RESEARCH

Knight Frank

HEALTHCARE
INVESTMENT **2014**

HIGHLIGHTS

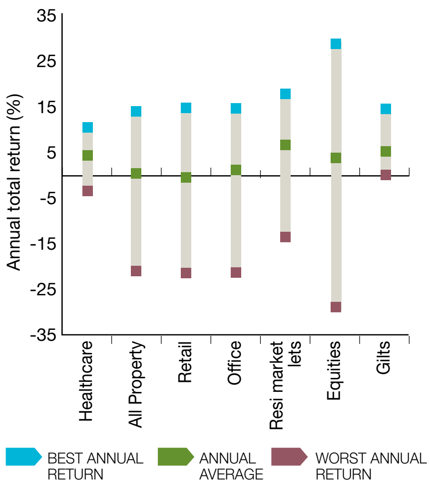
UK Healthcare is now widely considered a core property asset class, as the market continues to mature and attract a broad variety of investors, both domestic and overseas

Appetite for care homes in largely local authority funded areas is improving, with investors and funds increasingly considering UK regional cities

The sector is benefitting from improving availability of debt, with UK clearing banks increasing their lending exposure to Healthcare fixed income and established businesses

FIGURE 1

Total returns 2007 to 2013 inclusive



Source: IPD/Knight Frank Research

Image of Tall Trees, Chipping Norton, Oxfordshire. The home is operated by Caring Homes Group which was acquired by Griffin American REIT II for £297m.

UK Healthcare property is now widely considered as a mainstream asset class. A growing number of investors are including it within their portfolios, attracted by the sector's long term index-linked income and strong underlying demographics.

Key drivers

The UK Healthcare market has witnessed increased overseas appetite for sale and leaseback opportunities, with almost £2bn worth of deals occurring in 2013. The US REITs have dominated recent activity in the private pay care market. First, Griffin American Healthcare REIT II agreed to purchase 44 care homes from Caring Homes for £297m, and then HC REIT acquired 13 care facilities from Avery Healthcare for £140m. However, there has also been increased activity from Asia-Pacific funds and Middle Eastern institutions, as the sector benefits from being Shariah-compliant.

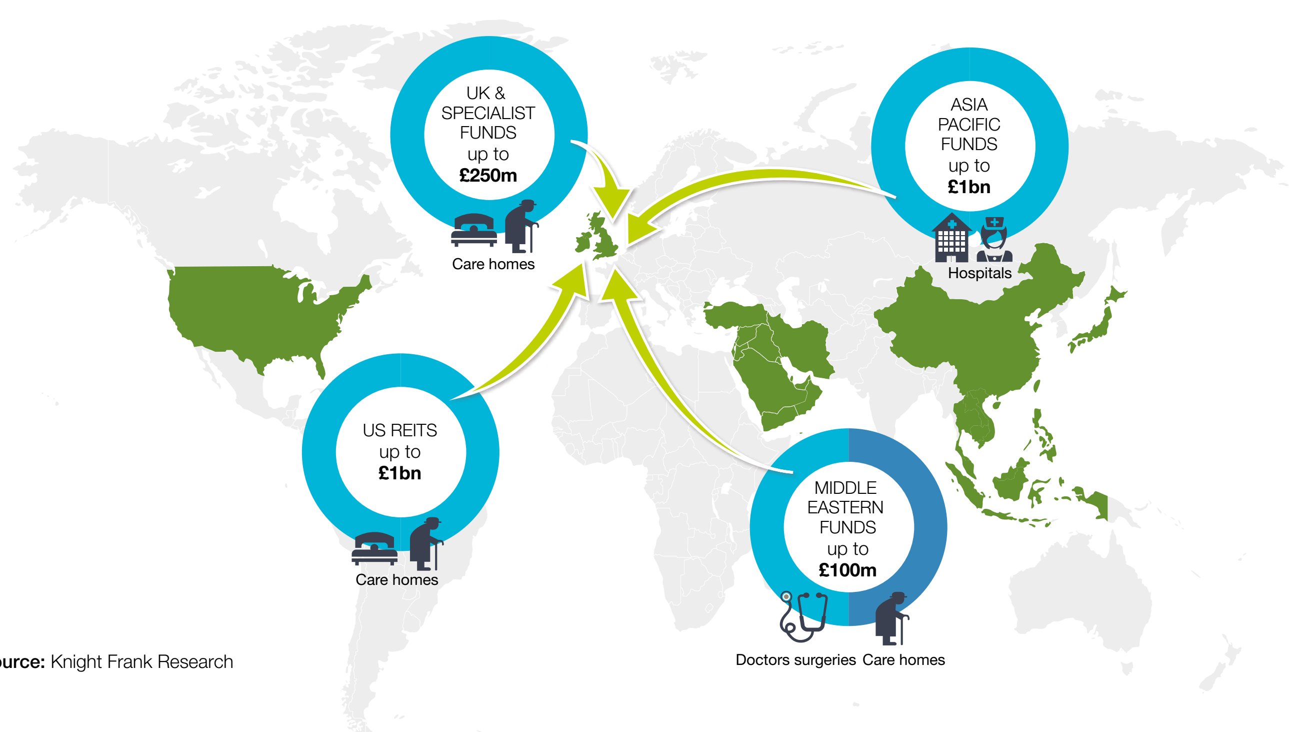
Investors are targeting a distinct range of properties based on asset size. Typically, the Asia-Pacific funds and US REITs are seeking large lot-sizes, such as hospitals and care home portfolios, priced between £100m and £1bn, while UK and Middle Eastern institutions are targeting care homes and surgeries between £25m and £250m. Forward funded pre-let agreements have been prominent among the specialist Healthcare funds such as MedicX, with lot sizes typically between £5m and £10m.

UK Healthcare property continues to attract investors because of the sector's characteristically long 25 to 35 year leases with RPI index-linked annual rental uplifts. Contrastingly, average lease lengths in the core commercial property sectors have been falling steadily over the past decade and, in 2013, stood at just six years for UK All Property, according to IPD's Lease Review.

The sector is benefitting from improving debt availability, with UK clearing banks increasing their lending exposure to Healthcare-fixed income deals during 2014. Subject to asset quality, business attributes and location, there is increasing evidence that banks and funds are prepared to invest and support established operators across the healthcare spectrum.

FIGURE 2

Global investment into the UK Healthcare market



Source: Knight Frank Research

Investment performance and yields

With total returns of 5.6% in 2013, Healthcare underperformed All Property (10.7%), reflecting the strong revival of investor interest for core property sectors (i.e. Retail, Industrial, Offices). However, Healthcare property continues to outperform the wider UK commercial property market over the longer term, recording average annual total returns of 5.5% p.a. between 2007 and 2013, compared with only 1.5% p.a. for All UK Property, according to IPD's Healthcare Index (Figure 1).

UK Healthcare has thus demonstrated an impressive risk-reward profile since the index was launched in 2007, with robust returns boosted by a relatively low degree of volatility in comparison with the UK's other main property sectors.

Performance between the main Healthcare sub-sectors varied in 2013, with primary care (doctors surgeries, dentists etc.) returning 7.2%, compared with 3.2% for secondary care (care homes, hospitals etc.), a result which stems from a 4.6% fall in capital value. Since 2007, primary care has performed well and lags only residential market-lets, with average annual total returns of 6.5%. The sector continues to outperform secondary care, which has seen average annual returns of 4.0% over the long term, albeit the IPD Index currently includes only a small number of modern purpose-built care homes.

In terms of pricing, Healthcare assets offer relatively high yields compared with the core commercial property sectors. At around 5.00%, prime care home assets command the lowest yields in the Healthcare sector, as demand for high quality purpose-built care homes and new development opportunities continues to outstrip supply. At 5.50%, surgeries command the second-lowest yields in the market, as they are normally backed by robust NHS covenants. Forward funding deals on large and mid-cap corporate care home operators continue to achieve yields between 6.75% and 7.50%.

Specialist nursing homes and independent hospitals command yields of c. 8.00%. This reflects the more challenging nature of the clientele and negative press coverage of mistreatment at specific care homes in the UK, albeit transaction levels are muted.

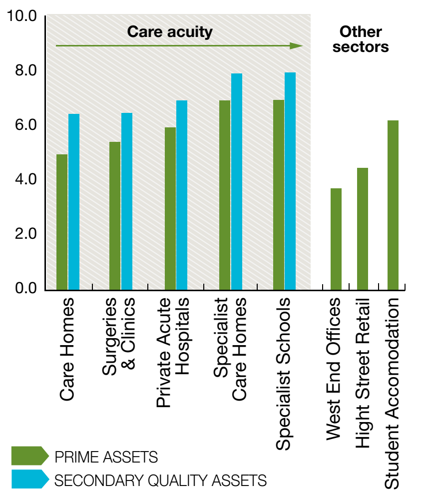
Sub-sector activity

As UK Healthcare evolves into a significant property asset class, it is important to recognise the different characteristics between each of its component sub-sectors. The primary care sector has become an established investment market. It is dominated by a number of specialist investors such as Assura, MedicX, PHP, Blackrock and Realstar. As well as specialist funds, large institutional investors are also looking to gain a foothold. Aviva, Artemis and Henderson are all shareholders in Assura, while Blackrock has put together a fund for investing in primary healthcare as well as other 'alternative' property sectors.

Primary healthcare remains far less volatile than commercial property in terms of rental growth thanks to the use of index-linked leases, traditionally 15 years, and the fact that covenant strength is supported by government and the NHS.

The care home sector is also a growing part of the market. The structural rise in user demand for elderly care is a key driver for investment into the sector. The key trends which will impact the sector in the future include not only the expansion of the elderly population (the number of over-85s in the UK will increase by 85% by 2030, according to forecasts from Experian), but also changes in health and dependency levels of the very elderly. This, and the fact that up to 80% of the UK's care home stock is arguably below 'institutional' quality, also provides a clear case for investment in future-proofed care facilities.

FIGURE 3
Prime healthcare yields



Source: Knight Frank Research

Key Healthcare transactions in the last 12 months

Address	Purchaser	Covenant	Price	NIY %	Date
44 care homes	Griffin American Healthcare REIT II (US)	Caring Homes	£297m	7.00%	Jul-13
13 care homes	HC REIT	Avery Healthcare	£140m	7.00%	Aug-13
13 care homes	Legal & General	Methodist Homes	£70m	6.15%	Dec-13
10 care homes in East Midlands	90 North	PrimeLife	£40m	n/a	Dec-13
Five care homes in Suffolk	Legal & General	Care UK	£31m	6.75%	Jan-14
Medical Centre in Chester	Primary Health Properties (PHP)	n/a	£18.5m	n/a	Feb-14
Two care homes in St Helens, Merseyside and Longridge, Preston	Target Healthcare REIT	Orchard Care Homes	£11.5m	7.00%	Oct-13
Two care homes in Manchester & York	Target Healthcare REIT	Ideal Carehomes Group	£8.9m	7.00%	Apr-14

Rent cover (EBITDARM profit over rent) is perhaps the most important consideration to prospective investors in care home facilities, as it needs to realistically reflect an operator's ability to pay the rent, given prevailing occupancy rates and fee pressures. Recent evidence suggests that rent cover between 1.6x to 2.0x is viewed as an acceptable requirement level for a new build facility, depending on operator covenant and location, including an allowance for capital expenditure and head office costs (Figure 4).

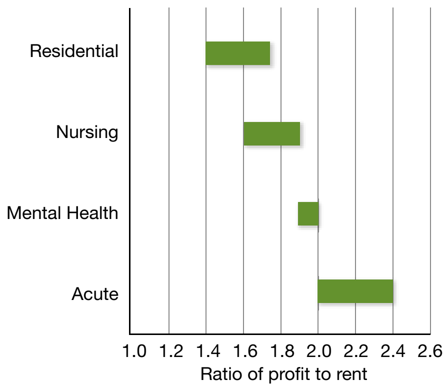
Investor opportunities

In the care home sector, lessons have been learned since the failure of Southern Cross and there are indications that investors are starting to increase their exposure to the local authority funded market once again. While the relative affluence of London and the South East continues to provide the focus of demand, investors are considering other regions and major regional cities such as Manchester and Edinburgh, which are typically more reliant on local authority funding. For example, in April 2014, Target Healthcare REIT exchanged contracts to acquire two care homes in York and Manchester for £8.9m at a NIY of 7.0%.

Most sale and leaseback investments in the elderly care market have been focused on personal care (i.e. residential care homes with non-professionally qualified care staff). However, with a shortage of large, high quality residential care homes available on the market, appetite for nursing care homes is improving with demand expected to increase over the next 12 months.

In the primary care sector, GP practices form a considerable part of the sub-sector with over 10,000 surgeries in the UK. Investment into the sub-sector will increase, as real estate assets are improved and rationalised to provide greater performance in terms of quality standards, running costs, energy consumption and meeting growing patient demand. Surgeries have already attracted interest from a wide range of potential buyers from pension funds to high net worth individuals, as it is easier to secure debt against their relatively small lot-sizes.

FIGURE 4
Indicative rent cover for care homes



Source: Knight Frank Research

KNIGHT FRANK VIEW

We expect investment in UK Healthcare property to remain strong, with further activity from overseas investors, particularly for large lot-sizes and portfolios. However, given funding pressures and political uncertainty investors will continue to focus on the best quality stock and prime covenants, particularly the not-for-profit operators where most UK institutional activity has taken place. Furthermore, negative press coverage of the care industry is not expected to dent investor enthusiasm for prime healthcare investments.

Care homes will continue to provide the bulk of healthcare investment opportunities for investors, in terms of the sheer number of assets, although hospitals attract the majority share of investment into UK Healthcare owing to the large lot-sizes involved. We expect to see a new type of care home model to emerge in urban locations. Operators will be looking to seek out mixed use development schemes and create intergenerational hubs, where student properties are sat alongside care homes and medical centres.

We also expect investment demand for modern, purpose-built Healthcare property to contribute to further yield compression. The refinancing of NHP, which owns the UK's third-largest residential care provider HC-One, and BMI Healthcare, an independent provider of private healthcare, is likely to put yields under downward pressure over the next 12 months. However, bar a few notable exceptions (Care UK, Runwood Homes), transactions with large corporate or mid-cap operator tenants are generally restricted to forward funding development pre-let deals, and we expect 2014 to test the yield profile on these covenants.

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