

MedicX Fund

Growing secure cash flow

FY14 results

Real estate

The 7.2% prospective yield on MedicX shares is supported by secure cash flows on a broad portfolio of modern primary care properties, on long leases, with quasi government backing. Debt is currently fixed at c 4.5% with similarly long duration. FY14 saw new equity of £48m invested, and more; we forecast further asset growth in FY15 and beyond, with some modest re-gearing from a low c 50%. Growth prospects for the primary care sector are strong and, despite some yield compression, the spread over funding costs remains attractive.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	All-in NAV/ share (p) ¹	DCF/share (p) ²
09/13	25.5	9.7	3.7	5.7	6.9	69.4	97.0
09/14	29.5	10.7	3.1	5.8	7.0	65.3	93.4
09/15e	33.4	12.8	3.6	5.9	7.2	65.7	N/A
09/16e	37.6	13.9	3.8	6.0	7.3	66.1	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation, asset revaluations, performance fees, exceptional items and share-based payments. ¹Including adjustment for mark-to-market valuation of long-term, fixed-rate debt. ²Investment adviser's DCF.

No surprises as growth progresses

FY14 adjusted (mainly to exclude £11.6m of valuation gains) earnings increased 12.5% to £10.7m. Continued investment of the proceeds of the c £48m early year equity raising saw property assets cross the £0.5bn threshold, and dividend cover continue to rebuild through the year (to 58.9% in H2). Valuation gains reflect yield compression from competition for attractively yielding assets, as well as modest rental growth. While this is a positive indicator for NAV, it does make it more expensive to acquire assets while maintaining a disciplined investment strategy. Fortunately funding conditions are similarly positive, and a healthy spread between income and funding costs has been maintained.

Primary care growth prospects remain strong

Despite continued sluggishness in new development approvals, MedicX committed £61.5m to new investment during FY14 and has a strong £100m pipeline of identified investment opportunities, of which the majority relates to forward funding opportunities and c £7m to immediately income-producing completed properties. Of this pipeline, c £33m is going through legal process. Ahead of the general election, the NHS is centre stage with both main parties agreed on the central role of the GP. The NHS five-year plan acknowledges the need for significant change and seeks to deliver additional and more integrated services in the community, with extended opening hours to improve access.

Valuation: Well supported 7.2% prospective yield

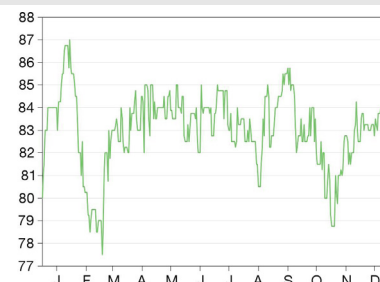
The prospective yield on the dividend indicated by the Fund as 5.9p in FY15, barring unforeseen circumstances, is 7.2%. With portfolio growth we forecast cover to build further, to c 61% in FY15 and c 64% in FY16. The investment adviser's DCF value per share of the Fund's predictable cash flows is 93.4p (see page 6).

17 December 2014

Price **82.3p**
Market cap **£295m**

Net debt (£m) as at 30 September 2014	255.2m
Shares in issue	358.1m
Free float	100%
Code	MXF
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.6)	(0.6)	0.0
Rel (local)	3.8	5.6	2.5
52-week high/low	87.0p	77.5p	

Business description

MedicX Fund is a specialist investor in primary care infrastructure. It holds a portfolio of 137 properties (including those under construction), let mainly to government-funded (NHS) tenants (90%) and pharmacies on GP surgery sites (8%).

Next events

Q1 ex-dividend date	12 February 2015
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Full year results summary

Full year results to 30 September 2014 produced no major surprises. The key details were the following:

- Rental income for the year grew by £3.9m or 16.0% to £28.1m (FY13 £24.2m). The annualised rent roll at 8 December was £32.8m (1 October 2013 £28.8m), including £1.6m for properties under construction. 90% is reimbursed by the NHS. Adjusting for the forward funding agreement announced in early October, we estimate the rent roll was c £32.6m at 30 September (c £31.1 for completed properties). At the same date, £11.4m of passing rents were under negotiation (FY13 £9.7m).
- Of the £32.8m annualised rent roll, 76% (FY13 75%) is subject to open-market rent reviews, 19% is RPI linked (20%), and 5% (5%) is subject to fixed uplifts. Open-market reviews are still sluggish (1.2% average uplift) with RPI uplifts of 3.0% and fixed uplifts an underlying 2.7%. The average increase was 1.8% (1.7%) on the £4.8m (£3.4m) of rent reviews agreed during the period. Management is comfortable with the current level of RPI linked rents as it expects open-market reviews to accelerate over time to reflect increases in building and land costs.
- Normalised EBITDA (excluding valuation gains and other one-offs) increased by £3.0m or 14.8% to £23.7m (FY13 £20.6m), with expense increases (14.4%) at a lower rate than revenues, as expected.
- Adjusted earnings (which exclude valuation movements, performance fees and fixed debt break costs) increased £1.2m or 12.5%. In per share terms, this was 3.1p per share, down from 3.7p due to the increased number of shares in issue following the early year equity increase to fund growth. As the proceeds were invested, adjusted EPS increased to 1.7p in H2 from 1.4p in H1. Valuation gains were a net £11.6m (FY13 £0.2m), driven by a decline in the valuation yield from 5.79% to 5.68% as well as rental growth.
- The progressive dividend policy was maintained with total declared dividends of 5.8p for the year (FY13 5.7p). A dividend of 5.9p is indicated for the current year, subject to unforeseen circumstances. The final quarterly dividend in respect of FY14 (1.45p) will be paid on 31 December 2014. As a result of the early year fund-raising, dividend cover was temporarily reduced. Measured against adjusted earnings this was 53.6% (FY13 58.9%). As adjusted earnings increased with investment, dividend cover also increased, to 58.9% in H2 versus 48.1% in H1. Management targets total shareholder return (share price plus dividends), of which the dividend yield (c 7%) is a large contributor, and while it expects dividend cover to further increase, full cover is not prioritised above taking appropriate long-term decisions for the Fund. 16.2% of FY14 dividends were taken as scrip.
- Total shareholder return was 12.0% for the year to 30 September 2014 (FY13 13.1%). Over the past five years, total shareholder return has averaged 10.4%, with a high of 13.1% in FY13 and a low of 8.6% in FY10. Discounted cash flow net asset value increased to £331.1m (FY13 £266.7m), but in per share terms decreased to 93.4p per share (FY13 97.0p per share). Adjusted net asset value per share was 65.8p per share (FY13 63.1p per share). Including fixed-rate debt at fair value (now a small negative given market rate movements), it was 65.3p (FY13 69.4p).
- Committed investment during FY14 was c £61.5m on a cash yield of 6.02%. Committed investment is now £518.2m in 137 primary healthcare properties (FY13 £456.7m in 121 properties). There is a strong pipeline of approximately £100m in further acquisition opportunities.
- Year-end net debt was £255.2m with adjusted gearing at 49.9%. Adjusting for cash, total drawn facilities of £288.4m carried an all-in fixed rate cost of 4.35% with an average unexpired term of

13.3 years (similar to the average unexpired lease term of 15.8 years). A new flexible £50m loan note facility with an agreed term of five years and an all-in fixed rate of 3.8% was agreed, with £15m drawn in H1 and the balance in December 2014.

Portfolio update

Total committed investment now stands at £518.2m spread over 137 properties (of which 131 are completed). The increase in the committed portfolio from 1 October 2013 is now £61.5m or 13.5%.

The average unexpired lease term on the properties is 15.8 years (FY13 17.0 years), and the properties have an average age of 6.9 years (6.0 years), with an average value of £3.8m (£3.7m).

New investment remains focused on larger, more modern properties, which the adviser believes will be better suited or better able to adapt to the expected evolution of primary care services. The NHS five-year plan indicates a period of significant change in the NHS overall, and the shape of primary care in particular. Further disposals of some smaller properties that do not meet this long-term investment criteria are therefore likely. Three such properties were sold during FY14, with an aggregate value of c £4.3m.

Asset growth driving income, with rent increases steady

The annualised rent roll on the portfolio is now £32.8m, of which £1.6m relates to the six properties that are currently under construction. Most of the properties under construction (outstanding commitment £18.6m) are expected to complete over the next 12 months and become income producing.

42 existing leases and rents of £4.8m were reviewed during the year, and generated an average uplift in rents of 1.8%. Open-market reviews (76% of the total) continue to be sluggish, at an average 1.2%, while RPI uplifts (19% of the total) and fixed uplifts (5% of the total) were 3.0% and 2.7% respectively.

The Investment Adviser is comfortable with the current mix of open-market versus RPI/fixed-level rents in the portfolio, believing that the market is close to acceleration in the former. Open-market rent increases have trailed RPI increases for a number of years, which more recently seems to reflect the subdued level of newly approved construction projects post NHS reform. This has provided little precedent for a general uplift in market rents. As the new NHS Property Services procurement system is bedded down, supported by pledges of additional funding for primary care new development, there should be more available evidence of the rent levels required to stimulate private investment, reflecting material recent building and land cost inflation.

The pipeline of identified investment opportunities remains strong at c £100m, of which the majority relates to forward funding opportunities and c £7m to immediately income-producing completed properties. Of this pipeline, c £33m is going through legal process.

Competitive pressure on attractive yields

The Investment Adviser describes current market conditions as “very warm”. Against the backdrop of still muted new development, investor demand for attractive properties has been strong. Institutional interest at the larger end of the market (properties valued at more than £10m), attracted to secure long-term yields, is of note.

These general market dynamics are reflected in the valuation gains recognised on the Fund's assets during the year. The portfolio value at 30 September was assessed by Jones Lang LaSalle at £517.7m on the basis that all properties under construction are complete. The net initial yield

reflected in this valuation was 5.68%, down from 5.79% a year earlier, and generated a gross valuation gain of £12.1m, partly offset by costs related to the purchase of new properties of £0.5m.

The Investment Adviser notes that current market conditions indicate the possibility of further valuation gains driven by yield compression, and while this is a positive indicator for NAV it does make it more expensive to acquire assets, and income, while maintaining a disciplined investment strategy. Fortunately funding conditions are similarly positive, and a healthy spread between income and funding costs has been maintained. The £61.5m of new committed investment and approved investments since 1 October 2013 have been made at a cash yield of 6.02% (actually higher than the 5.85% achieved in FY13), however there are indications that investment yields over the next few months will be slightly lower.

Average funding cost down slightly

Early in the FY14 financial year, MedicX raised £48.75m gross (£47.6m net) in additional equity by issuing 85m new shares at a price of 75p. 20m of the shares were immediately repurchased for treasury, to be re-issued to satisfy investor demand, including scrip dividend. Throughout FY14, 10.5m treasury shares were re-issued for cash, and a further 3.0m in recent days (all at a premium to NAV) and 4.0m shares were issued in respect of scrip dividends. The staggered re-issue of shares as investments were made has helped to limit the dilutive effects of the equity issuance. There were 7.1m shares remaining in treasury at 30 September, and we estimate that following the recent sale of treasury shares, the remaining balance will cover current year scrip requirements, assuming a 12% scrip take-up in respect of FY15 declared dividends.

In August the Fund raised £50m in a private placement of five-year duration loan notes to a single institution, at a fixed rate of 3.8%. £15m was drawn in August and £35m has been drawn in December 2014.

Total gross debt increased by c £12m, from £274m to £286m during FY14, and net debt increased from £247m to £255m. Period end adjusted gearing was 49.9% (FY13 56.4%). As the Fund continues to invest, we expect this level may move up, although it remains the intention to keep gearing within a range of 50-60%.

Since the FY14 year-end, the (£31.2m) GE Capital real estate loan (due April 2015) has been repaid, in part by drawing on the RBS (£25m) revolving credit facility, and utilising cash (£31.1m at 30 September).

To fund portfolio growth, MedicX is keen to take on additional longer-term fixed-rate debt at current interest rates, especially with flexible draw-down structures. It expects further institutional interest in this type of funding.

At 30 September, total drawn facilities of £288.4m (includes unamortised issue costs) carried an all-in fixed-rate cost of 4.35%, down from 4.45% a year earlier. The average unexpired term of 13.3 years remains similar to the average unexpired lease term of 15.8 years, although down slightly from the 15.8-year average unexpired term of the year before.

The outlook for primary care continues to be strong

The process of approval by NHS Property Services for new development projects remains frustratingly slow, but participants observe some signs of acceleration. Meanwhile, in the run up to the general election expected next year, the NHS is more than ever a political debating point. Both of the main parties continue to support general practice as the key resource and patient gateway for state healthcare in the UK. The NHS five-year plan acknowledges the need for significant change and seeks to deliver additional and more integrated services in the community, with extended opening hours to improve access. The autumn statement recently announced £1bn of additional funding over four years, for investment in primary care infrastructure.

Other fund developments

Octopus Investments completed its acquisition of MedicX Group, including the Fund adviser, MedicX Adviser, on 1 October 2014. The Investment Adviser has subsequently changed its name to Octopus Healthcare Adviser. For the Fund there is no change, although the Investment Adviser is now part of a larger, fast-growing UK fund management company with positions in several specialist sectors including an expanding healthcare business. Mike Adams, CEO, will continue to lead the investment team, and the Fund continues to be a core focus of the new Octopus Healthcare Adviser.

The Fund has also applied to the FCA to register as a self-managed alternative investment fund. For the purposes of the Alternative Investment Fund Manager Directive, it is categorised as a non-EU alternative investment fund and has elected to be its own manager.

Valuation and performance

Total shareholder return (dividends plus share price movement) in the year to 30 September 2014 was 12.0%. With a progressive dividend policy and dividend yield of c 7%, dividends are deliberately a substantial element of total return. Over the past five years, total shareholder return has averaged 10.4%, with a high of 13.1% in 2013 and a low of 8.6% in 2010.

Yield

Given the long-term predictable cash flows available to MedicX on its portfolio of assets, yield is obviously a key attraction of the shares. With an expected dividend for FY15 of 5.9p per share, the Fund offers a prospective yield of 7.2%.

Dividend cover was rebuilding through FY14 as expected, as proceeds raised early in the year were progressively invested. Our estimates indicate that this will continue to build through FY15 (60.9%) and FY16 (64.4%). As a forward-looking indicator, underlying dividend cover, adjusted to reflect the rents that will be earned on the completion of properties under construction, was 67.1% in FY14 and MedicX estimates that this would rise to c 73% on the assumption that further debt is raised to take gearing to 60% on similar terms to that existing, and the proceeds invested in additional asset growth.

We estimate underlying FY15 earnings (excluding valuation movements and other items) represent a healthy c 5.5 % return on average net assets (FY14 5.3%).

NAV

The group's net asset value per share as at 30 September 2014, adjusted to exclude the impact of deferred tax not expected to crystallise, financial derivatives and the impact of resetting debt costs, was 65.8p per share (30 September 2013 63.1p per share). On this basis, the shares trade on a P/NAV of 1.25x. Given the movement in market interest rates during the year, the market value of the Fund's fixed-rate debt increased (turning a positive impact on NAV of £17.4m into a small negative impact of £1.5m). On this basis (fixed-rate debt at market value), the NAV per share was 65.3p (FY13 69.4p) for a P/NAV of 1.26x.

Valuation yields may continue to firm. We estimate that a 0.5% reduction in the FY14 net initial valuation yield to 5.18% would increase the 30 September adjusted NAV per share by c 15p from 65.8p to c 80.0p.

Adviser's discounted cash flow model

Given the long-term, predictable cash flows, it is also appropriate to calculate a net asset value based upon discounted cash flows. This basis, as set out in the Investment Adviser's report, gives a net asset value per share of £331m (93.4p per share), based on a weighted average discount rate of 7.06% (30 September 2013: £266.7m, 97.0p per share). The DCF valuation did not fully benefit from the £11.6m of valuation gains (2.6% of the opening investment value) recorded in statutory net assets during the year as it assumes 1% pa capital growth). However, it was similarly affected by the increased number of shares resulting from the early year equity issue and the need to deploy the proceeds raised. The discount rates used are 7% for completed and occupied properties and 8% for properties under construction. These represent 2.5% and 3.5% risk premiums to an assumed 4.5% long-term gilt rate. The discounted cash flows assume an average 2.5% a year increase in individual property rents at their respective review dates. Residual values continue to be based upon capital growth at 1% a year from the current valuation until the expiry of leases (when the properties are notionally sold), and also assuming the current level of borrowing facilities.

For the discounted cash flow net asset value to equate to the share price as at 30 September 2014 of 83.5p per share, the discounted cash flow calculation would have to assume a 0.7% increase in rents a year, or a 0.3% capital reduction a year, or a weighted average discount rate of 8.2%. These reductions in rents and capital values would need to take place every year until the expiry of individual property leases.

Financials

FY14 performance was largely in line with our expectations, as shown in Exhibit 2. The small "beats" on normalised PBT and EPS mainly reflect slightly higher revenue and lower finance expenses than we had allowed for. Our normalised measure excludes investment manager performance fees (£1.9m versus £0.4m in FY13) as well as valuation gains (£11.6m versus £0.3m in FY13).

Exhibit 1: Performance versus forecast and estimate revisions

	Revenue (£m)			PBT (£m)			EPS (p)			DPS (p)		
	Forecast	Actual	% difference	Forecast	Actual	% difference	Forecast	Actual	% difference	Forecast	Actual	% difference
09/14	29.4	29.5	0%	10.1	10.7	5%	3.0	3.1	5%	5.8	5.8	0%
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
09/15e	34.4	33.4	-3%	13.4	12.8	-5%	3.8	3.6	-6%	5.9	5.9	0%
0916e	N/A	37.6	N/A	N/A	13.9	N/A	N/A	3.8	N/A	N/A	6.0	N/A

Source: Company data, Edison Investment Research

Our revised FY15 estimates are slightly lowered, and we have introduced FY16 estimates for the first time. The FY15 estimates are driven off lower revenues than previously forecast, with some offset from lower estimated costs. Additions to the property portfolio were c £14m lower than we had assumed for FY14, and despite the strong pipeline of investment opportunities, we have kept our assumption of £45m in additions for FY15, rising to £80m in FY16, acquired on a cash yield of 5.9%. MedicX hopes to exceed this level of portfolio growth, and has a medium-term target of c £100m pa. Some of the shortfall in FY14 investment versus our forecast was made up by valuation gains, and we have assumed further gains in FY15 and FY16. Our underlying assumption is that 1.8% pa rental increases translate into valuation gains at a valuation yield unchanged at 5.68%. With increased competition for assets it is possible that the valuation yield may fall further, which would increase valuation gains. However, against this, we have not allowed for any acquisition-related costs (£0.5m in FY14), which are certain to arise, if unpredictably. In both FY15 and FY16, EPS is slightly reduced by our assumption that scrip take-up will continue at a high level;



we have assumed 15% rather than the 8% previously. Increased scrip, of course, improves the cash cover of dividends.

MedicX has already guided to further progress in DPS, to 6.0p per share, barring unforeseen circumstances. Our forecasts show dividend cover (by adjusted earnings) continuing to increase, to 60.9% in FY15 and 64.4% in FY16 (FY14 was 53.6% overall, increasing to 58.9% in H2 versus 48.1% in H1).

Our portfolio growth forecasts assume that MedicX will raise additional debt, with forecast FY16 net debt increasing by c £134m to £389m, versus £255m at 30 September. We have assumed that this is raised at a similar average cost to the existing debt (all-in average cost 4.35%), although we note that recent funding has been arranged at rates below this. Our forecast net debt to portfolio value is 60.3% in FY16, the top of management's longer-term range. Adherence to this range would imply that should portfolio growth exceed our estimates, MedicX would be likely to seek additional equity funding as well as debt funding.

Exhibit 2: Financial summary

Year end 30 September	US\$000s	2011	2012	2013	2014	2015e	2016e
PROFIT & LOSS							
Revenue		12,474	16,633	25,537	29,488	33,427	37,639
Cost of Sales		(214)	(283)	(413)	(666)	(715)	(801)
Gross Profit		12,260	16,350	25,124	28,822	32,713	36,838
EBITDA		9,011	12,694	20,616	23,664	27,083	30,678
Operating Profit (before GW and except.)		9,011	12,694	20,616	23,664	27,083	30,678
Intangible Amortisation		0	0	0	0	0	0
Revaluation of investment properties		3,409	(-2,269)	248	11,649	8,369	8,759
Investment advisory performance fee / loss on disposal of property		(808)	(646)	(240)	(1,888)	0	0
Operating Profit		11,612	9,779	20,624	33,425	35,452	39,437
Net Interest		(4,957)	(7,138)	(10,959)	(12,989)	(14,291)	(16,766)
Profit Before Tax (norm)		4,054	5,556	9,657	10,675	12,792	13,912
Profit Before Tax (FRS 3)		6,655	2,641	9,665	20,436	21,161	22,671
Deferred tax on fair value movements in property values		665	0	(161)	(264)	0	0
Profit After Tax (norm)		4,054	5,554	9,656	10,675	12,793	13,914
Profit After Tax (FRS 3)		7,320	2,641	9,504	20,172	21,161	22,671
Average Number of Shares Outstanding (m)		170.5	229.4	263.4	341.4	356.2	362.3
EPS - normalised (p)		2.4	2.4	3.7	3.1	3.6	3.8
EPS - normalised fully diluted (p)		2.4	2.4	3.7	3.1	3.6	3.8
EPS - FRS 3 (p)		4.3	1.2	3.6	5.9	5.9	6.3
Dividend per share (p)		5.50	5.60	5.70	5.80	5.90	6.00
Gross Margin (%)		98.3	98.3	98.4	97.7	97.9	97.9
EBITDA Margin (%)		72.2	76.3	80.7	80.2	81.0	81.5
Operating Margin (before GW and except.) (%)		72.2	76.3	80.7	80.2	81.0	81.5
BALANCE SHEET							
Fixed Assets		213,603	365,067	426,649	502,906	556,275	645,034
Intangible Assets		0	0	0	0	0	0
Tangible Assets		195,589	337,853	399,502	492,252	535,621	624,380
Properties under construction		18,014	27,214	27,147	10,654	20,654	20,654
Current Assets		23,235	72,604	38,067	39,306	41,700	43,176
Stocks		0	0	0	0	0	1
Debtors		5,125	6,358	11,004	8,181	11,700	13,174
Cash		18,112	66,247	27,063	31,125	30,000	30,000
Current Liabilities		(9,316)	(16,088)	(19,994)	(56,688)	(26,270)	(29,427)
Creditors		(9,316)	(16,088)	(18,865)	(23,866)	(25,070)	(28,228)
Short term borrowings		0	0	(1,129)	(32,822)	(1,200)	(1,199)
Long Term Liabilities		(100,705)	(255,928)	(273,732)	(254,798)	(335,857)	(419,272)
Long term borrowings		(100,443)	(255,453)	(272,615)	(253,485)	(334,544)	(417,959)
Other long term liabilities		(262)	(475)	(1,117)	(1,313)	(1,313)	(1,313)
Net Assets		126,817	165,655	170,990	230,726	235,848	239,510
Net Assets excluding goodwill and deferred tax		127,081	165,916	171,832	231,764	236,834	240,493
NAV/share (p)		66.0	63.7	62.5	65.4	65.7	66.2
Adjusted NAV per share (p)		66.0	63.7	63.1	65.8	66.1	66.5
Est. value/share of Fund's long-term fixed rate debt (p)		2.0	0.6	6.3	0.0	0.0	0.0
NAV/share including benefit of long-term debt (p)		68.0	64.3	69.4	65.8	66.1	66.5
CASH FLOW							
Operating Cash Flow		8,879	14,222	18,515	23,639	24,769	32,363
Net Interest		(5,166)	(7,805)	(11,495)	(11,342)	(14,291)	(16,766)
Tax		0	0	0	0	0	0
Capex		0	0	0	0	0	0
Acquisitions/disposals		(29,453)	(55,793)	(30,428)	(42,161)	(45,000)	(80,000)
Financing		35,779	44,965	(1,757)	55,577	2,475	0
Dividends		(8,727)	(11,539)	(13,610)	(16,759)	(18,514)	(19,011)
Net Cash Flow		1,312	(15,950)	(38,775)	8,954	(50,562)	(83,414)
Opening net debt/(cash)		83,570	82,331	189,206	246,681	255,182	305,744
HP finance leases initiated		0	0	0	0	0	0
Other items (including debt assumed on acquisition)		(73)	(90,925)	(18,700)	(17,455)	0	(0)
Closing net debt/(cash)		82,331	189,206	246,681	255,182	305,744	389,158

Source: MedicX Fund data, Edison Investment Research

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