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Just What the Doctor Ordered

Medical-office condominiums offer healthy returns

BY JOBE DUBBS

They've been called everything from a passing fad to a minor niche market to a sound and sustainable business model with high growth potential. Some have dismissed their relevance. Others have hailed them as long overdue. They're medical-office condominiums and, if market dynamics are any indication, their recent boom will continue for quite some time.

From Niche Market to Mainstream

Clearly, the rise of medical-office condominiums reflects a growing niche market that will offer numerous long-term opportunities for real estate investors, developers and brokers alike.

Consider this: While office building construction has slowed in many regions of the country, medical-office condominium development shows no sign of abating. In fact, demand for medical condominiums is expected to increase dramatically because of the rising health care needs of the retiring "baby boomer" generation—an estimated 76 million people.

Indeed, as the age of the average baby boomer nears 60, health care spending will increase dramatically. Fueled in part by a growing senior population, total health care spending is expected to grow from $1.9 trillion to more than $2.9 trillion during the next five years.

This rising tide has profound implications for our nation's real estate economy. Case in point: More than $6 billion in new medical offices are expected to be built during the next five years, while sales volume of medical office buildings is expected to grow 300 percent, according to some analysts.

Medical condominiums have wide-ranging appeal to small businesses and professional firms such as primary care physicians, dentists, cosmetic surgeons and fertility clinics—just to name a few. These professionals prefer to cluster in medical hubs so they can network and take advantage of opportunities for referral services from complementary medical care providers.

While smaller office users such as dentists and sole practitioners may average anywhere from 1,400 to 2,500 square feet, larger medical office users can take up to 10,000 square feet or more of space.

As more lower-risk procedures are performed outside of hospital settings through outpatient services, demand for medical condominiums will only continue to escalate. And that's prompting many investors, developers and brokers to enter the fray.

Prescription for Success

Before entering any real estate market, an understanding of that market's unique characteristics is essential. The growing medical-office condominium market is no exception.

First and foremost, it's true that medical-office condominiums can be a better investment for property owners. Space often is sold early in the planning and construction process, which mitigates risk for investors and developers. In addition, medical condominiums typically have longer-term tenants and higher lease-renewal rates. While general office projects are characterized by three- to five-year leases and an average 60 percent renewal rate, medical-condominium leases average eight years and a 90 percent renewal rate.

Typically, medical-condominium users invest $50 to $90 per square foot in tenant improvements, compared with $30 per square foot for general office users, so it's a much higher switching cost for them to pick up and move. As a result, medical-condominium tenants are more likely to stay put. This provides steady cash flow and rent stability over the life of the property for the landlord.

From the developer's perspective, the very nature of the health care provider's profession makes development sites in higher population growth areas—such as California's booming Inland Empire—particularly attractive. Proximity to hospitals often is a criterion, especially because there is a huge trend in outpatient services as part of an effort to reduce overall health care costs.

But development of medical condominiums is much more than just a matter of picking the right location. These types of facilities require unique design elements that can increase the cost of development 20 percent or more compared with other office condominium projects. For example, medical-condominium users have unique electrical and complex plumbing needs that Class A and other office buildings may not require. They also need reinforced floors for heavy equipment, higher ceilings—especially for ambulatory surgery centers—and more parking.

While developments can range from mixed-use projects to buildings as small as 5,000 square feet, projects typically are designed to accommodate about four or five tenants per building. Buildings should typically be designed as single- or two-story, low-rise buildings ranging from 5,000 to 80,000 square feet. Park-like settings are ideal.

Not surprisingly, one of the biggest purchasing groups of medical-office condominiums is physicians. In some markets, they comprise as much as 60 percent of medical-office condominium owners. Partly, this is the result of physicians diversifying their investment portfolios because of still historically low interest rates, the instability of the stock market and slow growth in the national economy.

As savvy business professionals, physicians also know that it is often less expensive for a medical practice to own than rent. As owners, they have opportunities to build equity and, by renting other portions of their buildings, they can get an immediate return on their real estate investment, where returns range from 15 percent to 40 percent.

Besides, medical practices often make considerable investments in building improvements when they lease. Physicians in particular would rather invest that capital in a fixed asset rather than a variable cost.

There are numerous tax advantages as well as the benefits of a predictable, stable monthly expense and property appreciation. Plus, they are locked into a prime location.

But there's one other key reason why physicians are flexing their buying power: attractive financing. More often than not, medical providers have access to more favorable financing options than the typical buyer.

For example, while it's not unheard of for the average property owner to obtain financing with only 10 percent down, those loans usually come with higher fees attached. In contrast, many medical professionals easily qualify for 90 percent financing with minimum fees. That's because lenders view health care practices as less risky because of their higher net worth and proclivity to set up shop in a permanent location.

Some analysts claim that self-owned office condominiums may be as widespread as self-owned residential condominiums in the next decade. This certainly portends well for medical-office condominiums.

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