EDISON

Primary Health Properties

Outlook and FY19 results

Well positioned for further growth

Real estate

The merger with MedicX has been transformational for Primary Health Properties (PHP). It brought together two high-quality, complementary portfolios, delivered immediate operational and financial synergies with the potential for more, and provided investors with an increased market capitalisation and enhanced share liquidity. PHP is well placed to profitably address the substantial investment needs of the primary healthcare sectors in the UK and Ireland and benefit from increasing evidence of accelerating rental growth.

Year end	Net rental income (£m)	Adj. EPRA earnings* (£m)	Adj. EPRA EPS** (p)	Adj. EPRA*** NAV/share (p)	DPS (p)	P/NAV (x)	Yield (%)
12/18	76.4	36.8	5.2	105.1	5.40	1.49	3.4
12/19	115.7	59.7	5.4	107.9	5.60	1.45	3.6
12/20e	131.3	72.8	5.9	109.7	5.90	1.43	3.8
12/21e	138.6	77.2	6.2	113.7	6.10	1.38	3.9

Note: *Excludes valuation movements, amortisation of fair value adjustment to acquired debt, and other exceptional items. **Fully diluted. ***Adjusts for fair value of derivative interest rate contracts and convertible bond, deferred tax, and fair value adjustment on acquired debt.

Merger delivering benefits and underlying growth

The merger was a significant driver of FY19 performance but PHP continued to grow on a standalone basis. Of the £22.9m increase in adjusted EPRA earnings compared with FY18, MedicX contributed £15.6m. Merger cost savings of an annualised £4.0m were delivered and the average cost of borrowing was reduced from 4.0% to 3.5% with a marginal rate of 2.5%. DPS increased by 3.7% to 5.6p fully covered by EPRA earnings. The first quarterly dividend in respect of FY20 increased 5.4% to 1.475p (an annualised 5.9p), leading us to increase our DPS forecasts. We expect acquisitions, accelerating rental growth, and operational and financial cost savings to drive further growth.

Well placed for further growth

In both the UK and Ireland, 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. The requirement for larger, more flexible, higher-quality premises will provide significant investment opportunities in the coming years. The enlarged PHP is well placed to address this opportunity. At the time of reporting, it had £360m of available funding headroom and an acquisition pipeline totalling c £160m, of which £44m was in legal due diligence. Yields have tightened but reduced marginal funding costs and investment management fees have maintained a healthy positive spread on acquisitions.

Valuation: Secure income with growth

Income visibility is strong, with long leases and substantially upwards-only rents, 90% backed directly or indirectly by government bodies, with little exposure to the economic cycle, or fluctuations in occupancy. With dividends growing and fully covered by earnings, the FY20e yield is 3.8%, supporting a premium to NAV.

6 March 2020

Price	**157p**
Market cap	**£1,910m**
Net debt (£m) at 31 December 2019	1,067.3
Net LTV at 31 December 2019	44.2%
Shares in issue	1,136.2m
Free float	97%
Code	LSE
Primary exchange	PHP
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(1.3)	6.1	25.6
Rel (local)	10.1	12.9	32.9
52-week high/low		162.8p	123.0p

Business description

Primary Health Properties is a long-term investor in primary healthcare property in the UK and the Republic of 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

AGM	1 April 2020
Interim results	July 2020

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Edison profile page

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

Investment summary

Company description: Successful record of growth

In both the UK and Ireland, 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. The requirement for larger, more flexible, higher-quality premises will provide significant investment opportunities in the coming years. PHP has a proven record of successfully investing in the sector and, since it was founded, has delivered 23 years of unbroken dividend growth. The merger with MedicX has been transformational for PHP, bringing together two high-quality, complementary portfolios, delivering immediate operational and financial synergies with the potential for more and providing investors with an increased market capitalisation and enhanced share liquidity. PHP is well placed to profitably address the substantial investment needs of the primary healthcare sectors in the UK and Ireland and benefit from increasing evidence of accelerating rental growth.

Financials: Acquisitions

The merger was a significant driver of FY19 performance but PHP continued to grow on a standalone basis. Merger cost savings of an annualised £4.0m were delivered, contributing to a further reduction in the EPRA cost ratio to 12.0%. The average cost of borrowing was reduced from 4.0% to 3.5% with a marginal rate of 2.5%, and the balance sheet was strengthened. DPS increased by 3.7% to 5.6p fully covered by EPRA earnings and the first quarterly dividend for FY20 increased 5.4% to 1.475p (an annualised 5.9p). We expect acquisitions, accelerating rental growth and operational and financial cost savings to drive further growth. At the time of reporting FY19 results, £360m of funding headroom was available and the acquisition pipeline totalled c £160m, of which £44m was in legal due diligence. Yields have tightened but reduced marginal funding costs and investment management fees have maintained a healthy positive spread on acquisitions.

Valuation: Secure income with growth

The shares have re-rated since the transformational merger with MedicX such that our forecast full-year FY20 DPS of 5.90p now represents a prospective 3.8% dividend yield. Although this is below the average for the broad property sector and wider UK equity market, we forecast dividends to be fully covered by expected cash earnings, with good potential for further growth and, most importantly, backed by a secure, upwards only rent profile, c 90% funded directly or indirectly by the NHS in the UK or HSE in Ireland. Given the nature of this income stream it is tempting to draw comparison with the generic yield on 10-year gilts at little less than 0.5%. This secure and growing dividend return provides the basis for the valuation and in turn provides support for a continuing valuation premium to EPRA NAV.

Sensitivities: Low risk, low volatility

Historical returns on primary healthcare assets have been higher than other sectors of the UK commercial property market, with a lower level of volatility. This has been a function of secure and more resilient income and more muted yield shifts through the property cycle. The sector driven by demographics (aging, growing and sicker populations) rather than general economic conditions and is characterised by long leases, predominantly government backed, with minimal vacancy and (in the UK) upwards-only lease adjustments. There are nevertheless a range of factors that could affect the business, especially over the longer term, including structural changes in the markets in which the group operates, changes to government health and fiscal policies, funding conditions and operational performance (see page 13).

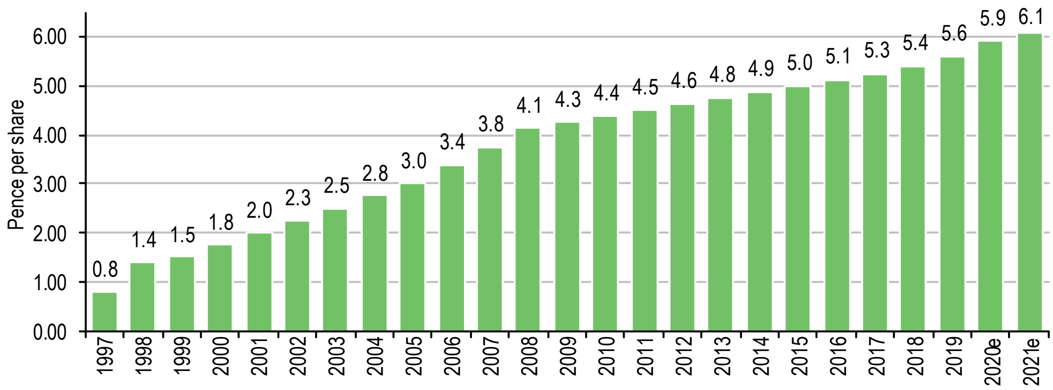
Leading UK primary healthcare REIT

Company overview

Primary Health Properties (PHP) is a UK real estate investment trust (REIT) and, following completion of the agreed merger with MedicX (14 March 2019), has become the leading long-term investor in modern, flexible, purpose-built primary healthcare facilities located across the UK and the Republic of Ireland (RoI). The majority of these are leased to general practitioners (GPs), government health service organisations (the UK NHS or RoI HSE) and other associated healthcare providers, such as pharmacies and dentists. Investment is targeted at assets that can generate long-term rental income with scope for capital gains.

The company was founded by Managing Director Harry Hyman in 1995. It floated on the AIM market of the London Stock Exchange (LSE) in 1996, moved to the Main Market of the LSE two years later and converted to REIT status in 2007. PHP has a proven record of successfully investing in the sector and since it was founded has delivered 23 years of unbroken dividend growth and targets a further increase, 5.9p for the current (FY20) financial year, fully covered by EPRA earnings.

Exhibit 1: 23 years of unbroken dividend per share growth



Source: PHP, Edison Investment Research

Primary healthcare property is a specialist sector alongside the broader mainstream commercial property subsectors (offices, retail, industrial). As well as having good growth prospects – driven by an ageing population with increasing healthcare needs – that are effectively immune to the economic cycle, the key factors that differentiate it from the broad commercial property sector are as follows:

- Long leases at inception. Typically 20–25 years, with upwards-only rent reviews in the UK.
- A strong tenant covenant: 90% of rent roll is funded directly or indirectly (through cost reimbursement) by the NHS in the UK or the HSE in the ROI.
- No speculative development and minimal vacancy. PHP itself is not a developer and only funds development properties on a pre-let basis.

Together, these characteristics provide PHP with a high level of income visibility and good opportunities for further growth, while returns have historically been much less sensitive to economic cycles than other commercial real estate subsectors.

Portfolio provides high-quality recurring income

Exhibit 2 shows a summary of PHP's portfolio as at 31 December 2019 (end-FY19). The almost 500 properties were externally valued at £2.41bn with a contracted rent roll of £127.7m and weighted average unexpired lease term (WAULT) of 12.8 years. The valuation reflected a net initial yield of 4.86%. The merger with MedicX provided a significant boost to the scale of the portfolio, adding 168 high-quality, complementary assets with a value of £0.84bn. The contribution to the overall portfolio from Ireland has continued to increase, with the 16 assets representing c 7% of the total by valuation, and a focus on acquiring larger, multi-disciplinary medical centres, especially in Ireland, has contributed to a further increase in the average lot size to almost £5m. The portfolio provides a stream of high-quality recurring income with good potential to grow through acquisitions of standing assets and pre-let developments, asset management and rental growth. The PHP portfolio of £2.41bn compares with that of close peer Assura, which last reported an end-September 2019 valuation of just over £2.0bn, comprising 560 properties. The two are differentiated by PHP's growing Irish portfolio (targeted to increase to perhaps 15% by value) and Assura's in-house development platform compared with PHP's use of forward funding to acquire third-party developed assets.

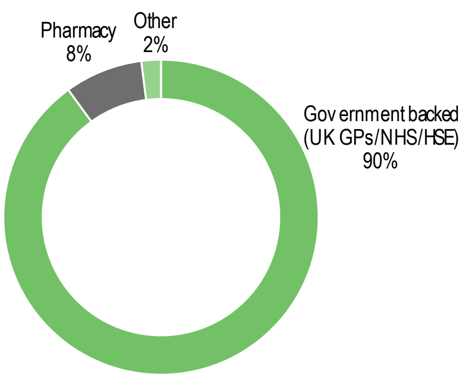
Exhibit 2: Portfolio summary as at end-FY19*

	PHP	MedicX	Combined
Total number of properties	320	168	488
Of which in Ireland	11	5	16
Investment portfolio value (£bn)	1.57	0.84	2.41
Contracted rent roll (£m)	82.6	45.1	127.7
Net initial yield (NIY)	N/A	N/A	4.86%
Average lot size (£m)	4.9	5.0	4.9
WAULT (years)	12.5	13.4	12.8
Occupancy	99.8%	99.1%	99.5%
Government backed rents	90%	90%	90%

Source: PHP. Note: A £2.8m forward funding acquisition in Wales announced in February is not included.

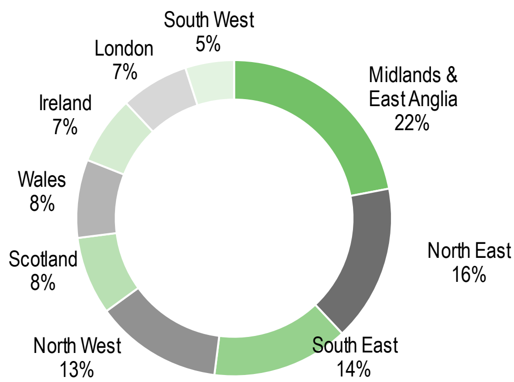
Exhibit 3 demonstrates the exceptionally strong tenant covenant of the portfolio, not only the 90% of rental income backed by government bodies but also co-located pharmacies and other associated medical services. The geographic spread of assets provides additional income diversification.

Exhibit 3: Covenant exposure by rent roll



Source: PHP. Note: End-FY19.

Exhibit 4: Geographic spread by valuation



Source: PHP. Note: End-FY19.

Income growth

Exhibit 5 shows a summary of the rent roll development in FY19 as well as some of the 'in-built' drivers of future growth. During FY19, in addition to the £44.4m of rents added by the MedicX merger, acquisitions added £2.0m and rental growth added £1.9m, taking the year-end total to £127.7m. PHP indicates that the portion of its larger acquisition and development pipeline that is under offer, as well as the anticipated uplift from the eventual settlement of outstanding rent reviews, has the potential to lift rent roll further to £133.7m. We forecast that further acquisition activity, asset management and rental growth will further lift rental income as explained in the Financials section of this note.

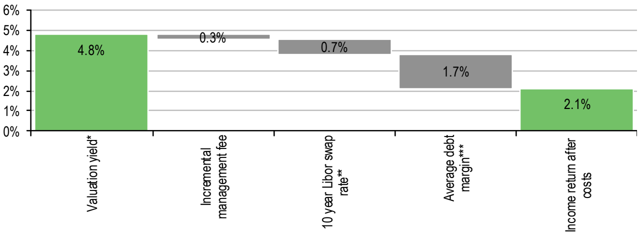
Exhibit 5: Contracted rent roll development

	£m
Rent roll as at end-FY18	79.4
MedicX merger	44.4
Acquisitions	2.0
Completed rent reviews & projects	1.9
Rent roll as at end-FY19	**127.7**
Acquisition & development pipeline (under offer)	3.5
Anticipated uplift from outstanding rent reviews and future projects	2.5
Pro forma rent roll	**133.7**

Source: PHP

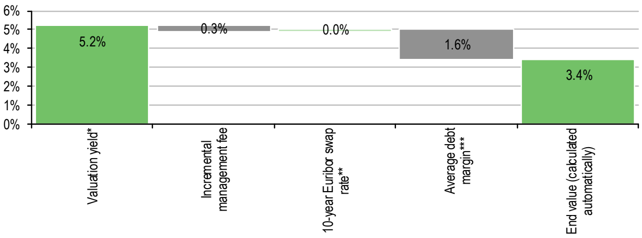
With the FY19 results, PHP reported an **acquisition pipeline** totalling c £160m of which £44m was in legal due diligence. Although yields have tightened in the UK over several years and the Irish yield premium over the UK has narrowed, supportive debt funding conditions and reducing marginal investment management fees (part portfolio growth and part management fee renegotiation), a healthy positive spread on acquisitions remains (Exhibits 6 and 7).

Exhibit 6: Illustrative yield gap on UK investment



Source: PHP. Note: *Portfolio valuation yield at 31 December 2019 as proxy for purchases. **At 31 January 2020. ***Incremental margin on debt facilities.

Exhibit 7: Illustrative yield gap on Irish investment



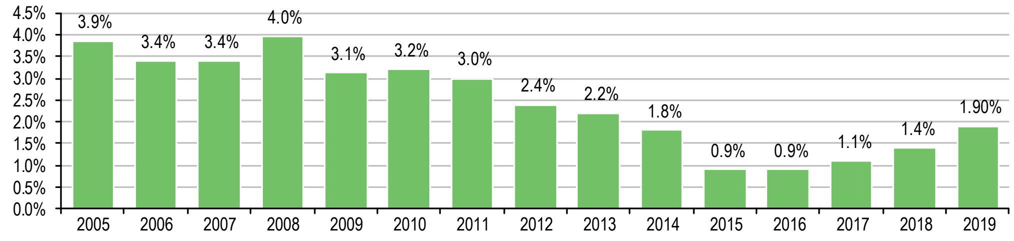
Source: PHP. Note: *Portfolio valuation yield at 31 December 2019 as proxy for purchases. **At 31 January 2020. ***Incremental margin on debt facilities.

Rental income will also benefit from development asset completions (included within contracted rent roll). There were six properties under development at end-FY19, four of which are in Ireland. The expected value at completion was £57m, of which c £25m remained to be spent. A seventh pre-let, forward-funded development asset in Wales was acquired in February 2020 with an expected total cost of £2.8m.

Rent growth continuing to accelerate

Low rates of inflation (in contrast to land and building cost inflation) and low open-market rent review increases in recent years have resulted in low overall levels of rent growth. However, the trend of the past three years has moved positively upwards, with an average uplift on review of 1.9% pa achieved by PHP in FY19.

Exhibit 8: Rental growth history (average annualised uplift on completed reviews in year)



Source: Company data, Edison Investment Research

Open-market rent reviews, typically on a three-yearly basis, account for 69% of the total with RPI-linked or fixed uplift agreements representing the balance. Across the market there is evidence that open-market rent reviews have failed to sufficiently capture the strong rise in land and build costs in recent years, in part the result of financial pressures and reorganisation within the NHS that slowed decision making on commissioning the development of new primary healthcare facilities. The dearth of new developments that this created restricted the opportunities for increased land and building costs to be adequately reflected in the rent reviews for existing assets. There is now a growing optimism that this is changing as NHS reforms bed down, plans take shape and development activity picks up. The rents required to encourage the flow of much-needed private investment that will support modernisation of the primary healthcare estate should increasingly be reflected in market rent levels across the estate. During FY19, uplifts of 3.0% and 3.1% were achieved on RPI-based and fixed uplift reviews. For open-market reviews (69% of the total), an average of 1.1% was achieved on 165 reviews including 52 where there was no uplift. In addition, a further 86 open-market rent reviews were agreed in principle, which will add £0.7m to the contracted rent roll when concluded, representing an uplift of 1.6% pa.

In addition to organic rental growth through rent reviews, PHP has an active programme of asset management projects such as extensions, refurbishments and lease extensions/re-gears. Extensions and refurbishments enhance the quality of the portfolio, support the tenants in improving their healthcare delivery, generate additional rents, and support lease extensions. Lease extensions extend both the WAULT and income visibility while enhancing valuation.

Management and governance

PHP is managed by the board of directors, comprising a majority of independent, non-executive directors selected to deliver an appropriate mix of diversity, skills and experience. With no direct employees, the board appoints specialist third-party advisers to assist with the day-to-day running of the group. Nexus TradeCo (Nexus) is appointed to provide property advisory and management services, including the services of the managing director and finance director, Harry Hyman and Richard Howell, as well as administrative and accounting services. The successful integration of MedicX during FY19 built on a highly successful track record of creating value for PHP and its shareholders since the company was founded in 1995.

The board

Immediately following the merger with MedicX, the board of PHP was reshaped to maintain an appropriate size and create a balance between PHP and former MedicX directors. With the board having overseen the successful integration of the team from MedicX's investment adviser (Octopus) into that of Nexus, as well as the integration of the respective property management and finance systems, further changes to the board are now planned. Reflecting the relative simplicity of the business model, the board will reduce in size from eight members to six, consisting of four independent non-executive directors and two executive directors. Accordingly, PHP will not seek a replacement for Helen Mahy (deputy chairman of PHP and former chairman of MedicX), whose decision to retire at the AGM scheduled for April 2020 was announced in November 2019 and Dr Stephen Kell will not be standing for re-election at the AGM. Following these changes, the board of PHP will include independent non-executive directors Steven Owen (chair), Peter Cole, Laure Duhot and Ian Krieger, along with executive directors Harry Hyman (managing director) and Richard Howell (finance director). Following the AGM, Ian Krieger will become senior independent director and Peter Cole will become chairman of the remuneration committee.

The investment advisor: Nexus

The Nexus property team brings broad experience across health sector real estate as well as in finance and company secretarial matters. It has continued to grow with the PHP business over the 24 years since this was launched, recently reaching 52 members of staff including 20 who came across from Octopus Healthcare Adviser Limited (Octopus), the investment manager to MedicX, and comprises a mix of property, finance and legal professionals.

The team is headed by Chris Santer, a qualified surveyor who joined Nexus in October 2017 and has over 20 years' real estate investment and development experience in the UK and continental Europe. Prior to joining Nexus, Chris was a director of portfolio management at PGIM Real Estate, the asset management arm of Prudential Financial Inc, and previously MGPA, the real estate fund management arm of Macquarie Bank.

Highly cost-efficient structure

Supported by savings related to the MedicX merger as well as underlying scale economies, PHP's 2019 EPRA cost ratio reduced to 12.0% (FY18: 14.3%) making it one of the lowest, if not the lowest, in the UK REIT sector. The majority (c 80%) of all administrative expenses relate to investment advisory fees and investment adviser performance incentive fees (PIF) with the balance of expenses related to other company running expenses. Our forecasts indicate a further reduction in the EPRA cost ratio in the current year (FY20) with a full year benefit from the merger cost savings and further business growth.

Exhibit 9: Further cost ratio improvement

£m unless stated otherwise	FY19	FY18
Total advisory fees	(8.3)	(6.6)
Performance incentive fees	(1.8)	(1.3)
Total other administrative expenses	(2.2)	(2.0)
Total administrative expenses	(12.3)	(9.9)
EPRA cost ratio	12.0%	14.3%
EPRA cost ratio excluding PIF	10.5%	12.6%

Source: PHP data

The property advisory fee payable to Nexus is comprised of a property management fee and an administration fee. For the first five years after the completion of the merger, the fees paid to Nexus for the management of the c £816m formerly MedicX investment portfolio is set at a fixed 0.225% pa (c £1.8m pa), reverting to the PHP fee schedule at the marginal rate thereafter. Nexus has agreed to rebate £2.5m of this amount back to the company, paid in equal monthly instalments over five years. On the remainder of the portfolio, including assets acquired after completion of the merger with MedicX, management fees are calculated on a sliding scale applied to gross asset value, which with incremental asset growth lowers the average fee. A revised fee schedule in place since 1 January 2019 reduced the marginal fee rate on assets above £2.0bn to 0.225% pa and to 0.20% on assets above £2.25bn, enhancing the attractiveness of further portfolio growth for investors. In respect of the administrative and accounting services provided by Nexus, it receives a fixed annual fee of c £1.215m, which may be increased annually in line with RPI subject to a 5% cap. Additionally, Nexus is entitled to a performance incentive fee (PIF) that gives Nexus 11.25% of the EPRA NAV total return (change in NAV plus dividends paid) above a hurdle rate of 8%, on a cumulative basis, with annual payments subject to an overall cap at the lower of 20% of the management fee payable to Nexus in that year or £2.0m. Half of any PIF payment is deferred to the following year, with performance against the hurdle rate (both positive and negative) carried forward in a notional cumulative account with any future payment subject to the account being in a surplus position. The Nexus team working on PHP's account, other than Harry Hyman, will receive a minimum of 25% of any PIF paid, to aid staff motivation and retention, of which 50% is to be satisfied in PHP shares, subject to a three-year holding period.

Financials

Strong FY19 growth reflects organic progress and transformational merger

The merger with MedicX completed on 14 March 2019 has been truly transformational for PHP. It brought together two high-quality, complementary portfolios, delivered immediate operational and financial synergies with the potential for more to follow, and provided investors with an increased market capitalisation and enhanced share liquidity. The merger was a significant driver of the 61% increase in the investment portfolio, 51% increase in net rental income and 62% increase in adjusted EPRA earnings but PHP continued to grow on a standalone basis. Of the £22.9m increase in adjusted EPRA earnings compared with FY18, MedicX contributed £15.6m.

The targeted immediate merger cost savings of an annualised £4.0m were delivered with some of the benefit to come through in the current year. An already low EPRA cost ratio fell further to 12.0%. The merger also created opportunities to refinance historically expensive debt and the average cost of borrowing declined from 4.0% to 3.5%. The marginal rate of borrowing is now 2.5%.

DPS has continued to increase, by 3.7% to 5.6p in FY19, with dividends paid fully covered by EPRA earnings. The first quarterly dividend in respect of FY20 increased 5.4% to 1.475p (an annualised 5.9p).

The balance sheet has been significantly strengthened leaving PHP well positioned for further portfolio growth.

Exhibit 10: Summary of FY19 financials

£m unless stated otherwise	FY19	FY18	FY19/FY18	H119	H219	FY19e
Net rental income	115.7	76.4	51.4%	53.8	61.9	117.0
Administrative expenses	(12.3)	(9.9)	24.2%	(5.9)	(6.4)	(12.2)
Net finance expense	(43.7)	(29.7)	47.1%	(20.0)	(23.7)	(44.5)
Basic adjusted EPRA earnings*	**59.7**	**36.8**	**62.2%**	**27.9**	**31.8**	**60.4**
Property revaluation	48.4	36.0		17.7	30.7	37.7
Profit on sale of properties	1.4	0.1		0.0	1.4	0.0
Fair value loss on derivatives	(5.4)	(1.8)		(2.3)	(3.1)	(2.3)
Fair value gain/(loss) on convertible bond	(28.2)	3.2		(1.8)	(26.4)	(1.8)
Exceptional items related to MedicX merger						
– contract termination fee	(10.2)	N/A		(10.2)		(10.2)
– exceptional revaluation loss	(138.4)	N/A		(138.4)		(138.4)
Amortisation of fair value adjustment on acquired debt	2.5	N/A		1.0	1.5	2.7
Tax charge	(1.1)	0.0		(0.4)	(0.7)	(0.4)
Basic IFRS earnings	**(71.3)**	**74.3**		**(106.5)**	**35.2**	**(52.3)**
Basic IFRS EPS (p)	(6.5)	10.5				(4.9)
Basic EPRA EPS (p)	4.8	5.2				5.0
Basic adjusted EPS (p)	5.5	5.2	5.8%			5.7
Diluted adjusted EPRA EPS (p)	**5.4**	**5.2**	**3.8%**			**5.7**
DPS (p)	**5.6**	**5.4**	**3.7%**			**5.6**
Dividend cover**	**1.01**	**1.01**				**1.03**
Adjusted EPRA NAV per share (p)***	107.9	105.1	2.7%			107.0
EPRA NAV total return	8.0%	9.8%				7.1%
Investment portfolio (bn)	2.41	1.50	60.6%			2.43
Net LTV	44.2%	44.8%				48.6%
EPRA cost ratio	12.0%	14.3%				11.8%

Source: PHP data, Edison Investment Research estimates. Note: *Adjusted EPRA earnings excludes valuation movements, amortisation of acquired fixed rate debt revaluation and other exceptional items. **Dividend cover is EPRA earnings as a percentage of dividends declared. ***Adjusted EPRA NAV excludes fair value movements in derivative interest rate contracts and convertible bonds, acquired fixed rate debt revaluation and deferred tax.

The strong 62% growth in EPRA earnings was the result of:

- Net rental growth of 51% to £115.7m driven by the MedicX merger (from the date of completion), a full period contribution from prior year acquisitions and development completions, a partial contribution from current year investments, and underlying rental growth.
- A 24% increase in recurring administrative expense, benefiting from the achieved £4m pa merger cost savings with a further impact to flow through in FY20.
- A 47% increase in net finance expenses (excluding positive non-cash amortisation to the fair value adjustment of acquired MedicX debt), reflecting the enlarged balance sheet but also benefiting from the refinancing measures that saw the average cost of debt reduce from 4.0% to 3.5%.
- Reflecting the increased number of shares in issue, basic adjusted EPRA EPS increased 5.8% from 5.2p to 5.5p. Allowing for the potential impact of conversion of the convertible bonds, fully diluted adjusted EPRA EPS increased 3.8% from 5.2p to 5.4p.

IFRS earnings were affected by the merger accounting impacts reported in H119 as well as valuation movements in respect of interest rate derivatives, the convertible bond and investment properties. The IFRS net loss for the year was £71.3m (H219: £35.2m profit).

Property revaluation gains were driven by rental growth and some further yield tightening in Ireland (UK unchanged). Adjusted EPRA NAV per share increased 2.7% to 107.9p.

Underlying forecast assumptions

Turning to our forward-looking estimates, the key underlying assumptions we make relate to asset growth and funding:

- New investment commitments of £125m in both FY20 (previously £150m) and FY21, a mix of fully let completed assets and forward funding commitments in both the UK and Ireland.
- For the UK we assume a blended cash yield on investment of 4.50% (previously 4.75%) for standing assets and 4.75% (previously 5.00%) for development assets, and in the RoI we assume 5.00% (previously 5.25%) for standing assets and 5.25% (previously 5.75%) for development assets. The blended yield on our assumed new commitments is 4.80% (previously 5.13%). Our change in yield assumption recognises the ongoing competition for assets. We assume a blended average 2.0% pa rental growth.
- Given that cash is deployed to forward funding agreements, the cash investment reflected in our estimates slightly lags the pace of investment commitments. We expect PHP to fund our assumed level of asset growth with existing cash resources and additional drawings of existing debt facilities. We have assumed no equity issuance in our forecasts, nor conversion of bonds. For new debt we assume a rate of 2.5%, consistent with the current marginal cost of debt.
- Our cost estimates are substantially driven by the fee schedules described in detail above. We have additionally allowed for £1.8m pa PIF payments to the investment adviser.
- We make no assumption of changes in market valuation yields (either up or down) and reflect the assumed rental growth in gross revaluation gains, partly offset by assumed acquisition costs. We estimate that a 0.1% decrease in the portfolio net initial yield would increase FY20e EPRA NAV per share by c 4p, with a 0.1% increase in net initial yield having a similar negative impact.

Balance sheet and funding

PHP has been active in terms of refinancing initiatives since completing the merger with MedicX, increasing its available capital, both debt and equity, reducing the average cost of borrowing from 4.0% to 3.5% (with a marginal cost of debt of 2.5%), and extending debt maturity (from 5.4 years to 7.2 years). As at 31 December 2019 (end-FY19) it had a widely diversified portfolio of debt facilities amounting to c £1.5bn of which c £1.2bn had been drawn. Including a healthy cash balance of £143.1m, temporarily buoyed by capital raising ahead of investment, net debt was c £1.1bn and allowing for capital commitments 0f £28.1m, the headroom available for further investment was almost £360m.

The key funding initiatives during the year were:

- The July 2019 issue of a new unsecured £150m/2.875% convertible bond and repayment at maturity of the more expensive existing £75m/5.375% retail bond. At the same time, £73.4m of unrequired loan facilities acquired with MedicX, of which little had been drawn, were cancelled.
- The September 2019 issue of €70m of 12-year euro-denominated senior secured loan notes at a fixed rate of 1.509%. This is PHP's second euro-denominated issue, providing attractively priced funding for its expanding Irish portfolio and hedging euro-currency exposure. The proceeds have been partially applied to repaying and cancelling a more expensive €32m facility with Bank of Ireland of which €26.2m had been drawn at a cost of 3.0%.
- The December 2019 £100m revolving credit facility agreed with HSBC, which provides for drawings in both sterling and euros. The facility has an initial three-year term with options to extend and has a variable interest rate of Libor plus 1.65%.
- The re-couponing of £100m of HSBC floating interest rate swaps to a fixed rate of 0.6875% for a one-off payment of £8.0m. The replaced swap agreements were at much higher fixed rates with £25m at 2.47% and £75m at 2.65%. Taking account of the one-off payment we would

expect the transaction to be broadly neutral to valuation but it has the benefit of reducing interest charges by c £1.6m pa to the benefit of interest and dividend cover.

- A £100m (£97.7m) equity raise via an accelerated book-building in September 2019 at 128p per share.

The end-FY19 loan to value ratio (LTV) was 44.2%, down from 47.8% at end-FY18 on a pro-forma basis adjusted for the subsequent merger with more highly geared MedicX. On the same basis, the average cost of debt reduced from 4.0% to 3.5% and the company continues to look at other opportunities for a further reduction, particularly in respect of debt maturities of c £420m by end-FY22.

With c 82% of debt facilities and c 98% of drawn debt either fixed rate or hedged with swaps, PHP is well protected against any unexpected increase in market interest rates.

Revised estimates

Our forecasts are updated to take account of the FY19 results as well as the £100m (gross) equity placing. Despite the slightly reduced assumption for new asset commitments noted above, our forecast adjusted EPRA earnings for FY20 and FY21 are increased, primarily driven by lower net finance expense (both lower borrowings and the ongoing reduction in the average cost of debt). On a fully diluted basis our forecast for adjusted EPRA EPS is slightly reduced, reflecting the share placing but also the likely conversion of the convertible bonds, given the strong rise in the share price since issue. The forecasts are based on materially lower gearing than previously with our expectation for end-FY21 LTV reduced from c 53% to c 47%; conversion of the convertible bonds would reduce this further, by an estimated c 6%. We expect PHP to distribute substantially all of its EPRA earnings and our DPS forecasts are increased for both FY20 and FY21.

Exhibit 11: Estimate revisions

	Net rental income (£m)			Adj. EPRA earnings (£m)			Diluted adj. EPRA EPS (p)			DPS (p)			Dividend cover			Adj. EPRA NAVPS (p)		
	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff
12/20e	133.5	131.3	-1.6	70.2	72.8	3.6	6.2	5.9	-5.2	5.8	5.9	1.7	106%	101%	-4.7	111.1	109.7	-1.5
12/21e	143.7	138.6	-3.6	72.8	77.2	6.0	6.4	6.2	-3.4	6.0	6.1	1.7	107%	104%	-2.5	115.6	113.8	-1.8

Source: Edison Investment Research estimates. Note: *Adjusted EPRA earnings excludes valuation movements, amortisation of acquired fixed rate debt revaluation and other exceptional items. **Dividend cover is EPRA earnings as a percentage of dividends declared. ***Adjusted EPRA NAV excludes fair value movements in derivative interest rate contracts and convertible bonds, acquired fixed rate debt revaluation and deferred tax.

Valuation

Historical returns on primary healthcare assets have been higher than other sectors of the UK commercial property market, with a lower level of volatility. This has been a function of secure and more resilient income and more muted yield shifts through the property cycle.

Strong primary healthcare property investment fundamentals, continuing low interest rates, long lease lengths and predominantly government-backed rents, accelerating rental growth and successful delivery of the targeted MedicX merger synergies have all contributed to a continuing strong performance from PHP shares over the past year.

The shares have re-rated since the transformational merger with MedicX such that our forecast full year FY20 DPS of 5.90p now represents a prospective 3.8% dividend yield. Although this is below the average for the broad property sector and wider UK equity market, we forecast dividends to be fully covered by forecast cash earnings, with good potential for further growth, and most importantly, backed by a secure, upwards only rent profile, c 90% funded directly or indirectly by the NHS in the UK or HSE in Ireland. Given the nature of this income stream it is tempting to draw comparison with the generic yield on 10-year gilts at little less than 0.5%. This secure and growing dividend return provides the basis for the valuation and in turn provides support for a continuing valuation premium to EPRA NAV.

Exhibit 12 shows the strong NAV total return performance over the past five years. Between the end of 2014 and the end of 2019, PHP generated an EPRA NAV total return of 68.6% or a compound 11.0% pa (dividends added back but not reinvested). Dividends paid have accounted for around half of the return, with capital returns contributing the balance including the impact of asset management, rental growth and yield tightening.

Exhibit 12: Five-year NAV total return of 11.0% pa compound

	2015	2016	2017	2018	2019	2015–19
Opening EPRA NAV (p)	79.7	87.7	91.1	100.7	105.1	79.7
Closing EPRA NAV (p)	87.7	91.1	100.7	105.1	107.9	107.9
Dividends paid in period (p)	5.00	5.13	5.25	5.40	5.60	26.38
NAV total return	16.4%	9.7%	16.3%	9.8%	8.0%	68.6%
Compound annual average return						11.0%

Source: PHP data, Edison Investment Research

With indications of open market rental growth picking up and the scope for further yield tightening less clear, we would expect the balance of future returns to shift towards income. At some point we are likely to enter a market environment in which valuation yields stop tightening and may even increase again, although the latter is only likely in the context of a broad property market yield shift. This would have no impact on the rental income from existing assets and would increase the cash yield available on acquisitions.

In Exhibit 13 we show the key valuation and performance metrics for PHP, a group of peers with similarly long lease exposure to a range of asset types with differing covenant strengths, the broad UK property sector and the FTSE All-Share Index. For comparative purposes, the data are on a trailing basis, using the last published EPRA NAVs and trailing 12-month dividends declared. Within the peer group, primary healthcare assets are differentiated by the strength of the tenant covenant (90% NHS/HSE). The mix of lease rental terms provides significant exposure to a pick-up in open-market rents compared with significant index-linked rents among peers. Given the multi-year lag in open-market rents and signs of acceleration, this may well prove advantageous.

Exhibit 13: Peer group comparison

	Price (p)	Market cap (£m)	P/NAV* (x)	Yield** (%)	Share price performance			
					One month	Three months	12 months	From 12M high
Assura	77	1853	1.44	3.6	-4%	-2%	33%	-8%
Civitas Social Housing	98	607	0.91	5.3	1%	10%	-1%	-5%
Impact Healthcare	107	341	1.01	5.8	-2%	-2%	4%	-7%
Lxi	128	667	1.07	4.4	-5%	-2%	5%	-9%
Secure Income	450	1453	1.07	3.7	-5%	8%	10%	-5%
Supermarket Income	105	353	1.08	5.5	-3%	-3%	2%	-5%
Target Healthcare	119	544	1.10	5.6	-3%	2%	3%	-4%
Triple Point Social Housing	96	337	0.92	5.3	-1%	8%	-5%	-7%
Tritax Big Box	133	2267	0.88	5.2	-7%	-10%	-7%	-18%
Average			**1.05**	**4.9**	**-3%**	**1%**	**5%**	**-8%**
Primary Health Properties	**157**	**1910**	**1.46**	**3.6**	**-4%**	**2%**	**24%**	**-6%**
UK property index	1,770			3.9	-7%	-7%	3%	-10%
FTSE All-Share Index	3,731			5.1	-11%	-7%	-6%	-13%

Source: company data, Edison Investment Research, Refinitiv. Note: *Based on last reported EPRA NAV. **Based on 12-month trailing dividends declared. Prices at 5 March 2020.

Sensitivities

As a long-term investor in a specialist sector of the commercial property market characterised by long leases, predominantly government backed, with minimal vacancy and (in the UK) upwards-only lease adjustments supported by predominantly fixed-cost debt, and with MedicX successfully integrated, we consider PHP to have low operational risk in a sector context. The sector is driven by demographics (aging, growing and sicker populations) rather than general economic conditions but there are nevertheless a range of factors that could affect the business, especially over the longer term, including structural changes in the markets in which the group operates, changes to government health and fiscal policies, funding conditions and operational performance, In particular we note:

- Enhancing organic rental growth, continuing property acquisitions are a significant driver of the growth that we forecast, requiring PHP to maintain a suitable pipeline of standing properties and development assets for investment on favourable terms and conditions. The enhanced scale of the group following the merger with MedicX and bringing together the strong industry relationships of both companies is a positive long-term indicator, evidenced by the current strong investment pipeline.
- Market environment:
  - As discussed above, the demand for healthcare in both the UK and the RoI seems set for further growth, while government and health service planning in both countries puts primary healthcare at the centre of measures to improve delivery and generate overall efficiencies. Primary healthcare estates need substantial modernisation and upgrading to meet this demand.
  - Attractive risk-adjusted yields have enticed new investors to the sector resulting in a tightening of yields over several years. Competition is greatest for the larger, purpose-built properties that are expected provide the best potential for longer-term rental growth and returns. However, favourable funding conditions have maintained a positive spread between acquisition yields and costs, including funding costs, while the spread in Ireland, where PHP has a strong and growing presence, remains above that in the UK. Signs of accelerating rental growth are a positive factor.
  - Government policy: while changes cannot be ruled out over the longer term, the UK government and all major parties support health service planning, which includes a larger, community-based role for primary care, with 24/7 access to GP services and supported by increased funding. The Irish government is similarly restructuring its primary care provision.
- General economic and monetary conditions: the non-cyclical nature of the sector reduces the impact of fluctuations in the wider economy and property market. We expect such fluctuations to have no material direct impact on PHP's income and, as has been the case historically, we would expect variations in property valuations to be less pronounced than for the broad commercial property sector.
- With c 82% of debt facilities and c 98% of drawn debt at end-FY19 either fixed rate or hedged with swaps, PHP is well protected against any unexpected increase in market interest rates in the short to medium term. While the average maturity of the debt facilities has increased to 7.2 years at end-FY19, it remains shorter than the WAULT (12.8 years at end-FY19), and without assuming further management action, there is a risk that over the long term interest rates, particularly real interest rates, may be higher as debt facilities mature.

Exhibit 14: Financial summary

£m	2017	2018	2019	2020e	2021e
Year end 31 December					
PROFIT & LOSS					
Net rental income	71.3	76.4	115.7	131.3	138.6
Administrative expenses	(8.7)	(9.9)	(12.3)	(13.2)	(13.8)
EBITDA	62.6	66.5	103.4	118.2	124.7
Net result on property portfolio	64.5	36.1	49.8	42.8	46.1
Other acquisition related value adjustment	0.0	0.0	(148.6)	0.0	0.0
Operating profit before financing costs	127.1	102.6	4.6	161.0	170.8
Finance income	0.3	0.1	1.4	0.7	1.1
Finance expense	(31.9)	(29.8)	(42.6)	(42.9)	(45.5)
Net finance expense	(31.6)	(29.7)	(41.2)	(42.2)	(44.4)
Net other income/expense	(3.6)	1.4	(33.6)	0.0	0.0
Profit Before Tax	91.9	74.3	(70.2)	118.8	126.4
Tax	0.0	0.0	(1.1)	0.0	0.0
Profit After Tax (FRS 3)	91.9	74.3	(71.3)	118.8	126.4
Adjusted for the following:					
Net gain/(loss) on revaluation	(64.5)	(36.0)	(48.4)	(42.8)	(46.1)
Profit on disposal	0.0	(0.1)	(1.4)	0.0	0.0
Fair value gain/(loss) on derivatives & convertible bond	3.6	(1.4)	33.6	0.0	0.0
Exceptional revaluation related to MedicX acquisition	0.0	0.0	138.4	0.0	0.0
Deferred tax	0.0	0.0	1.1	0.0	0.0
EPRA earnings	31.0	36.8	52.0	76.0	80.4
Exceptional item			10.2	0.0	0.0
Amortisation of fair value adjustment to acquired debt			(2.5)	(3.2)	(3.2)
Adjusted EPRA earnings	31.0	36.8	59.7	72.8	77.2
Period end number of shares (m)	619.4	769.1	1,216.3	1,216.3	1,216.3
Average Number of Shares Outstanding (m)	600.7	708.6	1,092.0	1,216.3	1,216.3
Fully diluted average number of shares outstanding (m)	665.5	732.7	1,138.5	1,316.7	1,316.7
Basic IFRS EPS (p)	15.3	10.5	(6.53)	9.8	10.4
Basic adjusted EPRA EPS (p)	5.2	5.2	5.5	6.0	6.3
Diluted adjusted EPRA EPS (p)	5.1	5.2	5.4	5.9	6.2
Dividend per share (p)	5.250	5.400	5.600	5.900	6.100
Dividend cover (Adj. EPRA earnings/dividends paid)	100%	101%	101%	101%	104%
EPRA cost ratio	13.2%	14.3%	12.0%	11.5%	11.4%
BALANCE SHEET					
Non-current assets	1,361.9	1,503.5	2,413.6	2,573.9	2,744.0
Investment properties	1,361.9	1,502.9	2,413.1	2,573.4	2,743.5
Other non-current assets	0.0	0.6	0.5	0.5	0.5
Current Assets	10.5	10.5	159.8	45.3	26.3
Cash & equivalents	3.8	5.9	143.1	28.6	9.6
Other current assets	6.7	4.6	16.7	16.7	16.7
Current Liabilities	(33.9)	(134.5)	(66.0)	(59.9)	(59.9)
Current borrowing	(0.8)	(102.4)	(6.1)	0.0	0.0
Other current liabilities	(33.1)	(32.1)	(59.9)	(59.9)	(59.9)
Non-current liabilities	(751.7)	(591.5)	(1,278.9)	(1,283.8)	(1,382.6)
Non-current borrowings	(729.6)	(573.7)	(1,257.8)	(1,262.7)	(1,361.5)
Other non-current liabilities	(22.1)	(17.8)	(21.1)	(21.1)	(21.1)
Net Assets	586.8	788.0	1,228.5	1,275.5	1,327.8
Derivative interest rate swaps	24.5	17.2	13.0	13.0	13.0
Change in fair value of convertible bond	12.3	3.4	22.7	0.0	0.0
Other EPRA adjustments	0.0	0.0	48.6	45.3	42.1
Adjusted EPRA net assets	623.6	808.6	1,312.8	1,333.8	1,382.9
IFRS NAV per share (p)	94.7	102.5	101.0	104.9	109.2
Adjusted EPRA NAV per share (p)	100.7	105.1	107.9	109.7	113.7
CASH FLOW					
Operating Cash Flow	60.1	68.5	94.0	116.4	122.9
Net Interest & other financing charges	(37.8)	(35.1)	(52.9)	(43.4)	(45.6)
Tax	0.0	0.0	0.0	0.0	0.0
Acquisitions/disposals	(75.4)	(101.9)	(47.4)	(115.7)	(122.2)
Net proceeds from issue of shares	(0.1)	111.0	97.6	0.0	0.0
Debt drawn/(repaid)	82.3	(5.6)	110.5	0.0	100.0
Equity dividends paid (net of scrip)	(29.8)	(34.7)	(54.4)	(71.8)	(74.2)
Other cash movements and FX	(0.1)	0.6	(11.9)	0.0	0.0
Net change in cash	(1.3)	2.1	137.2	(114.5)	(19.0)
Opening cash & equivalents	5.1	3.8	5.9	143.1	28.6
Closing net cash & equivalents	3.8	5.9	143.1	28.6	9.6
Debt as per balance sheet	(730.4)	(676.1)	(1,263.9)	(1,262.7)	(1,361.5)
Convertible bond fair value adjustment	12.3	3.4	22.7	22.7	22.7
Unamortised borrowing costs	(6.1)	(6.4)	(14.6)	(12.6)	(10.6)
Acquired debt fair value a		0.0	45.4	42.2	39.0
Net cash/(debt)	(720.4)	(673.2)	(1,067.3)	(1,181.8)	(1,300.8)
Net LTV	52.9%	44.8%	44.2%	45.9%	47.4%

Source: PHP data, Edison Investment Research forecasts

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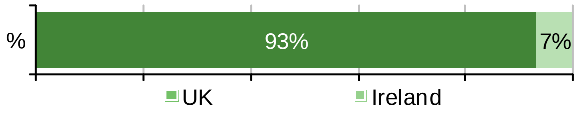
Revenue by geography (at 31 December 2019



Leadership team

Non-executive chairman: Steven Owen

Steven Owen joined the board in 2013 and has been non-executive chairman since 18 April 2018 when he also became chairman of the nomination committee. He is a chartered accountant with extensive expertise in investment and development in commercial property in a listed company environment. He began his career with KPMG before moving into property with Brixton, where he was finance director and subsequently deputy CEO. He was CEO and founding partner of Wye Valley Partners, a commercial real estate and asset management business.

Managing director: Harry Hyman

Harry Hyman founded PHP in 1996 and has served on the board as managing director since then. On the board he represents PHP's property adviser, Nexus TradeCo, of which he is also managing director and founder. He is a chartered accountant and in addition to his roles at PHP and Nexus TradeCo, he is a director of several private companies as well as being the non-executive chairman of two AIM-listed companies, Summit Germany, which invests in German commercial property, and Hertsford Capital, listed on the London Stock Exchange. In addition, Harry is a non-executive director of Biopharma Credit, which invests in the fast-growing science industry.

Finance director: Richard Howell

Richard Howell joined Nexus, the property adviser to PHP, in March 2017 and joined the board of PHP in the same month. He is a chartered accountant with more than 20 years' experience working with London listed commercial property companies, gained principally with LondonMetric Property and Brixton. Richard was part of the senior management team that led the merger of Metric Property Investments and London and Stamford Property in 2013 to create LondonMetric Property with a combined property portfolio of £1.4bn.

Principal shareholders (source: PHP Annual Report, data as at 11 February 2020)	(%)
Blackrock Investment Management	7.03
CCLA Investment Management	4.56
Vanguard Group	4.48
Investec Wealth & Investment	4.39
Hargreaves Lansdown (EO)	4.14
Charles Stanley	3.37

Companies named in this report

Assura Group (AGR), Civitas Social Housing (CSH), Impact Healthcare (IHR), LXi REIT (LXI), Secure Income REIT (SIR), Supermarket Income REIT (SUPR), Target Healthcare REIT (THRL), Triple Point Social Housing (SOHO), Tritax Big Box (BBOX).

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