Buy

3 December 2013

Primary Health Properties#

(PHP)

Data

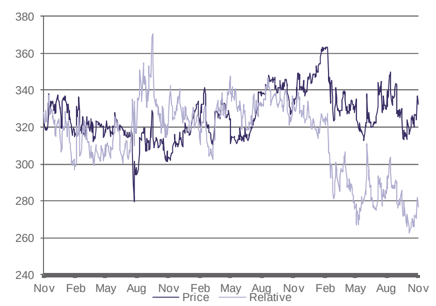
Price	337.5p
Target price	375p (was 350p)
Market cap	£326m
Adj NAV	305p
Free float	100%
Index	FTSE SmallCap
Sector	Real Estate
Next news	March - Finals
UK portfolio	100%

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



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#Corporate client of Peel Hunt

Transformational deal propels dividend cover

PHP is a member of a unique club of companies that have increased their dividends consecutively for 15 years or more, and the acquisition of Prime Public Partnership ("PPP") will help PHP to maintain that track record for the foreseeable future. The acquisition increases PHP's portfolio by £233m for a £41m equity outlay that is funded through the issue of shares to the vendor at a price above NAV – the perfect deal to restore PHP's dividend cover. Buy.

- The acquisition of PPP is PHP's **most significant transaction to date**, increasing the portfolio by **one-third**, achieving three years' worth of acquisitions in one go and **significantly accelerating the return to full dividend cover**.
- The deal will be **immediately accretive** to earnings, and the impact will be **substantially increased** once the portfolio's debt is refinanced. Management guides to an all-in-cost of 4.5% and this leads to our estimate for **dividend cover of 82% in Dec 2014E**, rising to **92% in Dec 2015E**.
- Once refinanced, the portfolio will contribute **over one-quarter of the combined group's PBT**, and this will more than offset the 13% increase in shares that will be issued to the vendors, who are locked in for 18months.
- Following the deal, the **LTV will rise to 63%** (vs 53% currently) and, once the c£50m of acquisitions in solicitors' hands complete, we estimate a LTV of 65% – the upper end of PHP's target range, but this should fall as values rise.
- PHP's investment case remains unchanged: a **super-secure income** stream that generates a **large dividend** that has risen for **17 consecutive years**. Based on our projections, the Dec 2015E dividend will yield 5.9% and will be almost fully covered by our EPS forecast, which includes conservative refinancing and rental growth assumptions and an acquisition rate which merely reflects transactions which are already in solicitors' hands.
- The shares trade on a **+13% premium** to our Dec 2013E NAV forecast (versus a sector average premium of +2%) and a prospective dividend yield of 5.6% – **the third largest dividend yield in the sector behind Redefine and NewRiver**.

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 (%)
2012A	32.7	10.2	n/a	33	18.5	5.5%	305	235	11%	43%
2013E	40.3	11.5	13%	29	19.0	5.6%	300	252	13%	34%
2014E	61.2	16.1	40%	21	19.5	5.8%	303	255	12%	32%
2015E	63.2	18.4	14%	18	20.0	5.9%	309	262	9%	29%

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Upgraded Peel Hunt forecasts

Dec 2013 forecasts upgraded:

- Our **adjusted NAV forecast of 300p** is unchanged, for a +13% prospective premium.
- The PPP acquisition will make little impact to our Dec 2013E P&L forecasts, given the transaction completes in early December and the Aviva debt will not be refinanced until at least Q1 next year.

We upgrade our 2013E EPS forecast by +6%

- However, after reviewing our model, we upgrade our 2013E PBT and EPS forecasts by 6% to £10.1m (from £9.5m) and 11.5p (from 10.8p) respectively, as a result of recent acquisitions and a positive IMS.
- DPS unchanged at 19.0p for a **5.6% dividend yield** and **61% cover.**

Table 1: New Peel Hunt forecasts

Source: Company accounts, Peel Hunt estimates

Y/end December	2012	H1 2013	2013E	2014E	2015E
Recurring pre-tax profits (£m)	7.4	4.3	10.1	17.8	20.4
Adjusted EPS (p)	**10.2**	**4.8**	**11.5**	**16.1**	**18.4**
EPS yield (annualised, %)	*3.0%*	*2.8%*	*3.4%*	*4.8%*	*5.5%*
DPS (p)	**18.5**	**9.5**	**19.0**	**19.5**	**20.0**
Yield (annualised, %)	*5.5%*	*5.6%*	*5.6%*	*5.8%*	*5.9%*
Cover (x)	*55%*	*50%*	*61%*	*82%*	*92%*
Adjusted NAV (p)	**305**	**301**	**300**	**303**	**309**
Discount/premium (%)	*11%*	*12%*	*13%*	*12%*	*9%*

Dec 2014E forecasts (incl. £50m of additional purchases):

Our forecasts assumes a conservative refinancing rate of 4.5%

- We assume the Aviva debt is refinanced from **its current rate of 5.9% to 4.5%** at the end of Q1 2014 – this is management's guidance and is a conservative assumption in our opinion (see page 6 for details).

We assume PHP makes £50m of additional acquisitions representing deals that were in solicitor's hands in Aug '13

- We also **assume PHP makes £50m of acquisitions** (excluding completed developments) by around March 2014 – this merely reflects the remaining purchases that were in solicitors' hands in August 2013. Previously we assumed £125m of acquisitions throughout 2014.
- Even on our **relatively conservative assumptions**, we upgrade recurring **PBT to £16.1m (from £14.8m)** and we upgrade **Adj. EPS to 16.1p (from 15.1p).**
- **Adjusted NAV increases to 303p** (from 300p); this accounts for reduced transaction costs (compared to our previous assumption on £125m of direct property purchases) following the corporate acquisition of PPP, which avoids stamp duty.
- DPS unchanged at 19.5p, for **5.8% yield and 82% cover.**

Dec 2015E forecasts

We now forecast 82% dividend cover by Dec 2014E, rising to 92% by Dec 2015E

- We now forecast adjusted NAV of 309p for an +9% premium
- Recurring PBT of £20.4m drives an adjusted EPS of 18.4p.
- DPS of 20.0p, for a **5.9% dividend yield and 92% dividend cover**.

Table 2: 2014E - P&L breakdown

Source: Company accounts, Peel Hunt estimates

Y/end December (£m)	PHP	PPP	Combined
Rental income	47.0	14.7	61.6
Finance lease income	0.3	0.0	0.3
Direct property expense	-0.6	-0.2	-0.8
Net rental income	**46.8**	**14.5**	**61.2**
Management fees	-3.8	-1.0	-4.8
Other administration expenses	-1.0	0.0	-1.0
Recurring EBITDA	**42.0**	**13.4**	**55.4**
Depreciation	0.0	0.0	0.0
Finance income	0.5	0.0	0.5
Finance expense	-28.8	-9.3	-38.1
Recurring pre-tax profit	**13.7**	**4.1**	**17.8**
Weighted shares in issue (m)	97.8	12.8	110.6
Adjusted EPS (p)	**14.0**		**16.1**
Dividend cover (%)	***72%***		***82%***

Table 3: F2015E - P&L breakdown

Source: Company accounts, Peel Hunt estimates

	PHP	PPP	Combined
Rental income	48.6	15.0	63.7
Finance lease income	0.3	0.0	0.3
Direct property expense	-0.6	-0.2	-0.8
Net rental income	**48.4**	**14.8**	**63.2**
Management fees	-3.5	-1.0	-4.6
Other administration expenses	-1.0	0.0	-1.0
Recurring EBITDA	**43.8**	**13.8**	**57.6**
Depreciation	0.0	0.0	0.0
Finance income	0.5	0.0	0.5
Finance expense	-29.1	-8.6	-37.7
Recurring pre-tax profit	**15.2**	**5.2**	**20.4**
Weighted shares in issue (m)	97.8	12.8	110.6
Adjusted EPS (p)	**15.6**		**18.4**
Dividend cover (%)	***78%***		***92%***

The PPP transaction

- PHP is acquiring **Prime Public Partnership ('PPP') for £41.1m** (the price is subject to adjustment, depending on the actual NAV at completion).
- PPP is largely owned by individuals who are also senior management of Prime Plc, a developer of primary health care centres which constructed the PPP portfolio.

The transaction is effectively a property acquisition in a 'corporate wrapper'

- Today's acquisition does not include any part of Prime Plc, its LIFT JV or the management team – it is effectively a property acquisition in a 'corporate wrapper'.

Increases PHP's portfolio by +33%

- The purchase is significant to PHP and increases **the portfolio by +£233mn or +33% to £942m.**
- PHP is funding the acquisition through **the issue of shares to the vendor at a price of 320p (a 6% NAV premium).**
- The acquisition includes £178m of long-dated Aviva debt at rates of between 5.3% and 6.1%. We understand the average rate is around 5.9%.

PPP is marginally accretive initially and very accretive once refinanced.

- The transaction will be marginally accretive before the debt is refinanced but the accretion will be substantially enhanced once refinanced (see page 6 for details).
- The equity consideration includes a £13.7m allowance for the estimated cost/ fees to reduce the long-dated Aviva interest rates, or an early repayment to refinance the Aviva debt (see page 8 for details).

The price and issued shares:

- The £41.1m price represents the expected net asset value of PPP at completion and is equivalent to 12.8m shares in PHP at 320p.

The £41.1m price will be paid through the issue of shares to the vendor.

- The price may rise to a maximum of £42.6m (13.3m shares), dependent on the exact NAV at completion. All the shares will be issued at 320p, as follows:
  - 12.6m upon completion.
  - up to 0.5m further shares, based upon the actual NAV at completion.
  - up to 0.2m further shares may be issued, subject to the amendment of an existing lease within 12 months.

The issue price represents a -1% discount to the closing price on 14 November 2013.

- The issue price of 320p represents:
  - a **+6% premium** to the June 2013 EPRA NAV of 301p.
  - a **–1% discount** to the closing price on 14 November (the night before announcement) of 324p.
  - a –5% discount to yesterday's closing price of 337.5p.
  - a +1% premium to PHP's June 2013 equity issue price of 315p
- The shares will be held by eight individuals, who will be 'locked-in' for 18 months (except one shareholder, with permission to sell up to £1m).

The PPP portfolio

- The portfolio consists of 54 properties with an aggregate valuation of £233m and an average lot size of £4.3m.
- The portfolio is weighted to the North of England (53%), Scotland (23%) and the Midlands (15%).
- PHP and PPP's combined portfolio totals 257 assets with an aggregate valuation (including committed developments) of £942m (after accounting for acquisitions since the interims of £48.7m).

Table 4: PHP and PPP's portfolio

Source: Company accounts, Peel Hunt estimates

(£m)	PHP existing property*	PPP portfolio
Investment property (£m)	£709m	£233m
Number of assets	203	54
Average lot size (£m)	£3.5m	£4.3m
Gross rent roll (£m)	c£41m	£14.3m
WAULT to break (yrs)	15.6 years	17 years
% fixed/index linked uplifts	*15%*	*21%*
LTV (%)	53%	76%

*As of Jun 2013 interims and adjusted for acquisitions announced since

PPP property income

- The portfolio has a passing rent of £14.3m, and we understand there will be direct property costs of c£200k - £300k.
- The rent roll based on the acquisition values (reflecting the lower transaction costs of a corporate acquisition) implies a gross yield of 6.1% and, after landlord costs, this would equate to a 6.0% cash net yield.
- The investment yield used in the independent valuation of the PPP portfolio assumes standard acquisition costs of 5.8% (which PHP is not paying in this transaction), and after these the investment yield is likely to be quoted as being in line with PHP's current investment yield of 5.7%.
- The PPP assets have an average unexpired lease term of 17 years to first break and 62% of leases have 15 or more years remaining on the lease.
- 94% of the rent is derived directly/indirectly from the NHS.
- Most of PPP's leases contain rent reviews that can by triggered only by the landlord – effectively upward only (and similar to PHP's current leases).
- 21% of leases are linked to RPI.

A development agreement with Prime

- As part of the transaction, PHP has agreed a five year development pipeline with Prime (not being acquired by PHP).
- This gives PHP the right of first refusal on Prime's future medical centre developments – a "*valuable source of future portfolio growth opportunities*".

Earnings-accretive

The debt assumed alongside the PPP portfolio currently totals £178m and is at an average rate of c5.9%. We estimate that, at this rate, the PPP portfolio would contribute around £3m to recurring PBT, but this rises to between c£4.9m if management refinances the debt within its guidance of 4.5% (all-in).

In our forecasts we assume a relatively conservative refinance rate of 4.5%, and we assume the debt is refinanced at the beginning of Q2 2014 – the PPP transaction completes in December 2013, but PHP needs to provide three months' notice to Aviva, and to allow time for negotiations with Aviva and/or new lenders. The 4.5% all-in cost looks relatively conservative, given the recent 12-year bond PHP issued last month with a margin of just 220bps.

Table 5 below shows the impact on our adjusted EPS forecasts for Dec 2014E and Dec 2015E of different refinancing rates; if PHP were to achieved an all-in rate of 4.0%, we would look to upgrade our adjusted EPS forecasts by +5%, and this would increase dividend cover to 87% for 2014E (from 82% currently) and to 96% for 2015 (from 92%).

A refi rate of 4.0% would increase dividend cover to 96% in Dec 2015

Table 5: Refinancing rate sensitivity
Source: Company accounts, Peel Hunt estimates

		Dec 2014E forecast			Dec 2015E forecast	
Refi Rate	Recurring PBT (£m)	Adj. EPS (pence)	Dividend Cover	Recurring PBT (£m)	Adj. EPS (pence)	Dividend Cover
3.75%	18.7	16.9	87%	21.8	19.7	99%
4.00%	18.4	16.6	85%	21.3	19.3	96%
4.25%	18.1	16.4	84%	20.8	18.8	94%
4.50%	**17.8**	**16.1**	**82%**	**20.4**	**18.4**	**92%**
4.75%	17.5	15.8	81%	19.9	18.0	90%

Guidance from PHP
PH (conservative) forecasts

PPP will contribute over 25% of PBT for a 12% increase in share capital.

Using our 4.5% assumption of debt costs post the refinancing, Chart 1 below shows the breakdown of the £4.9m PBT on an annualised basis, whilst Chart 2 demonstrates the accretive nature of the deal – the PPP portfolio will contribute over one-quarter of pre-tax profits, which will be funded through the issue of 12.8m shares, or just 12% of PHP's issued share capital.

Chart 1: Annualised PBT of PPP (post refi)

Source: Company accounts, Peel Hunt estimates

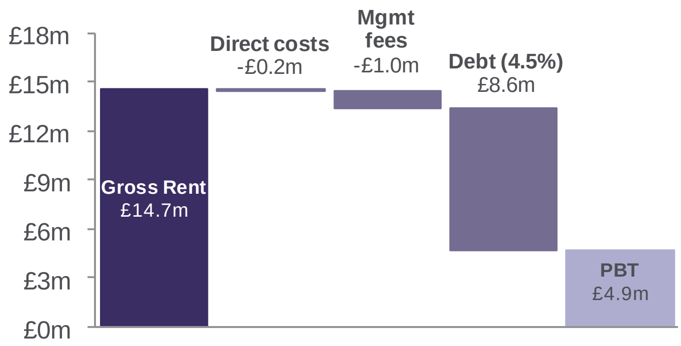
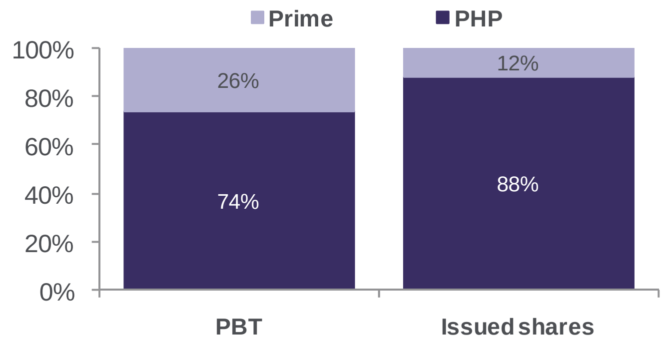


Chart 2: PPP contributes 26% of PBT from 12% of ISC

Source: Company accounts, Peel Hunt estimates



The recent management contract alteration will now save £1m per annum

As mentioned in our note *New advisory agreement improves dividend cover* on 26 September 2013, the recent amendment to the management contract would have an initial cost saving of £860,000 per annum, but this would increase as the company expands. We estimate that the saving following the PPP portfolio will now be in excess of £1.0m from the prior management contract, and this will further increase as more acquisitions are made.

Balance sheet impact

Acquisition price equates to PPP's EPRA NAV

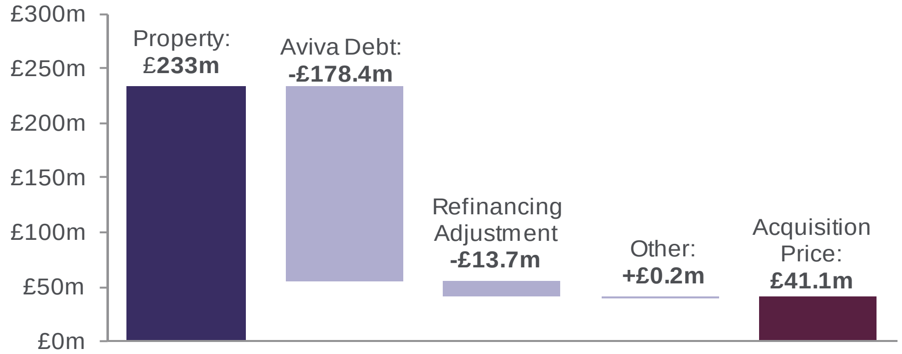
Although management expects to pay c£13.7m in order to refinance/repay the existing long-dated Aviva debt, importantly an allowance for this amount was included in the acquisition price; this effectively means the £41.1m expected acquisition price is equal to PPP's EPRA NAV.

Negligible impact on PHP's NAV

Therefore the impact to EPRA NAV will be negligible – the only impact to NAV will be from the transaction costs of £1.4m, which equate to approximately 1p per share. Our prior forecasts assumed acquisition costs that were significantly higher (albeit on less property) and therefore today's transaction leads to small upgrades to our EPRA NAV forecasts from 2014E onwards (see page 2).

Chart 3: PPP acquisition price equates to EPRA NAV

Source: Company accounts, Peel Hunt estimates



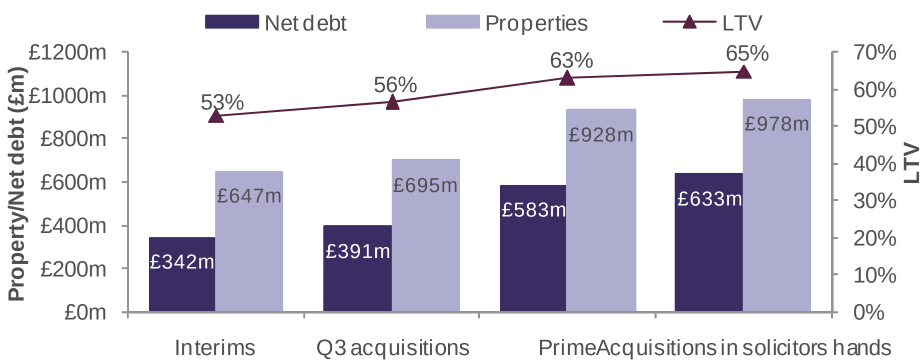
The PPP portfolio is highly leveraged, with £178m of debt on £233m of property, equating to a 77% LTV. This rises to 82% once the £13.7m early refinancing fee is accounted for. This is significantly higher than PHP's current LTV (53% at June 2013) and the transaction will therefore increase PHP's overall leverage.

We estimate a pro-forma LTV of 63%, rising to 65% once acquisitions in solicitors' hands complete.

We estimate, that following the acquisitions completed in Q3 (£47.8m) and the PPP acquisition, the LTV of the combined group will stand at 63%. This will rise to 65% once the c£50m of acquisitions in solicitors' hands complete. This is at the upper limit of PHP's target of maintaining LTV below 65%, but this will naturally reduce over time as valuations rise.

Chart 4: Impact on portfolio, net debt and LTV

Source: Company accounts, Peel Hunt estimates



Investment case

The longest weighted average lease length in our coverage

The most secure income stream in the sector:

- The average lease length of the combined PHP and PPP portfolios is c16 years – the longest in the sector.
- Over 90% of the income is directly or indirectly funded by the UK Government.

Government-backed, 100% occupied, no defaults.

- The estate is continually near-100% occupied and the company has never had a tenant default in its 17-year history.
- Around 17% of the combined portfolio now has fixed uplift leases or index-linked rent reviews, and the vast majority of the remaining leases are effectively upward-only reviews.

Consistent rental growth

- Rental growth of 2.4% was achieved in the most recent Q3 IMS, 2.3% was achieved in H1 2013, and 2.4% was achieved in 2012. The rent reviews are conducted every three years and, although rental growth has slowed over the last few years (expected to be c2% for 2013 as a whole), PHP is still significantly outperforming its peers outside of London.

High quality, modern portfolio

PHP's portfolio is now comprised of 257 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.

5.6% prospective dividend yield

One of the sector's highest dividend yields

At the current share price, our forecast DPS for 2013E of 19.0p yields 5.6% - the third highest dividend yield in our real estate coverage, and that from one of the longest, most consistent and most secure income streams available.

Chart 5: Real estate dividend yields

Source: Company accounts, Peel Hunt estimates

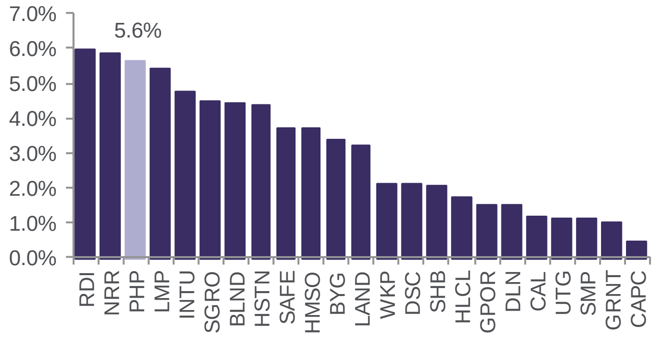
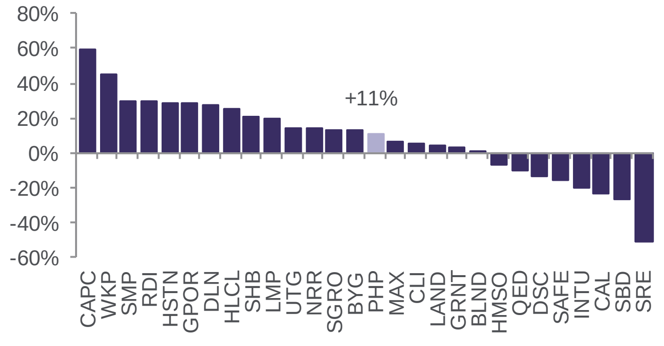


Chart 6: Real estate historical discounts

Source: Company accounts, Peel Hunt estimates



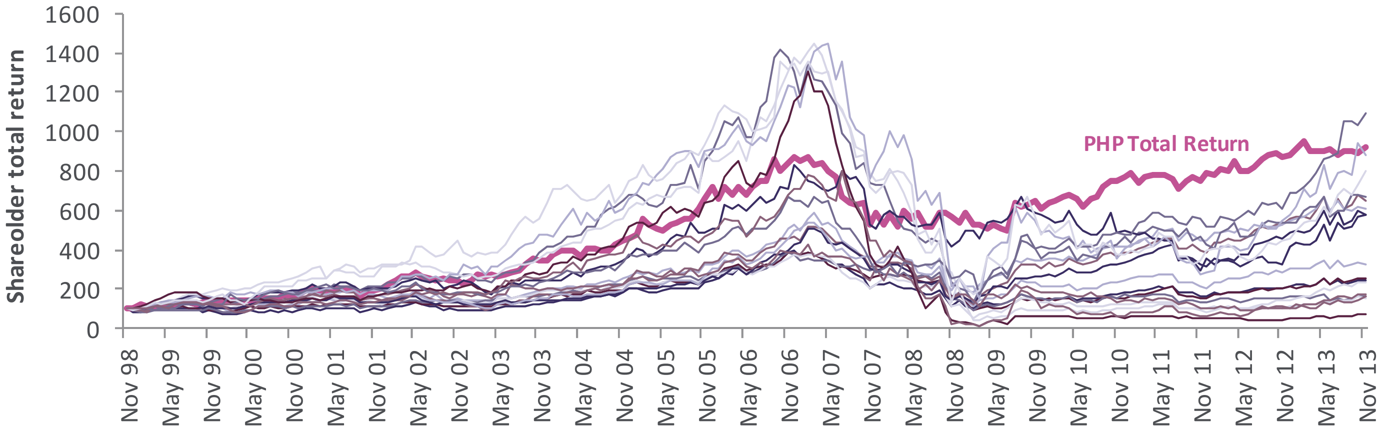
The 15-year club

PHP has raised its dividend every year for 17 years. Analysis by our Economics and Strategy research team shows that this puts PHP in a 'club' of just 36 listed companies in the UK across all sectors that have successfully raised their dividend every year for over 15 years.

This consistent dividend distribution has led to PHP consistently outperforming its property peers in total shareholder return on a long-term basis – Chart 7 below.

Chart 7: 15 year total shareholder return vs. listed property peers

Source: Company accounts, Peel Hunt estimates



Financial statements

Table 6: Financial statements

Source: Company accounts, Peel Hunt estimates

Y/end December	2011	2012	2013E	2014E	2015E
Per share data (p)					
NNNAV	246	235	252	255	262
Adjusted NAV	**319**	**305**	**300**	**303**	**309**
Basic EPS	19.0	1.6	10.2	22.4	26.8
Adjusted EPS	**14.5**	**10.2**	**11.5**	**16.1**	**18.4**
Dividend	**18.0**	**18.5**	**19.0**	**19.5**	**20.0**
Weighted shares in issue (m)	68	76	111	111	111
Key ratios (%)					
NNNAV discount	*37%*	*43%*	*34%*	*32%*	*29%*
Adjusted NAV discount	*6%*	*11%*	*13%*	*12%*	*9%*
Dividend yield	*5.3%*	*5.5%*	*5.6%*	*5.8%*	*5.9%*
Basic gearing	*179%*	*210%*	*207%*	*225%*	*220%*
EPRA gearing	***138%***	***162%***	***174%***	***189%***	***186%***
LTV	***57%***	***60%***	***63%***	***65%***	***64%***
Interest cover (x)	*1.6x*	*1.3x*	*1.4x*	*1.5x*	*1.5x*
Dividend cover (x)	*0.8x*	*0.5x*	*0.6x*	*0.8x*	*0.9x*
Income statement (£m)					
Net rental income	30.2	32.7	40.3	61.2	63.2
Admin/management costs	(5.1)	(5.1)	(5.0)	(5.8)	(5.6)
Recurring EBITDA	**25.1**	**27.6**	**35.2**	**55.4**	**57.6**
Depreciation	-	-	-	-	-
Finance income	0.4	0.5	0.5	0.5	0.5
Finance expense	(15.8)	(20.8)	(25.6)	(38.1)	(37.7)
Recurring pre tax profits	**9.7**	**7.4**	**10.1**	**17.8**	**20.4**
Exceptional items	(7.6)	(4.5)	-	-	-
Revaluation gain/(loss) on property	10.6	(1.8)	(1.2)	7.0	9.3
Tax	0.0	0.0	-	-	-
Net profit	12.7	1.1	8.9	24.7	29.7
Balance sheet (£m)					
Investment properties	526	622	923	983	995
Cash	0.1	25.1	16.0	9.7	5.5
Total assets	531	654	945	998	1,006
Total debt	(301)	(322)	(514)	(564)	(564)
Total liabilities	(363)	(475)	(667)	(717)	(717)
Shareholders' equity	168	179	279	282	290
EPRA NAV (£m)	**218**	**232**	**332**	**335**	**342**
Cash flow (£m)					
Operating cash flow	**24.0**	**35.4**	**10.1**	**17.8**	**20.4**
Net working capital	0.9	7.8	-	-	-
Tax	(0.0)	-	-	-	-
Investing cash flow	**(44.6)**	**(45.1)**	**(302)**	**(52.5)**	**(2.5)**
Acquisitions/disposals	(45.7)	(42.2)	(302)	(52.5)	(2.5)
Capital expenditure	-	-	2.5	2.5	2.5
Financing cash flow	**20.3**	**34.7**	**283**	**28.4**	**(22.1)**
Net borrowings	146.0	75.7	192	50.0	-
Dividends paid	(11.2)	(12.2)	(16.7)	(21.6)	(22.1)
Net cash	**(0.3)**	**25.0**	**(9.1)**	**(6.3)**	**(4.3)**

Recommendation structure and distribution as at 2 December 2013	Corporate No	Corporate %	Total No	Total %
Buy > +10% expected absolute price performance over 12 months	60	88%	163	57%
Hold +/-10% range expected absolute price performance over 12 months	8	12%	106	37%
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…

	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	x

Recommendation history

Company	Date	Rec	Date	Rec	Date	Rec	Date	Rec
Primary Health Properties	13 Jun 13	Buy	28 Feb 13	Hold	20 Nov 09	Buy		

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