Investment volumes reach £1.49bn in 2018, up 13% on 2017 reflecting another strong year of activity.

Favourable demographics and strong property performance remain a draw for domestic and overseas investors.

Expect transactions to remain elevated in 2019 as investors divest into healthcare and also senior living.
A BUOYANT SECTOR

Capital continues to flow towards healthcare as a range of investors seek opportunities in the sector.

Investment in the healthcare sector remained incredibly buoyant in 2018, able to resist yet another year of relative political and economic uncertainty. Documented transactions finished the year at £1.49 billion, exceeding the strong activity seen in 2017 by 13% and well above average levels measured across the last 10 years. As a further indication of market activity, Knight Frank advised on a record £5.5 billion of healthcare refinancing for a mixture of UK high street clearing banks, institutions and overseas capital.

Activity looks all the more encouraging when considering the Brexit backdrop which has impacted the broader investment landscape. As Figure 1 shows, transaction activity dipped in 2016 as investors digested the outcome of the referendum, but has surged and remained elevated since. This surge is part of a broader appetite for alternative property sectors but there are a number of unique factors that have driven a range of investors toward the healthcare sector in recent years.

- The UK’s ageing population will be one of the key structural shifts of the next 30 years, driving demand for elderly care services;
- Property fundamentals, including occupancy rates and care home fees, are at record highs even before the ageing time-bomb kicks in;
- Income for healthcare property is long-dated, typically comprising 30-year lease terms (RPI-linked) compared to average lease lengths of seven years within other commercial sectors;
- The sector provides a diverse mix of low-yielding property types, including elderly care homes, adult and supported living accommodation, and primary healthcare facilities.

Domestic and overseas investment

Domestic investors have been dominant buyers of healthcare property over the last five years, when compared to 2013 when 71% of capital came from abroad (Figure 3). Investment during this period came from US REITs whose interest declined somewhat as their investment strategies have shifted back towards the US. The current dip also reflects a relative lack of large scale portfolio opportunities, the kind of which are sought by highly capitalised global investors. Although overseas transactions have softened, appetite certainly remains. This was evidenced in the final month of 2018, when pan-European Healthcare REIT AEDIFICA, announced an expansion into the UK through the purchase of Lone Star’s 93 care home portfolio for a sum of £450 million. The acquisition was the largest documented healthcare transaction of 2018.

European funds are not the only global investors seeking exposure to UK healthcare. APAC infrastructure funds and APAC private equity firms are increasing their exposure to the UK healthcare sector through both property and operating company acquisitions. This is a trend we expect to continue looking forward and one that highlights the increasing globalisation of healthcare as an asset class.
Elderly care home transactions

Octopus Healthcare continues to make an impression on the elderly care market in 2018, with several notable deals. This included the purchase of a four-home portfolio in excess of £60m in the third quarter of 2018. Two of the properties will be let back to New Care, and a further two in Formby and Bramhall, are in development and set for completion later in 2019. Later in 2018, Octopus raised a further £130 million which will partly be used to acquire a further six properties across the Midlands. The homes are let on long-term leases to Care UK while an additional home is reportedly under development.

Target Healthcare REIT had another active year in the elderly care market. In June 2018, the specialist listed investor acquired two homes (Stratton Court & Kings Lodge) from Aura Care for £37 million in another sale-leaseback deal. Both assets are modern purpose-built care homes let to Aura Care on 30-year leases with RPI-linked rent increases. These traded at a yield representative of assets of a similar standard and location within the groups portfolio. Target also entered into a number of forward funding contracts for homes that broke ground in 2018. The largest of these was a £37 million deal to purchase two care homes (Cheviot Grove & Halshead House) from Hamberley Group, a developer and operator of luxury care homes and retirement living projects backed by Patron Capital. Forward funding deals such as this will likely become more common in the future as investors and developers look to create opportunities in an undersupplied market.

The prime end of the market, where yields have tightened to less than 4%, continues to attract interest from institutional investors. At a NIY of 4.0%, NILGOSC’s Local Government Pension Scheme for Northern Ireland acquired Lavender Fields Care Home in Kent for £20 million. Similarly, Orchard Street RA, who manage funds on behalf of world-wide institutional clients, acquired a 50-bed home for £14.2 million at a NIY of 3.85% in mid-2018.

Ground rent transactions

We also continue to see a significant amount of ground rent transactions as an alternative to the sale-leaseback structure. By selling the freehold interest on a portfolio of homes, operators can release crucial funds for repaying debt or reinvesting in their businesses. Operators are also able to reduce their regular rental obligations when compared to the sale-leaseback back option. Ground rent covenant levels are around 9% to 15% of EBITDAR, compared to significantly higher rental cover of 1.4x to 1.6x EBITDAR when all tenure interests are sold off.

Knight Frank acted on several such transactions on behalf of a number of vendors in 2018. The portfolios were purchased at yields of between 2.75% and 3.25%. The two biggest transactions were valued around £30 million each with rent set close to the market standard of circa 10% of EBITDAR.
INVESTMENT PERFORMANCE

Yields

Yields for different healthcare property types range from 4% to 6% with tenant covenant, the level of acuity, and the resident (or patient) profile being the main determining factors. We have seen continued compression in the elderly care segment with prime and super-prime care homes transacting at yields as low as 3.75% in 2018. This reflects well-located, purpose-built stock with the strongest covenant and operating in the sought-after self-funder market.

However, the more typical core stock, which tends to require more capital expenditure to bring up to standard and usually contains a more even mix of self-funded and publically funded residents is currently trading between 5.6% (NIY). While yield levels vary across healthcare segments, the scale of investor demand across the sector continues to increase and we expect this to keep yields compressed for the foreseeable future.

FIGURE 5
Average Healthcare Yields (NIY, %)

Total returns

With total returns of 10.9%, the healthcare sector outperformed the All UK Property average for the third consecutive year in 2018 and continues to look attractive against other property classes and of course equities, which slumped in 2018.

FIGURE 6
Total Returns (%)

Operations face the same set of challenges, particularly with staffing

High transaction volumes maintained in 2019

Increasing interest from overseas buyers

Operators face the same set of challenges, particularly with staffing in the healthcare market. The level of overseas interest in UK healthcare is a particular source of encouragement and there is strong evidence to suggest this trend will continue. A recent survey of global institutional investment by Octopus Healthcare, predicts that over the next five years more than a third of global institutions expect to increase their allocation to healthcare infrastructure by up to 10%. Furthermore, many respondents cited Europe and specifically the UK as a hotspot for healthcare investment. We expect to see continued overseas interest in healthcare going forward from a variety of regions, including APAC infrastructure funds as well as renewed interest from North America with the US Dollar looking strong against the Pound.

Insufficient investment opportunities are likely to be the biggest barrier. While development activity is beginning to escalate, we expect to see an increasing amount of forward funding deals in the short-term and long-term to create profitable healthcare assets. Specialist UK investors are beginning to deploy this strategy successfully, especially in the elderly care home sector, but more development is required to keep pace with demand.

Restrictive opportunities should also lead to increased interest in broader healthcare segments such as adult supported living and childcare. These markets have traditionally been fragmented but some consolidation will begin to create more scalable investment opportunities. Investors focused on healthcare are also likely to diversify into the senior living sector as this model emerges as another major alternative asset class. With new stakeholders entering both these sectors, due diligence and market insight will play an increasingly important role in investment decisions.

There are also a number of challenges facing operators. Government backed increases in the national living wage will continue to put pressure on staffing costs at a time when skilled nurses are already in short supply. This shortage could further be impacted by Brexit should implications result in a reduced pool of migrant workers in the UK. Operators have also been challenged by the regulator (Care Quality Commission) to provide a higher standard of service, both in terms of care provision and facilities. Such challenges must be factored into accounts when considering covenant strength and investment risk.
Footnotes

Front cover image: Moore Place, Esher, Anchor (Anchor Hanover)

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