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HEALTH LAW NEWS

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WEEKLY HEALTH CARE REAL ESTATE BRIEFING: OUR PREDICTIONS FOR 2024 – A MIXED BAG OF OPTIMISM TEMPERED BY REGULATORY HEADWINDS

On behalf of Hall Render's real estate service line, Joel and I want to thank you for being a loyal subscriber to our Weekly Health Care Real Estate Briefing. We have enjoyed producing the briefing over the past year and appreciate the feedback you have provided to us.

In previous years, we have produced a Year in Review article that has summarized some of the macro trends we covered over the previous year. While those articles have been well received, we decided to take a different approach this year. We thought it would be more interesting (and more fun) to produce an article that includes some of the major trends we covered over the past year, along with our predictions for 2024.

Here are our top 5 predictions for the health care real estate industry in 2024.

1. Regulatory Challenges Are the New Normal – In 2023, we saw a renewed interest by government regulators in health care. Regulatory oversight has taken multiple forms. At the federal level, there were several initiatives focused on the health care industry, including more aggressive guidance by the Federal Trade Commission on anticompetitive mergers, ownership disclosure requirements by the Centers for Medicare & Medicaid Services ("CMS") for skilled nursing facilities ("SNFs") and minimum staffing requirements published by CMS for SNFs. At the state level, there have been several initiatives focused on Certificate of Need ("CON") reform in states like Alabama, Georgia, Kentucky, North Carolina and South Carolina. Most of those initiatives have been focused on either repealing or amending CON laws to allow for greater access to health care services. At the local level, nonprofit providers have faced new challenges to long-standing property tax exemptions. Struggling communities are questioning whether nonprofit providers are providing enough charity care and community benefit to justify their property tax exemptions.

In 2024, we expect a continued interest by government officials in regulating health care in nearly all of the areas that were highlighted in 2023. In addition to those initiatives, there has been renewed interest by federal legislators in private equity's role in health care. We expect legislators will probe certain health care organizations and those investigations will likely result in regulators asking for more transparency in for-profit health care. That's ultimately what happened in the SNF sector. At the state level, we expect to see more interest in amending CON laws with a particular focus on granting exceptions for behavioral health care services and rural health care services. That is where most of the progress has been made in recent years. While certain groups are pushing for a total repeal of CON laws, that's unlikely to happen in most CON states. At the local level, we expect continued scrutiny of property tax exemptions being filed by nonprofit providers. As property values have fallen, so have property tax revenues. Local taxing officials are looking for ways to roll back long-standing property tax exemptions or restructure those exemptions to result in more property taxes being paid.

2. Improved Optimism in the Capital Markets – Most of us will look back on 2023 as a relatively bad year for the capital markets. A number of banks failed, interest rates hit new highs and traditional lenders were on the sidelines. The increased cost of capital has negatively impacted hospital and health care providers as well as real estate investors and developers. On the bright side, the Federal Reserve's recent announcement to hold its benchmark rate steady and to potentially cut rates in 2024 was welcome news.

In 2024, we expect relatively minor loosening in the capital markets. With a wave of commercial real estate loans maturing over the next twelve to twenty-four months, we believe many traditional bank lenders will continue to be on the sidelines. Loans tied to traditional office buildings continue to weigh on lenders - so much so that health care real estate developers and investors have begun describing their medical office assets as "medical outpatient buildings." While most of the traditional lenders do like the health care real estate sector, they still seem skittish. Loans that are being made on health care projects are covenant-heavy and lenders hold all of the cards. It seems easier to find traditional bank lenders willing to make loans for owner-occupied properties when compared to investment properties. While a slight reduction in interest rates in 2024 would be welcome news, we still believe that the capital markets will not substantially improve until 2025 or thereafter. We agree with the "Stay Alive Until '25" mantra that

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we heard from real estate veterans this year.

3. Transaction Volume Will Improve – In 2023, there was a Tale of Two Cities in terms of transaction volume. Health care real estate transactions were down 40% to 60%, depending on the asset type. On the other hand, merger and acquisition ("M&A") activity in the health care sector improved in 2023 and is now at pre-pandemic levels. Financial distress in the health care industry continued to be one of the primary drivers of M&A activity.

In 2024, we expect health care real estate transaction volume to improve based on renewed optimism that interest rates will go down. We believe that real estate investors tend to be more optimistic than most in the market. If interest rates do in fact go down, the latter half of 2024 could see a significant bump in transaction volume. Along the same lines, we expect M&A activity to continue on an upward trajectory in the health care sector. S&P recently issued a negative outlook for the nonprofit hospital sector based on higher-than-expected labor and operating costs. We believe that health care providers will continue to struggle with financial pressures in 2024 and that will drive an increase in M&A activity as providers look to achieve greater economies of scale. However, the FTC's recent scrutiny of anticompetitive mergers could be a meaningful headwind against M&A transactions.

4. New Projects Will Proceed, but Timelines May Be Extended – Higher interest rates and even higher construction costs don't seem to be slowing down large health system projects. While the price per square foot for new projects will likely increase in 2024, we expect new construction projects to proceed as planned. A number of providers have been waiting on the sidelines for economic conditions to improve and can't wait any longer. The most recent survey of commercial real estate development and construction professionals conducted by NAIOP found that the general sentiment index was slightly unfavorable for the next 12 months, but this rating has been consistent since September 2022. A number of developers and building owners predicted that local economic conditions will continue to improve. In the latter half of 2023, several multi-billion dollar health care construction projects were announced, the largest of which is Mayo Clinic's $5B expansion in Rochester, MN.

In 2024, we expect that health care construction projects will pick up as the risks of deferred maintenance and the drumbeat of new technologies pick up steam. Construction contractors and facility owners will likely continue to see extended lead times for certain materials and supplies, which may require more flexibility in force majeure provisions of construction contracts. While certain urban campus consolidation and expansion is sure to continue, we expect to see smaller, more strategic projects in new and emerging markets, such as suburbs and exurbs of large cities.

5. Growth Opportunities – There were 116 new ASCs reportedly built in 2023, 55 of which were opened by hospitals or health systems. Large ASC operators, such as USPI, SCA and AmSurg, continue to expand joint venture partnerships with hospital systems nationwide, looking to grow their outpatient ambulatory footprints. On the behavioral health front, some 47% of Americans live in a mental health workforce shortage area, which continues to be an area of focus in the post-pandemic world, where the global prevalence of anxiety and depression increased by 25% per WHO. Still, reimbursement of mental health services lags demand, creating shortages of behavioral health hospital development.

In 2024, we expect to see continued growth in the ASC, behavioral health and specialty hospital sectors. As hospital operators seek to expand from their core inpatient businesses and face increasing competition in the outpatient and telehealth spaces, we expect more hospitals will pivot toward the development of ASCs and specialty hospitals to diversify their revenue bases. We also expect that unique efforts such as Sheppard Pratt Solutions will allow hospitals to expand behavioral health development in a way that makes financial sense.

We always enjoy hearing from our subscribers. If you have any predictions for 2024, feel free to send us an email.

Happy New Year!

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