

By John Mugford

Turmoil. By most accounts, it's one of the best descriptions for the current state of the commercial real estate world. The problem stems from the shakeup in lending and the tighter restrictions being imposed by underwriters – which, according to most industry insiders, is a result of problems in residential mortgages.

Even so, it looks as if the world of medical real estate should continue to march to the beat of its own drum, as it's done for decades. Sure, there could be some slight and moderate changes and adjustments, even hiccups, as pricing stabilizes from record levels and some new players both large and small enter and exit the healthcare arena. And it's almost certain that the current credit crunch could have a negative impact on some deals.

But for the most part, the development of medical office buildings (MOBs) and other outpatient facilities should remain strong in 2008 and beyond. That should also be the case for MOB sales, at least once buyers and sellers come to the realization that pricing and cap rates are most likely stabilizing after a long run of reaching historic highs (for prices) and lows (for cap rates).

These were a few of messages coming from a rather esteemed panel of healthcare real estate professionals who gathered for a roundtable meeting in November 2007 at the offices of Trammell Crow Co. in Dallas.

The folks who took part in the panel discussion are members of the **Healthcare Real Estate Insights™** Editorial Advisory Board. Included on the 21-member board is Kevin O'Neil, president and senior managing director of Trammell Crow Healthcare Services (TCHS), which played host to the meeting in a conference room overlooking the Dallas skyline.

In the article starting on Page 2, we highlighted the discussion of current trends in development and new competition in the industry. The board also talked about the pros and cons of the RFP process and the effect that new sources of capital have had on healthcare real estate. For this article, we are focusing on the board's discussion of the credit crunch and its potential impact on this sector in 2008, and perhaps a few years beyond.

One thing is sure. Most of the developers on the board said they have their projects lined up for the coming year and that the pipeline is strong.



Crystal Ball in '08

HREI Board looks ahead to coming year

Crunch time

Board members jumped right into a discussion concerning the credit crunch and the effect it is having, and could continue to have, on healthcare real estate – both acquisitions and development.

Brent Tharp, VP of GE Commercial Finance in San Diego, said that lenders currently are not interested in accumulating a “big hold size” in their portfolios, in large part because of the current credit crunch and not because of anything to do with the fundamentals of healthcare real estate.

“If you brought me a \$300 million portfolio right now I’d have to go and find someone else who wants to participate in that deal,” Mr. Tharp said. “I talked with someone (from another commercial lender) recently and he said that if you’re looking at any deal of under \$50 million, the market is awash in capital. But he also said if you’re over \$50 million, every lender out there wants some level of market flexibility in their pricing and the initial deal structure.”

Moving forward in 2008, Mr. Tharp foresees more of the same.

“That’s because there are a lot of banks holding stuff that’s very toxic on their balance sheet that has nothing to do with healthcare,” he said. “That’s impacting the hold sizes, it’s impacting yield expectations, and it’s influencing what they want as a return on equity on any kind of transaction they take down.

“If you’re a bank and you have a \$300 million portfolio of CDOs (collateralized debt obligations) you can’t get rid of, you’re a lot less likely to take on a \$300 million healthcare deal,” he added. “And that means that a CEO of some finance company doesn’t care that it’s healthcare versus CDOs. All he cares about is that he has another \$300 million problem on his hands.”

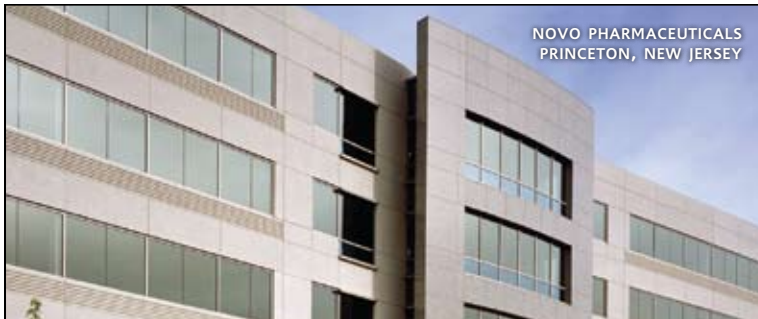
Board members also noted that they don’t believe the large banks and lending institutions have revealed all of their losses and write-offs on past deals.

Charles A. “Chuck” Elcan, EVP of medical office properties for Nashville, Tenn.-based HCP Inc. (NYSE: HCP), a publicly traded real estate investment trust (REIT), predicted “another big writedown” in coming weeks or months.

“To me, there’s a feeling that we haven’t seen all of the significant losses at the banks, and I mean with the downgrading of their portfolios,” added Malcolm Sina, CEO of Palm Beach Gardens, Fla.-based DASCO, a longtime developer and owner of MOBs. “I think there’s a lot more of that left to happen and that the Federal Reserve is going to clamp down, with even more clamping down on underwriting than there is right now.”

Agreeing with Mr. Sina was Angela Mago, SVP and national manager of the healthcare division at Cleveland-based KeyBank.

“It’s fair to say that there is still discovery going on,” she said.



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“We’ve seen all of the big firms do their bloodletting and it exceeded their expectations of where they thought the losses were going to be, and I think that’s going to continue.”

A couple of months ago, Jonathan L. “John” Winer, a partner with New York-based Ernst & Young LP, thought the worst of the real estate writedowns was over.

“At that time, I thought that from that point on it would be sort of a repair business,” Mr. Winer said. “But now I don’t really believe that at all. I guess I feel now that the worst news isn’t out. (I think) that the bottom of the functioning of the CMBS (Commercial Mortgage-Backed Securities) market and the asset-backed market is still a ways away. It seems like 2008 is just going to be a year of working through all of these problems.”

Impact on medical

Those problems, Mr. Winer said, could have an impact on medical real estate financing.

“It’s great that there are still portfolio lenders out there making loans, but the question is whether they’re going to get filled up on real estate exposure, not necessarily medical office, which would prompt them to say, ‘You know, I can’t securitize holding what I’ve got in my portfolio right now so I’ve just got to shut down the business until I can do just that,’” Mr. Winer said.

Charles B. “Chuck” Vogt, the SVP and senior strategy officer with Indianapolis-based BremnerDuke Healthcare Real Estate, added that it could take some time for commercial lending, including that for medical real estate, to return to some sense of normalcy.

“There’s no secondary market to let the pressure go out right now,” said Mr. Vogt. “And there’s a big overhang sitting on these firms’ books and it’s going to take them a while to make their way through those.”

Helping healthcare

And even though the credit crunch is making it more expensive to borrow money, Mr. Winer said the current market conditions and some new accounting regulations could end up helping the healthcare real estate industry, especially in the long term.

“I think for medical office it’s going to be great, in some respects, because what’s happening in the capital markets could blow up some of the secondary players who aren’t really in healthcare for the long term,” said Mr. Winer.

Board members had talked earlier in the panel discussion about the impact that neophyte healthcare developers and MOB owners can have, and in some cases are having, on the industry. Such firms are often local developers who win contracts by making “low-ball” offers to develop MOBs at local hospitals. Such deals often falter, board members said, because the developers do not understand the true costs involved in MOB development.

Costs to rise

When HREI™ asked board members for other potential outcomes of the current credit crunch, Mr. Tharp of GE Commercial said “the cost of capital is certainly going to rise, even if the financing market stabilizes.”

“All of this is pure and simply going to affect the cost of doing business,” he said. “The cost of capital is changing and I think people have an expectation that costs are going to return to what they were (in early 2007). Well, those people are daydreaming.”

For example, development deals are currently difficult to make work, what with the cost of construction and capital on the rise and yields on the decline, according to Mr. Winer.

“It’s hard right now to make new development deals work,” Mr. Winer said. “Then, with the cost of capital going up on top of that, is there sort of a perfect storm where we say the deal volume will go down because fewer projects are going to make sense.”

But then again, Mr. Moloney said third-party developers could benefit from the current turmoil in the bond insurance market – where the larger firms are under “enormous pressure.”

“To the extent that the trading premiums for insured bonds start to widen, materially, it shifts the balance back to third party ownership on a lot of projects,” Mr. Moloney said. “The dislocations in the capital markets could actually play to the favor of developers.”

“And I think one of the things we’re starting to see,” he added, “is that developers for a long time could always get capital for projects – I think they are looking for more robust connections to capital right now. And so I think that’s a trend we’ll see more of in 2008 – stronger connections between the capital piece and the developer piece.”

What about development?

In light of the current conditions of the credit industry, Murray Wolf, publisher of HREI™, asked what the impact could be on healthcare development in 2008.

“Do you think development is going to continue at the current, seemingly endless pace?” he asked.

Mr. Tharp answered that “something’s gotta give” because of the current credit conditions.

“With the increased cost of capital and increased cost of construction, the question becomes, ‘What does someone do about these new deals coming in?’” Mr. Tharp said.

“When a developer bids on these deals, the hospital now is now going to get a smaller ground lease payment, or in a fee simple deal whoever is selling the land is going to get less money for the land. On top of that, a smaller amount of construction costs will be

coming in, mainly because at some point someone needs a better yield. And on top of that, other elements of the cost structure that are not part of the cost commodity part, have to be adjusted.”

Mr. Wolf then rephrased his question about development: “What does the pipeline look like? Are the opportunities in the process right now that are going to result in projects in 2008?”

Gregory C. “Greg” Venn, president and CEO of Denver-based healthcare developer NexCore Group LP, said development prospects “look more robust than they did the year before.”

“I think all of us are growing – so how much of that impacts your opportunities?” he said “How much of it is due to our own growth and how much of it is just the fact that there are more opportunities in the market? I suspect it’s a little bit of both.”

Mr. Venn continued: “I think that even with all of the current cost pressures that are a part of the development process – the cost of construction and capital being the main ones ... hospital systems are going to sit down with a developer and figure out a way to make it work it, because they need the building.

“They might be building a replacement hospital and need an MOB with it, or they’re adding capacity. A lot of hospitals are looking at the next 15 years of demand, not the next 24 months of capital.

“In such cases, it takes some planning to make it all work. Can the

developer find a way for the hospital to pay for the parking garage or whatever it might take to make the project work.”

Mr. Wolf of HREI™ then asked Al Seeley, who is in charge of development for Chicago-based Lillibridge, about the 2008 development pipeline. Mr. Seeley attended on behalf of company chairman and CEO Todd W. Lillibridge, who could not attend.

“Sure it looks healthy,” Mr. Seeley answered. “But then again, 2008 is already in the bank as far as I’m concerned. It’s 2009 that I’m really thinking about.”

As he looks to 2008 and beyond, he said he foresees more hospital involvement in the development of MOBs, mainly because of the capital crunch and rising construction costs.

“Hospitals are getting more involved in site improvements, various licenses, parking garages and things like that – which are elements of a project that we used to take care of,” Mr. Seeley said.

Mr. Seeley predicts that more and more physicians will become part of syndications, “Today, probably 70 percent of our projects involve physician syndications and I think we’ll see more of those by 2009. It’s amazing because I think I’ve seen more physicians change to that in the last year than in the last decade.” □

This article originally appeared in the January 2008 edition of Healthcare Real Estate Insights™.



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