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TOO HOT? Feverish Health Care Investment By REITs Poses Risks for Investors

Analysts Worry 'Frothy' Market for Health Care Real Estate May Erode Yields, Leave Some Buyers With Bad Case of Debt

Medical real estate has emerged as one of the hottest property types of the year for investors, with REITs, hospitals and providers pumping billions of dollars into the space in a scramble to expand and acquire the specialized space, driven by the aging population and expanded health care options under Obamacare.

Some analysts, however, are concerned that certain investors may end up in traction. While the most recent acquisitions highlight the segment's continued rapid growth, Fitch Ratings recently issued a report raising questions about the risk that a growing pool of buyers from all end of the investment spectrum may end up overpaying for properties, pursue higher-yield, higher-risk assets, or go into debt to maintain the frenzied growth pace that investors have come to expect from the sector.

To date, publicly traded health care REITs, the largest suppliers of investment capital, have funded their growth conservatively and without significant leverage, benefiting from opportunistic equity raises at substantial premiums to net asset value (NAV), Fitch said. But the rating agency warned that growth expectations for this sector may be difficult to maintain.

"We believe the premiums reflect shareholders' expectations of continued growth, and continuing to satisfy these expectations may prove challenging," according to research headed by Fitch Director Britton O. Costa.

While publicly traded REITs remain the largest suppliers of health-care property capital, private buyers such as non-traded REITs are also jumping into the game, aggressively buying properties and keeping capitalization rates low and prices high, said PJ Camp, principal with Hammond Hanlon Camp LLC, a health care-focused independent investment banking and advisory firm.

"Clearly there are more players in the market than ever before. It's hard to find anyone who doesn't want to be in the space," Camp said during a presentation on MOB mergers and acquisition activity this week by Levin & Associates.

Medical office buildings, assisted-living facilities and other health care real estate were ranked as the most attractive property investment this year and over the next 12 months, for the first time surpassing multifamily and industrial assets, according to DLA Piper's 2014 State of the Market Survey released earlier this month.

However, despite their favored status, health-care properties are still not producing yields as high as some other asset classes, DLA Piper noted. The firm cited research from Green Street Advisors that the average cap rate on health care properties was about 6.8% in July -- down from about 7.2% a year earlier but still nearly two percentage points higher than average yields on office or apartment buildings.

Meanwhile, investors continue to raise cash and pour money into the health-care space, with the REIT sector being particularly active, including property acquisitions, M&A deals and initial public offerings.

Health Care REIT, Inc. (NYSE:HCN) announced recently that it anticipates acquiring about $1.7 billion of properties in the second half of 2014, including the previously announced deals to acquire HealthLease Properties REIT for $950 million, the $257 million transaction with Sunrise Senior Living to buy Gracewell Healthcare. HCN expects to invest $535 million in new deals expected to consummate before the end of the year.

The $1.7 billion volume for the last six months of 2014 includes $597 million of post-acute and long-term care properties, $468 million of seniors housing triple-net lease properties, $371 million of seniors housing operating properties and $306 million of medical office properties, HCN said.

The HCN deals follow similar blockbuster acquisitions by HCP, Inc. to acquire Brookdale, and two deals totaling $3.5 billion by Ventas Inc. (VTR), the biggest U.S. health-care REIT, as it expands its ownership of medical offices and seniors housing.

In separate deals announced in June, Ventas agreed to buy American Realty Capital Healthcare Trust (HCT) Inc. for $2.6 billion in cash and stock, along with 29 independent senior-housing communities in Canada from Lake Oswego, OR-based Holiday Retirement for $900 million cash.

While HCN's transactions focused on higher risk skilled-nursing assets and the rights to acquire future developments, the Ventas/HCT deals was priced at one of the lower cap rates to date, Fitch said.

"Large transactions are required to meaningfully increase earnings via external growth, as the average enterprise value of HCP, VTR and HCN is nearly $30 billion," Fitch said. "This dynamic may also drive REITs to employ higher leverage levels or pursue higher yielding, lower quality assets to make transactions accretive, especially as capitalization rates compress due to the competitive acquisition environment.

"Recently, we have seen health care REITs' share prices waver as the market began to question whether growth would be harder to come by," Fitch said.

Weighing supply, demand and demographics, it's easy to understand the attraction of health care properties to investors. Although typical build-out costs for medical space are more expensive than traditional office space, MOBs typically command higher rents and owners also benefit from a relatively stable tenant base, according to Ethan Vaisman, real estate economist for CoStar Portfolio Strategy.

That has led to an investment explosion in markets like Washington, D.C., where sales of MOB space have to almost $680 million since the beginning of 2013, more than the previous six years combined, in part due to one major deal in January 2014, Harrison Street Real Estate Capital’s purchase of five MOBs in Fairfax County in two separate transactions from Washington Real Estate Investment Trust for a combined $193.6 million.

Responding to the increased demand, D.C. developers added 334,000 square feet of medical office space to the region’s inventory in 2013 with another 285,000 square feet under construction so far this year, Vaisman said.

Like many U.S. metros, the population of people aged 65 or more in the Washington area has grown significantly over the last four years and is expected to outpace total population into the next decade. Demographics, coupled with a rise in the number of insured under the Affordable Care Act, should contribute to greater demand for space over the next few years, Vaisman said.