

Primary Health Properties

Irish site visit

Ireland enhancing overall growth

Primary Health Properties (PHP) recently held a capital markets day in the Republic of Ireland (RoI), where it now has eight assets and looks for further strong growth, towards 10% of the overall portfolio. The RoI market shares similar drivers and attractive characteristics to the UK and currently benefits from higher yields and lower funding costs. The visit provided additional comfort to our forecasts for further income and dividend growth driven by asset acquisition in both the UK and RoI, an improving outlook for rental growth and more opportunities to optimise average borrowing costs.

Year end	Net rental income (£m)	EPRA earnings* (£m)	EPS* (p)	DPS (p)	EPRA** NAV/share (p)	P/NAV (x)	Yield (%)
12/16	66.6	26.7	4.7	5.125	91.1	1.20	4.7
12/17	71.3	31.0	5.1	5.250	100.7	1.09	4.8
12/18e	75.9	36.9	5.2	5.400	105.4	1.04	4.9
12/19e	81.4	43.3	5.5	5.500	109.1	1.01	5.0

Note: *Diluted EPRA basis, excludes valuation movements and other exceptional items.
 **EPRA basis adjusts for fair value of derivative interest rate contracts and convertible bond.

UK and RoI fundamentals similarly positive

In both the UK and the RoI, there is broad political will to reform healthcare provision, placing more emphasis on primary care to meet the increasing healthcare needs of growing and ageing populations. This requires larger, more flexible, higher-quality premises and funding for their development. Like the UK, the RoI is catching up from a period of underinvestment, to meet the needs of an ageing population with increasingly complex healthcare needs. Its population growth is one of the fastest in Europe. It has plans to establish c 200 large, multi-disciplinary primary care centres (PCCs) and PHP analysis indicates that there are currently around half this number, and relatively few that are fit for purpose.

Growth opportunity with higher margin

PHP entered the RoI market in 2016 and the September acquisition of three large, recently purpose-built PCCs for €38.6m increased its portfolio in the country to eight assets with a value of more than €100m (c 6% of the group total). It sees further good growth opportunities, with the share of an otherwise growing portfolio rising to around 10%. PHP estimates Irish net initial yields to be currently c 6%, around 100bp above the yields currently available in the UK while marginal funding costs are lower. Euro-denominated borrowing will provide a natural hedge to FX risk. There are some differences between the RoI and the UK in terms of lease covenants, but we believe this is marginal, with 65–75% of the rents being derived from the HSE (the NHS equivalent) on long leases indexed to RoI CPI.

Valuation: Secure, dividend growth underpinned

We expect FY18 DPS, in the 22nd year of unbroken growth, to be fully covered by earnings, for a yield of 4.9%, while asset management and rental growth provide capital appreciation potential even if yield tightening slows. Revenues are supported by secure, long-term income, substantially subject to upward-only review, with little exposure to the economic cycle, or fluctuations in occupancy.

Real estate

2 November 2018

Price **110.4p**
Market cap **£809m**

€1.12/£

Net debt (£m) at 30 June 2018 631.4

Net LTV at 30 June 2018 44.6%

Shares in issue 732.4m

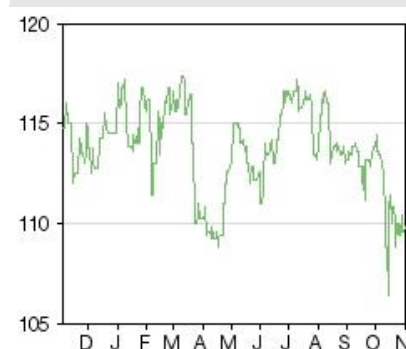
Free float 98%

Code PHP

Primary exchange LSE

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	(3.9)	(3.5)	(6.1)
Rel (local)	1.5	3.9	(1.0)

52-week high/low 117.2p 106.4p

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 event

Preliminary results February 2019

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

Investment summary

PHP recently hosted a capital markets visit to the RoI, providing attendees with an opportunity to view a number of the group's care centres within its growing Irish portfolio. The presentation that accompanied the visit, with details of each of the Irish assets, and a corporate video providing an overview of the portfolio can be found here:

<https://www.phpgroup.co.uk/investors/results-centre>

<https://www.brrmedia.co.uk/broadcasts/5bd04ebbb01efb6b20c2f611/event>

PHP began to invest in the RoI, a market driven by similar fundamentals to the UK, in 2016 and now has eight assets. This includes one forward-funded development that is currently under construction and is expected to complete in the autumn of 2019, in Bray.

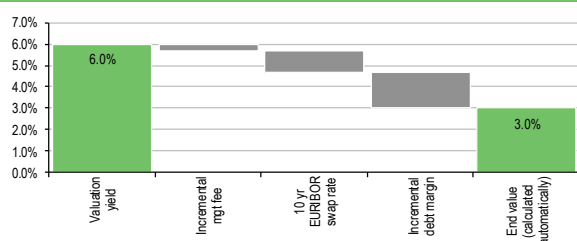
Exhibit 1: PHP's portfolio in the RoI

Location	Asset type	Date acquired	Area (sqm)	WAULT (years)	Acquisition price (€m)
Tipperary	Investment	October 2016	2,400	23.1	6.7
Carrigaline (completed)	Forward funding	August 2017	3,000	24.3	7.3
Mallow	Investment	February 2018	6,500	20.4	20.0
Mountmellick	Investment	May 2018	1,800	17.7	5.8
Celbridge	Investment	September 2018	3,500	23.9	13.0
Navan Road	Investment	September 2018	3,100	21.9	12.2
Newbridge	Investment	September 2018	4,100	20.3	13.4
Bray (under development)	Forward funding	Autumn 2019	4,800	25.0	22.3
Total			29,200		100.7

Source: PHP

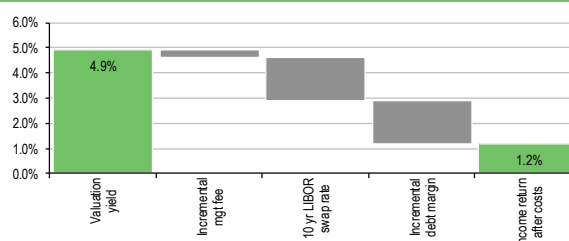
PHP has spent €101m acquiring its assets in the RoI, which have a value (including Bray at completion) of €106m, representing c 6% of the current portfolio value of more than £1.5bn, with a rent roll of €6.3m (c 7% of the total). The company sees further good growth opportunities in the RoI, with the share of an otherwise growing portfolio rising to around 10%. The impact of growth in the RoI portfolio on the overall group performance is compounded by the higher yields that are available. PHP estimates Irish net initial yields to be currently c 6%, around 100bp above the yields currently available in the UK. The growing portfolio will also be part-funded with euro-denominated debt, where funding rates can currently be locked in for 10 years at a lower cost than in the UK, further increasing the income contribution after costs. The relative net initial yield and marginal funding rates currently suggest a c 3% net margin over costs for new investment in the RoI compared with around 1.2% in the UK (Exhibits 2 and 3).

Exhibit 2: Illustrative net margin over costs – RoI



Source: PHP presentation, 18 October 2018

Exhibit 3: Illustrative net margin over costs – UK



Source: PHP presentation, 18 October 2018

There are some differences (discussed below) between lease terms and tenant covenants in the RoI and the UK (which are extremely low risk, with c 90% of rental income backed by the UK government directly or indirectly through GP reimbursement), but we think the difference is minimal. Euro-denominated debt will provide a natural hedge to much of the foreign exchange risk. Further growth in the RoI portfolio should continue to be an important driver of PHP's growth over the next

few years, while we also expect continuing growth in UK assets. Given the tightening in UK yields in recent years, an acceleration in UK open market rental growth (almost three-quarters of the total) would be especially beneficial in increasing income and stimulating new development, having failed to keep pace with the rise in land and building cost inflation. There were positive signs of movement in H118.

Similar market drivers

The fundamental drivers behind the demand for modern, purpose-built, flexible primary care facilities are similar in the RoI to those in the UK. The rate of population growth in the RoI is one of the fastest growing in the EU and is expected to increase by 20% to c six million by 2051. During this time, the proportion of the population over 65 is expected to increase by 150% by 2051 and the proportion over 80 by 270%. Chronic diseases and complex medical conditions are also increasing, as in the UK.

The mainstay of primary care in Ireland, as in the UK, is the GP, but in Ireland they have been fee charging 'businesses' and, as a result, private investment in primary care has been inhibited. To efficiently meet the growing need for healthcare provision, the government has developed various initiatives to modernise delivery, co-locating the provision of a range of care services including physiotherapists, dentists, mental health services, and pharmacies, as well as GPs, at a local level within modern PCCs. The Health Service Executive, the RoI equivalent of the NHS, is seeking to establish around 200 PCCs through the country and while PHP's analysis indicates that there are currently around half this number, it believes that only a small number of these are modern, purpose-built facilities capable of delivering the planned increasing reliance on community-based primary care.

- 12 PCCs were scheduled to open in the current year and one more in 2019.
- 31 further locations are under construction or development, at an advanced planning stage, or underway for design/planning purposes. A further 44 are at an early planning stage.

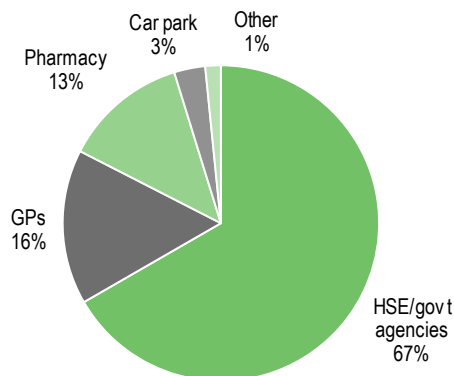
Reflecting the multi-use nature of the PCCs, the RoI investments made by PHP to date are relatively large, with an average lot size of almost £12m, more than twice the group average. Using this as guide to the scale of investment that may be required to deliver the 75 assets that are under construction or being planned suggests a market-wide pool of potential investment opportunities that could be somewhere between £750m and £1bn. Access to funding is an essential ingredient in delivering the planned developments and the government takes a positive approach to private sector funding.

When reporting the interim results in July 2018, PHP continued to show a strong group-wide pipeline of potential acquisitions, totalling more than £175m, both in the UK and in the RoI. Specifically in the RoI, this included the three assets acquired for €38.6m in September (Navan Road, Celbridge and Newbridge) and a further €24m of assets in negotiation. PHP also expressed confidence in gaining further access to the pool of potential transactions through the strong relationships it has built with owners and developers.

Differences in lease terms and tenant covenants

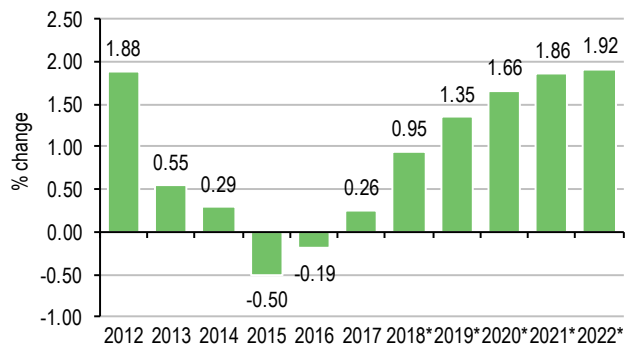
In the UK, around 90% of rent roll is funded directly or indirectly (through cost reimbursement) by the NHS, with much of the rest represented by co-located pharmacies. This is an extremely strong tenant covenant and although the position in the RoI is significantly different, we believe it is still very low risk. In the RoI, the HSE is the anchor tenant and is expected to account for 60–75% of rents. Exhibit 4 shows a breakdown of PHP's current RoI rent roll, with the HSE representing 67% and the GPs and pharmacies representing much of the balance. Although the GPs are fee charging, lower income households qualify for a medical card, which provides them with free access to GP services, such that around half of all GP fee income is effectively paid by the HSE.

Exhibit 4: PHP's current Rol rent roll mix



Source: PHP presentation, 18 October 2018

Exhibit 5: Trend in Rol CPI



Source: PHP, Central Statistical Office. Note: *Forecast.

The other main differences between the Rol and the UK are mainly related to lease terms:

- UK leases are effectively upwards-only, with the majority set on open market terms (at the option of the landlord) and the balance based on fixed uplifts or RPI inflation-linkage. In the Rol, rents are generally linked to CPI inflation compounded over a five-year period and in theory may go down as well as up. Exhibit 5 shows the trend in CPI forecast by the Rol Central Statistical Office, and we think a return to the short-lived negative CPI of 2015/16 is unlikely.
- Lease lengths for the HSE and GPs are as long as in the UK, typically 25 years at inception. Given the young age of the Rol assets, we estimate an average lease term, weighted by area of a little over 22 years, compared with the 13.2 years reported for the group portfolio at H118.
- Unlike the fully repairing and insuring leases that apply in the UK, in the Rol, under typical HSE leases, the landlord is responsible for the maintenance of the properties, but receives a CPI-linked fixed service level agreement contribution from which to pay for this. The GP's pharmacy and other tenants pay their share of the maintenance and communal expenses through the service charge. Given that most of the buildings are brand new, we would not expect significant near-term maintenance expense.
- A typical HSE lease also stipulates that the landlord must maintain a minimum number of GPs operating within the PCC and in theory could terminate the lease if the condition is not met. Given the attraction of the new PCCs to GPs compared with their often ill-suited home practices, we think it unlikely that PHP would be unable to maintain adequate GP numbers and in practice it seems highly unlikely that the HSE would hastily act to terminate the lease and incur the disruption of moving that this would entail.

No change to forecasts

We are not changing our estimates following the capital markets day but take considerable comfort in the prospects for continued accretive growth in the Rol. Our forecast for PHP typically include an expectation of c £100m of acquisitions annually, and for FY19 we have allowed for c 40% of this to be within the Rol.

The recent £22.8m UK acquisition of a modern keyworker accommodation property in Northumbria, let to the Northumbria Healthcare NHS Foundation Trust also falls within our property acquisition assumptions for the current year. It adds a large, good quality asset, with a strong covenant, with fixed rental uplifts and the unexpired lease of 29 years will increase the overall average.

Our forecasts also allow for the full conversion of the outstanding convertible bonds by the end of H119, and the recent adjustment to the conversion price (from 97.5p to 96.16p), a technical adjustment linked to cumulative dividends paid, has only a small impact on share count. There is currently £53.4m nominal of the convertible outstanding.

Valuation

PHP's long leases and secure covenant (with c 90% of rents derived directly or indirectly from the UK and RoI governments), based off a growing portfolio of good quality, modern, purpose-built primary healthcare assets, with no material linkage to the economic cycle, provide investors with considerably visibility over a growing stream of contracted rental income. PHP is now in its 22nd year of rising dividends, an unbroken record since listing. Moreover, as a result, healthcare property values have shown much less volatility than the broad commercial sector.

PHP has declared and paid four quarterly dividends in respect of FY18, an aggregate 5.40p per share, and with the recent market setback, the shares now offer a yield of 4.9%, and trade at only a modest (c 4%) premium to NAV. Our forecasts for further growth are underpinned by a full period contribution from recent acquisitions, continued deployment of the proceeds of April's equity issue into a strong pipeline of opportunities, including those in the RoI, an increasingly positive outlook for rental growth and further opportunities to lower average borrowing costs.

Exhibit 6: Financial summary

£m	2015	2016	2017	2018e	2019e
Year-end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Net rental income	62.3	66.6	71.3	75.9	81.4
Administrative expenses	(6.8)	(7.3)	(8.7)	(9.8)	(10.2)
EBITDA	55.5	59.2	62.6	66.0	71.2
Other income and expenses	0.0	0.0	0.0	0.0	0.0
Non-recurring items	0.0	0.0	0.0	0.0	0.0
Net valuation gain on property portfolio	39.8	20.7	64.5	31.2	24.1
Operating profit before financing costs	95.2	79.9	127.1	97.2	95.3
Net Interest	(33.7)	(32.5)	(31.6)	(29.2)	(27.8)
Non-recurring finance income/expense	0.0	0.0	0.0	0.0	0.0
Early loan repayment fees	0.0	(0.0)	0.0	0.0	0.0
Fair value gain/(loss) on interest rate derivatives and convertible bond, and swap amortisation	(5.5)	(3.7)	(3.6)	0.3	0.0
Profit Before Tax	56.0	43.7	91.9	68.3	67.4
Tax	0.0	0.0	0.0	0.0	0.0
Profit After Tax (FRS 3)	56.0	43.7	91.9	68.3	67.4
Adjusted for the following:					
Net gain/(loss) on revaluation	(39.8)	(20.7)	(64.5)	(31.2)	(24.1)
Fair value gain/(loss) on derivatives & convertible bond	5.5	3.7	3.6	(0.3)	0.0
Profit on termination of finance lease	0.0	0.0	0.0	0.0	0.0
Early loan repayment fees	0.0	0.0	0.0	0.0	0.0
Issue costs of convertible bond	0.0	0.0	0.0	0.0	0.0
EPRA basic earnings	21.7	26.7	31.0	36.9	43.3
Period end number of shares (m)	446.3	598.2	619.4	763.1	795.0
Average Number of Shares Outstanding (m)	445.6	560.0	600.7	706.8	781.5
Fully diluted average number of shares outstanding (m)	530.2	644.6	665.5	758.8	794.0
EPS - fully diluted (p)	11.2	7.3	14.7	9.3	8.6
EPRA EPS (p)	4.9	4.8	5.2	5.2	5.5
Diluted EPRA EPS (p)	4.8	4.7	5.1	5.2	5.5
Dividend per share (p)	5.000	5.125	5.250	5.400	5.500
Dividend cover	97.6%	100.0%	98.7%	101.3%	104.9%
BALANCE SHEET					
Non-current assets	1,100.6	1,220.2	1,361.9	1,473.5	1,600.9
Investment properties	1,100.6	1,220.2	1,361.9	1,472.8	1,600.2
Other non-current assets	0.0	0.0	0.0	0.7	0.7
Current Assets	7.0	8.4	10.5	6.4	10.5
Cash & equivalents	2.9	5.1	3.8	1.6	5.3
Other current assets	4.2	3.3	6.7	4.8	5.2
Current Liabilities	(34.9)	(32.3)	(33.9)	(67.1)	(33.9)
Current borrowing	(0.9)	(0.8)	(0.8)	(0.9)	(0.9)
Other current liabilities	(34.0)	(31.5)	(33.1)	(66.2)	(33.0)
Non-current liabilities	(727.4)	(697.1)	(751.7)	(636.8)	(739.0)
Non-current borrowings	(696.9)	(667.6)	(729.6)	(620.0)	(722.2)
Other non-current liabilities	(30.6)	(29.5)	(22.1)	(16.8)	(16.8)
Net Assets	345.4	499.2	586.8	775.9	838.6
Derivative interest rate swaps	35.3	33.3	24.5	16.1	16.1
Change in fair value of convertible bond	10.9	12.5	12.3	12.3	12.3
EPRA net assets	391.6	545.0	623.6	804.3	867.0
IFRS NAV per share (p)	77.4	83.5	94.7	101.7	105.5
EPRA NAV per share (p)	87.7	91.1	100.7	105.4	109.1
CASH FLOW					
Operating Cash Flow	57.1	56.8	60.1	68.1	72.0
Net Interest & other financing charges	(35.6)	(45.9)	(37.8)	(32.8)	(25.6)
Tax	0.0	(0.1)	0.0	0.0	0.0
Acquisitions/disposals	(29.5)	(97.4)	(75.4)	(78.7)	(103.4)
Net proceeds from issue of shares	(0.1)	145.2	(0.1)	111.1	0.0
Debt drawn/(repaid)	20.0	(31.8)	82.3	(35.0)	100.0
Equity dividends paid (net of scrip)	(21.1)	(24.7)	(29.8)	(34.8)	(39.2)
Other	0.0	0.0	(0.6)	(0.1)	0.0
Net change in cash	(9.2)	2.2	(1.3)	(2.1)	3.8
Opening cash & equivalents	12.1	2.9	5.1	3.8	1.7
Closing net cash & equivalents	2.9	5.1	3.8	1.7	5.4
Debt as per balance sheet	(697.7)	(668.4)	(730.4)	(620.9)	(723.1)
Unamortised borrowing costs	(5.8)	(4.8)	(5.5)	(4.2)	(2.0)
Net debt	(700.7)	(668.2)	(732.1)	(623.4)	(719.6)
Net LTV	62.7%	53.7%	52.9%	45.9%	48.3%

Source: Company accounts, Edison Investment Research

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