

Primary Health Properties

Acquisition

Continuing to find acquisition opportunities

Real estate

Primary Health Properties (PHP) has agreed the acquisition of a large and modern primary care facility in the Republic of Ireland (RoI), its third to date, at a cost of €20m. Yields in the RoI remain noticeably ahead of those currently available in the UK despite some signs of competition.

Acquisitions of c £70m since end-H1, and a current contracted rent roll of just over £73m, are in line with our forecasts for the year and sufficient to trigger investment adviser performance fees, now included in reported, but not underlying, earnings forecasts. Acquisitions, rent increases, and long and largely government-backed leases underpin PHP's attractive, growing and fully covered dividend, which we expect to continue its 20-year growth trend.

Year end	Revenue (£m)	Adj earnings* (£m)	EPS* (p)	DPS (p)	EPRA NAV/share (p)	P/NAV (x)	Yield (%)
12/15	63.1	21.7	4.9	5.000	87.7	1.30	4.4
12/16	67.4	26.7	4.8	5.125	91.1	1.25	4.5
12/17e	71.9	31.8	5.3	5.250	96.6	1.18	4.6
12/18e	77.9	34.7	5.7	5.360	99.1	1.15	4.7

Note: *Adjusted earnings are on an underlying EPRA basis, excluding valuation movements and other exceptional items, and further adjusted for performance incentive fees.

Strong investor interest continuing

PHP has continued to source asset growth in H217 despite continuing strong investor interest in the secure, long-term income streams available on primary healthcare property and tightening yields. 90% of PHP's UK rents and 75% in Ireland are government-backed, and the comparison with 10-year gilt yields of c 1.3% is stark. The net initial yield reflected in PHP's portfolio contracted from 5.17% to 5.04% in the first half of the year and, while we do not forecast further tightening (our forecast valuation gains are driven off rent growth), more recent updates from peers suggest this is possible. While good for reported NAV, yield tightening reflects an increased cost of acquiring assets for growth.

Structural growth opportunity

In both the UK and Ireland, there is broad political will to reform healthcare provision, placing more emphasis on primary care to meet the needs of growing and ageing populations with increasing healthcare needs. The requirement for larger, more flexible, higher-quality premises will provide significant investment opportunities for PHP and others in coming years. There are some indications that in the UK, NHS new-build commissioning of much needed properties may be starting to increase, providing opportunities for investment and support for market rental growth. Meanwhile, the RoI continues to offer yields that are perhaps 150bp higher, while continuing to provide a strong covenant.

Valuation: Secure and growing income

We are forecasting a fully covered FY18 prospective 4.7% dividend yield. Revenues are supported by secure, long-term income in a market that is much less sensitive to economic cycles than other commercial real estate subsectors, and therefore shows less volatility in occupancy, rents and valuation.

18 December 2017

Price 114.25p
Market cap £697m

Net debt (£m) at 30 June 2017	670.7
Net LTV at 30 June 2017	53%
Shares in issue	610.3m
Free float	98%
Code	PHP
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(0.2)	(4.4)	3.9
Rel (local)	(1.3)	(6.0)	(4.5)
52-week high/low		123.5p	105.2p

Business description

Primary Health Properties is a long-term investor in primary healthcare property in the UK and, more recently, Ireland. Assets are mainly long-let to GPs and the NHS or HSE, organisations backed by the UK and Irish governments, respectively. The tenant profile and long average lease duration provide an exceptionally secure rental income stream.

Next events

2017 results Expected February 2018

Analysts

Martyn King +44 (0)20 3077 5745
Andrew Mitchell +44 (0)20 3681 2500

financials@edisongroup.com

[Edison profile page](#)

Primary Health Properties is a research client of Edison Investment Research Limited

Continuing investment

PHP has agreed to acquire a large, modern primary healthcare facility in County Cork in the Republic of Ireland (RoI) for €20m. This is PHP's third acquisition in Ireland, where yields remain noticeably higher than in the UK, and its seventh acquisition in the second half of the current year to date. The overall portfolio has now reached 307 assets (H117: 300) with an aggregate gross asset value of more than £1.35bn (H117: £1.27bn) and contracted rent roll of just over £73m (H117: £69.7m). The three RoI assets represent an aggregate investment of c €34m or c £30m.

The County Cork health centre has a lettable area of 6,500sqm and will be fully let to the Health Service Executive (HSE), GPs and complementary tenants, including a dentist, optician and physiotherapist. The HSE is the government executive agency that provides healthcare in the RoI and it has committed to a new 25-year lease covering 65% of the rent roll. The GPs have also entered into long leases.

We show a brief summary of PHP's acquisitions since 30 June 2017 below and note that the amount committed year to date and indicated portfolio contracted rent roll are closely in line with our existing estimates.

Exhibit 1: Announced acquisitions in H217 to date				
Date of announcement	Asset	Asset type	Total cost (£000s)	GLA* (sqm)
27-Jul-17	Low Grange Health Village, Middlesbrough	Standing		
27-Jul-17	Evenwood Medical Centre, Bishop Auckland	Standing		
	Subtotal		27,100	N/A
27-Jul-17	Syston Health Centre, Leicestershire	Standing	8,400	2,575
18-Sep-17	Croft Medical Centre, Chelmsley Wood	Standing	4,670	1,175
09-Oct-17	Stenhousemuir	Standing	8,650	2,450
27-Nov-17	Wincanton Medical Centre, Wincanton	Standing	4,370	983
14-Dec-17	Medical Centre, County Cork	Standing	17,544	6,500
	Total		70,734	13,683

Source: Company announcements. Note: *Gross lettable area.

We have made no changes to our forecasts other than to update for the recent conversion of £10.4m nominal of the group's outstanding convertible bond issue, and to recognise forecast investment adviser performance fees (PIF) in our stated earnings estimates, as these are now likely.

The recent bond conversion was settled by the issue of 10.7m new shares. £72.1m nominal of the £82.5m nominal of bonds that were issued in May 2014 remain. They pay a coupon of 4.25% and mature in 2019 unless previously converted at a price of 97.5p. Under the terms of the issue, since May 2017 the company has had the option to redeem the bonds at par as long as their parity value exceeds £130,000. At mid-year 2017, the bond had a fair value of £96.4m and if PHP chooses to convert the whole bond, and to settle the conversion rights wholly in shares, it would issue c 85m new shares in aggregate, or c 14% of the pre-conversion share capital. Conversion eliminates the negative fair value adjustment recorded in the balance sheet (£13.9m at H117), with a corresponding income statement gain and no impact on EPRA earnings or NAV. The saving on debt costs (c £3.5m pa) would substantially offset the increase in dividend costs (£4.3m if based on full entitlement to our forecast 2018 DPS). On our forecasts, the dividend would remain fully covered, but cover would be slightly reduced before any benefit from accretive additional investment.

In April 2017, the investment advisory agreement with Nexus was revised, reducing the fees payable to Nexus for the management of the PHP property portfolio, backdated to 1 January 2017. At the same time the PIF was revised so as to be based on net asset value total return on an EPRA NAV basis rather than IFRS. The latter had been subject to impacts beyond the control of the adviser, including accounting changes and non-cash adjustments in relation to the mark to market

of interest rate swaps and the convertible bonds. The PIF entitles Nexus to 11.25% of the EPRA NAV total return (change in NAV plus dividends paid) above a hurdle rate of 8%. Performance against the hurdle rate is carried forward in a notional cumulative account, with any payment of the PIF in future years being subject to the account being in surplus. Further, payment in any one year is capped at the lower of £2m or 20% of management fees (we estimate this cap to represent a little more than £1.3m in the current year) and, for the first three years, that any payment does not reduce dividend cover below 98%.

Our reconfirmed estimates imply an EPRA NAV total return of 11.8% in FY17, sufficient to trigger payment of the PIF, with the amount capped to 20% of management fees. We have now allowed for c £1.0m in respect of FY17 PIF to be paid in two equal parts over this year and next, with next year's payment indicated by a forecast FY18 EPRA NAV total return that slightly exceeds the hurdle; the total forecast payment in FY18 increases as a result, including a small FY18 component, to c £0.6m. It is our practice to make adjustment to earnings for performance fees (c 0.1p per share in both FY17 and FY18) and so this has no change to our adjusted EPS forecasts or underlying dividend cover. Without adjustment, FY17 dividend cover would be c 100% compared with the underlying 101% (FY18: 104% versus the underlying 106%) that is shown in the financial summary table below. The summary table also shows EPRA EPS (including PIF) alongside adjusted EPS (excluding PIF).

Exhibit 2: Financial summary

	£'000s	2015	2016	2017e	2018e
Year end 31 December		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		63,115	67,439	71,883	77,909
Cost of Sales		(852)	(868)	(1,018)	(1,104)
Gross Profit		62,263	66,571	70,865	76,805
Administrative expenses		(6,807)	(7,332)	(8,295)	(8,663)
EBITDA		55,456	59,239	62,570	68,142
Other income and expenses		0	0	0	0
Non-recurring items		0	0	0	0
Net valuation gain on property portfolio		39,767	20,686	37,021	14,402
Operating profit before financing costs		95,223	79,925	99,591	82,544
Net Interest		(33,727)	(32,490)	(31,261)	(34,086)
Non-recurring finance income/expense		0	0	0	0
Early loan repayment fees		0	(24)	0	0
Fair value gain/(loss) on interest rate derivatives and convertible bond, and swap amortisation		(5,464)	(3,710)	(1,000)	0
Profit Before Tax		56,032	43,701	67,330	48,458
Tax		0	0	0	0
Profit After Tax (FRS 3)		56,032	43,701	67,330	48,458
Adjusted for the following:					
Net gain/(loss) on revaluation		(39,767)	(20,686)	(37,021)	(14,402)
Fair value gain/(loss) on derivatives & convertible bond		5,464	3,710	1,000	0
Profit on termination of finance lease		0	0	0	0
Early loan repayment fees		0	24	0	0
Issue costs of convertible bond		0	0	0	0
EPRA basic earnings		21,729	26,749	31,309	34,056
Adjust for performance incentive fee (PIF)		0	0	521	637
Adjusted earnings		21,729	26,749	31,830	34,693
Period end number of shares (m)		446.3	598.2	610.3	611.8
Average Number of Shares Outstanding (m)		445.6	560.0	599.8	611.2
Fully diluted average number of shares outstanding (m)		530.2	644.6	683.9	685.1
EPS - fully diluted (p)		11.2	7.3	10.4	7.6
EPRA EPS (p)		4.9	4.8	5.2	5.6
Adjusted EPS (p)		4.9	4.8	5.3	5.7
Dividend per share (p)		5.000	5.125	5.250	5.360
Dividend cover		98%	100%	101%	106%
BALANCE SHEET					
Non-current assets		1,100,621	1,220,155	1,329,987	1,453,656
Investment properties		1,100,612	1,220,155	1,329,787	1,453,456
Other non-current assets		9	0	200	200
Current Assets		7,034	8,442	6,810	8,569
Cash & equivalents		2,881	5,099	2,420	3,797
Other current assets		4,153	3,343	4,390	4,773
Current Liabilities		(34,864)	(32,260)	(34,838)	(36,176)
Current borrowing		(862)	(803)	(800)	(800)
Other current liabilities		(34,002)	(31,457)	(34,038)	(35,376)
Non-current liabilities		(727,431)	(697,141)	(751,112)	(857,840)
Non-current borrowings		(696,878)	(667,630)	(730,312)	(837,040)
Other non-current liabilities		(30,553)	(29,511)	(20,800)	(20,800)
Net Assets		345,360	499,196	550,848	568,210
Derivative interest rate swaps		35,278	33,306	24,700	24,700
Change in fair value of convertible bond		10,931	12,456	13,900	13,900
EPRA net assets		391,569	544,958	589,448	606,810
IFRS NAV per share (p)		77.4	83.5	90.3	92.9
EPRA NAV per share (p)		87.7	91.1	96.6	99.2
CASH FLOW					
Operating Cash Flow		57,145	56,838	62,718	69,097
Net Interest & other financing charges		(35,623)	(45,886)	(35,497)	(32,358)
Tax		0	(51)	0	0
Acquisitions/disposals		(29,477)	(97,359)	(71,967)	(109,267)
Net proceeds from issue of shares		(139)	145,232	0	0
Debt drawn/(repaid)		19,986	(31,837)	72,900	105,000
Equity dividends paid (net of scrip)		(21,083)	(24,734)	(29,835)	(31,096)
Other		0	15	(1,000)	0
Net change in cash		(9,191)	2,218	(2,680)	1,376
Opening cash & equivalents		12,072	2,881	5,099	2,419
Closing net cash & equivalents		2,881	5,099	2,419	3,796
Debt		(697,740)	(668,433)	(731,112)	(837,840)
Net debt		(694,859)	(663,334)	(728,693)	(834,044)
Net LTV		62.7%	53.7%	54.2%	56.7%

Source: Company data, Edison Investment Research

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the [Financial Conduct Authority](#). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Pty Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

DISCLAIMER

Copyright 2017 Edison Investment Research Limited. All rights reserved. This report has been commissioned by Primary Health Props, and prepared and issued by Edison for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. This research is issued in Australia by Edison Investment Research Pty Ltd (Corporate Authorised Representative (1252501) of Myonlineadvisers Pty Ltd (AFSL: 427484)) and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. The Investment Research is distributed in the United States by Edison US to major US institutional investors only. Edison US is registered as an investment adviser with the Securities and Exchange Commission. Edison US relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. As such, Edison does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison has a restrictive policy relating to personal dealing. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report. Edison or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Edison, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication. FTSE International Limited ("FTSE") © FTSE 2017. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.