Firm looking to invest up to $1 billion

WITH BERKSHIRE AS ITS NEW PARTNER, MONTECITO IS BACK IN THE BUYING MODE

By John Mugford

Chip Conk likes to call the years leading up to the recession as the "go-go" years for making acquisitions in the healthcare real estate sector.

COMPANIES

And Santa Barbara, Calif.-based Montecito Medical Acquisition Co., of which Mr. Conk is the CEO, certainly took part by go-going after medical office buildings (MOBs) at a rather nice clip.

Starting with a portfolio acquisition in 2006 and culminating with purchases in 2008, Montecito accumulated a $500 million portfolio, based on purchase price, with more than 2.5 million square feet of space.

The private company purchased some of the properties on its own and some with equity partners: Newport Beach, Calif.-based Buchanan Street, which did the investing for the California Public Employees' Retirement System (CalPERS); New York-based Clarion Capital Partners LLC; and Chicago-based Harrison Street.

In the aftermath of the go-go years, however, Mr. Conk describes the period after 2008 as the "no-no" years. Montecito certainly said no to acquisitions, as it did not make any purchases for 2-1/2 years and, instead, focused on managing its medical portfolio while selling some assets along the way.

Now, however, Mr. Conk says Montecito is getting back on the purchasing playing field, prompted by a changing healthcare landscape in which the delivery of services in conveniently located outpatient settings is becoming ever more critical for the country's providers.

The company appears well positioned from a capital standpoint to make medical real estate investments, as it has formed a joint venture (JV) partnership with Boston-based Berkshire Realty Ventures, a 40-year-old private equity firm with a long history in multi-family properties and hotels. It has raised more than $6 billion in third-party investor equity and has made more than $10 billion in direct and entity-level real estate investments.

The JV plans to spend anywhere from $700 million to $1 billion during the next three years or so on medical facilities acquisitions, development or both. The two entities have not revealed further financial details about the partnership, such as how much each company plans to contribute to the investments the JV plans to make.

According to a rough estimate by Mr. Conk, about 80 percent of the capital will be invested in acquisitions with the remainder being spent on development, most likely through providing capital for projects being developed by local or regional development companies with hospital relationships.

Even though its focus will be mostly on MOBs, the JV will also look at investing in cancer centers and other facilities that will be important aspects of the healthcare industry's new focus on the hub-and-spoke delivery model.

Still bullish

"We've known for a while that we wanted to get back into investing in medical properties," Mr. Conk says. "So we spent the better part of a year looking for a good capital partner. We knew the people over at Berkshire and

Chip Conk

know about all of their experience and their knowledge. They are very strong financially and they, too, were looking to enter the medical space."

Even though Mr. Conk acknowledges that there is quite a bit of capital chasing medical office buildings (MOBs) these days, he says the JV's approach is draw upon the many relationships it already has in the sector – with providers, developers and other owners – and to develop new ones.

"There is a lot of competition out there, but if you have the right relationships with the growing health systems – and/or with the regional developers who have relationships with health systems, like we do – and plan to develop, then we do think making $250 million or more worth of investments each year over the next three years is quite feasible," Mr. Conk says.

"We're seeing a need for capital from a venture like ours in the market, because many of those regional developers used to go to the bigger

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companies for capital," he adds. "But now, a lot of those bigger firms have their own in-house development groups. And in some instances, their banking sources are demanding more capital from them, or personal guarantees, so we feel we can be there as a capital source. And that can entail either acquiring buildings from developers who need liquidity to fund more development, or to fund, as much as 90 percent, even 100 percent, of the equity a developer with a good relationship with a health system might need for a project."

Because it is a private JV, Mr. Conk says the partnership is willing to fund smaller projects.

"We have the ability to be more entrepreneurial and are willing to do a 40,000 square foot building, if that's what a developer needs to continue, or establish, a relationship with system that could lead to more developments," he notes.

Another one of the reasons why Montecito is bullish on the sector is because of what its own research firm is telling it about the pent up demand for new space.

After the firm entered the healthcare real estate market, it acquired a research firm that provided information to hospitals and health systems, developers and investors, pinpointing locations where new facilities – both hospitals and outpatient centers – should be built or located.

"Development of new medical space basically stopped in 2007 and '08 and since then it has been moving along at about 20 percent of the annual amount in the years leading up to 2007," Mr. Conk says. "It has picked up a bit in 2011 and 2012, but it is still far from where it was in those go-go years."

The company's research firm, Montecito Research and Analytics, indicates a coming need for about 70 million square feet of new medical space nationwide.

"That probably would take place over the next 10 years or so," Mr. Conk says.

"With our research arm, we can target medical markets with the strongest growth characteristics where we should locate or acquire a facility," he says. "We really let it tell us where to go, even if's a secondary market. The data base had all of the doctors and all of the MOBs and by using its formula, it can tell us where there's a need and where a system can tap into solid growth and be successful in areas with good insurance coverage and self-pay customers."

The go-go years

As noted, Montecito Medical made quite a splash when it entered the MOB market back in 2006 and built, with partners, a portfolio of about $500 million.

"We got into the medical space because we were looking for a sector that did not have as many big bubbles as other property types," says Mr. Conk.

The medical acquisition company grew out of Montecito Property Co., which has been involved in converting multifamily rental properties into for-sale condominiums. The company did about $1.8 billion worth of business in a three-year period.

"We were actually more lucky than smart, hitting that condo conversion market at the right time," Mr. Conk says. In one particular offering in Phoenix, Montecito sold $90 million worth of high-end residential units in 90 minutes.

"It was crazy, but it was also an eye-opener for us in that it made us realize that we wanted to get into something more stable in which to invest our capital," he adds. "We looked at other property types but decided on medical, and it has been a good investment and remains a property type that we believe strongly in."

Since the company stopped buying MOBs in 2008, it has sold about half of its portfolio. In a recent sale, Montecito and one of its partners, Harrison Street, sold nine buildings in July to Newport Beach, Calif.-based Griffin-American Healthcare REIT II for $71 million, according to data from New York-based Real Capital Analytics Inc., a real estate research firm.

It still owns about six buildings with Harrison Street.

"In some cases, we don't necessarily want to sell certain assets, but the life cycle of our partners' funds might come to an end and they are looking to exit," he says.

An end strategy

As Montecito and Berkshire embark on their investment venture, there is an end strategy, according to Mr. Conk.

"We're not necessarily going to stop at that $700 million, or $1 billion, mark," Mr. Conk says.

"But we do have a liquidity strategy that would perhaps kick in in years five, six, seven, perhaps even eight, in which we would continue to own the portfolio in, perhaps, a public vehicle after an IPO (initial public offering), or we would sell to a public company or sell the portfolio outright to a sovereign fund. There is a start and an end to the strategy.

"When we saw that everyone was stopping their buying, even the REITs for a while there, we just decided to manage our portfolio and did not make any purchases for 2-1/2 years," says Mr. Conk. ❑