# Manager thinking

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**Sesfikile Capital**
**Manager of the Curate Momentum Flexible Property Fund**

## National Health REIT (NHR)

It may be an obvious thing to say, but not all property companies are the same. Of course, they own different kinds of properties, such as shopping centres versus industrial warehouses. But it's also true that certain companies perform in different ways in different economic environments.

The general perception of property shares is that they do well when the economies they operate in are doing well. Those are times when it is easy to find tenants, they can increase rentals at or even above the level of inflation, and cash flows are strong. However, this is not true across the board.

For example, one of the companies we look at outside of South Africa is a healthcare real estate company that owns a £4 billion portfolio of primary care facilities across the UK and Ireland. It leases space in these buildings to medical professionals. For its UK properties, the National Health Service (NHS) guarantees the rentals over approximately 90% of the space it owns. Similarly, the department of health in Ireland guarantees the same levels of rentals in that country, which form 25% of the portfolio. All Irish leases are also indexed to inflation.

As a result, the company's facilities are 99.3% occupied. On average, their leases run for 11 years. This means it has guaranteed revenue streams well into the future.

Thematically, healthcare is a necessity, and properties in this space are also more recession-resistant or less cyclical than other sectors such as offices and malls. Together with the guaranteed leases it has in place, this means that the company has one of the most defensive rental income streams in the listed property sector.

However, when we analysed it, we recognised that the NHS guarantee is not a 'blank cheque'. The NHS has a big say over how much the leases in the UK will increase every year. They also have a lot of pricing power because they are the only party that can agree to lease terms. This limits the company's ability to grow its earnings.

When we looked at how attractive the company is at its current price, we saw that it trades at a 7.7% dividend yield. That is well above the UK 10-year bond yield of 4.3%. It also trades at an 8.1% discount to its Net Asset Value (NAV) – in other words, the total value of all its properties. On top of this, our estimates showed that the company would be able to increase dividends by 2% to 2.5% per year over the next two years, and around 1.5% over the medium term after that.

All of this looks fairly attractive, but context is always important. Comparable European healthcare listed property companies trade at an 8.6% dividend yield and 22% discount to NAV and projected two-year dividend growth of 2.2% per year. So, this particular share is not quite as cheap as its peers.

Global REITs also show expected dividend growth of 5.5% per year over the next two to three years. That is some indication of how this kind of company is limited in its ability to grow its cash flows at the same rate as many other property stocks.

Turning to the balance sheet, NHR has a loan-to-value (or debt-to-assets) ratio of 47% with over 95% of debt fixed at an average interest rate of 3.4%. This does not compare favourably with the global REIT sector, which has an average loan-to-value ratio of 34% and around 80% of debt fixed.

Ultimately, we decided not to invest in this company. Our rationale was not just based on the numbers, but because property businesses like this typically outperform in a low interest rate or recessionary environment in economies that face the risk of deflation. Long leases that grow around 2% per year are great for protecting investors in times like that.

However, the UK economy has proven more resilient than many expected, and interest rates are likely to stay higher for longer. In addition, although inflation has come down significantly over the last 12 months, we don't expect deflation. If anything, the risk is for inflation to pick up again.

All of that means that the current economic environment favours sectors that operate with shorter leases that can grow rents above inflation. Despite its other strengths, this company is not one of them. We might own it in the future when the economic outlook is different, but right now we would rather hold others for the benefit of our investors.

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