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Equity Research

HOLD

Primary Health Properties plc

Acquiring growth

Target Price: 167p (162p)

Share Price: 162p

Key Data

Market Cap	£1967m
DS Real Estate	3,933
Sector	Real Estate
Stock Codes	PHP.L / PHP LN

Last Published Research: 12 February 2020

Absolute & Relative Performance

— *Absolute*

— *Relative to DS Real Estate*

Source *Datastream*

Investment Research

It has been a transformative year for PHP, the merger with MedicX nearly doubling the size of the portfolio. Significant synergies have already been realised and we expect more could be identified. PHP's shares have enjoyed outperformance over the last five years versus its peers and the sector, and its shares now trade on a 49% premium to NAV. Whilst this looks expensive, we feel this shows that investors are disregarding the NAV and instead highly valuing the income stream (due to its security and longevity). In this regard PHP has re-rated over the past year from a 4.7% to 3.7% dividend yield, and our base case is for this not to change (although given the low interest rate environment and ongoing demand for income it is possible the dividend yield could decline further). Our target price of 167p reflects a 3.7% dividend yield a year out, and we maintain our Hold rating.

- **A successful merger:** A year on from the merger with MedicX and the benefits are evident with a strong set of FY2019 results. Significant savings have been achieved via synergies realised reducing corporate costs (£4m pa), and via refinancings reducing the cost of debt (by 50bps). FY2020E will be the first full year post-merger, and we believe further synergies could be identified over the medium-term.

- **The benefits of acquiring in Ireland:** Whilst rental growth in the market is minimal (1.1% achieved last year on open market reviews), it is moving in the right direction. We expect acquisitions (forecast £100-£125m pa) to continue to be the main driver of rent roll growth, two thirds of which are expected to be in Ireland. PHP is gaining critical mass in this geography with 7% of the portfolio, targeting to increase to 15%. Acquisitions in Ireland are beneficial as PHP can enjoy a greater income return after costs versus the UK, and the assets provide exposure to a different covenant (HSE) and index linkage (Irish CPI). Further we forecast some yield compression in that market over the next few years (compared to flat valuation yields expected in the UK), which would provide valuation uplift and NAV growth.

- **Similar portfolios, differences in models:** The new larger PHP now has a portfolio size exceeding that of Assura, in excess of £2.4bn. This meaningful increase in its size means it is more of a comparable peer; the main differences being Assura's direct development pipeline versus PHP undertaking forward funding developments only, Assura's lower leverage (current LTV 36% vs PHP at 44%), and PHP's Irish exposure.

Year End	NAV	Premium/(discount) to NAV	NAV Growth	DPS ord	Yield	EPS	P/E
Dec	p	%	%	p	%	p	x
2019A	107.9	49.7	2.7	5.6	3.5	5.4	29.8
2020E	111.1 (from 110.6)	45.5	2.9	5.9 (from 5.8)	3.7	6.0	26.8
2021E	114.6 (from 115.0)	41.0	3.2	6.2 (from 6.0)	3.8	6.3 (from 6.2)	25.5
2022E	118.4	36.5	3.3	6.5	4.0	6.6	24.5

ACQUIRING GROWTH

A year on from the merger with MedicX and it is evident that PHP is reaping the benefits, having realised synergies securing significant reductions in company costs. Going forward, we expect minimal rental growth in the market (although there are signs it is moving in the right direction), therefore we expect the main driver of rent roll growth to be continued acquisitions. Valuation yields have tightened over the last few years and we do not expect much further movement, other than in Ireland where yields are higher, and where PHP is starting to gain critical mass from targeted acquisitions.

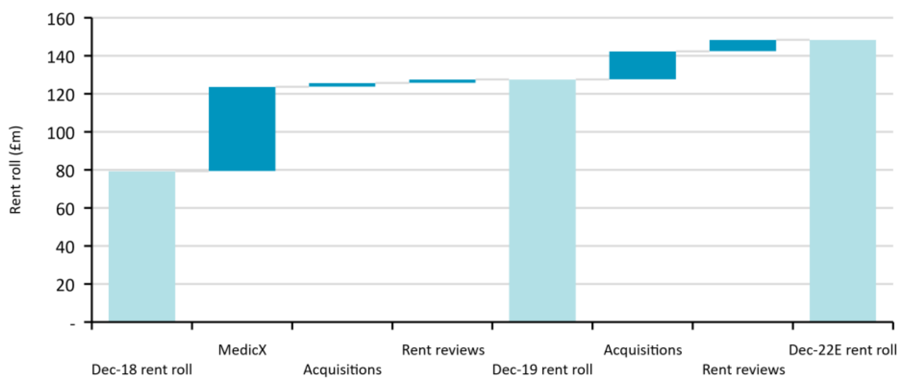
Reaping the full benefits of the merger

The merger with MedicX has seen two highly complementary portfolios come together to provide investors with an increased market capitalisation and share liquidity. There are also substantial cost savings from synergies, of which £4m pa has already been realised. This has led to a reduction in the EPRA cost ratio to a low 12%. FY2020E will be the first year to include MedicX for a full 12 months, therefore we could see further synergies identified. Significant savings have also been made from refinancing of historically expensive debt, with a 50bps reduction in the weighted average cost of debt secured in the year. The marginal cost of debt (2.5%) is significantly lower than the average (3.5%), therefore as drawdowns are made and refinancings occur, it is likely we will see further reductions in the medium term (not included in our forecasts therefore potential upside).

Acquisitions expected to be main driver of growth

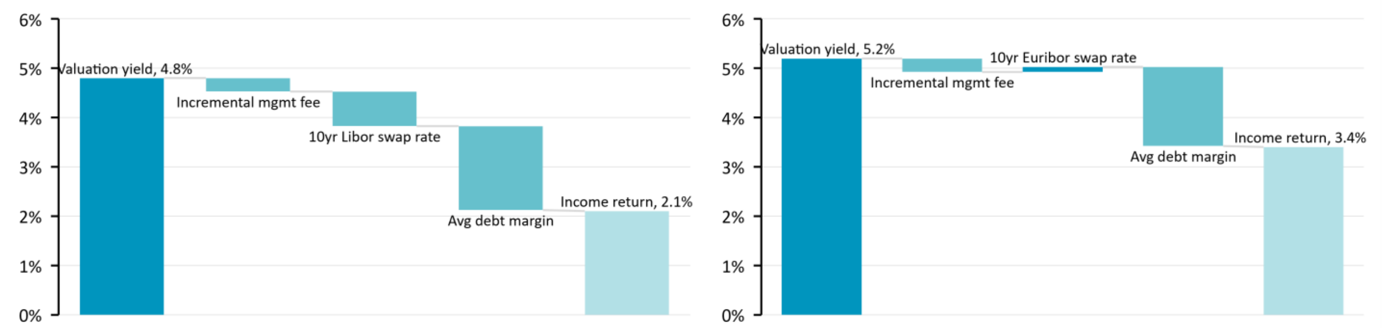
The key driver of growth will continue to be acquisitions (we forecast £100 - £125m pa, driving 71% of rent roll growth over the next 3 years – Figure 1). PHP currently has a pipeline totalling c£160m, with £44m in legals. Further additions will come from completion of forward funding developments; PHP currently has six properties under development (four in Ireland), with an expected value of £57m once complete.

Figure 1: Driver of growth predominantly acquisitions



***Source** Company data, Panmure Gordon*

Figure 2: UK vs Ireland income return after costs



***Source** Company data*

It is expected that approximately two thirds of acquisitions will be in Ireland, which show a greater yield gap between the acquisition yield and financing costs (income return after costs of 3.4% vs 2.1% in UK – Figure 2) than in the UK. PHP currently has 16 assets in Ireland (7% of portfolio by value), with a target to increase this to 15%. We also expect further yield compression (forecast 10bps pa) in Ireland, which will drive valuation uplifts and NAV growth. See Figure 3 for a sensitivity analysis on our FY2020E NAV from changes in the yield shift assumptions on the Irish and UK portfolios.

Figure 3: Sensitivity analysis on UK and Irish yield shift assumptions on FYY2020E NAV (p) and growth (%)

		Ireland yield shift (bps)				
UK yield shift (bps)		0	-10	-20	-30	-40
	0	110.8	111.1	111.4	111.7	112.0
	-5	112.8	113.0	113.3	113.6	113.9
	-10	114.8	115.0	115.3	115.6	115.9
	-15	116.8	117.1	117.4	117.7	118.0
	-20	118.9	119.2	119.5	119.8	120.1

		Ireland yield shift (bps)				
UK yield shift (bps)		0	-10	-20	-30	-40
	0	2.6%	2.9%	3.2%	3.5%	3.7%
	-5	4.5%	4.7%	5.0%	5.3%	5.6%
	-10	6.3%	6.6%	6.9%	7.1%	7.4%
	-15	8.2%	8.5%	8.8%	9.0%	9.3%
	-20	10.2%	10.4%	10.7%	11.0%	11.3%

***Source** Panmure Gordon*

Rental growth showing signs of improvement

We have been waiting for the rate of rental growth to start picking up for a while. Management states that there has been a definite firming of tone in the market, and rental growth whilst still minimal, is starting to increase (Figure 4). Growth in open market rent reviews has been slow due to a lack of evidence for valuers but again is moving in the right direction (1.1% in 2019, 0.4% in 2018, 0.3% in 2017). As development activity picks up in the market, there is more evidence of replacement costs and build cost inflation. There are currently 415 OMV rent reviews outstanding with an expected uplift equivalent to 1.2% pa. There is also an asset management opportunity on the re-gearing of expiring leases (37% of rent roll has an unexpired lease term <10 years – Figure 5). Although the rent may not necessarily increase (or be uplifted marginally), the extension of lease terms to c.20 years should result in the valuation yields tightening, creating valuation uplift.

Figure 4: Rental growth moving in right direction

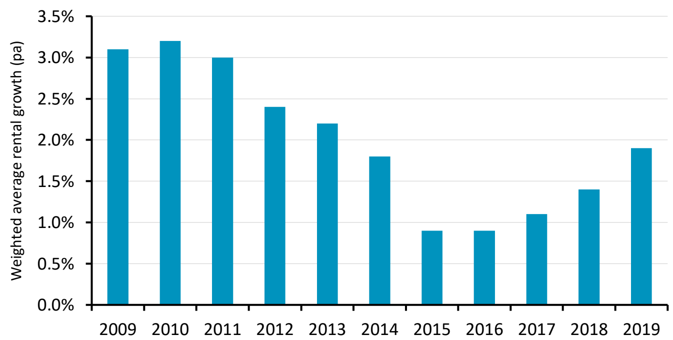
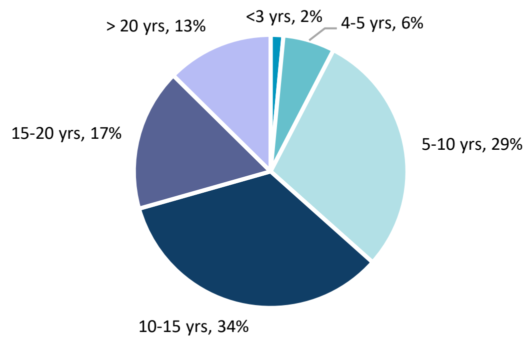


Figure 5: Opportunity in the expiring leases



***Source** Company data*

Two very similar peers

Following the merger with MedicX, PHP's portfolio is now larger than that of Assura with similar portfolio qualities (Figure 6). The key differences are:

- PHP only undertakes forward funding developments whereas Assura undertakes direct development (which will be stepping up post its acquisition of developer GPI)
- PHP's exposure to Ireland (growing from 7% now to a target of 15%) which provides exposure to a different government body (HSE) and a different index linkage (Irish CPI versus predominantly open market rent reviews in the UK) and,

- PHP's higher leverage (44% currently and expected to grow to 48%, within its target of 40 – 55%, vs 36% for Assura currently although we forecast this to reach 44% by FY2022E).

Figure 6: Two similar portfolios

	PHP (Dec 19)	Assura (Sept 19)
Number of properties	488	560
Value (£bn)	2.41	2.039
Contracted rent roll (£m)	127.7	104.4
Average NIY (%)	4.86%	4.72%
WAULT (years)	12.8	11.6
Government backed income (%)	90%	85%
Occupancy (%)	99.5%	98%
% rent roll fixed/index uplifts/ other	31%	30%
% rent roll open market reviews	69%	70%
Last average rent review uplift pa	1.90%	2.04%
Cost of debt (%)	3.50%	3.16%
LTV (%)	44%	36%
Average debt maturity (years)	7.2	6.9
EPRA cost ratio (%)	12%	12.8%

***Source** Company data*

Share price performance & valuation

PHP has outperformed both its primary healthcare and long income peers, and the wider UK real estate sector over the past 5 years (Figure 8) and on a year's view the shares are up 35% (Assura up 39%). Assura and PHP have both re-rated from a c.10% to c.50% premium to NAV over the last year, showing that investors are largely ignoring the NAV, instead valuing the shares based on their long-term and secure income streams. This can be illustrated by the dividend yields moving in 100 bps over the past year (Assura 4.4% to 3.4%, PHP 4.7% to 3.7%) (Figure 9). Whilst we think this is probably far enough and our target price of 167p reflects a 3.7% dividend yield a year out (hence our Hold rating) (sensitised in Figure 7), given the low interest rate environment and ongoing demand for yield, we could rationalise the dividend yield declining further.

Figure 7: Sensitivity analysis – Dividend yield a year out vs share price total return

	Dividend yield				
	4.2%	4.0%	3.7%	3.5%	3.3%
Implied target price (p)	148	155	167	177	188
12-month total return	-5.0%	-0.4%	7.2%	13.1%	20.0%

***Source** Panmure Gordon*

Figure 8: PHP outperformance over five years

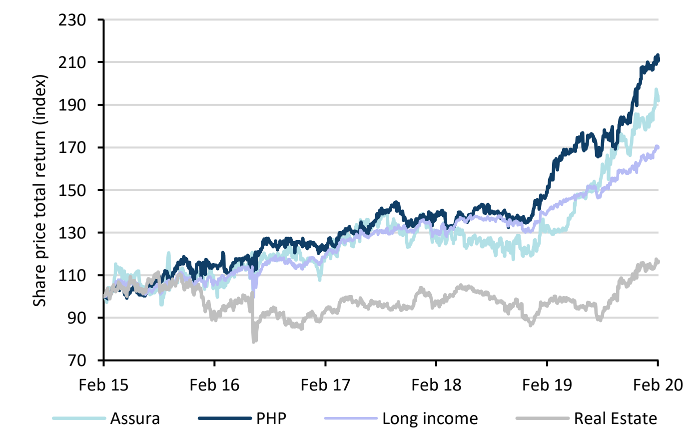
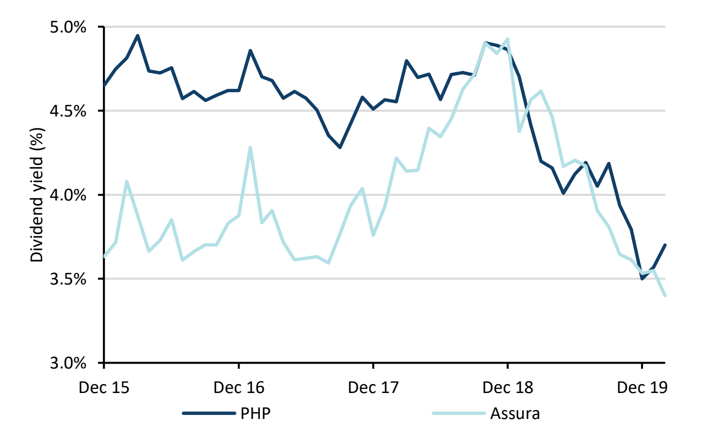


Figure 9: Highly valued income stream



***Source** Company data, Datastream*

The Numbers

2019 included c.9 months of results from the MedicX merger, with the first full year of impact being 2020E. We expect underlying rental growth of 1-2% pa driving dividend growth of c.3-5% pa. Our estimates allow for c.£1m pa of performance fees as we believe the company could report a total return of just over 8% pa.

We expect broadly flat valuation yields in the UK but a little compression (10bps pa) in Ireland. Together with income growth this suggests NAV growth of c.3% pa. We forecast the LTV to edge up a little to c.48% by FY2022E as the company becomes fully invested.

We allow for further acquisitions of £100-£125m pa, and expect some small disposals next year, as management fine-tunes the portfolio post the MedicX acquisition.

Figure 10: Financial Statements – Year end December

Income statement (£m)

Year End December	FY2017	FY2018	FY2019	FY2020E	FY2021E	FY2022E
Net rental income	71.3	76.4	115.7	130.2	137.3	144.0
Administrative expenses	-8.7	-9.9	-12.3	-13.2	-13.5	-13.8
EBIT	62.6	66.5	103.4	117.0	123.8	130.2
Net interest	-31.6	-29.7	-43.7	-43.7	-46.6	-50.1
Recurring PBT	**31.0**	**36.8**	**59.7**	**73.3**	**77.1**	**80.1**
Revaluations	64.5	36.0	48.4	34.8	39.4	43.4
Profit on the sale of inv properties	0.0	0.1	1.4	0.0	0.0	0.0
Exceptionals	0.0	0.0	-146.1	0.0	0.0	0.0
PBT	91.9	74.3	-70.2	108.1	116.5	123.5
Tax	0.0	0.0	-1.1	0.0	0.0	0.0
Profit/loss after taxation	91.9	74.3	-71.3	108.1	116.5	123.5
Adjusted diluted EPS (p)	**5.2**	**5.20**	**5.42**	**6.02**	**6.34**	**6.58**
Earnings growth (%)	*8.3%*	*0.0%*	*4.2%*	*11.1%*	*5.3%*	*3.8%*
DPS (p)	**5.3**	**5.40**	**5.60**	**5.90**	**6.20**	**6.50**
Dividend growth (%)	*2%*	*3%*	*4%*	*5%*	*5%*	*5%*
Dividend cover (x)	1.0x	1.0x	1.0x	1.0x	1.0x	1.0x
Interest cover (x)	2.0x	2.2x	2.4x	2.7x	2.7x	2.6x

Balance Sheet (£m)

Year End December	FY2017	FY2018	FY2019	FY2020E	FY2021E	FY2022E
Investment properties	1361.9	1502.9	2413.1	2562.9	2702.3	2845.7
Other fixed assets	0.0	0.6	0.5	0.5	0.5	0.5
Other current assets	-26.7	-27.5	-43.2	-43.2	-43.2	-43.2
Net debt	-726.3	-670.2	-1120.8	-1232.5	-1328.9	-1426.0
Other liabilities	0.0	0.0	-7.6	-7.6	-7.6	-7.6
Fair value of derivatives	-22.1	-17.8	-13.5	-13.5	-13.5	-13.5
Adjustments	36.8	20.6	84.3	84.3	84.3	84.3
Adjusted NAV	**623.6**	**808.6**	**1312.8**	**1350.9**	**1393.9**	**1440.2**
NAV per share (p)	**100.7**	**105.1**	**107.9**	**111.1**	**114.6**	**118.4**
NAV growth (%)	*10.5%*	*4.4%*	*2.7%*	*2.9%*	*3.2%*	*3.3%*
LTV (%)	*53%*	*45%*	*44%*	*46%*	*47%*	*48%*

Cash flow (£m)

Year End December	FY2017	FY2018	FY2019	FY2020E	FY2021E	FY2022E
Operating cash flow	**60.1**	**68.5**	**94.1**	**117.0**	**123.8**	**130.2**
Funds available for distribution	30.5	40.9	54.7	73.3	77.1	80.1
Free cash flow (pre-investment)	**0.7**	**6.2**	**0.3**	**3.3**	**3.6**	**2.8**
Property acquisitions	-75.4	-101.9	-49.9	-125.0	-100.0	-100.0
Development capex	0.0	0.0	0.0	0.0	0.0	0.0
Property disposals	0.0	0.0	2.5	10.0	0.0	0.0
Net cash from share issues	0.0	111.0	97.6	0.0	0.0	0.0
Other	72.9	-13.9	88.4	0.0	0.0	0.0
Net cash flow	**-1.8**	**1.4**	**138.9**	**-111.7**	**-96.4**	**-97.2**

Source *Company Data, Panmure Gordon*

Distribution of investment ratings for equity research (as of 18 Feb 20)			Rating: GUIDELINE (return targets may be modified by risk or liquidity issues)	
Overall Global Distribution (Banking Client*)			**Buy**	Total return of >10% in next 12 months
Buy	**Hold**	**Sell**	**Hold**	Total return >-10% and <+10% in next 12 months
60% (36%)	26% (1%)	14% (0%)	**Sell**	Total return <-10% in next 12 months
* Indicates the percentage of each category in the overall distribution that were banking and/or corporate broking clients				

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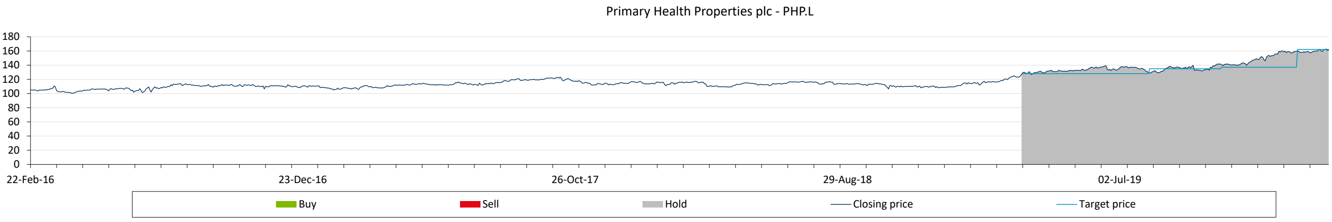

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