EDISON

Target Healthcare REIT

Post-FY22 update

Key drivers in place and borrowing costs fixed

Real estate

Target Healthcare REIT delivered strong absolute growth in FY22 and continued its record of positive NAV returns. However, with cash drag from slower than originally planned investment, and weak rent collection from a minority of homes, per share earnings and DPS cover declined. Although now fixed, higher interest rates will weigh on earnings and delay acquisitions, but we expect earnings growth and DPS cover to increase, supported by indexed rent growth and a recovery in rent collection.

Year end	Revenue (£m)	Adjusted earnings* (£m)	Adjusted EPS* (p)	NAV**/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
06/21	50.0	26.0	5.5	110.4	6.72	0.79	7.7
06/22	63.9	30.2	5.0	112.3	6.76	0.77	7.8
06/23e	68.1	36.3	5.8	110.8	6.76	0.79	7.8
06/24e	73.1	37.7	6.1	110.1	6.76	0.79	7.8

Note: *Adjusted earnings excludes revaluation movements, non-cash IFRS rental income adjustments, and includes development interest under forward fund agreements.
**Throughout this report, NAV and EPRA net tangible assets (NTA) are interchangeable.

Organic rental growth to drive increased DPS cover

Strong fee growth and increased occupancy are mitigating the impact of inflation on tenants. Rent cover is stable and underperforming homes are responding well to asset management. For Target, indexed rent uplifts continue, and with additional interest rate hedging recently put in place, all debt costs are now fixed or hedged at a blended interest cost of 3.3% pa. FY22 adjusted 'cash earnings' increased by 17% but adjusted EPS (5.0p vs 5.5p in FY21) was held back by slower capital deployment, cash drag and some specific weakness in rent collections. Dividend cover was 0.72x. Our forecast reductions mainly reflect the pause in acquisitions and a one-off hedging cost of c £2.5m/0.4p per share in FY23. FY24e EPS growth is reduced by c 3% and full DPS cover will take longer to achieve (FY24e 90%), but we expect continuing positive total returns of c 5% pa, allowing for a 0.4% widening in property valuation yield and a modest decline in EPRA NTA per share.

Sustainably meeting a long-term need

A growing elderly population and the need to improve the existing estate point to continuing demand for modern, high-quality, ESG-compliant residential facilities. With its unwavering focus on asset quality, these are the homes in which Target invests. The homes are appealing to its residents (two-thirds private pay) and support operators in providing better, more efficient, and more effective care. When let at sustainable rent levels in well-located in areas, with strong supply/demand characteristics, they will always be attractive to existing or alternative tenants and are key to providing sustainable, long-duration, inflation-linked income.

Valuation: Long-term, indexed income drives returns

Healthcare real estate has a track record of attractive risk adjusted returns, and we expect positive NAV returns for Target to be driven by DPS paid. The valuation is back to levels not seen since the peak of pandemic uncertainty, with a dividend yield of c 8% reflected in a P/NAV discount of 22%. DPS cover should gradually build but even if DPS were re-based, there would be no impact on total return.

7 November 2022

Price	**87p**
Market cap	**£533m**
Net debt (£m) at 30 June 2022	200.3
Gross LTV at 30 June 2022	25.8%
Shares in issue	620.2m
Free float	100%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(2.9)	(24.9)	(26.8)
Rel (local)	(6.0)	(22.7)	(23.9)
52-week high/low		122p	78p

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

H123 period-end	31 December 2022

Analyst

Martyn King +44 (0)20 3077 5745

financials@edisongroup.com

Edison profile page

Target Healthcare REIT is a research client of Edison Investment Research Limited

Key drivers remain in place and all borrowing costs are now fixed/hedged

FY22 results were very much in line with the forecasts that we published following the Q422 NAV update in early August. The Q123 report subsequently released shows operational progress continuing as expected, supported by the strong fundamentals of the care home property sector. With market expectations indicating a significant further increase in interest rates beyond the current 3.0% Bank of England (BoE) Base Rate, in early October, Target capped the SONIA rate payable on an additional £50m of variable rate debt facilities at 3.0% until November 2025. The premium paid for the cap was c £2.5m, a reduction in the Q223 NAV per share of c 0.4p. All borrowings are now fixed or hedged and on a pro forma basis, we estimate a blended running interest cost of drawn borrowing of 3.3%.

Nonetheless, capital costs have spiked higher across the market, which is not yet reflected in asset prices. Unsurprisingly, while this period of uncertainty persists, the company indicates a pause in new investments. We believe this to be a sensible approach, though it will slow the growth in earnings and delay the path to full DPS cover. The impact of rising capital costs and the revised path to dividend cover are the focus of this update, along with an update on the factors that continue to mitigate inflation risks for both the company and its tenants.

Strong absolute growth in FY22 but EPS and dividend cover were held back by cash drag and provisions

Despite the building headwinds of increased inflation and interest rates, and economic and political uncertainty in the UK, tenant operators have seen their occupancy ratios continue to recover towards pre-pandemic levels, while fees have grown strongly. Target estimates that the fees of its tenants are predominantly (67%) fully or partly (through top-ups) sourced from privately funded residents and 33% from public funding. It cites external industry data that indicates an acceleration in privately sourced fees compared with publicly sourced fees. A relatively small number of underperforming assets, typically reflecting exposure to recently opened or new-build homes and growing tenants with several new homes, held FY22 rent collection to 95% and provision charges amounted to £3.2m. Q123 rent collection increased to 96% and with ongoing asset management initiatives we expect a significant improvement in FY23 as discussed below. Meanwhile, rent cover remains stable at c 1.3x.

Driven by portfolio investment and inflation-indexed rent growth (4.6% on a like-for-like basis), annualised contracted rents increased 35% to £55.5m at end-FY22 versus £41.2m at end-FY21. Yet to fully reflect annualised contracted rent growth, FY22 revenues (c 19%) and adjusted 'cash' earnings (c 17%) both grew strongly. A total of £223m was deployed in acquisitions, including the c £160m acquisition of a high-quality, established 18-home portfolio, well known to the investment manager. Funding for growth was provided by the upsized £125m (gross) equity raise in September 2021 and a new £100m fixed rate long-term debt facility in November 2021, fixed for a blended 13 years at an attractive 3.1%.

Although FY22 growth was strong, it was slower than Target had expected earlier in the period, with capital deployment taking longer than planned and rent collection negatively affected by a small number of tenants (see below). Target had expected to complete the portfolio acquisition in October 2021, but access restrictions because of the pandemic delayed this until December. As economic and political uncertainties climbed through H222, additional deployment of available capital was slowed. As a result of cash drag and provisions, and an increase in borrowing costs towards the end of FY22, adjusted 'cash' earnings per share of 5.0p was lower than in FY21 (5.5p), covering

DPS by 0.72x. EPRA EPS of 6.6p (FY21: 7.2p) covering DPS 0.95x. Including like-for-like investment property gains of 4.2%, EPRA NTA per share increased 1.7% to 112.3p during FY22 and including DPS paid the EPRA NTA total return[1] was 7.8% (or 8.1% assuming dividend reinvestment).

In contrast to increasing areas of the mainstream UK commercial property market, there was no sign of widening valuation yields through FY22. However, during Q123, the positive impact of continuing indexed rent growth was offset by a slight expansion in the EPRA topped up net initial yield, from 5.82% at end-FY22 to 5.84%. EPRA NTA was nonetheless broadly stable at 112.1p and the quarterly accounting total return was 1.3%.

The end-Q123 investment portfolio was valued at £914m, with annualised contracted rent of £55.6m. The 100 homes (of which four are under construction) were fully let to 33 tenants with a weighted average unexpired lease term (WAULT) of 26.9 years. Effectively, all rents are upwards only and inflation-indexed (with caps and collars). Being modern and predominantly purpose built, the portfolio benefits from strong environmental credentials, fully compliant with expected BEEAM[2] 2030 requirements, with 93% EPC rated A-B and 100% EPC C or better. Demonstrating the quality of the assets in its portfolio and their ability to create social value, Target highlights that 97% of its rooms have full en-suite wet-room facilities compared with a UK industry average of just 29% and that while average rents per sqm are only a little higher than average, the average sqm per resident is significantly higher, including typically generous communal facilities.

The path to dividend cover

Although market developments will slow Target's well-charted path to full dividend cover, most particularly the volatility of money markets and increasing interest rates, the key drivers remain in place, with the management of debt costs becoming increasingly important. These comprise:

- Improved rent collection, which remains well underway. Adjusting for the £3.2m of credit loss allowances and bad debts, we estimate that FY22 dividend cover, on an adjusted earnings basis, would have been c 80% compared with the 72% reported.
- Upwards-only index-linked rent growth, applicable to 99% of the portfolio, with uplifts typically capped at c 4%. FY22 like-for-like growth was 4.1% or 3.8% excluding a positive impact from re-tenanting.
- The deployment of available capital into accretive portfolio growth. With acquisition prices yet to adjust to the increase in capital costs, Target indicates a slowdown in new deployment, but income should continue to increase from existing commitments, primarily to forward-funded acquisitions under construction on a fixed cost basis.
- Managing debt costs. The additional hedging of outstanding variable rate borrowings has removed the uncertainty of further interest rate increases over the short- to medium-term, providing additional flexibility within Target's longer-term debt strategy. By reducing near-term running interest expense, our forecasts dividend cover is enhanced.

[1] Change in NAV plus dividends paid. Unlike the company's measure of returns, we do not assume reinvestment of dividends. Consequently, the returns quoted by Target are higher and in FY22 amounted to 8.1%.

[2] Building Research Establishment Assessment Method

Change to our earnings estimates reflect the increased cost of capital and a pause in capital deployment

Our updated forecasts are negatively affected by increased interest costs and slower capital deployment. Excluding the non-recurring interest rate hedging premium paid (c £2.5m), included in EPRA 'net finance costs' in Exhibit 1, the underlying income statement interest expense is lower than we had previously assumed. Our previous forecasts had assumed a 4.0% SONIA benchmark for the drawn variable rate debt plus borrowing margin, and the SONIA rate that Target will pay has now been fixed at 3.0%. Additionally, we now assume no new commitments to investment, having previously assumed £30m. While this will benefit interest expense by reducing the cost of borrowing, it will have a negative impact on our forecast cash rental income. We have also prudently assumed a slower reduction in overall rent provisioning. Our forecast for FY23 adjusted earnings, which excludes the hedging premium, is little changed (-0.5%). FY24e is reduced by 2.7%. Dividend cover is reduced slightly from 0.87x to 0.86x in FY23e and from 0.92x to 0.90x in FY24e.

Exhibit 1: Forecast revisions

	New forecast		Previous forecast		Change		Change (%)	
£m unless stated otherwise	**FY23**	**FY24**	**FY23**	**FY24**	**FY23**	**FY24**	**FY23**	**FY24**
Cash rental income	57.1	61.7	58.0	63.4	(0.9)	(1.7)		
Non-cash IFRS adjustments	11.0	11.4	11.2	11.8	(0.2)	(0.3)		
Expenses	(12.2)	(12.6)	(12.1)	(12.1)	(0.1)	(0.5)		
Net finance costs	(12.2)	(11.5)	(10.4)	(12.6)	(1.8)	1.2		
Tax	0.0	0.0	0.0	0.0	0.0	0.0		
EPRA earnings	**43.7**	**49.1**	**46.7**	**50.5**	**(3.0)**	**(1.4)**	**-6.4%**	**-2.7%**
Non-cash IFRS adjustments	(11.0)	(11.4)	(11.2)	(11.8)	0.2	0.3		
EPRA earnings excluding IFRS adj.	**32.7**	**37.6**	**35.5**	**38.7**	**(2.8)**	**(1.1)**	**-7.9%**	**-2.7%**
Adjust for development interest under forward-funded agreements	1.0	0.1	0.9	0.1	0.1	0.0		
Adjust for interest rate cap premium	2.5	0.0	0.0	0.0	2.5	0.0		
Adjusted earnings	**36.3**	**37.7**	**36.4**	**38.8**	**(3.0)**	**(2.1)**	**-0.5%**	**-2.7%**
EPRA EPS (p)	7.1	7.9	7.5	8.1	(0.48)	(0.22)	-6.4%	-2.7%
Adjusted EPS (p)	5.8	6.1	5.9	6.3	(0.03)	(0.17)	-0.5%	-2.7%
DPS declared (p)	6.8	6.8	6.8	6.8	0.00	0.00	0.0%	0.0%
EPRA DPS cover (x)	1.04	1.17	1.11	1.20				
Adjusted DPS cover (x)	0.86	0.90	0.87	0.92				
EPRA NTA per share ("NAV") (p)	110.8	110.1	115.0	117.7	(4.2)	(7.6)	-3.7%	-6.5%
NAV total return	4.7%	5.5%	8.4%	8.2%				

Source: Edison Investment Research. Note: *In respect of movement in lease incentives and fixed rent review adjustments. **In respect of advances on forward-funded developments.

Dividend sustainability

The board has indicated that it sees a clear path to dividend cover exceeding 90% and feels it prudent to maintain DPS at the current level. Based on our FY24 adjusted earnings and DPS forecasts, full dividend cover requires a c £4m earnings uplift, which equates to less than two years of additional rent growth at 4% pa. If capital costs and/or acquisition yields move favourably to restore a sufficiently positive acquisition spread, and if greater certainty returns to the market, acquisitions would accelerate the achievement of full cover. We estimate that if c £45m of available debt capital were deployed at a 3% spread, the time to full dividend cover would be reduced by almost a year.

Target is primarily focused on income returns, and we would expect that maintaining a high distribution to shareholders is important to the board. It is nonetheless the case that there are some investors with a preference for fully covered dividends and we can also see some advantages that would arise from a rebasing of the dividend. An uncovered dividend requires capital resources to be diverted away from long-term growth and in the near term requires additional borrowing, which is unattractive at high borrowing rates. Moreover, whatever the level of dividends paid, there is no

impact on total accounting returns. A 20% rebasing of the dividend would be sufficient to restore underlying (excluding the hedging premium) cover for FY23, create a base for future growth, and at the current share price would represent a yield of more than 6%.

Several well-planned, recent or proposed changes to the board composition will be voted on at the AGM on 6 December, including a change of chairman and two new non-executive directors. With money market conditions evolving rapidly pace, this may provide a timely opportunity for the board to assess its position.

We expect income-driven positive total returns to continue

Target's record of consistently positive returns since it listed in January 2013, on both a quarterly and annual basis, has continued through Q123. This performance reflects the resilience of the sector and of Target's strategy. The average annual compound return over this period has been 6.0%, of which c 80% reflects dividends paid. Including dividends reinvested, Target's preferred measure, the average annual total return has been 7.8%.

DPS has increased each year since IPO, to 6.76p in FY22 (+0.6%) but we forecast a pause in DPS growth in current market conditions, allowing the company to build DPS cover.

Across the commercial property sector, income returns have historically shown less volatility than capital values, which have displayed material swings. Healthcare property returns have been less volatile than mainstream sectors, in many cases reflecting the non-discretionary, demographically driven nature of demand, visible long-term income streams and a shortage of adequate, sustainable supply. With government bond yields significantly higher than at the start of the year[3] there is a widespread expectation that the widening of property valuation yields (decrease in values), which is already apparent across much of the UK commercial property sector, will spread. The investment manager suggests that a widening of acquisition yield towards a range of 6.00–6.25% is likely in current market conditions. While this would represent a drag on valuation growth, offsetting the positive impact of indexed rent growth, it would have the advantage of lowering acquisition prices. Our forecasts are consistent with this expectation and allow for an upwards move to 6.25% by end-FY24.

In addition to the yield widening reflected in our forecasts, we estimate that a 10bp increase/decrease in yield would decrease/increase FY23e NAV per share by c 2.6p.

Based on our forecast property valuation, and including the gap between dividends and earnings, we expect the NAV total return to be c 5% pa through FY23 and FY24, with DPS payments partly offset by a slight weakening of NAV per share.

Exhibit 2: Consistently positive NAV* total return (not assuming dividend reinvestment)

	FY14**	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	Q123	FY14–Q123
Opening NAV (p)	98.0	94.7	97.9	100.6	101.9	105.7	107.5	108.1	110.4	112.3	98.0
Closing NAV (p)	94.7	97.9	100.6	101.9	105.7	107.5	108.1	110.4	112.3	112.1	112.1
DPS paid (p)	6.5	6.1	6.2	6.3	6.4	6.5	6.7	6.7	6.8	1.7	59.8
Dividend return (%)	6.6	6.4	6.3	6.2	6.3	6.2	6.2	6.2	6.1	1.5	61.0
Capital return (%)	-3.3	3.3	2.7	1.3	3.8	1.6	0.6	2.2	1.7	(0.2)	14.4
NAV total return (%)	3.3	9.7	9.0	7.5	10.1	7.8	6.8	8.4	7.8	1.3	75.4
Average annual total return (%)											6.0

Source: Target Healthcare REIT data. Note: *NAV is EPRA NTA per share. **22 January 2013 to 30 June 2014. Opening value adjusted for IPO costs

[3] The yield on the 10-year UK government gilt has increased from around 1% at the start of the year to around 4% recently, having reached a high of c 4.5% in late September.

FY23 rent collection should substantially improve

The lagged effects of COVID-19 on a minority of Target's tenant operators, particularly where occupancy had been slow to rebuild, were the main negative factors behind 95% rent collection in FY22. The company is well advanced in addressing the effects and in restoring rent collection towards pre COVID-19 levels, with Q123 already increasing to 96%. The three key areas of improvement, which Target says are of broadly equivalent significance, are:

- A portfolio of seven homes, operated by one tenant, where rents were only partly being paid, and where Target had begun a process of re-tenanting. As covered in detail in our September update the incumbent tenant has renewed its long-term commitment to the homes, has settled all rent in arrears and currently due, meanwhile pledging additional security. We believe that the decision of both parties to continue the tenancy reflects the more positive trading outlook for the homes, which had been negatively affected by the pandemic. Our estimate of the rent arrears recovered from the seven-home settlement amounts to c £1m, with a similar amount of rent provision write-backs reflected within Q123 income.
- Of two homes operated by one tenant, where rents were being partially paid, one home was re-tenanted towards the end of FY22 and the re-tenanting of the second has been largely implemented.
- The path to maturity ('stabilisation') of two homes located within the south of England, operated by one tenant, was further impeded by COVID-19, but have since seen improvement. Rents on one of the homes are now being paid in full and for the other are being partially paid. As part of its active management strategy, Target is considering options for a long-term solution.

Asset management is core to the strategy

It is worth reiterating from our previous research that asset management is core to Target's strategy, greatly facilitated by its unwavering focus on asset quality. Its investment thesis is that best-in-class properties in local areas with positive demand/supply characteristics and prevailing rental levels that are sustainable will always be attractive to existing or alternative tenants. The tenant recommitment to seven assets described above, and the continuing firmness of asset yields in recent months, provide tangible evidence of the appeal of modern, high-quality EPC-compliant assets to investors and operators alike.

Most homes in the portfolio are mature, stabilised and capable of sustaining high levels of occupancy under normal trading conditions. However, completed newly opened homes and forward-funded pre-let developments also provide access to modern, high-quality, ESG-compliant assets. Under normal trading conditions, newly opened homes typically require up to 36 months to build occupancy and establish a mature level of financial performance. However, the pandemic has increased pressure on home operators across the sector and lengthened the time required for new homes to reach maturity, especially for homes where private fee-paying occupancy was slower to recover. Pandemic aside, it is inevitable that some tenants, from time to time, will encounter operational or financial challenges and as an engaged landlord, Target makes available its industry knowledge and experience to provide support. In a minority of cases, the best solution for all stakeholders, including home residents, may be to seek a re-tenanting of the home and Target has a successful track record of achieving this where needed. With this in mind, our forecasts reflect a substantial improvement in rent collection through FY23 but out of prudence, in an uncertain external environment we have continued to build in a non-collection 'cushion' of c 2.5% of rents receivable. An improvement on this would further enhance our forecast increase in dividend cover.

Fee growth and occupancy improvements are mitigating inflationary pressure on tenants

The COVID-19 pandemic presented many operational financial challenges to home operators and although it may not be over, the effects have become considerably more manageable. The key concerns for the sector are now the rapid acceleration in inflation and staff shortages. In this environment, increasing occupancy and strong fee growth are mitigating inflationary cost pressures as well as the withdrawal of the government's pandemic financial support since March 2022. We note the additional factors that we believe will support operators in the current environment:

- The demand for care home places is effectively non-discretionary, at least for anything other than short periods. The pandemic provided an extreme example of this, with admissions highly restricted for a period, but occupancy is now rebuilding. For Target's tenants, home occupancy for mature homes[4] has increased to 84% from c 73% at the pandemic low point in early 2021. Reflecting greater average near-term flexibility over the timing of entry into a care home, homes focused on privately funded residents experienced a slight lag in occupancy improvement which now appears to be unwinding. Home operators report continuing strong enquiry levels and expect occupancy to continue to build towards pre-pandemic levels of up to 90%.
- UK care operators have a long-term track record of being able to pass through inflationary pressures to fee increases. Target cites data[5] indicating an acceleration in privately sourced fees (67% of the total for its portfolio and well above the market average of c 50%) compared with publicly sourced fees and says that its operators are reporting no push-back on fee increases as they seek to manage current inflationary pressures.
- Utility and food costs, two areas of significant inflationary pressure, remain at manageable levels. Target indicates that these typically continue to represent c 3% and 5% respectively as a percentage of home revenues.
- Staffing is understandably the key cost across the sector (typically c 50–60% of revenues) and staff availability has also been a challenge for some operators. A widespread recognition that improvements to staff levels and conditions are generally to be welcomed, and care home staff are not typically 'overpaid', has historically made it easier to pass through staffing costs to fee increases. Staffing pressures have begun to ease and have recently benefitted from the relaxation of immigration controls.
- While all rents paid to Target are linked to inflation, uplifts are typically capped at c 4% with a floor of c 2%. This means that while RPI inflation is above 4%, rental growth will lag in real terms, but this contributes towards rents remaining affordable for tenant operators and enhances the security of Target's income.

Occupancy growth and fee increases continue to support rent cover,[6] which for mature homes remains at c 1.3x and no longer benefits from government pandemic financial support. When initially setting rent levels, Target aims for rents to be a sustainable c 20% of revenues. Combined with other operational costs the company believes that mature home rent cover of 1.6x remains a realistic medium-term target as illustrated below (for a typical home).

[4] Homes that have had the same operator for a three-year period or more, and therefore excluding newly developed homes not yet stabilised.
[5] Sourced by Target from the specialist real estate consultant Carterwood.
[6] Rent cover is a key measure of the underlying profitability of tenants and the sustainability of rents. The ratio tracks operational cash earnings at the home level (before rent), or EBITDARM, with the agreed rent and is presented on a rolling 12-month basis.

Exhibit 3: Illustrative profitability structure for a mature Target care home

Split of revenues/costs	
Private fees	75
Local authority fees	25
Total income	**100**
Staff costs	(50)
Food and provisions	(5)
Cleaning, consumables and medical	(2)
Gross margin	**43**
Heat and light	(3)
Other overheads	(8)
EBITDARM	**32**
Rent	(20)
EBITDAM	12

Source: Target Healthcare REIT

All borrowing is now fixed or hedged

To fund portfolio growth since IPO, Target has steadily increased its capital resources, both equity and debt capital, sufficient to take advantage of opportunities in the market while avoiding excessive gearing and mitigating any drag on returns. Shorter term, variable rate debt is typically used in the asset accumulation phase (Target has mostly acquired individual properties, the late 2021 portfolio acquisition being an exception) to be 'packaged' for longer-term funding as appropriate.

In late November 2021 the company agreed a new £100m long-term institutional debt facility that was drawn in two tranches, with a blended 13-year maturity and 3.1% fixed cost. The financing was well timed, taking advantage of a tightening in the relevant gilt yield to 1%. As a result, end-Q123 borrowings of £223m were c 81% fixed (£150m) at a blended 3.18%, or hedged via a swap (£30m) at 0.3% plus a margin, or an attractive total interest cost of 2.48%. End-FY23 borrowings also included £43m of drawn variable rate debt, out of total variable rate debt facilities of £140m. The sharp rise in market interest rates in recent months has substantially increased the cost of variable rate borrowing. With market expectations indicating a significant further increase, in early October Target capped the SONIA rate payable on an additional £50m of variable rate debt facilities at 3.0% until November 2025. The premium paid for the cap was c £2.5m, a reduction in Q223 NAV per share of c 0.4p. On a pro forma basis, we estimate a blended running interest cost of drawn borrowing of 3.3%. At the same time, Target has exercised, with lender approval, its extension option on its £100m HSBC facility and inclusive of this the average term to maturity on its committed loan facilities was 6.9 years as at 1 November 2022.

The £150m of fixed rate debt has a weighted average maturity of more than 11 years and the swap arrangement matures in c three years along with the £70m of RBS facilities. The cap eliminates the remaining near-term interest rate risk and provides additional flexibility within Target's overall debt strategy. This should prove advantageous if market interest rates increase to a peak in early 2013 before gently declining. Since 30 June (end-FY22), the BoE has increased the base rate three times, taking it to 3.00% from 1.25%. BoE Base Rate is closely tracked by SONIA, the reference rate for Target's variable rate borrowing (before hedging). Money market expectations for the future development of SONIA/the base rate, reflected in the SONIA swap curve, have been volatile, indicating a peak of 4.5–6.0% by early 2023 before steadily declining towards a long-term level of 3–4%. Current rates are at the lower end of this range.

Available undrawn variable rate debt at end-Q123 was £97m, well above the end-FY22 capital commitments. At end-FY22, commitments were £38m, mostly relating to the remaining forward funding of properties under construction. We expect most of this to be paid by end-FY24. Our forecasts indicate that without further management action this will lead to a relatively modest

c £20m of exposure to unhedged, variable rate debt. Until there is greater certainty about the direction of money markets and the economy, we expect the company to pause additional investment/commitments and retain a higher than normal level of liquidity. As a long-term investor this may change, as interest rates begin to decline and if acquisition pricing begins to adjust to the sharp rise in the cost of capital.

Exhibit 4: Summary of debt facilities

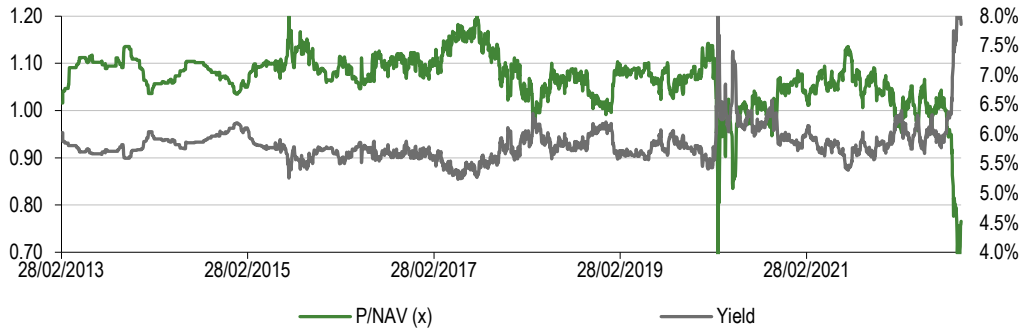
Lender	Facility type	Facility	Maturity	Margin
RBS	Term loan	£30m	Nov-25	Fixed with swap at 2.48%
	Revolving credit facility	£40m	Nov-25	SONIA + 2.33%
HSBC	Revolving credit facility	£100m	Nov-25	SONIA + 2.17%
Phoenix/Reassure	Term loan	£50m	Jan-32	Fixed 3.28%
Phoenix/Reassure	Term loan	£37m	Jan-32	Fixed 3.13%
Phoenix/Reassure	Term loan	£63m	Jan-37	Fixed 3.14%

Source: Target Healthcare REIT data.

Valuation

Based on the FY22 DPS, Target shares trade on a yield of 7.8%, in line with its post-IPO highs, most recently during the height of pandemic uncertainty. This has historically proven to be a very attractive entry point for investors. Similarly, at 0.78x the P/NAV is close the pandemic low point.

Exhibit 5: Price/NAV dividend yield history



Source: Refinitiv price data. Trailing basis using company NAV and annual DPS data

In Exhibit 6, we summarise the performance and valuation of a group of real estate investment trusts that we consider to be Target'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 6: Peer valuation and performance summary

	WAULT * (years)	Price (p)	Market cap. (£m)	P/NAV** (x)	Yield *** (%)	Share price performance			
						1 month	3 months	1-year	3 years
Assura	12	56	1659	0.92	5.4	4%	-18%	-23%	-24%
Civitas Social Housing	22	60	364	0.54	9.3	-6%	-25%	-36%	-29%
Home REIT	24	270	655	0.75	6.6	-7%	-31%	-28%	N/A
Impact Healthcare	20	103	416	0.89	6.3	2%	-13%	-13%	-6%
Primary Health Properties	11	111	1486	0.95	5.8	0%	-24%	-28%	-21%
Residential secure Income	N/A	91	168	0.86	5.7	-12%	-17%	-9%	-1%
Triple Point Social Housing	26	67	270	0.61	7.9	-7%	-27%	-32%	-24%
Average	**19**			**0.79**	**6.7**	**-4%**	**-22%**	**-24%**	**-18%**
Target Healthcare	**27**	**87**	**541**	**0.78**	**7.8**	**-3%**	**-25%**	**-27%**	**-22%**
UK property sector index		1,300				2%	-24%	-32%	-29%
UK equity market index		3,927				1%	-5%	-6%	-3%

Source: Company data, Refinitiv pricing at 4 November 2022. Note: *Weighted average unexpired lease term. **Based on last reported NAV/NTA. ***Based on trailing 12-month DPS declared.

Over one and three years, the share price performance of the group is ahead of the broad UK property market average, while dividend returns have been higher (we estimate the broad UK property market trailing yield to be currently c 5.3%). Compared with the per group average, Target's share price performance over the same period is a little below the average, contributing to a higher than average trailing dividend yield, while P/NAV is broadly in line. There are several positive indicators for the future share price performance including a combination of the long WAULT (with no break clauses) and upward-only, triple net rents, mostly linked to RPI. These provide considerable visibility over a growing stream of contracted rental income, in turn supported by the resilience of most tenants through the pandemic, a long-term trend for operator fee growth to at least keep pace with inflation, and a proven ability to re-tenant properties where appropriate.

While the path to DPS cover has been delayed, as we note above, a rebalancing of DPS would have no impact of accounting total returns, which have been consistently positive since IPO.

Recent financial performance in more detail

Full year results for the year ended 30 June 2022 (FY22) were published on 12 October, followed by the Q123 NAV update on 2 November. Many of the key financial metrics for FY22 were available from the Q422 NAV update published in early August, and the reported results were very much in line with our published forecasts. Exhibit 5 provides a summary and reconciliation from IFRS earnings to adjusted earnings.

Exhibit 7: FY22 financial summary

	FY22			FY21			FY22/FY21	Edison FY22e
£m unless stated otherwise	**IFRS**	**Adjustments**	**Adj. earnings***	**IFRS**	**Adjustments**	**Adj. earnings***	**Adj. Earnings***	**Adj. Earnings***
Rent revenue	48.8		48.8	41.2		41.2	18.6%	49.2
Income from guaranteed rent reviews & lease incentives	10.2	(10.2)	0.0	8.7	(8.7)	0.0		
Other rental income	4.7	(3.9)	0.8	0.0		0.0		
Other income	0.2		0.2	0.1		0.1		
Total revenue	**63.9**	**(14.1)**	**49.8**	**50.0**	**(8.7)**	**41.2**	**18.6%**	**49.2**
Investment management fee	(7.3)		(7.3)	(5.8)		(5.8)	26.1%	(7.4)
Credit loss allowance & bad debts	(3.2)		(3.2)	(2.7)		(2.7)		(3.3)
Other expenses	(3.2)		(3.2)	(2.6)		(2.6)	20.9%	(3.1)
Operating profit before property gains/(losses)	**50.2**	**(14.1)**	**36.1**	**38.9**	**(8.7)**	**30.1**	**19.8%**	**35.5**
Realised/unrealised gains/(losses) on properties	5.5	(5.5)	0.0	10.8	(10.8)	0.0		
Operating profit	55.7	(19.6)	36.1	49.6	(19.5)	30.1	19.8%	35.5
Net finance cost	(6.6)	0.0	(6.6)	(5.7)	0.9	(4.8)	37.2%	(6.1)
Development interest under forward fund agreements	0.0	0.8	0.8	0.0	0.6	0.6	21.0%	0.8
Net earnings	**49.1**	**(18.9)**	**30.2**	**43.9**	**(17.9)**	**26.0**	**16.5%**	**30.2**
Other data:			**FY22**			**FY21**	**FY22/FY21**	
Number of shares outstanding (m)			620.2			457.5	35.6%	620.2
Average number of shares outstanding (m)			599.1			457.5	31.0%	599.3
IFRS EPS (p)			8.20			9.23	-11.2%	8.23
EPRA EPS (p)			**6.62**			**7.16**	**-7.5%**	**6.59**
Adjusted EPS (p)			**5.05**			**5.46**	**-7.5%**	**5.04**
DPS declared (p)			6.76			6.72	0.6%	6.76
Dividend cover - EPRA earnings (x)			**0.95**			**1.05**		**0.94**
Dividend cover - Adjusted earnings (x)			**0.72**			**0.80**		**0.72**
IFRS NAV per share (p)			112.7			110.5		112.6
EPRA NTA per share (p)			112.3			110.4		112.3
EPRA NTA total return/accounting total return			7.8%			8.4%		7.8%
Investment properties including investment via loans			911.6			677.5	34.5%	916.9
Borrowings			234.8			130.0		(234.8)
Cash			34.5			21.1		31.1
Gross LTV (%)			25.8			19.2		25.8
Net LTV (%)			22.0			22.2		22.4

Source: Target Healthcare REIT historical data, Edison Investment Research FY22 forecast. Note: *Adjusted earnings excludes revaluation movements, non-recurring items, non-cash IFRS rental income adjustments, and includes development interest under forward fund agreements.

Focusing initially on adjusted 'cash' earnings, in particular we note:

- FY22 annualised contracted rental income increased to £55.5m or by 35% versus FY22, reflecting acquisitions, development completions and indexed rent growth (like-for-like 4.6%[7]). During Q123, annualised contracted rental income increased 0.3% to £55.6m, comprising a 0.7% increase from completed rent reviews (at an average 3.8% uplift) and 0.4% from rentalised performance payments and capex on existing assets, less 0.8% from the asset sold.
- FY22 cash rental income increased 19% to £48.8m, although not all the annualised growth in contracted rents was recognised in the period and will fully impact in FY23.
- FY22 investment management fees increased 26% to £7.3m, driven by the growth in net assets to which it is linked. NAV growth in the period included £122.5m of new equity raised net of issuance costs. Other expenses, before credit losses, increased 21% with the growth of the business and inflationary uplifts. Credit losses were £3.2m as discussed in detail above.
- FY22 net finance costs increased £37% to £6.6m, reflecting higher average debt to part-fund portfolio investment and increased borrowing costs.

[7] Like-for-like rent growth of 4.6% included a positive impact from the re-tenanting of properties. Excluding this it was 3.8%.

- Including a £0.8m contribution from development interest in respect of funds advanced for the construction of development properties, FY22 adjusted 'cash' earnings increased 17% to £30.2m.
- With equity raising increasing the average number of shares by 31% and capital deployment delayed, FY22 adjusted EPS was 5.05p (FY22: 5.46p), covering DPS 0.72x.
- Not shown separately in the table above, FY22 EPRA earnings, which excludes development interest but includes IFRS rent smoothing adjustments, also increased 17%, to £39.8m or 6.62p per share, covering DPS 0.95x.
- Including property revaluation gains of £5.5m, FY22 IFRS net earnings were £49.1m. On a like-for-like basis, FY22 revaluation gains were 4.2%, driven by rent uplifts. During Q123, like-for-like portfolio valuation growth was 0.1%, with the positive impact of underlying rental growth offset by a slight widening of the valuation yield from 5.82% at end-FY22 to 5.84%.
- With dividend payments not fully covered, end-Q123 EPRA NTA per share of 112.1p was very slightly down on end-FY22 (112.3p).

Exhibit 8: Financial summary

Year to 30 June (£m)	2020	2021	2022e	2023e	2024e
INCOME STATEMENT					
Rent revenue	36.0	41.2	48.8	57.1	61.7
Movement in lease incentive/fixed rent review adjustment	8.2	8.7	10.2	11.0	11.4
Other income	0.0	0.1	4.8	0.0	0.0
Total revenue	44.3	50.0	63.9	68.1	73.1
Gains/(losses) on revaluation	1.7	9.4	5.5	(11.0)	(11.4)
Realised gains/(losses) on disposal	0.6	1.3	0.0	0.0	0.0
Management fee	(5.3)	(5.8)	(7.3)	(7.674)	(7.597)
Credit loss allowance & bad debts	(2.1)	(2.7)	(3.2)	(1.2)	(1.5)
Other expenses	(2.2)	(2.6)	(3.2)	(3.3)	(3.4)
Operating profit	37.0	49.6	55.7	44.9	49.1
Net finance cost	(5.4)	(5.7)	(6.6)	(12.2)	(11.5)
Profit before taxation	31.6	43.9	49.1	32.7	37.6
Tax	0.0	0.0	(0.0)	0.0	0.0
IFRS net result	31.6	43.9	49.1	32.7	37.6
Adjust for:					
Gains/(losses) on revaluation	(0.2)	(9.5)	(5.6)	11.0	11.4
Other EPRA adjustments	(1.0)	(0.3)	(3.9)	0.0	0.0
EPRA earnings	30.5	34.0	39.7	43.7	49.1
Adjust for fixed/guaranteed rent reviews	(8.2)	(8.7)	(10.2)	(11.0)	(11.4)
Adjust for development interest under forward fund agreements	1.0	0.6	0.8	1.0	0.1
Adjust for interest rate cap premium	0.0	0.0	0.0	2.5	0.0
Group adjusted earnings	23.2	26.0	30.2	36.3	37.7
Average number of shares in issue (m)	440.3	475.4	599.1	620.2	620.2
IFRS EPS (p)	7.18	9.23	8.20	5.27	6.07
EPRA EPS (p)	6.9	7.2	6.6	7.1	7.9
Adjusted EPS (p)	5.3	5.5	5.0	5.8	6.1
Dividend per share (declared)	6.68	6.72	6.76	6.76	6.76
Dividend cover (EPRA earnings)	1.00	1.05	0.95	1.04	1.17
Dividend cover (Adjusted earnings)	0.76	0.80	0.72	0.86	0.90
BALANCE SHEET					
Investment properties	570.1	631.2	857.7	867.0	869.7
Other non-current assets	46.0	54.8	65.9	77.0	88.4
Non-current assets	616.1	686.0	923.6	944.0	958.1
Cash and equivalents	36.4	21.1	34.5	20.8	23.1
Other current assets	11.2	11.3	5.5	6.9	7.4
Current assets	47.6	32.4	40.0	27.8	30.5
Bank loan	(150.1)	(127.9)	(231.4)	(250.8)	(270.2)
Other non-current liabilities	(6.4)	(6.8)	(7.1)	(7.1)	(7.1)
Non-current liabilities	(156.5)	(134.7)	(238.5)	(257.9)	(277.3)
Trade and other payables	(13.1)	(18.5)	(26.4)	(24.3)	(26.0)
Current Liabilities	(13.1)	(18.5)	(26.4)	(24.3)	(26.0)
Net assets	494.1	565.2	698.8	689.6	685.3
Adjust for derivative financial liability	0.2	(0.3)	(2.3)	(2.3)	(2.3)
EPRA net assets	494.3	564.9	696.5	687.3	683.0
Period end shares (m)	457.5	511.5	620.2	620.2	620.2
IFRS NAV per ordinary share (p)	108.0	110.5	112.7	111.2	110.5
EPRA NTA per share (p)	108.1	110.4	112.3	110.8	110.1
EPRA NTA total return	6.8%	8.4%	7.8%	4.7%	5.5%
CASH FLOW					
Cash flow from operations	25.6	29.2	35.6	41.4	50.4
Net interest paid	(4.1)	(4.2)	(5.2)	(12.8)	(12.1)
Tax paid	(0.1)	(0.0)	(0.0)	0.0	0.0
Net cash flow from operating activities	21.5	25.0	30.4	28.6	38.3
Purchase of investment properties	(117.5)	(51.4)	(207.0)	(20.3)	(14.1)
Disposal of investment properties	14.1	7.8	4.4	0.0	0.0
Net cash flow from investing activities	(103.4)	(43.6)	(202.6)	(20.3)	(14.1)
Issue of ordinary share capital (net of expenses)	78.2	58.3	122.5	0.0	0.0
(Repayment)/drawdown of loans	44.0	(22.0)	104.8	20.0	20.0
Dividends paid	(29.2)	(31.5)	(39.8)	(41.9)	(41.9)
Other	(1.6)	(1.5)	(1.8)	(0.0)	(0.0)
Net cash flow from financing activities	91.4	3.3	185.6	(21.9)	(21.9)
Net change in cash and equivalents	9.5	(15.3)	13.4	(13.6)	2.3
Opening cash and equivalents	26.9	36.4	21.1	34.5	20.8
Closing cash and equivalents	36.4	21.1	34.5	20.8	23.1
Balance sheet debt	(150.1)	(127.9)	(231.4)	(250.8)	(270.2)
Unamortised loan arrangement costs	(1.9)	(2.1)	(3.4)	(4.0)	(4.6)
Net cash/(debt)	(115.6)	(108.9)	(200.3)	(233.9)	(251.7)
Gross LTV	24.9%	19.2%	25.8%	27.3%	29.0%
Net LTV	18.9%	16.1%	22.0%	25.1%	26.6%

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

EDISON

General disclaimer and copyright

This report has been commissioned by Target Healthcare REIT and prepared and issued by Edison, in consideration of a fee payable by Target Healthcare REIT. Edison Investment Research standard fees are £60,000 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia