EDISON

Target Healthcare REIT

Consistent returns and continuing growth

Results and acquisition update

Real estate

The FY21 results and Q122 trading update show a continuation of Target Healthcare REIT's consistent record of positive accounting returns on both an annual and quarterly basis, substantially delivered by growing dividends. Target says its pipeline of acquisitions is its strongest ever and deployment of the proceeds of its well-received recent equity raise and associated gearing promise further growth and diversification.

Year end	Rental income (£m)	Adj. net earnings* (£m)	Adjusted EPS* (p)	EPRA NAV/ share (p)	DPS (p)	P/NAV/ share (x)	Yield (%)
06/21	50.0	26.0	5.46	110.4	6.72	1.07	5.7
06/22e	58.4	33.4	5.63	111.2	6.76	1.06	5.7
06/23e	71.9	41.0	6.61	115.1	6.86	1.02	5.8
06/24e	76.5	42.2	6.81	119.6	6.96	0.98	5.9

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

DPS continuing to grow but deployment defers cover

Dividends and recurring earnings are continuing to increase, driven by acquisitions, development completions and inflation linked (predominantly RPI) rent reviews. The latter, along with continuing yield compression, is also generating increases in property valuations and supporting growth in net asset value. Deployment of the £125m (gross) proceeds of September's upsized and oversubscribed equity issue and associated debt funding substantially lifts our adjusted 'cash' earnings forecasts. The c 20% increase in shares outstanding reduces our adjusted EPS forecasts (by c 14% in FY22) but as acquisitions are completed and fully contribute, we expect DPS to grow further and be effectively covered by adjusted earnings in FY23 and FY24 (and well covered by EPRA earnings). We assume c £285m of acquisitions by end-FY22, including the imminent completion of a substantial 18-home portfolio (£9.1m in annual rents) while a prudent level of gearing (LTV of around 30%) is maintained.

Sustainably meeting a long-term need

The care home sector is driven by demographics rather than the economy and a growing elderly population and a shortage of quality homes suggests a strong demand in years to come. The pandemic has had a near-term impact on tenant operators, but rent collection remained robust and admissions and occupancy are rebuilding. Target is unwavering in its focus on asset quality (along with location and the operational and financial performance of tenants). It believes modern, purpose-built homes with flexible layouts and high-quality residential facilities are key to providing sustainable, long-duration inflation-linked income; appealing to residents and allowing tenants to provide better and more effective care.

Valuation: Attractive indexed, long-term income

The FY22e DPS represents an attractive 5.7% yield, with good prospects for continuing DPS growth, and supports the c 6% premium to Q122 net asset value. The robust performance of tenant operators and rent collections through the COVID-19 pandemic is a positive indicator for a re-rating/DPS yield tightening.

15 November 2021

Price	**118.2p**
Market cap	**£734m**

Net debt (£m) at 30 September 2021	7.2
Net LTV at 30 September 2021	1.0%
Shares in issue	620.2m
Free float	100%
Code	THRL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.6	(4.7)	4.2
Rel (local)	(0.7)	(6.1)	(11.3)
52-week high/low		125.4p	109.4p

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

Q122 DPS paid	26 November 2021

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Edison profile page

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

Consistent and continuing growth

In this note we discuss recent financial and operational performance and our expectations for capital deployment and portfolio growth and diversification. Target completed a substantial well-received, upsized and oversubscribed £125m (gross) equity raise in September, ahead of results for the year to 30 June 2021 (FY21) on 20 October. It has since provided an update on the three months that ended 30 September 2021 (Q122). Dividends and recurring earnings have continued to increase, driven by acquisitions, development completions and inflation linked (predominantly RPI) rent reviews. The latter, along with continuing yield compression, is also generating increases in property valuations and supporting growth in net asset value. With its equity raising, Target reported a strong £230m acquisition pipeline ('its strongest ever') across 24 modern, purpose-built care homes, with contracted rents of £12.9m reflected in an expected weighted average net initial yield of 5.6%. This provides us with comfort that the proceeds of the equity raise and associated capital raise will be deployed fairly swiftly and the investment manager can continue to identify attractive investment opportunities despite the continuing compression of market yields. We begin this report with a review of recent financial performance.

Exhibit 1: Summary of FY21 financial performance

	FY21		FY20		FY21/FY20		Edison FY21e	
£m unless stated otherwise	**IFRS**	**Adj.**	**Adj. Earnings***	**IFRS**	**Adjustments**	**Adj. Earnings***	**Adj. Earnings***	**Adj. Earnings***
Rent revenue	41.2		41.2	36.0		36.0	14.4%	40.7
Income from guaranteed rent reviews & lease incentives	8.7	(8.7)	0.0	8.2	(8.2)	0.0		
Total revenue	**50.0**	**(8.7)**	**41.2**	**44.3**	**(8.2)**	**36.0**	**14.4%**	**40.7**
Investment management fee	(5.8)		(5.8)	(5.3)		(5.3)	10.1%	(5.9)
Credit loss allowance & bad debts	(2.7)		(2.7)	(2.1)		(2.1)		(2.9)
Other expenses	(2.6)		(2.6)	(2.2)	0.0	(2.2)	20.8%	(2.5)
Operating profit before property gains/(losses)	**38.9**	**(8.7)**	**30.1**	**34.7**	**(8.2)**	**26.5**	**13.7%**	**29.5**
Realised/unrealised gains/(losses) on properties	10.8	(10.8)	0.0	2.3	(2.3)	0.0		
Operating profit	**49.6**	**(19.5)**	**30.1**	**37.0**	**(10.6)**	**26.5**	**13.7%**	**29.5**
Net finance cost	(5.7)	0.9	(4.8)	(5.4)	1.1	(4.3)	12.5%	(4.3)
Development interest under forward fund agreements	0.0	0.6	0.6	0.0	1.0	1.0	-33.6%	0.9
Net earnings	**43.9**	**(17.9)**	**26.0**	**31.6**	**(8.4)**	**23.2**	**12.0%**	**26.1**
Other data:			**FY21**			**FY20**	**FY21/FY20**	
IFRS EPS (p)			9.23			7.18	28.5%	
EPRA EPS (p)			7.16			6.92	3.5%	
Adjusted EPS (p)			**5.46**			**5.27**	**3.5%**	
DPS declared (p)			**6.72**			**6.68**	**0.6%**	
Dividend cover - EPRA earnings			1.05			1.00		
Dividend cover - Adjusted earnings			**0.80**			**0.76**		
IFRS NAV per share (p)			110.5			108.0	2.3%	
EPRA NTA per share (p)			**110.4**			**108.1**	**2.2%**	**108.1**
EPRA NTA total return/accounting total return			**8.4%**			**6.8%**		**6.4%**
Investment properties			677.5			610.1	11.1%	
Borrowings			130.0			152.0		
Cash			21.1			36.4		
Gross LTV			19.2%			24.9%		

Source: Target Healthcare REIT, Edison Investment Research

FY21 adjusted earnings were very close to our forecast and EPRA NTA and EPRA NTA total return were both above our forecast, driven by a stronger revaluation movement in H221. Adjusted earnings increased by 12% with strong revenue growth partly offset by credit loss provisions and bad debt charges relating to the small number of struggling tenants that have responded positively to active asset as discussed below. Equity raising to fund continuing asset growth held back earnings in per-share terms but cash-dividend cover improved and we expect full cover of progressive distributions as acquisitions/commitments (past and prospective) fully contribute.

Key features of the FY21 results included:

- Contracted rental income increased by 5.6% to £41.2m (and reached £43.2m by end-Q122, including the completion of two forward funded pre-let developments, acquisitions, and indexed rent uplifts). FY21 like-for-like rent growth of 0.1% was held by back by the re-tenanting of one home (see below) and relatively lower inflation for much of the period. Q122 growth included a 0.6% like-for-like uplift, with completed rent reviews showing an average 3.3% increase.
- Adjusted cash rental income (excluding non-cash IFRS smoothing adjustments) increased c £4.2m, or c 14% year on year, and total adjusted revenue by c 13%.
- Total expenses increased by £1.6m or c 16%, within which investment management fees increased by £0.5m or c 10%, in line with average net assets, and other administrative expenses increased by £0.5m or c 22%, reflecting the growth in business, equity raising, and fees associated with asset management initiatives, particularly aimed at the small number of struggling operators. Provisions for doubtful rental income also increased by c £0.5m to £2.7m.
- Interest expense increased with average borrowing through the year, although period-end debt was lower as equity proceeds were temporarily used to repay flexible debt.
- Lower interest income under forward-funding agreements reflected a lower average balance of funding extended in the period.
- Adjusted earnings increase by £2.8m or c 12% to £26.0m or adjusted EPS of 5.46p (FY20: 5.27p). The average number of shares was 8% higher in FY21. Not shown in Exhibit 1, EPRA earnings (which unlike adjusted earnings includes IFRS rent smoothing but excludes interest in respect of forward funding agreements) increased at a similar rate to £34.0m (FY20: £30.5m) or EPS of 7.16p (FY20: 6.92p).
- The EPRA cost ratio improved to 16.9% (FY20: 20.1%) and on the company's adjusted earnings basis the cost ratio was 20.1% (FY20: 25.7%). The total expense ratio (TER) was 1.55%, slightly above the FY20 level of 1.51% due to the increased equity base, yet to be fully deployed on a geared basis.
- DPS increased by 0.6% to 6.72p and was 105% covered on an EPRA basis and 80% covered by adjusted 'cash' earnings. A Q122 DPS of 1.69p has been declared, in line with the increased FY22 DPS target of 6.76p (+0.6%).
- IFRS earnings and net asset value included £9.4m of net unrealised gains on investment properties and held for sale assets and £1.3m of realised gains on disposal. On a like-for-like basis, valuations increased by 3.5%, a combination of rental growth and a compression in the EPRA topped up net initial yield to 5.83% from 6.04% at end-FY20. The Q122 portfolio value increased by 0.7% on a like-for-like basis, with the EPRA-topped up net initial yield compressing slightly to 5.82%.
- EPRA net tangible assets per share (EPRA NTA) increased 2.3% to 110.4p and including DPS paid the total return was 8.4%.[1] Q122 EPRA NTA per share increased 0.8% to 111.3% with a quarterly total return of 2.3%.

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[1]Dividends added back but not reinvested. On the company basis, including reinvestment of dividends, the total return was 8.8% in FY21 and 2.3% in Q122.

Exhibit 2: Q122 EPRA NTA development

Pence per share		Notes
EPRA NTA at 30 June 2021	**110.4**	
Revaluation gains	0.9	
Acquisition costs	(0.1)	
Net impact of equity issuance at a premium to NTA	0.4	
Movement in revenue reserve	1.1	EPRA earnings excluding IFRS rent smoothing.
4th FY21 interim dividend paid	(1.4)	Q421 DPS of 1.68p divided by the endQ122 increased number of shares.
EPRA NTA at 30 June 2021	**111.3**	

Source: Target Healthcare REIT

Portfolio and asset management developments

Target's portfolio continues to grow and at 30 September 2021 (end-Q122) was valued at £702.7m, comprising 79 properties (of which 76 operational and three pre-let forward-funded developments), let to 28 individual tenants (the largest, Ideal Carehomes, representing c 13% of the total). Two of the four assets under development at end-FY21 reached practical completion during Q122 (Rudheath, Cheshire and Droitwich Spa, Worcestershire) and one was acquired, in Holt, Norfolk, with a maximum commitment of £12.8m. Also during Q122, Target acquired a completed home in Liverpool for £5.5m (including costs).

Exhibit 3: Portfolio summary

	Sep-21	Jun-21	Dec-20	Jun-20
	Q122	FY21	H121	FY20
Properties	79	77	76	73
Beds	5,474	5,331	5,277	5,073
Tenants	28	28	27	27
Contracted rent (£m)	43.2	41.2	40.6	39
Portfolio value (£m)	702.7	684.8	647.7	617.6
WAULT*	28.8 years	28.8 years	28.7 years	29.0 years
EPRA Topped-up net initial yield	5.82%	5.83%	5.97%	6.04%

Source: Target Healthcare REIT. Note: *Weighted average unexpired lease term.

Since end-Q22, an additional pre-let forward-funded asset has been acquired in Weymouth, Dorset for a maximum consideration of £14.3m.

Resilient through the COVID-19 pandemic

The COVID-19 pandemic has had a financial impact on Target's tenant operators, especially due to curtailed admissions and reduced occupancy, although this has recently begun to normalise. In total, 95% of FY21 rents have been collected and rent cover[2] for mature homes (those that have had the same operator for a three-year period or more, therefore excluding newly developed homes not yet stabilised) was 1.5x compared with the c 1.6x that Target expects during normal trading conditions. The robustness of rent cover during a difficult trading period for tenant operators was partly attributable to the temporary government support that was put in place to support a vital service. Excluding this, Target estimates rent cover dipped to 1.2x but expects a return to 1.6x or more as trading conditions normalise. Setting rents at the right level is key to the sustainability of income and Target believes rent cover of 1.6x provides sufficient flexibility to allow for variances in occupancy and operational performance. As shown in Exhibit 4 it is consistent with rent costs at c 20% of revenues for the typical home.

[2]Rent cover is a key measure for measuring the underlying profitability of tenants and the sustainability of rents. The ratio tracks operational cash earnings at the home level (before rent) with the agreed rent and is presented on a rolling 12-month basis.

Exhibit 4: Illustrative revenue and cost structure as a basis for 1.6x rent cover

Split of revenues/costs	
Private fees	75
Local authority fees	25
Total income	**100**
Direct costs	(57)
Gross margin	**43%**
Overheads	(11)
EBITDARM*	**32**
Rent	(20)
EBITDAM**	12

Source: Target Healthcare REIT. Note: *Earnings before interest, depreciation, amortisation, rent and management costs or home level cash earnings before rent. **Home level cash earnings after rent.

Across the portfolio, COVID-19 case numbers have been very low in recent months, supported by the vaccination programme and easing of restrictions on home visits, with tenant operators reporting an increase in occupancy as admissions normalise. Having dipped by more than 10 percentage points to a little under 70% at the low point earlier in 2021, occupancy for mature homes improved by c five percentage points in Q122 and by a further c two percentage points in Q222, with strong enquiry levels from potential residents.

Most of the recent and ongoing rent arrears relate primarily to two tenants across four of the homes and, although not helped by the pandemic, reflect more fundamental performance issues. Asset management initiatives aimed at addressing these were delayed by the physical restrictions in place during the lockdowns but have recently completed. For one tenant, a new operator of two immature homes, trading performance has improved. For one of these homes, rents have been paid monthly in full since December 2020 and for the other home rent has been partially paid and Target expects the tenant to commence paying rent in full during Q4 2021. The position with the other tenant has been resolved with outstanding rents partially settled and the homes re-tenanted. The first re-tenanting occurred during FY21, providing an immediate valuation and net rental income uplift and the second has recently completed at a similar rent and short rent-free period to cover capex mitigated by a lengthened lease.

Consistent returns

The resilience of Target's strategy has been reflected in consistently positive accounting returns[3] since IPO in January 2013, on both a quarterly and annual basis up to 30 September 2021 (end-Q122). The cumulative total return (adjusted for dividends paid but not assuming reinvestment of dividends) over the period has been 67.7% or an average annualised rate of 6.1%. Dividends have accounted for c 80% of the total. On the dividend reinvested basis reported by Target, the annualised total return to 30 June 2021 was 7.8%. Most recently, Q122 showed a return on 2.3% (2.4% assuming dividend reinvestment).

Exhibit 5: NAV total return record

	FY14*	FY15	FY16	FY17	FY18	FY19	FY20	FY21	Q122	Cumulative
Opening EPRA NAV/NTA (p)	98.0**	94.7	97.9	100.6	101.9	105.7	107.5	108.1	110.4	98.0
Closing EPRA NAV/NTA (p)	94.7	97.9	100.6	101.9	105.7	107.5	108.1	110.4	111.3	111.3
DPS paid	6.5	6.1	6.2	6.3	6.4	6.5	6.7	6.7	1.7	53.0
EPRA NAV/NTA total return	3.3%	9.7%	9.0%	7.5%	10.1%	7.8%	6.8%	8.4%	2.3%	67.7%
Compound annual average return										**6.1%**

Source: Target Healthcare REIT, Edison Investment Research. Note: Company published total returns are on a dividend reinvested basis and are higher. *22 January 2013 to 30 June 2014. **Adjusted for IPO costs.

[3]Change in net asset value plus dividends paid. Unlike the company's measure of returns, we do not assume reinvestment of dividends. Consequently, the returns quoted by Target are higher.

Consistent returns reflect steady and visible income growth with inflation-linked rents and long-term, triple net leases. Notwithstanding the pandemic, tenant performance has been supported by strong demographically driven demand for care home places, a shortage of quality accommodation and above-inflation fee growth. Attracted by the resilient income profile of the care home property sector, investor demand has been, and remains, strong, especially for high quality assets, leading to yield compression and capital growth. New entrants to the investment market such as Cofinimmo from Belgium and Korian REIT from France raises the prospect that valuation yields will further compress, benefiting capital growth but increasing the prices that must be paid for assets. Nevertheless, as we discuss in the next section, the investment manager continues to identify attractive acquisition opportunities and is confident of delivering further accretive portfolio growth.

Equity raised for further growth

Having substantially deployed the proceeds of the February 2021 £60m (gross) equity raise,[4] and noting its strongest pipeline of acquisition opportunities to date, in September 2021 Target completed a further £125m (gross) equity raise, upsized[5] and oversubscribed. The c 108.7m new shares issued represented a c 21% increase in shares outstanding and the issue price of 115p was at a 4.2% premium to the 30 June 2021 EPRA NTA per share of 110.4p.

The strong pipeline of investment opportunities disclosed with the issue amounted to an aggregate c £230m (including costs), across 24 modern, purpose-built care homes, with an expected weighted average net initial yield of 5.6%. If completed, this pipeline would add 1,625 new beds, increase contracted rent by £12.9m pa, slightly increase the WAULT from 28.5 years to 28.8 years, and add further diversification, including seven new tenants, all known and approved by the investment manager. More specifically the announced pipeline comprised:

- A significant portfolio of 18 operational care homes for which an exclusivity agreement was in place and due diligence underway. Historically, to satisfy its strict acquisition criteria,[6] Target has built its portfolio in a granular way with a focus on individually selected assets. However, in this case the investment manager has an extremely in-depth knowledge of the portfolio assets, having sourced 17 of the 18 on behalf of the vendor. The portfolio generates £9.1m pa of contracted rent with 100% of rents collected through the pandemic.
- A further six assets in the final stages of due diligence, consisting of three operational modern care homes and three pre-let forward funded development projects.

Reflecting the upsizing of the equity raise and the investment manager's ability to identify attractive investment opportunities, we forecast Target to acquire assets to a value of £285m (including costs) by the end of March 2022 (end-Q322), including the c £34m committed since end-FY21.

Funding and balance sheet impact

Including the £125m (gross) equity proceeds and associated debt funding, our assumed level of investment should allow Target to maintain a prudent level of gearing (loan to value ratio (LTV) of

[4]Prior to the September equity raise, Target had had committed £51m to four modern care homes, including one pre-let forward funded development, since the February equity raise.

[5]Target initially targeted gross proceeds of c £100m but this was increased to £125m in consideration of strong investor demand for the shares and the strength of the acquisition pipeline.

[6]Target's strict acquisition criteria target high-quality, modern, purpose-built care homes with en-suite wet-room facilities. Just 3% of beds within the pipeline assets are en-suite only (ie without en-suite wet-room facilities).

around 30%), well below the maximum permitted level of 35%. Historically the company has targeted a c 25% LTV, but the robust performance demonstrated through the challenging pandemic period suggests that a slightly higher gearing level is consistent with the company's return targets and provides an offset the compression in asset yields.

With the September equity raise proceeds temporarily used to repay flexible debt, end-Q122 gross borrowing was £80m and including cash of c £73m the net LTV was just 1%. However, the required borrowing to complete the transactions that we expect is ahead of the existing aggregate £220m of facilities (Exhibit 6) but negotiations to add c £100m of long-term funding are at an advanced stage. Our forecasts assume that £300m of the increased facilities are drawn, sufficient to fund acquisitions and current and future investment commitments.

Exhibit 6: Summary of existing debt portfolio

Lender	Facility type	Facility	Term	Margin
RBS	Term loan	£30m	Nov-25**	SONIA + 2.18%
	Revolving credit facility	£40m*	Nov-25**	SONIA + 2.33%
HSBC	Revolving credit facility	£100m	Nov-23***	SONIA + 2.17%
ReAssure	Term loan & revolving credit facility	£50m	Jan-32	Fixed 3.28%

Source: Target Healthcare REIT. Note: *HSBC facility includes two one-year extension options subject to HSBC approval.

Of the total existing debt facilities, £80m are fixed rate/hedged and £140m floating rate. The weighted average term to maturity at end-FY21 was 4.8 years and the weighted average cost of drawn debt was 2.9%. All existing loans are secured against investment properties owned by the group with maximum LTV requirements of 50–60% and interest cover ratios of a minimum 300%. All covenants have been complied with during the past year.

ESG at the core of strategy

In common with most companies across the sector, Target is giving an increasing focus to its environmental, social and governance (ESG) strategy. As a starting point, the social impact that its homes can generate is significant and closely aligned with ESG principles. Target invests in modern, purpose-built care homes and within its investment selection puts an unwavering focus on the quality of the physical assets. It seeks good-quality tenants capable of providing strong levels of care, sustainably, over the long term and as an engaged landlord, works with tenants to support their operations and care quality. The contribution that modern, purpose-built homes can make in supporting care quality have been highlighted by the pandemic. Modern home configuration and design, including en-suite wet room facilities and generous communal space, make it possible to comfortably isolate individual floors, parts of floors or even individual rooms, to control the spread of infection, safely support visiting and exercise, and provide good air quality.

The board of Target is fully independent and brings a depth of relevant experience and skills to the company.

Having grown the portfolio with a focus on modern, purpose-built properties, incorporating sustainable and responsible investing principles, 100% of Target's homes have EPC[7] ratings of A-C, of which 92% are rated A-B.

[7]Energy performance certificates

Government reforms are positive for the sector

The fundamental drivers of the care home sector remain strongly positive, primarily driven by demographics (an ageing population with increasingly complex care needs) with little correlation to the wider economy. In recent years, capacity has failed to keep pace with this growing need and in many cases homes that are more reliant on local authority funding have been starved of the resources to maintain adequate staffing and levels of care. The recently announced reforms to health and adult social care aim to address this and targets a cumulative £36bn in new investment in health and social care over the next three years, funded by a 1.25% ring-fenced increase in the national insurance levy. It is the government's intention to improve the integration of the NHS and social care system to both improve outcomes and generate efficiencies (for example, freeing up hospital beds by increasing access to appropriate alternative care. Most of this new funding will go to the NHS, but £5.4bn pa of additional social care funding, including residential care for the elderly, will be available from 2022–25. The government will set out detailed plans in a 'white paper' later in the year, which is expected to make clear exactly how the new proposals will operate. Depending on the detail, as well as providing additional resources to fund more and better services, the reforms have the potential to provide greater certainty to care home operators in their long-term planning, an essential element in making sure that future needs are met.

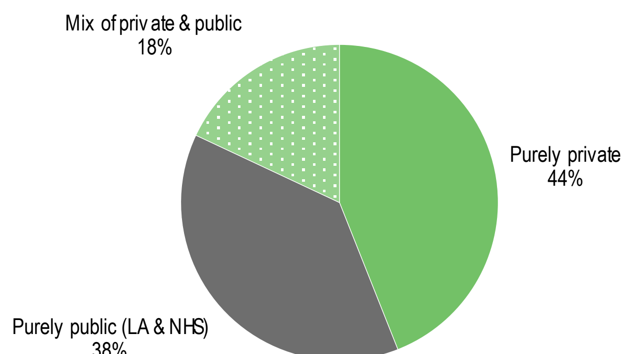
Under the government's proposals, more people will become eligible for state support for social care, including elderly care, and from October 2023 nobody will pay more than £86,000 for adult social care in their lifetime. Those with assets of less than £20,000 will have their care costs fully met by the state and those with assets of between £20,000 and £100,000 will receive some means-tested state support. State support currently cuts off where assets are more than £23,250.

Combined with the growing, demographically driven need for elderly care, the reduced funding burden on individuals is likely to increase the number of requests that local authorities receive for long-term care. In 2019/20, of the 1.9m requests to local authorities (of which 1.4m were from elderly people), only 839,000 of applicants received the care support requested, primarily reflecting limited resources available. The fees paid by local authorities to providers are currently too low and are reset annually, making it difficult for the providers to plan and recruit or retain staff. Because of low fees, local authority funded recipients of residential care are subsidised by privately funded residents and the government is keen to address this and ensure that local authorities pay a 'fair rate'. This appears to be positive for local authority funded fees and while the government is also proposing that self-funders will be able to ask their local authority to arrange their care for them so that they may find better value care, it remains to be seen how this will work in practice. We believe it is very unlikely that providers of self-funded care will be willing to accept lower fees, especially for existing residents. Operators that are focused on local authority funded care appear clear beneficiaries but operators that provide a mix of self-funded and local authority care should also benefit, and this includes many of Target's tenant operators. Across its portfolio, while 62% of underlying operator fees include some element of self-funding (44% purely self-funding and 18% a mix of self-funding and public funding),[8] 38% is purely publicly funded. Publicly funded fee exposure for Target's tenants has increased slightly through the pandemic as the industry-wide increase in vacancy has been tilted towards self-funding (at end-FY20 the purely self-funded share for Target operators was 48%). We believe this mainly reflects the greater discretion that self-paying residents are likely to have over the timing of admission as well as the desire by the NHS to free up hospital beds and is likely to revert as home occupancy returns to normal. The mix of

[8]Public funding comprises local authority funding and NHS funding.

funding is reflected in average weekly fees charged by operators, with an average of £966 at 30 June 2021 compared with the market average of £790 estimated by the Laing Buisson consultancy.

Exhibit 7: Sources of income for Target's tenant operators



Source: Target Healthcare REIT, 30 June 2021

Forecasts and valuation

Summary of forecast changes

Our forecasts are shown in detail in Exhibit 12 and summarised below. The September equity raise increased the number of shares outstanding by c 21% (and we estimate that this will increase FY22 average shares in issue by c 15%). We forecast the proceeds of the equity raise (and associated gearing) to be committed by the end of H122, but the full annualised impact will only be felt in FY24 as forward-funded projects complete during FY23.

Exhibit 8: Summary of forecast changes

	Rental income (£m)			Adj. net earnings (£m)			Adjusted EPS (p)			EPRA NAV/share (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
06/22e	56.4	58.4	3.5	33.6	33.4	-0.7	6.6	5.6	-14.3	109.4	111.2	1.6	6.80	6.76	-0.6
06/23e	59.5	71.9	20.7	35.5	41.0	15.4	6.9	6.6	-4.9	111.9	115.1	2.8	6.88	6.86	-0.3
06/24e	N/A	76.5	N/A	N/A	42.2	N/A	N/A	6.8	N/A	N/A	119.6	N/A	N/A	6.96	N/A

Source: Edison Investment Research

This has a notable impact on FY22e earnings, although we expect dividend cover to be maintained at the FY21 level (80%) on an adjusted ('cash') earnings basis. For FY23 and FY24 we forecast dividends to be effectively covered on an adjusted basis and well covered on an EPRA earnings basis, with DPS growing by c 1.5% pa in FY23 and FY24.

Exhibit 9: Dividend cover projections

	FY21 actual	FY22e	FY23e	FY24e
Dividend cover by EPRA earnings	105%	97%	119%	127%
Dividend cover by adjusted ('cash') earnings	80%	80%	96%	98%

Source: Target Healthcare REIT FY21 data. Edison Investment Research forecasts

Key forecasting assumptions

Our estimates assume £285m of new investment from end-FY21, including the c £34m of commitments already announced, all at a 5.6% net initial yield. We assume that £230m is committed by the end of 2021 (end-Q222), and that £45m of this commitment is to forward-funded developments that we assume will reach completion by Q323 (March 2023). We assume a further

£55m of commitment by March 2022 (Q322). The first full year rent contribution from all assumed investments and development completions is thus FY24. Our other forecasting assumptions include:

- Rent indexation of 3% pa, broadly in line with the treasury consensus expectations.
- Expenses substantially driven by investment manager fees with a marginal rate of 0.95% on average net assets of more than £500m. Other expenses include a sharp decline in impairment of rent receivables (£2.7m in FY21, or more than 6% of cash rents) with a return to a background level of c 1%.
- Gross revaluation movements broadly in line with rent indexation, effectively assuming no change in valuation yields. As reported under IFRS in the income statement, in FY22e this is substantially offset by acquisition costs and IFRS smoothing rent effects. Our revaluation assumptions have a positive impact on LTV. Assuming no revaluation impact (unlikely as given contractually indexed rent uplifts this would imply margin widening of c 0.5%) and would increase LTV by c 250bp.

Exhibit 10: Revaluation movements

£m	FY21 actual	FY22e	FY23e	FY24e
Gross unrealised revaluation movement (incl held for sale)	21.4	22.8	27.9	29.0
Acquisition costs written off	(2.3)	(11.5)	0.0	0.0
Movement in lease incentives	(0.9)	0.0	0.0	0.0
Net realised and unrealised valuation movement	18.2	11.3	27.9	29.0
Movement in fixed or guaranteed rent reviews	(8.7)	(9.7)	(12.0)	(12.8)
Gains/(losses) on revaluation of investment properties as per income statement	**9.4**	**1.6**	**15.9**	**16.2**
Acquisition costs as % purchase value	4.3%	4.2%	N/A	N/A
Gross revaluation as % opening portfolio value	3.5%	3.4%	2.9%	2.8%
Gross revaluation gain per share (p)	4.2	3.7	4.5	4.7

Source: Target Healthcare REIT FY21 data. Edison Investment Research forecasts.

Valuation

Target aims to provide shareholders with attractive and sustainable returns, primarily in the form of quarterly dividends. DPS has increased each year since IPO and has been the driver of consistent returns as shown in Exhibit 10 above. The current year DPS target of 6.76p (+0.6% vs FY21) represents an attractive yield of 5.7%. The shares trade at a c 6% premium to Q122 EPRA NTA per share of 111.3p, similar to the average since IPO but below the high of c 11%.

In Exhibit 11 we show a summary of the performance and valuation of a group of REITs that we consider to be Target's closest peers within the broad and diverse commercial property sector. The group is invested in the primary healthcare, supported housing and care home sectors, all targeting stable, long-term income growth derived from long-lease exposures.

Exhibit 11: Peer valuation and performance summary

	WAULT (years)	Price (p)	Market cap. (£m)	P/NAV (x)*	Yield (%)**	Target yield (%)***	Share price performance			
							1 month	3 months	YTD	12 months
Assura	11	70	1878	1.23	4.1	4.2	-4%	-10%	-8%	-8%
Civitas Social Housing	23	92	573	0.85	6.0	6.0	5%	-21%	-12%	-15%
Impact Healthcare	19	119	380	1.07	5.4	5.4	1%	1%	9%	14%
Primary Health Properties	12	151	2134	1.31	4.1	4.1	-2%	-10%	-1%	1%
Residential secure Income	N/A	98	168	0.93	5.1	5.1	0%	-8%	10%	8%
Triple Point Social Housing	26	96	387	0.90	5.4	5.4	-4%	-14%	-14%	-11%
Average	**18**			**1.05**	**5.0**	**5.0**	**-1%**	**-10%**	**-3%**	**-2%**
Target Healthcare	**29**	**118**	**734**	**1.06**	**5.7**	**5.7**	**2%**	**-4%**	**4%**	**4%**
UK property sector index		1,925					3%	-1%	20%	21%
UK equity market index		4,195					2%	1%	14%	18%

Source: Company data, Refinitiv pricing at 15 November 2021. Note: *Based on last reported NAV. **Based on trailing 12-month DPS declared. ***Based on current financial year company DPS target.

In terms of average share price performance, the peer group has trailed the overall UK property sector and FTSE All-Share Index over the past year as less defensive, more cyclical areas of the market have rebounded. Over the same period, Target's share price performance has been stronger than the average for the group, although its yield remains above average on both a 12-month trailing basis and based on each company's current financial year target dividends. Target's P/NAV is in line with the average. There are several factors that suggest a continuing positive outlook for the shares including a combination of the WAULT with no break clauses and upwards-only, triple net rents, mostly linked to RPI, which provides considerable visibility over a growing stream of contracted rental income. Rent indexation also offers considerable protection against inflation at a time when inflation expectations are increasing.[9] The resilience of Target's business model during the pandemic, with no interruption to quarterly dividends, is a further positive indicator for the rating of the shares.

[9]Most rents are capped and collared. Our expectation is that the average cap is c 4%, providing full inflation protection up to this level.

Exhibit 12: Financial summary

Year to 30 June (£m)	2017	2018	2019	2020	2021	2022e	2023e	2024e
INCOME STATEMENT								
Rent revenue	17.8	22.0	27.9	36.0	41.2	48.7	59.9	63.8
Movement in lease incentive/fixed rent review adjustment	5.1	6.3	6.4	8.2	8.7	9.7	12.0	12.8
Rental income	22.9	28.4	34.3	44.2	49.9	58.4	71.9	76.5
Other income	0.7	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Total revenue	23.6	28.4	34.3	44.3	50.0	58.4	71.9	76.5
Gains/(losses) on revaluation	1.6	6.4	6.2	1.7	9.4	1.6	15.9	16.2
Realised gains/(losses) on disposal	0.0	0.0	0.0	0.6	1.3	0.0	0.0	0.0
Management fee	(3.8)	(3.7)	(4.7)	(5.3)	(5.8)	(7.4)	(7.8)	(8.0)
Other expenses	(1.2)	(1.5)	(2.7)	(4.3)	(5.3)	(3.2)	(3.5)	(3.6)
Operating profit	20.1	29.6	33.0	37.0	49.6	49.3	76.5	81.1
Net finance cost	(0.8)	(2.0)	(3.1)	(5.4)	(5.7)	(7.1)	(10.0)	(10.2)
Profit before taxation	19.3	27.6	29.9	31.6	43.9	42.3	66.5	70.9
Tax	(0.2)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IFRS net result	19.1	27.6	29.9	31.6	43.9	42.3	66.5	70.9
Adjust for:								
Gains/(losses) on revaluation	(2.2)	(6.4)	(6.2)	(1.7)	(9.5)	(1.6)	(15.9)	(16.2)
Other EPRA adjustments	0.4	0.0	0.7	0.5	(0.3)	0.0	0.0	0.0
EPRA earnings	17.3	21.2	24.5	30.5	34.0	40.7	50.7	54.7
Adjust for fixed/guaranteed rent reviews	(5.1)	(6.3)	(6.4)	(8.2)	(8.7)	(9.7)	(12.0)	(12.8)
Adjust for development interest under forward fund agreements	0.0	0.3	2.0	1.0	0.6	2.4	2.3	0.3
Adjust for performance fee	1.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Group adjusted earnings	13.2	15.7	20.1	23.2	26.0	33.4	41.0	42.2
Average number of shares in issue (m)	252.2	282.5	368.8	440.3	475.4	593.1	620.2	620.2
IFRS EPS (p)	7.58	9.77	8.10	7.18	9.23	7.13	10.73	11.43
EPRA EPS (p)	6.87	7.50	6.63	6.92	7.16	6.86	8.17	8.82
Adjusted EPS (p)	5.23	5.54	5.45	5.27	5.46	5.63	6.61	6.81
Dividend per share (declared)	6.28	6.45	6.58	6.68	6.72	6.76	6.86	6.96
Dividend cover (Adjusted earnings)	0.83	0.82	0.82	0.76	0.80	0.80	0.96	0.98
BALANCE SHEET								
Investment properties	266.2	362.9	469.6	570.1	629.6	914.7	954.4	970.6
Other non-current assets	4.0	27.1	37.6	46.0	54.8	64.6	76.5	89.3
Non-current assets	270.2	390.1	507.2	616.1	684.4	979.3	1,030.9	1,059.9
Cash and equivalents	10.4	41.4	26.9	36.4	21.1	16.9	12.6	13.2
Other current assets	25.6	3.4	4.3	11.2	12.9	4.2	4.5	4.6
Current assets	36.0	44.8	31.2	47.6	34.0	21.1	17.1	17.9
Bank loan	(39.3)	(64.2)	(106.4)	(150.1)	(127.9)	(278.2)	(299.0)	(299.8)
Other non-current liabilities	(4.0)	(4.7)	(7.1)	(6.4)	(6.8)	(9.8)	(10.6)	(11.0)
Non-current liabilities	(43.3)	(68.9)	(113.5)	(156.5)	(134.7)	(288.0)	(309.6)	(310.8)
Trade and other payables	(6.0)	(7.4)	(11.8)	(13.1)	(18.5)	(22.5)	(24.4)	(25.2)
Current Liabilities	(6.0)	(7.4)	(11.8)	(13.1)	(18.5)	(22.5)	(24.4)	(25.2)
Net assets	256.9	358.6	413.1	494.1	565.2	689.8	714.0	741.8
Adjust for derivative financial liability	0.0	0.1	0.7	0.2	(0.3)	(0.3)	(0.3)	(0.3)
EPRA net assets	256.9	358.7	413.8	494.3	564.9	689.6	713.7	741.6
Period end shares (m)	252.2	339.2	385.1	457.5	511.5	620.2	620.2	620.2
IFRS NAV per ordinary share	101.9	105.7	107.3	108.0	110.5	111.2	115.1	119.6
EPRA NAV per share	101.9	105.7	107.5	108.1	110.4	111.2	115.1	119.6
EPRA NAV total return	7.5%	10.1%	7.8%	6.8%	8.4%	6.8%	9.6%	9.9%
CASH FLOW								
Cash flow from operations	4.4	23.6	20.5	25.6	29.2	46.4	51.0	53.0
Net interest paid	(0.6)	(1.4)	(2.3)	(4.1)	(4.2)	(6.3)	(9.2)	(9.4)
Tax paid	(0.5)	(0.1)	0.0	(0.1)	(0.0)	0.0	0.0	0.0
Net cash flow from operating activities	3.2	22.1	18.2	21.5	25.0	40.2	41.8	43.6
Purchase of investment properties	(63.3)	(90.0)	(99.6)	(117.5)	(51.4)	(283.5)	(23.8)	0.0
Disposal of investment properties	0.0	0.0	0.0	14.1	7.8	7.3	0.0	0.0
Net cash flow from investing activities	(63.3)	(90.0)	(99.6)	(103.4)	(43.6)	(276.2)	(23.8)	0.0
Issue of ordinary share capital (net of expenses)	0.0	91.7	48.9	78.2	58.3	121.9	0.0	0.0
(Repayment)/drawdown of loans	20.9	26.0	42.0	44.0	(22.0)	150.0	20.0	0.0
Dividends paid	(15.6)	(17.4)	(23.6)	(29.2)	(31.5)	(40.0)	(42.4)	(43.0)
Other	0.0	(1.5)	(0.3)	(1.6)	(1.5)	0.0	(0.0)	0.0
Net cash flow from financing activities	5.3	98.8	67.0	91.4	3.3	231.8	(22.4)	(43.0)
Net change in cash and equivalents	(54.7)	31.0	(14.5)	9.5	(15.3)	(4.2)	(4.4)	0.6
Opening cash and equivalents	65.1	10.4	41.4	26.9	36.4	21.1	16.9	12.6
Closing cash and equivalents	10.4	41.4	26.9	36.4	21.1	16.9	12.6	13.2
Balance sheet debt	(39.3)	(64.2)	(106.4)	(150.1)	(127.9)	(278.2)	(299.0)	(299.8)
Unamortised loan arrangement costs	(0.7)	(1.8)	(1.6)	(1.9)	(2.1)	(1.8)	(1.0)	(0.2)
Net cash/(debt)	(29.6)	(24.6)	(81.1)	(115.6)	(108.9)	(263.1)	(287.4)	(286.8)
Gross LTV	14.2%	17.1%	21.6%	24.9%	19.2%	28.8%	29.3%	28.5%
Net LTV	10.5%	6.4%	16.2%	18.9%	16.1%	27.1%	28.1%	27.2%

Source: Target Healthcare REIT, Edison Investment Research

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