 mean that respondents think the overall impact will be positive.
If the hospital were to sell any of its MOBs, what would be the driving reason?

- The final question in the survey mirrors an earlier question, asked of REITs, developers, advisors and brokers, exploring why healthcare systems would want to sell their facilities. Here is the same question posed to the healthcare systems themselves. Forty percent of healthcare system respondents say the primary reason they would sell properties would be to create liquidity and improve balance sheets, 30% would use the proceeds to fund growth strategies, 20% would modernize facilities and 10% would undertake new real estate development.

The top two reasons for selling office buildings were the same for the hospital system respondents and the other respondents (REITs, developers, advisors and brokers): liquidity and funding growth strategies. The latter group cited a broader range of reasons for selling properties whereas the hospital systems were more focused on the advantages of liquidity and growth. Whether more hospital systems pursue this strategy remains to be seen.

No respondents (0%) indicated that the need for electronic medical records or upgrading equipment was driving MOB sales.
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