Primary Health Properties plc

PHP – LSE; PHP.L

February 26, 2018 UK REIT

HOLD

COMPANY UPDATE

Price (23 February 2018)		117p
Changes	**Previous**	**Current**
Rating	-	HOLD
Target Price	-	120p

Key data

Bloomberg/Reuters codes:	PHP LN / PHP.L
Market cap (£m)	700
FTSE ALL SHARE	3,992
1mth perf (%)	2.5
3mths perf (%)	2.7
12mths perf (%)	9.7
12mth high-low (p)	124 - 106
Free float (%)	92

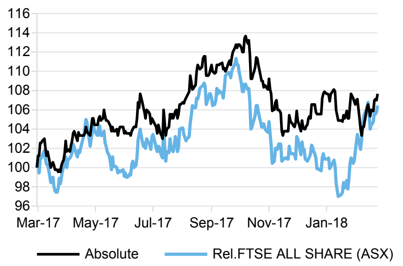
Key financials

Year to Dec	2017A	2018E	2019E
NAVPS adj (p)	101	105	109
Prem. to NAV (%)	16	11	7
EPS adj (p)	5.2	5.4	5.9
PE adj (x)	22.6	21.7	19.7
DPS (p)	5.3	5.4	5.6
Div yield (%)	4.5	4.7	4.8

Prices are as of close 23 February 2018

All sources unless otherwise stated: Company data, FactSet, Stifel estimates

Share price performance (indexed)



Pledging future growth

Summary

PHP's recent results showed the company continuing with its successful strategy of growth by acquisition, and we expect this to continue, with earnings growth augmented by a low marginal cost of debt (2.3% versus the prevailing average of 4.1%) with upside risk to our forecasts if rental growth returns to the sector; we are forecasting annual uplifts of just 0.5% on the open market rent reviews. The shares have been much less volatile than the REIT sector over the last few months, reflecting the defensive nature of the underlying asset class, and we expect them to remain relatively resilient this year, with the dividend yield of 4.7% well above the REIT average of 3.9%.

Key Points

Valuation & rating. PHP's shares have fallen just 1% year to date, out-performing the sector by 7%, and peers Assura (-9%) and MedicX (-2%). We believe that the shares will continue to be supported by the dividend yield, which at 4.7% is ahead of Assura's 4.2% (but note Assura's LTV is half that of PHP), and MedicX's earnings yield of 4.6% (MedicX is over-distributing, such that its dividend yield of 7.3% is not a like-for-like comparator). Given the stability of the asset class, which is characterised by long unexpired leases, c.90% of the rent roll effectively government-backed, and commitment from the UK and Irish governments to support primary healthcare, we think the sector will remain a "haven" for investors as we detailed in our recent note. Our target price of 120p assumes that PHP's shares trade at a 4.5% dividend yield, which gives an expected 12-month total shareholder return of 8.2%, hence our Hold rating.

Low rental growth has limited organic EPS growth... Rental growth on open market rent reviews (74% of PHP's rent roll) has been low for a number of years for PHP and its peers, due largely to the lack of development activity in the sector, which has been held back by NHS restructuring following the introduction of Clinical Commissioning Groups. There are some signs that development-led rental growth is returning to the sector, which would boost earnings growth for the company, but with open market rent reviews settled in 2017 delivering uplifts averaging only 0.3%, a meaningful increase in the rate of growth still seems some time away.

...but plenty of scope to grow by acquisition. In our view, PHP needs to continue on its path of acquisition-led growth in order to maintain its unmatched track record of 21 years of successive dividend growth (the dividend CAGR since 1998 has been 7%). The company acquired £72m of assets last year, which was a similar level to the year prior (£74m), and it has a targeted pipeline of £150m. The Government reaffirmed its commitment to investment in the primary healthcare sector in November's Budget, with £2.6bn of funding identified for investment in NHS buildings, and this followed a pledge made jointly by PHP, Assura and MedicX last August that the three REITs could invest £3bn between them into the primary healthcare estate over the next five years. The Government is backing new developments in the sector, both financially and with cross party political support; we think PHP will be able to source acquisitions and forward fund developments, which will enable earnings and dividend growth to continue.

Upside risk to forecasts. There is upside risk to our forecasts if the REIT and government investment in the sector leads to sufficient levels of developments such that the rate of rental growth increases. We assume acquisitions totalling £125m pa over the next three years, and in this note show what would happen to our forecasts if PHP were to fulfill 1/3rd of the REITs' £3bn investment pledge - we believe it would require the raising of equity.

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Key data[1]

Key profit and loss data (£)

	2017A	2018E	2019E	2020E
Net rental income	**71.3**	**76.8**	**83.8**	**91.2**
Other income	(0.5)	(0.2)	(0.1)	(0.2)
Administration expenses	(8.2)	(8.5)	(8.9)	(9.3)
JV EBIT	0.0	0.0	0.0	0.0
EBIT	**62.6**	**68.0**	**74.8**	**81.7**
Capitalised interest	0.0	0.0	0.0	0.0
Net interest	(31.6)	(34.8)	(35.7)	(38.1)
JV interest	0.0	0.0	0.0	0.0
Recurring PBT	**31.0**	**33.3**	**39.1**	**43.5**
Change in fair value of derivatives	(0.3)	0.0	0.0	0.0
Revaluation	64.5	27.8	28.5	29.2
JV revaluations	0.0	0.0	0.0	0.0
Profit on sale of properties	0.0	0.0	0.0	0.0
Profit on sale of JV properties	0.0	0.0	0.0	0.0
Exceptionals	(3)	0	0	0
PBT	91.9	61.0	67.5	72.8
Tax on ordinary activities	0.0	0.0	0.0	0.0
PAT adj	91.9	61.0	67.5	72.8
EPS adj (p)	**5.2**	**5.4**	**5.9**	**6.4**
DPS (p)	**5.3**	**5.4**	**5.6**	**5.7**
DPS growth (%)	2.4	2.9	2.5	2.5
Interest cover (x)	2.0	2.0	2.1	2.1
Div cover (x)	1.0	1.0	1.1	1.1

Key cash flow data (£)

	2017A	2018E	2019E	2020E
Operating cash flow	**60.1**	**68.0**	**74.8**	**81.7**
Funds available for distribution	34.0	33.3	39.1	43.5
Free cash flow (pre investment)	**4.2**	**(0.4)**	**0.9**	**4.5**
Property acquistions	(75.4)	(125.0)	(125.0)	(125.0)
Development expenditure	0.0	0.0	0.0	0.0
Property disposals	0.0	0.0	0.0	0.0
Net cash from share issues	0	0	0	0
Other	69	0	0	0
Net cash flow	**(1.8)**	**(125.4)**	**(124.1)**	**(120.5)**

Key balance sheet (£)

	2017A	2018E	2019E	2020E
Investment properties	1,361.9	1,514.7	1,668.2	1,822.4
Investments	0.0	0.0	0.0	0.0
Other fixed assets	0.0	0.0	0.0	0.0
Other current assets	(26.4)	(26.4)	(26.4)	(26.4)
Net debt	(726.6)	(852.0)	(900.5)	(1,021.1)
Provisions	(22.1)	(22.1)	(22.1)	(22.1)
Adjustments	36.8	36.8	24.5	24.5
NAV adjusted	623.6	651.0	743.6	777.3
NAVPS adj (p)	**101**	**105**	**109**	**114**
NAVPS adj growth (%)	10.5	4.4	3.4	4.5
NNNAVPS (p)	**93**	**98**	**102**	**107**
Loan to value (%)	53.4	56.2	54.0	56.0

Key information

Target price methodology/risks

Our target price of 120p assumes a 4.5% dividend yield one year forward. The main risk is a radical change in government policy (unlikely).

Business description

Primary Health Properties plc (PHP) is a REIT that invests solely in freehold and long leasehold healthcare properties that are let principally to GPs, NHS organisations and associated healthcare users.

The company engages in a limited amount of development activity in conjunction with recognised development partners with schemes de-risked by first entering into a pre-let with a GP. PHP has a portfolio value of £1.4bn, and derives 90% of its income from the UK Government. The company is externally managed by Nexus TradeCo.

Senior management

Harry Hyman (Managing Director)

Richard Howell (Finance Director)

Key dates

August 2018 - 1H19 results

Major shareholders

BlackRock - 5.7%

Investec Wealth - 5.1%

Charles Stanley - 4.7%

Unicorn - 4.3%

Troy - 4.0%

CCLA - 3.8%

Website

www.phpgroup.co.uk

[1] Year end December
Data in millions, except per share and percentages
Source: Company data, FactSet, Stifel estimates

Updated forecasts

We have updated our forecasts following the company's full year results, as shown in Figure 1. Our FY18E EPS forecast has been reduced following slightly lower-than-expected rental income growth last year, and also the dilution from conversion of £19.3m of the convertible bond in FY17E. There is £63.2m (nominal value) of the convertible bond outstanding, with a conversion price of 97.5p, and we expect this to convert on maturity in May 2019, which will result in 64.8m new shares, increasing the number of shares in issue by 10%. Our FY19E EPS forecast has been increased by 1.1%, reflecting the company's marginal cost of debt at 2.3%, which is lower than we had previously forecast. The company is set to benefit from the low cost of debt on any new drawn facilities (PHP has £101m of undrawn facilities) as it continues making acquisitions, and also on the refinancing of its £75m retail bond in 2019, which has a coupon of 5.38%, and management has confirmed it will not renew this.

Figure 1: PHP forecast change summary

	FY17A		FY18E		FY19E		FY20E	
	Old	**New**	**Old**	**New**	**Old**	**New**	**Old**	**New**
EPS	5.3	5.2	5.6	5.4	5.9	5.9	n/a	6.4
change		*-2.9%*		*-4.6%*		*1.1%*		*n/a*
DPS	5.27	5.28	5.40	5.43	5.54	5.57	n/a	5.71
change		*+0.1%*		*0.5%*		*0.5%*		*n/a*
NAV	97.9	100.7	102.4	105.1	105.7	108.7	n/a	113.6
change		*+2.8%*		*2.6%*		*2.8%*		*n/a*
LTV	56%	53%	58%	56%	54%	54%	n/a	56%
change		*-5.0%*		*-3.1%*		*0.5%*		*n/a*

Source: Stifel estimates, Company data

Our forecast dividend growth rate is unchanged at 2.5% pa, with the 0.5% increase in our forecasts due to the slightly higher-than-expected increase in the final quarterly dividend last year, which was up 3% on the prior quarter. We are forecasting dividend cover of 0.99x in FY18E, and 1.1x thereafter, i.e. the dividend is generally covered by earnings.

Our assumptions for capital growth are unchanged at 2% pa, with the 2-3% increase in our NAV forecasts due to rebasing following the higher-than-expected end-December NAV.

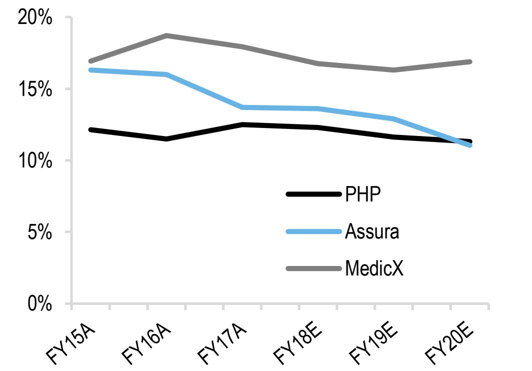
Performance incentive fee

As PHP's portfolio has grown, the company has benefitted from the ratcheting down of management fees which taper down to a marginal fee rate of 0.25% of GAV for assets above £1.75bn, a level we forecast the company will reach during early FY20E.

The terms with the external adviser, Nexus, were revised last April, introducing lower marginal fee rates, and changing the performance fee terms such than Nexus receives 11.25% of the total EPRA NAV return above an 8% threshold. The total return is now based on EPRA NAV, rather than IFRS NAV, since the latter included the mark-to-market valuation of the company's derivatives and bonds, which do not reflect the underlying performance of the businesses. The performance fee is subject to clawback, and none had been paid from 2007-2016 due to the cumulative deficit created by debt mark-to-market adjustments in the calculation of the fee which totalled £12.1m, which had effectively rendered the performance fee structure redundant. With the removal of this deficit following the change to the total return definition, a performance fee of £0.5m was generated in FY17E, impacting EPS by less than 0.1p, or 1.5%.

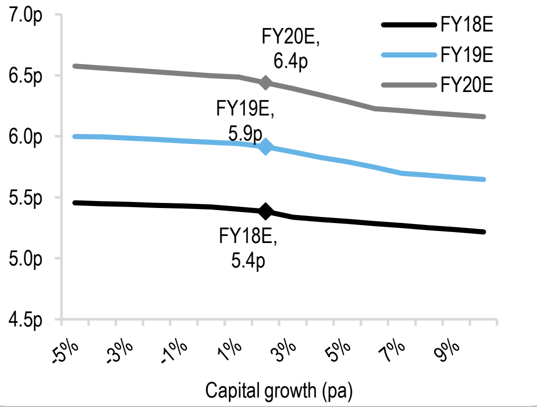
Since our total NAV return forecasts are above 8% in each of the next three years (our CAGR total return is 9%, broadly comprising 4% NAV growth and a 5% dividend return on NAV), our forecasts include a performance fee of c.£0.2m pa. Even including this, PHP has amongst the lowest cost ratios in our coverage universe; the REIT average EPRA cost ratio is 20.6%, versus PHP at 12.5% last year, which is lower than its peers as shown in Figure 2.

Figure 2: EPRA cost ratios



Source: Company data, Stifel estimates

Figure 3: Sensitivity of PHP's EPS forecasts to capital growth



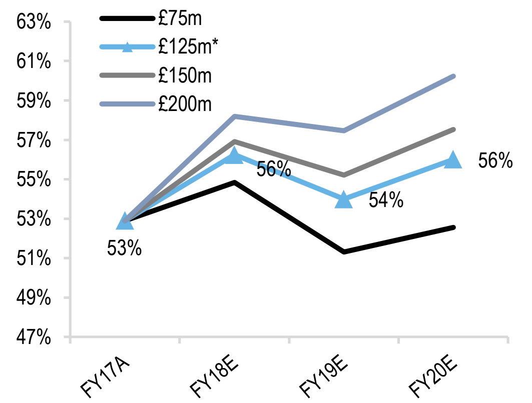
Source: Stifel estimates

Figure 3 shows the potential impact of the performance fee on our EPS forecasts at different levels of capital growth. If capital growth is less than c.1% in any given year, no fee is payable. The fee is also bound at the upper end of the range since it cannot be more than the lower of 20% of the management fee or £2m, and it is also restricted such that it cannot push dividend cover lower than 0.98x. As a result, the marginal impact of high levels of capital growth is limited only to the extent that the management fee is higher. Overall, the performance fee can adversely impact earnings by no more than £2m in any given year, which is c.6% of EPS.

Acquisitions and the £3bn pledge

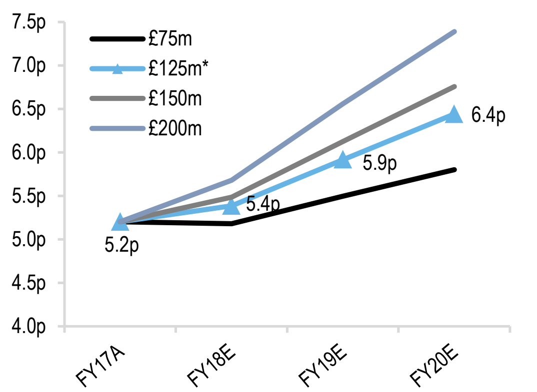
We are forecasting acquisitions of £125m pa, comprising £75m pa in the UK, and £50m in Ireland, which over the next three years, including the offsetting reduction in debt following the conversion of the convertible bond and 2% pa capital value growth, results in an LTV of 56%, up from the current 53%. If PHP were to aim to comprise 1/3 of the £3bn pledge made by the REITs last year, over five years the company would need to increase its rate of acquisitions to £200m pa. (We would highlight this is not a *target* of the REIT management teams, more a statement of intent that would require £3bn of assets to be available, i.e. the government must do its part and accelerate the pace at which developments are commissioned by the NHS.)

Figure 4: Sensitivity of LTV to acquisitions, with 2% pa capital growth assumption constant (£m pa)



Source: Stifel estimates, Company data
** Stifel forecast*

Figure 5: Sensitivity of EPS forecasts to rate of acquisitions (£m pa)



Source: Stifel estimates, Company data
** Stifel forecast*

We show in Figure 4 the impact that different acquisition rates would have on the company's LTV, assuming no portfolio recycling, and Figure 5 shows the impact on our EPS forecasts. By FY20E the LTV would reach 60% if acquisitions total £200m pa, which is the maximum operating limit set by the Board. We therefore think that if PHP were to achieve £1bn of acquisitions over the next five years, it would need to raise equity.

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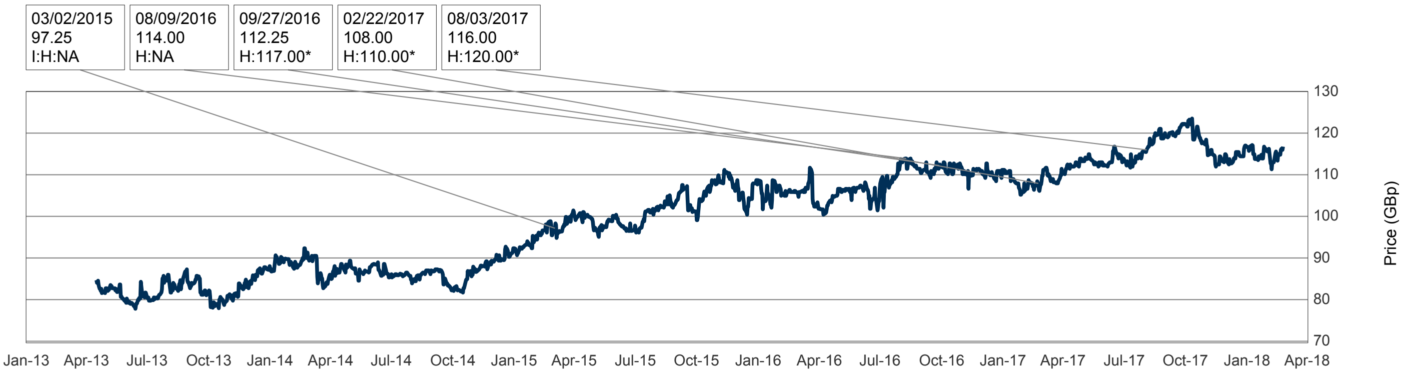
Primary Health Properties plc (PHP.LN) as of February 23, 2018 (in GBp)



*Represents the value(s) that changed.
Buy=B; Hold=H; Sell=S; Discontinued=D; Suspended=SU; Discontinued=D; Initiation=I

Powered by: BlueMatrix

For a price chart with our ratings and any applicable target price changes for PHP.LN go to
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