RESEARCH

HEALTHCARE

CAPITAL MARKETS **2016**

HIGHLIGHTS

UK healthcare performed well in 2015, achieving a double-digit total return for the first time in five years

Favourable demographics will continue to support demand for UK healthcare in the post Brexit environment

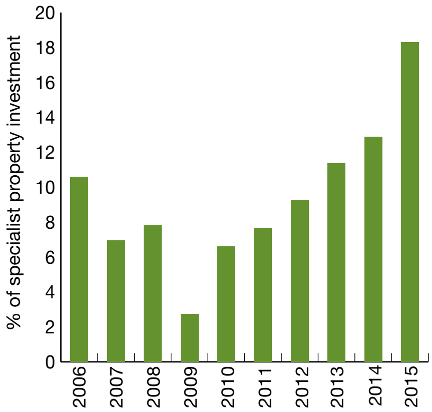
The lower investment risk associated with healthcare should see it perform well in relation to wider UK property

The hot transactional market in 2015 drove strong investment performance with an IPD healthcare return at 10.4% - the first double-digit return for five years.

Following a very strong 2015, the UK healthcare sector saw relatively subdued activity in the first half of 2016, in line with the wider market. In the wake of the Brexit vote, healthcare looks to its core characteristics of lower volatility and higher income yield to drive investor demand.

FIGURE 1

Healthcare share of total UK specialist property investment volumes



Source: Property Data/Community Care Market/ Knight Frank Research

UK healthcare has established itself as a mainstream real estate asset class within the specialist property arena. It has grown over the past seven years, from 3% of total specialist investment in 2009 to just over 18% in 2015 (Figure 1) and now represents 2% of institutional holdings as measured by IPD.

The UK healthcare sector saw £1.57bn of transactions in 2015. This is 62% above the five year average and more than double the ten year average (Figure 2). Post Brexit, and in line with the wider investment market, transactions have been relatively subdued with c.£92m worth of healthcare facilities changing hands in the first half of 2016. Current subdued transaction activity belies the sustained interest of US buyers who are consolidating their position in the UK healthcare sector through M&A activity at the operational level. For example in January 2016 US based Acadia Healthcare Company acquired the Priory operation for £1.51bn, adding to Acadia's existing ownership of PiC, Care UK's former mental health services

FIGURE 2

Healthcare property investment

(£bn)

Source: Property Data/Community Care Market/ Knight Frank Research

and Craegmoor, making Acadia a major provider of healthcare services in the UK market.

Despite the slowdown in activity in the first half of 2016, institutional appetite for healthcare remains strong. Investors continue to be attracted to the healthcare sector because of its stable long term index linked income. This is evidenced by new entrants into the healthcare market over the past 12 months that include KFIM, who acquired Amathea Care Centre for the Long Income PUT in April 2016 and BlackRock who acquired St Martin's Grange for the UK Long Lease Fund in February 2016.

The healthcare investment market has also for the first time in recent years seen the use of ground rent transactions as an alternative to sale and leaseback.

Highfield Care Home, Saffron Waldon

This type of investment vehicle enables investors to release cash for reinvestment in growth opportunities whilst maintaining a freehold interest in the property. The first transaction of this kind took place in February 2016 when CareTech Holdings PLC, a provider of specialist social care services in the UK, supported its growth strategy through a ground rent agreement with the property investment company Alpha Real Capital. This more innovative approach to healthcare investment shows investors have become very comfortable with the property type.

Favourable demographics underpin rising occupier demand in the healthcare sector. Not only is there a rise in user demand for elderly care with the number of over 80s set to double over the next 25 years, but increased average life expectancy beyond retirement age is associated with changes in health and dependency levels of the very elderly. This is reflected in ever rising occupancy levels, which have increased up to 88.3% (2014/15).

From an investors' viewpoint, healthcare offers the benefits of diversification with characteristically long 25-35 year leases with RPI-linked annual rental uplifts. This compares with an average lease length of just over seven years in the wider commercial property market, according to the IPD Lease Events Review 2015.

Investment performance and yields

The hot transactional market in 2015 drove strong investment performance with an IPD healthcare return at 10.4%, which is the first double-digit return for five years. Whilst this underperformed the more volatile office market, healthcare outperformed retail.

Over the longer term, healthcare assets have outperformed the All Property average and other major class assets. Since inception of the Healthcare Index in 2007, the healthcare sector has recorded a nine year annualised average return of 6.4%, outperforming the All Property average by 100 bps, and both equities and gilts which achieved 3.6% and 6.3%, respectively (Figure 3).

On a risk-adjusted basis healthcare has outperformed UK equities, UK gilts and UK commercial property, delivering the highest returns with the lowest volatility over the period 2007 to 2015 (Figure 4).

Performance within healthcare types was similar in 2015, albeit with different capital and income components. Primary healthcare, offers the first point of contact for patients, which includes GP, dentist surgeries and primary care centres. Secondary healthcare is for longer term treatment and includes medical hospitals, specialist treatment, physical and learning disability homes, mental health hospitals and care homes. Primary healthcare saw stronger capital growth in 2015 of 4.2% while secondary healthcare had a higher income return of 7.2%; both had income returns above the IPD All Property average of 4.8%, compared with an average healthcare income return of 6.4%.

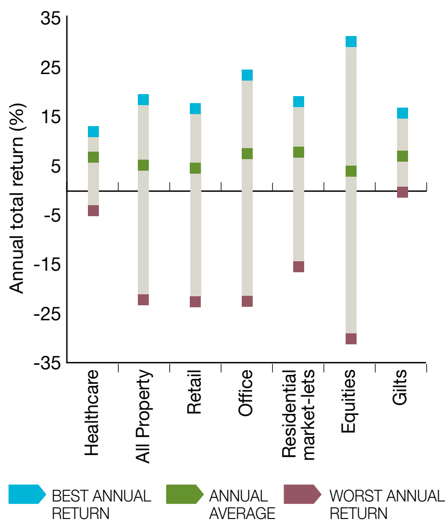
BREXIT – A POSITIVE FOR HEALTHCARE INVESTMENT

The unexpected 'leave' vote in the UK Referendum on membership of the European Union has caused considerable consternation across the property market. Much of the concern has centred on the rapid rate of redemptions in the commercial property retail funds managed by a number of the largest Institutional investors. Whilst the majority of these funds held significant cash reserves the scale and speed of redemptions left funds with little choice but to 'gate' redemptions. In effect this means that unit holders were barred from selling their holdings until a later date. These funds are now in the process of an orderly disposal of some of their property holdings to liquidate and return funds to investors as and when they reopen. There has been no systemic effect of the Brexit vote – it is largely based on a knee jerk reaction from retail investors which arguably caused contagion. Whilst some micro markets will be directly affected (when we know what the actual effect of the vote is – which may still be some way off) the underlying fundamentals are largely as they were pre referendum.

It is instructive to see that as and where the retail funds are conducting disposals they are often appreciating that their most liquid assets are those in prime locations or those let on long term leases to good covenants with indexed rent reviews – a salutary lesson that will only exacerbate the demand for these types of deal in the future as investors beginning to appreciate these crucial facets in their real estate investment.

FIGURE 3

Total returns 2007 to 2015



Source: MSCI / Knight Frank Research

In general, the higher the level of acuity in underlying care the higher yield. This partly reflects the covenant strength associated with the type of healthcare, albeit there are of course exceptions to the rule.

For example, surgeries and clinics command the lowest yields at c.5.00%, as they are usually backed by strong NHS covenants. At the other end of the spectrum, specialist nursing homes and independent hospitals command yields of between 5.50% and 7.50%, reflecting the more challenging nature of the client.

In addition to covenant strength, relative yields are driven by quality of stock. A top quality physical asset may yield between 6.50% and 7.50%, whilst adding in a strong covenant such as Methodist Homes may push that prime yield down to c.4.75%.

Investor Opportunities

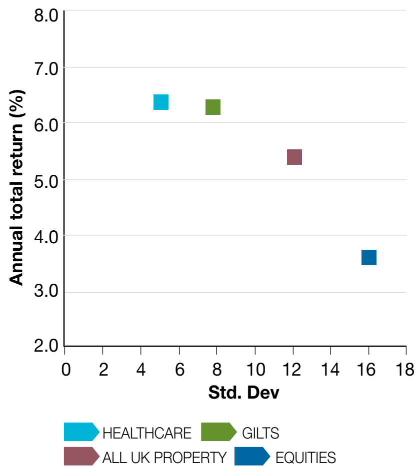
Whilst there is uncertainty surrounding the post Brexit economy, there are positives for real estate such as a weaker exchange rate, which should continue to encourage non-domestic buyers. For UK healthcare this may drive further US investment and may also encourage investors to remain in the UK for longer rather than repatriating capital at unwelcome exchange rates.

Healthcare is well placed in comparison to other property types in weathering any downturn in the UK economy and property investment market. Demand on the occupier side for health care is ultimately driven by the domestic population which will continue to need the services offered by the operators. The demographic story of the UK will not be dramatically affected by the Brexit decision.

On the development front, healthcare is lagging other types of property with more than three-quarters of existing care home stock in the UK in need of upgrading. While costs are prohibitive the growth in demand and shortage of supply, with just 6,000 new care beds being supplied each year, implies a future shortfall.

In terms of regional location, there is more scope away from the established and high performance markets where there is competition for land, particularly residential development. This may bode well in a lending market which will be keen to remain lending but will want to

FIGURE 4
Healthcare risk return profile vs other assets 2007-2015



Source: Knight Frank Research / MSCI

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Key healthcare transactions in the last 12 months

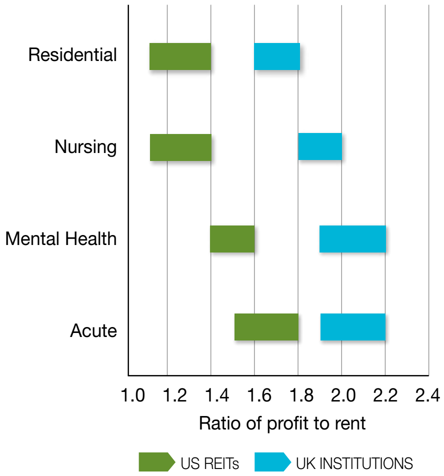
Address	Purchaser	Covenant	Price	NIY	Date
74-bed care home	Target Healthcare REIT	Priory Group	£5.75m	7.00%	May-16
Amathea Care Centre	KFIM Long Income PUT	Methodist Homes	£3.48m	5.75%	Apr-16
St Martin's Grange	BlackRock UK Property	Care South	£7.21m	5.50%	Mar-16
12-bed specialist care home	Target Healthcare REIT	HSN Care	£2.30m	7.00%	Feb-16
69-bed care home	Target Healthcare REIT	Care Concern Group	£3.90m	3.90%	Dec-15

Source: Knight Frank Research

move down the risk curve. Healthcare development lending should remain much less risky than that of other sectors.

With regard to subsectors, there are greater opportunities in the smaller mid-market groups focused on care homes rather than acute care provision.

FIGURE 5
Indicative rent cover for care homes



Source: Knight Frank Research

Notwithstanding the future impact of the National Living Wage and the extent to which additional costs are passed on, recent evidence suggests an indicative rent cover of between 1.6 to 1.8 as the current acceptable requirement level for a new build facility, depending on space, operator covenant and location, including an allowance for capital expenditure and head office costs (Figure 5).

KNIGHT FRANK VIEW

Thus far in 2016, given the uncertainty of the markets, UK healthcare fixed income appears to be holding up well. Anecdotal evidence from lenders and investors is that the defensive characteristics of the sector will potentially make it the leading commercial asset class to invest in. Time will tell.

Interestingly, post the UK Referendum result, there has been increasing activity from Asia-Pac investors seeking, in particular, UK healthcare investments. Unsurprisingly North American funds, and not just the US REITS, are looking to take advantage of the currency play. It is estimated there is around £1bn of healthcare assets under offer and market sentiment suggests this should hold strong.

Domestic head winds such as the National Living Wage have been tempered by the surprising above inflationary local authority care home fee increases. It's difficult to see how there could be further yield compression, even for prime future proof product on indexed linked leases with annuity grade covenant, but Knight Frank's house view is that prime and secondary yields will hold firm for Q3 and Q4. On balance UK healthcare fixed income is performing well and could be the stellar asset class of 2017.

Cedar Court Care Home, Cranleigh

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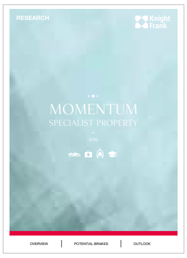

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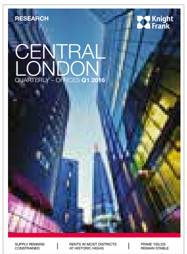

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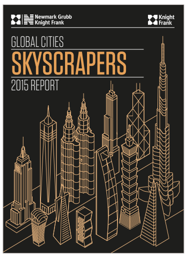

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