Is There A Soft Underbelly To The Rock Solid Healthcare Property Market?

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The Australian healthcare property market is in a growth phase with unprecedented low yields being achieved over the last twelve months, with some results perhaps surprising even the most optimistic of vendors. The sale of the Evolution Healthcare hospital portfolio (three assets) in April this year on a blended equated market yield of 5.37% (5.62% initial yield) epitomises this newly established benchmark level in Australia, albeit that the result is likely to be superseded by Vital Healthcare Property Trust's (a subsidiary of a Canadian based listed REIT Northwest Healthcare Properties) purchase of The Hills Clinic, in Kellyville, New South Wales for a reported equated market yield of circa 5.35%.

It is the length of lease term and security of tenant covenant that is driving these results, with the Evolution Healthcare portfolio and The Hills Clinic all offering a minimum 25 year Weight of Average Lease Expiry (WALE). All four hospitals are operated by Healthe Care, who themselves are going through a substantial growth phase and have emerged as one Australia's most reputable hospital operators. Given the strength and length of lease covenant, it is understandable why listed and unlisted funds are willing to pay these prices, particularly in view of what other traditional institutional grade assets in the retail, commercial and industrial market sectors are returning. So the question becomes, is the same yield compression warranted for medical centres?

Narregate Medical & Dental Centre

Source: CBRE Information Memorandum

These assets are often multi-tenanted, with not all tenants considered to be of an 'A-Grade' status. Not only do multi-tenanted assets increase the cost of management, it also generally translates to shorter WALEs. Nevertheless, these assets are trading at similar, if not stronger levels than hospitals, as exampled by the recent sale of the Narregate Medical & Dental Centre in the outer metropolitan Melbourne suburb of Narre Warren. Situated approximately 39 radial kilometres south-east of the Central Business District, this modern two-storey centre, which is leased to Primary Health Care sold for $11.68 million in July 2017, representing an equated market yield of 4.95%.

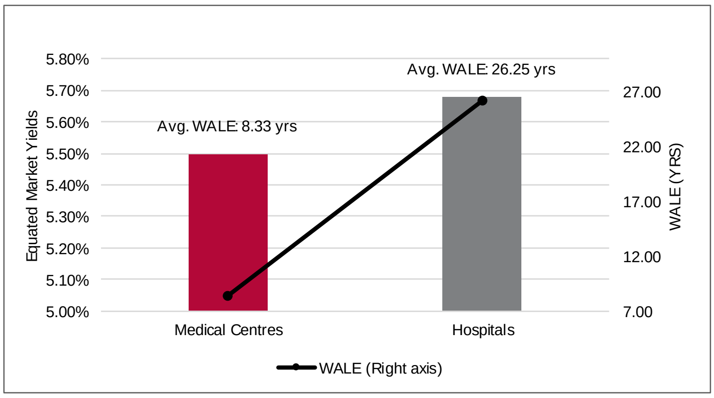
Primary Health Care is a well-regarded operator and the centre is within relatively close proximity of Westfield Fountain Gate Shopping Centre (Australia's second largest when measured by floor area), however the property's relatively short WALE of 3.27 years, with no guarantee that the tenant is to remain in occupation is compounded by the presence of several other undeveloped sites in the immediate area. These sites provide the potential for a competitor to enter the market, or worse still provide an alternative home for Primary Health Care's business enterprise at lease end.

This is not the only sale result of a medical centre that has raised eyebrows in the last twelve months with the following table detailing some recent key transactions:

Medical Centre Sales				
Address	**Date**	**Price**	**EMY**	**WALE (Yrs)**
Arkaba Medical Centre, Parkside, SA	Aug-17	$13,500,000	5.79%	5.36
16 - 18 Banksia Street, Heidelberg, VIC	Apr-17	$24,600,000	5.80%	14.08
GP Plus Health Care Centre, Elizabeth, SA	Nov-16	$42,000,000	5.59%	13.82
Clock Medical Centre, Balwyn, VIC	Oct-16	$8,030,000	5.11%	3.66

We are also aware of another medical centre transaction that is close to being announced reflecting an equated market yield of 5.74%, with a WALE of 9.80 years.

Based on these aforementioned sales, in addition to two other hospital transactions (Hirondelle Private and Abbotsford Private), which have all occurred within the last twelve months, the following graph demonstrates the average equated market yield (and respective average WALEs) being paid for hospitals and medical centres:



Based on the sales analysed, the graph reveals that on average purchasers are paying 0.17% sharper yields for medical centres than hospitals, despite hospitals offering significantly longer lease term security. We acknowledge that hospitals are specialised assets and some consideration must be given to this, however you would expect the longer WALE's to experienced operators would help mitigate this risk for purchasers.

We also highlight the recent negative press surrounding established medical centre operators, a number of whom are ASX listed companies.

The decline in private health insurance participation rates by consumers, along with general costs increasing at rates quicker than health fund rebates, appear to be the driving forces behind the issues faced by medical centre operators. There is no doubt that the decline in private health insurance goes hand-in-hand with increased costs of living and the housing price affordability, particularly in Melbourne and Sydney, which have Australia's highest population rates.

Moving forward, we also foresee new challenges that operators are likely to be faced with, including increasing operating costs as energy, water and council rates continue to rise. There is also the long mooted government intervention on capping pathology market rents. A wide spread industry practice is for larger operators to takeout a head lease agreement over an entire medical centre and then sub-lease a small portion to a pathology sub-tenant. This higher than average sub-lease income then provides the operators with the ability to help off-set their own rental payments. If these pathology rents are subsequently capped, it would further compromise the operator's capacity to meet their own rental payment obligations.

This all leads to the following question; if these established, experienced and well-regarded medical centre operators are facing headwinds in the current economic environment, how will they, let alone the smaller operators perform in the future as new challenges arise? The possible outcome/solution could be a reduction in achievable rental rates, or alternatively the introduction of increased incentive levels above that currently being offered, which sits around 5%, if any at all.

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