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Changing tides in primary healthcare: what does value for money look like today?

AVISON YOUNG

Preface

Recent dramatic changes in the UK economy and the need to meet longer-term sustainability goals are having significant impacts on all sectors of the commercial property market. This paper looks at some of the challenges faced in primary health care premises.

1. The NHS Long Term Plan

The NHS Long Term Plan is for primary health care to be provided by GPs operating at scale, which means offering a growing breadth of services. To do this, GPs are now working in larger primary care teams and networks. This consists of GPs and allied health professionals seeing their patients from GP surgery premises based in the community. While some work can be undertaken online, many consultations and treatments must still be face-to-face. For patient confidentiality reasons, the online work should be provided from a suitable confidential place. It, therefore, makes sense that this place is the GP surgery premises, so practitioners are always using the space but can use both working methods. While the amount of face-to-face consultations reduced temporarily during the Covid-19 pandemic, NHS Digital data shows they have now returned to pre-pandemic levels.

2. GP surgery premises need to be fit for purpose

It is important each region has a supply of suitable, well-maintained and accessible buildings that are big enough to house the larger primary care teams. They must also be flexible enough to cope with the changing demand for services over time.

A significant part of the current estate is no longer suitable – even now, many surgery premises are still converted houses; dated, small, and inflexible. Many proved relatively inaccessible during the Covid-19 pandemic, with patient segregation less easy to manage due to the buildings' inflexibility.

3. Development needs to be viable

It is important for the NHS Long Term Plan that market conditions exist which support the continued upgrading of purpose-built GP surgery premises and replacement of converted houses. This is crucial for meeting the NHS decarbonisation target.

The recent dramatic changes in the economy had slowed down developments, and in most regions completely stopped progress in primary care.

This paper seeks to offer some practical solutions from a property perspective on where the property market needs to see change in order to support the development / investment required in the sector.

Harry Hyman

CEO, Primary Health Properties

Key themes

01

We need more primary health care facilities

- The latest data from the 2021 Census, the *NHS Long Term Workforce Plan* and industry surveys reinforce the need to deliver and modernise primary health care assets.
- The age and specification of much of the existing estate is a contributing factor to high numbers of GPs leaving the sector in the UK and is also affecting quality of care.
- Modern assets improve patient outcomes, help retain skills and take pressure off acute hospitals. They are also integral to the sector delivering on decarbonisation commitments.

02

Costs are a major obstacle to development

- Primary healthcare development activity has been battling rising construction costs for much of the last decade.
- This has worsened over the last two years with costs soaring.
- The specialist nature of buildings in the sector, evolving ESG needs and according material & skill requirements mean it has been worse affected than most.
- The cost of debt has also increased substantially, putting further pressure on viability.
- The outlook remains challenging as build costs will remain high and key construction materials are still seeing strong upward pricing pressure.

03

Rents have fallen in real terms while yields have softened, making development & investment unviable

- Due to the nature of rent setting, there has been very muted rental growth over the last decade and in real terms rents have fallen. Rental growth in other sectors has been substantially better.
- Prior to the start of the current interest rate hiking cycle, yield compression had compensated for the lack of rental growth and allowed development to remain viable.
- In the face of rising costs and with values / yields softening, rents will need to increase in order for development in the sector to be viable.

04

Rental tone needs to be rebased to reflect true market level

- Our case studies illustrate the viability challenges facing development in the sector.
- They show how build cost inflation has made schemes unviable at current rental levels and therefore not viable for investors and developers.
- Nationally (excluding London), rents need to be excess of £325 psm to make schemes viable as shown in our case studies.

Conclusions and recommendations

- Substantial rental growth is required to reflect inflation, build cost pressure and rising cost of capital.
- The sector requires a rethink by District Valuers as to how rent reviews on existing properties are handled. This will restore confidence to the investment community and prevent a shift of capital to other sectors in the UK or primary care in other countries.
- ICBs will need to grasp the development dilemma. Much needed schemes will simply not progress unless viability issues are addressed.
- Value for money must ensure a balanced judgement in line with HM Treasury's guidance across rent reviews, lease renewals and new developments.
- Achieving these will help address demand for healthcare and better accommodation for our key healthcare workers and patients.

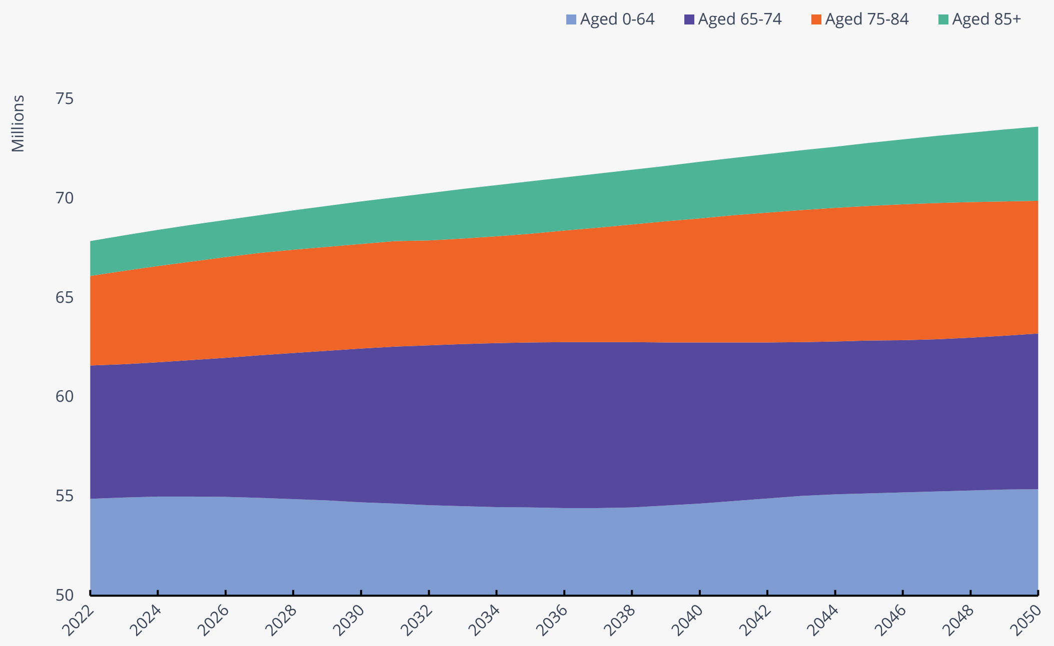
Our rapidly ageing populations needs more primary care facilities

- The main driver for increased primary care demand is the ageing population with more complex care needs. The 2021 census showed that there has been a 1.8m increase in the number of people in England & Wales aged over 65 since 2011.
- Experian population projections show that by 2050 this number will have increased by a further 40%, equivalent to almost 5.3m additional people aged over 65. The highest rate of growth will be seen in those aged 85+.
- All regions will see growth in elderly age groups but it is much more pronounced in some, notably the South East & West.
- Elderly people have greater healthcare needs. Recent statistics estimated that people aged 65 and over in the UK are expected to live almost 50% of their remaining lives with a limiting long-term physical or mental health condition.
- Addressing the unmet care and support needs of an ageing population has been identified as an urgent public health priority but so far progress has been inadequate.
- Digital advances have not reduced demand for face-to-face/physical space, especially for the older population.

> *There is a worryingly high proportion of GP services being run out of old residential buildings. GPs need modern, flexible premises, not decades old buildings that are simply unfit for purpose.*

Sir Norman Lamb
Former Health Minister

The proportion of elderly people will significantly increase

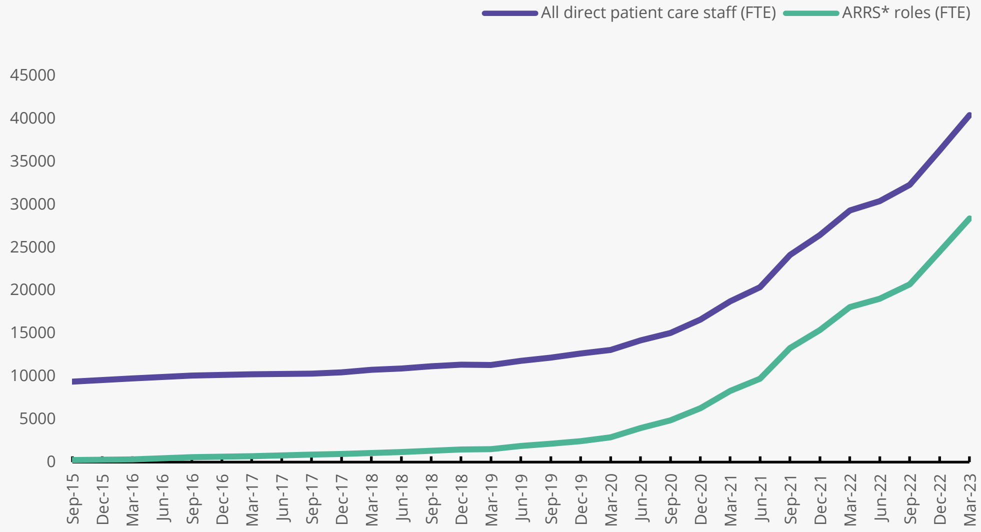


Source: Experian

Modern primary care facilities help attract and retain staff and respond to higher demand for care space

- Increasing investment into primary care needs to be a policy priority. Society is facing serious and worsening strain from; declining GP numbers, rising healthcare demand, difficulty recruiting/retaining staff and facilities that are no longer fit for purpose. All this is having knock-on effects for patients.
- In 2020, the government announced a drive to recruit 6,000 new GPs by 2024 but the most recent data shows that numbers are still falling, with a loss of 443 GPs in the last year.
- This is a vicious circle with the lack of modern, fit for purpose facilities contributing to GPs leaving the sector which in turn increases pressure on those remaining.
- Along with GP recruitment, the NHS Long Term Workforce Plan, published this year, identifies the need to deliver more proactive and preventative care.
- To achieve this, the number and proportion of NHS staff working in mental health, primary and community care roles will need to increase by 73% by 2036/37.

Since March 2019, the number of full-time equivalent (FTE) direct patient care staff working in general practice (who are not GPs or nurses) has increased by more than 29,000



*= Additional Roles Reimbursement Scheme (ARRS) is a funding programme aimed at supporting the recruitment of a range of primary care workers, including 17 additional reimbursable roles besides GPs.

Source: The Health Foundation

> **Buildings need to be flexible to cater for more staff and services, especially as treating patients in a primary care centre is more cost effective than in a secondary centre setting.**

“A survey for the General Medical Council found that nearly a third of GPs were likely to leave general practice in the coming year while a BMA survey found two-thirds of GPs over the age of 55 suggested they were intending to retire within three years.”

Source: Health & Social Care Committee

“Inaction in the face of demographic change is forecast to leave us with a shortfall of between 260,000 and 360,000 staff by 2036/37.”

Source: NHS Long Term Workforce Plan

Investment is needed to meet decarbonisation goals by the NHS

- The NHS has committed to reaching net zero by 2040 for the emissions that it directly controls and 2045 for those that it can influence.
- So far most of the attention has been focused on hospitals and secondary care. Primary care is responsible for approximately 23% of the total NHS emissions footprint — about 5.75 million tonnes per year, amounting to 1% of UK greenhouse gas emissions.
- The estate plays a major part in these targets. Improving insulation, modernising heating systems, and switching to renewable energy sources and modes of transport – is required.
- Given the condition of primary healthcare assets across the UK, the scale of capital investment required to make buildings more energy-efficient is significant.
- Without financial support and/or real rental growth to underpin investment in the sector, the additional costs of decarbonisation will make achieving the NHS decarbonisation target unviable.
- A long term and consistent approach is necessary to enable asset owners to invest in their buildings and attract private finance to the sector.

Sources: BMA, Lancet Planet Health, NHS

Today

35 years — **Average age of GP premises in England**

7% — **NHS proportion of UK's total carbon emissions**

23% — **Primary care contribution to NHS Emissions**

2040 onwards

Net Zero

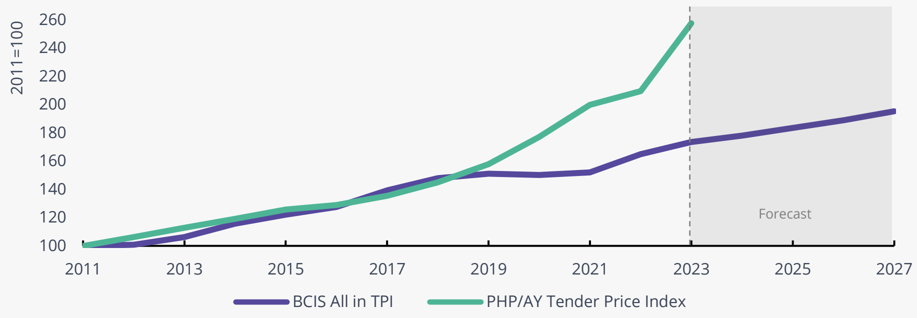
2040 – for the carbon emissions under NHS direct control

2045 – for the emissions from the wider supply chain to achieve a net zero healthcare system

Rising construction costs and cost of debt have put unprecedented pressure on development

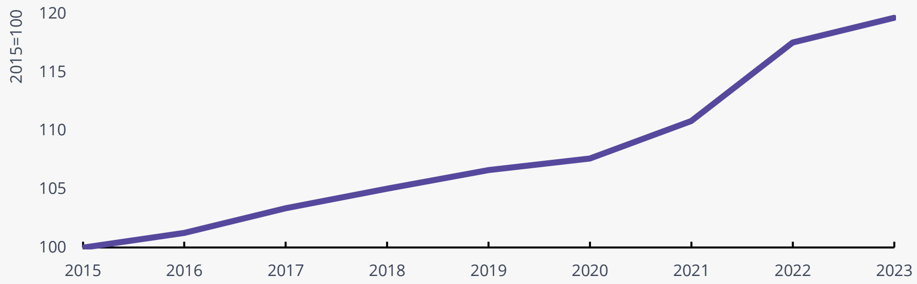
- 2022 & 2023 saw record levels of inflation across construction & tender price measures. This is a major obstacle to development viability across all sectors.
- BCIS All In Tender Price Index (TPI) rose 13% in 2022 and has risen 74% since 2011.
- Increases in build costs for primary health care assets have seen even more drastic rises. This is due to the need for specialist materials and contractors.
- Viability in the sector has been under pressure for the last ten years as rental growth has failed to keep up with construction costs but the situation has dramatically worsened over the last two years.
- In response to the rising cost of capital, yields are softening and in the absence of increased rental values, development and refurbishment are no longer viable.
- There is increasingly scrutiny around the environmental credentials of assets, with the higher specifications required putting further pressure on viability.

Very significant build cost inflation, with primary care particularly affected



Source: BCIS, AY, PHP

Repair & maintenance costs have also seen high inflation



Source: ONS

OUTLOOK

LABOUR

Ageing workforce
Reduced access to migrant labour
Lack of new entrants
Near term contractor capacity limited

MATERIAL PRICES

Likely to be less volatile with some prices easing but others will continue to be increasing

INTEREST RATES

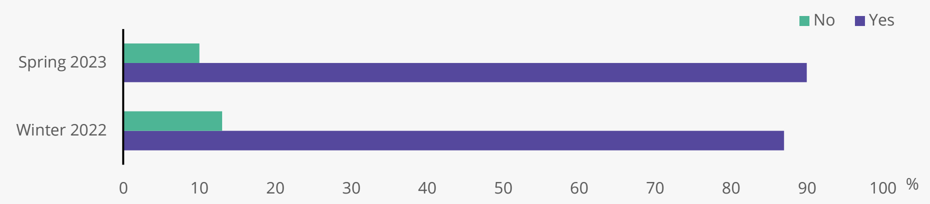
Interest rate trajectory is now expected to be higher for longer than previously predicted

Cost inflation will continue to impact viability adversely

- Build cost expectations for the next 12 months indicate a slowing in the rates of increase that we have seen over the last two years.
    - Wholesale energy prices have significantly fallen back since this time last year (although remain x3 higher than pre-pandemic levels).
    - Material prices have been the chief factor driving build cost inflation. At the headline level this is now improving but prices remain very high.
- However, the improvement in the headline figure masks some key risks. Certain critical materials for construction are still seeing very sharp price increases and constrained availability.
    - Iron ore, the 'backbone' of industry was one of the key drivers of inflation early last year and then fell back sharply. Prices have increased around 30% since Nov-22.
    - Copper is critical in construction and inventories are at the lowest levels since 2008. Prices have risen 20% since Nov-22.
    - Concrete, another essential construction material has seen prices consistently increasing without any drawback since 2021. Since Nov-22 prices have risen 18%
- The other major inflationary risk is the cost of labour. Labour scarcity is an ongoing structural challenge for the industry which has been exacerbated by Brexit and Covid.
    - More than 240,000 workers left the industry between 2019 and 2022.
    - Latest CITB forecasts project the requirement for an additional 225,000 workers by 2027.
- This has contributed to average weekly earnings for construction workers rising sharply over the last two years, having fallen during the height of the pandemic.
- In response the government has added five construction occupations, including bricklayers and plasterers, to the government's "shortage occupation list".
    - This will take time to have any real impact if it succeeds in attracting migrant workers which it has notably failed to do across some other occupations.
- Overall, while the outlook is better, it remains inflationary and very challenging for viability. Other factors such as the cost of debt are seeing renewed uncertainty and adding pressure. Risks are weighted firmly to the downside.

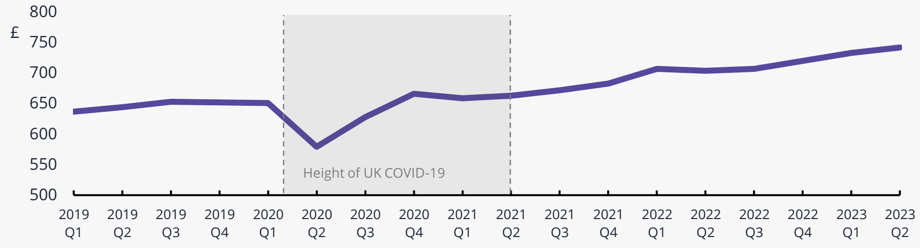
➢ **Key components of cost will continue to grow albeit at a slower pace.**
➢ **Overall build costs are unlikely to reduce from current levels.**

Is inflation impacting the viability of schemes?



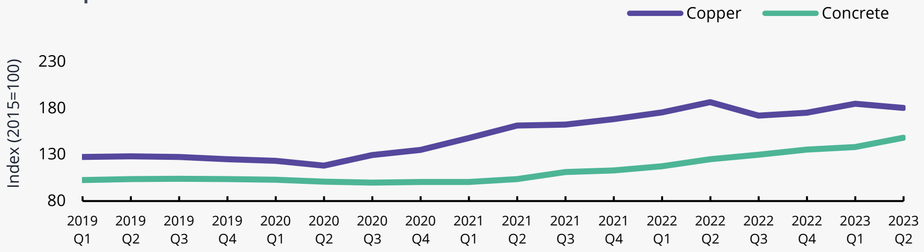
Source: Gleeds

Average weekly earnings (construction)



Source: Oxford Economics

Material price inflation



Source: ONS

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Primary care rents have fallen in real terms & underperform against other sectors

- The lack of rental growth relative to other sectors and inflation is a deterrent to investors.
- The sector drastically needs to attract investment to address the modernisation and decarbonisation of assets and shortfall of supply.
- Rental growth is far behind the main real estate sectors and also performs poorly compared to other 'alternative' sectors such as student housing.
- Primary healthcare rental growth has been dramatically outstripped by inflation meaning rents have actually fallen in real terms over the last decade.
- Inflation looks set to remain at levels far higher than the post Global Financial Crisis (GFC) norms for longer than expected. Build cost inflation significantly outpacing rental growth has been a long running trend but this dramatically accelerated over the last two years.
- Despite this, the sector continued to attract funding for development due to yield compression.
- The current monetary outlook has brought this prospect to an end for the foreseeable future.
- The sector is facing multiple headwinds and rent setting is the main lever in mitigating their impact and attracting investment to the sector which is a critical societal need.

1% 10 yr average annual market rental value growth for primary healthcare

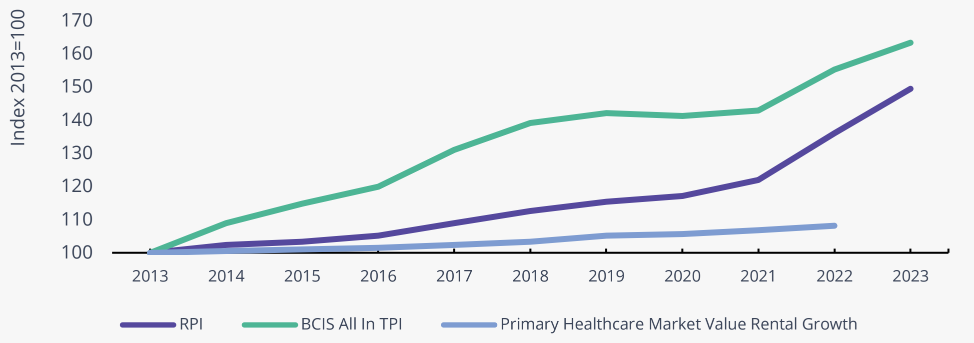
4% 10 yr average annual RPI growth

> *"Currently primary care rents are just not increasing enough to support continued investment into the sector."*

Rachel Beverley-Stevenson
Co-founder & Exec Chair, OneMedical Property

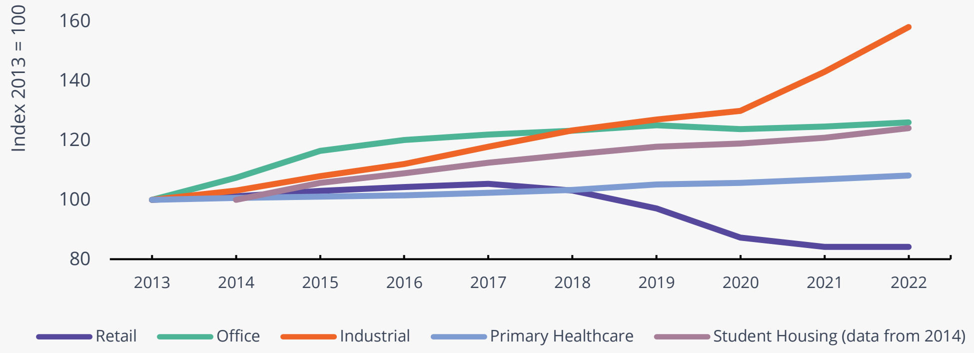
➢ **Rental growth needs to return to the rates seen before the GFC, +4% pa annual growth across the sector, with higher growth for modern fit-for-purpose assets.**

Primary care rents have fallen in real terms



Source: MSCI, Oxford Economics, BCIS

Primary care rental growth has underperformed other sectors despite strong underlying demand



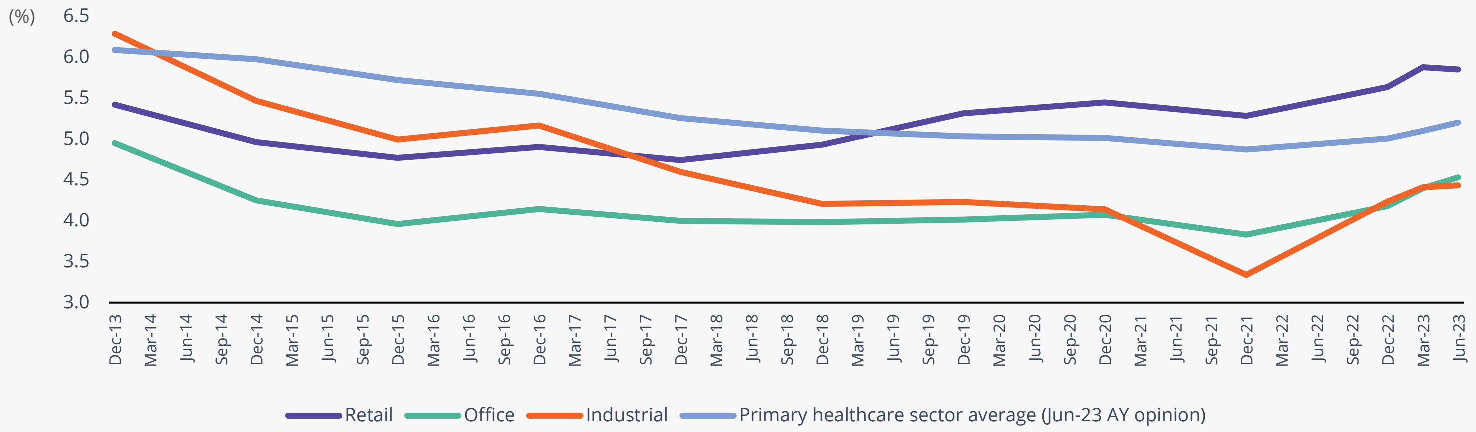
Source: MSCI, Oxford Economics, BCIS

Rental growth is required to bridge the gap left by a weakening investment market and cost increases

- The last ten years have seen a largely consistent trend of yield compression in the primary healthcare sector.
- This has enabled investors to deliver total returns that make participating in the sector appealing.
- Yields across real estate sectors have moved out over the last 12-18 months.
- The yield compression that enabled the sector to deliver attractive total returns despite lacklustre rental growth is unlikely to return while the inflation outlook remains unstable.
- The combination of low rental growth, little prospect of yield compression and the lack of repricing relative to other sectors means primary healthcare will struggle to attract new development.

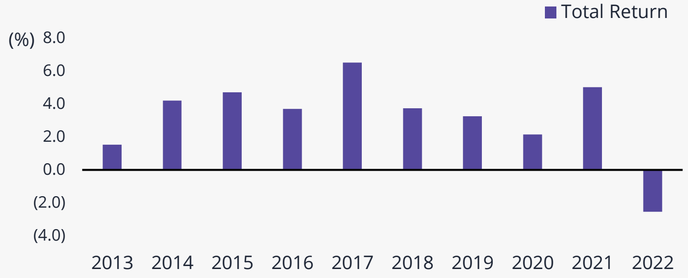
> *In today's market, developments are not viable based on appraisals with today's yields, costs and District Valuers' opinion of rents.*
>
> **Wayne Ashton**
> *Healthcare Consultancy & Development Director, Eric Wright Group*

Net initial yield movement



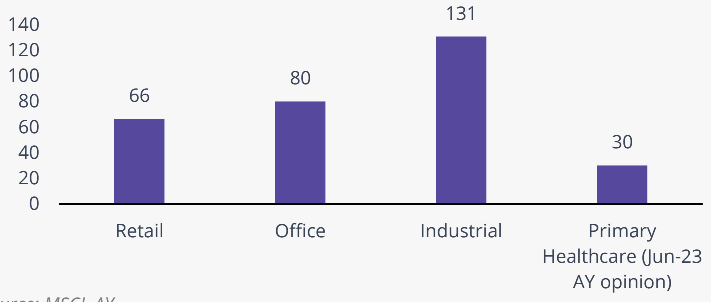
Source: MSCI, AY

Total property return - primary healthcare



Source: MSCI

Yield correction (bps) Jun-22 to Jun-23

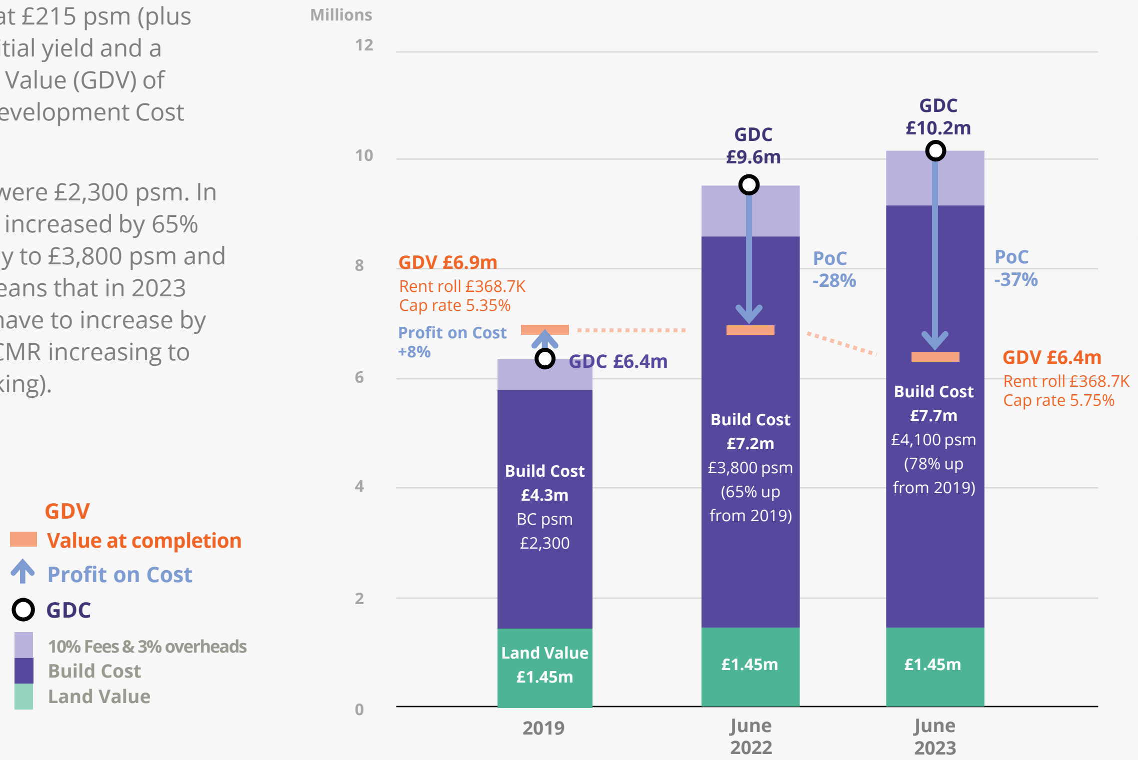


Source: MSCI, AY

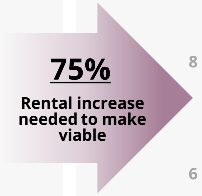
Real life case studies indicate that a substantial increase in rents is now needed to ensure viability

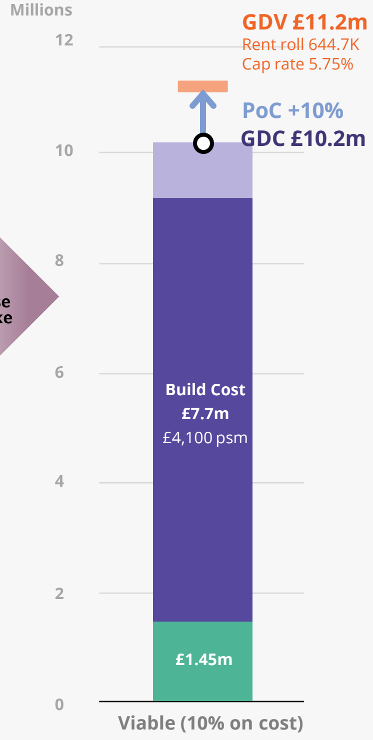
Case Study I: Eastbourne, South East

- In 2019, the project was viable (8% profit on cost). This reflected Current Market Rent (CMR) at £215 psm (plus parking), a 5.35% initial yield and a Gross Development Value (GDV) of £6.9m. The Gross Development Cost (GDC) was £6.4m.
- In 2019 build costs were £2,300 psm. In 2022 and 2023 they increased by 65% and 78% respectively to £3,800 psm and £4,100 psm. This means that in 2023 the rent roll would have to increase by 75%, equivalent to CMR increasing to £354 psm (plus parking).



Source: PHP, AY





- Acceptable Profit on Cost is now 10% to reflect increased risks and cost of capital.
- To breakeven with June 2023 costs, with the initial yield at 5.75%, the total rent roll needs to rise by 75%.
- We would highlight the same trend all over the country, see next page for further case studies.

> *Historically, there was a link between the rent and cost equation. However, today the gap is unsustainable and holding back GP development.*
>
> **Frank Convery**
> *Principal, Avison Young*

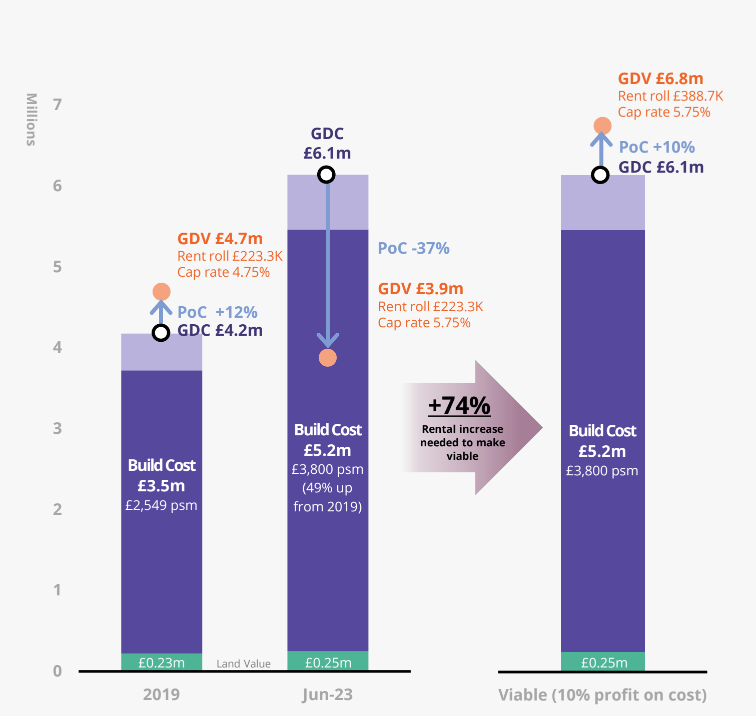
Up and down the country, developments face the same challenges, rental tone must rise whilst still providing value for money

Across these case studies, we see +70% increase in rent needed from 2019 levels for new builds outside London (c.21% pa). Rental tone across the country must rise to recognise inflation and cost pressure, whist still providing value for money.

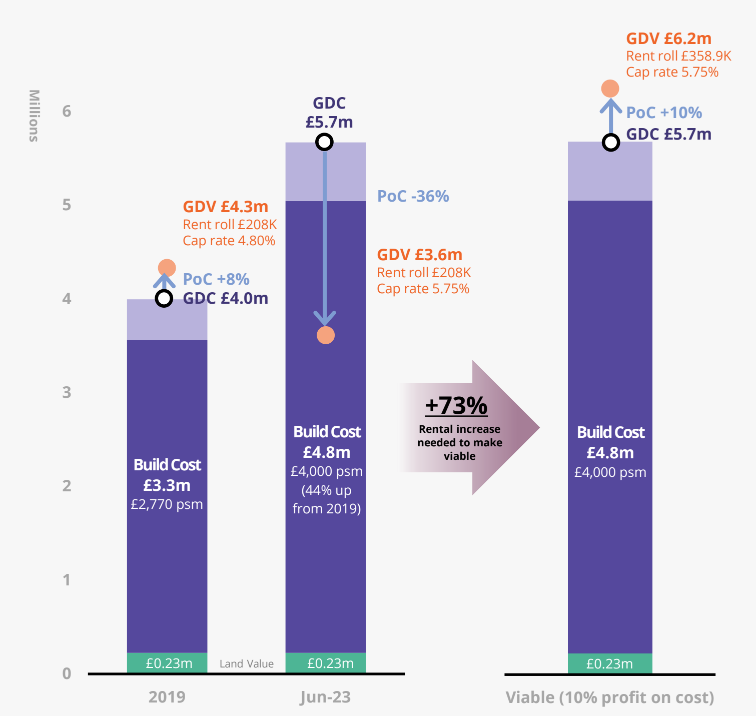
GDV
Value at completion
Profit on cost

GDC
10% Fees & 3% overheads
Build Cost
Land Value

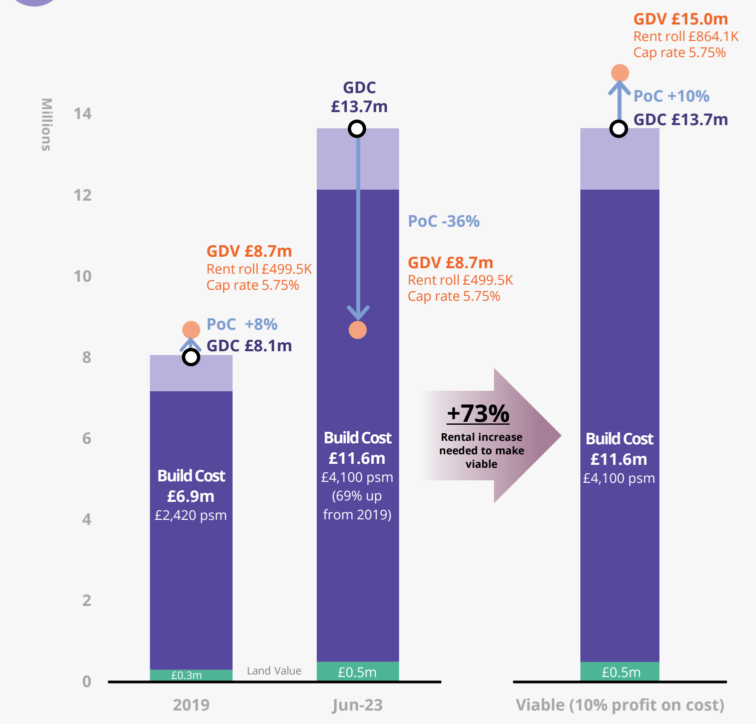
II. Mountain Ash, Wales



III. Ashton, Wigan, North West



IV. Swindon, South West



Source: PHP, AY

Conclusion

1. Our healthcare sector is in need of a fresh perspective, particularly in how rent reviews for existing properties are managed.

2. It is clear that significant increases in rental rates are necessary. These increases must take into account; inflation, the escalating cost of construction, the rising cost of capital and the need for building specifications to incorporate the latest environmental standards.

3. It is crucial that District Valuers reconsider their approach to this matter and increase the rental tone. By doing so, we can rebuild confidence within the investment sector, preventing the current migration of capital which has moved to more lucrative markets within the UK (e.g. care homes/social housing) or abroad to the Republic of Ireland (Primary Care and Enhanced Community Care Centres) and further afield.

4. When assessing various aspects of our healthcare infrastructure, including rent reviews, lease renewals, and new developments, we must always ensure Value for Money. This approach should be in harmony with the guidance provided by HM Treasury, ensuring that there are well-balanced and prudent judgments and not solely based on historic rental comparables.

5. Integrated Care Boards (ICBs) must confront a challenging dilemma in their development efforts. It is evident that many vital projects will remain unviable unless we address the pressing issue of viability.

6. Implementing these recommendations will not only have a positive impact on our healthcare system but will also go a long way in meeting the growing demand for healthcare services. Delivering care provision through primary care instead of secondary care provides cost savings, and better community outcomes. Additionally, it will help provide improved accommodation for our invaluable healthcare workers and the patients they tirelessly serve.

7. In conclusion, these measures are not just about financial considerations; they are about the well-being of our healthcare system and the people it serves. Let us work together to ensure that these recommendations are put into action for the betterment of our healthcare infrastructure and the benefit of all.

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