Target Healthcare REIT

Outlook and placing

Growing strongly with asset quality focus

Real estate

Target is continuing to grow its portfolio and income strongly, supporting dividend growth. Capital values also continue to increase. LTV remains modest but available resources are committed to funding pre-let developments of modern, purpose-built assets. With a near-term pipeline of £79m in acquisition opportunities, a placing of shares at 109p has been proposed, to raise up to £40m. The c 6% dividend yield is backed by very long-dated, RPI-linked leases and supported by careful asset and operator selection, and we continue to forecast a fully covered dividend in FY20.

Year end	Revenue (£m)	Adj. net earnings* (£m)	Adjusted EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/NAV per share (x)	Yield (%)
06/17	23.6	13.2	5.23	101.9	6.28	1.07	5.7
06/18	28.4	15.7	5.54	105.7	6.45	1.04	5.9
06/19e	34.4	20.4	6.01	106.3	6.58	1.03	6.0
06/20e	39.3	23.1	6.80	108.8	6.71	1.01	6.1
06/21e	40.3	23.7	6.98	111.5	6.84	0.98	6.3

Note: *Adjusted earnings exclude revaluation movements, non-cash income arising from the accounting treatment of lease incentives and guaranteed rent review uplifts, acquisition costs and performance fees, and include development interest under forward fund agreements.

Strong portfolio and income growth

With strong portfolio and rent growth, adjusted earnings rose 19% in FY18 and adjusted EPS by 6%. FY18 DPS rose 2.7% and the Q119 DPS was lifted by a further 2%. Capital values are rising with rent growth, operational performance and market yield tightening. EPRA NAV rose 3.7% in FY18 to 105.7 and was 106.1p at end-Q119. Gross LTV remains modest (16.3% at end-Q119) but cash and undrawn debt is mostly committed to pre-let investments under development. In underlying terms, our forecasts are little changed with faster development offsetting yield tightening and the FY20 DPS fully covered by adjusted earnings. With a strong pipeline of investment opportunities (£79m near term), Target is proposing to raise up to £40m in a share placement at 109p, not yet reflected in our forecasts.

Demographics support long-term growth

Demographics should support growing care home demand for years to come, while there is an undersupply of the modern, well-designed homes, fully equipped with en-suite wet rooms and suitable communal spaces, that differentiate Target's investment strategy. Investors continue to be attracted by long lease lengths and upwards-only RPI-linked rental growth, with strong competition for assets. Although increasing asset prices have a positive impact on the NAV, they make Target's disciplined approach to acquisitions, targeting 'future-proof assets', an essential ingredient in delivering attractive and sustainable long-term returns.

Valuation: Attractive, growing dividend

Target offers a growing dividend, with visible potential for growth, that we expect to be fully covered by adjusted earnings in FY20. The dividend represents a highly attractive c 6% yield that supports a modest c 3% premium to NAV.

1 November 2018

Price	**110p**
Market cap	**£373m**

Net debt (£m) at 30 September 2018	42.0
Gross LTV at 30 September 2018	16.3%
Shares in issue	339.2m
Free float	96%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.5)	(1.8)	(3.7)
Rel (local)	3.4	7.8	2.8
52-week high/low		117.8p	101.5p

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 event

Close of placing	7 November 2018

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Edison profile page

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

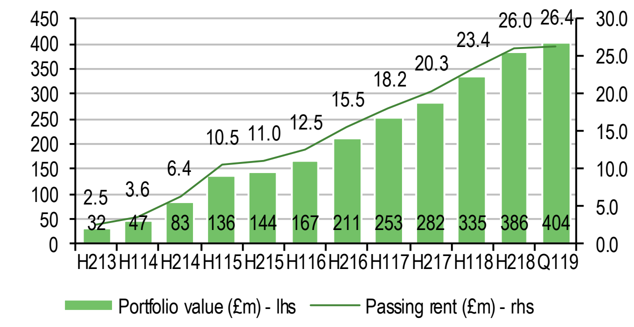
Investment summary

Target Healthcare REIT invests in modern, purpose-built residential care homes across the UK and is externally managed by Target Fund Managers, a sector specialist investment manager with an experienced team. Target aims to provide investors with attractive quarterly dividend income through a portfolio that is diversified by tenant, geography and the payment profile of the end-user care home residents. Target's approach to care home investment is focused on the quality of the physical asset and its location, alongside a comprehensive assessment of tenant capabilities, both before and after investment. From IPO in March 2013 to the end of September 2018 (Q119), the company delivered a shareholder return (share price growth plus dividends) of 52%. The annualised quarterly dividend amounts to 6.58p per share, a c 6% yield on the share price, which the company anticipates will be fully covered as available capital resources are fully deployed. Medium-term gearing is targeted at c 25%.

Care home investment is characterised by long lease lengths at inception, with rents usually linked to inflation, providing a high degree of visibility to future contracted rental income. The demand for care home places is being driven by the ongoing demographic shift to an ageing population with more complex care needs. Yet the number of care homes is lower today than it was in the late 1990s and much of the existing stock (older, inadequate, or poorly converted premises) falls below best standards. There is an undersupply of modern, well-designed homes, fully equipped with en-suite wet rooms and suitable communal spaces, and Target's focus on such assets differentiates it within the quoted sector. 85% of the homes within the Target portfolio have been built since 2008 and substantially all (96%) of the rooms are single occupancy with full en-suite facilities including wet-room showers.

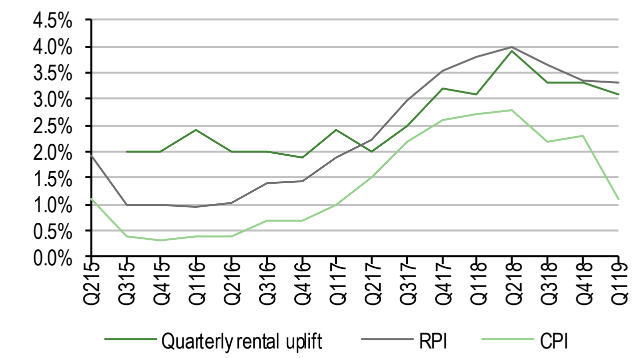
As at 30 September 2018 (Q119), Target's portfolio had grown to 58 homes, let to 21 different tenants, with an annualised passing rent of £26.4m (excluding the effect of short-term, rent-free periods), and valued at £403.7m, reflecting an EPRA topped-up net initial yield of 6.41%. The weighted average unexpired lease term (WAULT) was 28.3 years, with leases mostly linked to RPI and a small number with fixed rent uplifts.

Exhibit 1: Growing assets and rental income



Source: Target Healthcare REIT

Exhibit 2: Rents linked to inflation



Source: Target Healthcare REIT, Bank of England

With existing debt and equity capital resources now substantially committed, on 24 October, Target announced a placing of new shares, targeting gross proceeds of £40m, to part-fund a continuing strong pipeline of immediate and near-term further investment opportunities of c £79m. The placing is expected to close on 7 November 2018.

Update on financial results and acquisitions

In this section, we review the recently published detailed annual results for the year to 30 June 2018 (FY18) and the Q119 NAV and trading update that followed shortly afterwards, as well as the recently announced placing of shares to part-fund a continuing strong investment pipeline.

FY18 results in line, with main trends continuing through Q119

With many of the key financial metrics already provided in the Q4 NAV update published in July, the underlying FY18 results were very much in line with our forecasts, and key trends such as strong growth in the portfolio and rent revenue, and capital growth driven by rental increases and yield tightening continued through Q119.

Exhibit 3: Summary of FY18 key financial data

(£m)	FY18			FY17			FY18/FY17
	IFRS	Adjustments	Adjusted earnings	IFRS	Adjustments	Adjusted earnings	Adjusted earnings
Rent revenue	22.0	0.0	22.0	17.8	0.0	17.8	24%
Income from guaranteed rent reviews & lease incentives	6.3	(6.3)	0.0	5.1	(5.1)	0.0	
Development interest under forward fund agreements*	0.0	0.3	0.3	0.0	0.0	0.0	
Other income	0.0		0.0	0.7		0.7	
Total income	**28.4**	**(6.1)**	**22.3**	**23.6**	**(5.1)**	**18.4**	**21%**
Base investment management fee	(3.2)		(3.2)	(2.8)		(2.8)	15%
Investment manager performance fee*	(0.6)	0.6	0.0	(1.0)	1.0	0.0	
Other expenses	(1.5)		(1.5)	(1.2)		(1.2)	18%
Operating profit before property gains/(losses)	**23.2**	**(5.5)**	**17.7**	**18.6**	**(4.1)**	**14.4**	**22%**
Revaluation of investment properties	6.4	(6.4)	0.0	2.2	(2.2)	0.0	
Cost of corporate acquisitions	0.0	0.0	0.0	(0.6)	0.4	(0.2)	
Operating profit	**29.6**	**(12.0)**	**17.7**	**20.1**	**(5.9)**	**14.2**	**24%**
Net finance cost	(2.0)		(2.0)	(0.8)		(0.8)	
Tax	0.0		0.0	(0.2)		(0.2)	
Net earnings	**27.6**	**(12.0)**	**15.7**	**19.1**	**(5.9)**	**13.2**	**19%**
Other data			**FY18**			**FY17**	**FY18/FY17**
IFRS EPS (p)			9.77			7.58	29%
Adjusted EPS (p)			**5.54**			**5.23**	**6%**
EPRA EPS (p)*			5.25			4.84	9%
DPS declared (p)			**6.45**			**6.28**	**3%**
Dividend cover			**0.83**			**0.82**	
NAV per share, IFRS & EPRA (p)			**105.7**			**101.9**	**4%**
Investment properties			362.9			266.2	
Gross LTV			17.1%			14.2%	

Source: Target Healthcare REIT, Edison Investment Research

The key highlights in respect of trading and financial performance are:

- Target's portfolio continues to grow, with the market value increasing to £385.5m in FY18 (FY17: £282.0m) and to £403.7m by end-Q119. Ten new assets were added during FY18 for an aggregate investment commitment of £106.5m, and a further £31.0m committed to four additional assets during Q119. Of the 58 portfolio assets as at end-Q119, 52 were operational and six were pre-let sites being developed under forward-funding agreements. Target had also exchanged contracts to acquire a pre-let development asset at a future date, upon completion.
- Like-for-like valuations continue to increase, driven by upwards-only rent reviews, trading performance and market yield tightening. In FY18, the increase was 6.6%, with a further 1.1% in Q119.
- FY18 rent revenue increased 24% to £22.0m but is yet to fully reflect portfolio growth. The annualised passing rent on completed assets grew 28.1% during FY18, to £26.0m, and increased to £26.4m as at end-Q119. Completed rent reviews generated like-for-like rental growth of 3.2% in FY18 (FY17: 1.7%, with a similar trend continuing into Q119 [3.1%]).

- Base management fees and other administrative costs grew with the portfolio, and performance fees linked to the portfolio total return outperformance of the IPD UK Annual Healthcare Property Index were at a slightly lower level. A revised management fee structure (discussed in detail on page 8) is in place for the current year, introducing a tiered base fee structure with reducing rates at higher NAV levels, allowing shareholders to benefit from the increasing economies of scale that a larger portfolio provides. Performance fees have been discontinued.
- EPRA earnings per share increased by 8.5% in FY18 to 5.25p. Adjusted earnings per share, which adjusts for the performance fees (discontinued in the current year), and development interest on forward-funding agreements (explained in detail on page 11) increased by 5.9% to 5.54p.
- Quarterly dividends per share amounting to an aggregate 6.45p were declared in the year, a 2.7% increase on FY17. The Q119 DPS was increased by 2.0% to 1.64475p, an annualised 6.58p per share. FY18 dividends were 82% covered by adjusted earnings (total dividends paid as percentage of total adjusted earnings) and Target continues to expect dividends to be fully covered by adjusted earnings when the group is fully invested in operational assets. Gearing is targeted at a relatively modest 25% over the medium term (Q119 gross LTV 16.3%).
- FY18 EPRA NAV increased by 3.7% to 105.7p and increased further in Q119 to 106.1p. Including dividends paid, the EPRA NAV total return was 10.5% in FY18 and 1.9% in Q119.

Continuing growth

Target has £51m of imminent acquisitions, which it expects to commit to by the end of November, and a further £28m of near-term potential acquisitions that are at an advanced stage of negotiation with the vendors and are expected to complete by the end of this calendar year. All together, these opportunities comprise two forward-funded assets and three purpose-built standing/operational assets, mostly located in the south-east of England, with an aggregate 333 beds, all with en-suite wet rooms, and a WAULT of more than 30 years. The forward-funded opportunities are expected to be fully operational in mid-2019 (end-FY19). The blended net initial yield is expected to be c 5.6%, below the current portfolio yield, which Target says reflects the south-east focus of the assets, their quality, the operational track record of the tenants and the prospects for rental growth.

Target estimates that as of 12 October 2018, it had c £18m of uncommitted capital resources available for further investment, as shown in Exhibit 4. We believe that this is a conservative estimate, as it includes up to c £19m of deferred consideration on previously executed acquisitions, which is the maximum amount payable (it may be less) subject to certain contracted conditions being met, a minority of which may become payable in the near future. Where deferred consideration is payable it also includes an uplift in the rent payable by the tenant, at a rate broadly similar to the acquisition yield, and in our model is effectively captured within assumed investment commitments.

Exhibit 4: Net available funding for further investment

	(£m)
Cash as at 12 October 2018	22
Undrawn debt facilities	64
Available funding	**86**
Existing investment commitments	(36)
Maximum deferred consideration on prior acquisitions	(19)
Corporate needs	(13)
Net available funding	**18**

Source: Target Healthcare REIT

To part-fund the identified investment opportunities, the company proposes to issue up to 36.7m shares at 109p per share, a premium to the end-Q119 NAV per share of 106.1p, on a non-pre-emptive basis, under the existing placing programme that was approved by shareholders in February 2018. The placing programme allows for the issue of up 150m new ordinary shares up until 31 January 2019, including the 87.0m shares (£94.0m gross proceeds) issued in February. Target expects to be able to commit the proceeds of the equity raise quickly, thereby minimising cash drag, with any additional funds required being provided by new borrowing facilities and/or additional equity as required.

The prospects for further portfolio growth also look strong as the company has an extensive pipeline of longer-term opportunities.

High-quality, diversified portfolio

As at 30 September 2018 (Q119), Target's portfolio was valued at £403.7m, comprising 58 homes, of which 52 were operational and 6 were pre-let sites being developed under forward-funding agreements. Target had also exchanged contracts to acquire a pre-let development asset at a future date, upon completion. With an annualised passing rent of £26.4m (excluding the effect of short-term, rent-free periods) the portfolio valuation reflects an EPRA topped up net initial yield of 6.41%. The WAULT of 28.3 years remains very high, a combination of 30–35-year leases at inception and the low average age of the portfolio. The leases on two recently acquired homes have rent-free periods averaging around one year, which reduces the EPRA net initial yield to 5.88% currently, but assuming no other rent-free periods are agreed, the EPRA net initial yield will converge on the higher topped-up yield by September 2019. Target has from time to time granted rent-free periods, of short duration compared with the long-lease terms, when acquiring newly opening homes, assisting the operators through the start-up period.

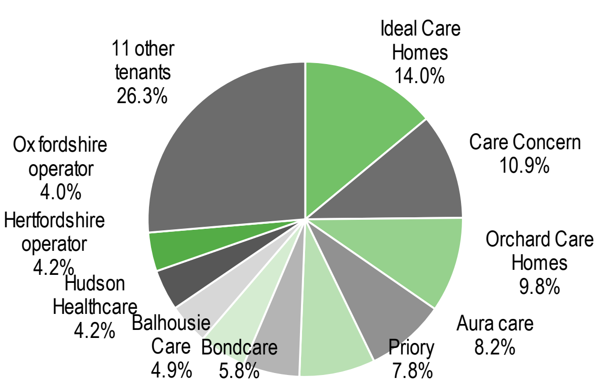
Exhibit 5: Portfolio summary

	Q119	FY18	FY17
Properties	58	55	45
Of which operational properties	52	51	45
Operational beds	3,592	3,552	3,096
Tenants	21	21	16
Portfolio passing rent on completed properties (£m)	26.4	26.0	20.3
Portfolio value (£m)	403.7	385.5	266.2
WAULT (years)	28.3	28.5	29.5
EPRA topped-up net initial yield (%)	6.41	6.44	6.75
Average lot size (£m)*	7.5	7.4	6.3
Average beds per property*	69.0	69	69

Source: Target Healthcare REIT. Note: *Edison Investment Research estimate

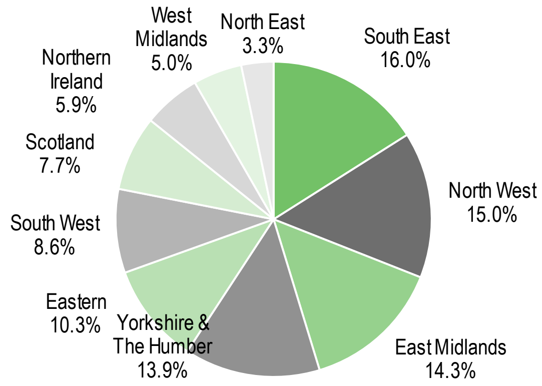
Target's income stream is diversified across 21 operating tenants, an increase of five over the past year, mostly mid-sized care home operators managing more than five homes. Using the detailed data as at 30 September 2018, the largest tenant (Ideal Care) represents 14.0% of passing rent (Exhibit 6). Target expects that completion of the acquisition pipeline will further diversify the tenant base. The portfolio is also well diversified by region (Exhibit 7), with the south-east area representing the largest geographical concentration. Target does not publish the look-through mix of end-user funding given the difficulty of bringing together data from each of the providers; however, we would anticipate that self-funder revenues are likely to represent around two-thirds of the total.

Exhibit 6: Diversification by tenant



Source: Target Healthcare REIT. Split by passing rent as at 30 September 2018.

Exhibit 7: Portfolio by location



Source: Target Healthcare REIT. Split by passing rent as at 30 September 2018

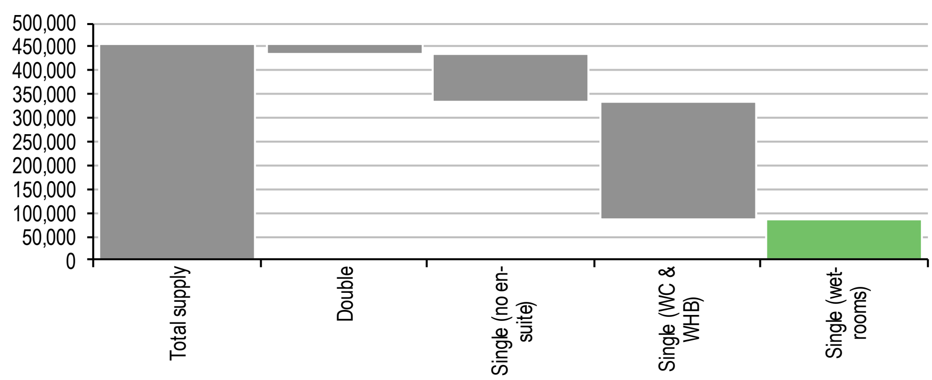
All of the leases are fully repairing and insuring, and upwards-only, with the majority RPI-linked, subject to caps and collars, although some have fixed annual uplifts.

Future-proof asset selection

Target's approach to investment in the sector reflects a desire to provide stable and sustainable, long-duration rental income with which to support dividend policy. To this end, it puts a very strong focus on the quality of the physical asset and its location, alongside an in-depth assessment of the operational capabilities and financial performance of the tenant, both before and after investment. Target believes that modern, purpose-built homes with flexible layouts and high-quality residential facilities, including single-occupancy bedrooms complete with en-suite wet-rooms, not only provide the best environment for residents and their care providers, but are more likely to provide sustainable, long-duration rental income. Target only invests in these 'future proof' homes and avoids older adapted properties, and homes with small bedrooms and poor en-suite facilities, a lack of public and private space, and narrow corridors with stairs.

85% of the homes in the Target portfolio have been built since 2008 and 96% of the rooms have full en-suite wet-room facilities. In contrast, data sourced from LaingBuisson suggests that rooms with full en-suite wet-room facilities represent a minority (only around one-fifth) of the care home stock, with the vast majority of en-suite facilities representing WC and hand-wash basis facilities only. To a large extent, this reflects the average age of the care home stock, with 79% of all homes built prior to January 2000 (source: Target, LaingBuisson).

Exhibit 8: A minority of the UK care home stock has full en-suite wet-room facilities



Source: Target Healthcare REIT

Targeting good quality tenants

The quality of rental income depends not only on lease length and how rents are reviewed, but also on the performance of the tenants. Prospective tenants' operational ability, care ethos and finances are scrutinised before acquisitions are made and Target maintains an ongoing dialogue with its tenants after investing. The company says that the majority of the portfolio continues to perform well, which is reflected in the fact that 96% of the assets in the portfolio maintained or increased their value in FY18. Two assets are currently subject to more focused asset management, which usually involves supporting the tenant towards improved performance and may occasionally lead to a change in the operator of the asset.

When assessing a potential new acquisition, Target looks for:

- 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;
- a solid financial performance of the individual home. Target expects an investible home to generate or have the potential to generate earnings before interest, tax, depreciation, amortisation, rent and management costs (EBITDARM) of c 1.6x rent when fully operational;
- a waiting list of new residents when fully operational;
- staff turnover that is not too high;
- good feedback from existing residents; and
- the quality of the home manager.

When invested, Target is an engaged landlord and invests considerable resource in its ongoing property management role. The purpose is to add value to the rental covenant and help to ensure that this endures over the long period of the lease. Target maintains an ongoing dialogue with its tenants, and receives and reviews management accounts for each home on a regular basis.

Each home is visited at least every six months, providing an opportunity to ensure that they are maintained by tenants in good condition and to assess the quality of care being provided by the tenant.

When tenants request it, Target makes available to them its expert operational skills and senior management experience. It also arranges regular gatherings that act as a forum for Target and its tenants to share experiences and best practice.

As part of Target's own engagement and monitoring process, it also considers the results of the assessments carried out by the industry regulators. A summary of the inspection ratings on Target's tenants versus the industry average for homes with more than 40 beds (a more comparable measure), with Target's tenants above average, is shown in Exhibit 9.

Exhibit 9: Regulatory quality assessment.

(%)	Over 40 beds		Target	
Outstanding	2.9	71.7	5.9	74.5
Good	68.8		68.6	
Requires improvement	25.7	28.3	23.5	25.5
Inadequate	2.6		2.0	

Source: Target Healthcare REIT. Note: inspection ratings used by other regulatory bodies have been converted to the most appropriate CQC rating. As at 30 September 2018.

Management and governance: specialist manager

Target Healthcare REIT is overseen by an independent board of directors and is externally managed, under a management contract, by Target Fund Managers. The investment manager was founded in 2010 by Kenneth MacKenzie, its chief executive, and is a sector specialist manager with a highly experienced team investing exclusively in the UK care home market. The investment manager's approach to investment in the sector is to focus on modern, purpose-built care homes let to quality operators, capable of delivering sustainable income while also contributing to improving standards of provision across the sector. We provide biographies of the key members of the investment team on page 15. In addition to Target Healthcare REIT, the investment manager is also manager of Kames Target Healthcare Property Unit Trust, with a similar investment remit, but whose investment period is now over. A third fund managed provides flexible, bespoke funding solutions to finance a wide range of transactions in the elderly healthcare sector.

The independent non-executive chairman of the board is Malcolm Naish, a chartered surveyor with more than 40 years' experience of working in the real estate industry. Before becoming chairman of Target in 2013, Mr Naish was director of real estate at Scottish Widows Investment Partnership (SWIP) until 2012. At SWIP, he had responsibility for a portfolio of commercial property assets spanning the UK, continental Europe and North America, and for SWIP's real estate investment management business. In addition to Target, Mr Naish is a director of GCP Student Living and Ground Rents Income Fund.

The other independent directors of the company bring broad experience of the real estate, healthcare, and the fund management and administration sectors; they are Professor June Andrews OBE, Gordon Coull, Thomas Hutchison III, Hilary Jones and Craig Stewart.

The company has an indefinite life but shareholders are invited to vote on continuation at five-yearly intervals. The last vote was held in November 2017 and the next vote is expected in 2022.

Revised management fee introduces scale benefits

The investment management agreement runs until 30 September 2019. Recognising the prospects for further portfolio growth, with effect from 1 July 2018, the management fee arrangements have been revised so as to introduce a tiered base fee structure with reducing rates at higher NAV levels, allowing shareholders to benefit from the increasing economies of scale that a larger portfolio provides. At the same time, the performance fee has been removed.

Under the old arrangement, in place since IPO, the investment manager has been remunerated through a base management fee, set at 0.9% of net assets, with a performance fee set at 10% of any portfolio total return performance in excess of that for the IPD UK Annual Healthcare Property Index. The maximum amount of total fees payable to the investment manager was capped at 1.25% of average, and since IPO has averaged 1.23%, with the investment manager earning a performance fee in each year.

The revised management fee structure introduces a higher base fee (but no performance fee) on net assets up to £500m, with the marginal rate of fees declining at higher levels of net assets (Exhibit 10).

Exhibit 10: Revised management fee structure

Net assets	Fee margin
First £500m	1.05%
£500m to £750m	0.95%
£750m to £1,000m	0.85%
£1,000m to £1,500m	0.75%
£1,500m+	0.65%

Source: Target Healthcare REIT. Rates effective 1 July 2018.

Based on our forecast NAV, we expect total management fees to be immediately lower under the new structure than previously, although the base fee will be slightly higher. However, because the adjusted earnings definition has excluded the performance fees (ie added them back), the higher base fee will slightly reduce adjusted earnings until NAV increases further.

The market environment for operators and investors

Operator market

The number of people in the UK aged 85 or older is expected to double by 2040 (source: ONS), with increasing numbers requiring specialist care that can only be adequately provided in a residential setting. The number of care home beds has in recent years failed to keep pace with this growing need and has in fact declined from a peak of 563,000 in 1996 to 466,000 in 2018, as local authorities have substantially withdrawn from care home operation and given greater focus to in-home domiciliary care. The private sector, both for profit and not-for-profit, is now the dominant provider of care, although local authorities remain a significant funder of beds at c 50% of the total, either in full or with some top-up from residents and their families.

Across the industry, this combination of growing demand, shrinking supply and the shift from local authority to private sector provision continues to generate sustained, above-inflation growth for the private sector operators, although performance is mixed across the sector. Given the pressures on local authority funding and their significant pricing power, in general there is a clear differential between the fees that they pay compared with the fees paid by self-funded residents. In many cases, the local authority fees paid are insufficient and are effectively cross-subsidised by self-funders. Operators that rely heavily on local-authority-funded residents may struggle to cope with industry-wide pressures from staff costs and regulatory pressures to improve standards of care. This is more so if the homes from which they operate are older, often converted and poorly configured. The problems facing the wider industry inevitably receive much media attention and 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. Meanwhile, longer-term funding for adult social care continues to be debated publicly, along with closer co-operation between health and social care.

Much of the new care home development is focused on geographical areas with supportive demographics and which can support a high share of self-funded residents. However, while many older, struggling homes continue to exit the market, the net increase in new beds in the year to March 2018 was just 900.

Investment market

The care home investors market has continued to be active, attracting strong demand from a range of buyers, while the supply of high-quality homes remains tight. This is particularly the case in the part of the market in which Target operates – modern, purpose-built homes with flexible layouts and high-quality residential facilities, including single-occupancy bedrooms complete with en-suite shower or wet-rooms. Market yields vary according to asset quality (Exhibit 11), among other factors, and the lower yields attached to modern, high-quality assets reflects the expectation that these assets are best placed to generate sustainable, long-term income with a lesser requirement for capital expenditure and a lesser risk of obsolescence.

Exhibit 11: Illustrative summary of care home segment valuations

Category	Description	Price per bed (£000s)	Multiple range (x)	Yield range (%)
Super prime	Best-in-class, high-value location	> 300	> 12	4.00–4.50
Prime	Modern, purpose-built, fully compliant	> 150	> 9.0	5.00–6.00
Tier 1	Older, purpose-built, single en-suite	> 70	> 7.0	6.00–7.50
Tier 2	Mixed converted/extended, part en-suite	> 40	> 6.0	9.00–10.00
Obsolete	Small, low-value conversions, compliance issues	Up to 40	> 5.0	No market
Specialist care	Best in class, high fees	N/A	> 8.0x	> 5.50%
Hospitals – prime	Modern, private sector	N/A	> 10.0x	4.75% - 5.50%

Source: CBRE UK healthcare: bucking the late cycle trend, May 2018

The illustrative yields shown in Exhibit 11 are dated as of May 2018. There continues to be a general tightening of investment yields across the sector as investors target the long-term, index linked income streams that it offers.

Financials

We have updated our forecasts to take account of the recently published detailed results for the year to 30 September 2018 and the outline financial data contained in the 27 July Q4 NAV report. The underlying variances from our FY18 forecasts were minimal and the underlying changes to our forecasts are also modest.

The shortfall in FY18 revenues versus forecasts is due to the accounting principles adopted in respect of the interest due to Target on development funds extended under forward-funding agreements. This has not been included within the income statement as we had assumed (as 'other income') but is instead included within adjusted earnings. For this reason, we have switched our primary focus to 'adjusted earnings' rather than EPRA earnings (which does not include development interest), believing this to provide a better indication of the earnings potential of the company on a fully developed basis. However, as the forward-funding agreements currently captured within our forecasts complete by H120, the difference between EPRA and adjusted earnings disappears.

One other point of note in respect of the forecasts for FY19 and FY20 is that although we expect the new management fee structure to reduce overall fees, it has a small negative impact on our forecast adjusted earnings. The reason for this is that although total forecast fees are lower, the base fee is slightly higher while the performance fee (discontinued) was previously added back to adjusted earnings (at c £1m pa). This change accounts for the FY19 and FY20 reduction in forecast adjusted earnings.

Exhibit 12: FY18 performance versus forecast, and forecast revisions

	Revenue (£m)			Adjusted EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Forecast	Actual	Diff (%)	Forecast	Actual	Diff. (%)	Forecast	Actual	Diff. (%)	Forecast	Actual	Diff. (%)
06/18	29.3	28.4	(3.0)	5.60	5.54	(1.0)	105.7	105.7	0.0	6.45	6.45	0.0
	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)
06/19e	35.5	34.4	(3.2)	6.24	6.01	(3.6)	106.2	106.3	0.1	6.58	6.58	0.0
06/20e	39.3	39.3	(0.1)	7.06	6.80	(3.8)	108.8	108.8	0.0	6.71	6.71	0.0
06/21e	N/A	40.3	N/A	N/A	6.98	N/A	N/A	111.5	N/A	N/A	6.84	N/A

Source: Edison Investment Research

Our forecasts continue to indicate that the growing DPS will be fully covered by adjusted earnings in FY20, which will include a substantially full year of income contribution from the acquisitions assumed within our forecasts. These are discussed in detail below, and represent our estimate of full deployment of the currently available capital resources. We have not yet included any proceeds from the current placing and, as a result, our investment assumption is less than the £79m pipeline that Target hopes to complete by the end of this calendar year. To the extent that the company acquires assets in excess of that which we have assumed, we will include these and any additional equity and debt funding as they occur, noting that the company continues to invest with the aim of fully covering DPS when fully invested.

Accounting for forward funding

In FY18, Target included within adjusted earnings £261k of development interest due in respect of forward-funding agreements. The development interest is non-cash and accrues on the amounts advanced during the construction phase, rolling up until completion, when it is offset against the purchase value of the property. Development interest never appears in the income statement but may be seen at completion as a valuation gain (the difference between the property value and the amount paid net of the interest accrual). EPRA earnings would exclude any revaluation gain and also does not capture the development interest. This is why we think adjusted earnings to be a better indication of earnings potential. The approach adopted by Target is similar to that taken by investors in the student accommodation sector.

Underlying forecast assumptions include acquisitions and funding

The key forecasting assumptions that we have made are:

- New investment commitments of £76m (previously £80m) by the end of Q319 (end-March 2019). We have included the Q1 announced commitments of £31m and assumed an additional £45m, an amount that we estimate is consistent with fully deploying the currently available capital resources under our existing forecasts. The £45m of assumed additional investment commitment is split equally between let standing assets at an assumed yield of 5.25% (previously 5.75%) and commitments to forward fund, and acquire at completion, development assets at an assumed yield of 6.00% (previously 6.45%). The blended yield of c 5.65% is similar to the blended yield reflected in Target's pipeline opportunities (5.60%) but lower than the 6.10% that would be generated by our previous assumptions, reflecting the quality of the asset we would expect the company to target as well the further increase in market asset pricing.
- The acquisition of let standing assets feeds directly into rent roll and rental income. We also assume 2.0% pa rent growth. As cash is extended to meet forward-funding commitments, over an assumed 18-month period, we allow for the accrued development interest to be earned on outstanding average balances, within adjusted earnings, until completion, at a rate equal to the expected investment yield. At completion, the assets add to rent roll within IFRS earnings.
- Our assumptions indicate full commitment of the existing capital funding resources (equity plus available debt) by the end of H119. However, given that cash is deployed to forward-funding agreements over time, our modelling does not show the existing £130m of debt facilities fully drawn until end-FY19. This assumes a slightly faster pace of investment spend than previously (approximately 18 months), which is more in line with recently indicated expected completion dates. In total, £66m of the debt has been swapped to a fixed rate of 3.12% pa until June 2019 and 3.07% pa thereafter until September 2021. The currently undrawn debt pays variable interest at 2.12% above three-month Libor (which we assume to be 0.75% across the forecasting period) including the amortisation of arrangement costs. By end-FY20, we forecast the gross LTV at c 26.0% and the net LTV at c 25.5%.

Valuation

Within the broad commercial property universe, Target is differentiated by its focus on modern, purpose-built 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 has very long-term leases, even compared with a group of long-lease income peers shown in Exhibit 13. This, and RPI-linked rent growth, provide investors with considerably visibility over a growing stream of contracted rental income and offer considerable protection against inflation.

Target is very focused on income to generate shareholder returns and with the current annualised quarterly dividend amounting to 6.58p, the shares yield 6.0%, well ahead of the median 4.8% yield on the broad range of property companies and REITs that we track. Management's aim, consistent with our forecast, is for a progressive dividend, fully covered by earnings when the group is fully invested.

Exhibit 13: Last published WAULT

Company	Recent WAULT (years)	Date
Target Healthcare	28.3	September 2018
Secure Income	21.4	June 2018
Impact Healthcare	19.2	June 2018
Supermarket Income	19.0	June 2018
Tritax Big Box	14.1	June 2018
MedicX Fund	14.0	June 2018
PHP	13.2	June 2018
Assura	12.6	December 2017

Source: Company data

In Exhibit 14, we show the key valuation and performance metrics for Target and this same group of companies that similarly target long-lease exposures across a range of property types, including healthcare property, 'big box' distribution centres, supermarkets and leisure assets.

Exhibit 14: Summary of long-lease REITS

	Price (p)	Market cap (£m)	P/NAV (x)	Yield (%)	Share price performance (%)			
					1M	3M	12M	From 12M high
Assura	54	1288	1.03	4.8	(1)	(6)	(11)	(16)
Impact Healthcare	103	198	1.07	5.8	(1)	(1)	0	(5)
PHP	110	814	1.06	4.9	(3)	(3)	(6)	(8)
MedicX Fund	78	345	0.97	7.7	(4)	(2)	(14)	(15)
Secure Income	380	1222	0.99	3.5	(3)	0	1	(5)
Supermarket Income	102	187	1.06	5.4	(1)	(1)	1	(4)
Tritax Big Box	143	2108	0.98	4.6	(3)	(6)	(2)	(10)
Median			**1.03**	**4.9**	**(3)**	**(2)**	**(2)**	**(8)**
Target Healthcare	110	371	1.04	5.9	(4)	(3)	(5)	(7)
UK property index	1,704			4.2	(2)	(7)	(1)	(10)
FTSE All-Share Index	3,847			4.5	(7)	(9)	(6)	(11)

Source: Historical data. Priced as at 30 October 2018.

Although all of the companies listed in Exhibit 14 are focused on generating long-term income and have WAULTs that are above the average of the broad property sector, there remains considerable differences between them, particularly in terms of asset type and the tenant covenants that support the long-term contractual income. For example, the WAULTs for the primary care asset investors are, on average, shorter, and although upwards-only, a significant share of the leases are subject to open-market review rather than being indexed. However, the vast majority of leases benefit from significant direct or indirect (through general practitioner reimbursement) government backing. Lease terms for the other companies are predominantly index-linked, with tenant exposures being mostly corporate, across a range of sectors – industrial, supermarkets and care home operators. The group also includes Impact Healthcare, another investor in care homes. Impact follows a very different investment strategy to Target, and its portfolio assets are in general smaller and older, and despite an ongoing investment programme are likely to face some physical constraints in upgrading facilities such as the provision of en-suite wet-rooms. This is reflected in a higher EPRA net initial yield of 7.09% (as at H118). It also has a less diversified tenant base, with the majority of H118 portfolio income generated by one tenant group.

Compared with this narrow peer group of long income investors, in addition to having the longest WAULT, Target offers a yield that is also above the median (4.9%) for a broadly similar P/NAV. Share price performance is quite mixed within the group, but Target has outperformed the broad property sector, and the FTSE All Share Index over the past year.

Sensitivities

The visibility to Target's contractual income is provided by long leases and RPI-linked rent increases. Additionally, the company plans further accretive acquisition of assets. We see the key sensitivities as relating to the following:

- The failure of any of the tenants could negatively affect the collection of contractual income. Target seeks to mitigate this risk through a rigorous investment process, ongoing oversight of all its homes and operators, and the increasing diversity of its tenant base. Were any operator or home to fail, a focus on investing in homes situated in areas with supporting demography should make the home attractive to another operator.
- Key operational and financial risks to the tenant operators include: their ability to maintain high standards of care and compliance with stringent and evolving regulatory oversight; upwards pressure of staff costs and local shortages, especially for trained nursing staff; and budgetary pressures on the local authorities that fund c 50% of UK care home beds. Good quality, modern, purpose-built accommodation provides advantages to operators in terms of care quality and may be more likely to attract self-funded residents for whom industry fees are on average materially higher than for local-authority-funded residents.
- With a tight supply-demand balance, the strong investor interest in care home assets has continued to see valuations increase and the yields available on investment tighten, particularly for good quality, modern, purpose-built assets. The reduction in the spread between investment yields and funding costs that this implies should be offset to some extent by the revised management fee structure, which sees the marginal management fee costs fall as the portfolio increases in scale.
- RPI-linked rent increases provide good income protection against inflation, providing inflation does not rise too much. We understand that Target's RPI-linked leases are subject to caps and collars, and we would expect the blended cap to be around 4%. Should inflation increase significantly, above c 4%, the cap to rental growth could mean that income growth could lag the growth in expenses and funding costs. We would nevertheless expect such conditions to generate more significant challenges to the mainstream commercial property market where occupancy is also likely to be more volatile.
- Target has £130m of committed term loan and revolving credit facilities charged at a margin over three-month Libor. At Q119, £66.0m of the term borrowing facility had been drawn, all swapped into a fixed rate of 3.12% pa until June 2019 and 3.07% pa thereafter until September 2021. The remaining £64.0m of undrawn debt facilities are at a blended variable rate of 2.21% pa above three-month Libor. Assuming no change in the differential between Libor and RPI, the impact on the variable funding costs arising from any increase in Libor should be matched by increases in rental income, providing that RPI does not rise above the cap on rent increases.

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Exhibit 15: Financial summary

Year to 30 June (£000s)	2014	2015	2016	2017	2018	2019e	2020e	2021e
INCOME STATEMENT								
Rent revenue	3,817	9,898	12,677	17,760	22,029	27,989	32,913	33,881
Movement in lease incentive or rent review	1,547	3,760	4,136	5,127	6,334	6,400	6,400	6,400
Rental income	5,364	13,658	16,813	22,887	28,363	34,389	39,313	40,281
Other income	0	66	61	671	3	0	0	0
Total revenue	5,364	13,724	16,874	23,558	28,366	34,389	39,313	40,281
Gains/(losses) on revaluation	(2,233)	(839)	425	2,211	6,434	(1,128)	2,297	2,533
Cost of corporate acquisitions	0	(174)	(998)	(626)	0	0	0	0
Total income	3,131	12,711	16,301	25,143	34,800	33,261	41,611	42,814
Management fee	(648)	(1,524)	(2,654)	(3,758)	(3,734)	(4,513)	(4,639)	(4,829)
Other expenses	(780)	(880)	(992)	(1,236)	(1,458)	(1,500)	(1,600)	(1,600)
Total expenditure	(1,428)	(2,404)	(3,646)	(4,994)	(5,192)	(6,013)	(6,239)	(6,429)
Profit before finance and tax	1,703	10,307	12,655	20,149	29,608	27,248	35,372	36,385
Net finance cost	190	(716)	(929)	(808)	(2,010)	(2,893)	(3,772)	(3,772)
Profit before taxation	1,893	9,591	11,726	19,341	27,598	24,355	31,600	32,612
Tax	(4)	(39)	(24)	(219)	11	0	0	0
Profit for the year	1,889	9,552	11,702	19,122	27,609	24,355	31,600	32,612
Average number of shares in issue (m)	105.2	119.2	171.7	252.2	282.5	339.2	339.2	339.2
IFRS earnings	1,889	9,552	11,702	19,122	27,609	24,355	31,600	32,612
Adjust for rent arising from recognising guaranteed rent review uplifts + lease incentives	(1,547)	(3,760)	(4,136)	(5,127)	(6,334)	(6,400)	(6,400)	(6,400)
Adjust for valuation changes	2,233	839	(425)	(2,211)	(6,434)	1,128	(2,297)	(2,533)
Adjust for corporate acquisitions	0	174	998	420	0	0	0	0
EPRA earnings	2,575	6,805	8,139	12,204	14,841	19,083	22,902	23,679
Adjust for development interest under forward fund agreements					261	1302	153	0
Adjust for performance fee	150	466	871	997	550	0	0	0
Group adjusted EPRA earnings	2,725	7,271	9,010	13,201	15,652	20,385	23,055	23,680
IFRS EPS (p)	1.80	8.02	6.81	7.58	9.77	7.18	9.32	9.61
Adjusted EPS (p)	2.59	6.10	5.25	5.23	5.54	6.01	6.80	6.98
EPRA EPS (p)	2.45	5.71	4.74	4.84	5.25	5.63	6.75	6.98
Dividend per share (declared) (p)	6.00	6.12	6.18	6.28	6.45	6.58	6.71	6.84
BALANCE SHEET								
Investment properties	81,422	138,164	200,720	266,219	362,918	452,440	462,087	464,620
Other non-current assets	0	2,530	3,742	3,988	27,139	34,920	42,139	48,676
Non-current assets	81,422	140,694	204,462	270,207	390,057	487,360	504,226	513,296
Cash and equivalents	17,125	29,159	65,107	10,410	41,400	10,445	2,726	3,363
Other current assets	6,524	6,457	13,222	25,629	3,365	3,365	3,365	3,365
Current assets	23,649	35,616	78,329	36,039	44,765	13,810	6,091	6,728
Bank loan	(11,764)	(30,865)	(20,449)	(39,331)	(64,182)	(128,782)	(129,382)	(129,982)
Other non-current liabilities	0	(2,530)	(4,058)	(3,997)	(4,673)	(4,673)	(4,673)	(4,673)
Non-current liabilities	(11,764)	(33,395)	(24,507)	(43,328)	(68,855)	(133,455)	(134,055)	(134,655)
Trade and other payables	(3,089)	(3,623)	(5,002)	(5,981)	(7,360)	(7,360)	(7,360)	(7,360)
Current Liabilities	(3,089)	(3,623)	(5,002)	(5,981)	(7,360)	(7,360)	(7,360)	(7,360)
Net assets	90,218	139,292	253,282	256,937	358,607	360,354	368,902	378,010
Period end shares (m)	95.2	142.3	252.2	252.2	339.2	339.2	339.2	339.2
IFRS NAV per ordinary share	94.7	97.9	100.4	101.9	105.7	106.2	108.8	111.4
EPRA NAV per share	94.7	97.9	100.6	101.9	105.7	106.3	108.8	111.5
CASH FLOW								
Cash flow from operations	3,172	8,081	8,906	4,394	23,627	20,596	25,855	27,315
Net interest paid	161	(514)	(681)	(615)	(1,366)	(2,693)	(3,572)	(3,572)
Tax paid	0	(47)	(164)	(543)	(122)	0	0	0
Net cash flow from operating activities	3,333	7,520	8,061	3,236	22,139	17,902	22,283	23,743
Purchase of investment properties	(51,894)	(51,736)	(34,833)	(37,698)	(89,981)	(90,650)	(7,350)	0
Acquisition of subsidiaries	0	(5,845)	(27,091)	(25,552)	0	0	0	0
Net cash flow from investing activities	(51,894)	(57,581)	(61,924)	(63,250)	(89,981)	(90,650)	(7,350)	0
Issue of ordinary share capital (net of expenses)	44,520	46,644	97,501	0	91,729	0	0	0
(Repayment)/drawdown of loans	8,646	22,525	(12,808)	20,906	24,456	64,000	0	0
Dividends paid	(4,364)	(7,074)	(9,681)	(15,589)	(17,353)	(22,208)	(22,652)	(23,105)
Other	0	0	14,799	0	0	0	0	0
Net cash flow from financing activities	48,802	62,095	89,811	5,317	98,832	41,792	(22,652)	(23,105)
Net change in cash and equivalents	241	12,034	35,948	(54,697)	30,990	(30,955)	(7,719)	638
Opening cash and equivalents	16,884	17,125	29,159	65,107	10,410	41,400	10,445	2,726
Closing cash and equivalents	17,125	29,159	65,107	10,410	41,400	10,445	2,726	3,363
Balance sheet debt	(11,764)	(30,865)	(20,449)	(39,331)	(64,182)	(128,782)	(129,382)	(129,982)
Unamortised loan arrangement costs	(497)	(645)	(551)	(669)	(1,818)	(1,218)	(618)	(18)
Net cash/(debt)	4,864	(2,351)	44,107	(29,590)	(24,600)	(119,555)	(127,274)	(126,637)
Gross LTV	15.1%	22.8%	10.5%	14.2%	17.1%	26.9%	26.0%	25.5%
Net LTV	0.0%	1.7%	0.0%	10.5%	6.4%	24.8%	25.5%	24.8%

Source: Target Healthcare REIT, Edison Investment Research

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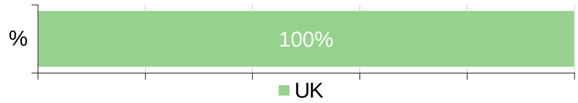
Revenue by geography



Leadership and management team

Non-executive chairman: Malcolm Naish

Malcolm Naish is a qualified surveyor with more than 40 years' experience of working in the real estate industry. Before becoming chairman in 2013, he was a director 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 for SWIP's real estate investment management business. In previous roles, he was director and head of DTZ Investment Management, 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 chaired the Scottish Property Federation for 2010/2011. He is also a director of GCP Student Living and Ground Rents Income Fund.

Chief executive, Target Fund Managers: Kenneth MacKenzie

Kenneth MacKenzie, a chartered accountant with 40 years of business leadership experience, is founder and chief executive of Target Fund Managers (previously Target Advisers). As part of this role, he leads the creation and management of Target Fund Managers' client funds and also oversees fund-raising and investor liaison for Target Healthcare REIT. In 2005, he led the acquisition of Independent Living Services, Scotland's largest domiciliary-care provider, later engineering its sale to a private equity investor. He had previously negotiated the proposed acquisition of a large UK independent-living business in a joint-venture with the US care-home operator, Sunrise Senior Living. Before becoming involved in the healthcare sector, he owned businesses in fields as diverse as publishing, IT, shipping and accountancy.

Finance director, Target Fund Managers: Gordon Bland

Gordon Bland is finance director of Target Fund Managers, where his responsibilities extend to advising on strategic planning, formulating business plans, financial modelling, budget analysis, regulatory control, managing relationships with debt partners and ensuring the provision of financial reporting to stakeholder groups.

He is a chartered accountant with extensive experience of financial reporting within the asset management industry and, prior to joining Target, he worked at PricewaterhouseCoopers for almost 10 years. That included two years at its Toronto office, where he served asset management and financial-services clients in the UK, Canada and Australia. His clients included SWIP, Scottish Widows, Lloyds Banking Group, Gartmore, Baillie Gifford and Schroders.

Head of investment, Target Fund Managers: John Flannelly

John Flannelly has been head of investment at Target Fund Managers since its inception in 2010. He is a chartered accountant with 20 years' experience, including 12 years spent in real-estate investment management. He has primary responsibility for investment activity across the Target Fund Managers business, with involvement in the appraisal of hundreds of care-homes for its client funds. His career began with Arthur Andersen, where he worked on audits, financial due diligence and corporate finance projects. He later moved to the Bank of Scotland to structure MBO finance packages, and then into real-estate investment management. Immediately prior to joining Target Advisers, he was investment director for an institutional investor, where he held board positions at a UK top-10 care-home operator and a care-home development business.

Head of healthcare, Target Fund Managers: Andrew Brown

Andrew Brown has been Target Fund Managers' head of healthcare since the business began in 2010, where his primary responsibilities include inspecting properties owned by client funds as well as prospective acquisitions during due diligence. The team that he leads performs Target Fund Managers' in-house demographic and market analysis. Andrew grew up in the care business and he and his family developed one of the largest continuing care retirement communities in the UK, Auchlochan Trust. He is also an investor in Trinity Care plc. He has played the role of developer, builder and operator of care homes resulting, all of which has produced a community of approximately 350 care beds, almost 100 retirement properties and over 300 staff. These facilities included both residential care homes and nursing homes and Andrew was directly responsible for operations.

Head of asset management, Target Fund Managers: Scott Steven

Scott Steven joined Target Fund Managers in 2017 and became head of asset management in 2018. His experience spans a variety of asset management, corporate finance, and banking roles, initially with Bank of Scotland where he qualified as a chartered banker. During 15 years with the bank, he worked in the private equity and pan-European property investment businesses. Latterly, under the Lloyds Banking Group umbrella, he led a team with responsibility for managing and restructuring substantial corporate real estate assets.

Principal shareholders	(%)
Premier Fund Managers	7.7
Investec Wealth & Investment	6.9
Bank of Montreal	6.7
CCLA Investment Management	3.7
BlackRock	2.8
Rathbone Brothers	2.0
Alder Investment Management	1.9

Companies named in this report

Assura (AGR), Impact Healthcare (IHR), Primary Health Properties (PHP), MedicX Fund (MXF, Secure Income REIT (SIR), Supermarket Income REIT (SUPR), Tritax Big Box (BBOX)

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