

Buy

15 April 2016

Primary Health Properties[#]

PHP

DATA

Price	103p
Target price	125p
Market cap (post raising)	c£625m
Dec'15 NAV	88p
Free float	100%
Index	FTSE SmallCap
Sector	Real Estate
Next news	March - Finals
UK portfolio	100%

DESCRIPTION

The group is engaged in the generation of rental income and capital growth through investment in primary health care property in the UK leased primarily to GPs, Primary Care Trusts, health authorities & other associated health care users

PERFORMANCE

Source: Bloomberg



ANALYSTS

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£150m over-subscribed equity raise for expansion

PHP has successfully raised £150m at a premium to NAV in order to fund a c£158m pipeline of opportunities. As would be expected, the initial cash-drag reduces our forecasts; however, the leverage is significantly reduced, the market cap/liquidity of the shares will increase significantly and, most importantly, the progressive dividend will remain fully covered. We also look to upgrade as and when PHP exceeds our current acquisition assumptions. Buy.

Over-subscribed £150m issue

- PHP has raised £150m (exceeding the original £120m target) at 100p, representing a 9.5% discount to the price prior to announcement (21 March) and a 14% premium to the December 2015 NAV.

Use of proceeds

- **New acquisitions:** PHP has a pipeline of £116m in the UK and €54m in the Republic of Ireland.
- Existing **developments** require £24m and the company has also allocated £14m towards **asset management** initiatives on the existing portfolio.
- PHP is also considering the redemption of elements of its **interest rate swap portfolio**. We understand around £10-15m may be allocated here.

Benefits of the issue

- **Accretive** – With a marginal cost of debt at c3.25% (for 10 year money) and the most efficient cost-base in the UK real estate sector, further acquisitions will be earnings accretive as they complete.
- **Reduce leverage** – Leverage will reduce to around 50% immediately following the issue and we estimate this will rise to 55% as the initial pipeline is completed (from 63% in December 2015, the highest in our coverage).
- **Improve liquidity** – The market cap of PHP increases by almost one-third to c.£625m and we would expect increased liquidity and investor interest.

New forecasts

- We reduce our EPS forecasts for 2016, 2017 and 2018 by 9%, 9% and 5% respectively, to take account of the initial cash-drag and reduced leverage. Importantly, the dividend (unchanged) remains covered for each of the next three years.

STATS

Source: Company accounts, Peel Hunt estimates

Y/E Dec	Net Op Inc (£m)	Adj EPS (p)	EPS growth (%)	PER (x)	DPS (p)	Div yield (%)	Adj NAV (p)	NAV/3net (p)	Premium to NAV (%)	Premium to 3net (%)
2015A	62.3	4.9	19.0	21.1	5.0	4.9	88	77	17.1	32.8
2016E	63.7	5.2	6.0	19.9	5.1	5.0	95	88	7.7	17.3
2017E	69.6	5.5	6.4	18.7	5.3	5.1	99	91	3.6	12.4
2018E	75.2	5.8	5.6	17.7	5.4	5.2	106	99	(3.3)	4.4

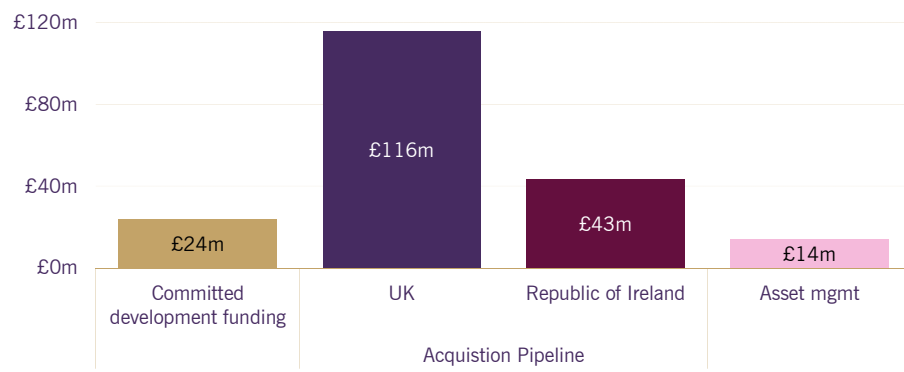
Use of proceeds

1. Majority of proceeds to be invested in new developments/acquisitions

- Committed development and funding:** PHP has set aside c£24m to fund the remainder of its committed developments including: Swindon (total £10.4m), Ipswich (£6.7m), Colwyn Bay (£4.6m) and Wrexham (£3.5m).
- Strong pipeline for acquisitions:** PHP has identified a pipeline of opportunities in both the UK and the Republic of Ireland, totalling c£158m. Around three-quarters is in the UK and the remainder in Ireland. We estimate that the blended yield on the pipeline to be around c5.6%, with the Irish assets (c7%) increasing the overall blend.
- Asset management:** PHP also aims to invest a proportion of funds into the active management of its existing assets such as building extensions in order to generate additional returns. Identified projects would commit up to £13.7m.

Chart 1: Intended use of proceeds

Source: Company accounts, Peel Hunt estimates

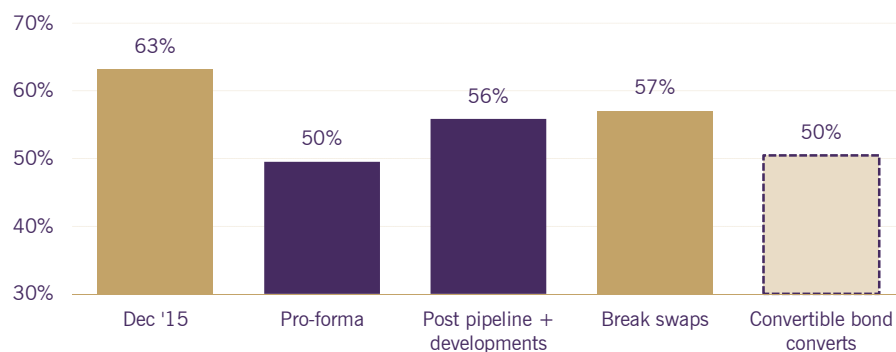


2. Reduce leverage

- Initially, PHP will pay down the debt drawn on the revolving credit facility until the proceeds are fully invested to help offset any cash drag.
- The initial pay down of debt will reduce the LTV to 50% immediately after the equity issue (from 63% at December 2015) and we estimate that as the company completes on the pipeline, the LTV will rise up to around 55%.
- Assuming the £82.5m convertible bond stays 'in the money', PHP can elect to convert this into further equity from next summer 2017, and this would further reduce the LTV by around another 7%.
- The company's long-term LTV target remains at 45-65% but following the issue, the company will not go any higher than 60%.

Chart 2: Reduced LTV

Source: PHP, Peel Hunt



3. Potential break of selected interest rate swaps

- PHP will continue to monitor its interest rate swap portfolio and will consider the redemption or restructuring of parts of the portfolio.
- By issuing equity at a premium to NAV, the company is able to spend around £10-15m breaking swaps with no impact on the pro-forma EPRA NAV and this is what we assume in our forecasts.
- Note: as of December 2015, the cost to break the whole interest rate swap portfolio, including forward starting swaps, would be approximately £35m, but interest rates have fluctuated since that date.

New forecasts and assumptions

- **Acquisitions.** We assume the company makes £80m of purchases this financial year, with the remainder of the £158m pipeline completing in 2017. We assume an average purchase yield of 7% in Ireland and 5.1% in the UK (compared to their valuation yield of 5.3%).
- **Debt funding.** We assume debt is initially repaid and that PHP's marginal cost of finance is around 3.25% (including the ten-year swap rate of c1.4%).
- **Swap break costs.** We assume around £15m is spent to break interest rate swaps in order to reduce the cost of debt. The exact impact will be dependent on particular money-market rates and negotiations with the various swap providers, but we assume that this reduces the swap charges by around 35% per annum and that this begins in FY2017 when various forward starting swaps 'kick-in.' We estimate that the average annualised cost of debt across the group will reduce by up to c40bps once such cancellation kick-in.
- **Equity issue costs.** We assume an all-in cost of 3%.
- **Our underlying property assumptions are unchanged.** We assume a +3% revaluation gain per annum, which is driven by small amounts of rental growth that drives 5-10bps of yield compression pa (to 5.1% net initial by December 2018).

Forecasts

- **EPRA EPS:** We reduce our EPRA EPS forecasts by 9%, 9% and 5% respectively over the next three years. This takes into account the initial cash-drag and also the reduced leverage within the business. We will look to upgrade as further purchases are made in excess of our assumptions. Importantly, the dividend remains covered each year (1.0x, 1.0x and 1.1x).
- **Dividend:** We retain our dividend forecasts for yields of 5.0%, 5.1% and 5.2% over each of the next three years.
- **EPRA NAV:** Is unchanged for 2016 but we reduce our December 2017 and December 2018 forecasts by -4% and -6% to take into account the small dilution from the issue (our previous forecasts were higher than 100p), the swap breakages and the lower LTV (leverage magnifies revaluation gains).

Table 1: New Peel Hunt forecasts

Source: Company accounts, Peel Hunt estimates

	FY015A	FY16E			FY17E			FY18E		
	Actual	New	Old	Change	New	Old	Change	New	Old	Change
Recurring PBT	£21.7m	£28.6m	£25.5m	12%	£32.8m	£26.9m	22%	£34.6m	£27.3m	27%
Adj EPS	4.9p	5.2p	5.7p	-9%	5.5p	6.0p	-9%	5.8p	6.1p	-5%
P/E	21x	20x			19x			18x		
DPS	5.0p	5.1p	5.1p	0%	5.3p	5.3p	0%	5.4p	5.4p	0%
Dividend yield	4.9%	5.0%			5.1%			5.2%		
Cover	1.0x	1.0x			1.0x			1.1x		
Adj NAV	88p	95p	95p	0%	99p	103p	-4%	106p	112p	-6%
Premium/Discount	17%	8%			4%			-3%		
LTV	63%	52%	64%	-12%	54%	64%	-10%	55%	64%	-9%

All numbers are before the conversion of the convertible bond which could start from Summer 2017

Investment case

Super-secure income stream drives a progressive dividend

- 91% of rent is directly/indirectly derived from the UK government, a long 15-year average lease length, 99.7% occupancy upward-only rent reviews and no tenant defaults in the company's history.
- 5% dividend yield is the seventh highest in our coverage, comfortably ahead of the sector average (3.6%) and is expected to continue to grow at c2-3% pa.
- After many years of partial cover, the dividend is now back to full cover (was 107% in H2 2015) and the dividend will remain covered going forward.

Growing sector

- There are 1.3m visits to GP's every day in the UK and, with an ageing and increasing population, the government has declared primary care the "bedrock" of the NHS, with a 24/7 service targeted by 2020.
- c40% of GPs believe their existing properties are not fit for purpose and 70% believe their property is inadequate for the range of services they would like to deliver.

Total return prospects

- The average property yield of 5.3% still looks conservative given:
 - This is almost 2.5x the 15-year gilt, with little additional income risk.
 - This is still significantly higher than large supermarket properties, which still trade as low as 4.25%.
- Our new forecasts assume just 25bps of further yield compression (top 5.1% net initial) and this equates to a three-year accounting total return of almost 40% or 12% compounded per annum.

Super-efficient structure

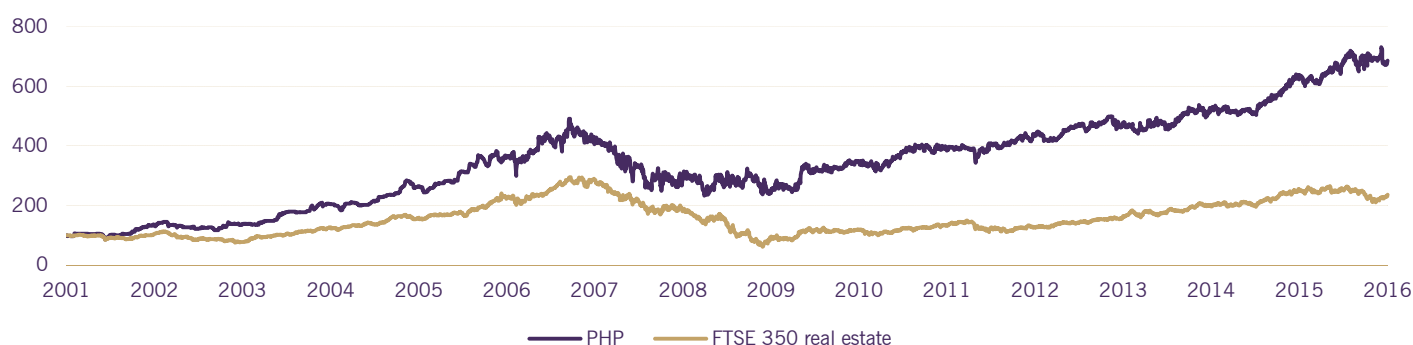
- PHP is not only the most efficient of the medical property companies, but the most efficient of all UK real estate companies, with a cost ratio of 11.5%.

Top track-record

- 14% compounded annual shareholder return since IPO – one of the best track records in the property sector
- PHP has raised its dividend every year since the IPO and is one of only a handful of companies in the UK to have achieved this over such a long period.

Chart 3: PHP long-term out-performance (total shareholder return)

Source: DataStream, Peel Hunt estimates



Valuation

We largely value PHP on its earnings metric given the nature of the business. Compared to its peers, PHP looks the best value on almost any metric (except for dividend, where MedicX pays a significantly higher, but uncovered dividend).

Chart 4: P/E ratio – PHP between 5-15% cheaper

Source: Company accounts, Peel Hunt estimates

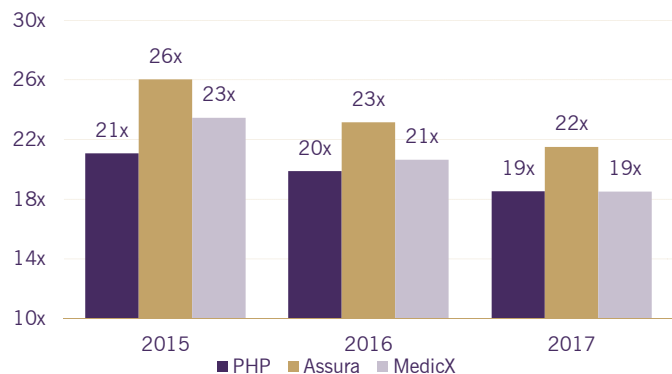


Chart 5: EV/EBIT – PHP between 4-17% cheaper

Source: Company accounts, Peel Hunt estimates

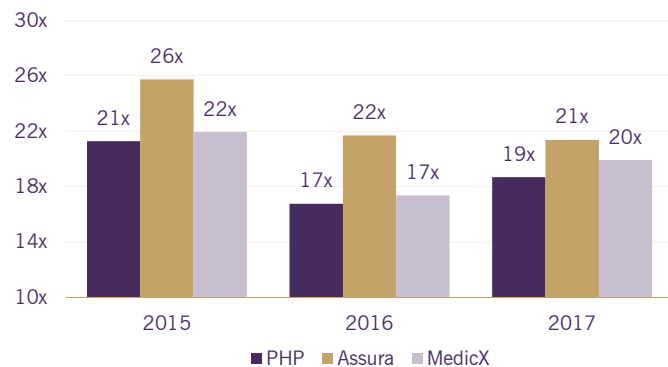


Chart 6: NAV premium/discount

Source: Company accounts, Peel Hunt estimates

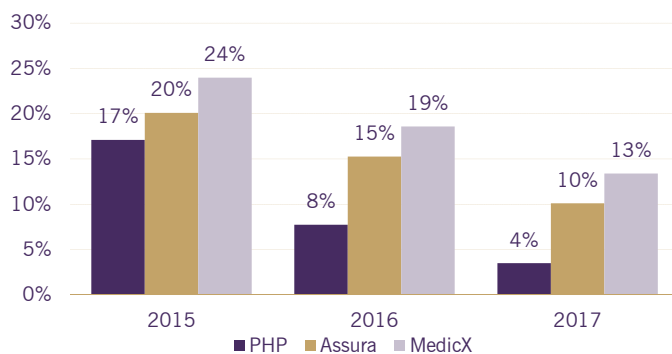


Chart 7: Dividend yield

Source: Company accounts, Peel Hunt estimates

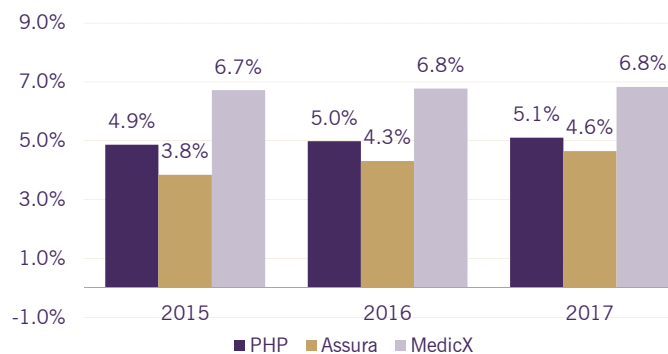


Chart 8: EPRA cost ratio

Source: Company accounts, Peel Hunt estimates

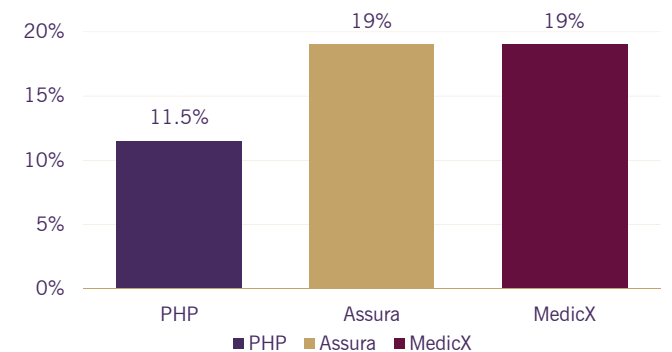
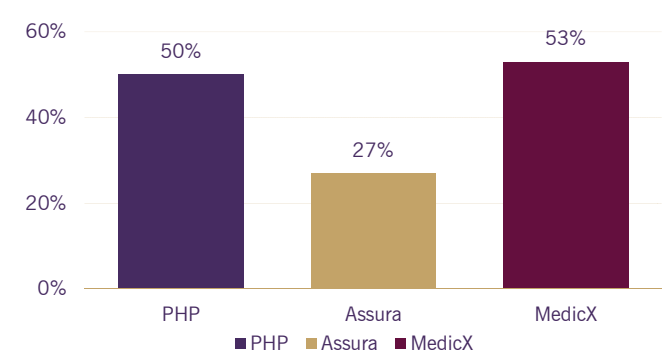


Chart 9: LTV (pro-forma)

Source: Company accounts, Peel Hunt estimates



Financial statements

Table 2: Financial Statements

Source: Company accounts, Peel Hunt estimates

Year ended 31 December	FY014A	FY015A	FY16E	FY17E	FY18E
Per share data (pence)					
NNNAV	69	77	88	91	98
Adjusted NAV	80	88	95	99	106
Basic EPS	8.3	12.6	10.9	9.0	12.2
Adjusted EPS	4.1	4.9	5.2	5.5	5.8
Dividend	4.9	5.0	5.125	5.250	5.375
Number of shares (m)	445	446	596	596	596
Key ratios					
NNNAV discount	48%	33%	18%	13%	5%
Adjusted NAV discount	29%	17%	8%	4%	(3%)
P/E ratio	25x	21x	20x	19x	18x
Dividend yield	4.7%	4.9%	5.0%	5.1%	5.2%
LTV	64%	63%	52%	54%	55%
Dividend cover	0.8x	1.0x	1.0x	1.0x	1.1x
Income Statement (£m)					
Net rental income	59.3	62.3	63.7	69.6	75.2
Admin/mgmt costs	(6.8)	(6.8)	(6.8)	(7.2)	(7.4)
Recurring EBITDA	52.5	55.5	56.9	62.4	67.7
Finance income	1.0	0.7	0.7	0.7	0.7
Finance expense	(35.3)	(34.5)	(29.1)	(30.3)	(33.9)
Recurring pre tax profits	18.2	21.7	28.6	32.8	34.6
Exceptional items	(10.5)	(5.5)	-	(13.9)	-
Revaluation gain/(loss) on property	29.2	39.8	31.4	34.9	38.2
Tax	-	-	-	-	-
Net Profit	36.9	56.0	60.0	53.8	72.8
Balance Sheet (£m)					
Investment properties	1,026	1,101	1,212	1,322	1,435
Cash	12.1	2.9	18.6	6.2	8.8
Total assets	1,044	1,108	1,235	1,332	1,448
Total debt	(667)	(698)	(648)	(723)	(798)
Total liabilities	(735)	(762)	(712)	(787)	(862)
Shareholders equity	309	345	523	545	586
EPRA NAV	355	392	569	591	632

Recommendation structure and distribution

Recommendation distribution at 14 April 2016

	Corporate No	Corporate %	No	%
Buy	73	82%	160	54%
Add	8	9%	44	15%
Hold	7	8%	76	26%
Reduce	0	0%	10	3%
Sell	0	0%	5	2%
Under Review	1	1%	2	1%

Until 7 September 2015, Peel Hunt's Recommendation Structure was as follows: Since 7 September 2015, Peel Hunt's Recommendation Structure is as follows:

Buy, > +10% expected absolute price performance over 12 months	Buy, > +15% expected absolute price performance over 12 months
Hold, +/-10% range expected absolute price performance over 12 months	Add, +5-15% range expected absolute price performance over 12 months
Sell, > -10% expected absolute price performance over 12 months	Hold, +/-5% range expected absolute price performance over 12 months
	Reduce, -5-15% range expected absolute price performance over 12 months
	Sell, > -15% expected absolute price performance over 12 months
	Under Review (UR), Recommendation, Target Price and/or Forecasts suspended pending market events/regulation

NB The recommendation is the primary driver for analyst views. The target price may vary from the structure due to market conditions, risk profile of the company and capital returns

Peel Hunt...

Company	Shareholding (%) held by				during the last 12 months		
	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	Date	Rec
Primary Health Properties	13 Jun 13	Buy						

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