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In a Sick Market, Medical Offices Are a Healthier Asset

You are listening to Reach MD XM160, the Channel for Medical Professionals. Some real-estate investors are discovering that medical office buildings are for a healthier prognosis than other assets in the current market. This is the business of medicine; I am your host Dr. Larry Kaskel, joining me today is John Sweet, the managing director at Ziegler Healthcare Real Estate Fund to discuss why medical office buildings are considered a healthy and stable asset in the current economic down turn.

DR. LARRY KASKEL:

Mr. Sweet welcome to the show.

MR. JOHN SWEET:

Thanks very much.

DR. LARRY KASKEL:

Well, what is going on in the real estate sector in terms of medical office buildings as we speak?

MR. JOHN SWEET:

Well, medical office buildings has a subset of office building group, has become increasingly more popular over the last I'd say 6 or 7 years, and one of the reasons for that is that medical office buildings tend to have and maintain a pretty high occupancy rate. There is not a lot of turn over in those buildings. Doctors tend to stay put, because their patients get used to visiting them at the location and its important to stay there.

DR. LARRY KASKEL:

All right, so how can we take advantage of that? Are there REITs out there that are publicly traded that we can buy, or did we already missed the boat because if we are talking about its already too late, the big money is already in it.

MR. JOHN SWEET:

Well no, I mean I think the entire real estate arena has been hit fairly substantially 20 to 30% over a course of the last 6 months and in particularly the last 3 months, and health care real estate funds and there are about 15 publicly traded health care REITs out there that have had experienced some downturn and there are some opportunities in it right now, because the fundamentals haven't changed, it just that they get tagged along.

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DR. LARRY KASKEL:

Right, so guilty by association. They have been brought down and there maybe some real value there. If we turned the clock back 7 years, how good of an investment would it have been to buy one of these REITs? Would it have been a good return, incredible return or just a grand slam?

MR. JOHN SWEET:

I would say it would say be considerably above the norm in terms of returns over a 7-year period leading up to again in the last until about June of this past year. Your probably saw compounded returns in excess of 20 percent annually, which includes the combination of both appreciation and the value as well as dividends. REITs as a whole, if you look at them over a longer period of time, have traditionally had about 7 percent annual dividend and about 3 percent real growth.

DR. LARRY KASKEL:

Hmm hmm.

MR. JOHN SWEET:

So it has been about 10 percent produce, but in the last 7 years and in particularly in the health care you've seen a fairly significant growth pattern in that area, as the value of the medical real estate properties increase fairly substantially.

DR. LARRY KASKEL:

I mean 20% is a pretty nice number these days. Who is investing in these buildings? Is it just the Joe of the street through the REITs, I mean who are the major REITs and tell me a little about that if you can.

MR. JOHN SWEET:

Love taking about my competition, but Healthcare REITs which is out of Toledo is on the New York stock exchange, it has been a very produce for a long, long time. The Healthcare Real Estate Investment Trust is an all-encompassing term, which tends to include senior living as well as medical buildings.

DR. LARRY KASKEL:

Hmmm

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MR. JOHN SWEET:

A pure play in the medical side would be a recalled Medical Properties Trust and then the largest I believe of all of the Healthcare Real Estate Funds is Healthcare property investors HCPI, also on the New York stock exchange and they have I think about 10 or 11 billion dollars worth of assets, and all of those are pretty well managed and run and paid fairly substantial dividends in the 7 plus percent range.

DR. LARRY KASKEL:

The fund you've managed I take it is not pubically traded.

MR. JOHN SWEET:

It is private.

DR. LARRY KASKEL:

It is private, okay.

MR. JOHN SWEET:

It is a private fund, yes.

DR. LARRY KASKEL:

So, how do you do compared to these guys?

MR. JOHN SWEET:

Well because we've only been added for the last 3 years in building our private funds, which are in the limited partnerships. We haven't really had a chance to test the waters, shall we say in terms of the evaluation, but we've been able to generate cash returns to our investors in excess of 7 percent annually in the last 3 years, and we hope that we can continue to do that on an ever-increasing basis, because most of our properties have pretty long lease terms in them with annual increases in the rent, which are usually tied either to a percentage or to a change in the CPI now. For the first time we may see the consumer price index going down. So, we do have floors also so we don't see our rents diminished. So from that standpoint we have done relatively well and prior to starting this I was one of the folks involved in the creation of public REIT called Windrose Medical Properties Trust and that particular REIT we took public in 2002 and in end of 2006 it was sold to Healthcare REIT, the large Toledo organization. So, I have been on the public side also.

DR. LARRY KASKEL:

If you have just tuned in, you are listening to the business of medicine on ReachMD XM160 the Channel for Medical Professionals. I am

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Dr. Larry Kaskel your host and I am talking today with John Sweet managing director at Ziegler Healthcare Real Estate Fund and we talking about why medical office buildings are considered a healthy and stable asset in the current economic downturn.

John, do you think next time my lease expires and I have the opportunity to perhaps buy a condominium in the next office building, should I do that instead of continuing to pay another 10 year lease.

MR. JOHN SWEET:

You might, really all depends on a number of factors. For instance I do know that _____ minimizing medical offices is little bit more prevalent in the Southeast and in the Southwest where there is high growth areas and maybe you'd want to have more than a single office in particular and different markets within your area in order to capture a larger portion of the patient base. On the other hand you may be in better shape if you wish to be a tenant in a larger medical multichannel medical office building in which there are opportunities for patient referrals and other things within that building so that the interactivity of your practice and other practices maybe beneficial to what your doing. Those are consideration that need to be made, but having said that we encourage in any buildings that we acquire whether they be multichannel or just a couple of tenants in the building that the physicians have a portion ownership along with us.

DR. LARRY KASKEL:

Have some skin in the game.

MR. JOHN SWEET:

Skin in the game, because for us it means that there is a high probability that when their lease does comes up for renewal, that as an owner they probably are going to renew. On the other side is that in the event that there it comes a time when they no longer continue practicing and they need to have an exit strategy how do they get out of their investment. They don't necessarily have to resell or sell the building or refinance it. We would be in a position to buy out their interest.

DR. LARRY KASKEL:

Hmm that's nice. That is a very nice sweet thing from John Sweet. I should entertain that next time when my lease expires.

MR. JOHN SWEET:

There you go.

DR. LARRY KASKEL:

Let's get back to the markets and money. We talked earlier about the Healthcare REITs that kind of got brought down by the entire market being brought down. If you compare to other real estate REITs have they fared better, even though they have still come down

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some.

MR. JOHN SWEET:

Absolutely they have. Their balance sheets were very conservative in terms of the level of depth they have had on their books, because medical leases tend to be a little longer than in a lot of other asset classes for instance office building or apartments and other things where you have 1,2, and 3 year leases. It's pretty common to have 5, 7, and 10-year leases with medical facilities and with that means there is a stability to the building.

DR. LARRY KASKEL:

Hmm hmm.

The lease is coming up for a new spread out and so you have less of these circumstance that we are experiencing today with some of the large office REITs that were built on speculation, where they haven't leased up at the rate that the developer thought they would or they were put up with short-term money that is now coming for renewal and with the vacancy factor so high, it is tough to get them released. Those are the issues that are driving down a number of larger REITs. The medical buildings tend to be built against a built up demand. You don't see development of medical buildings on spec very often.

DR. LARRY KASKEL:

So, there are not a lot of speculators out there that are building medical office buildings.

MR. JOHN SWEET:

There hasn't been and its _____ from a lack of trying. It is more to do with the fact that even in the go, go days of the banks lending to anyone. There is something about the medical industry that the banks aren't quite sure of. They don't understand it particularly well. They feel it is a little tougher to underwrite. So a developer coming in and saying I have got my building, I'd like to build the building here and I have 80 percent of it leased up, that's what it gets financed, it is coming in and saying this is a hot area, there is going to be lot of residence coming here, we know a lot of doctors will be coming here and we would like to build this building that doesn't get financed.

DR. LARRY KASKEL:

So what I am hearing is that there is an opportunity right now to put money into these REITs that we are at a pretty good time, and that these publicly traded companies have been undeservedly been brought down, is that a fair statement.

MR. JOHN SWEET:

That is a fair statement and I think if you look at there is a list you can go to with NAREIT, which is the National Association of REITs and they will list by group and you can pull up their site and then go up to Healthcare REITs and you can see the grouping of the publicly

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traded Healthcare REITs, and if you just kind of kick through them and look at their dividends I think you will find that the average dividend this is coming from the _____ for a second, because I have _____, it's probably somewhere north of 8 percent.

DR. LARRY KASKEL:

Wow! Your getting 8 percent of weight and the potential of that is a rise in value also.

MR. JOHN SWEET:

Right.

DR. LARRY KASKEL:

And so you said earlier that some of those REITs are kind of mixed in with assisted livings and I don't think I'd really be interested in that, because that industry is just not done well. You would think it would have done well, but it hasn't. So to find that pure play can you mention those REITs again?

MR. JOHN SWEET:

I would say Healthcare REIT, well they do have senior living in there, but you will find that they have a pretty strong medical property portfolio. Medical Properties Trust is another one, Healthcare Property Investors HCPI, Healthcare Realty Trust.

DR. LARRY KASKEL:

And if you look at these, do you want to find one that has the least amount of the debt, does that matter?

MR. JOHN SWEET:

The answer to that is yes. In typically the Healthcare REITs have about 40 to 50%, maybe somewhat lower. I think Healthcare REIT has about 35% debt on its books. So, these are not overly leverage you known 3 to 1, 4 to 1 things like that. This is less than 50-50 and they tend to be long-term financings that are in good space there, so I would say that that's some of the ones I would look at.

DR. LARRY KASKEL:

John, are there any cautions to be aware of. Some people say that Healthcare REITs are totally recession proof, is that true.

MR. JOHN SWEET:

Well I don't you know I think we've all learnt a lesson over the last few months. There is nothing out there that never say never so; we as a firm besides being a real estate are very active in the capital markets having been around for over a hundred years raising financing for particularly for both senior living and not for profit hospitals and what we are seeing in the market of late is that the companies in order to save money are to some extent changing their benefit packages and putting more the onus of Health insurance on the backs of their employees and with that has come a slowdown in the number of elective procedures that are services that are being done. Secondly, we are seeing that as the employee is expected to pickup a larger portion of the co-pay of this insurance that the bad debts at both the hospital and the physician practice levels are starting to grow somewhat, and the other thing is that in an effort to reduce cost a number of plans have moved out of the PPO world and moved into more of a manage care model and with that has come low reimbursement to the provider and so there is a little stress on it out there. Having said that it certainly is still a very, very strong industry and one that we feel confident that will continue to grow.

DR. LARRY KASKEL:

So going forward would you say that the trends are that there will still be investment in Healthcare real estate.

MR. JOHN SWEET:

There will, there has been a cycle that hasn't played it self out, but has had a significant amount of play and that is that the hospitals themselves owned an awful lot of medical office buildings primarily on campus, but also off campus. We have seen the hospitals monetizing their ownership and those meaning selling them off to third parties or as they built the new ones having third parties build and own the properties, and so that has been going on for about 5 or 6 or 7 years. Depending upon what happens with the whole concept of physician owned hospitals especially hospitals, acute care hospitals and other things. We certainly believe that there will be more and more of development of new medical facilities that are state of the art that can do a much more efficient and better job of providing care to people. Particularly as our population age is so very and very enthusiastic about that and we think that more and more services will be provided on an outpatient basis leaving the acute care hospitals to the severely ill.

DR. LARRY KASKEL:

John Sweet thank you very much for talking with me today.

MR. JOHN SWEET:

My pleasure.

DR. LARRY KASKEL:

John Sweet is the managing director at Ziegler Healthcare Real Estate Fund and he joined us today to talk about why medical office buildings are considered a healthy and stable asset in this environment.

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