28/08/2013

Primary Health Properties

Raising Expectations On Good Interims

Share price, p: 348

Long-Term BUY

FORECASTS

Y/e 31 December	2012A	2013E	2014E	2015E
Rental Income £000	33,151	40,416	48,307	55,269
EBITDA £000	25,857	34,821	41,441	47,881
PBT adj. £000	7,383	9,500	13,500	19,500
EPS (underlying) p	10.2	11.0	13.8	19.9
Div. p	18.5	19.0	19.5	20.0
NAV p	242.8	207.8	209.4	216.7

VALUATION

Y/e 31 December	2012A	2013E	2014E	2015E
EV/Rental Inc. x	18.2	19.3	19.0	18.4
EV/EBITDA x	23.4	22.4	22.2	21.3
P/E x	34.3	31.6	25.2	17.5
PEG x	(1.0)	3.8	1.0	0.4
P/NAV (EPRA) x	1.4	1.7	1.7	1.6
Yield %	5.3	5.5	5.6	5.7
ROCE/WACC x	0.9	0.6	0.7	0.8

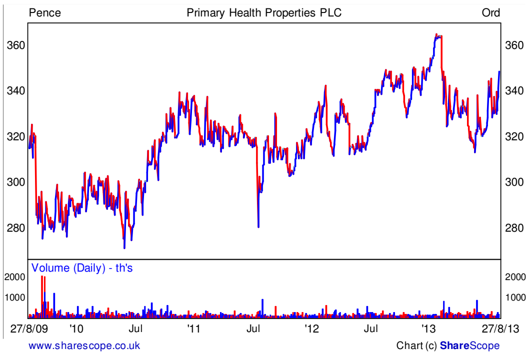
SHARE DATA

12m Lo - Hi p	300.6	-	366.0
Mkt Cap. £m			340.5
Issued shares m			97.8
Normal Mkt Size			2,000
30 Day Ave. Vol, 000			107
30 Day Ave. Value £000			358
Beta			0.30

SHARE PERFORMANCE	1m	3m	12m
Actual %	3.2	7.7	2.9

Reporting Calendar

Interim	August
Preliminary	February
AGM	April



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Primary Health Properties PLC ('PHP'), a leading dedicated UK healthcare infrastructure REIT, specifically investing in modern primary healthcare assets leased principally to GPs, NHS organisations and other related health care providers, released good interim results on 22 August 2013 and announced its 17th year of successive dividend growth.

Key points to note for the six months ended 30 June 2013 are that PHP successfully completed the refinancing of expensive acquired debt at lower rates with a long term funding partner whilst also achieving an over-subscribed £68.5m equity raise.

The company also completed four acquisitions worth £15.9m, which helped lift the total annualised rent roll including development properties by 2.1% to £39.7m (31 December: £38.9m), while the total portfolio including development properties increased by 2.3% to £660.5m (31 December 2012: £645.4m). NAV per share increased 12.9% to 265.9p (31 December 2012: 235.5p) although the EPRA NAV fell 1.2% to 301.3p (31 December 2012: 305.0p).

Since 30 June 2013, the pace of capital deployment has not slowed with 16 properties being acquired for £45.6m, including Primary Health Care Centres Ltd. The total portfolio as at 22 August 2013 stands at £706.2m, comprising 202 assets generating an annualised contracted rent roll of £42.6m. The portfolio's net initial yield remains stable at 5.71% compared to 5.72% as at 31 December 2012 while the cash yield on historic cost is running at around 7%.

The outlook remains positive, particular as the hiatus created by the anticipation and subsequent implementation of the Health & Social Care Act 2012 fades and the primary care market begins, in earnest, to deliver the reforms desired by patients and politicians.

These results, supported by the rapid deployment of capital at consistently attractive net initial yields, have encouraged us to increase our profit and earnings expectations by circa 5% for the financial years ending 31 December 2013 through 2015.

They also indicate that the company is delivering on its key investor objective of restoring dividend cover to 100%. Based on our estimates, dividend cover will continue to improve, although it may not be fully restored until early 2016.

In our opinion, PHP remains an attractive long-term investment opportunity because of its financial strength and its secure and growing income stream which should result in sustained NAV upside and real dividend growth.

Key Highlights

- Second interim dividend of 9.5p brings the full year distribution to 19.0p, an increase of 2.7%
- 17th successive year of dividend growth
- Total annualised rent roll including development properties rose 2.1% to £39.7m (31 December 2012: £38.9m)
- Total portfolio including development properties increased 2.3% to £660.5m (31 December 2012: £645.4m)
- £61.5m of assets acquired as at 22 August 2013
    - Four acquisitions worth £15.9m acquired during period ended 30 June 2013
    - 16 properties acquired since 30 June 2013 for £45.6m, including Primary Health Care Centres Ltd
- Portfolio net initial valuation yield remains stable at 5.71% (31 December 2012: 5.72%)
- Total portfolio as at 22 August 2013 stands at £706.2m, comprising 202 assets generating an annualised contracted rent roll of £42.6m
- NAV per share increased 12.9% to 265.9p (31 December 2012: 235.5p)
- EPRA NAV fell 1.2% to 301.3p (31 December 2012: 305.0p)
- Major equity raise completed raising £65.8m net of expenses
- Completed refinancing of expensive acquired debt at lower rate with long term funding partner
- Available debt funding headroom of at least £115m post the latest acquisitions
- Outlook remains positive.

Interim Results

The company reported results for the six months ended 30 June 2013 in line with expectations, with rental income rising 22.2% to £19.606m due principally to a first time contribution from last December's Apollo acquisition. Rent reviews have been completed on £3.6m (out of a total £19.3m as at 31 March 2013) and increased by an average of 2.3% pa, which although marginally below last year's 2.4% was a considerable improvement on last March's 1.64%. We anticipate that the company will complete these outstanding rental reviews at no less than the reported 2.3% pa level in the next few months.

TABLE: STATEMENT OF COMPREHENSIVE INCOME, £000

Six months ended 30 June	**2013**	**2012**	**% change**
Rental income	19,606	16,038	22.2
Finance lease income	87	172	(49.4)
Rental & related income	**19,693**	**16,210**	**21.5**
Direct property expenses	(153)	(175)	(12.6)
Administrative expenses	(2,890)	(2,592)	11.5
Non-recurring expenses: project costs	(200)	0	N/a
Operating Profit	**16,450**	**13,443**	**22.4**
Profit on sale of finance lease	641	0	N/a
Net valuation gain/(deficit) on property portfolio	240	631	(62.0)
Operating profit before financing costs	**17,331**	**14,074**	**23.1**
Finance income	172	175	(1.7)
Finance costs	(12,545)	(9,308)	34.8
Early loan repayment fee	(825)	0	N/a
Fair value gain/(loss) on derivative int rate swaps & amortisation of cash flow hedging reserve	9,446	(785)	N/a
Pre-tax profit	**13,579**	**4,156**	**226.7**
Taxation	1	0	N/a
Profit for period	13,580	4,156	226.8
EPS (reported)	17.4p	5.9p	194.9
EPS (underlying)[1]	**4.8p**	**6.1p**	**(21.3)**
Dividend	9.5p	9.25p	2.7
Dividend cover	0.52x	0.66x	

Source: Company
Note: [1] Excludes one-off items and movements in fair value of properties and derivative and provision for early loan repayments.

Overall property expenses, excluding £0.2m of expensed project costs, increased 10% to £3.043m but continue to decline as a percentage of the portfolio under management, which currently stands at £706.2m (31 December 2012:

£645.4m). Finance costs increased 34.8% to £12.545m due to the impact of a full six months of higher borrowing margins from the 2012 debt refinancing and acquisition driven growth in overall debt. The £10.231m swing to a £9.446m fair value gain on derivative interest rate swaps and amortisation of cash flow hedging is a paper adjustment (i.e. non-cash item) but clearly shows the continuing volatility in the interest rate swaps market. PHP sold an asset held on a finance lease to the NHS that generated a surplus of £0.641m. The £0.825m charge relates to the one-off early repayment fee incurred when PHP repaid the Aviva loans acquired with the Apollo acquisition.

The reported pre-tax profit increased from £4.156m to £13.579m while EPS increased from 5.9p to 17.4p, however, the underlying EPS (i.e. excluding one-off items) fell from 6.1p to 4.8p.

Property Portfolio

During the 6 months ended 30 June 2013, PHP completed the acquisition of four primary care assets for a total consideration of £15.9m and brought the total number of properties under management to 186. These acquisitions comprised two standing let properties and two further development properties. Lambert Smith Hampton independently valued the property portfolio as at 30 June 2013 at £660.3m at open market value and on the basis that all development commitments were completed. This valuation increased to £660.5m when some expansion land held at cost was included. The annualised rent roll stood at £39.7m as at 30 June 2013.

ASSETS UNDER MANAGEMENT AS AT 30 JUNE 2013

	Number of Properties		Aggregate Value, £m	
Investment properties	180		632.5	
Properties in the course of development	6		14.0	
Total Properties		**186**		**646.5**
Finance leases & expansion land			0.2	
Total owned leased		**186**		**646.7**
Balance of purchases committed at period end			13.8	
Total owned, leased & committed		**186**		**660.5**

Source: Company

Since 30 June 2013, PHP has completed the purchase of 16 properties – 11 through the acquisition of Primary Health Care Centres Limited – for a total consideration of £45.6m. These acquisitions increased the number of properties under management to 202 and the total value of the portfolio to £706.2m, lifting the annualised rent roll to £42.6m.

PHP, despite continued competitive market conditions, has a good pipeline of acquisition opportunities with some £55m of property transactions with solicitors, which, subject to timing, should result in the company closing on at least £100m of asset purchases by the end of the year.

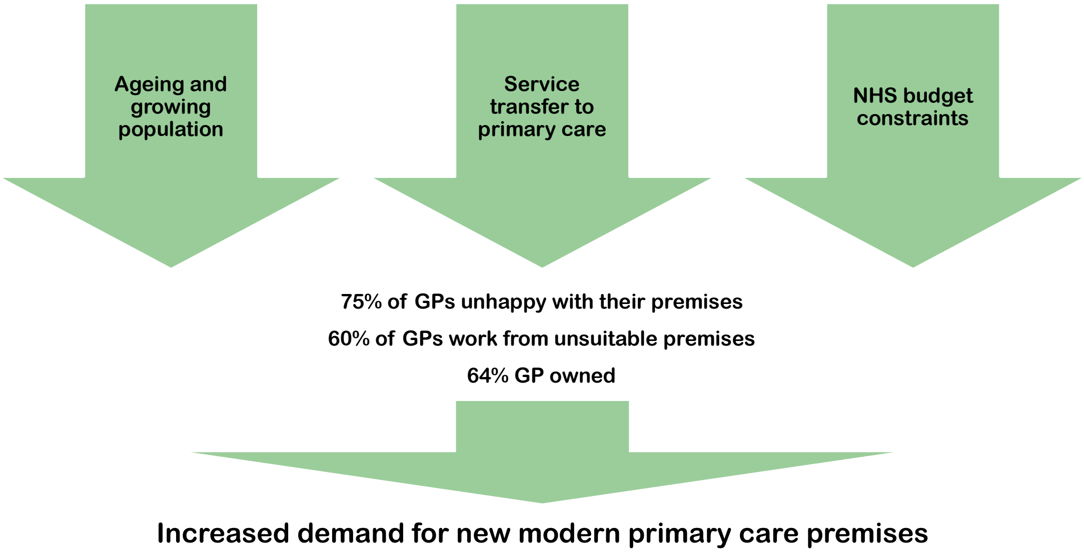
Over the next couple of years, the company will continue to acquire at least £100m pa of new primary care assets that should be fully fungible through debt at favourable long-term interest rates because of the quality of the tenant (ultimately, HM Government).

Primary Care Market

The UK Health & Social Care Act 2012 that will, over time, drive more NHS services from the secondary care market (e.g. hospitals) into the primary care sector (i.e., GPs), has now been implemented. It has resulted in the replacement of PCTs in England by NHS England and localised Clinical Commissioning Groups with responsibility for £80bn of the NHS budget. The PCT estate and occupational leases were transferred to a new UK Government indemnified corporate entity, NHS Property Services. Importantly, the Act included no changes to the principles of GP premises cost reimbursement.

The run up to and implementation of the Health & Social Care Act 2012 did slow the procurement of primary care assets in England but, more recently, NHS England and NHS Property Services have issued new operating guidelines that will speed up the approval process. Nevertheless, there is significant and growing pressure upon the primary care sector for modern fit-for-purpose premises to meet the political and patient objectives of the Act. GPs, who see over 1m patients per day, will remain the gatekeepers for the UK's health care services but according to the Care Quality Commission, which is responsible for regulating GP premises, about 20% of those premises fail registration.

PRESSURE ON PRIMARY CARE ESTATE

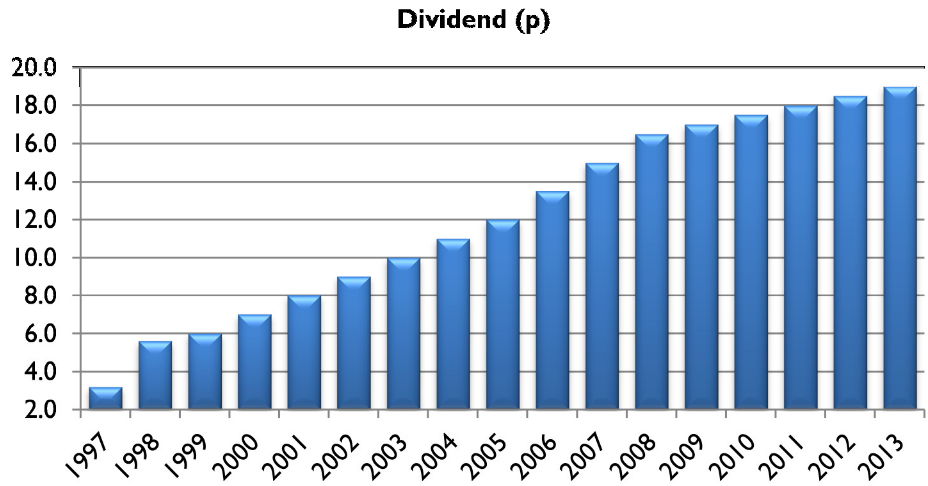


Source: Overview of the UK Primary Care Property Sector, GVA Grimley, October 2010

Dividend

The company is committed to maintaining a progressive dividend policy while fully restoring cover to 100%. In the case of the former, PHP has increased the full year distribution by 2.7% to 19.0p through payment of a second interim payment of 9.5p. This marks the 17th successive annual increase.

GRAPHIC: DIVIDEND GROWTH



Source: Company

Significantly, as can be seen from the following table, these interim results indicate that the company is also delivering on its key investor objective of restoring dividend cover to 100%. Based on our estimates, dividend cover will continue to improve, although it may not be fully restored until 2016.

TABLE: DIVIDEND COVER

Six months ended	Dividend Cover	Key Events
30 June 2013	52%	Impact of Apollo acquisition, equity raise to fund pipeline
31 December 2012	45%	First period at higher margins on debt, Retail bond issued
30 June 2012	68%	Core debt refinance completed in April 2012

Source: Company

Forecasts

PHP, following its over-subscribed equity issue in early June, closed the first half trading period ended 30 June 2013 with a robust balance sheet (52.8% LTV) and increased debt facilities from new providers. Since then the company has begun actively deploying that capital into assets that are returning net initial yields within the range of 5.7% - 6%, despite competitive market conditions.

So far, PHP has successfully deployed £45.6m and has a strong and growing pipeline with some £55m of asset acquisitions in the hands of solicitors. We believe that PHP has the financial capacity to support at least £100m p.a. of new asset acquisitions through to the end of 2015 when it should be within striking distance of its strategic target of £1bn of assets under management.

It is distinctly likely that the demand from GPs and other primary care providers for larger modern premises will increase now that the temporary dislocation created by the implementation of the Health & Social Act 2012 is fading into the past. If this proves to be the case then PHP may be investing at an annual rate of £120m - £130m during 2014 and beyond but our projections remain more prudent than this.

Finally, the company is currently securing uplifts on its annual round of rental reviews at an average of 2.3%, which is better than the rates applied in our financial model and has resulted in a modest increase to our 2013 – 2015 estimates.

Valuation

Most REITs are cyclical because of the assets that they manage (e.g., retail, industrial, etc.) but they do provide an early indication of changes in cyclical activity within an economy. However, some of the niche REIT markets are relatively non-cyclical. In the case of the UK Healthcare REIT sector this is because of:

- Availability of long leases from a high credit rated Government agency (the notable exception within the quoted UK Healthcare peer group would be Target Healthcare, which is an asset manager of privately operated nursing homes);
- Growing demand for modern, fit for purpose primary care assets due to
  - An historic under investment in primary healthcare assets;
  - NHS reforms driving patients away from costly secondary care back into primary care; and
  - An ageing population;
- Resulting in consistent and sustainably higher investment returns, irrespective of the timeframe examined.

A primary investment driver for a REIT is yield, usually a combination of the sustainable rate of growth and actual yield at investment. UK Healthcare REITs offer investors consistently better yields; the weighted average yield for the quoted UK Healthcare REITs is 5.57% compared with 3.68% for the entire sector (source: www.ft.com, FTSE Actuaries Share Indices, 22 August 2013).

Table: UK Healthcare stocks

Company	Bloomberg	Price, p	Est. PE *(12/2013)*	Price/Book	Price/Rental Income	Gross Yield
Assura Group	AGR:LN	35.0	18.42x[1]	0.93x	5.00x	3.46%
Medicx Fund	MXF:LN	78.5	19.94x	1.35x	6.98x	7.29%
Primary Health Properties	PHP:LN	341.0	31.28x	1.28x	7.15x	6.18%
Target Healthcare REIT	THRL:LN	105.0	N/A	N/A	N/A	2.12%
Weighted Average			**23.07x**	**1.13x**	**6.11x**	**5.57%**

Sources: Bloomberg (prices as at 23 August 2013) – consensus forecasts; Barclays Stockbrokers (Medicx underlying data)
Notes: [1]Est. PE to 03/14 (Bloomberg)

When looking at PHP in the context of its quoted UK Healthcare peer group, its yield is markedly more attractive. Moreover, it has consistently grown its dividend – 2013 marks its 17th year of dividend growth – but its dividend has been increased at a faster rate than its peer group. Finally, we do not anticipate any policy change as the company drives towards restoration of full cover within the next few years.

Business: One of the UK's leading dedicated healthcare Real Estate Investment Trusts ('REIT') specifically investing in and managing primary healthcare assets.

Income Statement, £000

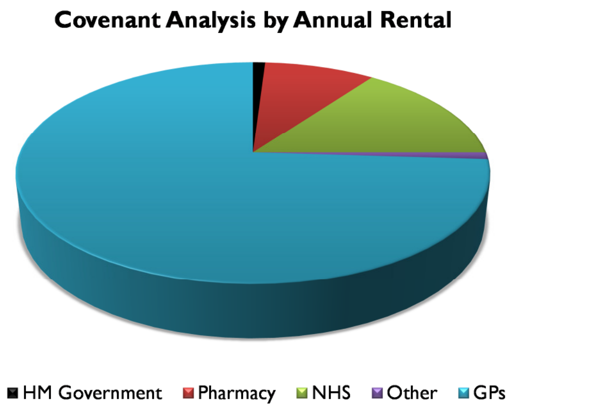
Y/e 31 December	2009A	2010A	2011A	2012A
Rental income	**21,332**	**26,915**	**30,676**	**33,151**
Direct property expenses	(210)	(398)	(436)	(402)
Admin. expenses	(3,088)	(4,646)	(5,123)	(5,124)
Operating profit (clean)	**18,034**	**21,871**	**25,117**	**27,625**
Asset sale profit	0	0	312	0
Net property revaluation	1,615	22,790	10,584	(1,768)
Adj. Operating Profit	**19,649**	**44,661**	**36,013**	**25,857**
Net finance expenses	(10,181)	(12,722)	(15,417)	(20,242)
Provisions	0	0	0	(1,564)
Fair value & amortisation	1,318	(4,714)	(7,947)	(2,922)
Pre-tax (reported)	**10,786**	**27,225**	**12,649**	**1,129**
Eps (reported) p	26.6	41.3	19.0	1.6
Eps (underlying) p	18.4	14.7	14.5	10.2
Dividend p	17.0	17.5	18.0	18.5
Cover (underlying) x	1.1	0.8	0.8	0.5

Cash Flow Statement, £000

Y/e 31 December	2009A	2010A	2011A	2012A
Operating activities	19,649	44,661	36,013	25,857
Change in w/cap	(508)	3,057	949	7,807
Revalue movement inv. props.	(1,615)	(22,790)	(10,584)	1,768
Other	(1,575)	(1,934)	(2,310)	0
Operating Activities	**15,951**	**22,994**	**24,068**	**35,432**
Taxation	0	(193)	(43)	0
Net financing	(3,392)	(3,199)	(5,415)	(10,471)
Other income(expense)	(6,495)	(8,503)	(13,331)	(9,868)
Free Cash Flow	**6,064**	**11,099**	**5,279**	**15,093**
Investment properties	(23,413)	(25,234)	(45,712)	(42,221)
Net (acquisitions)/disposals	0	(45,673)	788	(3,298)
Dividends paid	(5,562)	(9,810)	(11,199)	(12,209)
Shares issued	60,748	0	15,605	18,399
Net changes in borrowings	(38,300)	69,776	34,946	49,255
Movement in Cash & Equivalents	**(463)**	**158**	**(293)**	**25,019**
Net (Cash)/Debt	**165,878**	**267,027**	**301,232**	**376,477**

Balance Sheet, £000

as at 31 December	2009A	2010A	2011A	2012A
Investment properties	341,890	469,290	525,586	622,447
Net inv. Infinance leases	3,014	3,036	3,069	3,100
Derivative int. rate swaps	1,386	413	24	0
Fixed Assets	**346,290**	**472,739**	**528,679**	**625,547**
Trade Debtors	442	775	793	689
Other Debtors	1,560	1,807	1,840	2,227
Net inv. Infinance leases	49	48	30	21
Cash & cash equivalents	212	925	77	25,096
Current Assets	**2,263**	**3,555**	**2,740**	**28,033**
Term loans & overdrafts	0	3,557	592	79,934
Derivative int. rate swaps	12,208	16,859	23,866	7,523
Bk. loan & bond int. accrual	0	937	1,555	3,313
Trade Creditors	1,468	1,288	1,286	951
Other payables	2,007	4,658	2,990	6,423
Def'd rental income	4,638	5,942	6,624	7,811
Provs. for liabs. & charges	0	0	0	1,564
Current Liabilities	**20,321**	**33,241**	**36,913**	**107,519**
Retail bond	0	0	0	73,755
Term loans & overdrafts	166,139	263,888	300,747	247,905
Derv. Int. rate swaps	9,322	14,419	25,639	45,311
Other creditors	856	0	0	0
Non-Current Liabilities	**176,317**	**278,307**	**326,386**	**366,971**
Net Assets	**151,915**	**164,746**	**168,120**	**179,090**
NAV (basic) p	247.2	262.3	246.2	235.5
NAV (EPRA) p	279.9	311.5	318.7	305.0
Leverage:				
Net Shareholder %	109.2	162.1	179.2	210.2
Net Cap. Employed %	50.5	59.8	60.8	60.1
Interest Cover x	1.76	1.73	1.61	1.36



Major Shareholders

Investec Wealth & Investment	6.0%
Blackrock Inc.	4.1%
Nexus Group	4.1%
Brooks Macdonald	3.9%
Troy Asset Management	3.8%
Brewin Dolphin	3.6%
Legal & General	2.8%