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Primary Health Properties REIT

19 years' uninterrupted dividend growth

There have been 19 years' unbroken increasing dividends paid since founding. For 2016 we estimate 106% cover. PHP acquires medical assets with upward only rents at c200bps ahead of costs of funds. 2015 profits were significantly enhanced by rising operational and financing efficiencies. Cost of debt stands at 4.7%, and falling. So what comes next? Predicability in a difficult / late-cycle world. Likelihood of further progressive tightening of yields. The assets were valued on a net initial yield basis 5.32% 2015, (tightening 10-20bps pa in recent years) a continuing trend. With upward only rents, this is a secure and growing real estate investment.

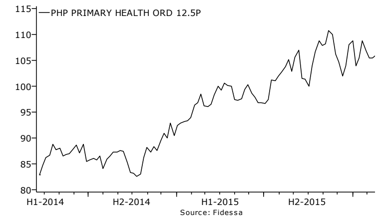
- **Strategy:** PHP grows its portfolio, enhancing support for dividend growth, helping efficiency optimisation. PHP's EPRA Cost Ratio, the admin costs as a proportion of net rental income, fell to 11.6% H1 2015 and 11.5% full year (vs 12.7% H1 prior and 12.0% 2014). This is a strong performance within the sector.
- **Stability and growth:** 10.0% NAV rise 2015. PHP has trebled its portfolio size in five years. PHP's reputation, partners and track record assist when buying both standing assets and new stock. 2016 EPS would grow even with nil acquisitions, but we see an acceleration in acquisitions, including entering Irish Republic.
- **Valuation:** This (healthcare) quoted real estate sub-sector trades at a premium to NAV, as indeed it does also in the USA. PHP's shares are valued on the basis of its assets and a robust progressive dividend, with cover rebuilt to over 100%. The resilience of the shares in recent market turbulence is fully justified.
- **Risks:** There is de minimis rental or void risk, but is exposure to future interest rate trends. Loan/asset value is 62.7%. Average debt maturity is steady, around six years, with a small amount of forward Swaps. As incremental management costs are below average, faster expansion enhances dividend cover further.
- **Investment summary:** We calculate PHP Total Shareholder Return (TSR) CAGR of over 15% over the past five years. In 2015 TSR was 23.5%. Investors in this REIT are exposed to an asset class which yields well above cost of funds, with rent being upwards only and AAA covenant. There is some exposure to future interest rate trends – partly mitigated by Swaps and closely monitored.

Financial summary and valuation

Year end Dec (£m)	2012	2013	2014	2015	2016E	2017E
Income	33.2	42.0	60.0	63.1	67.8	72.7
Finance cost	(21.8)	(26.9)	(35.5)	(33.7)	(35.0)	(37.2)
Declared profit	1.1	20.2	36.9	56.0	34.7	37.0
PBT Adj. (pre revaln)	7.3	9.5	18.2	21.7	24.7	27.0
EPS Reported (p)	0.5	5.7	8.3	12.6	7.7	7.9
EPS Adj. (p)	2.5	2.7	4.1	4.8	5.4	5.6
DPS (p)	4.63	4.75	4.88	5.00	5.15	5.38
Net (Debt)	(377.9)	(587.2)	(655.2)	(694.7)	(744.4)	(792.9)
Dividend yield (%)	4.3	4.4	4.5	4.7	4.8	5.0
Price/NAV	1.80	1.53	1.51	1.38	1.30	1.24
NAV (p)	59.4	70.0	69.6	77.6	82.0	86.3
EPRA NAV (p)	75.7	76.5	79.7	87.7	92.1	96.0

Source: Hardman & Co Research

Real Estate



Source: Fidessa

Market data

EPIC/TKR	PHP
Price (p)	108.0
12m High (p)	111.0
12m Low (p)	85.0
Shares (m)	447.0
Mkt Cap (£m)	482.8
EV (£m)	1175.8
Free Float* (%)	96%
Market	Main LSE

*As defined by AIM Rule 26

Description

Acquisition and ownership of modern primary medical properties in UK and expanding into Ireland

Company information

Non exec Chair	Alun Jones
MD	Harry Hyman
CFO	Phil Holland

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Next event

Feb 2016	Annual results
Apr 2016	AGM
Aug 2016	Interim results
Nov 2015	IMS

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Strategic positioning

With a strategy of investing in secure long term rental streams…

PHP invests in modern primary medical real estate assets which are in strong demand and offer secure long term returns. Lease income is effectively Government paid, with upward only rents payable on 20 year + leases.

As a result, there have been 19 years' unbroken dividend increases paid since founding.

….the 19 years' existence of PHP has seen continual progressive dividends

The January 2016 RICS UK survey of commercial property found overall buying interest, which rose in the last quarter, rose at its slowest pace since Q3 2013. It considers that the restricted overall supply will maintain price movements in positive territory. RICS chief economist (at the release of the survey in last week January) stated: "Indeed, the prospect of a 'low for longer' interest rate environment provides further comfort for those parts of the property market where values are looking a little stretched." We agree with the positive comment on 'low for longer' whilst PHP income stream is very strong. Debt cost 4.67% in 2015, compared to 5.15% in 2014.

A broader market downturn may well be coming

Given the resilience of the asset class, the performance of the stock was relatively very strong in the crisis years post 2007. It is important that returns have been very respectable during the recent cyclical upturn in UK real estate. We calculate that over the past five years, PHP's total shareholder return compound annual growth rate has been over 15%. Total Shareholder Return in 2015 was 23.5% (vs 2014 12%).

In the last downturn, PHP held up well and into the upturn, the past five years TSR has been a robust 15% pa, almost exactly as good as the sector as a whole

The strategy in both the downturn and the upturn has plainly delivered.

That is a positive point in itself, but with the UK real estate cycle no longer near its low point and some risks appearing in the macro-economy, the PHP combination of growth, income and security is all the more attractive. REITS as a whole have been weak in share price terms for much of this year.

Property is being acquired at 5.0%+ cash yield (i.e. after marginal management costs of 0.325%) and incremental cost of bank debt (based on 5 year rates of 1.35% down from 1.75% start year just a month ago, plus PHP's average margin of 185bps) sits at 3.2%. We note the entry to the ROI market, offering a pickup c200bps greater.

Currently acquiring assets at 5.0% net (post costs) cash yield with cost of money 3.2%. Also now entering Republic Ireland

PHP's first forward funding investments into the Republic of Ireland are in solicitors' hands. The government typically represents 60-75% of income, secured on 20+ years lease terms. The remainder of the tenants are primary health providers. MedicX announced it was entering this field half a year ago. We consider the amount of new stock being developed to be sufficient to supply the appetite of all current buyers/ forward development funders, without significant rises in prices for some while.

PHP will receive income from developers forward-funded by PHP, in a similar fashion to its UK operations. We model £10m assets on PHP's balance sheet by end this year, £25m next, but this is subject to revision. Rents are in € as would be debt. We consider up to €100-130m as being a possible appetite – over a number of years.

Performance and valuation

An asset class yielding strong returns and low variability

In 2015, PHP's total property return was 9.7% vs IPD All Property Index 13.8% in 2015.

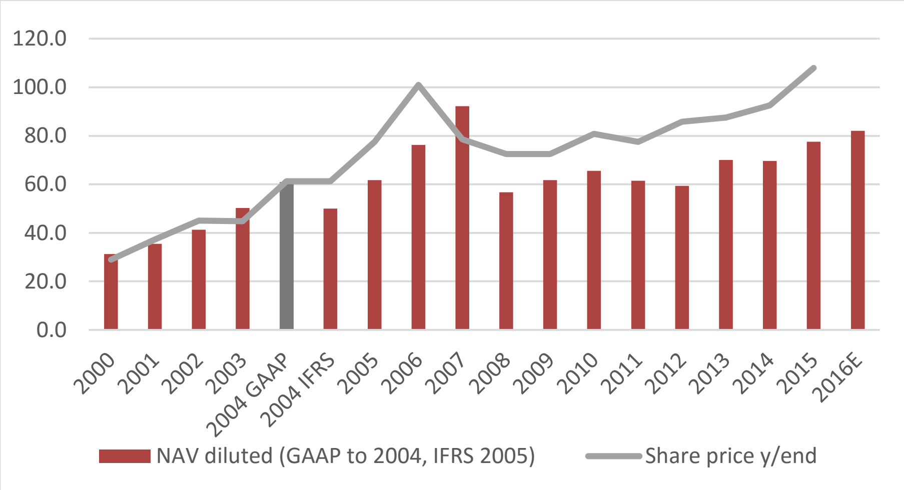
Since 2007 (source IPD), UK primary health assets have returned 7% pa (over 80% of that being rent streams) on a standard deviation of 4.5. All healthcare respective figures are 6% and 5.3% standard deviation. IPD All-property has achieved an annual

3.5% return on 13% standard deviation. For the record, equities stand at 3.5% return and 17% standard deviations.

The long term trend in share price has been to rise to a premium to NAV – justified by the track record and as with the premium rating of the real estate sector as a whole

The share price premium to NAV has expanded over a longer term time period, but much of this can be attributed to the higher basis of stating NAV under GAAP which was adopted until 2004 (see the 2004 two series comparable below – lighter bar). On constant accounting, investors are hardly paying a higher premium to NAV compared to the rating PHP was on prior to its achieving its enviable track record. The premium is not stretched either by 1) recent standards or 2) compared to the rest of the sector. Note EPRA principally excludes adjustment for (expensive) historic swaps.

PHP share price and NAV



Source: Hardman & Co Research, PHP statements and accounts

Risks and Investment conclusion

PHP's reported profits are driven by rent rises and changes in capitalisation rates. Rents are upwards only. Covenant is AAA if not even higher, were that possible. Voids are virtually non-existent. One point is the relative valuation momentum. Clearly, such a resilient portfolio has a 'low beta' and real estate stocks whose income is more GDP-related or confidence driven will perform better in a recovery cycle and worse – often much worse – in the down cycle of the real estate.

The main operational sensitivity is to changes in interest rates for longer term debt. Its maturity profile is 5.8 years. There is a 're-banking' risk (and opportunity) which is very manageable because the assets are robust (valuations did not move hugely even in the global financial crisis) and financial institutions willing lenders (even in the global financial crisis).

PHP shares are appropriate for portfolios seeking a growing and securely based dividend offering, at a yield premium to the market. PHP is run efficiently, both with regards its administrative costs and its treasury management. There is a risk if rates rise without PHP taking 'avoiding action.' First, we take the view that rate rises will be modest and particularly with a view to 5-10 year interest rates, there may well be no material rise at all in the coming years. Secondly, PHP actively and successfully manages treasury risk. We thus see a policy of funding with medium-term (as opposed to very long) maturity profile debt as being one which suits and benefits PHP and its shareholders.

PHP is delivering against its own strategic objectives. It has delivered resilient and strong progressive returns. It has grown the portfolio. It has increased its efficiencies. Funding has been derived from a diversified range of providers.

One point to note. Original investors at PHP float have seen dividends of approximately 2x the share price being paid to them. The quantum (and sustainability) of dividends are absolutely crucial here.

Financial summary

Profit & Loss account

Year end December £m	2010	2011	2012	2013	2014	2015	2016E	2017E
Total Income	26.9	30.7	33.2	42.0	60.0	63.1	67.8	72.7
Rise in income %	*26.3*	*14.0*	*8.2*	*26.5*	*42.9*	*5.2*	*7.4*	*7.2*
Operating Profit	21.9	25.1	27.6	35.5	52.5	55.4	59.7	64.2
Operating profit margin %	*82.3*	*82.9*	*83.9*	*84.7*	*87.5*	*87.8*	*88.1*	*88.3*
Admin expenses as % net rental income	*17.7*	*17.1*	*16.0*	*14.7*	*11.5*	*10.9*	*10.6*	*10.3*
Net Finance Costs	-12.7	-15.4	-21.8	-26.9	-35.5	-33.7	-35.0	-37.2
Adjusted Pre-tax Profit	**9.7**	**11.0**	**7.3**	**9.5**	**18.2**	**21.7**	**24.7**	**27.0**
Reported Pre-tax Profit (incl revaluations)	25.2	11.4	1.1	20.2	36.9	56.0	34.7	37.0
Adjusted EPS (p) excludes all reval'n	**3.9**	**4.1**	**2.5**	**2.7**	**4.1**	**4.8**	**5.4**	**5.7**
Reported EPS (p)	10.3	4.8	0.5	5.7	8.3	12.6	7.7	7.9
Dividend Per Share (p)	**4.38**	**4.50**	**4.63**	**4.75**	**4.88**	**5.00**	**5.15**	**5.38**
Rise in dividend %	*2.9*	*2.9*	*2.8*	*2.7*	*2.6*	*2.6*	*3.0*	*4.4*
Dividend cover (dil adj) %	*88.2*	*91.4*	*54.3*	*56.1*	*84.0*	*97.4*	*105.9*	*105.9*
Shares in Issue, No., Avge	250.4	266.9	290.8	356.4	444.4	445.6	452.7	467.7
EPRA Shareholders' Funds	195.7	217.5	230.4	330.9	354.2	391.6	423.8	456.4
Cash	0.9	0.1	25.1	9.3	12.1	2.9	5.3	9.8
Net debt	-266.0	-301.2	-377.9	-587.2	-655.2	-694.7	-744.4	-791.9
NAV (p)	**65.6**	**61.5**	**59.4**	**70.0**	**69.6**	**77.6**	**82.0**	**86.3**
EPRA NAV (p)	**77.9**	**79.6**	**75.7**	**76.5**	**79.7**	**88.0**	**92.1**	**96.0**
Rise in NAV %	*6.2*	*-6.2*	*-3.5*	*18.0*	*-0.6*	*11.5*	*5.7*	*5.2*
Rise in EPRA NAV %	*11.3*	*2.2*	*-4.9*	*1.0*	*4.2*	*10.4*	*4.7*	*4.3*
Debt LTV %	56.1	56.7	61.7	61.6	64.1	63.1	63.1	62.8

Source: PHP accounts and Hardman & Co estimates

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