May 19, 2014

Equity Research

WELLS FARGO SECURITIES

HC REITs: MOBs--State Of The Transaction Market

Highlights Of Conference Call With CBRE

Real Estate

- On Friday (5/16), we hosted a conference call with Chris Bodnar, Senior Vice President within the Healthcare Capital Markets Group at CBRE to discuss the state of the transaction market within the medical office building (MOB) sector. Below are some of the more-relevant questions and answers from our discussion. Overall, we came away confident that pricing on upcoming private market transactions should continue to demonstrate cap rate compression for this asset class and that MOB assets in particular remain one of the most sought after assets within the healthcare REIT space. We believe it is important to point out that the two top-performing healthcare REITs through Q1 were the two more pure-play MOB owners, HTA and HR.
- **Supply Demand Imbalance Continues.** While 2014 has been projected to be a record year for MOB transaction volumes following a year of about $7B in total in 2013, volume thus far has lagged. It is clear, however, that the lack of investment volumes year to date is not due to a lack of demand, which remains quite strong. Demand for class A on-campus assets as well as class A off-campus with some form of hospital affiliation remains very healthy and pricing on deals that close are expected to demonstrate further cap rate compression.
- **Strong Demand and Pricing Could Shake Loose Some Added Supply.** There is the potential that some initial long-term holders may bring some of their product as the environment remains heavily weighted towards sellers.
- **MOB Investors Are Chasing the Hospital Systems Not Just the Campus.** Demand trends highlight an increasing focus on being partnered with the right health systems as opposed to simply being “on-campus.” Cap rates are narrowing considerably between on-campus assets and off campus assets that are associated with a well-respected healthcare system sponsored project or if a significant portion of the asset is leased by a dominant health system.
- **HC REITs Continue To Be Aggressively Looking for Deals.** While HC REITs did not account for a large percentage of 2013 acquisition volumes the fact that the stock prices lagged considerably from May through year-end may have played a role. This year, the stocks have performed well (up +20.5% YTD for the broader Healthcare REIT group vs the RMS at +16.2% and the S&P at +2.4%) and the REITs seem eager to put capital to work in the space. Brokers are seeing them actively present in many deals.
- **Debt and Financing Environment Is Quite Healthy, Which Could Be Keeping Assets From Coming to Market.** The ability for owners to tap debt capital for MOBs through various sources (Life Companies, CMBS, Commercial Banks, CTL, etc) remains wide open currently and quite attractive with LTVs creeping up and interest rates remaining low. While it helps on the demand and pricing front it is likely impacting the amount of product that is coming to market.
- *Please note: a replay of the call is available until 5/23/14, by dialing: (855) 859-2056 (domestic) and/or (404) 537-3406 (international); replay ID: 41460834. Also, a copy of the slide deck associated with the call is available upon request. Please contact your Wells Fargo sales representative for more information.*

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Please see page 4 for rating definitions, important disclosures and required analyst certifications
All estimates/forecasts are as of 05/19/14 unless otherwise stated.

Cap Rates from Survey

Class A On-campus assets saw the biggest increase in those respondents that believe the cap rate will be in the 6-6.5% range (43% up from 27%; and 11% in the year prior), which also had the largest percentage of respondents (43%; compares to last year when 42% believed cap rates would be in the 6.5-7.0% range).

Class A Off-campus assets saw the biggest increase in those respondents that believe the cap rate will be in the 6.0-6.5% range (12% up from 5%), while the largest percentage of respondents (39% vs. 37% LY) believe the cap rate will be in the 7.0-7.50% range.

Class B On-campus assets saw the biggest increase as well as the most respondents believe the cap rate will be in the 7.0-7.5% range (50% up from 40%).

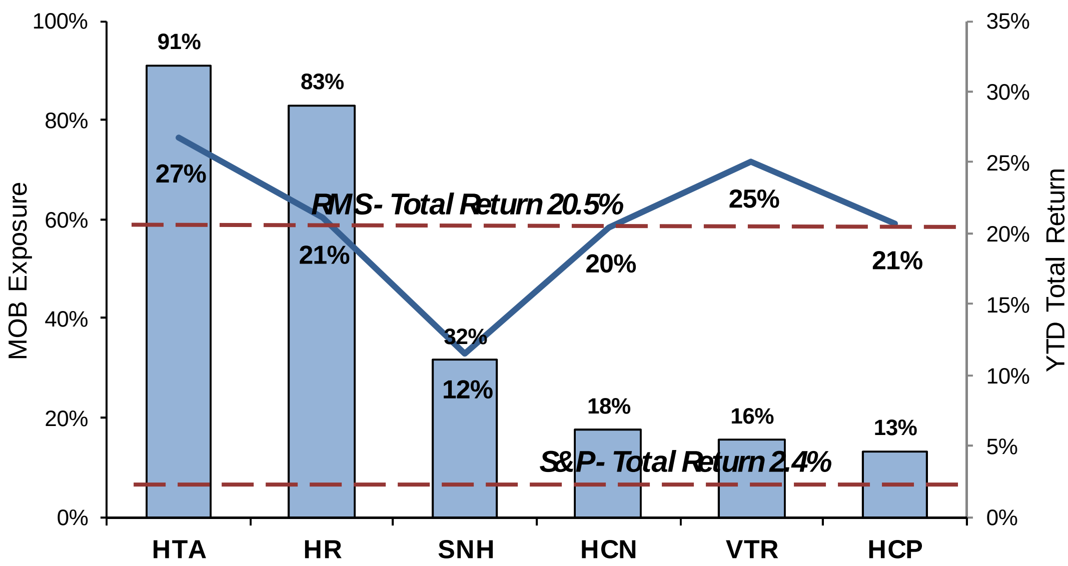
Class B Off-campus assets saw the biggest increase as well as the most respondents believe the cap rate will be in the 7.5-8.0% range (44% up from 30%).

The results of this survey seem consistent with current trends and suggest a 100-200bp premium for Class A On–campus over Class B Off-campus assets this year. The spread between Class A On-campus and Class A Off-campus is expected to be between 25-50bps currently.

We believe it is important to point out that the two top performing Healthcare REITs through Q1 were the two more pure-play MOB owners, Healthcare Trust of America (HTA, Outperform, $12.32) and Healthcare Realty (HR, Market Perform, $25.15). We continue to favor this property type and believe the secular trends continue to benefit fundamentals and should result in increased interest for the asset class from various capital sources. Note: valuation holds us back from assigning HR shares our highest rating at this time.

Year to date, HTA (91% of total portfolio MOB) and HR (83%) have outperformed the immediate peer group by generating 27% and 21% total returns, respectively, year to date. This compares to the RMS of +16% and the Healthcare REIT group at +20%. The other REITs with at least 10% of their portfolios represented by MOBs and their respective year-to-date total returns are illustrated in Table 1.

Table 1. Healthcare REITs with Considerable MOB Exposure and Relative Total Return Performance YTD



Source: Wells Fargo Securities, LLC and SNL Financial

Additional Conference Call Takeaways

Trends in Healthcare Capital Markets

- 2013 was the best year on record with about $7 billion in sales volume in the MOB sector.
- Public REITs did not account for a large portion of the transactions.
- Looking at 2014 – pricing has gotten even more aggressive since the end of last year but it has been a much slower start to the year as far as closed deals. It's certainly not due to a lack of demand however.
- There is currently an imbalance of supply and demand and there is the potential that some holders of MOB assets that had expected to be long term in nature may bring some of their product to market as they see the potential pricing.

2014 CBRE MOB Investor Survey

- Top-tier HC investors are projected to be allocating $8 billion to the acquisition of MOBs in 2014 – of that about $3 billion is attributable to the non-traded REITs.
- 84% of respondents stated they would be net buyers of MOB assets in 2014.
- Big trend recently is to chase the hospital systems not the campus – they're seeing spreads narrow considerably on a cap rate basis between on campus assets and off campus assets if the off campus asset is associated with a well-respected Healthcare system sponsored project.
- Cap rates are expected to remain at all-time lows across all classes of MOB assets.

Competition for the Asset Class

- HC REITs continue to be a large player and aggressive in the market -- while HC REITs did not account for a large percentage of 2013 acquisition volumes the fact that the stock prices lagged considerably from May through year end most likely played a role. This year the stocks have performed well and they are seeing a big push from the REITs to put capital to work.
- Non-traded REITs continue to emerge as stiff competition for these assets – top players currently are AHI, ARC, CNL and CTV. AHI started capital raising for REIT III and the WSJ is reporting that REIT II is currently being shopped around to potential suitors that may include several public, traded names though management of the REIT has not commented. While this portfolio is not a pure-play MOB portfolio it will be interesting to see if it trades and how aggressive the pricing is and if the HC REITs get outbid considering there have been very limited portfolios of size to hit the market recently. Aggressive pricing on this portfolio with interest from outside the public REIT arena could justify even lower cap rates used in NAV estimates.
- New institutional funds are pursuing MOBs – seeing more interest from life companies and pension fund money. Pension money should be the leading driver of pricing of core assets this year.
- High net worth individuals have been more active as well with a lot of the acquirers being board members of hospitals--key attribute with these deals is they are typically more dependent on debt.

Debt Markets/Financing

- Life companies are currently underwriting at 60-65% LTVs with 10-yr loans in the 4.25% with a 30-yr amortization ("am") and 5-yr paper at 3.3%.
- CMBS market closer to 70-75% LTV with 4.75% on 10-yr money/30-yr am and 4.6% for 5 year.
- Commerical Banks at 50-60% LTV with 5 yr floating at 1.9% or LIBOR + 175 going up to 2.4% or 225 over LIBOR on 70% LTV deals – swap to fix spreads of 180bps
- Credit Tenant Leases (CTL financing) – 100% LTV 15 year lease with 4.2% interest rate; 30 yr lease at 4.9% interest rate
- Funding alternatives overall seem plentiful with attractive pricing.

Trends

- Seeing a wider acceptance by institutional funds for the product type – seeing a lot of pension fund money coming through the deals and they should set pricing for core assets in 2014.
- The number of REITs investing capital in the MOB space continues to increase including non-traded REITs and those focused on single tenant assets.
- Health Systems are going to think real estate strategies. Healthcare systems have been holding off on their real estate strategies to a certain extent until they figure out the full impact of Healthcare changes. While they still don't have this fully figured out they have made good progress and they're expected to start being more active with their real estate holdings.

The CBRE U.S. Healthcare Capital Markets Group specializes in providing healthcare real estate investors with acquisition, disposition and debt & equity recapitalization strategies; assisting healthcare providers with strategic capital planning (including monetization of non-core real estate); and advising health systems and physician groups in the developer selection process. More information can be found at: www.cbre.us/services/capitalmarkets/healthcare/Pages/home.aspx

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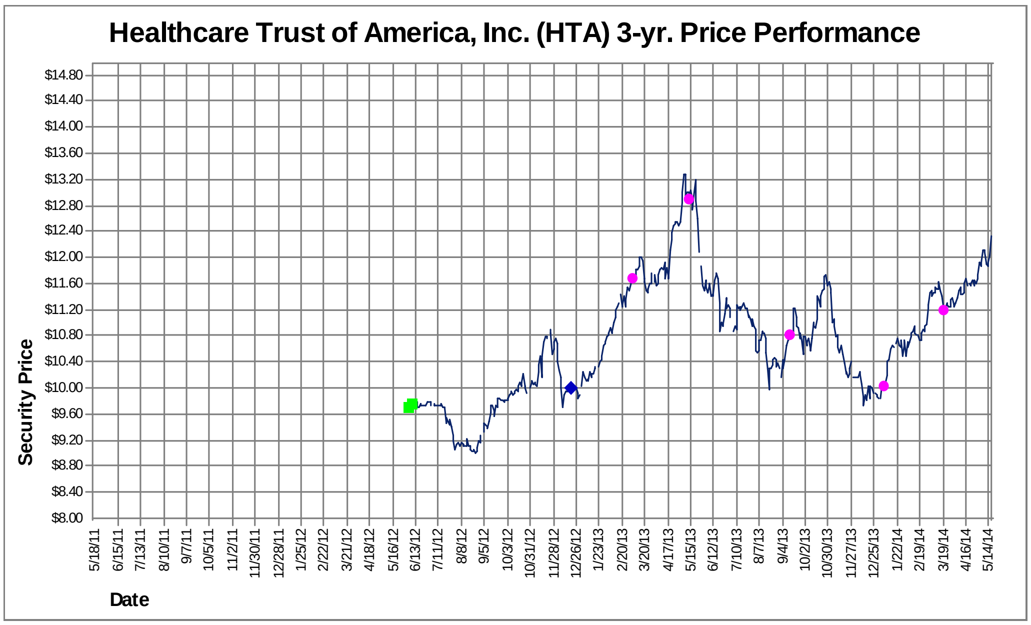


	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
❐	6/6/2012		Lists on NYSE at $9.90			
	12/20/2012		Stender			
◆	12/20/2012	9.94	1	10.50	11.50	10.00
●	3/5/2013	11.64	1	12.00	13.00	11.69
●	5/14/2013	12.89	1	13.00	14.00	12.89
●	9/13/2013	10.79	1	12.00	13.00	10.80
●	1/6/2014	10.04	1	11.00	12.00	10.04
●	3/20/2014	11.22	1	12.00	13.00	11.18

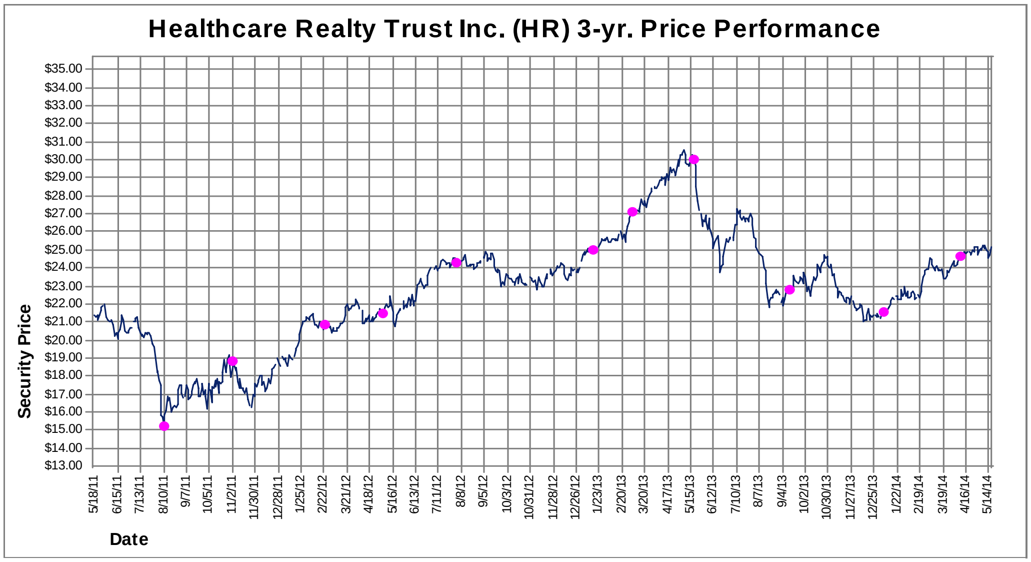
Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- ❐ Split Adjustment

Rating Code Key

1	Outperform/Buy	SR	Suspended
2	Market Perform/Hold	NR	Not Rated
3	Underperform/Sell	NE	No Estimate



	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	5/18/2011		Stender			
	5/18/2011	NA	2	22.00	24.00	21.35
●	8/10/2011	15.45	2	16.00	17.00	15.16
●	11/3/2011	18.73	2	20.00	18.00	18.78
●	2/23/2012	20.55	2	18.00	20.00	20.83
●	5/3/2012	21.49	2	20.00	22.00	21.49
●	8/1/2012	24.28	2	21.00	23.00	24.28
●	1/16/2013	24.98	2	22.00	25.00	24.96
●	3/5/2013	27.10	2	25.00	28.00	27.07
●	5/20/2013	30.23	2	27.00	30.00	30.01
●	9/13/2013	22.78	2	23.00	25.00	22.80
●	1/6/2014	21.55	2	22.00	24.00	21.55
●	4/9/2014	24.54	2	23.00	25.00	24.66

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

Rating Code Key
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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