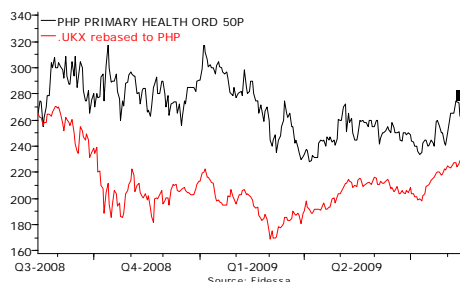


Primary Health Properties 304.25p

Satisfactory Interims

18 August 2009

Share Price: 304.25p



12m High: 321p

12m Low: 228p

Market Cap: £107.3m

Shares in Issue: 35.27m

NAV/Share: 290p

Gearing: LTV 66%

Interest Cover: 1.6X on operating profit, 2.0X 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 long term leases. The rent GPs pay is reimbursed by the public sector.

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PHP's interim results are precisely where we expected them to be and put Primary Health Properties halfway to our forecast of £6.3m full year profit, 18.5p eps and 17p total dividend. The net asset backing per share, at 290p, is solid, absolutely in line with industry trends and slightly below the current share price. The only negative is a downward restatement of prior year numbers because of the complexities of swap interest accruals. Last year's numbers were ahead of our expectations at the time. Now we know why.

Key points from the results are:

- PHP's property portfolio is 100% let.
- Rental growth is 'approximately 4% per annum', in excess of the inflation rate and suggesting the pattern of revenue, eps and dividend growth will continue.
- PHP's development pipeline has slowed significantly – as we have stated before this management has had a 'safety first' approach throughout the financial crisis, and this defensive strategy clearly continues.
- The company is operating within borrowing covenants with a sensible, but not excessive, safety margin.
- Borrowing facilities are not due for renewal until 2013, significant interest rate hedging is in place for ten years out and beyond.
- 78% of current rental income secure for greater than 15years. Only 1% of leases have a life of less than 5years.
- Covenants are utterly secure.

PHP is the largest and most orthodox of the quoted companies specialising in ownership of GP surgeries. Its shares yield close to 6.0% and offer a high level of security. The structure of tax legislation also gives PHP shares a modest tax advantage over bond investments for the private investor. The 'safety first' philosophy and the unbroken 13 year record of dividend increases makes this an ideal share for income investors.

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	22.0	15.75	5.2
2008A**	19.7	4.6	16.2	18.8	16.50	5.4
2009E	20.8	6.3	18.5	16.4	17.00	5.6
2010E	22.2	7.0	20.0	15.2	17.50	5.8

* EPRA basis

** Restated – see text

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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, PCTs and the Government. Therefore 90% of PHP's entire rent roll is paid, at one remove, by the NHS. The remainder of the rent roll is pharmacies.
- The average unexpired lease length of PHP's properties is 18 years, with no break clauses and upward only three year reviews.
- The property portfolio is 100% let and PHP does not buy a new property unless it has a pre-let rental agreement with the tenant.
- Past rent increases have in general been at or above the inflation rate.

The Interim Results

Rental Income is 14.5% ahead of H1 in the previous year and very slightly ahead of the immediately preceding half.

Net Interest Costs are 26% higher than in H1 2008, when the portfolio was somewhat smaller and therefore borrowings significantly less. Interest costs are lower than in the immediately preceding half, however. There may be some distortions here caused by the restatement of prior year interest costs. PHP's loan book is largely hedged, so the big reductions in interest rates seen over the past twelve months have limited relevance.

Administrative Expenses have been well contained and are lower than at this time last year. The shareholders are on a 'payment holiday' from the performance based element of the management company's charges. A £60.0m deficit in net asset value needs to be made up before any further performance incentive fees are payable.

Tax - There is no Corporation Tax charge. As a REIT, PHP is not liable for mainstream corporation tax.

Fair Value Gains and Losses on Derivatives - We ignore these for the purposes of calculating the underlying rate of profitability. They have, however, swung from a negative to a positive in the past six months.

Valuation Loss on Portfolio - This, again, is a non-cash item which can be ignored for adjusted p&l purposes. The loss, at £8.0m, is higher than in H1 2008 (£4.7m), but lower than in the immediately preceding half.

Dividend – An interim dividend of 8.5p has been declared, 3% higher than the prior half year dividend.

Asset Value

Chartered surveyors Lambert Smith Hampton have valued the portfolio on an initial yield basis of 6.06%, and an expected reversionary yield basis of 6.25%. This is very much in line with the valuation metrics used by the surveyors acting for other medical property companies recently.

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Valuing medical properties is somewhat different to valuing a standard commercial or retail property portfolio, because there is minimal practical possibility of a tenant defaulting or going into administration, there are no voids of any significance because of the long average lease term, and rent increases tend to either track or exceed the inflation rate.

This Interim valuation has produced a valuation of the investment properties of £315.7m, vs. £316.9m at end-December 2008. The effect of gearing, and the dilutive effect of a modest capital raising at 220p/share during the Spring have reduced the net asset value per share from 318p to 290p.

Throughout the sector – not just at PHP – the feeling is that the medical property market is starting to harden again, and that the bottom may have been seen in valuation terms. We do not expect PHP's NAV per share to fall any further, unless the company decides to undertake a further fundraising or acquisition using paper with shares below 290p.

There is a strong case for using a DCF basis for valuing medical properties, because of their good covenants and long unexpired lease term. On a DCF basis, and applying a discount rate of 7%, PHP's investment properties are valued at £379m and PHP's shares have a net asset value of 466p. This figure of course can vary significantly according to the input numbers chosen. This 466p/share figure is derived using the same inputs as those used by fellow quoted medical company MedicX.

The High Court Verdict

Earlier this year PHP announced that its challenge to the dispute resolution procedures to be followed by the NHS in determining the level of Department of Health reimbursement of rents for GP's leasehold premises had been successful. As a result of this judgment future rent review decisions are expected to be fairer and more transparent and in some cases rents may be higher than those previously determined.

Slower Growth From Now On

PHP has reduced the rate at which it takes on new properties. Its strategy is to find a prospective GP practice tenant, match it up with a property development, and then contract to buy the completed property from the developer at a fixed price, subject to signing of the lease. The coming squeeze on NHS spending will reduce (but not eliminate) activity in this area. PHP is concerned to make sure it stays well within its bank covenants so is being very careful not to overstretch itself.

The committed development portfolio at end-June was £34.2m, no higher than six months previously and just under 10% of the total portfolio.

Conclusion

PHP is a defensive share providing income focused investors with an attractive dividend yield of circa 6%. For those investing in PHP due to the shares' bond like characteristics this yield is made even more attractive when tax considerations are taken into account.

At 304.25p the shares are trading at a slight premium to their EPRA net asset value of 290p and at a 35% discount to their DCF value of 466p per share.

There are signs in the sector that property yields are hardening. PHP has noted this as has fellow quoted medical property company MedicX. Any further signs of yield hardening will only serve to underpin PHP's 290p net asset value.

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Financial Results to 30 June 2009

FYE December £m	H1 2008	H1 2009	Var %	12m 2008
P&L				
Annualised delivered rent roll (passing rent, before delivery of all commitments)	18.6	20.1	8.1%	19.6
Rental and related income	9.2	10.6	15.2%	19.7
Administrative expenses, of which	(2.2)	(2.1)	-5.5%	(5.0)
Operating profit before revaluation & financing	7.0	8.5	21.7%	14.7
<i>as a % of rental and related income</i>	<i>76.2%</i>	<i>80.5%</i>	<i>5.6%</i>	<i>74.6%</i>
Net valuation loss	(4.7)	(8.0)	70.2%	(17.7)
Operating profit /(loss) before financing	2.3	0.5	-77.0%	(3.0)
<i>as a % of rental and related income</i>	<i>33.0%</i>	<i>6.2%</i>		<i>ns</i>
Financing income/costs	(4.4)	(5.4)	<i>ns</i>	(10.0)
Fair value gain/(loss) on derivatives	1.6	3.0	<i>ns</i>	(10.7)
Reported profit /(loss) before tax	(0.5)	(1.8)	<i>ns</i>	(23.7)
Tax charge	(0.2)	0.0		(0.2)
Reported profit /(loss) after tax	(0.7)	(1.8)	<i>ns</i>	(23.9)
Adjusted profit before tax	2.9	3.2	10.0%	4.7
Adjusted profit after tax	2.7	3.2	17.7%	4.5
<i>* items excluded from adjusted earnings</i>				
<u>Per share data:</u>				
<i>Average number of shares</i>	33.6	34.5	2.7%	
Earnings (loss) per share p	(2.1)	(5.4)	<i>ns</i>	
Adjusted earnings (loss) per share p	8.0	9.2	14.6%	
Dividend p	8.25	8.50	3.0%	
Balance Sheet				
Investment and development properties	322.9	315.7	-2.2%	
Total properties owned and leased	325.8	318.7	-2.2%	
Commitments, incl.deposits & development loans	26.9	34.2	27.1%	
Total portfolio (owned, leased and committed)	352.7	352.9	0.1%	
Bank debt, net of cash	198.7	207.2	4.3%	
<i>as a % of investments</i>	<i>61.5%</i>	<i>65.6%</i>	<i>6.7%</i>	
Gearing debt as % gross assets	58.3%	64.6%	10.8%	
Interest cover	1.59	1.59	0.5%	
Revaluation surplus/(deficit)	(4.7)	(8.0)	<i>ns</i>	
Net assets	125.4	85.9	-31.5%	
<u>Per share data:</u>				
Shares in issue end of period	33.6	35.2		
NAV per share p	373.3	243.7	-34.7%	

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Management	Major Shareholders												
<p>Chairman: Graeme Elliott</p> <p>Managing Director: Harry Hyman</p> <p>Property Director: Tim Walker-Arnott</p> <p>Property Management: A team of six based in Woking.</p>	<table> <tr> <td>Aberdeen Asset Management</td> <td>7.4%</td> </tr> <tr> <td>Nexus Group (Harry Hyman)</td> <td>6.5%</td> </tr> <tr> <td>AXA Framlington</td> <td>4.7%</td> </tr> <tr> <td>Montanaro Fund Managers</td> <td>4.5%</td> </tr> <tr> <td>Rensburg Investment Management</td> <td>4.0%</td> </tr> <tr> <td>Legal & General Group PLC</td> <td>3.9%</td> </tr> </table>	Aberdeen Asset Management	7.4%	Nexus Group (Harry Hyman)	6.5%	AXA Framlington	4.7%	Montanaro Fund Managers	4.5%	Rensburg Investment Management	4.0%	Legal & General Group PLC	3.9%
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Legal & General Group PLC	3.9%												
Key Dates	Key Milestones												
<p>Final Results: February 2010</p> <p>Annual Meeting: April 2010</p>	<p>1994 Business model put forward by Harry Hyman</p> <p>1995 Purchase of small portfolio and incorporation</p> <p>1996 Floated on AIM, shortly afterwards upgrading to the Official List.</p> <p>2002 Wanless Review proposing reforms in the NHS</p> <p>2007 PHP converts to REIT status Darzi Interim Report launching the reform of public primary care</p> <p>2008 (May) Largest acquisition, Port Talbot (£15.6m) (June) Darzi Review expanding on initial reform</p>												

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