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KEYNOTE INTERVIEW

Medical office buildings prove defensive, durable and in demand



*As outpatient care takes center stage in modern healthcare, medical office buildings offer investors strong stable returns amid economic shifts, note **Al Rabil** and **Peter Westmeyer***

Fifteen years ago, the medical office building (MOB) sector changed drastically. New reimbursement procedures and technological advances in medicine ushered in a fundamental shift toward outpatient care, enabling healthcare systems to deliver services more efficiently with better outcomes, at lower cost and with higher margins. The shift has seen MOB become an important subset of the larger healthcare ecosystem, say Kayne Anderson CEO Al Rabil and Remedy Medical Properties founder and CEO Peter Westmeyer.

Q What underscores investors' conviction in the medical office building sector?

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Peter Westmeyer: The fundamentals are so compelling. If you are looking at the same data we are, it is hard not to be attracted to the space. As an asset class, it is defensive, non-cyclical and supported by long-term demographic tailwinds. With our \$7.2 billion joint-venture acquisition of 18 million square feet of outpatient medical space from Welltower, we are investing in a change in the delivery model of healthcare. There are numerous factors that culminate in this opportunity.

The key characteristics of the sector are investment-grade tenancy, a high

barrier to entry and relatively no new speculative supply. We are the largest owner and operator in the sector and one of the largest developers in the country as well, with nearly \$500 million in new starts over the last 12 months, and of that almost 90 percent is pre-leased. The retention rate of our tenants is over 90 percent, too. There is a lot of durability in this asset class.

Al Rabil: Over 11,000 Americans will turn 65 every day for the next 20 years. Almost 5,000 Americans turn 80 every day. The greatest healthcare spend occurs in that 65-plus cohort. People under 45 average two doctor's visits annually, while people over 65 average seven visits a year. There is a mountain

of stats we can pile on, but the bottom line is we are seeing massively escalating healthcare demand, and those needs are not being met by a dearth of new supply.

We focus on leasing to the five highest-margin specialties across healthcare: orthopedics, oncology, cardiology, diagnostics and neurology. We are dealing with medical providers who are unable to deliver care virtually and who have a payer base capable of supporting their needs. We believe this to be the most recession-resistant part of the healthcare ecosystem; it is not highly correlated with macroeconomic conditions.

Healthcare represents roughly 20 percent of US GDP, making medical office a virtually irreplaceable asset class. We have been addressing the question of how hospitals and healthcare systems compete in an evolving ecosystem. We are engaging with systems across the country and helping to build out their delivery system.

We have a huge conviction for this asset class. Historically, it has never been below 90 percent occupancy nationally, and throughout covid we had a 99 percent collection rate in our portfolio with no defaults. We believe it to be the lowest volatility asset class.

Q The long-term shift from inpatient to outpatient care has been a consistent topic surrounding MOB investment. Why is that trend so resilient?

AR: This trend started in 2010 when reimbursement dynamics changed. Outpatient facilities resulted in lower cost with better outcomes. Technology allowed procedures once done in a hospital setting to be done in an outpatient setting. Insurers began pressuring providers to operate in the lower-cost setting.

Further, insurers were spending massive amounts of money on patients' hospital visits, which then became exacerbated when they contracted a secondary hospital-borne illness. So,

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"There is a massive amount of runway in this asset class"

AL RABIL

they changed reimbursements to incentivize the healthcare system to promote outpatient, off-campus facilities. The move changed the ecosystem overnight.

Since then, that trend has been strengthening. The past 15 years have seen a dramatic shift. We went from 90 percent of care within a hospital to now having 90 percent of care at outpatient facilities. Patients have a better experience all around, with better care, lower costs and more personalized care. These outpatient facilities do not have the immense cost of surprise visitation. Outpatient facilities are working on aching knees and shoulders, not accidents and emergencies. That makes the overall cost of care lower.

PW: The outpatient transition is driven by providers looking to expand

margins and market share, patients looking for better outcomes and more convenience, and payors looking to extract costs and waste from the system without sacrificing the quality of care. Performing a procedure at an inpatient facility costs a lot more. Insurers are trying to fight waste, so they have pushed the cost burden onto providers.

Site neutrality will pay the same rate for a procedure regardless of location. Therefore, their margin depends heavily on the delivery setting, so if they can deliver that procedure in a more cost-effective environment, they can increase their margins.

In effect, insurers have set up an environment that reduces costs to the system and provides incentives to go to a lower-cost setting. It is both cost and convenience driving outpatient growth, and it's my belief that the outpatient boom will continue.

Q What are the current cap rate trends and investor appetite for MOB assets compared to other commercial real estate sectors?

AR: Outpatient medical is just starting to get the recognition it deserves. Over time, the lack of volatility, durable growth and resilience to changes in the macroeconomic outlook will be increasingly reflected in cap rates and valuations. That has not been the case thus far as the sector remains massively underinvested globally for two big reasons.

First, while still dominated by owner/operator hospital systems, prior to 2010, institutional investment was negligible. Second, nowhere else in the world has a healthcare system like the US. Foreign investors have a hard time even understanding what outpatient medical is as an asset class. That hurdle is quickly being overcome.

Historical cap rates are not indicative of what you will see over the next 10-15 years. Today, high-end medical office is at 5.5-6 percent. There has been a recognition of the recession-resistant



Q Is the rising popularity of telehealth having an impact on demand for traditional medical office buildings?

AR: We have seen very little impact, particularly in part of the sector we focus on, which still requires physical space. Things like an MRI must be done in an office. We do not see a significant number of doctors trying to work from home. The telemedicine dynamic works well for some things, like mental health or symptom management, but by and large, this sector is immune to remote dynamics.

dynamic and durability. Over time, you will see a reduction in cap rates as investors recognize the safety and security that exist in this asset class.

In terms of an absolute cap rate, that depends on macro factors. With a lower-interest-rate environment, I would not be surprised to see high-end medical office trading in the low 5s, with some transactions in the 4 percent range over the next several years.

Q What should potential investors understand about outpatient healthcare?

PW: Stability. Add outpatient to any portfolio and it gets more stable. Occupancy has never dropped below 90 percent; this is a slow and steady business and every fundamental points toward long-term durability. Every characteristic screams stability for investors.

Q What are the benefits of strategic partnerships with experienced industry participants in the healthcare space?

AR: Sourcing and execution. We have forged relationships with a significant number of large systems. Over time, they see that we understand the tenants and have operating capabilities that

reduce their overall costs, so the system can accrue gains. Given our size and scale, we can help successful tenants grow.

Most of these healthcare systems own real estate by default, not by desire, and they do not have alternative sources of capital. This is a massive shift taking place and it will continue. With the Welltower announcement, we are buying a \$7.2 billion portfolio with roughly \$4.9 billion in debt and \$2.5 billion in equity. We have become a go-to buyer because very few firms can execute on that size of transaction.

PW: We have 500 employees nationwide and all we do is medical. A lot of the people we employ are former healthcare workers. They speak the language and they understand the concerns. When we sit across from our healthcare partners, they know we understand their business, which leads to sourcing opportunities through organic growth, build-to-suit development and sale-leaseback arrangements.

Q What are the key risks in this space, and how can investors manage them?

PW: Not all MOB assets are created equal. We target the five

highest-margin businesses in our space, so if reimbursement does get cut, we are insulated. The biggest risk from our perspective is not aligning with the right system or the right services. We spend significant time upfront assessing to make sure our assets and our healthcare providers are the correct combination.

It is all about picking the right services, tenant and location. A low percentage of our portfolio is leased to primary care providers, for example, because we view that service line as – although hugely important to the healthcare ecosystem – a lower-margin service with less stickiness.

Q What does the future of MOB investing look like in the US and around the world?

AR: There is a massive amount of runway in this asset class. We have only touched the tip of the iceberg in terms of what can be done. Twelve years ago, we had 2.5 million square feet; today, we control over 52 million square feet. That is still a small portion of an overall market that is massively underinvested. While we are thrilled with the Welltower transaction, we are actively looking at the next 10-15 years in an even more opportunistic way. ■