PEEL HUNT

Buy

20 August 2015

Primary Health Properties#

PHP

DATA

Price	414p
Target price	450p (was 400p)
Market cap	£468m
Jun '15 EPRA NAV	339p
Net Debt	£680m
Index	FTSE SmallCap
Sector	Real Estate

STATS (PRIOR TO CHANGES)

Source: Company accounts, Peel Hunt estimates

Y/E Dec	2014A	2015E	2016E	2017E
Net Op Inc (£m)	59.3	61.5	65.1	68.9
Adj EPS (p)	16.4	18.7	21.8	24.2
EPS growth (%)	54.4	13.8	17.0	11.1
PER (x)	25.6	22.5	19.2	17.3
DPS (p)	19.5	20.0	20.5	21.0
Div yield (%)	4.6	4.8	4.9	5.0
Adj NAV (p)	319	330	346	365
NAV/3net (p)	278	293	309	328
Prem/Nav (%)	32	27	21	15
Prem/3net (%)	51	43	36	28

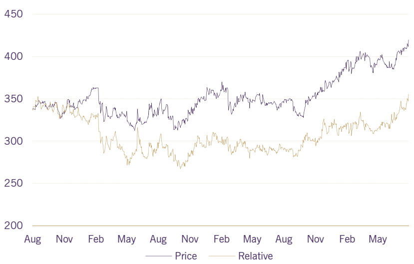
CHANGES TO FORECASTS

Source: Company accounts, Peel Hunt estimates

Y/E Dec	2015E Old	2015E New
Adj NAV (p)	330	350
Adj EPS (p)	18.7	19.4
DPS (p)	20.0	nc

PERFORMANCE

Source: Bloomberg



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#Corporate client of Peel Hunt

Interims: upgrading EPS - back to full dividend cover

Today's interims contain strong earnings performance and valuation growth. There has been continued yield compression with more to come in H2 leading to a 6% NAV upgrade. A swap restructuring has today resulted in a 4% EPS upgrade and PHP will now be back to full dividend cover in H2, faster than expected. The shares trade significantly cheaper than their closest peers on an earnings basis and the near 5% dividend backed by super-safe income looks attractive. Buy.

Interim Highlights

- **EPRA NAV +6.3% to 339p –** already above our full year forecast of 330p. NAV was driven by a LFL portfolio valuation gain of 2.3% which was from 14bps yield compression to a 5.61% equivalent yield (from 5.75% at Dec 2014)
- **EPRA EPS increased +20.3% to 8.9p** from H1 last year as the full impact of reduced management costs and debt refinancing are realised.
- The EPRA cost ratio (all admin/mgmt. contract expenses dividend by gross rent) has fallen from 12.0% at Dec 2014 to 11.6%. PHP is the most cost-efficient stock under our coverage and is significantly more efficient than its peers, Assura (17% cost ratio) and MedicX (c19%).
- Looking forward, in July PHP terminated an £80m interest rate swap contract at 4.8% which would have lasted one year to July 2016. This results in a short-term 43bps average reduction in the cost of debt from 4.9%. The cost to PHP of £3.2m (c3p to NAV) will be more than offset by the £1.7m saving in each of H2 2015 and H1 2016 and leads us to EPS upgrades today. From July 2016 a further £60m of swaps at 4.5% 'kick in', hence the saving is only short-term, although there could be scope for further savings should the forward starting July 2016 swaps be renegotiated. PHP also purchased two new swaps covering £90m at c2.6% starting in 2018/19.
- **Whilst DPS has risen +2.6% to 10.0p, dividend cover has increased to 89%** (Dec 2014: 84%). The Board's main priority is returning to **full dividend cover** and post today's EPS upgrade we forecast 97% cover for this year (equates to over full cover in H2) and 1.1x cover for 2016.
- **LTV of 63%** (from 64% at Dec 2014). £87m of undrawn debt facilities remain which will cost a low c1.7% to drawn down (after allowing for saving in commitment fees). The LTV includes the unsecured £82.5m, 5-year convertible bond issued in May 2014 as debt. The convertible coupon is 4.25% with a current 390p conversion price.
- Rental growth of 1.1% was lower than last year (1.8% at Dec 2014) as previously guided by management.
- **£34m of acquisitions; more to come -** Income yield on acquisition is 5.65%and all will complete by Jan 2016. These are new buildings let on 21.3 year leases on average (vs the 15 year portfolio average). This follows seven acquisitions worth £43m across the whole of 2014. Although acquisitions are

harder to find, PHP still have a "strong pipeline" of opportunities, with some in solicitors' hands.

- **Other news:** PHP announces a move to quarterly dividends starting in Jan'16 and also announced a 4-for-1 share split subject to EGM approval.

A growth sector – an aging population & govt backing more surgery visits

- The government continues to support expansion in the primary health care sector by supporting the NHS Five-Year Forward View which sets out plans for more "integration out of hospital services based around the needs of local populations" which should lead to greater number of modern, larger surgeries.
- Data available from advisers involved in the sector (Savills/EC Harris) shows that half of all primary care premises are over 30 years old and most are residential conversions which are unlikely to be able to service an increasing number of visits and the additional services that will need to be provided. The latest BMA premises survey (July 2014) revealed that 70% of GPs believe their premises are too small to deliver extra services and the government is also pledging to have 24hr/7 day a week GP access and 5,000 more GPs.

New forecasts and valuation

FY Dec 2015 forecasts – upgraded:

- **Adj EPS +4% to 19.4p** (from 18.7p) for a 21x PE. This means the H2 earnings of 10.5p will cover the dividend 1.05x.
- **DPS unchanged at 20.0p** for 4.8% dividend yield.
- **Adj NAV upgraded +6% to 350p** (from 330p) for an 18% prospective premium. Despite the small 3p reduction from the swap cancellation, we expect further yield compression in H2.

FY Dec 2016 forecasts – upgraded:

- **Adj EPS +2% to 22.3p** (from 21.8p) for an 19x PE.
- DPS unchanged at 20.5p for 5.0% dividend yield, **which will be fully covered 1.09x** and is forecast to grow to 5.1% for the year to Dec 2017.
- **Adj NAV +6% to 365p** (from 346p) for a 13% prospective premium.

Valuation compared to its peers

- PHP's newly upgraded forecasts compare well to its closest peers, MedicX and Assura (both using consensus). Given the nature of the companies, we believe EPS is the most sensible valuation metric, as it enables the payment of fully covered dividends:
  - **PHP trades on an EPS yield of 4.7%** vs. **Assura on 3.9%** and **MedicX on 4.4%**. PHP's EPS is also growing the fastest. We forecast +15% growth for 2016 vs. consensus growth rate of +7% for AGR and +6% for MXF.
  - On NAV, PHP trades on a +18% prospective premium versus Assura on +12% premium and MedicX on +16%.

Our assumptions for PHP

- **Yield compression?** Given the weight of money chasing the sector, PHP expect some further yield compression in H2, but a gradual amount (not 25-100bps as seen in other sectors!). We assume 5bps yield compression in H2 and 8bps over 2016, reaching an equivalent yield of 5.47% by Dec 2016.
- **Rental growth?** We assume 1.1% rental growth over 2015 (in-line with the rise reported today) rising to 1.3% for 2016 as construction cost inflation starts to feed into rental growth.

Recommendation structure and distribution as at 20 August 2015		Corporate No	Corporate %	No	%
Buy	> +10% expected absolute price performance over 12 months	81	90	180	60
Hold	+/-10% range expected absolute price performance over 12 months	9	10	113	38
Sell	> -10% expected absolute price performance over 12 months	0	0	8	3

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…

	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	

Recommendation history

Company	Date	Rec	Date	Rec	Date	Rec	Date	Rec
Primary Health Properties	13 Jun 13	Buy						

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