



RESEARCH

2011 HEALTHCARE

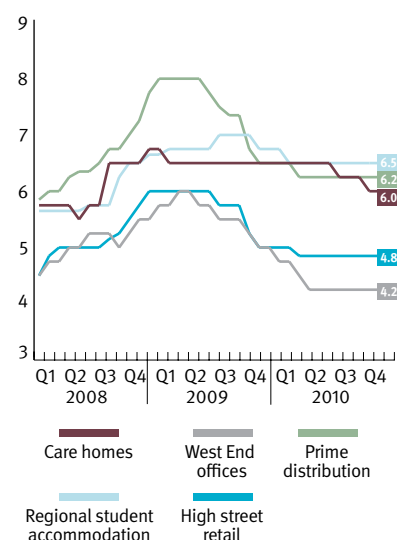
Investment

Knight Frank

Outlook

- With the rebound in commercial property values slowing in recent months, income looks set to be the main driver of performance in early 2011. The care home sector is well placed in this regard. Characterised by long 25 to 35 year leases and fixed annual RPI uplifts, this sector is expected to continue to attract robust investment demand throughout 2011.
- However, investment interest will remain restricted to high quality care homes in relatively affluent areas, focused on those leased to established operators with solid trading performance. Prime care home yields are expected to remain stable at c.6.00% in 2011, although secondary and tertiary assets may see continued yield softening reflecting declining occupancy rates and fee pressures.
- The poor performance of certain operators in 2010 will make it essential that prospective investors closely examine underlying asset value, levels of sustainable rent cover and re-letting prospects. In addition, the possible failure of small scale operators may well trigger further opportunities for management contracts among large corporate operators with good covenants.
- With some operators struggling with debt and loan to value covenant breaches, the trend towards sale and leasebacks is expected to gain momentum in 2011. Forward funding and pre-let developments will also become more frequent. With liquidity remaining problematic, equity-backed investors are working closely with operators to identify new build leasehold opportunities within their landbanks as an alternative to the traditional model of operator freehold development.
- The profile of purchasers into the care home sector has widened recently to include increasing numbers of international investors, as well as the re-emergence of a number of healthcare specific funds, such as MedicX and BlueSky Global Investors. The latter are looking to build substantial portfolios with a spread of tenants and each has significant funds to spend in 2011.

Figure 1
Prime Healthcare yields
(%)



Source: Knight Frank

Table 1
Key healthcare transactions in 2010

Address	Purchaser	Operator	Price (£m)	Rent (£)	NIY %	Date 2010
Atkinson Court, Leeds	Private Investor	Priory Group	6.16	455,160	7.00	Mar
Kingsfield Care Centre, Faversham	Citrus	Southern Cross	7.38	560,000	7.40	Mar
Two Homes in Leamington & Bristol	Aprirose REI	MHA	19.10	Confidential	5.45	Aug
Carterton, Oxon	Private Investor	MHA	6.80	419,737	5.83	Aug
Loxley Park, Sheffield	MedicX	Signature	8.50	630,000	7.25	Sep
Confidential	Private Investor	Runwood Homes	10.24	672,000	6.20	Oct

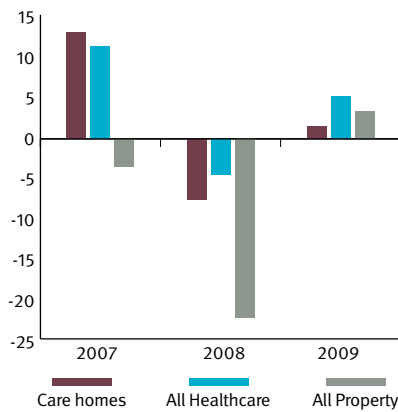
Source: Knight Frank LLP Note: all vendors were private landlords



In August 2010, Knight Frank sold the freehold interest of The Homestead, Carterton for £6.8m to a private investor, reflecting a net initial yield of 5.83%.



Figure 2
Total returns
(% p.a.)



Source: IPD

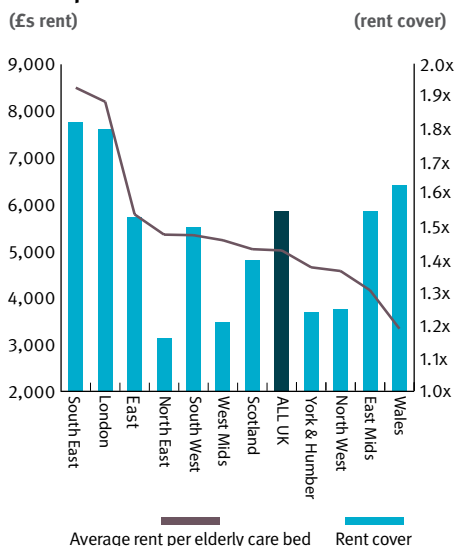
“The defensive nature of the health sector and requirement for modern purpose built facilities is an increasingly attractive proposition for investors.”

Tim Meggitt, COO, MedicX Healthfund

Market Commentary

- The Healthcare sector – and care homes more specifically - were impacted far less by the recent downturn compared with other commercial property sectors. According to IPD, care homes recorded modest total returns of 2.1% p.a. between 2007 and 2009, relatively impressive when viewed against All Property total returns of -8.0% p.a. over the three year period (Figure 2).
- Healthcare’s relative independence from discretionary spending and long leases are key strengths compared with more conventional asset classes. Care homes typically provide investors with lease lengths of 25 to 35 years, which compares with a falling average of 9.7 years for UK All Property (i.e. retail, offices & industrial). Care home rents are also typically linked to annual RPI uplifts with a collar and cap.
- Analysis of over 1,000 Knight Frank valuations and transactions of corporately operated care homes provides important insight into regional level performance. Unsurprisingly, average rents per bed are highest in London and the South East, with average rents of over £8,000 per annum. In contrast, the majority of the UK’s other regions show average rents per bed in the range of to £4,500 p.a. to £5,500 p.a. with Wales showing the lowest, at c. £3,300 per bed p.a. (Figure 3).
- Rent cover (rent as a proportion of profit) provides a more insightful means of understanding asset performance for investors. Across the entire sample size, average rent cover for the UK stands at 1.55x, although a broad range of results is evident between individual care homes throughout UK, with significant variation seen between regions (Figure 3).
- Average rent cover is highest in London and the South East at 1.81x with high demand for private care in these regions and potential for further rental growth. Similarly, Wales surprises with rent cover of 1.63x, with the low rents per bed indicating that many homes in the region may be under-rented.
- In contrast, the North East has the lowest average rent cover, at 1.16x, reflecting the low occupancy rates and relative oversupply of care bed provision at present. Given that average rents per bed are actually above the all UK average, it would suggest care homes are presently over-rented in the region. The same might also be said, although to a lesser extent, for the West Midlands.
- Anecdotally, the UK’s largest care home operator, Southern Cross, has seen levels of rent cover decline in many of its leased facilities. With rental levels set by the freeholder, falling occupancy rates and local authority freezes in fee levels have squeezed its margins, impacting financial performance and share value.
- Investor appetite is overwhelmingly focused on prime facilities in relatively affluent locations, where occupancy rates are strong and dependence on local authority funding less significant. Evidence from a number of notable transactions, highlighted in Table 1, indicates that prime care home yields moved in by c.50bps since summer 2010, having been static for two years prior, to stand at c.6.00%.
- A number of corporate care provider deals were either sale and leaseback or forward funding agreements, both key emerging trends in the market. With liquidity an ongoing concern, such arrangements are providing an important source of equity release, necessary either to manage LTV covenant breaches or as a means to expand their portfolios.
- An increasingly common condition associated with pre-let agreements is for tenants to request a buy-back option, usually within a specified period from lease commencement and at a pre-agreed value. Likewise, tenants are now regularly obliged to provide their landlords with quarterly management accounts or trading information.
- Where there is appetite for new build facilities, it has been noted that new care home developments are currently being set with rent covers of between 1.6x and 1.8x, while new specialist care typically has higher rent covers of 1.8x to 2.0x, partly reflecting the higher risks concerning occupancy rates at these facilities.

Figure 3
Rents per bed and rent cover
(£s rent)



Source: Knight Frank LLP

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