Update

Edison investment research

2 March 2009

Primary Health Properties

Year End	Revenue (£m)	PBT* (£m)	DPS (p)	Yield (%)	NAV/ share (p)**	Disc.to NAV (%)
12/06	12.2	3.6	13.5	5.1	N/A	N/A
12/07	15.7	2.6	15.0	5.6	374	29
12/08	19.6	5.4	16.5	6.2	320	15
12/09e	21.4	6.2	17.0	6.4	300	11

Note: *PBT and EPS are normalised, excluding goodwill amortisation and unrealised valuation gains or losses (FY06 & FY07 proforma per 2007 Report & Accounts); **EPRA NAV

Investment summary: Solid foundations

PHP is not immune to the challenges facing the UK commercial property sector. Headline results reflect the dual impact of upwards adjustments to valuation yields on the portfolio and lower interest rates on the MTM value of its swaps. However, both are non-cash items and the underlying story is continued rental growth within a portfolio that, unlike most of the sector, has minimal risk of voids or tenant default. Stable cash flows underpin the dividend, while rental growth is still being achieved at reviews due to demand for an asset class in short supply.

Primary care property: Relative outperformance

The results confirmed a 10% decline in the value of primary care properties in FY08, well below that reported by other segments of UK commercial property. That reflects a shift to a 6.2% aggregate reversionary valuation yield, from 5.5% a year earlier. All other components of the appraisal remain intact, such as rent and occupancy levels.

Stable finances: Fully let portfolio and rental growth

Revenues are derived from a portfolio that is near fully let to government-backed covenants. The group’s principal debt facilities do not mature until 2013 and cover existing liabilities and current commitments. LTV was 65% at end FY08 and is subject to a 75% cap (70% from October 2009).

Sensitivities: H109 outlook for UK commercial property

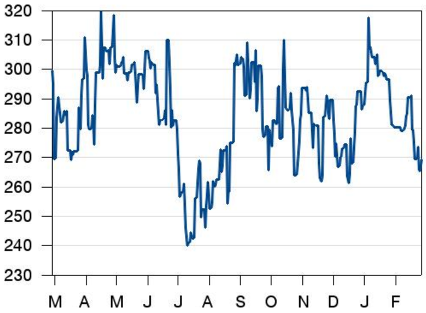
More limited access to credit on attractive terms will constrain short-term growth and, despite the distinct profile of the portfolio, UK commercial property remains out of favour after its worst year on record. Valuations may be influenced by the general trend, but historically low interest rates should apply the brake to further yield rises.

Valuation: Yield support

The shares are supported by a secure 6.4% prospective yield, from revenue paid by NHS-backed tenants. The shares are at a discount to EPRA NAV/share of 320p and our DCF-based appraisal of the portfolio value of 379p/share.

Price	267p
Market Cap	£90m

Share price graph



Share details

Code	PHP
Listing	FULL
Sector	Real Estate (UK-REIT)
Shares in issue	33.59m

Price

52 week	High	Low
	321.0p	237.0p

Balance Sheet as at 31 December 2008

Debt/Equity (%)	257
NAV (EPRA) per share (p)	320
Net borrowings (£m)	203

Business

PHP invests in primary healthcare property, which is let to GPs, PCTs and other NHS entities backed by the UK government. This tenant profile provides an exceptionally secure rental outlook.

Valuation

	2007	2008	2009e
P/E relative	22%	215%	160%
P/CF	5.9	5.4	5.3
EV/Sales	10.4	14.9	13.7
ROE	19%	7%	9%

Revenues by geography

UK	Europe	US	Other
100%	0%	0%	0%

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

Primary care property: Strong core proposition

The results confirmed anticipated declines in the value of primary care property during 2008, but at a scale well below that experienced by other segments of the UK commercial property market. The 10% fall was due entirely to an increase to a 6.2% reversionary valuation yield, from 5.5% a year earlier. The relative outperformance of UK office and retail property reflects the portfolio's long leases, undoubted covenants and the limited supply of the asset class.

At end FY08 the group held a portfolio of 113 properties, including five contracted schemes. These are 99.9% let, with an average outstanding lease length of 18 years. Approximately 90% of the £19.6m rent roll is derived directly or indirectly from the NHS, with the remainder mainly let to pharmacy operators. The year end rent roll was 21% up over 12 months, with 85% due to new properties deliveries, and 15% increased rents secured during the year.

Rents: 12.4% increases at review in FY08

Rent reviews completed during FY08 added £0.47m to the rent roll and Exhibit 1 below shows the timing of reviews across the portfolio. The group has achieved an average increase of 12.4% over the last three years, equivalent to an increase of just below 4% pa. That performance improved over the last 12 months; comparable figures for the three years to FY07 were 11% and 3.4% pa. A review of PHP's rent review performance against inflation reveals that over the last four years, its reviews have out-performed RPI by 0.85% pa. Some £19.6m of rents fall due for review over the next three years. £1m of rent is reviewed on a longer pattern and £0.5m is reviewed annually.

Exhibit 1: Forthcoming rent reviews

Year	Rent (£m)
2009	5.72
2010	5.49
2011	7.36
Longer pattern	1.00

Source: PHP Preliminary Results RNS

NAV declines: MTM impact of interest rate swaps

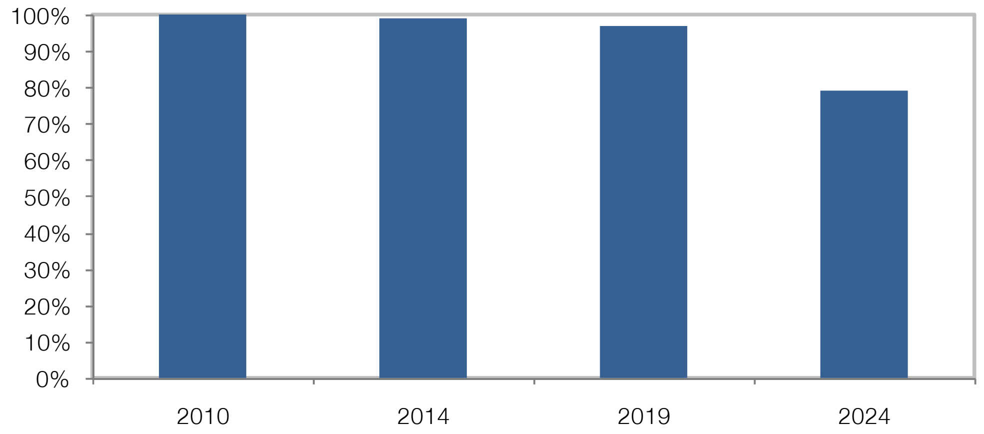
A £17.7m fall in portfolio valuations was equivalent to 52.7p per share. Further downward pressure on NAV resulted from the impact of recent sharp falls in UK interest rates on the mark-to-market valuation of the group's portfolio of interest rate swaps, held to mitigate exposure to interest rate rises. Although this affects headline FY08 NAV and profits, it is a non-cash adjustment. We therefore refer to the EPRA NAV/share calculation, which adds back to IFRS NAV unrealised losses relating to financial instruments, which resulted in an end FY08 NAV/share of 320p (FY07 374p). The all inclusive IFRS NAV/share figure, with property and MTM adjustments was 235.8p (369.4p).

Finances

The group's stable financial position is a function of the revenue visibility provided by its fully let portfolio and mainly government-backed leases. The above valuation adjustments do not affect group cash flow, which remains sufficient to cover forecast overheads, interest costs and dividends.

Around 80% of group lease income has over 15 years to run. Exhibit 2 illustrates rental cash flow as a percentage of the year end rent roll. It ignores any subsequent increases and lease renewals, but shows that the group would still receive 97% of its current income in 10 years' time.

Exhibit 2: Security of income by term certain



Source: PHP Preliminary Results RNS

There is, however, some short-term constraint on PHP's ability to grow the portfolio due to more limited access to credit on attractive terms. The group ended FY08 with total borrowings of £206m, ie 65% loan to value and within the 75% limit defined within its debt covenants, falling to 70% from October 2009. The portfolio could absorb a further 13% fall in values before it tests the higher current LTV covenant, which would require a further material increase in valuation yields to 6.8%, assuming static rents. In reality, rents are expected to progressively benefit from rolling reviews.

It is not possible to state with certainty that valuation yields will not increase further during 2009, but we see no argument for any deterioration in the portfolio's revenue profile, ie a UK government-backed rental stream akin to the long gilt, which currently yields 4.22% for the equivalent period. Against a backdrop of historically low interest rates further outward yield shifts seem counter intuitive, despite property market weakness. The also group reported that it has received indicative terms for a new 20 year £50m secured facility. As the terms of this facility do not include a LTV covenant, it would if confirmed, provide PHP with further scope to manage its finances to avoid any breach. Interest cover, as defined in the group's loan facility agreements was 2.2x at the year end, compared with its 1.3x covenants.

Outlook: Yield supported by revenue profile

The group is cash flow positive at the operational level. Its principal facilities do not mature until 2013 and are sufficient to cover existing liabilities and current commitments. The portfolio is close to 100% let, with a weighted average outstanding lease length of 18 years. Approximately 91% of rents are reimbursed by or paid for by the NHS.

The dividend policy is to distribute a minimum of 90% of the profits of its tax exempt business in accordance with UK-REIT legislation. PHP paid two interim dividends of 8.25p/share in March and November 2008. It proposes to pay an interim dividend of 8.5p/share in April 2009.

Exhibit 3: Financials

£'000s	2006	2007	2008	2009e
Year end 31 December	UK GAAP	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	11,131	22,209	19,619	21,400
Cost of Sales	0	0	0	0
Gross Profit	11,131	22,209	19,619	21,400
EBITDA	8,843	14,412	14,508	17,953
Operating Profit (before GW and except.)	8,843	14,412	14,508	17,953
Intangible Amortisation	0	(5,551)	0	0
Exceptionals	0	0	0	0
Other	0	0	0	0
Operating Profit	8,843	8,861	14,508	17,953
Net valuation gain on property portfolio	14,997	1,107	(17,707)	0
Net Interest	(5,437)	(10,844)	(9,150)	(11,800)
Profit Before Tax (norm)	3,406	3,568	5,358	6,153
Profit Before Tax (FRS 3)	18,403	(876)	(12,349)	6,153
Tax	(2,466)	20,485	0	0
Profit After Tax (norm)	940	24,053	5,358	6,153
Profit After Tax (FRS 3)	15,937	19,609	(12,349)	6,153
Average Number of Shares Outstanding (m)	22.7	28.3	33.6	33.6
EPS - normalised (p)	4.1	85.0	16.0	18.3
EPS - FRS 3 (p)	70.3	69.3	(36.8)	18.3
Dividend per share (p)	13.5	15.0	16.5	17.0
Gross Margin (%)	100.0	100.0	100.0	100.0
EBITDA Margin (%)	79.4	64.9	73.9	83.9
Operating Margin (before GW and except.) (%)	79.4	64.9	73.9	83.9
BALANCE SHEET				
Fixed Assets	205,188	290,095	320,133	326,000
Investment properties	199,569	282,495	316,862	323,000
Development properties	0	2,853	282	0
Other incl. derivative interest rate swaps	5,619	4,747	2,989	3,000
Current Assets	5,018	7,561	2,987	3,050
Derivative interest rate swaps	0	0	454	0
Debtors	1,033	3,646	1,808	2,000
Cash	3,973	3,862	675	1,000
Current Liabilities	(5,325)	(11,281)	(22,702)	(21,600)
Creditors	(5,325)	(11,281)	(22,702)	(21,600)
Short term borrowings	0	0	0	0
Long Term Liabilities	(133,556)	(162,838)	(221,237)	(235,700)
Long term borrowings	(112,363)	(159,219)	(204,088)	(205,000)
Other long term liabilities	(21,193)	(3,619)	(17,149)	(30,700)
Net Assets	71,325	123,537	79,181	71,750
CASH FLOW				
Operating Cash Flow	8,785	12,743	16,526	17,042
Net Interest	(5,437)	(10,844)	(9,150)	(11,800)
Tax	(34)	(826)	(1,322)	0
Capex	0	0	0	0
Acquisitions/disposals	(20,405)	(81,565)	(48,869)	0
Financing	0	41,443	0	0
Dividends	(2,803)	(5,979)	(5,542)	(5,829)
Net Cash Flow	(19,894)	(45,028)	(48,357)	(587)
Opening net debt/(cash)	87,688	108,390	155,357	203,413
HP finance leases initiated	0	0	0	0
Other	(808)	(1,939)	301	0
Closing net debt/(cash)	108,390	155,357	203,413	204,000

Source: Company accounts/Edison Investment Research