

BIG THEME



Rents for student accommodation are high, but demand is higher due to an influx of international students

Generate income via specialist property

From student halls to care homes, specialist property funds are the way to go for defensive long-term income

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Property funds typically conjure up images of offices, distribution hubs and shopping centres – and the appealing income they offer. But care homes, student halls and big-box storage also offer the benefits of property investing, and are potentially less exposed to Brexit-related fallout. And some are trading at lower premiums to net asset value (NAV) than they have been in the past.

Open-ended commercial property funds have been in the spotlight recently after altering the prices for investors selling the funds (see page 44). Henderson, M&G and Standard Life Investments were among the companies that altered prices on their commercial property funds in response to a spike in withdrawals from mainstream investors.

But there is a less well-known group of closed-end funds that invest in student property, healthcare and big-box storage, which are less correlated to the broader market and have taken less of a beating

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following the outcome of the referendum on British membership of the European Union. Charles Cade, head of investment company research at Numis, says: "Looking at the listed real-estate investment trusts (Reits), the larger more liquid names such as **British Land (BLND)** and **Land Securities (LAND)**

have seen the biggest declines (around 20 per cent). By contrast, those with a higher income return, such as the UK property income companies or those funds focused on healthcare property and student accommodation have fared better."

Whether it's international students coming to the UK or a growing population of older

people needing care, the funds in this sector benefit from a supply and demand imbalance, pushing up the value of their assets and ensuring long-term income streams. And a number look cheap relative to their history – despite increased appetite for the sector.

In the UK, a record £13bn was invested in specialist property in 2015, according to Knight Frank, a 60.6 per cent increase on the previous year. Knight Frank defines specialist property as hotels, healthcare, student accommodation and automotive. Specialist property also accounted for 18.3 per cent of all UK commercial real estate investment in 2015, far exceeding the previous consecutive highs – 2013's 11.4 per cent and 2014's 12.9 per cent.

Closed-end advantage

Closed-end funds such as investment trusts are a good structure for investing in illiquid assets such as property. Unlike open-ended funds, investment trusts have a set number of shares in issue, which investors have to sell on the secondary market to other investors if they want to get out of them. They cannot demand the trust gives them their money back.

That is a crucial advantage with an asset such as property that cannot easily be sold to pay back investors taking their money out of the fund. During the financial crisis when the commercial property sector plummeted, a number of open-ended property funds were closed or semi-closed as managers struggled to keep up with investor redemptions. As a result of this, managers of open-ended property funds now generally retain a chunk of their assets in cash to meet redemptions, although this can be drag on returns.

Student accommodation

There are two specialist closed-end funds invested in the fast-growing prime, purpose-built student property sector – a far cry from the rat-infested digs that student housing usually calls to mind. **GCP Student Living (DIGS)** and **Empiric Student Property (ESP)** invest in prime, purpose-built student properties featuring home cinemas and rooftop gardens. Rents for these buildings are high, but demand is higher due to an influx of international students. According to Numis: "EU students represent only 6 per cent of all full-time students in the UK, and therefore the rent roll is not dependent on these students."

Non-EU international students currently account for 60 per cent of GCP Living's portfolio. In the past three to four years, according to Tom Ward, co-manager of the fund, the number of international students has been growing at a rate of 5-6 per cent ▶

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► year on year, but the “real issues are on the supply side, where not enough good accommodation is being built”. That constraint is evidenced in the fact that all of GCP Student Living’s portfolio is currently fully occupied.

Nick Barker, co-manager of GCP Student Living, adds: “The removal of the student cap for the 2015-16 academic year has helped increase further the supply/demand imbalance in the sector. UCAS undergraduate acceptances increased 3 per cent year on year to a record of around 532,000, with 14 per cent of students coming from overseas (6 per cent from the EU and 8 per cent outside of the EU).”

GCP, launched in May 2013, was the first listed fund to invest in student property and, despite outperforming Empiric by some margin, is now trading at a discount to NAV for the first time in three years. Both funds have driven up their share prices and NAV per share dramatically since launch. GCP has returned more than 40 per cent since 2013, while Empiric has returned 17 per cent since launching two years ago in July 2014. Empiric’s NAV has also risen from 98.1 per share at launch to 104.3p, but GCP’s is higher still at 134.1p per ordinary share, despite having a smaller portfolio of assets.

That is partly due to the nature of GCP’s investments. Although it has three assets outside London, the fund’s managers prefer prime, large-scale London investments due to the constrained market and high demand for places.

Empiric has 75 properties across 29 cities in the portfolio as well as a number of forward-funded projects.

The soaring demand for student property is demonstrated by the fast pace of acquisitions and oversubscribed share issues undertaken by both funds. In May 2016 GCP Student Living exceeded a £50m fundraising target by more than 20 per cent, using the capital to fund a new acquisition – a forward-funded 580-bed building in Wembley.

Meanwhile, Empiric has been on an acquisitive binge this year, with an oversubscribed £90m fundraising resulting in a £120m issue in March, which was used for new buildings around the country, including in Leeds, Leicester, St Andrews, Reading and Manchester. Broker Winterflood commented at the time: “Empiric Student Property has performed reasonably well since its launch and has grown considerably, from £85m to its current market capitalisation [£545m].”

“However, the fund has significantly underperformed GCP Student Living, its closest peer, which we suspect reflects how acquisitive Empiric has been and its focus on universities outside London. Nevertheless, the 5 per cent yield remains attractive and could increase further if the target increase in gearing is achieved.”



Big boxes

The surge in online shopping has meant a surge in demand for vast warehouses for the raft of goods being delivered all over the UK. Massive logistics warehouses, however, are in short supply, making Tritax Big Box REIT (BBOX) an excellent investment proposition.

The trust, which is in the Association of Investment Companies (AIC) Property Specialist sector, was the first listed fund to invest in UK big boxes and has grown astronomically since its initial public offering (IPO) in 2013. It now owns 28 assets and has reached a size of £1.3bn. The main boon for the trust is the difficulty of sourcing new warehouses and its ability to levy rent increases as a result.

The trust is yielding 4.8 per cent and is trading at a premium of 1 per cent. That is reflective of its highly positive 2015, which saw it meet its target of a fully covered 6p dividend and return 24.15 per cent, far exceeding its target of 9 per cent a year. The issue for this trust will be whether or not it is able to continue growing at this pace. Stifel says: “The shares are trading at a premium to NAV despite low growth potential, which we believe is due to the dividend yield [of 4.8 per cent], considerably above the REIT average of 3.4 per cent.”

It will also face issues if demand for big boxes wanes in favour of smaller, more dispersed hubs located further into city centres. However, Tritax boasts a 100 per cent let portfolio with long unexpired leases and has consistently managed to buy at higher than market yields by buying off market. It has also been adding to its portfolio in recent months following an oversubscribed share issue in February, which raised £200m.

Stifel says: “We expect it to continue growth through acquisition as in the past, without dilution of NAV and in an earnings-accretive manner.”

GCP is trading at a 1.9 per cent discount to NAV – its 12-month average is a 4.2 per cent premium – while Empiric is trading on a premium of 4.3 per cent. Empiric has a higher yield, but in the half-year to December 2015 had declared or paid dividends equating to 3p, comparable with GCP’s 2.82p. And Empiric’s share price is lower.

Healthcare

The UK has a severe lack of appropriate medical and care home buildings at a time when the section of the population most in need of primary care is mushrooming. The number of over-85s is set to double in the next 20 years and nearly treble in the next 30 years, while the stock of buildings fit for purpose is shrinking. Target Healthcare REIT (THRL) and MedicX Fund (MXF) invest in care homes and primary healthcare properties, respectively, which benefit from very long-term and often government-backed contracts. It means both have delivered steady long-term returns and high yields consistently since launch, yet both are trading at below their average premiums.

MedicX invests in purpose-built primary healthcare properties leased to GPs, who are at the centre of the government’s agenda to overhaul the NHS and are under pressure to find new ways of working. Primary health centres are set to take on an increasing burden of care in the future, meaning MedicX’s portfolio is benefiting from fast rental growth and growth in property values, as demand for those kinds of properties increases. In the six months to March 2016, MedicX’s rent intake increased by 6.6 per cent to £13.7m and its portfolio appreciated by £4.1m, resulting in a yield of 5.36 per cent in March, which has since risen to 7 per cent. It is one of the longest-running funds in the specialist sector and has returned 54.4 per cent over five years.

The fund does not forward fund or develop projects, meaning it mainly collects rent from already occupied and successful assets with income streams. It has ramped up dividends by 19 per cent since inception, paying out a total of 5.9p per share in 2015. However, its current dividend is not fully covered, at 63 per cent, and it is aiming to increase that cover in the next three years. The main downside to this fund is its eye-watering premium to NAV of 19.1 per cent.

Target Healthcare REIT, which invests in high-spec care homes with very long leases, often running up to 30 years, is trading at a historically low premium of 6.8 per cent. It listed in March 2013 after raising £45.6m and now has a market cap of £274m. Its group of high-quality, purpose-built care homes boast contracts often linked to inflation, meaning it is able to consistently raise rents and drive up the value of its portfolio.

The fund only invests in modern care homes with strong rental cover, and the portfolio has a low loan-to-value ratio of 18.8 per cent. In the six months to December 2015 it pushed up its rent roll by 0.9 per cent from £11m in 2014 to £12.5m at the end of last year, and total dividends were boosted to 3.09p, up from 3.06p in the previous year.

Target Healthcare REIT is not fully invested, but when it is its dividends will be fully covered by its earnings. At the moment its dividends are roughly 87 per cent covered, with new assets and a recent fundraising taken into account. The trust completed an oversubscribed share issue in April, which raised £80m, and since then has announced four new investments in Northern Ireland, Merseyside, Essex and West Yorkshire. Broker Stifel upgraded its rating from suspended to buy in May, on the basis that the fund's recent fundraising gives management "extra firepower" to expand. It is yielding 5.7 per cent.

Numis argues that the healthcare property sector deserves the premium it trades on. The broker says: "In our view, the wider premium versus commercial property can be justified by the lower volatility of asset values and relatively high dividend yields on offer."

Numis adds that the sector has "strong income characteristics and a relatively defensive asset base compared with general commercial property. The market also favours the support of a government covenant, a feature of the primary health sector in common with public private partnership (PPP) infrastructure assets. As a result, we expect the primary health property funds to remain in demand while we remain in a low interest rate environment."

Understanding property fund charges

Property funds are excellent income payers, but they can be expensive. And perhaps a bigger issue than the price you pay is the difficulty in understanding what that price is. Open-ended funds have an easy-to-find ongoing charge in their investment documents, but closed-ended property funds do not, and there is no easy way to compare like with like when it comes to what you are charged.

You are likely to come across many different annual charge figures and many different names for those.

The main divergence is between:

- Those who argue that the ongoing costs associated with running a property portfolio, including site, utility and cleaning costs, should be counted on the cost figure quoted to investors.
- Those who argue that these are not really the costs of running the fund and say these costs should not be counted.

The metric most frequently cited by trusts themselves is the total expense ratio (TER), defined as the annual costs of running the fund divided by the fund's total assets. Those annual costs can include administrative costs, staff costs and management costs. However, the figure does not include performance fees, which are often charged by these funds and can push up the price, or other ongoing property costs.

Annual costs

Funds	Non-recoverable fees	Mgmt fees/ admin fees	Performance fee	Other operating expenses	Latest reported NAV average	Ongoing charge incl. misc. costs	Ongoing charge excl. misc. costs
Empiric Student Property	na	£3.5m	na	£2.6m	£265.35m	2.2%	1.2%
GCP Student Living	£2.53m	£2m	na	na	£124.02m	3.65%	1.61%
Target Healthcare	na	£1.14m	£0.47m	£0.88m	£115.52m	1.7%	1.7%
MedicX	£0.90m	£4.57m	na	£0.94m	£246.95m	2.6%	2.2%
Tritax Big Box REIT	na	£6.31m	na	£1.52m	£711.7m	1.1%	1.1%

Source: Numis, based on last published company reports, as at 23 Jun 2016

Premium, discounts and yields

	Premium/ discount (%)	12-month average (%)	Yield (%)	NAV (p)	Dividend cover (%)
Empiric Student Property	4.3	7.1	5.2	104.3	68.5
GCP Student Living	-1.9	4.3	3.9	134.1	73
MedicX	19.1	23.4	7	69.7	71
Target Healthcare	6.8	11.5	5.7	100.6	87
Tritax Big Box REIT	1	6.2	4.8	124.4	100

Source: Winterfoot, as at 27 Jun 2016. Dividend cover: Numis, as at 23 Jun 2016

Performance: total cumulative return (%)

Fund	1-m	3-m	6-m	1-yr	3-yr	5-yr
Empiric Student Property	-2.9	1.1	-1.6	5.1		
GCP Student Living	-3.8	-3.5	-3.3	5.8	4d.5	
MedicX	-5.1	-3.5	-1.3	8.9	32.2	54.4
Target Healthcare	-0.1	-2.1	0.7	5.7	19.3	
Tritax Big Box REIT	-9.1	-6.4	0.2	13.4		
AIC Property Specialist sector average	-4.3	-3.0	1.1	15.4	31.9	10.7

Source: Trustnet, as at 27 Jun 2016

Matthew Read, senior analyst at Marten & Co, argues that the TER is a fair figure to use. "I think the actual cost of running the properties is a separate discussion, it's not really the cost of running the fund," he says.

We asked Numis to compile cost figures for each fund based on their last published annual reports, one including property and miscellaneous operating expenses, and one with those stripped out. The final costs include management fees but not performance fees. Management fees tend to reduce as the net assets of the fund increase – Tritax receives 1 per cent up to and including

£500m and 0.8 per cent above £750m. GCP, Tritax and Empiric do not charge performance fees, but MedicX and Target Healthcare do. Target Healthcare charges an annual performance fee of 10 per cent of the amount by which the total return of the fund's portfolio is in excess of the total return of the IPD Healthcare Index.

Tritax has the lowest ongoing charge

figure, at 1.1 per cent when miscellaneous costs are stripped out, and Empiric is also low, at 1.2 per cent; however, that rises to 2.2 per cent if miscellaneous costs listed in the balance sheet are included, according to Numis.

Bear in mind that these costs are based on last published net assets and do not take account of the speedy rates of acquisition undertaken by many of these trusts.

Dividend cover

Dividend cover is important if you want to be sure that your assets will keep paying out. Trusts with dividends well covered by earnings will be able to keep paying out while others might look shakier. Again, this is not easy to work out for trusts with growing asset books. Colette Ord, investment director at Numis, says: "MedicX have forward funded assets that they've committed to and will develop, so I have given them the benefit of forward funded assets in the dividend cover number, as well as for Tritax and Empiric."

"Be wary of figures on earnings cover because some of these are new and in growth phase, so Empiric's historic cover is 30 per cent but forward funding and acquisitions will mean that the full-year dividend is likely to have a much higher cover."

'MedicX invests in purpose-built primary health-care properties leased to GPs, who are at the centre of the government's agenda to overhaul the NHS'