MedicX Fund

FY15 interim results

No surprises with interim results

Real estate

NHS planning suggests good growth prospects for the primary care property sector, and the election result suggests policy continuity. MedicX Fund offers a low-risk approach; it is neither developer nor operator but a long-term investor. A broad portfolio of modern primary care properties, long, quasi government-backed, leases, and similar duration fixed-rate debt with modest (c 50%) gearing, provide secure cash flows to support the c 7.2% prospective yield. Interim results show earnings growth on track with dividend cover building.

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	7.0	69.4	97.0
09/14	29.5	10.7	3.1	5.8	7.1	65.3	93.4
09/15e	33.7	13.0	3.6	5.9	7.2	63.5	N/A
09/16e	37.2	13.7	3.7	6.0	7.3	63.9	N/A

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

Growth as expected, with dividend cover increasing

Adjusted earnings (excluding £12.8m of valuation gains) increased 49% to £7.0m compared with H114 (and 17% vs H214). Dividend cover is showing the expected trend increase. Strong competition for attractively-yielding completed assets is driving valuation gains. While this increases 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. The Fund committed £17.2m in H1 (mostly in better-yielding forward-funding commitments) and expects this to accelerate in H2, based on a strong investment pipeline of c £100m.

Post-election growth prospects remain strong

The outcome of the election provides continuity in the government's approach to the NHS, enabling the process of change to continue without significant delay or alteration. The five-year plan acknowledges the need for significant change in the NHS. It seeks to deliver additional and more integrated services more efficiently in the community, with the GP remaining the cornerstone of NHS delivery, providing extended opening hours to improve access. GP practices will need to become more competitive to survive, and larger, better premises will be needed. The medium-term prospects for asset growth for long-term investors in modern, purpose-built premises, such as MedicX Fund, appear strong.

Valuation: Attractive yield with cover increasing

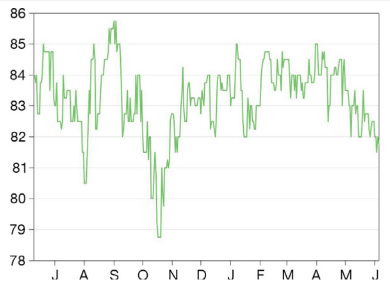
Barring unforeseen circumstances, a dividend of 5.9p is indicated for FY15 – a prospective yield of 7.2%. With portfolio growth, dividend cover is building; we forecast 61% in FY15 and c 62% in FY16. The Investment Adviser's DCF value per share of the Fund's predictable cash flows is currently 93.5p.

8 June 2015

Price	**81.75p**
Market cap	**£298m**

Net debt (£m) at 31 March 2015	265.6m
Shares in issue	364.4m
Free float	100%
Code	MXF
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.5)	(1.8)	(2.7)
Rel (local)	(0.6)	(0.7)	(4.5)
52-week high/low		85.8p	78.8p

Business description

MedicX Fund is a specialist investor in primary care infrastructure. It holds a portfolio of 142 properties (including those under construction), let mainly to government-funded (NHS) tenants (90%) and pharmacies on GP surgery sites (8%).

Next event

Q3 ex-dividend date	13 August 2015

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Edison profile page

MedicX Fund is a research client of Edison Investment Research Limited

Summary of half-year results to 31 March 2015

Results for the six months to 31 March 2015 showed strong underlying profit growth (with continued valuation gains), as previous asset growth contributed to revenues and the revenue increase outstripped costs growth. As a result, dividend cover is showing the expected trend in improvement. The key highlights were:

- Rental income grew 24% (or by £3.2m) compared with H114, to £16.7m. Growth in H115 vs H214 was 14%. The annualised rent roll increased to £33.9m (30 September £32.8m), including £1.7m for properties under construction. 90% is reimbursed by the NHS, while an additional 8% represents rents from pharmacy operations that are co-located with medical centres.
- 74% of the rent roll is subject to open-market rent reviews, 21% is RPI linked and 5% is subject to fixed uplifts. Open-market reviews remain sluggish (1.4% average uplift) with RPI uplifts of 2.9% and fixed uplifts an underlying 2.5%. The average portfolio increase was 1.7% on the £1.4m of rent reviews agreed during the period. Management is expecting an acceleration in market rental growth to follow a pick-up in new development schemes, which should set new, higher, rental evidence to reflect underlying increases in building and land costs.
- Normalised EBITDA (excluding valuation gains and other one-offs) increased by £2.7m or 25% to £13.8m (H114 £11.1m). Growth vs H214 was 9%. Compared with H114, expense increases (15.8% excluding the H114 performance fee accrual and down 11.0% in total) continued to trail revenue growth (22.9%) as expected.
- Adjusted earnings (which exclude valuation movements, performance fees and fixed-debt break costs) increased £2.3m or 49% to £7.0m compared with H114. Growth vs H214 was 17%. In per share terms, adjusted earnings were 2.0p per share, up from 1.4p (1.7p in H214). Valuation gains, driven primarily by a further decline in the valuation yield (to 5.57% from 5.68% at 30 September 2014) as well as rental growth, were a net £12.8m (£11.6m for FY14 as a whole).
- Maintaining the progressive dividend policy, a second quarterly dividend of 1.475p was declared (payment date 30 June). A dividend of 5.9p is indicated for the current year, subject to unforeseen circumstances (FY14: 5.8p). Dividend cover, measured against adjusted earnings, reached 67% in H115 (compared with 48% in H114 and 59% in H214). H2 cover is likely to fall back a little while new funding from the recent loan note issue is deployed. Management's primary target is total shareholder return (share price plus dividends), of which the dividend yield (c 7%) is a large contributor. While it expects dividend cover to further increase, full cover is not prioritised above taking appropriate long-term decisions for the Fund.
- Total shareholder return was 5.4% during the six months (12.0% for FY14 as a whole) and has averaged 10.5% pa during the five years to September 2014. On unchanged assumptions, the discounted cash flow net asset value (NAV) increased to £340.6m (30 September 2014: £331.1m) or 93.5p per share (FY14: 93.4p per share). Adjusted NAV per share was 68.8p per share (FY14: 65.8p per share). The decline in gilt yields during the period increased the mark-to-market liability on the fixed-rate debt (from £1.5m to £26.6m), but is also an indicator that debt-raising conditions are favourable. Including this mark-to-market effect, NAV per share was 61.5p (FY14: 65.3p). Gilt yields have shown considerable volatility, and on 19 May 2015, when the Fund reported, the NAV on this measure was closer to 64p.
- Committed investment during the six months was £17.2m, representing three forward-funding commitments (£14.7m) and one completed investment (£2.5m). One of the development properties also completed in the period, within budget. The committed portfolio was £535.5m (30 September 2014: £518.2m) in 141 primary healthcare properties, of which 133 were

completed and income-producing, with all but one expected to complete within 12 months. The Investment Adviser reported a strong pipeline of approximately £100m in further acquisition opportunities. The majority of this (c £97m) relates to forward-funding with currently relatively few opportunities for the fund to acquire high-quality completed assets at its required yield. One further investment, a forward-funding agreement at a cost of £2.9m, has since been announced, taking the portfolio to 142 properties. At 19 May 2015, the average age of the portfolio was 7.2 years with a remaining average unexpired lease length of 15.4 years.

- Net debt was £265.6m at the end of the period (FY14: £255.2m) with adjusted gearing at 49.7%, at the lower end of the 50-65% range targeted over time. Adjusting for cash, total drawn facilities of £291.5m carried an all-in fixed-rate cost of 4.52% with an average unexpired term of 14.2 years (closely matching the average unexpired lease term). In April, the Fund issued £50m of new long-term loan notes to a single investor, maturing in 2018, with no amortisation, at an all-in rate of 3.838%, reducing the average weighted fixed-rate cost of debt to 4.42% with an average weighted term of 14.0 years. £25m was drawn at issue and a second £25m tranche will be drawn in September. In February 2015, the Fund issued, and immediately repurchased for treasury, 32.8m shares. These shares have been and will continue to be used to satisfy further investor demand, including scrip dividends, with sales at above NAV per share. 2m shares were sold for cash in February and March at 83.5p per share.

Portfolio update

Following the £17.2m of new commitments in H1, the total committed portfolio stood at £535.5m as of 31 March 2015, spread over 141 properties (of which 133 are completed). The completed, income-producing, portfolio was valued at £518.9m. Of the eight properties that were under development, seven are expected to complete over the next 12 months. One further investment, a forward-funding agreement at a cost of £2.9m, and due to complete in May 2016, has been announced since the interim results. This takes the portfolio to 142 properties, of which 134 are now complete and fully let. The annualised rent roll has now increased to £34.0m.

The average unexpired lease term on the properties of 15.4 years as at 31 March provides security over future cash flows, while the average age of 7.2 years and average value of £3.9m provides support that the portfolio as a whole is focused on larger, more modern properties, which should be able to meet the NHS's changing needs and create longer-term value. The five-year plan indicates a period of significant change in the NHS overall, and the shape of primary care in particular. New investments continue to be targeted at such properties, and the adviser has shown a willingness to dispose of smaller properties that may be unlikely to meet this long-term investment criteria. Three such properties were sold during FY14, with an aggregate value of c £4.3m. As of 31 March 2015, c 1% of the portfolio was in properties valued at less than £1m and 6% in properties valued between £1-2m. The average value of the four new investments in H1 was £4.3m.

Post-election outlook for primary care is positive

The process of approval by NHS Property Services for new development projects has remained frustratingly slow, but participants observe signs of acceleration, and the medium-term outlook remains strong. The future of the NHS took centre stage during the UK general election campaign. Among the major parties there was broad support for increased NHS funding and for the NHS five-year plan, which acknowledges the need for significant change within the NHS. It seeks to deliver additional and more integrated services more efficiently in the community, with the GP remaining the cornerstone of NHS delivery, providing extended opening hours to improve access. The outcome of the election provides continuity in this approach, enabling the process of change to continue without significant delay or alteration. With this continued political drive for GPs to provide a range of services that have traditionally been provided in hospitals, the quality, capacity, and flexibility of the GP surgery estate is becoming yet more important. These changes also put the spotlight on GP practices, encouraging the existing trend towards GP consolidation to create larger, multi-practitioner groups that can better provide the range of services required. At a time when more GPs are likely to be required (the Health Secretary recently estimated that an additional 5,000 GPs will be needed during the next five years), as many as one in three GPs think their workload unmanageable (source: GPonline), while recruitment, retention and GP incomes (in real terms) have all been falling. Around 70% of existing GP premises are regarded as unfit to sustain existing services or expand to deliver new services. It is clear that GP practices will need to become more competitive to survive, and that larger, better premises will be needed. The future prospects for asset growth for long-term investors in modern, purpose-built premises, such as MedicX Fund, appear strong.

The Investment Adviser's stated strategy is to invest in properties that are flexible enough to meet the current needs of the NHS as well as future requirements. When successfully implemented, this aligns investors' desire for long-term stable returns while at the same time providing clinically-efficient infrastructure to society's benefit. In addition, the Fund actively works with its GP tenants to assist with property enhancements that can support property valuations and protect long-term income and returns.

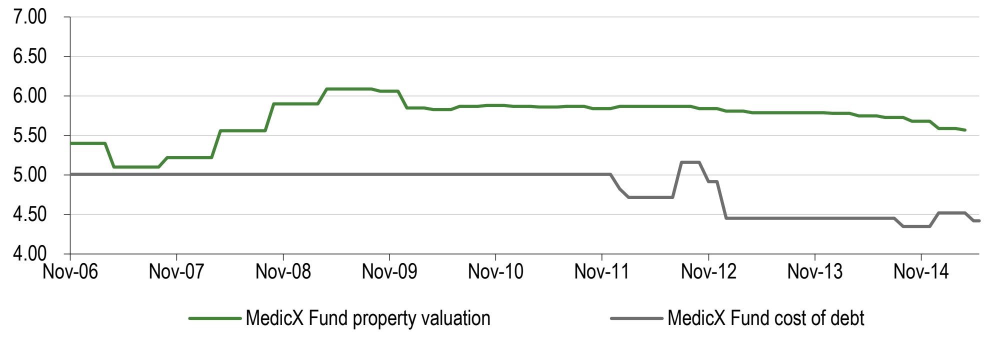
Competitive pressure on yields but spreads protected

Against the backdrop of recently muted new development, investor demand for attractive properties has remained strong, putting downwards pressure on investment yields. Institutional interest at the larger end of the market (properties valued at more than £10m), attracted to secure long-term yields, is of note.

Reflecting the market trend of yield compression, the mid-year valuation of the portfolio, conducted on the basis that all properties under construction are complete, generated a gross revaluation gain of £13.6m, partly offset by purchase and related costs of £0.8m.The net initial yield reflected in this valuation was 5.57%, down from 5.68% at September year end. While revaluation gains are positive for NAV, yield compression does make it more expensive to acquire assets, and income, while maintaining a disciplined investment strategy. Competition for portfolios of completed assets is particularly strong, with market participants indicating that some are changing hands at cash yields of below 5%, above market valuation. MedicX currently has little appetite for portfolios, if so highly priced, and completed assets in aggregate represent just c £3m of an otherwise healthy c £100m total pipeline of identified investment opportunities. £97m relates to forward-funding opportunities where the Fund is preferred investment partner and where cash returns of c 5.5% remain available.

Funding conditions have remained positive, evidenced by the Fund's recently agreed long-term borrowing at 3.838%, and a healthy spread between income and funding costs has been maintained. The Investment Adviser expects that this gap will come under competitive pressure and believes that now is a good time to lock in this attractive spread, expecting forward-funding agreements to accelerate during H2, utilising debt gearing rather than equity.

Exhibit 1: property yield versus borrowing cost



Source: Company data, Edison Investment Research. Data to 19 May 2015.

Valuation and performance

Total shareholder return (dividends plus share price movement) in the six months to 31 March 2015 was 5.4%, and during the five years to 30 September 2015 it averaged 10.5% per year, with relatively low volatility (a high of 13.1% in FY13 and a low of 8.6% in FY10). A feature of the primary care property sector is the security and visibility of income, with long leases, effectively full occupancy, and substantially government-backed rents. Income returns form an even greater share of total returns than for the mainstream commercial property sector, with less volatility in both income and capital values. The Fund's business strategy is low risk; it is neither a developer nor an operator, and the external management agreement gives certainty over costs. Growing dividends are deliberately set at a level whereby they represent a substantial element of the total return, supported by the security of income, even though not fully covered by adjusted earnings. There is a scrip dividend alternative for shareholders who do not wish to take their returns in dividends.

Yield valuation

Yield is a key attraction of the shares, and with an expected dividend for FY15 of 5.9p per share, the Fund offers a prospective yield of 7.2%.

Dividend cover is rebuilding as the proceeds of earlier equity raising are progressively invested and begin to make a full contribution to earnings. H1 showed 67% cover, based on underlying earnings, but this is likely to be lower in H2 while new funding from the recent loan note issue is deployed. Our estimates indicate that for FY15 as a whole, dividend cover will build to 61.0%, with 62.4% in FY16. MedicX estimates that cover would increase 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 yielding 5.5%.

We estimate underlying FY15 earnings represent a healthy c 5.4 % return on average net assets (FY14: 5.3%). Valuation movements are excluded from earnings on this measure but do inflate the asset base on which returns are measured.

NAV valuation

NAV per share, adjusted to exclude the impact of deferred tax not expected to crystallise, financial derivatives and the impact of resetting debt costs, was 68.8p per share at 31 March 2015, up from 65.8p in September. At a price of 81.75p, this puts the shares on a P/NAV of 1.19x. The decline in gilt yields during the period increased the mark-to-market liability on the fixed-rate debt from £1.5m to £26.6m, and including this, NAV per share was 61.5p, down from 65.3p at 30 September. Gilt yields have shown considerable volatility, and on 19 May 2015, when the Fund reported, the NAV on this measure was closer to 64p.The P/NAV on this measure is of 1.27x.

The 5.57% valuation yield on the MedicX fund portfolio at 31 March remained above the IPD All Property index yield of 5.26% at 30 April, and substantially above the prime yield of nearer to 4%. If valuation yields continue to firm, the Fund estimates that a 0.25% reduction in the H115 net initial valuation yield to 5.32% would increase the adjusted NAV per share by c 7.0p, from 68.8p to c 75.8p.

Adviser's discounted cash flow model

The Investment Adviser regularly publishes its own NAV based on discounted cash flows. The basis for the calculation, along with key sensitivities, is clearly set out in the Investment Adviser's report, and on an unchanged assumption set it generated a NAV of £340.6m (30 September 2014: £331.1m) or 93.5p per share (FY14: 93.4p per share). 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 on 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 NAV to equate to the share price at 31 March 2015 of 85.0p per share, the discounted cash flow calculation would have to assume a 1.0% increase in rents a year, or a weighted average discount rate of 8.0%.

Financials

As we would expect from the long-term investment nature of the Fund and the security of cash flows, there were few surprises in the H1 results. Our revised estimate for FY15 is slightly higher, reflecting small positive changes in both rent income and debt costs, despite slightly lower assumed asset growth (c £38m vs £45m previously). For FY16 we have a small reduction in our forecast earnings, reflecting the assumption of a higher proportion of forward-funding agreements relative to completed investments in the assumed asset growth (unchanged at £80m); for forward-funding agreements, fees ('other income' in the P&L) are earned on the amounts advanced during the development period, but the investments do not fully contribute to income until complete and occupied. The revenue deferred during FY16 by this effect should be made up in FY17 as the development properties complete.

For both FY15 and FY16, the increase in all-in NAV per share (NAV including the mark-to-market movement) benefits from a lower assumed negative adjustment of c £18m vs £22m, mirroring the adjustment indicated as of 22 May 2015 when the H1 results were reported.

Exhibit 2: Forecast changes

	Revenue (£m)			EPS (p)			DPS (p)			Adj. NAVPS (p)			All-in NAVPS (p)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
09/15e	33.4	33.7	1.0	3.5	3.6	3.4	5.90	5.90	0.0	67.5	68.3	1.2	61.4	63.5	3.4
0916e	37.6	37.2	(1.2)	3.8	3.7	(1.4)	6.00	6.00	0.0	68.0	68.7	1.0	61.9	63.9	3.2

Source: Company data, Edison Investment Research

The path to increased dividend cover is very slightly slowed in FY16 by our new forecasts. MedicX has already guided to further progress in DPS, to 6.0p per share, barring unforeseen circumstances. Our revised forecasts show dividend cover (by adjusted earnings) continuing to increase, to 61.0% in FY15 (previously 60.9%) and 62.4% in FY16 (previously 64.4%).

Our forecasts assume that portfolio growth is funded by additional debt, taking net debt to £380.3m by the end of FY16 (previously £385.6m) at a similar average cost to the existing debt. This would take the ratio of net debt to portfolio value to 58.8% in FY16, closer to the top of management's longer-term range. Adherence to this range would imply that if portfolio growth exceeds our estimates, MedicX may seek additional equity funding as well as debt funding.

Exhibit 3: Financial summary

Year-end 30 September	£000s	2013	2014	2015e	2016e
PROFIT & LOSS					
Revenue		25,537	29,488	33,723	37,199
Cost of Sales		(413)	(666)	(845)	(823)
Gross Profit		25,124	28,822	32,878	36,376
EBITDA		20,616	23,664	27,168	30,308
Operating Profit (before GW and except.)		20,616	23,664	27,168	30,308
Intangible Amortisation		0	0	0	0
Revaluation of investment properties		248	11,649	15,393	9,215
Investment advisory performance fee / loss on disposal of property		(240)	(1,888)	0	0
Operating Profit		20,624	33,425	42,561	39,523
Net Interest		(10,959)	(12,989)	(14,148)	(16,616)
Profit Before Tax (norm)		9,657	10,675	13,020	13,692
Profit Before Tax (FRS 3)		9,665	20,436	28,413	22,907
Deferred tax on fair value movements in property values		(161)	(264)	(1,130)	0
Profit After Tax (norm)		9,656	10,675	13,021	13,694
Profit After Tax (FRS 3)		9,504	20,172	27,283	22,907
Average Number of Shares Outstanding (m)		263.4	341.4	356.9	367.3
EPS - normalised (p)		3.7	3.1	3.6	3.7
EPS - FRS 3 (p)		3.6	5.9	7.6	6.2
Dividend per share (p)		5.70	5.80	5.90	6.00
Gross Margin (%)		98.4	97.7	97.5	97.8
EBITDA Margin (%)		80.7	80.2	80.6	81.5
Operating Margin (before GW and except.) (%)		80.7	80.2	80.6	81.5
BALANCE SHEET					
Fixed Assets		426,649	502,906	557,562	646,777
Intangible Assets		0	0	0	0
Tangible Assets		399,502	492,252	531,534	625,749
Properties under construction		27,147	10,654	26,028	21,028
Current Assets		38,067	39,306	31,676	39,881
Stocks		0	0	0	1
Debtors		11,004	8,181	6,676	14,879
Cash		27,063	31,125	25,000	25,000
Current Liabilities		(19,994)	(56,688)	(20,027)	(27,898)
Creditors		(18,865)	(23,866)	(20,027)	(27,898)
Short term borrowings		(1,129)	(32,822)	0	0
Long Term Liabilities		(273,732)	(254,798)	(321,569)	(407,509)
Long term borrowings		(272,615)	(253,485)	(319,341)	(405,281)
Other long term liabilities		(1,117)	(1,313)	(2,228)	(2,228)
Net Assets		170,990	230,726	247,642	251,251
Net Assets excluding goodwill and deferred tax		171,832	231,764	248,391	251,997
NAV/share (p)		62.5	65.4	67.9	68.3
Adjusted NAV per share		63.1	65.8	68.3	68.7
Est. value/share of Fund's long-term fixed rate debt (p)		6.3	-0.5	-4.8	-4.8
NAV/share including benefit of long-term debt (p)		69.4	65.3	63.5	63.9
CASH FLOW					
Operating Cash Flow		18,515	35,578	24,690	29,977
Net Interest		(11,495)	(11,342)	(13,720)	(16,616)
Tax		0	0	0	0
Capex		0	0	0	0
Acquisitions/disposals		(30,428)	(42,161)	(37,938)	(80,000)
Financing		(1,757)	55,577	6,669	0
Dividends		(13,610)	(16,759)	(17,484)	(19,301)
Net Cash Flow		(38,775)	20,893	(37,783)	(85,940)
Opening net debt/(cash)		189,206	246,681	255,182	294,341
HP finance leases initiated		0	0	0	0
Other items (including debt assumed on acquisition)		(18,700)	(29,394)	(1,376)	0
Closing net debt/(cash)		246,681	255,182	294,341	380,281

Source: Company data, Edison Investment Research

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