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2020: Trends in the Senior Living Sector

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Introduction

Welcome to our 2020 trends report on issues and opportunities in the UK senior living sector.

Over the last few years, we have seen an acceleration in the emergence of new purpose built senior living developments in the UK.

As more high quality developments are brought forward, specifically designed and operated to meet the needs and aspirations of senior occupiers, we are beginning to see a shift in public perceptions about senior living schemes. There are signs that the stigma around moving into specialist senior living accommodation is beginning to fade.

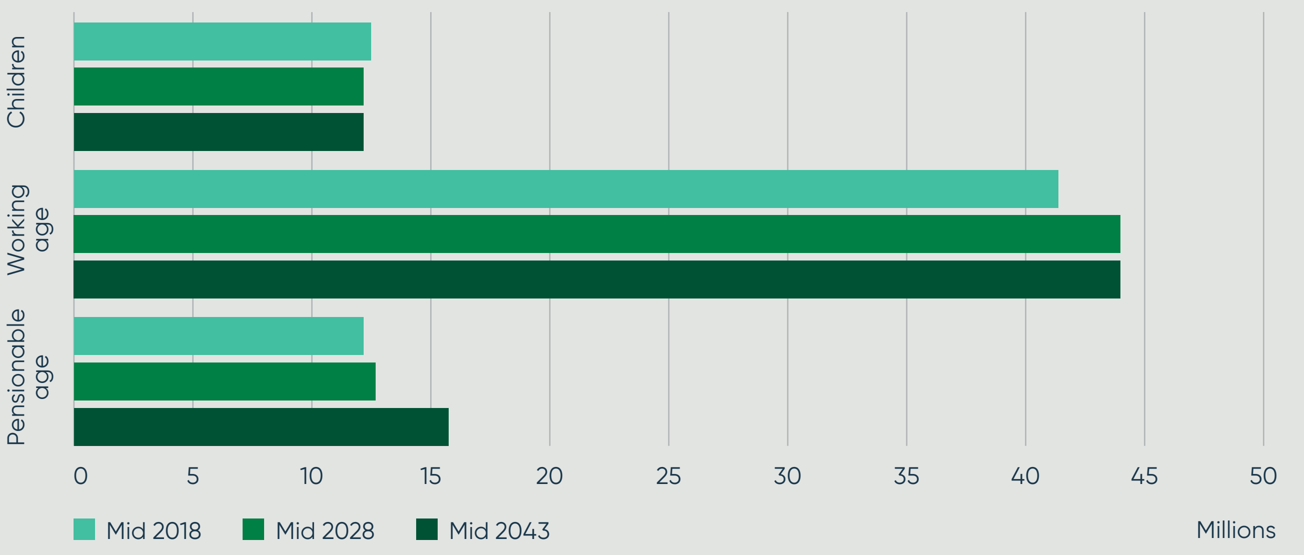
Office of National Statistics (ONS) data indicates that the population of the UK is ageing and it is projected to continue to age (National Population Projections). By 2050, it is projected that one in four people in the UK will be aged 65 years or over - an increase from almost one in five in 2018. In 50 years' time, there is projected to be an additional 8.2 million people aged 65 years and over in the UK – a population roughly the size of present-day London.

Such changing demographics and the shift in public perceptions, together with the need to address wider UK housing supply issues, will undoubtedly drive demand for new senior living developments in the coming years. It is clear that there is currently a structural undersupply of appropriate housing to meet the existing and anticipated growth in demand.

The number of people of pensionable age is projected to grow the most

UK population by life stage, mid 2018, mid 2028 and mid 2043

Source: Office for National Statistics – National population projections: 2018-based (Release date: 21 October 2019)



Notes:

1. Children are defined as those aged 0 to 15 years.
2. Working age and pensionable age populations are based on State Pension age (SPA) for the stated year. Under current legislation, the SPA in mid 2028 and mid 2043 will be 67 years old for both sexes.

Senior living has certainly grabbed the attention of big investors with the likes of Legal & General, Goldman Sachs, AXA Investment Management and Schroders all taking growing stakes in the sector. Major deals are hitting the headlines, such as Riverstone Living's forward purchase of a £300m retirement living scheme in Kensington in 2019. And substantial new schemes are securing planning - in 2020, Legal & General's senior living business Inspired Villages was given the go ahead for a £215m scheme on the site of its former head office in Kingswood, Surrey, a development reported to be one of the UK's largest retirement communities by value.

We anticipate increased activity in both the sales and rental markets for senior living over the next few years with a significant growth in the investment appetite for new purpose built schemes. In its 2019 Senior Living Annual Performance Review (Knight Frank Senior Living Annual Performance Review - 2019), Knight Frank comment:

"Given the growth of investment in the Senior Living sector in recent years, an increase in delivery of units is widely expected. We have analysed the future plans of all major operators against past delivery to forecast a 30% increase to the current stock of private living senior units by the end of 2023. This equals an additional 50,000 private sale and rental units being delivered in the next four years."

The Covid-19 lockdown resulted in large numbers of seniors being isolated, distant from family, friends and amenities. Following the pandemic, we anticipate that there may be an upsurge in demand for the lifestyle change offered by purpose built retirement communities: privacy and independence in a safe, secure and supported environment in close proximity to on-site or local amenities.

However, there will also be a need to develop strong operational capabilities to service the pipeline of new developments. The shortage of experienced operators in the UK market will need to be addressed, perhaps drawing on the talent and expertise available in other jurisdictions where the senior living sector is more prevalent and mature. New operating platforms are likely to emerge in the UK in tandem with real estate.

In this report, we look at some of the legal and practical issues facing the senior living sector and those looking to take a stake in the opportunities it holds.

We would welcome the opportunity to explore any of the issues referred to in this report with you in greater detail.

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Event fees

Regulation to demystify event fees

In March 2019, the Ministry of Housing, Communities and Local Government confirmed that it intends to act on the recommendations in the Law Commission's 2017 report on Event Fees in Retirement Properties (Law Commission Report). This provides welcome clarity for consumers, stakeholders and investors on an element of retirement living previously burdened by uncertainty and claims of unfair practice.

What are event fees?

An event fee is a deferred payment which is imposed on a leaseholder pursuant to the terms of some long leases of retirement properties. Event fees may be referred to by a variety of different names including exit fees, transfer fees, deferred management fees, contingency fees and selling service fees. Where imposed, the leaseholder must pay the event fee on the occurrence of certain events such as resale, sub-letting or change of occupancy, with amounts ranging from 1% to up to 30% of the purchase price.

Operators have argued that such fees mean that residents pay a lower monthly service charge, as the balance of the costs associated with maintaining communal amenities is recovered by the landlord through the event fees. The Associated Retirement Community Operators (ARCO), the main body representing the retirement living sector in the UK, has suggested that, for certain retirement properties, without an event fee the amount consumers would have to pay by way of service charge would more than double.

The rationale for event fees is therefore to make retirement housing more affordable by deferring part of the payment for provision of communal facilities and services until users come to sell. For consumers who are 'asset rich and income poor', this payment structure may be beneficial. The Law Commission has therefore focused on reform rather than abolition of the use of event fees in retirement properties.

The Recommendations and the Government's Response

The Law Commission's recommendations focus principally on restricting when an event fee can be charged, limiting the amount which might have to be paid in certain cases and increasing transparency of what event fees are and when they are payable. The specific measures recommended include (amongst others):

- imposing restrictions on when event fees can be charged, particularly limiting them to when the property is sold or sub-let or where there is a change in occupancy following the resident's death or when the property is no longer the resident's primary home
- a cap on the fees charged on sub-letting or change of occupancy
- protections that prevent an event fee being charged in unexpected circumstances, such as when a resident's partner or carer moves into the property
- introduction of standardised disclosure documents providing information such as how much the event fee will be and how it is calculated, who it is payable to and the service or benefits (if any) the resident can expect to receive as a result of paying the fee
- the creation of an online database to facilitate the provision of such key information to estate agents and prospective buyers.

The Government has confirmed its intention to implement the majority of the Law Commission's recommendations.

It has confirmed it will introduce a new statutory code of practice which will ensure that event fees cannot be charged unexpectedly. Event fees that breach this new code will potentially be unenforceable. Landlords and operators will be required to make event fees crystal clear to people before they buy.

The Government is exploring two issues in further detail: firstly, whilst it agrees with the aims of the recommendation to establish an online database to provide information to prospective buyers, it intends to commission further research to understand the best means to achieve this; secondly, whilst the Government also agrees with the aims of the recommendation for spouses' and live-in carers' succession rights to stay at a property without payment of an event fee, it has said it wishes to understand better the implications for both consumers and new supply.

What's changed?

Though we are yet to see the Government's new code of practice, there is some evidence to suggest that the Law Commission's recommendations have already led to a change in approach to event fees by operators in the sector.

A comparison of the lease offered by one retirement property provider before and after the Law Commission's report was published shows the introduction of more explicit terminology around event fees and a clearer explanation of how they are calculated and used.

We await the longer term effects of the recommendations, but the proposed steps to regulate event fees are welcome in that they go some way to removing the stigma attached to such fees. We predict that increased regulation, coupled with increased certainty as to how the code will operate, is likely to encourage greater activity in this sector.

Planning policy

Use Class and affordability requirements – impact on viability

The delivery of sufficient housing is an ongoing issue for the UK planning system and a hot topic for local and central Government. As the UK population ages, the delivery of homes that meet the needs of the retirement community is an increasingly important part of this picture.

This is reflected in recent guidance published by the Ministry for Housing and Local Government and in National Planning Policies. These policies define 'older people' as those over or approaching retirement age including the active, newly-retired and very frail elderly whose housing needs encompass accessible and adaptable general housing through to the full range of retirement and specialised housing products. Local planning authorities are required to actively plan for the housing needs for this community and can count the housing provided to older people against their housing requirement. This latter point is a useful confirmation for retirement sector developers wishing to make a planning case for the delivery of homes against an identified shortage or the release of general market housing as a result of their development.

Notwithstanding the planning policy support above, there are still a number of grey areas when it comes to obtaining planning permission for, and delivering, retirement living developments. One recurrent question is which planning use class applies to retirement housing. Most developments will either fall within Class C2 (residential institutions) or Class C3 (dwellinghouse) depending on the level of care provided. However, this is a matter for the relevant local authority to determine which can lead to inconsistencies across the country and delays in validating and assessing planning applications.

A related issue is the requirement (or not) to deliver affordable housing as part of retirement living developments. In many local authority areas, Class C3 developments will trigger an affordable housing requirement whereas Class C2 developments will not. This is the case in London, where the emerging London Plan draws an express distinction between 'specialist older persons housing' and 'care home accommodation'. The former, which covers a wide range of products targeted at the over 55 community, is required to deliver affordable housing in the same way as a market housing development. Given the Mayor of London's strategic target of 50% affordable housing in all new developments, and the related planning policies requiring a minimum of 35% affordable housing to avoid viability assessments and benefit from the fast-track planning application route, this is likely to remain a hurdle for retirement sector developers for the foreseeable future.

In its decision in the LifeCare Residences appeal against the decision of the Council of the London Borough of Camden (APP/X5210/W/18/3198746 10 June 2019), the Planning Inspector considered (at paragraphs 179-203) whether or not the capital value of event fees should be taken into account in viability assessments to determine the level of affordable housing to be provided. In relation to the deferred management fee (DMF) proposed to be charged at the appellant's new development, he concluded that the "evidence does not support omission from the viability assessment of future DMF income, suitably capitalised and making any allowance for the inclusion of notional ground rents". This decision is likely to have an impact on the delivery of new retirement living schemes in the capital. LifeCare Residences' Chief Executive, Nigel Sibley, shared his frustrations at London's planning requirements in an interview with Care Home Professional (The Big Interview) and his outlook will no doubt resonate with many other stakeholders in the sector.

Leaseholder reform

Leaseholder rights and leasehold reform

The retirement living sector is one which attracts 'downsizers'. These are people who have never owned a leasehold property and as such are unaware of the obligations and benefits of this type of ownership.

A leaseholder needs to understand a lease is a contract authorising exclusive use of a property for a number of years starting from a certain date.

Service charges

Leases in the senior or retirement living sector, typically, include what is known as a 'deferred service charge' clause. That is the service charge for major works or extraordinary costs are payable on the sale of the property. The sums usually cover the repairs and replacement of the roof or lift for example. This may be included in the event fees referred to earlier in this report.

Regular or variable service charges are for those services of a recurring nature and are set out in the Lease. Leases with a deferred payment clause can be seen as beneficial given the annual service charges are reduced. The deferred sum is usually 1% or higher of the sale price depending on how long the property has been owned by the person selling.

Service charges are subject to various statutory provisions, in particular the Landlord and Tenant Act 1987. A Landlord of a lease must comply with the statutory requirements as well as the obligations set out in a lease and this provides tenants with the following rights:

1. Rights to a summary of all service charge income and expenditure within six months of the end of an accounting year.
2. Rights to be consulted in respect of service charges, works over a certain value or a long term contract that is longer than 12 months. The latter must relate to the provision of services.
3. A right to challenge the service charge if the service charges are considered to be unreasonable.

Management

In respect of the management of the building or development, the owner of a lease is entitled individually or collectively entitled to the following:

(a) Join with the other tenants to have a formally recognised residents association.

(b) Serve notice under the Commonhold Leasehold Reform Act 2002 to exercise a right to manage the building or development.

(c) Serve notice under the Leasehold Reform Housing and Urban Development Act 1993 (the '1993 Act') to make a claim for the freehold or a lease extension.

(d) Make an application to the tribunal to appoint a manager on behalf of the tenants.

(e) Receive notice under the Landlord and Tenant Act 1987 in the event the landlord or freeholder is selling its interest in the Building.

A recognised residents association must be consulted and given an opportunity to comment before a landlord appoints a new managing agent and likewise a recognised residents association must be consulted with regard to any major costs and repairs.

There are also codes of practice which give protection for people in retirement housing.

These include NHBC Sheltered Housing Code of Practice, The Association of Retirement Housing Managers (ARHM) and The Private Retirement Housing Code of Practice, an Associated Retirement Community Operators Consumer Code.

Freehold properties and proposed reform to leasehold system

Freehold houses which are situated on an estate or development and subject to a management scheme, that is a scheme for the maintenance of any common parts and or the exterior of the buildings, do not enjoy the same options when it comes to challenging a change of management. Likewise, leasehold houses do not enjoy the same benefits of consultation afforded to flats. The Government is looking to remedy this anomaly.

The Government is currently consulting with regard to the elimination of ground rent or certainly the reduction of ground rent in leasehold properties. The Government has announced a wide range of possible reforms and these propose to:

1. Ban new leasehold houses.
2. Reduce ground rents on newly created leases to zero.
3. Consider ways of making it cheaper and easier for leaseholders to extend their leasehold purchase of the freehold.
4. Introduce stronger regulation for managing agents (mandatory qualification).
5. Make service charges and other fees fairer and more transparent.
6. Make it easier for leaseholders to take over the management of their building (please see Management section).
7. Address the gaps in housing redress options so that more people have access to independent redress schemes like an ombudsman.

The Law Commission reported in January 2020 in respect of the proposals for the price payable for a freehold and or a lease extension under the 1993 Act. It set out three alternatives but does not recommend any particular option. In all options the price to be paid by the tenants is likely to be less than the current method of calculation.

Reform of the leasehold system was included in the manifestos for the 2019 General Election. This provided a further indication that, with Brexit out of the way, Government is expected to press ahead with implementing some reforms.

However, it is likely that retirement leasehold properties will benefit from a number of exemptions to such reform. In its response to the consultation on implementing reforms to the leasehold system published in June 2019 (Government Response June 2019) the Government confirmed:

"On balance, we feel there is merit in concerns raised about banning the use of leases in retirement properties, not least as such properties are part of a wider community setting. The Government has also recently announced support for the Law Commission's recommendations on the use of event fees, which recommends their continued use alongside improved transparency and consumer protections. The Government is committed to supporting the development of housing for older people to help them live independently in their own homes. We will provide an exemption from the ban for retirement properties."

And in relation to reform of ground rents the Government confirmed:

"The Government believes that there is merit in the argument that ground rent is used to fund building costs in retirement developments. As retirement developments are often in central areas of towns and villages close to local amenities, developers must pay a higher price for land. In comparison to a normal leasehold block, there are fewer saleable units in a retirement development. This is because a higher proportion of floor space is needed for the communal areas. Ground rent, therefore, is used by retirement developers to recover this lost income and maintain their ability to invest in future projects."

"One retirement developer told us that the number of sites they have delivered has reduced since our announcement to reduce ground rents in December 2017, which they stated was because they were not including ground rent income in their land purchase viability assessments. This suggests that the supply of retirement developments would be negatively impacted if no exemption is granted to the retirement sector."

"We will therefore proceed with the proposal to exempt retirement properties from the policy. This will apply to both newly established leases and existing buildings where a new lease is granted. It will also apply to conversions of existing buildings (for example, a conversion of a large existing freehold house into retirement flats with a ground rent). However, this exemption will be subject to the conditions listed in the consultation document. This includes offering prospective leaseholders the choice of paying a higher purchase price in exchange for a ground rent at a peppercorn (zero financial value). These conditions will also apply on re-sale of retirement properties. Some retirement developers rely on the use of event fees and others on ground rents as part of their business models. To avoid the risk of double charging, the retirement ground rent exemption will only apply where event fees are not used."

Such exemptions will be welcomed by developers and investors in retirement developments.

Commonhold

The Government is looking again at commonhold. The Commonhold and Leasehold Reform Act 2002 (the '2002 Act') introduced commonhold as an alternative to leasehold. The main provisions of the 2002 Act came into force in September 2004. Commonhold allows for the ownership of a freehold flat within a larger residential development and participation in the management of communal areas and shared services, without the existence of leases or third-party freeholders. This form of ownership also operates in the Australian Strata Title system and the condominium system in the United States, as well as Belgium, France and Germany. The use of commonhold had been expected to be taken up by developers for new build sites. To date, there are very few commonhold title registered in England and Wales and developers and banks are wary of the system as currently drafted. The Law Commission has considered reforms to reinvigorate commonhold and its recommendations were due to published in Spring 2020, but this has now been delayed due to the Covid-19 pandemic.

Use of data

Hidden technology – transparency of data capture

The senior living sector is continuing to see a change in the expectations of residents around the types of services that are available to them in newly developed accommodation. As a result there is an unprecedented increase in the amount of data that can and will be captured. The general theme of 'all-inclusive living' is on the rise and operators now often provide all utilities as well as perceived essentials such as Wi-Fi and digital security systems. Health and wellbeing add-ons such as gym facilities and concierge services are also growing in popularity. All of this means that much more data on residents is being captured.

As well as offering attractive facilities to prospective residents, the capture of so much data could significantly enhance value for investors, if handled correctly. However, as many residents are increasingly aware of and concerned with privacy issues, greater accountability and transparency will be needed both to meet legal requirements and to satisfy resident concerns. It is inevitable that more data will also be shared with third parties operating or maintaining services and it will be the responsibility of developers and operators to ensure that data sharing arrangements are handled properly.

Developers, owners and operators in the senior living sector need to be on top of compliance issues relating to the data that they are capturing on residents.

Almost any information about a resident can be personal data, the times that they enter or leave a building, their utility preferences and usage, their concierge requests. The GDPR introduced clarity on the rights of individuals with regard to their personal data and the responsibilities of those who process it. It is important to remember that almost anything that happens with personal data from collection to storage to sharing to destruction is considered to be 'processing' under the law. That means there must be a legal basis for all such actions. Data cannot just be collected because it might prove to be useful or because collecting it is easier than not doing so.

We would like to see more transparency on how the data is collected and used, to build relationships between the residents and the accommodation providers. This has already happened in other markets, particularly in student accommodation and we expect this to be a key issue for owners and operators of senior living schemes going forward. Burying information about data handling in fine print is not going to meet the requirements of the law and it is certainly not going to meet the expectations of privacy regulators who are likely to be unforgiving of operators who fail to meet their obligations in this space because of the potential vulnerability of the data subjects in question.

A significant area of concern is the amount of 'special category' data available to operators in the senior living sector. Special category data is personal data that the law considers to be particularly sensitive. This includes information revealing racial or ethnic origin, biometric data for the purpose of uniquely identifying a natural person (increasingly relevant in security systems) and data concerning health.

Health and medical data is likely to be relevant to senior living service providers as some understanding of the medical needs of residents can be valuable to ensure their safety. In assisted and monitored living arrangements this could represent a lot of personal data to ensure the safety of residents. But knowledge of mobility issues, short or long term can also be valuable in almost any development to ensure that facilities are adaptable and accessible. Smart technology is being rapidly advanced to improve the provision of care in senior living schemes. Developers and architects are incorporating sophisticated 'hidden' tech-solutions into the design and construction of buildings that allow residents to maintain their privacy and independence but enable support to be provided where necessary. Examples include motion sensors to monitor the activity of residents and alert staff to any potential problems and automated pill dispensers to manage and track medications. It is essential that residents have a clear understanding of how data of this sort is captured and used - in many cases owners and operators will need to obtain explicit consent from all residents to capture their data.

With so much data available cyber security concerns have never been more pressing. Operators of senior living premises have control of data that can identify the addresses of vulnerable people and they should take particular care to ensure that they are meeting best-practice recommendations on data security. The negative publicity of an unavoidable breach, aside from the human cost and legal risks, could be extremely damaging.

Data capture is naturally creating challenges and opportunities for investors into senior living. The rise in technology required for fit-outs c reates an opportunity to capture more data and enhance value. The data analytics can be used to target specific audiences and optimise use so the need for compliance with GDPR is self-evident to avoid the potentially heavy fines but also commercially necessary for any data driven revenue model.

Click **here** to visit our Global Data Hub for more information and check-lists to ensure you comply with the GDPR and put the right procedures and priorities in place.

Health and safety

Spotlight on food safety

A thorough and attentive approach to the management of health and safety in the senior living space is essential. The reputational damage associated with a health and safety incident can be fatal to a business and this is particularly true of one that caters to vulnerable people in a context where their needs are – or should be - known.

None of this should be new or surprising but, in a post Covid-19 world, it is harder than ever to understand the extent of an operator's responsibilities (and liabilities). Depending upon the nature of the development and the type of services offered on site, the degree of liability that the operator can disclaim will vary. However, since liability for death and personal injury can never be disclaimed and since residents may be vulnerable, an excess of caution will generally be required. This applies as much to traditional risks such as slip and trip hazards as to newer causes for concern. We expect to see the introduction of touch free facilities and touch hygiene measures on all sites, to ensure the safety of residents who are particularly at risk from Covid-19. Failure to make these resources available could lead to a serious reputational problem as well as legal liability.

A particular tension for senior living spaces is the need to deliver personalised services whilst ensuring consistency with health and safety protocols. One such risk area that is growing in prominence at present is food safety and allergens. Increasingly senior living sites have food provision services available to residents, either through communal eating spaces or through personalised concierge services. Standard food safety protocols are essential and will be subject to regulation (depending upon the nature of the site) but flexibility to meet the dietary requirements and preferences of individual residents is also non-negotiable. New regulations governing food labelling may also have an impact upon any development that offers food to take away - residential sites are not exempt and penalties for food safety violations can be strict, so it is prudent to take regular specialist advice, to ensure that current requirements are being met.

In all health and safety matters clear communication is crucial. In everything from warning signs and food labelling to contractual terms and liability waivers, the needs and comprehension levels of the intended reader must be taken into account. Unless all warnings and documents are clear, easily understandable and prominently displayed or readily available, they are unlikely to provide any legal protection. We anticipate a significant investment in the manner and meaning behind health and safety communications in the short to medium term.

IP and branding

Protecting brand value

Senior living establishments present some of the most significant opportunities for the development and enhancement of IP that can be found anywhere in the residential property sector. Branding and name recognition have not traditionally factored heavily in the value of real estate offerings but the stress of choosing a senior living solution can be mitigated by offering prospective residents and their families the comfort of a brand with clear values and recognisable standards.

There is of course an inherent risk in multi-site branding (an incident or quality failings on one site can have a far more significant effect upon the reputation of other sites if there is an umbrella brand that covers them all) but for well operated developments, the benefits will significantly outweigh the risks. The benefits of strong branding for residential developments are evident elsewhere, particularly in the student accommodation market, but the particular needs of senior residents make it even more valuable in senior living where residents are often not intending to move in the future so the security of a strong brand when making their choice can have extra appeal.

Branding is not the only intellectual property for developers and operators to consider and protect. With so much smart technology being developed for senior living spaces, it is important to ensure that the right in any bespoke or novel technologies are properly protected. Much will be licenced in from specialist providers but any new tech that is developed for a specific site should be treated as potentially valuable intellectual property. Anything that could be considered a new invention should be kept confidential until legal advice has been sought to protect it. Anyone who is hired to work on the development of new technology by a developer should complete an assignment of the resulting IP and a waiver of moral rights (if appropriate), to ensure that the developer is able to enjoy the profits of the work they have funded.

The value of data should not be forgotten as part of the developer/operator's portfolio. Although data privacy requirements mean that personal data must be treated with great care, there is huge value in anonymised data. For multi-site operations in particular, data that shows residents' preferences and use of facilities can facilitate significant efficiencies as well as more effective marketing. Often overlooked, data can combine with other IP in a developer/operator's portfolio to add significant and unique value to a business.

Modular construction

Addressing the structural undersupply

For those involved in the development of new buildings, including retirement properties, modular construction is often seen as a possible way to construct buildings quickly and mitigate the impact of rising labour and material costs. Whilst there are many benefits to adopting modular construction methods, it should be used with caution.

What is Modular Construction?

Modular construction (also referred to as 'off-site construction') can mean anything from small prefabricated elements such as bathroom 'pods' or façade systems up to full apartments, where only the central core is constructed on site and the rest of the building is constructed off-site. Modular construction also comes in the form of timber or steel frames which are produced in a factory, delivered to site as 'flatpacks' and then assembled on site in a number of weeks.

Modular construction could be well suited to retirement living properties which contain multiple rooms of a standardised size and specification, be this bathrooms or full apartments, provided that the project is of sufficient size to ensure economy of scale.

What are the benefits?

The benefits of modular construction mainly derive from cost savings. Whilst modular construction can be more expensive than standard construction this is counterbalanced by the shortened construction period on site. Work on the ground can be carried out in parallel with the construction of the modules. In addition, because the modules are constructed in a factory setting, delays due to adverse weather are mitigated. Further, less labour is required on site as the majority of the work can be carried out at the factory utilising local labour.

Risks

There are a number of issues specific to modular construction that ought to be considered by developers and funders, and we have summarised some of the key legal points below.

Quality - quality control is potentially more difficult than in traditional construction as manufacturing issues are difficult to rectify once the module is on site. Developers and their funders need to have a presence at the place of construction of the modules to be able to monitor and inspect the modules and identify any issues before they leave the factory. Rights of access and inspection to the factory will be required along with a right to be present for all tests carried out on the modules.

Interface – there needs to be clear risk allocation between the structural engineer responsible for designing the frame or core, the mechanical and electrical engineer responsible for designing the cabling and plumbing and the design of the modules, as there is less scope for correcting 'design clashes' than when traditional construction methods are used.

Fixing design – modular construction requires both the design of the overall project and the detailed design to be fixed at an early stage, so that the modules can go into production. Once that process is underway design changes are very difficult and expensive to implement.

Payment – significant advance payments are usually required to be made to the module supplier, due to the bespoke nature of the modules. Developers and funders therefore need to ensure that there is sufficient security over the modules and the components within them at all stages of manufacture. This can be achieved (to some extent) by third party bonds and vesting agreements.

Title – there are two title issues which require specific consideration when it comes to modular construction. One is ensuring that the developer or funder has title over the constructed modules before their delivery to site. The second issue is that often a developer will provide certain elements of the modules to the module supplier for the supplier to incorporate into the module, such as tiles, or white goods, so any contract needs to deal with title in the developer's goods to ensure that title is retained.

Insolvency risk – in the event of insolvency of the module supplier, it will be difficult to find another supplier that can continue to deliver modules to the same specification, and it will have a huge impact on programme, certainly more so than finding a contractor to continue to build out a traditional construction project. Therefore it is critical to understand the financial covenant strength of the modular supplier and obtain appropriate performance security through bonds or guarantees or to look to cover off the risk through insurance.

Transit risk/Insurance – the risk of damage to the modules in transit needs to be considered and the risk allocated appropriately, backed by suitable insurances.

Modular construction is clearly going to play a key part in the future of construction and has the potential to revolutionise the construction market but developers and funders must ensure that these key risk areas are addressed if they are to reap the benefits.

Finance

Opportunities for lenders

Investment opportunities

The retirement living sector benefits from plenty of investment opportunities. These include UK sourced investment and increasing jurisdictional inward investment. Sterling exchange rates are currently favourable for those who are seeking to acquire property in the UK and look to remain this way. We may find that Asian and Pacific Rim investors in particular will take advantage of these market conditions given their familiarity with the sector in their domestic markets. For example in Australia and New Zealand, over 5% of over-65s now live in a retirement village, in comparison with only 0.6% of the UK's elderly population. In Singapore, spending on care for the elderly is expected to hit USD 49 billion by 2030. The experience and confidence of overseas investors, and the favourable exchange rate, may open the door to further investment in retirement living in the UK.

Funding

A key attraction to the retirement living sector is that it benefits from generally being privately funded rather than having to rely on the support of local authority funding. The realities of living in a 'swanky retirement village' was covered by a 2019 article in The Telegraph, which noted that affluent retirees are ready to pay for a privately-owned house/apartment within a luxury community space, where a library; gym; swimming pool; restaurant and many social activities are available. Residents can expect gardening, cleaning and maintenance provision at a price as well as a round-the-clock duty manager. The fees for this are extracted via a substantial service charge and/or a large deduction from monies realised on the sale of the house, when retirees move on to places offering a greater care element.

Lending

Opportunities for lenders are vast, given the demand-led growth in the sector and the consequent requirement for external funding. Potential borrowers range from single site owner/operators to borrowers owning and/or operating vast portfolios. As with all asset-classes, each type of borrower is accompanied by its own advantages and disadvantages for credit purposes. The business model/offering of a proposed retirement village will drastically effect whether a lender sees the lending opportunity as credit worthy. Higher-end retirement villages that are privately funded and have less focus on the care aspects are likely to be more attractive to lenders. Lenders that can be flexible in their lending models hold the upper hand. However, all lenders must ensure that their interests are protected through the careful structuring of the deal, due diligence, documentation and the security package.

Structuring

At the simplest level, a borrower could be a single site freehold property owner and operator with simple funding requirements. Structuring this type of deal is straightforward. However, on the financing of a portfolio of retirement living sites, lenders can expect to see Opco-Propco structures, third party management and/or operating vehicles, offshore jurisdictions and various funding streams (whether intra-group or from a third party) that need to be considered at an early stage. If the financing involves the construction of a retirement village, the parties may opt for a forward funding structure (where the borrower purchases the land and a developer contracts with the borrower to carry out the development), since this offers a tax incentive for the borrower in the form of reduced stamp duty land tax. Also in this scenario, the developer will receive payment (for the land which is to be developed) as soon as the empty site is sold to the borrower, rather than having to build the property and sell it before recouping on its investment. Tax advantages/benefits will play a key part behind any structure and any borrower or lender should ensure they are properly advised in this regard.

Sale and leaseback models are commonly seen (given the benefit of the release of capital) and, so long as due diligence is undertaken to ensure that the terms of the lease are market facing, can be easily bankable. However, some conservative lenders are veering away from financing sale and leaseback properties, given the perceived maturity of this economic cycle and the deferred priority of payments under such leases ahead of third party creditors on insolvency. The long income/income strip products (forward funding arrangements that are then sold back to the occupier at the end of the lease) that are quickly growing in the hotels market are not yet commonly seen in the care homes/retirement living sector but once a precedent is set with an institutional investor, this could change, impacting debt financing models in this space.

Economies of scale are a key factor to any successful retirement living business and the numbers of beds/units to be offered will be considered by lenders when they are reviewing the prospective borrower's business plan. From a financing perspective, any fewer than 50 beds/units is often considered inefficient.

Lenders will also want to ensure that the relevant companies required for the day-to-day operation of the retirement village are security providers or, as a minimum, enter into a duty of care agreement with satisfactory step-in rights.

Certain retirement living homes within a portfolio may be funded by third party lenders or there may be a senior lender and a mezzanine lender at portfolio level. However, the priority arrangements and/or intercreditor principles should also be negotiated at an early stage to ensure that the overall deal is palatable for the relevant lender(s).

Loan agreement

Although any loan agreement in respect of a retirement village financing will be based on core corporate and real estate loan agreement principles, bespoke provisions should also be incorporated. At a business level (and non-specific to the retirement living sector), lenders should be open to the different facilities being made available to borrowers, whether development facilities and/or investment facilities with incorporated capex lines. In growing or transitional portfolios, the borrower's ability to designate certain retirement villages in a portfolio as 'investment' properties or 'development' properties with the right to re-designate during the term of the loans provides borrowers with the flexibility they need to operate a profitable retirement living business. Development facilities that flip into investment facilities on practical completion are common. On the financing of retirement village portfolios, allocated loan amounts (ALAs) and release premiums should be considered carefully. An ALA is the portion of the total commitment which is allocated to each asset in the financing. In this context, as assets within the portfolio are sold, lenders will require some or all of the disposal proceeds to be applied in prepayment of the loan(s). Such a prepayment of proceeds will be a condition of such disposal being permitted under the loan agreement. In instances where only some of the disposal proceeds are prepaid, the amount that the borrower will need to prepay is expressed as a release price, which in simplest terms is calculated as a percentage of the ALA (eg 110%). This may be a blanket percentage applied to each asset, or a variable percentage (larger percentages may apply to 'trophy' assets). The difference between the ALA and the release price is known as the release premium. Lenders will need to stipulate figures which allow borrowers to operate within their business model, whether that means disposing of an asset not delivering the required return (so they can focus on more profitable retirement villages), or disposing of certain assets to provide financial support for the remaining assets or new acquisitions. Flexibility here can benefit both borrowers and lenders but as with any portfolio, care needs to be taken from a lender perspective that they are not left with a portfolio 'rump' (see comment on 'trophy' assets above).

As to the financial covenants that lenders test against: debt service cover ratios; leverage; debt yield and loan-to-value covenants are commonly seen. However, given that the payment terms for residents vary from scheme to scheme (although equal monthly payments are common), account must be taken for the possible 'lumpy' nature of income as a result of advance payments, any standard ongoing payment terms and/or the turnover of residents. For example and as set out above, a resident purchasing a leasehold interest in a retirement village will commonly pay a deferred management/exit fee linked to RPI and the number of years residing at the property on the sale of that leasehold interest. Residents deem this preferable to building such fee into a monthly payment and retirement living providers are comfortable that the fee is effectively secured.

Retirement living income is not rental income as one would see on any tenanted real estate financing. Consequently, break clauses or tenant contributions are not relevant when calculating income. Instead, 'operating income' and EBITDA are key, and, given the uneven cash-flow profile, lenders may, for the purpose of financial covenant calculations, choose to adopt a blended rate, eg nine month look back, three month look forward, allocating income to future calculation periods or requiring a reserve for finance costs over 12 months. As to how any advance payments are treated once a client no longer resides at the retirement village, this will depend on the payment terms of that retirement village. However, if a retirement village retains any advance payment, the borrower will want this to be treated as income rather than as a capital payment.

If a retirement village offers 'personal care' or any form of nursing, the relevant provider will need to be authorised to do so by the Care Quality Commission (CQC) (which monitors, inspects and regulates all health and social care services). It is therefore key that any loan agreement contains covenants as to the standard to which the care at the retirement village is operated/delivered. These would include maintaining a minimum standard for CQC purposes (which ranges from outstanding to inadequate), usually with 'good' as minimum. Mechanics can be included in a loan agreement around improvement plans and increased reporting obligations in the event that a retirement village's rating is downgraded to 'requires improvement' rather than having an immediate event of default. However, it would be advisable for any lender to detail the following as additional events of default: the termination of a CQC registration; the termination of any registration in respect of a nominated individual if he or she is not replaced within a set time period; any failure to implement CQC recommendations. 'Key-man' provisions may also be appropriate.

If relevant, other general undertakings would cover 'care related' covenants to ensure minimum staffing levels, the maintenance of contracts for the day-to-day operation of the retirement village and requiring any relevant capex spend levels. Ensuring the management of the retirement village(s) and the operations behind them meet a minimum standard is vital to ensuring profitability. The amount of time a unit/room is vacant between a departure and the room becoming available for occupancy and overall occupancy levels critically impacts cash-flow, so having hard covenants in this respect is also advisable. An obligation on the borrower to have quarterly meetings with the lender to update on the retirement village's business and operations provides lenders with an additional ability to monitor the performance of a loan. Given the competitive nature of the retirement living sector, non-compete covenants are also seen and should be considered.

The usual conditions precedent are relevant to a retirement village financing but a lender would also want to be comfortable with (if applicable) care related conditions precedent, eg a standard form care service contract between the operator and a resident in acceptable terms together with regulatory-related conditions precedent.

Security

The basic security package in any retirement village financing does not differ from any other financing – the usual all-asset debenture, share security and assignment of any subordinated debt and duty of care agreements and collateral warranties (each as applicable) are generally always required by lenders. Lenders must ensure that they are properly advised and thorough due diligence is undertaken to ensure that the security structure would deliver as expected on an enforcement scenario. Guarantees at parent/sponsor level can also serve to make the loan more creditworthy.

The usual methods of enforcement apply to any retirement village financing. However, if the relevant retirement village does provide any 'personal care'/nursing services and if a sale of the operating business is structured as a business/asset sale, any buyer would have to be registered with the CQC. The CQC would also have to approve the business sale. Although this is not an insurmountable issue, it can delay a sale and it is within the gift of the CQC to block any sale (although given the current market and the need for retirement villages/care providers, it is hard to see why it would choose to do so when the potential buyer is CQC registered).

A sale can be structured by way of share sale which then avoids the CQC sale requirements, but any buyer would need to be comfortable with the liabilities left in the borrower/borrowing group and mindful of the ongoing CQC regulatory requirements. The fall-back position would be to close the care business and realise the value in the property itself and any assets that could be sold to interested buyers although alternative use options may be limited either by planning or local policy positions.

Tax

Navigating the UK tax regime

With the demand for senior living developments increasing as a result of an aging population, there is increased opportunities for investors and developers to invest in new purpose built senior living developments in the UK. UK resident and offshore investors and developers investing in senior living accommodation, whether with a view to deriving rental income from the property or realising long-term capital appreciation on disposal, need an understanding of the UK tax regime before making this investment.

In recent years, HMRC has made legislative changes to ensure that UK property (and income derived from it) is fully within the scope of UK corporation tax, regardless of whether it is held by a UK company or a company that is not resident in the UK for tax purposes. HMRC's stated policy objective is to 'level the playing field' between UK and offshore structures. As such, historic offshore structures which preserved gains on UK property from UK corporation tax will no longer have the benefits as previously enjoyed. With effect from April 2019, all non-UK persons are brought within the scope of UK tax (capital gains tax for individuals or corporation tax for companies and certain other 'non-natural persons') on gains arising from direct and indirect disposals of UK property – regardless of whether the property in question is residential or commercial. Therefore, any offshore investors and developers looking to invest in senior living accommodation using a company will be subject to UK corporation tax on any subsequent disposal of the property. The current rate of corporation tax on income and gains is 19%.

Further, whereas prior to April 2020 offshore investors and developers were subject to UK income tax (at the basic rate of 20%) on UK property income profits (i.e. rent), changes have come into force from April this year to bring these offshore structures within the scope of UK corporation tax on profits (at 19%) of the UK property business and this also includes profits arising from loan relationships or derivative contracts that the offshore structure is party to for the purpose of that property business or enabling it to generate UK property income. This also means recent (complex) rules relating to restrictions on the tax deductibility of interest (known as 'corporate interest restriction') now apply to offshore and onshore companies. Broadly, this regime limits tax relief for financing costs to 30% of EBITDA of a UK taxpayer group in a given accounting period (subject to a de minimis of £2m in financing costs always allowable). These rules can therefore restrict tax relief available for the costs of funding a development against rental income received from retained accommodation.

One point that has not changed amongst the switch from income tax to corporation tax is that offshore investors will still be required to register for gross payment of rent under the Non-resident Landlord Scheme on their senior living accommodation investment. If registration does not take place, then the tenant or agent (as the case may be) is required to withhold roughly 20% of the rental amount and remit this amount to HMRC quarterly.

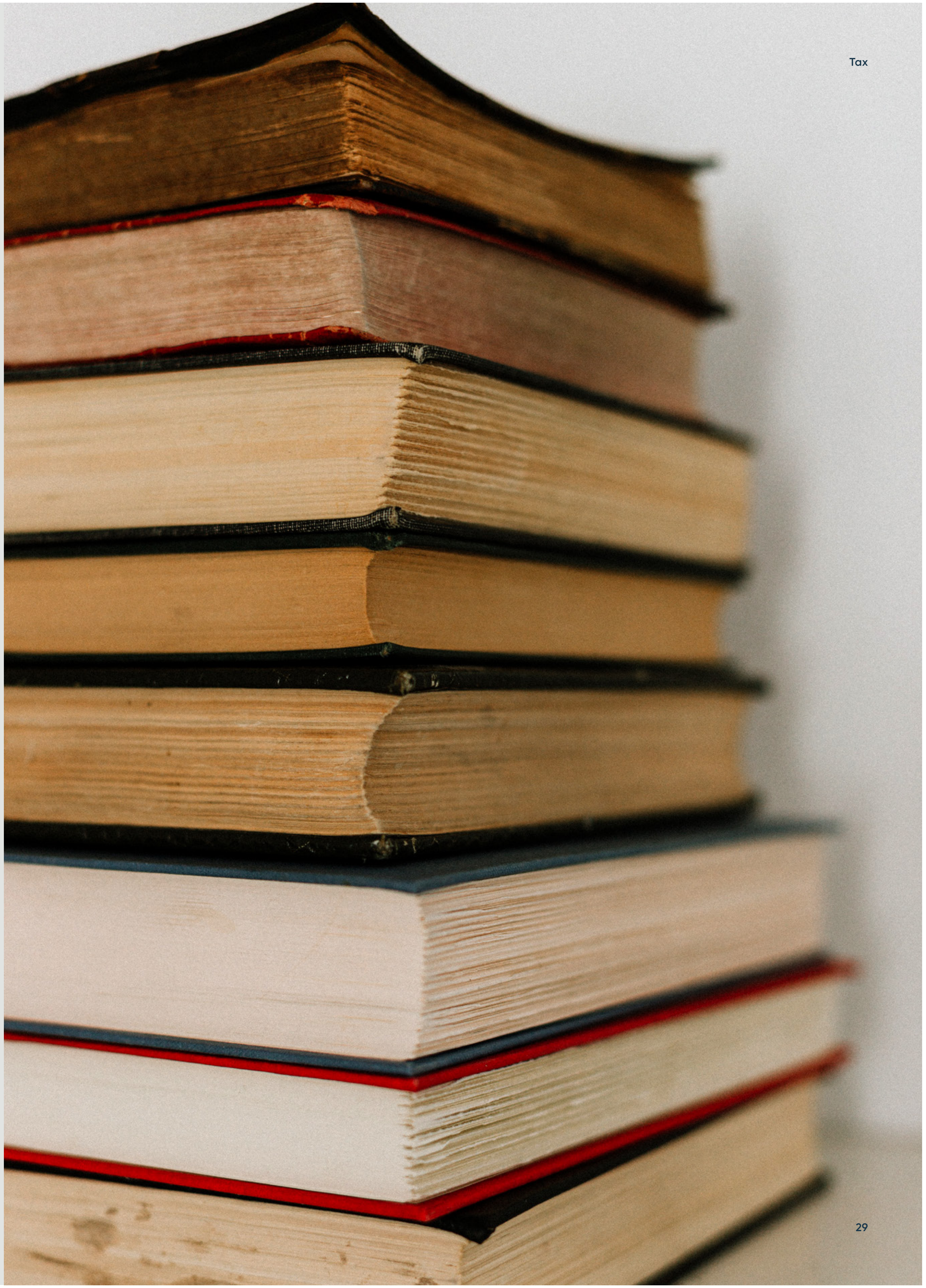
In terms of repatriating profits, it may be possible to structure the investment into UK senior living accommodation in such a way as to enable profits to be returned to investors without significant UK tax leakage on an exit. Typical routes include payment of dividends (or other distributions on a winding up of an investment vehicle) or repayment of shareholder debt (with accrued interest). No UK withholding tax applies to dividends, and interest may be eligible to be repatriated without any withholding tax or other UK tax leakage depending on the offshore jurisdiction involved or certain exemptions are available.

It is also important to consider the stamp duty land tax (SDLT) and value added tax (VAT) implications when developing/investing in senior living accommodation. The UK SDLT regime is a tax imposed on the purchaser of property or land in England and Northern Ireland and similar rules apply to Scottish properties. The tax rates applicable to the property depend on whether the property is residential property or commercial property. Commercial property benefits from lower rates of SDLT compared to residential property. Homes or other institutions providing residential accommodation with personal care for persons in need of personal care by reason of old age or disablement will not be considered, for SDLT purposes, are not residential property (meaning the lower commercial SDLT rates might apply to the acquisition of these kinds of accommodation), although advice should be taken on each project to ensure that the SDLT costs are correctly analysed.

The development of a senior living accommodation site will incur large costs which will most likely be subject to VAT. Normally, the sale of land/property is exempt for VAT purposes meaning that the VAT incurred on developing the property is not recoverable. Depending on the facts, developers may be able to recover these VAT costs on the disposal (or lease) of UK property if an onward sale meets certain conditions.

From 29 October 2018, a new Structures and Building Allowance (SBA) was introduced on qualifying costs for new non-residential structures and buildings. With effect from April 2020, the rate of SBA is 3% on a straight-line basis. The SBA is aimed at relieving the construction costs for new structures and buildings used for qualifying purposes over its lifetime. Whether this allowance will be available when developing senior living accommodation depends on whether a building providing accommodation with 'personal care' (built for those in need of care due to old age or disability) is being constructed as this will mean the structure is not residential and therefore SBA can be claimed. General accommodation for persons of old age will not, unfortunately, benefit from SBA. 'Personal care' as per HMRC guidance does not include remote monitoring (for example in caretaker-managed independent living) or the provision of meals. What it would involve is the administering of personal hygiene, feeding, medication or therapy, such as physiotherapy. General accommodation for persons of old age, and which is delivered through self-contained individual apartments is considered to be in residential use and SBA therefore cannot be claimed. Again, advice should be sought on the facts to determine what allowances or tax reliefs may be available.

It is also worth noting that Event Fees for tax and accounting purposes is something we envisage will be of interest to HMRC and we might expect to see specific guidance on this point from HMRC in the future.



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