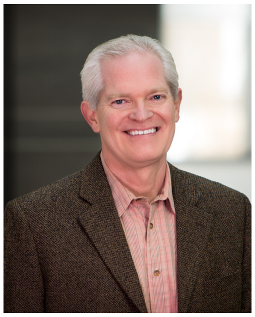
Omaha, Nebraska

Medical Office Market Overview

Volume 5 | January 1, 2018

CUSHMAN & WAKEFIELD | LUND COMPANY



The Cushman & Wakefield / Lund Company Medical Office Report is produced annually for the benefit of owners, investors, owner-occupants and tenants of medical office buildings throughout the metropolitan Omaha, NE area. Inventory as referenced in the Report includes traditional medical office buildings, owner-occupied community clinics, ambulatory surgery centers and specialized outpatient treatment facilities. If a property caters to both office and medical uses, it must have at least half existing medical occupancy to be included in the inventory.

The Report is prepared by Richard Secor, Jr., Partner, Cushman & Wakefield/Lund Company, a 35 year veteran of the commercial real estate industry and a member of Cushman & Wakefield's Healthcare Practice Group. The Practice Group is a national platform of real estate professionals with a focus on the sales, leasing, valuation, management and financing of healthcare properties around the United States, including medical office, assisted living, skilled nursing and hospital facilities.

AFFORDABLE CARE ACT UPDATE

Although President Donald Trump and fellow republicans on Capitol Hill have failed in their attempts to formally repeal the Affordable Care Act ("ACA"), there still continues to be political maneuvering to weaken the Program further. The President, for example, issued an Executive Order in October to allow Association Health and Short-Term Health Insurance Plans, which are low cost coverage plans that provide fewer benefits to insured individuals. These programs will cause healthy people to exit current Exchange Plans, leaving a pool of sick members, having the effect of increased costs and future higher insurance premiums for those remaining on the Exchange. Moreover, imbedded in the recent Tax Reform legislation, is the repeal of the requirement that people pay a tax penalty if they're not insured. Also, there are cuts in federal subsidies available for low income individuals acquiring insurance on the Exchange. Many of these individuals would not be participating in the Exchange without the tax penalty and subsidies. Consequently, they will be dropping out of insurance coverage. President Trump's and Congress' recent actions no doubt will further weaken the ACA, making dramatic reform inevitable.

The Exchange, where individuals on-line can compare available health plans, sign up for coverage and qualify for income tax credits and other subsidies to reduce out of pocket costs, continues to be plagued with issues, one in particular is the dropping out of several national insurance companies. Insurance claims or benefits are exceeding premium costs due to an unbalanced pool of unhealthy versus healthy enrollees, including those with preexisting conditions, broader coverage and "drop in-drop out" enrollees, those that discontinue paying premiums once they received needed medical care. Nevertheless, it is estimated that 11M people will have addressed coverage on The Exchange for 2018. This is a 10% increase over 2017. Nationally, insurance premium costs on The Exchange are projected to rise 34%. This is in contrast to 25% in 2017. In Nebraska and Iowa, where there is just one insurance company participating (Medica), insurance premium costs are forecasted to rise at least 42% and 69%, respectively. 94,000 Nebraskans and 64,000 Iowans participate in The Exchange. Interestingly, because of the higher insurance premiums on The Exchange, many individuals are contemplating dropping out and foregoing insurance coverage altogether, while others are considering Direct Primary Care ("DPC") programs that would be supplemented with Catastrophic Health Insurance Coverage. These two, when combined, seem to be a cost effective alternative for healthcare. Moreover, DPC programs have two distinct advantages to patients in that there is direct access to physicians and there's an elimination of having to address insurance claims, a heavy burden for both patient and physician.

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With all its criticisms, the fact that there has been an approximate 40% decline in the number of uninsured (estimated to reflect 19.4 M people) since the inception of the Act, cannot be ignored. The addition of the newly insured however, is not without cost, as approximately 50% of those individuals now receive Medicaid, while the majority (85%) of the remaining approximate 50% who now have private insurance, qualify for federal subsidies. However, now that there are Executive Orders and Tax Reform legislation that would reduce federal subsidies for lower income individuals, the price for insurance coverage will no doubt, increase for those participants or may require those individuals to drop current health insurance plans. Even though there are currently more insured, the majority of hospital systems interestingly, are providing more uncompensated care because insured individuals either can't afford the out of pocket costs or choose not to pay. The implication of many more insured, coupled with a growing 65+ year old population base, should continue to fuel the need for medical services and thus additional medical office space demand in the future.

Those individuals covered in Group Insurance Programs or Employer sponsored programs, are seeing rising deductibles, less coverage and higher participant premium costs. Premium costs continue to rise with large and small firm Group Health Programs. Average price increases of 6% are slated for 2018. Employers consequently, are focusing on wellness plans and offering more narrow plans as a means of controlling long-term and short-term costs, respectively.

In general, Hospital Systems and Physician Groups continue to experience budget constraints due to less overall revenue (primarily due to cuts in reimbursements from Private Insurance, Medicare and Medicaid and the shift from a payment system of fee-for-service to value-based.

THE ECONOMY

The National economy continues to improve. The unemployment rate is 4.1%, the lowest since December 2000 (3.9%). 13 states are below 4.1%. Hawaii has the lowest rate, 2.2%. Nebraska's rate is 2.7%. The national 2018 unemployment rate is projected to drop further to 3.9%.

Gross Domestic Product ("GDP") growth for 2017 is projected to be 2.5%. That same rate is forecasted for 2018. GDP growth for 2016 was 1.6%. We are said to be entering a "new normal" of slow growth. For the next four years, average annual growth in GDP is estimated to be 2.5%. This is promising relative to the average annual growth in GDP the last four years, 2013-2016, which was 2.1%. In contrast, however, the U.S. average annual growth in GDP, 1948-2015, was 3.1%.

There continues to be greater optimism among investors, economists and policymakers that the economy will continue to improve as a result of President Donald Trump's and Congress' actions on tax reform and less government regulation. This hope continues to drive the Stock Market to record gains. The Dow Jones Industrial Average ("DJIA") gained 25% in 2017. On December 31, 2016, the DJIA was 19,763; at year-end, 2017, 24,719.

As a measure to curb anticipated inflation, The Federal Reserve raised the Federal Funds Rate (the rate of which banks borrow from one another) 25 basis points three times this year. Three more similar increases area planned for 2018.

Although the economy appears to be performing well, there are still concerns of inflation, consumer confidence, sustained job growth and a major stock market correction.

"On average, $10,345 is spent annually on healthcare per individual in this country."

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Healthcare and the Economy

The Healthcare industry in the United States represents a significant portion of GDP, currently at 17.8%. This translates to approximately 3.2 trillion dollars of annual expenditures for hospital visits, medications and other healthcare. By 2021, it is forecasted that healthcare expenditures will approximate 20% of GDP. More than 10% of jobs (1 of 9) are in Healthcare. Healthcare, most certainly, plays a vital role in our economy.

Although there appears to be a slight slow-down in healthcare cost growth, it still is rising more rapidly than the overall economy and certainly wage growth. Overall healthcare costs increased 5.8% during 2015, the fastest rate in eight years. As a matter of perspective, on average, $10,345 is spent annually on healthcare per individual in this country. This figure of course, is substantially skewed because of treatment costs for the very sick people. Consumers continue to incur significant increases in costs due to higher deductibles and premium costs whether enrolled in Employer Sponsored Programs or The Exchange.

> It is estimated that health insurance premium costs will rise on average 34% for those participating in the Exchange and 6% in Employer Sponsored Programs.

Demographics and Behavioral Impacts on Healthcare

There are 78 million baby boomers. Those people celebrating their 65th birthday are at the rate of 8,000 per day. Probable life expectancy of a 65 year old today is 84 years of age. As a consequence, nearly 20% of Americans will be 65 years of age or older by 2030. This is a staggering statistic with huge implications to the healthcare industry to accommodate geriatric care.

Interestingly, only 10 – 15% of one's good health is attributed to healthcare services. The remaining 85-90% is related to behavior, genetics and social determinants. The future emphasis on healthcare, no doubt, will continue to be preventative care.

National, Regional, and Local Healthcare Trends

- Increased consumer spending as a percentage of Gross Domestic Product (GDP)
- Consumer transition from being a "Passive Patient Purchaser" to "Active Healthcare Consumer"
- Provider shift from "Fee-For-Service" to "Value-Based Payment" model
- Provider shift to "better patient experience"
- Continued improvement of Hospital System efficiency to address value-based care
- Increased emphasis of Hospitals for acute care only
- Increased emphasis of Ambulatory Care Centers ("ACC"), located in retail suburban settings, to serve consumers more cost efficiently and conveniently for outpatient services

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Healthcare and the Economy

- Increased employment of physicians by Hospitals
- Continued increase of alignment of larger Physician Groups to particular Hospital Systems
- Continued decline in the number of small Physician Groups
- Continued emergence of "Quick or Urgent Care" practices within existing general practice clinics (expansion of hours), in units that are in-line or freestanding locations built for the purpose, units within discount stores, grocery and drugstores and in corporate office settings
- Continued growth of Tele-Health programs that enable patients to receive diagnosis, schedule appointments and to comparatively shop for specific care
- Increasing medical records use among physicians, nurses and consumers allowing for instant access to patient records
- More high tech data analysis for better patient care
- More behavioral healthcare demand
- Vertical integration among industries in healthcare, i.e., insurance company ownership of primary and specialty care practices, pharmacy ownership of insurance companies, etc.

Sources: Bureau of Labor Statistics, AHA 2015 Environment Scan, The Washington Post, Deloitte University Press, The Atlantic, The New York Times, The Kiplinger Letter, USA Today, Forbes, Fortune, Omaha World-Herald, Midwest Real Estate News, Heartland Real Estate Business, National Conference of State Legislatures, Society for Human Resource Management, The Conference Board, PWC Health Research Institute, Marcus & Millichap, Cushman & Wakefield 2017 Medical Office Investor Survey and various white papers from Cushman & Wakefield Healthcare Practice Group and Centers for Medicare & Medicaid Serves (NHE Fact Sheet)

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Current Medical Office Building Statistics

Space Availability

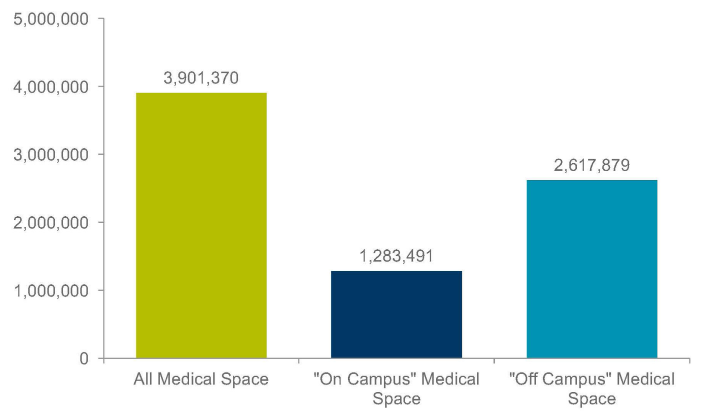
Among 135 buildings recently surveyed, there is approximately 3.9M SF of Medical Office Building ("MOB") inventory in the metropolitan area. Available space reflects approximately 230K SF or approximately 5.9% of all medical space. Nationwide, average medical office space vacancy approximates 7.9%. In contrast, the traditional office building market in Omaha (non-owner-occupied) approximates 21M SF of inventory with 2.3 M SF or 11.1% of space availability (vacant and sublease space). Omaha, to be sure, has a healthy Medical Office Building market.

Approximately 1.3 M SF of total MOB space reflects "On-Campus" space, space located on Hospital campuses; while the remaining 2.6 M SF, "Off-Campus" space. Space availability in each category reflects 84 K SF (6.6%) and 146K SF (5.6%), respectfully.

It is important to note that several hospitals continue not to categorize some of their current vacant space in their On-Campus MOBs as "available" as they are reserving it either for temporary relocation space to accommodate displaced medical operations as a result of construction activity or are reserving such space for undetermined long-term use.

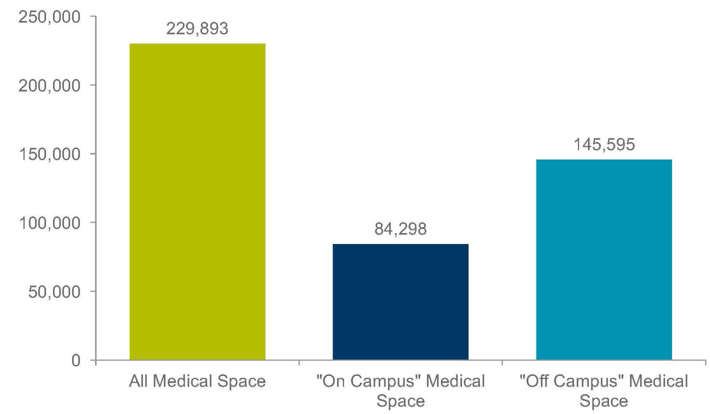
Total Market SF

Omaha, Nebraska



Available SF

Omaha, Nebraska



Current Medical Office Building Statistics

Investment Activity & Pricing

Physicians Realty Trust ("DOCREIT") recently bought three MOB's from CHI: Immanuel One (73K SF), 6829 North 72nd Street, CHI Health Clinic (131K SF), 7710 Mercy Road and CHI Health Clinic (79K SF), 2412 Cuming Street. Since these three properties were acquired as part of a larger portfolio purchase, specific sale data for each is not available.

In addition to the DOCREIT acquisitions, there were two other transactions. A local private investor acquired the Midwest Pain Clinic Building (27K SF), 825 North 90th Street. The sale price was $4.475M ($166 PSF). A local investment group purchased Lakeside Three Professional Center (21K SF), 16929 Frances Street. The sale price was $2.5M ($119 PSF).

After a seven-year streak of year-over-year declines, average capitalization rates have begun to increase. The increases however, have been very small, 10-15 basis points, depending upon class of product and location whether on or off campus. Current national averages are 5.95% and 6.50% for Class "A" MOBs on and off campus, respectively; 7.45% and 8.35% for Class "B" MOBs, correspondingly. MOBs are still considered a favored asset class among all commercial real estate asset classes given the strong demand for office space due to principally an aging population needing healthcare services. Sale volumes for this preferred investment, like other real estate classes, is expected to decline if interest rates continue to increase.

Rental Rates & Trend

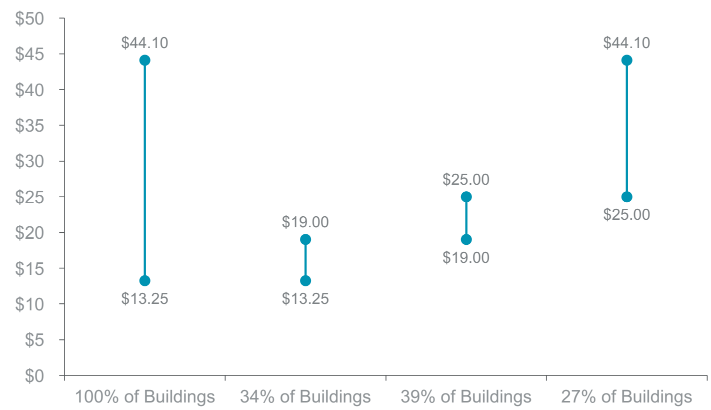
General local on campus MOB full service rental rates range from $18.50 to $31.50 PSF with off campus $13.25 to $45.60 PSF. The significant lower rate range, particularly in the off-campus sector, reflect older MOBs, containing available space that probably will not be used as medical office space again because of location, size or condition. The higher rate range in both classifications reflect newer specialty medical space.

Sale Trends

"After a seven-year streak of year-over-year declines, average capitalization rates have begun to increase. The increases however, have been very small, 10-15 basis points, depending upon class of product and location whether on or off campus."

Full Service Rent PSF

Omaha, Nebraska



*Based upon 56 buildings surveyed.

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Project Activity

Recent Project Completions

- CHI Health Creighton University academic, in patient services and trauma unit relocation to CHI Health Bergan Mercy Hospital, 75th & Mercy Road.
- Nebraska Medicine Fred & Pamela Buffet Cancer Center (577,000 SF; $323M), 44th & Dewey Avenue Vicinity.
- Nebraska Medicine Clinic (13,000 SF), 86th & Giles Road.
- Nebraska Medicine Clinic (13,000 SF), 168th & Giles Road.
- Methodist Hospital Surgical Center Expansion & Renovation ($90M), 84th & Dodge Streets.
- Methodist Women's Hospital Neonatal Intensive Care Unit (NICU) expansion ($18M), 192nd & West Dodge Road.
- Kountze Memorial Lutheran Church Medical Clinic (4,400 SF "Methodist Community Health Clinic"), 26th & Douglas Streets.
- Children's Hospital's acquisition of current HDR Corporate Buildings and Durham Plaza, 84th & West Dodge Road, comprising 201,000 SF for all three buildings located on 7 acres. The intended use is administrative when all current tenants vacate buildings. Interestingly, the Hospital's current campus contains just 7 acres.

Projects under Construction

- Hope Lodge, a cancer-only lodging facility for patients and their families (32 rooms), 81st & West Dodge Road. Scheduled completion is late January 2018.
- Children's Hospital Expansion & Renovation (500K SF Expansion & 100K SF Renovation; $450M), 84th & Dodge Streets. The expansion project includes construction of a 10-story building to house relocation of the NICU from Methodist Hospital, new and expanded pediatric intensive care unit (PICU), surgical areas, a larger emergency department, a fetal care center and expansion of hematology and oncology. The expansion will enable the Hospital to expand bed count from 140 to 250. As a matter of perspective, this project represents a two-fold increase of Gross Leasable Area (GLA) on campus. Scheduled completion is spring, 2021.
- Methodist Health System's relocation of its corporate headquarters from 84th & Dodge Streets to 168th & Pacific Streets. Scheduled completion on the three-story, 160,000 SF, building is late 2018.

Nebraska Medicine Fred & Pamela Buffet Cancer Center

Methodist Health System's new corporate headquarters

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Project Activity

- Nebraska Medicine Davis Global Center for Advanced Inter-professional Learning (192K SF; $119M), 42nd & Emilie Streets. The facility will house the National Center for Health Security and Bio-preparedness, including quarantined 20-beds for observing people exposed to infectious diseases. In addition, the facility will contain the Inter-professional Experiential Center for Enduring Learning ("iEXCEL"). Scheduled completion of the four-story building is late fall 2018.

- Nebraska Organ Recovery broke ground on a two-story, 22K SF facility located between 38th Avenue and 39th Street in close proximity to the Nebraska Medical Center, where most transplants occur and also to its largest donor hospital. Scheduled completion is late 2018.

Announcements

- Children's Hospital's pending acquisition of 7 acres from Methodist Health System west of its most recent purchase of the HDR Corporate Buildings and Durham Plaza, 84th & West Dodge Road. The additional area is slated for parking and long-term growth. After this acquisition, the Hospital's footprint west of the intersection will be twice that of its current campus (14 acres vs. 7 acres).

- A revised announcement of a new Veterans Administration (VA) Hospital Clinic, to provide primary care, specialty care and ambulatory surgery to be located on current VA campus, 42nd & Center Streets ($86M; 157K SF). This is a scaled down project relative to the previously announced development, and of course, the original Government -sponsored 1M SF, $560M VA Hospital replacement. The alternative is a planned public-private partnership. Funding will be provided by the VA ($56M) and Private Donors ($30M). Construction is scheduled to begin spring, 2018 with facility completion, fall 2020.

- OPUS Group's intended development of a four-story, approximate 106K SF Medical Office Building, at Southport, 126th & Giles Road, La Vista, NE. The firm is currently marketing the site to various Hospital Systems and Physician Groups. The Project will need to be substantially pre-leased before construction commences.

- Dignity Health (San Francisco, CA) and Catholic Health Initiatives (Englewood, CO), parent of CHI Health in Nebraska and western Iowa, have completed their due diligence and have formally announced a merger between the two entities to occur during the second-half, 2018. The merged system would represent the largest not-for-profit hospital system by revenue ($28B). Dignity has 39 hospitals; CHI, 100.


Children's Hospital 10-story Expansion and Renovation