U.S. Research Report

Healthcare Services

Q2 2022

Inflation Compounds Healthcare Cost Concerns

Cost containment has long been a core issue for the U.S. healthcare industry. Consumer Price Inflation (CPI) has ramped up to a four-decade high. When combined with reimbursement concerns, healthcare providers' ability to drive down costs and sustain profit margins is increasingly challenged.

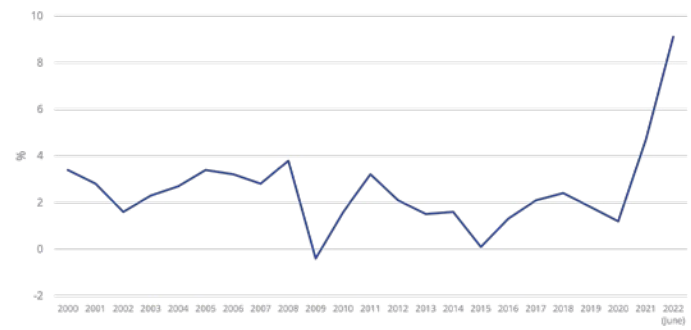
Rising CPI is also impacting the medical office sector. On the supply side, rapidly rising material costs and labor shortages are causing delivery delays and extended fit-out periods for new properties. In addition, the Fed's aggressive stance on raising interest rates to curb inflation, coupled with higher bond yields, is causing investors to reconsider their real estate strategies.

In this report, we address the dual impact of high inflation on the healthcare industry and medical real estate and provide insights about the future.

Economic Context

The rate of inflation in the U.S. is at a 40-year high. June's CPI – the principal measure used by the Bureau of Labor Statistics (BLS) – reached a 9.1% annualized rate, up from 7% at year-end 2021 and 5% one year earlier in May 2021. The June number is the highest since November 1981. The ramp up in prices began in April 2021, following 10 years where annualized CPI typically ran in the 1% to 2.5% range. The highest reading recorded during this period was 2.9% in June 2018.

U.S. Consumer Price Inflation (Annual Average)



Source: BLS

What is driving the rapid increase in CPI to such elevated levels? It is a confluence of factors including strong consumer demand, a tight labor market, companies retaining pricing power, elevated gasoline prices and supply-chain stress

Key Findings

- *CPI is at a four-decade high and set to remain elevated for another 12 to 18 months.*
- *Rising out-of-pocket costs are making healthcare less affordable.*
- *The disconnect between provider pricing and insurer reimbursement is widening.*
- *Providers are employing multiple approaches to reduce overheads.*
- *Medical office (MOB) fundamentals remain strong, with sales volume at an all-time high.*
- *While no property class will be immune to the impact of high inflation, the MOB sector is well placed to weather the storm.*

aggravated by the COVID-related China lockdown and the continued Russian-Ukraine war. Energy and food prices are rising rapidly with increases of 34.6% and 10.1% respectively, over the past 12 months. Driven by the escalation in gasoline prices, transportation costs have also risen sharply at a 7.9% annualized rate over the same time-period.

Looking forward, any descent in CPI is expected to be gradual. Consensus Economics projects that CPI will still be close to 8% at the close of 2022. Although cooling should occur in 2023, with CPI projected to run at around 3.5%, this is still elevated compared to the 10-year average of 1.8% during 2011 to 2020.

The Federal Reserve's (Fed) long-run inflation target of 2% is based on core Personal Consumer Expenditure (PCE) inflation, which omits food and energy costs. Core PCE stands at 4.7% as of May 2022, down from a 40-year high of 5.2% in March. This measure is expected to remain elevated over the next year-and-a-half, closing out 2023 at around 3%.

To curb inflation, the Fed raised interest rates by a combined 150 basis points at its past three meetings from March through May 2022. The 75-basis point rise in May was the highest since 1994 and was followed by another 75-basis point increase in July. The consensus is that one more 75-basis point rise will occur, with the fed-funds rate projected to reach 3.25% to 3.5% by the close of this year.

There is concern that moving rates up aggressively could weaken the economy, thereby raising the risk of recession. A July survey of over 60 economists by the Wall Street Journal showed a 49% chance of a recession occurring in the next 12 months. The U.S. could skirt a recession by providing continued robustness in the labor market and heathy consumer demand. However, the economy should continue to slow. Oxford Economics projects real GDP growth of 2.3% in 2022, falling to 1.3% in 2023.

Implications for the Healthcare Industry

The U.S. has the most expensive healthcare system in the world, leading in healthcare spending per capita. Spending has increased consistently year-over-year and is projected to continue to do so.

The Centers for Medicare & Medicaid Services (CMS) forecasts that healthcare spending will increase by 4.6% this year to $4.5 trillion. At the same time, out-of-pocket costs hitting households are projected to climb by 6.1% in 2022 and average 4.6% annually through 2030. High inflation, rising insurance premiums and higher deductibles are making healthcare less affordable at a time when providers are looking to raise the price of services to bolster their own cost concerns.

The American Hospital Association summarized the situation as follows: "The current inflationary environment has put unprecedented pressure on America's hospitals and health systems. These shifts in the healthcare environment are putting enormous strain on hospitals and health systems, which will continue into 2023 and beyond."

How does inflation fit into this picture? Let us consider hospitals first. The Advisory Board has identified the following issues:

- Hospital staff may demand higher wages or compensation packages as the cost of living escalates. Driven by the demands placed by COVID-19, including staff burnout, there has been a continued exodus of clinicians and skilled nurses from the industry. As a result, hospital systems face the challenge of retaining staff while avoiding a hike in labor costs, which already make up 50% or more of total hospital expenses.

- Supply-chain challenges and increases in the cost of raw goods needed for hospital supplies and medical devices could further add to expenses which already escalated during the pandemic. This could also impact drug expenses which are already up by 28.2% over pre-pandemic levels.

- Higher inflation may also result in decreased demand for healthcare services, particularly elective procedures, as inflation outpaces wage growth. Lower demand for services could reduce hospital revenue.

- Historically, hospital price increases have been modest, rising by 2.1% annually over the past decade according to the BLS. However, this could prove untenable with persistently high inflation and, potentially, reduced demand.

At its core, healthcare is a fee for service system. When more services are provided, more fees are paid. The business of health is structured not only to provide care, but also to see as many patients as possible, perform as many procedures as possible, and discharge quickly to maximize patient turnover. The current climate of high inflation, rising costs, and fewer patients, presents considerable challenges to such a model.

How are providers paid for their services? Government programs – principally Medicare and Medicaid – account for 37% of healthcare spending in the U.S. Private health insurers account for an additional 34%. Provider costs continue to increase but to what extent will this be matched by reimbursement from the healthcare insurance industry? Inflation is serving to further heighten this dynamic.

Providers typically negotiate their contracts with insurers in three-year cycles. Those currently negotiating can use inflation as leverage, but providers that negotiated in the past two years will have to absorb more of the hit to the bottom line, potentially causing them to draw from their reserves. In addition, there is also a lag effect between rising costs and higher reimbursement. Public and private payers are typically unwilling to negotiate reimbursement levels that fully offset inflation.

Government payers are not expected to make up for the expense-revenue mismatch. Medicare has proposed a 3.2% increase for inpatient payments in 2023, falling markedly short of both inflation and providers' rising costs. This places increased pressure on negotiating higher reimbursement levels with private insurers.

HCA Healthcare and Universal Health Services, for example, are looking to raise their prices for services by 7.5% to 15% as they negotiate new contracts with payers. Similarly, The University of Vermont Health Network (UVM) is seeking approval for a 19.9% commercial rate increase in 2023 to curb the impact of inflation. UVM estimates the total cost of inflation for the fiscal year 2023 at $164.6 million.

With costs rising sharply and reimbursement not keeping pace, healthcare systems are not just facing lower profit margins but, in some cases, operating losses. Recent examples include:

- Ascension, one of the largest private healthcare systems in the U.S., reported a loss of $884 million in the first quarter of 2022, citing an 8.7% year-over-year rise in operating costs.

- Kaiser Permanente posted a net loss of $961 million in Q1 2022, driven by a 9.5% year-over-year increase in operating expenses. Higher than anticipated COVID-19 costs, supply chain disruptions, and worker shortages all contributed to the shortfall.

- Trinity Health, while remaining profitable, has seen a marked drop in net income which totaled $43 million in the first nine months of fiscal year 2022, down from $3.19 billion in the same period a year earlier. The modest gain was made possible by the $128.7 million sale of Gateway Health Plan.

inflationary conditions, property values tend to increase as inflation climbs.

Physical assets, such as real estate tend to be more resistant during periods of price volatility. When coupled with guaranteed income streams from credit tenants and the ability to raise rents, the case for owning commercial real estate is strong.

However, the cause of inflation matters. When inflation is driven by strong economic growth, CRE benefits through rising rents, low vacancy, and higher income growth expectations. Conversely, if inflation is driven by the higher cost of goods, such as in the current climate, CRE investment returns can be negatively impacted – vacancy is elevated, and property owners find it harder to attract tenants and raise rents.

The relationship between inflation and interest rates is a key factor. When rising inflation leads to higher interest rates, capitalization (cap) rates increase and returns decline. As interest rates rise, CRE's yield premium over fixed-income investments narrows, causing some investors to opt for the relative safety of bonds.

CRE cap rates have yet to rise in response to the higher cost of financing and, when they do, it is unlikely there will be a uniform response across all property types. The multifamily and industrial sectors are currently viewed as more resilient and are attracting the greatest share of investment dollars. Conversely, there is more hesitancy about the office sector due to a lack of clarity over the impact of hybrid working and future space requirements.

A 10-year Treasury rate of more than 3% is considered a tipping point. Rates stand at 2.58% at the time of writing. The 10-year is seen as a risk-free way of investing and one that investors use to measure the value of riskier investments such as CRE.

How are these factors impacting healthcare real estate? So far, the MOB sector is exhibiting resilience and robust performance despite mounting economic headwinds. MOB vacancy across the top 100 markets stands at 7.9% as of Q2 2022 compared to 15.1% for the overall office sector. Average triple-net MOB rents are up by 1.9% over the past 12 months to $23.02 per square foot.

With absorption outpacing new supply, developer confidence remains strong with 50.5 million square feet of MOB space under construction at Q2 2022, up from 42.7 million square feet at the corresponding point in 2021.

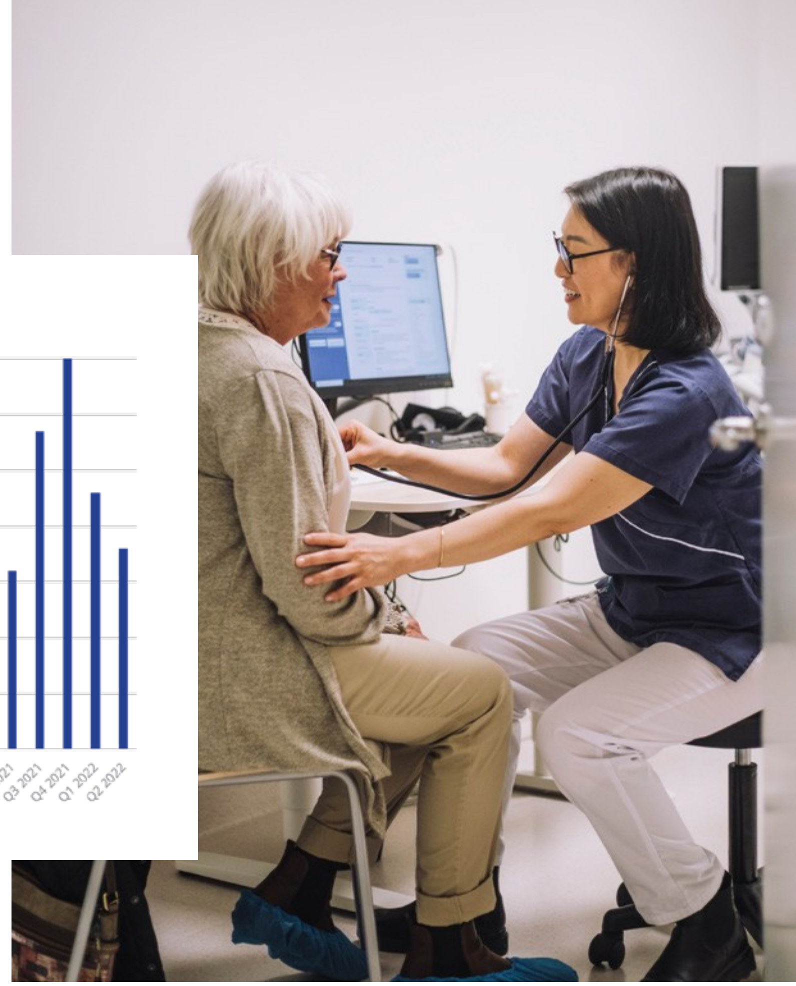
MOB investment is at an all-time high with total sales volume of $21.2 billion during the 12 months to Q2 2022. The median cap rate across these transactions

How are healthcare providers reducing their overheads in the face of high inflation and rising costs? Here are some approaches that are being employed:

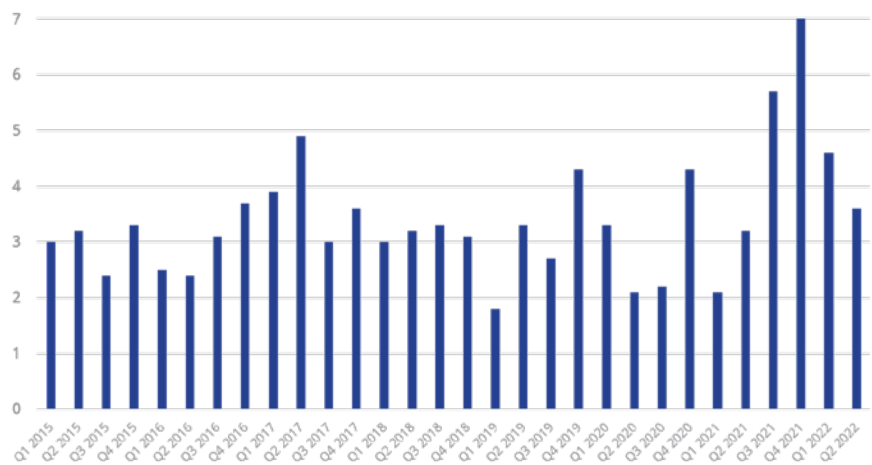
- Reducing Services. There is a constant flow of hospitals suspending or ceasing services and closing facilities due to financial challenges and staffing shortages. The range of services being impacted is wide, ranging from birth centers to behavioral health facilities.
- Staff Cuts. Healthcare providers and manufacturers made the most job cuts of any business sector through the first half of 2022. Over 19,000 jobs were cut, up 54% from the corresponding period in 2021.
- Lowering Real Estate Costs. Centene Corporation recently announced plans to shed 65% of its U.S.-leased space, as well as subleasing and selling owned properties, with an anticipated saving of $200 million per year.
- Mergers & Acquisitions. After a subdued first quarter, M&A activity is increasing as providers seek to achieve greater efficiencies and economies of scale.

Impact on Healthcare Real Estate

Commercial real estate (CRE) has traditionally been viewed as a hedge against inflation. While most investments, including stocks, react negatively in was 5.8%, with sub 4% trades for premium assets occurring in each of the past three quarters. However, 67% of respondents in a recent Revista poll expected MOB cap rates to rise in the second half of 2022.



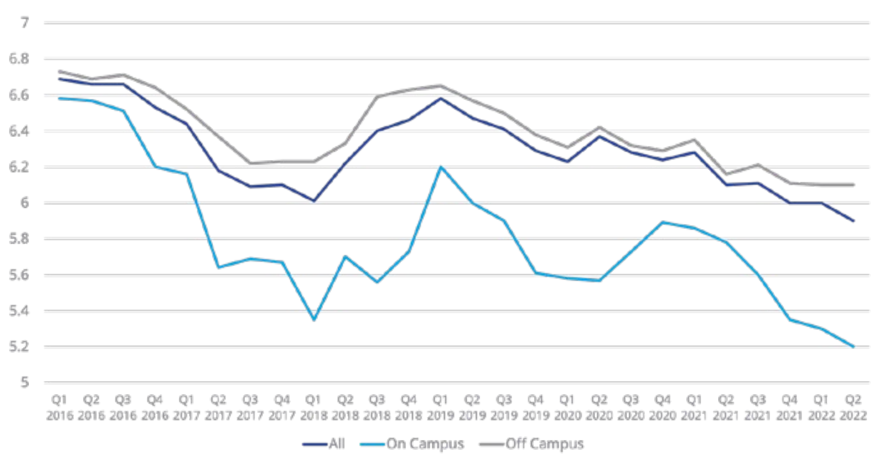
Medical Office: Quarterly Sales Volume ($Bn)



Source: Revista

Any increase in MOB cap rates is expected to lag the anticipated uptick in interest rates and should be modest due to strong investor demand for healthcare real estate, which is outpacing the supply of available product. Just over half of MOB inventory is owned by hospitals, healthcare systems and providers which further limits the number of assets brought to market.

Medical Office: Average Cap. Rates 2016 – Q2 2022 (%)



Source: Revista

However, there has been an increase in physician practices monetizing their real estate assets. Smaller providers are less able to buffer the impact of high inflation and rising costs. Sales by this user group totaled $2.6 billion in the year to Q2 2022, up from $1.5 billion in the year to Q2 2021. Expect more healthcare providers to reassess their real estate overheads, including whether it is better to lease or own.

Construction activity may slow in the face of rising labor and material costs. This is impacting both lead-in times and fit-out periods. However, this is endemic across all commercial construction and not just limited to MOB assets. Development costs are estimated to be rising by 10% per quarter impacting profit margins and causing a sharp increase in tenant improvement allowances.

While no property sector will be immune to the impact of high inflation and rising operating costs, the MOB sector is well placed to weather the storm. Underlying business fundamentals for medical tenants are stronger than a typical office tenant. There is greater stability in demand for medical services and, potentially, pent up demand from procedures canceled or postponed during the pandemic. U.S. Census data estimates that one in five Americans will be 65 or older by 2030, rising to one in four by 2060, thereby underpinning demand for medical office facilities.

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