A YEAR OF CHALLENGES AND OPPORTUNITIES

'CARE THOUGHTS' JANUARY 2022

1. Introduction

2022 is likely to be a year of challenges and opportunities for Care providers as they move on from managing the problems posed by Covid in 2020 and 2021.

First the challenges:

Inflation is rising sharply as can be seen from the table set out below. While the figures for CPI are bad, the figures for RPI are worse.

	2021											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
UK - CPI	0.7%	0.4%	0.7%	1.5%	2.1%	2.5%	2.0%	3.2%	3.1%	4.2%	5.1%	5.4%
UK - RPI	1.4%	1.4%	1.5%	2.9%	3.3%	3.9%	3.8%	4.8%	4.9%	6.0%	7.1%	7.5%
US	1.4%	1.7%	2.6%	4.2%	5.0%	5.4%	5.4%	5.3%	5.4%	6.2%	6.8%	7.0%
Eurozone	0.9%	0.9%	1.3%	1.6%	2.0%	1.9%	2.2%	3.0%	3.4%	4.1%	4.9%	5.0%
Germany	1.0%	1.3%	1.7%	2.0%	2.3%	2.3%	3.8%	3.9%	4.1%	4.5%	5.2%	5.3%

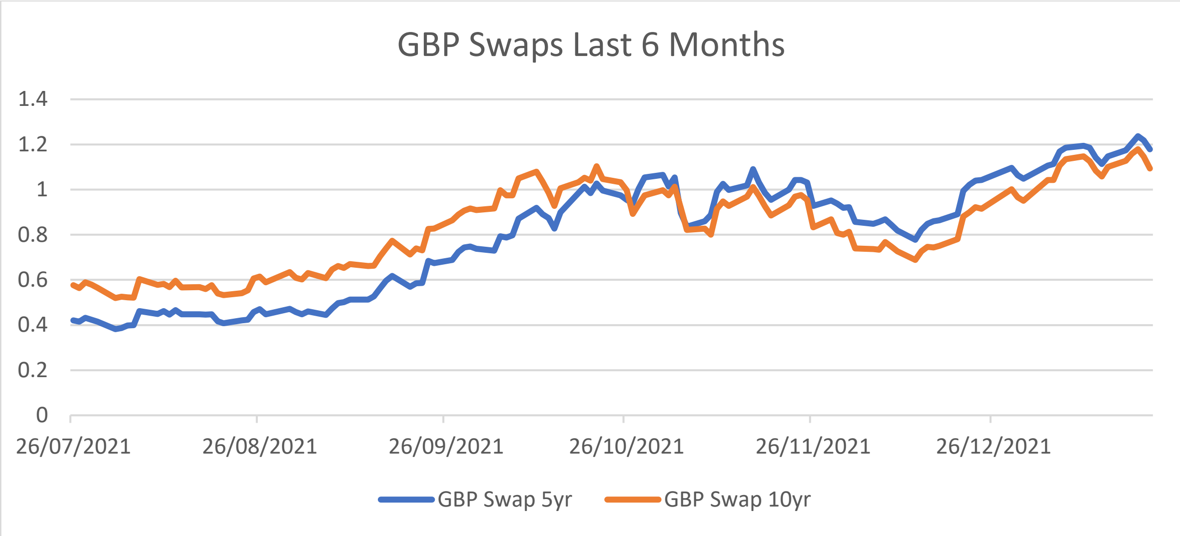
With CPI set to peak at over 6% during 2022 and RPI currently running 2% higher, the impact on care providers is likely to be substantial. There is a risk that costs will rise faster than revenues putting additional pressure on margins:

- Rising wage costs
- Effect of higher energy bills
- Growing costs of raw materials.

As the government is under pressure to reduce spending post Covid, inflation can pose a particular problem for operators dependent on local authority contracts – where price increases always show a tendency to lag inflation – while operators with long dated RPI index linked leases will be particularly hard hit (even where there are caps on annual increases) as their rents are likely to rise by 5%+ a year.

These challenges will be compounded by rising interest rates. In December the Bank of England Monetary Committee raised bank base rate from 10bps to 25bps. Economists and the market are now anticipating that this is just the first of a number of increases this year.

As can be seen from the graph below, the cost of fixing 5 and 10 year loans has already increased and. Allia C&C anticipates that the cost will continue to rise over the next 6 months.



Ultimately lower operating margins and higher interest costs risk undermining the credit standing of care providers – particularly as most operators face significant refinancing risk as they are largely dependent on 5/6 year bank facilities.

But this is where the good news is starting to emerge…

Over 2021 the funding market for care providers has started to improve significantly.

From Banks:

- There is a significant increase in the number of lenders keen to write new loans
- While most are still restricted to 5 years there is some improvement on pricing.
- There is also a more relaxed approach on covenants, especially Debt to EBITDA, and
- A return to longer dated facilities for favoured clients with two banks now quoting 10 – 25 years, though with a 10 year maximum average life.

Meanwhile, in the Private Placement Market

- There is an increasing willingness amongst investors to consider owner-operators if reputational risks can be addressed or OpCo/PropCo structures used.
- The first two Private Placements secured on Care Homes were completed in December for REITs specializing in owning – but not operating – Care Homes
- Both deals are for amounts well in excess of the minimum £25m issue size with a 10 – 15 year average life.
- Meanwhile the Pricing is very competitive with bank lending.

And finally on the Public Bond Market

- Two wholesale issues were successfully completed
  - for Korian, a £200m perpetual issue (quasi equity) with a three year non call feature where the coupon was fixed at 4.125% with a step up of an additional 5% at year 3 if not called.
    This was a very aggressive credit structure for a business with a substantial European asset base, but considerable lease obligations, and
  - for Voyage Care (B/B+), a £250m 5.875% 5 year issue to refinance the existing debt in the business at 483bps over gilts.

    It was triggered by a change in control and replaced significantly more expensive senior and second lien debt

- While a further £10m of 10 year of unsecured money was raised for Greensleeves, a Care Home charity
    - On a yield of 4.5%, ½% lower than the level it obtained in December 2020
    - To give a spread to gilts of about 390bps (now trading at about 303bps)

Allia C&C believes the improvement in borrowing opportunities will continue into the first half of 2022. It will create a wider range of funding alternatives for Care Home providers:

- Greater range of lenders and investors
- Wider spread of maturities
- More competition on pricing and covenants.

2. Moving forward in 2022.

Despite the challenges posed by Covid, Care Home operators generally outperformed expectations in 2021, with the absence of serious bad publicity on Care Home operations and a rapid recovery in occupancy supported by increases in fees.

It led to a significant shift in the attitudes taken by lenders to the sector.

In the second half of 2020, many banks severely restricted new lending, with activity focused on the need for covenant waivers on existing debt, with costs rising and occupancy levels falling.

Strong central and local government payments to address the impact of Covid combined with the ability to reserve unused capacity at Care Homes meant the recovery in revenues was faster than anticipated, with many organisations reporting only limited falls in operating profits at the end of the year.

Despite regional variations, 2021 saw this trend continue – underpinned by an increasing shortfall in capacity as the closure of old homes continued to outpace the development of new facilities.

This underpinned asset valuations where new homes commanded a premium over the cost of construction on completion and benefited from a further uplift when they became fully operational.

This has allowed care operators to:

- Reduce the effective level of gearing on their existing estate, while
- Raising debt for expansion without using sale and leasebacks on new properties

It has also led to a serious reassessment of the credit characteristics of the sector from both Banks and Institutional investors.

Care Home operators can leverage on this situation in 2022 in a number of different ways

- Diversify their sources of funding – moving beyond their traditional bank lenders to create a more varied portfolio of debt
- Aim to extend the maturity of their loans – by seeking longer dated bank loans and funding from the Private Placement and bond market
- Take advantage of increased competition on lending to simplify the mix of covenants on their debt, and
- Look to fix a significant amount of their borrowing for periods of between 3 – 10 years to guard against the impact of rising interest rates
- Raise additional debt to cover the upgrading and expansion of the estate.

Allia C&C believes the first half of 2022 represents a perfect opportunity for doing this with the risk that delay into the second half or 2023 will leave operators facing a significantly less attractive environment:

- Impact of inflation on operating margins
- Tightening interest rate environment deterring lenders
- Potential of higher borrowing costs.

3. Prospect for the future

The last ten years have been a challenging period for Care Home operators

- Significant increase in regulation
- Requirements to substantially upgrade facilities
- Reduction in local authority payments
- Failure of the larger, over leveraged operators

While this adversely impacted the attitudes of lenders, it contributed to a more focused and professional sector which survived the difficulties of Covid in remarkably good order.

Lenders have started to recognise this and a reassessment is now taking place of the opportunities presented by the sector - which is an essential service. This is supported by a growing focus on the social benefit generated by lending – ESG – which has become a driver for Banks, Private Placement lenders and public bond buyers.

Allia C&C has been in the forefront of this process providing advice and arranging debt. Its innovative RCB Bond platform has created an opportunity for the first time for Care Home operators to borrow medium term debt unsecured, without the need to navigate complex financial covenants.

We would look forward to discussing any questions you have on funding.

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