A SPOONFUL OF SUGAR: TRENDS IN MEDICAL OFFICES AND LIFE SCIENCES BUILDINGS
W/ PETE BULGARELLI CHRIS BODNAR [03.09.2021]

Spencer Levy
I'm Spencer Levy and this is The Weekly Take. From huge hospital systems to neighborhood doctors and dentists, healthcare delivery is a trillion dollar sector and an office space niche that's played an important evolving role during the pandemic. On this episode, we're going to the doctor visiting the medical office sector with a pair of highly experienced health care, real estate specialists.

Pete Bulgarelli
Medical office in life sciences and several other post acute categories have really not even skipped a beat during this pandemic. And the reason for it is that people still need their care.

Spencer Levy
That's Pete Bulgarelli. The President and CEO of Lillibridge Health Care Services and executive vice president of Ventas and S&P 500, REIT, headquartered in Chicago. The company has a portfolio of more than 350 medical office buildings in the U.S., serving an estimated 16000 physician tenants daily and over 40 million patient visits each year. He joins us from Naples, Florida.

Chris Bodnar
It's the evolution of business getting more competitive. Providers realize that they need to provide care in a more affordable outpatient setting and need to make their services more convenient for the patient.

Spencer Levy
And that's Chris Bodnar, Vice Chairman and Co-head of healthcare and Life Sciences Capital Markets with CBRE. Based in Denver, Chris started as a CBRE intern in 2003 and by now has been involved in deals worth more than 15 billion dollars, covering more than 50 million square feet of medical real estate. We'll look at how medical office differs from traditional office and dedicated life science space. We'll delve into what's driving change in academic medical centers and research institutions in markets across the country and what's driving the capital markets as well. We'll discuss challenges posed by the pandemic, how operators, investors and developers are adapting. We'll also touch on talent and demographics. Technology, of course, telehealth in particular, what it all means for the future and more. No need to make an appointment. Coming up, an examination of medical office real estate. That's right now on The Weekly Take. Welcome to The Weekly Take, and this week we're going to be talking about medical office buildings and life sciences with two of the leading experts in the space. Pete, many people think that medical office buildings are just suburban office with a bunch of doctors in it. But that's not correct, is it? Tell us what a medical office building is.

Pete Bulgarelli
The core distinction here is really what has purposes. It's supporting physicians in providing medical care to patients, you know, and so as a result, handicapped parking is key. The way you get through a building is key. And then it all depends on where they're going within your building. Is it to a high acuity location where maybe there are surgeries and so forth, in which case there is a lot of infrastructure and there's a lot of procedures you need to follow

in order to maintain a safe environment for those patients and those physicians.

Spencer Levy
Well, Chris, let's go into a little bit more detail there. In addition to the ingress and egress that Pete was talking about, the nature of the patients, the safety issue involved, because you have patients that are not well, there's also a lot of redundancies and power and light if they have surgical capability. Isn't that correct, Chris?

Chris Bodnar
Yeah, there's a lot that goes into it. You know, the ways that the physicians deliver care and utilize their space is much different than traditional office. Like you said, electrical capacity is one of them. Having gurney size elevators is probably another thing. There's a lot of different components that make up a medical office buildings, and it all comes down to best serving the patient.

Spencer Levy
It's interesting when we talk about medical office, when we talk about life sciences, a lot of people say in the suburban business say, oh, my buildings next we can convert it. But it's not that easy, is it?

Pete Bulgarelli
No, it's really not that easy. And, you know, the truth of the matter is converting an existing office building into a medical office or life sciences building many of the points that Chris made, the load factors, the slab to slab heights, the gases and so forth that are in the building, very difficult to replicate with an employee structure. People talk about it. They think it's simple, but it's a very difficult thing and usually it's not economic to make the conversion.

Spencer Levy
I got into this business 20 years ago. There was a big distinction between not just medical office and suburban office, but on campus versus off. Seems we've had a transformation of the space over the last 20 years where it used to be the case where on campus was the place to be now might be off. What's your point of view, Chris?

Chris Bodnar
It's the age old question that keeps changing year after year. I think it's the evolution of business getting more competitive. Providers realized that they need to provide care in a more affordable outpatient setting and need to make their services more convenient for the patient. It's of my opinion, but I do think the days of the independent physician are dead. It's very hard for a physician to be entrepreneurial in today's environment compared to 20 years ago. A lot of that has to do with these medical students coming out of school with really high levels of debt. Malpractice insurance is incredibly expensive and you're seeing these physicians that are coming out of school, medical school, wanting to really focus on a work life balance. And so the easy way of getting into the spaces is either through a health system or through a large provider group. And again, those groups are wanting to provide services in a convenient and affordable setting for the patient itself. And that lends it very well to doing off campus products. There will always be a need for on campus. You know, the best example that we usually like to give is woman services. You know, OBGYN, obviously, those physicians can put their services out into the community, away from the campus. But when it comes down to it, those physicians need to make rounds at the hospital. They obviously need to deliver babies. And so there always be, you know, a

necessity to have those types of practices on campus.

Pete Bulgarelli
So I largely agree with Chris, and that would be no surprise. The fact is, health systems are getting lower reimbursements than what they did in the past. Would they have to do is they have to expand their footprint. They have to have a larger collection basin in which to capture those patients, to funnel them to the more acute high acuity areas like hospitals. So there's no doubt that off campus MOBs are expanding. They're multiplying, but that doesn't necessarily make them the best investment as a real estate asset. Ventas's portfolio is about 70 percent on campus or adjacent to campus. So we're a believer in the on campus MOBs as an investment. First of all, it's rarer. There's only so much land that's on a hospital or adjacent to a hospital campus, and that's one of the first rules. And real estate investment is do you have a differentiated product? The second is and this may continue to change over time, but there are significant financial benefits or physician groups to do their procedures, not in the hospital, but on campus and outpatient facilities, and they can be considered HOBD, outpatient department, and they can still charge the full hospital rates for an X-ray for a procedure. And that's a big financial incentive for people to stay on or near campus. And the final point, which Chris already said, is that a lot of the procedures need to be able to go back and forth to the hospital to check on their patients, admit patients and perform procedures. So we think that in some cases off campus MOBs will be excellent investments, but in most cases, inpatient or on campus MOBs will be a very good investment.

Spencer Levy
want to point to a job that you guys were invested in here in Baltimore. You invested in a company called Wexford and did a life sciences center right on the campus of University of Maryland Hospital. Tell us a little bit about that.

Pete Bulgarelli
Yes, we're very proud of our relationship with Wexford, a Baltimore based development company that has specialized in developing life sciences campuses, not so much buildings, but campuses. As a result, we with them develop ecosystems, life sciences ecosystems on top university campuses such as Yale, such as Duke, such as Washington U and St. Louis, Penn in Philadelphia. And if you think about it, Yale doesn't really need someone like Ventas to pay for a building. But what Yale realizes they're not very good and the same with Duke and Wake Forest and so forth is creating this ecosystem where scientists, researchers and students want to stay on campus, where it attracts venture capital, which attracts the pharma companies to joint venture with universities. Wexford is a leader in that business and we're very fortunate to have them as a partner in the life sciences business.

Spencer Levy
So, Chris, I think what Pete's talking about is a research report we did about a year ago. It's called Eds and Meds and Eds and Meds is really the name of the game here where they all go together. What's your point of view, Chris?

Chris Bodnar
Well, so, you know, there's life sciences and medical office are very different product types, and there are some major similarities. And I think, Spencer, you gave a great example of University of Maryland. You know, academic medical centers like University of Maryland provide both patient and patient care and research, and both are core to their mission and they're both interconnected. So I don't I don't want to speak for Pete and Ventas, but I think that that probably has part to do with your evolution of acquiring life sciences assets like the

one in Maryland and going outside of the traditional cluster cities, cluster markets. And I think you really have to ask yourself, why would an investor be willing to do that? And I think it's really because of these academic medical centers are creating their own market and their own talent. You know, I think a great example is Los Angeles in Orange County, which wasn't considered a life sciences market 10 years ago, and now is the number seven market in the country for NIH funding. And where is that funding going? 80 percent of that funding is going to UCLA, USC, UC Irvine and Cedar Sinai, all groups that we work with on the medical front who are also, you know, academic medical centers that are very focused on research, too. So I think that they are interconnected. The bricks and mortar are very different, but it's that relationship with these academic medical centers, Pete which I think tell me if I'm wrong, is what attracted you guys to this space?

Pete Bulgarelli
No, you're exactly right, Chris. I mean, it's if you look at our Philly complex, which is one of our most successful, you got Penn medicine and you have University of Pennsylvania and you've got Drexel together, all intermixed in virtually all of our research buildings in Philadelphia. There is a medical use, just a straight medical use, as well as medical research, as well as life sciences. In St. Louis, our highly successful complex and St. Louis is jointly sponsored by Washington University in Burns, U.S. Hospital. And so as a result, it's a great mixing in the academic medical research front between the two different entities that are driving the change that we're seeing across the world.

Spencer Levy
Let's turn now to the pandemic. Pete what has been the impact of the pandemic on medical office and other forms of medical real estate? And how do you see it going forward?

Pete Bulgarelli
Well, it's interesting. Various types of health care assets have performed extremely well during the pandemic and others have struggled a bit. The most obvious being senior housing has struggled. On the flip side, medical office in life sciences and several other post-acute categories have really not even skipped a beat during this pandemic. And the reason for it is that people still need their care. They still need to see their physicians. They still have issues. Now, they may get their care in different ways or they might delay some procedures, but ultimately they still need the services of their physicians and their health systems provide to them. So as an example, Ventas, surprising to me we gave earnings guidance pre Covid for medical office and for life sciences. And by the end of 2020, we actually hit our earnings guidance in 2020 because it largely didn't affect the operations in the buildings. It just caused the buildings to be used in different ways.

Chris Bodnar
I think the biggest thing is technology. Spencer, the thing that gets talked about probably most frequently is telehealth. The government did some things to facilitate telehealth, allowing it to be rapidly accepted. A lot of that had to do with reimbursement rates with insurance companies. But, you know, I would say telehealth is probably one of those big things that has accelerated, you know, post COVID hitting the market.

Spencer Levy
Let's dig into that for a second, because I often say that technology is the great game changer for many of things here. And I use an example sometimes of my Grandma Bess and my Grandma Bess she was 95 years old when I moved her from her apartment in Rego Park,

Queens, to a assisted living center in Stamford, Connecticut. Why did I move her? I moved her because she lost mobility and hard to get to the doctor. But if there were self-driving cars, maybe she would have stayed longer. And if there was telehealth, maybe she would have stayed longer. So let me just ask a direct question, Pete. Is technology a friend or a foe of health care real estate?

Pete Bulgarelli
Well, I think it's absolutely a friend. I mean, we're highly supportive of telehealth, as Chris described, and, you know, went up to, what, 47 percent of total visits in April of 2020 when there weren't any choices. And now it's down to, you know, say seventeen percent. But pre COVID, it was like one percent. It was almost nothing. And so it's it certainly has a place and I think is going to help the physicians be more productive, you know, the successful practices, the practices that really connect with their patients and have excellent care will thrive and allow them to be larger and serve more patients through telehealth than some of the less successful practices that they may compete with. So I absolutely think the telehealth is a plus for the industry. And I think in the long term, it's going to be very positive for medical office real estate.

Chris Bodnar
Yeah, I just like to add on that, you know, most groups that we talk to, most provider groups are telling us that telehealth is really a tool in their toolbox and it could be utilized as a first line of defense and serve as a relief valve for overcrowded waiting rooms, overbooked physicians, especially in primary care. The fact is, we have a shortage of physicians and nurses in this country and telehealth is a tool that will possibly will help bridge that gap.

Spencer Levy
So let me let me push this just a little bit further, if I could, because I want to just give an example of where telehealth may have a disruptive effect and that's in the X-ray technicians, where I understand many X-rays that are taken the technicians are in Israel or India or someplace reading them during the night. But the other disrupter is retail, because retail right now is obviously going through significant challenges related to restaurants, gyms, movie theaters, and now may be an alternative site for medical care. What's your point of view, Pete?

Pete Bulgarelli
When we started this conversation, we talked about converting, you know, old office buildings into medical office buildings. Retail in many ways fits into that category. Again, what you see today in retail is you'll see primarily the dentist, the orthodontist, the ophthalmologist and so forth. Where in the general as the family practitioners and so forth who are in locations that are very convenient to their patients. And so you what you see is a dichotomy of where physicians want to locate. There are the generals who need to be very close in order to be competitive to where their patients are housed. The other piece of it is it the procedurals want to be very close to the hospitals where they have higher acuity needs and do very sophisticated things that may come in or out of the hospital. They get paid more if they're on campus versus off campus. And so you really do see a splitting of the desires of physicians to be in various locations depending what their practices are. I think retail absolutely has a place in this world. It is very convenient for a variety of different procedures.

Spencer Levy
There's a term we use in the business called the Doc in the Box, the emergency care places

that are just replace the bank branch down the street from my house. Chris, how does that play into your business and do you see a lot more of that in the future?

Chris Bodnar
I do see more retail and it goes back to what we talked about earlier, just providing more convenience for the patient. We are actually selling a facility in Sugar Land, Texas, right now. That is a former retail center single story product. But what it provides the providers, the patients, is a setting where it's easy to park. They can park right in front of their provider practice. There's signage right in front of the practice. So it's easy to find and there's no common areas. And so it reduces the cost for the tenant because most medical tenants are on triple net leases. So it reduces how much they have to spend on that space. You know, the doc in the box, I think urgent care is going to be, you know, something that's going to stay continue to be convenient. I think telehealth may be somewhat of a disruptor for some of the urgent care. And then you're seeing a lot of these health systems partner with groups like Emerus providing micro hospitals. So I think that that's a trend to stay as well.

Spencer Levy
Well, I got three kids under the age of 16, and thank God for some of these docs in a box because it's so much faster to get in and out of there than it would be for you to take my kid with broken fingers, toes, arms, you name it, in our hospitals. And so let me talk about efficiency.

Pete Bulgarelli
Yeah. For us, it's really about acuity levels. You know, what exactly is being done? We're focused in on practices that have very high acuity that need the complex equipment and need the adjacent the specialists to kind of assist and to do referrals back and forth, because that makes the rules stay very sticky. You know, if you can just at least renewal time does move, you know, half mile down the road and just replicate what you did at the former bank branch. That's not necessarily the world's greatest real estate investment. It may be fantastic for the patients. It might be fantastic for the physicians, but it may not be so good for the real estate investors behind it.

Spencer Levy
Well, let's go to that now. The real estate investors, Chris, tells her where the world is today on the value of medical office buildings Chris.

Chris Bodnar
Yeah, I've received more incoming calls from new equity to that. Health care and life sciences sector in the last year than I've experienced in the last decade, it's interesting and I think groups like Ventas and other operators in the space have a distinct advantage. And it's really for two reasons. It's the intellectual capital that a group like Ventas has, and it's the relationships with these providers. Intellectual capital is the expertise of the employees at the operating level, and infrastructure in place can raise a significant amount of capital. And I think that that just talks to the imbalance of supply and demand, Spencer, which is driven pricing to all-time highs for medical and life sciences.

Spencer Levy
Is that a good thing or a bad thing? We always want more capital in our space, but what we've seen in what we call operational real estate or OPRE, just this flood of new money of people that weren't traditionally there. So my question to you, Chris, is that sustainable?

Chris Bodnar
It is sustainable. There's just different ways to do it. And I think utilizing institutional capital can be done in many forms. What the institutional capital realizes, like I said before, is that their best course of making a good investment is doing it alongside of an operator. So the challenge for some of these institutions is going to be able to place large chunks of capital at a time there is significant competition. But I think it it's healthy for our space.

Pete Bulgarelli
We've seen this as well, and we think it's a real plus for the industry. And we have we have adjusted our capital structure so as to accommodate this. So we're REIT. But we have in March of 2020, we established an institutional fund. And so we've raised three billion dollars in essentially pension capital that is looking to invest in the space and utilize, as Chris said, the expertise and the relationships we have. We've also established a sovereign fund which has different objectives and different timeframes for the use of their money. So we now have several platforms by which to invest into health care and life sciences, real estate, whereas prior to March we had one, which is our balance sheet.

Spencer Levy
So you now have essentially two or three different pockets and costs of capital, depending upon which type of asset you're pursuing.

Pete Bulgarelli
That correct is correct. This exactly right.

Spencer Levy
Because I'm going to ask you a few numbers now. So the average cap rate on a medical office building 20 years ago probably was eight and a half. Then it got down into the sevens after the global financial crisis. Where is it today?

Chris Bodnar
We get the question a lot and we usually say it depends. But, you know, on the low side, you know, we are seeing cap rates going sub five percent right now for the highest quality products. Obviously, looking at where the product is located, the credit behind the tendency, the term remaining escalations, all those things factor into where a cap rate is. But I think what's even more outstanding to me is seeing where, you know, these constants are for new developments. I think those have compressed I don't think I've seen a new lease constant for new development above seven percent in several years now. So it is competitive. You're seeing a lot of the build a core type models, which is allowed those development yields to compress even further. But, yeah, I'm sure Pete doesn't like me saying these numbers out there because I'm sure he wants to buy these medical buildings in life sciences facilities, a much higher cap rates. But I do think that that is the reality.

Spencer Levy
So, Chris, let me stay with you for just another moment, because we see so many nontraditional capital sources entering the space, including high net worth individuals and others who have never invested here before. So let's assume that a pre pandemic, we had mostly specialists in the space. What percentage of the capital markets right now are new players to the space? Chris, what would you say?

Chris Bodnar
I'd say we probably have 30 percent new players in our sector and it takes time for them to

make an impact. So, you know, we like to typically say it takes them a year to go through their white paper phase and, you know, just go through all the things that we just talked about, you know, on versus off campus, you know, if you're on campus is typically going to be on a ground lease well, why is that going to be on the ground lease for the hospital wants to put some restrictions in place so that you're not putting competing uses in the building itself. So there's so many nuances in the sector that this new capital really has to learn. And it goes back to that intellectual capital that we talked about previously is that, you know, groups like Ventas and others have that and understand that. And it's also the relationships. There is a lot of new capital certainly in the sector. The problem is trying to find the operator that can help them place it.

Pete Bulgarelli
Hey, Chris, I just have a question for another competitor in the marketplace these days is really the health systems themselves in some cases are willing to buy their MOBs back that they once sold some. You know, 10 years ago, are you seeing a lot of that or is it pretty sparse?

Chris Bodnar
We saw a lot of that pre pandemic. You know, these health systems had a lot of cash on their balance sheet and, you know, had the opportunity to acquire some of their assets. Post pandemic, you know, a lot of health systems had to make very big capital outlays. I mean, we talked to one health system, for example, who was building a 12 story medical building and was considering mothballing the whole thing for two years to, you know, basically fund the other objectives that they needed to during COVID. When I originally got into the space, you know, one of my mentors told me that health care is going to go in the way of hospitality. You know, you look at hotels and hospitality and look at Marriott and Hilton and all these brands. At one point in time, they actually own their real estate. And then they eventually decided that they can make a much better return on their capital, just investing in their operations so that philosophy and the health care space has taken a lot longer and my perspective to be adopted. But I do think at some point it will go there.

Spencer Levy
Well, I for one, vote for health care going like hospitality because I want nothing more than a pina colada and 18 holes of golf just prior to getting a serious procedure. So if they do that, I'm heading back to the MOB. So we've talked a little bit here about the markets. And you've mentioned some of your deals, Pete, in Philadelphia, in North Carolina. Chris, you mentioned some deals in Southern California and Texas. So as a traditional real estate professional, when I think about markets, I think about demographics, I think about growth, and I think about how am I going to not just buy into it, but what's it going to look like five, 10 years down the road? Pete, what are the key demographics you look for in a new investment and specifically not just population size, but age and things like that?

Pete Bulgarelli
The first gate is the basic demographics, its overall population growth. And also, just as importantly, is what we call payer mix, is what type of insurance the people in this community generally have. Is that Medicaid is a Medicare as a private payors itself pay. Those are the first step. So we go through and look at the attractiveness of the medical office building. The next step that you take is what health system is it associated with or is it associated with the health system and within the health system what hospital is it associated with? And then you start looking at who's inside the building, what types of practices, how sticky are those practices to stay in the building? And then finally, you look at the quality of

the building itself. It's almost a pyramid which starts with the base demographics than the health of the system, the health of the hospital, health of the tenants, and then finally the quality of the building.

Chris Bodnar
Pete did a great job explaining all the metrics that investors look at when investing in a deal. It does get very nuanced and you're probably aware of this. But, you know, we do a lot of work, CBRE, with health systems out there on helping them identify where they want to be located going forward. And it goes back to, you know, our company helping retailers, you know, the Starbucks and, you know, different fast food chains deciding what corner do they want to be on? Where is the population growth? We have a new system at CBRE called Dimension Med, which overlays all those traditional demographic factors, but also overlays what Pete mentioned, which is, you know, payer mix. You know, what percentage of the population is insured by Medicare, Medicaid versus private insurance? You know, looks at market share of the health systems where all the other health systems are located, where different providers are located. It helps these health systems make an educated decision on where they should be located going forward. So I think the way health systems are looking at it are the exact same way that investors are looking at making, you know, investments in the sector.

Spencer Levy
Pete, from your point of view, you've been in this business for 30 years. What are the next 10, 15 years look like for medical real estate? How is it changed because of the pandemic?

Pete Bulgarelli
It's changing so quickly. It's amazing. I mean, it's just, you know, every year it seems to accelerate more and more. I mean, it's what I'm sure Chris would agree with me on this. The one thing that all the health systems have done is they've accumulated a massive amount of real estate while they've been acquiring physician practices. So I think one of the things that is almost a certainty is the health systems will rationalize the footprint that they have. They will develop core facilities either on campus, off campus or whatever. And I think that they will dispose of a lot of extraneous kind of old doctors buildings that they've acquired with the physician practices. Technology, as we've talked about, with telehealth and emerging technologies, the face of medicine and the use of medical office buildings will change dramatically over the next 10 years. And what we've seen with some of our new medical office buildings is the acuity goes up in those buildings. It's a certainty that acuity is going up for the procedures that are performed within these medical office buildings and outside of the hospital that the facilities themselves with within that building need to change. They need to accommodate gurneys. They need to be able to switch on MRI machines as new technology takes place and in some cases do procedures where there might even be overnight stays in some of these medical office buildings, which is a completely different dynamic than what we're seeing today. But the overriding thing that I see is that the 65 plus age group is going to be 21 percent of the population in about 10 years. Right. And they consume 36 percent of total health care spend. So you're going to have this push and pull between the use of technology to making these buildings more efficient with a dramatically increased amount of demand hitting these buildings, these physicians in these practices.

Spencer Levy
Thank you. And Chris would love to hear your crystal ball. How do you see the next 10 years in medical real estate, specifically medical office?

Chris Bodnar
We could talk for another hour about trends and where we think this this sector's going. But I will highlight technology again, like Pete said, you know, if you look back five to 10 years, doing a total knee replacement on an outpatient setting was unheard of. And the fact that they can you know, surgeons can now do that on an outpatient basis and get reimbursed by Medicare and Medicaid is a huge technology change. I think the other thing that we're really going to look at, too, when I mentioned reimbursement and we're seeing this a lot already, is that the distinction between the provider and the insurance company is converging. You're seeing a lot of insurance companies actually getting into the provider business as well.

Spencer Levy
So on behalf of The Weekly Take, it was great to talk about medical office and other forms of health care real estate first with Pete Bulgarelli, the president and CEO of Lillibridge Health Care Services and EVP at Ventas. Pete, thank you for joining us.

Pete Bulgarelli
Spencer is a great conversation. It's a pleasure meeting you. And Chris was great catching up and look forward to talking going forward.

Spencer Levy
Well, Pete, you were terrific. And Chris Bodner, vice chairman, health care and life sciences, capital markets at CBRE, longtime friend and colleague. Chris, thank you.

Chris Bodnar
Thank you. Thank you for your friendship. Pete, great to chat with you. And again, I appreciate you taking the time.

Spencer Levy
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