

Nationwide Health Properties (NHP)
Getting into the MOB Game in a Big Way

February 27, 2008 ■ Recent Price \$31.40 ■ DJIA 12,694 ■ RMZ 859

I. Overview

Nationwide Health Properties (NHP) recently announced that it had entered into a series of transactions with Pacific Medical Buildings (PMB), a private owner/developer of medical office buildings (MOBs). The deals will establish the REIT as a large player in the increasingly popular property type. Historically, NHP has not been an investor in the sector, but over the past year management clearly outlined its desire to make MOBs a major component of its health care real estate portfolio. The PMB deal is strategically sound in that it brings a high-quality portfolio, a property management capability, and a relationship with a talented, well-respected developer. A primary concern is the “full” price that NHP had to pay to establish a firm footing in the MOB space.

II. Deal Specifics

NHP has committed to buy a portfolio of existing MOBs plus another batch currently under construction for a total of \$915 million. These purchases will take place over a three-year period. NHP also has the right to buy up to another \$1 billion of properties that PMB expects to develop over the next seven years. Finally, NHP will purchase a 50% interest in PMB’s property management operation, which primarily leases and operates the PMB assets rather than MOBs owned by third parties. The properties

NHP is buying represent a high-quality portfolio concentrated in Southern California, with the balance located in the Western U.S. and Hawaii. Most of the MOBs are located on acute care hospital campuses that are owned or affiliated with creditworthy hospital systems.

The portfolio should generate a high-quality, durable cash flow stream, albeit with modest same-property NOI growth prospects. These characteristics are typical of high-quality MOBs, which usually provide investors with significantly less cash flow volatility over the long-run compared to traditional office buildings or many other property types. The PMB portfolio should provide NHP with inflation-like rent growth, high tenant retention, and limited cap-ex during the next several years. The modest NOI growth potential is the result of in-place rents that are close to market, limited near-term lease rollover, and occupancy that will already be in the mid-90% range when NHP closes the acquisitions.

NHP bought \$120 million of the \$915 million total during 4Q07, and it expects to purchase another \$485 million during '08. Financing for the '08 tranche will come from a) \$201 million of assumed fixed-rate debt with a coupon of 5.9% and 9 years remaining to maturity; b) roughly \$100 million of OP units with a collar of \$29-33/sh; and c) \$220 million of net sales proceeds from a pending \$305 million senior housing sale. The variety of funding sources provides some comfort given the current turbulence

Exhibit 1

The PMB portfolio is comprised of high-quality MOBs primarily located on hospital campuses. Over half of the properties are in California. Average occupancy for the completed properties is 94%. The newly constructed buildings will be acquired when stabilized at over 90% occupancy. The portfolio should generate a durable cash flow stream, albeit with modest same-property NOI growth prospects.

Acquisition Year	Location	Est. Pct. of Value	Rentable Sq. Ft.	Sq. Ft. Per Property	Average Age	Investment (\$ millions)	Price Per Sq. Ft.	Nominal Cap Rate (1)
2007	Washington State (nr. Portland)	13%	386,483	55,212	17 years	\$120	\$327	6.2%
2008	CA (10), NV (3), OR, AZ, HI	53%	1,282,777	80,174	6 Years	\$485	\$378	6.2%
2009	California	20%	287,742	95,914	CIP	\$180	\$626	5.8%
2010	California	14%	247,625	123,813	CIP	\$130	\$525	5.8%
Total		100%	2,184,627	78,022		\$915	\$419	6.1%

(1) Average term remaining on ground leases for 23 properties is 64 years including extensions.
Sources: NHP and Green Street Advisors' estimates.

Important disclosure on the last page.

in the credit markets, although there is no certainty the senior housing sale will actually close as scheduled in 2Q08. In addition, the OP units will be NAV neutral at the low end of the collar and slightly NAV accretive at the high end. Funding for the '09 and '10 tranches has not been specifically identified, but NHP's total leverage ratio (based on the market value of its assets and liabilities) at the end of '08 should be around 40%, which should provide significant financing flexibility. A key concern is what the cost of that financing might be if interest rates or credit spreads were to stay at current levels or rise further, and/or liquidity in the real estate capital markets remains poor at that time.

III. Risk-Adjusted Pricing is Full, but not Outrageous

NHP estimates that the initial \$915 million round of acquisitions will produce an initial stabilized cap rate of about 6.1%. The structure of the deal requires a couple of adjustments to this reported figure. First, 23 of the 28 properties in the portfolio are subject to ground leases. Hospital systems are usually reluctant to cede control of land on their campuses to third-party owners, so most on-campus MOB's involve ground leases. The 6.1% nominal cap rate requires a haircut when compared to real estate acquisitions where the buyer owns both the structure and the land. The reason is that **ground-leased**

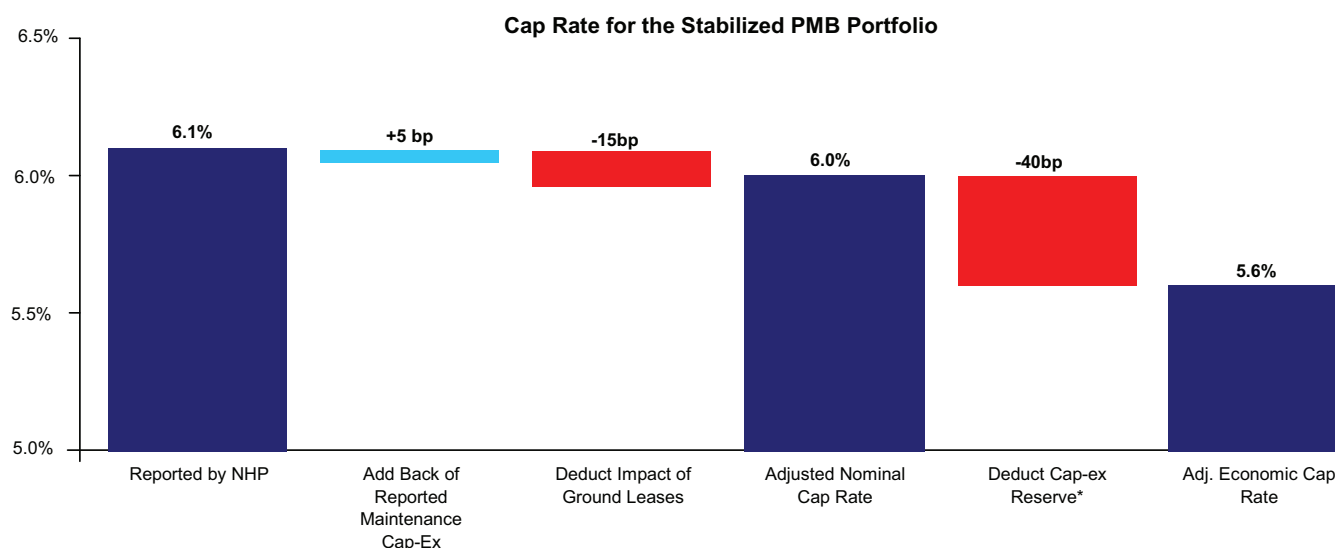
buildings have no residual value to the owner upon maturity of the lease, so the buyer needs to receive a higher yield. The longer the remaining ground lease term, the smaller the required adjustment. The 64-year average remaining term in this deal translates to a 15 basis point haircut.

Second, NHP will be responsible for funding the tenant improvement and leasing costs for the portfolio over time. In many of the REIT's traditional triple-net leased investments, the tenant pays the cap-ex costs. We estimate that the normalized cap-ex burden in an MOB portfolio is about 8-10% of NOI. This figure is lower than the 12-20% reserve for traditional office buildings primarily because tenant retention at high-quality MOB's is very high. In addition, MOB tenant improvements tend to be significant upon initial construction of the building, but the limited variations on how to configure the space for subsequent tenants helps keep the remodeling costs down. NHP will probably incur smaller cash outlays than 8-10% of NOI in the early years of its ownership since the MOB's will be relatively new and tenant turnover will be low. Nevertheless, the economic (i.e. after cap-ex) cap rate for the portfolio is likely closer to 5.6%, which is a better figure to use when comparing this large investment to those made by REITs in other property types.

While the market is often fixated on initial cap rates, the total return an investor expects to enjoy over the long-term is a much more meaningful measurement

Exhibit 2

NHP reported that the nominal cap rate on the \$915 million portfolio acquisition will be 6.1%. After adjusting for a cap-ex reserve and the yield impact of the ground leases prevalent throughout the portfolio, the economic cap rate is about 5.6%



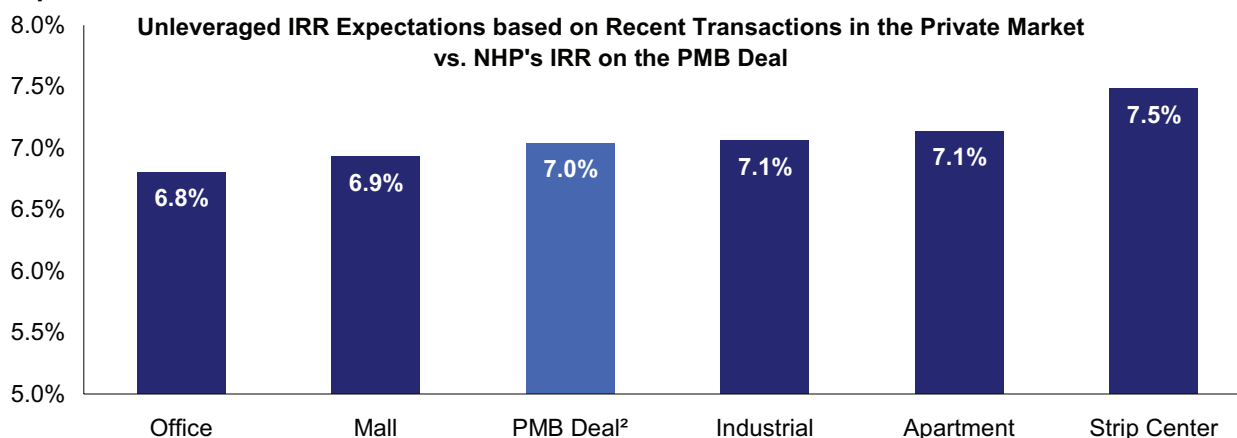
* Assumes normalized tenant improvement and lease commission reserve equal to 8% of NOI

Exhibit 3

The total returns that real estate investors are likely to achieve can be assessed by combining the initial yield and growth forecasts shown below. The property sector figures represent market-weighted averages for REIT-owned properties within our coverage universe.

Sector	Nominal Cap Rate	Economic Cap Rate	Projected NOI Growth					Long Term ¹
			'09	'10	'11	'12	'13	
Apartment	6.0%	5.3%	3.7%	3.1%	3.0%	3.0%	3.0%	1.4%
Industrial	6.1%	5.5%	3.4%	3.1%	2.7%	2.5%	2.5%	1.2%
Mall	5.9%	5.3%	3.2%	2.5%	2.5%	2.5%	2.5%	1.4%
PMB Deal	6.0%	5.6%	2.4%	2.4%	2.4%	2.4%	2.4%	1.3%
Office	5.5%	4.6%	5.6%	6.0%	5.3%	4.5%	4.4%	1.4%
Strip Center	6.5%	5.9%	2.9%	2.8%	2.8%	2.8%	2.8%	1.2%

NHP may have paid a reasonable price for PMB when compared to unleveraged long-term returns across property sectors. Given the steady nature of cash flows, one could argue that MOB's do not require a return premium over other sectors.



(1) Long-term growth rates are lower than inflation because buildings require significantly more cap-ex to maintain their value as they age.

(2) Estimated for the stabilized PMB portfolio only.

Sources: Green Street Advisors, NHP and American Council of Life Insurers

of deal pricing. As summarized in Exhibit 3, the total unleveraged return (i.e. the IRR) NHP is projected to achieve on the \$915 million portion of the PMB deal is approximately 7.0%. That figure is roughly equal to the total returns that private market investors in apartments and industrial buildings appear to be accepting based on recent sales transactions. The PMB total return is at the low end of the range typically seen on MOB transactions, but the high quality of the portfolio and the West Coast concentrations are two important reasons why the deal should command a lower return. **Our conclusion is that the MOB pricing NHP negotiated is full, but not outrageous, especially when considering the cash flow durability of the portfolio.**

IV. Development Pipeline – A Valuation Swing Factor

In addition to purchasing existing assets and those well along in their construction, NHP will also have the right to purchase PMB's new development starts up to \$1 billion over the next seven years. The objective of the arrangement is to place the construction risk and most of the leasing risk on PMB, while placing most of the cap rate risk and a limited amount of the leasing risk on NHP. On a typical deal it is expected that the development profit will be split roughly 50%/50% between the two parties.

PMB will present new projects to NHP. If the REIT chooses to participate, the project costs will be locked in, and the cap rate that NHP will pay when construction is completed will be set. Cost overruns are borne by PMB; cap rate increases during construction will reduce NHP's share of the profits (and

Are Medical Office Buildings Systematically Mispriced?

We published a report last year that concluded that the perceived risks associated with MOB are sometimes overstated and that the cap rate premium often ascribed to MOB versus traditional office properties in the same market can be too wide. The report described the economics of owning MOB and the primary allure of the low-risk, medium-reward nature of the business. To access that report, [click here](#). Some of the key findings are summarized below:

Benefits

- **Monopoly position/limited competition particularly for MOB located on hospital campuses.** Doctors place a high premium on convenience to the hospital.
- **High tenant retention.** Once tenants are in an MOB, they tend not to move. High-quality MOB generally have high occupancy rates (over 90%).
- **Less cyclicity than office buildings.** MOB rent growth is steadier than that experienced in traditional office where imbalances in supply and demand have historically resulted in substantial rent volatility.
- **Lower cap-ex and releasing costs than office buildings.** First generation tenant improvements are high in MOB. However, the long-term releasing and cap-ex costs are lower than for a traditional office building as a result of strong tenant retention, the absence of leasing brokers on most deals, and limited ways to reconfigure the typical 2,500 s.f. doctor suite.

Risks

- **Hard to push rents.** Affiliated hospitals do not want an MOB landlord that will aggressively increase rents due from doctors who are key to patient referrals and generating hospital revenue.
- **Typically on ground leases.** Ground leases can have important value and cap rate implications depending on how they are structured, and operating restrictions in the leases can affect the tenant mix.
- **Shared parking with hospital can be a problem.** High volumes of doctors' visits require an abundance of parking. Getting the parking right is extremely important.

vice versa if costs or cap rates move favorably). If lease-up goes poorly in terms of pace or rent levels, the cap rate NHP agreed to will be applied to a lower NOI stream – i.e. it will pay less for the building because the NOI came in below expectations. PMB shoots to deliver stabilized development returns that are roughly 200 basis points above prevailing cap rates. At current yields and cap rates, that translates to development profit margins in the 30%-range, which the two parties will roughly split if everything goes as planned.

As outlined, the risks and rewards in this program appear to be reasonably balanced. In addition, NHP is provided with a sizable pipeline of high-quality MOB acquisitions. Playing the money partner role in this development structure is not ideal since so much of the profit is left on the table for the partner. Yet, NHP has no development infrastructure, and “renting” one from PMB may provide the most efficient course in the short-run until NHP can build or buy a platform (perhaps even the PMB team) down the road.

A primary risk to the carefully crafted development agreement is that PMB personnel will be

leasing the new developments, and there are dozens of tricks that developers can play to manipulate the short-term NOI (and thus the value) of the property. Since the cap rate NHP will commit to pay will be fixed at the beginning of the development process, any lease transactions that artificially inflate the NOI to which that cap rate will be ascribed will cause NHP to overpay. Examples of ways to “goose” short-term NOI include providing substantially above-market tenant improvements in return for above-market rent, or agreeing to free rent in the latter part of the lease in return for above-market cash rent early in the lease.

Another more subtle way to boost the sales price is to move way out on the credit-quality spectrum and lease space to health care providers that can pay their rent in the short-run, but may not have the financial capacity to honor their lease obligations over the long-run. Finally, the developer here has little incentive to find an optimal long-term tenant mix (e.g. filling the building with complementary specialists that can refer business to each other) that would support high occupancy and better rent growth into the future.

An important mitigant to these concerns is that NHP will own 50% of the entity doing the leasing and, therefore, will have some oversight capability. But being brand new to the MOB game, NHP may not be fully conversant on what to look for in the leases it is overseeing. In addition, the employees of that entity are coming from PMB, and it remains to be seen whether their loyalties are aligned with the seller or the buyer of the developed properties.

There is certainly no reason that we are aware of to think that PMB will be anything but fully honorable in their dealings under the agreement. Nevertheless, the structure does open a very big window of opportunity to lease buildings in a manner that ultimately causes NHP to overpay, and libraries could be filled with stories of private developers taking advantage of their money partners in the past. It remains to be seen if the development value creation NHP hopes to share in ultimately pans out over the next several years. The uncertainty suggests that a very low value be placed on the development "option" for now.

V. Recommendation

A lot of the attention regarding the NHP/PMB deal has focused on the relatively low initial cap rate, especially when compared to the more traditional investments made in the health care REIT sector. However, the risk profile of the PMB deal is much lower than the typical senior housing, skilled nursing, or hospital investment made by the health care REITs, and the long-term NOI growth prospects are similar.

A total return analysis (i.e. IRR) suggests that the PMB deal implies pricing that is similar to what investors are accepting in other property types even though some of those sectors have historically produced much greater cash flow volatility (i.e. risk) than the PMB portfolio poses for NHP. If little-to-no value is placed on the current value of the development agreement, the pricing on the NHP deal should be considered "full". Yet, when combined with the strategic merits of the MOB expansion, plus the favorable initial financial structure of the deal, **this appears to be a deal worth doing for NHP.**

NHP currently trades at a 6.4% premium to our NAV estimate, which is slightly higher than the NAV premium at which the average health care REIT currently trades. Our NAV-based REIT Pricing Model indicates that NHP should trade at a 9.8% premium. When applied to our NAV estimate of \$29.50/sh, a warranted price of \$32.40/sh is indicated.

The market's initial reaction to the PMB deal was overly negative as NHP underperformed its health care REIT peers by nearly 300 basis points on the day the deal was announced. We continue to rate NHP a BUY at the current price.

Jim Sullivan
Rosemary Pugh

Appendix A

The majority fo PMB's portfolio is located in Southern California. The balance is located up and down the West Coast and in Hawaii.



Source: Company Filings

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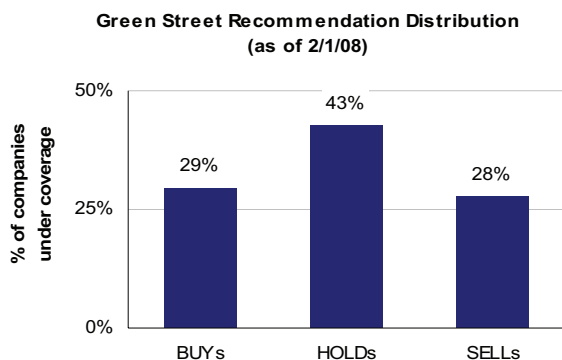


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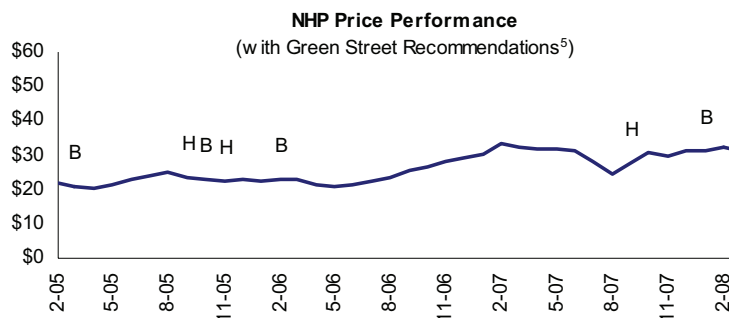
At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.



Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".^{1, 2}

Total Return of Green Street's Recommendations				
Year	Buy	Hold	Sell	NAREIT Eqty ⁴
2008 YTD ³	5.1%	6.6%	6.1%	-1.0%
2007	-6.5%	-22.3%	-27.6%	-15.7%
2006	45.4%	29.9%	18.4%	35.1%
2005	26.3%	18.3%	-1.9%	12.2%
2004	42.3%	28.4%	15.6%	31.6%
2003	42.7%	37.2%	20.9%	37.1%
2002	17.7%	2.6%	1.9%	3.8%
2001	35.7%	19.1%	11.9%	13.9%
2000	53.6%	29.3%	4.4%	26.4%
1999	14.2%	-9.2%	-20.2%	-4.6%
1998	-0.6%	-15.1%	-16.4%	-17.5%
1997	37.1%	14.2%	5.8%	20.3%
1996	47.3%	30.2%	17.5%	35.3%
1995	23.6%	14.3%	-0.4%	15.3%
1994	20.5%	-0.7%	-9.3%	3.2%
1993 ³	29.4%	5.4%	6.7%	12.4%
Total Return³	3866.0%	385.2%	18.5%	483.5%
Annualized	27.8%	11.1%	1.1%	12.5%

The chart below shows NHP's price performance over the last three years, along with Green Street's recommendations during that time.



1) Historical results through January 3, 2005 were independently verified by Ernst & Young, LLP. E&Y did not verify stated results subsequent to January 3, 2005. Past performance results cannot be used to predict future performance. For a complete explanation of study, see 5/9/03 report "How are We Doing?".

2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly", pg. 13-16. Beginning with May 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, are not included in the primary exhibit and therefore not included in the calculation of total return. Beginning with March 2003, all Hotel companies are excluded.

3) Study uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 29, 1993 through February 1, 2008.

4) Not directly comparable to Green Street's performance indices because NAREIT includes more companies and uses market-cap weightings. Green Street's returns are equally-weighted averages.

5) Green Street has only three recommendations: BUY ("B"), HOLD ("H") and SELL ("S"). The firm does not consistently publish price targets and therefore price targets are not included in this graph.