

Demand outweighs supply in medical office market

BY STEVE HABEL
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**Norman
Gelfand**

The law of supply and demand is alive and well in the Austin area, and that old principle has spilled over to the medical office space market. With Austin's health-conscious population booming, more medical professionals — and office space for those practitioners — are needed.

Medical professionals who already own offices or have well-negotiated leases don't realize how good they have it. Some doctors wanting to move to Austin are put off by high lease rates — so much so that many are opting to purchase property and roll the dice that the long-term advantages will outweigh the many potential downsides.

More medical condos are being built in Austin because the city's quality of life and its aging population are attracting more doctors to Central Texas. Advances in medicine and health care procedures also act as catalysts, drawing more specialists to town.

Furthermore, federal law changes have required hospitals and existing medical offices owned by medical groups to be competitive with the private sector.

Private market opens up

No longer can doctors be given under-market lease rates in return for referring patients to a facility. This has made medical condos more competitive, opening up more of the private market.

Norman Gelfand, president of the Gelfand Group, which specializes in tenant representation and has many doctors and dentists on its client list, says the demand for medical office space is strong.

"I have difficulty finding space for the medical professionals who work with me," he says. "Right now, I am working with three dentists and two doctors, and we are having difficulty in finding anything."

Physicians owning the office space where they practice makes sense in some cases, Gelfand says. He says ownership is a financial decision based on how the physician wants to use his or her working capital.

The return on investment of ownership must meet the doctor's investment criteria — meaning the lost interest income on the down payment, combined with the interest payment of the mortgage and the three-year writeoff period, must be compared to the cost of rent and the total writeoff of the rent payments.

"The reason to own is the return on investment of the specific property," Gelfand says. "An example is if the lease rate, less operating costs, will determine a better net operating income to the buyer. To be advantageous, all investments must stand on their own."

As with everything in life and in business, however, there is a flipside to the ownership coin. Neighborhood demographics can change, making properties less desirable.

Moreover, there is the certainty that medical or dental procedures will evolve, possibly rendering an office's interior layout obsolete or impractical. Also, changes in government regulations, city ordinances or building codes can create unanticipated remodeling costs.

There are cash-flow considerations too. Oftentimes, buying rather than leasing ties up a doctor's working capital, making alternative investment opportunities difficult or impossible. Furthermore, a lease tends to be a more flexible option when partnership changes occur.

The cost of ownership

According to Gelfand, medical condos typically sell for \$139 to \$169 per square foot for a cold shell, with another \$60 to \$100 per square foot for internal finishout. In comparison, rental rates for finished-out space range between \$17 to \$28 per square foot. But tenants must factor in additional expenses, such as taxes, insurance, electric bills, building maintenance and janitorial fees.

Al Ranney in the Austin office of commercial real estate firm The Kucera Companies says market demand is pushing rental rates even higher. He is developing the new Northwest Hills Medical Center.

"Medical rental rates are increasing in certain areas of town," he says. "They remain the strongest rates among professional offices."

Rates for finished-out space are higher for medical condos because interior finishouts cost more.

For instance, plumbing for handwashing stations is needed in every exam room. And exam rooms are typically smaller than regular offices, creating more hard walls to construct.

However, if doctors purchase a shell condo and build it out themselves, there is little difference in initial rates from other types of office space.

"At the same time, one must understand that the higher finishout cost of medical space creates a higher amortization cost and it adds to the overall cost of the condo," Gelfand says.

Medical condos also are more expensive than regular office condos because they require 50 percent more parking spaces. That means a purchaser will have to weather higher land costs and higher parking lot improvement costs.

Another consideration is that medical condos often receive more traffic than normal office space, thus necessitating higher maintenance and replacement expenses.

Hank Marcantoni, an oral surgeon who is relocating to Austin from Minneapolis, visited here several months ago in search of office space.

After a futile search for leases, Marcantoni decided to purchase 4,700 square feet of office space on two levels in a building in the 4100 block of Duval Street.

"I approached ownership versus leasing by initially obtaining advice from my commercial broker, my attorney, my banker and my accountant," Marcantoni says. "Their input was an important part of the equation. The other key factor is my financial situation."

Marcantoni says he was able to obtain 100 percent financing at a fair market rate.

"This was important for me, because, in my situation, I plan on building an ambulatory surgical center in my office," he says. "This will be a costly venture. And, because of this large investment in building out my office space, it makes more fiscal sense to own versus lease."

"I also feel that making an investment in the community and city will be beneficial for everyone. This is why ownership makes sense for me."

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