RESEARCH

Knight Frank

HEALTHCARE
CAPITAL MARKETS **2019**

HIGHLIGHTS

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

MARKET CHARACTERISTICS

DEMAND DRIVERS

Ageing population
Shortage of care beds
Long-dated RPI linked income

INVESTORS

REITs & niche funds
UK Institutions
Overseas Interest

PROPERTY TYPES

Elderly Care
Adult & Supported Living
Primary Care

KEY PERFORMANCE INDICATORS

INVESTMENT VOLUME

£1.49 billion in 2018
Up 13% from 2017

HEALTHCARE YIELDS

3.75% to 6.00%
Variation across asset types and acuity

PERFORMANCE

Total returns of 10.9% in 2018
Exceeding 5-year average of 8.3%

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 and 2018 was no different. UK REITs and quoted property companies were the largest net buyers (Figure 2) with acquisitions of £800 million, accounting for 55% of investment in the sector.

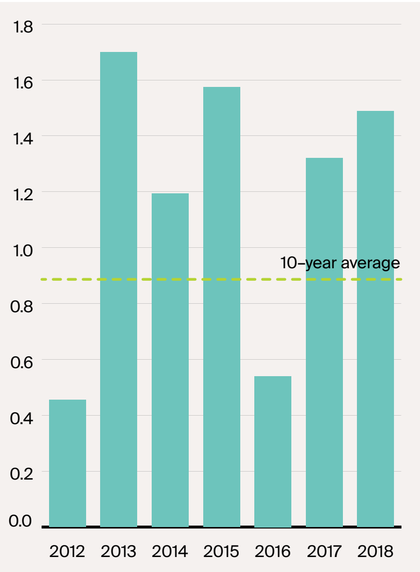
Much of this investment has come from specialist REITs and niche funds who have been better placed to acquire healthcare stock from care operators. As such, the market is seeing a significant number of sale-leaseback deals, helping REITs to grow their portfolios and operators to dispose of assets and capitalise on record pricing.

Direct property investment from overseas buyers has been more subdued over the last five years, when compared to 2013 when 70% 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[1].

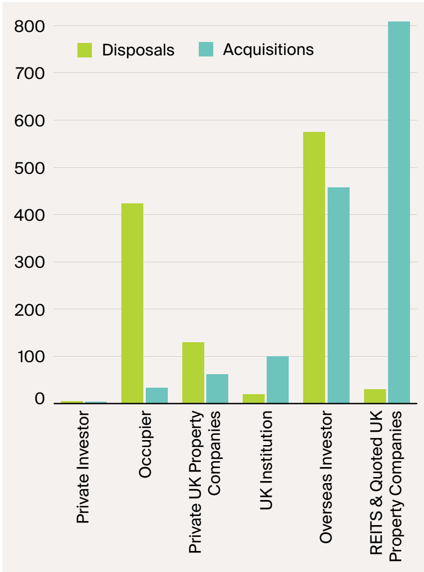
European funds are not the only global investors seeking exposure to UK healthcare. APAC infrastructure funds and APAC private equity firms are increasing their exposure to the UK healthcare sector through both property and operating company acquisitions. This is a trend we expect to continue looking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

FIGURE 1
Volume of healthcare transactions (£bn)



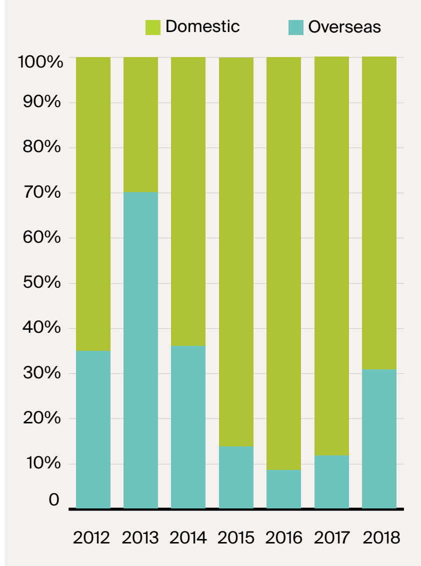
Source: Property Data, Knight Frank Research

FIGURE 2
Acquisitions and disposals by investor type in 2018 (£m)



Source: Property Data, Knight Frank Research

FIGURE 3
Overseas vs domestic healthcare property investment



Source: Property Data, Knight Frank Research

Moore Place, Esher, Anchor-Hanover

ELDERLY CARE TRANSATIONS IN 2018

PROJECT	PURCHASER	NUMBER OF ASSETS	COVENANT	PRICE	DATE
Project Forest	AEDIFICA	93	Multiple	£450m	Dec-18
Care UK Portfolio	Octopus Healthcare	6	Care UK	£110m	Dec-18
New Care Portfolio	Octopus Healthcare	4	New Care	£60m+	Oct-18
Stratton Court & Kings Lodge	Target REIT	2	Aura Care	£37m	Jun-18
Chawley Grove & Halstead House	Target REIT	2	Hamberley Care Homes	£37m	Nov-18
Lavender Fields Care Home	La Salle/NILGOSC	1	Greensleeves	£20m	Sep-18

Source: Property Data, Knight Frank Research

Please refer to the important notice at the end of this report

ELDERLY CARE HOME SECTOR

Elderly care home transactions

Octopus Healthcare continue 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 £133 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[2].

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 (Chawley Grove & Halstead 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 (Local Government Pension Scheme for Northern Ireland) acquired Lavender Fields Care Home in Kent for £20 million. Similarly, Orchard Street IM, 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-lease back option. Ground rent cover levels are around 9% to 15% of EBITDARM, compared to significantly higher rental cover of 1.4x to 1.8x EBITDARM 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 EBITDARM.

Grosvenor Manor, Chester, New Care Homes

SPECIALIST HEALTHCARE MARKETS

The adult care and supported living market

The adult care home and supported living segment also saw a significant inflow of capital in 2018. While this market is both much smaller and more fragmented than the elderly care sector, an impressive £350 million was invested into the segment in 2018, making up 24% of all recorded healthcare deals (Figure 4). Nearly all acquisitions were from a handful of specialist social housing REITs which have been raising significant funds in recent years.

This market is also undergoing a period of transformation with a shift away from large institutional adult care homes in favour of smaller community-based supported living residential accommodation. This is due to a changing narrative on how care for vulnerable adults should be delivered, but also because supported living is a cheaper alternative cost to local authorities – the principle funders of adult care[3].

Supported living residences make very stable long-term investments for several reasons. Adults requiring supported living often reside in the same property for the duration of their life, supporting income; Rental payments are supplemented through government-backed housing benefit; and risk of closure is limited by the fact that residences do not require registration under the Health and Social Care Act 2008, with care provided under separate operator contracts. With this in mind, supported living accommodation has been a strategic focus of social housing REITs over the last two years.

Case study – Civitas Housing Group

Civitas Social Housing PLC is a listed social housing REIT that has made a particular impact in the supported living market since launching to the stock market in 2016. With a property portfolio valued at £675 million, spanning across circa 557 properties (as of September 2018), Civitas have acquired a significant share of the supported living market by forming a number of partnerships with regional care providers and housing associations. This close collaboration is a vital part of its strategy and helped the company to make acquisitions in excess of £240 million in 2018.

One such collaboration has been with Auckland Home Solutions, a registered care home provider to vulnerable adults in the North East. Much like the sale-leaseback deals we have seen in the elderly care market, Civitas acquired multiple properties across 3 portfolio deals (totalling £74 million) from Auckland in the second half of 2018, leasing them back on 25-year lease terms with rent uplifts linked to CPI over the full period. The Civitas approach has not only helped the REIT make the most of increasing demand for supported living accommodation, but also shows how long-term partnerships are increasingly becoming the approach of choice across the healthcare arena[4].

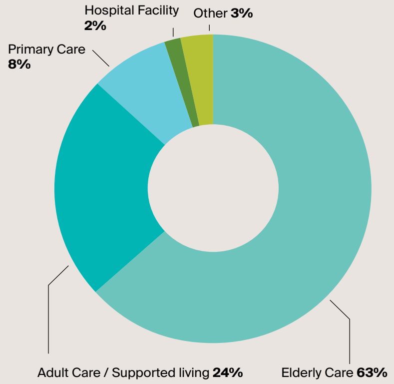
Civitas Social Housing PLC

Primary care

The primary care segment has also seen some significant transactions in 2018. As with the adult care and supported living segment, key deals have been dominated by specialist REITs. In the largest such deal of 2018, MedicX purchased a portfolio of 12 purpose-built facilities in Northern England for a total sum of £63.8 million and at a NIY of 4.4%. A bigger piece of news concerning MedicX was the announcement, in January 2019, that the REIT will be merging with Primary Healthcare Properties to create a combined fund of £2.3 billion.

Assura Group, another of the largest Primary Healthcare REITs in the UK, also added Stratford Healthcare Centre to their extensive portfolio. The multi-service community facility is one of the largest primary healthcare acquisitions on record and indicates continued appetite from GPs and the NHS to relinquish ownership of their premises.

FIGURE 4
Investment by property type 2018 (Total = £1.49bn)



Source: Property Data, Knight Frank Research
NB: Figures are for documented transactions only

SPECIALIST HEALTHCARE TRANSACTIONS IN 2018

PROJECT	PROPERTY TYPE	PURCHASER	NUMBER OF ASSETS	COVENANT	PRICE	NIY	DATE
12 Primary Care Centres	Primary Care	MedicX	12	One Medical Property Ltd	£63.8m	4.40%	Jun-18
Social Housing Portfolio	Supported Living	Civitas Social Housing	8	Auckland & Falcon Housing	£38.3m	Unidsclosed	Oct-18
Social Housing Portfolio	Supported Living	Civitas Social Housing	67	MySpace Housing Solutions	£37.6m	Undisclosed	Aug-18
Stratford Healthcare Centre	Primary Care	Assura Group	1	NHS	£31.3m	4.25%	Oct-18

Source: Property Data, Knight Frank Research

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.

Yields for adult care and supported living accommodation are around 200-300 basis points higher than prime elderly care home stock, although assets will vary. This is in part because of the more specialised care requirements that adults with learning disabilities or mental health issues may have, and partly because the resident profile is almost entirely funded from local authority and NHS money which translates to greater income risk. More limited investment demand has controlled capital value growth with specialist REITs like Civitas Social Housing and Triple Point Housing dominating acquisitions in 2018.

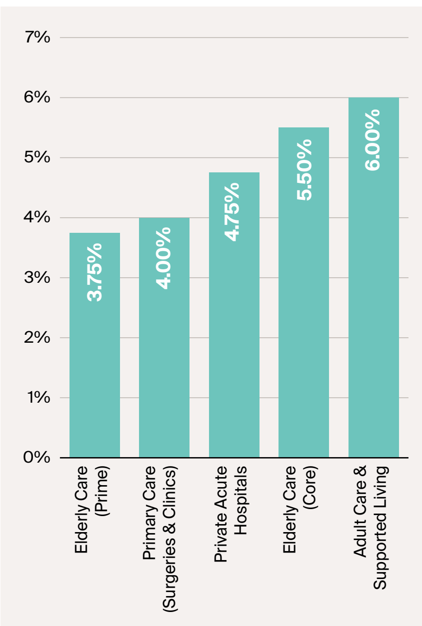
Total returns

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.

High returns of 20% in the industrial sector are partly down to the structural changes being brought about by rapid growth in e-commerce. The healthcare sector is also commencing a structural shift in demand with the baby boom generation now beginning to enter retirement age. Care home occupancy is expected to remain high in years to come, supporting a healthy outlook for healthcare returns.

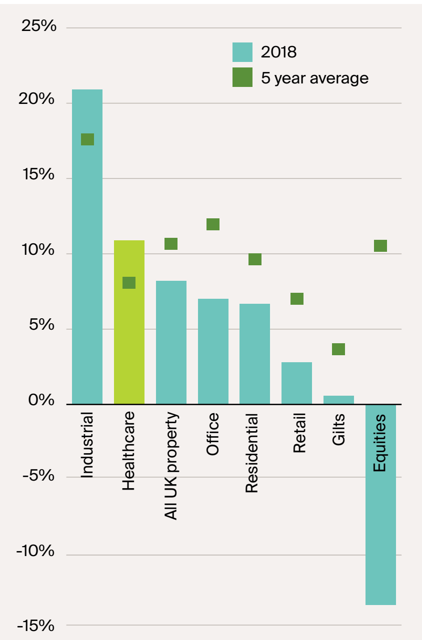
Across a five-year basis, healthcare has averaged a total return of 8.3% which looks more in keeping with other commercial sectors. The historical stability in healthcare returns means that the sector also looks strong when assessed on a risk-adjusted basis. As Figure 7 shows, risk-adjusted returns outperform all other commercial sectors except industrial. These attractive risk-adjusted returns are doing much to encourage institutional investors, with lower risk appetite, into the healthcare sector[5].

FIGURE 5
Average Healthcare Yields (fixed-income, %)



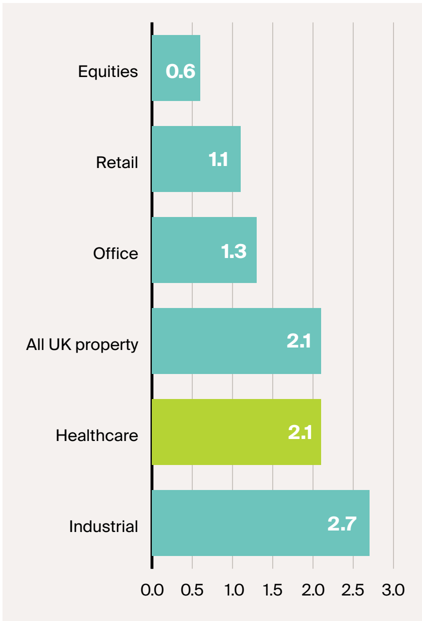
Source: Knight Frank Research

FIGURE 6
Total Returns (%)



Source: MSCI

FIGURE 7
Risk-adjusted Return (Sharpe Ratio*)



Source: MSCI
*Sharpe ratio calculated as 5-year average return on asset, less the risk free rate (10-year government bond yields), over 5-year standard deviation

Stratford Healthcare Centre, Assura PLC

OUTLOOK

High transaction volumes maintained in 2019

Increasing interest from overseas buyers

Diversification into specialist healthcare assets and senior living

Operators face the same set of challenges, particularly with staffing

> "The level of overseas interest in UK healthcare is a particular source of encouragement and there is strong evidence to suggest this will continue."

Making accurate predictions about property performance is no easy task in the current political context. However, we maintain our view that healthcare is a sector least affected by the impact of Brexit, instead driven by domestic factors and favoured for its long-dated income stream. We expect transaction volumes in 2019 to mirror the elevated levels seen in 2017 and 2018 as investors search for returns with a long-term horizon and healthcare REITs continue to grow their portfolios.

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%[6]. 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.

Restricted 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 be further 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 taken into account when considering covenant strength and investment risk.

Footnotes

1. AEDIFICA SA/NV. 2019. ABOUT. [On website]. Belgian listed healthcare REIT. *https://www.aedifica.be/*
2. Octopus Healthcare. NEWS. 2018. [On Website]. *https://octopushealthcare.com/news/*
3. Laing Buisson, Adult Specialist Care UK Marker Report (2nd Edition), Written by William Laing
4. Civitas Social Housing PLC. 2019. ABOUT. [On website]. *http://civitassocialhousing.com/about-civitas/*
5. Octopus Healthcare, Healthcare Infrastructure – Understanding the opportunity for institutional investors, 2018 *(https://octopusgroup.com/insights/global-institutions-are-embracing-the-opportunity-to-invest-in-healthcare-infrastructure/)*
6. Octopus Healthcare, Healthcare Infrastructure – Understanding the opportunity for institutional investors, 2018 (*https://octopusgroup.com/insights/global-institutions-are-embracing-the-opportunity-to-invest-in-healthcare-infrastructure/)*

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

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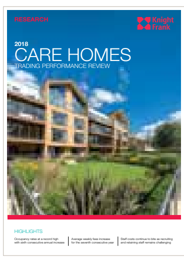
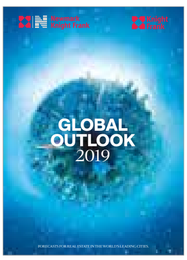


Care Homes Trading Performance Review – 2018

Healthcare Development – 2018



Global Outlook 2019

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