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Remodelled

The sale & leaseback model came under intense scrutiny following the collapse of Southern Cross, so how has it changed since? *Sunniva Davies-Rommetveit* reports

A pariah sector. This is what the care home market felt like after the painfully public collapse of Southern Cross, says Ian Wilkie, director at Healthcare Property Consultants. Indeed, the demise of the UK's biggest and once incredibly successful care home provider completely knocked the wind out of experts and operators alike. Bruised egos quickly transformed into finger-pointing, and at one stage it seemed as though passing the blame would never stop.

At the time of the meltdown, then-chief executive of Southern Cross Jamie Buchan told HealthInvestor that outside forces were to blame. It was the credit crunch, rising food and utility bills, and dropping local authorities' residential care fees. In fact it seemed to be everyone's fault except for the operator's previous owner, private equity firm Blackstone Capital Partners.

For others, though, the buck had to stop with the PE firm and managerial team that had taken Southern Cross on a vehemently aggressive growth path, introducing a sale and leaseback model in order to do so. Selling assets and leasing them back allowed Southern Cross to rapidly become the UK's biggest operator, with 750 care homes in total.

But the model failed on the back of the 2008 financial crisis – and as local authorities (LAs) cut residential care fees, the amount Southern Cross owed its landlords burgeoned. Finally, in summer 2011, the game was up and various landlords decided to take back their homes and close Southern Cross for good.

Nearly four years on and experts still smart when Southern Cross is mentioned. But the sale and leaseback model never went away, despite the doom and gloom of 2011. Care UK did a sale and leaseback deal for three of its care homes with TIAA Henderson Real Estate for £48.9 million in February 2015. M&G also did a £223 million sale and leaseback deal on six private hospitals with Priory Group in October 2014. So, the model has certainly not lost all appeal with the sector.

Mo Mannan, director at Colliers International Healthcare, says that while the way Southern Cross employed sale and leaseback played a large part in its difficulties, there were other significant factors behind its ultimate collapse. These include its senior management team being "too focused on growing the business rather than paying much-needed attention to operational issues".

So instead of ditching the sale and leaseback model, operators and landlords have fine-tuned it since Southern Cross's crash. Property firms are now much more analytical when buying assets and deciding which operators to lease them to. This is unlike Southern Cross, which adopted an almost "indiscriminate strategy" of building standard design homes "anywhere it found land on the back of demography" Mannan says. The home operator did not take into account whether an area was oversubscribed or whether potential local residents could self-pay or be local authority funded. This strategy meant many of its homes became largely reliant on the public purse and thus exposed to the funding squeeze.

Nowadays, the care market's prominent investors, such as Real Estate Investment Trusts (REITs), are a lot more meticulous when deciding on areas to buy assets. "Never be overconfident about your asset's high quality and relative good value, and always do your homework to determine whether the local area of interest is oversubscribed," Kenneth MacKenzie, managing partner at Target Healthcare REIT, advises.

This healthy dose of scrutiny has resulted in operators, advisors and landlords being much more clued up on the key performance indicators (KPIs) to look out for – such as occupancy, rent cover, payroll cost percentage, payroll cost per resident, food cost per resident, ebitdar percentage, average fee and the split of fees between private clients and local authorities. "Fundamentally, all or some of these KPIs serve to give an early warning of a shift in the business if there is any notable change," Wilkie explains.

Along with better oversight, the sale and leaseback contracts themselves have become tighter. Step-in clauses are usually more stringent, allowing landlords to intervene quickly if a tenant starts defaulting on the rent. For instance, minimum rent covers are now often required. If this is breached for a sustained period, profit from the property is "held within an escrow account until the tenant is out of breach for an equal period", says Julian Evans, head of healthcare at Knight Frank. This is intended to avert the situation that Southern Cross found itself in in May 2011, when it pleaded with its landlords to defer 30% of its rent for four months.

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Of course, receiving regular financial updates from the operator to keep abreast of KPIs could prevent things ever getting so bad as to intervene like this. It is notable that REITs include updates on their tenants in their quarterly financial updates: these landlords know that keeping a close eye on operation standards leads to a healthier return.

REITs or investors can also consider taking a stake and investing in the operators running the care home. They do this by funding the operator if it wishes to acquire new sites. “Both investing and having a stake in the business gives REITs or investors excellent visibility of trade performance but more pertinently demonstrates their confidence in the operating business,” Evans explains.

Target Healthcare has its own clinical assurance board to regularly check the quality of care provided by the care home operators it partners with. REITs are not simply “arm’s length landlords that collect the rent,” Target’s MacKenzie explains. “We’re active supporters of our operators, and these must report to us if or when occupancy/care standards fall.”

For many, though, Southern Cross’ Achilles heel was its cripplingly low rent cover (that is ebitdar divided by rent) – which could be as low as 1.25 times in the mid-noughties. The operator’s overconfidence that the boom would never end meant that its rent was often set too high with fixed annual increases, which relied on fee levels and profitability only rising. With the onset of the financial crisis, Southern Cross had to pay increasingly unaffordable rents despite local authorities cutting fees, seeing rent cover fall and profits ebb away.

Traditional landlords shy away from such dangerously low rent covers now, preferring to remain around the 1.7 times to 2.0 times mark. “We’ve all learnt from the perfect storm that was Southern Cross. Rent cover is now about ensuring that rent levels remain sustainable for operators in the long-run,” Evans says.

However, there is a stock quality problem in the UK care home market. According to Knight Frank analysis, half of the 500,000 beds in UK care homes require renovation, and the total cost for replacing these 250,000 beds is approximately £15 billion. This obsolescence of property stock is arguably causing more landlords (especially REITs) to increase their rent, thereby pushing rent cover lower than what is considered comfortable for operators. “There is currently a danger that rent cover is again being squeezed due to a lack of investment opportunities,” warns Mannan.

Looking forward, then, there is a much more clued up set of investors and operators in the sector following the Southern Cross debacle. Awareness about sustainable rent covers and increased financial oversight means a repeat in the breakdown of the sale and leaseback model seems unlikely anytime soon, which is positive. But, an increasingly overheated market has seen rent covers beginning to take a tumble once again. If left unchecked, this could be another ticking time bomb for the sector to contend with.

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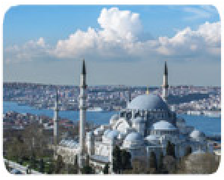

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