Impact Healthcare REIT

Quarterly update

Strong cash flow underpins further DPS growth

Real estate

Impact Healthcare REIT's Q423 update shows a continued strengthening in operational and financial tenant performance, reflected in a record level of rent cover and 100% rent collection. With cash flow remaining strong, we expect the FY23 DPS of 6.77p (+3.5%) was fully covered by adjusted 'cash' earnings and the FY24 DPS target has been set at 6.95p (+2.7%). We will review our forecasts with the full year results in late March.

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	0.79	7.5
12/23e	53.4	33.9	8.2	114.5	6.77	0.76	7.8
12/24e	56.2	34.6	8.3	118.9	6.95	0.73	8.0
12/25e	59.4	38.4	9.3	123.9	7.10	0.70	8.2

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

100% rent collection and rent cover at record level

Although FY23 earnings and NAV are not yet available, Impact does say that the FY23 DPS, and its target for FY24, are both in line with its aims of paying a growing dividend, fully covered by adjusted earnings. Contracted rents increased 13% y-o-y to £49m, driven by inflation-linked rent reviews and a significant and accretive acquisition. Tenant operators have benefited from the continuing post-pandemic recovery in occupancy (to 88.2% versus 87.4% a year earlier) and strong fee growth (c 14%). With rent increases capped at c 4%, rent cover of 2.2x is at its highest since Impact listed in 2017. Rent collection was 100% in Q4 and more than 99% for the year, and the seven homes that were previously leased to Silverline are showing improved performance under the new operator. During the turnaround, no rents are due (but are included in contracted rent roll), but the progress made gives us confidence in our expectation of a full resumption of rental payments in FY25.

Structurally supported and affordable

Providing a strong tailwind, Impact operates in a structurally supported market, where care demand is driven by the demographics of a growing elderly population rather than the economy. Leases are long term (Impact has a 21-year weighted average unexpired lease term) and inflation indexed, while caps at c 4% manage the risks for landlord and tenant alike. Based on an affordable level of rents for tenants, the Q3 portfolio EPRA 'topped-up' net initial yield of 6.9% generates strong cash flow, underpinning returns. DPS has increased each year since listing in 2017, driving consistently positive accounting returns, averaging 7.1% per year. High asset yields, combined with stable, long-term cash flows, have mitigated the impact of rising capital costs on care home properties and rental growth drove valuation uplifts in Impact's portfolio in each of the first three quarters of 2023.

Valuation: Income-driven, long-term returns

The FY24 DPS target represents an attractive yield of 8% and we forecast this to be fully covered by growth in adjusted 'cash' earnings. Meanwhile, the shares trade at a 24% discount to the last published (September) EPRA NTA per share.

31 January 2024

Price	**87p**
Market cap	**£359m**
Gross debt (£m) at 31 December 2023	184.8
Gross LTV at 31 December 2023* *Based on 30 Sept. portfolio valuation	27.7%
Shares in issue	414.4m
Free float	91.9%
Code	IHR
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(3.8)	6.5	(18.4)
Rel (local)	(2.8)	0.6	(16.9)
52-week high/low		108p	79p

Business description

Impact Healthcare REIT invests in a diversified portfolio of UK 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

FY23 results	Late March 2024

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Edison profile page

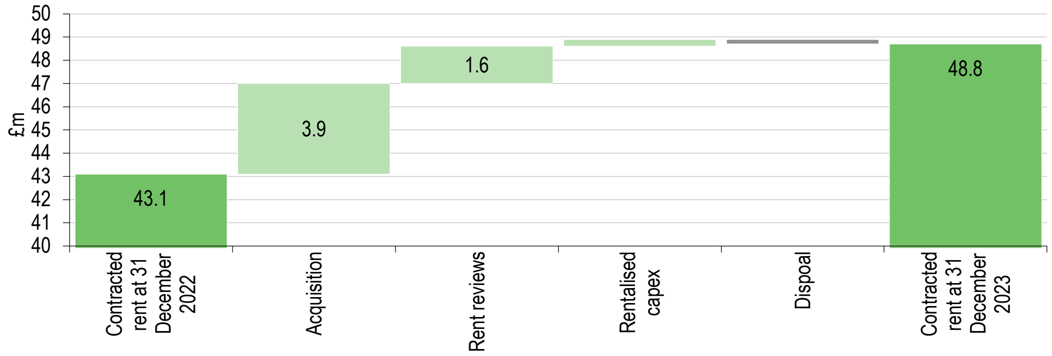
Impact Healthcare REIT is a research client of Edison Investment Research Limited

Further details from the trading update

Rent growth driven by reviews and acquisition

The acquisition of a six-home portfolio of homes in January 2023 and annual rent reviews were the main drivers of contracted rent growth, adding £3.9m and £1.6m respectively (an average 4.1% pa uplift).

Exhibit 1: Growth in FY23 contracted rents



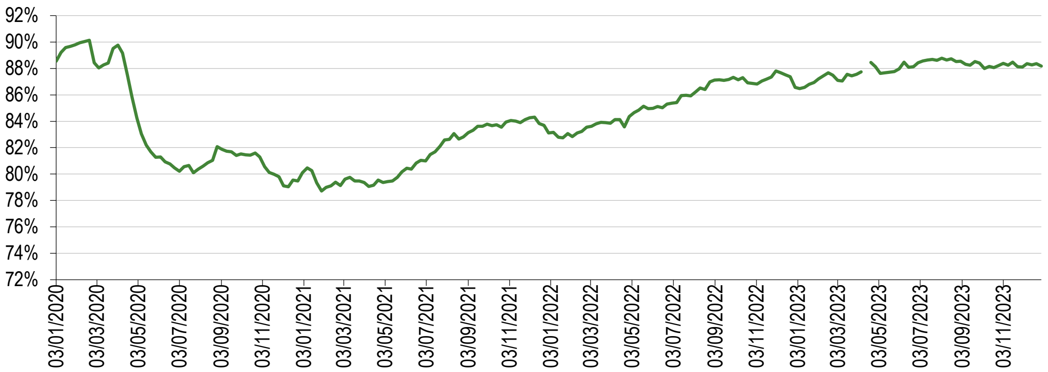
Source: Impact Healthcare REIT

As discussed in a previous note, the acquired homes, each with good Energy Performance Certificate ratings and an established track record of delivering strong operational performance, added more than 400 beds to Impact's portfolio, mostly with ensuite bathrooms. They are let to existing tenant, Welford, on 35-year leases with annual RPI-linked uplift (capped and collared). Despite the increased cost of capital, the acquisition gross initial yield of 7.0%, combined with an innovative financing structure, was immediately accretive. The £56m funding comprised new equity issued to the vendors, attractively priced at the last published NAV despite the prevailing share price discount, and cash/newly drawn debt, hedged for two years at a total all-in cost of 6.5%. By the time the debt cost hedging matures, contracted rent is expected to have increased with indexation, while the market consensus is for interest rates to be falling.

Tenant performance remains strong

The average home-level occupancy achieved by Impact's tenants increased to 88.2% during the year from 87.4% at end FY22, with upside remaining to the c 90% pre-pandemic level. The level of increase has levelled out in recent months, and in this respect we note indications across the sector that some operators are increasingly focused on ensuring that fees for new residents are appropriate to the level of required care, as opposed to simply prioritising occupancy. Average weekly fees have grown strongly, up 12% in the 12 months to September, with the preliminary data indicating faster growth in the final quarter of the year, to 14% in the 12 months December.

Exhibit 2: Tenant home-level resident occupancy

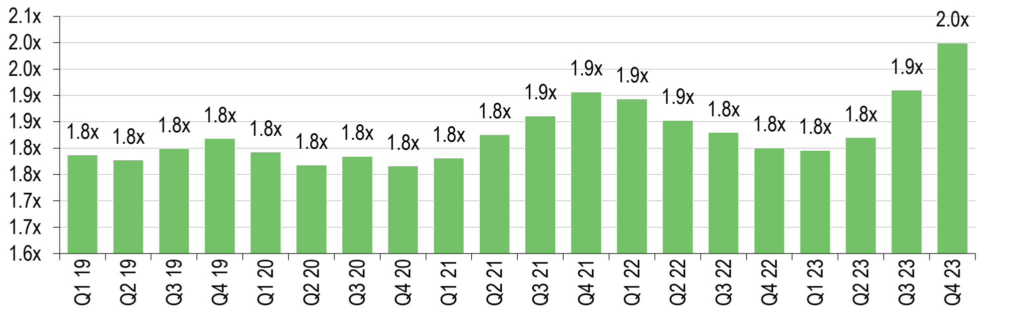


Source: Impact Healthcare REIT

In addition to higher occupancy and strong fee growth, the caps on rent increases have also protected tenants against the pressures of elevated inflation, just as they are designed to do. Similarly, over previous periods of low inflation, the floors on rent increases (typically c 2%) have worked to the company's advantage.

Average rent cover[1] during the three months to end-September (Q3 rent cover) was 2.2x (1.9x in Q322) and was the strongest quarterly tenant performance since Impact listed in 2017. Based on the December data thus far received, Q4 was maintained at this high level despite operators typically reporting lower seasonal profitability in the period, reflecting the timing of increases in fees and staff costs. Impact estimates that on a rolling 12-month basis, average rent cover for 2023, as a whole, was 2.0x compared with 1.8x in 2022.

Exhibit 3: Rent cover on a rolling 12-month basis



Source: Impact Healthcare REIT

Turnaround of Silverline assets progressing well

The strength of rent cover across the portfolio provides a strong indication that the problems encountered by Silverline stemmed from its inability to respond effectively to industry challenges and were not indicative of wider stresses among Impact's 13 tenants. The portfolio of seven homes that were previously tenanted and operated by Silverline continues to show improved performance under the management of Melrose, an affiliate of the Minster Group, since June 2023.

1 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.

Impact says that portfolio of four homes in Scotland has an average occupancy of 88% and is now cash flow positive. Negotiations are well advanced to transfer these homes back to rent generating operational leases.[2]

The portfolio of three homes in Bradford is expected to be cash flow positive by the end of the first quarter of 2024, with discussions underway on a proposed change to the management of the properties.

Our current forecasts do not assume rental income from the seven properties until the start of FY25, with positive cash flow meanwhile used to repay inter-company borrowing. From the beginning of FY25, we assume rental income of £1.6m pa, in line with previous rent paid by Silverline.

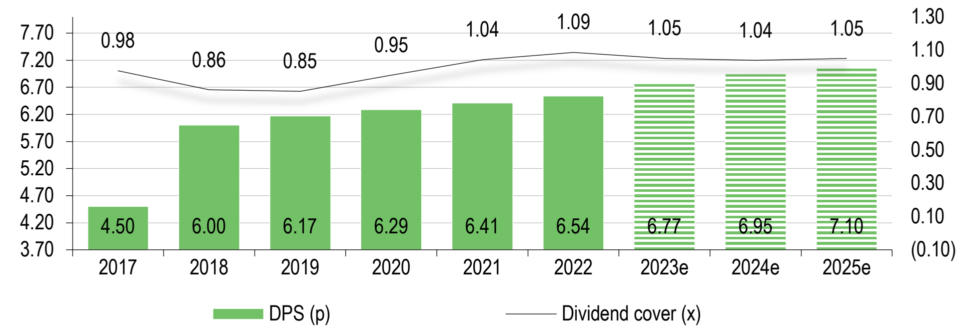
DPS has increased each year since listing in 2017

DPS has increased each year since listing in 2017, driving consistently positive accounting returns, averaging 7.1% per year up to 30 September 2023. Distributions have been fully covered by EPRA earnings throughout and since 2019, as the portfolio increased in scale, by adjusted 'cash' earnings. In H123, DPS was 109% covered by cash earnings and, including non-cash IFRS rent smoothing adjustments, 123% by EPRA earnings.

The trading statement indicates that the FY23 DPS of 6.77p was fully covered by adjusted earnings, in line with dividend policy. Ahead of the FY23 annual results being published, our current forecasts show FY23 DPS covered by 1.05x and the increased FY24 DPS target by 1.04x.

With the interest costs on 95% of the £185m end-2023 debt fixed or hedged, interest rate fluctuations pose little risk to our FY24 forecasts. Although the interest rate hedges that are in place are of relatively short duration (£50m matures at end 2024 and £50m in August 2025), this provides Impact with the flexibility to review its longer-term financing at a point when a decline in interest rates is implied by the current market yield curve.

Exhibit 4: Progressive dividends and cash cover



Source: Impact Healthcare REIT data, Edison Investment Research

[2] During the turnaround period, no rent is due from Melrose, with surplus cash flows directed initially at the repayment of inter-company borrowings. See our June update note.

Exhibit 5: Financial summary

Year to 31 December (£m)	2021	2022	2023e	2024e	2025e
Cash rental income*	30.5	39.1	46.3	47.6	50.0
IFRS adjustments for guaranteed uplifts and lease incentives	5.9	6.4	7.4	8.6	9.4
Gross rental income	36.5	45.4	53.7	56.2	59.4
Net other income/(expense)	0.0	0.0	0.0	0.0	0.0
Bad debt charge	0.0	0.0	(0.4)	0.0	0.0
Net rental income	36.5	45.4	53.4	56.2	59.4
Administrative & other expenses	(5.8)	(7.0)	(7.6)	(7.7)	(7.8)
Realised gain on disposal	0.3	0.1	(0.0)	0.0	0.0
Operating profit before change in fair value of investment properties	31.0	38.6	45.7	48.5	51.6
Unrealised change in fair value of investment properties	4.2	(16.3)	12.9	10.0	10.4
Operating profit	35.2	22.3	58.6	58.5	62.0
Net finance cost	(3.3)	(5.4)	(10.8)	(13.9)	(13.9)
Profit before taxation	32.0	16.9	47.9	44.5	48.1
Tax	0.0	0.0	0.0	0.0	0.0
Profit for the year (IFRS)	32.0	16.9	47.9	44.5	48.1
Adjust for:					
Realised and unrealised gain/(loss) on investment properties	(4.5)	16.1	(12.9)	(10.0)	(10.4)
Change in fair value of interest rate derivatives	(0.1)	(0.4)	(1.1)	0.0	0.7
EPRA earnings	27.4	32.6	33.9	34.6	38.4
Rental income arising from recognising rental premiums & fixed rent uplifts	(6.0)	(6.5)	(7.5)	(8.6)	(9.4)
Amortisation of loan arrangement fees	1.0	1.2	1.5	1.5	1.5
Interest received on rate cap	0.0	0.1	1.5	2.5	0.4
Other adjustments	0.4	0.3	0.1	0.0	0.0
Adjusted earnings	**22.7**	**27.7**	**29.5**	**29.9**	**30.9**
Average number of shares in issue (m)	339.8	390.1	414.2	414.4	414.4
Basic & diluted IFRS EPS (p)	9.41	4.33	11.56	10.75	11.60
EPRA EPS (p)	8.05	8.37	8.19	8.34	9.26
Adjusted EPS (p)	**6.68**	**7.11**	**7.11**	**7.22**	**7.45**
Dividend per share (declared)	**6.41**	**6.54**	**6.77**	**6.95**	**7.10**
EPRA earnings dividend cover	126%	128%	121%	120%	130%
Adjusted earnings dividend cover	**104%**	**109%**	**105%**	**104%**	**105%**
NAV total return	8.4%	3.8%	10.7%	9.3%	9.7%
EPRA cost ratio	15.8%	16.6%	15.2%	13.7%	13.1%
BALANCE SHEET					
Investment properties	437.6	504.3	616.7	640.6	659.0
Other non-current assets	62.0	68.1	38.0	46.6	56.0
Non-current assets	499.7	572.4	654.6	687.2	715.0
Cash and equivalents	13.3	22.5	17.1	15.6	10.2
Other current assets	1.6	1.5	5.3	2.2	1.3
Current assets	14.8	24.1	22.4	17.8	11.4
Borrowings	(110.9)	(122.4)	(186.1)	(197.6)	(199.1)
Other non-current liabilities	(2.6)	(4.3)	(2.4)	(2.4)	(2.4)
Non-current liabilities	(113.5)	(126.7)	(188.5)	(200.0)	(201.5)
Borrowings	0.0	(14.8)	0.0	0.0	0.0
Other current liabilities	(6.7)	(9.1)	(10.8)	(11.4)	(12.1)
Current Liabilities	(6.7)	(23.9)	(10.8)	(11.4)	(12.1)
Net assets	394.2	445.9	477.7	493.6	512.9
Adjust for derivative financial liability/(asset)	(0.1)	(0.4)	(3.2)	(0.8)	0.3
EPRA net tangible assets (NTA)	**394.2**	**445.6**	**474.5**	**492.9**	**513.2**
Period end shares (m)	350.6	404.8	414.4	414.4	414.4
IFRS NAV per ordinary share	112.4	110.2	115.3	119.1	123.8
EPRA net tangible assets (NTA) per share	**112.4**	**110.1**	**114.5**	**118.9**	**123.9**
CASH FLOW					
Net cash flow from operating activities	(13.9)	29.5	38.2	41.1	42.8
Purchase of investment properties (including acquisition costs)	(28.1)	(71.9)	(48.6)	(6.0)	0.0
Capital improvements	(1.1)	(11.2)	(4.5)	(8.0)	(8.0)
Other cash flow from investing activities	1.6	5.4	2.2	0.0	0.0
Net cash flow from investing activities	(27.6)	(77.7)	(50.8)	(14.0)	(8.0)
Issue of ordinary share capital (net of expenses)	34.6	60.5	(0.0)	0.0	0.0
(Repayment)/drawdown of loans	38.2	27.7	48.5	10.0	0.0
Dividends paid	(21.9)	(25.7)	(27.8)	(28.6)	(28.8)
Other cash flow from financing activities	(4.1)	(5.1)	(13.5)	(10.0)	(11.3)
Net cash flow from financing activities	46.8	57.4	7.2	(28.6)	(40.2)
Net change in cash and equivalents	**5.3**	**9.3**	**(5.5)**	**(1.5)**	**(5.4)**
Opening cash and equivalents	8.0	13.3	22.5	17.1	15.6
Closing cash and equivalents	13.3	22.5	17.1	15.6	10.2
Balance sheet debt	(110.9)	(137.2)	(186.1)	(197.6)	(199.1)
Unamortised loan arrangement costs	(3.6)	(5.1)	(4.7)	(3.2)	(1.6)
Net cash/(debt)	**(101.3)**	**(119.7)**	**(173.7)**	**(185.2)**	**(190.6)**
Gross LTV (net debt as % gross assets)	22.3%	23.8%	28.2%	28.5%	27.6%

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

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