

MedicX Fund

Signs of rental growth

MedicX Fund's (MXF, MedicX) H117 results show a higher level of investment than we had assumed, with Irish acquisitions funded from equity issuance at a substantial premium to NAV. This, together with continued yield compression, has increased EPRA NAV to 74.4p per share, above our forecasts, while slightly diluting EPRA EPS, and therefore reducing dividend cover. The dividend has been increased and MXF expects to pay 6p in respect of 2017, equating to a yield of 6.7% on the current share price, supported by highly secure, long-term income derived mainly from government sources.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	EPRA NAV/ share (p)	DCF/share** (p)
09/15	33.7	13.5	3.74	5.90	6.5	70.8	94.9
09/16	35.5	14.2	3.79	5.95	6.6	73.2	96.6
09/17e	38.5	14.9	3.60	6.00	6.6	74.7	N/A
09/18e	42.9	16.5	3.85	6.05	6.7	74.9	N/A

Note: *PBT and EPS are normalised, excluding deferred taxation, revaluation gains and performance fees. **Investment adviser's DCF value/share.

More investment than forecast

MedicX has committed to £48.8m of investment in six properties so far in FY17 with a cash yield of 5.28%, including a fourth primary care centre (PCC) in the Republic of Ireland. Of this, £42.4m was invested in H1. As well as investing more than expected, the pipeline of acquisitions is strong and includes potentially the fund's first standing let acquisitions in the Republic of Ireland and Northern Ireland as well as investment by a new joint venture (JV) with the General Practice Investment Corporation. The increased pace of investment is encouraging and we have increased our assumption for the year as a whole from £77m to £97m.

Rent growth showing signs of movement

The recent uptick in inflation has been of benefit to RPI-linked rents and progress has been made towards the execution of NHS plans to upgrade primary care infrastructure. An independent report by Sir Robert Naylor has highlighted the need for private sector investment in primary care and its conclusions are endorsed by the current government. While the awaited rise in rental growth through open market review has not yet arrived, it is coming closer. We have not adjusted our rent growth assumptions, but would now highlight it as a sensitivity to the upside from FY18.

Valuation: Secure yield

MedicX is entering its tenth year of dividend growth and offers one of the highest yields in the sector. Although cover has dipped in H117, to 59% from 63% in FY16, we expect it to return to 2016 levels as development assets reach completion in 2018. The board is committed to the progressive dividend policy and points to future rent growth making it sustainable. Our dividend assumptions are unchanged. The secular drivers of demand for modern, purpose-built primary care premises persist, and MXF's c 19% premium to last reported EPRA NAV is in line with peers that derive income from long-term, government-backed leases.

Interim results

Real estate

31 May 2017

Price **90.25p**

Market cap **£386m**

£1/€1.16

Net debt (£m) at 31 March 2017 337.0

Shares in issue 427.4m

Free float 100%

Code MXF

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 0.3 1.4 2.9

Rel (local) (3.5) (2.7) (13.9)

52-week high/low 92.25p 80.00p

Business description

MedicX Fund is a specialist investor in primary care infrastructure. Properties are let mainly to government-funded (NHS or HSE) tenants (c 89%) and pharmacies (c 8%) on GP surgery sites. It has one completed property in the Republic of Ireland and three under development.

Next events

Q2 ex-dividend 17 August 2017

Year-end 30 September 2017

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Summary of interim results

MedicX's H117 results show the impact of continued yield compression and the issue of 23.25m shares at an average premium to NAV of c 20% in the period: EPRA NAV per share has increased 1.6% since 30 September 2016 to 74.4p, although the increased number of shares diluted EPRA EPS, which was 1.75p in the half (H116: 1.83p). Below we summarise the main points from the results and then look at other developments in the period.

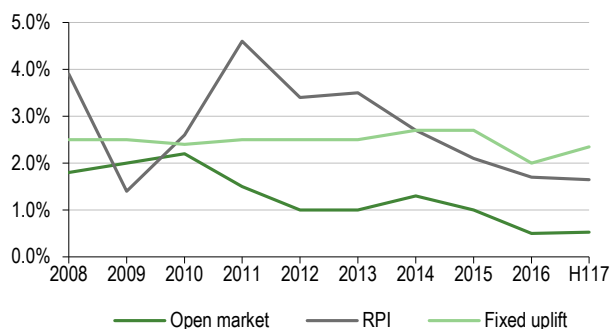
- Portfolio value increased 7.8% to £660.3m (30 September: £612.3m). The majority of the increase was due to £42.4m of additions, with a contraction in yields from 5.22% to 5.17% over the half contributing to a £6.6m increase in asset valuations. There was also a slight (£0.1m) headwind as the pound strengthened against the euro, reducing the sterling value of Irish assets, and a single asset was sold for its book value of £0.8m.
- The new assets helped increase the rent roll by £1.9m to £39.1m, of which 89.7% is paid directly or reimbursed by the NHS, Irish GPs or the HSE. Rent reviews on £5.3m of existing rents gave an average annual increase of 1.08%. As in recent periods, open market reviews delivered the lowest increase, averaging 0.53%, whereas index-linked and fixed uplifts were 1.65% and 2.35% on average respectively. Reviews of £22.8m of rents are ongoing.
- MedicX has funded acquisitions in part using equity, with net proceeds from sales of shares from its block listing facility of £20.2m. Additional debt of £11m was drawn in the period, taking net debt to £337.0m (30 September £315.3m) and the net gearing (net debt to gross assets less cash) ratio remained stable at 50.4% (30 September 50.8%); the board's upper limit is 65%, however an average of 50% is expected over time.
- The weighted average cost of debt is 4.38%, as was the case in 2016, the average maturity of 13.2 years remains close to the weighted average unexpired lease term of 14.3 years for the portfolio. MedicX entered into a new facility agreement with the Bank of Ireland in March, for €29.1m. This provides development finance and then a term loan for five years once the four Irish secured assets reach completion (as Mullingar PCC already has). The development funding has a margin of Euribor +4%, reducing to 3% once rents start after completion. Once drawn, this facility will reduce the average cost of debt to 4.27% and the average term to 12.6 years.
- A quarterly dividend of 1.5p was announced in April and a total of 6p is expected to be paid in respect of FY17 (FY16: 5.95p), equivalent to a 6.7% yield on the current share price. Dividend cover from EPRA earnings was reduced, mainly because of the higher number of shares, from 63% to 59%, with less difference on an underlying basis (including rents from property under construction). Underlying cover was 71% in FY16 and 70% in H117.

Outlook

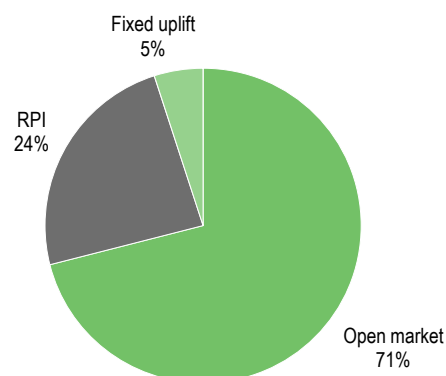
For MedicX specifically, the short-term outlook is good: the dip in dividend cover in H117 was mainly due to the £20.7m investment in the four Irish assets being funded initially entirely from equity; and the use of the block listing facility increased the share count, diluting earnings, and therefore dividend cover, by 3.2%. The drawdown of euro-denominated debt to fund the remaining development costs will stop that effect and, once complete, the Irish PCCs are expected to contribute €3.4m of rent each year, increasing dividend cover.

There are also encouraging signs that rental growth may pick up after several years of growth behind the long-term average. This is being driven by three factors: first, an increase in inflation – 24% of rents are index-linked, so rising inflation will have a direct effect on rental growth in future periods. Second, the proportion of the portfolio on which rent reviews are index-linked is rising – all

the Irish assets have five-yearly rent reviews linked to CPI, in line with HSE policy, and two large assets acquired recently near Birmingham are partly RPI linked. Management reports that as the need for new and relatively large premises in the UK becomes more pressing, clinical commissioning groups (CCGs) and NHS England are exploring longer leases on index-linked uplifts in return for lower headline passing rents. This leads to the third factor of rising land and construction costs, which are higher today than in the past. New schemes will only be built based on higher rents than have previously been agreed, which will feed through to rent reviews on existing stock.

Exhibit 1: Past rent uplifts by type of review


Source: Company data

Exhibit 2: Rent review breakdown by value


Source: Company data

Demand for modern primary care properties is robust and the investment pipeline is reported to be strong, at £110m, split roughly evenly between the UK and Ireland. The fund was able to invest £42.4m in H117, well over half our assumption for the full year, which was £77.5m. The second half has already seen €15.5m committed to a fourth Irish asset. We have therefore increased our investment assumption for FY17 to £97m and the effect on our estimates is explained on page 4.

The outlook for the wider market remains positive and unchanged: primary healthcare property continues to perform well and to attract investment, further reducing yields on modern, purpose-built assets such as the ones in which MedicX invests, which puts upward pressure on valuations, although it makes new investment more expensive. MedicX has taken several steps to ensure that it can maintain its pipeline of assets with as little concession on yield as possible. Apart from the move into Ireland, it has renewed the framework agreement with the General Practice Investment Corporation (GPIC), announced a new framework agreement with Medcentres and has entered into a JV with GPIC, which will effectively be an incubator for new assets to add to the portfolio. We expect that MedicX will be able to maintain its disciplined approach to investment, and examine the measures taken in more detail on pages 4-5.

Investor demand for assets is currently not being met by new supply. In the UK, the overwhelming majority of GPs are reimbursed for all their work, and for premises costs, by the NHS. This means that all new developments have to be approved and that there is no speculative development. It is expected that the execution of Sustainability and Transformation Plans (STPs) published as drafts in October 2016 by the 44 regional boards for review by NHS England will lead to increased development of the primary care estate. The King's Fund report on these STPs, published in February 2017, notes that: "All STPs set out proposals for redesigning primary care and community services and delivering more services outside of hospitals and in people's homes. These proposals invariably describe commitments to break down barriers between services and to develop care that is more integrated, including between the NHS and local authorities. General practices are typically at the heart of these new care models..."

Various individual STPs include specific plans for new primary care premises, and it is likely that some more development will take place at an increasing pace as the wider NHS Five Year Forward

View is put into action, scheduled to be by 2020. As new premises are built, they will provide new comparisons for district valuers when setting rents on existing stock. Newer buildings will have been constructed at greater cost, rents will have been agreed in advance at a level that provides a return on the developers' investment, and an increase in supply should therefore be beneficial for rental income from existing primary care assets.

The general election may delay some decisions, but is highly unlikely to change the direction of travel for healthcare in the UK, which is for primary care to be remodelled to provide more services and make them more easily accessible, alleviating pressure on acute care hospitals and freeing up hospital beds. All political parties are committed to improving the provision of healthcare and we therefore expect the demand for modern primary care premises to translate into new development in the medium term.

Changes to estimates

The principal effects on our FY17 estimates have come from the issue of shares: the greater number of shares has slightly reduced our EPS forecast and therefore dividend cover, but increased equity and therefore NAV per share. In FY18, the effect of portfolio growth above our previous assumptions gives higher revenues. We now assume £97m of new investment in FY17, vs £77m previously and maintain our assumption of £100m in FY18. These amounts are shared between standing let assets (which provide an immediate rental income), development assets (which provide an immediate return on the funding provided to the developer) and forward funded (where there is capital committed but not necessarily any return until money is actually spent). There is a lag therefore between commitment and income. Investment in 2016 was slightly behind our assumptions, so H117 has seen slightly lower revenue than we had forecast, but because H117 investment was strong, our expectations for 2018 are up. This change mitigates the effect of the new shares on EPS. We have not changed our dividend forecasts.

Exhibit 3: Changes to estimates

	Revenue (£m)			EPS (p)			DPS (p)			Dividend cover (%)			EPRA NAV/share (p)			EPRA NNAV/share (p)		
	Old	New	% chg	Old	New	% chg	Old	New	% chg	Old	New	pp chg	Old	New	% chg	Old	New	% chg
09/17e	39.4	38.5	(2.1)	3.9	3.6	(7.3)	6.00	6.00	0.0	64.4%	59.1%	(5.3)	73.7	74.7	1.4	57.4	63.0	9.7
09/18e	42.7	42.9	0.4	3.9	3.9	(1.6)	6.05	6.05	0.0	64.9%	63.8%	(1.1)	74.1	74.9	1.0	57.9	63.2	9.0

Source: Edison Investment Research

Apart from allowing for £0.25m of costs associated with REIT conversion (see below), our other assumptions all remain unchanged. We do not forecast further yield compression, although sustained low interest rates may continue to increase investor demand for assets with secure income streams.

Any change in rent increases on review would also have an impact on our estimates; we assume an annualised increase of 1.5% pa on one-third of the portfolio (rent reviews on UK assets are typically every three years), close to the average achieved in H117. Accelerated NHS approvals for new development would likely help exceed our assumption. Management does not intend Irish assets to comprise more than 15% of the portfolio; rents on these are typically reviewed every five years and are indexed to CPI. In April, [Irish CPI](#) was running at 0.9%, so we have not adjusted our assumption.

Other developments

Since our [Outlook note](#) in December, MedicX has made several other announcements, including the intention to convert to a REIT and the launch of a joint venture with GPIC, which we examine below.

REIT conversion

On 15 March the fund announced its intention to ask shareholders to vote on MXF becoming a UK tax resident and converting to a REIT. This will not have any immediate effect on the fund itself, its portfolio or our estimates. The London Stock Exchange website has a [summary](#) of the REIT requirements, with the main criteria already being satisfied by MXF, including the level of distributions made, the type of business it conducts, the capital and share structure of the Fund and its listing. If shareholders support the conversion, MXF will move its management and control to the UK and change the composition of the board, with the appointment of Mrs Helen Mahy as a non-executive director being the first step in both processes. The rationale for the proposed conversion is clear: as MXF generates more taxable profits, shareholder returns can be protected under the REIT regime, which would exempt MXF from corporation tax on its income and capital profits from the UK qualifying business. It will change the tax status of distributions made to shareholders by MXF too: 90% of a REIT's UK property rental business profits must be distributed to shareholders as a Property Income Distribution (PID), which is taxed in the same way as income from a let property. Other distributions may be made as normal dividends (most REITs pay some PID and some dividends) and are taxed accordingly.

The conversion to a REIT will not affect our forecasts significantly: we have already assumed that MXF is tax efficient in making our estimates and we do not expect the total level of distributions to be affected. We have allowed for £0.25m of exceptional relocation costs and fees and no ongoing additional expenses.

Joint venture with GPIC

The JV was announced at the end of January and is effectively an incubator for properties that do not currently meet the criteria for inclusion in MedicX's portfolio, but may do so in future. It widens the range of properties to which MedicX will have access in future, without compromising the quality of the investment portfolio. The other participant in the JV is the developer General Practice Investment Corporation (GPIC), with which MedicX already has a framework agreement under which over £80m of assets have been delivered to the fund since 2012 (the framework agreement has also been extended for five years).

The JV is jointly controlled and called GP Property, and is expected to make its first investment in the near future. It will invest in properties that do not yet meet MedicX's investment policy, for instance properties that have unexpired leases less than 15 years long, but where there is an opportunity to improve the building or the lease so that it does meet the criteria. GP Property will therefore seek strategic investments in assets that are expected to lead to asset management opportunities or contracts for new developments. MedicX will provide the capital, initially agreed to be up to £15m, and GPIC will provide the asset management and development expertise. MedicX will receive a 5% pa preferred return on its capital, topped up to 8% compounded on any disposal of investment properties or sale into MedicX Fund. Any profits above that level will be shared equally with GPIC. Exhibit 4 illustrates the returns to MedicX from the JV up to that level, assuming an initial contribution of £15m and the assets being sold five years later. The top line shows the capital invested as if it were rising at an 8% compound rate pa, line two shows the annual 5% preferred return and line four shows the top-up payment in year five to reach an 8% compounded return.

Exhibit 4: Illustration of GP Property returns to MedicX Fund (£000s)

Year	0	1	2	3	4	5
Capital (increasing 8% pa)	15,000	16,200	17,496	18,896	20,407	22,040
Annual return to MXF		750	750	750	750	750
Cumulative return		750	1,500	2,250	3,000	3,750
Top-up amount						3,290
Compounded 8% return						7,040

Source: Edison Investment Research

GP Property can borrow up to 50% of gross asset value, but there is no near-term intention to take on debt. If GP Property needs further capital from MedicX Fund beyond £15m, approval will be sought from MedicX's shareholders. Octopus Healthcare's Investment Adviser agreement with MedicX will be extended to cover GP Property, providing the same management, rent collection and back office services for the same fee as if the assets were owned directly by MedicX Fund (but paid by the JV).

Most importantly, MedicX Fund will have the option every five years to acquire directly properties delivered by the JV if they meet its investment policy. We have not increased our investment assumptions for the forecast period at this stage, but view the JV and the extension of the framework agreement as positive for the future pipeline, which was reported to stand at c £80m of assets under negotiation or in solicitors' hands in the February NAV update.

Valuation

MedicX Fund continues to offer a high prospective dividend yield of 6.7% with the dividend 59% covered by earnings generated by a portfolio of rents with a weighted average unexpired lease term of over 14 years. The vast majority (c 90%) of these rents are effectively underwritten by the UK and Irish governments, and therefore provide a secure, long-term source of income. The shares trade at a premium of c 19% to reported EPRA NAV. For comparison, the UK Treasury 6% 2028 Gilt currently trades at a c 53% premium to par value. We would argue that MXF's premium reflects the quality and length of its revenue streams, the underlying demographic drivers of demand for primary care premises and the political will in the UK and Ireland to reform the provision of care, but still compares favourably to other investments with similar characteristics.

Exhibit 5: Financial summary

Year end 30 September	£'000s	2013	2014	2015	2016	2017e	2018e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		25,537	29,488	33,669	35,517	38,545	42,883
Cost of Sales		(413)	(666)	(902)	(1,195)	(1,326)	(1,048)
Gross Profit		25,124	28,822	32,767	34,322	37,219	41,835
EBITDA		20,616	23,664	27,255	28,566	31,370	36,856
Operating Profit (before GW and except.)		20,616	23,664	27,255	28,566	31,370	36,856
Intangible Amortisation		0	0	0	0	0	0
Revaluation of investment properties		248	11,649	25,603	15,523	11,195	9,776
Investment advisory performance fee / loss on disposal of property		(240)	(1,888)	0	(1,522)	(25)	0
Costs of REIT conversion		0	0	0	0	(250)	0
Operating Profit		20,624	33,425	52,858	42,567	42,291	46,632
Net Interest		(10,959)	(12,989)	(13,736)	(14,380)	(16,450)	(20,352)
Profit Before Tax (norm)		9,657	10,675	13,519	14,186	14,920	16,505
Profit Before Tax (FRS 3)		9,665	20,436	39,122	28,187	25,841	26,281
Deferred tax on fair value movements in property values		(299)	(264)	(3,293)	(1,556)	(1,072)	0
Profit After Tax (norm)		9,657	10,675	13,519	14,186	14,920	16,505
Profit After Tax (FRS 3)		9,366	20,172	35,829	26,631	24,769	26,281
Average Number of Shares Outstanding (m)		263.4	341.4	361.3	374.5	413.9	428.3
EPS - normalised (p)		3.7	3.1	3.7	3.8	3.6	3.9
EPS - FRS 3 (p)		3.6	5.9	9.9	7.1	6.0	6.1
Dividend per share (p)		5.70	5.80	5.90	5.95	6.00	6.05
Dividend cover		63.8%	53.6%	63.3%	63.8%	59.1%	63.8%
BALANCE SHEET							
Fixed Assets		426,649	502,906	553,479	612,264	704,007	816,283
Intangible Assets		0	0	0	0	0	0
Tangible Assets		399,502	492,252	544,490	597,410	689,452	796,283
Properties under construction		27,147	10,654	8,989	14,854	14,556	20,000
Current Assets		38,067	39,306	63,688	29,487	27,942	28,788
Stocks		0	0	0	0	0	0
Debtors		11,004	8,181	6,778	8,519	7,942	8,788
Cash		27,063	31,125	56,910	20,968	20,000	20,000
Current Liabilities		(19,994)	(56,714)	(20,862)	(21,906)	(19,856)	(21,970)
Creditors		(18,865)	(23,866)	(18,966)	(19,923)	(19,856)	(21,970)
Short term borrowings		(1,129)	(32,822)	(1,896)	(1,983)	0	0
Financial derivatives		0	(26)	0	0	0	0
Long Term Liabilities		(273,732)	(254,798)	(342,208)	(341,684)	(399,335)	(509,138)
Long term borrowings		(272,615)	(253,485)	(336,412)	(334,307)	(390,889)	(500,692)
Other long term liabilities		(1,117)	(1,313)	(5,796)	(7,377)	(8,446)	(8,446)
Net Assets		170,990	230,700	254,097	278,161	312,758	313,963
Net Assets excluding goodwill and deferred tax		171,832	231,764	258,428	284,048	319,717	320,922
NAV/share (p)		62.2	65.1	69.6	71.7	73.1	73.2
EPRA NAV/share (p)		62.5	65.4	70.8	73.2	74.7	74.9
Est. value/share of Fund's long-term fixed rate debt (p)		6.3	-0.4	-6.9	-15.2	-10.1	-10.1
EPRA NNAV/share including benefit of long-term debt (p)		68.5	64.7	62.7	56.4	63.0	63.2
CASH FLOW							
Operating Cash Flow		18,515	23,639	23,362	25,949	31,789	38,125
Net Interest		(11,495)	(11,342)	(13,210)	(14,541)	(16,171)	(20,352)
Tax		0	0	0	0	0	0
Capex		0	0	0	0	0	0
Acquisitions/disposals		(30,428)	(42,161)	(23,316)	(36,281)	(80,857)	(102,500)
Financing		(1,757)	55,577	6,119	12,408	33,801	0
Dividends		(13,610)	(16,759)	(19,247)	(21,582)	(24,066)	(25,075)
Net Cash Flow		(38,775)	8,954	(26,292)	(34,047)	(55,503)	(109,802)
Opening net debt/(cash)		189,206	246,681	255,182	281,398	315,322	370,889
HP finance leases initiated		0	0	0	0	0	0
Other items (including debt assumed on acquisition)		(18,700)	(17,455)	76	123	(1)	(0)
Closing net debt/(cash)		246,681	255,182	281,398	315,322	370,826	480,692

Source: MedicX Fund, Edison Investment Research

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