PRIMARY HEALTH PROPERTIES - HEALTHY REITING

Primary Health Properties - Healthy REITing

Following the transformational merger with MedicX (completed March 2019) we examine the drivers for continued strong shareholder returns

Primary Health Properties (LON:PHP) is a real estate investment trust (REIT) that holds a portfolio of 484 primary health facilities in the UK (94% of the portfolio) and Ireland (6%). The business model is to manage the properties for rental income and to grow the portfolio over time. The asset base has some attractive characteristics for yield-focused investors:

- 90% government-backed rent
- 99.5% occupancy rate
- Weighted average unexpired lease time: 13.4 years

This stable rental income base has allowed PHP to pay a steadily growing dividend, with increases every year since listing in 1997.

High returns at low risk

We would normally expect a 'safety' play like PHP to offer commensurately lower returns to shareholders; however, PHP has achieved a 14.1% annual total shareholder return over the last five years, versus 4.6% for the UK REIT sector. In this report we examine PHP's strong financial returns in terms of:

- Solid rental income yield on property
- Low-cost ratio

We also examine PHP relative to sector peers on other characteristics such as lease terms and rental escalations.

Conclusion

We believe that the conditions remain in place for PHP to continue generating strong returns in the next few years, and to continue its unbroken run of dividend increases. Furthermore, in March 2019 PHP completed its transformational merger with MedicX, providing an enlarged portfolio, further improved cost ratio, and likely reduced the cost of financing over time. We include these factors in our detailed forecasts (pages 9-11) which support continued outperformance for the shares.

REAL ESTATE

11/06/2019

SHARE PRICE	52 WEEK LOW
136.49p	106.40p
MARKET CAP	52 WEEK HIGH
1,550.73M	137.80p
NAV	NET DEBT
0	0

MAJOR SHAREHOLDERS

1) ...
2) ...
3) ...

Shares in Issue	
Avg Volume	319303
Primary index	
EPIC	PHP
Next Key Announcement	
Sector	Real Estate

SHARE PRICE CHART

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Company Information

Currently unavailable

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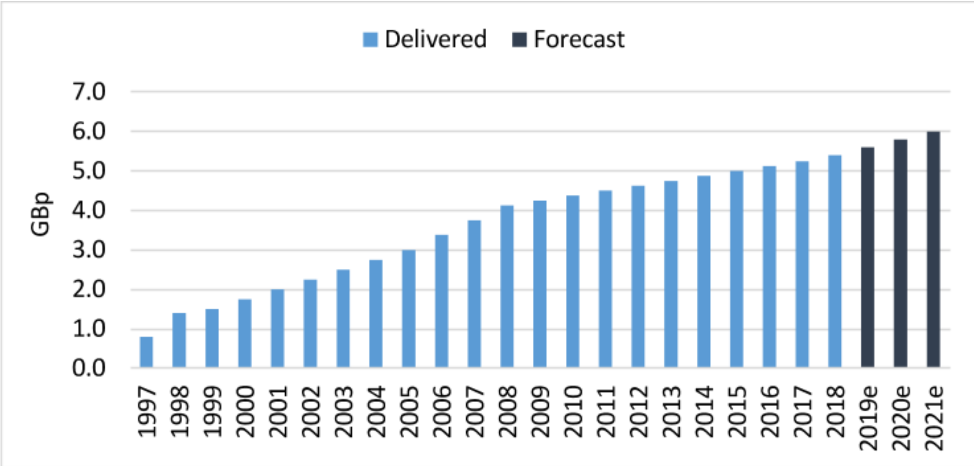
Year end Dec 31	2018	Current	2020	2021
Portfolio value (£mln)	1,502.9	2,446.0	2,608.0	2,778.0
Net rental income (£mln)	76.4	115.5	130.8	139.7
EPRA earnings (£mln)	36.8	60.0	69.8	72.7
EPRA EPS (GBp)	5.2	5.6	6.1	6.4
DPS (GBp)	5.4	5.6	5.8	6.0
EPRA NAV / share (GPp)	105.1	106.2	108.9	112.1
Gearing (LTV%)	45.8	51.3	52.5	53.7

Strong total shareholder return driven by growing dividend

The chart above shows the five-year record of PHP in terms of total shareholder return (dividend income + share price increase). This shows an annualised return for PHP of 14.1%, compared with 6.0% for the FTSE 350, and 4.6% for the UK REIT sector.

The average dividend return (dividend paid / starting share price) for PHP over this period was 5.4% with the rest of the 14.1% total return coming from share price growth. The dividend is an important part of the overall investment thesis. PHP has increased its dividend every year since listing in 1997. Very few stocks in the UK market have this kind of track record.

Dividend history



Source: Historic data from Primary Health Properties, forecasts from Capital Network

Primary health assets produce very steady cash returns

Portfolio - primary healthcare facilities

PHP's growing dividend stream is underpinned by one of the safest asset bases in the UK real estate sector – primary healthcare facilities. These are local health centres usually encompassing general practitioner (GP) surgeries, sometimes alongside other NHS services, pharmacies and dentists. The focus is on area 'hub' facilities rather than very small neighbourhood GP practices, as these 'hubs' are a core feature of local health infrastructure that do not tend to shut down or relocate.

In both the UK and Ireland the national health authorities have a committed policy of strengthening primary health care. This reflects the need to reduce pressure on hospital-based services, and to meet the needs of an ageing population.

In the UK PHP owns 469 properties, representing 7.5% of the addressable market, leaving plenty of headroom for further growth.

The following image shows a typical PHP property.

Typical property - Oakwood medical centre, Leeds

Source: Primary Health Properties

Primary healthcare facilities have some attractive qualities as a tenant base:

- Occupancy rates are high, and tenant turnover is low
- Properties are typically let under long lease terms. PHP has a weighted average unexpired lease term (WAULT) of 13.4 years
- Government is the direct payer for 90% of rents. This leads to a dependable and timely payment of rents

Merger with MedicX

In March 2019 PHP completed its transformational merger with MedicX. The MedicX portfolio is entirely complementary to PHP's existing asset base, and the deal creates a strong platform for growth, with increased scale and financial resources. The following table summarises some of the important metrics in relation to the deal.

Transformational impact of the MedicX merger

PHP merger with MedicX, in figures

	PHP	MedicX	Pro-Forma
Total properties	318	166	484
Ireland properties	10	5	15
Portfolio value (£bn)	1.5	0.8	2.3
Ave. lot size (£mln)	4.8	4.8	4.8
Occupancy	99.7%	99.0%	99.5%
Govt backed rent	90%	90%	90%

Source: Primary Health Properties

In addition to the benefits of scale that the merger brings, it has also led to a reduction in PHP's cost ratio (more on p7) with £4mln of cost synergies realised immediately on completion of the deal. The merger also gives rise to an expected lower cost of financing and access to additional property expertise from the MedicX team.

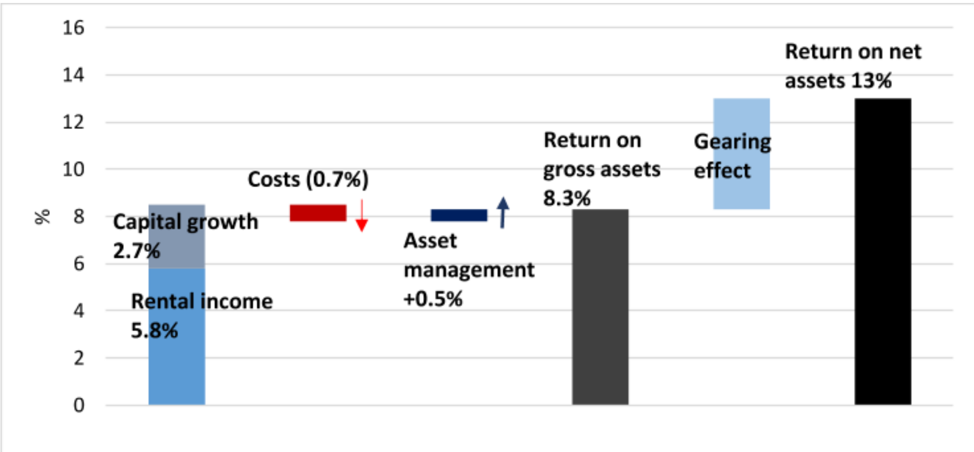
Total returns driven by stable rental income yields

How does PHP generate returns for shareholders?

Primary healthcare assets generate solid rental yields. PHP reports a net initial yield of 4.85% on its portfolio, which roughly translates as saying £1mln of investment gets you £48,500 of rental income. This is in contrast to some sectors of the UK non-residential property market, with yields in the prime west London office sector, for example, compressed down to 3.25% (Savills data).

Based on the secure rental income and steady capital gains, PHP has generated a 13% return on net assets per year over the last five years. The breakdown of this return on investment is illustrated in the following chart:

Total shareholder returns



Source: Capital Network

This 13% return on net assets has been the main driver of shareholder returns. Over the five years, PHP has delivered a 14.1% total shareholder return. The additional 1.1% per year has come from share valuation expansion – the stock market assigning PHP a higher multiple of market cap to net assets.

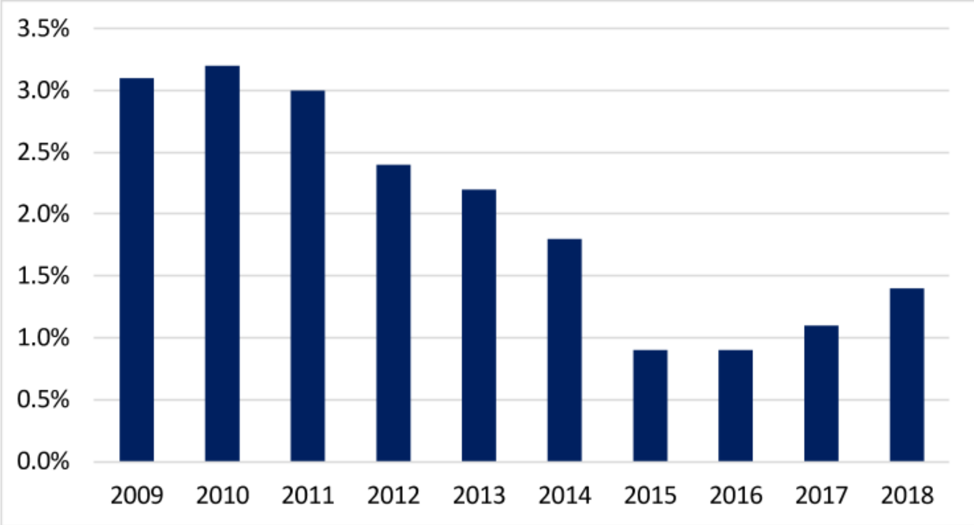
Going forward, we are not counting on further stock market valuation expansion; however, we do expect that a strong portfolio return (rents + property capital gains) will be sustainable and that the property returns model will continue to be the main driver for share price performance.

Comparing PHP with the REIT sector - metrics

Next, we consider some of the metrics that support our view that PHP’s cash flow stream offers a high degree of dependability.

The following chart shows the annual rent escalations that PHP has realised over the last 10 years.

Annual rent increases



Source: Primary Health Properties

Rent escalations have been consistently positive - in contrast to the wider REIT space

If we compare PHP's rent escalation history with the wider REIT segment, the important feature is that PHP has not suffered decreases in rent during the last decade. The commercial property sector suffered rent declines in 2009 and 2010, and we believe that cyclical risks remain an issue for the wider sector. The stability in health care is a clear positive.

The rent review mechanisms in the primary healthcare space contribute to stability:

- Within PHP's expanded portfolio, 31% of rents reviews are on a fixed escalation basis or are linked to the retail price index (RPI), while 69% are based on an open market review.
- Open market review rents are effectively "up only", with reductions only possible if both parties choose to agree to it.

We believe that the slowdown in rent escalations in 2015-2016 began to make the primary healthcare market appear less attractive to private capital. The pick-up in 2017 and 2018 suggests, in our view, that the NHS is recognising the need to attract investment. We expect the pace of rent escalations to increase moderately again in 2019-2021.

Occupancy

PHP has an occupancy rate of 99.5% and primary healthcare assets tend to achieve high levels of occupancy, due to the low turnover of tenants and controlled nature of the market. The following chart compares PHP with various UK REIT peers based on occupancy rates.

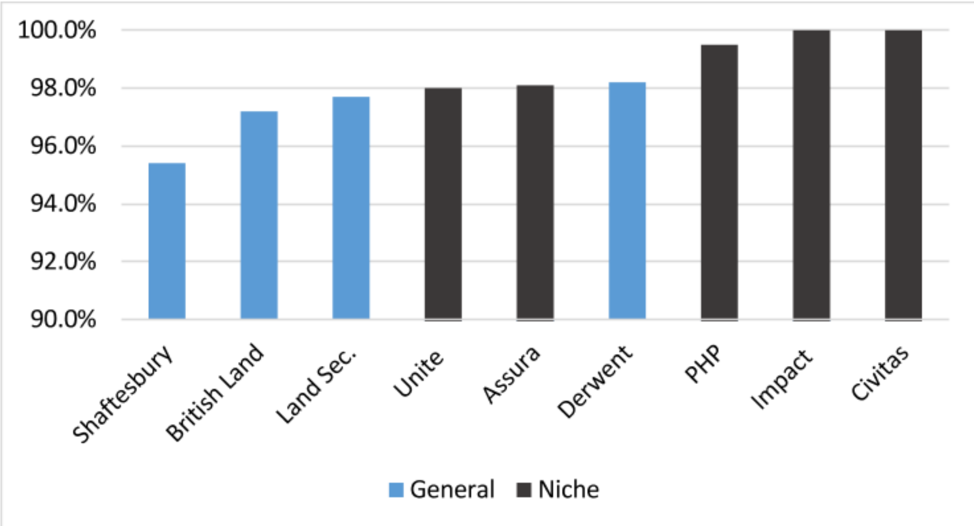
We have divided the peer group into two categories:

General: These are primarily focused on office and retail, which account for the majority of the overall UK REIT space. The names we have chosen are some of the big names in the sector: British Land (LON:BLND), Derwent London (LON:DLN), Land Securities (LON:LAND), and Shaftesbury (LON:SHB).

Niche: We have chosen niche players that share some similar characteristics with PHP – Civitas (LON:CSH) is in social housing, Unite Group (LON:UTG) in student accommodation, Impact Healthcare (LON:IHG) in care homes, and Assura (LON:AGR) in primary healthcare.

Occupancy rates typically higher among the "niche" players than the generalists

Occupancy rate



Source: Capital Network

* Unite Group figure is for properties leased to universities

The chart shows that PHP, along with Impact Healthcare and Civitas, has close to 100% occupancy; in fact, all of our niche players have 98% occupancy or better, owing to the nature of the tenant base.

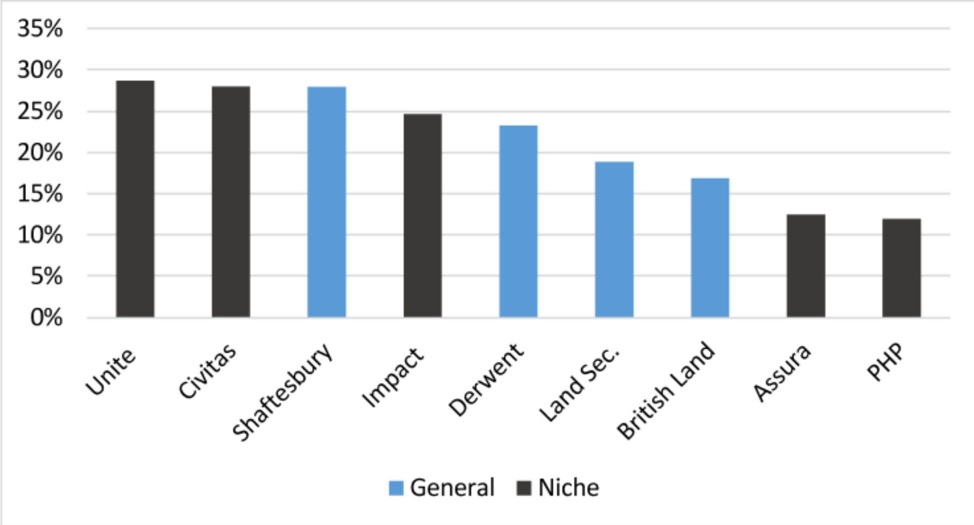
Cost Ratio

We next compare PHP with its peers based on cost ratio. For this purpose, we use the cost ratio defined by the European Public Real Estate Association (EPRA). It is calculated by expressing the sum of property expenses (net of service charge recoveries and third-party asset management fees) and administration expenses (excluding exceptional items) as a percentage of gross rental income.

The following chart compares our peer group sample using the EPRA cost ratio. Most of these companies explicitly publish an EPRA cost ratio, and the figure is taken from their publications. In the cases of Unite and Civitas, we have constructed the ratio based on raw data from their accounts.

PHP leading the peer group on cost ratio

Cost ratio



Source: Capital Network

On the cost ratio measure, there are two stand-out names among the group – PHP and Assura, which is the other healthcare REIT within the group.

Among the other niche players, there are some that scored well on occupancy rates (the previous chart), but not so well on the cost ratio measure. We do not suggest this is a measure of 'efficiency' as such – different business models have different cost structures. Nonetheless, it's a reassuring feature of PHP that rent drops through nicely to earnings and thus to dividends.

Conditions remain in place for continued financial performance

Looking forward

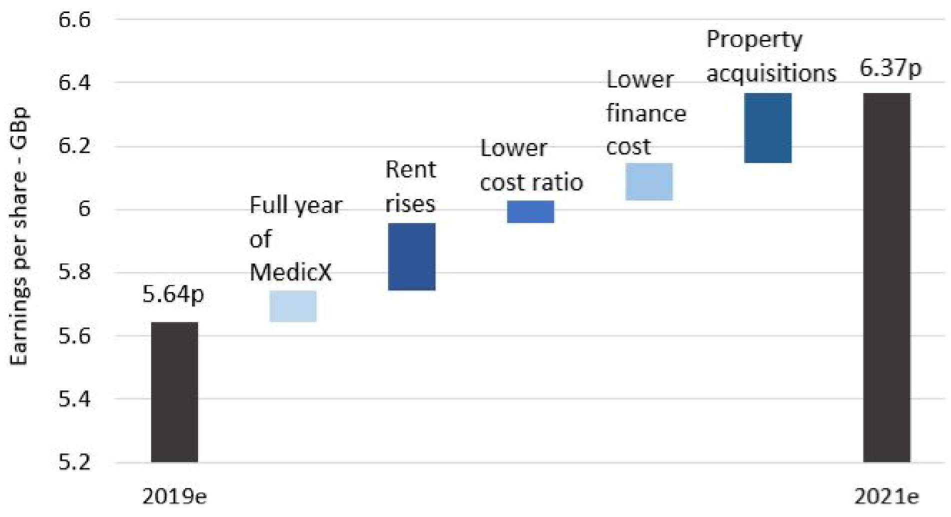
We have shown that PHP has a strong track record of delivering robust returns to shareholders based on a low risk asset base.

We next consider the outlook for 2019e to 2021e – does the record continue?

An important financial metric in the REIT space is the EPRA earnings per share (EPS). This is the EPS as defined by the European Public Real-estate Association. It is the industry standard measure of profit per share based on rental income (not capital gains). This is important because the EPRA EPS represents the profit per share available for paying dividends.

The following chart shows our forecast EPRA EPS progression from 2019 to 2021e.

EPS bridge



Source: Capital Network

Various components are supporting future earnings growth, which supports dividend growth

The elements of the chart can be described as follows:

- The MedicX merger is accretive to EPS but in 2019 only nine months of that merger benefit applies, whereas 2021 reflects a full 12 months of merger accretion.
- We are forecasting rent rises of 1.8% per year in 2020 and 2021. At fixed cost ratio assumptions, these would give rise to a 0.2p increase in EPS
- In addition, we expect a further modest decrease in the cost ratio, beyond that which has been delivered through the merger with MedicX
- We are forecasting 20bps (basis points - 100 bps = one percentage point) decrease in the cost of debt financing.
- Finally, we are forecasting £245mln of further property acquisitions during 2020-2021, with EPS accretion arising from these acquisitions.

We concluded that PHP is on track to deliver further continued gains in EPS, and therefore to be able to continue growing the dividend.

Financials

The following tables summarise our financial forecasts

Income Statement

Yr to December (£-mln)	2017 A	2018	2019 E	2020 E	2021 E
Rental income	72.5	79.6	118.5	134.0	143.0
Direct property expense	(1.2)	(3.2)	-3.0	-3.2	-3.3
Net rental income	***71.3***	***76.4***	***115.5***	***130.8***	***139.7***
Admin and operating expenses	(8.7)	(9.9)	(11.5)	(12.0)	(12.5)
Operating profit before revaluations	62.6	66.5	104.0	118.8	127
Finance income	0.3	0.1	-	-	-
Finance cost	(31.9)	(29.8)	(44.0)	(49.0)	(54.5)
EPRA earnings	***31.0***	***36.8***	***60.0***	***69.8***	***72.7***
Other financial	(3.6)	1.4	-	-	-
Profit on disposal/Other		0.1	-	-	0
Income tax expense	-	-	-	-	-
Net result on property portfolio	64.5	36.0	36.0	42.0	45.0
Operating profit	***127.1***	***102.5***	***140.0***	***160.8***	***172.2***
Other comprehensive income	2.8	4.1	(147)		
IFRS income	***94.7***	***78.4***	***(51.0)***	***111.8***	***117.7***
EPS - Fully Diluted (GBp)	***14.7***	***9.8***	***9.0***	***9.8***	***10.3***
EPRA EPS (GBp)	***5.1***	***5.2***	***5.6***	***6.1***	***6.4***
Dividend per Share (GBp)	***5.25***	***5.4***	***5.60***	***5.80***	*6.00*

Source: Capital Network

Balance sheet

Yr to Dec (£-mln)	2017 A	2018	2019 E	2020 E	2021 E
Cash and marketable securities	*4*	*6*	*5*	*11*	*9*
Receivables/other	*6*	*5*	*7*	*8*	*9*
Current Assets	***10***	***11***	***13***	***19***	***18***
Property	*1,362*	*1,503*	*2,446*	*2,608*	*2,778*
Other non-current	-	*1*			
Total Assets	***1,372***	***1,514***	***2,459***	***2,627***	***2,796***
Short-term debt	*1*	*102*	*2*	*2*	*2*
Payables/other	*18*	*16*	*17*	*18*	*18*
Deferred income	*15*	*16*	*17*	*18*	*18*
Long-term debt	*730*	*574*	*1,259*	*1,379*	*1,499*
Other non-current liabilities	*22*	*18*	*18*	*18*	*18*
Deferred share payments	-	-	-	-	-
Total Liabilities	***786***	***726***	***1,313***	***1,435***	***1,555***
Share capital	*78*	*96*	*96*	*96*	*96*
Premium	*81*	*221*	*221*	*221*	*221*
Retained earnings	*296*	*370*	*406*	*452*	*501*
Reserves	*133*	*102*	*423*	*423*	*423*
Shareholders' equity	***587***	***788***	***1,146***	***1,192***	***1,241***
Liabilities and shareholders' equity	***1,372***	***1,514***	***2,459***	***2,627***	***2,796***
Gearing (LTV%)	***53.4%***	***44.6%***	***51.3%***	***52.5%***	***53.7%***
NAV/Share (GBp)	***94.7***	***105.1***	***106.2***	***108.9***	***112.1***

Source: Capital Network

Cash Flow

Yr to Dec (£-mln)	2017 A	2018	2019 E	2020 E	2021 E
Operating profit	127.1	102.5	140.0	160.8	172.2
Fair value adjustments and capital gains/losses	(64.5)	(36.0)	(36.0)	(42.0)	(45.0)
Other non-cash	(1.4)	(1.6)	-	-	-
Taxes paid	-	-	-	-	-
Operating cash before WC and interest	**61.2**	**64.9**	**104.0**	**118.8**	**127.2**
Movement in receivables	(3.1)	2.2	(2.9)	(0.5)	(0.5)
Movement in payables	2.0	1.4	2.0	2.0	-
Cash from operations	**60.1**	**68.5**	**103.1**	**120.3**	**126.7**
Property investment	(75.4)	(101.9)	(110.0)	(120.0)	(125.0)
M&A - debt acqd and transaction cost			(475.0)		
Disposals	-	-	-		
Interest received	0.3	-	-	-	-
Cash flow from investing	**(75.1)**	**(101.9)**	**(585.0)**	**(120.0)**	**(125.0)**
Share issue	-	115.0	-	-	-
Cost of share issue	(0.1)	(4.0)	-	-	-
Other financing	(13.1)	(10.7)			
Interest paid	(26.1)	(25.2)	(44.0)	(49.0)	(54.5)
Debt increment	82.3	(5.6)	585.0	120.0	120.0
Dividends	(29.8)	(34.7)	(59.5)	(66.1)	(68.5)
Cash flow from financing	**13.2**	**34.8**	**481.5**	**4.9**	**(3.0)**

Source: Capital Network

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