Health & Social Care - Covenants

MPA Medical Property Advisers

MPA has put together these fact sheets to provide basic background information on the medical property market. Whilst most of the information is derived from fact or evidence based, we have also included our opinions. The views are general, but we can expand on any issue with particular regard to specific investor requirements. From time to time we will update these sheets and the latest versions will be found on our website www.medicalpropertyadvisers.com under 'Further Information'.

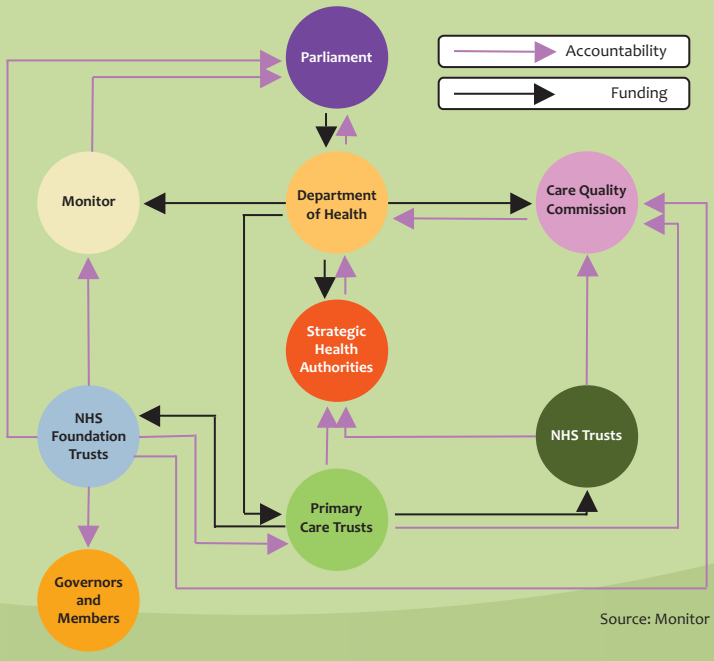
Overview

The following explains the various covenant strengths of health and social care bodies that enter into commercial leases in the UK. This is an overview and does not seek to be comprehensive. Covenants in this sector are often assumed to have a direct link to the NHS. However, the structure can be complicated and it is imperative that an investor or developer understands who is providing the surety on the specific lease in question. The recent White Paper "Equity and excellence – Liberating the NHS" will mean assessing covenants going forwards is essential.

NHS Trusts

We have included in this definition all Trusts that fall within the NHS, including NHS Acute Hospital Trusts, Mental Health Trusts, and Ambulance Trusts, but excluding NHS Foundation Trusts which are dealt with separately. By 2013 we expect all NHS Trusts to have converted to Foundation Trust status.

These are provider trusts and deal with the provision of health services to a local population. Funding is split between direct government funding and PCT commissioned services funding, although the majority comes through the PCT.



Source: Monitor

NHS Trusts are covered by the National Health Service Act 2006, as amended (The Act). The Act makes provision for the transfer of liabilities of certain NHS bodies (including PCTs) in the event of financial failure, merger or takeover and they become the responsibility of the Secretary of State for Health. The liabilities, including contracted rent and revenue payments, are transferred to another NHS body of a similar or better standing.

Leases on smaller buildings may be available from NHS Trusts and will provide good secure income streams; however most of the larger buildings, like hospitals, will be procured and held through the Private Finance Initiative (PFI) which is a public/private partnership. There may be opportunities for investment through a secondary market in these schemes.

Foundation Trusts

NHS Foundation Trusts are not-for-profit public benefit corporations. They provide both hospital and mental health services. Whilst retaining the core principles of NHS care – free care, based on need and not ability to pay – they are not directed by Government and can decide their own service delivery and strategy. They can retain surpluses and utilise debt to improve local patient services.

The Board is elected by local members which makes them more responsive to the needs and wishes of the local health economy. They are regulated by Monitor, an independent body set up to assess the financial, governance, and provision of mandatory services on a quarterly and annual basis. When assessing financial risk, Monitor looks at the achievement of their plan, their underlying performance, financial efficiency, and liquidity.

Unlike NHS Trusts, which are covered by the Act (See above), Foundation Trusts are not afforded the same protection. In the event of financial difficulties, Foundation Trusts are covered by the Health and Social Care (Community Health and Standards) Act 2003 where an order may be made by the Secretary of State to transfer any property or liabilities to another NHS body. However, this is discretionary rather than obligatory.

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Primary Care Trusts

PCTs are now at the centre of the NHS, controlling 80% of the annual NHS budget. They are tasked with ensuring that local health and social care services are commissioned and work effectively. PCTs are responsible for ensuring that there are enough services accessible for people within their local area.

PCTs are NHS organisations and benefit from direct government funding. Annual budgets will typically run into hundreds of millions of pounds and they are often challenged in balancing their annual liabilities from commissioning patient services with the increasingly pressurised Central Government funding.

A PCT on a lease is regarded as a strong covenant - high annual revenue funding from the government and the backing of the National Health Service (Residual Liabilities) Act 1996 (the Act).

Valuers and investors do not currently differentiate between the covenants of individuals PCTs. The newly established Care Quality Commission (CQC) rates the performance of every NHS Trust in England on the basis of overall quality of care and financial management. This may provide a future comparative measure for PCTs. Care must be taken when PCT configurations change to ensure their liabilities remain covered by this Act.

General Practitioners

GPs are at the forefront of the provision of primary care delivery within the NHS. They are private contractors, not part of the NHS, and do not have the same intrinsic covenant strength. The security of income from a GP lease comes from the way they are funded and the barriers to entry into their 'market'.

GPs are employed by the NHS (by PCTs) on effective 6 month rolling contracts. Notice can be given at any time, but due to the nature of the services provided and the need of the PCT to ensure the continuity of local primary care services, these contracts are unlikely to be withdrawn. The annual rent for GP premises is fully reimbursed by the NHS, giving leases to GPs a very strong, if indirect, covenant strength.

The paper covenant strength of a GP Practice is only as good as the individual practitioners who are named on the lease. However, a modern purpose-built surgery will always be in demand for the provision of primary care services within a locality as long as it is fit for purpose. There are strict controls on the setting up of new Practices which removes the likelihood of direct competition for any established GP surgery.

It is possible to differentiate between GP practices based on the type of contract they have with the NHS. Under the General Medical Services (GMS) contract, the payment of rent is ring-fenced as it comes direct (albeit through the Practice) from the PCT. Under a Personal Medical Services (PMS) contract, GPs are paid a global sum which includes rent and rates. This may increase the risk to rental payments although GP default is very rare and valuers have not historically differentiated between GMS and PMS contracts.

If a Practice does fail, there are a number of potential outcomes: Provided the premises still meets the needs for delivery of primary care in the locality, the PCT may seek to install temporary doctors until such time as a new Practice can be formed, or the patient list is taken over by another Practice – the lease will then be assigned to the new Practice. If another, or new, Practice cannot be found, the PCT may take an assignment of the lease in order to continue the delivery of essential services. In the unlikely event that the premises are no longer needed for the provision of services, the normal commercial alienation provisions under the lease will apply and the most appropriate alternative use will be secured.

Private/Independent Providers

These provider covenants should be viewed and assessed in the same way as any other private sector company with regard to a suitable period of audited accounts. Larger companies can provide a good degree of comfort over financial capability, but governance and management efficiency are also important and we have seen some high profile cases amongst large provider companies recently. Smaller companies may seem to be a riskier prospect, but it is essential to fully understand, not just the performance of the whole company, but also the performance of individual units. Every situation must be considered on its own merits.

Another area to consider is the financial covers imposed under the terms of the lease. If these are too onerous it may disincentivise the operator to maximise performance and cause undue pressure on the company's finances.

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