Numis Securities Ltd

Marketing Communication

Investment Companies

12 March 2010

Price: **291.5p**

Yieldt:6.0%

Market Cap: **£179**

RIC/BLBG: **PHP.L / PHP LN**

(Current share price timed at 12.30pm 12th March 2010)

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Primary Health Properties*

Superior Dividend Story

We re-iterate our view that Primary Health Properties (PHP) is the best way to play the niche primary healthcare property sub-sector. Our central case is the quality of the dividend story and attractive valuation relative to its closest peer MedicX Fund (MXF). This is enhanced by what we believe to be a strong management team with an impressive track record and industry knowledge base. Furthermore, we favour the uncomplicated business model, lower fees and scope to grow the portfolio further, a key driver of future dividend outperformance. PHP commands a 5% premium to EPRA NAV and offers a fully covered 6% prospective dividend yield, a major differentiator compared with MXF (7.5% yield, 30% covered by EPS and 8%premium to NAV).

- **Sector Characteristics:** The niche primary care property sub-sector offers attractive returns with cashflow characteristics akin to infrastructure funds or index-linked gilts. In particular, income visibility is strong given typical 20 year leases, rents often have indexation or upward only reviews and the principle covenant is the government. Voids and rent collection issues are not a feature, a stark contrast to the broader commercial property sector. Furthermore, capital values are less volatile given the 'needs based' nature of the property. Both PHP and MXF seek to benefit from this by buying primary healthcare facilities, collecting the rent and paying out a dividend to shareholders.
- **Primary Health Properties (PHP):** Listed in 1996 and became the UK's first dedicated healthcare REIT in 2007. The company has a portfolio of 130 modern, purpose-built healthcare facilities leased to GPs, Primary Care Trusts (PCTs), and pharmacies. Following an equity raise in H2 09, the group has a solid balance sheet and has added further scale with c18 new assets at a cost of £41.4m leaving c£21.5m of available funds for future purchases. These will be key to any future dividend outperformance. PHP has grown DPS for each of the past 12 years. We estimate current LTV of c58%, comfortably below the 70% covenant.
- **Medicx Fund (MXF):** Listed in late 2006, is a closed-end vehicle with a portfolio of 51 primary health assets leased to GPs, PCTs and pharmacies. The fund recently raised £24.6m: coupled with debt and cash facilities this provides access to c£44m for investments with the potential to add £2.75m of income. However, this is far from sufficient to cover the current DPS from recurring cashflow. We calculate that the fund needs to generate at least £17m of income compared with the current £11.8m rent roll. We estimate current LTV is 68% compared with 75% covenant.
- **Relative Valuation:** PHP trades on a 5% premium to EPRA NAV and yields a fully covered, prospective 6% compared to the commercial REIT peer group yielding 4% on average. MXF commands an 8% premium to NAV but offers an uncovered (30% by EPS) yield of 7.5%.

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Introduction

Both PHP and MXF boast the following positive attributes;

- High cashflow visibility resulting from long lease lengths and strong covenants
- Attractive dividend yield although cover levels vary significantly
- Lower volatility in asset values compared with other commercial property assets
- Growth potential – significant market share upside coupled with right of first refusal to a pipeline of assets
- Premium rating

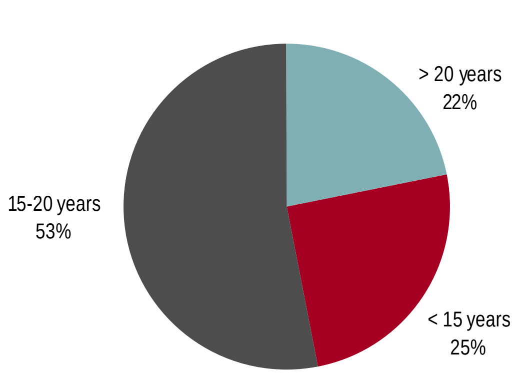
In the following sections, we compare the two peers in respect of the points above and conclude that PHP has the strongest investment case based on its high quality dividend (fully covered from cashflow), strong track record, scale and relative valuation.

Cashflow visibility

Both offer long-term income

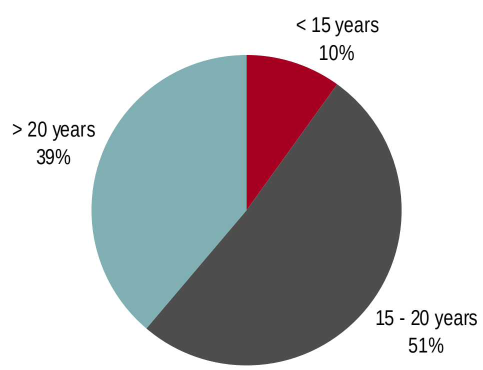
As the following charts illustrate, there is little difference between the two peers in respect of lease length. Whilst PHP does have a greater proportion of leases under 15 years this reflects the maturity of the business compared with MXF. Only 1% of PHP's leases have less than 5 years remaining.

Figure 1. PHP Lease Lengths



Source: Company Data/Numis Securities Investment Companies Research

Figure 2. MXF Lease Lengths

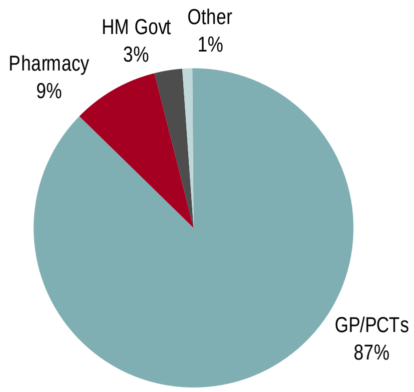


Source: Company Data/Numis Securities Investment Companies Research

Strong covenants

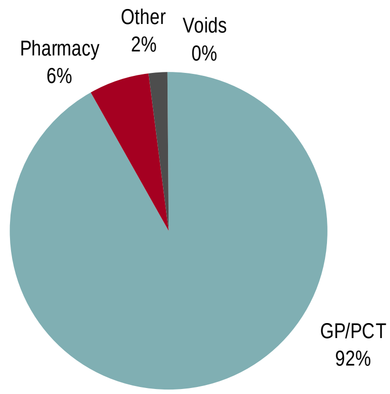
Covenant strength is equally impressive for both companies with 90% of rent effectively guaranteed by the government. Neither group has any voids or rent collection issues, a stark contrast to the commercial property peers where voids are typically double-digit.

Figure 3. PHP Covenant Analysis



Source: Company Data/Numis Securities Investment Companies Research

Figure 4. MXF Covenant Analysis



Source: Company Data/Numis Securities Investment Companies Research

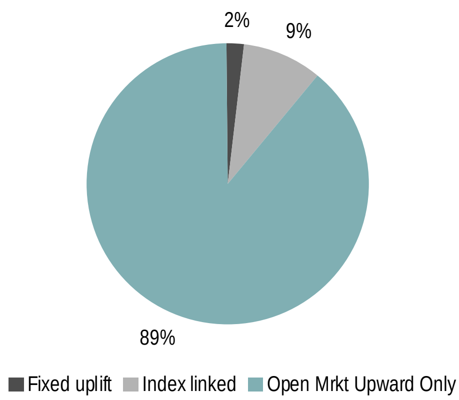
PHP has fractionally more pharmacy exposure at 9

PHP has fractionally more pharmacy exposure at 9%. However, these are not stand alone high street premises but are usually next to GP surgeries providing a steady footfall of customers. Rents are higher and leases are typically co-terminus with the adjoining GP surgery. To date there have been no issues with any pharmacy paying rent and if this were to be the case there would be a long-line of replacement tenants willing to take the lease.

Triennial rent reviews, usually upward only

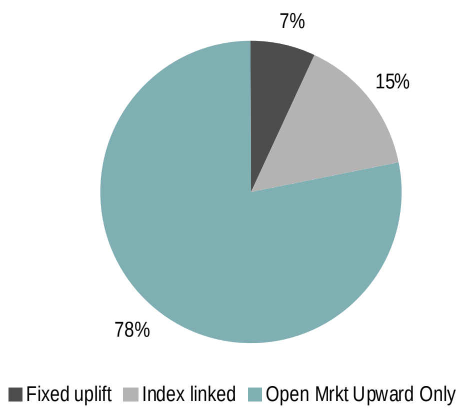
Both rent rolls feature triennial reviews which provide potential to increase revenues on a regular basis. Index linked rents have a floor at 0% and fixed rents typically increase 2-2.5% every three years.

Figure 5. PHP Rent Review Statistics



Source: Company Data

Figure 6. MXF Rent Review Statistics



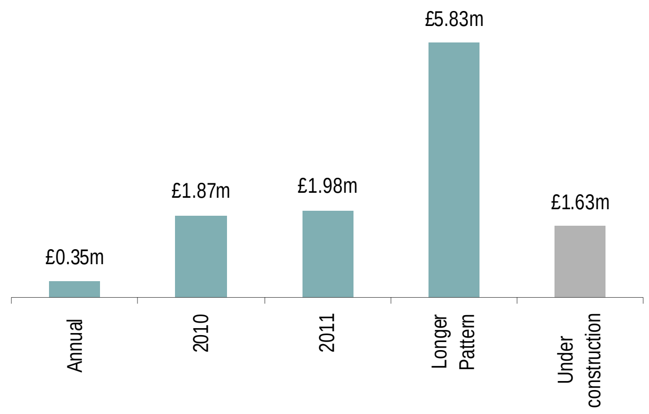
Source: Company Data

The following charts illustrate the quantum of rent which will be reviewed in each of the next few years.

Figure 7. PHP Rent Review Profile

Source: Company Data

Figure 8. MXF Rent Review Profile



Source: Company Data

Majority of income is subject to open market reviews

For both PHP and MXF, the majority of income is subject to open market reviews. The appropriate market rents are decided by the District Valuers Office, a government agency. Rents are decided taking into account the replacement cost of the asset as well as market evidence. Whilst in theory, rents can be lower and are subject to government affordability measures, this is rarely the case. A key driver of this is the impact of a rising replacement costs resulting from the requirement for higher specification buildings. Thus supporting rental increases.

Furthermore, PCTs and landlords such as PHP and MXF can appeal to the NHS litigation authority if they believe rent decisions are unfair. The ability of management teams to negotiate with the district valuers office is key and we believe that PHP are particularly strong in this regard.

Indeed, the group recently challenged the review process to ensure that where a PCT appeals the rent review decision, the outcome must be decided by an independent panel of chartered surveyors. Previously it had been decided by the Chief Exective's Office of the District Valuer, this was deemed unfair.

Lower Volatility

Valuation yields less volatile than commercial assets

Given the 'needs based' nature of primary care assets, favourable income characteristics and generally matching supply and demand, valuation yields have been less volatile in the current downturn compared with other commercial real estate assets. We expect this to remain the case.

The following table illustrates the significant difference in yield shift between PHP, MXF and other property sub-sectors.

Table 1. Yield Shift from Peak to Current

	PHP	MXF	Prime Retail	Prime Industrial	Prime Office
Valuation yield at market peak (%)	*5.2*	*5.1*	*4.6*	*5.7*	*4.9*
Current (%)	*6.0*	*5.8*	*8.0*	*8.7*	*8.3*
Movement	80 bps	70 bps	340 bps	200 bps	340 bps

Source: Company Data/Numis Securities Investment Companies Research/ IPD

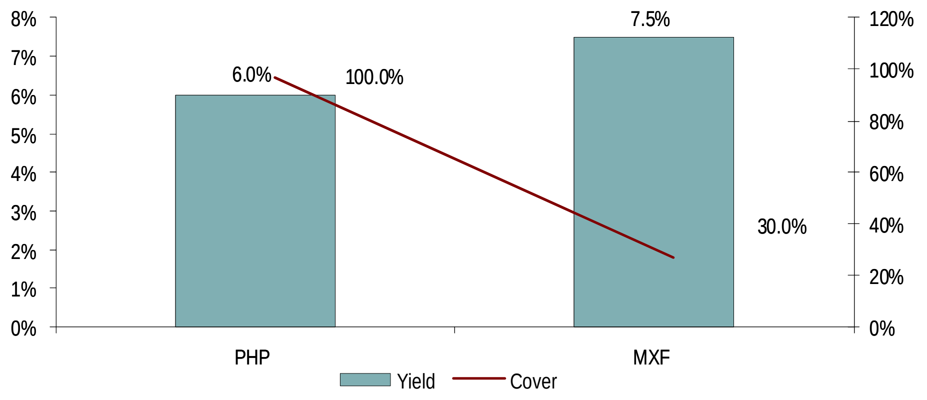
Both companies have their assets independently valued. PHP use Lambert Smith Hampton whilst MedicX use King Sturge.

Attractive Yield

PHP offers superior dividend cover

The favourable cashflow characteristics mentioned previously allow both companies to offer an attractive dividend yield.

Figure 9. Dividend Yield and Cover



Source: Numis Securities Investment Companies Research

For PHP, we forecast DPS for 2010 of 17.5p, equivalent to a 6% prospective yield. We estimate the cost of this can be met fully from recurring profits.

MXF aims to pay 5.4p per annum, equivalent to a 7.5% yield although the cost of this cannot fully be met from recurring cashflow. Indeed dividend cover is the lowest amongst our property and infrastructure peer groups at just 30%.

MXF need to generate rent of at least £17m to cover the current DPS

We calculate that MXF needs to generate rent of at least £17m to cover the current DPS target, this compares to the current £11.8m rent roll. At current market yields, this implies MXF would need access to a further £72m of funds following the recent £24.6m capital raise.

The tables below illustrate the historic cover along with our assumptions for dividend cover in 2010.

Table 2. Historic Financials

	PHP Dec 2009	MXF Sept 2009
Rental Income	21.3	8.8
Other Income	0.3	0.6
Total Income	**21.6**	**9.4**
Mgt Fee	(3.4)	(2.2)
Other fees & Expenses	0.1	(1.1)
Total Expenses	**(3.3)**	**(3.3)**
EBITDA	18.3	6.1
Finance Income	0	0.3
Finance Costs	(10.3)	(5.1)
Adjusted EPS	**8.1**	**1.4**
DPS (p)	17.25	5.3
DPS Cost (£m)	(5.6)	(6.1)
DPS Cover (%)	***145***	***24***
Total Assets	**348.6**	**179.5**
Total Liabilities	**196.6**	**113.6**
NAV (£m)	**151.9**	**66.0**
EPRA NAV (£m)	**173.4**	**64.8**
EPRA NAV (p)	**280.0**	**62.0**

Source: Company Data

Table 3. Forecast Financials

	PHP Dec 2010F	MXF Sept 2010F
Total Income	27.0	12.0
Total Expenses	(3.8)	(3.3)
Net Finance Costs	(12.2)	(5.6)
Recurring PBT	11.0	3.1
Adj EPS	17.6	2.3
Prospective DPS (p)	17.5	5.4
Shares in Issue	61.5	139.3
DPS Cost (£m)	(10.8)	(7.5)
DPS Cover (%)	***100***	***43***
Total Assets	427.0	215.5
Total Liabilities	273.9	124.8
NAV	153.1	90.7
EPRA NAV* (£m)	174.6	97.1
EPRA NAV* (p)	**285**	**70**

**Adds back swaps, deferred tax and goodwill*
Source: Numis Securities Investment Companies Research

For PHP we assume the following:

Total Income: 2% rental growth on the existing portfolio and incremental income of £5.0m from a combination of new assets purchased over the year (52%) and the remainder from the delivery of assets forward funded in previous financial periods. Having made a number of purchases during Q1 2010, we estimate the group needs to add another £0.6m of rental income to meet our forecast assumptions. At current yields this implies a further £9.6m of assets.

Total Expenses: Assumes £3.3m of management fees and £500k other expenses. PHP management charge 1% on the first £50m of property assets and 75bps above this level.

Finance Costs: PHP currently has c£265m of agreed debt facilities. We anticipate year-end debt will reach £245m at an average cost of 5%. The group has £188m of debt swapped at 5.5%, we anticipate that additional debt will be at a lower rate of c1.4% although we would expect this to be swapped out at some point in the year. We have not assumed any additional credit lines. We believe it will be necessary to add additional finance to growth the portfolio from 2011 onwards.

For MXF we assume the following:

Total Income: 2% rental growth on the existing portfolio and incremental income of £2.4m. We assume 66% of this is from the delivery of assets forward funded in previous financial periods and the remainder from new investments. We estimate the fund needs to add another £0.9m of rental income to meet our forecast assumptions. At current yields this implies a further £14.4m of assets.

Total Expenses: Assumes £2.2m of management fees and £1.1m other expenses. MXF management charge 1.5% on the first £150m of property assets and 0.75% above £300m. Based on the current size of the property portfolio we believe the fee profile is less attractive than PHP in our view.

Finance Costs: We assume that MXF ends the year with £113m of debt with an average cost of 5%.

Risks to our assumptions include

- a lower than anticipated acquisition rate
- a higher cost of debt
- a step change in valuation yields for primary health assets

Growth Potential

Substantial market place provides good scope for growth

The market place for primary health assets in the UK is substantial, comprising 10,400 surgeries, 3,000 of which need to be replaced or substantially modified. As a result there is plenty of scope for both companies to grow the asset base depending on availability of funds and product.

Pipeline and access to product is key

Both companies have access to a good pipeline of assets including new developments. MXF has the right of first refusal to assets under construction by MedicX Group, parent company of MXF's investment adviser. PHP has the right of first refusal on all property developments brought forward by CareCapital Group for a period of three years. We understand there are seven identified projects at various stages of completion. To date PHP has proven more successful in finding let-standing properties which has helped the group to offer a fully covered DPS.

Both peers have funds available to invest having recently raised capital for growth opportunities. In September 2009, PHP raised £57.5m via the issue of shares at 230p, diluting EPRA NAV from 289.8p at 30th June 2009 to 260.3p following the placing. However, a strong rental performance, new purchases and a moderate improvement in property values saw EPRA NAV as at Dec 2009 recover to 280p. The group has a further c£21.5m to invest (assuming no new lines of credit) which should boost NAV and income cover further.

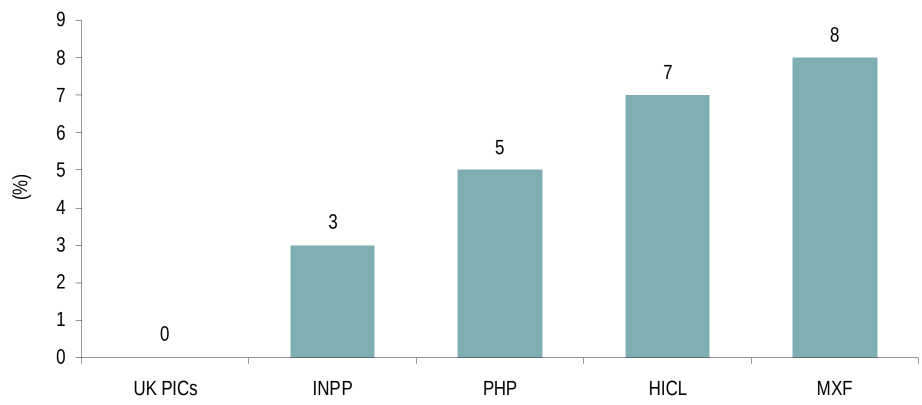
MXF recently raised £24.6m out of a targeted £62m via the issue of 34m shares at 72p, a 7% premium to last reported NAV of 67.6p. The proceeds will be used predominantly for forward funding assets rather than let-standing investments. We calculate the fund has c£44m available for future purchases. However, we remain concerned that this is far from sufficient to improve DPS cover to an acceptable level.

Premium Rating

PHP deserves to trade at a premium to its closest peer MedicX

The following chart illustrates the current rating relative to other real estate and infrastructure peers. MXF commands the greatest premium which looks unjustified given the superior nature of the dividend at PHP.

Figure 10. Current Ratings



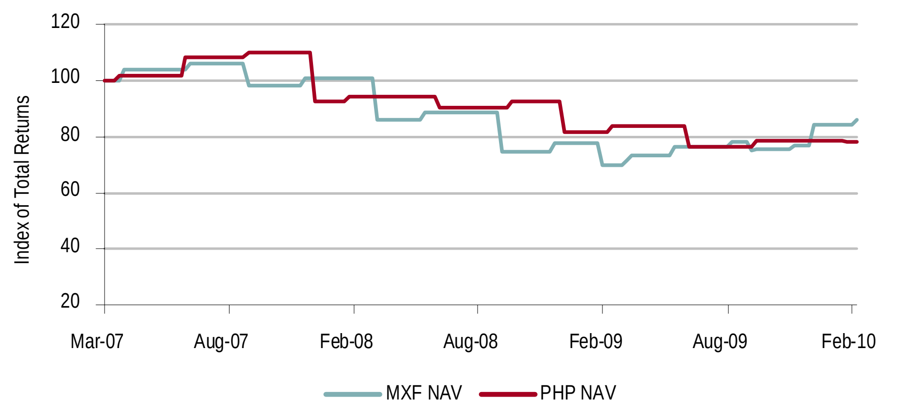
Source: Numis Securities Investment Companies Research

Appendix

PHP has largely outperformed MXF

Looking over the past three years, PHP has largely outperformed MXF in respect of NAV total returns.

Figure 11. 3 Yr Absolute NAV Total return

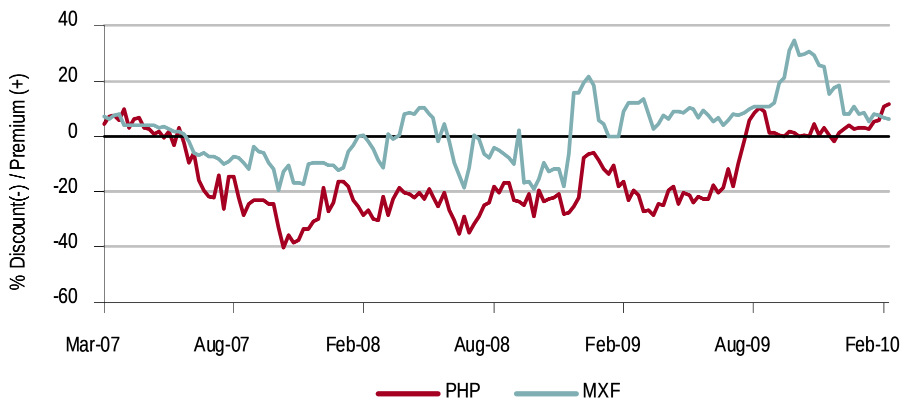


Source: Datastream/Numis Securities Investment Companies Research

…but MXF commands the same premium rating

However, MXF has typically traded on a higher rating over the same period and currently trades in line with PHP.

Figure 12. 3 Yr Discount



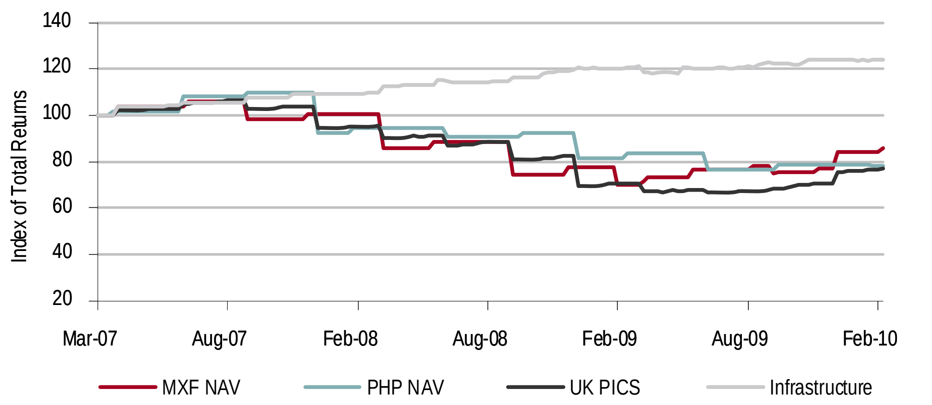
Source: Datastream/Numis Securities Investment Companies Research

Different marketing message between the two funds

In part, we suggest this reflects the different marketing message between the two funds. MXF markets itself as an infrastructure play rather than a real estate play. To some extent we have some sympathy with this given the long-term nature of the majority of its debt. However, more recently, additional facilities signed by the fund are shorter-term (5 year maturity), similar to other real estate operators and PHP. We believe that future funding is also likely to be short-term in nature which dilutes the argument in our view.

Whilst we believe there are similar cashflow characteristics between the healthcare investors and infrastructure funds, it is also worth noting that the total NAV return profile has more closely mirrored the real estate peers.

Figure 13. 3 Yr Absolute NAV Total Returns

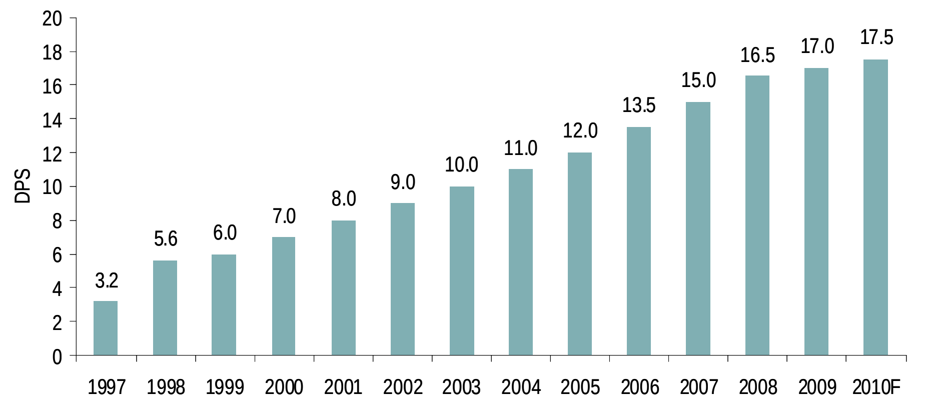


Source: Datastream/Numis Securities Investment Companies Research

PHP has a strong record compared with other real estate shares

Against the real estate peer group, we believe that PHP has a strong record in respect of total returns. In share price terms, PHP has been the best performing property share over the last decade. It is also interesting to know that a person which invested in PHP at IPO (1997) would have had their initial outlay repaid through dividends. The following chart illustrates the impressive track record of dividend growth since 1997.

Figure 14. PHP Annual DPS Growth



Source: Company Data/Numis Securities Investment Companies Research

Table 4. PHP Financials Summary

	Dec-07A 18 Mths	Dec-08A	Dec-09A	Dec-10F
Rent & Related Income	22.2	19.7	21.3	26.7
REIT Charges	(5.2)	(0.2)	0.0	0.0
Admin Recurring	(7.6)	(4.2)	(3.5)	(3.8)
Admin Non Recurring	(5.7)	(0.8)	0.4	0.0
Admin Costs	(18.5)	(5.2)	(3.1)	(3.8)
Finance Costs	(13.0)	(12.1)	(10.3)	(12.2)
Finance Income	2.2	2.9	0.1	0.0
Net Finance Costs	(10.8)	(9.2)	(10.2)	(12.2)
Recurring Profit/Loss Before Tax	3.8	5.3	8.1	10.8
Deferred Tax	(3.9)	0.0	0.0	0.0
Deferred Tax release on REIT Conversion	29.6	0.0	0.0	0.0
Profit/(Loss)	18.6	5.3	8.1	10.8
Shares in issue	33.6	33.6	61.4	61.4
EPS	12.0	15.9	13.1	17.6

Source: Company Data/Numis Securities Investment Companies Research

Table 5. MXF Financials Summary

	Sep-07A	Sep-08A	Sep-09A	Dec-10F
Rent & Related Income	5.0	8.2	9.4	12.0
Other	(1.4)	(1.7)	(1.1)	(1.1)
Mgt Fee	(2.0)	(2.3)	(2.2)	(2.3)
Per Fee	0.0	0.0	(0.9)	0.0
Admin Costs	(3.4)	(3.9)	(4.2)	(3.3)
Finance Costs	(4.2)	(5.1)	(5.1)	(5.6)
Finance Income	2.3	1.9	0.3	0.2
Net Finance Costs	(2.0)	(3.2)	(4.7)	(5.5)
Recurring Profit/Loss Before Tax	(0.4)	1.1	0.5	3.2
Tax	0.5	2.9	0.4	0.0
Profit/(Loss) After Tax	0.2	1.1	0.5	3.2
Adj EPS	0.3	1.4	0.5	2.3

Source: Company Data/Numis Securities Investment Companies Research

Our historic information incorporates data from conversion to a REIT for PHP and from Listing for MXF.

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The company has seen a draft of the note and has made no comments.