Retirement Communities in the UK

Market Review P1
Financing and Policy P3
Event Fees as an Asset Class P4

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Key Points

Market

- Significant investments in retirement communities by major insurers AXA and Legal & General, with Bupa already committed to Richmond Villages, signal a rapidly maturing sector
- Large-scale mid-market developments of 250+ units are being rolled out by several operators, which will popularise the retirement community concept further
- New entrants to the market are principally from a real estate rather than care background, prompting new strategies to outsource care and to acquire domiciliary care providers.

Policy

- Clarity on the Law Commission and, by extension, government view of Event Fees has given market participants increased comfort on levying such fees; they are likely to become industry-standard
- The government's proposal to introduce legislation on leaseholds for houses may adversely affect the sector, but there is a case to be made for exemption of retirement communities.

Dan Conaghan
Director
d.conaghan@conaghanco.com
T: 020 3709 4571

Thomas Stringer
Associate
t.stringer@conaghanco.com
T: 020 3709 4571

Conaghan & Company
29 Farm Street
London W1J 5RL

www.conaghanco.com

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It Takes a Village: Scaling the Sector

The retirement communities sector in the UK may fairly be said to have come of age. Consolidation, not least by major insurers, a wave of new entrants and the expansion of existing operators' portfolios all point towards a maturing market. The growing recognition of Event Fee annuity streams as a valuable, if nascent, asset class of their own provides an added incentive for participants. But while the outlook remains positive, lenders' and investors' enthusiasm for the sector is tempered by the scarcity of good development sites, particularly in greater London, and macro concerns over a stagnant UK housing market.

Two major insurers have entered the market in recent months, largely by acquisition. **Legal & General Capital** acquired English Care Villages and Renaissance Villages in August and November respectively, creating a new mid-market brand called Inspired Villages Group. L&G's aim is to build a 3,000-unit portfolio, with new-build units likely to come from L&G Modular, its modular homes construction group. The GBP 40m English Care Villages acquisition brought two schemes, while the GBP 102m (including debt; a 13% discount to book value) acquisition of Renaissance Villages from Helical PLC brought a further four – a total of 1,000 units. **AXA Investment Managers-Real Assets** acquired Retirement Villages Group from an investor group including RVG's chairman Nigel Welby, in October 2017. The portfolio of 14 villages comprising 1,274 independent living units and 402 care beds traded for, we believe, up to GBP 175m. The care homes will be managed by HC-One under new 25-year leases.

We see the moves by AXA and by L&G in particular as part investment play and part learning experience in what is still a nascent market. As major insurers, the exposure to Event Fee income streams will also be attractive. We estimate, for example, that a mid-market operation of scale (a target of 3,000 units) such as L&G's Inspired Villages would generate in excess of GBP 21m per annum at steady state (assuming an average seven-year stay, a 10% Event Fee, an average unit price of GBP 500,000).

We note a significant number of recent new entrants to the market, predominantly from the residential real estate sector and mostly with little or no background in the provision of care. Many intend to outsource their care offering or acquire domiciliary care providers (as **Auriens**, the central London-focused operator, has done with Draycott Nursing) at an appropriate point. In almost all cases, with Auriens being a notable exception, new entrants intend to charge Event Fees. Such fees will likely range from 10% to 30%.

Among the new arrivals is **Amicala**, a partnership between DGS Capital and Lipton Rogers, the development firm formed by Sir Stuart Lipton and Peter Rogers who are veterans of the London real estate market. Amicala will build a series of retirement communities for the over-75s in central and greater London. Similarly, **Goldman Sachs'** Special Situations Group has partnered with the **Riverstone** vehicle to develop a portfolio of premium retirement communities in London Zones 1-4. We note Goldman Sachs' historic investment in Rothesay Life, a bulk annuity consolidator, which it exited in August 2017 after a 10-year hold and a planned IPO (albeit one which did not proceed), and see this as a likely template for its investment in retirement communities.

The other major recent entrant to the market is **Liberty Retirement Living**, a GBP 200m joint venture between the Places for People Group and Octopus Investments to create a 2,500-unit portfolio. Led by Jane Barker, Liberty's plan envisages the development of five villages per year, each comprising 100 units, many of which will be of modular construction, with mixed tenure. Event Fees will be charged on the for-sale units. It has six retirement communities currently in construction and planning. The venture complements Places for People's Girlings Retirement Rentals business, acquired in 2014, which now lets and manages 2,500 rental retirement properties.

Liberty's offering is positioned in the mid-market, where it will likely compete with **Audley Group's Mayfield Villages** brand. Audley is building out its first 253-unit Mayfield village in Watford, Hertfordshire, with starting prices of GBP 262,500 – significantly lower than comparable villages in the upper-mid market nearby. Audley, now owned by Moorfield Audley Real Estate Fund, has GBP 400m to deploy for Mayfield Villages and expects to build a portfolio of 2,500 units over time. Mayfield will undoubtedly grow the mid-market and we expect other operators to pursue the very substantial cohort of prospective retirees with budgets of circa GBP 250,000 – 350,000.

Development

The Search for Sites

The scarcity of development sites, with or without C2 planning consent, is proving a drag on the sector, particularly in the London area. In theory, the softening in the residential market and the natural advantage which retirement community operators bring with their bids – the absence of affordable housing quotas for C2 and, arguably, their ability to pay more because of the cashflow from future Event Fees – should ease the market. In practice, there are few suitable, large sites (1-2 acres) in greater London and stiff competition in the Home Counties. Proposed developments on greenbelt land are proving problematic, given the sensitivities of both public and government.

In central London, values for retirement community development sites vary widely and appraisals range between GBP 1,000 – 3,000 per sq ft. Auriens begun marketing its scheme at the 0.75-acre, former Thamesbrook Hospital site in Chelsea SW3, which commanded bids of well over GBP 60m; and the 2.7-acre Heythrop College site in Kensington W8, where bidding exceeded GBP 100m. In Clapham SW4, Apache Capital has struck a deal with Audley to build out and operate a 150,000 sq ft scheme (replacing previous operating partner Red & Yellow). The Clapham development will have a GDV of GBP 125m, implying 80-90 units, with practical completion scheduled for 2020. Meanwhile, LifeCare Residences intends to develop its site in West Hampstead NW6, acquired in 2016, with an 82-unit scheme and a 15-bed nursing home. Similar retirement living schemes are planned nearby by Elysian Residences and Audley. We expect stiff competition for London sites among existing operators and newcomers including Amicala and Goldman Sachs in 2018.

Outside London, we are seeing development sites in affluent areas around the M25 change hands at cGBP 1.0-2m per acre. We note the arrival of Birchgrove, a new retirement community operator with a rental-only model and backed by Bridges Fund Management which intends to acquire sites in the south-eastern counties; its first scheme will be on a site in Sidcup, Bexley. Audley plans further sites in Surrey, Hampshire, Berkshire (its first scheme in partnership with a housebuilder, in this case Berkeley) and Worcestershire. There continues to be strong interest from other operators in sites in the Henley/Maidenhead and Reading areas.

We expect investment to follow the market in the North East and North West of England, areas which are predicted to see increasing house prices over the next five years while the south/south east flatlines. One example is the proposed large-scale scheme near York by the Galtres Garden Village Development Company. The scheme envisages 290 retirement homes and a care home as part of a 1,750-unit development.

All the operators we consider to offer retirement communities with care are privately-held. However, we expect **Audley Group** to be first to consider a public listing as its premium portfolio matures (and as Mayfield Villages is rolled out). Its most recent accounts note that by 2020 it expects to have 24 villages (currently 15) and over 3,000 retirement properties across the UK. Audley also provides an insight into its Event Fee model, which it calls a ‘deferred management charge’ and which contributed GBP 4.6m of accrued income in 2016. The charge is ‘calculated at either 0.5% or 1% per year of occupation [by a resident / owner], or part thereof. It may not be capped or may be capped at either 5% or 15% of sale proceeds or agreed valuation of said premises’. Overall, although Audley acknowledges that, like other operators, it is ‘exposed to the general risk of a downturn in the housing market’, because its residents generally have to sell their home in order to acquire an Audley property, the company notes that it is able to ‘capitalise on a potential GBP 1.7 trn of mortgage-free housing wealth held by over 65s’. This remains the continuing – and, in our view, compelling – investment thesis for the sector.

Scaling the Sector - Largest Operators and Market Size by 2023

Brand	Owner	Event Fee	2018A		2023F	
			Villages	Units	Villages	Units
The ExtraCare Charitable Trust	The ExtraCare Charitable Trust	Y	18	4,318	26	6,398
Liberty Retirement	Places for People / Octopus Invts	Y	6	544	25	3,044
Audley Retirement Villages	Moorfield Audley Real Estate Fund	Y	15	1,411	24	3,000
Inspired Villages Group	Legal & General Capital	Y	6	1,000	15	2,500
Mayfield Villages	Moorfield Audley Real Estate Fund	Y	1	253	10	2,500
Retirement Villages UK	AXA Invt Mgrs - Real Assets	Y	14	1,274	24	2,250
Anchor	The Anchor Group	Y	9	630	20	1,530
Richmond Villages	Bupa	Y	9	700	15	1,300
MHA	Methodist Homes	na	9	450	18	900
LifeCare Residences	LifeCare Residences	Y	3	250	7	500
Other Operators			100	6,000	300	18,000
Total				**16,830**		**41,922**

Notes:
Villages and units in 2018 include those in development
MHA - retirement villages only; the company accommodates a total of 2,660 in 64 retirement communities
Sources: Conaghan & Company; company reports

Operators including Audley and the insurers who have ambitions to create multi-thousand portfolios of units are shaping the sector landscape, as the table above illustrates. They join long-established charities such as **The ExtraCare Charitable Trust**, **Anchor** and **MHA** as large-scale players. At the premium end of the market, we expect further London developments from **LifeCare Residences**, leveraging strong interest in its Battersea Place development; from **Elysian Residences**, which is building two villages, at Stanmore and Hampstead; and from a clutch of new entrants. Overall, we expect the core, (ie largely privately-run and for-profit) retirement community sector to approximately triple in the next five years.

Domiciliary and Residential Care

What 'Good' Looks Like

How are operators of retirement communities handling the provision of day-to-day domiciliary care and residential care? Besides a general trend to embrace assistive technology and iPad-based care compliance, broadly speaking, three models are emerging:

- Integrated care
- Care 'by acquisition'
- Outsourced Care

By 'integrated care', we mean home-grown and a core part of an operator's offering and ethos. LifeCare Residences, for example, has a strong track record of delivering care in-house. It received a 'Good' inaugural rating by CQC for its Battersea Place development (June 2017). (Interestingly, only eight people out of 105 occupied apartments were receiving care six months after opening, illustrating the need to phase care and care staff to match a retiree cohort which is predominantly active and healthy at entry). Integrated care has other potential advantages, including allowing an operator to make a strong case to planning authorities for C2 consent and to local councils that it will become a major employer in its area.

The trend for solving the care piece 'by acquisition' is exemplified by Audley's acquisition of Red Kite and Auriens purchase of Draycott Nursing to provide care for the residents of its two London developments. It may be that other domiciliary care providers, in a sector which is under pressure, find a new lease of life under the aegis of expanding retirement community operators.

Outsourced care is a well-established practice in the sector. For example, Rangeford's partnership with MHA at its Mickle Hill village in Pickering, North Yorkshire, and Amber Infrastructure Group's partnership with Bluebird Care in the West Midlands. Outsourcing is likely to increase as new entrants to the market with pure real estate backgrounds but little or no experience of care delivery.

For longer-term care, where a village is co-located with a care home, there is an increasing trend to bring in experienced care home operators. Besides the deal struck between AXA IM and HC-One for Retirement Villages UK's care home portfolio, we note the arrangement between Castle Retirement Living and Care UK, whereby Care UK will operate a 72-bed home adjacent to the Castle's retirement village in Windsor and provide a 'menu of professional care' to village residents.

Such outsourcing and partnerships mitigate risk for operators and investors, in terms of direct exposure to CQC oversight, but can engender a 'care gap' in the overall offering. The danger of village operators losing control of care and of residents finding themselves caught between a real estate owner-operator and a third-party care provider is a real one.

Financing

There is steady appetite for financing site acquisition and construction of retirement communities from the main clearing banks, challenger banks and real estate debt funds. At the banks, the traditional configuration whereby a CRE team will assess the 'residential' element of a retirement community, while colleagues in the healthcare team form a view on the 'care' element is gradually being updated as the market matures. Metro Bank, for example, has assembled a single multi-disciplinary team to look at transactions in the sector. This cultural shift will make it easier for operators to navigate the debt market for development finance. However, we have yet to see any serious appetite to lend against prospective Event Fee annuity streams.

Besides the clearing banks, other active lenders include Bank Leumi, which has financed Audley developments, and Octopus, which is raising the Octopus Retirement Fund (ORF) to deploy capital in the sector. Octopus already oversees its own Rangeford and Aura retirement village brands and has supported Castle Retirement Living's 65-unit scheme at Windsor, currently under construction. We also note Investec's support for Auriens and that of Coutts and AIG for Audley.

On the equity side, we see gradual but growing interest in the sector. Besides the insurers and Goldman Sachs, referred to above, we note the presence of Amber Infrastructure Group, a large infrastructure and real estate investor, which is building a high-quality portfolio of independent living and extracare developments; its first schemes are in Henley, Oxon, and in Balsall Common, West Midlands.

Traditional private equity has been slow to enter the market, partly because development and maturity lead times exceed most funds' investment horizons, which are typically 5-7 years. We expect to see further interest from longer-dated funds, such as the large US and Canadian pension funds and Sovereign Wealth Funds in due course.

Anecdotally, we are also aware of equity interest from several large US investors, particularly in rental product in the UK, and from American and Australasian operators seeking to enter the UK market.

Policy

The principal policy issue affecting retirement communities has been the validity or otherwise of Event Fees levied on resales. Following a lengthy consultation, the Law Commission, an independent body, made a series of recommendations to the Department for Communities and Local Government (DCLG) in 2017. These centred on making Event Fees fair and transparent, and allowing exemptions from such fees for residents in certain circumstances.

The UK government's response to the Law Commission's report has been positive. In a letter (26 November) to Sir David Bean, the Commission's chair, Alok Sharma MP, the erstwhile Minister for Housing and Planning, welcomed the 'recommendations to help ensure fairness and transparency in the leasehold retirement sector'. He added that 'not only will this benefit older leaseholders, but it will give sector lenders the confidence to lend and builders to build more retirement homes'. Implementation of the Commission's recommendations will inevitably take time, however.

Event Fees aside, the announcement on 21 December by the Communities Secretary Sajid Javid MP, of a ban on leaseholds for most new-build homes will be closely tracked. The government will introduce legislation to prevent the sale of new build leasehold houses (and it appears that this is specifically for houses rather than for apartments) 'except where necessary such as shared ownership'. Changes will also be made so that ground rents on new long leases – for both houses and flats – are set to zero.

In DCLG's summary of consultation responses elicited prior to the announcement, it states that 'In relation to retirement villages, respondents noted that leasehold was particularly helpful given the high level of shared services in retirement villages, and to ensure that age restrictions were maintained on future sale. Similarly, where a retirement village is a specialist development, providing housing with extra care, the services to new owners needed to be managed through the covenants in the lease.' The case for 'limited exemptions' may well apply to retirement community residential units, but this remains to be seen. ARCO, the retirement community sector's association which is led by Audley CEO Nick Sanderson and Anchor's CEO Jane Ashcroft, has said it will lobby DCLG 'to emphasise the specific requirements of retirement communities providing care and support and to better understand how this will apply to our sector'.

Service Charges

'Fix & Cap' – Subsidy and Marketing Tool

Most retirement community operators require residents to pay a Service Charge (in London, at least GBP 1,000 per month, in the Home Counties, typically GBP 600-700 per month). Typically, Service Charges cover maintenance costs of the village, such as estate management, cleaning, refuse collection, insurance and, in some cases, utilities.

Some operators offer to 'fix and cap' the Service Charge such that it remains at the level it was at the residents entry point and is not subject to annual increases. This is a potentially powerful marketing tool, providing peace of mind for residents who are often 'income poor'. Fixing also helps justify Event Fees payable on exit and contributes to the 'enjoy now, pay later' pitch.

From the operator's point of view, what is the cost of such fixing and capping and is the implicit 'subsidy' worth it?

If we assume a GBP 600 monthly Service Charge and 4.0% per annum inflation, over seven years (the typical assumed average resident's length of stay), the cumulative charges would be GBP 50,400 and the lost revenue would be cGBP 6,500 over the period. In present value terms, using a 10% discount rate, the cost of the subsidy is cGBP 3,900.

Note that this loss in future revenue does not necessarily imply a cash loss. If, for instance, in year one the operator generated a 15% profit margin on the Service Charge, they would still have managed to generate a net profit over the seven year period, albeit a very modest one.

While the subsidy is small and the fix and cap may have a disproportionate beneficial effect on sales and marketing of units, clearly in a portfolio of retirement communities each of which may have 100-150 residents, the cumulative cashflow effects of fix and cap require careful consideration.

Event Fees as an Asset Class

We expect Event Fees will soon be regarded as a standalone asset class as the retirement community market matures. *To recap: Event Fees are charged to leaseholders of residential units when they exit the retirement community. Typically, the lease, which is non-assignable, reverts to the operator on the departure or death of the lessee and the operator has the right of resale. At such resale, a percentage of the gross proceeds is retained by the operator; this occurs at each exit 'event', in perpetuity, creating a valuable annuity income for the operator. In our view, such annuities will also become highly attractive to external investors.*

The following example looks at the present value of the expected Event Fees for a retirement community with a GDV of GBP 100m and an event fee of 25%. We assume a 15% Discount Rate (early stage investment in Event Fees carries similar risk to an equity investment); our other assumptions are highlighted in blue below.

General Assumptions

Number of Units	100
Average Unit Value (GBPm)	1.0
Total GDV (GBPm)	100.0
Average Length of Stay	7 years
Event Fee Level	25.0%
Discount Rate	15.0%

Event Fee Projections

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual HPI			3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Perpetual HPI									3.0%
Average Unit Value		1.00	1.03	1.06	1.09	1.13	1.16	1.19	1.23
GDV		100.0	103.0	106.1	109.3	112.6	115.9	119.4	123.0
Number of Events at Steady State			14.3	14.3	14.3	14.3	14.3	14.3	14.3
Event # Build Up (% of Steady State)			10%	20%	30%	50%	75%	90%	100%
Number of Events			1.4	2.9	4.3	7.1	10.7	12.9	14.3
Value of Units Sold			1.5	3.0	4.7	8.0	12.4	15.4	17.6
Event Fee Valuation									
Event Fee Revenue			0.4	0.8	1.2	2.0	3.1	3.8	4.4
Value of Event Fees; end of Year 7 onwards									37.7
Total			**0.4**	**0.8**	**1.2**	**2.0**	**3.1**	**3.8**	**42.1**
Present Value	**21.8**		0.3	0.6	0.8	1.1	1.5	1.7	15.8

In the above example, the Present Value of the Event Fee income stream is GBP 21.8m. For illustrative purposes, an operator might wish to realise the value of, say, a third of this, perhaps to fund a further development. From the investor's point of view, this instrument delivers a base IRR equal to that of the Discount Rate (in this case 15%). This assumes expectations around longevity – longevity clearly influences the number of 'Events' – and house price inflation (HPI) are correct, and that there is no yield compression. Based on this, the indicative returns profile is as follows:

Percentage of Event Fee Acquired	**33.3%**
Cash Paid for Share of Event Fees	**7.3**

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash In	(7.3)	(7.3)							
Cash Out (Event Fees)	5.2		0.1	0.3	0.4	0.7	1.0	1.3	1.5
Cash Out (At Putative Exit)	12.6		-	-	-	-	-	-	12.6
Net Cash Out	**10.5**	**(7.3)**	**0.1**	**0.3**	**0.4**	**0.7**	**1.0**	**1.3**	**14.0**
IRR	**15.0%**								
Cash Multiple	**2.4x**								

In the following two scenarios – overleaf – we look at the progression of the investment case as (a) the first village matures; and (b) a portfolio of Event Fee annuity streams is assembled from further villages.

Over time, as the first village matures and Event Fees approach steady state, the risk associated with the Event Fee cash flow declines, and we would expect to see yield compression. We assume, therefore, that the Discount Rate decreases by 2.5% to 12.5%, to reflect this reduction in risk, as follows:

Discount Rate (reduced by 2.5%)		12.5%							
Perpetual HPI		3.0%							
		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash In	(7.3)	(7.3)							
Cash Out (Event Fees)	5.2		0.1	0.3	0.4	0.7	1.0	1.3	1.5
Cash Out (At Putative Exit)	15.9		-	-	-	-	-	-	15.9
Net Cash Out	**13.8**	**(7.3)**	**0.1**	**0.3**	**0.4**	**0.7**	**1.0**	**1.3**	**17.3**
IRR	**17.9%**								
Cash Multiple	**2.9x**								

Eventually, one can envisage a basket of Event Fee instruments which would lend itself to securitisation and wider distribution. Although this is some way off, we are aware of institutions actively considering this putative asset class. We note that much of the thinking around longevity risk and mortality rates done in the pensions industry from 19xx onwards may well find new expression in Event Fees derived from retirement real estate. Under this scenario, we would expect further yield compression, particularly where portfolios are diversified across operators, target markets, and geographies. Below, we assume a further reduction in the discount rate down to 10%, as follows:

Discount Rate (reduced by 5.0%)		10.0%							
Perpetual HPI		3.0%							
		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash In	(7.3)	(7.3)							
Cash Out (Event Fees)	5.2		0.1	0.3	0.4	0.7	1.0	1.3	1.5
Cash Out (At Putative Exit)	21.5		-	-	-	-	-	-	21.5
Net Cash Out	**19.5**	**(7.3)**	**0.1**	**0.3**	**0.4**	**0.7**	**1.0**	**1.3**	**23.0**
IRR	**22.0%**								
Cash Multiple	**3.7x**								

A further observation is that, conceptually, using a 10% Discount Rate, and a 3% rate of House Price Inflation, is similar to using a 7% cap rate. In our view, the market which we expect to emerge for this asset class is unlikely to accept Discount Rates on Event Fees much lower than this, due to the underlying risk that, despite the obvious attractions of the annuity stream, it depends on the operating business and the direction of house prices. Despite this, we note that some market participants are more bullish and are happy to compare steady-state Event Fees to, for example, ground rents and have been using lower cap rates accordingly. We maintain a more cautious view, but expect a consensus to emerge once Event Fees begin to flow in volume.

Conaghan & Company
29 Farm Street
London W1J 5RL

T: 020 3709 4570

www.conaghanco.com

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