

Target Healthcare REIT

Care home specialist

Initiation of coverage

Real estate

Target Healthcare REIT is a specialist investor in modern, purpose built residential care homes, the demand for which is rising, driven by structural demographic changes throughout the UK. The manager selects modern, purpose-built assets suited to their local area and population. The assets are acquired at yields of c 7% and let on long leases (c 30 years) to high quality operators, with regular contact to ensure they are well-run. These long and secure income streams underpin a growing dividend yielding c 6% which, on our estimates, will be 100% covered once the group is fully invested, expected by the end of FY18.

Year end	Total income (£m)	EPRA EPS (p)	EPRA NAV/share (p)	Price/EPRA NAV/share (x)	DPS (p)	Yield (%)
06/15	12.7	5.71	97.9	1.11	6.12	5.6
06/16	16.3	4.56	100.6	1.08	6.18	5.7
06/17e	22.6	4.75	100.7	1.08	6.28	5.8
06/18e	26.6	6.34	102.3	1.07	6.34	5.8

Note: EPRA EPS excludes revaluation gains and movements in the fair value of financial derivatives and debt swap contracts.

Structural support for the investment case

The population over the age of 60 is expected to increase by 58% from 20.1m in 2014 to 31.8m in 2039. As people live longer and need more care, the already high demand for care homes will increase further. Tighter regulation, local authority budget pressures and rising costs have caused many operators to exit the market, although those with well-run modern facilities which can attract self-funded residents and well-motivated staff continue to see occupancy levels over 90%. There is increasing scope for an investor with Target's expertise to continue to provide capital to support this essential service and earn attractive returns.

Careful asset selection ensures income quality

The manager's primary selection criteria concern the care market fundamentals in the vicinity of each home before the tenant's operational and financial strength, although financial criteria include a market yield of 7% typically and for the tenant's EBITDAR to cover rent c 1.6x. This approach seeks to ensure the longevity of the investment case for each home even if the operator exits the market and differentiates Target from other investors in the sector. The manager has operational experience in the sector and takes a close interest in the care quality and operational performance of each home to mitigate risks to the income stream.

Valuation: Secure, long-term income

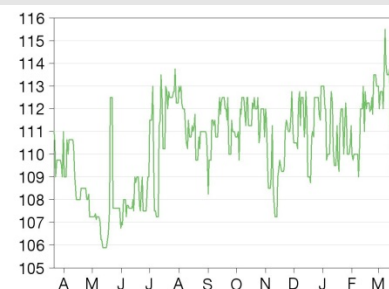
Target pays a dividend yield approaching 6% and currently 72% covered by EPRA earnings, which we see rising to 100% in FY18 once the group is fully invested. Capital values are typically stable relative to other real estate subsectors and the long leases and diversified tenant base provide security of income. Although it has the longest average lease term in the sector, inexpensive debt and a low LTV ratio, Target trades at a lower premium to EPRA NAV than its peers of c 11% vs 18% on average in the wider group. This may fall as dividend cover rises.

20 March 2017

Price 109p
Market cap £275m

Net cash (£m) at 31 December 2016	6.4
Shares in issue	252.2m
Free float	90%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.6)	1.2	(1.5)
Rel (local)	(3.3)	(4.6)	(17.2)
52-week high/low	115.5p	105.9p	

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

Trading update	August 2017
Full year results	September 2017

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

Investment summary

Target is a specialist investor in UK residential care properties. Since listing in March 2013 it has raised £223m which has been invested in a portfolio of 41 assets across the UK. The portfolio was valued at £253m at 31 December 2016. Target's main focus when assessing assets is on the suitability of each property and the operator's standard of care; the operator's financial strength is a secondary, although important, consideration. The manager seeks to invest in areas with good demographics for the care home business, a shortage of modern, high-quality care homes and the availability of well-motivated and experienced senior staff. Assets are let on very long leases to generate predictable and rising income underpinned by demographic trends supporting demand for residential care. Target only invests in modern, high-quality assets and visits its care homes regularly to check the quality of care. The tenant list leans towards the high-end of the sector, where self-funded residents provide the majority of income and operators tend to be more profitable. Rents underpin a 72%-covered dividend of 6.18p per share (c 5.7% yield) which the board aims to have fully covered when the REIT is fully invested (occurring in FY18 on our estimates). With c £26m of cash at 31 December 2016 and a long-term LTV target of c 20%, vs 8.3% at present, Target has around £60m of funds to deploy without further equity funding.

Valuation: Undemanding vs peers

The current c 11% premium to NAV is less than the average of 18% for other property companies with long leases. Looking at EPRA earnings yield on EPRA NAV, Target appears to be valued below peers, and the same is true on a comparison of dividend yields, possibly because the dividend is not yet fully covered. However, as Target becomes fully invested and dividend cover reaches 100%, which we expect in FY19, the P/EPRA NAV ratio could move closer to the group average. For now, it appears to be a relatively inexpensive and low risk opportunity for investors to access long term, secure streams of income.

Financials: Simple and predictable

Target's leases are subject to upwards-only rent reviews, mostly capped-and-collared RPI-linked, but with some on fixed uplifts. The advisory fee is 0.9% of NAV and other costs are fairly stable, including effectively fixed debt, making the company's earnings relatively predictable apart from a total return-based performance fee. The board has a progressive dividend policy and targets full cover when the company is fully invested. We therefore forecast earnings to rise faster than the dividend, with full cover achieved in FY18. We have not included any investment beyond existing cash and available debt to a level of 20% LTV, leaving potential for upside to our earnings forecast.

Sensitivities: Tenant quality and future investment

With such long leases on index-linked, capped-and-collared or fixed uplifts, low gearing and hedged debt, Target's earnings should follow a broadly stable path. Tenant risk is mitigated by frequent visits to each home, the manager's close relationship with operators, deep understanding of the sector, and operational abilities of the 15 underlying tenants (16 when the latest acquisition closes). Due to the nature of the assets, even if a tenant were to run into difficulty it is likely that each home would be attractive to a competing operator on similar terms. In the near term, yield movements could affect NAV (likely to the upside) although in the long term NAV will be affected more by rental growth than yield fluctuations. We have assumed that Target will be fully invested using existing debt up to 20% LTV and cash by the end of FY18 (30 June 2018). If the manager is able to invest more quickly, we would expect full dividend cover to be achieved sooner and should the board decide to increase funding further using debt or equity, we would also expect higher earnings.

Company description: REIT in an attractive niche

Target is a UK-listed specialist investor in residential care homes. It aims to provide long-term, stable and sustainable income via rising dividends based on secure income streams. These come from a high-quality portfolio of 41 care homes across the UK, let to 15 operators on leases averaging 29.4 years and valued at £253.1m (31 December 2016). The majority of leases are RPI-linked and subject to upwards-only annual reviews, although some have fixed annual uplifts. Prospective tenants' operational ability, care ethos and finances are scrutinised before acquisitions are made and discipline is exercised in acquiring only assets offering attractive yields at sustainable rental levels (7% net initial yield has been the benchmark to date). This has helped Target to build a portfolio generating passing rent of £18.2m at 31 December 2016 at a 6.7% initial yield without sacrificing lease length. The weighted average unexpired lease term has remained over 28 years at all times and in H117 it rose to over 29.

The quality of rental income depends not only on lease length and how rents are reviewed, but on the tenants' performance. This performance stems from the commercial success of the individual homes, which in turn depends on the provision of high-quality care to a local population where demand will be sustained. To that end, Target maintains close relations with all its tenants and while it does not inspect homes in the way that the regulator can (not having access to care plans etc), it is able to check that the fixtures and fittings are being maintained, that the general standard of care is good and that the homes are well-run. When assessing a potential new acquisition the manager's criteria include:

- Areas with strong economies but a lack of high-quality care homes and supportive demographics. Target will invest in less wealthy areas if supply and demand dynamics are favourable.
- The financial performance of the individual home is examined and Target expects an investible home to generate earnings before interest, tax, depreciation, amortisation, rent and management costs (EBITDARM) of c 1.6x rent.
- A waiting list of new residents.
- Staff turnover is not too high.
- Good feedback from existing residents.
- The individual home manager is crucially important.

Target Advisers looks at several hundred homes a year and the healthcare partner, Andrew Brown, has extensive experience in the sector, having developed and run one of the largest retirement communities in Europe with his family (see below for further details). The manager estimates that it invests in less than 10% of the opportunities it is offered, and in many cases the decision not to invest is made for operational rather than financial or property-related reasons. This aspect of Target's investment process differentiates it from other investors in the sector and is central to the long-term security of its income streams.

Target is also financially conservative. The current LTV of 8.3% is one of the lowest in the sector and management targets a level of 20% once fully invested. The company has raised £222.5m of equity in its IPO and subsequent issues and has £50m of debt facilities, of which £21m has been drawn and had cash of £26.7m at 31 December. Allowing for the increase in LTV and dividend payments, the company has c £60m of funds to invest. We explain the company's finances in more detail in the financials section, but would list the low LTV limit among Target's differences from peers with similarly long rental income streams.

Management

Target Healthcare REIT is externally managed by Target Advisers, which was founded in 2010 by Kenneth MacKenzie, who remains the managing partner. Target Advisers also acts as investment manager to Kames Target Healthcare Property Unit Trust which also invested in homes specialising in needs-based care, but whose investment period is now over. The investment management agreement can be terminated by either party on 12 months' notice provided that notice does not expire before 30 September 2019. In case of the manager's breach of contract, negligence, wilful default, fraud or insolvency, or if there is a change of key managers which the Target's board has not approved, the board may terminate the contract immediately.

Mr McKenzie led the acquisition of Independent Living Services in 2005, which was then Scotland's largest provider of domiciliary care. He expanded the business and eventually sold it to a private equity buyer. He had previously been involved in the acquisition of a large UK independent living business by a US care home operator, the experience and contacts from which led him to found the Kames Target Healthcare Property Unit Trust.

Target Advisers' investment partner, John Flannelly, has extensive experience managing real estate investments for an HBOS subsidiary and therefore as a board member of investee companies, including the parent of Caring Homes Group, a large UK elderly care company.

The healthcare partner is Andrew Brown, who grew up in the care home his parents managed in Scotland and subsequently established Auchlochan Trust, a major charitable retirement community with around 350 beds and 100 retirement properties. His experience and understanding of the operation of care homes and communities is essential to the investment process. Mr Brown's team views over 100 homes a year and visits each of Target Healthcare REIT's properties regularly. He is in contact with each home's manager at least once every two months. Brief biographies of the directors of Target Healthcare REIT are on page 12.

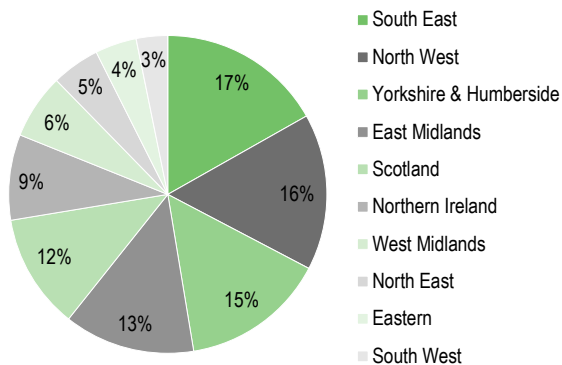
The manager is remunerated through a management fee of 0.9% of Target's net assets, plus a performance fee of 10% of the group's portfolio total return outperformance of the IPD UK Annual Healthcare Property Index¹. Performance fee periods are calendar years and performance fees paid are subject to clawback if cumulative performance is below the index. The maximum amount of fees payable to the investment manager is 1.25% of average net assets over the year.

Portfolio

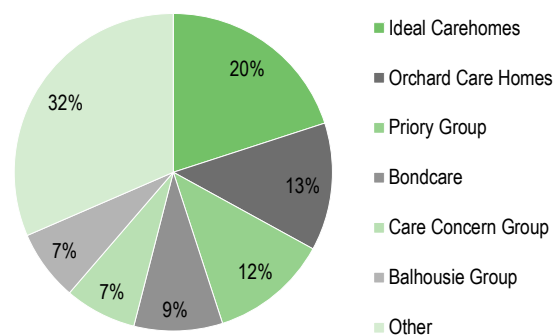
Target's portfolio was originally concentrated in Scotland and northern England, but is now diverse in terms of its tenant base and geographic spread (Exhibits 1 and 2). The charts below do not include the recently announced acquisition of two homes in Dorset let to the Care Concern Group on 35 year leases, but we have adjusted the reported figures for the addition of 70 beds. The value and the rental income of the latest additions to the portfolio have not been made public, but we have made the assumption in our modelling that they are let on similar terms to the portfolio average and do not exceed our total investment assumptions. All leases are fully repairing and insuring and have upwards-only rent reviews, either on fixed increases or RPI-linked. Two leases also have variable rental agreements whereby Target receives the fixed base rate of rent plus a figure which varies according to how well the home performs. The tenants are mostly mid-sized care home operators managing more than five homes and Target does not own all the homes managed by any one operator (although all of Ideal Carehomes' homes are owned by either Target Healthcare REIT or Kames Target Healthcare).

¹ The MSCI UK Annual Healthcare Property Index measures ungeared total returns to directly held standing property investments from one open market valuation to the next.

The 43 care homes have 2,867 rooms (including the latest acquisitions), all with en suite lavatory facilities and the vast majority with wet rooms. Each home also has additional facilities such as a hairdressing salon, cinema, library or spa. The homes almost all less than ten years old with most built in 2010 or later. The high quality and youth of the individual assets underpin the portfolio's longevity and therefore its ability to produce steady income streams for decades without major capital expenditure. All leases are fully repairing and insuring and operators are responsible for the majority of fixtures and fittings. Target's visits to the homes provide an opportunity to ensure that these are in good condition and that fixtures are replaced before they wear out, preserving the fabric of the asset and assessing the quality of care being provided by the tenant. Where structural changes are required (extensions for instance), Target will invest further capital in its portfolio.

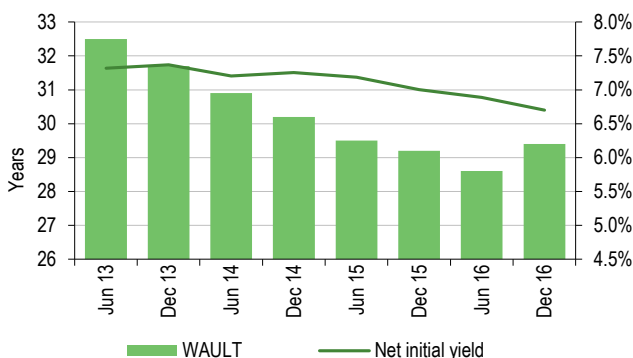
Exhibit 1: Portfolio value analysis by region


Source: Target Healthcare REIT data at 31 December 2016

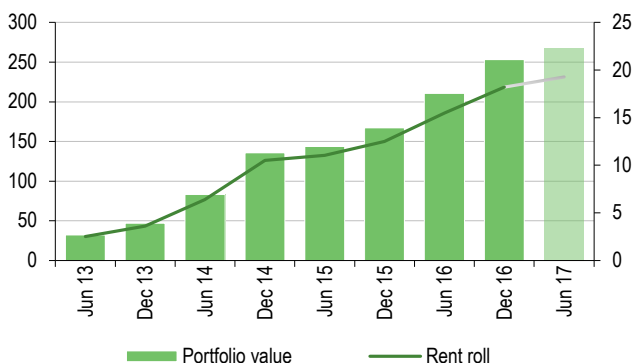
Exhibit 2: Portfolio value analysis by tenant


Source: Target Healthcare REIT data at 30 September 2016

The portfolio had a rent roll of £18.2m at 31 December, a 17.6% increase on June 2016. We expect portfolio value and rent to continue to grow at a similar rate for the next year as the £60m of existing funds are invested. At 31 December Target was committed to acquire a purpose-built care home in Essex for £9.2m including costs and one in Nottinghamshire for £5.6m. Both are modern and purpose-built and are expected to complete when the properties have been fitted out to the company's standards, due to be in March and April respectively. Aside from these, Target has a pipeline of single and multi-asset opportunities across the country.

Exhibit 3: WAULT and EPRA net initial yield


Source: Target Healthcare REIT data

Exhibit 4: Portfolio value and annual rent


Source: Target Healthcare REIT data and Edison estimate for June 2017

As noted above, Target has been able to increase the weighted average unexpired lease term (WAULT) of the portfolio with additions in H117 and it remains high at over 29 years (as of December 2016). The portfolio valuation yield has fallen slightly over time but is still high, at 6.7% and the net initial yield on acquisitions is around the 7% blended initial yield modelled when Target was launched. Although there is competition for assets yielding secure long-term income, we

believe Target's network and expertise mean it is well-placed to continue to invest at similarly attractive yields, maintaining the portfolio's ability to underpin a progressive dividend which we expect to be covered by EPRA earnings when the company is fully invested.

The UK healthcare property market

Healthcare property is a subsector of commercial real estate characterised by long leases, effectively no vacancy, a strong state presence in the occupier mix and growing demand for modern facilities. All of these characteristics reflect the fact that healthcare is an essential social service whose demand is driven by an ageing and increasing population.

The Office for National Statistics (ONS) expects the UK population to increase from 64.6m in 2014 to 74.3m in 2039, a rise of 15%. This will be accompanied by a shift in the national age profile as the large cohort of people born in the 1960s outlives its predecessors and outnumbers younger people: the population over the age of 60 is expected to increase by 58% from 20.1m in 2014 to 31.8m in 2039. The older part of the population tends to have greater healthcare needs and constitutes the majority of those in residential care homes.

Exhibits 5: UK population age projections

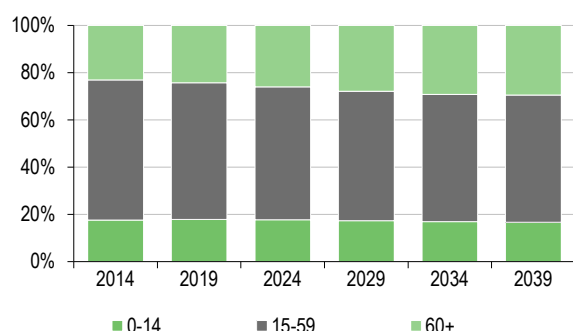
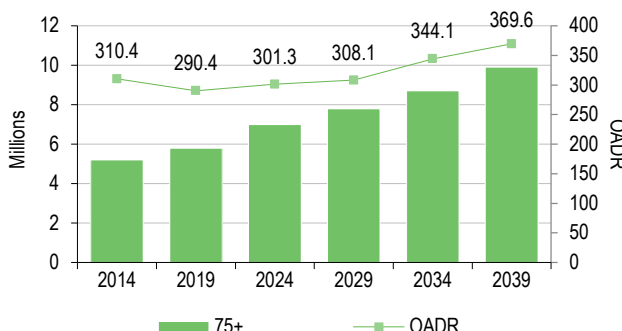


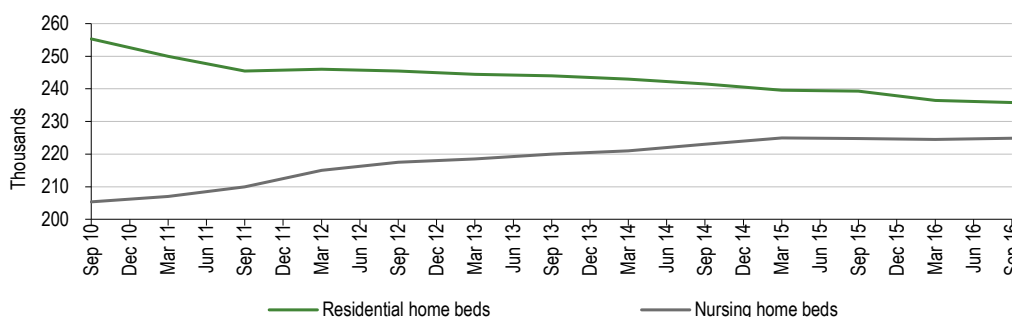
Exhibit 6: UK population age projections and old age dependency ratio (OADR)



Source: ONS, Edison Investment Research. Note: OADR = number of people of pensionable age per 1,000 people of working age.

This demographic trend is common to most developed countries and is already affecting healthcare in the UK at every level, from primary care (GPs) to hospitals and residential care. The government has responded and is planning for future demand by reforming the healthcare sector. How increased need from a larger elderly population translates into an increase in provision of residential care is unclear and will depend on personal and policy decisions: choices between domiciliary and residential care, funding structures, how elderly people with medical conditions are treated and in what setting, be it clinical or domestic.

Exhibit 7: Numbers of nursing and residential home beds



Source: CQC, Edison Investment Research

While these factors remain imponderable, it does seem clear that additional care home places will be in demand over the next several decades, and that a recent decline in residential care beds (c 12% since 2010) has not been completely offset by an increase in nursing home beds, which bodes well for investors in property in the sector.

The decline in bed numbers despite a growing elderly population implies that more people are being cared for in their own homes by family or by professional service providers (the number of domiciliary care companies in England has grown by 47% since 2010) or that some people are not getting enough care. The decline has been due in part to many smaller operators exiting the market, facing pressures on several fronts. In the following section we will examine the current structure of the residential care market and the issues it faces.

Market size and structure

LaingBuisson estimated in a 2015 report that 433,000 older or disabled people were in care homes, which had a capacity of 487,000 (89% occupancy, which is generally considered a healthy level by operators). In England the Care Quality Commission (CQC) currently monitors 14,520 residential homes run by 7,225 operators, whereas residential care was historically dominated by the state. According to a study by the University of Manchester, local authority homes accounted for over 90% of beds as late as the 1980s; now 90% of the available beds are in non-state homes. The fragmentation of the market is considerable, with a very long tail of single-home businesses accounting for three-quarters of operators and over a third of homes.

Exhibit 8: Homes by number of care homes in group

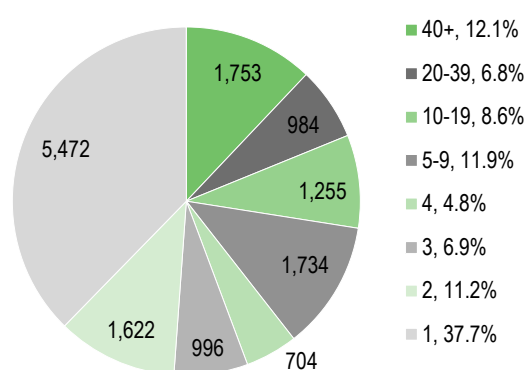
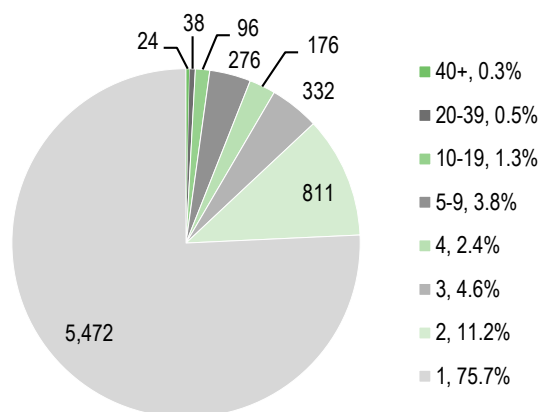


Exhibit 9: Operators by number of care homes run



Source: CQC, Edison Investment Research. Note: Data as at 1 January 2017

The 2015 LaingBuisson report estimated that 37% of residents were directly state-funded and a further 12% received local authority top-ups, while the NHS funded 10%. This market was worth £15.9bn, which largely went to for-profit providers, with significant charitable and state minorities.

The issues facing operators fall into three main areas: costs, fees and regulation. The provision of care is capital intensive, requires a large and well-motivated workforce, is closely monitored by the regulator and the wider public (with severe consequences for poor care) and has a dominant buyer in the form of local authorities. We examine these factors below.

State monopsony

Central government austerity measures have restricted the funding available to local authorities for care provision, who, as purchasers of almost 60% of the market, have considerable pricing power. Although there are large regional variations in costs and fees, local authorities usually pay less per capita than privately-funded residents, meaning that the latter group subsidises the care of the former. Age UK estimates that local authorities pay between £421 and £624 per week and self-

funders pay from £603 to £827. Over half the residents cared for by several of the biggest operators are state-funded (Barchester being the exception, which targets the high-end private market).

Exhibit 10: 2015 UK residential care recipients by funding (thousands)

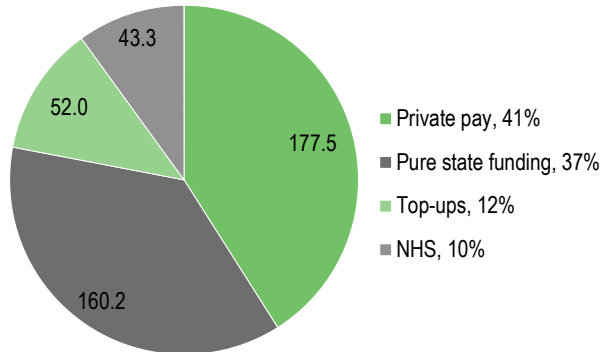
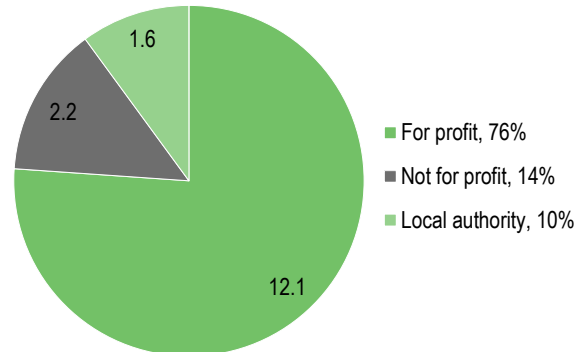


Exhibit 11: 2015 UK residential care recipients by providers by revenue (£bn)



Source: House of Commons briefing paper, The care home market, February 2017, Edison Investment Research

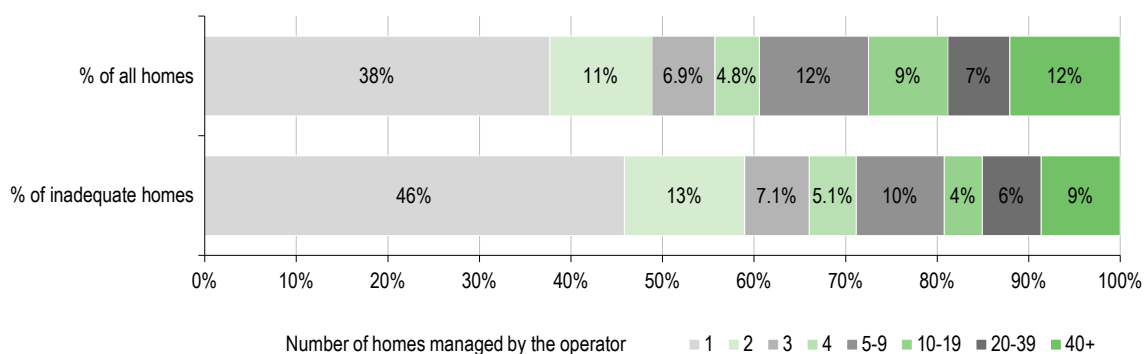
Rising staff costs

The National Living Wage is set to rise from £7.20 an hour to £9.00 by 2020 and increased from the old minimum wage of £6.70 in April 2016. More highly qualified and paid staff understandably demanded similar raises and it is estimated that staff costs have increased by c 10% across the industry since the introduction of the living wage. Staff costs currently comprise c 50-55% of the cost of running a care home, and with wage increases that proportion is likely to rise by 2020, squeezing earnings unless price increases can be implemented. For that reason, investors in the sector prefer wealthier areas with more self-funding residents.

Regulation

The establishment of the CQC has also had an effect on the market. The CQC inspects homes regularly and marks each one in five areas of performance: how safe, effective, caring, responsive and well-led they are. An overall rating of “inadequate” or “requires improvement” discourages people from joining, and homes can be barred from accepting new residents until issues have been dealt with. The new rigour the CQC has brought to regulating the care market is welcomed by operators, but inspections can be time-consuming for home managers and poorly-run homes may suffer losses of business if they score badly. Larger operators have proportionally fewer homes that score badly in CQC inspections. Of the 312 homes that the CQC has rated “inadequate”, 46% were single-home operations, although those operators accounted for only 38% of all care homes. Two-home operators were also relatively overrepresented in the “inadequate” category.

Exhibit 12: Care homes rated inadequate overall, as % of all homes and % of homes by size of group



Source: CQC, Edison Investment Research. Note: Data as of 1 January 2017.

While the smaller operators who account for c 80% of beds have been most affected by rising costs, price pressure and increased regulatory zeal, the larger operators have not been immune. Southern Cross, once the largest operator by far, failed in 2011 as a result of its debt and rent burden after the financial crisis. Some existing major operators are troubled; Four Seasons Group is reported to be struggling to keep up debt payments, and Bupa Care Homes is for sale. However Barchester, Care UK and HC-One, the third to fifth largest operators, appear to be performing better. Of these, Barchester targets the high-end market while the others have around 70% local authority-funded residents (above average) and therefore more exposure to government austerity.

Residential care from a real-estate perspective

Although pressures on operators are important, residential care homes present a potential source of sustainable, predictable long-term rental income from financially stable tenants. For this reason there has been considerable interest in the sector. Assets in wealthier and more densely populated parts of the country, especially the south-east, have been popular with institutional and overseas investors because they have high numbers of privately funded residents. The attraction of these assets has been emphasised by low bond yields in recent years, and as a result, yields on high-quality modern care homes with privately funded residents in south-east England have come under pressure. For a specialist investor with close relationships with operators, there are opportunities in the rest of the country as well. Target is currently the one of only two UK-listed specialist investors in the sub-sector but other landlords include operators themselves, pension funds, foreign investors including sovereign wealth funds and, notably, private equity companies. The latter have been criticised in the past for buying operators that owned their own homes, selling and leasing back the properties and over-gearing balance sheets. Private equity remains a presence in the market as an owner of operators (Four Seasons is owned by Terra Firma) and as a landlord.

Financials

As noted earlier, Target's finances are relatively simple. The only slightly unusual part of its reporting is the rent-smoothing effect that arises from an IFRS requirement: where rent increases over the life of a lease are known, the company is required to report the average rental income over the life of the lease as revenue each year. In the first half of the lease this means that a figure higher than the actual rent received is reported. An adjustment for this is made when calculating EPRA earnings. The additional reported rent is accrued as a liability and netted off the valuation gains on the investment portfolio. In the second half of the life of each lease, actual rental income is higher than reported income and the accrued liability unwinds. This treatment means that the portfolio value is neither inflated nor deflated, and EPRA earnings represent an accurate picture of the company's rental profits.

Income statement

Target reports rental income (as described above), the gain from rent review adjustments and gains on portfolio value as income, and provides EPRA earnings figures too. We assume that the revaluation gains of 2% of the opening portfolio value are made each year, roughly in line with inflation and implicitly allowing for rent increases in line with inflation to increase the portfolio value proportionately without any valuation yield changes. Without exact details of all the leases, we cannot forecast the rent smoothing effect exactly, and assume that movements in the year due to fixed increases are the same each year (which we believe to be conservative, because they should diminish each year unless new fixed-increase rents are added). We net this figure (£2.7m in H117, and the same each half year in our forecasts) off the revaluation gains. We assume that rents represent a constant yield on portfolio value, which has been 7.16% over the last two halves. Rents therefore increase in line with portfolio growth as new assets are added and as revaluation gains

are made. We assume costs continue at c 7% of rental income, plus a management fee of 0.9% of average forecast net assets each year. We have also allowed £0.8m per annum for a performance fee. The company's interest rates on current borrowings of £21m are fixed to September 2021 with two swaps: one paying 0.85% and receiving three-month Libor until June 2019 and the second paying 0.70% and receiving the same. Non-utilisation fees are 1% per annum and we have assumed that any further drawings are 75% hedged on the same terms as existing debt.

On these assumptions, we forecast EPRA earnings per share rising significantly, from 4.6p in FY16 to 4.8p in the current year and 6.3p and 6.6p in FY18 and FY19 respectively as Target becomes fully invested and LTV increases towards 20%. This will cause dividend cover to rise to 100% in FY18 and 104% in FY19.

Balance sheet

Target was in a net cash position on 31 December and borrowings have already been described. The £50m loan incurs interest at 1.5% over three-month Libor (currently fixed with swaps). We have assumed that in the next three halves Target can secure additional debt and draws £39m, buying £60m of assets, including the £14.8m already committed to. This will take the company to 20% gross LTV by the end of H118 on our estimates. The aforementioned rent smoothing adjustments will affect revaluation gains, meaning that on our assumptions, which include no yield compression and, we believe, conservative ERV increases, these will be relatively small. With the dividend not being fully covered by earnings, we therefore forecast slower increases in EPRA NAV per share during the forecast period from 100.6p in June 2016 to 100.7p in June 2017 with acceleration thereafter once the dividend is covered to 102.3p in June 2018 and 105.2p in June 2019.

Valuation

We have compared Target to other UK-listed investors in healthcare property and Tritax Big Box REIT, which shares the long lease profile and high occupancy rate of those companies. All the comparators have mainly index-linked rent reviews with some fixed uplifts. We have not included LXI REIT yet, because it only listed on 27 February 2017, but will do in future.

The table below shows statistics relating to each company's ability to generate income in the long term (rental yields, costs of debt and lease length) and how it currently distributes that income (dividend yield on NAV and dividend cover). Despite having the longest WAULT, biggest spread between the cost of debt and portfolio yield and comparing well on other metrics, Target is at the bottom of the group in terms of its premium to NAV. This may be a result of the level of dividend cover, but we would argue that a rating closer in line with the peers would be justified.

Exhibit 13: Comparative data

	Market cap (£m)	Price/EPRA NAV (x)	Price/EPRA EPS (x)	Div. yield on NAV (%)	EPRA EPS yield on NAV (%)	Dividend cover (%)	Cost of debt (%)	Portfolio NIY (%)	Spread (%)	WAULT (years)	LTV (%)
Target	275	1.07	24.1	6.2%	4.4%	72%	2.35%	6.70%	4.35%	29.4	8.3%
Assura	960	1.22	24.0	5.1%	5.1%	100%	4.28%	5.40%	1.12%	13.5	34.0%
MedicX	365	1.21	23.4	8.1%	5.2%	64%	4.45%	5.25%	0.80%	15.5	50.8%
PHP	657	1.20	22.7	5.6%	5.6%	100%	4.65%	5.17%	0.52%	13.7	53.7%
Secure Income REIT	791	1.05	30.0	1.8%	3.5%	180%	5.10%	5.40%	0.30%	23.0	56.0%
Tritax Big Box	1,609	1.08	23.6	4.7%	4.5%	81%	2.85%	4.80%	1.95%	16.3	32.2%
Average	876	1.15	24.8	5.9%	4.8%	86.1%	4.27%	5.20%	0.94%	16.4	45.3%
Correlation (ex Target)		1.00	-0.96	0.68	0.96	-0.60	0.10	0.20	-0.06	-0.90	-0.12

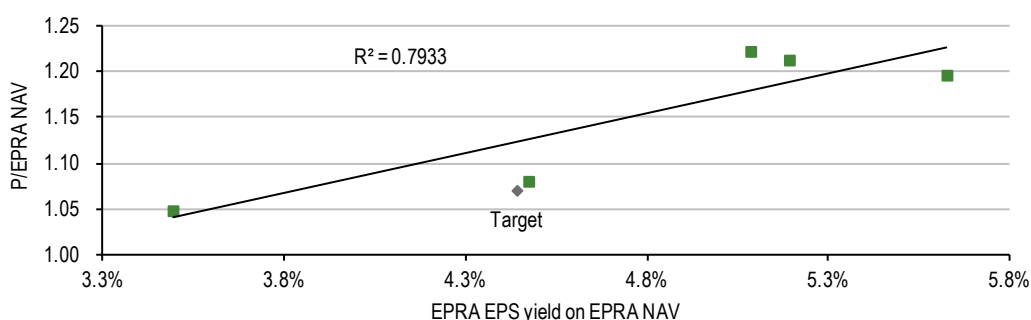
Source: Target Healthcare REIT data, Edison Investment Research. Note: Prices as at 16 March 2017, NAV and other data as at last report date.

The table also shows the correlation between P/EPRA NAV and each factor. The closest positive relationship is with EPRA EPS yield on NAV, which is equivalent to the companies' free cash flow

yield and indicates their ability to pay a dividend covered by EPRA earnings. Among property companies investing in more mainstream office, industrial and retail properties, the strongest correlation is with the spread between portfolio yields and the cost of debt. Most UK REITs currently trade at a discount to EPRA NAV. This implies that the market is confident in the ability of long-lease specialists to generate earnings, values their lease lengths (hence the premiums to NAV) and compares them with each other on an earnings basis.

This is illustrated in Exhibit 14, which shows EPRA earnings yield on EPRA NAV against the share price premium to EPRA NAV per share for the peer group. The companies generating a higher earnings yield trade at higher premiums. We would argue that Target's security of income would justify a rating closer in line with the peer group.

Exhibit 14: Peer group P/EPRA NAV ratios vs EPRA earnings yields



Source: Bloomberg, Edison Investment Research

Sensitivities

Target's ability to pay its growing dividend depends on the security of its long-term leases. The possibility of a tenant failing to pay is mitigated by the rigour of the investment process and Target's ongoing oversight of all its homes and operators, and the diversity of the tenant base reduces risk. Were any operator or home to fail, the focus on investing in homes situated in areas with supporting demography should make the home attractive to another operator. Dividend cover should rise as more funds are deployed and we forecast full cover in FY18. If the company can invest faster, this is likely to be achieved sooner.

Target's funding position is conservative and we expect the company will not have difficulty securing further debt. We have not forecast any equity capital increases, but in order to keep LTV under 20% and continue to grow the portfolio, these will be necessary in future. At the current share price a capital increase would be NAV accretive, but this would depend on the market at the time, with a rising interest rate environment potentially crimping the premium to NAV.

In the long term, the UK's ageing population will need more care. This is likely to necessitate more residential care beds, which have been declining in number in recent years as smaller operators exit the market and older facilities cease to meet the required standards. This should lead to increased demand for modern, purpose-built homes of the sort Target invests in. While competition for these may increase, there are likely to be more opportunities for an experienced and well-regarded landlord and investor such as Target, and we expect the sensitivity to be to the upside as the market grows. If interest rates were to rise, there might be less institutional competition for assets as non-specialists looked to other asset classes for secure long-term income.

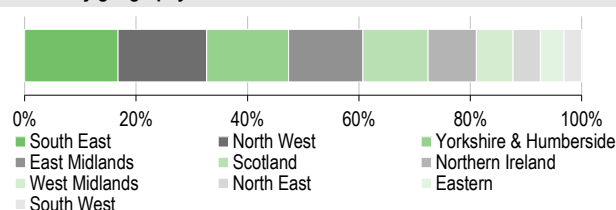
Exhibit 15: Financial summary

Year end 30 June							
INCOME STATEMENT							
£000s	2013	2014	2015	2016	2017e	2018e	2019e
Rent revenue	2,291	3,817	9,898	12,677	18,054	22,456	23,267
Movement in lease incentive or rent review	860	1,547	3,760	4,136	5,143	5,446	5,446
Rental income	3,151	5,364	13,658	16,813	23,197	27,902	28,713
Other income	0	0	66	61	195	0	0
Total revenue	3,151	5,364	13,724	16,874	23,392	27,902	28,713
Gains/(losses) on revaluation	(3,225)	(2,233)	(839)	425	2,181	(134)	989
Cost of corporate acquisitions	0	0	(174)	(998)	(3,006)	(1,212)	0
Total income	(74)	3,131	12,711	16,301	22,566	26,556	29,701
Management fee	(808)	(648)	(1,524)	(2,654)	(3,447)	(3,093)	(3,122)
Other expenses	0	(780)	(880)	(992)	(1,434)	(1,925)	(1,981)
Total expenditure	(808)	(1,428)	(2,404)	(3,646)	(4,881)	(5,018)	(5,103)
Profit before finance and tax	(882)	1,703	10,307	12,655	17,685	21,538	24,598
Net finance cost	93	190	(716)	(929)	(1,075)	(1,461)	(1,460)
Profit before taxation	(789)	1,893	9,591	11,726	16,610	20,076	23,138
Tax	(14)	(4)	(39)	(24)	(533)	0	0
Profit for the year	(803)	1,889	9,552	11,702	16,077	20,076	23,138
Movement in valuation of interest rate swap	0	0	0	(316)	223	0	0
Total comprehensive income for the year	(803)	1,889	9,552	11,386	16,300	20,076	23,138
Average number of shares in issue	58,618,032	105,231,661	119,160,560	171,734,587	252,180,851	252,180,851	252,180,851
IFRS earnings	(803)	1,889	9,552	11,386	16,300	20,076	23,138
Adjusted for rent arising from recognising guaranteed rent review uplifts + lease incentives	(860)	(1,547)	(3,760)	(4,136)	(5,143)	(5,446)	(5,446)
Adjusted for valuation changes	3,225	2,233	839	(425)	(2,181)	134	(989)
Adjusted for corporate acquisitions	0	0	174	998	3,006	1,212	0
EPRA earnings	1,562	2,575	6,805	7,823	11,983	15,977	16,703
Adjusted for performance fee	0	150	466	871	745	800	800
Group adjusted EPRA earnings	1,562	2,725	7,271	8,694	12,728	16,777	17,503
IFRS EPS (p)	(1.37)	1.80	8.02	6.63	6.46	7.96	9.18
EPRA EPS (p)	2.66	2.45	5.71	4.56	4.75	6.34	6.62
Adjusted EPS (p)	2.66	2.59	6.10	5.06	5.05	6.65	6.94
Dividend per share (declared)	0.00	6.12	6.12	6.18	6.28	6.34	6.34
BALANCE SHEET							
Investment properties	46,004	81,422	138,164	200,720	280,240	300,905	301,894
Trade and other receivables	0	0	2,530	3,742	3,763	3,763	3,763
Non-current assets	46,004	81,422	140,694	204,462	284,003	304,668	305,657
Trade and other receivables	1,300	6,524	6,457	13,222	16,474	16,474	16,474
Cash and equivalents	45,354	17,125	29,159	65,107	11,941	401	6,562
Current assets	46,654	23,649	35,616	78,329	28,415	16,875	23,036
Total assets	92,658	105,071	176,310	282,791	312,418	321,544	328,694
Bank loan	0	(11,764)	(30,865)	(20,449)	(48,256)	(53,256)	(53,256)
Interest rate swap	0	0	0	(316)	(93)	(93)	(93)
Trade and other payables	0	0	(2,530)	(3,742)	(3,763)	(3,763)	(3,763)
Non-current liabilities	0	(11,764)	(33,395)	(24,507)	(52,112)	(57,112)	(57,112)
Trade and other payables	(1,363)	(3,089)	(3,623)	(5,002)	(6,497)	(6,497)	(6,497)
Current Liabilities	(1,363)	(3,089)	(3,623)	(5,002)	(6,497)	(6,497)	(6,497)
Total liabilities	(1,363)	(14,853)	(37,018)	(29,509)	(58,609)	(63,609)	(63,609)
Net assets	91,295	90,218	139,292	253,282	253,809	257,935	265,085
Period end shares	95,221,629	95,221,629	142,298,226	252,180,851	252,180,851	252,180,851	252,180,851
NAV per ordinary share	95.9	94.7	97.9	100.4	100.6	102.3	105.1
EPRA NAV per share	95.9	94.7	97.9	100.6	100.7	102.3	105.2
Earnings yield on EPRA NAV	2.8%	2.6%	5.8%	4.5%	4.7%	6.2%	6.3%
Dividend yield on EPRA NAV	0.0%	6.5%	6.3%	6.1%	6.2%	6.2%	6.0%
CASH FLOW							
Profit before tax	(789)	1,893	9,591	11,726	16,610	20,076	23,138
Adjusted for							
Interest receivable	(93)	(201)	(99)	(173)	(138)	(80)	(80)
Interest payable	0	11	815	1,102	1,213	1,541	1,540
Revaluation gains on property portfolio	2,365	686	(2,921)	(4,787)	(6,201)	(666)	(989)
(Increase)/decrease in trade and other receivables	(440)	(558)	(308)	(233)	(931)	0	0
Increase/(decrease) in trade and other payables	1,300	1,341	1,003	1,271	19	0	0
Total working capital adjustments	3,132	1,279	(1,510)	(2,820)	(6,037)	796	471
Interest paid	0	0	(613)	(854)	(1,002)	(1,541)	(1,540)
Interest received	93	161	99	173	138	80	80
Tax paid	0	0	(47)	(164)	(25)	0	0
Total other adjustments	93	161	(561)	(845)	(889)	(1,461)	(1,460)
Net cash flow from operating activities	2,436	3,333	7,520	8,061	9,684	19,411	22,149
Purchase of investment properties	(49,229)	(51,894)	(51,736)	(34,833)	(50,149)	(20,000)	0
Acquisition of subsidiaries	0	0	(5,845)	(27,091)	(27,932)	(1,212)	0
Net cash flow from investing activities	(49,229)	(51,894)	(57,581)	(61,924)	(78,081)	(21,212)	0
Issue of ordinary share capital	95,740	45,450	47,802	100,279	0	0	0
Expenses of issue	(1,882)	(930)	(1,158)	(2,778)	0	0	0
Sale of shares from treasury	0	0	0	14,799	0	0	0
(Repayment)/drawdown of bank loan	0	11,946	19,225	(10,638)	28,000	5,000	0
(Grant)/repayment of development loan	0	(3,300)	3,300	(2,170)	0	0	0
Dividends paid	(1,711)	(4,364)	(7,074)	(9,681)	(15,514)	(15,950)	(15,988)
Net cash flow from financing activities	92,147	48,802	62,095	89,811	12,486	(10,950)	(15,988)
Net change in cash and equivalents	45,354	241	12,034	35,948	(55,912)	(12,752)	6,161
Opening cash and equivalents	0	16,884	17,125	29,159	65,107	9,195	(3,557)
Closing cash and equivalents	45,354	17,125	29,159	65,107	9,195	(3,557)	2,604
Net debt	0	(17,125)	(17,395)	(44,658)	36,315	52,855	46,694

Source: Company data, Edison Investment Research

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Revenue by geography

Management team
Non-Executive Chairman: Malcolm Naish

Mr Naish is a chartered surveyor with over 40 years' experience. He was head of real estate at Scottish Widows Investment Partnership (SWIP) with responsibility for a portfolio of commercial property assets spanning the UK, Continental Europe and North America, and SWIP's real estate investment management business. Prior to joining SWIP he was director and head of DTZ Investment Management. He was a founding partner of Jones Lang Wootton Fund Management, and UK managing director of LaSalle Investment Management. In 2002, he co-founded Fountain Capital Partners, a pan-European real estate investment manager and adviser. He was also chair of the Scottish Property Federation for 2010/11.

Investment Partner, Target Advisers: John Flannelly

Mr Flannelly is a chartered accountant and formerly head of Uberior Ventures, an HBOS investment vehicle. He was involved in several acquisition and development opportunities within the elderly healthcare sector while on the board of Myriad Healthcare, the parent of the Caring Homes Group, a UK top-10 ranked elderly care provider. John was also part of the team responsible for HBOS's investment in another large UK operating care home business. He subsequently represented HBOS's interest on the board of a business set up to develop new care homes for lease to care home operators. He began his career at Arthur Andersen working in audit and due diligence before moving to Bank of Scotland.

Managing Partner, Target Advisers: Kenneth MacKenzie

Mr MacKenzie founded Target Advisers having led the acquisition of Independent Living Services. He had previously worked on the acquisition of another healthcare business by Senior Sunrise Living, a US care home operator. Before becoming involved in the healthcare sector, he owned businesses in the publishing, IT, shipping and accountancy sectors.

Healthcare Partner, Target Advisers: Andrew Brown

Mr Brown grew up in the care business and with his family developed one of the largest continuing care retirement communities in the UK, Auchlochan Trust. He has played the role of developer, builder and operator of care homes resulting in a community of c 350 care beds, c 100 retirement properties and a staff of over 300. These facilities included both residential care homes and nursing homes and Andrew was directly responsible for operations. Auchlochan was also an investor in Trinity Care plc.

Finance Director: Gordon Bland

Mr Bland is a chartered accountant. He started his career at PricewaterhouseCoopers in audit and assurance. His 10 years there included two in Toronto and work for clients including SWIP, Scottish Widows, Gartmore, Schroders, Lloyds Bank and Baillie Gifford.

Portfolio Partner, Target Advisers: Donald Campbell

Mr Campbell is a Chartered Accountant with 28 years' experience. As a partner at Deloitte for 16 years he specialised in tax advisory work: clients included care home operators, property investors and fund managers. At Target he reviews monthly financial performance data provided by the operators to ensure compliance with the lease terms and reports financial information and KPIs to the board quarterly.

Principal shareholders

	(%)
Investec Wealth & Investment	9.3
CCLA Investment Management	4.2
Blackrock	3.7
Two Sigma Holdings VC Acquisition Vehicle II	2.8
Rathbone Brothers	2.7
Alder Investment Management	2.5
Premier Fund Managers	2.0
Henderson Global Investors	1.8

Companies named in this report: Assura, MedicX, Primary Health Properties, Secure Income REIT

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