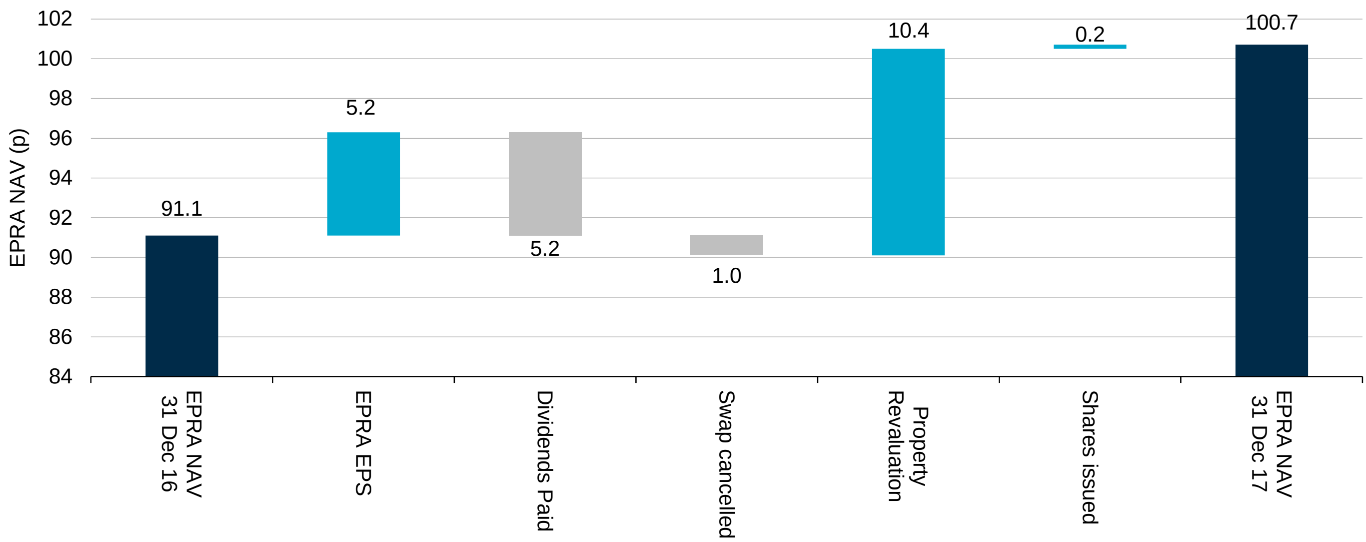
Property – Healthcare

Primary Health Properties* – Strong Final Results: 21st year of dividend growth

- **16.4% NAV Total Return**: In its final results for the 12 months to 31 December 2017, Primary Health Properties (PHP) reported an EPRA NAV of 100.7p, an increase of 10.5% over the year, and 4.8% since 30 June. Including dividends paid, NAV total return was 16.4%, strongly outperforming IPD quarterly UK Commercial Index (+10.3%) over the same period. Key drivers included a 5% increase in the value of the property portfolio to £1.36bn, reflecting a 26bps tightening of the average Net Initial Yield to 4.91%, boosted by strong investor demand for the asset class, and the impact of asset management.

PHP EPRA NAV Bridge - 31 Dec 2017



Source: Company & Numis Securities Research

- **Rent Reviews:** During 2017, PHP concluded 101 rent reviews with a combined rental value of £12.6m, adding £0.5m to the rent roll, equating to 2.1% pa (1.1% pa including open market reviews where no uplift is anticipated). This compares to the increase of 0.9% pa achieved in 2016. Of these reviews, 0.3% pa was achieved on open market reviews (1.3% pa excluding nil increases), 2.3% pa on RPI-based reviews and 5.0% pa on fixed uplift reviews. 74% of rent reviews are on an open market basis, reviewed typically every three years, and are impacted by land and construction cost inflation. Management comments that there have been significant increases in these costs in recent years, which would be expected to driver further rental growth in the future. The balance of the PHP portfolio has either RPI (19%) or fixed uplift (7%) based reviews.

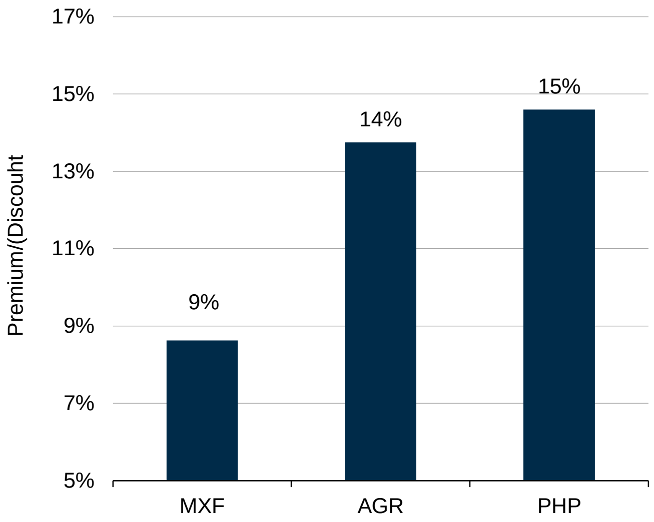
- **High Quality Earnings:** Acquisitions completed in 2016 and 2017, together with organic rental growth increased net rental income by 7.1% (£4.7m) to £71.3m. Notably, acquisitions contributed £3.4m, developments added £1m and rent reviews and asset management added £0.7m. Combined with a 2.8% reduction in net financing costs to £31.6m, EPRA earnings rose 15.7% to £31.0m and EPS grew 8.3% to 5.2p.

- **Low Cost Portfolio:** Administration costs, excluding the performance fee of £0.5m, increased by 12.3%, to £8.2m reflecting the increased size of the portfolio and £0.3m of fixed and “one-off” set up costs relating to the Irish portfolio. The total admin costs represent a charge of 60bps of GAV and an EPRA cost ratio of 12.5% (13.2% including perf fee), while higher than the 11.5% achieved in 2016, it continues to be one of the lowest in the listed real estate sector.

- **Active Portfolio Management:** As at 31 December, the portfolio comprised 306 healthcare centres (including 1 under development). Occupancy remains high at 99.7%. As at 31 December, the WAULT was 13.2 years, although management highlight potential to enhance this through active management. In 2017, the manager re-geared a number of leases back to 20 years. In 2017, 10 assets were added for £71.9m (adding 5.4% to rent roll), including its second acquisition in Ireland. In line with its strategy to focus on hub primary healthcare centres serving large patient lists, the new properties had a large average lot size of £7.2m and average patient list of 14,000. As a result, the acquisitions increased the average lot size in the portfolio to £4.5m. In addition, PHP expects to complete the acquisition of Mallow, County Cork later this month for £17.8m (€20.0m). The centre is one of the largest modern primary care facilities in the country and PHP's third asset in Ireland.
- **Dividends:** PHP has paid dividends of 5.25p in the year to 31 December 2017, an increase of 2.4% compared with 2016, and representing the 21st successive year of dividend growth. The total value of dividends distributed in the year increased by 17.2% to £31.4m, and were substantially covered by EPRA earnings. The board has declared a quarterly dividend of 1.35p, equivalent to 5.4p on an annualised basis, an increase of 2.9% compared with 2017. The Company intends to maintain its strategy of paying a progressive dividend that is covered by earnings in each financial year.
- **Board Changes:** PHP had already announced the retirement of Chairman, Alun Jones, who will be replaced by senior NED Steven Owen. Today, it also announced the retirement of Dr Ian Rutter and Mark Creedy, to be replaced by Ian Kreiger, and Dr Stephen Kell, OBE. Ian Kreiger was a Senior Partner and Vice Chairman at Deloitte and is currently Senior Independent Non-Executive Director and Chairman of the Audit Committee at Safestore Holdings and Premier Foods. He is also a Non-Executive Director at Capital & Regional. Stephen Kell, OBE is a General Practitioner and Managing Partner of a large medical practice in Worksop, Nottinghamshire with 14 partners, 32,000 patients and which operates across five sites.
- **Revised Advisory Agreement:** In April 2017, PHP announced revised terms to its management agreement. This included a lower additional fee increment as PHP continues to add scale. In particular, the fee payable for gross assets above £1.5bn, previously 0.3%, was reduced to 0.275% for gross assets between £1.5bn and £1.75bn and 0.25% for gross assets between £1.75bn and £2.0bn. In addition, the terms under which the manager, Nexus, is entitled to a Performance Fee were amended. Nexus continues to be entitled to 11.25% of the "total return" above a hurdle rate of 8.0%, but this will now be based on the change in EPRA NAV plus dividends paid, rather than the change in IFRS NAV plus dividends paid. Changes in IFRS NAV include the impact of changes in the mark-to-market valuation of derivatives and convertible bonds, which do not reflect the performance of the underlying property portfolio. The performance fee in respect of any year is capped at the lower of 20% of the management fee or £2.0m. Furthermore, for the three years from 1 January 2017, the payment of any performance fee is restricted if it would cause dividend cover to fall below 98%. No performance was paid between 2007 to 2016, reflecting the notional deficit of £12.1m due to IFRS mark-to-market adjustments. This was eliminated in 2017, and resulted in the £0.5m performance fee payment in 2017.
- **Investment** F**irepower and Pipeline:** As at 31 December 2017, total available loan facilities were £844.3m of which £724.1m had been drawn. Contracted capital commitments at the balance sheet date totalled £23.0m and result in headroom of £101.0m from existing facilities available. Capital commitments comprise acquisitions of £17.3m, developments of £4.2m and asset management projects on site of £1.5m. As at 31 December, LTV stood at 52.9%, with an average cost of debt of 4.09% (down 56bp in the year). The weighted average maturity was extended to 6.3 years, up from 5.1 years in 2016. Management highlight a pipeline of £150m of potential acquisitions. Against a competitive market backdrop, it will remain disciplined on acquisition pricing ensuring it adds only high quality, earnings accretive assets with the opportunity for future growth.

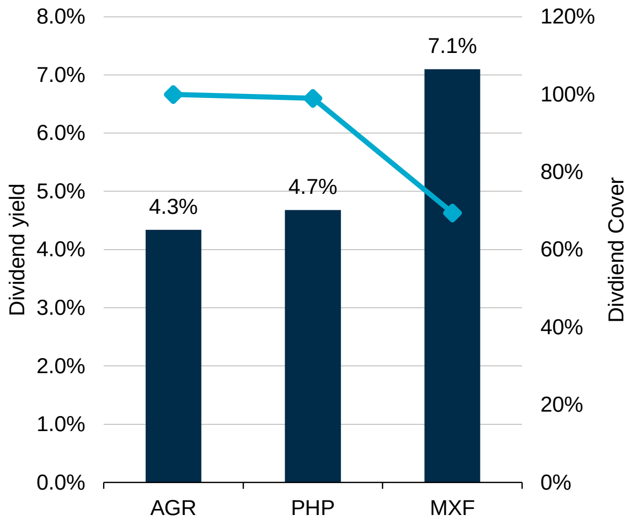
- **Numis Views**: In recent years, investors have been increasingly attracted to long-lease income generated by high quality real estate assets. In our view, PHP continues to offer these characteristics with a WAULT of 13.2 years, effectively upward only leases and over 90% of income funded by government bodies (NHS or HSE) which underpins an attractive, predictable yield for investors. Market fundamentals remain firmly supported by strong supply/demand dynamics which make primary healthcare one of the most defensive areas of the real estate market, in our view. In particular, the sector is not subject to speculative development, supply is constrained, while occupier demand continues to rise, reflecting key demographic trends of an ageing and growing population.
- Whilst the premium to NAV of PHP, and its wider primary health peer group, contrasts to discounts assigned to general commercial REITs, we believe this is justified based on the lower volatility of asset values, and relatively high, predictable dividend yields on offer. In addition, we note the inflation linkage on 19% of PHP's leases will also be viewed positively in the current macro backdrop. PHP shares currently trade on a 15% premium to 31 December NAV and 4.7% yield, versus a sector average premium (market cap weighted) for the healthcare peers of 12.2% and yield of 4.9%.

Primary Healthcare Peers - Premium to NAV



Source: Company & Numis Securities Research

Primary Healthcare Peers - DPS Yield and Cover



Source: Company & Numis Securities Research

** Denotes that this company is a corporate broking client of Numis Securities.*

Note: all prices, NAVs and discounts as at close of business at 14 February 2018 unless otherwise stated.

The research analyst who prepared this report was Colette Ord

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