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Is medical real estate immune to COVID?

Despite the pandemic, buildings that cater to health practitioners are still hot properties.

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MedProperties Group

MedProperties Group is forging ahead with the development of a seven-story medical office building next to Oakbrook Center mall on speculation, or without any tenants signed.

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COVID-19 continues to ail investors in most types of commercial real estate. But many of those that own health care properties are feeling good.

While the pandemic jacks up vacancy, hampers property values and raises critical questions about the future of the retail and hospitality and traditional office sectors, medical office buildings have been largely free of those economic symptoms.

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Properties are trading at prices similar to or higher than those paid before the crisis began, rent collections have barely felt a pinch and new sources of capital are looking for a way in. Even the specter of more patients receiving medical care virtually and eroding some of the need for in-person treatment hasn't scared off real estate investors, which are betting heavily that the coronavirus will instead accelerate the trends that have made medical offices more popular in recent years.

It's a signal that health care real estate, fueled by a global health crisis, is poised to grow from a niche, defensive wager for investors spooked by a downturn into a trendy pick. And the Chicago area could be a big target market with several large health systems moving quickly to expand their outpatient footprints.

"This pandemic has only increased the need for the type of facilities we acquire and operate," says Peter Westmeyer, CEO of Chicago-based Remedy Medical Properties, whose firm has more than 20 million square feet of properties in its portfolio.

Buildings that house medical practices started drawing far more investors over the past decade for several reasons. One is demographic: By 2030, there will be 30 million more people age 65 and over nationwide than there were in 2012, according to an estimate from the U.S. Census Bureau, driving unprecedented demand for health care. Major health systems, meanwhile, have been pushing more services into outpatient facilities thanks to advances in technology and new payment models, boosting the market for buildings with the infrastructure to handle clinical testing and lab work.

Hospital systems have also been consolidating and acquiring more independent physician groups, making massive health systems—which typically come with a high level of credit—the anchor tenants of office buildings instead of small private practices. Seventy-one percent of all medical office building projects that broke ground last year were affiliated with hospitals, up from an average of around 60 percent during the previous few years, according to health care real estate research firm Revista.

Locally, growing chains including Amita Health and NorthShore University HealthSystem, as well as academic hospitals like Rush University Medical Center, have invested heavily in outpatient care both on and off their campuses.

All of that helps explain why sales of medical office buildings more than doubled between 2012 and 2017 to $14.7 billion, and why annual volume has remained above $13 billion since then, according to a July report from brokerage Jones Lang LaSalle. And more money is pouring in: In 2019, dedicated medical office building real estate funds raised nearly $7.4 billion in capital, 47 percent more than they did the year before, according to financial data tracking company Preqin.

DEAL VOLUME FALLS

The coronavirus threatened to derail that momentum, with deal volume falling during the second quarter to its lowest mark for that period since 2014, according to data from real estate investment banking firm Hammond Hanlon Camp. Telemedicine became the norm for patients during those months, raising questions about how much in-person care it would replace permanently. A May report from consulting firm McKinsey projected that $250 billion—or 20 percent—of all spending on health care in the United States could be done virtually in the wake of the pandemic.

But it hasn't taken long for real estate investors to get over those concerns. While property values for offices nationwide were down slightly year over year nationwide in July and

August, medical office building property values were up by 1 percent, according to data from research firm Real Capital Analytics.

Matt Campbell, founder of Chicago-based health care real estate developer MedProperties Group, says the emergence of mainstream virtual care "is probably the first real competitive element that's come into our world in the last 20 years," but it's unclear whether it will substantially slow the powerful forces driving demand.

"We're as surprised as anybody at how strong the demand is, pushing all the way through the pandemic. It's been shocking," says Campbell, whose company recently broke ground in Buffalo Grove on an outpatient facility leased to Northwest Community Healthcare and is planning another medical office building in downtown Park Ridge.

Campbell is so bullish about demand continuing to soar that MedProperties is now seeking permits to build a seven-story, 78,000-square-foot medical office building next to Oakbrook Center mall on speculation, or without any tenants signed. The firm landed an equity partner to fund the project, which will be part of a larger $500 million redevelopment of the former McDonald's Plaza office property.

"It comes down to what is the lowest-cost way to provide care," he says, and "hospitals are going to continue to push more of the simpler, straightforward care they're providing to medical (office) campuses."

HEADWINDS REMAIN

There are still headwinds facing health care property landlords beyond the rise of telemedicine. While hospital systems consolidating and snapping up private practices helps, it also leads to redundancy of outpatient locations in a given community, meaning some leases won't be renewed. Major retail pharmacies such as CVS and Walgreens Boots Alliance are also adding more clinical space to serve their communities, posing more competition for certain services.

Plus, not all health system tenants are winning bets. Some are being stretched to the financial brink by low reimbursement rates from insurers, one reason cited by both Westlake Hospital in Melrose Park and MetroSouth Medical Center in Blue Island when shuttering last fall. The American Hospital Association estimated in a recent report that hospitals nationwide suffered "catastrophic financial challenges" between the beginning of March and the end of June, collectively missing out on $50 billion in revenue per month.

But that distress could also help medical office landlords as hospitals—which own more than half of all medical office buildings nationwide, according to Revista—turn to selling and leasing back real estate to fortify their balance sheets.

In one recent deal, Chicago-based sale-leaseback specialist Oak Street Real Estate Capital, which is best known for buying retail and industrial properties that are rented back to the sellers, paid $204 million for a 23-building portfolio of medical offices leased back to West Reading, Pa.-based hospital system Tower Health.

Many hospital systems have sold outpatient buildings in recent years to generate cash, says Oak Street co-founder Marc Zahr, but during the COVID-19 crisis, "the ones that had historically had a stronger view about not doing so have started to explore it."

Inline Play

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