Buy

21 February 2012

Primary Health Properties

(PHP)

Data

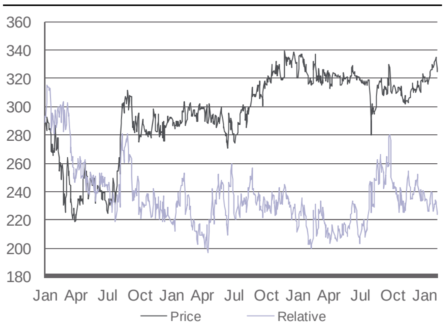
Price	320p
Target price	345p
Market cap	£218m
Free float	100%
Index	FTSE SmallCap
Sector	Real Estate
Next news	Feb - Finals
UK sales	100.0%
European sales	0.0%
North American sales	0.0%
Rest of World sales	0.0%

Description

Engaged in the generation of rental income and capital growth through investment in UK primary health care property, leased primarily to GPs, Primary Care Trusts, health authorities and associated health care users

Performance

Source: Bloomberg



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Finals: solid result but increased finance costs

The key metrics: over 16 years' unexpired on tenant leases, 90% of income effectively derived from quasi-government guarantees (no tenant default in PHP history) and above all, 15 years of uninterrupted dividend growth, provide the backbone to the one steady performer amongst medical centre specialist stocks. An ideal stock for private clients/smaller funds oriented to dividend growth. PHP have now refinanced £300m in total (including £175m announced today) although at higher margins overall (average 230bps vs 70bps). We reduce our forecasts due to increased financing costs going forward but retain our Buy.

FY11 Result highlights

- **Adj. NAV +2.3% to 318.7p** (FY10: 311.5p). The result came in below our forecast of 328p mainly due to a £2.9m (4p per share) expense to break £35m of swaps and lower EPS leading to a partially uncovered dividend.
- **An 18.0p DPS** was paid during the year**,** up 2.8% from 17.5p in FY10. The fifteenth year of consecutive growth. The H2 (April 12) dividend is up to 9.25p vs 9.0p in H1 and will be payable on 5 April 12 with an ex-dividend date of 7 March.
- Recurring (Adj). **EPS down 1.2% to 14.5p** (FY10: 14.7p) due to higher financing costs. The greater debt level due to acquisitions in the period and an increasing expense rose the interest charge by **£3m** (or **4.3p per share**) which also included a £0.4m write off on arrangement fees on debt refinanced.
- **Debt maturity strengthened**: Ahead of schedule, PHP are completing the refinancing of the debt expiring in January 13. PHP has renewed or agreed terms on **£300m**, improving the maturity profile (now **5.6 years** from 3.5 years at the end FY10) and increasing the number of lenders. This leaves only around £30m, or 7.6%, of the debt book to be renegotiated this year. However, the cost of debt has risen to an average of **5.0%** from 4.6% at FY10.
- A revaluation uplift of **£10.6m** was evenly spread across H1 and H2. The uplift was supported by 3% rental growth while the initial yield shifts downwards marginally to 5.74% (FY10: 5.79%)
- Acquisitions: in the year, eight properties were purchased for £48m.

Stats*

Source: Company accounts, Peel Hunt estimates

Y/E Dec	Net Op Inc (£m)	Adj PBT (£m)	Adj EPS (p)	EPS growth (%)	DPS (p)	PER (x)	Div yield (%)	Adj NAV (p)	NNNAV (p)	Prem/NAV (%)	Prem/ NNNAV (%)
2010A	21.9	9.1	14.7	(20.1)	17.5	2.17	5.5	311.0	262	2.9	22.2
2011A	25.1	10.0	14.5	(1.2)	18.0	22.0	5.6	318.7	246	0.0	30.0
2012E	28.1	10.0	14.7	1.4	18.5	22.1	5.8	328.7	258	(2.6)	25.0
2013E	30.2	11.3	16.6	12.9	18.5	19.3	5.8	341.2	270	(6.2)	19.2

*including our new EPS and NAV forecasts for 2012 and 2013

- Annual rent roll **up 12% to £31.4m** (vs £28m in FY10 and £21m in FY09). Acquisitions drove the majority (85%) of the increase with 12% of the increase from rent reviews (the weighted average rental growth was 3.0%) and 3% from asset management projects. The WAULT is **16.3 years** (FY10: 16.9 years).

The average margin across the Group's debt portfolio will be **230bps vs 70bps** in 2010. This will increase total finance costs going forward.

FY Dec 12 forecasts reduced:

- **Adjusted NAV 329p** (formerly 342p) for a -**3% prospective discount to NAV**. Reduced due to the lower NAV starting point at Jan 12 and lower EPS leaving an uncovered DPS.
- **Adjusted EPS 14.7p** (formerly 18.7p). Reduced due to higher interest costs post the £300m refinancing whereby **the average margin on the Group's debt will increase from 70bps to 230bps**. Meanwhile the swap portfolio (hedged at c4.8%) is long dated and does not fully mature in the near term, which would otherwise have helped counteracted the increase in margin. However, £35m of swaps were cancelled in FY11 for £2.9m (see page 3), which should help to offset the margin increase.
- DPS unchanged 18.5p for a **5.8% dividend yield** and 0.8x cover.

We believe the dividend will increase to c**0.9x covered by FY13** (our Adj. EPS FY13 forecast is 16.6p) and fully, or near fully, covered by FY14 as the £78m of undrawn debt facilities remaining is invested in acquisitions yielding c6%.

PHP has renewed or agreed terms on £300m for an average term of 4.6 years. The average cost of debt rose from 4.6% to 5.0% in 2011.

Refinancing progress

During the year, the £16m equity fundraise in April (at 305p) was complemented by a new, £50m revolving credit facility, a £75m loan and PHP have agreed terms on a £175m four-year loan. The only **outstanding near-term refinancing is a £30m** facility with Allied Irish Banks, which will continue to its original maturity of Jan 13. Discussions are in place to refinance with a new lender but the existing resource may be used. The details of the new loans agreed are:

- As announced today, terms have been agreed to refinance the bi-lateral loans from RBS and Santander totalling **£175m** for four years commencing in mid March on an interest-only basis. The max LTV agreed has reduced from 70% to 65%.
- In Nov 11 a **£75m** interest only debt facility was refinanced with Aviva for seven years at a **fixed all-in rate of 4%**. Of this, £50m was used to repay bi-lateral loans from RBS and Allied Irish Banks. The £25m remaining has and will be used to fund commitments and further acquisitions.
- In Jul 11, a new **£50m** interest only revolving credit facility from Clydesdale was arranged for three years at 180-200bps margin; £14m is drawn and the remainder of the balance is to be used to fund acquisitions in 2012.

Chart 1: Old PHP debt maturity as of Dec 2010

Source: Company accounts, Peel Hunt estimates

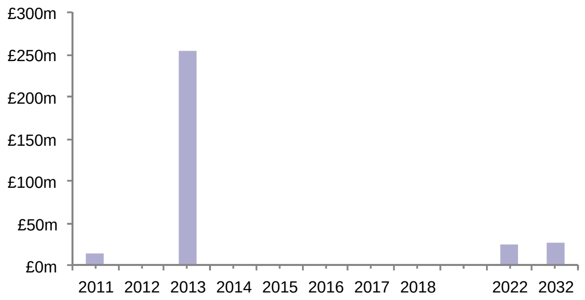
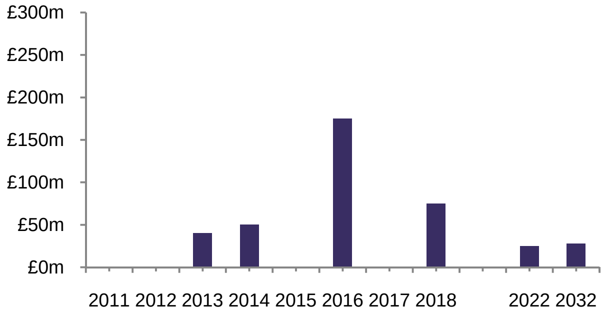


Chart 2: New PHP debt maturity as of Dec 2011

Source: Company accounts, Peel Hunt estimates



There are **£78m** of undrawn facilities are available

Total debt and hedging

- Borrowings drawn total **£303m** of **£392m** available. Post commitments the headroom is lower at **£78m** while cash is £77k. We expect at least c£50m to be used to fund acquisitions in the year; potentially more should a larger portfolio be presented to the market.
- All-in cost of debt increased to 5.0% from 4.6% FY10
- Covenants:
  - LTV 57.8% (vs 57.6% FY10) against a maximum 70% covenant and minimum 65% covenant (on the new £175m RBS/Santander facility).
  - Minimum ICR covenant 1.x vs 2.0x actual (FY10: 2.2x)
- Interest rate hedging:
  - For FY12 there are c**£173m of interest rate swaps** with a long average maturity. Some of the swaps in the portfolio are forward starters, therefore the amount of swaps will rise marginally. The maximum effective at any point in time is **£181m in 2013** but reduce from there on. In addition, the rate charged on the swaps will not rise above **c4.8%** going forward.
  - In Dec 11 **£2.9m** was spent in order to cancel £35m of interest rate swaps and a £15m interest rate floor maturing at dates across 2013, along with the refinancing of the debt that previously matured at that time, in order to prevent over-hedging. This cost reduced EPRA (Adj) NAV by **4p** per share.
  - The unrealised mark-to-market liability on the remaining derivative portfolio increased from £31m to £50m as expected due to underlying interest rate movements. This is excluded from EPRA NAV but included in NNNAV leading to a widening discrepancy between the two measures.

In Dec 11 **£2.9m** was spent in order to cancel £35m of interest rate swaps and a £15m interest rate floor maturing at dates across 2013

Further 2011 highlights

- £15.7m **equity fund raise** in April at 305p per share – the proceeds funded acquisitions to generate further growth.
- **Asset Management**: five projects were completed in 2011 at a total cost of £1.4m. A further nine projects (two on site) have been agreed so far for 2012 for a total projected cost of £3.5m which should generated a 34% capital value uplift on cost and a 6.2% rental yield on cost.
- **Developments** delivered in the year:
  - 26k sq ft practice built in Cowbridge for £6.9m (delivered in Feb 11)
  - 24k sq ft practice built in Shefford for £5.5m (Mar 11)
  - 40k sq ft practice built in Oswestry for £8.8m (July 11)
  - 17k sq ft practice built in Blackpool for £4.1m (Aug 11)
  - 15k sq ft practice built in Newark for £4.3m (Sept 11)
  - 17k sq ft practice built in Chesham for £4.1m (Dec 11)

Investment case

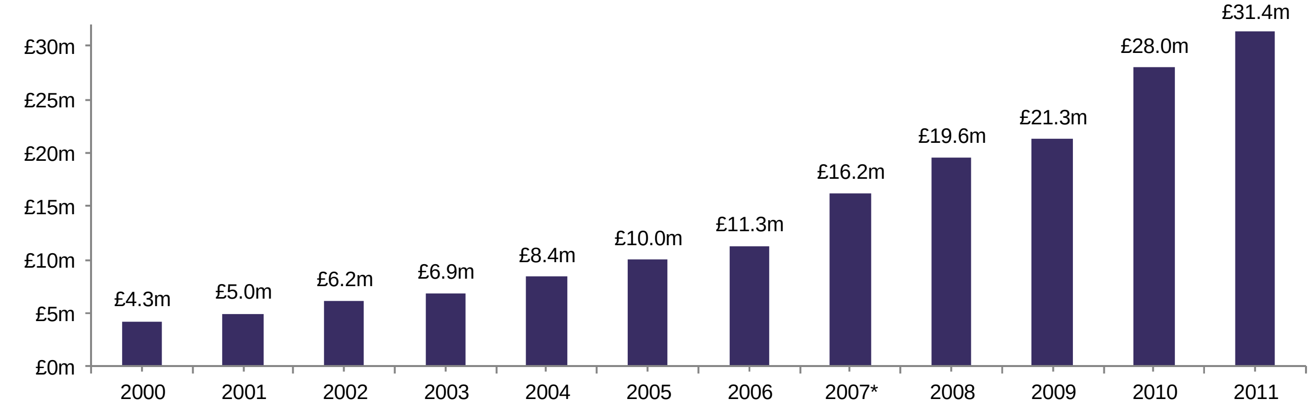
Despite refinancing concerns, let us not forget the unquestionable ability of PHP to generate truly defensive income in terms of both the tenant covenant and lease length, which we believe clearly outweighs debt concerns, the external management structure and the funding of future growth through further equity fundraisings. Fundamentals of the investment case:

98% of the annual rent roll expires in six years or more

- A UK REIT with 100% let portfolio primarily to GPs (75% of annual rent)
- Defensive tenant covenants – 90% of rent roll from NHS. Low risk profile
- 67% of the annual rent expires in over 15 years time and just 2% **expires within five years** (WAULT 16.3 years).
- Leases subject to upwards only rent reviews: 95.4% are subject to triennial reviews – most are open market but some fixed (1.9%) and index linked (11.5%)
- Rental growth of 3.0% this year vs 3.22% in FY10 and 3.12% in FY09
- Rental uplifts drive valuation increases – not dependent upon underlying yield shift (see the next page for the increase in rent roll over the past 11 years from acquisitions and rental uplifts).
- 156 properties plus a further five that are committed to purchase – upon acquisition of these five properties, the rent roll will increase by a further £0.9m to £32.3m.
- Scope to expand the portfolio considerably. PHP centres cover just c2.5% of the UK population.

Chart 3: PHP – contracted rent roll at year end

Source: Company accounts, Peel Hunt estimates (*note: 2007 was an 18 month period)



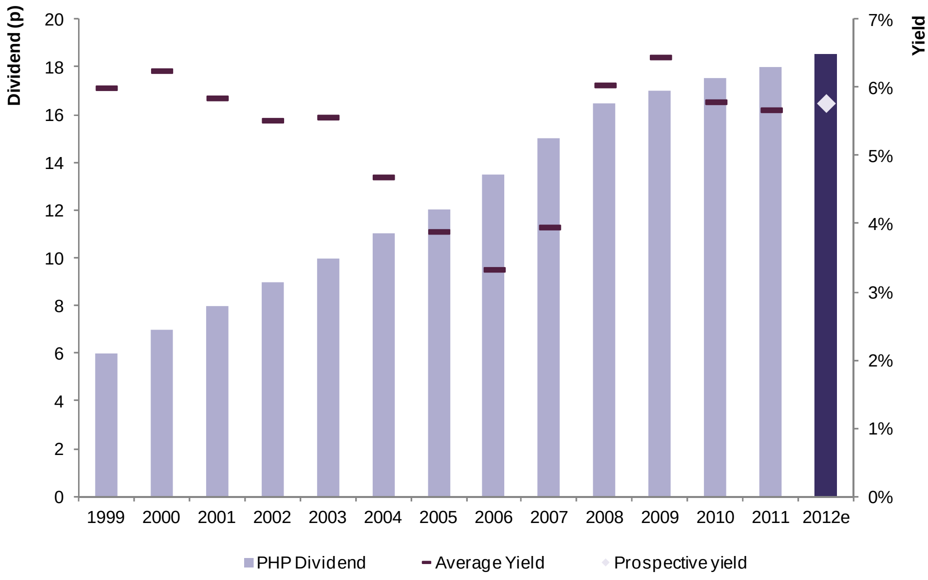
Bond-like, defensive characteristics

- Much of the company's expertise involves treating with, and securing agreements from, doctors moving into generally larger, more multifunctional facilities. This is in line with the intentions of the Health & Social Care Bill.
- The portfolio is valued every six months as an aggregation of individual values – no portfolio premium exists in the valuation.
- A **progressive dividend policy that has been maintained for the last 15 years** (see chart on the next page).
- The dividend yield has bond-like characteristics. Historically, the dividend has yielded between 3.5% (at the lowest) and up to 6.5% dividend yield over the past 12 years vs 10 year gilts returning 2.2% as in the following table:

A progressive dividend policy that has been maintained for the last 15 years

Chart 4: Progressive Dividend Policy

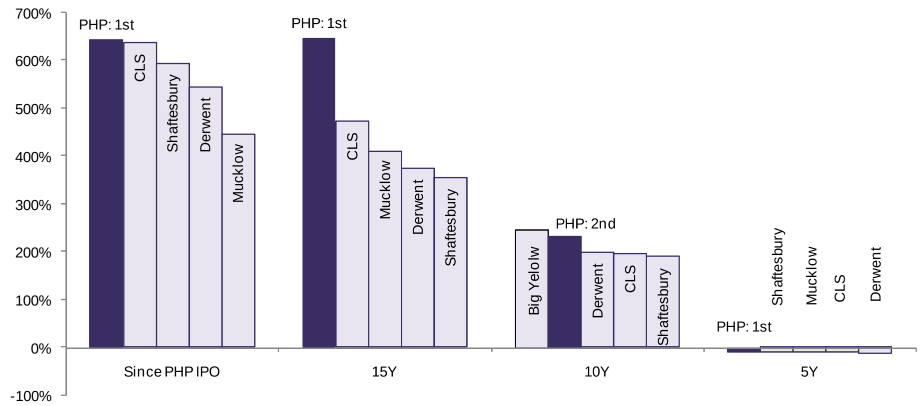
Source: Company accounts, Peel Hunt estimates



- Moreover, 2010's total return (measured against the IPD UK healthcare index – published annually) comprises outperformance of 13% compared with the benchmark 11%. In May, the figures for 2011 will be published.
- And finally, PHP has been either the **first or second** company in our coverage to generate the greatest total return (in terms of share price and dividend growth) over the last 15 years, 10 years and 5 years as well as since IPO.

Chart 5: Top 5 companies generating the highest total return

Source: Company accounts, Peel Hunt estimates



A unique and highly defensive income stream

In conclusion:

Although we expect total financing costs to increase going forward over FY12 and FY13, leaving a partially uncovered dividend. However, we still see the income stream, prospects for rental growth and covenant strength as **unique and highly defensive** brining certainty in an increasingly uncertain economic environment. A must, in our view, for private clients/smaller funds oriented to bond-like dividend characteristics. Buy.

Recommendation structure and distribution as at 20 February 2012		No	%
Buy	> +10% expected absolute price performance over 12 months	159	55
Hold	+/-10% range expected absolute price performance over 12 months	100	35
Sell	> -10% expected absolute price performance over 12 months	30	10

Peel Hunt…

	Shareholding (%) held by					during the last 12 months	
Company	Analyst	Company in PH (>3%)	PH in Company (>3%)	makes a market in this company	is broker to this company	has received compensation from this company for the provision of investment banking services	has acted as a sponsor/broker/NOMAD/ financial advisor for an offer of securities from this company
Primary Health Properties				x	x	x	x

Recommendation history

Company	Date	Rec	Date	Rec	Date	Rec
Primary Health Properties	20 Nov 09	Buy				

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