NATIONAL REPORT

Marcus & Millichap
THE VARA GROUP

MEDICAL OFFICE

2H/25

Slowing Medical Office Construction Bolsters Investment Outlook

Select states dominate below-average 2025 development pipeline. While up from last year, total medical office completions in 2025 will be 1 million square feet short of the past decade average of 11 million square feet. An increasing share of deliveries, however, are taking place in just three states: Texas, Florida and California. In 2024, these states comprised about 30 percent of the national delivery tally. This year, that figure grows to over 50 percent. This will elevate short-term supply pressure in some metros, including Houston, Dallas-Fort Worth, Sacramento and Orlando, while leaving many other markets with fewer completions. Annual delivery tallies will fall 40 percent or more in metros like Boston, Atlanta and Nashville.

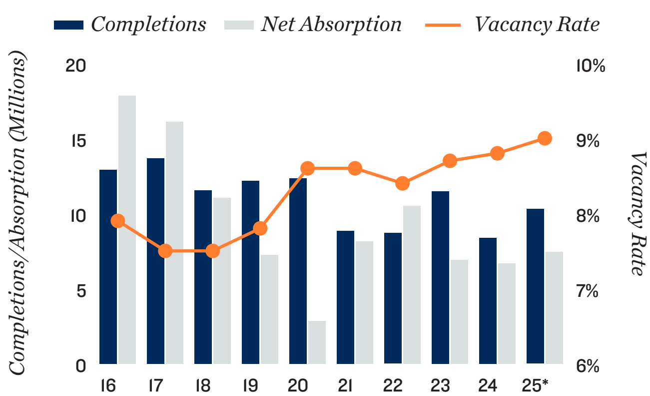
Demand to see steady gains despite cost concerns. The national vacancy rate will climb 40 basis points this year to 9.2 percent, as openings slightly outpace leasing while older stock becomes less viable. The overall vacancy rate among medical offices built prior to 1980 is about 200 basis points higher than that of properties constructed since 2010. For facilities that meet tenants' contemporary needs, an age 65-plus population that will grow roughly 10.0 percent in the next five years speaks to steadily increasing space demand. Outpatient volumes are set to expand 10.6 percent over the next half decade, versus a 0.9 percent rise in inpatient volumes. Still, rising costs remain a challenge. Providers face high administrative and skilled labor costs, while consumers face total health care cost increases well above the rate of inflation, prompting some to delay non-essential care. All of which poses potential barriers to rapid expansion.

Medical Office Investment Highlights

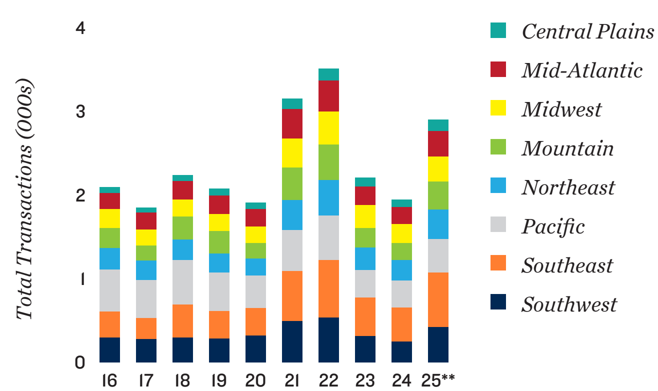
Deal flow accelerates, led by private investors. Medical office investment accelerated roughly 40 percent on an annual basis during the 12 months ended in June. About 95 percent of trades were in the sub-$10 million price tranche, as private buyers took advantage of a slew of lower-priced opportunities. Many pursued value-add strategies with conversions, deferred-maintenance and high vacancy assets or portfolio improvements through 1031 exchanges. Others found sellers willing to ink sale leasebacks, allowing buyers to trade into less management-intensive assets with established tenants. Elevated borrowing costs pushed more capital-intensive purchasers to the sidelines, resulting in a substantial slowdown in trades over $10 million. Over the year ended in March, the mean price per square foot inched up to $295, while the average cap rate held steady at 7.4 percent.

Sun Belt leads investment growth; California cooling. Together, the 10 most active major metros for medical office trades account for about one in every five transactions. Of those markets, eight are in the Sun Belt. Dallas-Ft. Worth and Phoenix lead by a wide margin, followed by Atlanta, Los Angeles and Houston. Chicago and Philadelphia, which are home to the nation's first- and fifth-largest populations age 65-plus, respectively, also rank in the top ten. Overall, national medical office trades were up nearly 60 percent from the 2015-2019 average during the year ended in June. A handful of markets have seen fewer recent deals, however. Notably, the Inland Empire is California's only metro to see an uptick in post-pandemic trading, while the San Francisco, Los Angeles and San Jose tallies have fallen at least 30 percent each.

National Supply and Demand Trends



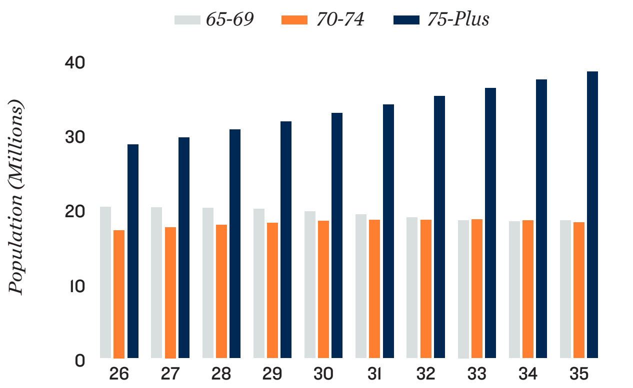
Medical Office Trades by Region



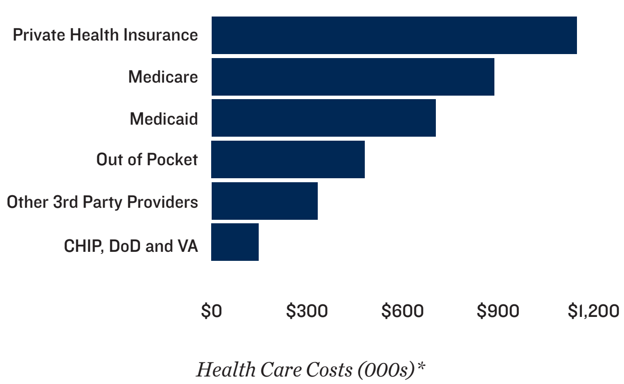
** Forecast; ** Trailing 12 months through 2Q*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Population Forecast by Age



Personal Health Care Spending



**Total personal health care costs paid out in 2022*

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; Moody's; MedPAC

Long-Term Demand Drivers, Tenant Profiles Bolster Outlook; Potential Headwinds Invite Caution

Sector fundamentals positioned to strengthen. Medical office space demand will continue to rise long term, with the over-70 population projected to grow more than 25 percent by 2035. Along with a higher prevalence of chronic conditions, rapid growth in this cohort will bolster demand for conveniently located care options, reinforcing co-location trends. In addition, rising construction costs are likely to further restrict development moving forward. Reduced supply pressure may contribute to sustained growth in both average marketed rents and in-place rates, potentially reinforcing NOI for well-tenanted properties. Meanwhile, investors and health networks may seek to convert more retail and traditional office spaces to reduce the cost of new floor plans. Still, challenges remain. Telehealth allows some services to be provided without an office visit. A shortage of up to 86,000 physicians and RNs is also anticipated by 2036 due to barriers to education. The impact of this shortfall on operations may be eased however by technology improvements. Nearly two thirds of physicians reported in a 2024 survey to using artificial intelligence tools in some capacity, helping with tasks varying from note taking to assistive diagnosis. How far A.I. can take the industry however is unclear.

Changing policy raises uncertainty; MOBs relatively insulated. Under current policy and new rules established by the "One Big Beautiful Bill" Act, the Congressional Budget Office estimates that 16 million fewer people will have insurance coverage by 2034. This is likely to result in an uptick in uncompensated care costs; however, an outsized portion of these costs — historically over half — falls on hospitals. Community-based providers perform roughly one fourth of this care, while office-based physicians provide the smallest portion, positioning MOBs to better withstand a potential drop in coverage. Still, the long-term effects of recent funding changes at the Department of Health and Human Services and the potential impact of ongoing legislation and executive action on research funding, Medicare and Medicaid remain unclear. As a result, more investors are seeking assets with long-term, credit-grade tenants and strong NOI. While cap rates vary widely based on considerations beyond lease term, the spread in cap rate between assets with in-place leases under five years or over 10 years is expected to be at least 100 basis points.

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Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Moody's Analytics; Real Capital Analytics; Census Bureau; Congressional Budget Office; American Medical Association; American Medical Group Association; KFF

Price: $500