FUNDING CARE HOMES AND SUPPORTED HOUSING

FINDING A NEW STRUCTURE

'CARE THOUGHTS' FEBRUARY 2023

1. Introduction

During the last 5 years approximately £3bn[1] has been invested in the acquisition of care homes and specialised supported housing[2] through Real Estate Investment Trusts ("REITs") listed on the London Stock Exchange.

These companies initially locked into strong demand from investors: they mixed positive social impact with high-quality, long-term, inflation-linked revenue derived from real estate assets leased to a diversified group of care providers and asset managers. An added attraction was that much of the income ultimately appeared to be sourced from payments made by the UK Government.

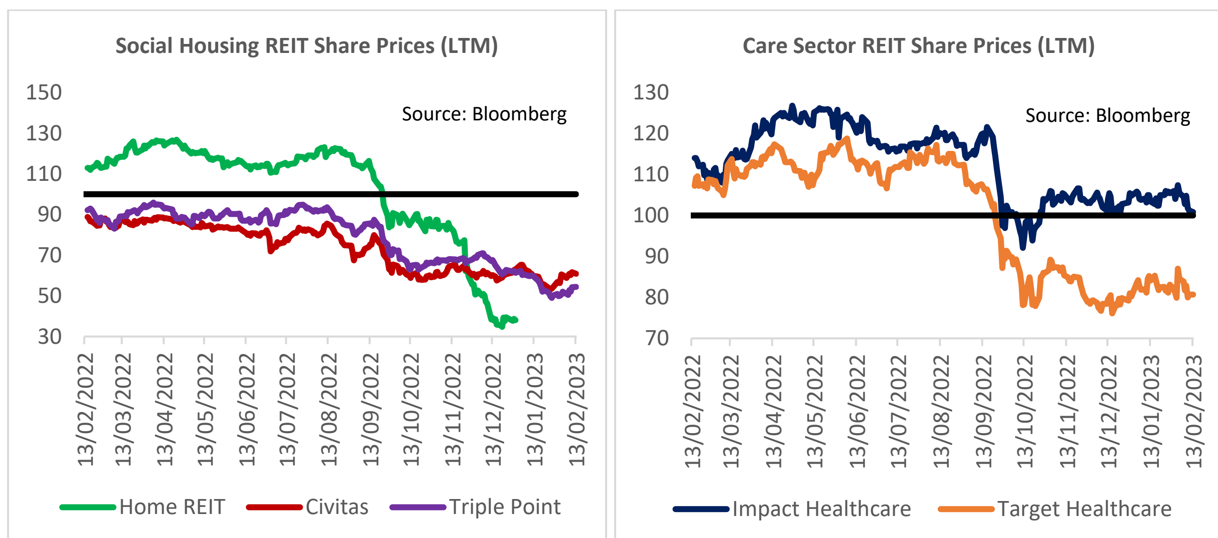
While funding models differ between residential care and specialised supported housing, both suffer from a shortage of suitable accommodation and face problems raising longer dated debt with appropriate covenants and maturities. Therefore, the arrival of a new group of investors is undoubtably welcome.

REITs have a number of attractions. They provide a channel to bring institutional and retail equity capital into the sectors. Moreover, they offer a way for large institutional investors who are concerned about the reputational and operating risks of lending directly to care providers to deploy capital - by separating the ownership and funding for the property from the delivery of care.

However, using long-dated, inflation-linked lease agreements involves care operators taking on contracts with limited flexibility that are expensive to unwind. These operators are generally thinly capitalised businesses, often charities or CICs, where lease agreements leave them with commitments that are a multiple of their net assets, effectively creating exceptionally high levels of leverage.

As a result, the viability and governance ratings of many Regulated Providers were recently reduced to "non-compliant" by the Regulator of Social Housing (RSH) while unregulated entities struggle to meet their obligations. There are also disputes over the level and quality of maintenance where this is shared with the REIT.

Publicity around this aspect has contributed to a sharp reduction in share prices of many REITs, to a point where they can no longer issue new equity.



[1] See Appendix 1.
[2] This paper focuses on specialised supported housing for residents with a care package commissioned via a local authority or health commissioner, and where the housing provider charges exempt rents.

It raises the question of whether for all its attractions there is a solution better suited to the needs of care operators in funding the delivery of accommodation. Allia C&C is actively exploring, with both operators and investors, a care fund more appropriately structured to their needs.

We would be very interested to hear your thoughts on this.

2. The challenge of the current leasing model.

For organisations focused on delivering care or providing appropriate accommodation to those in need, entering into long-term lease contracts can appear very attractive as it allows them to take on properties without major capital outlays, at what are initially affordable costs.

This means they can expand operations rapidly to meet the needs of their clients, while generating an immediate surplus from the use of the property.

At the same time, it involves taking on long-term commitments which are very expensive to unwind. This leaves them with high effective levels of borrowing without the flexibility to dispose of assets if they no longer suit the business model. Furthermore, with the cost of servicing the debt rising by inflation, albeit often floored and capped at 0 and 5%, there is a risk that the cost of the property rises to a point where it is no longer competitive.

This matters, as there will be a churn of residents over the life of the contract, with the average stay of care home residents at 1-2 years while on specialised supported housing it can fluctuate from periods of under 1 year to life. As a consequence, lessees have to consider the need to attract new residents in 5-10 years' time to meet the requirements of the lease contract, something which will depend on both the suitability of the accommodation at that stage and the cost of the facility relative to other providers.

Some indication of the scale of this problem can be seen from the figures set out below where we inflate the cost of a 30-year lease by some very conservative assumptions on inflation over the life of the contract, and then compare it with payments on a fixed rate loan - where repayment of the debt comes from savings from not using an inflation-linked lease.

Please note that if we raised the long-term rate of inflation from 2 to 3% this would have the impact of increasing annual lease payments by a further £300,000 to £1.4m in 30 years' time.

	Interest Cash Payments - 6.25% 30Y Loan	**Rental Cash Payments - 6% 30Y Institutional Lease**	**Net Saving/Cost**
Year 1	(625,000)	(600,000)	(25,000)
Year 5	(623,857)	(668,686)	44,829
Year 10	(598,912)	(738,283)	139,371
Year 15	(539,548)	(815,124)	275,576
Year 20	(430,913)	(899,963)	469,050
Year 25	(252,622)	(993,632)	741,010
Year 30	0	(1,097,050)	1,097,050

Based on £10m principal. Full calculations and assumptions are shown in Appendix 2.

It demonstrates the scale of the movement in lease payments that can arise over a long period of time.

Managing the impact of this on the business is exacerbated by the expense of unwinding the contract if the property is no longer suitable. While this will vary from contract to contract, lessees will almost inevitably be required to pay a cancellation charge. This is likely to represent a significant proportion of the discounted value of the future lease payments – particularly if cancellation occurs early in the contract.

To give some indication of the scale of this on a 30-year inflation linked lease we set out below the calculations as they would apply to a standard inflation linked bond of the same maturity. We have assumed that the early termination fee will be calculated on 50% of the yield on the outstanding lease payments, so a discount rate of 3%.

	Early Termination Fee - 6% 30Y Institutional Lease
Year 1	(11,760,265)
Year 5	(9,530,006)
Year 10	(7,088,599)
Year 15	(4,982,621)
Year 20	(3,165,985)
Year 25	(1,598,940)

This is bad enough. However, the nature of the contract also leaves lessees in a position where they struggle to build a robust capital base to support their future operations. Lease payments are set at a level which enables the owner to recoup the capital cost of the asset by the end of the contract, while also earning an acceptable return. This means the lessee effectively pays for the asset without ever owning it – leaving a balance sheet which is likely to remain asset poor.

If the asset then ceases to be appropriate to its needs, instead of selling it and reinvesting the proceeds in the business, the lessee will generally need to pay a penalty to cancel the contract. This is true even where there is an arrangement to acquire the asset for a nominal amount at the maturity of the contract.

As noted above, the RSH has been particularly focused on the difficulties this creates for thinly capitalised Regulated Providers operating in the specialised supported housing sector. As a result it has reduced the regulatory ratings of all the major clients of Civitas and Triple Point to non-compliant, citing concerns over Governance and Viability and seeking a change in the arrangements on future (and existing) leases.

Civitas – Largest RPs

Provider	**% of Total Units[4]**	**Regulatory Status[5]**
Auckland/Qualitas	20.0%	Non-compliant
Falcon	18.5%	Non-compliant
beST	12.9%	Non-compliant
Inclusion	11.0%	Non-compliant
Trinity	5.3%	Non-compliant

Triple Point – Largest RPs

Provider	**% of Total Units[3]**	**Regulatory Status**
Inclusion	29.1%	Non-compliant
Parasol	8.5%	Non-compliant
Falcon	8.0%	Non-compliant
Hilldale	7.6%	Non-compliant
My Space	7.1%	Non-compliant

Not surprisingly this has triggered a particularly sharp fall in their share price.

[3] Source: https://www.triplepointreit.com/filedownload.php?a=137-631afac7cb5c0
[4] Source: https://www.civitassocialhousing.com/media/2013/csh_hy22_418-web.pdf
[5] See https://www.gov.uk/government/publications/regulatory-judgements-and-regulatory-notices

While the effect on the healthcare REITs has been much less pronounced, the underlying problem remains, with the value of the care homes significantly impacted by their regulatory status and levels of occupancy.

To protect against this, the REITs seem to have reserved certain rights in their contract to reassign the operator if its performance is unsatisfactory.

3. The Need for a New Solution

The attraction of REITs for investors lies in their ability to lock into a predictable long-dated inflation linked revenue stream; while the problem for the care providers/asset operators lies in the requirement to sign up on this for the long-term.

This can be addressed by building in break clauses giving both parties the right to reset the pricing or break the contract without the payment of unacceptable/unaffordable penalties. This gives the operators a degree of certainty on the ability to continue using the asset at an affordable price, while giving the owner a degree of protection against breaking the contract. This appears to be the solution the RSH is suggesting to operators.

Unfortunately break clauses inject a degree of uncertainty into the model for investors and leave them exposed to changes in the value of the assets over time if new operators cannot be found to take over the leases. This may inject an unacceptable degree of uncertainty into the model and adversely impact the returns they will require from leasing the assets.

It also still leaves the operators effectively paying for the capital cost of the asset over time without the benefit of acquiring it. This leaves them asset poor and exposed to the risk of high penalty charges if the asset no longer suits the business.

We believe there may be three alternatives on funding that address these problems.

a. To reach out to ESG investors – and particularly the pension funds through a private equity structure, better suited to the development of the platform over time. This could operate the same lease structure but with 5-year breaks designed to address the inflexibilities referred to above.

   It would have the benefit of bringing those investors directly concerned by social outcomes in their areas of activity, like Local Authority Pension Funds, into direct contact with the development and management of the platform ensuring a sympathetic approach to clients from managers of the fund.

   It would also allow the managers to resolve any problems without the need to address any short term implications for the share price.

b. There is then the alternative of developing a shared ownership structure whereby the lessee can acquire an increasing interest in the asset over time. This should align its interest with that of the lessor as both will be incentivised to ensure the value of the property is maximised through the provision of quality services and periodic updates to ensure it remains suited for purpose.

   It has the advantage of allowing the lessee to use any surplus from operations to build up its asset base over time and use this as collateral to reduce its operational leverage and grow the business over the longer term.

We anticipate this is may also be better suited to a private equity structure above where investors can assess the complexities involved and follow the gains in value it generates.

c. The third alternative is to develop a debt fund to provide secured fixed income funding for maturities of between 7–10 years (or longer if possible). While clearly this would involve the need of borrowers to access top up capital, it would provide then with a greater degree of certainty on the cost and maturity of borrowing within a more supportive framework.

   Again the pension funds are the most probable investors where the structure allows them to benefit from a predictable high quality income and deliver strong social impact, while leaving them removed by one degree from the risk of underperformance on the delivery of care.

We would be interested in hearing from you and engaging on any of the issues raised above, We are in discussions with investors that are looking to fund care assets but feel constrained by the current options available to them.

Appendix 1 – Description of REITs

	Area of Focus	Share Capital Outstanding (£m)[6]
Home Reit PLC	Supported housing – exempt accommodation	791
Civitas Social Housing PLC	Supported housing – exempt accommodation	606
Triple Point Social Housing Re	Supported housing – exempt accommodation	403
Impact Healthcare Reit PLC	Residential care homes	414
Target Healthcare REIT PLC	Residential care homes	620
Total		**2,834**

Appendix 2 – Funding calculations

Financing Assumptions

	Loan	Institutional Lease
Term	30-year amortising loan	30-year
Principal Value	£10m	£10m
Funding Cost	6.25% fixed interest	Total annual rental payments 6% of principal value
Inflation Link	No	CPI-linked with 5% cap and 0% collar
Early repayment	Excess cash paid into sinking fund	Early termination fee 50% of discounted future rental payments, no break clause

Inflation Assumptions

	2025	2026	2027	Long-term
CPI	4.00%	3.00%	2.00%	2.00%

Years 1-5

	2024	2025	2026	2027	2028
Interest Cash Payments - 6.25% 30Y Loan	(625,000)	(626,563)	(626,723)	(625,723)	(623,857)
Rental Cash Payments - 6% 30Y Institutional Lease	(600,000)	(624,000)	(642,720)	(655,574)	(668,686)
Net Saving/Cost	**(25,000)**	**(2,563)**	**15,997**	**29,852**	**44,829**

Assumes 31 March financial year-end.

Years 5-10

	2029	2030	2031	2032	2033
Interest Cash Payments - 6.25% 30Y Loan	(621,055)	(617,243)	(612,339)	(606,259)	(598,912)
Rental Cash Payments - 6% 30Y Institutional Lease	(682,060)	(695,701)	(709,615)	(723,807)	(738,283)
Net Saving/Cost	**61,004**	**78,458**	**97,276**	**117,548**	**139,371**

[6] Source: Bloomberg.

Years 10-15

	2034	2035	2036	2037	2038
Interest Cash Payments - 6.25% 30Y Loan	(590,202)	(580,024)	(568,268)	(554,818)	(539,548)
Rental Cash Payments - 6% 30Y Institutional Lease	(753,049)	(768,110)	(783,472)	(799,142)	(815,124)
Net Saving/Cost	**162,847**	**188,086**	**215,204**	**244,323**	**275,576**

Years 15-20

	2039	2040	2041	2042	2043
Interest Cash Payments - 6.25% 30Y Loan	(522,324)	(503,006)	(481,440)	(457,466)	(430,913)
Rental Cash Payments - 6% 30Y Institutional Lease	(831,427)	(848,055)	(865,016)	(882,317)	(899,963)
Net Saving/Cost	**309,102**	**345,050**	**383,577**	**424,850**	**469,050**

Years 20-25

	2044	2045	2046	2047	2048
Interest Cash Payments - 6.25% 30Y Loan	(401,598)	(369,325)	(333,887)	(295,065)	(252,622)
Rental Cash Payments - 6% 30Y Institutional Lease	(917,962)	(936,322)	(955,048)	(974,149)	(993,632)
Net Saving/Cost	**516,365**	**566,997**	**621,161**	**679,084**	**741,010**

Years 25-30

	2049	2050	2051	2052	2053
Interest Cash Payments - 6.25% 30Y Loan	(206,309)	(155,859)	(100,990)	(41,398)	0
Rental Cash Payments - 6% 30Y Institutional Lease	(1,013,505)	(1,033,775)	(1,054,450)	(1,075,539)	(1,097,050)
Net Saving/Cost	**807,196**	**877,915**	**953,461**	**1,034,141**	**1,097,050**

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