180 YEARS Australian Unity Real Wellbeing

Outlook for Australia’s healthcare property sector

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A Q&A with Chris Smith

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Tell us about Australian Unity’s Healthcare Property Trust.

Australian Unity’s Healthcare Property Trust (AUHPT) has grown to become one of Australia’s largest unlisted healthcare property funds, with assets worth around $2.6 billion.

The AUHPT—now over 22 years old—has a portfolio spanning hospitals, GP and day hospital based medical centres, medical office (in precincts), aged care facilities, and healthcare related assets such as pathology laboratories.

To clarify; when I say aged care, this is quite distinct from—and shouldn’t be confused with—independent living or retirement villages. Aged care has a nursing and personal care component and is financially supported by the Federal Government, whereas independent living is more closely aligned with the residential sector and doesn’t really attract much support from the Federal Government.

Artist’s impression of Knoxfield Aged Care development in Victoria

The AUHPT’s portfolio is comprised of many high-grade hospital and medical centre assets with long leases to market-leading healthcare operators. The AUHPT’s investment objective is to deliver sustainable, quarterly income distribution payments, plus the opportunity for long-term capital growth. Throughout its history, the AUHPT has provided investors with consistent income returns and capital growth.

The AUHPT’s weighted average lease expiry (WALE) is ~15.5 years and its gearing is ~20%. (as at 30 June 2021).

How big is Australia’s healthcare real estate market?

The healthcare property market in Australia is relatively small compared to other sectors such as retail, office and industrial. Ten years ago, the sector had gross assets of about $925 million. As an estimate, there is now around $8 billion of Australian healthcare property held by real estate investment trusts (REITS) that continues to grow as cap rates compress, developments are completed, and additional properties are acquired by REITS.

What’s your approach to building and managing the portfolio?

The AUHPT portfolio has a unique portfolio of assets that have been acquired and developed over a long period of time—many that have grown through several brownfield developments that are aligned with the tenant’s business growth. Where possible, we plan for at least a 30-year time frame.

We have also applied different layers of diversification to the AUHPT’s portfolio including property type, geographic locations, source of income and different price points that provide liquidity flexibility (if required for redemptions).

What kind of assets appeal to you, and what’s your approach to asset development?

Everyone wants a newish hospital in a major capital city that is well located with a strong lease covenant and further development potential. These opportunities are rare. Sometimes repositioning opportunities come along that need some patience and brownfield development to reset the tenant’s business and the real estate offer. Occasionally, we will participate in these opportunities however these are more of a value-enhancing initiative rather than core business.

We are still acquiring property, however since 2003, we have been undertaking brownfield developments (extensions to existing buildings) and since 2014, we have been involved in greenfield developments (new building on new sites).

We have also undertaken various building conversions into healthcare assets—including conversion of an aged care facility in Brunswick, Victoria into rehabilitation hospital beds, an office building in Townsville, Queensland into a mental health clinic, and a hotel in Ipswich, also in Queensland into an aged care facility.

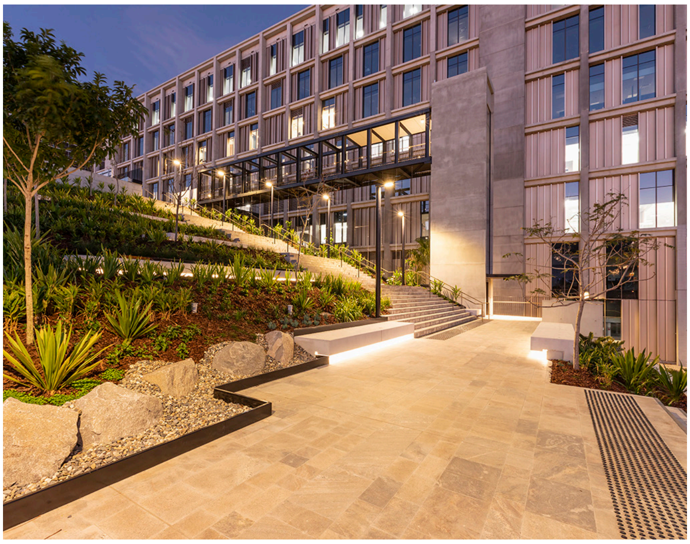
The development pipeline is an important part of the AUHPT’s growth strategy and has several benefits including: stamp duty efficiency; modern purpose-built buildings; master planned future growth; and better depreciation, so that a higher proportion of the investor income is tax deferred.

Based on the current property market and consumer-demand for services, we see the most opportunity in pursuing more greenfield developments in key health precincts.

How does being part of the Australian Unity Group help guide the Healthcare Property Trust's approach?

Investors in the AUHPT enjoy privileged access to the thinking, networks and intellectual property across the healthcare sector because of the operations and experience of our parent, the Australian Unity Group.

For example, the recent completion of the Surgical, Treatment and Rehabilitation Service (STARS) public hospital at Herston Quarter in Brisbane was a direct result of Australian Unity's 99-year lease on the precinct as master developer with the Queensland State Government. Without this, the STARS development would otherwise have been an opportunity we just would not have been able to provide investors. This is just one of the practical and positive out-workings of being part of the Australian Unity Group.



STARS development at Herston Quarter, Brisbane

Australian Unity also has significant interests in aged care. Has this informed the Healthcare Property Trust's expansion into aged care?

The Australian Unity Group does have significant businesses across aged care and AUHPT is well-positioned to benefit from the intellectual property and thinking from these operations.

We have been investing in aged care for the last 12 years, since our first acquisition of the Constitution Hill Aged Care Facility in Northmead, New South Wales in late 2008. We have reviewed a few portfolios over the years but always wanted to invest in properties that are built for tomorrow's market, not yesterday's market.

There are a lot of older, smaller facilities coming to market that are now close to obsolescence. Recently, we have identified a few opportunities to participate in and will continue to seek to invest into aged care assets that are built with future needs and demand in mind.

There seems to be an increasing amount of institutional interest in healthcare and medical assets.

Since emerging from the GFC, the attributes of the healthcare sector have become more appreciated by institutional investors who are seeking long-term stable income in a sector that has strong thematics driven by an increasing population and a higher proportion of the population that is ageing.

In recent years, we have also seen uncertainty creep into the retail sector because of online trading—further advanced during the COVID-19 lockdowns in 2020 and 2021. In addition, the office sector faces some uncertainty at present so large superannuation and pension funds are looking to invest more into the industrial, healthcare and alternative sectors. This applies to both onshore and offshore investors.

In recent years we have seen a number of new entrants to the healthcare property market in Australia, including Arena REIT, Canadian Northwest, Singapore's GIC (through Northwest), US based Medical Properties Trust, Barwon, Dexus, Heathley/Centuria and more recently RAM and HomeCo.

To put it simply, there is significantly more demand than supply so there has been significant capitalisation rate compression, more particularly during 2021.

What are some of the challenges facing healthcare real estate?

Limited supply of stock and an ongoing low interest rate environment is driving capitalisation rate compression. We are mindful of the growing concern that some purchasers are not pricing-in risk appropriately in a quest to quickly secure properties coming to market which can carry risk in the medium to longer-term. This will become evident in the next downturn when capitalisation rates are adjusted, which we saw play out in 2009.

Do you see cap rates compressing further in this sector?

I think we will see more capitalisation rate compression in FY22 driven by a persistent low interest rate environment, strong global capital seeking placement and both onshore and offshore institutional investors trimming retail and office sector allocations.

I have previously managed investment funds that owned industrial property and I think healthcare property has stronger long-term fundamentals. By way of example, healthcare property tenants make significant investments in fit-out and are more likely to remain trading from that location. Of course, each property is different, so you do need to be careful in your acquisition due diligence and knowledge of the market, particularly the primary and secondary catchments of the usages in that specific location.

As stated previously, I think capitalisation rates will compress further in FY22, particularly for the long WALE assets with strong tenant covenants. We have seen some recent examples of this leading up to 30 June 2021 and reported in July. The sales evidence will start flowing through property valuations in due course.

What are your views on some of the trends we're seeing play out across the sector. For example, Medibank are exploring their own form of hospitals, medical services with doctors, and Centuria, who are looking at a doctor/insurer-led model—are these trends that could shake up the industry?

It's still early days on these models, however it makes sense for some hospital surgeons as the relationship shores up volume through referrals from the health fund.

Lastly, can you tell us about the recent outcome that saw NorthWest pull its bid for AUHPT?

The withdrawal of the proposal followed efforts by NorthWest/GIC to adjourn the scheduled unitholder meeting until 7 September 2021. It was while the matter was before the Federal Court on 14 July 2021 to decide this adjournment, that NorthWest/GIC was informed of the position of unitholders, who had already voted overwhelmingly against the NorthWest/GIC proposal. NorthWest/GIC subsequently decided to withdraw its proposal.

Unitholder support for the recommendation by the Board of Australian Unity Funds Management (AUFM)—AUHPT's responsible entity—that unitholders vote against the most recent proposal was overwhelming, with a significant number of unitholders lodging proxy votes with AUFM to have their voices heard.

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