Numis Securities Limited

Investment Companies

For FSA purposes this is a Marketing Communication

3 October 2012

Price: 339p

EPRA NAV (30 June): 314.90p

Market Cap: £254m

Premium: 7.9%

Yield: 5.4%

Ticker: PHP LN

Website: www.phpgroup.co.uk

(Current share price(s) timed at 8:05AM on 03 Oct 12)

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**Primary Health Properties is a corporate broking client of Numis Securities*

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Primary Health Properties

Healthy yield

PHP offers exposure to the defensive primary health property sector, which benefits from long leases, full occupancy and a strong tenant covenant, allowing high visibility of income. As a result, we believe PHP is a quality yield story with low NAV volatility compared with its commercial property REIT peers. In our view, these remain attractive characteristics in the current low interest rate, risk averse environment. In the year to date, management has positioned the business for further growth. PHP now has an improved funding position and increased operational flexibility having diversified and extended its finance sources. With c.£110m to deploy, we expect PHP to deliver modest DPS growth and enhance dividend cover, building on a record of 16 consecutive years of DPS growth.

- **Solid results:** Interim results to 30 June featured positive momentum in the rent roll, EBITDA and DPS, although higher funding costs reduced recurring profit and dividend cover as expected. EPRA NAV was broadly stable (down 1.2% since 31 Dec) demonstrating the defensive nature of healthcare assets relative to commercial property. PHP declared an interim DPS of 9.25p (covered 68%) in line with expectations. EPRA NAV was 314.9p, down 1.2% since 31 Dec reflecting modest dilution from the May equity issuance (6m shares issued at 305p, a 4% NAV discount). Property yields were stable at 5.74%. Basic NAV including marking interest rate swaps to market rose modestly to 248.9p from 246.3p at 31 Dec. LTV improved fractionally to 56.4%.
- **Increased investment firepower:** In the year to date, PHP extended the maturity of its core bank debt (£175m) and diversified funding sources by issuing a £75m, unsecured retail bond yielding 5.375% pa providing improved operational flexibility to grow the asset base. Any assets acquired with bond proceeds could be used as security for existing or new bank debt, potentially lowering LTV and reducing the cost of future debt. We estimate PHP has firepower of c.£110m to deploy into a mix of let standing (immediately yielding) and forward funded assets (pre-let, yielding on completion) at accretive prices.
- **Acquisitions key to growth:** We expect acquisitions to support future DPS and NAV growth as well as restoring dividend cover (from recurring profits) to historic levels of > 90%. £21m of acquisitions have completed to date, and we expect the pace to pick up. A further £37.5m of deals are in solicitors' hands and the pipeline is strong. Importantly, there remains a positive yield gap between acquisition yields and finance costs. New opportunities are likely to include single property deals and portfolios available through managements extensive contacts and an increased level of development following the enactment of the Health & Social Care Act in March.
- **Outlook:** We anticipate market values and therefore NAV to remain broadly stable and further modest growth in DPS in 2012/13, reflecting lower rental growth and a focus on rebuilding dividend cover. The pace of investment and mix of purchases between let standing and forward funded assets will determine how quickly dividend cover will rebuild. Our current estimates assume dividend cover rises to c.90% by Dec 2014.

Interim Results Summary

Solid operational performance

In the six months to 30 June, PHP delivered a solid operational performance reflecting the strong income characteristics and defensive nature of the property portfolio.

- 2.8% increase in annualised rent roll

Growing rent roll – 2-3% pa looks sustainable

The annualised rent roll grew 2.8% to £33.3m, reflecting acquisitions and 2.7% average rental growth achieved on reviews. PHP added four properties during the period, at a cost of £11.5m. Whilst rental growth was lower than the 3% achieved in 2011, we believe it is a good performance in a generally weak property market. Management believe that annual growth of 2-3% is sustainable.

- 6.3% EBITDA growth

EBITDA growth

EBITDA was £13.4m compared with £12.6m at 30 June 2011, reflecting the impact of previous acquisitions and a stable cost base. Fees paid to the joint managers under the external management contract represented 0.77% of gross assets. Management fees as a percentage of gross assets should start to fall as the portfolio increases in size, reflecting the sliding fee rate on gross assets over £500m.

- 25% increase in net finance costs

Higher finance costs as expected

Reflecting increased average margins from 70 to 230 bps and an increase in debt to fund acquisitions, finance costs increased to £9m up from £7.2m at 30 June 2011. PHP had drawn £301m of £459.2m available funds. LTV was 56% compared with a typical maximum LTV of 65%.

- 20% decline in recurring profits

Recurring profits fell but should improve as investment firepower is deployed

Recurring profit fell y-on-y reflecting increased finance costs and a slower acquisition rate, as expected. However, as PHP deploys its c.£110m investment firepower into earnings-accretive assets combined with rental growth, we would expect recurring profit growth and continued improvement in dividend cover.

- 16th consecutive year of DPS growth

5.5% prospective yield

PHP declared a 9.25p DPS (ex date 26 Sept) to be paid in October giving an annualised DPS of 18.5p reflecting a 5.4% yield. Our estimates assume a DPS of 19p for the year to Dec 2013 implying a prospective yield of 5.6%.

- 1.2% decrease in EPRA NAV to 314.9p

Broadly stable EPRA NAV

Although property values increased £0.6m, EPRA NAV declined reflecting modest dilution from the small equity issuance in May. Basic NAV incl. an unrealised mark to market impact of the interest rate swap portfolio, was 248.9p up from 246.3p at 31 Dec. Our forecasts assume EPRA NAV at 31 Dec 2012 of 316p, rising to 321p in Dec 2013.

- Strong property outperformance

Strong portfolio performance

The portfolio has outperformed both IPD healthcare and All Property indices over 1, 3 and 5 years. In the 12 months to 30 June 20112, total return was 7.2% compared with IPD All Property at 4.4%, thus demonstrating the resilience of the asset class.

- Outlook

Acquisitions key to future growth

We anticipate market values and therefore NAV to remain broadly steady and further modest growth in DPS in the next 12 months. The pace of investment and mix of purchases between let standing and forward funded assets will determine how quickly dividend cover (from recurring profits) returns to historic levels (>90%). Our estimates assume c.60% cover for Dec 2012 rising to c.90% by Dec 2014.

Performance

Defensive property sub-sector

At the portfolio level, PHP has outperformed both the IPD healthcare and All Property indices over 1, 3 and 5 years. Total return for the 12-month period to 30 June was 7.2% compared with 4.4% for the IPD All Property index.

Table 1. Real Estate Performance to Dec 2011

(%)	1 Year	3 Years	5 Years
PHP	10.1	10.1	6.6
IPD Healthcare Property Index	9.4	7.5	5.7
IPD All Property Index	7.8	8.7	(0.9)

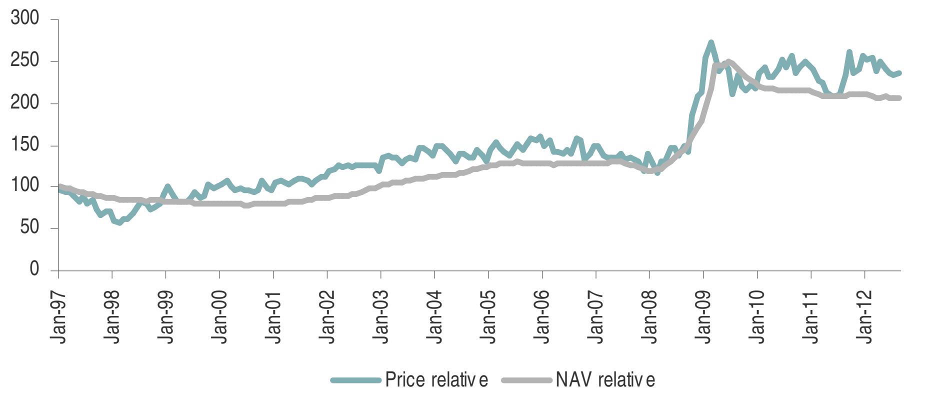
Source: Company Data

The defensive nature of PHP's asset base has been a key driver of outperformance, in our view. In particular, the company has a high degree of income visibility supported by long-leases (>16 yrs), a fully let portfolio and strong tenant covenant (NHS). When combined with virtually no oversupply risk, asset values have proven to be less volatile than commercial assets through the real estate cycle.

Impressive long-term performance record

These characteristics have supported an impressive long-term share price and NAV performance record relative to commercial REITs. Moreover, PHP has delivered 16 consecutive years of dividend growth, and remains one of the highest yielding UK REITs.

Figure 1. PHP Price & NAV Relative to UK Commercial Peers

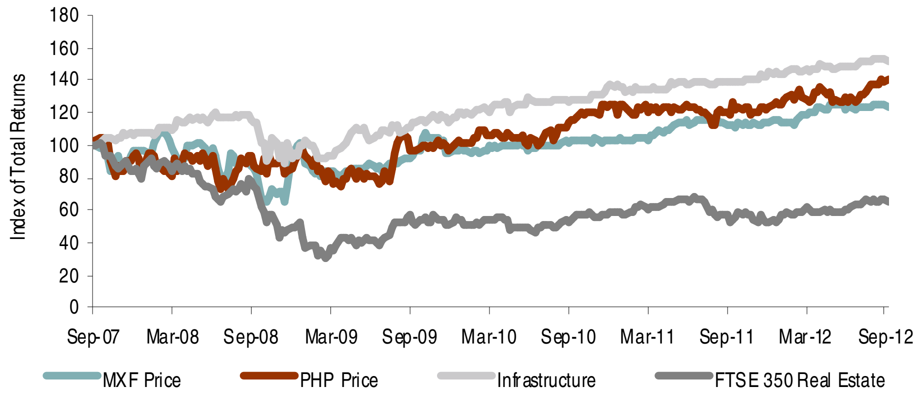


Source: Numis Securities Research Department

Market favours high yield, low NAV volatility

As the charts below illustrate, the market has rewarded this relatively strong performance with a premium of c.7.9% to historic EPRA NAV at 30 June 2012 or 5.9% to our Dec 13 EPRA NAV estimate of 321p. Indeed, share price returns and premiums have been similar to other high yielding stories with low NAV volatility, such as Infrastructure stocks. In the current low interest rate, risk-averse environment, investors continue to favour these characteristics that should continue to underpin PHP's share price performance.

Figure 2. 5 Year Absolute Price Total Returns

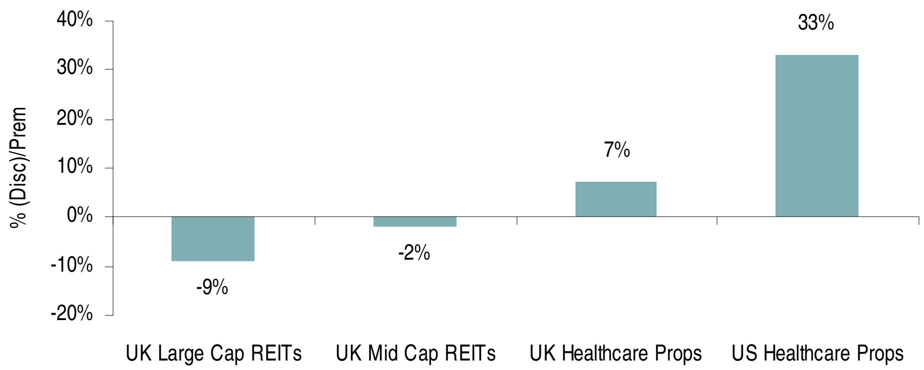


Source: Numis Securities Investment Companies Research

Premium to commercial REITs can be justified at this stage of the cycle

PHP shares are currently trading on a 5.9% premium to our Dec 13 EPRA NAV estimate compared with the sector average for the three listed UK primary health peers of 7%. Whilst we feel that on average the UK health peers are fairly valued, we believe a premium to commercial REITs can be justified at this stage in the real estate cycle. It is interesting to note that according to forecasts by CBRE Clarion, the global real estate securities manager, US healthcare property plays command substantially higher premiums to NAV than their UK healthcare property counterparts, despite having a typically shorter lease profile and lower proportion of government backed income.

Figure 3. Ave. Premium to EPRA NAV



Source: Numis Securities Investment Companies Research Department/CBRE Clarion

Investment firepower

We anticipate a relatively stable outlook for the kind of property assets in which PHP invests, featuring modest rental growth (2-3% pa) and broadly stable valuation yields. We also anticipate further dividend growth in 2013, albeit modest as management focuses on enhancing dividend cover from recurring profits.

Access to capital and assets key for EPS & DPS growth

Against this backdrop, the pace of future NAV and DPS growth will be determined by access to attractively priced capital and new assets. We believe PHP looks well placed in both regards. In H1 the company extended the maturity of the majority of its core bank debt and further diversified its funding sources following the period end, becoming the first UK REIT to issue a retail bond.

First UK REIT to issue a retail bond

In July 2012, PHP issued a seven-year, £75m bond with a 5.375% pa coupon. The bond is unsecured, and is covenant light giving attractive operational flexibility for PHP to grow its asset base. To avoid cash drag, £50m of the proceeds have initially been used to pay down the revolving element of bank loans on a short term basis and will be redrawn to fund acquisitions.

Considerable investment firepower

The company now has considerable investment firepower of c.£110m (after repayment of AIB loan) from a variety of sources with staggered maturity dates. The weighted average maturity of debt is now 5.4 years, whilst this is not the longest amongst its peer group, it is much improved from 12 months ago.

Table 2. Finance Facilities

Provider	Maturity	Facility (£m)	Available for Investment (£m)
RBS	Mar-13	5.0	5.0
AIB	Jan-13	27.0	0
Clydesdale	Jul-14	50.0	28.6
RBS/Santander	Mar-16	175.0	24.3
Aviva	Nov-18	75.0	0
Aviva	Dec-20	25.0	25.0
Aviva	Jan-32	27.2	0
Total Bank Debt at 30 June		384.2	82.9
Retail Bond at 24 July	Jul-19	75.0	75.0
Total Facilities		459.2	157.9

Source: Company Data

Margin between group debt cost and purchase yields

Although the overall cost of group debt has increased (as expected) with average margins up from 70 to 230 bps over Libor, there is still a comfortable margin between finance and acquisition costs. We estimate an average blended cost of available group debt of c5.1% (including undrawn facilities), which compares with acquisition yields of between 5.8-6.25% depending on whether the asset is let standing (yielding day one) or forward-funded (yielding on completion). New assets should therefore be earnings accretive.

Furthermore, following the retail bond issue, management has some flexibility to potentially reduce the blended cost of debt going forward. In particular, any assets acquired with the proceeds could be used as additional security for existing or new bank debt. Using lower amounts of senior secured debt on purchases could result in lower margins being charged, in our view.

Acquisition pace to pick up

Following a relatively slow H1 for acquisitions, the pace of investment has picked up in H2, and we would anticipate further transactions before the year end. Acquisitions made in the year to date are as follows.

Table 3. Acquisitions Year to Date

Forward funding	Date	Cost (£m)	Est. Incremental £m Rent PA	Tenant/Completion Notes
Stourbridge,	19-Sep	8.5	0.53	10 GP practice, 25-year term Completion H2 2013
Newton Abbott	10-Sep	3.0	0.19	6 GP practice, 25-year term, Completion H2 2013
Let Standing				
Luton	20-Jul	3.9	0.23	17 years on lease
Caerphilly	21-May	3.8	0.23	20-year lease, 4 GP's and local health board
Watton Medical Centre, Norfolk	24-Apr	2.7	0.16	
Total		21.9	1.34	

Source: Company Data

We understand a further £37.5m of potential deals are in solicitors' hands. Our current forecasts assume a total of £30m of deals complete in 2012 and £70m in 2013, supporting modest growth in the DPS and an improvement in dividend cover from recurring profit. Any shortfall will be made up from substantial distributable reserves.

Table 4. DPS and Dividend Cover Estimate

	Dec-12F	Dec-13F	Dec-14F
Recurring Profit (£m)	7.9	9.6	12.8
Dividend per share Est. (p)	18.5	19.0	19.5
Implied Dividend cost (£m)	12.96	14.17	14.55
Bond coupon cost PA (£m)	2.01	4.03	4.03
Div cover from recurring profit (%)*	*59*	*67*	*88*
Div Cover incl. revaluation (%)	*76*	*96*	*122*

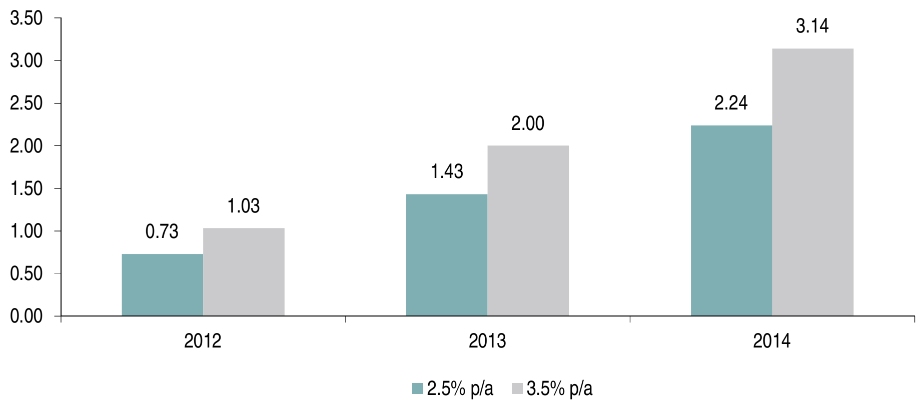
**Net of all finance costs including bond coupon*
Source: Numis Securities Investment Companies Research

Acquisitions and rental growth will enhance dividend cover and support modest growth

We estimate that PHP needs to generate c.£43m of annual rental income (£33.3m currently) to fully cover our DPS estimate and the retail bond coupon from recurring profits. This implies an additional £10m of rent. Assuming PHP uses its c.£110m of its firepower to add new stock to the portfolio, this could add a further c.£7m of rent assuming current market yields.

In addition, incremental income generated through rent reviews will have an immediate positive impact on dividend cover. The following chart illustrates the potential incremental cash flows in the event that existing rents increase in line with the long-term trend range of 2.5-3.5% pa at rent review.

Figure 4. Potential Incremental Income on Rent Reviews



Source: Company Data

Factoring in rental growth at the lower end of this range at 2.5% pa would add £2.2m of incremental income by 2014. If rental growth were 3.5%, this would add £3.14m.

In summary, we believe that through a combination of rental growth, further acquisitions and tight cost control, PHP should return to full dividend cover from recurring profit in the relatively near term.

Financial Summary

Table 5. Income Summary

	Dec-11A	Dec-12F	Dec-13F	Dec-14F
Rent & Related Income (£m)	30.7	33.3	37.6	41.2
Admin Costs (£m)	(5.5)	(5.6)	(6.3)	(6.6)
Net Finance Costs (£m)	(15.4)	(19.8)	(21.8)	(21.8)
Recurring Profit/Loss Before Tax (£m)	9.8	7.9	9.6	12.8
Profit/Loss before tax incl. revaluations (£m)	12.7	9.9	13.6	17.8
Recurring EPS (p)	14.3	11.0	12.8	17.2
DPS (p)	18.0	18.5	19.0	19.5
Shares in issue (m)	68.2	71.9	74.6	74.6
Implied Dividend Cost (£m)	12.2	12.96	14.17	14.55

Source Numis Securities Investment Companies Research

Table 6. Balance Sheet Summary

	Dec-11A	Dec-12F	Dec-13F	Dec-14F
Property (£m)	528.7	584.2	658.2	703.2
Total Assets (£m)	531.4	587.4	661.4	706.4
Debt (£m)	(300.7)	(310.3)	(407.9)	(437.9)
Total Liabilities (£m)	(363.3)	(401.0)	(471.0)	(501)
Net assets (£m)	168.1	186.4	190.4	205.5
Basic NAV (incl swap mark to market) (p)	247	250	255	275
EPRA NAV (£m)	217.6	236	240	255
EPRA NAV (p)	317*	316	321	341
LTV (%)	*57*	*56*	*62*	*62*

** Restated for equity issuance*
Source Numis Securities Investment Companies Research

We summarise key assumptions as follows:

Rental growth: We assume modest rental growth of 2% on average in both 2012 and 2013 and 1% in 2014. This will be bolstered by c.£30m of acquisitions in 2012, £70m in 2013, and £30m in 2014.

Admin Costs: We assume the external management fee comprises c.75% of admin costs. As gross assets grow the fee will ratchet down as follows:

- 1% of gross assets up to £50m
- 0.75% charged on gross assets between £50-500m
- 0.525% charged on gross assets between £500-750m
- 0.4375% charged on gross assets over £750m

Finance Costs/Debt: Assumes current agreed facilities only with a blended cost of c5.1%.

Property assets: We assume PHP adds £30m of new assets in 2012 rising to £70m in 2013 and a further £30m in 2014. These will be financed through existing debt facilities.

EPRA NAV: As with other REITs, we believe the key measure of portfolio performance is EPRA NAV on the basis of European Public Real Estate Association ("EPRA") best practice recommendations. EPRA NAV is the main measure to assess companies on a going concern basis, with assets and liabilities not expected to crystallise, such as the fair value of derivatives.

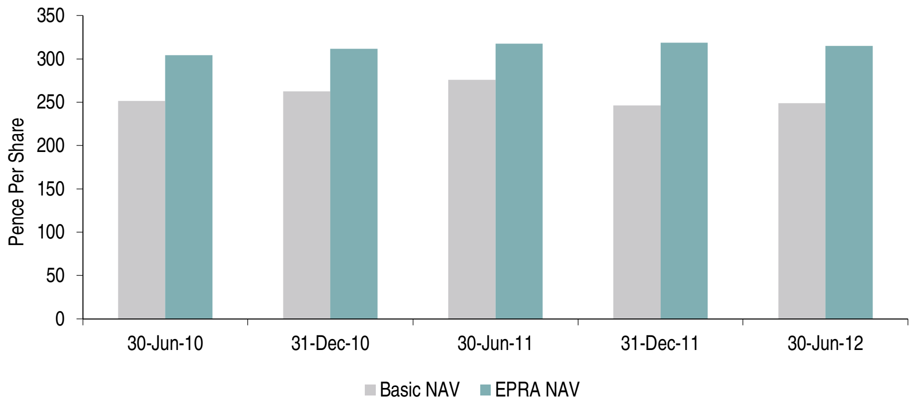
Our EPRA NAV assumes modest valuation uplifts of c.£4m in 2013 and £5m in 2014. We also assume that PHP continues to successfully avoid crystallising mark to market losses on its interest rate swaps, which has proven to be the case historically.

Given the long average lease length of the portfolio, PHP uses interest rate swaps to mitigate exposure to variable interest-rate risk. It is Group policy to maintain the proportion of floating rate interest exposure at between 20-40% of total interest rate cost

The portfolio of interest rate swaps are with RBS and AIB. The contracts have a variety of expiry dates and will hedge interest rate exposure by fixing the cost of a maximum of c.£180m of its available c.£270m (at 30 June) debt at c.4.75%. As at 30 June, the mark to market valuation of the entire swap portfolio was £49.3m.

In theory, the liability may crystallise if PHP were to repay the related debt or cancel its swaps, we assume that neither scenario is likely in the near term. Although we expect the £27m AIB debt to be repaid on maturity (Jan 2013), we understand that PHP is able to leave the swaps in place and provide security against any mark to market liability (c.£11m currently). Given the recent bond issue and available debt facilities, we believe the company has ample resources to provide any security that may be required. The chart below illustrates the NAV in recent periods including and excluding the value of the swaps.

Figure 5. EPRA NAV (p) and NAV incl. mark to market of swaps (p)



Source: Company Data

Given the visibility of its cash flows, PHP also publishes a DCF valuation of its portfolio that underpins the EPRA NAV, in our view. The company can expect to receive minimum future lease payments of at least £530m from its existing asset base excluding any future rental growth. This bodes well for future dividend payments and underpins the EPRA valuation, in our view. Key DCF assumptions include a discount rate of 7%, 2.5% rental growth pa, and 1% growth pa in residual values which equates to an additional 63p of NAV.

Appendix

Portfolio Summary

Long lease length

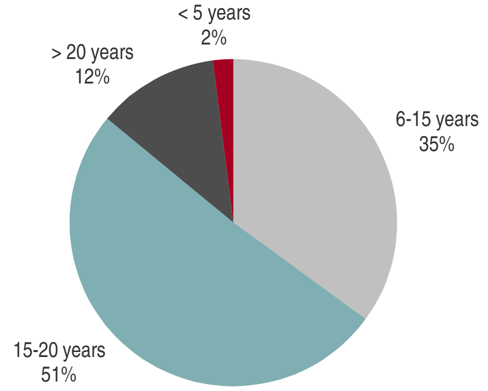
Ave unexpired lease term of 16 years

The average unexpired lease length of the portfolio is 16.0 years, which coupled with regular upward-only rent reviews gives high visibility of cash flow, particularly compared with commercial real estate operators. PHP can expect to receive minimum future lease payments of at least £530m from its existing asset base, excluding any future rental growth.

Asset management potential from shorter leases

Where leases are shorter than average, management undertakes asset management initiatives to enhance longevity of income. Five projects have been approved for 2012 including pharmacy additions and minor refurbishment works. The total projected cost is £3.2m, rental yield on cost of 7.2%, and should deliver a valuation surplus over cost of 32%.

Figure 6. PHP Lease Lengths



Source: Company Data

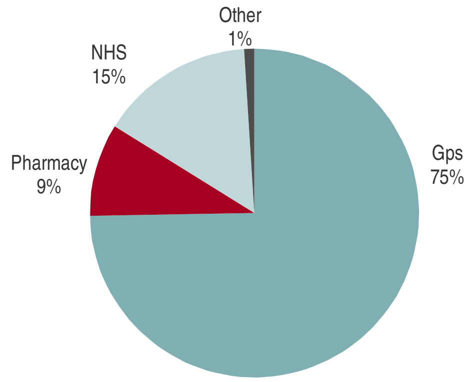
New leases are typically 20-25 years

New leases are typically 20-25 years, which is in stark contrast to commercial property lease lengths that are just over five years on average.

Strong tenant covenant

Another comfort factor for dividends is the strength of the underlying tenant covenant. Of the total income, 90% is paid either directly or indirectly by the UK government.

Figure 7. Covenant Strength



Source: Company Data

Government reimburses GP rent costs

In the case of GP tenants, the typical payment structure is quarterly. The most common lease in the portfolio provides that the relevant government body (NHS or PCT) pays GPs the current market rent for their premises, plus an allowance of 5% for any repairs. In turn, GPs pay the current market rent to PHP and accept responsibility for all repairs and maintenance.

Pharmacy operators pay higher rents

Nine per cent of rents come from pharmacy operators including national players such as Lloyds, Rowlands and Boots. Their premises are usually next to GP surgeries, have co-terminus leases and command a higher rent per sq ft.

Table 7. Portfolio Rental Levels

Tenant	Area (sq m)	Area (sq ft)	Rent (£psm)	Rent (£psf)
NHS	164,686	1,772,020	174	16.17
Pharmacy	9,959	107,162	286	26.57
Other	3,257	35,040	127	11.81
Total	177,902	1,914,222	179	16.67

Source: Company Data

Regular, upward only rent reviews

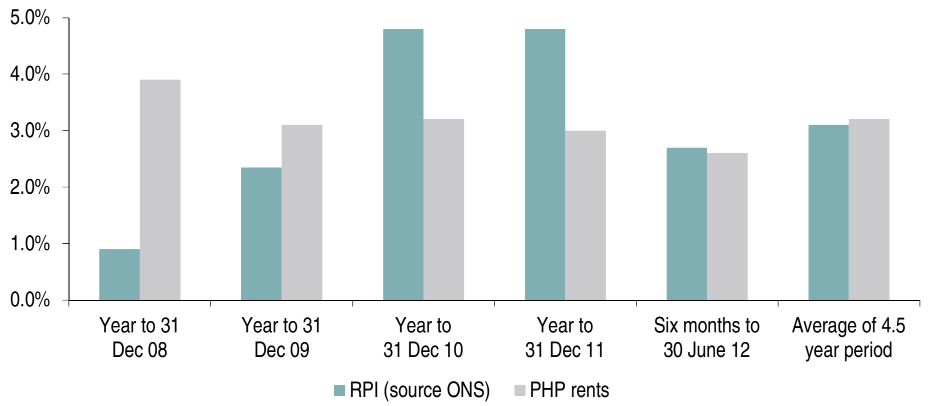
GP rents are typically subject to triennial reviews that provide the potential to increase revenue on a regular basis.

Inflation Protected Revenues

12% index linked

The regular rent review process provides an element of inflation protection as 12% of total rent roll is index linked with a floor at 0%: 2% is subject to a fixed uplift, typically increasing 2-3% pa every three years.

Figure 8. PHP Rent Review Performance vs Inflation



Source: Company Data

Higher replacement costs will drive rental growth

The balance is subject to effective upwards only open market reviews, agreed with the District Valuer's Office, a government agency. Key inputs into deciding a fair rent include the replacement cost of the asset, as well as general inflation and market evidence. In particular, replacement costs continue to rise, driven by tighter building regulation, higher specification requirements and increasing raw material prices. This should support rental growth across the portfolio.

Lower Volatility of Asset Values

Valuation yields less volatile than commercial property assets

Lambert Smith Hampton values PHP's portfolio every six months based on the individual value of each property. Given the favourable income characteristics, strong covenants and generally matched supply and demand of primary care assets, valuation yields have been less volatile than other commercial real estate assets. The following table illustrates the significant difference in yield shift across property types in the cycle.

Table 8. Yield Shift - Peak to Current

	PHP	Prime Retail	Prime Industrial	Prime Office
Valuation yield at cycle peak (%)	*5.2*	*4.3*	*5.3*	*4.5*
Valuation yield at cycle low (%)	*6.2*	*7.6*	*8.7*	*8.2*
Movement	100 bps	330 bps	340 bps	370 bps
5 Year average (%)	*5.7*	*5.6*	*6.5*	*5.9*

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

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