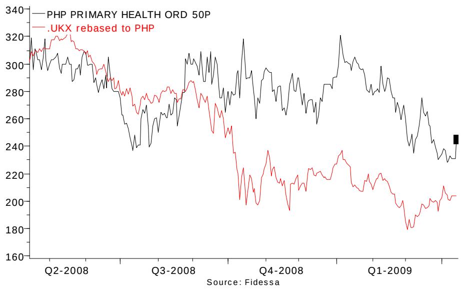
Primary Health Properties 243p

Defensive, with a 7% yield

16 April 2009

Share Price: 243p



12m High: 321p

12m Low: 237p

Market Cap: £85m

Shares in Issue:35.27m

NAV/Share: 316p

Gearing: LTV 64%

Interest Cover: 1.7X on operating profit, 2.1X on rental income

EPIC Code: PHP

Sector: Real Estate

Market: London Full List

Brokers: Numis Securities/Peel Hunt

PR: Bell Pottinger +44 (0)20 7861 3232

Website: www.phpgroup.co.uk

Description: PHP lets out GP surgeries to GP partnerships on 18+ year leases. The rent GPs pay is reimbursed by the public sector.

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The modest capital raising undertaken by Primary Health Properties last month increases the safety margin at this company and gives it some extra protection for its covenants in the event of a further adverse yield shift. This epitomises the 'safety first' approach at this company. The dilution involved was tiny, at least partly because the amount of capital involved was so modest (it increased the number of shares in issue by 5%). The discount was also small – 13.7% to the pre-issue price. There were no pre-emption rights.

Over the last twelve months PHP shares have outperformed the Real Estate sector, rightly so because of the average unexpired lease length of 18 years and the high quality of its tenants – GP surgeries, Primary Care Trusts and Area Health Authorities don't go bust, unlike the tenants of retail parks and office blocks.

PHP has also heavily outperformed the FTSE 100 over the past twelve months.

On an eight week basis PHP has underperformed the Real Estate sector as more volatile, and risky, stocks bounce back from their lows.

We expect PHP to continue its unbroken run of dividend increases in the current year. The shares yield 7% prospectively and a yield of this size is highly unusual in a company of this quality and with such defensive qualities.

Y/E	Group Sales	Adjusted Profit*	Adjusted EPS*	P/E ratio	Divi	Yield
December	£m	£m	p.		p.	%
2007A	15.7	4.2	13.8	17.6	15.75	6.5
2008A	19.7	6.3	18.8	12.9	16.50	6.8
2009E	20.8	6.3	18.5	13.1	17.00	7.0
2010E	22.2	7.0	20.0	12.1	17.50	7.2

** EPRA basis*

Primary Health Properties – Key Points

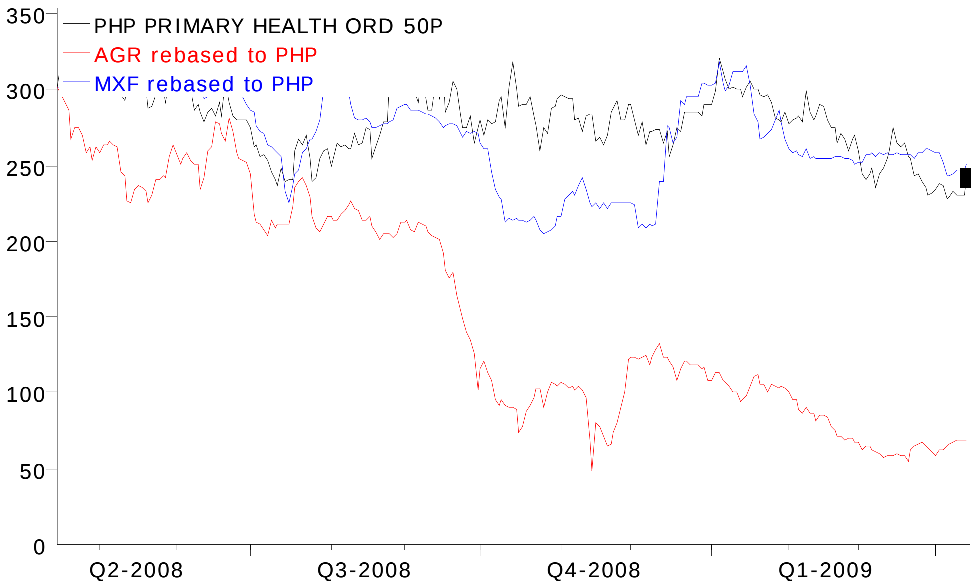
Primary Health Properties was formed in 1994, obtained a quote on AIM in 1996 and upgraded to the Official List shortly afterwards. It paid its first dividend in 1996 and since then has increased its dividend every year.

The company has only one function. That is to invest in GP surgeries and other very closely related health facilities.

- The rents GPs pay are 100% reimbursed to them by Primary Care Trusts. 90% of PHP's rent roll is from GP practices. Therefore 90% of PHP's entire rent roll is paid, at one remove, by the NHS. The remainder of the rent roll is pharmacies.
- Average unexpired lease length is 18 years, with no break clauses and upward only three year reviews.
- The property portfolio is 99.9% let and PHP does not buy a new property unless it has a pre-let rental agreement with the tenant.
- Rental growth of 4% p.a. was achieved in 2008, and the past pattern of rent increases has in general been at or above the inflation rate.

Performing Well vs. Peer Group

Of the three major quoted property companies that own GP surgery freeholds, the two best performers have been those that have restricted their activities to their core business. Both Primary Health Properties and **MedicX Fund** (MXF, London Official List, £68m market cap) have performed identically on a twelve month basis. The laggard is **Assura Group** (AGR, London Official List, £84m market cap) which is in the process of expanding its business model in order to operate the pharmacies in its premises and provide other medical services. Assura is not without its good points, but it is playing a different game.



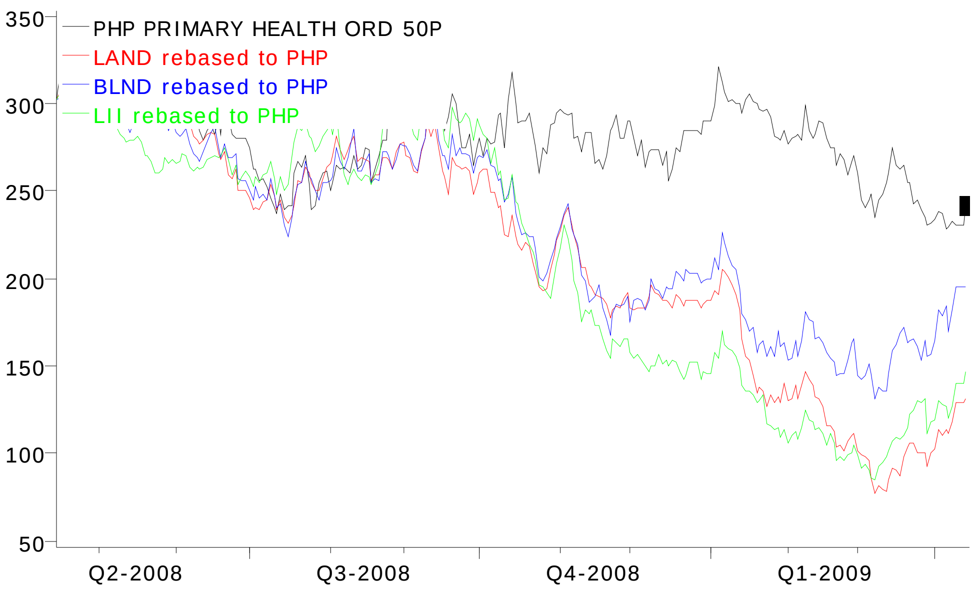
Source: Fidessa

Two other quoted companies provide an investment route into GP surgeries. **Ashley House** (ASH, AIM, £32m cap) has just raised £2.3m of additional capital by placing 3.5m new shares with Invesco Perpetual at a 4% discount. Ashley House is planning to expand in the NHS LIFT market. The final company, **Care Capital,** is considerably smaller.

Performance vs. Property Majors

For most of the bear market, Primary Health Property shares significantly outperformed the giants of the quoted Real Estate marketplace, Land Securities, British Land and Liberty International. PHP also performed considerably better than all of the quoted Real Estate share indices and almost every other quoted property/real estate company on any of the three British stock markets. This was entirely understandable. PHP's tenant base is in practice not far short of gilt edged, because the GP tenants are reimbursed their rent costs by Government bodies. The company has never had a medical tenant rental default. By comparison, generalist property companies have suffered from tenants going into administration, and on shorter term leases from voids that then prove impossible to re-let at an economic rent. Also, PHP's development risk is limited to a negligible sum in loans advanced to construction companies working on potential sites where it has a purchase option. These loans account for less than 1% of total assets.

Since the beginning of February, however, the investment management community's perception of risk has altered. The refinancing of many major quoted property companies may have involved ruinous dilution for existing shareholders who did not have the funds to take up pre-emption rights, but they did secure the capital base for these companies. The investment community has also become more willing to look at potential upside, and has been prepared to take on the additional risk that these companies represent.



Source: Fidessa

PHP's Capital Raising – Modest But Sensible

The end-March capital raising increased the number of PHP shares in issue by 5%, and took place at a 13.7% discount to the pre-announcement share price. This compares to the following discounts for recent capital raisings by other quoted companies in the Real Estate sector:

	Date of Capital Raising	Amount Raised £m	No. Shares Increased by	New Money Price p.	Discount %	Price Now p.
Assura Gp	Nov 2008	£30m	35%	37p	10%	26p
British Land	Feb 2009	£740m	67%	225p	53%	450p
Hammerson	Feb 2009	£584m	140%	150p	62%	315p
Land Secs	Feb 2009	£755m	62%	270p	51%	573p
Segro	Mar 2009	£501m	1,200%	10p	87%	24p
Workspace	Jan 2009	£87m	500%	10p	69%	13p

With hindsight, of the companies in this table Assura Group struck the best deal, by raising its new money at a discount of only 10% to the market. It issued its cash call relatively early in the cycle, and took a relatively modest sum both in absolute terms and in relation to its own size. It is the only company in the table whose shares are currently trading lower than the price of the cash call.

For four of the five other companies in the table, those who put in capital at the demand for new money have more than doubled their new investment, and the fifth, the rather smaller Workspace, has produced a gain of 30%. Of course, in most cases investors are still down on the share price immediately before the placing or rights issue. But these fundraisings, which between them saw an additional £2.7bn committed to the Real Estate sector, have been overwhelmingly good news for new shareholders.

PHP's Share Issue – The Details

	Dec-08 Before Placing £m	Change on Placing £m	Dec-08 After Placing £m
Investment Properties	316.86		316.86
Other Assets	5.80		5.80
Total Assets	323.12		323.12
Term Loans	204.09	-3.6	200.49
Short Term Borrowings	1.91		1.91
Total Borrowings	206		202.4
REIT Conv charge payable	2.23		2.23
Other Current Liabilities	6.87		6.87
Total Liabilities	215.1	0	211.5
Total Equity	108.02	3.6	111.62
No. Shares Fully Dil	33.59	1.68	35.27
NAV per Share p.	322		316
Gearing, Loan To Value	65.0%		63.9%
Debt Covenant unitil3/2010	75%		75%
Debt Covenant from 3/2010	70%		70%
Investment Properties Covenant Headroom £m			
Until 3/2010	42.19		46.99
From 3/2010	22.57		27.72
Investment Properties Covenant Headroom %			
Until 3/2010	13.3%		14.8%
From 3/2010	7.1%		8.7%
Investment Yields			
Passing Rent	19.6		19.6
Yield on passing rent at 31.12.2008*	6.2%		6.2%
Yield bases that comply with covenants			
Until 3/2010*	7.1%		7.3%
After 3/2010*	6.7%		6.8%

** Using simple Passing Rent/Investment Property Value. The co. uses the more complex RICS formula that contains some minor adjustments.*

Court Case Victory

In March, Primary Health Properties fought a court case to challenge the dispute resolution procedures to be followed when determining the level of rent to be reimbursed by the Department of Health for GP's leasehold premises. PHP stated that 'an improvement in the level of reimbursed rent, even on a small number of properties, could have significant revenue implications for PHP'.

Vulnerabilities

No company is without its downside risk. For Primary Health Properties these are in our opinion well contained, and merit its inclusion on any list of defensive stocks in both the Real Estate and the Healthcare areas. Our assessment of the potential vulnerabilities is as follows:

- The yield valuation basis on GP surgeries. At end-December 2007, PHP's properties were valued by its independent valuers Lambert Smith Hampton on a 6.2% yield basis (this takes passing rent, as disclosed in the Annual Report, in relation to the value of investment properties; the RICS valuation method makes minor adjustments to that basic formula that result in a slightly different number). PHP accounts for less than 1% of all GP properties, and this is a well established and liquid property market. The yield basis of valuing the portfolio has a different figure every year. At end-December 2007 Lambert Smith Hampton applied a 5.7% yield as the basis for the valuation. In the late 1990s the yield basis was out at 8%. If the yield basis used in future is pushed out to beyond 6.8%, then PHP would be at risk of breaking its borrowing covenants from March 2010, and would be forced to either sell properties or undertake a further small capital raising. *Our view: even in 2009, it is difficult to construct a scenario where this would be a serious practical issue.*
- Interest rate swaps do not provide complete protection against rising interest rates. The cover is not unlimited, and it expires in 2013. Our view: this will only become an issue if the British economy re-enters a period of very high inflation (>10% p.a.). In this case the upward rent reviews on property ought to provide very significant protection. *We would expect PHP to continue its rolling programme of hedging its debt, re-fixing its borrowing costs as far out as practicable.*
- Mark to Market on the Interest Hedges. These have resulted in losses under IFRS accounting for the last two accounting periods. Our view: This is a non-cash item and an accounting issue that runs contrary to common sense. Would the investment community seriously have been happy for PHP to have unlimited exposure to fluctuating interest rates? *A hedge is an insurance policy, and to complain about a hedge that has cost money is very much like complaining about having paid fire insurance because your building has not burnt down.*

Conclusion

Management has made the right decision in engaging in a small capital raising. Investors should be delighted with the way that this company has performed in the medium and long term, and be satisfied with its performance short term even if the shares have halved from their 2007 high point.

Income funds and private client brokers in particular will find it difficult to better the 7% yield that PHP offers in a stock as safe and reliable, and with a track record, like this. For private client brokers, as a Full List stock it does not qualify for IHT portfolios, but otherwise, the only investment negative is that PHP's stable, defensive characteristics mean that it is unlikely to be the fastest performer if the quoted property sector is at the beginning of a sustained recovery.

Primary Health Properties

16 April 2009

Management	Major Shareholders
Chairman: Graeme Elliott **Managing Director:** Harry Hyman **Property Director**: Tim Walker-Arnott **Property Management:** A team of six based in Woking.	Aberdeen Asset Management 7.4% Nexus Group (Harry Hyman) 6.5% James Hambro 6.5% AXA Framlington 4.7% Montanaro Fund Managers 4.5%
Key Dates	**Key Milestones**
Annual Meeting: April 2009 **Interim Results:** Late August/early September 2009	1994 Business Model put forward by Harry Hyman 1995 Purchase of small portfolio and incorporation 1996 Floated on AIM, shortly afterwards upgrading to the Official List. 2002 Wanless Review proposing reforms in the NHS 2007 Darzi Interim Report launching the reform of public primary care 2008 (May) Largest acquisition, Port Talbot (£15.6m) 2008 (June) Darzi Review expanding on initial reform

Primary Health Properties

16 April 2009

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