

Buy
14 May 2014

Primary Health Properties[#] (PHP)

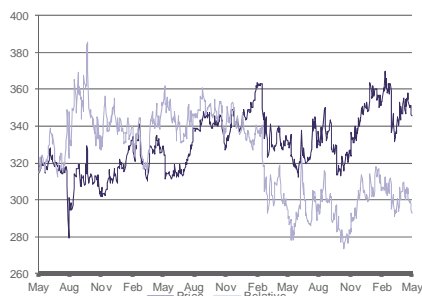
Data	
Price	346p
Target price	390p
Market cap	£384m
Dec '13 NAV	300p
Free float	100%
Index	FTSE SmallCap
Sector	Real Estate
Next news	Aug - Interims
UK portfolio	100%

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



Analyst

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Convertible to fund further accretive acquisitions

PHP continues its growth strategy via a new £75m convertible bond to invest into an **“attractive pipeline” of acquisitions**. Once the proceeds are fully invested, the deal will add c1p to EPS, while the premium and dividend protection provide attractive terms to equity investors. PHP’s dividend of 5.8% is the highest in the sector and is from the most secure income stream with rapidly improving cover – Buy.

Convertible bond highlights

- A **£75m, senior, unsecured** convertible bond with **five-year** maturity.
- **Coupon of 4.25%** (below PHP’s average 4.85% all-in cost of debt).
- **Conversion price of 390p, or a +16% premium** – well above the current 300p net asset value.
- Importantly, the dividend protection is set at a level that will **ensure the conversion premium is not materially reduced** as dividends are paid.

Use of proceeds

- Proceeds will be used to expand the portfolio further. In Q1, PHP outlined an **“attractive pipeline” of acquisition opportunities** and, following the increase in available resources, we await further announcements.
- Initially, PHP will use the proceeds to pay down revolving credit facilities, in order to reduce the immediate impact of the interest charge on earnings (see page 2).

New forecasts

- We reduce our Dec 2014E EPS by **-4%** to 15.4p (from 16.0p), but increase Dec 2015E and Dec 2016E EPS by **+1%** and **+4%** (to 18.9p and 21.0p), and this equates to **dividend cover of 0.8x, 0.9x and 1.0x** over the next three years.
- We also reduce our NAV forecasts marginally to account for higher acquisition costs, by -0.4%, -1% and -1% respectively over the next three years.
- The shares currently trade on a **+10% NAV premium and 5.8% dividend yield** – the **highest in the sector** and from the **safest income stream**. Buy.

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)	Disc/Nav (%)	Disc/3net (%)
2013A	41.6	10.6	4.5	32.5	19.0	5.5	299.5	273.7	15.4	26.3
2014E	57.4	15.4	45.0	22.4	19.5	5.6	305.6	279.7	13.1	23.5
2015E	63.2	18.9	22.6	18.3	20.0	5.8	309.5	283.6	11.6	21.8
2016E	67.6	21.0	11.2	16.4	20.5	5.9	320.6	294.8	7.8	17.2

Financial impact

Impact on the P&L

- The 4.25% convertible coupon will be partially mitigated initially by paying down revolving credit facilities which have a margin of c2.35% (PHP's average bank lending margin). Following repaying the revolvers, even if no acquisitions were made for the rest of 2014, this would reduce PHP's EPS by only around 0.8p. However, our forecasts assume further acquisitions and we therefore reduce our 2014 EPS by 0.6p or 4%.
- **As acquisitions complete, the convertible will become EPS-accretive.** Once all proceeds are fully invested at an investment yield of around 5.75%, we estimate the proceeds will generate an additional **£0.9m of recurring profit c0.8p per share** on an annualised basis

Impact on the balance sheet and leverage

- The convertible will be accounted for as debt, but this will be revalued in the balance sheet at each reporting date.
- As the convertible will initially pay down revolving credit facilities, there will be no initial impact on LTV. However, as the proceeds are invested, the LTV will rise towards 66% (from 62% at December 2013). #Corporate client of Peel Hunt

Likelihood of the bond converting

- The bond can be converted at any time between 41 days after settlement and the bond maturity in May 2019, but only if the market price is above the conversion price (390p). However, the initial premium of +16% means this is unlikely to occur in the near term unless the share price performs strongly.
- Importantly, **dividend protection is high at 19.5p**. This is in line with our 2014E dividend forecast, and therefore the initial conversion premium is unlikely to reduce materially as any dividend amounts over 19.5p are paid.
- Assuming the dividend rises by 0.5p each year over the next five years, we estimate the conversion price could fall by 5p in total over the course of the bond. This would reduce the conversion price from 390p to 385p, or by just 1%.
- This 390p conversion price equates to a high +30% premium to the Dec 2013 EPRA NAV of 300p, and a +21% premium to our new Dec 2016E NAV forecast of 321p (the latest date we estimate).
- If we assume our Dec 2016E NAV forecast rises by 3% pa in 2017 and 2018 (driven by 3% rental growth and no yield shift), we could see a 340p NAV by December 2018. To this figure, the conversion price would equate to a +17% NAV premium and a 5.5% prospective dividend yield (assuming the DPS rises by 0.5p each year to 22p for the year to December 2019) – this remains a higher rating than that on which PHP currently trades.
- As the conversion price of 390p is still +15% ahead of the 340p Dec 2018E NAV estimate, the bond is likely to be accretive to NAV upon conversion by approximately +2%.
- If converted, the bond would represent c19m new ordinary shares, or 17% of the existing issued share capital.

Investment case

- At the current share price, PHP's dividend yields 5.8%, the highest dividend yield of our coverage of 30 UK-listed real estate stocks. Not only is it the highest dividend yield, but PHP also provides the most secure income stream in the sector:
 - The average lease length of PHP's portfolio is **c16 years** – the longest in our coverage.
 - Over **90% of the income** is directly or indirectly funded by the UK Government.
 - The estate is continually **near-100% occupied** and the company has **never had a medical tenant (including pharmacy) default in its 18-year history**.
 - Around 21% of the portfolio now has fixed uplift leases or index-linked rent reviews. The remaining leases are effectively upward-only reviews.
- The portfolio itself comprises over 260 modern, high-quality primary health care centres that require minimal capex and have limited ongoing landlord costs (we forecast direct costs of around 1% of rent).
- This enables PHP to distribute a large, consistent and rising dividend, and the company is one of the very few to have raised its dividend consistently over a long period (18 years).

New Peel Hunt forecasts

Dec 2014E forecasts

- We reduce our adjusted EPS forecast to 15.4p (from 16.0p) to account for the overall increase in interest charges and the possible delay in the completion of acquisitions.
- We also reduce our NAV forecast marginally to 306p (from 307p) to account for c1p of bond issue costs.
- We maintain our 19.5p dividend forecast, for 5.8% yield and 79% cover – the largest dividend yield in the sector.

Table 1: New Peel Hunt forecasts

Source: Company accounts, Peel Hunt estimates

Y/end December	2013	2014E		2015E		2016E	
	Actual	New	Old	New	Old	New	Old
Recurring PTP (£m)	9.5	17.0	17.7	20.9	20.7	23.2	22.2
Adjusted EPS (p)	10.6	15.4	16.0	18.9	18.7	21.0	20.1
DPS (p)	19.0	19.5	19.5	20.0	20.0	20.5	20.5
Cover (x)	56%	79%		94%		102%	
Dividend yield (%)	5.6%	5.8%		5.9%		6.1%	
Adjusted NAV (p)	300	306	307	309	314	321	323
Premium (%)	+13%	+10%		+9%		+5%	

Dec 2015E forecasts

- We increase our adjusted EPS forecast marginally to 18.9p (from 18.7p), with acquisitions offsetting the higher debt cost from the convertible.
- Adjusted NAV is reduced slightly to 309p (from 314p) to account for more acquisitions and therefore higher acquisition costs.
- DPS maintained at 20.0p, for 5.9% yield and 94% cover.

Dec 2016E forecasts

- We increase our adjusted EPS to reflect the accretive nature of the convertible bond once fully annualised – adjusted EPS rises to 21.0p (from 20.1p).
- Adjusted NAV marginally reduced to 321p (from 323p).
- DPS maintained at 20.5p, for 6.1% yield and 102% cover.

Recommendation structure and distribution as at 14 May 2014	Corporate No	Corporate %	Total No	Total %
Buy > +10% expected absolute price performance over 12 months	65	86%	159	56%
Hold +/-10% range expected absolute price performance over 12 months	11	14%	107	38%
Sell > -10% expected absolute price performance over 12 months	0	0%	16	6%

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	28 Feb 13	Hold				

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