

Primary Health Properties PLC

Company update

Real Estate

23 February 2015

A year of growth

Price: 389p

FY14A was a transformational year for PHP as the company increased its net rental income by 43%, and more than doubled EPRA earnings per share. Acquisitions and cost reductions have driven dividend cover to 84% during a temporary period of over-distribution, whilst maintaining an 18 year unbroken record of dividend growth. We maintain our HOLD rating.

Valuation & rating. PHP's shares have risen 4.1% year to date, underperforming the sector by 2.7%, and trade at a 19% premium to current NAV (i.e. NAV as at today) and we think it may take time for the NAV to grow to the current share price. The dividend yield of 5.2% is significantly ahead of the REIT average of 2.9%, but with leverage high at 64% and dividend cover around a year away, we retain our HOLD rating.

A stable asset class. Primary healthcare property is characterised by high/full occupancy (99.8% at end-December for PHP), stable valuation yields compared to the wider real estate market, strong tenant covenants (91% of rent effectively backed by the NHS, the remainder pharmacies), and long leases (average 15.3 years) with fixed uplift/index-linked/upward only rent reviews (4%, 19% and 77% of rent, respectively). The demand for new premises is fuelled by demographic pressures of an ageing population and the obsolescence of much of the existing stock of primary healthcare property. This is compounded by NHS budget constraints driving healthcare provision into the more cost-effective primary setting as new technologies enables healthcare to be moved out of the relatively expensive hospital environment. We believe the enduring low-risk, low valuation volatility and high income characteristics of the asset class will persist.

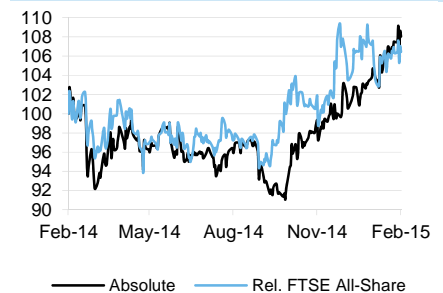
Stronger-than-expected 2014. PHP reported EPRA EPS of 16.4p in FY14A, ahead of our forecast 15.5p, with the more than doubling of earnings driven by cost cutting and acquisitions. Dividend cover is being restored ahead of expectations, and we believe that on a run rate basis, full dividend cover could be restored by the end of 2H15E.

Updated forecasts. We have updated our forecasts to take into account the increased rental income and lower costs reported for FY14A. Our updated EPRA EPS forecasts are: FY15E 18.7p (from 18.5p), FY16E 21.3p (21.1p) and FY17E 22.3p (new). Our dividend forecasts are unchanged with the growth trajectory of 0.5p/2.6% pa, consistent with the company's track record of 18 years of unbroken dividend growth, such that the shares have a prospective dividend yield of 5.2% at the current share price. Our upgraded NAV forecasts are: FY15 330p (from 320p), FY16E 348p (332p) and FY17E 366p (new).

HOLD

Unconnected research

Share price performance (indexed)



Key data

Stock code	PHP LN
Market cap (£m)	432
FTSE All-Share	3710
1mth perf (%)	3.2
3mths perf (%)	8.8
12mths perf (%)	8.1
12mth high-low (p)	393 - 328
Free float (%)	96

Key financials

Year to Dec	2014A	2015E	2016E
NAVPS adj (p)	319	330	348
Prem./(Disc.) (%)	22.0	18.0	11.9
EPS adj (p)	16.4	18.7	21.3
P/E adj (x)	23.7	20.8	18.3
2 yr NAV CAGR (%)	na	4.9	4.4
DPS (p)	19.5	20.0	20.5
Div yield (%)	5.0	5.1	5.3

All data as at 14:15 on 20 February 2015

All sources unless otherwise stated: Company data, Factset, Oriel Securities

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Key data¹

Key profit & loss data (£m)	2014A	2015E	2016E	2017E
Net rental income	59.3	63.9	68.2	71.6
Other income	0	0.1	0.1	0.3
Administration expenses	(6.8)	(4.8)	(5.1)	(5.4)
JV EBIT	0	0	1.0	1.0
EBIT	52.5	59.1	64.2	67.5
Capitalised interest	0	0	0	0
Net interest	(34.3)	(38.3)	(40.5)	(42.7)
JV interest	0	0	0	0
Recurring PBT	18.2	20.8	23.6	24.8
Change in fair value of derivatives	(2.5)	0	0	0
Revaluations	29.2	13.7	19.0	19.8
JV revaluations	0	0	0	0
Profit on sale of properties	0	0	0	0
Profit on sale of JV properties	0	0	0	0
Exceptionals	(8.1)	0	0	0
PBT	36.9	34.5	42.6	44.6
Tax on ordinary activities	0	0	0	0
PAT	36.9	34.5	42.6	44.6
EPS adj (p)	16.4	18.7	21.3	22.3
DPS (p)	19.5	20.0	20.5	21.5
DPS growth (%)	2.6	2.6	2.5	4.9
Interest Cover (x)	1.5	1.5	1.6	1.6
Dividend Cover (x)	0.8	0.9	1.0	1.0

Key cash flow data (£m)	2014A	2015E	2016E	2017E
Operating cash flow	49.0	59.1	64.2	67.5
Funds available for distribution	25.0	20.8	23.6	24.8
Free cash flow (pre investment)	4.3	(1.4)	0.8	0.9
Property acquisitions	(54.9)	(75.0)	(75.0)	(50.0)
Development expenditure	0	0	0	0
Property disposals	0.5	2.0	2.0	2.0
Net cash from share issues	0	0	0	0
Other	52.9	0	0	0
Net cash flow	2.8	(74.4)	(72.2)	(47.1)

Key balance sheet data (£m)	2014A	2015E	2016E	2017E
Investment properties	1,026.2	1,112.9	1,204.9	1,272.7
Investments	0	0	0	0
Other fixed assets	0.0	0.0	0.0	0.0
Other current assets	(26.7)	(26.7)	(26.7)	(26.7)
Net debt / (cash)	(425.7)	(500.1)	(572.2)	(619.3)
Provisions/fair value on derivatives	(264.8)	(264.8)	(264.8)	(264.8)
Adjustments	45.5	45.5	45.5	45.5
NAV adj	354.6	366.9	386.7	407.4
NAVPS adj (p)	319	330	348	366
NAV adj growth (%)	6.4	3.5	5.4	5.4
NNNAVPS (p)	293	304	322	340
Net debt/equity (%)	120.0	136.3	148.0	152.0
Loan to value (%)	63.8	65.6	66.5	66.7

Key information

Business description

PHP is a REIT that invests solely in freehold and long leasehold healthcare properties that are let principally to GPs, NHS organisations and associated healthcare users. The company engages in a limited amount of development activity in conjunction with recognised development partners with schemes de-risked by first entering into a pre-let with a GP. PHP has 265 healthcare centres with a portfolio value over £1bn, and derives 91% of its income from the UK Government. The company is externally managed by Nexus TradeCo.

Senior management

Harry Hyman (Managing Director)
 Phil Holland (Finance Director)
 Tim Walker-Arnott (Property Director)

Key dates

August - 1H15 results

Major shareholders

Private individuals - 9.7%
 Investec Wealth - 5.8%
 BlackRock - 5.0%

Website

www.phpgroup.co.uk/

¹Year end December
 Source: Company data, FactSet, Oriel Securities estimates

Updated forecasts

Stronger-than-expected FY14A

We have updated our forecasts following stronger-than-expected full year results from PHP, which showed higher earnings growth than we had forecast (EPRA EPS 16.4p vs our forecast of 15.5p) resulting in dividend cover of 84%, up from 57% a year before. The company has achieved this with three drivers of earnings growth:

1. **Increase in revenue through acquisitions.** PHP acquired Prime Public Partnerships (PPP) in late 2013 adding £14.4m to the rent roll by the addition of 54 high quality assets for £233m. A further £43m of acquisitions were made during FY14A, which together with the PPP assets comprised much of the 43% increase in net rental income during the year.
2. **Management cost reduction.** The provision of property advisory and administration services has been consolidated into the single external manager, Nexus TradeCo, following the termination of the agreement with J O Hambro as the previous joint advisors in May 2014. This has resulted in significantly lower administration fees, potentially lower property service fees in the near future and a simplification of the fee structure. We estimate the cost saving to be c.£1.2m pa, with FY15E the first year in which this saving is fully reflected in earnings. The total expense ratio was reduced to 69bps in FY14A, down from 88bps.
3. **Debt cost reduction.** PHP has fully refinanced £178m of debt acquired with the PPP assets, reducing the rate on that debt by more than 100bps. An £82.5m Convertible Bond was issued in May 2014 (coupon 4.25%, conversion price 390p per share), and £235m of bank facilities were restructured in August 2014, reducing lending margins by an average of 55bps. We believe the average interest rate at end-December was c.5%, but with a marginal cost of new debt closer to 3%.

Valuation growth in the investment portfolio of 3.2% led to a 6.3% increase in NAV to 319p at end-December, above our forecast of 310p (we had assumed capital growth of 2.4% in FY14A).

Earnings and dividends per share

We have updated our earnings forecasts to reflect the higher rent roll following acquisitions FY14A, and also the lower cost of debt as described above. Our assumptions for future acquisitions are unchanged at £75m pa in FY15E and FY16E, and we assume acquisitions of £50m in FY17E (new). Our updated EPRA EPS forecasts are: FY15E 18.7p (from 18.5p), FY16E 21.3p (21.1p) and FY17E 22.3p (new).

Our dividend forecasts are unchanged with the growth trajectory of 0.5p/2.6% pa, consistent with the company's track record of 18 years of unbroken dividend growth. Our new earnings forecasts show that dividend cover is 94% in FY15E (up from 92%) rising to full cover of 104% in FY16E (from 103%). We believe that on a run-rate basis the company will have achieved full cover by the end of 2015, in line with management guidance given at the time of the PPP acquisition. Achieving full cover is dependent on the rate of acquisitions, and although management commented at its results that it would not hurry the acquisition program at the expense of finding the right assets to fit the existing portfolio, we believe the risk is to the upside on the timing of the return of full dividend cover.

NAV per share

Our upgraded NAV forecasts assume modest inward yield shift of 2bps pa (unchanged assumption), consistent with the historic low volatility of the primary healthcare property asset class. PHP reported rental growth of 1.8% for 135 rent reviews concluded in FY14A (which includes rent reviews outstanding from previous years, when we believe rental growth was slightly higher). Management commented that it expects rental growth at similar levels for the immediate future, but to increase as the rate of new development approvals increases. With this in mind, we leave our income growth assumption for the portfolio valuation unchanged at 1% in FY15E, and increase it to 1.5% pa in FY16E and FY17E. Our updated NAV forecasts with these assumptions are: FY15 330p (from 320p), FY16E 348p (332p) and FY17E 366p (new).

Recommendation history

Primary Health Properties PLC

<u>Date</u>	<u>Recommendation</u>
Initiated: 16-Sep-2014	HOLD

Disclosures on interests

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