

18 August 2009

Primary Health Properties

Year end	Revenue (£m)	PBT* (£m)	DPS (p)	Yield (%)	NAV/share (p)**	Disc to NAV (%)
12/07	22.2	3.6	15.0	5.0	374	20
12/08	19.6	4.6	16.5	5.5	318	6
12/09e	21.4	6.1	17.0	5.7	327	8
12/10e	22.7	7.0	17.5	5.8	338	11

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

Investment summary: Steady as she goes

The stability at the core PHP's proven investment model is reflected in the interims, a fully let portfolio and positive cash flows from long leases to strong tenants. Its properties occupy a niche that has performed steadily throughout the market turmoil and with UK commercial property values beginning to stabilise at the quality end, there is less potential for further downward adjustment. Recent share price strength has closed the gap vs forecast NAV, but PHP retains an attractive yield and remains at a discount to our DCF appraisal of highly visible revenue streams.

Interims: Robust trading performance

Adjusted operating profit was £3.2m (£2.6m H108), before £5m of non-cash charges, ie a £3m gain from fair value gains on derivatives and £8m of property write-downs. Adjusted operating profit fully covered interim dividends at a cost of £2.9m.

Finances

Aggregate group debt at the mid-year was £207m, well within facilities of £265m. Overall net loan to value was 66%, relative to a 75% maximum debt covenant (70% from March 2010) and ICR 1.9x (1.3x covenant).

Sensitivities

NHS spending is only one factor influencing PHP's prospects, but a commitment to primary care points to further government investment in this resource. The group's existing portfolio contains scope for organic growth. As access to debt and equity improve, we expect PHP to return to the acquisition trail.

Valuation: Underpinned by existing assets

Our DCF appraisal of future revenues (100% let portfolio, WA lease length c 18 years) is 375p/share. The sector has recently seen a surge in popularity, but a 5.7% prospective yield remains attractive relative to most UK-REITs.

Price 300p
Market Cap £106m

Share price graph



Share details

Code PHP
Listing FULL
Sector Real Estate (UK-REIT)
Shares in issue 35.27m

Price

52 week High 321.0p Low 231.0p

Balance Sheet as at 30 June 2009

Debt/Equity (%) 241
NAV (EPRA) per share (p) 289.9
Net borrowings (£m) 207

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

	2008	2009e	2010e
P/E relative	213%	143%	145%
P/CF	6.1	6.5	5.6
EV/Sales	15.5	14.8	14.8
ROE	6%	7%	7%

Revenues by geography

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

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Investment summary: Steady as she goes

Company description: Investor in dependable asset class

Primary Health Properties (PHP) is one of the UK's leading investors in primary healthcare property. This asset class generates an exceptionally secure rental income stream. Some 90% of group rents are derived from GPs (reimbursed by the NHS), ie effectively UK government risk. The balance is mainly pharmacies co-located within its properties, also strong covenants. Such property is in relatively short supply and PHP's portfolio has a low risk profile, ie 100% let, on leases with, on average, nearly 18 years unexpired.

Valuation

The shares trade at above mid-year 289.9p EPRA NAV/share and a 8% discount to our FY09e estimate, after recent strong performance. The leading UK-REITs are currently at 20% plus premiums to NAV forecasts, which suggests investors expect strong near-term recovery in property values, amplified by geared balance sheets. PHP's would benefit from similar influences; mid-year balance sheet gearing was 257%. If, however, the property market recovery proves more pedestrian than anticipated, PHP's attractions include a prospective fully covered FY09e dividend of 17p/share, ie a 5.7% yield, with the prospect of further increases in line with revenue growth (rent reviews have recently achieved an annualised 4% increase). Our 375p DCF appraisal of the group's secure, predictable revenue profile uses lower growth assumptions than recently achieved.

Sensitivities

PHP's experience of investing in the primary care niche should limit operational risk. If the UK commercial property market has indeed passed its low point, a combination of steady investment yields and underlying revenue growth will progressively be recognised in NAV recovery. Opportunities for acquisition-led growth will depend on investor and lender appetite for debt and equity on sufficiently attractive terms, but in the meantime, there is potential for further organic and incremental portfolio growth; there was £12.9m of new commitments in H109. There is uncertainty over the impact of potential curbs on NHS budgets, especially imposed by a new government from 2010. This should be manageable, as provision of primary care will remain a key component of government strategy to care for an ageing population on a relatively static budget.

Financials

First-half performance was robust. Adjusted operating profit was £3.2m (£2.6m H108), before a £5m non-cash charge and fully covered interim dividends (cost £2.9m). The annualised rent roll on completed properties had reached £20.1m at the mid-year, 8% ahead year-on-year. Rental growth from reviews concluded in 2008 achieved an average increase of c 12% over the three-year rent review cycle, ie an annualised rate approaching 4%. The interim statement reports that actual rental growth in H109 has been similar to 2008. Group debt at end H109 was £207m, well within borrowing facilities of £265m (£255m of term loans expiring 2013 and a £10m overdraft). Aggregate group loan to value ratio was 66%, relative to a 70% maximum covenant from March 2010. Interest cover was 1.9x (1.3x covenant).

Investment summary: Solid H109 performance

Despite the sector's recent revival, H109 included some of the toughest trading conditions ever experienced by the sector. At the trading level, PHP's portfolio was largely unaffected, but external valuations inevitably reflected some of the turmoil. The interims nonetheless reveal robust trading. Adjusted operating profit was £3.2m (£2.6m H108), before a £5m non-cash charge. The latter comprised £3m fair value gains on derivatives (mark to market gain on certain callable swaps) and £8m of negative property revaluations.

Exhibit 1: Interim results – Analysis of Trading Performance

	30 June 2009	30 June 2008	30 Dec 2008
Annualised rent roll on completed properties	20.1	18.6	19.6
Operating profit before revaluations and finance costs	8.5	7.0	14.7
Net finance costs	(5.3)	(4.4)	(10.0)
Operating profit before revaluation result, fair value gain/(loss) on derivatives, UK-REIT charges and non-recurring items	3.2	2.6	4.7
Fair value gain/(loss) on derivatives	3.0	1.6	(10.7)
Revaluation loss including write-downs	(8.0)	(4.7)	(17.7)
Loss before tax	(1.8)	(0.5)	(23.7)
Taxation	-	(0.2)	(0.2)
Loss after tax	(1.8)	(0.7)	(23.9)
Dividends paid	2.9	2.8	5.5

Source: PHP interim results RNS

The annualised rent roll on completed properties reached £20.1m at the mid-year, 8% ahead year-on-year. Rental growth from reviews concluded in 2008 achieved an average increase of c 12% over the three-year rent review cycle, ie an annualised rate approaching 4%.

Portfolio valuation

Exhibit 2 below sets out the valuation yields applied by Lambert Smith Hampton at the midyear external valuation. This shows an aggregate initial yield of 6.06% and a 6.25% reversionary yield.

Exhibit 2: External valuation, assumptions and NAV

	30 June 2009	30 Dec 2008	30 June 2008
Net assets (£m)	£85.9m	£78.3m	£125.4m
Aggregate initial valuation yield	6.06%	5.97%	5.55%
Aggregate reversionary valuation yield	6.25%	6.16%	5.75%
EPRA net asset value	289.9p	317.6p	358.4p
Net asset value per share	243.7p	233.1p	373.4p

Source: PHP interim results RNS

Property agents and companies have reported yields hardening for high-quality, well-let UK commercial property. Although PHP's niche is not directly comparable with most of the commercial sector, its portfolio values have been affected by weakness elsewhere, despite progress in terms of lettings and rent reviews. Although the legacy of the growth years has yet to fully unwind, values may well have reached their nadir. From PHP's perspective, stable yields, steady rent increases running at an annualised rate approaching 4% and the fundamental resilience of the property class may see its assets gradually regain their upwards momentum over the next 12 months.

Exhibit 3: Portfolio breakdown

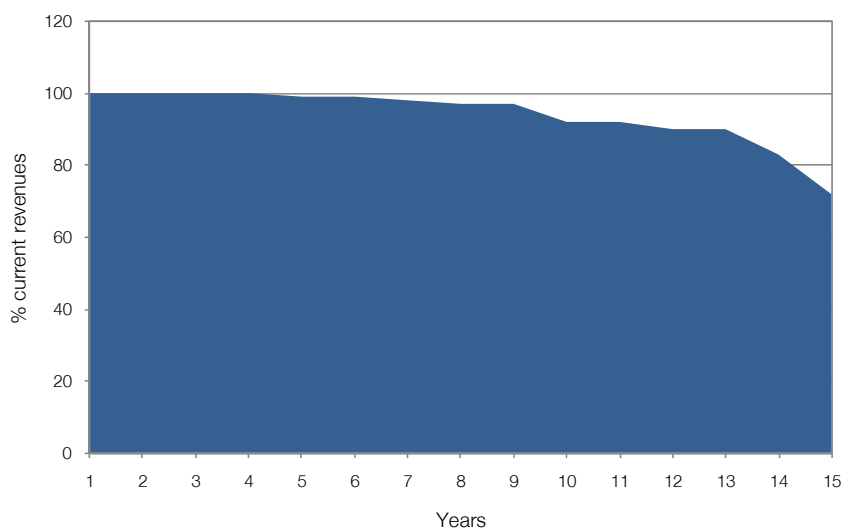
	30 June 2009	30 June 2008	30 Dec 2008
Investment properties	314.2	319.1	314.4
Properties in the course of development	1.5	3.8	2.5
Total investment properties	315.7	322.9	316.9
Finance leases	3.0	2.9	3.0
Total owned and leased	318.7	325.8	319.9
Development loans	0.0	0.0	0.3
Total owned and leased (including development loans)	318.7	325.8	320.2
Committed	34.2	26.9	34.0
Total owned, leased and committed	352.9	352.7	354.2
Closing annualised rent roll (no completed properties)	20.1	18.6	19.6

Source: PHP interim results RNS

Financials

Group debt at end H109 was £207m, well within borrowing facilities of £265m (£255m of term loans expiring 2013 and a £10m overdraft). Aggregate group loan to value ratio was 66%, relative to a 70% maximum covenant from March 2010. Interest cover was 1.9x (1.3x covenant).

Although the outlook for valuations is more stable than was the case six months ago, the nature of group debt covenants leave modest headroom for further downward adjustments. We do not regard this issue as critical, but should it become more acute than anticipated, management has a number of options. It could seek to issue further equity, in line with the £3.7m placing in March at 220p/share. Alternatively, it may renegotiate the terms of borrowing facilities or arrange new loans on improved terms. Finally, it may sell some smaller units to reduce debt. Enormous flexibility is provided by the portfolio's highly visible, long-term revenue profile. This is illustrated by Exhibit 4 below, ie 15 years from end June 2009, the group would still receive 78% of its current revenues. This does not take into account any lease renewals or rent reviews during the period.

Exhibit 4: Security of income by term certain – from end June 2009

Source: PHP interim results RNS

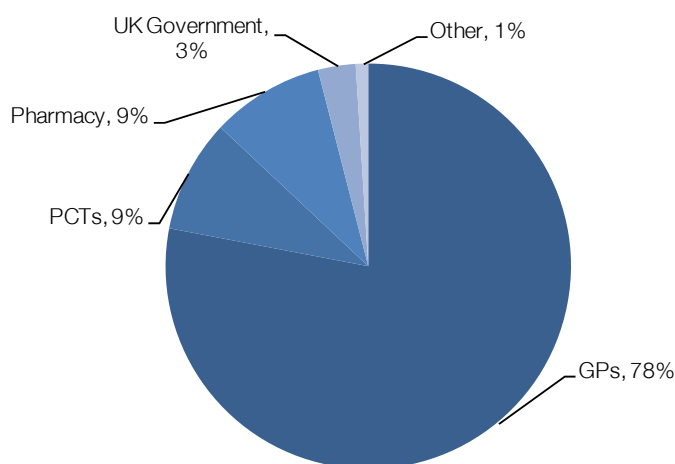
Sensitivities: PHP growth prospects & NHS investment

The medium-term strategy remains to grow the portfolio via acquisition, yet operate within a fundamentally stable business model that management steered comfortably through the property slump. This would inevitably require both new equity and additional debt on suitable terms. It is difficult to assess whether the property and banking environments have eased sufficiently to make this possible, although PHP's investments represent high-quality security.

There is, however, potential for organic growth within the group's existing portfolio of 111 properties (plus another four still under development). This includes both ongoing rent reviews and possible initiatives to enlarge and enhance revenues. This potential is arguably not fully reflected in the current valuation.

The investment portfolio is 100% let with an unexpired weighted average lease length of just below 18 years. Some 90% of rents are effectively paid by the UK government and most of the other 10% by pharmacies co-located in its primary care centres. These are also exceptionally strong covenants, operating from locations with a captive customer base, ie the daily flow of patients with prescriptions, fully sufficient to provide the core revenues to fully cover tenant overheads and margins.

Exhibit 5: Analysis of annualised rent by tenant



Source: PHP interim results RNS

High court decision enhances prospects on appeal

The prospects for rent review have been enhanced by a recent High Court judgement in PHP's favour. At the end of March, the group successfully challenged 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. The outcome is a fairer, more transparent basis for rent reviews that PHP expects, in some cases, to result in levels of rent on appeal to be higher than would have been the case under the previous system.

NHS spending on primary care estate

The outlook for NHS budgets is another issue. The next government will have to find cuts in public spending and the health budget will inevitably be subject to close examination. The extent to which any decisions will affect PHP are less easy to predict. The impact will be somewhat indirect, as the nature of the long leases on the group's existing portfolio protects it from any impact on revenues. Additionally, it could be argued that a shortage of new primary care property (if development were curtailed) could benefit rent reviews, even if it reduced opportunities for future acquisition.

In any case, the latter scenario does not fit with the government/NHS need to drive efficiencies through the health service. Indeed, investment in the primary care estate (and diverting resources from acute care) may be pivotal to meeting future targets.

Both major parties insist that spending on healthcare through the NHS is at the heart of their policy agendas. Nonetheless, decisions regarding disposal of discretionary NHS budgets must involve at least some element of unpredictability, particularly post an election, as a new government will surely seek to rein in public spending.

Valuation: 5.7% yield, DCF appraised at 375p/share

The shares trade at close to mid-year 290p EPRA NAV/share. That's still behind the leading UK-REITs, currently stand at 20% plus premiums to forecast NAV, as investors look forward to the impact of a short-term recovery in property values on geared balance sheets. PHP's portfolio would benefit from similar influences, with mid-year balance sheet gearing of 257%.

We expect adjusted pre-tax profit of £6.1m for the current year and £7m for FY10e. EPRA NAV/share should recover in H209 and beyond, on the back of steady or declining yields and underlying increases in rents due for review, currently running at c4% pa. We have not attempted to predict the gains or losses on the group's swap portfolio.

Dividend: second interim payment of 8.5p/share

The 8.5p interim payment is in line with forecasts. PHP has declared fully covered FY09e dividends of 17p/share ie a 5.7% yield, with the prospects of further increases in line with growth in revenues. PHP has recently reported annualised 4% increases at rent reviews. We forecast a 3% increase in the dividend to 17.5p for 2010e. Dividend policy is to distribute at least 90% of the profits of its tax-exempt business in accordance with UK-REIT legislation.

DCF appraisal of UK government-funded revenue stream

Finally, we also believe that the group's revenue profile justifies a DCF appraisal.

It provides greater certainty than is typically the case for UK commercial property investors. Rents are paid by the NHS (UK government) and pharmacy operators, based upon long-term leases (weighted average approaching 18 years unexpired) with three-year reviews. There is potential to retain tenants beyond the life of the existing leases, unless there is a fundamental change in the means by which health services are provided within the UK.

We have used more conservative growth assumptions to generate a DCF value of 375p/share.

Exhibit 6: Financials

Year end 31 December	£'000s	2006	2007	2008	2009e	2010e
		UK GAAP	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		11,131	22,209	19,691	21,400	22,700
Cost of Sales		0	0	0	0	0
Gross Profit		11,131	22,209	19,691	21,400	22,700
EBITDA		8,843	14,412	14,668	17,885	19,023
Operating Profit (before GW and except.)		8,843	14,412	14,668	17,885	19,023
Intangible Amortisation		0	(5,551)	0	0	0
Exceptionals		0	0	0	0	0
Other		0	0	0	3,000	0
Operating Profit		8,843	8,861	14,668	20,885	19,023
Net valuation gain on property portfolio		14,997	1,107	(17,707)	(8,000)	0
Net Interest		(5,437)	(10,844)	(10,045)	(11,800)	(12,000)
Profit Before Tax (norm)		3,406	3,568	4,623	6,085	7,023
Profit Before Tax (FRS 3)		18,403	(876)	(13,084)	(1,915)	7,023
Tax		(2,466)	20,485	(160)	0	0
Profit After Tax (norm)		940	24,053	4,463	6,085	7,023
Profit After Tax (FRS 3)		15,937	19,609	(13,244)	(1,915)	7,023
Average Number of Shares Outstanding (m)		22.7	28.3	33.6	35.0	35.3
EPS - normalised (p)		4.1	85.0	13.3	17.4	19.9
EPS - FRS 3 (p)		70.3	69.3	(39.4)	(5.5)	19.9
Dividend per share (p)		13.5	15.0	16.5	17.0	17.5
Gross Margin (%)		100.0	100.0	100.0	100.0	100.0
EBITDA Margin (%)		79.4	64.9	74.5	83.6	83.8
Operating Margin (before GW and except.) (%)		79.4	64.9	74.5	83.6	83.8
BALANCE SHEET						
Fixed Assets		205,188	290,095	320,133	328,000	353,000
Investment properties		199,569	282,495	316,862	325,000	350,000
Development properties		0	2,853	282	0	0
Net inv. in fin leases/ deriv. int. Rate swaps		5,619	4,747	2,989	3,000	3,000
Current Assets		5,018	7,561	2,987	3,050	3,250
Derivative interest rate swaps		0	0	454	0	0
Debtors		1,033	3,646	1,808	2,000	2,200
Cash		3,973	3,862	675	1,000	1,000
Current Liabilities		(5,325)	(11,281)	(23,597)	(21,600)	(22,100)
Creditors		(5,325)	(11,281)	(23,597)	(21,600)	(22,100)
Short term borrowings		0	0	0	0	0
Long Term Liabilities		(133,556)	(162,838)	(221,237)	(220,000)	(239,000)
Long term borrowings		(112,363)	(159,219)	(204,088)	(212,000)	(231,000)
Other long term liabilities		(21,193)	(3,619)	(17,149)	(8,000)	(8,000)
Net Assets		71,325	123,537	78,286	89,450	95,150
CASH FLOW						
Operating Cash Flow		8,785	12,743	16,526	16,079	19,023
Net Interest		(5,437)	(10,844)	(10,045)	(11,800)	(12,000)
Tax		(34)	(826)	(1,322)	0	0
Capex		0	0	0	0	0
Acquisitions/disposals		(20,405)	(81,565)	(48,869)	(6,000)	(20,000)
Financing		0	41,443	0	0	0
Dividends		(2,803)	(5,979)	(5,542)	(5,853)	(6,172)
Net Cash Flow		(19,894)	(45,028)	(49,252)	(7,574)	(19,149)
Opening net debt/(cash)		87,688	108,390	155,357	203,413	211,000
HP finance leases initiated		0	0	0	0	0
Other		(808)	(1,939)	301	(13)	149
Closing net debt/(cash)		108,390	155,357	204,308	211,000	230,000

Source: Company accounts/Edison Investment Research

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