LIBERUM

UK | REAL ESTATE | PHP LN | MARKET CAP £1,530m | 25 July 2019^

Primary Health Properties

Delivering on the promised merger synergies

HOLD

Target price 130p | Published price 134p

PHP's underlying performance was positive through H1, with improving rental growth and a 1-2bps contraction in net initial yields. NAV remained flat at 105.2p, 2% ahead of our forecast, with a +0.8% LFL property valuation gain (+£17.7m) offset by merger costs. EPRA EPS +12% y/y and DPS +4% were broadly in line with our forecasts. Positively, rent reviews have shown further steady improvement with annualised growth of 1.9% rising from 1.7%. Synergies have already delivered a £4m p.a. reduction in the enlarged group's operating cost base, further enhancing earnings growth. We expect PHP's portfolio to continue to benefit from long-term structural growth, driven by a growing and ageing UK population coupled with efforts to improve the efficiency and cost effectiveness of the NHS by expanding the scope of services provided by GPs. The shares trade on a CY19E P/NAV of 1.29x vs the sector at 0.89x and offers a dividend yield of 4.1%.

Good start to FY19: NAV 2% ahead of our forecasts

H1 EPRA NAV remained flat on FY18 at 105.2p, 2% ahead of our 103.1p forecast, helped by rental growth and 1-2bps contraction in net initial yields on the portfolio, offsetting a 1.4p impact from the MedicX merger.

EPRA EPS +12% to 2.8p was broadly in line with our 2.9p expectation and the DPS +3.7% to 2.8p was in line with our expectation of 2.8p.

Improving rental growth

Positively, annualised rental growth has shown further signs of improvement +1.9% vs. +1.7% in FY18 and narrowing the gap to peer Assura (2.2% as at March 19). Comparable new build evidence, used to price open market reviews, is now beginning to be reflected in lease renewals with management expecting this to result in further rental growth in the future.

The portfolio remains well let at 99.5%, with a long weighted average unexpired lease length of 13.0yrs. The EPRA cost ratio decreased further to 12.2% (vs 14.3% FY18 and 14.2% in H1 last year) as the portfolio benefits from a lower management fee on the enlarged portfolio. The merger with MedicX crystallised a number of operating and finance cost saving synergies and PHP has already delivered a £4.0m p.a. reduction in the enlarged Group's operating costs.

0.8% valuation gain

A +0.8% LFL increase in the property portfolio was ahead of our expectation. PHP saw a 1-2bp contraction in net initial yields in the period but the combination of the MedicX and PHP's portfolios resulted in the blended net initial and true equivalent yields remaining unchanged at 4.85% (vs FY18 4.85%) and 4.99% (vs FY 18 4.99%) respectively. Rental growth environment accounted for the majority of the surplus whilst yield compression accounted for the balance.

Higher LTV but lower cost of debt

LTV has increased to 47.9% (vs. 44.8% in FY18) following the acquisition of MedicX which operated with a higher LTV. Interest cover at 2.7x remains comfortably above the covenant 1.3x.

PHP issued a £150m convertible bond within the period, replacing the group's £75m retail bond with a lower cost financing option. The bond carries a coupon of 2.875% (vs. the retail bond's 5.375%) and reduces the average weighted cost of debt to 3.75% (vs 3.86% in H1 18). This will, nevertheless, have a dilutive impact on fully diluted EPS.

A summary of the MedicX acquisition; the purchase of a high quality portfolio

PHP's merger with MedicX completed on 14th March 2019. As a result of the transaction, existing PHP shareholders held 69.4% of the enlarged company, with MedicX shareholders holding the balance. PHP and MedicX's portfolio's are highly complementary, offering opportunities from scale benefits and a reduction in the EPRA cost ratio. £4m of savings p.a. are expected from the end of the first full year (0.4p per share in the enlarged company). MedicX's portfolio of properties included 166 in the UK and 5 in Ireland at the time of the merger. Similar to PHP, MedicX had a focus on larger lot sizes, in order to align its portfolio with the rising volumes and broadening scope of services increasingly provided by GPs. The average size per asset of the enlarged PHP group is c.1,300sqm, which compares to c.950sqm at Assura. Larger fit-for-purpose buildings allow greater patient, organisational and cost benefits to the healthcare system, reducing strain on A&E and the wider NHS. We continue to believe this strategy will drive superior value in the long term.

Taking share in a low-risk, growth market

We expect PHP's portfolio to benefit from long-term structural growth, driven by a growing and ageing UK population coupled with efforts to improve the efficiency and cost effectiveness of the NHS by expanding the scope of services provided by GPs. The majority of the existing primary care estate is considered unfit for purpose to meet this growing demand. Leases are long-dated and contain upward only rent review provisions. The merger with MedicX accelerates the benefits of scale increasing operational efficiency and with the potential to reduce the cost of capital. However, we believe this is fairly reflected in the group's current premium to NAV and premium vs the sector. The shares currently trade on a CY19E P/NAV of 1.29x, with a P/E of 23.1x and a dividend yield of 4.1%.

Figure 1: Summary financials & valuation (not updated for H1 results)

Valuation Summary (CY)	**2018A**	**2019E**	**2020E**	**2021E**
P/NAV (x)	1.28	1.29	1.27	1.26
P/E (x)	25.9	23.1	22.0	20.5
Div Yield (%)	4.0%	4.1%	4.3%	4.5%
EV/Sales (x)	20.5	22.2	20.7	19.9
EV/EBITDA (x)	24.5	25.1	23.3	22.4
EV/EBIT (x)	24.5	25.1	23.3	22.4
FCF Yield (%)	3.6%	2.5%	4.5%	4.8%

Financials (FY - Dec y/e)	**2018A**	**2019E**	**2020E**	**2021E**
Gross rental income (£m)	79.6	117.8	135.6	145.3
Net rental income (£m)	76.4	114.6	131.8	141.1
Gross to net (%)	*96.0%*	*97.3%*	*97.2%*	*97.2%*
Adj. EBITDA (£m)	66.5	104.0	120.3	129.4
EBITDA margin (%)	*83.5%*	*88.2%*	*88.8%*	*89.0%*
Adj. EBIT (£m)	66.5	104.0	120.3	129.4
EBIT margin (%)	*83.5%*	*88.2%*	*88.8%*	*89.0%*

Adj. net Interest (£m)	-29.7	-42.4	-51.1	-54.6
Adj. PBT (£m)	36.8	61.6	69.3	74.8
Adj. EPRA EPS - diluted (p)	**5.2**	**5.8**	**6.1**	**6.6**
DPS (p)	5.4	5.6	5.8	6.1
Cover (x)	*1.0*	*1.0*	*1.1*	*1.1*
Diluted EPRA NAV (p)	**105.1**	**104.3**	**106.2**	**106.3**
Net cash/(debt) (£m)	-676.6	-1,188.1	-1,276.6	-1,362.6
LTV (%)	45%	49%	51%	52%

Source: Liberum

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