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How will health care reform affect commercial real estate?

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As health care reform takes hold, investors and experts look at the horizon

How will federal health care reform change the real estate landscape for the sector?

While the future is somewhat uncertain, local real estate professionals expect the sector to remain relatively robust because of an aging population and the expansion of health insurance increasing traffic to health care facilities, especially on the outpatient side.

Along with bringing more patients into the mix, a continued emphasis on making care as cost-effective as possible is expected, said Steve Brown, executive director of the health care advisory group for Bloomington-based Cushman & Wakefield/NorthMarq.

"While no one has a crystal ball, we do know that efficiency in the delivery of care is going to be the driver, without question," Brown said. "Every system and larger practice is thinking that way in how they prepare themselves."

Brown also thinks it's likely the Twin Cities market will see more consolidation among providers, which might render some facilities "duplicative." If so, some off-campus real estate currently used for care would be repurposed for other uses or put on the market.

Cindy Fisher, director of commercial assets for the Minot, N.D.-based Investors Real Estate Trust (IRET), doesn't think the U.S. Patient Protection and Affordable Care Act will have a "huge impact" on health care real estate valuations. About 25 percent of IRET's holdings are health care facilities, many in the Twin Cities. She expects a continuing high level of development and acquisition activity, particular in the medical office building category.

One aspect of the law that will affect providers' real estate decisions is the creation of the accountable care organization (ACO), a payment and care delivery model that links provider reimbursements to quality metrics and reductions in the total cost of care for an assigned population of patients.

Strategic sites for clinics

Medicare and Medicaid reimbursement to ACOs will be based less on the amount of business they generate and more on the results they produce in caring for defined populations, said Len Kaiser, director of network development for the St. Paul-based HealthEast system. That will increase the emphasis on strategically locating outpatient facilities, he said.

With or without health care reform, hospitals and health systems have adopted a more strategic, more efficient approach to managing their real estate, experts say.

The Minneapolis-based Davis Group assembled individual investors to pool the $2.8 million to develop the Crystal Medical Center, at 5700 Bottineau Blvd. in Crystal, in partnership with Northwest Family Physicians. (Staff photo: Bill Klotz)

One example is taking advantage of a "soft" office-space market to relocate non-medical functions outside of medical facilities to leased space, thereby freeing up space to expand health care space at a lower cost, according to Ray Piirainen, the director of real estate for Minneapolis-based Fairview Health Services.

When Fairview merged with University of Minnesota Hospitals and Clinics about 10 years ago, "we needed more space" for on-campus health care functions, Piirainen said.

Fairview moved its central business office and other functions to leased spaced in the Stinson Office Park at 323 and 400 Stinson Blvd. in Minneapolis. It now has about 175,000 square feet of space in the park, which was acquired for $44 million last year by Artis Real Estate Investment Trust, a diversified Canadian REIT.

As in other industries, some health care systems have opted to lease rather than own clinics and other outpatient facilities. It's a way to monetize assets, for one thing. But leasing offers more flexibility to adapt to the changes in the organization's space needs and in the marketplace, according to Kaiser.

In 2005, the St. Paul Port Authority issued bonds to buy the Midway Hospital Building from HealthEast then lease it back to HealthEast. The building currently houses much of HealthEast's corporate support services, home care and outpatient surgery.

Medical office buildings drawing investors

Michael Sharpe, a principal with the Minneapolis-based Davis Group, says the medical office building sector is drawing more attention from high-net worth investors, with the prospect of earning annual returns of 8 percent or more, Sharpe said. The Davis Group develops and leases medical properties and consults with health care providers.

One recent project: The Davis Group assembled individual investors to pool the $2.8 million necessary to develop the Crystal Medical Center, in partnership with Northwest Family Physicians. The 45,000-square-foot medical office building is at 5700 Bottineau Blvd. in Crystal.

The Davis Group has helped to develop about a half-dozen similar projects in the past five years and hopes to develop three more facilities in 2013, Sharpe said.

The popularity of health care real estate as an investment is reflected in the performance of health care REITS. During the period from 2001 through 2010, real estate trusts that own health-care-related properties delivered annualized total returns of 19.9 percent, on average, according to the personal finance website Kiplinger.com. In the same period, property-owning REITs as a group returned an average of 11.4 percent.

There are good reasons for the sector's popularity. Most medical office building properties have triple net leases, in which tenants are responsible for paying property taxes, insurance and maintenance costs, according to Davis Group Principal Mark Davis. Because the building owner doesn't have to pay those variable costs, the triple net feature allows for a more predictable cash flow stream. Also, triple net leases often include contractual annual rent escalations, providing steady cash-flow growth over time.

The growth of health care REITS has spurred more interest by other REITs in acquiring properties like medical office buildings, said Alex Young, senior vice president of development with Eagan-based MSP Commercial, which has developed outpatient facilities.

REITS "are actively searching for portfolios to purchase," Young said. "They want to beef up their numbers. We have been approached by a number of them."

Young said his group has not considered selling because it's in the business of developing a portfolio of solid health care properties — most of them stand-alone facilities not located on hospital campuses — and managing them long term.

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