CBRE

PRIMARY CARE

WHAT DRIVES VALUE AND WHY?

Andrew Surgenor BSc Hons MRICS

Senior Director – Healthcare

19 November 2015

AGENDA

- Investor's View
- Banker's View
- Why the need for new development?
- What is being done about it?
- Valuation Drivers
- Yields
- Impact of Change
- Summary

INVESTOR'S VIEW

Rent Reviews

- OMRV
  - Can take years to resolve with DV
  - Landlord and GP additional cost and risk (2013 Directions)

- RPI or Fixed uplift
  - Instant resolution
  - More likelihood of uplift
  - Cap and Collar

- Upward and Downwards
  - Instant de-institutionalisation
  - Sector specialist accept with landlord only trigger

INVESTOR'S VIEW

Term of Years

- Quoted sector WAULT is important to shareholders
  - Assura (14.2), Medicx (15.6), PHP (15.1)
- Banking dependant
  - Minimum WAULT on redemption date
- Valuation dependant
  - Deferral of residual values

Other

- Repairs
  - FRI – Institutional Standard
  - TIR – Sector acceptable, within reason
- User
  - Tight definition for reimbursement
- Alienation
  - NHS Bodies (RLA no longer applies)
- Break Clauses
  - Armageddon Aviva standard

BANKER'S VIEW

- Investor Lending
- Owner occupied lending
- Surgery development
- Banks lend to serviceability, not security

BANKER'S VIEW - INVESTMENTS

Rental Income

Net rent rather than gross is key for debt serviceability.

- Net rental income (after costs) used.
- Loan repayments are stressed at interest margin plus base rate at 4%.
- Net rental cover / loan repayments typically required to be 110% minimum at stressed rate.
- Debt serviceability usually determines LTV.

Term

- Max term of loan (in years) is influenced by length of the unexpired lease term (in years).
- Break clauses may reduce term and / or amount that can be lent

Also need to understand:

- Respective responsibilities of landlord and tenant e.g. FRI?
- Rights of assignment of the lease.
- Financial strength of tenant.
- Future capital expenditure.
- Voids / letting history.

BANKER'S VIEW – OWNER OCCUPIED

- Availability up to 100% of value and 25 years
- If not 75% or more of GMS/PMS then scales down to property investment
- National rent + other rents to be > 100% of repayments
- KIV stress test of rising interest rates
- Quality / longevity of premises

BANKER'S VIEW - DEVELOPMENT

- 100% funding potentially for owner occupied
- KIV potential positive impact of Capital Allowances
- Consider end game / exit
- Professional support team?

MEDICAL CENTRE STOCK

- c. 8,300 Surgeries
- 60% + GP owned
- 60%+ termed substandard by NHS
- < 50% purpose built, many 20 years old +
- Single GPs account 25% of stock
- Corporate owned c.20%

EXAMPLES OF THE 60%

Converted

Listed

Older Purpose Built

OBSOLESCENCE ISSUES

- Small consulting rooms
- Inefficient heat and light
- DDA compliance
- Increased repairs and running costs
- Not viable to upgrade or extend
- Impact on patients and staff
- Risk that rent reimbursement flat lines
- Inability to expand services
- Impact on attracting new partners, staff and patient retention

ENERGY ACT

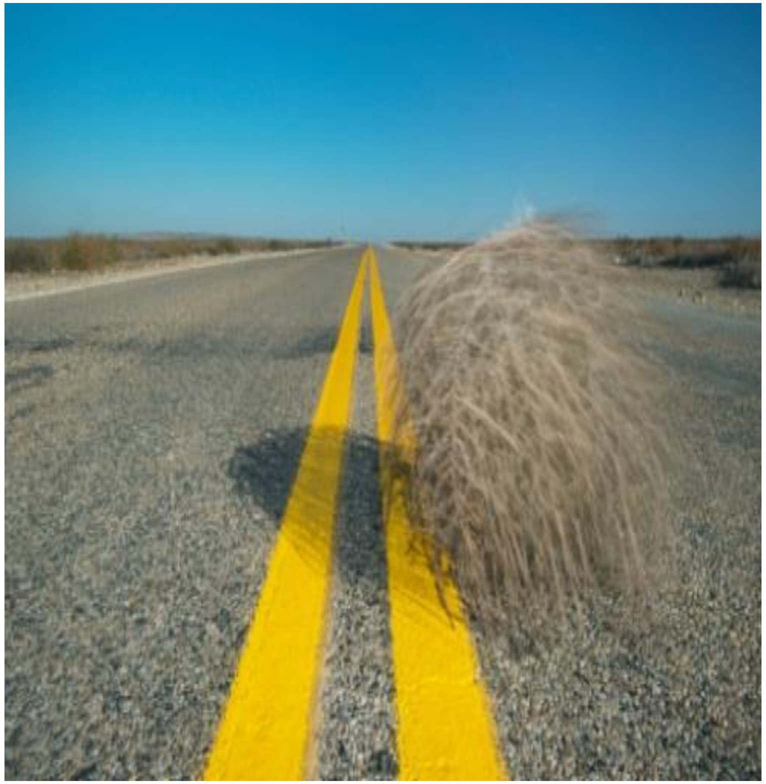
- April 2018 is fast approaching
- E and below will become unlettable
- 67% of commercial property is rated D – G
- 20% are F – G already

CQC

Care Quality Commission

- Early days but will inspection process will gain momentum
- In elderly care, it accelerated closures
- Enforcement powers, including closure
- Political pressure to improve standards
- Potential risk to reimbursement and contracts
- Multi tier market with widening gaps

WHAT THE NHS APPEARS TO BE DOING?



WHAT IS THE NHS REALLY DOING?

- Slow Progress
- Five Year Forward View with £1bn to invest over 5 years
- Only 0.2% of NHS Budget
- How much will actually get spent, on what and when?
- Needs more cash invested quickly
- 5,000 surgeries = £25bn - £30bn
- **Must** involve the Private Sector
- Collaboration with common goals and commercially minded process

HOW FAR DOES £1BN GO?

Medical Centre - Capital Cost		
Assumed size	2,000	m2
Cost to build	2,200	per m2
Build cost	£4,400,000	
Land	£1,000,000	
Total Cost	**£5,400,000**	
NHS Funds	£1,000,000,000	
Units Developable	185	

- 5,000 surgeries will need replacing
- Build cost c. £2,200/m^2
- Construction cost and land prices rising fast

WHO IS INVESTING AND WHY?

- Specialist investors eg Assura, PHP, Octopus MedicX and MCD
- Institutions attracted by Government backed long term rents
- Strong debt availability and bonds
- Needs driven – not speculative
- Minimal risk of tenants defaulting
- 20 year+ leases with no breaks
- Downsides over rent review process, alienation and TIR terms

MARKET PRICING

- Limited volume of transactions
- Strong demand but low supply
- Lack of development pipeline
- Yield compression below 2007 peak
- RPI attracts best pricing
- Narrowing gap on unexpired terms of 12 years +

MARKET PRICING

Selection of deals over last 12 months

➢ London	5.6%	14 years
➢ London	4.95%	10 years
➢ Yorkshire	4.8%	23 years
➢ London	5.4%	1 years
➢ Portfolio (21)	7.5%	7 years
➢ Scotland	<5%	25 year RPI

MARKET PRICING

- Wide variance on yields
- Prime 4.75% - 5.25%
- RPI and London 0.25% stronger
- Modern stock 5.25% - 6.0%
- First generation 6.0% - 6.75%
- Converted/Old 7.5%+
- Discount for <10 years unexpired

PRIVATE SECTOR LEVERAGE

Medical Centre - Pump Prime	
Assumed size	2,000 m2
NIA	1,800 m2
Rental uplift - old to new	£80 per m2
Extra annual cost to NHS	£144,000 pa
Total Rent over 21 years	**£3,024,000**
NHS Funds	£1,000,000,000
Units Developable	330 +80%

THE OBSTACLES

- Slow decision making
- Insufficient rent funding commitments
- Apparent lack of commercial pragmatism
- New buildings cost money and attract higher rents
- Investors need to make a return and be able to service debt costs

COST AND RETURN

Medical Centre - Investment Value	
NIA	1,800 m2
Rent per m2	200 per m2
Rent (net of LL costs)	£342,000 pa
Cap rate	5.25 %
Net Value after costs	**£6,100,000**
Return on capital invested	11.5 %

POSITIVES ALTERING THE DRIVERS

Medical Centre - Investment Value with RPI		
Value Target	£6,100,000	
Cap rate	5.00	%
Rent (net of LL costs)	£322,000	pa
Rent per m2	188	per m2
Saving to NHS over 21 years	**£342,000**	

Medical Centre - Investment Value with RPI 30 years		
Value Target	£6,100,000	
Cap rate	4.50	%
Rent (net of LL costs)	£305,000	pa
Rent per m2	169	per m2
Saving to NHS over first 21 years	**£777,000**	

NEGATIVES ALTERING THE DRIVERS

Medical Centre - Investment Value with 10 year Lease	
Value Target	£6,100,000
Cap rate	6.75 %
Rent (net of LL costs)	£436,000 pa
Rent per m2	255 per m2
Additional Cost to NHS over **10** years	**£940,000**

CONCLUSION

- Obsolescence time bomb
- Public/Private view of the solution disconnect
- Private sector can fund replacement of 5,000 surgeries
- Adjusting lease length and covenant strength makes schemes unviable
- Strong yields cannot continue to plug the gap long term
- Don’t tinker with the commercial fundamentals
- Collaboration is the key

CBRE