EDISON

Impact Healthcare REIT

Portfolio update

Resolving sole underperforming tenant issue

Real estate

Impact Healthcare REIT has successfully negotiated the transfer of the operation of the homes leased to one of its 13 care home tenants, which, as previously disclosed, in H123 has not paid its contractual rent (3.4% of the group total). The transfer is structured to maintain continuity of staffing and care while generating operational improvements. Under the terms of the transfer, our forecasts for FY23 and FY24 are reduced but we expect full dividend cover to be maintained. Meanwhile, the broader portfolio continues to perform well, with 100% of rents received from each of the company's other tenants, which has been the case since launch.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPRA EPS* (p)	EPRA NTA/ share (p)	DPS (p)	P/NAV (x)**	Yield (%)**
12/22	45.4	32.6	8.4	110.1	6.54	0.88	6.7
12/23e	52.6	34.7	8.4	111.4	6.77	0.87	7.0
12/24e	54.6	35.7	8.6	114.3	6.96	0.85	7.2
12/25e	57.0	37.9	9.2	116.0	7.10	0.84	7.3

Note: *EPRA earnings exclude fair value movements on properties and interest rate derivatives. **P/NAV and yield are based on the current share price.

Continuity with operational improvement

Silverline, which operates seven of Impact's 138 care homes, has not paid its contractual rent (£1.6m pa/3.4% of total contracted rents) for the first two quarters of 2023, although the shortfall was partly covered by the utilisation of rent deposits. In line with Impact's stated goal of resolving the situation by mid-2023, Silverline's tenant operating companies have been sold on a solvent basis to a newly created affiliate (Melrose Holdings, MHL) of existing tenant Minster Care Group. MHL will immediately take on operational responsibility for the homes, supported, under a service agreement, by Minster, which has a long track record of taking on and improving underperforming care homes. Impact will provide MHL with a three-year loan facility of up to £1.6m, at a rate of 8% pa on drawn funds, providing working capital and capex funding during the initial phase of the planned turnaround in the performance of the homes. Cash surpluses generated by the homes will first be utilised to pay management fees of £1k per bed to Minster (c £400k pa currently plus VAT). Any surplus cash after this will be used to repay the loan facility and accrued interest to Impact and once repaid, will be paid as rent, variable during this initial turnaround period. Impact is confident in the quality of the assets and their ability to deliver good quality care at affordable rents. Silverline's problems appear to stem from operational challenges that were aggravated during the pandemic, and we do not believe these are representative of Impact's wider portfolio.

Fully covered DPS growth maintained

Reflecting the continuing pause in rent receipts, the company estimates a net c £1m negative impact on profitability (of which c £0.5m was reflected in our previous forecasts). We assume that surplus cash from the homes is used to repay the loan facility during FY24 and that rents resume (at £1.6m pa) in FY25. FY23e adjusted EPS is 0.1p lower (102% DPS cover) and FY24e is 0.2p lower (102%). FY25 benefits from MHL rents, completion of the Norwich development and indexation.

13 June 2023

Price	**97p**
Market cap	**£402m**
Gross debt at 31 March 2023	£187.3m
Gross LTV at 31 March 2023	28.3%
Shares in issue	414.4m
Free float	90%
Code	IHR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.2)	0.7	(21.0)
Rel (local)	(1.2)	2.8	(22.8)
52-week high/low		124p	90p

Business description

Impact Healthcare REIT, traded on the Main Market of the London Stock Exchange, invests in a diversified portfolio of UK healthcare assets, primarily residential and nursing care homes, let on long leases to high-quality operators. It aims to provide shareholders with attractive and sustainable returns, primarily in the form of dividends, underpinned by structural growth in demand for care.

Next events

H123 results — Expected August 2023

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The transfer avoids disruption and incentivises an operational turnaround

Impact held extensive discussions with a number of alternative care providers before concluding that the transfer to MHL was the most attractive solution and in the best interests of all stakeholders. MHL's acquisition of the Silverline tenant companies on a solvent basis (ie including its liabilities) avoids a period of uncertainty for home residents and the staff that care for them and commences a process of operational improvement immediately. It is unlikely this would have been possible had Impact sought a potentially lengthy lease reassignment or if the Silverline operating companies had been forced into default, and we believe that the turnaround experience provided by Minster has been secured in a cost-effective manner.

MHL is wholly owned by connected parties of Mahesh Patel, who is both the controlling shareholder of Minster and a principal in the investment adviser,[1] making this a related-party transaction. It is however the case that the close relationship between Minster, the company, and its investment adviser that has facilitated Minster's involvement on terms that have been scrutinised and benchmarked by the independent board and verified with a range of external advisers. Mahesh Patel has a 35-year track record of owning and managing care homes and, while Minster does not benefit directly transfer, other than its service fee, MHL is incentivised to turn around the homes and repay its liabilities, including drawn loan balances with Impact.

Free cash surpluses (after the Minster fees) pass directly to Impact in the form of loan repayments and accrued interest and, once the loan is repaid, variable rents. Of course, MHL/Minster may be unsuccessful in engineering a turnaround, reducing or even eliminating cash payments to Impact, but we think this an unlikely result. Rather, there is an upside opportunity for Impact, beyond restoration of the existing rents, which are set at a low level (c 60% of the portfolio average as per Exhibit 1). As any surplus in excess of the Minster fees (a fixed rate per bed) passes to Impact, this may in time exceed the previous rent level. If such a point is reached or in sight, we would expect the company to seek opportunities to revert to a normal lease structure or potentially dispose of some or all of the assets where these are deemed non-core.

Exhibit 1: Summary of Silverline operated assets

	Acquired	Number of rooms	Rent pa (£m)	Rent per room (£000)	Valuation (£m)	Valuation per room (£000)
The Beeches, Bradford	Mar-20	60				
Willow Bank, Bradford	Mar-20	59				
Laurel Bank, Bradford	Mar-20	63				
Total Silverline Bradford		**182**				
Springhill, Kilmarnock	Nov-21	61				
Stobhill, Glasgow	Aug-22	60				
Baillieston, Glasgow	Aug-22	60				
Cardonald, Glasgow	Aug-22	35				
Total Silverline Scotland		**155**				
Total Silverline		**398**	**£1.60**	**£4.0**	**£18.50**	**£46**
Total portfolio		7231	£47.90	£6.6	£635.40	£88

Source: Impact Healthcare REIT data, Edison Investment Research

1 Mahesh Patel directly or indirectly owns 72.5% of Minster Care Group. Impact came to market in March 2017 with an agreement to acquire a significant number of assets (the seed portfolio) from its initial tenants, Minster Care and Croftwood Care, both part of the Minster Care Group. As Impact's portfolio has grown and diversified, from an opening combined 100%, by end-FY22, the share of contracted income represented by the Minster Care Group had reduced to 37%. Mahesh Patel is also a significant investor in Impact, with direct or indirect ownership of 3.1% at end FY22.

Silverline problems not reflective of the wider Impact portfolio

In our May 2023 update, we focused on the strategic drivers of Impact's strong performance since listing in 2017, amid a structurally supported sector, which has nonetheless been challenged by the pandemic and, more recently, high inflation.

We noted that Impact's initial investment alongside Silverline, in turnaround assets, before the impact of COVID-19 had become apparent or the pandemic declared, was in contrast to its core focus on stabilised assets, with a consistently positive trading history and a good reputation in the local markets in which they operate, at affordable rents that can sustain high levels of rent cover.[2] In retrospect, although this deviation from the core strategy was unfortunate, it is worth noting that this is the only rent collection problem experienced by Impact since listing. Rent collection for Q123 was 98% (96% excluding the £0.2m Silverline rent deposit release) and we expect a similar level for H123. Excluding Silverline, rent collection is 100%, as has been the case since listing, with no lease variations.

For the wider portfolio, strong fee growth and increased home-level occupancy have continued to offset inflationary impacts, maintaining average rent cover at a strong 1.8x.

Our revised forecasts

Our revised forecasts assume a full repayment of lending to MHL by end FY24 and a full restoration of rents (at the previous level of £1.6m) from the beginning of FY25, forecast for the first time.

Impact has estimated that the rental default by Silverline, partly offset by rental deposits, and including the impact of the new arrangements agreed with MHL, will likely amount to a reduction in earnings versus its original FY23 budget of c £1m. Around half of this was reflected in our last published forecasts in May 2023, representing c £0.5m in our revised forecasts.

For FY24, we assume no rents are received from the homes operated by MHL (previously £1.6m), with any cash surplus used to repay MHL borrowings. For FY25, with all the debt repaid, we assume a sufficient cash surplus to support rental income of £1.6m. We also expect a first-time c £1m contribution from the Norwich forward-funded development, expected to reach practical completion by end FY24.

Any drawings on the MHL loan arrangement are covered in our previous cash projections, with no requirement for additional drawings on Impact's own debt facilities.

The FY24 rent reduction arising from the MHL arrangements is partly offset by increased rent indexation (3.5% versus 3.0% previously) reflecting the stubbornness of inflation.

We understand that the lease variation, from a set rent to a variable rent, will reduce portfolio contractual income but correspondingly increase rent collection.

Although our forecast earnings are reduced, we continue to expect increased DPS to be fully covered by adjusted 'cash' earnings, 102% in both FY23 and FY24, increasing to 106% in FY25.

2 Rent cover is a key metric used by Impact in monitoring and assessing the ability of individual homes and operators to support the rents that it expects from its portfolio sustainably. The ratio tracks home-level earnings before interest, tax, depreciation, amortisation, rent and group management overheads (EBITDARM), or operational cash earnings, on a rolling 12-month basis divided by rents over the same period. It excludes 'turnaround' and 'immature' homes. Immature homes are defined as homes that are newly opened or are undergoing major capital improvement requiring partial closure. The rent cover calculation excludes eight properties that are defined as turnaround or immature.

Exhibit 2: Forecast revisions

	New forecast			Previous forecast		Forecast change			
£m unless stated otherwise	**FY23e**	**FY24e**	**FY25e**	**FY23e**	**FY24e**	**FY23e**	**FY24e**	**FY23e**	**FY24e**
Cash rental income	39.3	40.6	42.5	39.8	41.4	(0.5)	(0.9)		
Interest from loan investments	6.1	6.5	6.5	6.1	6.5	0.0	0.0		
Net revenue*	45.4	47.1	49.0	45.9	47.9	(0.5)	(0.9)	-1%	-2%
Net finance costs	(8.6)	(9.5)	(9.5)	(8.7)	(9.5)	0.0	0.0		
Administrative costs	(8.1)	(8.3)	(8.4)	(8.1)	(8.3)	0.0	0.0		
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Adjusted earnings	28.7	29.3	31.2	29.1	30.1	(0.5)	(0.9)	-2%	-3%
IFRS adjustments	7.2	7.6	7.9	7.3	7.6	(0.0)	0.0		
Loan fee amortisation	(1.2)	(1.2)	(1.2)	(1.2)	(1.2)	0.0	0.0		
EPRA earnings	**34.7**	**35.7**	**37.9**	**35.2**	**36.5**	**(0.5)**	**(0.9)**	**-1%**	**-2%**
EPRA EPS (p)	8.4	8.6	9.2	8.5	8.8	(0.1)	(0.2)	-1%	-2%
Adjusted EPS (p)	6.9	7.1	7.5	7.0	7.3	(0.1)	(0.2)	-2%	-3%
DPS declared (p)	**6.8**	**7.0**	**7.1**	**6.8**	**7.0**	**0.0**	**0.0**	**0%**	**0%**
EPRA DPS cover	**124%**	**124%**	**129%**	**126%**	**127%**				
Adjusted DPS cover	**102%**	**102%**	**106%**	**104%**	**105%**				
EPRA NTA per share (NAV) (p)	111.4	114.3	116.0	111.5	114.6	(0.1)	(0.3)	0%	0%
NAV total return	7.5%	8.6%	7.4%	7.6%	8.7%				

Source: Edison Investment Research. Note: *Includes interest earned on investments via loans.

Impact has a clear and progressive dividend policy linked to rental growth. The FY23 DPS target represents an attractive yield of 7.0%. Meanwhile, the shares trade at a 14% discount to Q123 NAV per share of 112.6p. NAV increased from 110.17p at end FY22, with an increase in property values driven by like-for-like rental growth from its long, upward-only, index-linked leases.

The Silverline assets

Following detailed internal and independent assessment, Impact believes that the assets that were operated by Silverline are capable of providing an attractive and sustainable return with good levels of care, subject to enhanced stewardship, relating mainly to improvements in occupancy and staffing costs (with reduced reliance on expensive agency staffing).

Silverline became Impact's 11th tenant in March 2020, as the new operator of three homes acquired in Bradford for £7.5m, with the initial rent of £630k pa reflecting a gross yield of 8.1%. The homes were all purpose-built to a high standard by the vendor, providing 182 rooms, all ensuite. Under previous management, the homes had been through a period of underperformance and were acquired as a turnaround opportunity, to be operated by Silverline. Silverline operated other homes in Yorkshire, including one in Bradford, and presented Impact with plans to generate the required operational improvement.

The unfolding pandemic, with its negative impact on occupancy and staffing costs,[3] appears to have had a significantly negative impact on Silverline's wider performance and its ability to turn around the Impact-owned homes in Bradford. During 2021, the withdrawal of lending facilities led to several Silverline-owned and operated homes being forced into administration, triggering a reassessment of its strategy, including a greater focus on nursing care.

In November 2021, Impact completed the acquisition of Springhill Nursing care home in Kilmarnock, Scotland, for £3.25m, in a sale and leaseback with Silverline, with the initial rent of £243k pa just under 2x covered and reflecting a gross yield 7.5%. For Impact, the acquisition was attractively priced and immediately accretive and had the added benefit of freeing up capital for Silverline, supporting its business repositioning. Springhill is a four-storey Georgian building with a substantial purpose-built extension offering a total of 61 beds with ensuite wet room facilities. It was acquired with an EPC rating of C531 with a strategy to achieve an equivalent EPC rating of B.

3 Across the industry, staff shortages, including the impacts of sickness, infection control and reduction in the international movement of trained care staff, all increased the requirement for agency staff at a much higher cost.

The acquisition of three further Scottish properties was agreed in March 2022 and completed in August 2022, adding 155 beds, all ensuite. The aggregate consideration of £8.1m and initial rents of £628k reflected a gross yield of 7.75%. The homes were acquired with EPC ratings of English-equivalent B on one home and English-equivalent C on two homes, with a strategy to bring these two homes to English-equivalent B.

Exhibit 3: Financial summary

Year to 31 December (£m)	2019	2020	2021	2022	2023e	2024e	2025e
Cash rental income	19.1	25.9	30.5	35.9	39.3	40.6	42.5
Interest income from loaned portfolio investments	0.0	0.0	0.1	3.2	6.1	6.5	6.5
Rental income arising from recognising rental premiums, fixed rent uplifts & lease incentives	4.9	4.9	5.9	6.4	7.2	7.6	7.9
Net rental income	24.0	30.8	36.5	45.4	52.6	54.6	57.0
Administrative & other expenses	(4.6)	(5.3)	(5.8)	(7.0)	(8.1)	(8.3)	(8.4)
Realised gain on disposal	0.0	0.2	0.3	0.1	0.0	0.0	0.0
Operating profit before change in fair value of investment properties	19.4	25.7	31.0	38.6	44.5	46.4	48.6
Unrealised change in fair value of investment properties	9.1	5.6	4.2	(14.5)	(0.5)	4.7	(2.0)
Change in fair value of loan asset call option				(1.8)	0.0	0.0	0.0
Operating profit	28.5	31.3	35.2	22.3	44.0	51.0	46.6
Net finance cost	(2.1)	(2.5)	(3.3)	(5.4)	(10.6)	(11.5)	(11.4)
Profit before taxation	26.3	28.8	32.0	16.9	33.5	39.6	35.2
Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit for the year (IFRS)	26.3	28.8	32.0	16.9	33.5	39.6	35.2
Adjust for:							
Change in fair value of investment properties Including loan assets)	(9.1)	(5.6)	(4.2)	16.3	0.5	(4.7)	2.0
Gain on disposal	0.0	(0.2)	(0.3)	(0.1)	0.0	0.0	0.0
Change in fair value of interest rate derivatives	0.4	0.1	(0.1)	(0.4)	0.8	0.8	0.8
EPRA earnings	17.6	23.1	27.4	32.6	34.7	35.7	37.9
Rental income arising from recognising rental premiums & fixed rent uplifts	(4.9)	(4.9)	(6.0)	(6.5)	(7.2)	(7.6)	(7.9)
Amortisation of loan arrangement fees	0.4	0.7	1.0	1.2	1.2	1.2	1.2
Amortisation of lease incentive			0.1	0.1	0.0	0.0	0.0
Non-recurring costs	0.2	0.0	0.0	0.1	0.0	0.0	0.0
Gain on disposal	0.0	0.2	0.3	0.1	0.0	0.0	0.0
Adjusted earnings	13.4	19.1	22.7	27.7	28.7	29.3	31.2
Average number of shares in issue (m)	254.0	319.0	339.8	390.1	414.1	414.4	414.4
Basic & diluted IFRS EPS (p)	10.37	9.02	9.41	4.33	8.08	9.55	8.49
EPRA EPS (p)	6.95	7.25	8.05	8.37	8.38	8.61	9.15
Adjusted EPS (p)	5.26	5.98	6.68	7.11	6.92	7.07	7.52
Dividend per share (declared) (p)	6.17	6.29	6.41	6.54	6.77	6.96	7.10
EPRA earnings dividend cover	113%	115%	126%	128%	124%	124%	129%
Adjusted earnings dividend cover	85%	95%	104%	109%	102%	102%	106%
NAV total return	9.5%	8.5%	8.4%	3.8%	7.5%	8.6%	7.4%
EPRA cost ratio		17.1%	15.8%	16.6%	17.4%	17.2%	16.6%
BALANCE SHEET							
Investment properties	310.5	405.7	437.6	504.3	517.8	534.0	540.0
Other non-current assets	10.1	15.9	62.0	68.1	132.5	139.3	146.5
Non-current assets	320.7	421.6	499.7	572.4	650.3	673.3	686.5
Cash and equivalents	47.8	8.0	13.3	22.5	8.8	8.9	3.7
Other current assets	0.6	0.1	1.6	1.5	2.1	1.4	1.6
Current assets	48.3	8.1	14.8	24.1	10.9	10.3	5.3
Borrowings	(23.5)	(74.2)	(110.9)	(122.4)	(183.4)	(194.6)	(195.8)
Other non-current liabilities	(1.8)	(2.8)	(2.6)	(4.3)	(4.3)	(4.3)	(4.3)
Non-current liabilities	(25.2)	(77.0)	(113.5)	(126.7)	(187.7)	(198.9)	(200.1)
Borrowings	0.0	0.0	0.0	(14.8)	0.0	0.0	0.0
Other current liabilities	(3.1)	(3.1)	(6.7)	(9.1)	(10.6)	(11.0)	(11.6)
Current Liabilities	(3.1)	(3.1)	(6.7)	(23.9)	(10.6)	(11.0)	(11.6)
Net assets	340.7	349.5	394.2	445.9	462.8	473.8	480.1
Adjust for derivative financial liability/(asset)	(0.1)	(0.0)	(0.1)	(0.4)	(1.1)	(0.4)	0.4
EPRA net tangible assets (NTA)	340.6	349.5	394.2	445.6	461.7	473.4	480.5
Period end shares (m)	319.0	319.0	350.6	404.8	414.4	414.4	414.4
IFRS NAV per ordinary share (p)	106.8	109.6	112.4	110.2	111.7	114.3	115.9
EPRA net tangible assets (NTA) per share (p)	106.8	109.6	112.4	110.1	111.4	114.3	116.0
CASH FLOW							
Net cash flow from operating activities	14.9	21.0	(13.9)	29.5	(24.2)	33.3	34.6
Purchase of investment properties (including acquisition costs)	(73.4)	(88.5)	(28.1)	(71.9)	(4.5)	(3.5)	0.0
Capital improvements	(8.2)	(1.7)	(1.1)	(11.2)	(9.5)	(8.0)	(8.0)
Other cash flow from investing activities	0.1	0.9	1.6	5.3	6.1	6.5	6.5
Net cash flow from investing activities	(81.5)	(89.3)	(27.6)	(77.7)	(7.9)	(5.0)	(1.5)
Issue of ordinary share capital (net of expenses)	132.2	0.0	34.6	60.5	11.2	0.0	0.0
(Repayment)/drawdown of loans	(0.9)	51.2	38.2	27.7	45.0	10.0	0.0
Dividends paid	(16.1)	(20.0)	(21.9)	(25.7)	(27.7)	(28.6)	(28.8)
Other cash flow from financing activities	(2.2)	(2.8)	(4.1)	(5.1)	(10.2)	(9.5)	(9.5)
Net cash flow from financing activities	112.9	28.5	46.8	57.4	18.4	(28.2)	(38.3)
Net change in cash and equivalents	46.3	(39.8)	5.3	9.2	(13.7)	0.1	(5.2)
Opening cash and equivalents	1.5	47.8	8.0	13.3	22.5	8.8	8.9
Closing cash and equivalents	47.8	8.0	13.3	22.5	8.8	8.9	3.7
Balance sheet debt	(23.5)	(74.2)	(110.9)	(137.2)	(183.4)	(194.6)	(195.8)
Unamortised loan arrangement costs	(1.7)	(2.2)	(3.6)	(5.1)	(3.9)	(2.7)	(1.5)
Net cash/(debt)	22.7	(68.4)	(101.3)	(119.8)	(178.5)	(188.4)	(193.6)
Gross LTV (net debt as % gross assets)	6.8%	17.8%	22.3%	23.8%	28.3%	28.9%	28.5%

Source: Impact Healthcare REIT historical data, Edison Investment Research forecasts

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