Health Care: A Growing Force in Retail Real Estate (Part II)

Understanding the Operational and Locational Challenges of Incorporating an Unfamiliar Component Into the Tenant Mix

Abstract: This is the second and concluding part of a summary of a recent interview with Chad Pinnell, Managing Director of JLL’s Health Care Solutions group. It delves into the operational and locational issues related to health-care tenants in retail real estate, including the converging interests of the health-care and shopping center industries; how daily operations for health-care and retail tenants differ; the impact of health-care tenants on retail real estate; the advantages of having a health-care facility; locational challenges and how to ease them; and changing ownership of medical practices and how that affects their credit.

Converging interests of health care and retail real estate

Medical facilities represent a major form of development that shopping centers are observing with increasingly avid interest. Approximately 33% ($9.8 billion) of the construction value of expected medical real estate completions in 2018 will be new medical office buildings.1 According to Revista, an Arnold, Md.-based firm that tracks health-care property data and related industry information, (See Chart 1.) Yet conditions affecting both the health-care and retail real estate industries have been paving the way for common ground and explorations between the two sectors for a while now.

Lessons Learned

- Approximately $9.8 billion of the construction value of expected medical real estate completions in 2018 will be new medical office buildings.
- Doctors’ instructions to patients lead to prescriptions that can be fulfilled in stores, thus benefiting retailers in the same shopping center or mixed-use project.
- Retail real estate design and location considerations with health-care systems in mind will involve such factors as signage, parking, outparcels, and neighborhoods.
- Ambulatory care facilities are more compatible with retail real estate than high-acuity facilities such as hospitals, both in demographics and the relative lack of complexity necessitated.
- Different health-care facilities will involve varying consumer willingness to travel (e.g., families will travel farther to avail themselves of life-saving treatment than they would for more routine care).
- Matching consumer-patient profiles enable developers and shopping center owners to consider synergies between a retailer and health-care facility.
- Several major advantages may result when a health-care facility locates in retail real estate, including critical mass, familiarity, scalability, barriers to entry, visibility, co-branding and/or brand drafting.
- Landlords should also be aware of potential challenges involved in having health-care tenants, such as underwriting, the “you’re not wanted here” syndrome, physical structures unsuited to health care, and rents and terms.
- Hospital affiliations may provide greater overall tenant stability and credit ratings than independently owned health-care practices, as the hospitals themselves become the lessees.
- Retailers and shopping center owners need to invest as much time in understanding the business models of various health-care facilities.

Until recently, for instance, health systems did not consider revenue when exploring new facilities. (See Figure 1.) In fact, the entire idea of revenue in the pro forma is new or non-existent to health systems.

However, most executives understand very well high-margin and low-margin modalities, or therapeutic agents or methods. Orthopedics, neurosurgery, oncology, and women’s health are among the best revenue- and margin-generating modalities. Retail real estate executives should realize that pediatrics, primary care, and behavioral health generate far fewer revenues on the margin, but are absolutely critical to the patient-referral network. As with banks, “switching costs” are high so referrals at the primary care level are essential in fostering more specialized practice.

Health systems should look to retailers to expand that referral pattern. A unique characteristic of a visit to a doctor is that patients leave with instructions for improving their health. This can result in a referral pattern that can benefit retailers. For instance, a grocery retailer might have a dietitian who can help a patient adhere to the doctor’s recommended weight-loss regimen, creating a potential partnership.

Additionally, health-care systems are beginning to follow smart signage practices for all the same reasons that retailers do. For a long time, it was anathema for health-care systems even to talk about advertising. Over the past decade, they have gotten much better at understanding the importance of a common brand, the meaning of their logo, and the effectiveness of prominent, visible signage, in welcoming colors.

Health-care systems also require heavy parking demand. Fortunately, they are typically busy earlier the day, when retailers are the slowest. With retail parking demand at its peak from late afternoon to evening, the two uses complement each other. This strong synergy increases the use rate of parking spaces, which in turn means more traffic flow to the shopping center.

In addition to parking, another serious consideration in designing with health-care tenants in mind involves outparcels. Malls’ openness to ground leases reduces the capital outlay required for new construction, thus providing “reasonable” medical rents, in line with the market. There is no need to acquire expensive (and usually desirably located) land. While credit is strong and lease terms are long, required tenant improvements are much higher than for a traditional retail tenant. Furthermore, some mall owners may be reluctant to have patients co-mingling with patrons and may require a separate entrance, which can be cumbersome and cost-prohibitive.

In contrast, outlot, freestanding locations at the periphery of malls work much better than retrofitting, a space such as a big-box department store. Additionally, outparcels give prominence to the retailer or the health system better than in-line space. They impart identity to the space and transmit consistent messages to the community about delivery use and strength of care.

Neighborhoods also play a role in location decisions for health-care systems. Obviously, both health systems and retailers are attracted to high-income, growing neighborhoods. However, health systems’ insurance reimbursement can inspire different locational models.

Sometimes income is not the driving factor, but rather high employment with health benefits. A $50,000 UPS worker with great benefits might be just as attractive as a $200,000 self-employed person. Also, health-care business models now developing may be profitable in low-income neighborhoods thanks to expanded Medicaid coverage provided by the ACA. Henry Ford Health in Detroit is an example of coverage and health care for everyone. An owner of a shopping center that has seen declining retail tenancy due to shifting neighborhood employment or income could benefit from a relationship with a health system.

Neighborhoods that have seen an influx of immigrants might also be compatible with certain health-care modalities. Cardiac care facilities, for instance, might find a home in low-income neighborhoods that may have a high propensity for cardiac episodes.

Traditionally, it can take up to 10 years to move a large project such as a hospital through the health-care system. But ambulatory-care facilities are not as complex to develop as high-acuity facilities, and retail real estate offers health-care operators an alternative model of how to expand quickly or “scale”: big, medium, or small “boxes” that can be fit to meet the needs of a particular market. Instead of one deal at a time, a health-care developer can do multiple.

How daily operations of health-care facilities differ from retail

High-acuity care facilities—typically, hospitals that may require beds and an intense focus on individual patients—do not co-exist readily with retail. They are subject to government regulations from the Centers for Medicaid/Medicare Services and/or The Joint Commission that are designed to ensure the safety of the patient, doctors, staff, and visitors.

Ambulatory care facilities, on the other hand, are a good deal more compatible with retail, both in demographics and the relative lack of complexity necessitated. There are about 20.9 million square feet of medical office buildings under construction as of mid-year 2018, according to Revista.2 (See Chart 2.) Nevertheless, the difference between ambulatory care operations and retail will vary as widely as the difference between McDonald’s and Petland’s. Generally, health facilities require some specialization in construction and a higher level of facility care.

2 Ibid.
To their relief, landlords are finding that lease terms for health-care tenants are better than for retail. Lease lengths—sometimes running 15 years—extend longer than average, but A+ credit ratings make this easier to justify and the center as a whole will benefit from the resulting stability. Meanwhile, average cap rates for off-campus medical office buildings were 6.4% as of Q2 2018, according to Revista.

Generally, most shopping center customer traffic (utilization) patterns are higher in the evenings and weekends. Health-care delivery, on the other hand, historically has been a daytime business. This is important to a shopping center owner considering a mass solicitation for health-care tenants. For example, if a major landlord wants to attract health-care tenants across its portfolio, patient-consumer buying patterns by time of day become important to understand. A landlord could use this information to educate retail tenants on how the resulting cross-patronage will increase consumer traffic without straining parking, and while still impacting incremental sales.

Impact of health-care tenants on shopping by length of time, retail spending and tenant-mix synergies

Time also figures into another aspect of health-care patients: willingness to travel. The consumer might not want to drive more than a few blocks or a few minutes for a burger, but would travel to an outdoor sporting-goods retailer from several states away. The same is true in health care: A mother might not want to drive more than 10 minutes to take her 12-year-old to an orthodontist, but would fly five states away to obtain the best oncology care for her mother.

Lifestyle centers offer particular opportunities. They may have some combination of high-end stores (e.g., Nordstrom’s, Tiffany’s and Apple), hotels (Hilton, Marriott and Hyatt) and restaurants (Cheesecake Factory and Morton’s). These centers are destinations that draw people from long distances while providing experiences they will want to enjoy for a day or two. Yet an orthopedic practice that caters to Baby Boomers in need of knee and hip replacements will share patient-consumer profiles almost identical to the lifestyle center: i.e., high-income, lifestyle-oriented, health-conscious, experience-focused, and willing to travel and stay overnight to obtain the health care they desire. This co-tenancy benefits retail and health care alike.

Such matching consumer-patient profiles enable developers or shopping center owners to consider the possible synergies between a retailer and health-care facility. For instance, a tenant-mix assessment would doubtless consider which restaurant brands might best fit. A lifestyle center with Nordstrom’s, Macy’s and Saks Fifth Avenue will attract a different restaurant brand than a rural Walmart center.

Similarly, examples abound of potentially fruitful health-care tenant and retailer co-tenants:

- A sports medicine and orthopedic center and a sporting goods anchor. The consumer shopping at Dick’s might have a high propensity for a sports-related injury. By contrast, the patients seeing the orthopedic therapist will have a high propensity to buy sporting equipment. These correlations are important and should always be thought through.
- Community care centers’ co-tenancy in a grocery-anchored shopping center makes sense.
- A pediatric center works well near a grocery.
- Dermatology, allergy, aesthetics, and dentistry also have a logical place in the shopping environment just like Subway, Petland, Dollar Tree, and other retailers have their logical fits.

As retail and health-care business models blend and merge, these co-tenancy relationships will become more apparent and the next relationship more obvious.

For example, a major supermarket chain that sells food, prescription medicine and low-acuity care is arguably a wellness store more than a grocery store. When stores like Kroger partner with traditional high-acuity health systems, the two together can tackle big public health issues like type II diabetes. Consumer buying behavior is directly correlated to the likelihood of developing pre-diabetes and diabetes. Kroger (or Walmart, Aldi, Giant Eagle, Whole Foods) and Kaiser (Providence, Cleveland Clinic, HCA, Mayo Clinic) together can make contact with nearly 60 million people every week. Such a partnership could help bend the food consumption trend toward greater health.

One possibility, for instance, would be a partnership to establish a program to ensure patient-consumers are properly taking their prescribed life-saving medications. That may produce a massive downward shift in health-care spending on high-acuity problems. If the average heart attack costs $50,000, and simply making better eating decisions and taking proper medication can prevent the cardiac episode, then the “system” should logically encourage $100 wellness visits.

Knowing one’s user: what health-care systems can learn from retailers

Correlations between retailers and health-care systems may be enhanced as the latter learn more about how their potential co-tenants learn about customers. A recent report by PwC outlines two particular assets possessed by stores:

First, retailers can anticipate patients’ needs because they understand consumer behavior and purchasing patterns.

Second, retailers have improved key capabilities, mostly as a result of technological advances, that many health-care providers may not have developed to the same degree: “online bill pay, facilities, a social media presence, online scheduling and digital product support.”
Advantages of locating a health-care facility in retail real estate

Several major advantages result when a health-care facility locates in retail real estate:

- **Critical mass**: This is a familiar concept to retailers, but not to health systems. But progressive health systems are finally embracing the need for patient-consumer outreach. The core buyers for the services of a health-care establishment are the same as for shopping centers: 25-55 year-old females.

- **Familiarity**: Retailers have learned over time that product familiarity increases the likelihood of buying on demand. Shopping centers can offer patient-customers repeated access to health-care facilities.

- **Scalability**: Reciprocal business benefits enable scalability (i.e., the capacity to be changed in size or scale). Outparcels offer a prime means in this process, as seen in the case of banks that have, over the years, secured useful peripheries of grocery-anchored projects.

- **Barriers to entry**: Among the first priorities of newcomers to a community is going to a grocery store. Once that loyalty is established, other tenants can build on that. A community care center building near the major grocery store in town has patient-consumers similar to grocery shoppers. Once a health-care system is established near such a powerful draw, it forms a hurdle that is difficult for competitors to surmount.

- **Visibility**: Once, health-care systems chose locations largely on the basis of land costs. This relegated them to the back of the lot, on poorly visible sites—a far cry from what retailers managed. In contrast, retail real estate provides visibility in a way that health-care systems have seldom experienced.

- **Co-branding and/or brand drafting**: Nearby tenants can help overcome a poorly developed or poorly perceived brand. If a strategy for a health-care system involves growing sports medicine and orthopedics, then locating the facility near a major sporting-goods retailer is logical. If breast cancer is the system’s specialty, then perhaps a co-branding effort with a major department store would help elevate the brand. Likewise, if retailers want to create a brand perception of wellness, then a partnership with a health system can move this along rapidly. If a coffee shop wants to be seen as the nation’s healthy choice, then a partnership with a national health system or insurance provider that labels foods and drinks with a health rating is a possibility. A consumer entering the coffee shop would find each item labeled with an insurer’s healthy lifestyle rating. Both companies benefit, and every consumer could make healthier choices backed by the best doctors in the country.

Potential locational challenges of health care in a retail real estate setting

Before making deals, landlords in shopping centers or mixed-use projects should also be aware of potential issues that may arise in having a health-care tenant in their properties:

- **Underwriting**: Figuring out risk is difficult until after a few deals are concluded, and that is compounded because of lack of familiarity with health-care modalities. Health-care business models are complicated and require specific training to assess whether a deal is a right fit for a shopping center. For example; mom-and-pop health-care facility may require a different process than a $50 billion company with an A+ credit rating. It is as crucial, then, to understand a health-care facility’s business model as it is to know a retailer’s.

- **The “You’re not wanted here” syndrome**: This might be the biggest hurdle facing a health-care system moving into a retail environment. The facility might have to counter misperceptions that it might take up too much parking, or that its users are sick people who will spread illnesses. To deal with this problem, it is helpful to educate the leasing agent and property owner about the many types of medical practices. For instance, wound care or dialysis may treat very sick patients, but pediatrics, dermatology, family medicine, orthopedics, and most other practices see mostly well patients for check-ups or minor ailments. Similarly, Rural King and Nordstrom’s attract different types of shoppers.

- **Physical structures unsuited for health care**: Retail real estate design has tended to be homogeneous to allow for very different types of retailers. Health care, though, might have its own particular needs: higher ceiling heights, oxygen tanks, electricity, plumbing, natural light, lighted intersections to enable emergency vehicles to move in and out quickly. Certain code requirements may also be mandated by the Center for Medicaid and Medicare Services. These challenges may be eased if the facility locates on an outparcel.

- **Rents and terms**: Rent structures, tenant improvement allowances, and lease terms are different for medical office buildings than for shopping centers. Generally speaking, retail has higher rents and receives higher tenant allowances than medical office buildings. To put this in perspective, health-care tenants concentrating on costs would have to be informed about the potential revenue that could come from additional traffic.

Easing challenges of health-care locations in retail real estate

Retailers and shopping center owners should invest the time to understand the business models of the various types of health-care modalities as well as they understand retail business models at a micro level. One does not speak of a general health-care “business model” any more than one would refer to a generic retailer “business model.” Narrowing down to particular types is essential to understand how to assess the potential tenant.

For leasing managers, it makes the most sense to analyze the consumer profile and trade area of the shopping center. For example, if the center is focused on children or families, then a pediatrician would fit that profile. At that point, leasing personnel could engage health-care decision-makers on why locating in the center would benefit them.

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Additional considerations in assessing a potential health-care tenant

Long-term stability and credit are as important in assessing a health-care tenant as a retailer in a shopping center. In this context, the question of increased hospital ownership of physician practices has become more relevant. As of July 2016, 29 percent of physician practices were hospital-owned, with the number of hospital-owned practices increasing by 36,000 from July 2012 to July 2016, according to a study by the nonprofit Physicians Advocacy Institute and Avalere Health. American Medical Association (AMA) data show that the newest generation of doctors is more likely than older age cohorts to join larger multispecialty practices to leverage administrative and payer partnerships as well as lifestyle choices.

As more physician practices move from private to hospital ownership as a result of the ACA, a health-care tenant’s hospital affiliation becomes increasingly important. The risk profile of an independently owned practice is significantly higher than one for a health-care system. Hospital affiliations, then, may provide greater overall tenant stability and credit ratings, as the hospitals themselves become the lessees.

Conclusion

With health care constituting 9.1% of total employees in the U.S., the sector represents a major force in the U.S. economy. Incorporating it into U.S. retail real estate—and, more important, ensuring its profitability there—will require intense understanding of its multiple specialties and particular economies, however—the same attention to detail called for by different retail types. Furthermore, shopping center professionals must speak to such potential new tenants not only about costs but also about revenues.

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5 AMA data cited in Bita Kash and Debra Tan, "Physician Group Practice Trends: A Comprehensive Review," Journal of Hospital and Medical Management, Vol. 2 No. 1:3 (2016), p. 2, Table 1. More than one-fourth (27%) of under-40 physicians in the AMA study belonged to multi-specialty groups, versus 21.6% and 20.3% for the 40-54 and 55+ age groups, respectively.