EDISON

Primary Health Properties

Continuing to find acquisition opportunities

Acquisition

Real estate

Primary Health Properties (PHP) has agreed the acquisition of a large and modern primary care facility in the Republic of Ireland (RoI), its third to date, at a cost of €20m. Yields in the RoI remain noticeably ahead of those currently available in the UK despite some signs of competition. Acquisitions of c £70m since end-H1, and a current contracted rent roll of just over £73m, are in line with our forecasts for the year and sufficient to trigger investment adviser performance fees, now included in reported, but not underlying, earnings forecasts. Acquisitions, rent increases, and long and largely government-backed leases underpin PHP's attractive, growing and fully covered dividend, which we expect to continue its 20-year growth trend.

Year end	Revenue (£m)	Adj earnings* (£m)	EPS* (p)	DPS (p)	EPRA NAV/ share (p)	P/NAV (x)	Yield (%)
12/15	63.1	21.7	4.9	5.000	87.7	1.30	4.4
12/16	67.4	26.7	4.8	5.125	91.1	1.25	4.5
12/17e	71.9	31.8	5.3	5.250	96.6	1.18	4.6
12/18e	77.9	34.7	5.7	5.360	99.1	1.15	4.7

Note: *Adjusted earnings are on an underlying EPRA basis, excluding valuation movements and other exceptional items, and further adjusted for performance incentive fees.

Strong investor interest continuing

PHP has continued to source asset growth in H217 despite continuing strong investor interest in the secure, long-term income streams available on primary healthcare property and tightening yields. 90% of PHP's UK rents and 75% in Ireland are government-backed, and the comparison with 10-year gilt yields of c 1.3% is stark. The net initial yield reflected in PHP's portfolio contracted from 5.17% to 5.04% in the first half of the year and, while we do not forecast further tightening (our forecast valuation gains are driven off rent growth), more recent updates from peers suggest this is possible. While good for reported NAV, yield tightening reflects an increased cost of acquiring assets for growth.

Structural growth opportunity

In both the UK and Ireland, there is broad political will to reform healthcare provision, placing more emphasis on primary care to meet the needs of growing and ageing populations with increasing healthcare needs. The requirement for larger, more flexible, higher-quality premises will provide significant investment opportunities for PHP and others in coming years. There are some indications that in the UK, NHS new-build commissioning of much needed properties may be starting to increase, providing opportunities for investment and support for market rental growth. Meanwhile, the RoI continues to offer yields that are perhaps 150bp higher, while continuing to provide a strong covenant.

Valuation: Secure and growing income

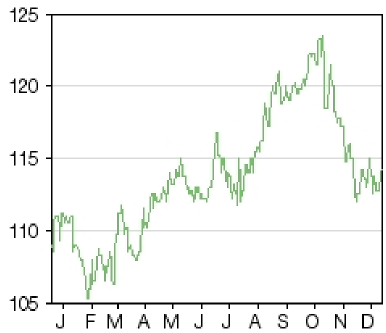
We are forecasting a fully covered FY18 prospective 4.7% dividend yield. Revenues are supported by secure, long-term income in a market that is much less sensitive to economic cycles than other commercial real estate subsectors, and therefore shows less volatility in occupancy, rents and valuation.

18 December 2017

Price	**114.25p**
Market cap	**£697m**

Net debt (£m) at 30 June 2017	670.7
Net LTV at 30 June 2017	53%
Shares in issue	610.3m
Free float	98%
Code	PHP
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.2)	(4.4)	3.9
Rel (local)	(1.3)	(6.0)	(4.5)
52-week high/low		123.5p	105.2p

Business description

Primary Health Properties is a long-term investor in primary healthcare property in the UK and, more recently, Ireland. Assets are mainly long-let to GPs and the NHS or HSE, organisations backed by the UK and Irish governments, respectively. The tenant profile and long average lease duration provide an exceptionally secure rental income stream.

Next events

2017 results	Expected February 2018

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Edison profile page

Primary Health Properties is a research client of Edison Investment Research Limited

Continuing investment

PHP has agreed to acquire a large, modern primary healthcare facility in County Cork in the Republic of Ireland (RoI) for €20m. This is PHP's third acquisition in Ireland, where yields remain noticeably higher than in the UK, and its seventh acquisition in the second half of the current year to date. The overall portfolio has now reached 307 assets (H117: 300) with an aggregate gross asset value of more than £1.35bn (H117: £1.27bn) and contracted rent roll of just over £73m (H117: £69.7m). The three RoI assets represent an aggregate investment of c €34m or c £30m.

The County Cork health centre has a lettable area of 6,500sqm and will be fully let to the Health Service Executive (HSE), GPs and complementary tenants, including a dentist, optician and physiotherapist. The HSE is the government executive agency that provides healthcare in the RoI and it has committed to a new 25-year lease covering 65% of the rent roll. The GPs have also entered into long leases.

We show a brief summary of PHP's acquisitions since 30 June 2017 below and note that the amount committed year to date and indicated portfolio contracted rent roll are closely in line with our existing estimates.

Exhibit 1: Announced acquisitions in H217 to date

Date of announcement	Asset	Asset type	Total cost (£000s)	GLA* (sqm)
27-Jul-17	Low Grange Health Village, Middlesbrough	Standing		
27-Jul-17	Evenwood Medical Centre, Bishop Auckland	Standing		
	Subtotal		27,100	N/A
27-Jul-17	Syston Health Centre, Leicestershire	Standing	8,400	2,575
18-Sep-17	Croft Medical Centre, Chelmsley Wood	Standing	4,670	1,175
09-Oct-17	Stenhousemuir	Standing	8,650	2,450
27-Nov-17	Wincanton Medical Centre, Wincanton	Standing	4,370	983
14-Dec-17	Medical Centre, County Cork	Standing	17,544	6,500
	Total		**70,734**	**13,683**

Source: Company announcements. Note: *Gross lettable area.

We have made no changes to our forecasts other than to update for the recent conversion of £10.4m nominal of the group's outstanding convertible bond issue, and to recognise forecast investment adviser performance fees (PIF) in our stated earnings estimates, as these are now likely.

The recent bond conversion was settled by the issue of 10.7m new shares. £72.1m nominal of the £82.5m nominal of bonds that were issued in May 2014 remain. They pay a coupon of 4.25% and mature in 2019 unless previously converted at a price of 97.5p. Under the terms of the issue, since May 2017 the company has had the option to redeem the bonds at par as long as their parity value exceeds £130,000. At mid-year 2017, the bond had a fair value of £96.4m and if PHP chooses to convert the whole bond, and to settle the conversion rights wholly in shares, it would issue c 85m new shares in aggregate, or c 14% of the pre-conversion share capital. Conversion eliminates the negative fair value adjustment recorded in the balance sheet (£13.9m at H117), with a corresponding income statement gain and no impact on EPRA earnings or NAV. The saving on debt costs (c £3.5m pa) would substantially offset the increase in dividend costs (£4.3m if based on full entitlement to our forecast 2018 DPS). On our forecasts, the dividend would remain fully covered, but cover would be slightly reduced before any benefit from accretive additional investment.

In April 2017, the investment advisory agreement with Nexus was revised, reducing the fees payable to Nexus for the management of the PHP property portfolio, backdated to 1 January 2017. At the same time the PIF was revised so as to be based on net asset value total return on an EPRA NAV basis rather than IFRS. The latter had been subject to impacts beyond the control of the adviser, including accounting changes and non-cash adjustments in relation to the mark to market of interest rate swaps and the convertible bonds. The PIF entitles Nexus to 11.25% of the EPRA NAV total return (change in NAV plus dividends paid) above a hurdle rate of 8%. Performance against the hurdle rate is carried forward in a notional cumulative account, with any payment of the PIF in future years being subject to the account being in surplus. Further, payment in any one year is capped at the lower of £2m or 20% of management fees (we estimate this cap to represent a little more than £1.3m in the current year) and, for the first three years, that any payment does not reduce dividend cover below 98%.

Our reconfirmed estimates imply an EPRA NAV total return of 11.8% in FY17, sufficient to trigger payment of the PIF, with the amount capped to 20% of management fees. We have now allowed for c £1.0m in respect of FY17 PIF to be paid in two equal parts over this year and next, with next year's payment indicated by a forecast FY18 EPRA NAV total return that slightly exceeds the hurdle; the total forecast payment in FY18 increases as a result, including a small FY18 component, to c £0.6m. It is our practice to make adjustment to earnings for performance fees (c 0.1p per share in both FY17 and FY18) and so this has no change to our adjusted EPS forecasts or underlying dividend cover. Without adjustment, FY17 dividend cover would be c 100% compared with the underlying 101% (FY18: 104% versus the underlying 106%) that is shown in the financial summary table below. The summary table also shows EPRA EPS (including PIF) alongside adjusted EPS (excluding PIF).

Exhibit 2: Financial summary

£'000s	2015	2016	2017e	2018e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	63,115	67,439	71,883	77,909
Cost of Sales	(852)	(868)	(1,018)	(1,104)
Gross Profit	62,263	66,571	70,865	76,805
Administrative expenses	(6,807)	(7,332)	(8,295)	(8,663)
EBITDA	55,456	59,239	62,570	68,142
Other income and expenses	0	0	0	0
Non-recurring items	0	0	0	0
Net valuation gain on property portfolio	39,767	20,686	37,021	14,402
Operating profit before financing costs	95,223	79,925	99,591	82,544
Net Interest	(33,727)	(32,490)	(31,261)	(34,086)
Non-recurring finance income/expense	0	0	0	0
Early loan repayment fees	0	(24)	0	0
Fair value gain/(loss) on interest rate derivatives and convertible bond, and swap amortisation	(5,464)	(3,710)	(1,000)	0
Profit Before Tax	56,032	43,701	67,330	48,458
Tax	0	0	0	0
Profit After Tax (FRS 3)	56,032	43,701	67,330	48,458
Adjusted for the following:				
Net gain/(loss) on revaluation	(39,767)	(20,686)	(37,021)	(14,402)
Fair value gain/(loss) on derivatives & convertible bond	5,464	3,710	1,000	0
Profit on termination of finance lease	0	0	0	0
Early loan repayment fees	0	24	0	0
Issue costs of convertible bond	0	0	0	0
EPRA basic earnings	21,729	26,749	31,309	34,056
Adjust for performance incentive fee (PIF)	0	0	521	637
Adjusted earnings	21,729	26,749	31,830	34,693
Period end number of shares (m)	446.3	598.2	610.3	611.8
Average Number of Shares Outstanding (m)	445.6	560.0	599.8	611.2
Fully diluted average number of shares outstanding (m)	530.2	644.6	683.9	685.1
EPS - fully diluted (p)	11.2	7.3	10.4	7.6
EPRA EPS (p)	4.9	4.8	5.2	5.6
Adjusted EPS (p)	4.9	4.8	5.3	5.7
Dividend per share (p)	5.000	5.125	5.250	5.360
Dividend cover	98%	100%	101%	106%
BALANCE SHEET				
Non-current assets	1,100,621	1,220,155	1,329,987	1,453,656
Investment properties	1,100,612	1,220,155	1,329,787	1,453,456
Other non-current assets	9	0	200	200
Current Assets	7,034	8,442	6,810	8,569
Cash & equivalents	2,881	5,099	2,420	3,797
Other current assets	4,153	3,343	4,390	4,773
Current Liabilities	(34,864)	(32,260)	(34,838)	(36,176)
Current borrowing	(862)	(803)	(800)	(800)
Other current liabilities	(34,002)	(31,457)	(34,038)	(35,376)
Non-current liabilities	(727,431)	(697,141)	(751,112)	(857,840)
Non-current borrowings	(696,878)	(667,630)	(730,312)	(837,040)
Other non-current liabilities	(30,553)	(29,511)	(20,800)	(20,800)
Net Assets	345,360	499,196	550,848	568,210
Derivative interest rate swaps	35,278	33,306	24,700	24,700
Change in fair value of convertible bond	10,931	12,456	13,900	13,900
EPRA net assets	391,569	544,958	589,448	606,810
IFRS NAV per share (p)	77.4	83.5	90.3	92.9
EPRA NAV per share (p)	87.7	91.1	96.6	99.2
CASH FLOW				
Operating Cash Flow	57,145	56,838	62,718	69,097
Net Interest & other financing charges	(35,623)	(45,886)	(35,497)	(32,358)
Tax	0	(51)	0	0
Acquisitions/disposals	(29,477)	(97,359)	(71,967)	(109,267)
Net proceeds from issue of shares	(139)	145,232	0	0
Debt drawn/(repaid)	19,986	(31,837)	72,900	105,000
Equity dividends paid (net of scrip)	(21,083)	(24,734)	(29,835)	(31,096)
Other	0	15	(1,000)	0
Net change in cash	(9,191)	2,218	(2,680)	1,376
Opening cash & equivalents	12,072	2,881	5,099	2,419
Closing net cash & equivalents	2,881	5,099	2,419	3,796
Debt	(697,740)	(668,433)	(731,112)	(837,840)
Net debt	(694,859)	(663,334)	(728,693)	(834,044)
Net LTV	62.7%	53.7%	54.2%	56.7%

Source: Company data, Edison Investment Research

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