CUSHMAN & WAKEFIELD

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COMPASS

Navigating the Minneapolis-St. Paul Commercial Real Estate Market

MEDICAL OFFICE

Medical Office Prognosis Remains Good; Systems Pause to Adjust to Changing Healthcare Environment

The Twin Cities medical office market continues demonstrating strong vital signs including steady demand for space, increasing absorption, stable vacancy rates, and an uptick in rental rates. The construction pipeline has slowed, as demand catches up with new supply.

Future new construction will primarily be build-to-suits for healthcare systems. However, developers continue pursuing key sites in prime submarkets for multi-tenant medical office buildings (MOBs).

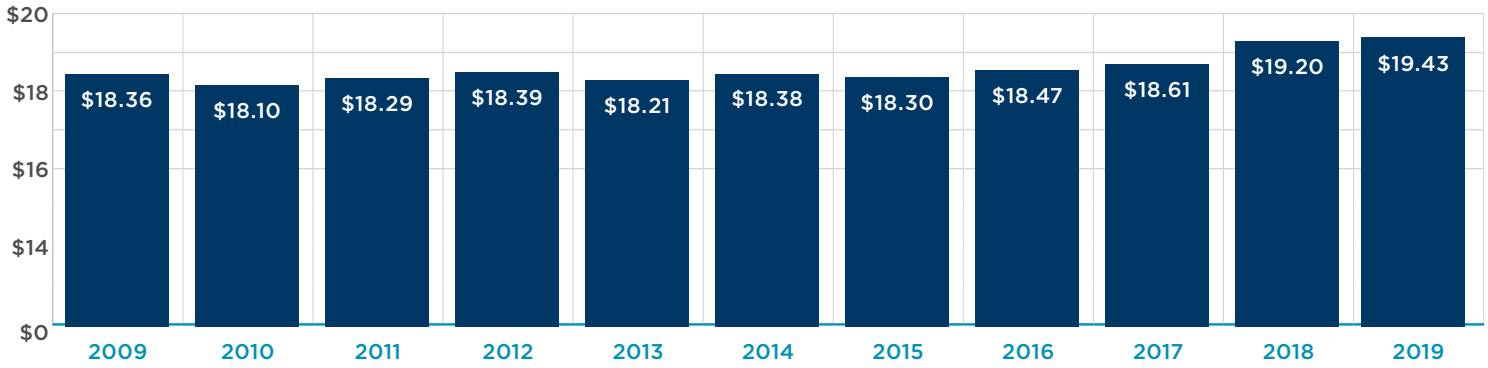
Many uncertainties are at play in healthcare. "Disruptors" include baby boomers' growing medical needs, new technologies, changes in reimbursements/regulations, uncertainty around healthcare policy, impact of mergers/acquisitions, millennials' desire for convenience, patients' healthier lifestyles, and overall changes in healthcare delivery.

These factors are impacting how medical real estate is used and drive space requirements. For instance, the market has seen a move away from multi-tenant buildings to single-tenant and system-driven facilities offering services under one roof, and a shift from on-campus to off-campus properties.

Following their last round of multimillion-dollar reinvestments to update and expand core assets, systems have pumped the brakes on activity. Most are in the process of completing renovations to older facilities to stay competitive and accommodate new technologies and healthcare delivery models that improve efficiencies and patient experience. Now, there is a pause as systems regroup and re-strategize to seek ways to operate more efficiently.

MEDICAL HISTORICAL RENTAL RATES (AVG NET)

Source: Cushman & Wakefield



As reimbursements decrease and healthcare costs increase, systems are feeling pinched and looking for ways to reduce costs. HealthPartners announced layoffs and plans to close all retail pharmacies. Allina Health is facing similar challenges.

Following the latest mergers and acquisitions, systems are wrapping their arms around their new combined organizations and working on internal efficiencies. They are undertaking long-term planning to integrate and consolidate their different business units. Systems often vacate redundant spaces after completing mergers as they consolidate into more efficient footprints. Conversely, consolidation also means fewer independents to backfill MOBs, but specialty groups like dental, dermatology, and mental health services continue to seek space.

As buildout costs continue to rise, developers and landlords are offering medical users significant tenant improvement packages in the $80- to $150-per-square-foot (psf) range. In return, longer leases are the norm, particularly for new construction. Tenants are signing 12- to 15-year leases, up from the typical seven to 10 years, and rents are in the $25- to $30-psf range. Healthcare groups are willing to commit to longer leases and pay higher rents, as it provides a more predictable cash flow, and reduces the large upfront investment for the costly buildout.

For developers and landlords, the higher lease rate and bigger tenant improvement allowance will be recaptured largely through rental income over the lease term and higher building valuation when they go to sell the asset.

Quoted average net rental rates have ticked up only slightly to $19.43 psf despite the influx of new construction. However, much of the new construction is single-tenant and not reflected in the multi-tenant universe.

Investor appetite for Twin Cities medical office properties remains voracious, as the sector has proven to be recession-resistant with high renewal rates and solid demographics. However, there is a shortage of available product for sale and significant competition for assets that are on the market. Due to the limited inventory, some investors are stretching investment parameters to include assets with medical-related tenants. Among notable sales was Harrison Street Real Estate Capital's purchase of the Summit Orthopedics building in Eagan for $29.4 million.

OUTLOOK

Activity should remain steady with positive absorption forecasted. Several projects could be announced, and there are several letters of intent in the 20,000-sf range. Internal system consolidations will continue, which could include layoffs and more right-sizing due to gained efficiencies from mergers.

Rising tenant improvement costs will continue to push longer lease terms and higher rental rates. Capital will continue chasing assets as investors are drawn to the sector's strong fundamentals. However, supply will likely remain limited. Smaller medical office buildings designed for individual and small practices are becoming outdated, and some will be redeveloped.

MEDICAL VACANCY & ABSORPTION

Source: Cushman & Wakefield

SUBMARKET	TOTAL # OF BLDGS	NRA	VACANT SPACE	% VACANT	% VACANT W/SUBLEASE	1ST HALF 19 ABSORPTION	2ND HALF 19 ABSORPTION	2019
Off Campus	76	3,293,474	397,729	12.10%	12.70%	(2,242)	30,195	27,953
On Campus	40	3,205,650	276,563	8.60%	9.10%	443	14,903	15,346
Total Market	**116**	**6,499,124**	**674,292**	**10.40%**	**10.90%**	**(1,799)**	**45,098**	**43,299**

ABOUT THE AUTHOR

THE COMPASS REPORT

 The report was created by experts using Twin Cities commercial property data from 2019. The Compass report includes information for multi-tenant office, industrial and retail projects greater than 20,000 SF and multifamily for-rent properties. Not included are owner occupied, government or single-tenant buildings. Not all information and insights we've collected can be published in any given issue.

ABOUT CUSHMAN & WAKEFIELD

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 51,000 employees in 400 offices and 70 countries. In 2018, the firm had revenue of $8.2 billion across core services of property, facilities and project management, leasing, capital markets, valuation and other services. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

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