

Target Healthcare REIT

Q4 NAV and update

Portfolio performing well and growing

Target is making good progress in the deployment of its available capital resources, including the £94m (gross) proceeds of February's equity issue and extended, but unutilised, debt facilities. A significant pipeline of investment opportunities remains, on terms that management believes are consistent with dividend cover on a fully invested basis. We continue to forecast full investment in the current financial year and dividend cover in FY20. The 5.7% dividend yield is backed by very long-dated, RPI-linked leases, and supported by careful asset and operator selection.

Year end	Revenue (£m)	EPRA net earnings* (£m)	EPRA EPS* (p)	EPRA NAV/share (p)	DPS (p)	Price/EPRA NAV/share (x)	Yield (%)
06/16	16.9	8.1	4.7	100.6	6.18	1.12	5.5
06/17	23.6	12.2	4.8	101.9	6.28	1.10	5.6
06/18e	29.3	14.8	5.2	105.7	6.45	1.06	5.7
06/19e	35.5	20.2	6.0	106.2	6.58	1.06	5.8
06/20e	39.3	23.0	6.8	108.8	6.71	1.03	6.0

Note: *EPRA earnings exclude revaluation movements, non-cash income arising from the accounting treatment of lease incentives and guaranteed rent review uplifts, and the costs of acquisitions.

Q418 progress on NAV returns and asset growth

Q4 EPRA NAV per share increased to 105.7p, benefiting from revaluation gains, and combined with the 1.6125p DPS paid, the three-month EPRA NAV total return was 2.2%. In total, £73.0m (including costs) has been deployed since the equity raise and, with £52.0m of investment opportunities at an advanced stage of due diligence and significant additional opportunities at an earlier stage, full deployment of existing capital resources should soon be achieved. We have slightly trimmed our forecasts for EPRA EPS through FY20 as a result of the continued tightening of investment yields, but still expect equity and debt resources to be fully invested during FY19, driving sufficient earnings growth to fully cover dividends in FY20.

Strong demographics support growth

Demographics should support growing care home demand for years to come. Tighter regulation, local authority budget pressures and rising costs have caused many operators to exit the market, but often overlooked is the ability of well-managed, efficiently run homes, in locations with a good demand-supply balance to effectively and sustainably meet this need. Investors continue to be attracted by long lease lengths (Target weighted average unexpired lease term, or WAULT, is 28.5 years) and RPI-linked rental growth, with strong competition for assets. Although increasing asset prices have a positive impact on NAV, they make Target's disciplined approach to acquisitions, focused on assembling a diversified portfolio of modern, purpose-built and future-proof assets, an essential ingredient in delivering attractive and sustainable long-term returns.

Valuation: Attractive yield, cover at full investment

Target offers a growing dividend, which we expect to be fully covered by EPRA earnings in FY20, with an attractive 5.7% yield that supports a modest c 6% premium to NAV.

Real estate

9 August 2018

Price **112.5p**
Market cap **£382m**

Net debt (£m) at 30 June 2018	24.6
Gross LTV	17.2%
Net LTV	6.4%
Shares in issue	339.2m
Free float	96%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	3.2	3.2	(5.8)
Rel (local)	1.3	0.8	(8.8)
52-week high/low		122.5p	101.5p

Business description

Target Healthcare REIT invests in modern, purpose-built residential care homes in the UK let on long leases to high-quality care providers. It selects assets according to local demographics and intends to pay increasing dividends underpinned by structural growth in demand for care.

Next events

FY18 results September/October 2018

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Q418 progress on NAV total return and asset growth

Target Healthcare REIT's recent Q4 NAV update showed a further increase in EPRA NAV per share in the three months to 30 June 2018 (the final quarter of the 2018 fiscal year) to 105.7p (Q318: 105p). Net gains on investment property valuation added c 1.2p, while the per share movement in the revenue reserve after performance fees (income earnings of EPRA earnings) remains below dividends per share, reflecting the more than one-third increase in share count that resulted from February's £94m (before costs) capital raise, the proceeds of which are in the process of being deployed. Taking the quarterly change in EPRA NAV per share together with dividends per share paid of 1.6125p, we calculate a NAV total return of 2.2%. On the same basis, we estimate a c 10% NAV total return for the year, including DPS paid during the year, of 6.4p.

Exhibit 1: Quarterly NAV per share development					
Pence (p) per share	Q418	Q318	Q218	Q118	FY18 total
	Jun-18	Mar-18	Dec-18	Sep-17	
EPRA NAV per share at start of period	105.0	104.4	103.3	101.9	101.9
Net gains/(losses) on investment property revaluation	1.2	0.4	1.2	1.6	4.4
Net effect of equity issuance	-	0.3	-	-	0.3
Movement in revenue reserve, before performance fee accrual	1.2	1.2	1.6	1.5	5.5
Performance fee accrual	(0.1)	(0.1)	(0.1)	(0.1)	(0.4)
Dividends paid, per share outstanding at period end*	(1.6)	(1.2)	(1.6)	(1.6)	(6.0)
EPRA NAV per share at end of period	105.7	105.0	104.4	103.3	105.7
Dividends paid, per qualifying share**	1.6125	1.6125	1.6125	1.5700	6.4075
NAV total return	2.2%	2.1%	2.6%	2.9%	10.0%

Source: Target, Edison Investment Research. Note: *The dividend impact on the quarterly NAV bridge is calculated using the period-end number of shares. **The dividends paid per share used in the NAV total return calculation reflect the DPS actually paid to qualifying shareholders in each period.

Target continues to make progress in deploying its available capital and has now committed c £73.0m to the acquisition of completed and let care homes and to funding the development, and acquisition at completion, of new care homes (see below). The total portfolio value at end FY18 reached £385.5m (market value, before IFRS adjustment for fixed/guaranteed minimum rent reviews), comprising 55 assets, of which 51 were operational and delivering an annualised rent roll of £26.0m (end FY17: £20.3m). The portfolio valuation reflects a net initial yield of 6.44% (end FY17: 6.75%) and revaluation gains continued through Q418 with a like-for-like gain of 2.0%. Rental growth is also continuing, with 13 rent reviews completed during the quarter providing an average uplift of 3.25% pa and resulting in a 0.8% quarterly increase in the like-for-like rent roll. The WAULT was 28.5 years at the end of Q418.

With an end-Q218 cash balance of £41.4m and undrawn debt facilities of £64.0m (drawn debt £66.0m), Target has substantial resources to meet its existing investment commitments (predominantly forward-funding development commitments and some asset management spending) and to complete additional acquisitions from a continuing strong pipeline of opportunities (see below).

Exhibit 2: Summary balance sheet					
£m	Q418	Q318	Q218	Q118	Q417
	Jun-18	Mar-18	Dec-18	Sep-17	Jun-17
Investment properties*	385.5	341.4	334.9	296.6	282.0
Cash	41.4	85.3	14.9	16.8	10.4
Net current assets/(liabilities)	(2.4)	(4.7)	(5.5)	(3.8)	4.5
Bank loan	(66.0)	(66.0)	(81.0)	(49.0)	(40.0)
Net assets	358.5	356.0	263.3	260.6	256.9

Source: Target. Note: *Market value, before IFRS adjustments for fixed/guaranteed minimum rent reviews.

Careful asset selection required in competitive market

While longer-term funding for adult social care continues to be debated publicly and the problems facing the wider industry inevitably receive much media attention, what is often overlooked is the ability of well-managed operators, with efficiently run homes, in locations with a good demand-supply balance to effectively and sustainably meet this need.

Investor interest in such homes remains strong and is continuing to drive a tightening in valuation yields, especially for purpose-built homes in prime locations, focused on self-funded residents. While this is positive for NAV, the yield tightening also highlights the strong competition for quality assets in the market. In this environment, selective investment in modern, purpose-built homes that are most likely to be future proof and to effectively and profitably meet care needs over many years is essential; we believe Target remains focused on building such a portfolio. Target has always put a strong emphasis on selecting the right assets matched with the right tenant, and its growing portfolio is increasingly diversified by tenant (now more than 20), by geography and by resident payment profile, with a relatively high proportion of those who are self-funded. Forward-funding agreements provide access to assets and operators that may otherwise be unavailable. Target itself is not a developer and funds the development of the homes, with agreement to acquire them at completion, on a pre-let basis. As long as the location and operator of the home is carefully selected, the additional risk compared with the acquisition of operational homes should be minimal.

Good progress with funds deployment

During Q418, Target invested £37.0m (including costs) in the acquisition of two luxury care homes in Cirencester and Camberley. Both assets, totalling 137 bedrooms, are let to subsidiaries of Aura Care Living, which becomes Target's 21st tenant, on 30-year full repairing and occupational leases with RPI-linked rent increases subject to a cap and collar.

The Q418 investment follows the £21.9m (including costs) that was committed to acquiring and forward funding the development of three new care homes in Q318. These were a 70-bed home at Earl Shilton, Leicestershire, for a total cost of c £6.3m, let on a 35-year RPI-linked lease subject to cap and collar to Care Concern (an existing tenant of the group); and two new care homes, with an aggregate 138 beds, located near Shrewsbury, Shropshire and in Preston, Lancashire, for a combined cost of £15.6m, to be let on more than 30-year duration leases to Rotherwood Healthcare and L&M Healthcare respectively (both new tenants to the group) on RPI-linked leases with caps and collars.

Most recently, since the end of Q418 Target has committed a further £13.9m (including costs) to two additional assets. One of the assets is a 43-bed care home in Doncaster, South Yorkshire operated by an existing tenant of the group, Orchard Care Homes. The full repairing and insuring lease has 24 years remaining and is subject to annual RPI-linked rent increases subject to caps and collars. The other asset is a development site for an 80-bed care home in Burscough, Lancashire. The development will be carried out in partnership with Athena Healthcare, and in addition to acquiring the site, Target will forward fund the development under a capped development contract. On completion, expected in late 2019, the home will be let to Athena on a 35-year lease with RPI-linked rent increases subject to a cap and collar.

Investment pipeline remains strong

Target says it has £52.0m of investment opportunities at an advanced stage of due diligence, and that the majority of these are expected to complete over the next few months. This would leave the proceeds of the February capital increase fully deployed such that the group would once again begin to draw on its debt facilities. In Q318 £15m of revolving debt was temporarily repaid. In

addition to these immediate opportunities, a significant value of earlier stage pipeline opportunities is also being assessed by the investment manager.

The broader pipeline is constantly evolving as new opportunities arise and are then subjected to robust consideration with respect to building quality, the ethos and operational capabilities of the operator, rental prospects, and the likelihood of meeting the group's investment criteria. Although investment yields have tightened, Target continues to identify assets it believes will both meet its near-term objective of generating sufficient income earnings to cover dividend payments when fully invested, as well as generating sustainable value creation over the longer term.

Once existing capital resources have been deployed, we would expect Target to consider increasing its capital resources further, both equity and debt. The February 2018 shareholder meeting approved a one-year placing programme, allowing for up to a maximum 150m shares to be issued including the 87m initial share issue completed at the time, at the discretion of the company, as and when it identifies suitable acquisition opportunities.

Financials

From the Q418 NAV report we have a good guide to many of the key financial figures in respect of the FY18 year, for which we expect Target to report in detail in a few weeks. FY18 EPRA NAV appears slightly above of last published forecast, benefiting from higher revaluation gains than we had allowed for, and DPS is in line with expectations for the year. The quarterly NAV reports also provide an indication of the contribution of income returns (EPRA earnings) to NAV growth for the year, and suggest H218 EPRA EPS of c 2.2p, or c 2.4p before investment manager performance fees. This suggests full-year EPRA EPS of c 5.2p, lower than the c 5.6p that we had previously forecast, which we attribute to the timing of acquisitions. The significant amount of funds deployed in the period was actually lower than we had allowed for, based on the published acquisition pipeline that was in place at the time of the capital raise. We expect this to be made up in the coming months and our revised forecasts for FY19 and FY20, detailed below, reflect no material change in aggregate to our investment assumptions over the forecast period to end-FY20. We do factor in a slight reduction in the assumed yield on those investments, reflecting continuing strong investor interest in the asset class, reflected in a market-wide increase in asset prices/reduction in valuation yields. Our FY20 EPRA EPS forecast continues to reflect what we believe to be a fully invested position and, while it is reduced by 1.1%, it remains sufficient to cover the DPS, which we have assumed to grow at c 2% pa.

Exhibit 3: Estimate revisions

	Revenue (£m)			EPRA EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
June 18e	29.1	29.3	0.5	5.58	5.21	-6.7	104.2	105.7	1.4	6.45	6.45	0.0
June 19e	36.3	35.5	-2.0	6.12	5.95	-2.7	105.8	106.2	0.4	6.58	6.58	0.0
June 20e	38.6	39.3	1.9	6.86	6.78	-1.1	108.4	108.8	0.4	6.71	6.71	0.0

Source: Edison Investment Research

The key forecasting assumptions that we make relate to assets growth and funding:

- New investment commitments of £80m by the end of Q319 (end March 2019), split roughly equally between let standing assets at an assumed yield of 5.75% and commitments to forward fund, and acquire at completion, development assets at an assumed yield of 6.45%. The blended yield of c 6.1% is lower than the 6.25% that we had previously been assuming, reflecting the further increase in market asset pricing. A little more than £40m of investment commitment that we had allowed for in H218 has been pushed into FY19, although the aggregate amount over the forecasting period, measured since the capital raising, remains similar.

- The acquisition of let standing assets feeds directly into rent roll and rental income. We also assume 2.0% pa rent growth. As cash is extended to meet forward-funding commitments, over an assumed 18-month period, we allow for other income to be earned on outstanding average balances, until completion, at a rate equal to the expected investment yield. At completion, the assets add to rent roll.
- On a committed basis, we believe the investment commitments assumed represent full investment of the current funding resources (equity plus available debt). However, given that cash is deployed to forward-funding agreements over time, our modelling does not show the existing £130m of debt facilities fully drawn until mid-FY20. In total, £31m of the debt is fixed at a rate of 2.36% and the balance pays interest at 1.65% above three-month LIBOR, which we assume to be 0.75% across the forecasting period. By end FY20, we forecast the gross LTV at c 26% and the net LTV at c 25%.
- In addition to management fees charged at 0.90% of average net assets, our forecasts allow for performance fees of c £1.0m pa, slightly lower than our forecast for FY18. These are generated by portfolio total return outperformance compared with the IPD UK Annual Healthcare Property Index.

Valuation

Within the broad commercial property universe, Target is differentiated by its focus on care home assets, which appear primed to benefit from the ongoing demographic shifts, and the very long nature of leases arrangements in the sub-sector. Target's WAULT of 28.5 years at 30 June 2018 is one of the longest of all REITs and, combined with upwards-only rent reviews, mostly capped-and-collared RPI linked, there is considerable visibility to future contracted rental income in real terms.

In Exhibit 4 we show the key valuation and performance metrics for Target and a group of peers that also benefits from lease exposure to both care homes and primary healthcare property. Like care homes, primary healthcare property is also a beneficiary of demographic trends. Compared with care homes, primary healthcare WAULT tends to be lower (closer to 15 years) but has the advantage of substantial government backing for lease payments, either directly or indirectly through GP rent reimbursement. As a whole, the group has de-rated slightly over the past 12 months, with historical P/NAVs reducing slightly and prospective dividend yields increasing slightly. Target's share price is c 10% below its 12-month high (of 123p in August 2017) and its P/NAV is down from a peak of c 1.20x. One possible trigger for the group de-rating is the increase in long-term interest rate expectations in late 2017/early 2018 (the generic 10-year UK gilt yield was close to 1.7% in February 2018), with the subsequent retracement to c 1.3% triggering a relatively modest correction. Other factors may include equity issuance (including significant cash calls from Assura and PHP as well as Target) and the continuing increase in the valuation of (and cost to acquire) both care home and primary healthcare assets.

Exhibit 4: Peer comparison

	Price (p)	Market cap (£m)	P/NAV* (x)	Yield** (%)	Share price performance			
					1 month	3 months	12 months	From 12m high
Assura	56	1349	1.08	4.6	-1%	-4%	-11%	-16%
Impact Healthcare	103	197	1.01	5.9	0%	0%	-1%	-5%
PHP	115	846	1.11	4.7	-1%	1%	0%	-6%
MedicX Fund	81	352	1.00	4.8	-1%	1%	-10%	-12%
Target Healthcare	113	382	1.06	5.7	1%	2%	-5%	-9%
Median			1.06	4.8	-1%	1%	-5%	-9%
UK property index	1,824			3.9	-1%	-2%	3%	-3%
FTSE All-Share Index	4,206			4.0	0%	1%	2%	-3%

Source: Company data, Edison Investment Research, Bloomberg data. Note: Priced at 6 August 2018. *Last published NAV. **Yield based on expected current year dividend. For MedicX we use the Edison forecast DPS for the year to September 2019.

Target's prospective yield of 5.7% is above the group median and its historical P/NAV is in line with the average. Impact Healthcare, another investor in care homes, has a slightly lower P/NAV compared with Target, and a slightly higher prospective yield, but its market capitalisation is somewhat lower and it still has a relatively concentrated tenant base. As noted above, our forecasts for Target include further dividend growth and the potential for full dividend cover in the year to June 2020.

Exhibit 5: Financial summary

Year to 30 June (£000s)	2014	2015	2016	2017	2018e	2019e	2020e
INCOME STATEMENT							
Rent revenue	3,817	9,898	12,677	17,760	22,757	27,778	31,371
Movement in lease incentive or rent review	1,547	3,760	4,136	5,127	6,400	6,400	6,400
Rental income	5,364	13,658	16,813	22,887	29,157	34,178	37,771
Other income	0	66	61	671	100	1,363	1,573
Total revenue	5,364	13,724	16,874	23,558	29,257	35,541	39,344
Gains/(losses) on revaluation	(2,233)	(839)	425	2,211	6,142	(2,737)	2,042
Cost of corporate acquisitions	0	(174)	(998)	(626)	(432)	0	0
Total income	3,131	12,711	16,301	25,143	34,967	32,805	41,385
Management fee	(648)	(1,524)	(2,654)	(3,758)	(4,345)	(4,839)	(4,881)
Other expenses	(780)	(880)	(992)	(1,236)	(1,799)	(1,600)	(1,648)
Total expenditure	(1,428)	(2,404)	(3,646)	(4,994)	(6,144)	(6,439)	(6,529)
Profit before finance and tax	1,703	10,307	12,655	20,149	28,823	26,366	34,856
Net finance cost	190	(716)	(929)	(808)	(1,883)	(2,512)	(3,410)
Profit before taxation	1,893	9,591	11,726	19,341	26,941	23,854	31,447
Tax	(4)	(39)	(24)	(219)	(2)	0	0
Profit for the year	1,889	9,552	11,702	19,122	26,939	23,854	31,447
Average number of shares in issue (m)	105.2	119.2	171.7	252.2	284.8	339.2	339.2
IFRS earnings	1,889	9,552	11,702	19,122	26,939	23,854	31,447
Adjusted for rent arising from recognising guaranteed rent review uplifts + lease incentives	(1,547)	(3,760)	(4,136)	(5,127)	(6,400)	(6,400)	(6,400)
Adjusted for valuation changes	2,233	839	(425)	(2,211)	(6,142)	2,737	(2,042)
Adjusted for corporate acquisitions	0	174	998	420	432	0	0
EPRA earnings	2,575	6,805	8,139	12,204	14,829	20,191	23,005
Adjustment for performance fee	150	466	871	997	1,116	960	960
Group adjusted EPRA earnings	2,725	7,271	9,010	13,201	15,945	21,151	23,965
IFRS EPS (p)	1.80	8.02	6.81	7.58	9.46	7.03	9.27
EPRA EPS (p)	2.45	5.71	4.74	4.84	5.21	5.95	6.78
Adjusted EPS (p)	2.59	6.10	5.25	5.23	5.60	6.24	7.06
Dividend per share (declared) (p)	6.00	6.12	6.18	6.28	6.45	6.58	6.71
BALANCE SHEET							
Investment properties	81,422	138,164	200,720	266,219	359,470	430,644	459,675
Other non-current assets	0	2,530	3,742	3,988	4,933	5,866	6,289
Non-current assets	81,422	140,694	204,462	270,207	364,403	436,510	465,964
Cash and equivalents	17,125	29,159	65,107	10,410	41,416	5,156	4,964
Other current assets	6,524	6,457	13,222	25,629	25,247	31,647	38,047
Current assets	23,649	35,616	78,329	36,039	66,663	36,803	43,011
Bank loan	(11,764)	(30,865)	(20,449)	(39,331)	(64,958)	(105,558)	(130,000)
Other non-current liabilities	0	(2,530)	(4,058)	(3,997)	(3,000)	(3,000)	(3,000)
Non-current liabilities	(11,764)	(33,395)	(24,507)	(43,328)	(67,958)	(108,558)	(133,000)
Trade and other payables	(3,089)	(3,623)	(5,002)	(5,981)	(4,600)	(4,600)	(7,026)
Current Liabilities	(3,089)	(3,623)	(5,002)	(5,981)	(4,600)	(4,600)	(7,026)
Net assets	90,218	139,292	253,282	256,937	358,508	360,155	368,950
Period end shares (m)	95.2	142.3	252.2	252.2	339.2	339.2	339.2
IFRS NAV per ordinary share	94.7	97.9	100.4	101.9	105.7	106.2	108.8
EPRA NAV per share	94.7	97.9	100.6	101.9	105.7	106.2	108.8
CASH FLOW							
Cash flow from operations	3,172	8,081	8,906	4,394	20,141	21,770	28,417
Net interest paid	161	(514)	(681)	(615)	(1,265)	(1,912)	(2,968)
Tax paid	0	(47)	(164)	(543)	(201)	0	0
Net cash flow from operating activities	3,333	7,520	8,061	3,236	18,676	19,858	25,450
Purchase of investment properties	(51,894)	(51,736)	(34,833)	(37,698)	(67,109)	(73,911)	(26,989)
Acquisition of subsidiaries	0	(5,845)	(27,091)	(25,552)	(20,432)	0	0
Net cash flow from investing activities	(51,894)	(57,581)	(61,924)	(63,250)	(87,541)	(73,911)	(26,989)
Issue of ordinary share capital (net of expenses)	44,520	46,644	97,501	0	92,120	0	0
(Repayment)/drawdown of loans	8,646	22,525	(12,808)	20,906	26,000	40,000	24,000
Dividends paid	(4,364)	(7,074)	(9,681)	(15,589)	(17,438)	(22,208)	(22,652)
Other	0	0	14,799	0	(810)	0	0
Net cash flow from financing activities	48,802	62,095	89,811	5,317	99,872	17,792	1,348
Net change in cash and equivalents	241	12,034	35,948	(54,697)	31,006	(36,260)	(191)
Opening cash and equivalents	16,884	17,125	29,159	65,107	10,410	41,416	5,156
Closing cash and equivalents	17,125	29,159	65,107	10,410	41,416	5,156	4,964
Balance sheet debt	(11,764)	(30,865)	(20,449)	(39,331)	(64,958)	(105,558)	(130,000)
Unamortised loan arrangement costs	(497)	(645)	(551)	(669)	(1,042)	(442)	0
Net cash/(debt)	4,864	(2,351)	44,107	(29,590)	(24,584)	(100,844)	(125,036)
Gross LTV	15.1%	22.8%	10.5%	14.2%	17.2%	23.0%	26.1%
Net LTV	0.0%	1.7%	0.0%	10.5%	6.4%	21.9%	25.1%

Source: Target, Edison Investment Research

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