Target Healthcare REIT

Funded for growth opportunities

Update on portfolio growth

Real estate

Target has recently raised an additional £94m in new equity and has extended its debt facilities by £40m, providing the capital resources to pursue an immediate investment pipeline of more than £100m. The strength of the pipeline and flexible debt facilities limit the drag from cash, while the expanded portfolio offers further diversification and scale economies to counter increasing asset prices. The shares have slightly de-rated during the process and offer an attractive 5.8% yield and growing dividend, which we expect to be fully covered on a fully invested basis.

Year end	Revenue (£m)	EPRA net earnings* (£m)	EPRA EPS* (p)	EPRA NAV/ share (p)	DPS (p)	Price/EPRA NAV/share (x)	Yield (%)
06/16	16.9	8.1	4.7	100.6	6.18	1.10	5.6
06/17	23.6	12.2	4.8	101.9	6.28	1.08	5.7
06/18e	29.1	15.9	5.6	104.2	6.45	1.07	5.8
06/19e	36.3	20.8	6.1	105.8	6.58	1.05	6.0

Note:*EPRA earnings exclude revaluation movements, non-cash income arising from the accounting treatment of lease incentives and guaranteed rent review uplifts, and the costs of acquisitions.

Significant new capital for growth

With £94m of additional equity and borrowing facilities increased to £130m, our revised estimates allow for £140m of new committed investment by the end of FY19, with the majority (c £120m) in the current year. Including existing commitments, we believe this would represent full investment, with borrowing facilities fully drawn and a net LTV of c 25%. The equity raising (at 108p) has no material effect on EPRA NAV per share (104.4p at end-2017) despite acquisition costs. Full dividend cover is delayed, but at an assumed 6.25% average yield on investment we expect 102% cover in FY20, as investments made by the end of FY19 make a full contribution to earnings.

Strong pipeline for swift deployment

In addition to £20m of existing commitments, advanced negotiations are underway for the immediate acquisition of two forward funding assets for an aggregate £19m (including costs) as well as for a £61m (including costs) pipeline of additional assets, including a modern care home and 4 forward funding assets. Negotiations have also begun regarding the potential acquisition of a portfolio of care homes for an estimated £62m (including costs). Clearly, the investment manager continues to identify a range of opportunities that meet its investment criteria and while the acquisitions completed may differ from those identified, the prospects for swift investment of the additional capital appear strong.

The yield has increased with NAV premium reduced

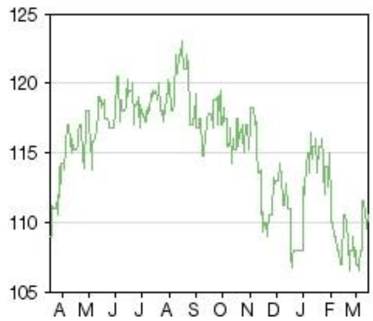
Since last October, when Target flagged the scale of its investment opportunity, in excess of capital resources, the premium to EPRA NAV has drifted lower, with the yield increasing. In part this may reflect more hawkish market interest rate expectations, but leaves the shares with an attractive and growing 5.8% yield and more modest 7% premium to NAV.

16 March 2018

Price	**110.5p**
Market cap	**£375m**

Net debt (£m) as at 31 December 2017	66.1
Gross LTV as at 31 December 2017	24.2%
Shares in issue	339.2m
Free float	90%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	0.9	4.7	0.0
Rel (local)	1.7	9.0	1.5
52-week high/low		122.5p	105.6p

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

Interim results	March 2018

Analysts

Martyn King	+44 (0)20 3077 5745
Andrew Mitchell	+44 (0)20 3681 2500

financials@edisongroup.com

Edison profile page

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

Continuing accretive growth opportunities

Target has for some time made clear that its intention is to grow its portfolio further, with a view to capturing the positive spread between rental income and funding costs as well as operational efficiencies, but also to continue to diversify the portfolio both by the number of assets and tenants. When the company announced its FY17 results in October 2017, it stated that the investment manager was performing due diligence on a range of further acquisition opportunities that it believed would meet its investment criteria and in aggregate had a value in excess of the capital that was available.

It invested c £34m (including costs) during the quarter ended 31 December, including three significant care home acquisitions, but that was only a part of the opportunity that had been identified. That took end-2017 debt to £81m (from its £90m of debt facilities at the time), and effectively represented full or near full deployment, in a total of 18 care home acquisitions, of the £84m proceeds from the equity raise that took place April 2016.

New debt and equity capital raised

The first stage of increasing the capital resources available to Target was to negotiate a new £40m revolving credit facility, with an initial three-year term and an option for two one-year extensions. However, gross gearing, or borrowing as a percentage of gross assets (overwhelmingly represented by the investment portfolio), is limited to 35% at the time of drawdown. In practice, a lower level of c 20% is targeted by the board over the medium term, while exceeding this occasionally to fund the growth of the portfolio also limited cash drag. The second stage of the capital raising process was therefore to increase equity capital resources. At the beginning of February Target announced an initial placing, open offer and offer for subscription at 108p (a premium to the end-December 2017 EPRA NAV per share of 104.4p), subsequently raising gross proceeds of £94m through the issue of 87.0m new shares in the initial issues. Shareholders also gave approval for a one-year placing programme, allowing for further issuance, up to a maximum 150m shares including the initial issues, at the discretion of the company, as and when it identifies suitable acquisition opportunities.

With the prospectus to accompany the share issue, Target stated that it had identified a pipeline of investment opportunities comprising:

- £39m of imminent acquisitions and capital commitments in respect of the existing portfolio. The imminent acquisitions comprised two forward funding assets for which negotiations were at an advanced stage, with an aggregate consideration of up to £19m (including the costs of acquisition). The assets are in Shropshire and Lancashire and Target has entered into non-binding heads of terms, expecting to commit to funding and acquiring both assets by the end of March 2018.
- A £61m (including costs) pipeline of additional assets, also at an advanced stage of negotiation, comprising a modern care home in Birmingham and four additional forward funding opportunities in Powys, Buckinghamshire and two in Oxfordshire.

Target's intention is to optimise the deployment of the £94m net proceeds from the initial issue, and its debt facilities in the acquisition of the imminent and pipeline assets. Depending on the timing of investments, some of the revolving debt may be repaid for a time and should the acquisition of these assets not complete, Target intends to direct its available resources towards the acquisition of further properties that have been identified by the investment manager. This includes a portfolio of care homes with an estimated acquisition value of £62m (including costs).

The investment market is competitive, requiring selectivity

While longer-term funding for adult social care continues to be debated publicly, and the problems facing the wider industry inevitably receive much media attention, what is often overlooked is the ability of well-managed operators, with efficiently run homes, in locations with a good demand-supply balance to effectively and sustainably meet this need.

Investor interest in such homes remains strong and is continuing to drive a tightening in valuation yields, especially for purpose-built homes, in prime locations, focused on self-funded residents. The average net initial yield on Target's portfolio tightened further in the quarter to end-2017, to 6.58% versus 6.69% in September. While this is positive for NAV, the yield tightening also highlights the strong competition for quality assets in the market.

In this environment, selective investment, in homes that are most likely to effectively and profitably meet care needs over many years is essential and we believe that Target remains focused on building just such a portfolio. Target has always put a strong emphasis on the careful selection of operators and growing share of forward funded assets in the investment pipeline gives access to modern, purpose-built homes. Target is not a developer and forward funding agreements allow it to acquire pre-let care homes at completion, meanwhile funding the development cost. So long as the location and operator of the home is carefully selected, the additional risk compared with the acquisition of operational homes should be minimal.

Earnings updated to include capital raise and investment

We have updated our forecasts to include the equity issue, the increase in total debt facilities and a revised assessment of how the increased funds are likely to be deployed. In short, given the scale of potential opportunities to which management refers, we assume the increased resources to be fully invested by the end of FY19. However, the FY19 investment will not fully contribute to earnings in that year, so we have extended our forecast period out to FY20 to illustrate the likely benefit. The FY20 forecast assumes no new investment and is perhaps best seen as an illustration of the potential earnings, dividend paying capacity and dividend cover that the new level of capital resources (equity and debt), fully invested, is capable of generating.

Our revised forecasts assume:

- An increase in the number of shares by 87.0m to 339.2m, with gross proceeds of £94.0m less issue costs that we have assumed to be £1.4m or 1.5%.
- An aggregate commitment to new investment of c £140m (including costs) between December 2017 (H118) and June 2019 (H219). This splits c 50:50 between investment in let standing assets and commitments to forward funding agreements.
- An aggregate cash investment of c £151m between H118 and end-FY20. The investment is spread over a longer timeframe than the commitments because of the forward funding element and the aggregate amount exceeds the total committed because of commitments, made prior to H118, brought forward.
- The aggregate amount of new investment commitment is broadly equivalent to the aggregate value of the Imminent Acquisition Assets, the Pipeline Assets, and the potential portfolio acquisition, although the actual assets acquired, and the amounts committed to, may differ.
- We have assumed a 6.25% yield on all new investment, earned from the point of cash investment. Each asset will differ, but the assumed average, lower than the net initial yield of 6.58% reflected in the December 2017 portfolio valuation recognises the continuing strong investor interest in the asset class and market yield tightening. Income from the forward funding

assets takes the form of coupon payment on the funding provided, and reported as other income, until rental income is reported at completion.

- In our view the investments that we have assumed represent full investment of the capital resources now available, with the £130m of debt facilities fully drawn and a net LTV of 25.7%.

Faster than previously assumed investment increases our revenue forecasts for FY18 and FY19. The negative impact on EPRA EPS in FY18 from the increased number of shares is minimal, aided by Target having a strong pipeline of opportunities to quickly deploy the funds raised, as well as the ability to reduce the revolving debt usage in the near term to manage cash drag. The impact on FY19 is positive as a result of higher revenues and the effect of operational gearing. EPRA NAV is little changed, with the benefit to NAV per share from share issuance at a c 3.4% premium to the December 2017 EPRA NAV per share of 104.4, effectively off-setting share issuance costs and the additional property acquisition costs that we have assumed as a result of increased investment.

Exhibit 1: Forecast revisions

	Revenue (£m)			EPRA EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
June-18e	28.9	29.1	0.8	5.69	5.58	-1.9	104.1	104.2	0.1	6.45	6.45	0.0
June-19e	34.2	36.3	5.9	5.87	6.12	4.3	106.5	105.8	(0.7)	6.58	6.58	0.0
June-20e	N/A	38.6	N/A	N/A	6.86	N/A	N/A	108.4	N/A	N/A	6.71	N/A

Source: Edison Investment Research

Our forecasts indicate that EPRA earnings per share will be 87% of DPS in the current year, a slower increase on the 77% reported in FY17. This increases to 93% in FY19, with full cover og 103% achieved in FY20. The FY20 cover may be regarded as indicating the potential for full dividend cover on a fully invested basis. In reality, this may be deferred if Target continues to identify suitable further investment opportunities and raises additional capital (equity and debt) to fund these.

Strong yield attraction

Within the broad commercial property universe, Target is differentiated by its focus on care home assets, which appear primed to benefit from the ongoing demographic shifts, and the very long nature of leases arrangements in the sub-sector. Target's weighted average unexpired lease term (WAULT) of 28.9 years at 31 December 2017 is one of the longest of all REITs, and combined with upwards-only rent reviews, mostly capped-and-collared RPI-linked, there is considerable visibility to future contracted rental income in real terms.

In Exhibit 2 we show a summary of the valuations and share price performances for a small group of companies that similarly target long leases. The closest comparators are perhaps Assura, MedicX and Primary Health Properties, all investors in modern primary healthcare facilities, primarily used by GPs. The average WAULT is a little lower at c 15 years, but the tenant covenant is strengthened by having NHS backing, directly or indirectly. In broad terms, the group shown in Exhibit 2 has outperformed the FTSE All Share Index over the past 12 months, and also offer a higher yield, supporting valuations above NAV.

Exhibit 2: Valuation comparison with other long lease property investors.

	Price (p)	Market cap (£m)	P/NAV* (x)	Yield** (%)	Share price performance			
					1 month	3 months	12 months	From 12M high
Assura	58	1,387	1.10	4.5%	0%	-1%	3%	-10%
Medicx	83	356	1.06	7.3%	-1%	1%	-6%	-11%
Primary Health Properties	117	729	1.17	4.6%	2%	3%	6%	-5%
Secure Income REIT	371	855	1.00	3.8%	4%	3%	7%	-3%
Tritax	148			4.5%	4%	2%	3%	-3%
Average		**647**	**1.08**	**5.2%**	**2%**	**2%**	**3%**	**-6%**
Target Healthcare	112	378	1.07	5.8%	3%	-2%	-2%	-10%
FTSE All-Share Index					1%	-3%	0%	-7%

Source: Bloomberg data as at 12 March 2018. Edison forecasts for MedicX, Primary Health Properties, Target. *Last published NAV. **Yield based on expected current year dividend.

Target's share price is c 10% off its 12-month high (of 123p in August 2017) and its P/NAV is down from a peak of c 1.20x. We suspect that increased expectations for interest increases and the recent equity issue are the main contributing factors. Its prospective yield is well above the average for the group, and second only to MedicX, and its P/NAV is very slightly below the average. As noted above, our forecasts include further dividend growth and the potential for full dividend cover in the year to June 2020.

Exhibit 3: Financial summary

Year to 30 June (£000s)	2014	2015	2016	2017	2018e	2019e	2020e
INCOME STATEMENT							
Rent revenue	3,817	9,898	12,677	17,760	22,838	28,242	31,602
Movement in lease incentive or rent review	1,547	3,760	4,136	5,127	5,414	5,414	5,414
Rental income	5,364	13,658	16,813	22,887	28,252	33,656	37,016
Other income	0	66	61	671	861	2,604	1,576
Total revenue	5,364	13,724	16,874	23,558	29,113	36,259	38,592
Gains/(losses) on revaluation	(2,233)	(839)	425	2,211	151	1,373	3,341
Cost of corporate acquisitions	0	(174)	(998)	(626)	0	0	0
Total income	3,131	12,711	16,301	25,143	29,265	37,632	41,933
Management fee	(648)	(1,524)	(2,654)	(3,758)	(4,158)	(4,801)	(4,881)
Other expenses	(780)	(880)	(992)	(1,236)	(1,700)	(2,100)	(2,200)
Total expenditure	(1,428)	(2,404)	(3,646)	(4,994)	(5,858)	(6,901)	(7,081)
Profit before finance and tax	1,703	10,307	12,655	20,149	23,407	30,731	34,852
Net finance cost	190	(716)	(929)	(808)	(1,945)	(3,183)	(3,389)
Profit before taxation	1,893	9,591	11,726	19,341	21,462	27,548	31,463
Tax	(4)	(39)	(24)	(219)	0	0	0
Profit for the year	1,889	9,552	11,702	19,122	21,462	27,548	31,463
Average number of shares in issue (m)	105.2	119.2	171.7	252.2	284.8	339.2	339.2
IFRS earnings	1,889	9,552	11,702	19,122	21,462	27,548	31,463
Adjusted for rent arising from recognising guaranteed rent review uplifts + lease incentives	(1,547)	(3,760)	(4,136)	(5,127)	(5,414)	(5,414)	(5,414)
Adjusted for valuation changes	2,233	839	(425)	(2,211)	(151)	(1,373)	(2,782)
Adjusted for corporate acquisitions	0	174	998	420	0	0	0
EPRA earnings	2,575	6,805	8,139	12,204	15,897	20,761	23,267
Adjustment for performance fee	150	466	871	997	960	960	960
Group adjusted EPRA earnings	2,725	7,271	9,010	13,201	16,857	21,721	24,227
IFRS EPS (p)	1.80	8.02	6.81	7.58	7.54	8.12	9.28
EPRA EPS (p)	2.45	5.71	4.74	4.84	5.58	6.12	6.86
Adjusted EPS (p)	2.59	6.10	5.25	5.23	5.92	6.40	7.14
Dividend per share (declared)	6.00	6.12	6.18	6.28	6.45	6.58	6.71
BALANCE SHEET							
Investment properties	81,422	138,164	200,720	266,219	399,057	448,587	465,147
Trade and other receivables	0	2,530	3,742	3,988	5,061	5,816	6,064
Non-current assets	81,422	140,694	204,462	270,207	404,118	454,403	471,211
Trade and other receivables	6,524	6,457	13,222	25,629	24,261	29,675	35,089
Cash and equivalents	17,125	29,159	65,107	10,410	10,723	9,942	1,251
Current assets	23,649	35,616	78,329	36,039	34,984	39,617	36,340
Bank loan	(11,764)	(30,865)	(20,449)	(39,331)	(75,699)	(125,279)	(130,000)
Other non-current liabilities	0	(2,530)	(4,058)	(3,997)	(3,997)	(3,997)	(3,997)
Non-current liabilities	(11,764)	(33,395)	(24,507)	(43,328)	(79,696)	(129,276)	(133,997)
Trade and other payables	(3,089)	(3,623)	(5,002)	(5,981)	(5,981)	(5,981)	(5,981)
Current Liabilities	(3,089)	(3,623)	(5,002)	(5,981)	(5,981)	(5,981)	(5,981)
Net assets	90,218	139,292	253,282	256,937	353,425	358,764	367,573
Period end shares (m)	95.2	142.3	252.2	252.2	339.2	339.2	339.2
IFRS NAV per ordinary share	94.7	97.9	100.4	101.9	104.2	105.8	108.4
EPRA NAV per share	94.7	97.9	100.6	101.9	104.2	105.8	108.4
CASH FLOW							
Profit before tax	1,893	9,591	11,726	19,341	21,462	27,548	31,463
Adjusted for							
Net interest payable	(190)	716	929	808	1,945	3,183	3,389
Revaluation gains on property portfolio	686	(2,921)	(4,787)	(7,339)	(5,567)	(6,789)	(8,757)
Cost of corporate acquisitions	0	0	0	626	0	0	0
Change in receivables/payables	783	695	1,038	(9,042)	5,709	(756)	(248)
Net interest paid	161	(514)	(681)	(615)	(1,577)	(2,603)	(3,318)
Tax paid	0	(47)	(164)	(543)	0	0	0
Net cash flow from operating activities	3,333	7,520	8,061	3,236	21,972	20,584	22,530
Purchase of investment properties	(51,894)	(51,736)	(34,833)	(37,698)	(132,687)	(48,157)	(13,219)
Acquisition of subsidiaries	0	(5,845)	(27,091)	(25,552)	0	0	0
Net cash flow from investing activities	(51,894)	(57,581)	(61,924)	(63,250)	(132,687)	(48,157)	(13,219)
Issue of ordinary share capital (net of expenses)	44,520	46,644	97,501	0	92,590	0	0
Sale of shares from treasury	0	0	14,799	0	0	0	0
(Repayment)/drawdown of loans	8,646	22,525	(12,808)	20,906	36,000	49,000	4,650
Dividends paid	(4,364)	(7,074)	(9,681)	(15,589)	(17,562)	(22,208)	(22,652)
Net cash flow from financing activities	48,802	62,095	89,811	5,317	111,028	26,792	(18,002)
Net change in cash and equivalents	241	12,034	35,948	(54,697)	313	(781)	(8,691)
Opening cash and equivalents	16,884	17,125	29,159	65,107	10,410	10,723	9,942
Closing cash and equivalents	17,125	29,159	65,107	10,410	10,723	9,942	1,251
Debt	(11,764)	(30,865)	(20,449)	(39,331)	(75,699)	(125,279)	(130,000)
Net cash/(debt)	5,361	(1,706)	44,658	(28,921)	(64,976)	(115,337)	(128,749)
Net LTV	0.0%	0.0%	0.0%	10.5%	15.5%	24.1%	25.7%

Source: Edison Investment Research

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the Financial Conduct Authority. Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Pty Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

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
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia