

## MEDICAL OFFICE BUILDINGS TAKE THE SPOTLIGHT IN LA

While medical office buildings can be great investments, investors must realize the challenges of this niche product type.

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Medical office buildings and other healthcare-related office products are extremely meaningful components to the Los Angeles office market. According to CoStar, medical office space represents nearly 10 percent of the total occupied office square footage in Los Angeles. This figure is only exceeded by the financial services (including insurance and real estate), general services and legal industries.

Medical office vacancy rates in the Los Angeles region are less than 10 percent, which is substantially lower than that of traditional office space, which hovers near 17 percent. This number becomes even more significant when you realize that the compounded five-year return for healthcare-related real estate was about 15 percent. This is compared to the compounded five-year return for traditional office space, which is about 5 percent, according to the FTSE NAREIT US Real Estate Index. Medical office buildings also command higher rental rates than comparable office product, which increases their attraction for investors.

President Obama's re-election last year, as well as the Supreme Court's decision to uphold his healthcare reforms, has ensured us that we will see the Affordable Care Act implemented in the future. As a result, about 30 million citizens will likely be added to the healthcare market. An influx this large suddenly gaining access to "affordable" healthcare will undoubtedly trigger an increased demand for healthcare-related real estate. Additionally, the percentage of Americans aged 65 and older is expected to increase from 13 percent (in 2010) to about 20 percent by 2030. As the number of physician visits is sure to increase, Medicare, Medicaid and Social Security will almost certainly take up an even larger share of the U.S. gross domestic product.

These factors bode well for both the near- and long-term future of medical office buildings and other healthcare-related real estate. However, owning and operating this real estate comes with its own unique challenges. Physicians and other healthcare providers typically desire a level of technological amenities that is not present in traditional office space. This creates an increased risk of functional obsolescence. Healthcare confidentiality

concerns also require medical office building operators to accept restrictions on premises inspections and other access rights, which are not present in traditional office leases. Ownership must also provide for, or at least help facilitate, medical waste disposal.

Demand for medical office buildings located on hospital campuses is likely to remain strong. The appeal of a built-in tenant base, however, comes

with significant restrictions. For example, hospitals generally prohibit medical office building operators from leasing to non-privileged physicians or to facilities that compete with those located in the hospital. They may also restrict an owner's ability to sell to a group that competes with the hospital. This leads many ownership groups to seek out hospital-adjacent locations that aren't tethered to such restric-

tions. However, those locations may command lower rental rates. They may also be more difficult to fill.

Medical office building ownership and operation requires a greater level of operational sophistication than other office classes. Although these issues can challenge ownership, they also create barriers to entry by real estate investors who are unfamiliar with, or simply frightened, by them.



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