Buy

21 February 2018

Primary Health Properties#

PHP

DATA

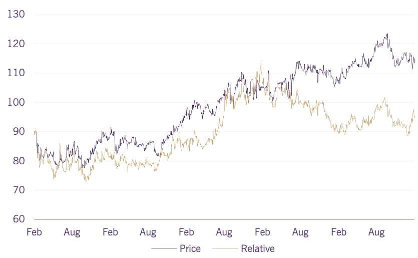
Price (close 16/2)	116p
Target price	125p
Market cap	£712m
Free float	100%
Index	FTSE SmallCap
Sector	Real Estate
Next news	July - Interims
UK portfolio	99%
European portfolio (Ireland)	1%
North American portfolio	0%
Rest of World portfolio	0%

DESCRIPTION

The group is engaged in the generation of rental income and capital growth through investment in primary health care property in the UK leased primarily to GPs, Primary Care Trusts, health authorities & other associated health care users

PERFORMANCE

Source: Bloomberg



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Corporate client of Peel Hunt

The lean, mean, secure income-generating machine
Primary Health Properties (PHP) delivered FY17 results ahead of expectations. A total accounting return for the year of 16.4% and a 21st year of consecutive dividend growth are both testament to the attractive characteristics of the underlying asset class, as well as PHP's scale and low cost base. We present here our new 2020 forecasts as well as highlighting some of the differences between PHP and its two quoted peers. On most metrics, PHP continues to screen well while remaining the cheapest of the three. On a prospective P/E of 20x and yield of 4.7%, the shares continue to warrant Buy.

Primary health property remains an appealing asset class. We continue to find the underlying characteristics of primary health real estate attractive, benefitting from a powerful cocktail of political support for primary care, demographic trends, and a current primary care estate in large parts in need of modernisation. Despite recent yield compression (PHP reported 26bp in 2017), initial yields of c4.9% remain conservative against other parts of the real estate market once the longevity (13-year lease length) and security (c90% Government-derived) of the income streams are factored in.

Unrivalled long-term returns. PHP now has a track record of 21 years of consecutive dividend growth, helping to support enviable long-term total shareholder returns. Management alignment, coupled with an efficient cost base, provides a good foundation for future returns.

Does size matter? Over the past three years, or so, Assura has been highly acquisitive, adding over £500m of assets to create the largest of the quoted portfolios. However, this growth has come at the expense of lot size, with the average size of a PHP asset now c40% larger than its peer. While the portfolios broadly attract the same valuation yield currently, future growth may differ.

PHP provides the cheapest exposure in our view. An undemanding prospective 2019E P/E ratio of 20x is not only the lowest among the trio of primary care landlords, but provides investors with an attractive and covered dividend yield of 4.8%. Furthermore, over the past five years, PHP shares have attracted an average NAV premium of 16%, and on our forecasts the shares grow into the current narrower premium over the next three years with compound NAV per share growth of c4% per annum.

STATS

Source: Company accounts, Peel Hunt estimates

Y/E Dec	Net Op Inc (£m)	Adj EPS (p)	EPS growth (%)	PER (x)	DPS (p)	Div yield (%)	Adj NAV (p)	NAV/3net (p)	Disc/NAV (%)	Disc/3net (%)
2017A	71.3	5.2	8	22.3	5.3	4.5	100.7	94.7	15.2	22.5
2018E	74.1	5.7	10	20.4	5.4	4.7	105.0	99.4	10.5	16.7
2019E	77.6	5.8	2	20.0	5.6	4.8	109.2	103.8	6.2	11.8
2020E	81.4	6.0	3	19.3	5.7	4.9	113.9	108.6	1.8	6.8

PHP versus peers: a brief appraisal

Although PHP, Assura (Hold, TP 56p), and MedicX (Reduce, TP 78p) have broadly similar business models, there are some key differences. Below we take a look at four areas: performance; portfolios; corporate structure; and leverage.

Performance

Over the past 20 years, PHP has delivered annual returns approaching 15%

PHP now has a near 22-year track record as a public company and, over this period, it has delivered very good returns for shareholders. As the table below shows, PHP has delivered a compound total shareholder return of nearly 15% over the past 20 years. This compares with a 5.2% per annum return from the EPRA UK index over the same period.

Table 1: CAGR total shareholder returns

Source: Datastream

	PHP	Assura	MedicX	EPRA UK
1 year	10.4%	13.9%	4.4%	11.6%
3 years	13.1%	11.4%	8.9%	2.5%
5 years	11.6%	18.4%	10.4%	10.6%
10 years	11.2%	-3.9%	7.8%	2.8%
20 years	14.6%	n/a	n/a	5.2%

Furthermore, among peers PHP has delivered the best returns over three (13.1%) and ten-year (11.2%), and again better than the wider sector over both periods. In fact, among the trio, at least one of the stocks has delivered sector beating returns in each of the five periods shown in the table. Over the past five-years Assura has performed the strongest, largely reflecting the previous low rating following underperformance from the previous management team.

Portfolios

In aggregate, and based upon the latest published reports, the three primary care businesses owned combined assets of c£3.6bn, the vast majority being in the UK with a handful (PHP and MedicX) in Ireland. In terms of portfolio size, Assura's stood at c£1.53bn (Sept17), followed by PHP's at c£1.36bn (Dec17), and MedicX's portfolio at c£0.7bn (Dec17).

Chart 1: Acquisition volumes

Source: Company accounts, Peel Hunt estimates

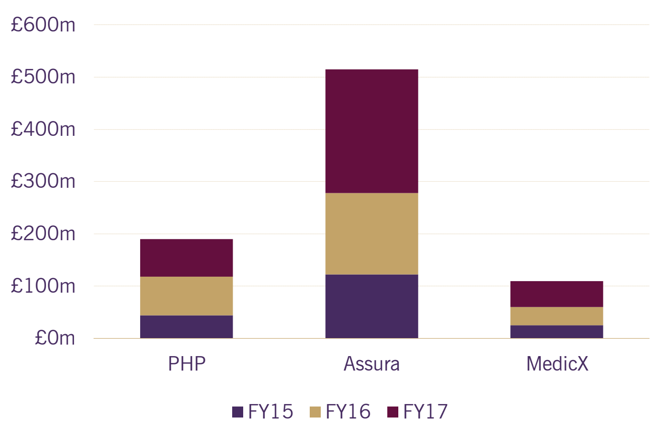
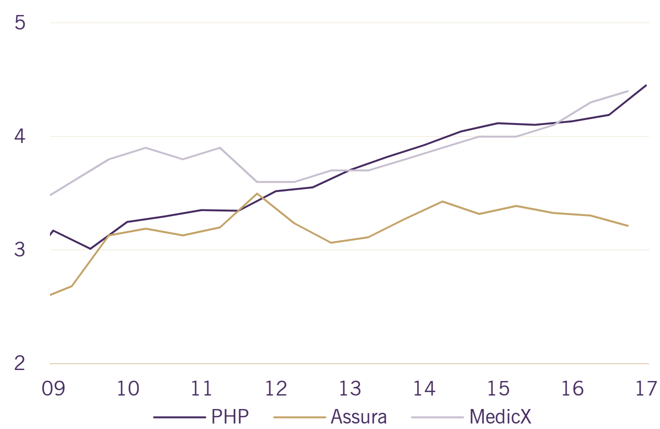


Chart 2: Portfolio average lot size (£m)

Source: Company accounts, Peel Hunt estimates



PHP's average lot size is c40% higher than Assura's

As chart 1 above shows, Assura has been highly acquisitive over the past three financial years, buying a cumulative £515m of assets – approaching double the value of assets acquired by both PHP and MedicX combined over the comparable periods.

Interestingly however, chart 2 shows that while the average lot size of the PHP and MedicX portfolios have broadly followed each other, reaching c£4.5m at the end of 2017, Assura's has remained around £3.25m over the past four years.

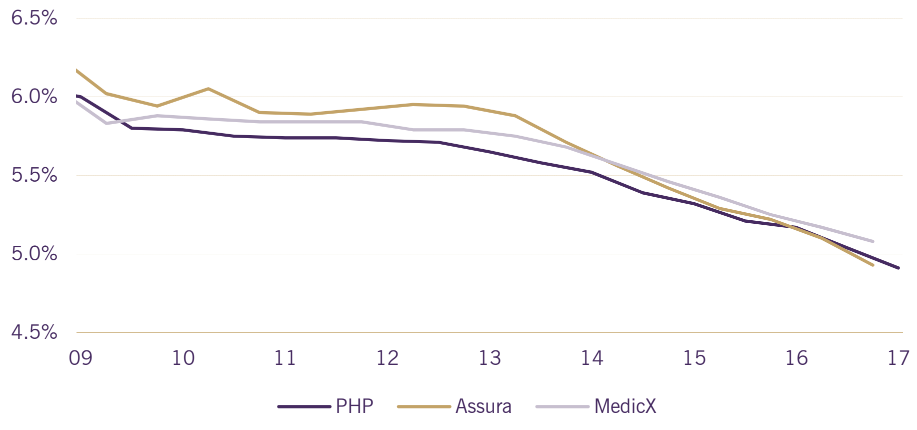
This suggests that although Assura has grown its portfolio considerably more aggressively than its peers, it has done so by buying considerably smaller assets.

Consistent portfolio yields

Despite the variation in asset size, there is no discernible difference in the valuation yields across the three portfolios, as shown in the chart below. In fact, the trend for yield tightening has been very consistent with increasingly minor differences in the net initial yields on the three portfolios.

Chart 3: Portfolio net initial yield

Source: Company accounts, Peel Hunt estimates



Corporate structure

We see PHP as the pioneer of the investor friendly external management structure

PHP and MedicX are both externally managed, while Assura has internal management. Generally, investors tend to express a preference for the latter although an increasing number of externally-managed vehicles provide both cost efficiencies and a clear alignment of interest. In both instances, we believe PHP to be a pioneer.

As charts 4 and 5 below show, PHP has:

- Amongst the lowest cost ratios in the whole real estate sector (alongside Assura);
- A particularly high management ownership in the vehicle, with management controlling equity worth c£13m, considerably higher than its peers.

As already discussed, PHP's track record is very strong, with shareholders benefiting from very good long term returns, including 21 years of unbroken dividend growth.

Chart 4: Director ownership

Source: Company accounts, Peel Hunt estimates

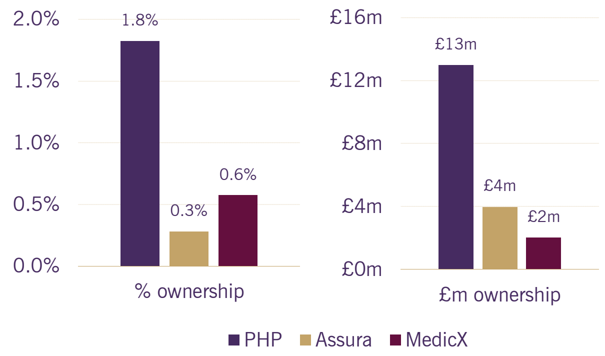
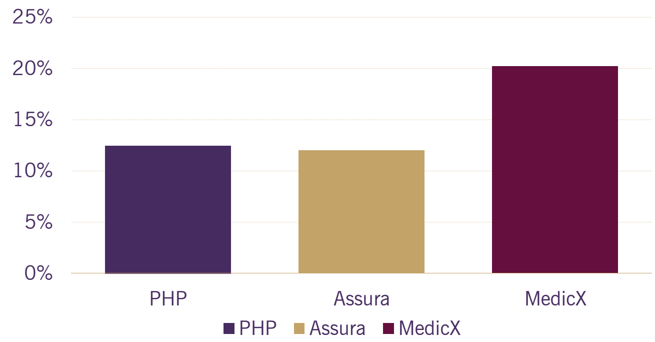


Chart 5: EPRA cost ratios (estimated for MedicX)

Source: Company accounts, Peel Hunt estimates



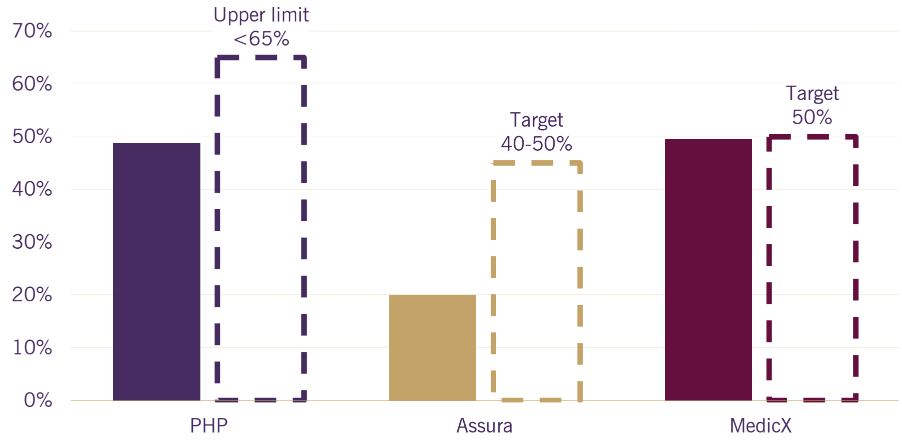
Financial leverage

Following its recent £310m equity raise, Assura's LTV has fallen considerably such that it is now some way below both peers and its target LTV of 40-50%.

For PHP and MedicX, an LTV of c50% is considered high for the real estate sector (the average is currently c30%). However, given the income security (both longevity and covenant) combined with the historically stable nature of the yields, we believe all three of these companies are justified in running higher LTVs than the rest of the sector.

Chart 6: Loan to Value ratios: actual and target/limits

Source: Company accounts, Peel Hunt estimates



PHP's LTV of 49% assumes the remaining convertible bond converts (it is currently well in the money). LTV is 53% before conversion.

PHP's interest cover was 2.25x in FY17

Arguably, interest cover is a more relevant metric for businesses focussed on income generation rather than capital appreciation. For PHP, interest cover in FY17 was 2.25x, based upon a weighted interest rate of 4.09%.

Forecasts & valuation

We set our below our forecasts following the FY17 results published last week and today include our new FY20 numbers.

Table 2: Key forecasts

Source: Company accounts, Peel Hunt estimates

	FY17A	FY18E	FY19E	FY20E
EPRA earnings per share (p)	5.2	5.7	5.8	6.0
Dividends per share (p)	5.3	5.4	5.6	5.7
EPRA NAV per share (p)	100.7	105.0	109.2	113.9
LTV (%)	*52.9*	*51.7*	*50.1*	*50.6*

Key points to note are:

- Our forecasts underwrite robust earnings growth of 4.4% per annum over the next three years, taking EPRA EPS to 6.0p per share in FY20E;
- We conservatively assume rental growth of c1.5% per annum, on average, and £50m per annum of further acquisitions (FY17: £72m);
- Our dividend per share forecasts show accelerated growth of c2.8% per annum compound (FY17: 2.4%), on a covered basis. Our FY20E estimates imply a pay-out ratio of c95.5%;
- Our NAV per share forecasts show growth of c4.2% per annum compound, adding over 13p (13%) to the FY17 print of 100.7p;
- We assume a further 7bp of yield compression (5bp in FY18E, 2bp in FY19E), against 26bp witnessed over the course of 2017. This takes our December 2020 net initial yield to c4.84% (Dec17: 4.91%).

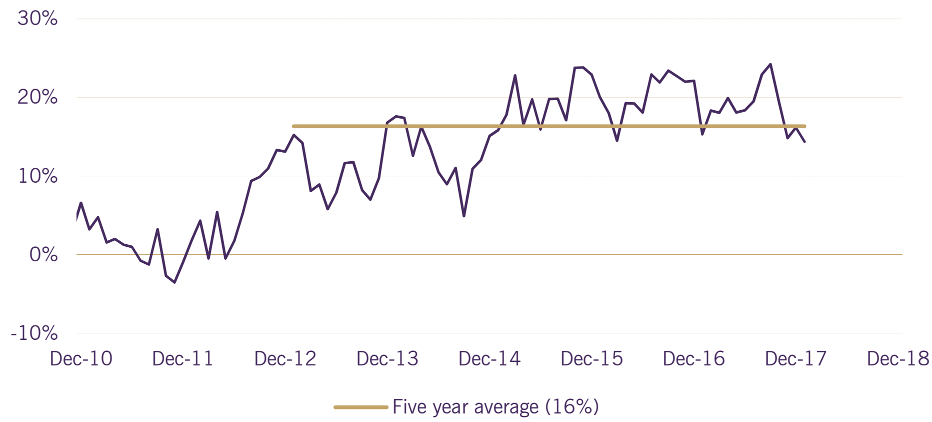
A justified long-term NAV premium

PHP's five year average NAV premium is 16%

PHP, and its peers Assura and MedicX, arguably have led the way (alongside the self-storage operators) in having valuations by the equity market based upon corporate earnings rather than on respective net assets. This has meant that the businesses have enjoyed long periods of time trading at material premiums to prevailing NAVs. In the case of PHP, and as the chart below shows, over the past five years the average NAV rating has been a premium of 16% – against a sector that has traded at a discount of 5% over the same period.

Chart 7: PHP NAV premium/discount (%)

Source: Company accounts, Datastream, Peel Hunt estimates



Looking forward, our NAV forecasts for each of the three puts PHP on the smallest premium at the end of 2020 (chart 8). This, of course, reflects PHP's capital structure which delivers superior NAV growth given broadly similar growth across the three portfolios, as well as MedicX's uncovered dividend.

Chart 8: NAV premium/discount (calendarised)

Source: Company accounts, Peel Hunt estimates

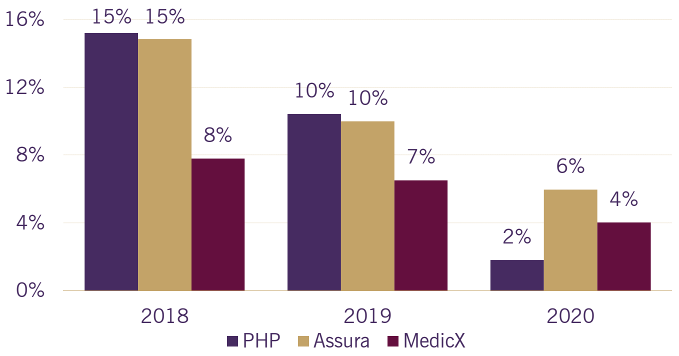
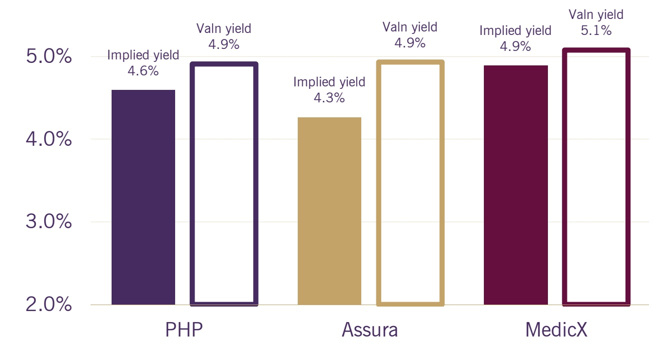


Chart 9: Implied property yields

Source: Company accounts, Peel Hunt estimates



PHP's share price implied property yield is 4.6%

PHP also looks favourable against Assura on an implied property yield basis. This looks through PHP's higher LTV and shows that our estimate of the implied yield of 4.6% (based upon current share prices) is around 30 basis points higher than Assura at 4.3%.

Income remains the key valuation driver, and PHP is cheap

On various income-based measures of valuation, PHP remains cheaper than both Assura and MedicX. As the two charts below show, on ratios of P/E and EV/EBIT, PHP compares favourably over each of the next three years. With respect to the former, its relative attractiveness in calendar year 2019 is clear, with a prospective P/E ratio of 19x against 21x for both Assura and MedicX.

Chart 10: P/E ratios (calendarised)

Source: Company accounts, Peel Hunt estimates

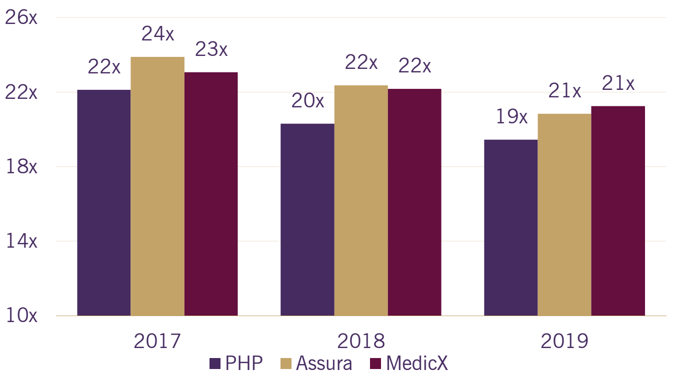
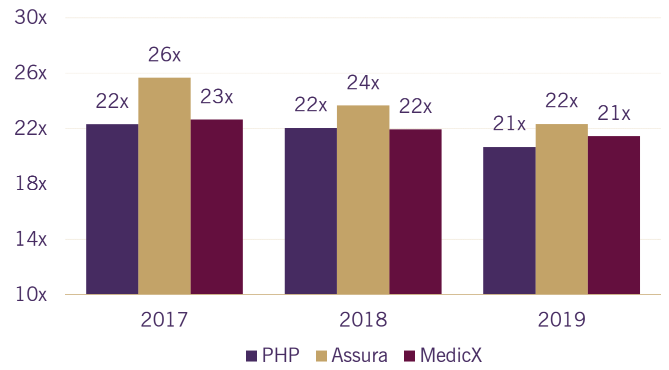


Chart 11: EV/EBIT ratios (calendarised)

Source: Company accounts, Peel Hunt estimates



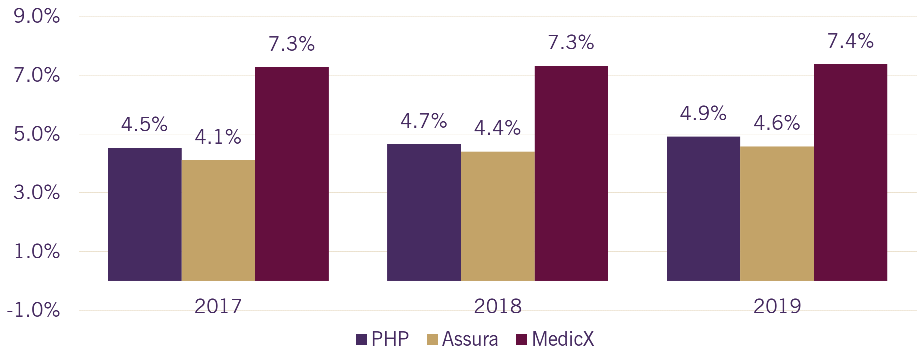
While we have concerns about MedicX's policy of paying dividends materially in excess of the Fund's underlying earnings (in FY17, dividends paid of £24m compared to operating cash flow of £15.1m), both PHP and Assura are forecast to pay covered, growing dividends over our estimate periods.

PHP has a prospective and covered dividend yield of 4.7%

For PHP, based upon the current share price, a yield of 4.7% for the 12 months to December 2018 compares to 4.4% for Assura (12 months to March 2019). Both compare favourably to a sector average yield of c4.0% over the same period, particularly when the underlying characteristics of the income streams are taken into consideration.

Chart 12: Dividend yields (calendarised)

Source: Company accounts, Peel Hunt estimates



Recommendation structure and distribution

	Recommendation distribution at 20 February 2018				All research published in the last 90 days	
	Corporate No	Corporate %	No	%	Corporate %	%
Buy	76	80	183	54	77	54
Add	12	13	52	15	12	15
Hold	6	6	75	22	6	22
Reduce	0	0	20	6	0	6
Sell	0	0	3	1	0	1
Under Review	6	6	8	2	5	2

Peel Hunt's Recommendation Structure is as follows:

Buy, > +15% expected absolute price performance over 12 months
Add, +5-15% range expected absolute price performance over 12 months
Hold, +/-5% range expected absolute price performance over 12 months
Reduce, -5-15% range expected absolute price performance over 12 months
Sell, > -15% expected absolute price performance over 12 months
Under Review (UR), Recommendation, Target Price and/or Forecasts suspended pending market events/regulation

NB The recommendation is the primary driver for analyst views. The target price may vary from the structure due to market conditions, risk profile of the company and capital returns

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Recommendation history

Company	Disclosures	Date	Rec	Price	Target Price
Assura	4	06 Dec 17	Hold	59p	56p
		24 Nov 17	Hold	58p	55p
		16 Nov 17	Hold	58p	57p
		15 Feb 17	Hold	56p	55p
MedicX Fund	4	06 Dec 17	Reduce	78p	78p
		01 Feb 17	Hold	89p	85p
Primary Health Properties	1,4,5,6	16 Feb 17	Buy	108p	125p

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