CARE REAL ESTATE

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CUSHMAN & WAKEFIELD

REPORT 2023

WHAT'S MOVING THE GERMAN MARKET FOR CARE AND ASSISTED LIVING REAL ESTATE?

A look at current developments, challenges and opportunities

"THE STRUCTURAL DEMAND FOR CARE REAL ESTATE IS GROWING MASSIVELY, WHILE AT THE SAME TIME PRICE INCREASES AND REGULATORY REQUIREMENTS ARE PUTTING FURTHER PRESSURE ON OPERATORS. NEVERTHELESS, THE ASSET CLASS CONTINUES TO BE OF INTEREST TO INVESTORS."

JAN-BASTIAN KNOD
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Head of Healthcare Advisory

CONTENT

FOREWORD

Care real estate has been a major hit in recent years: With the demographic shift and the increasing number of smaller households, the market has grown enormously. Care real estate has risen from a niche to become an established asset class. This is also because, in comparison to other asset classes, it is more resistant to market fluctuations and digitalisation, whose effects on the real estate market have become clear in the wake of the Covid-19 pandemic. At the same time, structural demand continues to rise inexorably. As a result, the German care real estate market has long since ceased to be attractive only to specialist investors – many other institutional investors also beat a path to care real estate in recent years.

At the same time, the care real estate market follows special rules: For example, it is heavily regulated by various federal and state statutes and is also closely tied to the operators of the facilities. These are under increasing pressure in view of the generally rising costs and new regulations. Insolvencies of large operators have recently made headlines. For investors, this means taking a close look at refinancing. Against this backdrop, assisted living is also of interest to many investors: Less regulated and extremely popular with residents, this sector has grown strongly in recent years.

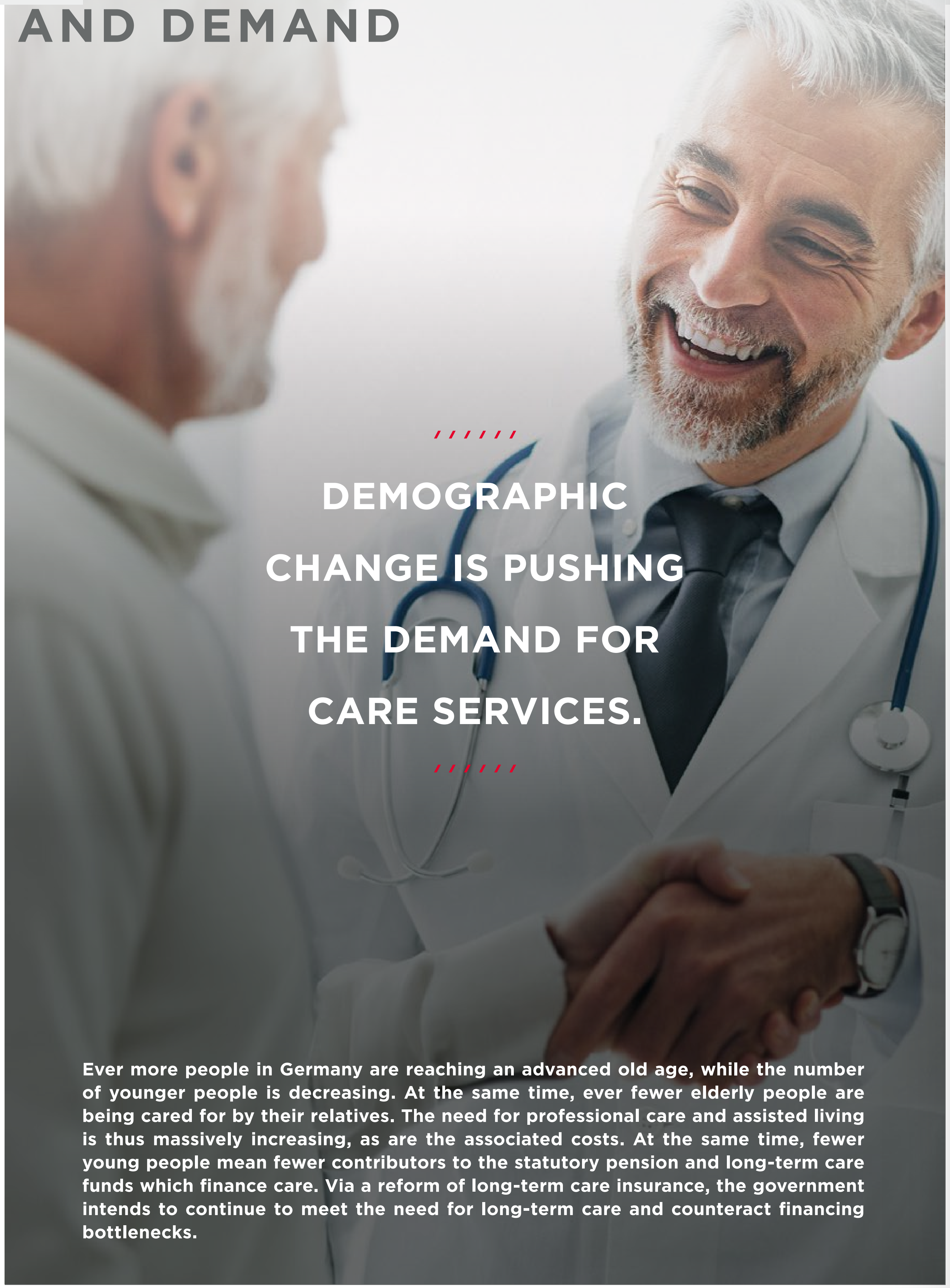
With a transaction volume of EUR 1.7 billion, the care real estate market has proven itself to be solid with good levels of demand overall in 2022. However, the uncertain market environment caused by geopolitical developments led to the strong start being followed by a subdued second half of the year, with a 30-basis-point increase in the nursing home prime yield. Above all, there was restraint regarding development projects. In addition to the liquidity of the operators, increasing ESG requirements have become the focus of attention regarding investors' portfolios – many are concerned about acquiring a property which is on the way to becoming a "stranded asset". 2023 began with subdued transaction activity and a slight increase in prime yields, which is likely to continue over the remainder of the year, however the assisted living asset class in particular remains stable and even with slight growth compared to Q1 2022.

How is the German care real estate market developing in view of the tension between excess demand on the one hand and the shortage of skilled workers, cost increases and stricter legal requirements on the other? We provide an overview of the structure and current trends and shed light on the market from various perspectives: Dr. Karl Reinitzhuber, CEO of the market-leading care real estate developer Carestone, explains how projects remain feasible in times of stricter ESG requirements, increased construction costs and inflation. Berthold Becker, Managing Director at Healthcare Investor of the Year 2022 TSC Real Estate sets out the challenges of current market events for us and how care can continue to succeed sustainably in the future.

We hope you enjoy reading.

Jan-Bastian Knod
Head of Residential Investment Germany
Head of Healthcare Advisory

DEMOGRAPHICS AND DEMAND



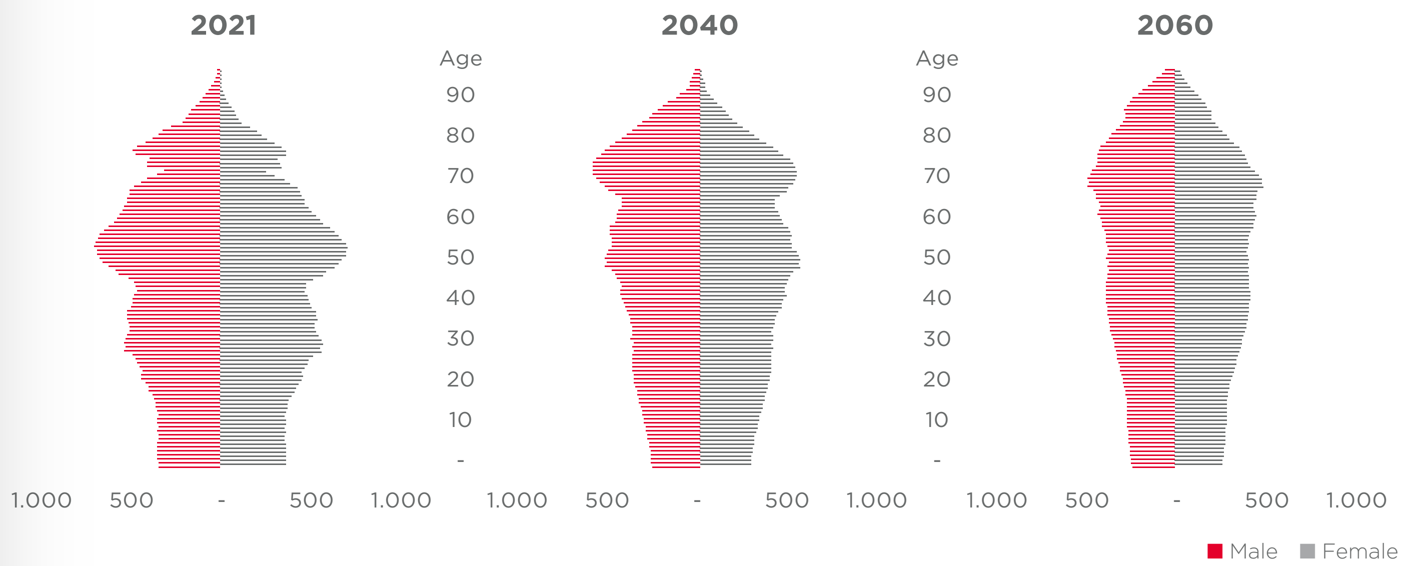
DEMOGRAPHIC CHANGE IS PUSHING THE DEMAND FOR CARE SERVICES.

Ever more people in Germany are reaching an advanced old age, while the number of younger people is decreasing. At the same time, ever fewer elderly people are being cared for by their relatives. The need for professional care and assisted living is thus massively increasing, as are the associated costs. At the same time, fewer young people mean fewer contributors to the statutory pension and long-term care funds which finance care. Via a reform of long-term care insurance, the government intends to continue to meet the need for long-term care and counteract financing bottlenecks.

Germany is getting older

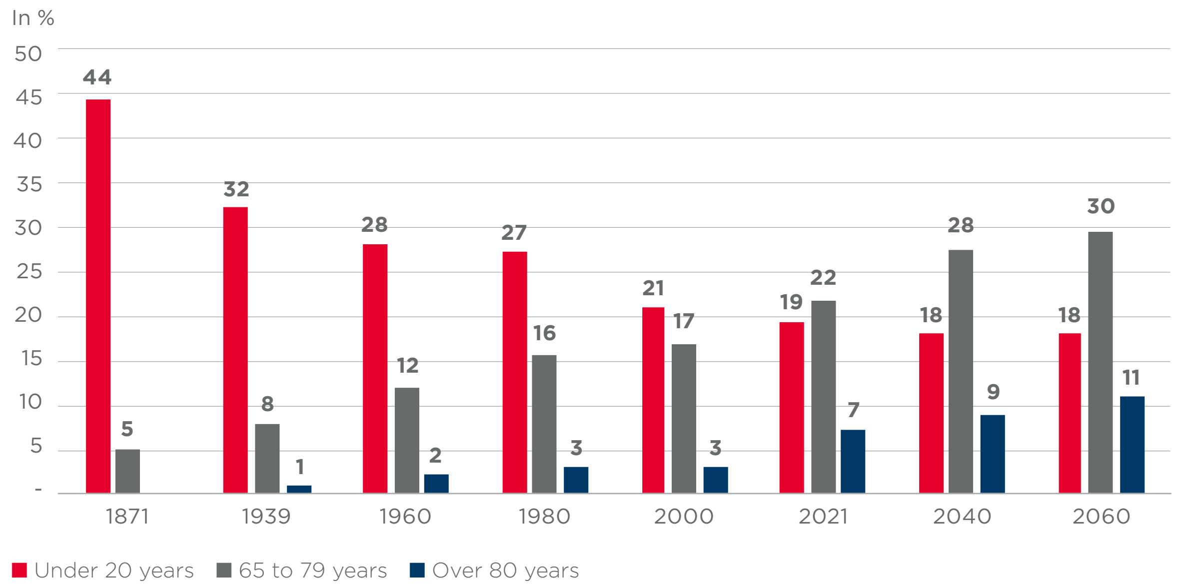
Around 31 percent of the German population – over 25 million people – were over 60 years old in 2021, and eight percent over 80 years of age. This trend will continue to intensify in the coming years, as a large proportion of baby boomers – born between 1946 and 1967 – are just reaching retirement age. Thus, with a low level of population growth overall, the proportion of the elderly will increase.

Forecast of the shift in the age structure in Germany



Source: Federal Statistical Office (Destatis),, Cushman & Wakefield, 2023

Age groups – historic development and prognosis from 1871 to 2060



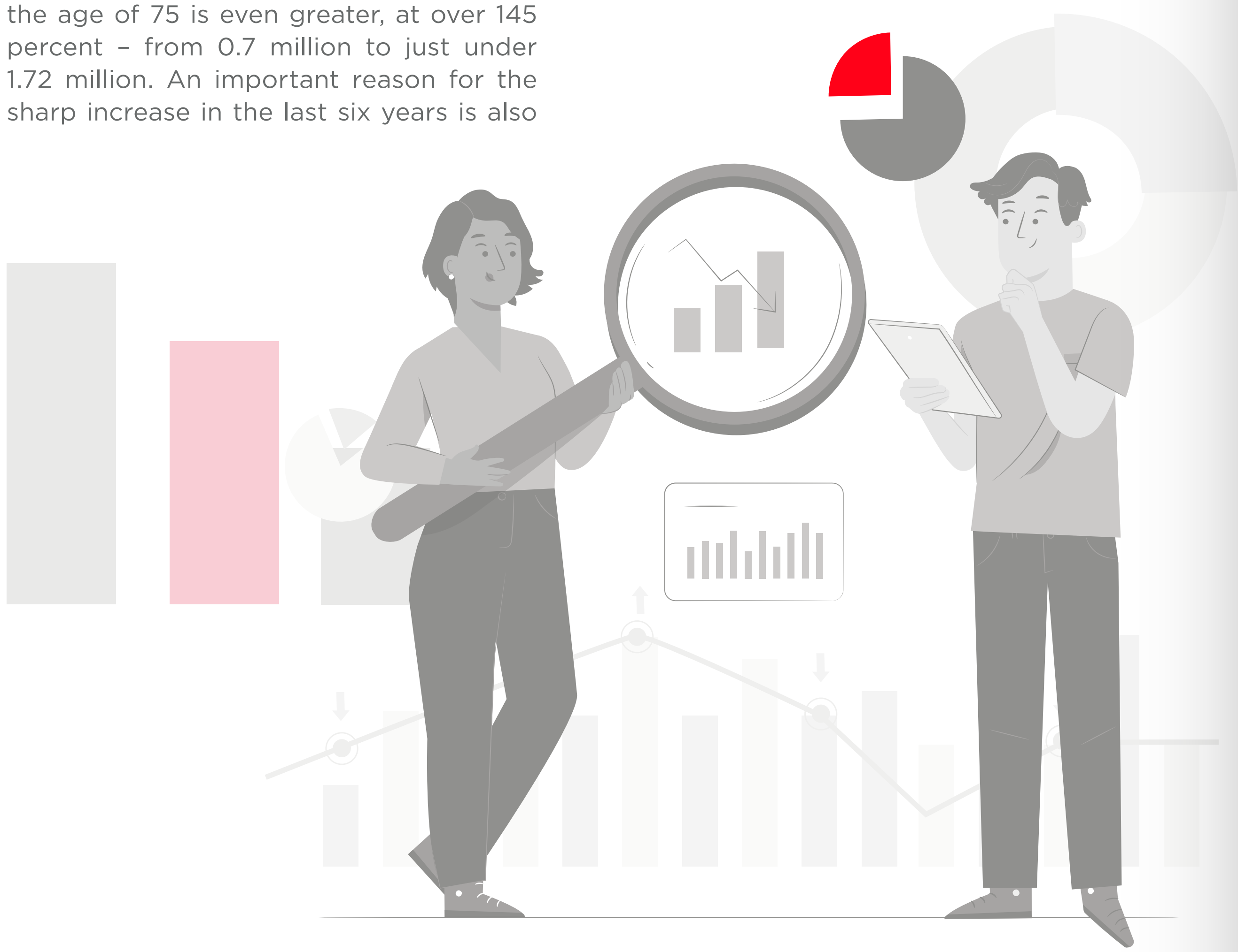
Source: Federal Statistical Office (Destatis), Cushman & Wakefield, 2023

Rural regions and the new federal states are ageing the most

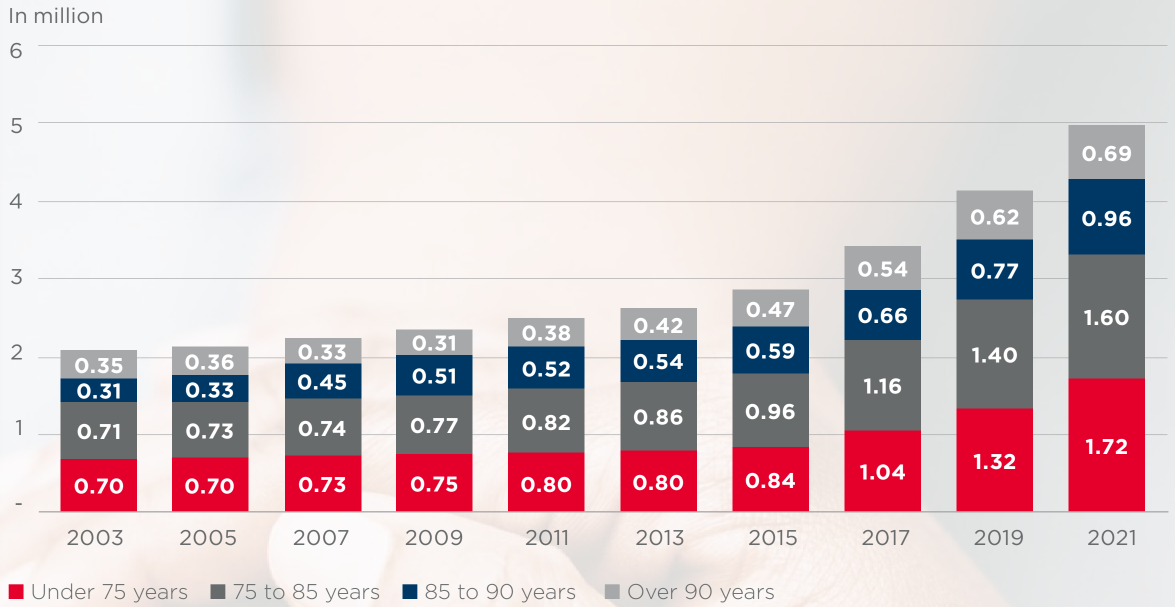
Demographic change affects the whole of Germany, but there are regional differences: the "new" federal states which formerly comprised the GDR ("East Germany") are the most affected, with the "old" western federal states following suit in subsequent years. Large cities such as Hamburg and Munich are also younger on average than rural regions: the higher quality of life and the better work, educational and training opportunities make the cities attractive for young people. A further reason is the influx of migrants from abroad, who are often younger than the average German population and also move predominantly to the cities. However, care facilities and services are equally in demand everywhere – although there is a higher proportion of people in need of care in rural areas and in the "new" federal states, there are also large numbers in the cities.

The demographic age shift and a broader definition of who requires long-term care increase the number of those who require care

Higher life expectancy and the larger proportion of people over 65 are causing the number of people requiring care to skyrocket: between 2003 and 2021, it rose by 139 percent, from 2.07 million to just under five million. The increase in the number of people requiring care before the age of 75 is even greater, at over 145 percent – from 0.7 million to just under 1.72 million. An important reason for the sharp increase in the last six years is also the broader definition of who qualifies as requiring long-term care under the Long-Term Care Insurance Act, which has been in force since January 2017. As a result of this change, more people were recorded as requiring care.



Development of the number of people registered as requiring care

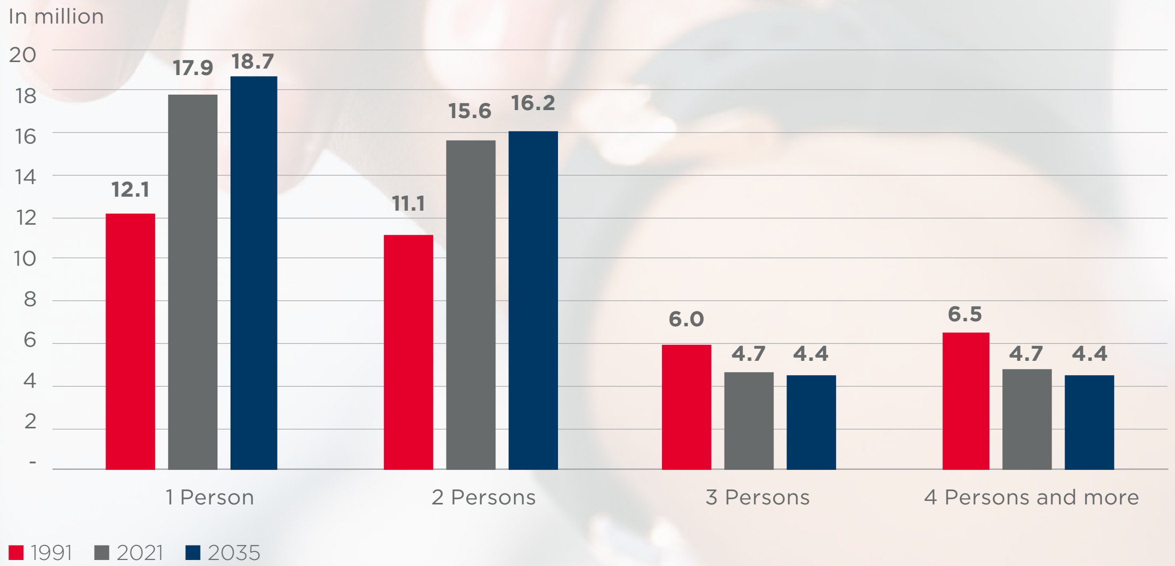


Source: Federal Institute for Population Research (Destatis), Cushman & Wakefield, 2023

Smaller households make it increasingly difficult for relatives to provide care

Care by relatives decreases with age. Younger people are moving away from their region of origin more often than in the past, so there are increasing more smaller households with only one or two people in a generation. Older people are often alone in their final years of life – a trend that will continue to intensify to 2035 and beyond.

Development and forecast of household sizes from 1991 to 2035

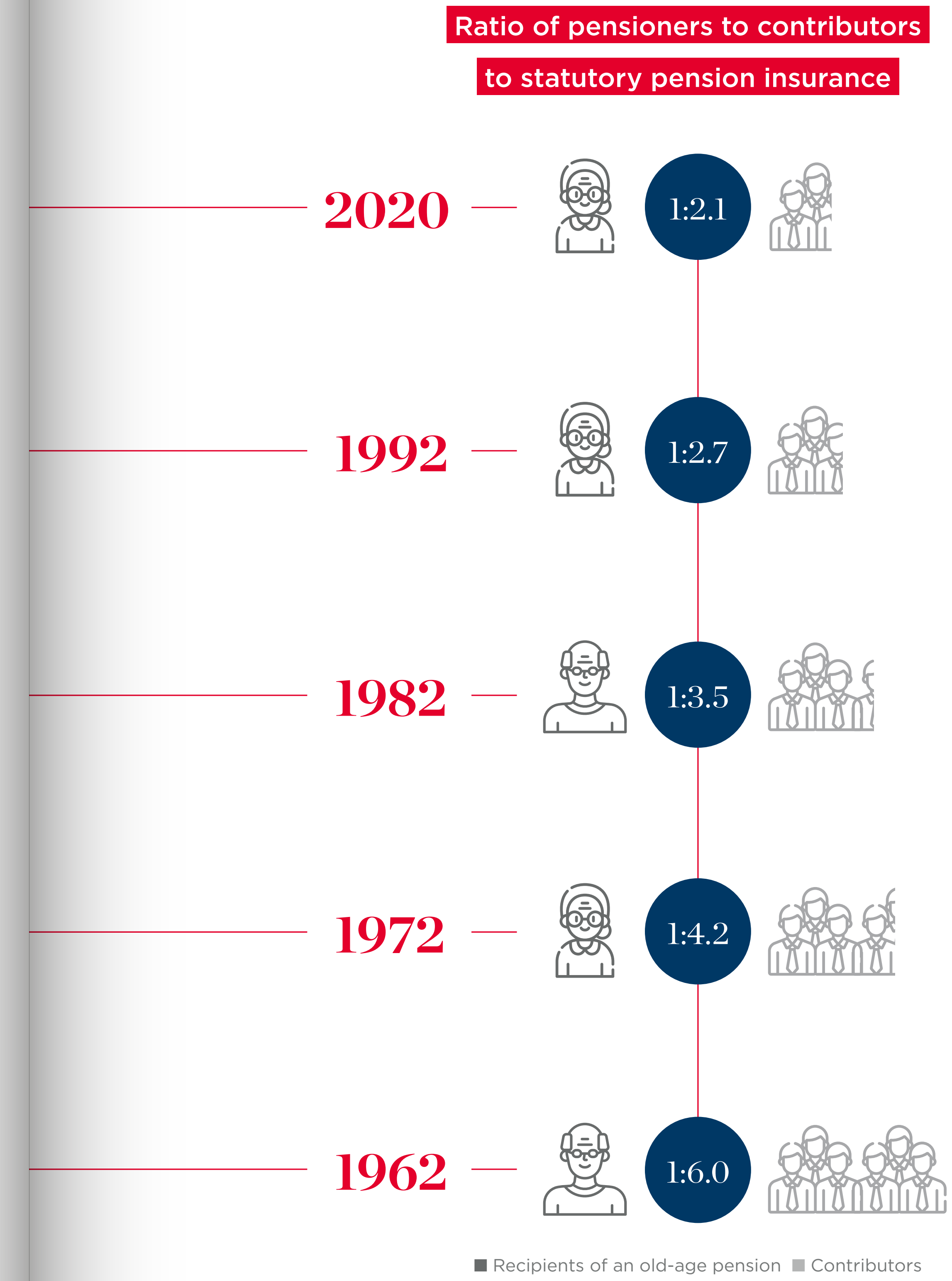


Source: Federal Institute for Population Research (Destatis), Cushman & Wakefield, 2023

More old-age pensioners, fewer contributors – pension provision is becoming more expensive

In Germany, long-term care services are covered by long-term care insurance, but often the elderly people have to additionally pay a contribution from their pensions. Both pensions and long-term care insurance are financed by the contributions paid by employees subject to social security contributions. They pay 18.6 percent of their gross salary into the statutory pension insurance and 3.05 percent into the statutory long-term care insurance – the employer matches this contribution in each case. However, due to the demographic shift, this pay-as-you-go system is coming under increasing pressure: While in 1960 there were six contributors for every retired pensioner, in 2020 there were only 2.1. This trend will continue.

In order to secure the funding of the system in future, the Ministry of Health is planning a reform of long-term care insurance. For example, on 26.05.2023, the Bundestag already decided to increase the care contribution rate from 3.05 percent to 3.40 percent from July 2023, with further increases possible in the future. This should help relieve the burden on long-term care insurance and pension funds.



Source: Federal Institute for Population Research (Destatis), Deutsche Rentenversicherung – Association of German Public Pension Insurers, Cushman & Wakefield, 2023

FORMS OF CARE
OVERVIEW

HOW DO PEOPLE REQUIRING CARE LIVE IN GERMANY?

Elderly people are still predominantly cared for at home – by relatives, ambulant care services or both. However, assisted living arrangements are increasingly in demand because relatives often do not live locally or a person's own home is no longer suitable due to declining mobility. Assisted living facilities are significantly less regulated by law than conventional residential care homes, often offer those requiring care more self-determination and are therefore increasing in popularity. Hybrid models are also possible – such as day-care facilities. The various models are aimed not only at the elderly, but also at younger people requiring care, including intensive care patients.

People requiring care can choose between different housing models

How elderly people in Germany are cared for depends on the level and necessity of care required as well as their personal wishes. The costs are borne by the long-term care insurance funds, although the scope can be supplemented by private funds. A private contribution is also foreseen for inpatient care. The main models are the following:

Ambulant care, in which people live at home and are cared for there by ambulant care services and also receive domestic support. The scope depends on the degree and need of care required.

Semi-inpatient facilities, in which people requiring care receive care for a limited period of time. These include, for example, day-care facilities that offer meals, care and daytime activities, but usually do not have their own beds.

Inpatient care, in which people live in a senior residence or nursing home and are cared for by caregivers around the clock. It also includes the provision of food, housekeeping, various activities and swift medical assistance in case of emergency.

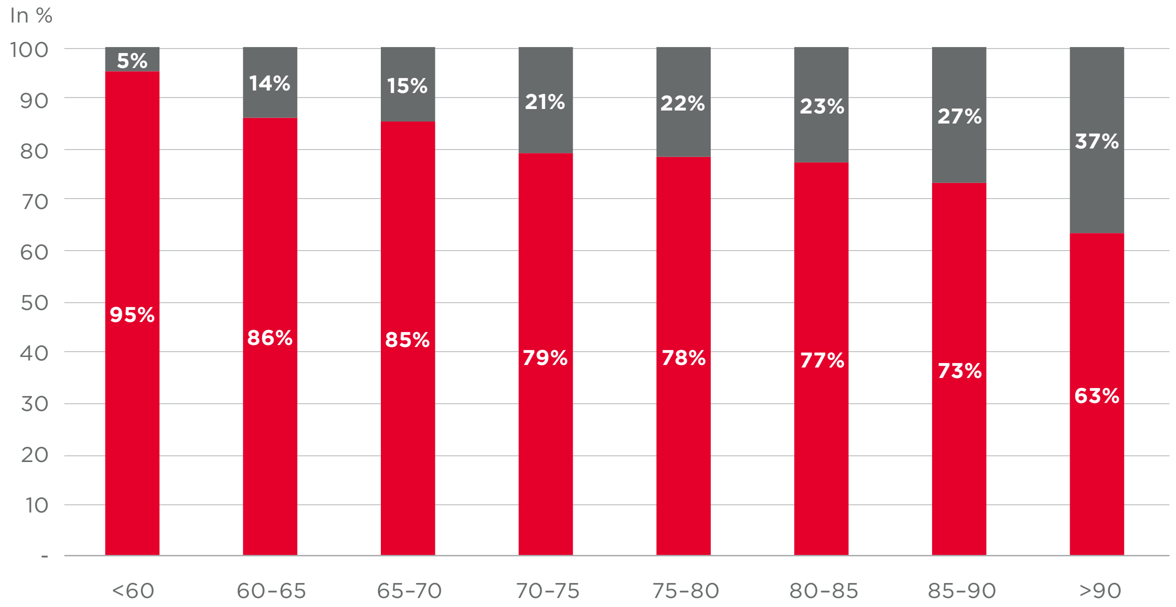
Assisted living, in which people live in their own barrier-free apartments, which are usually affiliated with an ambulant care service or an inpatient facility. Care and domestic assistance levels can be flexibly adjusted.

LIVING IN YOUR OWN APARTMENT
SELF-DETERMINATION WITH OBSTACLES

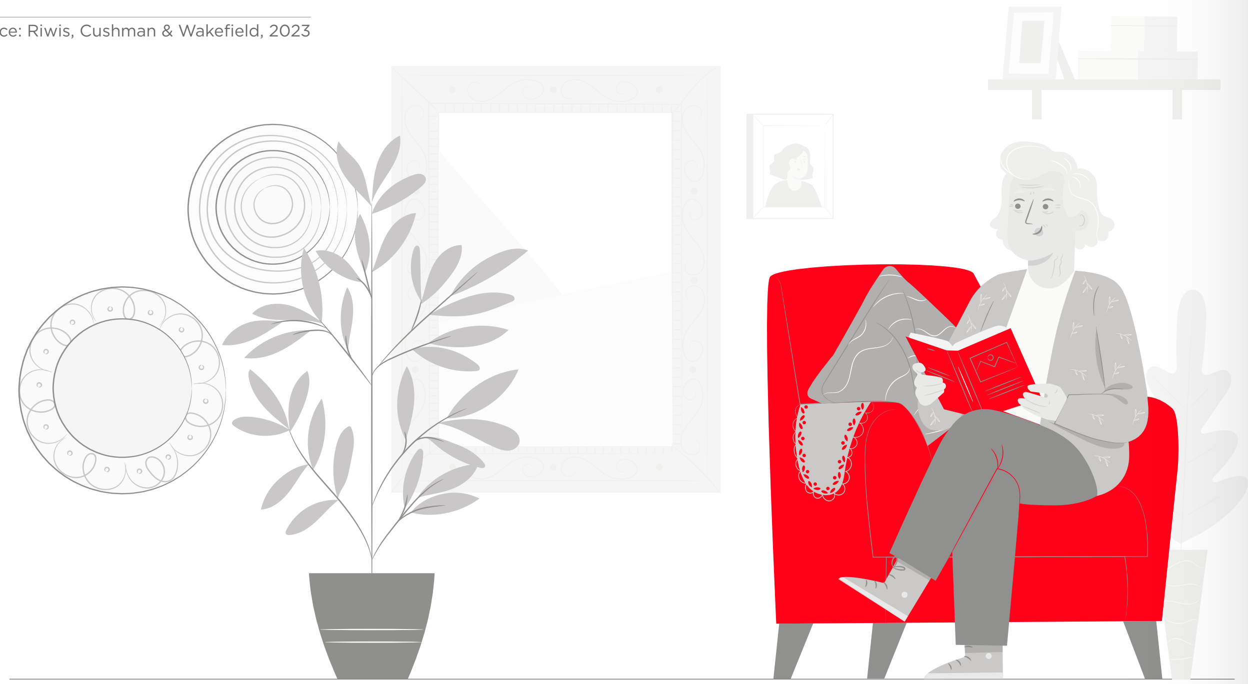
Requiring long-term care makes it difficult to live within one's own four walls

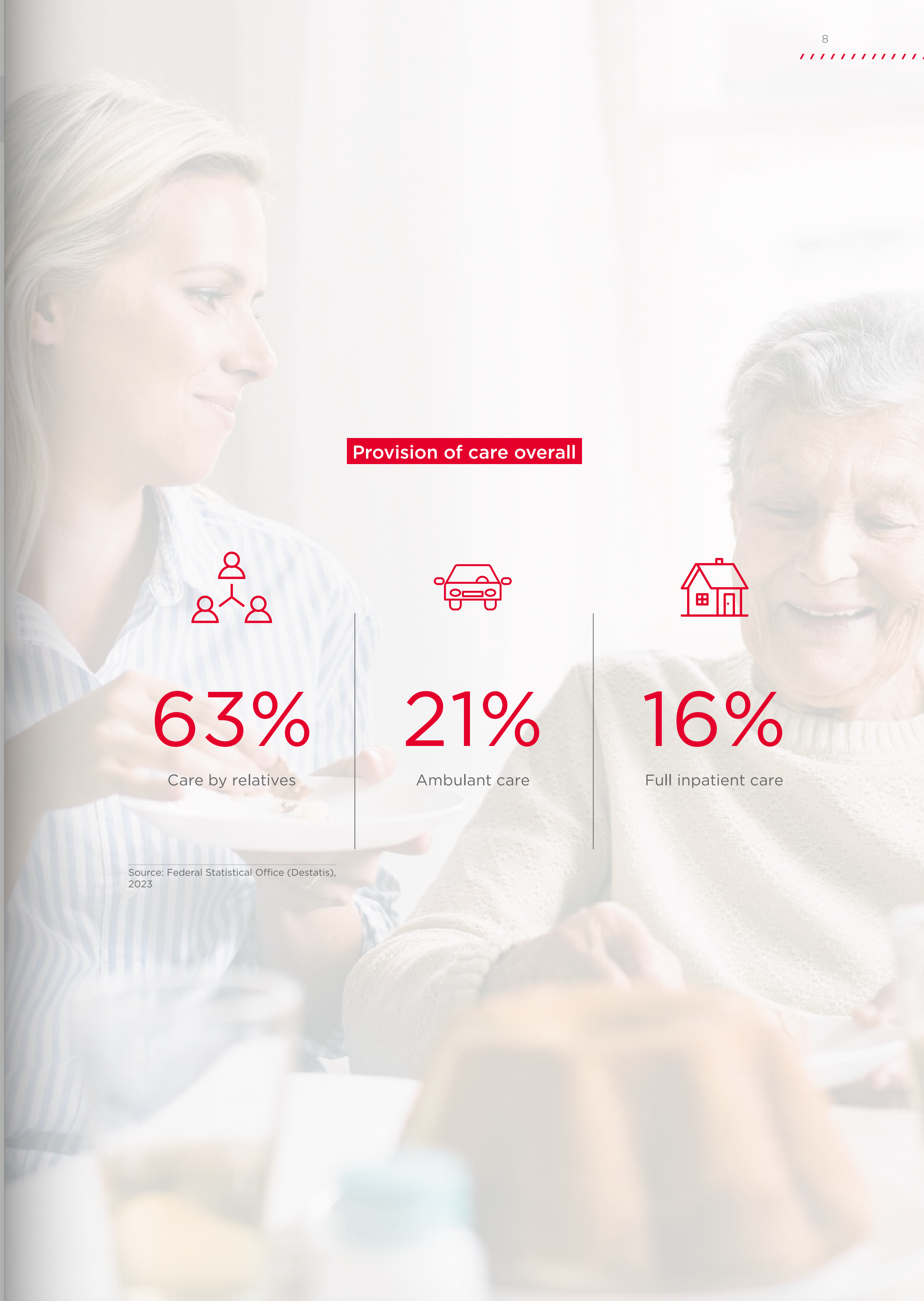
63 percent of those in need of care in Germany are cared for at home by relatives, and a further 21 percent by ambulant care – both at home and in appropriate facilities. This often enables them to be more independent than living in a nursing home with a mostly predetermined daily routine. One hurdle, however, is the layout, furnishings and equipment of one's own home, which often are not suitable for people with physical or mental limitations. This is one of the reasons why the proportion of people receiving full inpatient care increases with age.

People in need of long-term care by age and type of care 2021



Source: Riwis, Cushman & Wakefield, 2023





Provision of care overall

63% Care by relatives

21% Ambulant care

16% Full inpatient care

Source: Federal Statistical Office (Destatis), 2023

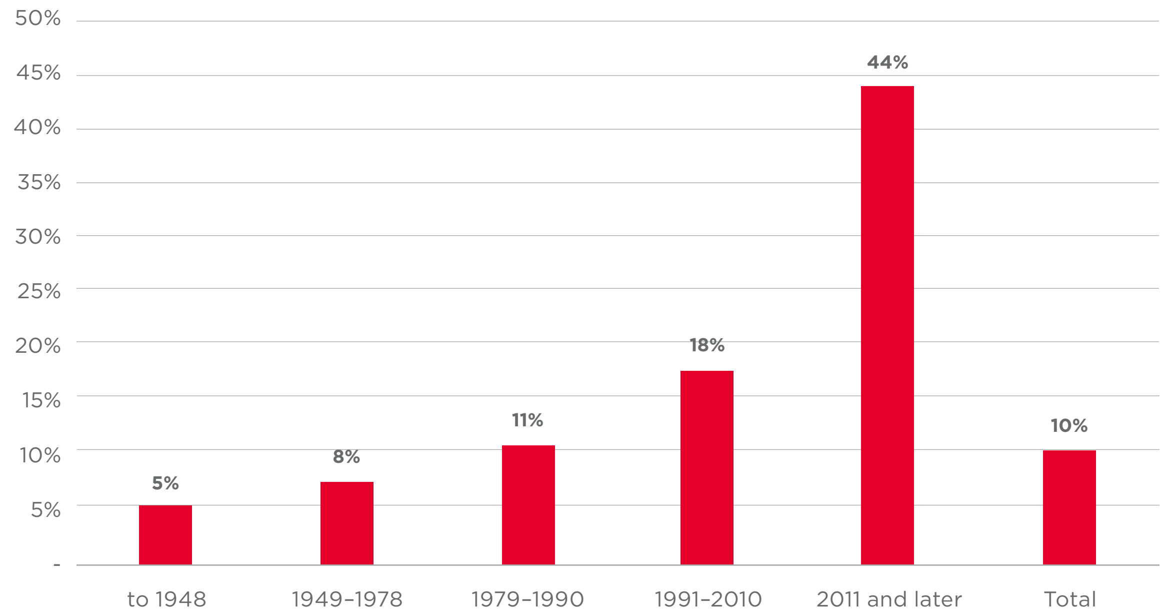
The demand-supply gap for barrier-free housing is huge

According to the Federal Statistical Office, only 15 percent of over-65s' apartments and houses have barrier-free access – and only ten percent of homes in Germany as a whole. The situation is much better for newer apartments than for older ones: While only about five percent of buildings dating from before 1948 are barrier-free, the figure is already 44 percent for properties built from 2011 onwards.

The deficit is even greater for barrier-free accommodation which makes up only around two percent of the total housing stock. According to KfW, there was already a supply gap of 2.4 million barrier-free apartments by 2018. The construction of more apartments is therefore essential for the coming years and will become more urgent in view of the current low level of construction activity. According to KfW calculations, there will still be a shortage of two million barrier-free apartments by 2035 – but this figure is based on the higher level of construction activity from pre-crisis times.

Investment in this segment thus remains a socially sensible and equally profitable strategy.

Apartments with barrier-free access by year of construction



Source: Federal Statistical Office (Destatis), Cushman & Wakefield, 2023

Barrier-free dwellings, households with limited mobility and the resulting supply gap

	Barrier-reduced apartments (in million)	Households with limited mobility (in million)	Supply gap (in million)
2018	0.6	3.0	2.4
2025	1.1	3.2	2.1
2030	1.4	3.6	2.2
2035	1.7	3.7	2.0

Source: KfW, Cushman & Wakefield, 2023

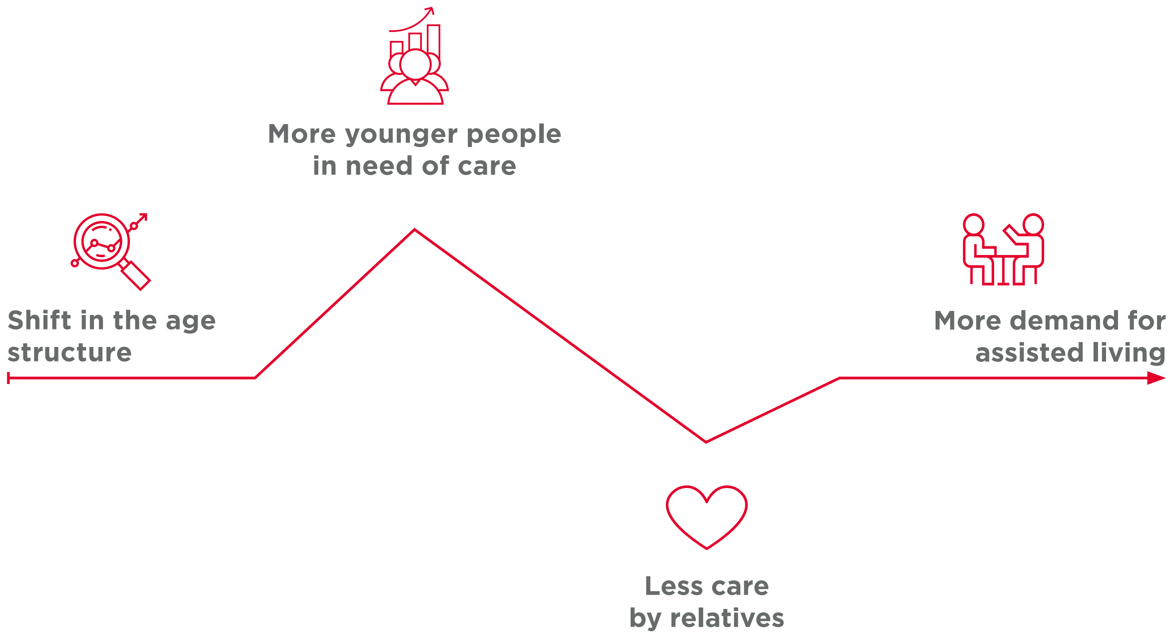
What does barrier-free living mean?

Barrier-free living means that the apartment can be reached without steps or raised thresholds. The kitchen and bathroom offer enough space for people in wheelchairs or with walkers, and the corridors and doors are correspondingly wide. The shower is floor level.

INPATIENT CARE
WELL-LOOKED-AFTER ROUND THE CLOCK

The demand for assisted living in old age is growing

The socio-demographic developments and the often-inadequate equipment of their own homes mean that ever more people are dependent on assisted living or decide in favour of it. Especially in the case of high care requirement patients, residential care offers security, as the care staff is always on site and medical help can usually be reached quickly in an emergency.



Regulation changes cause tightening of supply

The demand for inpatient care places is already greater than the supply, with long waiting lists in some places. In view of the socio-demographic developments, this will continue. The residential (care) home legislation of the federal states also contributes to this: In order to comply with home residents' right to privacy and personal space, many federal states have introduced or are planning to introduce a mandatory single-room quota. In North Rhine-Westphalia, the rate is 80 percent for existing buildings, and 100 percent for new buildings. In Baden-Württemberg, 100 percent single-room accommodation is generally mandatory, double rooms may only be offered at the express request of the residents.

Other federal states are following suit: Lower Saxony, for example, also introduced a single-room quota of 70 percent in 2022 and set larger room sizes for new buildings as well as other requirements for equipment. Grandfathering exceptions for existing facilities is also scheduled to expire in 2032. Hesse has adopted a single-room quota of 100 percent for new buildings. In order to accommodate the excess demand to a degree, there is one exception: rooms of over 22 square metres may be offered, for short-term care only, as double rooms.

Occupancy rate of inpatient care homes in 2021

Source: Riwis, Cushman & Wakefield, 2021

Due to the nationwide high level of demand, the occupancy rate is high throughout Germany. It tends to be higher in economically structurally-strong regions than in structurally-weak areas. North Rhine-Westphalia as well as Thuringia and Saxony have the lowest occupancy rates.

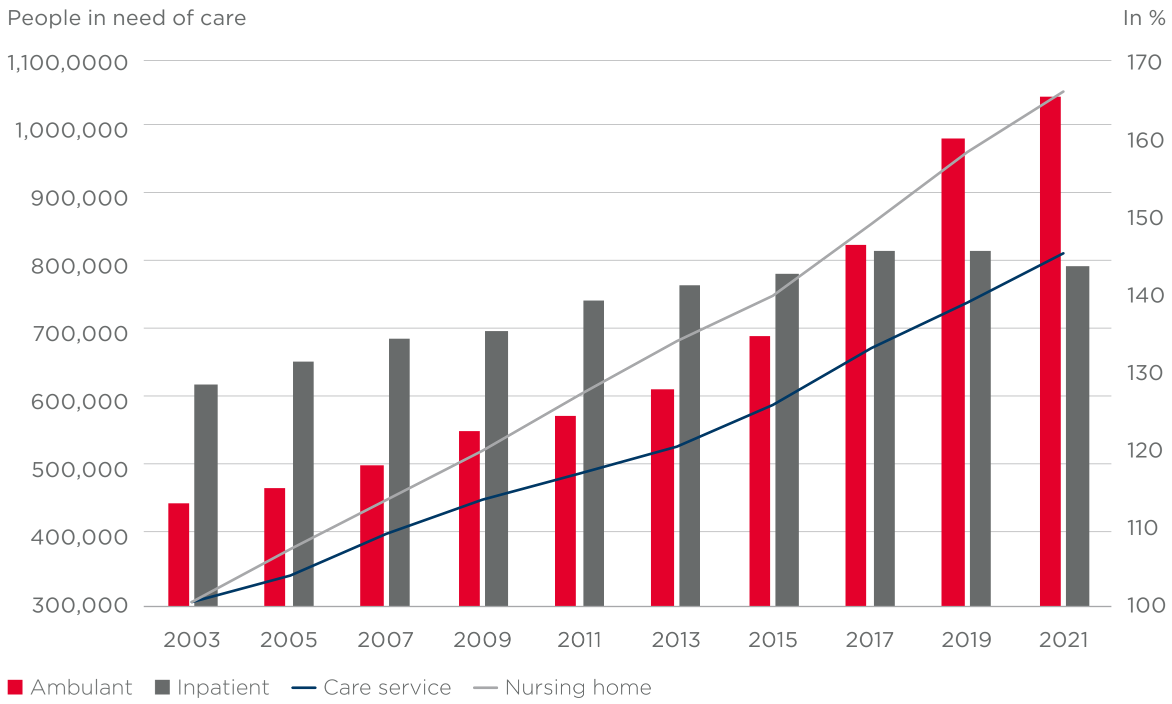
Care Strengthening Laws lead to more people being entitled to care

In order to provide people with the best possible care in old age, politicians have assured better financial support in the form of the "Care Strengthening Laws" – including for ambulant care services within their own four walls. The second Care Strengthening Act of 2017 also broadened the definition of who requires long-term care, making more people entitled to it.

Accordingly, the proportion of ambulant care already increased by 60 percent between 2013 and 2019. The number of people designated as requiring inpatient/residential care recently decreased for the first time, falling by three percent from 2019 to 2021. This drop may be Covid-19-related and short-term, but still shows that ambulant care is gaining traction and continues to grow, having permanently overtaken inpatient care since 2017: In 2021, around 1.05 million people in Germany received ambulant care and just under 793,000 were inpatients. Nevertheless, the number of inpatient care facilities has increased by 24 percent in the same period, while the number of ambulant care services has only increased by 21 percent. There is a lot of catching up to do in both inpatient care and ambulant care.

The demand for ambulant care with semi-inpatient care and age-appropriate living is thus higher than ever before – and will continue to rise.

Numbers of people in need of care by type of care



Source: Federal Statistical Office (Destatis), Cushman & Wakefield, 2023

ASSISTED LIVING
THE NEW MAJOR PLAYER IN CARE

Self-sufficient with all options

In assisted living facilities, the elderly live in their own barrier-free apartments. These usually have a kitchenette and one or two rooms, which they can furnish themselves and move into alone or as a couple. Often, the facilities are spatially and operationally connected to an ambulant care service or nursing home. For the residents, this has the advantage that they can flexibly book domestic support and care services depending on their needs and level of care and at the same time retain the greatest possible independence. A move to the inpatient area is also often uncomplicated.

How does assisted living work?

How do the operators lease?

As a rule, the operator concludes a lease or operating lease agreement with the property owner for up to 20 years. A tenant's renewal option of five or ten years provides the opportunity to extend beyond this period. The lease is often concluded as double or triple net with annual indexation of the rent at 80 to 100 percent of the change in the consumer price index. The operator, in turn, concludes sublease agreements with the residents and the service providers, for example an ambulant care service.

How do the residents rent?

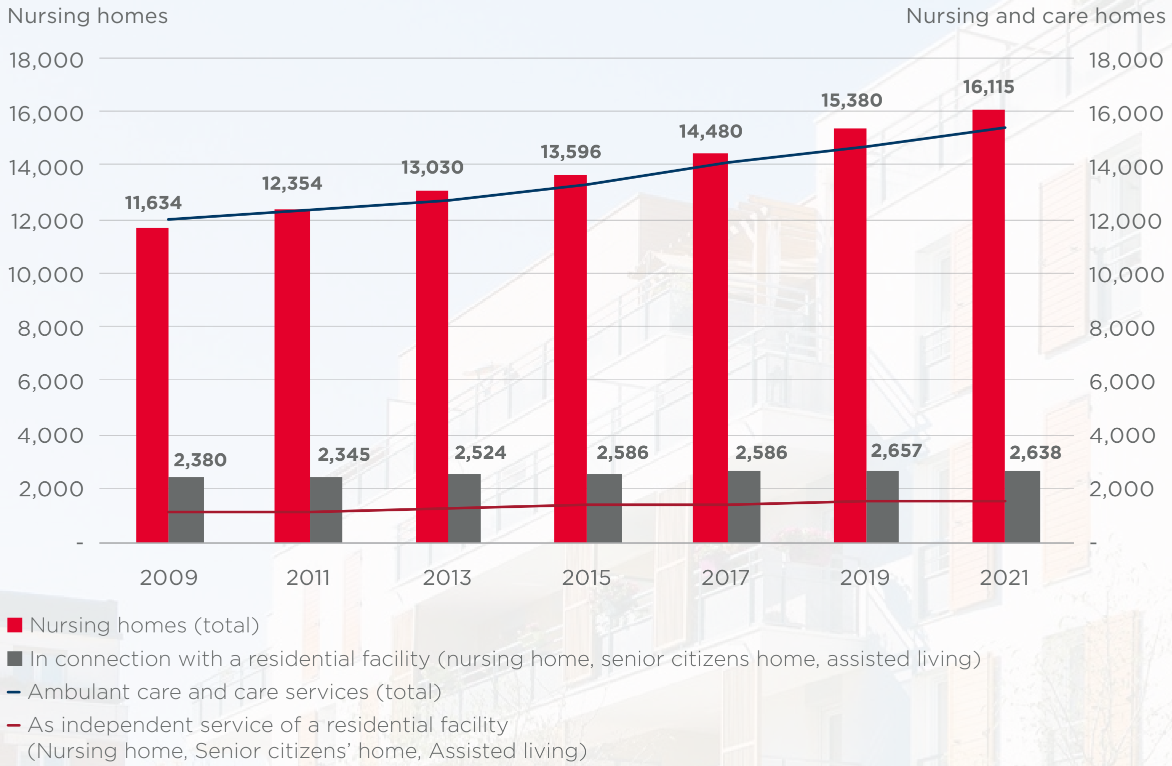
The resident concludes a residential lease agreement with the operator as well as a contract for additional care, support and housekeeping services. These can range from simple care tasks to semi-inpatient care and include, for example, apartment cleaning, laundry service or even regular meals together and group activities. The costs depend on the size and fit-out of the apartment as well as the additional services. Rent, care allowance and additional services are borne by the resident. In the event of long-term care being required, the insurance will cover the care service.

Source: Care Invest, Cushman & Wakefield, 2023

Few nursing homes have an attached residential facility

While the number of nursing homes increased by a total of 34 percent between 2009 and 2021, from 11,634 to 16,115, it was only 14 percent for nursing homes with attached assisted living residential facilities. This means that only about 18 percent of all nursing homes have an affiliated residential facility. Independent ambulant care services at an assisted living facility are therefore predominated operated separately from inpatient nursing homes. However, an assisted living facility can be attractive for many nursing homes in order to cover the entire housing needs of people requiring care.

Numbers of nursing homes, nursing and care services as well as residential facilities



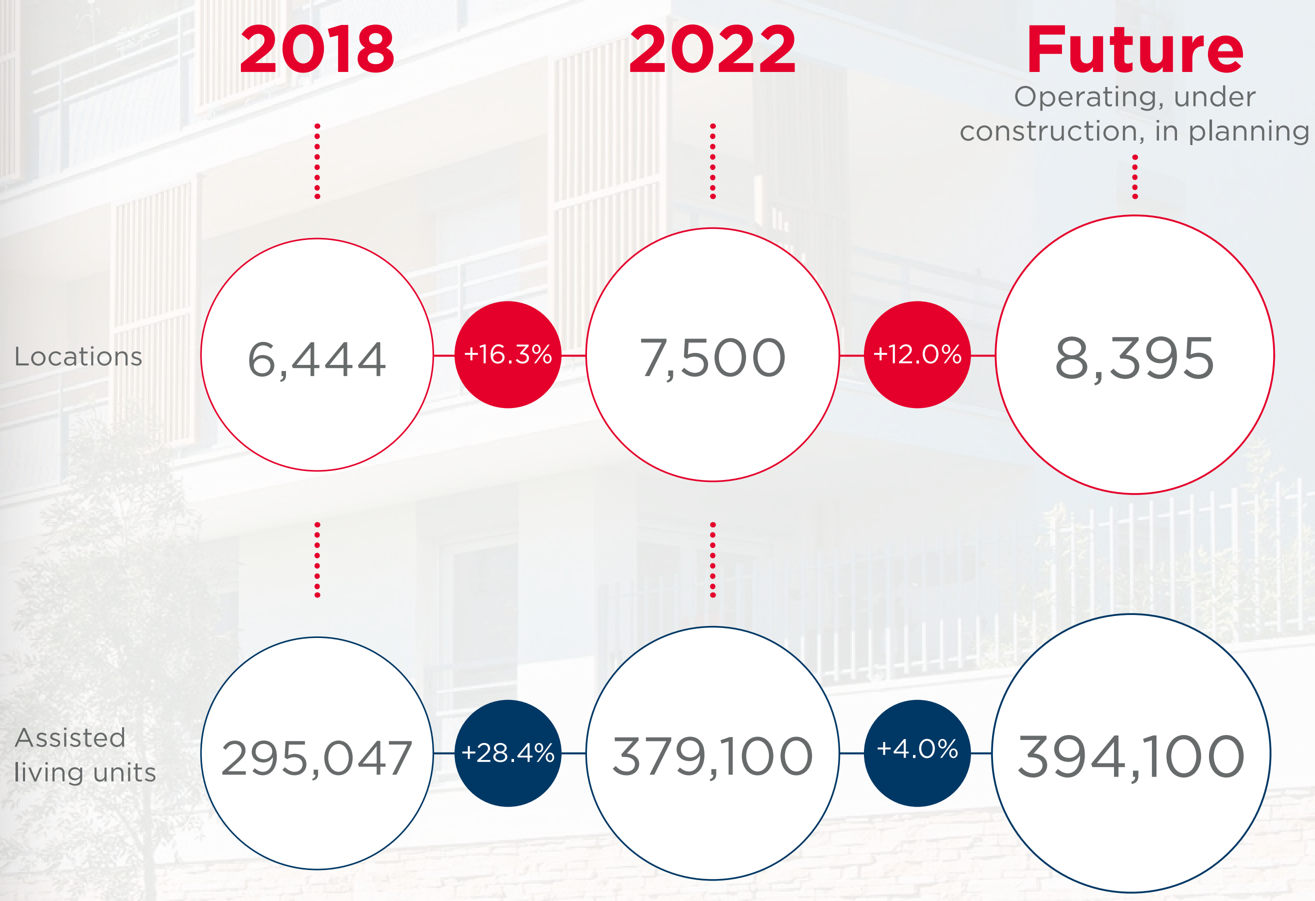
Source: Statistische Bundesamt (Destatis), Cushman & Wakefield, 2023

The excess demand is growing

In 2022, Germany had 379,100 assisted living units in 7,500 locations. The number of institutions varies greatly from region to region: While North Rhine-Westphalia, Mecklenburg-Western Pomerania and Saxony have almost comprehensive coverage, there are strong deficits in many districts in Bavaria, Thuringia and Rhineland-Palatinate. And the demand will continue to increase: in 2021, 96 percent of all municipalities already reported a supply gap, which will widen in the coming years. The structurally weak regions with a high level of emigration will be hit hardest. The new construction pipeline was well-filled in 2021 and 2022, but a decline is expected due to supply bottlenecks as well as rising construction costs, inflation and interest rates.

For investors, however, new buildings remain important – because only they can meet the increasingly exacting ESG requirements and enable operators to operate sustainably.

Development of assisted living: 2018, 2022 and in the future



Source: Pflegemarkt.com, Cushman & Wakefield, 2023

Assisted living is less regulated than inpatient care

Assisted living is neither a protected term, nor are there any nationwide binding structural standards for this segment. Nevertheless, state-specific quality standards have been established, such as the Baden-Württemberg quality seal for assisted living. Another uniform standard is DIN 77800, which since 2006 has defined all services and contracts according to "quality requirements for providers of assisted living for the elderly". For barrier-free living, DIN 18040 Part 2 is the structural quality standard.

However the strict regulatory standards that apply to nursing homes do not apply to assisted living. As the residents' services and care contract is decoupled from the accommodation contract, assisted living does not fall under the home legislation of the federal states – this would only apply if the (sub)lease also regulated care services. The Housing and Care Contract Act (WBVG) also does not apply to assisted living.

This regulatory gap offers an attractive advantage for operators and real estate investors – such as residential investors.

Assisted living in the premium segment: Niche with demand

Assisted living in the premium segment is characterised by good-to-very-good locations in attractive cities or scenic rural regions. The complexes and the spacious apartments are equipped to a high standard and exclusively designed. The service and catering are similar to what a five-star hotel has to offer with a 24/7 concierge service. Often the facilities also offer a wellness area and an attractive programme of cultural events. The market leader in this segment is Berlin-based operator Tertianum Premium Residences.

The demand for premium housing is increasing due to the growing gap between rich and poor. Wealthy people requiring care appreciate the high standard of the residences and are willing to pay a correspondingly higher price for them.

NON-HOSPITAL INTENSIVE CARE
NICHE WITH GROWTH

The market is also growing in out-of-hospital intensive care

Not only elderly people require care, intensive care facilities for patients of all ages also form a significant component of the care landscape in Germany. More than 1,500 ambulant intensive care services are in use nationwide. Ideally, the staffing ratio should be one to three carers per patient. The costs are borne by the health insurance company.

Non-hospital intensive care supports critically ill patients in a life-threatening or foreseeably life-threatening state of health. These patients often suffer from complex diseases of the cardiovascular system, kidneys, respiration or central nervous system and require individual care around the clock. Specialised care communities offer patients with a similar clinical picture as well as the degree and level of care the best possible care outside a clinic, for example:

Intensive care and ventilation apartments

Intensive care and ventilation apartments accommodate patients in residential groups of three to 14, depending on the federal state: In Bavaria, for example, a maximum of twelve patients are permitted to live in an ambulant assisted living community. Unlike in care provided at home, the staffing ratio is lower than one-to-one and thus more economical. In total, there are about 970 intensive care shared apartments in Germany, 95 percent of which are run by private operators and only five percent by non-profit operators.

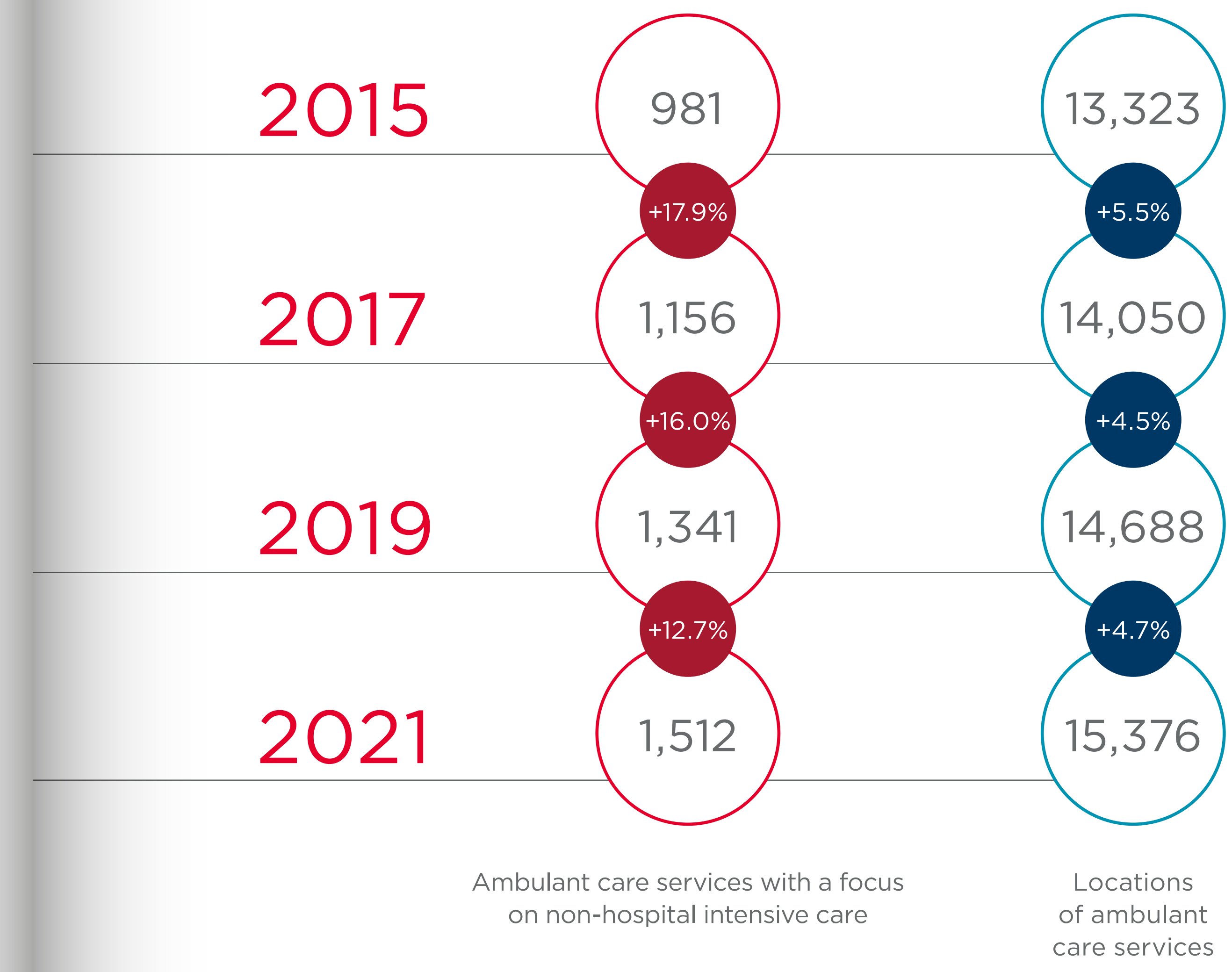
Paediatric Intensive Care

Paediatric intensive care specialises in ventilation and intensive care for children and adolescents. About ten percent of all intensive care services in Germany focus on this.

Treatment Care F or Phase F

Treatment care F cares for patients with severe damage to the brain or nervous system, such as patients in a vegetative state or with other severe impairments of mental and physical functions, who are often artificially fed, treated via an indwelling catheter or have a tracheotomy. There is currently no nationwide range of such facilities in Germany.

Development of the number of intensive care services nationwide



Source: bock.net, Pflegmarkt.com, Cushman & Wakefield, 2023

INVESTMENT MARKET
FOR CARE REAL ESTATE

THE DEMAND FOR CARE REAL ESTATE AS AN IMPACT INVESTMENT REMAINS HIGH.

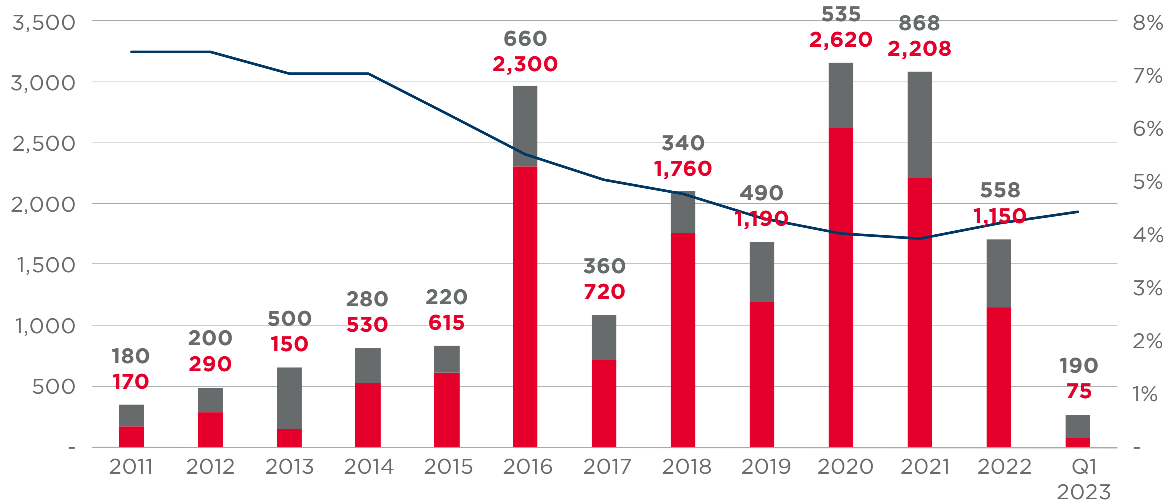
Care real estate has taken-off strongly in recent years with investors, with many new entries to the sector. In 2022, the care real estate investment market remained stable with a high level of demand, although the second half of the year was more subdued: rising costs – also those due to regulatory changes – inflation and increasing ESG requirements impacted property developers as well as operators, who are under increasing pressure. Investors also became more cautious. The operator market continues to be characterised by consolidation. In interviews, both developer Carestone and investor TSC Real Estate would like to see more predictability from politicians.

Care real estate has become a sought-after asset class

In 2021, Germany had around five million people designated as requiring care, 16,000 nursing homes facilities and an increasing number of assisted living facilities. The German care market has grown strongly in recent years and care real estate has established itself from a niche to a sought-after asset class. The ongoing structural increase in demand has attracted many investors to the market - and no longer just specialist investors: In 2022, more institutional investors entered the care market, including residential investors seeking an entry to care real estate.

Assisted living in particular is very popular because, unlike inpatient care, it is governed by far fewer regulations.

Transaction volume and prime yield of care real estate



Quelle: Statistisches Bundesamt (Destatis), Cushman & Wakefield, 2023

The market was relatively stable in 2022

In 2022, the care real estate market once again proved relatively stable and sought-after. Compared to many other real estate sectors, the care market was extremely liquid, but it also suffered decreases in transaction volume and a slight increase in prime yields compared to the previous year: The transaction volume in 2022 was EUR 1.7 billion, with an increase in prime yields of around 30 basis points to 4.2 percent. A year-end surge, like those of 2020 and 2021, failed to occur, due to the uncertainty caused by rising interest rates and energy costs as well as the war in Ukraine.

Strong start but setback in the second half

2022 was very much "a game of two halves": In the first half, many large transactions were completed at absolute prime yields, with both development projects and existing properties in high demand. In the second half, the market turned – the uncertainty of many investors, especially regarding development projects, led to an increase in demand for immediate cash flow from existing properties. At the same time, however, the requirements for real estate ESG standards increased, bringing the timeframe regarding when a property might reach "stranded asset" status into focus.

It will be interesting to see how investors and operators continue to react to rising investment costs due to the Tariff Compliance Act, increasing single-room quotas and rising energy and construction costs. As a result of operator insolvencies, these issues and the refinancing of operators will increasingly come into focus.

Q1 2023 shows that demand for care properties as an impact investment remains high. Assisted living in particular remained a focus of investors' attention and did not experience a slump in transaction volume compared to Q1 2022.

Nevertheless, the transaction volume fell by 36 percent from EUR 415 million in Q1 2022 to EUR 265 million in Q1 2023 of which EUR 190 million was for properties in the assisted living sector. The prime yield for nursing homes, still at 4.2 percent in 2022, rose to 4.4 percent in Q1 2023. A further increase is expected over the remainder of the year. This decline in transaction volume accompanied by rising yields is mainly due to the ongoing uncertainty in the market, longer-lasting transaction processes and the changed financing environment. In particular, assets with a low level of ESG compliance are avoided by investors in order to minimise the risk of acquiring a future "stranded asset". The high level of liquidity in the market is therefore also being held back by more cautious sources of capital, higher property quality requirements and compliance checks with ESG target criteria.

Property development projects suffer slump – but remain crucial

A slump in development project transactions took place from mid-2022 onwards. The reasons are complex: For example, construction costs have still not stabilised and are causing great uncertainty. Supply bottlenecks also make it difficult to meet planned completion dates. In addition, the inflation rate and interest rates are high, due to which investors often do not achieve the desired purchase price. Nevertheless, new KfW funding conditions are intended to prevent a further halt to the construction of care real estate – these are essential for creating further capacity. Development projects will play an important role in the future – because only they can fulfil the demand for care places and meet the ESG standards required by many investors.

In focus: ESG

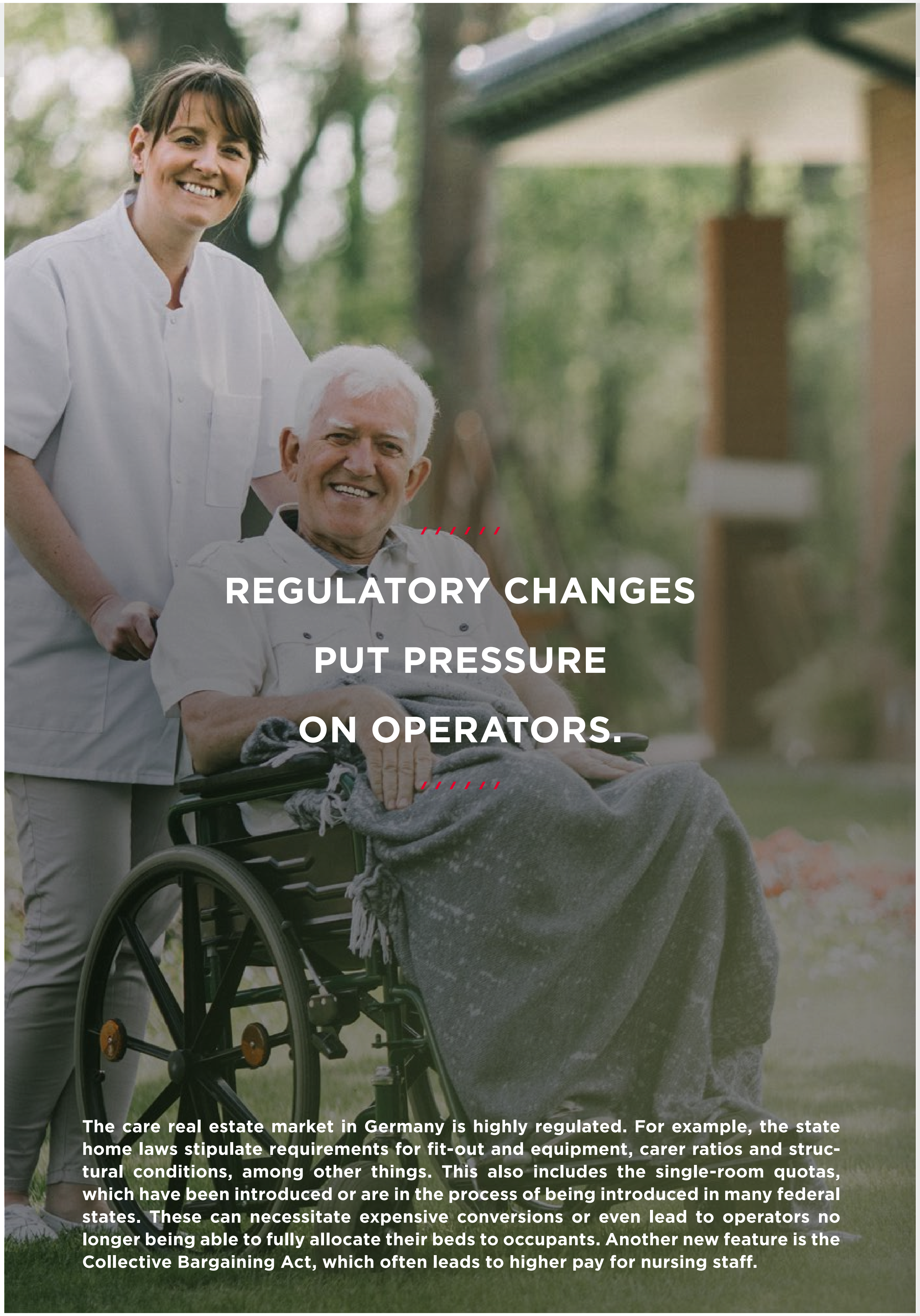
ESG, Environmental, Social and Governance aspects, considered as binding criteria for sustainable investment are increasingly influencing investment decisions in the care real estate market and is reflected in investment strategies.

But which ESG aspects do investors pay particular attention to? A survey among 125 investors in the care real estate market conducted by Cushman & Wakefield reveals the following: 86 percent see energy efficiency measures as particularly important in their portfolio, 64 percent gave this rating to the social component and a further 64 percent gave it to sustainable corporate governance. While the "S" and the "G" of ESG are closely-linked to the operator, the "E" mainly concerns the energy efficiency of the building. In general, it turns out that this is the main focus.

Since hardly any care properties are DGNB, LEED or BREEAM certified so far, many investors are increasingly looking to KfW energy consumption standards for new buildings, whereby they should operate at energy consumption levels equivalent to 55 percent, and now even closer to 40 percent, of previous average levels, of a reference previous average levels.

However, older existing properties are often unable to meet the high energy efficiency standards required for the "E" of ESG. With the new Article 9 funds, many investors are therefore also relying on a manage-to-green strategy: Here, care properties that do not actually fulfil the requirements of the investment strategy are purchased and upgraded accordingly.

In the current market environment, the ESG investment strategy is having an increasing influence on the purchase and sale of care real estate – prices for care real estate are increasingly viewed in a differentiated manner and non-ESG-compliant assets tend to be penalised.



REGULATORY CHANGES PUT PRESSURE ON OPERATORS.

The care real estate market in Germany is highly regulated. For example, the state home laws stipulate requirements for fit-out and equipment, carer ratios and structural conditions, among other things. This also includes the single-room quotas, which have been introduced or are in the process of being introduced in many federal states. These can necessitate expensive conversions or even lead to operators no longer being able to fully allocate their beds to occupants. Another new feature is the Collective Bargaining Act, which often leads to higher pay for nursing staff.

In focus: Collective Bargaining Act

Since the first of September 2022, there has also been a collective bargaining obligation in nursing care in accordance with the Health Care Development Act (GWVG). The care staff must therefore be remunerated in accordance with collective bargaining agreements or (in the case of church-affiliated operators) church labour law regulations. This has implications for the various stakeholders in the care sector:

Care homes

Institutions have to pay wage adjustments in accordance with their own tariff, which is based on that of another institution or on an average tariff for the federal state. There are lower limits: Semi-skilled care assistants receive at least EUR 13.70 per hour, qualified care assistants EUR 14.60 and fully qualified care staff EUR 17.10. As a result, care charges must be renegotiated and adjusted, and residents must be informed. Existing supply contracts must be renewed when they expire in accordance with the new law.

Carers

For their work, carers receive adjusted, often better pay in accordance with collective bargaining agreements. The main beneficiaries of this are those who were previously paid well below the new rates. In particular, private and private institutions are in the front line here, while many church affiliated and welfare associations were already paying in accordance with tariffs beforehand.

People requiring care

For those requiring care, the already high burden will continue to increase: Their own contribution via the investment costs must cover the higher wage costs, which is why an increasing number of social welfare recipients is expected in the coming months and years. This also places a heavy burden on the municipal authorities.

In view of these changes, 2023 will be challenging for many providers and institutions – the increase in energy costs, rising inflation and the new tariff compliance law present further challenges. The refinancing of the operators to achieve a sustainable operating lease will also be of particular interest from an investor's perspective. After all, only with a sustainable operating lease do investors have greater security via a stable cashflow from rental income.

The operator market continues to consolidate – via private equity investors and mergers

One example of the increasing consolidation in the market is the Schönes Leben Group, a portfolio company of Waterland Private Equity, which was founded in 2017. Schönes Leben entered the care market via the takeover of compassio, an established southern German operator, and bought up other operators such as Mediko, Gut Köttenich and SPIES. Thus, the Schönes Leben Group joined the top-5 largest operators in the German inpatient care market within five years.

Furthermore, the operator market is characterised by takeovers of smaller or non-operating competitors: Alloheim was able to take over more than ten companies of the now insolvent Convivo group. Nevertheless, non-profit operators such as Johanniter and the Evangelische Heimstiftung are also leaders in the field of inpatient care.

The largest operators in Germany

Inpatient care

	Operator of inpatient care	Care places 2021	Care places 2022
1	Alloheim Senioren-Residenzen	24,600	26,800
2	Korian Deutschland	27,032	26,722
3	Orpea Deutschland	19,750	20,577
4	Schönes Leben Gruppe	7,250	8,364
5	Johanniter Seniorenhäuser	7,787	7,951
6	Evangelische Heimstiftung	7,520	7,762
7	Domicil Senioren-Residenzen Hamburg	7,656	7,347
8	Dorea Familie*	6,626	6,846
9	Convivo Unternehmensgruppe*	6,119	6,439
10	AWO Westliches Westfalen	6,396	6,396

Assisted living

	Operator of assisted living	Care places 2021	Care places 2022
1	Convivo Unternehmensgruppe*	6,066	8,602
2	Augustinum	7,512	7,522
3	Korian Deutschland	3,146	3,103
4	Alloheim Senioren-Residenzen	2,600	3,000
5	Advita Pflegedienst	2,122	2,418
6	AWO Westliches Westfalen	2,335	2,335
7	KWA Kuratorium Wohnen im Alter	2,210	2,180
8	ASB Baden-Württemberg	2,407	2,179
9	Pflegebutler	-	2,150
10	Johanniter Seniorenhäuser	1,682	1,558

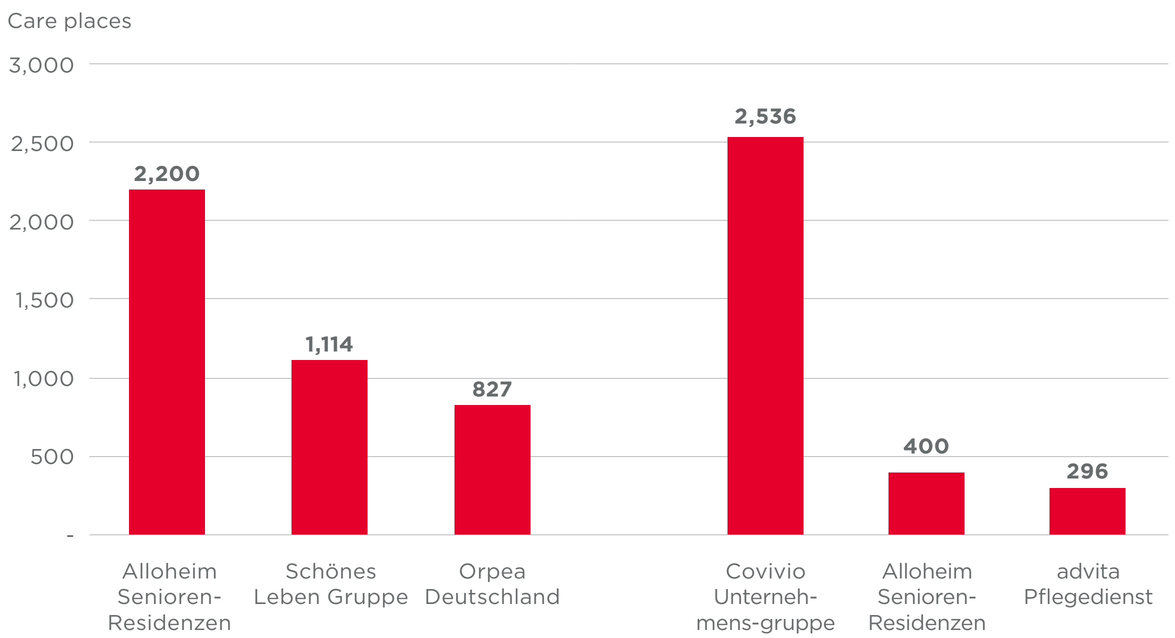
***Ongoing insolvency proceedings**
Source: Care Invest, 2023

Assisted living showing strong growth

Many operators, such as Korian, Alloheim and Johanniter, are not only leaders in inpatient care, but also in assisted living. In addition to inpatient care, assisted living has become the largest care real estate asset class in Germany and is becoming increasingly popular. Particularly interesting for those requiring care: The relatively new type of care requires numerous new buildings. The high standard in combination with modern space concepts is a reason for many people requiring care to say goodbye to their own home earlier and to continue the possibility of independent living in assisted living. In recent years, Convivo and advita have been among the driving forces in assisted living.

Largest increases 2021 to 2022

Inpatient care | **Assisted living**



Source: Care Invest, 2023

In focus: Operator insolvencies

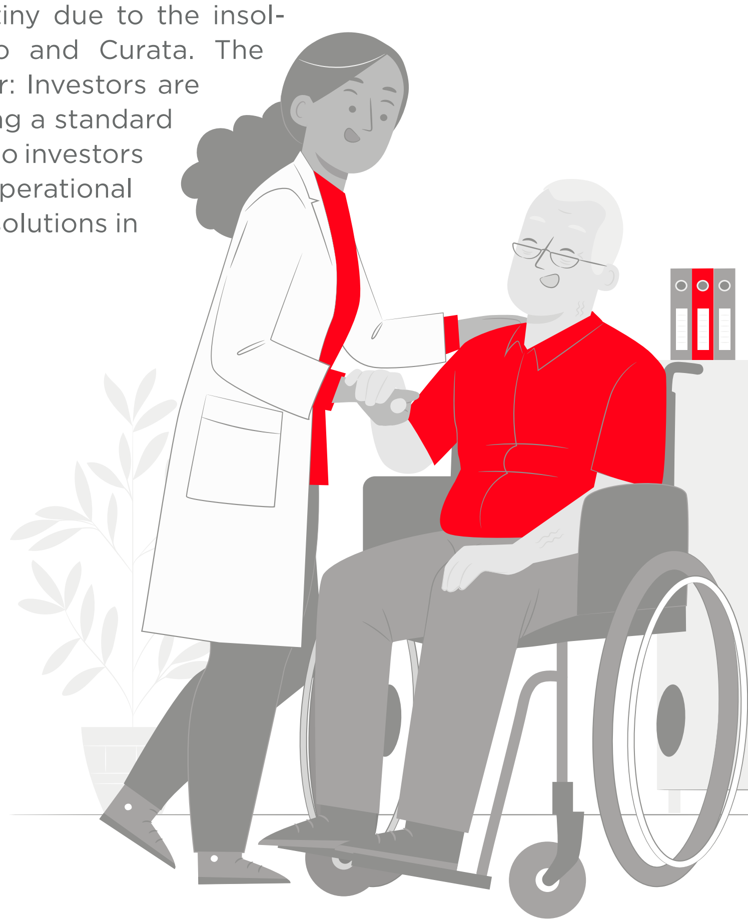
The strong growth of the care industry has also shown its downsides, especially since 2022: With the insolvency of one of the leading operators, the Convivo Group, the market experienced a setback. Although other operators are successively taking over former Convivo businesses, some nursing home and assisted living facility closures may still happen. This also partly eliminates Convivo's well-filled development pipeline, which would have created many new beds.

But it is not only Convivo that has had to file for bankruptcy in recent months. Curata also filed for bankruptcy – albeit in self-administration – as did Novent Holding and the Hansa Group. The Dorea family, which still ranked 8th among the largest inpatient care operators in 2022, also filed for insolvency in self-administration of several of their operating companies. Self-administered insolvencies are used by many operators in order to be able to take advantage of protective shield proceedings and achieve better reorganisation and restructuring measures.

The operator market is thus experiencing difficult times and will continue to consolidate. The current insolvencies mean a capacity reduction, which weighs heavily in times of a simultaneous lack of places and high demand at the same time.

Operators are under increased scrutiny

The operator market is under particular scrutiny due to the insolvencies of large operators such as Convivo and Curata. The challenges for operators are becoming greater: Investors are increasingly analysing operators and demanding a standard for reporting obligations in lease agreements – so investors can also have a constant overview of the operational business and work together with operators on solutions in possible crisis situations.



“ THE MARKET NEEDS TO FIND A BALANCE BETWEEN RENTS, CONSTRUCTION COSTS, INTEREST RATES AND RETURN ON INVESTMENT

The closure of the major KfW subsidy programme came as a surprise to many project developers. In the meantime, the programme has been restarted, but is now much more limited. How did you deal with the abrupt closure?

Sustainability, of both the product and the company, is one of the strategic foundations of the Carestone Group. Our new buildings are always constructed with heating and energy supply from renewable sources. For the second successive year, Carestone as a company has successfully undergone an ESG rating from the certifier Morningstar Sustainalytics and published a sustainability report. Given the high standards of our products, we can fulfil the requirements of the current KfW promotional programme relatively easily and secure subsidies for our private investors.

While we fully support ambitious climate targets, we still believe that predictability, reliability and a sufficient budget would be conducive to the effectiveness of government programmes. In light of the high social demand for care and senior living, we believe that a programme specially tailored to this class of real estate to create sufficient care infrastructure makes a lot of sense.

The sharp rise in construction costs and supply bottlenecks continue to make it difficult to implement many construction projects. How do you see the past and future developments?

Carestone is currently active in new construction and modernisation projects on around 40 active construction sites. During the period of sharp increases in construction costs and disruptions to supply chains over the past two years, we were not affected by any major problems or additional demands. We see the reasons for this in the very trusting relationships with general contractors and subcontractors as well as the proven and optimised planning and construction processes and contracts. Every Carestone project is fully and stably planned at the time the construction contract is awarded. Changes to the construction process do not occur.

Construction prices have been moving sideways for some time. Against the backdrop of falling demand and halted projects in the market, we expect construction prices to fall modestly over the next twelve months.

What impact do the changing financing environment and high inflation rates have on you as a property developer?

We continue to experience a high level of trust in Carestone from our approximately two dozen partner banks and receive sufficient offers for construction and purchase financing of projects. In the case of short-term variable project financing, margins and Euribor have naturally picked up in line with the current interest rate environment and political and macroeconomic uncertainties.

The growing demands on sustainable and energy-efficient buildings and at the same time space requirements of the operators make it difficult to build new retirement homes. How are you dealing with that?

The Carestone care and senior citizens’ property is a sustainable product optimised with the experience of 20 years and two hundred projects. We see Carestone much more as a driving force in innovation and continuous improvement and not as a passive recipient of external requirements.

In your opinion, what are other major challenges in the realisation of healthcare properties?

In order to meet the huge social demand for care and senior citizens’ properties, the market will have to find a balance between rents, construction costs, interest rates and investment returns. These adaptation processes will certainly take some time. Operators are in an arduous phase of refinancing increased carers’ salaries, energy costs and indexed rents by public payers. Funding programmes and more effective refinancing processes by the public sector can make important contributions to accelerating adaptation processes and stabilising care as a whole.

Carestone plans, builds and sells real estate in the senior living segment nationwide. With more than 25 years of experience, over two billion euros in project volume and more than 17,500 units sold, Carestone is the leading developer of senior living and care properties in Germany. With an in-house construction and development team of architects, draughtsmen, engineers, project developers and asset managers, Carestone covers the entire value chain of real estate development.

Dr. Karl Reinitzhuber

Carestone
CEO

“ INVESTING IN CARE REAL ESTATE CAN BE A VERY BENEFICIAL DEFENSIVE INVESTMENT STRATEGY

You have become one of the leading investors in the healthcare sector in Germany and were named Investor of the Year in 2022. What is your strategy for 2023?

Despite the challenging market environment, we were able to generate a considerable transaction volume of around EUR 240 million last year, mainly in the healthcare real estate sector. We see the price decline, which had already been clearly indicated in the second half of 2022, continuing in the course of 2023 so far. Even though operators, especially of inpatient care facilities, are sometimes facing massive challenges, we firmly believe in the sustainable prospects of senior citizen and healthcare real estate. What is currently lacking, however, in order to be able to implement investments more consistently, is the ability to plan the framework conditions, especially with regard to interest rates and, derived from this, price developments. Having said that, we can highlight five key aspects of our strategy for 2023:

In view of the current and, in our view continuing low predictability, especially with regard to interest rate and price developments, our investment activities in the Core and Core+ areas in 2023 will be characterised by a restrained and selective approach. Due to the multiple challenges faced by operators, we are placing an even greater focus on the assessment of tenants, their framework conditions and their economic situation. In this context, we have already created an additional branch of consulting last year with ‘PFE Consulting – Care, Promote and Preserve’. This focuses on advising operators and operating companies, also with regard to the often-difficult succession planning and further development.

Another key part of our strategy, in addition to the traditional area of Core/Core+, is the identification and implementation of appropriate investment opportunities in the value-add segment. Compared to recent years, we see the framework conditions for this as increasingly favourable in the coming months. Anticipating this, we have tapped into appropriate sources of capital in recent months and are now working intensively on identifying, structuring and implementing investments with a focus on value creation. In doing so, we are looking for senior citizens’ and healthcare properties that need to be adapted and/or are problematic or properties with conversion potential, such as office buildings or hotels at B and C locations.

As we began to do in early 2022, we will also focus on real estate in the health and life sciences sector in 2023 and the coming years. In our view, real estate for research, development, manufacturing and processing in the pharmaceutical, biotech, health-tech, food, medical technology and related lifestyle products, often in conjunction with expanded health care, represents the infrastructure of the core segments of healthcare real estate. What is important is that the fundamental drivers here are the same as for senior and healthcare properties. This is also reflected in our acquisition profile.

Last but not least, in 2023 we will continue to focus on optimising our real estate portfolio and ESG – in particular on E and decarbonisation. In 2022, we analysed our entire portfolio with regard to CO_2 and energy consumption and classified it in the CRREM path. In addition we have defined concrete measures, including cost indications, in all significant properties in order to make them CO2-neutral or at least to progress them substantially along the CRREM path. 2023 stands for the implementation of measures, of course in coordination with our customers and tenants.

What do you think are the biggest challenges for 2023?

The most prominent topic is the development of interest rates and the market and the associated difference between seller and buyer expectations. This is accompanied by uncertainty and a lack of predictability. This situation will be with us for the remainder of 2023 and very probably well beyond.

In addition, the developments in the operator market of care real estate and health care properties should be mentioned. Although the individual entrepreneurial framework conditions and operator histories play a not-insignificant role, the combination of the Tariff Compliance Act, increased energy costs and a continuing shortage of skilled workers, combined with a very sluggish refinancing of nursing care rates as well as adjustment of investment cost rates, is causing massive difficulties for many operators, especially in the case of care real estate.

Another and increasing challenge will be the topic of ESG, which in our view is currently rather in the background, but will come to the fore all the more once the market situation has adjusted.

What makes the German care real estate market particularly attractive for you as an investor?

Despite the existing but surmountable challenges, we see the key drivers of the care and healthcare industry and their fundamental data as a strong argument for investing in senior citizens, care and healthcare properties. These are primarily the structural and sustainable demand due to the ageing society and the low correlation of the nursing and healthcare industry with economic cycles and developments and thus the relatively cyclically-decoupled rental income. In conjunction with the system of long-term care and health insurance funds in Germany and the socio-societal relevance, investing in senior citizens, nursing and healthcare properties can be a holistically very advantageous defensive investment strategy.

The TSC Real Estate Group, based in Berlin, specialises in integrated and sustainable investment and the asset management of senior living and healthcare properties as well as real estate in the health and life sciences sector. In addition, TSC Real Estate has many years of expertise in the investment and management of residential and mixed-use properties. With its own teams in Germany, Italy, Spain and Luxembourg, TSC Real Estate currently manages approx. EUR 2.0 billion of assets under management (AUM) across Europe, approx. EUR 1.6 billion of which, with 163 properties, is in Germany, for investors in both the core/core+ and value-add sectors. As an operating partner, TSC Real Estate manages properties in compliance with ESG criteria along the entire value chain and throughout the entire investment and life cycle.

Berthold Becker

TSC Real Estate
Managing Director

ESG WILL COME MUCH MORE INTO FOCUS AS A REAL COST FACTOR

However, it is important to emphasise that this asset class is still a niche and requires special expertise. The numerous care home regulations and legal statutes, the selection and evaluation of the operators and their concepts, the analysis of the location-dependent competitive situation and the evaluation of the ongoing shortage of skilled workers are just a few examples that require in-depth, and sometimes years-long, expertise.

What challenges do you already see as critical for owners of care real estate and to what extent are they connected to the operator?

An essential criterion in the assessment of the quality of care and healthcare properties is determined by the operator. Even though we are primarily real estate investors, we believe that understanding the operator as well as their business model and individual framework conditions is essential. In this respect, we deal intensively with operators and operator models and their business plans, as they are crucial for the success of real estate investment.

For operators in the health sector and especially in the care sector, there are currently some demanding challenges: In addition to the increasing regulatory requirements and the ongoing shortage of skilled workers, these have also included increased energy costs, higher personnel costs due to the Collective Bargaining Act and personnel leasing and increased inflation with simultaneous tough renegotiation of care and investment cost rates. The sheer liquidity in the often very drawn-out negotiations with authorities is also a major hurdle, especially for smaller companies.

In addition, the politically-induced increasing ambulantisation efforts are a challenge for many operators. Even though we support ambulant care as a tool in principle, some measures of the Ministry of Health's planned reform are or doubtful benefit and not expedient in our view. This tends to concern the symptoms of problems rather than constitute meaningful cause elimination.

Economic challenges and extensive difficulties on the operator side also affect the owner with regard to the reliability of rental income. Especially in a time of rental uplift opportunities due to increased inflation, sensitivity and creativity are required on both sides in order to work together sustainably and in the long term.

The number of people in requiring care in nursing homes, which fell for the first time, made the market sit up and take notice. How do you see this development?

From our point of view, this is undoubtedly a temporary development and should be seen specifically as a post-Covid reaction. All forecasts point to a further increase in the number of people requiring care in the coming years. For example, the current statistics of the Federal Statistical Office from 2023 show care rates of +37 percent and +55 percent from 2021 to 2055 in two scenarios. In this respect, we see structural demand as one of the fundamental framework factors of the senior citizens' real estate market and thus as a continuing clear argument not only for the advantageousness of investing in senior citizens' or nursing care real estate, but even as a socially urgent task. This task cannot be tackled without the structured and proactive involvement of private capital.

Sustainability is already an important topic for you as an investor. What is your strategy for this or with regard to impact investments and your current portfolio?

We do not consider the regulatory requirements adjusted at the end of 2022, according to which Article 9 requirements can only be fulfilled by properties that are already ESG-compliant, to be expedient and in some places counterproductive. In our view, a significant part of the solution to the climatic and ecological challenges lies more with existing property.

We have given a lot of thought to how we can act as sustainably as possible with new properties, but even more so with and with existing properties. With Alex Ubl, who has held the position of ESG and sustainability specialist at TSC Real Estate since January, we have further strengthened our team in terms of content and resources. In doing so, we deliberately chose someone who has the technical knowledge, but also understands the regulatory and investment aspects of the ESG dimension. Alex Ubl is a CFA and has in the past played a key role in the development of funds for renewable energies, among other things.

Our focus at the moment is clearly on the "E" of ESG. In 2023, for example, after comprehensive analyses, we will implement the energy optimisation of the entire real estate portfolio – of course taking economic aspects and the CO_2 levy into account, which has been adjusted since the beginning of the year. Since the question of who invests and who benefits from the investments and to what extent is not always easy to answer, this also requires extensive coordination and negotiations with tenants.

On the acquisition side, ESG is on everyone's lips, but we do not believe that the "E" is already sufficiently reflected in the price development, particularly regarding existing properties. In our view, the necessary costs for corresponding measures – assuming the intention to create or retain an almost institutional product – have not yet been priced-in to some extent. Regardless of the fact that the politically planned speed of implementation will be difficult to maintain, as the weighting of the interest rate problem decreases, ESG will come into focus much more strongly and concretely as a real cost factor and find its way into business plans – both for acquisition and existing properties. Accordingly, in the short and medium term, we see a further intensified decline in prices for existing properties and a slowdown in the price decline for new properties.

ESG or impact and sustainability are increasingly being weighed in our decisions, in investment decisions as well as on the portfolio side and, last but not least, at the level of TSC Real Estate.

OUTLOOK

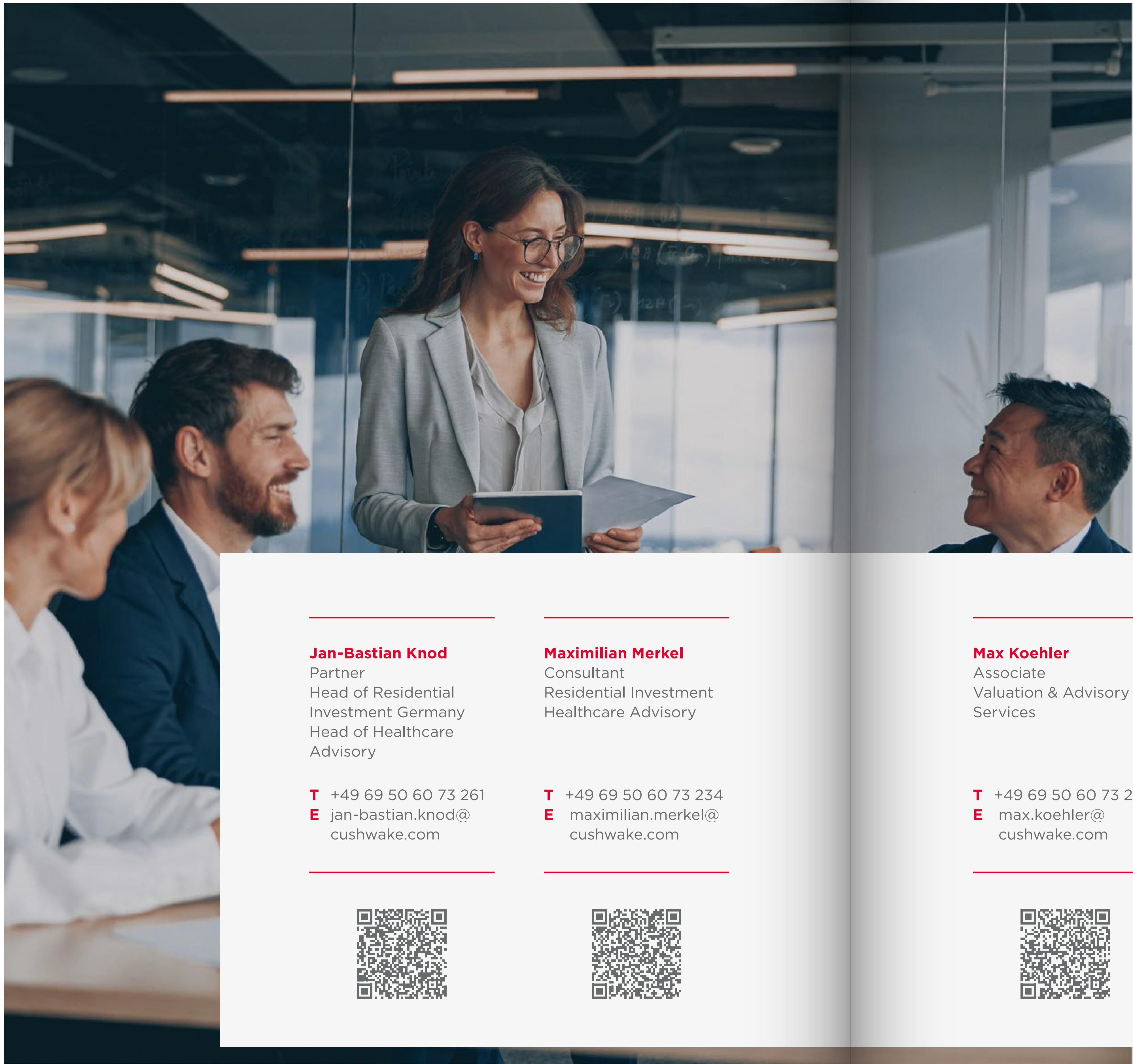
With the demographic shift and the further decline in family care, the number of people requiring care in institutions throughout Germany has also increased. This development will continue in the coming years and drive up the demand for suitable facilities. Against this backdrop, the care market has grown massively. In particular, ambulant care at home and in assisted living facilities have increased sharply: For people designated as requiring care, the numbers receiving ambulant care overtook the number in inpatient care in 2017. But inpatient care also continues to grow despite a recent slight decline in demand. In Q1 2023, the transaction volume for assisted living facilities remained stable compared to nursing homes – an indication that investors are focusing on this asset class.

Demand significantly exceeds supply despite the growth. And operators are currently under great pressure: higher energy costs, staff shortages, stricter regulatory requirements such as single-room quotas and the new tariff compliance law make refinancing more difficult – in part because beds sometimes remain unoccupied. At the same time, last year's price increases, inflation and supply bottlenecks led to major market uncertainty, prolonged transaction processes and declining construction activity, further exacerbating shortages. However, the demand and number of bids in such transaction processes are still high. This is shown by the high liquidity in the market for nursing homes and assisted living facilities as well as the increased concentration of many investors on these property types. Recent insolvencies of large operators are making investors more cautious, especially regarding inpatient care. However, the increasing degree of operator consolidation also offers the opportunity for further professionalisation in the sector: Strong and economically healthy operators can take over less well-positioned ones and transfer their own efficiencies.

In addition to more intensive operator analyses, the topic of ESG is moving further up the list of investor priorities – especially energy efficiency. Due to the lack of certified buildings in the care sector, KfW standards are used as a guide for new buildings. While many investors avoid existing properties with poorer energy efficiency standards, others are focusing specifically on upgrading these properties as part of manage-to-green strategies.

Looking to the future, development projects remain essential to create further capacity and meet the structurally growing demand for care places – and also to meet many investors' ESG standards. New subsidy conditions from KfW provide attractive incentives to design an attractive investment product despite high construction costs and interest rates. It remains to be seen how investors will continue to deal with the current challenges, and also the possible opportunities – because exciting investment opportunities arise, even during crises.

CONTACT



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The health-care real estate market **at a click**

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