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Hedging their bets

Infrastructure funds are seeking the predictable haven of social care to meet institutional investor demand, find **Clare Connell** and **Henry Hunt** of Connell Consulting

Some of the most significant transactions in social care over the last 12 months have involved infrastructure funds; for example, AMP Capital acquired specialist care provider The Regard Group, and Antin Infrastructure Parnters bought specialist school group Kisimul.

At first glance, it may seem odd that infrastructure funds are engaging with the health and social care space. After all, they have historically invested predominantly in vast energy projects, and other utilities, as well as airports, ports, and toll roads. As a high-profile example, Macquarie Infrastructure, the largest infrastructure fund by assets under management, up until only recently owned 26.3% of Thames Water, has stakes in three UK power stations, and a mobile and TV mast company. As another example, AMP Capital owns Newcastle Airport, and recently announced the acquisition of Leeds Bradford Airport.

However, other than transport and utility investments, infrastructure funds also look to social infrastructure. Social infrastructure refers to essential services, which underpin the operation of society; these could include services such as schools, hospitals, or care homes.

The presence of infrastructure funds in the UK health and social care sector is set to grow because infrastructure fund investors are lining up to take advantage of the high-risk adjusted returns available from health and social care. The specialist care segment is particularly interesting them as they see a large share of revenues generated from safeguarded local and central government funds.

The care sector has certain characteristics that align with the long-term goals of the institutional investors who back infrastructure funds, because they need to maintain a relatively low-risk portion within their investable funds.

For a start, infrastructure funds tend towards investments that are pinned to inflation, and rely on a steady, relatively low risk cash flow that will continue to rise over the long term. Traditionally, an infrastructure fund could invest in UK train companies, where ticket prices are pegged to the retail price index with the biggest uplift in five years as of January 2018 at 3.6%. Health and social care funding, particularly specialist care, is similarly driven by inflation-guarded revenue.

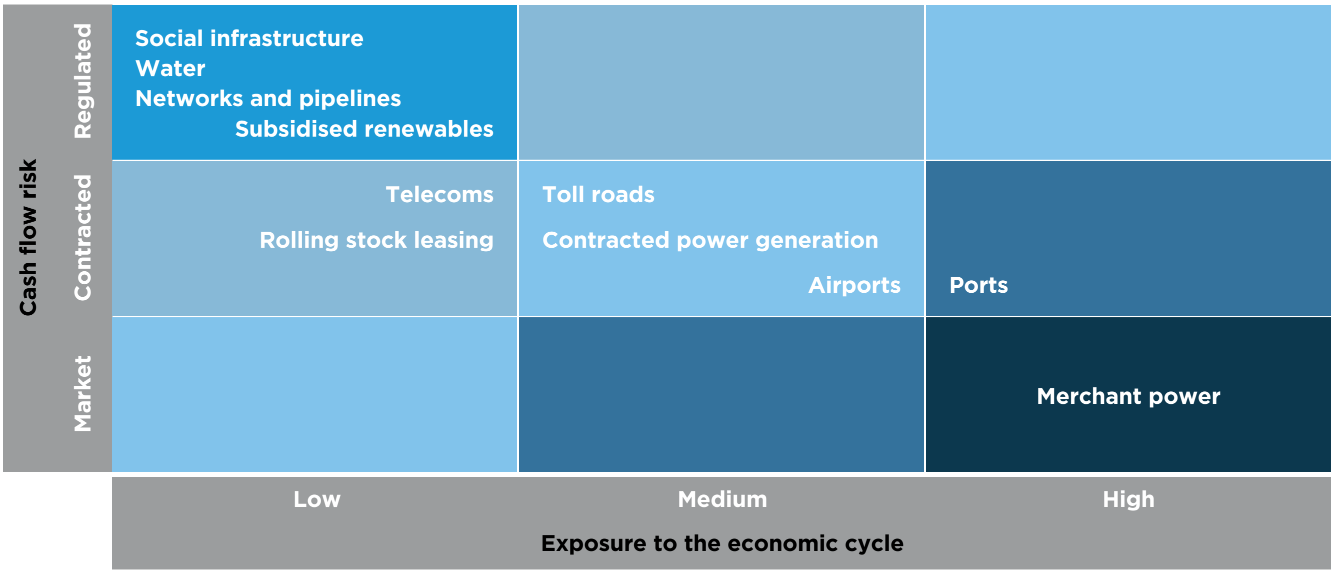
Specialist care funding in particular is very closely linked to inflation, in that funding bodies – local authorities (LAs), clinical commissioning groups (CCGs) and the NHS – have an obligation under the Care Act to maintain and increase fees as a means of protecting vitally important health and social services. It's worth bearing in mind that CCGs and LAs have a statutory duty of care to support people with eligible care needs, such as those with learning disabilities or mental health issues, so very few placements in specialist services are funded by private individuals, whose capacity to afford fees indefinitely would be limited, let alone with year-on-year increases.

Meanwhile sub-sectors of specialist care, like special schools and other children's services, as offered by Kisimul, are particularly protected; they tend to be the last services to receive cuts during rounds of austerity. A vulnerable child let down by social services will, quite rightly, make headlines and actually will end up costing LAs much more in the long-term, through prolonged health and social care requirements or even costs associated with the justice system.

Elderly care does also have its appealing characterstics for infrastructure funds. While elderly care funding comes from private individuals as well as government sources, according to LaingBuisson, 'pure self-payers account for a 49% share by value', meaning 51% of revenue is, like specialist care, given inflationary uplifts as standard. The other 49%, underpinned by high home-ownership levels in the UK, has its own guarantee, as when the self-payers run out of savings, the LA picks up the bill. It must be said, this guarantee has terms and conditions; commissioners will move someone to a cheaper home if weekly fees are well above what they would normally pay for a service user with LA funding from the get-go. Additionally, where child services are the last services to have their budgets pruned, elderly care may be the first.

FIGURE 1: SOCIAL INFRASTRUCTURE AS A DEFENSIVE ASSET

Sensitivity of infrastructure assets to the economic cycle and cash-flow risk (illustrative)



Source: Deutsche Asset Management, Research Report: Why Invest in Infrastructure, May 2017

However, most funders are keenly aware of, and sympathetic to, policy changes that will impact on the bottom line of the providers they rely on. Things like the national living wage, introduced in April 2016 and standing at £7.50 per hour for workers over 25 from April 2017, have been included in planned uplifts to provider fees in most micro-markets. Providers have successfully made the case that growing minimum wages for carers is an unviable additional cost that an already stretched industry could not bear; not without significant consequences to the ability to deliver good quality, safe care.

Social care is also resilient to economic cycles due to inelastic demand patterns; a working-age service user's stay in a residential home is not linked to their disposable income and inclination to save based on external economic factors. Whether through expansion or contraction they require the same level of care, and at the same cost. Therefore, even amongst infrastructure fund assets, social care can be considered low-risk in the context of economic fluctuations; airports may see a drop in traffic, and therefore revenue, if not as many people can afford holidays abroad for example (*figure 1*).

Institutional investors, such as pension funds, usually try to allocate around 5% of their cash toward infrastructure as a hedge against market volatility; and it's clear from all these characteristics that social care offers that hedge.

But why are they interested now? Cash flow predictability has been a characteristic of social care for a while. The answer may well be infrastructure funds are being driven by an anticipation of increased volatility across capital markets, which have up until recently been calming. A return to more volatile markets occurred in February, with share prices falling 4% in the FTSE100 by the end of the month, and the VIX 'Wall Street Fear Gauge' increasing to levels not seen since the 2015 Chinese currency devaluation. While The Regard Group and Kisimul acquisitions pre-date February volatility, it's likely that fund managers have been anticipating a correction to an unusually tame few years.

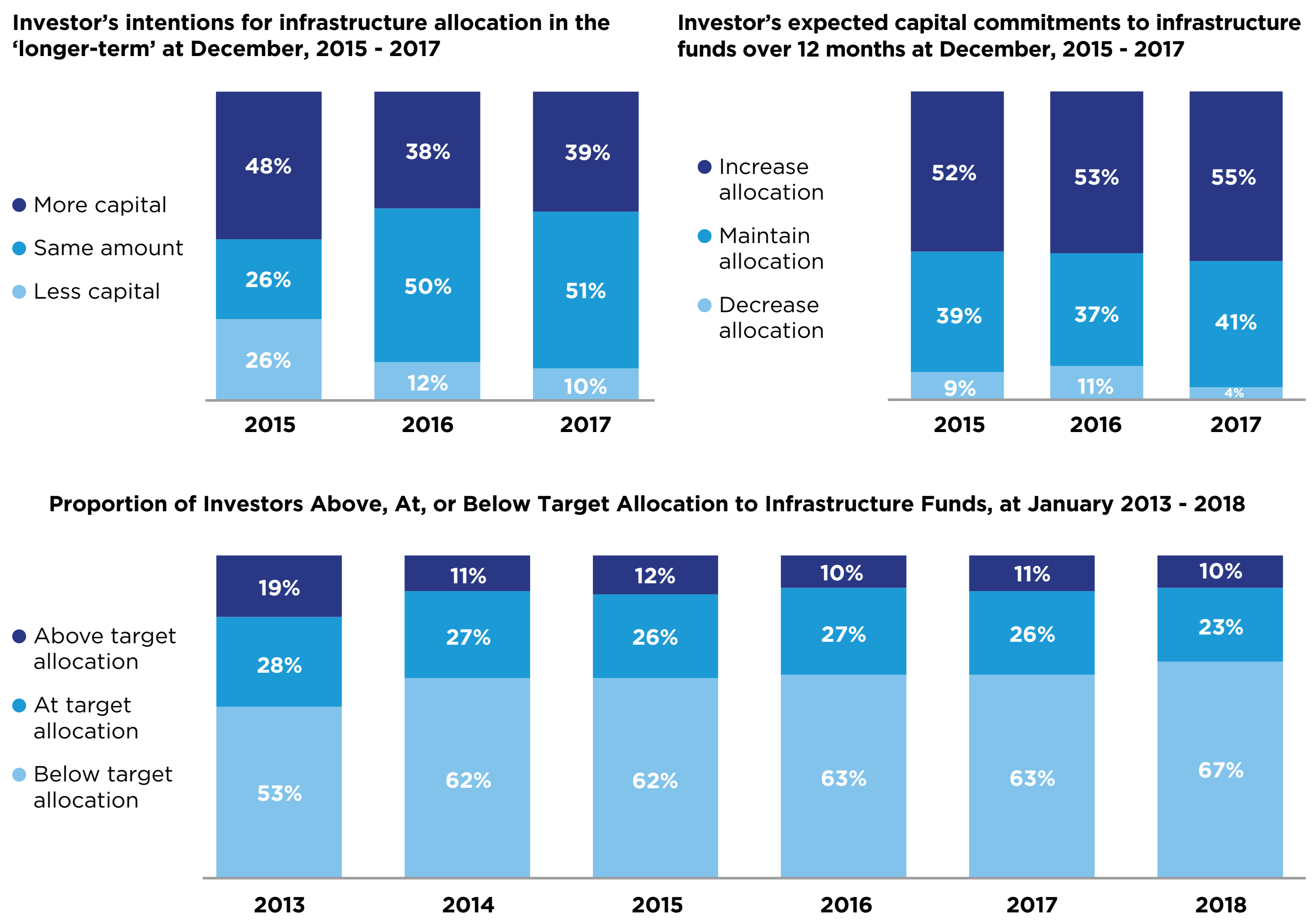
According to Preqin, a collator of data in the alternative assets industry, institutional investors are expecting to increase capital commitments to infrastructure funds over the 12 months (from December 2017). And, in the longer term, 55% of respondents to Preqin's surveys suggest that infrastructure allocations will increase, with only 4% hoping to reduce exposure, as opposed to 11% at the same point in 2016 (*figure 2*).

Not only will target allocations increase, but it's likely that investors will make a more concerted effort to reach those targets given the volatile capital markets. The average current allocation to infrastructure by institutional investors sits at 4.1%, below an average target allocation of 5.6%. So there's room to grow within current allocations which themselves are expected to increase in the long-term. A lot of cash will be entering infrastructure funds then, with a considerable portion being funnelled toward health and social care.

This is good news for providers of specialist care, as the number of potential buyers grows. For certain providers, the opportunity for investment from an infrastructure fund, rather than other alternative asset platforms, may be worthwhile. Where a private equity firm might tend toward a five-year investment period, with potentially aggressive cost-cutting and restructuring deployed as a means of increasing margins, an infrastructure fund will look to the longer-term. Macquarie Infrastructure has a standard 10-year lifetime on funds for example, but others can be upward of 15 and sometimes even over 25 years. This is because they aim to benefit from inflation-linked, predictable cash flow rather than attempting to fundamentally overhaul how a provider is managed.

That's not to say that infrastructure funds are passive investors. As with private equity, portfolio management skills are vital and specific experience is required in the commercial market, as well as in the regulatory, financial, governance and stakeholder aspects of ownership. There is significant scope within that experience to make improvements that can lead to capital appreciation realised on disposal. While infrastructure funds are more interested in income yield rather than gains from disposal, asset improvement is certainly an important ▶

FIGURE 2: INFRASTRUCTURE FUND ALLOCATIONS



Source: Preqin, Investor Outlook Alternative Assets H1 2018 & Infrastructure Fund Manager Outlook H2 2017

driver of initial investment. And the long-term revenue visibility in social care allows infrastructure fund managers to implement long-term strategies that maximise asset value. This includes the optimisation of capital expenditure and access to long-term financing.

A good quality asset with a solid management team, requiring experienced, but not overbearing investors with a longer-term strategy, should, therefore, look toward infrastructure funds.

One impact of the growing interest from investors in health and social care is that valuations of good quality care groups have been increasing and will increase further. As a growing number of funds attempt to find a home for their non-invested cash, they end up paying multiples above historic levels in order to outbid competitors. Assets with particularly strong fundamentals can expect to benefit from a surplus of cash from investors looking to move quickly.

However, it is easy to understate the risk in social infrastructure. While other infrastructure assets like airports or train lines benefit from quasi-monopoly positions, care homes can be usurped by competing homes and a poorly-run care home group will quickly see referrals dry up and margins crash. Infrastructure funds, while keen to sink their cash, must maintain a wariness for the pitfalls of health and social care – not all portfolios are alike and although the sector as a whole will see fees at least rise in line with inflation, particular services and groups will be frozen out of fee uplifts if quality is not maintained and cost justified.

The funds should also note, while specialist services, like The Regard Group and Kisimul, are particularly good targets for acquisition, there may still be strong opportunities in the elderly care market. With favourable demographic shifts and a broadly sympathetic political context, good quality providers can benefit from inflation-linked revenue for decades.

Infrastructure funds and their investors, then, should be wary of provider quality, but with a robust appreciation for the commercial viability of specific services, it should be clear which are worth the investment.

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