

Impact Healthcare REIT

Business update

Accretive acquisitions and attractive financing

Late in 2021 Impact Healthcare REIT (IHR) announced significant investment activity amounting to £52m and its debut transaction in the institutional debt market. The investments are accretive to earnings and the new long-term fixed rate debt is attractively priced, reflecting lender confidence in the robustness of the business model, and provides a good match to IHR's long-term income profile.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	EPRA NAV/share (p)	DPS (p)	P/NAV/share** (x)	Yield** (%)
12/19	24.0	17.6	6.9	106.8	6.17	1.11	5.2
12/20	30.8	23.1	7.3	109.6	6.29	1.08	5.3
12/21e	36.4	27.5	8.5	112.3	6.41	1.05	5.4
12/22e	41.4	33.5	9.6	116.9	6.57	1.01	5.6

Note: *EPRA earnings exclude fair value movements on properties and interest rate derivatives. **P/NAV and yield are based on the current share price.

Converting a strong investment pipeline

IHR has completed the £3.25m acquisition (before costs) of an established care home at a 7.5% gross yield and exchanged contracts for the £11.0m (before costs) acquisition of two established homes in Northern Ireland at a 7.8% gross yield. It has also invested £37.5m in a portfolio of 12 established homes, initially by way of a loan to an existing tenant, which has been able to take immediate operational control of the homes pending the completion of a potentially lengthy regulatory approval process. Once this process completes, we expect IHR to exercise its purchase option to acquire the homes at a 7.2% gross yield. Meanwhile, the loan earns interest at a similar level (net of tax). The £75m of new institutional debt is attractively priced at 2.97% with a weighted average maturity of 14 years. It provides additional debt capacity to pursue a continuing strong investment pipeline and locks in a positive spread compared with IHR's income profile.

Core income with asset management potential

Driven by demographics rather than the economy, a growing elderly population and a shortage of quality care homes suggests a strong demand in years to come. IHR's business model is built around long-term partnerships with a growing list of selected tenant operators, investing alongside them in suitable properties that they can operate efficiently, providing a good quality of care, to sustain a growing stream of long-term rental income. Its portfolio comprises a majority of core, good-quality, upper middle-market homes alongside value-add assets where, working in partnership with tenants, there is potential to upgrade/extend facilities and reposition homes in their local markets. Asset management benefits residents and operators and offers enhanced returns on a pure 'buy-and-hold' strategy.

Valuation: Robust, indexed, long-term income

FY21e DPS represents an attractive yield of 5.4%, with strong prospects for fully covered dividend growth (on both an EPRA basis and an adjusted 'cash' basis) from acquisitions and predominantly RPI-indexed rent uplifts. This supports a c 6% premium to Q321 NAV per share, similar to the average since IPO.

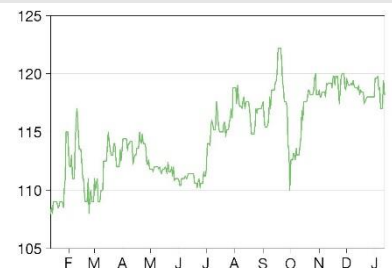
Real estate

12 January 2022

Price 118p
Market cap £414m

Gross debt (£m) at 30 September 2021	67.5
Gross LTV at 30 September 2021	14.5%
Shares in issue	350.6m
Free float	90.6%
Code	IHR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.5)	3.9	8.9
Rel (local)	(2.7)	(0.4)	(1.5)
52-week high/low		122p	108p

Business description

Impact Healthcare REIT, traded on the Main Market of the London Stock Exchange, invests in a diversified portfolio of UK healthcare assets, primarily residential and nursing care homes, let on long leases to high-quality operators. It aims to provide shareholders with attractive and sustainable returns, primarily in the form of dividends, underpinned by structural growth in demand for care.

Next events

Q421 NAV update	Expected late January 2022
FY21 results	March 2022

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Further details

Significant acquisition progress

In late December 2021, IHR announced a total investment of £52m in 15 care homes (including a portfolio of 12 homes), in each case allowing it to grow with existing tenants. The transactions comprise:

- The completed acquisition of Springhill Nursing care home in Kilmarnock, Scotland for £3.25m (before costs) in a sale and leaseback transaction with existing tenant, Silverline, which now operates four IHR-owned homes.¹ The home is a four-storey Georgian building with a substantial purpose-built extension offering 61 beds with en suite wet room facilities. The initial rent is £243k pa, a 7.5% gross yield on the consideration, with a fixed lease term of 25 years, no break clauses and annual RPI uplifts, capped and collared between 2% and 4%.
- The exchange of contracts for the acquisition of two care homes in Northern Ireland for an aggregate £11.0m (before costs), subject to re-registration by the local regulator,² expected to be procedural. The homes, one in north-west Belfast and one in the coastal town of Larne, provide a combined 147 en suite bedrooms and will be operated by Electus, an existing tenant. On completion, this will take IHR's total number of homes in Northern Ireland to five, all operated by Electus.³ The Northern Irish investment market is somewhat less competitive than elsewhere in the UK and yields are typically higher. The initial rent is £855k pa, a 7.8% gross yield on the consideration, with a fixed lease terms of 25 years with no break clauses and annual RPI uplifts, capped and collared between 2% and 4%.
- An initial investment of £37.5m in a portfolio of 12 care homes in Fife, Scotland, providing 480 high-quality en suite beds within established residential areas. The structure of this transaction initially appears complex, although we expect it will ultimately result in IHR taking direct ownership of the homes, which will be let to Holmes Care Group, an existing tenant. IHR's initial investment has been made by way of a loan to Holmes, allowing it to complete the acquisition of the previous owner/occupier, Kingdom Homes, whose owners are retiring. By this route, Holmes has taken immediate operational control of the homes, avoiding a potentially lengthy transition period while regulatory approvals⁴ are sought to register the homes in new legal entities. IHR has the option to acquire the property assets⁵ once the regulatory approvals have been received, later in 2022, and we expect it to do so. Meanwhile, IHR will receive interest payments on the loan at 8.6% pa,⁶ generating immediate income. The loan has been structured to include protections for IHR's shareholders, including security over the homes and operational covenants. New 30-year leases have been pre-agreed, on IHR's standard terms, with an initial rent of £2.7m, reflecting a gross initial yield of 7.2%. The transaction includes an additional £2.5m deferred payment, subject to the future performance of the homes that, if payable, will result in increased rental payments.

¹ IHR's first transaction with Silverline was in March 2020, when it acquired three homes.

² The Northern Irish regulator is the Regulation and Quality Improvement Authority.

³ IHR's first transaction with Electus was in December 2020 when it acquired three homes.

⁴ Scottish homes are regulated by the Care Inspectorate.

⁵ Holmes also has the option to sell the property assets to IHR. Both options allow IHR to fix the future price of the property assets and rents in advance.

⁶ Interest received by IHR is taxable under UK REIT tax rules. On a net basis the loan interest is similar to future rental income.

Assuming the exercise of options on the Holmes acquisition and completion of the assets where contracts have been exchanged, IHR's portfolio would increase to 124 properties with an annualised rent roll of more than £38m.

IHR reports a continuing strong investment pipeline.

New long-term institutional debt

The £75m of new long-term institutional debt represents IHR's first transaction in the institutional debt market. It comprises two tranches at a blended average rate of 2.97%⁷ and a weighted average maturity of 14 years. The terms are attractive and IHR attributes this to the resilience of its strategy and the performance of its tenants during the pandemic. The first tranche (£37m) was drawn in late December 2021 and the second tranche (£38m) will be drawn in June 2022. The long-term, fixed-rate nature of the debt locks in a positive spread compared with IHR's income profile and this spread should increase as rental income increases with inflation. IHR's total weighted average debt maturity has increased to 4.7 years and will increase as the second tranche is drawn.

Most of the proceeds will be used to fund the growth in the portfolio, including the transactions detailed above, while £10m has been used to cancel a portion of the group's revolving credit facilities.

Forecast changes

IHR continued to trade well in the three months ending 30 September 2021 (Q321) with the portfolio performing as expected and rents continuing to be collected in full. NAV per share increased to 111.82p (H121: 110.66p) and including DPS paid, the NAV total return was 2.5% bringing the total return in the first nine months of FY21 to 8.5%. Income and capital values both benefitted from continuing inflation-linked rental growth, with an average 3.79% uplift was achieved on completed reviews in the quarter. Like-for-like growth in total portfolio property valuations was 1.4%, further benefiting from valuation yield compression (end-Q321 net initial yield of 6.67% compared with 6.75% at end-H121).

Exhibit 1 shows the relatively modest changes to our forecasts, extended to FY23. FY21 is slightly reduced by the timing of acquisitions, more than made up for in FY22 by an increased acquisition assumption, with growth continuing in FY23, including a full-year contribution from FY22 acquisitions.

Exhibit 1: Summary of key forecast data

£m unless stated otherwise	New forecasts			Old forecasts		Change	
	FY21e	FY22e	FY23e	FY21e	FY22e	FY21e	FY22e
EPRA earnings	27.5	33.5	35.4	28.0	33.0	-2%	2%
IFRS rent adjustments	(6.4)	(6.3)	(7.0)	(6.3)	(6.6)		
Amortisation of loan arrangement fees	0.9	0.9	0.9	0.9	0.9		
Adjusted 'cash' earnings	22.0	28.1	29.3	22.6	27.3	-3%	3%
EPRA EPS (p)	8.50	9.56	10.10	8.66	9.42	-2%	2%
Adjusted EPS (p)	6.78	8.02	8.36	6.98	7.79	-3%	3%
DPS (p)	6.41	6.57	6.76	6.41	6.57	0%	0%
EPRA dividend cover	133%	146%	149%	135%	143%		
Adjusted earnings dividend cover	106%	122%	124%	109%	119%		
EPRA NTA per share	112.3	116.9	121.7	112.6	117.0	0%	0%

Source: Edison Investment Research

⁷ £37m at 2.932% and £38m at 3.002%, both maturing in 2035.

Our forecasts assume IHR exercises its option to purchase the 12 homes that constitute the 'Kingdom' portfolio⁸ and an additional £30m of capital deployment by the end of March 2022 (by end-Q122). We assume a 7.25% yield on consideration on this capital commitment, which makes some allowance for the continuing strong investor interest in care home properties, although this may prove to be conservative; management hopes to achieve yields consistent with the c 7.5% historical trend. Adjusting for the acquisitions/investments already announced, our capital deployment assumption is increased c £22m compared with our last published forecast. This reflects IHR's continuing strong investment pipeline and its increased borrowing capacity. Nonetheless, our forecast borrowings of up to c £160m remains well below total debt facilities of £206m (£230m including a £24m accordion option). We forecast a gross loan to value ratio of 27.7% at end FY22, above the company's medium-term target of 25% but below its self-imposed ceiling of 30%.

All rents are inflation linked (predominantly to RPI), capped at around 4.0% with floors at around 2.0%, and we have assumed an average 3.0% increase in FY22/FY23, which based on current levels may prove conservative.⁹ The company adjusted earnings measure shown in Exhibit 1 excludes non-cash IFRS rent smoothing adjustments (relating to fixed rent increases and lease incentives) and amortisation of loan arrangement fees. Adjusted earnings approximate to cash earnings and a more conservative indicator of dividend paying capacity than EPRA earnings. We forecast 106% cover of dividend by adjusted earnings in FY21 (133% cover on an EPRA earnings basis), increasing to 122% (146% on an EPRA basis) in FY22. Increasing dividend cover demonstrates the strong cash flow emerging from the growing portfolio. Under the company's progressive dividend formula, linked to rental growth, the 2.5% DPS growth that IHR targeted for FY21 looks back to rent indexation achieved in FY20. The increase in cover that we forecast indicates there is significant scope for future dividend growth beyond the level suggested by this formula, although we have not forecast this.

We expect property revaluation movements will continue to be driven by rental growth and asset management initiatives in combination with 'buying well', contributing to NAV growth.

Exhibit 2: Income statement revaluation movement				
£m	FY20	FY21e	FY22e	FY23e
Gross revaluation movement	13.1	12.5	14.3	12.0
Acquisition costs written off	(2.7)	(1.4)	(2.8)	0.0
Net revaluation movement	10.5	11.1	11.5	12.0
IFRS rental smoothing and lease incentive adjustment	(4.9)	(7.1)	(6.3)	(7.0)
Gains/(losses) on revaluation of investment properties as per income statement	5.6	4.0	5.2	5.1
Acquisition costs as % purchase value	3.1%	4.5%	3.3%	n.a.
Gross revaluation as % opening portfolio value	4.1%	3.0%	3.1%	2.1%
Gross revaluation gain per share (p)	4.1	3.6	4.1	3.4

Source: Impact Healthcare REIT historical data, Edison Investment Research forecasts

Valuation

The current year DPS target of 6.41p (+1.9% vs FY20) represents an attractive yield of 5.4%. The shares trade at a c 6% premium to Q321 unaudited NAV per share of 111.82p, which is similar to the average premium since IPO and below the high of c 11%.

IHR aims to provide shareholders with attractive and sustainable returns, primarily in the form of quarterly dividends. DPS has increased each year since IPO, with a clear and progressive dividend

⁸ This has no effect on earnings by substituting rental income for the post-tax interest on the loan to Holmes Care.

⁹ RPI increased by 7.1% in the 12 months to November 2021 although the Bank of England continues to forecast that inflationary pressures will begin to ease.

policy, targeting growth in line with the inflation-linked rental uplifts received in the preceding financial year. Dividends paid have driven the consistently positive quarterly total returns since IPO in 2017, with aggregate NAV total return (adjusted for dividends paid, but not reinvested) from IPO to end-Q321 of 40.9%, a compound annual return of 7.8%.

In Exhibit 3 we show a summary of the performance and valuation of a group of REITs that we consider to be IHR's closest peers within the broad and diverse commercial property sector. The group is invested in the primary healthcare, supported housing and care home sectors, all targeting stable, long-term income growth derived from long-lease exposures.

Exhibit 3: Peer group comparison

	WAULT (years)	Price (p)	Market cap (£m)	P/NTA* (x)	Yield** (%)	Target yield*** (%)	Share price performance			
							1 month	3 months	YTD	12 months
Assura	12	69	2017	1.17	4.2	4.3	-1%	-5%	-11%	-11%
Civitas Social Housing	23	97	595	0.89	5.7	5.7	-1%	8%	-8%	-8%
Home REIT	19	125	699	1.19	2.0	4.4	3%	16%	18%	N/A
Primary Health Properties	12	150	1994	1.30	4.1	4.3	-2%	-3%	-2%	-2%
Target Healthcare	29	116	718	1.04	5.8	5.8	-1%	0%	2%	1%
Triple Point Social Housing	26	96	385	0.90	5.4	5.4	-2%	-1%	-14%	-12%
Average	20			1.08	4.5	5.0	0%	2%	-3%	-6%
Impact Healthcare	19	118	414	1.06	5.4	5.4	-1%	3%	8%	9%
UK property sector index		1,932					-1%	6%	21%	23%
UK equity market index		4,242					2%	4%	15%	11%

Source: Company data, Refinitiv price data at 10 January 2022. Note: *Based on last published EPRA NTA/NAV per share. **Based on trailing 12-month DPS declared. ***Based on company target DPS for current financial year.

Compared with the peer group average, IHR has a clearly higher yield while its P/NAV is slightly below the average. There are several factors that suggest a continuing positive outlook for the shares including a combination of the long weighted average unexpired lease term (WAULT) with no break clauses, fully repairing and insuring leases and upwards-only rents, mostly linked to RPI, which provides considerable visibility over a growing stream of contracted rental income. It also offers considerable protection against inflation at a time when inflation expectations are increasing. The robust tenant performance reported by IHR during the COVID-19 pandemic, with no interruption in rent collections, is a further positive indicator for covenant strength.

Exhibit 4: Financial summary

Year to 31 December (£m)	2017	2018	2019	2020	2021e	2022e	2023e
INCOME STATEMENT							
Cash rental income	9.5	13.9	19.1	25.9	30.1	35.1	40.3
Rental income arising from recognising rental premiums, fixed rent uplifts & lease incentives	(0.1)	3.4	4.9	4.9	6.4	6.3	7.0
Net rental income	9.4	17.3	24.0	30.8	36.4	41.4	47.2
Administrative & other expenses	(2.3)	(4.3)	(4.6)	(5.3)	(5.7)	(6.0)	(6.2)
Operating profit before change in fair value of investment properties	7.1	13.0	19.4	25.6	30.7	35.4	41.0
Change in fair value of investment properties	2.4	4.1	9.1	5.6	4.0	5.2	5.1
Gain on disposal	0.0	0.0	0.0	0.2	0.2	0.0	0.0
Operating profit	9.5	17.2	28.5	31.3	34.8	40.6	46.1
Net finance cost	0.0	(0.7)	(2.1)	(2.5)	(3.2)	(1.2)	(5.6)
Profit before taxation	9.5	16.5	26.3	28.8	31.6	39.4	40.5
Tax	(0.0)	0.0	0.0	0.0	0.0	(0.6)	0.0
Profit for the year (IFRS)	9.5	16.5	26.3	28.8	31.6	38.8	40.5
Adjust for:							
Change in fair value of investment properties	(2.4)	(4.1)	(9.1)	(5.6)	(4.0)	(5.2)	(5.1)
Gain on disposal	0.0	0.0	0.0	(0.2)	(0.2)	0.0	0.0
Change in fair value of interest rate derivatives	0.0	0.1	0.4	0.1	(0.0)	0.0	0.0
EPRA earnings	7.1	12.4	17.6	23.1	27.5	33.5	35.4
Rental income arising from recognising rental premiums & fixed rent uplifts	0.1	(3.4)	(4.9)	(4.9)	(6.4)	(6.3)	(7.0)
Amortisation of loan arrangement fees	0.0	0.2	0.4	0.7	0.9	0.9	0.9
Non-recurring costs	0.0	0.7	0.2	0.0	0.0	0.0	0.0
Adjusted earnings	7.1	9.9	13.4	18.9	22.0	28.1	29.3
Average number of shares in issue (m)	162.6	192.2	254.0	319.0	323.9	350.6	350.6
Basic & diluted IFRS EPS (p)	5.82	8.57	10.37	9.02	9.77	11.06	11.56
Basic & diluted EPRA EPS (p)	4.35	6.47	6.95	7.25	8.50	9.56	10.10
Basic & diluted adjusted EPS (p)	4.39	5.17	5.26	5.93	6.78	8.02	8.36
Dividend per share (declared)	4.50	6.00	6.17	6.29	6.41	6.57	6.76
EPRA earnings dividend cover	97%	108%	113%	115%	133%	146%	149%
Adjusted earnings dividend cover	98%	86%	85%	94%	106%	122%	124%
BALANCE SHEET							
Investment properties	156.2	220.5	310.5	405.7	443.7	541.3	550.4
Other non-current assets	1.7	5.7	10.1	15.9	23.0	29.2	36.2
Non-current assets	157.9	226.2	320.7	421.6	466.7	570.5	586.6
Cash and equivalents	38.4	1.5	47.8	8.0	8.1	4.0	6.3
Other current assets	0.1	0.6	0.6	0.1	38.0	0.5	0.5
Current assets	38.5	2.1	48.3	8.1	46.1	4.5	6.8
Borrowings	0.0	(24.7)	(23.5)	(74.2)	(112.4)	(158.3)	(159.1)
Other non-current liabilities	(1.7)	(1.9)	(1.8)	(2.8)	(2.7)	(2.7)	(2.7)
Non-current liabilities	(1.7)	(26.6)	(25.2)	(77.0)	(115.2)	(161.0)	(161.9)
Borrowings	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current liabilities	(1.2)	(3.3)	(3.1)	(3.1)	(3.7)	(4.2)	(4.8)
Current Liabilities	(1.2)	(3.3)	(3.1)	(3.1)	(3.7)	(4.2)	(4.8)
Net assets	193.5	198.3	340.7	349.5	393.9	409.8	426.8
Adjust for derivative financial liability/(asset)	0.0	(0.5)	(0.1)	(0.0)	(0.0)	(0.0)	(0.0)
EPRA net assets	193.5	197.9	340.6	349.5	393.9	409.8	426.8
Period end shares (m)	192.2	192.2	319.0	319.0	350.6	350.6	350.6
IFRS NAV per ordinary share	100.6	103.2	106.8	109.6	112.3	116.9	121.7
EPRA NAV per share	100.6	102.9	106.8	109.6	112.3	116.9	121.7
CASH FLOW							
Net cash flow from operating activities	8.2	10.0	14.9	21.0	23.8	29.0	34.6
Purchase of investment properties (including acquisition costs)	(153.3)	(55.1)	(73.4)	(88.5)	(33.1)	(88.3)	0.0
Capital improvements	(0.5)	(3.9)	(8.2)	(1.7)	(2.5)	(4.0)	(4.0)
Other cash flow from investing activities	0.0	0.0	0.1	0.9	(35.8)	40.7	0.0
Net cash flow from investing activities	(153.8)	(58.9)	(81.5)	(89.3)	(71.5)	(51.6)	(4.0)
Issue of ordinary share capital (net of expenses)	189.3	(0.1)	132.2	0.0	34.6	0.0	0.0
(Repayment)/drawdown of loans	0.0	26.0	(0.9)	51.2	38.1	45.0	0.0
Dividends paid	(5.3)	(11.6)	(16.1)	(20.0)	(21.9)	(22.9)	(23.5)
Other cash flow from financing activities	0.0	(2.3)	(2.2)	(2.8)	(3.2)	(3.6)	(4.7)
Net cash flow from financing activities	184.0	12.0	112.9	28.5	47.7	18.5	(28.3)
Net change in cash and equivalents	38.4	(36.9)	46.3	(39.8)	0.1	(4.1)	2.3
Opening cash and equivalents	0.0	38.4	1.5	47.8	8.0	8.1	4.0
Closing cash and equivalents	38.4	1.5	47.8	8.0	8.1	4.0	6.3
Balance sheet debt	0.0	(24.7)	(23.5)	(74.2)	(112.4)	(158.3)	(159.1)
Unamortised loan arrangement costs	0.0	(1.3)	(1.7)	(2.2)	(2.1)	(1.2)	(0.4)
Net cash/(debt)	38.4	(24.5)	22.7	(68.4)	(106.4)	(155.5)	(153.2)
Gross LTV (net debt as % gross assets)	0.0%	11.4%	6.8%	17.8%	22.3%	27.7%	26.9%

Source: Company data, Edison Investment Research

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