

Healthcare systems continue to expand into the suburbs as population grows

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Healthcare Trends Commentary by Beth H. Young

At least two facts come together to make a very healthy medical real estate market: (1) Houston leads the nation in population growth, and (2) the Accountable Care Act requires health care providers to improve care while reducing expenses. The Greater Houston Partnership says healthcare payroll employment grew between June 2015 and June 2016 by 25,000 people. With Houston being home to the world's largest medical center - Texas Medical Center - taking advantage of the economies of scale leads to a strategy for many local health systems to proceed with mergers, acquisitions and expansions.

In spite of low oil prices and related layoffs, Houston's healthcare real estate market continues to expand as it responds to the city's irrepressible growth. Although Houston's office sublease space has increased to over eleven million square feet (as of early August 2016), medical office space being offered for sublease is only about one (1%) percent of that category. Hoping to have an advantage over office buildings with lots of sublease space, some office buildings that were previously considered strictly office properties have started advertising their available space as medical-office buildings (MOB's), particularly if it is located near a hospital or medical campus. Demonstrating why landlords may want to call their property "medical," in the first quarter of 2016, over 116,000 square feet of medical office space was absorbed - and because of the need for that kind of space, over two million square feet of medical office space is currently under construction in Houston.

Although MOB vacancy rates have increased from 11.8 to 12.4 percent in the last year, one must take into consideration new medical office facilities in the market, soon-to-be occupied. A perfect example is the newly opened Spring Valley Medical Plaza, a 68,000 square foot MOB and surgery center along I-10/Katy Freeway near the Memorial Hermann campus. Four of the five floors are leased at opening. The landlord quotes lease rates at \$31.00/NNN per rentable square foot (RSF) per year. Having clinic space plus the ability to provide outpatient procedures that were previously only available in an inpatient setting provides lower cost for patients at a much more convenient location.

Market Indicators <small>Relative to prior period</small>	Annual Change	Semi-Annual Change	Semi-Annual Forecast*
VACANCY	↑	↑	↓
NET ABSORPTION	↓	↓	↑
NEW CONSTRUCTION	↓	↓	—
UNDER CONSTRUCTION	↓	↓	↓

*Projected

Summary Statistics <small>Houston Medical Office Market</small>	Q2 2015	Q4 2015	Q2 2016
Vacancy Rate	11.8%	11.7%	12.4%
Net Absorption <small>(Thousand Square Feet)</small>	313.9	629.6	116.7
New Construction <small>(Thousand Square Feet)</small>	335.1	821.8	276.2
Under Construction <small>(Thousand Square Feet)</small>	2,762.4	2,760.0	2,070.8

Asking Rents Per Square Foot Per Year

Average	\$25.11	\$25.42	\$25.02
Class A	\$27.64	\$28.11	\$28.23
Class B	\$24.78	\$25.16	\$24.68

Healthcare Trends - continued

Some MOB's may become less important as a place to treat illnesses and become more relevant as a place for preventive care and wellness. With the goal being to provide an enhanced patient experience and better care, numerous MOB's are being developed within the Inner Loop of Houston and the suburban areas including The Woodlands, along the Highway 290 corridor, in Clear Lake, Sugar Land, Katy, Humble, Kingwood and Tomball. In addition, several rehabilitation and assisted living facilities are under construction in Conroe, Katy, League City (Clear Lake area) and Inner-Loop Houston.

Class A advertised lease rates for medical office space are slightly higher than a year ago, increasing from \$27.64 to \$28.23/gross per RSF per year, while Class B product has decreased by ten cents to \$24.68 per RSF, according to our data provider, CoStar Property. However, recently constructed MOB's are priced near a lease-rate range of \$27.00 - \$32.00/NNN (rather than gross), plus operating expenses ranging somewhere between \$12.00 and \$14.00 per RSF per year.

Notable Expansions/New Developments

Adding to the new development of medical office space, most of the major hospital systems in Houston are building, remodeling and expanding their campuses, particularly in the suburbs. Memorial Hermann Health System acquired the Houston Orthopedic and Spine Hospital, located near the Galleria, adding to its three Ironman Sports Medicine Institutes and seven joint centers around Houston. Memorial Hermann opened a 64-bed hospital in Pearland (south Houston), completed its 100,000 square foot Medical Plaza II (MOB) on the Memorial Hermann Katy Hospital campus, plans to build a five-story patient tower with 90 more patient rooms at their campus in Humble (northeast Houston), is building a 176,000 square foot, six-story medical office building (MOB) in The Woodlands and has a \$14 million expansion project scheduled for completion in 2018 in Houston's southeast region. Late last year, a 23-bed Clinical Decision Unit opened in the Southeast hospital's emergency center; now another 3,000 square feet are being added to accommodate the busy emergency center which sees an estimated 200 patients daily. Memorial Hermann approved plans to invest \$25 million in its Woodlands hospital location for expansion, adding 36 surgical beds, 10 intensive-care unit beds, one cardiac catheterization lab and renovation to the main entrance.

Near The Woodlands, CHI St. Luke's opened its Springwoods Village Hospital on the south side of The Woodlands where ExxonMobil has practically created a new submarket all its own. CHI St. Luke's has also expanded into Lake Jackson (south of Houston on the gulf coast) through Brazosport Regional Health System, one of the area's largest health systems as of early February. CHI St. Luke's added 24/7 emergency locations to its system this year and moved forward with construction on the second phase of its \$1.1 billion McNair campus in the Texas Medical Center. The facility will also house two of their affiliated health brands – the Texas Heart Institute and Baylor College of Medicine.

Job Growth & Unemployment

(not seasonally adjusted)

UNEMPLOYMENT	5/15	5/16
HOUSTON	4.4%	4.8%
TEXAS	4.3%	4.2%
U.S.	5.3%	4.5%

JOB GROWTH	Annual Change	# of Jobs Added
HOUSTON	0.2%	5.1K
TEXAS	1.4%	169.4K
U.S.	1.7%	2.4M

Medical Office

CLASS A RENTS AND VACANCY



CLASS B RENTS AND VACANCY



Notable Expansions/New Developments - continued

Texas Children's Hospital has a new 548,000 square foot facility that will open in The Woodlands in 2017, being the first in the area to offer services exclusively for children and adolescents. Also opening there in 2017 is Houston Methodist's 470,000 square foot hospital. Plans include 187 beds and 600 employees, however, may expand to have as many as 400 beds upon opening.

M.D. Anderson will start construction on a 170,000 square foot facility on 35 acres in Houston's Energy Corridor this year, merging three West Houston operations. Plans include clinical offices, lab/imaging and supportive care, which will begin moving into the new center between 2018 and 2022 as the current leases expire. A little further west in the suburb of Katy, Houston Methodist is expanding the west hospital campus by adding a six-story, 228,000 square foot building with additional beds, OR's, imaging and emergency department.

The University of Texas Medical Branch (UTMB), the largest employer in Galveston county (one of five counties in the greater Houston area and located south of Houston) opened a new 142,000 square foot hospital in League City. On Galveston Island, UTMB opened the new Jennie Sealy Hospital, a 765,000 square foot facility, in April

In the next five years, the Galveston-Brazoria population is expected to exceed 800,000 people; so UTMB is also expanding in Alvin, Angleton and Galveston itself. Clinics in Alvin, Angleton, Dickinson, Friendswood, Lake Jackson, League City, Texas City and Webster are all part of an extensive network of care offered on the south side of Houston, but the system estimates that they need an additional 1,000 doctors to service the area. Bay Area Regional Medical Center opened a Heart and Vascular Center in its Webster hospital, housing some of the latest tools and technology available. The hospital is pursuing a Level III Trauma Designation. By the end of the year, three more floors of private patient rooms will open including medical, surgical and ICU beds. Sacred Oak Medical Center, an 80-bed specialty behavioral hospital, is under construction at Clearpoint Crossing on Space Center Boulevard. Phase one is expected to open in October 2016. The 40,000 square foot building is being renovated from restaurant to medical, and will be expanded to 60,000 square feet once it's open. And in the first partnership of its kind, M.D. Anderson Cancer Center will lease space from UTMB for a treatment center away from the Texas Medical Center.

Sales Activity

Houston's healthcare investment sales activity included 19 transactions, with an average price per square foot of \$227 and an average cap rate of 7.43%. Listed below are a few transactions that closed in the first half of 2016.

Significant Sales Transactions - Q1 & Q2 2016								
BUILDING NAME	SUBMARKET	RBA (SF)	YEAR BUILT	BUYER	SELLER	SALE PRICE	\$/SF	CLOSED
Copperfield Professional Plaza 7825 N Hwy 6	FM 1960/Hwy 249	25,480	1991	DBI Investments, LLC	Terramark	\$3.36M	\$132	Apr-16
Woodlands Medical Arts Center I 17198 St Lukes Way	Conroe/Outlying Montgomery Co	96,199	2001	Physicians Realty Trust	Catholic Health Initiatives	\$21.7M	\$226	Jun-16
¹ Mid-town Surgical Center 2105 Jackson St	Midtown	8,936	1979	Jackson Street Surgical Center, LLC	Mid-Town Surgical Center, LLP	Undisclosed	N/A	Jan-16

¹Colliers International transaction

Sources: CoStar and Real Capital Analytics

Monetization and Acquisitions

Healthcare providers have many reasons to need more capital and consider monetization of some properties. A few of the factors that will have an effect on their books include new government regulations requiring the implementation of EHR's, construction of modern facilities and the requirement for advanced medical devices and additional personnel. Some systems may want to take advantage of the favorable market conditions, have the ability to reinvest the money, enhance the care provided to the communities they serve or simply strengthen their operational and financial performance. With that in mind, monetization is a popular subject. Memorial Hermann Health System demonstrated how to do it by selling a portfolio of 11 MOB's for \$225 million to HCP Inc., a REIT specializing in healthcare properties, including properties in The Woodlands, the southeast, southwest and northwest campuses in Houston. Memorial Hermann, the largest not-for-profit healthcare system in southeast Texas, will lease back the buildings on initial 10-year terms with four 5-year renewals.

The rationale for mergers and acquisitions is to create economies of scale, providing more negotiating leverage and ultimately stronger



Monetization and Acquisitions - continued

balance sheets. 3,144 hospitals are now part of health systems nationwide, an increase of 18 percent in the past decade. Foundation HealthCare Inc. out of Oklahoma City acquired Houston's University General Hospital, which filed for bankruptcy protection in 2015. The newly named Foundation Surgical Hospital of Houston was purchased for \$33 million and is a 69-bed hospital located at 7501 Fannin Street on the south side of the Texas Medical Center (TMC).

Healthcare Trust of America acquired seven properties located on-campus including the 251,000 square foot building next to Tenet Healthcare's Park Plaza hospital on the north side of the TMC. This acquisition increased HTA's investment in the TMC to 425,000 square feet.

Hospital Prices

Revista, a website that specializes in healthcare real estate, published a graph demonstrating the increasing price per square foot for hospital transactions in 2014 and 2015. Covering many specialties of hospitals including acute care, rehab and long-term, the trend showed a continuous quarterly price climb from as low as \$262 per square foot in early 2014 to \$316 per square foot in late 2015.

There have been a handful of old and obsolete hospitals close in the last few years. Vacant hospitals are popular property types for renovations and re-use. Some investors plan to turn them into clinical and ASC locations, while other investors will be operators of safe houses for homeless juveniles, churches and rehabilitation facilities including state-backed penal-system locations to treat drug and alcohol-dependent residents. Prices for older, closed hospitals are usually under 70 dollars per square foot, and it's even more common to see them being offered at purchase prices closer to annual lease rates.

Physician Tenants

Independent physicians are being stressed on renewals based on how much they can afford to pay. Not all doctors can handle rising lease rates. There will be more shared space for clinics or multiple doctors. Some

will want timeshare, co-locating or merging of their businesses. However, many physicians are expanding with second and third office locations from the medical center to the suburbs.

We're being contacted by doctors who signed leases and then learned the quality of property management is not what they had expected. They won't settle for it and are finding ways to break their leases and move to better buildings.

In Houston, some owners of office buildings that are located near hospitals have signed non-compete agreements with the nearby health systems, forcing some medical specialists and medical tenants into the hospitals' adjacent MOB's if they want to be located near the hospitals.

Primary care providers are learning that easy access for patients is key; so many former retail centers near residential areas have become well-leased with medical users, especially if they have emergency departments, urgent care facilities or a large drug store in the project.

Summary

The outlook for the Houston healthcare market is bright. The plan for better access to higher quality healthcare at a lower cost is happening throughout this giant city. Health systems are building well-equipped hospitals and medical properties in the Texas Medical Center as well as the larger suburbs. They are well planned, flexible, and efficiently modern layouts for multiple specialties, levels of treatment and entertainment. It's not surprising that investors want to own these properties, and medical tenants (and patients) are benefitting from the trends.

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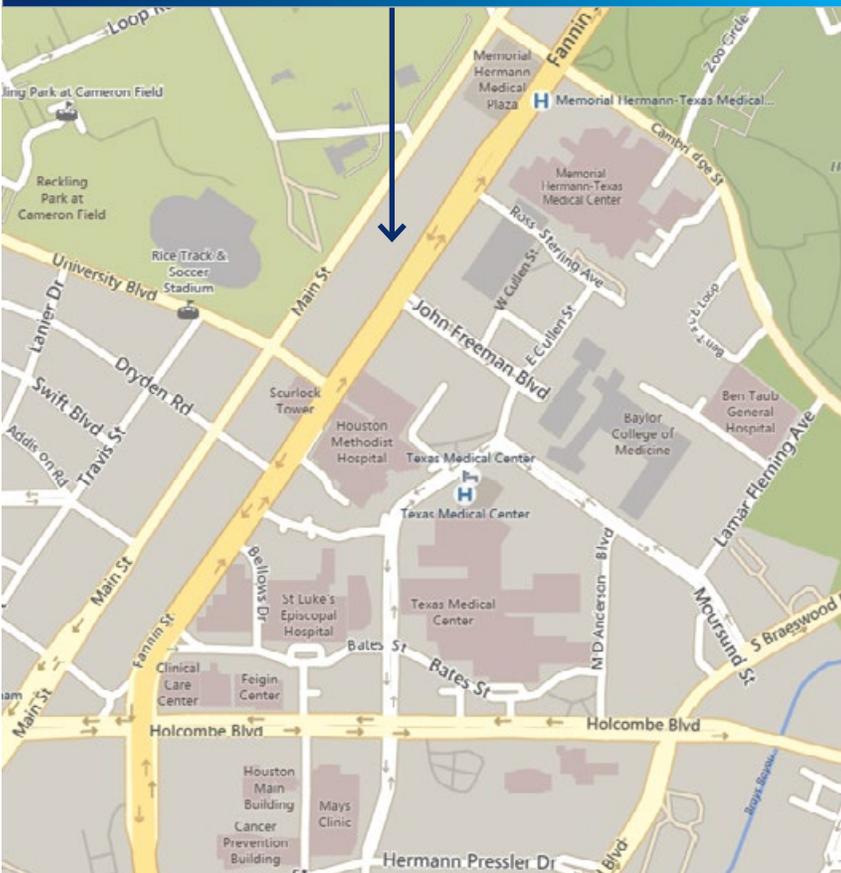
Houston Area Hospital Locations



Houston MSA Health Care

- > 128 Hospitals
- > 18,681 Hospital Beds
- > 16,070 Licensed Physicians
- > 299,600 Health Care & Social Assistance Jobs
- > 5.2% Annual Employment Growth (June 2015 - June 2016)

Texas Medical Center Map



Texas Medical Center

- > World's Largest Medical Complex (1,300 Acres)
- > 54 Member Institutions
- > 7.2M Patients Annually
- > 106,000 Employees
- > 5,000 Physicians
- > 49,000 Life Science Students
- > \$960 Million in Charity Care

Texas Medical Center

The Texas Medical Center (TMC) – the world’s largest medical center – represents one of Houston’s major economic drivers and core industries with an estimated regional annual economic impact of \$20 billion. TMC is also one of Houston’s largest employers with more than 106,000 employees, including physicians, scientists, researchers and other advanced degree professionals in the life sciences.

The internationally-renowned, 1,345-acre TMC is the world’s largest medical complex of member institutions, including leading medical, academic and research institutions, all of which are non-profit and dedicated to the highest standards of research, education and patient and preventive care. Over 50,000 students – including more than 20,000 international students – are affiliated with TMC, including high school, college and health profession graduate programs. More than 8.0 million patients visit TMC each year, including approximately 16,000 international patient visits.

In addition to the medical facilities and institutions of higher learning, TMC is also home to more than 290 professional buildings. Overall, the complex covers over 18 miles of public and private streets and roadways, with 50 million square feet of existing patient, education and research space. TMC has continued to grow and expand over the past several decades with the majority of growth occurring in the past ten years. The Center is located in the 110-acre University of Texas Research Park, a joint effort between the University of Texas Health Science Center, M.D. Anderson and General Electric Healthcare. TMC spends billions of dollars on research and charity care annually.

Texas Medical Center Member Institutions

Baylor College of Medicine	Nora’s Home
CHI St. Luke’s Health	Prairie View A&M University
Children’s Memorial Hermann	Rice University
City of Houston Department of Health and Human Services	Ronald McDonald House Houston
Coleman HCC College for Health Services	Sabin Vaccine Institute
DePelchin Children’s Center	Shriners Hospital for Children – Galveston
Gulf Coast Regional Blood Center	Shriners Hospital for Children – Houston
Harris County Institute of Forensic Sciences	St. Dominic Village
Harris County Medical Society	Texas Children’s Hospital - <i>World’s Largest Children’s Hospital</i>
Harris County Public Health and Environmental Services	Texas Heart Institute
Harris Health System	Texas Medical Center Hospital Laundry Cooperative Association
Health Science Center Texas A&M University	Texas Medical Center YMCA
Houston Academy of Medicine	Texas Southern University
Houston Hospice	Texas Women’s University
Houston Methodist	The Health Museum: John P. McGovern Museum of Health and Medical Science
Institute for Spirituality and Health	The Texas Medical Center Library
LlfeGift	Thermal Energy Corporation (TECO)
MD Anderson Cancer Center - <i>World’s Largest Cancer Hospital</i>	TIRR Memorial Hermann
Memorial Hermann	University of Houston
Menninger Clinic	University of St. Thomas
Michael E. Debakey High School for Health Professions	UT Health
Michael E. Debakey Veterans Affairs Medical Center	UTMB Health



The University of Texas M.D. Anderson Cancer Center in the Texas Medical Center, ranked #1 in U.S. News & World Reports “Americas Best Hospitals 2016-2017” for cancer care.

Houston Healthcare Industry In The News

One of the most iconic medical office towers in the South Main/Medical Center submarket is available for sale in a 3-property portfolio. The 506,000-SF O'Quinn Medical Tower at St. Luke's sits just outside of the Texas Medical Center campus and has 323,000 square feet of medical office space, 100,000 square feet of out-patient and laboratory facilities and 22,000 square feet of retail space.

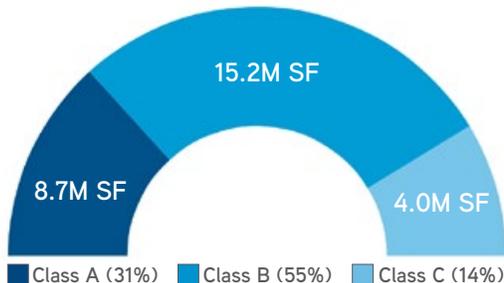


Q2 2016 Houston Medical Office Highlights



Houston's healthcare and social assistance job growth is extremely healthy **growing 12.7% in three years.**

12-Month Percent Change June - June
 2015 - 2016 5.2%
 2014 - 2015 4.8%
 2013 - 2014 2.7%



FOR MORE INFORMATION

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