RESEARCH

2013

HEALTHCARE

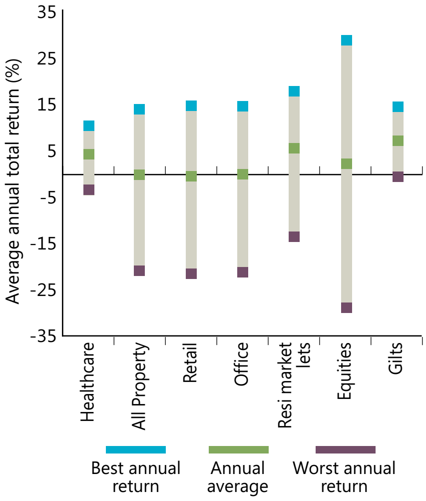
Investment

HIGHLIGHTS

- Healthcare's defensive attributes have prompted a growing number and variety of investors to include it within their property investment strategies, with the traditional UK Funds joined by overseas capital and specialist Healthcare funds.
- The UK Healthcare investment arena has become an increasingly global marketplace, with major portfolio deals and funding arrangements involving capital from North America, the Middle East and Asia Pacific.
- Demand for Healthcare assets is strong, but remains focused on modern, future-proofed facilities. The increasing weight of money seeking prime Healthcare facilities and a lack of suitable product is putting downward pressure on yields.
- There are indications that strong appetite for sale and leaseback arrangements has returned, with lessons learned from the demise of Southern Cross. A further £2bn of deals is expected to trade by mid-2014.

The arrival of overseas investors in the UK Healthcare property market over the past year could mark a sea-change for the sector. For larger lot-sizes, such as hospital and care home portfolios, UK Healthcare is increasingly seen as an opportunity to invest in relatively high yielding assets which offer long-term fixed income.

Figure 1
Total returns 2007 to 2012 inclusive



Source: IPD/Knight Frank Research

Key drivers

UK Healthcare property has attracted significant investment activity over the past 12 months, with sale and leaseback deals, corporate acquisitions and forward funding agreements seen across the Healthcare property spectrum. The dramatic arrival of the US REITs to the market is significant, and arguably reflects UK Healthcare's gradual emergence as a mainstream asset class.

Healthcare's characteristically long, RPI-linked leases are a key draw, providing investors with relatively secure income compared with other property sectors. While average lease lengths for the traditional core commercial property sectors stand at just six years (BPF/IPD 2011), new-build Healthcare assets typically come with 25 to 30 year leases.

With regard to the care home sector, another key investment driver is the structural rise in user demand for elderly care. The latest forecasts from Experian indicate that the population of over-85s in the UK will expand by 85% by 2030. This, and the fact that a substantial proportion of the UK's care home stock is (or soon will be) unfit for purpose, provides clear case for investment in future-proofed care facilities.

Healthcare investment performance

Since the IPD Healthcare Index was launched in 2007, the sector has recorded average annual total returns of 5.4%, significantly outperforming All UK Property's flat returns of 0.0% p.a. over the period. Indeed, of the main property sectors, Healthcare lags only residential market-lets, with returns of 6.6% p.a. (Figure 1).

Healthcare has also demonstrated an impressive risk-reward profile since the index was launched, with robust returns augmented by a relatively low degree of volatility in comparison with the UK's other main property sectors (Figure 1).

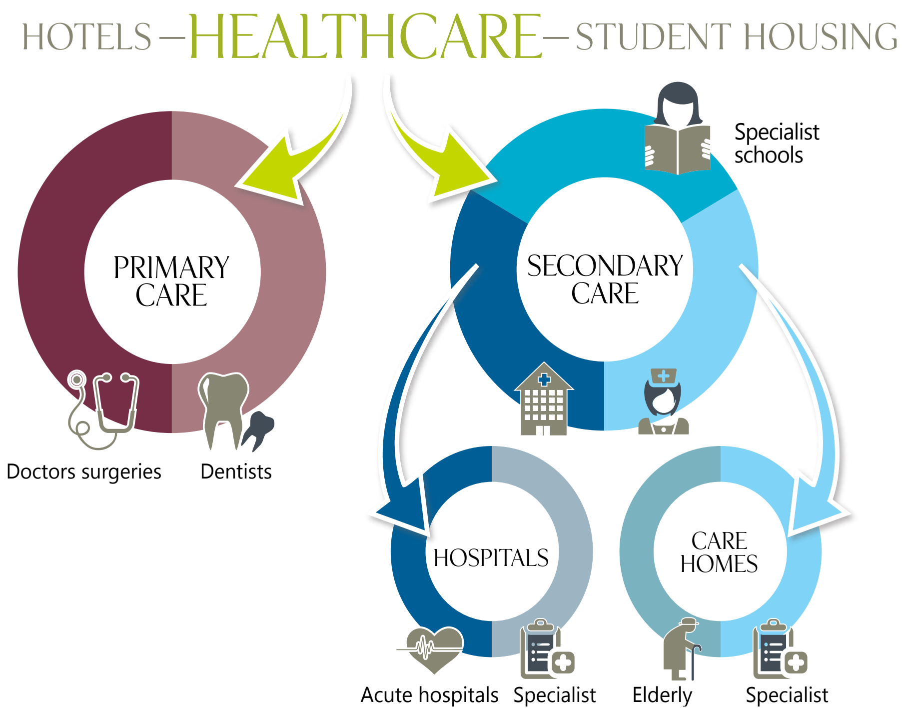
IPD's Healthcare Index results for 2012 reveal a notable divergence in performance between the main Healthcare sub-sectors, with Primary Healthcare returning 6.8% compared with -3.1% return for Secondary Healthcare (care homes, hospitals etc), a result which stems from a 9.2% fall in capital value.

However, IPD's index on Secondary Healthcare is weighted towards poorer quality facilities, and this is borne out in the performance for 2012. IPD's results for Secondary Healthcare would therefore be expected to improve as the proportion of modern, future-proofed care home facilities contained within the index increases.

Risk and pricing

Healthcare property is relatively high-yielding compared with other more 'core' property sectors, particularly so considering its stable income-generating characteristics. All things being equal, prime yields across the

The healthcare sector within specialist property



Healthcare property spectrum increase as the level of acuity in underlying care needs rises (Figure 2).

With demographic trends supporting underlying demand, the main downside risks to Healthcare investment relate more to political uncertainty, the sustainability of rental levels and covenant strength.

At 5.75%, surgeries command amongst the lowest yields in the Healthcare sector, as they are normally backed by robust NHS covenants. In contrast, specialist nursing homes and independent hospitals command prime yields of c. 8%, reflecting the more challenging nature of the clients and the perceived risks generated by negative media coverage which have highlighted mistreatment at specific units.

The market for prime elderly care facilities is two-tiered. Methodist Homes and BUPA are considered to be the best covenants, with prime yields at c. 5.75%. However, actual investment activity has centred on the second tier, where the physical asset is of a high quality, but operator covenant strength carries greater risk. Here, yields for future-proofed stock range from c. 6.5% to 7.5%.

Market trends

2012 marked the arrival of large-scale direct investment into UK Healthcare by overseas investors. First, US-based Health Care REIT acquired Sunrise Senior Living, which entailed the transfer of five high quality UK care homes for £154m, then HCP acquired a £175m share of Four Seasons' debt, following its buyout by Terra Firma. More recently, in July 2013, Griffin American Healthcare REIT II agreed to purchase 44 care homes from Caring Homes for £297m.

Overseas activity has also extended to include capital from the Middle East and Asia-Pacific. In January, Spire agreed to a £700m sale and leaseback of 12 hospitals to an investment consortium, comprising Malaysian fund MEP and two hedge funds.

The arrival of the major US REITs in the UK market is potentially highly significant. The US REITs have a notable competitive advantage over their UK equivalents, as debt is cheaper in the US, allowing for higher investment returns.

In addition, US legislation allows REITs to engage more closely at the operational level, over and above simple ownership of physical property assets. This crucial difference means that much greater emphasis is placed on the underlying trading performance of the asset.

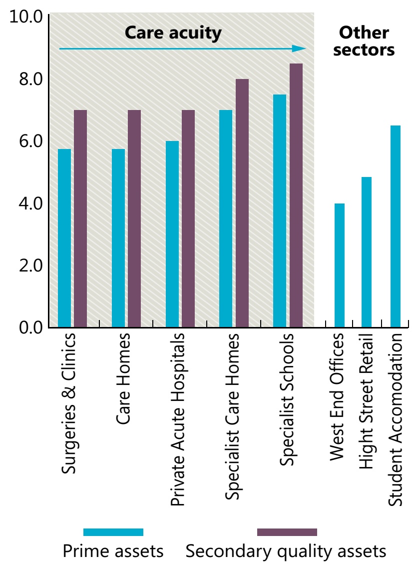
Nevertheless, the domestic market for UK Healthcare investments is becoming more mature and liquidity is improving. Some years after the launch of the PHP REIT in 2007, March 2013 saw the launch of Target Healthcare, a new £46m UK REIT for care home investments. Furthermore, specialist UK Healthcare funds such as Bridges Ventures and MedicX are becoming more established, and this is helping to foster a more collaborative approach between tenant and landlord compared with the traditional institutional approach, which tends to focus on covenant strength.

The elderly care home market remains geographically polarised. While operator demand for new care homes is generally strong, ongoing local authority funding pressures have focused investment and development activity into relatively affluent parts of the UK, where average fees are higher and private fee-paying residents are more prevalent.

Lessons have been learned since the failure of Southern Cross and there are indications that appetite for sale and leaseback deals has returned among a number of key operators, particularly as the high street clearing banks are firmly back in the market for fixed-income deals.

Bristol Hospital in the Spire portfolio. Knight Frank advised on the £700 million hospital portfolio sale.

Figure 2
Healthcare yields



Source: Knight Frank Research

Table 1 **Key healthcare transactions in last 12 months**

Address	Purchaser	Covenant	Price	NIY %	Date
Spire Portfolio (12 hospitals)	Moor Park Capital	Spire Healthcare	£700m	7.00%	Jan-13
44 care homes	Griffin American Healthcare REIT II (US)	Caring Homes	£297m	7.00%	Jul-13
Five care homes	Health Care REIT (US)	Sunrise	£154m	6.90%	Mar-13
Five care homes in Suffolk (Forward funded)	Schroders (SPF)	Care UK	£28m	7.00%	Feb-13
Four care homes	Target Healthcare REIT (UK)	Ideal Care Homes	£18m	7.25%	Mar-13
GP Surgery, Cambridge (Forward funded)	MedicX	GMS	£5.2m	5.70%	Mar-13

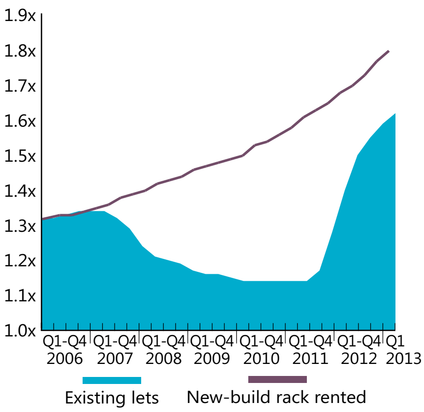
Source: Knight Frank LLP

RESEARCH

However, with limited future-proofed care home stock available, the bulk of recent investment has been realised via forward funded pre-let deals for new-build developments. Indeed, c.70% of new care home announcements over the past 12 months have involved such arrangements, some of which include a 5-year 'buy-back' option for the operator.

Rental levels in the care home sector have not increased materially in real terms since we last reported 12 months ago. In London and the South East, average rents for modern, future-proofed care homes stand at £9,400 per bed and £9,850 per bed respectively. These rental levels are considerably higher than typical rents seen in the UK's other regions, and reflect the prevalence of self-funded over publically funded care.

Figure 3
Indicative rent cover for care homes



Source: Knight Frank Research

A key part of the investment process in any care home is to set a sustainable level of rent cover (EBITDARM over rent). Evidence from recent pre-let deals suggests that rent cover has drifted upwards over the past 12 months, with 1.8x currently regarded as an acceptable requirement for a new-build facility targeting the self-funded market (see Figure 3). In order to protect value, deals are also including debenture arrangements and these demonstrate a closer partnership between landlord and tenant.

Investment opportunities

Approximately £2bn of sale and leaseback deals are expected to occur within the UK Healthcare market up to mid-2014. Given their sheer number, care homes will offer the largest investment opportunity, although hospitals may take the majority share of absolute investment into UK Healthcare owing to the large lot-sizes involved. Surgeries will continue to attract a plethora of investors from pension funds to high net worth individuals, as it is easier to secure debt against their relatively small lot-sizes.

Both international and UK clearing banks continue to increase their appetite to lend on Healthcare fixed income and going concerns. Subject to best in class management, asset quality, business attributes and location, there is increasing evidence that banks and funds are prepared to invest and support quality operators across the spectrum of Healthcare asset classes.

KNIGHT FRANK VIEW

Despite a gradual recovery in the core property sectors, Knight Frank expects investor demand for high quality Healthcare assets to remain strong which, over time, will elevate the sector from an alternative to a mainstream asset class.

However, political uncertainty and funding pressures will continue to frame investment demand towards the best quality stock and covenants. Furthermore, negative media attention, often sensationalist, has failed to dent investors' enthusiasm for prime Healthcare investments.

We expect greater interest from overseas investors, particularly in large lot-sizes and portfolios. However, in the care home sector, overseas interest will remain focused on the 'vanilla' facilities, i.e. self-funded residential care homes. We also expect more activity from Middle Eastern investors, given Healthcare's strong ethical compliance with sharia law.

Robust investment demand for modern, purpose-built Healthcare property is expected to put yields under downward pressure over next 12 months. However, the finite amount of existing new-build stock will mean that much of the inward flow of investment to the sector will come via forward-funded pre-lets.

Commercial Research
Oliver du Sautoy
Associate
+44 20 7861 1593
oliver.dusautoy@knightfrank.com

Healthcare
Julian Evans
Head of Healthcare
+44 20 7861 1147
julian.evans@knightfrank.com

Newmark Knight Frank Global

Front cover image: Silvermere Care Home (Avery Healthcare), Cobham, Surrey