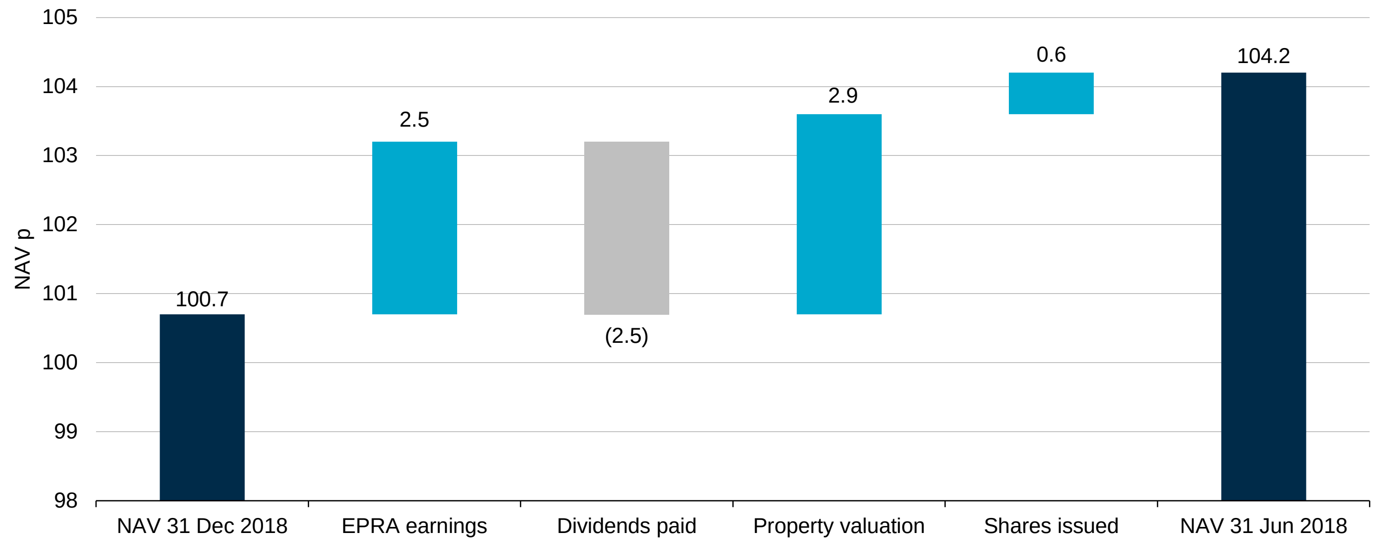
Primary Health Properties* - H1 NAV total return 6.2%; 22nd year of dividend growth

- **Strong NAV Total Return:** PHP has published an EPRA NAV at 30 June of 104.2p, up 3.5% from 100.7p at 31 December and ahead of our 101p estimate. Key drivers included a £21.2m (1.5%) uplift in the portfolio valuation to £1.41bn, split evenly between Net Initial Yield shift of 6bps to 4.85%, and asset management which added 2.9p to NAV. Including dividends paid in the period, NAV total return was 6.2%, which compares favourably to the UK Commercial Property Investment Company (UK PICs) peer group average of 4.8%. Dividends paid of £16.8m were fully covered by EPRA earnings, which rose 11% to £17.1m. Reflecting £115m of shares issued in the period, earnings were 2.5p per share, a fraction lower than H1 2017 at 2.6p.

PHP H1 2018 NAV Bridge- 30 June



Source: Company & Numis Securities Research

- **Solid Portfolio Performance:** As at 30 June, the portfolio comprised 308 assets valued at £1.41bn, implying an average lot size of £4.6m. The portfolio includes three Irish assets valued at £33.4m. The valuation uplift, combined with the growing income resulted in a total property return of 4.3% in the period, 10bps lower than the IPD monthly All Property total return of 4.4% which was driven largely by the Industrial sector. The stability of the property valuation reflects the compelling portfolio metrics, with 90% of the long term cash flows funded directly or indirectly by the NHS in the UK or HSE in Ireland. The portfolio also benefits from an occupancy rate of 99.7%, and a WAULT of 12.9 years with only 1.3% of income expected to expire in the next three years, underpinning the attractive dividend yield on offer.

- **Dividends:** PHP has declared a third quarterly dividend of 1.35p, equivalent to 5.4p pa (4.6% yield), and represents the 22nd successive year of dividend growth. The board reiterates its strategy to pay a progressive dividend that is covered by earnings.

- **Positive Rental Growth Trend:** The contracted rent roll stands at £74.4m, up from £72.3m at 31 December reflecting acquisitions in the period and an annualised uplift on 143 rent reviews of 3.0% (equivalent to 1.7% pa) adding £0.6m. This continues the positive trend in rental growth over the last two years and compares with 1.1% achieved in 2017 and 0.9% in 2016. In the H1 period, 0.5% pa was achieved on open market reviews, 2.7% pa was secured on RPI-based reviews and 2.8% pa on reviews with fixed uplifts. Management notes that a further 25 open market reviews have been agreed in principle, and these will add a further £0.1m (equivalent to 1.0%) to the contracted rent roll.

- **Reduced Borrowing Costs:** As at 30 June, LTV was 44.6%, down from 52.9% at 31 December. This is expected to fall to 40.5% on a pro-forma basis excluding the convertible bond. The average cost of debt reduced by 23bps to 3.86%, including the impact of cancelling £70m of 4.52% fixed rate swaps post the period end, for a one-off payment of £5.0m (equivalent to 0.7p on NAV). This resulted in total interest savings of £2.5m pa.

- **Market Outlook:** Management notes that the UK market for primary healthcare property continues to be highly competitive with strong yields and prices being paid by investors, driving further yield compression in H1 2018. While management notes that discipline is required in respect of acquisition pricing, it continues to secure opportunities in the UK and Ireland. Notably, the sector continues to achieve cross-party support to deliver essential assets, with GP surgeries performing the critical function of providing access to the NHS.
- **Equity Deployment:** Having raised £115m in April, at a 7% premium to EPRA NAV including post period end transactions, the manager has committed £53m (46% of equity raised), acquiring four assets, a forward funded development and 19 asset management projects. This will rise to c.80% on completion of a further £37m of transactions which have been agreed and are in advanced stages of legal due diligence. Against a competitive market backdrop, management highlights that it remains disciplined on acquisition criteria, but has a strong pipeline of acquisitions totalling over £175m in the UK and Ireland.
- **Numis Views:** In H1 2018, PHP continued its impressive record of delivering attractive shareholder returns, including 22 years of dividend growth. NAV progression (+3.5%) was ahead of our expectations, reflecting a combination of asset management and modest yield shift driven by strong investment market demand for the asset class. Including dividends, PHP's NAV total return of 6.2% compares favourably with the wider commercial real estate peer group, were NAV total returns averaged 4.8% in H1.
- The earnings story, a key reason to own the shares, remains robust underpinned by one of the most attractive rent rolls in the listed real estate space, providing both longevity and predictability. We are particularly encouraged by the continued positive momentum in rental growth, which has been restrained in recent years by the lack of development deliveries across the sector.
- Overall, we view these as strong results following a busy period, with growth prospects underpinned by a healthy balance sheet. Assuming limited yield compression and steady deployment of proceeds, we believe PHP can deliver attractive NAV total returns CAGR of c.8.5% pa over the next three years. As a result, it remains our preferred play in the primary healthcare real estate subsector. The shares (£852m market cap) are currently trading on 11% premium to June NAV and yield of 4.6%.
- To a large extent we believe the wider sector's premium rating is justified by the high quality of income that derives from the UK government reimbursement of GP rents. We acknowledge the yield shift has been significant in recent years, and do not model significant further compression from here, but we remain of the view that the sub-sector benefits from unrivalled supply demand dynamics. We also feel comfortable that GP surgeries remain attractively priced on a risk adjusted basis compared with other sub-sectors of the real estate market. For example, we note that long leases to supermarket tenants are currently commanding NIY's of 4.5%, while certain Social Housing assets, which are not always purpose built, are also valued around 5% or lower. The final comfort factor is the incremental cost of funding across the peer group, which continues to offer a significant margin.

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

Note: all prices, NAVs and discounts as at close of business at 24 July 2018 unless otherwise stated.

The research analyst who prepared this report was Colette Ord.