

# MedicX Fund

NAV update

## Attractive income

MedicX Fund Limited's portfolio of primary healthcare assets is effectively fully let with 89% of rents paid directly or indirectly by the UK and Irish governments. These have a weighted average unexpired lease term of more than 14 years, providing a secure and predictable income stream that supports a 6.7% dividend yield, which we expect to be 59% covered by EPRA earnings (excluding non-cash profits) in FY17e, rising to 64% in FY18e. A recent NAV update showed that yields in the sector continue to fall, contributing to positive valuation gains on top of dependable rents.

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	6.6	70.8	94.9
09/16	35.5	14.2	3.79	5.95	6.7	73.2	96.6
09/17e	38.4	14.9	3.59	6.00	6.7	75.1	99.7***
09/18e	43.7	16.9	3.95	6.05	6.8	75.4	N/A

Note: \*PBT and EPS are normalised, excluding deferred taxation, revaluation gains and performance fees. \*\*Investment adviser's DCF value/share. \*\*\*As at 30 June 2017.

## NAV update

EPRA NAV per share was 75.5p per share at 30 June, up 1.1p (1.5%) since 31 March after payment of 1.5p/share in dividends over the quarter. This was driven in part by a continued contraction in valuation yields from 5.17% to 5.12% over the period as well as the issue of new shares at a premium to EPRA NAV. Both factors show that demand for high yielding assets is strong, with institutional and REIT investors competing for modern, purpose-built medical facilities with long leases and shareholders attracted by the dividends these generate. As well as the pipeline of modern primary care assets in the UK, MedicX has diversified into the Republic of Ireland (RoI) including a JV with the General Practice Investment Corporation (GPIC), which will effectively act as an incubator for future portfolio additions.

## REIT conversion to protect earnings

As previously announced, in the board's opinion it would be in shareholders' interests to convert the company into a REIT in order to protect profits from UK tax charges as past tax losses are utilised and the amount of interest that can be deducted from profits for tax purposes is reduced by new rules. Consequently, changes to the board composition and the articles of the company have been proposed, and management is to be relocated from Guernsey to the UK. This has no impact on our estimates, which already allow for one-off costs of £0.25m.

## Valuation: Premium in line with peers

Demand for primary healthcare assets is driven by long-term structural demographic trends in both the UK and RoI, and in both countries the governments have embarked on restructuring programmes to improve the provision of primary care, with backing from all major political parties. The sector is therefore likely to grow and already enjoys effectively no vacancy as well as high-quality tenant covenants. MedicX's dividend yield is the highest in the sector and it trades at a similar premium to EPRA NAV (c 20%) to its closest peers.

## Real estate

30 August 2017

**Price** **89.25p**
**Market cap** **£382m**

€1.10/£

Net debt at 30 June 2017 (£m) 331.5

Shares in issue 428.5m

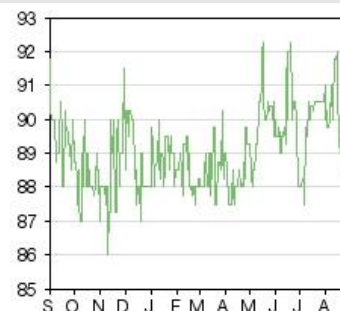
Free float 100%

Code MXF

Primary exchange LSE

Secondary exchange N/A

## Share price performance



%	1m	3m	12m
Abs	(1.4)	(0.8)	(3.0)
Rel (local)	(0.9)	1.9	(10.1)

52-week high/low 92.2p 86.0p

## 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

Final results 12 December 2017

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## Announcement summary

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The Q317 update confirmed that demand for primary healthcare infrastructure continues to be strong in both the UK and Ireland with some progress on the NHS's plans. It also gave details of investment activity and portfolio valuation changes in the period which we summarise below.

- EPRA NAV per share rose 1.1p or 1.5% from 74.4p to 75.5p after 1.5p of dividends paid. This increase was driven mainly by revaluation gains, but also by the issue of 16.5m shares at an average price of 88.15p, a premium of over 18% to EPRA NAV and equivalent to 0.52p per share at 30 June (436.0m shares in issue, of which 7.5m were held in treasury).
- The investment manager's discounted cash flow calculations gave a value for MedicX's portfolio and debt of £427.3m or 99.7p per share on 30 June, up from £405.4m and 98.4p per share at 31 March. The valuation used unchanged assumptions: 2.5% average annual rent increase for individual properties on review dates, residual values based on 1% capital growth until lease expiry (and notional sale) and discount rates of 7% on occupied properties and 8% on development assets (a weighted average of 7.07%).
- Investor interest in the sector has been strong, and has pushed up the value of existing assets to reflect a yield of 5.12% versus 5.17% at 31 March, contributing to a £4.6m valuation gain on the existing portfolio in the quarter ended 30 June 2017. Additionally, £6.8m of capital investment brought the portfolio's net book value to £671.6m (31 March: £660.2m). A further £1m was deployed via the GP property joint venture with GPIC for the acquisition of a standing let GP surgery in Lewisham.
- Practical completion was reached for the properties at Streatham, Brynhyfryd and Mullingar and all the tenants of those assets have moved in. Three standing let properties were acquired at Leavesden, Walsall and Birmingham which have total annual rent of £1.2m. MedicX also committed to forward funding agreements for properties at Cromer in the UK and Tallaght in Dublin.
- As well as Cromer and Tallaght, properties are under construction at Brynmawr in the UK and Crumlin and Rialto in Dublin. The Rialto asset is due to be completed in late 2018 and the other four should be finished within the next 12 months. MedicX also expects to sign a contract to extend its Mullingar property by over 900 square metres soon, to accommodate another HSE department.
- The 76 rent reviews in the three quarters to 30 June gave an average increase of 0.98% to the annualised rent roll from the relevant assets, compared with 1.20% in the year to 30 September 2016. RPI-linked and fixed uplift reviews generated increases of 1.66% and 2.38% respectively, while open market reviews gave an average rise of 0.36%. This has led us to trim our rental increase assumption for 2017 slightly, which we discuss in the next section.
- The Investment Adviser continues to have access to a strong investment pipeline in both the UK and Rol with £80m of assets under negotiation or in the hands of solicitors.
- In July 2017 MedicX raised £27.5m through the sale of loan notes to a new institutional lender. These have fixed interest of 3%, no amortisation and mature on 30 September 2028. Combined with the theoretical full drawdown of the new Bank of Ireland development loan facility, the notes result in an all-in fixed cost of debt of 4.27% and an average term of 12.7 years. Gearing (total debt/total assets, both net of cash) stood at 53.7% following the July issue of loan notes.
- Since the period end the board has announced a quarterly dividend of 1.5p in respect of the quarter and expects to pay a total annual dividend of 6.0p, up from 5.95p in the prior year. MedicX has also applied for a new block listing of 14.8m shares which it intends to use to

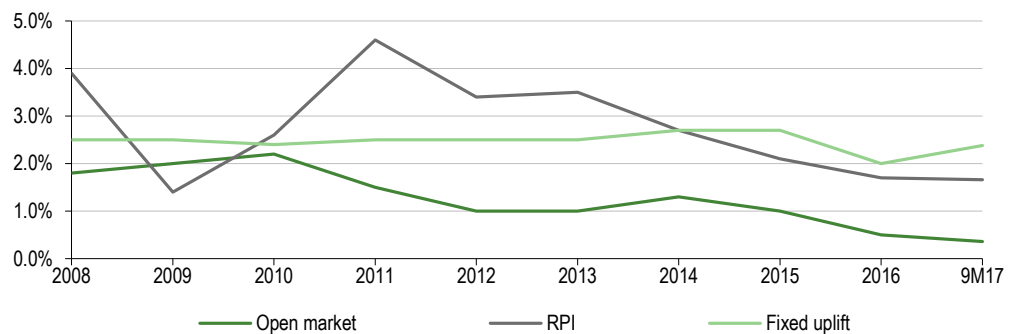
satisfy continuing investor demand and to fund further investments in line with the company's investment policy.

In the next section we examine developments in the primary healthcare real estate market before explaining some changes to our estimates.

## Market update

Although rental increases through open market review were relatively small (Exhibit 1), and we have reduced our estimate of annual rent growth for FY17 to 1.0% from 1.5%, three current trends should be of benefit to rent growth in future: progress is being made on Sustainability and Transformation Plans (STPs), which should translate into more approvals for new facilities in England; MedicX and its peers report that District Valuers (who agree rents on behalf of the NHS where it is the effective tenant) increasingly accept that rising land and construction costs should be reflected in rental increases; and the recent trend of rising inflation should feed through to the 24.5% (as at 31 March 2017) of MedicX's rents which are linked to RPI. We address these points in order below.

**Exhibit 1: MedicX annual % rental increase by different forms of review**



Source: Company data

STPs are the plans submitted in draft form at the end of 2016 by 44 English regions, made up of one or more Clinical Commissioning Groups (CCGs), to show how they intended to deliver improved care more efficiently, in accordance with NHS England's Five Year Forward View. The government has confirmed that it will provide an additional £325m of funding to support the 15 plans which have made the most progress in defining clinical strategies in each area. In some STPs the level of detail is very high, with the south west London STP envisaging £138m of spending on primary care estate over the next five years, for instance. While other areas are at an earlier stage of planning, the overall direction of travel is clear, that primary care infrastructure, of the type MedicX invests in, will be upgraded, which should provide MedicX with new opportunities to invest.

MedicX's comment that District Valuers are beginning to acknowledge that rent increases should reflect cost increases echoes those of other investors in the sector. The construction of more new primary care facilities should also help: with no speculative development in the sector, newly built assets are pre-let on mutually acceptable rents and provide comparisons to be taken into account when valuers review rents on older assets.

More broadly, the demand for modern, purpose-built facilities such as those MedicX invests in is supported by secular demographic trends and the better provision of primary care has cross-party political support in both the UK and RoI, as well as in both countries' health departments. The asset class remains highly attractive to investors as a source of stable income, which has seen yields fall in recent years. This is of benefit in terms of portfolio valuation gains, but also reflects increased competition for assets. MedicX's diversification into RoI, without significantly reducing the quality of

its income streams, goes some way to mitigating competitive pressures in the UK, and its JV with GPIC adds further scope to its investment remit without affecting the quality of the portfolio (explained in more detail in our [last note](#)).

## REIT conversion

MedicX has issued a circular to shareholders, available on the [national storage mechanism](#) and on the company website, [www.medicxfund.com](http://www.medicxfund.com), detailing the rationale for and process of REIT conversion as well as explaining the implications for shareholders. Conversion to a REIT was first proposed by the board in March and an EGM will be held at 4.30pm on 12 September for shareholders to vote on the issue. In summary, although the company's non-UK resident subsidiaries are not liable for UK corporation tax, they are liable to pay income tax, and the company's UK resident subsidiaries are subject to corporation tax. Hitherto, none has incurred any current tax, through the use of capital allowances and the utilisation of past tax losses. It is expected that after the current financial year, ending on 30 September, the majority of tax losses will have been utilised and some subsidiaries will be liable to tax on their profits in FY18. HMRC has also announced that it intends to apply new Corporate Interest Restriction rules (lowering the amount of interest and other finance costs which may be deducted from profits in calculating tax liability) retrospectively from 1 April 2017.

The board has therefore determined that REIT conversion would be in the best interests of shareholders. The effect of conversion would be to exempt the company from corporation and income tax on profits from its qualifying UK rental business, subject to REIT qualification requirements. From a shareholder's point of view, the main effect will be a change in the composition of the distributions they receive from the company: REITs are required to pay out 90% of their net rental income from qualifying property business to shareholders in the form of a property income distribution (PID). This will usually be paid net of the minimum (20%) level of UK income tax unless a shareholder can show they are exempt from that tax (for instance if the shares are held in an ISA or the holder is a charity). PIDs are taxed as property income in the UK, rather than as dividends. Any distribution above the minimum REIT requirement will be a dividend and subject to the appropriate, and different, tax. Because MedicX distributes more than it would be required to as a REIT, its future distributions are likely to be a mixture of PIDs and dividends, and we have not changed our dividend forecasts as a result of the likely conversion. Shareholders opting to receive scrip dividends will still be able to in the normal way although scrip dividends will be taxed as income.

## Changes to estimates

Exhibit 2 below shows the main changes to our estimates following the announcement. We have taken the opportunity to refresh our estimates with little change to the current year but earnings and dividend cover increased for next year.

**Exhibit 2: Changes to estimates**

	Revenue (£m)			EPS (p)			DPS (p)			Dividend cover (%)			EPRA NAVPS (p)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	pp change	Old	New	% change
09/17e	38.5	38.4	-0.5%	3.6	3.6	-0.3%	6.00	6.00	0.0%	59.1%	59.0%	-0.1%	74.6	75.1	0.8%
09/18e	42.9	43.7	1.8%	3.9	3.9	2.4%	6.05	6.05	0.0%	63.8%	65.4%	1.6%	74.7	75.4	1.0%

Source: Edison Investment Research. Note: Percentage changes subject to rounding differences.

Given its selective approach and strong investor competition for assets, we now think it unlikely that MedicX will reach the level of annual commitment that we had forecast for the current year. However, with a strong pipeline of potential investments and signs that UK commissioning may be

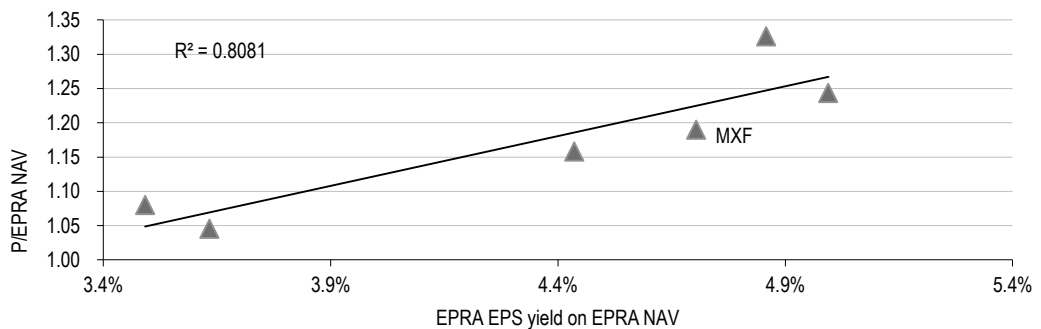
picking up, we maintain our investment forecast for next year. We have reduced the estimated FY17 commitment total to £62.7m from £97.4m while continuing to assume a level of £100m in FY18.

The impact on revenues is partly offset by a change in the pace at which we allow for development properties to complete and earn rents and also by a correction to our previous rent calculation. The net effect is that while our rental income forecasts are not materially changed, despite a slightly lower asset base, earnings and dividend cover in FY18 benefits from a lower borrowing requirement and hence lower interest costs.

## Valuation

MedicX's long-term, stable and largely government-backed income streams and 6.7% yield continue to be attractive to investors and the shares trade at a c 20% premium to EPRA NAV of 75.5p, in line with peers. The investment manager's internal DCF valuation of the portfolio and debt gives a figure of 99.7p per share, using discount rates of 7% for completed properties and 8% for developments (for a weighted average of 7.07%). The dividend is expected to be 59% covered by EPRA earnings in FY17, rising to 64% next year on our estimates. Exhibit 3 compares the share price premium to EPRA NAV with the EPRA earnings yield (EPRA EPS/EPRA NAV) for a number of companies/REITs that focus on assets with long lease duration (the constituents are listed in the note to the table). This analysis irons out differences in distribution policy and concentrates on underlying returns. Other things being equal, a high earnings yield is likely to support a high P/NAV. The sample size is relatively small but we note that in keeping with the sector, MedicX trades at a premium to EPRA NAV which is seen to be supported by an above average earnings yield. We also note that the recent strength of the euro should be beneficial to the sterling valuation of MedicX's RoI assets (a move of c 0.6p per share since 30 June which we do not currently include in our forecasts).

**Exhibit 3: Comparative valuation of REITs with significant healthcare property holdings**



Source: Bloomberg, company data. Peer group: Assura, Impact Healthcare REIT, MedicX Fund, Primary Health Properties, Secure Income REIT and Target Healthcare REIT.

**Exhibit 4: Financial summary**

Year end 30 September	£'000s	2013	2014	2015	2016	2017e	2018e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>							
Revenue		25,537	29,488	33,669	35,517	38,355	43,673
Cost of Sales		(413)	(666)	(902)	(1,195)	(1,511)	(1,699)
Gross Profit		25,124	28,822	32,767	34,322	36,844	41,975
EBITDA		20,616	23,664	27,255	28,566	30,997	36,005
Operating Profit (before GW and except.)		20,616	23,664	27,255	28,566	30,997	36,005
Intangible Amortisation		0	0	0	0	0	0
Revaluation of investment properties		248	11,649	25,603	15,523	12,897	10,210
Investment advisory performance fee/loss on disposal of property		(240)	(1,888)	0	(1,522)	(275)	0
Operating Profit		20,624	33,425	52,858	42,567	43,619	46,214
Net Interest		(10,959)	(12,989)	(13,736)	(14,380)	(16,117)	(19,104)
Profit Before Tax (norm)		9,657	10,675	13,519	14,186	14,880	16,901
Profit Before Tax (FRS 3)		9,665	20,436	39,122	28,187	27,502	27,110
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	14,880	16,901
Profit After Tax (FRS 3)		9,366	20,172	35,829	26,631	26,430	27,110
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	6.4	6.3
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%	59.0%	65.4%
<b>BALANCE SHEET</b>							
Fixed Assets		426,649	502,906	553,479	612,264	685,617	791,327
Intangible Assets		0	0	0	0	0	0
Tangible Assets		399,502	492,252	544,490	597,410	663,296	768,077
Properties under construction		27,147	10,654	8,989	14,854	22,321	23,250
Current Assets		38,067	39,306	63,688	29,487	27,866	29,041
Stocks		0	0	0	0	0	0
Debtors		11,004	8,181	6,778	8,519	7,866	9,041
Cash		27,063	31,125	56,910	20,968	20,000	20,000
Current Liabilities		(19,994)	(56,714)	(20,862)	(21,906)	(19,666)	(22,603)
Creditors		(18,865)	(23,866)	(18,966)	(19,923)	(19,666)	(22,603)
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)	(379,398)	(481,310)
Long term borrowings		(272,615)	(253,485)	(336,412)	(334,307)	(370,952)	(472,864)
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	314,420	316,455
Net Assets excluding goodwill and deferred tax		171,832	231,764	258,428	284,048	321,379	323,414
NAV/share (p)		62.2	65.1	69.6	71.7	73.5	73.8
EPRA NAV/share (p)		62.5	65.4	70.8	73.2	75.1	75.4
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	63.4	63.7
<b>CASH FLOW</b>							
Operating Cash Flow		18,515	23,639	23,362	25,949	31,302	37,767
Net Interest		(11,495)	(11,342)	(13,210)	(14,541)	(15,838)	(19,104)
Tax		0	0	0	0	0	0
Capex		0	0	0	0	0	0
Acquisitions/disposals		(30,428)	(42,161)	(23,316)	(36,281)	(60,765)	(95,500)
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)	(35,566)	(101,912)
Opening net debt/(cash)		189,206	246,681	255,182	281,398	315,322	350,952
HP finance leases initiated		0	0	0	0	0	0
Other items (including debt assumed on acquisition)		(18,700)	(17,455)	76	123	(64)	(0)
Closing net debt/(cash)		246,681	255,182	281,398	315,322	350,952	452,864

Source: Company data, Edison Investment Research

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