Market Update - Healthcare

Winter 2014

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Since we last reported in the Spring, the market for all care assets has shown notable ongoing improvement and as we expected, there has been a healthy number of completed transactions to demonstrate this optimistic new world we live in.

The elderly market has seen notable transactions with the acquisition of Gracewell and property based deals for Prime Life and the 20 strong Maria Mallaband portfolio. Individual assets have also been moving quickly and this greater level of activity throughout the market provides comforting depth.

Within the specialist space there have been a record number and value of corporate transactions including Aitch, Tracscare, Partnerships in Care, Voyage and Regard as well as Cambian's IPO. It appears likely that despite various issues (see below), the overwhelming mood is positive and the direction of travel is for gradually rising values over the next few years. To what extent this will be supported by rising profitability is an interesting point, but we should expect to see ongoing investments in the sector by everyone from international private equity groups to individual first time buyers and the massive mid market in between. The reasons behind this optimism are as follows: -

- Projected increases in demand for care over the next 10-15 years;
- Demand from investors for latest generation purpose built stock;
- The expectation that care homes are (becoming, finally) an established asset class with associated greater liquidity and harder yields.
- Expectations that public spending on health and social care can only improve;
- Likelihood of increasing private fees, partly as a result of Dilnot;
- Existing independents seeking economies of scale.
- First time buyers attracted to perceived high returns on capital, good margins and rising values.

Now that there is widespread evidence that values are rising the general mood has gone from fear to optimism and broadly the main priority is to be invested. As a result of this U turn (over 18 months), buyers are less choosy, DD is less protracted and deals are happening more quickly.

REGULATORY CHANGES

The CQCs investigative regime changed on 1 October and this will most likely create a more rigorous regime making it ever harder for poor care to persist, and whilst day to day this may create hassles for managers and operators, for the wider sector, we consider it generally a good thing.

The National Minimum Wage also went up on 1 October with a new standard minimum rate of £6.50 and for many homes this is now the trigger for the annual review, whilst many fees will only get reviewed in April. Even for homes paying above the national minimum, it acts as a trigger in order to maintain differentials. Whilst wage rates are low, wages overall remain a red issue or even threat for some operators.

TRADING

Occupancy: - Our evidence shows occupancy has improved over the last few years, although whether this is due to poorer quality homes closing and there being less double rooms generally, is hard to say but occupancy at or above 95% is now increasingly common, especially in the south.

Fees: - The gulf between Social Services and private fees in the south continues to grow but we are also seeing homes in all areas achieve more private fees, with some operators being more successful at grasping the nettle. Some operators are now reaping the benefits of capex investment programmes that have lifted cosmetic and clinical standards so even whilst the catchment area is unchanged, the fee profile has improved.

We remain of the view that for many homes some Social Services fees will be unavoidable and there is no harm in that, but clearly operators need to have a strategy of investment in physical standards and marketing to maximise their share of private fees.

Margins: - The spectrum of margins is considerable reflecting the variation we see in home capacity and average fee, and well run care homes can be found across a range of say 20%-45% EBITDA. A summary of EBITDA in cash terms per bed is set out overleaf.

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Development: - The appetite for development remains strong and we are seeing increasing interest in a classic property development model; i.e. where the developer has no interest in either operating or owning the eventual building, although with pressure from house builders and narrow margins, it is a difficult deal to complete.

There is a lack of sites available and most operators prefer still to buy conditional upon planning and so develop a scheme that fully meets their needs rather than buy off the shelf.

Specialist Care: - As noted there has been a raft of substantial corporate deals with more action in the last nine months than the previous five years. Private Equity was involved at some point in every transaction. These deals make clear that demand is strong but narrowly focused on operators providing first class care in reasonably high quality settings and typically catering for a range of needs across the care spectrum including residential care, supported living and possibly domiciliary care, fostering and other forms of asset light activity.

Whilst these deals have all been for multi-site corporates, they do lend support to our confidence that the market for individual units is beginning to pick up and this will provide opportunities for existing operators to exit as well as reshape their portfolios.

Multiples of EBITDA

We see the market for individual unencumbered freehold assets, in terms of currrent run rate EBITDA multiples as follows:-

Care Home Type	Multiple Range	The Best	Comments	Movement since Spring 2014	EBITDA per bed
Elderly – Prime i.e. new purpose built	9.0 - 10.0	12.0	Strong demand	↑	£15-25,000
Elderly - Secondary i.e. older purpose built and good conversions	6.5 - 8.0	8.5	Good sales evidence across spectrum	↑	£8-15,000
Elderly - Tertiary i.e. largely non-compliant, lacking scale	5.0 – 6.5		Demand only if potential for improvement, otherwise alternative use	↑	£4-7,000
Specialist incl Supported Living i.e. elderly, MD etc	4.0 - 7.5	8.0	Increasingly active	↑	£30 – 45,000
Sites (£ per bed)					
Good	£15-30,000	£60,000	Operators are selective but strong demand for good sites	↑	
Secondary	£5-£15,000		Local over supply is a risk	↔	
Turnkeys	£80-£125,000	£150,000	Need to be marketed before construction starts	↑	

Notable Transactions

Overall we are reporting improvements across the market and transactional evidence supports this.

ES Group acted for Target Healthcare REIT in its acquisition of a new build 72 bedroom care home in Hinckley, Leicestershire. (see left!). The care home has been leased on completion to Care Concern Group for a 35 year term giving a net initial yield in excess of 7%. The rent is subject to an annual RPI review with a cap and collar. Headquartered in Slough, Care Concern Group currently operate 20 care homes across the UK. The home was developed by a local operator who took the opportunity to realise the asset and a substantial gain.