In 2017, investment transactions reached £1.32bn, an 88% increase from the 10-year average. Favourable demographics and long-dated income will continue to support demand for UK healthcare assets in the post-Brexit environment. The healthcare arena will continue to be dominated by fixed-income transactions and we expect 2018 transaction volumes to exceed those witnessed in 2017.
The UK healthcare sector saw documented investment transactions reach £1.32bn in 2017, which is an increase of 88% when compared with the 10-year average (Figure 1).

Following the EU referendum, 2016 saw relatively subdued market activity in the UK healthcare sector. However, 2017 was a strong year for healthcare investments. Investors, both domestic and international, sought defensive sectors to invest in, attracted by the long-dated income, typically comprising 30-year lease terms, with either Retail Price Index-linking (RPI-linked) or fixed uplifts. When comparing this with the average lease length of 7 years for other commercial properties, the care home sector remains an attractive target for investors. The sector’s institutional appeal is broadened by low yield conditions in both the bond markets and broader commercial property markets. The fundamentals of the care home sector remain robust.

In 2017, the market share of specialist property reached a record 28% of all UK commercial property investments. UK Healthcare investments made up 8% of all specialist property transactions in 2017, which elevates this sector firmly into the mainstream.

Who is investing?
Domestic purchasers have always had a strong presence within the healthcare market, and their dominance continued in 2017. As illustrated in Figure 2, 64% of 2017 investment was from REITs and quoted UK property companies, followed by 12% UK institutions and 12% private UK property companies. In the past few years, the healthcare arena has witnessed competitive tension on

![Majesticare, Fernhill House, Worcester](image-url)
the sale of large care home portfolios offered to the market. However, with these opportunities becoming scarce, REITs and quoted UK property companies have shifted focus onto smaller care home groups.

Activity from US REITs has become subdued owing to the scarcity of scalable mainstream platforms and US focussed issues which has diverted their attention to other specialist sectors. As a result just 2% of all investors were from overseas. (However, please note, from the data sources available, not all US REIT transactions are captured, which will have an inconsequential impact on our analysis.)

Figure 3 illustrates the volume of transactions by investor type. REITs and quoted UK property companies invested £741m in healthcare during 2017, followed by UK Institutions at £214m. Although only 2% of investment was from overseas, two large transactions, notably Omega Healthcare Inc.’s purchase of Gold Care Homes for £88m, contributed to £158m of inbound investment.

**Case studies**

Impact Healthcare REIT, which trades on the specialist fund segment of the London Stock Exchange, invested £149m in the Seed Portfolio comprising 56 residential care homes and 2,479 beds with a Minster Group covenant at 7.6% net initial yield (NIY). An initial lease term of 20 years has been agreed with an option to extend for a further 10-year period, with annual RPI-linked uplifts. Subject to financing, Impact Healthcare REIT’s board has approved an asset management programme which will introduce a further 92 beds across three homes for an investment of £7.9m and delivering a rent increase of circa 54%, which is estimated to complete in 2018 (1).

US REIT Omega Healthcare Inc. continued its expansion within the UK by acquiring 18 care homes for £88m with a Gold Care Homes covenant at 7.0% NIY. With this transaction concluded, in total, Omega has acquired 53 care home facilities in the UK backing two UK care home operators.

Project Bardon comprises 8 assets in total, purchased by two investors, AEW UK (advised by Knight Frank) for £22m with the NIY at 6.1% and LXi REIT Plc for £29m with the NIY at 6.5%. The covenant for both investors is with PrimeLife Limited and the investments are for unexpired lease terms of 31 years subject to RPI-linked upwards annual reviews.

Investment yields compressed further over 2017 with four care homes leased to Baycroft bought at 4.00% NIY by Aviva’s Lime Property Fund. They paid a consideration of £71m for this transaction. The deal structure comprises a forward-fund, which relates to developments based in Letchworth, Flitwick, Bedford and Watford. Once the assets have reached practical completion, the properties will be leased to Baycroft for a 30-year term. Lime Property Fund is a long-lease property fund with a net asset value in excess of £2bn. Their target is to invest in strong and stable covenant and with leases in excess of 15 years linked with RPI or fixed rental uplifts (2).

Similarly, institutional investor Ropemaker Properties, which is the holding company of the BP Pension Fund, agreed a 30-year lease term with annual RPI-linked rent reviews with a Care UK covenant, achieving a NIY of 4.5%. The 80-bed care home scheme in Sidcup, which was purchased for £17m, will provide a much-required state-of-the-art care facility. This deal was also structured on a forward-funding basis. In the year ahead, we expect to see continued appetite for

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**FIGURE 3**

**Healthcare property investment**

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Investment (£bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>REITs &amp; quoted UK property companies</td>
<td>£641m</td>
</tr>
<tr>
<td>UK Institutions</td>
<td>£214m</td>
</tr>
<tr>
<td>Private UK property companies</td>
<td>£62m</td>
</tr>
<tr>
<td>Overseas investors</td>
<td>£31m</td>
</tr>
<tr>
<td>Owner occupiers</td>
<td>£15m</td>
</tr>
<tr>
<td>Others</td>
<td>£36m</td>
</tr>
<tr>
<td>Private investors</td>
<td>£8m</td>
</tr>
</tbody>
</table>

Source: Property Data / Knight Frank Research
investment within the healthcare space from institutional investors. 2017 has also witnessed a surge of investments in supported living assets, mainly driven by REIT Civitas Social Housing Plc. They work in partnership with the Housing Association and Local Authorities. In total, they invested £240m in 2017 in portfolios of supported living assets, with long-term indexed leases and tenancies already in place. This REIT has already completed two supported living investment transactions in 2018 at £6.7m and £3m and will continue its acquisition trail in 2018.

Furthermore, Welltower, the US healthcare REIT, has agreed a development partnership with Quantum Group, through its Encore Care Homes subsidiary which provides Welltower an exclusive option to acquire £250m of Quantum’s development pipeline (3).

Further evidence of additional capital coming into the market is supported by HC-One’s agreement to purchase 122 Bupa care homes for £300m and Fremont Realty Capital’s acquisition of Porthaven Care Homes.

Knight Frank also leased circa 1,500 beds on behalf of Lone Star Funds in 2017 to operators, creating investment value for the investor and providing operators with the benefit of EBITDAM on rack-rented assets for nil premium.

Yields
As shown in Figure 4, prime healthcare yields range from 4% to 6% dependent on factors such as tenant covenant, location and the level of acuity. Prime healthcare yields have compressed further for elderly care homes to 4% driven by the current supply shortage in the market. The entrenched crisis in UK care home bed provision shows no sign of abating and the issue will be further exacerbated as the baby boomer generation ages at a rate faster than new care homes can be developed. This will inevitably increase investor appetite, support further new entrants into the market and subsequently drive up prices to maintain the downward pressure on yields.

Figure 4 illustrates how prime healthcare yields are in-line with some of the other property sectors, such as high street retail and London hotels. A sharpened prime healthcare yield will not detract from investor interest in the market, as they will gain comfort from long-dated income with strong covenants.

In general, the yield increases as the acuity level in the underlying care provided rises, as illustrated in Figure 4. For instance, in August 2017, Toscafund Asset Management purchased Circle Hospital in Reading for £60.5m achieving a NIY of 8.5%. This yield is reflective of the challenging trading at the asset. At the other end of the spectrum, care homes, surgeries and clinics command the lowest yields as they are usually backed by strong covenants.

Yield compression is also a function of the quality of stock, location and

Key healthcare transactions in 2017

<table>
<thead>
<tr>
<th>Project</th>
<th>Purchaser</th>
<th>Number of assets</th>
<th>Covenant</th>
<th>Price</th>
<th>NIY</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Seed Portfolio</td>
<td>Impact Healthcare REIT</td>
<td>56</td>
<td>Minster Group</td>
<td>£149m</td>
<td>7.6%</td>
<td>Feb-17</td>
</tr>
<tr>
<td>Project Maya</td>
<td>Omega Healthcare Inc.</td>
<td>18</td>
<td>Gold Care Homes</td>
<td>£88m</td>
<td>7.0%</td>
<td>May-17</td>
</tr>
<tr>
<td>Project Spirit</td>
<td>Aviva Investors/The Lime Property Fund</td>
<td>4</td>
<td>Baycroft</td>
<td>£71m</td>
<td>4.0%</td>
<td>Oct-17</td>
</tr>
<tr>
<td>Project Bardon</td>
<td>AEW UK Long Lease REIT, LXi REIT Plc.</td>
<td>8</td>
<td>PrimeLife Limited</td>
<td>£51m</td>
<td>6.5%</td>
<td>Nov-17</td>
</tr>
<tr>
<td>Queen Mary’s Hospital</td>
<td>BP Pension Fund/Ropemaker Properties</td>
<td>1</td>
<td>Care UK</td>
<td>£17m</td>
<td>4.5%</td>
<td>Jul-17</td>
</tr>
</tbody>
</table>

Source: Property Data/Knight Frank Research
resident funding profile. One Housing Group is a prime example: it produces state-of-the-art purpose-built care home facilities via the Baycroft brand, backed by a strong covenant and operating in the sort after self-funder market and achieving 4% NIV.

Institutional investors are typically covenant led whereas small boutique funds are more holistic in their approach, with a keen eye to the quality and location of the asset. Healthcare lenders such as Octopus and Target are increasingly purchasing SPV covenants and yields in this market are now sharpening from the 6.5%-7.5% range seen over the last half a decade into the 5%-6% range.

Rental market
Current letting demand in the UK care home market is principally from corporate operators for large, new, purpose-built facilities with all en suite wet room accommodation. The UK healthcare rental market has evolved significantly over the last five years. There are three distinct types of major investors as noted elsewhere: niche healthcare or opportunistic funds, institutional investors and the US REITs. There is currently a dislocation in their assessment of rental structures.

The US REITs tend to structure their rents off a lower rent cover of around 1.3x-1.4x triple net (after an allowance for management costs and capex) but seek a wider yield spread (6-7% but have, in recent months, retracted somewhat from the market).

UK funds, both niche and institutional now acquire fixed-income off rent covers of between 1.6x-2.5x (Figure 5), subject to the acuity of the registration i.e. the more acute or specialist the client base, the higher the rent cover. Generally rent covers on elderly lettings range between 1.6x and 1.8x EBITDARM which when assessed on a triple net basis are achieving 1.4x-1.6x cover.

### Ground rent

In 2016, we advised on a ground rent investment transaction for the first time, as an alternative to the traditional sale and leaseback structure. Alpha Real Capital acquired a ground rent portfolio of 41 care facilities operated by CareTech Plc. on a 150 year FRI ground lease. This deal helped CareTech Plc raise £30m in cash to invest in the development of their business.

Alpha Real Capital also completed a £130m ground rent transaction with HC-One in 2017 allowing the care home group to repay its loan facility with HCP (4).

![Ground rent chart]

**Source:** Knight Frank Research

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Colten Care, Wellington Grange, Chichester
Similarly, BC Partners concluded a ground rent transaction with Alpha Real Capital on their Elysium portfolio for a lease term of 125 years (5). This was in order to help finance the acquisition of the seed portfolio, disposed of by Acadia after the CMA ruling on the merger of Priory and Partnerships in Care. Ground rent yields are in the region of 3.5% with rent levels based on a percentage of EBITDARM between 10% and 15%. By selling the freehold interest for a long lease, operators can release capital in order to reinvest or develop care homes and fulfil lower rental obligations when compared with the sale and leaseback model. It is an innovative financing structure and an estimated £500m of ground rent transactions are in the deal pipeline for the year ahead.

Performance

The robust transactional market in 2017 drove strong investment performance with an IPD healthcare return of 11.9% which represents the highest rate for five years (Figure 6). Healthcare returns outperformed all UK commercial property, residential property, retail and office markets and performed well-above gilt returns of 1.75% in 2017.

Analysing the IPD returns over a five-year period (Figure 6) healthcare assets have, at 7.0%, outperformed gilt yields which achieved 3.3% but underperformed all UK commercial property, residential, retail and office asset classes and equities. This again emphasises the record year within the healthcare arena during 2017 when compared with the five-year period returns identified.

We have applied the Sharpe Ratio to identify the risk-adjusted return. As shown in Figure 7, healthcare outperformed equities and gilts and is almost on a par with all UK commercial property, which makes the risk-adjusted return for healthcare very attractive.

Outlook

After witnessing subdued investment activity in 2016, following the EU referendum, the market underestimated the upside in 2017. We expect the momentum to be maintained, with 2018 transaction volumes to exceed those witnessed in 2017.

In our view the healthcare sector is one that is least affected by Brexit volatility, as demand for healthcare services is typically driven by domestic factors. Just weeks into 2018, we have already witnessed healthcare transaction volumes reach £75m. Furthermore, Impact REIT has agreed a deal at £17m for the purchase of three homes in the North East region with covenant Prestige Care at an initial 20-year lease term with an option to extend by a further 10 years with annual upwards-only rent reviews. The deal is scheduled to complete in Q1 2018. In addition, Octopus Healthcare has successfully completed a fundraise of £85m in January to focus exclusively on the UK care home market.

We can expect further investment from infrastructure funds and the emergence of new UK REITs and Asia Pacific funds. AMP Capital’s acquisition of The Regard Group is a prime example of this where the global investment manager entered the UK specialist care sector for the first time in 2017 (6). We also estimate that there is circa £3.5bn of UK private equity and circa £22bn of overseas private equity looking to enter the UK care home market.

Attracted by the UK’s ageing population, an under provision of care home beds, the attractiveness of long-dated income and a weakened Sterling, we envisage overseas investors will re-enter the buoyed market in the coming year.

Furthermore, pension funds and institutions are increasingly diversifying portfolios into the healthcare sector, as

![FIGURE 6](source: MSCI/Knight Frank Research)

**Total returns (%)**

![FIGURE 7](source: MSCI/Knight Frank Research)

**Risk-adjusted Return (Sharpe Ratio)**
they remain under pressure to match their liabilities against long-dated income. However, it is the lack of stock, not demand that will be the greatest impediment to activity. We believe that further funds will be invested to support the development of new care homes in 2018.

The healthcare arena will be dominated by fixed-income transactions in the year ahead with a surge in propco transactions. We will subsequently witness more companies splitting their models into “propcos” and “opcos”. This will harden if a few talked about opco sales at healthy multipliers gain traction. Opco values are tangible but the UK still awaits a pure opco to transact and set a precedent and follow in the footsteps of the European models.

We also estimate an increase in sale and leaseback transactions as operators take advantage of historic low cap rates which allows them to recycle proceeds for platform growth.

Pre-lets on both forward-fund and commitment to purchase at practical completion for new build care facilities are at a record high with Knight Frank currently mandated to lease over 2,500 beds throughout the UK.

Some of the challenges ahead?

In 2017 operators had to react to staffing challenges ahead of Brexit, the social care funding crisis, the introduction of, and subsequent increase in, the National Living Wage and rising food and property costs. 2017 also witnessed a shift toward personal care home developments targeting the private pay market, partly in response to the shortfall of qualified nurses within the UK. These operational challenges will have an adverse impact on at least 6,600 homes in the UK going forward and could result in further home closures. This will invariably provide owners of healthcare assets with great pricing power in the year ahead.

In regards to regulatory changes, there are the proposed changes to Capital Gains Tax for overseas buyers in the Autumn’s budget and lease accounting changes which come into effect on the 1st January 2019 which will have a larger impact on the lessees. Base rate increases, expected in 2018, will have a limited direct impact on returns this year.

Over the past five years, the sector has witnessed a substantial increase in build costs triggered by the required specification to keep-up with market standards and attract the private pay market, the price inflation on raw materials and the shortfall of skilled labour force. Accordingly, developers will need to revisit their build specifications to examine where costs can be controlled and where the uplift in build costs can filter through into average weekly fees. The increasing build costs coupled with rising land values are a few of the driving factors for rental increases and yield hardening.
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