Primary Health Properties

Interim results to end-June 2012

Edison investment research

Portfolio growth to pick up in H2

Real estate

The interim results included 6% growth in rental income y-o-y, on the back of rent reviews that averaged 2.7% pa and acquisitions, but lower profit and EPS due to higher finance charges on new debt. The first seven months of 2012 have seen £175m of debt refinance, an £18m equity issue and a £75m retail bond issue in July. That puts c £130m of headroom in place to be used to fund acquisitions, with income surpluses increasing dividend cover. Our assumptions – c £60m pa of acquisitions this year, £50m pa in FY13 and 2.5% pa at rent reviews – push cover up to 74% in FY13 vs 67% this year. The group sees potential to scale up faster and close the gap in FY14. The pipeline of new assets – £49m currently in solicitors' hands – on top of £16m so far this year, could see it beat our growth target. Acquisitions should be EPS accretive, as net initial yields being achieved are generally between 5.75% and 6.25% pa, ahead of incremental debt costs.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	EPRA NAV (p)
12/10	26.9	9.1	14.7	17.5	5.0	311
12/11	30.7	9.7	14.6	18.0	5.2	319
12/12e	34.2	9.0	12.5	18.5	5.3	318
12/13e	38.1	10.4	13.9	19.0	5.5	319

Note: *PBT and EPS are normalised, excluding intangible amortisation and exceptional items.

Interim results: Lower profit reflects debt margin increase

Rents were higher, in line with increased portfolio scale and reviews, but underlying interim profit fell to £4.4m (H111: £5.4m) due to higher average debt costs resulting from increased margins after recent debt refinancing. We estimate the average cost of debt at 5.1% pa currently (FY11: 5.02%) if all facilities were fully drawn, including the new £75m retail bond, although incremental debt is available at LIBOR plus 2.5%, currently below 4% pa all-inclusive. We have adjusted forecasts for this and 'cash-drag' as new funds await deployment. There is c £157m of undrawn debt and cash – £130m headroom for acquisitions net of a £27m loan maturity, with c £10m commitments to fund and £49m of assets in solicitors' hands.

NHS reforms expected to drive demand for new assets

Recent NHS reforms seek to increase patient choice and shift budget responsibility towards GPs. The process is expected to move more patient services into local communities and devolve non-critical care and diagnostic activities from general hospitals, both of which will need an upgrade to existing primary care facilities. That should increase demand for the kind of modern, specialist premises funded by PHP.

Valuation: 5.3% dividend yield, 378p mid-year DCF

We see the yield as the key to the valuation, even though the dividend is uncovered. We anticipate another 0.5p pa dividend increase in FY13e, so prospective yields of 5.3% at the current share price this year, 5.5% next. Any shortfall will be met from cash/debt (reducing NAV/share) until cover is restored. Mid-year EPRA NAV/share was 314.9p (FY12: 318.7p), the manager's DCF of future cash flows 378p/share.

18 September 2012

Price	347p
Market cap	£259m

Shares in issue	74.6m
Free float	94%
Code	PHP
Primary exchange	LSE
Other exchanges	N/A

Share price performance

%	1m	3m	12m
Abs	2.0	8.4	10.3
Rel (local)	0.8	0.0	(0.3)
52-week high/low		349p	302p

Business description

Primary Health Properties invests in primary healthcare property in the UK, principally let to GPs, PCTs and other NHS entities backed by the UK government. That tenant profile provides an exceptionally secure rental outlook.

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Primary Health Properties is a research client of Edison Investment Research Limited

Investment summary: Healthcare property UK REIT

Company description: UK government-backed long-term rents

PHP is a UK REIT. It generates revenues from long-term leases on a portfolio let predominantly to UK government-backed tenants, which provides a secure, visible revenue stream. It owns 165 freehold or long-leasehold interests in purpose-built UK primary healthcare facilities, including commitments. The majority are leased to GPs, other NHS-backed organisations or healthcare users such as pharmacies, on leases with a weighted average unexpired term of 16 years at end-H1. PHP seeks to grow by open-market acquisitions of existing fully-let assets, or financing development of new pre-let facilities.

Valuation: 5.3% FY12 dividend yield and growing cover

We believe the shares are driven by the prospective yield even though the dividend is uncovered, as the UK REIT structure encourages distribution of a growing revenue stream. Dividend cover has fallen below 100% over the last couple of years and we estimate 67% cover this year, 74% by end-FY13, mainly due to the increased cost of new/refinanced debt and slower than anticipated investment of cash to date in a less active development market. This is reflected in reductions to forecasts in the table below. However, we still expect 0.5p pa dividend growth in FY13, with the earnings shortfall to be covered from cash or undrawn debt, resulting in equivalent falls in NAV until cover is restored.

Exhibit 1: Changes to forecasts

	Revenue (£m)		%	PBT (£m)		%	EPS (p)		%
	Old	New	Change	Old	New	Change	Old	New	Change
12/11	30.7	N/A	N/A	9.7	N/A	N/A	14.6	N/A	N/A
12/12e	34.7	34.2	-1	9.8	9.0	-8	13.9	12.5	-10
12/13e	38.1	38.1	N/A	10.8	10.4	-4	14.5	13.9	-4

Source: Edison Investment Research

Management believes it can grow cover sooner if it achieves faster portfolio growth than we project – £60m pa acquisitions this year, £50m in FY13 – and 2.5% pa rent review uplifts. The £49m of deals in solicitors' hands and reported pipeline under negotiation at the mid-year suggest there may well be potential for PHP to exceed our assumed growth rate.

Sensitivities: Passing Health and Social Care Act reduces uncertainty

Medium-term growth will hinge on continued access to debt and equity on acceptable terms and open market acquisitions. After recent fundraisings, there is c £130m of headroom for asset purchases net of the £27m AIB facility due to mature next January. That covers our £110m acquisition forecast to end-FY13 (which includes £10m of commitments at the half year), without recourse to new equity issues or debt facilities. Management confirmed that it continues to see a strong pipeline of acquisition opportunities at EPS-accretive terms. Net initial yields are generally between 5.75 and 6.25% pa for existing and forward-funded investments, above its all-in debt finance costs despite recent increases in average loan margins. The supply of opportunities to forward fund developments of new assets is expected to pick up gradually on the back of the Health and Social Care Act, which became statute in March 2012. It may not fully regain momentum until H213 as the Primary Care Trusts, which currently commission new properties in England, will be abolished in April 2013 and replaced by largely GP-managed, localised clinical commissioning groups (CCG). They are expected to push harder to move healthcare services into local communities and require new primary care facilities.

Interim results to end-June 2012

The first half saw a 5% increase in rental income vs H211, due to both acquisitions and rent reviews completed during the period. In H112, PHP achieved average annual increases of 2.7% on reviews over £3.07m of its rent roll, ahead of the 2.5% pa built into our forecasts. Rental growth has averaged 3% pa over the past three years and historically, group rental increases have broadly tracked inflation. Management confirms that rental growth is still being achieved at review, although the lower rate reflects wider market conditions, with the agreement process being disrupted by the phased abolition of PCTs. Around 12% of portfolio rent is directly linked to the Retail Prices Index (RPI).

Underlying operating profit fell vs the previous period. Net finance costs have increased over the last few periods, due both to increased debt-to-fund acquisitions, but more materially in H112 from an EPS perspective, resulting from higher margins on new and refinanced facilities. H112 finance cost also included a £0.4m expense for arrangement fees for bank debt refinanced in the period.

Exhibit 2: Summary financial performance

	H1 2010	H2 2010	% chg	H1 2011	% chg	H2 2011	% chg	H1 2012	% chg
Rents and related income	12.0	14.9	+24	15.2	+2	15.5	+2	16.2	+5
Expenses	(2.2)	(2.8)	+27	(2.6)	-7	(3.0)	+15	(2.8)	-7
Underlying operating profit	**9.8**	**12.1**	**+23**	**12.6**	**+4**	**12.5**	**-1**	**13.4**	**+7**
Net finance costs	(5.8)	(7.0)		(7.2)		(8.2)		(9.0)	
Underlying pre-tax profit	**4.0**	**5.1**	**+28**	**5.4**	**+6**	**4.3**	**-20**	**4.4**	**+2**
Underlying pre-tax margin	33%	34%		36%		28%		27%	
Profit on sale of AHMP shares	0.0	0.0		0.3		0.0		0.0	
Change in fair value of derivatives	(5.0)	0.3		1.0		(9.0)		(0.8)	
Revaluation of property portfolio	17.8	5.0		5.2		5.4		0.6	
Profit before tax	**16.8**	**10.4**		**11.6**		**0.7**		**4.2**	
Dividend cost (net of scrip)	(5.4)	(5.4)		(5.4)		(5.4)		(6.0)	
Scrip dividend value				(0.3)		(0.3)		(0.3)	
Dividends paid per share	**8.75p**	**8.75p**		**9.00p**		**9.00p**		**9.25p**	

Source: Primary Health Properties interim statement. Note: Percentage changes refer to consecutive half years.

Conversely, underlying operating profit benefited from a fall in expenses relative to H211 and should progressively benefit from an external management fee structure under which percentage rates reduce as the portfolio value increases. The fees paid to the joint managers in H112 were 0.77% of gross assets, in line with last year, but this should decline in percentage terms in future periods as a lower incremental fee is applicable in respect of gross assets above £500m, under the new management agreement from February 2011. The amended fee structure is calculated as a percentage of PHP's gross asset value, as follows:

Exhibit 3: Amended fee structure

Gross assets	Total fee
First £50m	1.00%
Between £50m and £500m	0.75%
Between £500m and £750m	0.525%
Above £750m	0.4375%

Source: Primary Health Properties

In line with the above, administrative expenses have fallen slightly y-o-y as the portfolio has grown, to 16% at end-H112 (H111: 16.1%). There is no performance-incentive fee payable to the joint managers for the first half (H111 and FY11: nil). Under the terms of the management agreement, a £58.4m deficit must be made up in Triple Net NAV before any further performance-incentive fee will be payable.

Growth potential underpinned by £130m of headroom

Recent debt and equity issues underpin acquisitions in H2 and FY13. In total, £300m of facilities have been secured since July 2011. Group loan-to-value including commitments is c 57%; we expect it to increase in H2 as acquisitions in solicitors' hands complete. PHP also concluded a £18.4m equity issue in May and July, post the period end, a £75m 5.375% pa retail bond issue that matures in 2019. We estimate that the group has the following funds available for portfolio investment.

Exhibit 4: Investment headroom – funds available and current commitments (£m)

Undrawn bank facilities at end-H112	82.9
Retail bond	73.7
Cash at end-H112	1.0
Current funds available	**157.6**
Repayment of AIB facility	(27.0)
Commitments (including Luton acquisition, post half year end)	(10.2)
Acquisitions agreed, in solicitors hands	(49.0)
Available to fund investment pipeline	**71.4**

Source: Edison Investment Research

The renewal of short-term banking facilities extended the weighted average maturity of group debt to 5.4 years. Average margins on aggregate bank debt post recent refinancing has increased from 0.8% to 2.3% over Libor in line with terms available for UK commercial property generally, although group assets and long-term, UK government-backed rents remain highly acceptable security for lenders.

The additional funding cost explains lower underlying interim pre-tax profit (excluding property revaluations and changes in the mark-to-market value of derivatives), margins and EPS and recent falls in dividend cover. Additionally, the £75m retail bond issue will temporarily exacerbate the issue as the funds are fully drawn – and the 5.375% pa coupon payable from July – but not yet deployed.

Portfolio: Assets outperforming other UK commercial property

PHP acquired four properties during the first half for £11.5m. At the mid year, its portfolio (164 assets) was independently valued by Lambert Smith Hampton at £545.2m including commitments, a small revaluation surplus of £0.63m vs H111. In the valuer's opinion, investment yields were stable during the period at a 5.74% initial yield, in line with the previous six months and an actual 7.1% yield on cost. The equivalent yield on the portfolio is 6.1%, including full reversion to market rents.

The nature of the tenant profile provides highly predictable, stable cash flows and asset valuations. Relative to the IPD Healthcare Property Index (published annually in May) for 2012, PHP's assets outperformed in 2011, with a total return (rent and capital growth) of 10.1% vs 9.4% for the primary care element of the index. For the 12 months to 30 June 2012, the group's portfolio showed an annualised 7.19% total return vs 4.4% for the IPD All Property Index, which represents the aggregate performance of all UK commercial property. The average lease has another 16 years to run and 90% of the rent rolls is paid directly or funded by the UK government. The portfolio is 99.4% let, with rents predominantly paid quarterly in advance by GPs (or directly by PCTs) and pharmacy tenants.

Strategy: Acquisitions and forward-funded developments

The two main strands to the group's growth strategy are to:

1. Grow the portfolio via acquisitions of new medical centres. These will be either open market purchases of existing, let assets or agreements to finance and purchase pre-let new centre developments.

PHP does not carry out development of new centres, but sources opportunities and provides finance to specialist third-party primary care developers to create new investments. It will not commit funding or acquire properties unless the development has approved planning consent and an agreement for lease with the GP tenants, with district valuer confirmation for the rent to be reimbursed to GP surgeries.

2. Proactively manage the existing portfolio to add value.

This will include lease renewals, rent reviews, expansion/modification of existing premises and lease improvements such as negotiating extended maturity dates, which improve revenue visibility and are likely to be reflected in improved external valuations, particularly for assets with shorter lease lengths.

Asset management projects were completed at three sites in H1. Capital expenditure was £0.5m and c £0.03m was added to the rent roll, adding an average additional lease period of over 14 years. PHP has approved nine further projects at various stages in the development process, with an expected cost at pre-agreed returns on capital of £5m. Around 60% of group assets currently contain co-located pharmacies, providing scope for additions here too.

Accelerated rate of acquisitions expected in second half

Since the half year, PHP has contracted to buy an existing fully-let investment in Luton for £3.9m. Terms have also been agreed for another £49m of medical centre assets that are in solicitors' hands, the majority of which it expects to contract before the end of FY12. A 'significant pipeline' of other acquisition opportunities is in various stages of negotiation. Including recent acquisitions, PHP now owns 165 primary healthcare assets, 160 complete and five forward-purchase commitments, with a total value of c £552.5m. The contracted annualised rent roll is £33.2m including commitments – relative to £16.2m in H1. The weighted average unexpired lease term is 16 years (FY11: 16.3 years).

The group has sought to acquire larger assets over the last few years and increasing the average property size over a financial year is a core component of its investment strategy. Larger assets are more likely to be major 'hubs' for primary care services, with multiple GP practices the ability to provide a wider range of ancillary services in-house. As the latter is a core component of recent NHS reform, these are seen as better placed for revenue and capital value growth and a source of ongoing asset management opportunity. PHP's asset management strategy includes plans to dispose of smaller assets seen as sub-scale and increase the average property size as it grows its portfolio.

Exhibit 5: Current portfolio weighting (including acquisitions post half year end)

Capital value	No. of assets	Value (£m)	% of portfolio
>£9m	4	46.51	8
£3m - £9m	73	325.16	59
£1m - £3m	83	176.87	32
0 - £1m	5	3.91	1
	165	**552.45**	**100**

Source: Primary Health Properties interim results

Primary care property: Attractive, non-cyclical niche market

PHP invests exclusively in the UK primary healthcare property market, a niche and non-cyclical segment of UK commercial property. Despite the current challenges facing wider UK commercial property, the specialist nature of PHP's sector derives some insulation from continued demographic and political drivers behind the provision of primary care. We therefore expect it to continue to generate suitable investment opportunities.

According to Investment Property Databank (IPD) data, primary care property (a constituent of the IPD Healthcare Index) achieved an annual return of 6.3% for the five years to December 2011. That compares with a negative 0.7% pa return for the IPD All Properties Index. IPD's 'peak to trough' falls for property values in the three years to end-FY11 were 34.5% for general UK commercial property, 15.8% for UK residential and 4.4% for healthcare.

Despite the above, primary care assets are still available for acquisition at net initial yields above PHP's underlying funding costs. Average sector investment yields are c 5.75%, an attractive, highly-stable return relative to other sources of long-term UK government revenues and historically low interest rates. Acquisitions should provide an immediate boost to both cash flow and EPS.

PHP's ability to access new investments is supported by its long-term trading relationships with developers. Although NHS reform resulted in delays to commissions for new facilities, demand for modern, well-specified medical centres is expected to be driven by a government-led shift from secondary care (hospitals) towards primary and community care.

Health and Social Care Act 2012

The new NHS reforms received Royal Assent on 27 March 2012, removing some of the uncertainty over its future structure. The passage of the Act reduced the number of approvals of new primary care developments over the previous 18 months. With the replacement of Primary Care Trusts due in April 2013, there is potential for the pipeline to return to more normal levels by FY14.

The new Act transferred budgetary and commissioning responsibilities to GPs and local clinicians. The plan is to establish clinical commissioning groups (CCGs), which PHP expects over time will result in an increased number of opportunities to fund and acquire new medical centre properties, as GPs seek ways to provide more care facilities in their local communities efficiently.

Within UK healthcare, the traditional NHS model has revolved around GPs as the gatekeepers to specialist services located in large centralised hospitals. However, technological developments are increasingly reducing the size and complexity of the equipment required to diagnose and treat patients and this is enabling GPs to perform more procedures and diagnostics in primary care facilities in the community, rather than from major, centralised secondary care facilities such as hospitals.

The intention of the latest reform is to improve patient access and choice, reduce costs and increase efficiency. That should create stable demand for modern, specialised facilities from which primary care and ancillary services can be delivered efficiently.

PHP estimated that it had a 2% market share of all UK primary care properties at end-May 2012, with c 1.65m patients registered within its portfolio of medical centres. It has a strategy to progressively increase that share over the next few years and expects GPs to continue to lease their properties, as this is a flexible structure and relatively easy to assign between partners.

Finances: Long-term, UK government-backed revenues

Approximately 74% of PHP's revenue is derived from assets leased to GPs, whose rent and premises costs are reimbursed by the NHS. Another c 16% is received from PCTs, health boards and other NHS bodies. The remainder is predominantly from pharmacies within medical centres. The portfolio was 99.4% let at the mid year.

The rental profile is thus exceptionally secure, with strong underlying tenant covenants, as the UK government effectively funds c 90% of the current rent roll via the NHS. The rest is mainly derived from pharmacies adjacent to or within primary care facilities and excellent covenants due to the underlying stability of operations co-located within a primary care facility. PHP has not experienced a medical tenant default since its incorporation in 1995.

Approximately 95% of the rent roll is reviewed every three years. At the end of June, 13.7% of the rent roll had fixed rental uplifts or was formally linked to the RPI, with the rest reviewed to open market rents. The latter are negotiated between the group and the district valuer, who acts for the GPs or other NHS-related tenants. These rent reviews are based primarily on precedents from other medical centres and build-cost inflation, rather than reference to comparable evidence from non-medical commercial property in the vicinity. Arguably, that provides an advantage in the current UK property market, where at best there is generally a flat outlook for commercial rents in a poor economic backdrop.

A further distinction is provided by the portfolio's 16-year weighted average unexpired lease term. The majority of the group's occupational leases are effectively subject to upward-only rent review clauses, which insulates revenues from any wider UK economic downturn. Competitive pressures are also very limited, as speculative development of primary care assets is rare, which limits potential for vacant space and any reduction in rental or property values.

Balance sheet: £175m of debt refinance extends average maturities

The group has successfully secured or refinanced £300m of banking facilities since July 2011. It refinanced debt provided by RBS and Santander in April 2012 via a new £175m club facility provided by RBS/Santander. This has a four-year term and is split into a £125m term loan and a £50m revolving debt facility. The main covenants for this facility are a 65% maximum aggregate loan to value and 1.4x minimum interest cover.

Exhibit 6: Debt facilities at end-June 2012

Provider	Maturity	Facility (£m)	Drawn (£m)	Headroom (£m)
Royal Bank of Scotland	March 2013	5.0	0.0	5.0
Allied Irish Banks	January 2013	27.0	27.0	0.0
Clydesdale Bank	July 2014	50.0	21.4	28.6
RBS/Santander	March 2016	175.0	150.7	24.3
Aviva	November 2018	75.0	75.0	0.0
Aviva	December 2020	25.0	0.0	25.0
Aviva	January 2032	27.2	27.2	0.0
Total		384.2	300.0	82.9

Source: Primary Health Properties interim results presentation

PHP achieved the recent debt refinancing without any requirement to break or reduce its outstanding derivatives portfolio, so avoiding any breakage cost that may have resulted if it had to terminate these swap contracts early. PHP had a £173m portfolio of interest rate swaps in place at end-H112 with

expiry dates out to 2026, similar to end-FY11. These effectively convert floating-rate debt into fixed-rate and as interest rates have fallen, accounting convention requires that a liability is recognised in the balance sheet to represent the potential cost of terminating these agreements at that balance sheet date. This paper-only valuation was £49.3 m (FY11: £49.5m) at the mid-year, £42.2m of long-term and £7.1m short-term liabilities. Some of this movement is reflected in the P&L, but has no cash impact unless the swaps are terminated ahead of contracted maturity.

£27m AIB facility to be repaid by January 2013

The group's existing bilateral loan with AIB was restructured into a separate security pool when the new club facility was finalised. PHP repaid £3m of this facility, reducing the balance to £27m. Other terms and conditions are unchanged and the maturity remains January 2013. It is clear that AIB will not refinance this facility, but PHP has capacity to repay it now from cash and undrawn facilities, or let it run to expiry.

As a result of refinanced debt and new facilities secured in FY11, the weighted average maturity of group debt increased by over three years to 5.6 years. The average margin on debt facilities is now 2.3% vs 0.8% previously, which reflects higher market rates for commercial property loans.

Placing raised £19m in May 2012

Following completion of the debt refinance in April, PHP raised £19m (c £18.4m net of commissions and expenses) via a placing of 6.23m new shares at 305p at a 6.2% discount to the previous closing mid-market price. This provides equity to capitalise on a reported steady pipeline of property acquisition opportunities.

The group is in discussions with banks to secure additional debt to finance medium-term growth, although equity is in place to maintain the overall level of borrowings within internal gearing limits for the forecast period.

5.375% retail bond, launched in July 2012, raised £75m

The group launched a £75m retail bond (aimed directly at retail, rather than institutional investors) in July. This yielded 5.375% pa at launch and matures in July 2019. The bond is tradable on the open market by retail investors via stockbrokers or wealth managers.

The initial minimum subscription was £2,000, with multiples of £100 thereafter and the bonds pay a fixed rate of interest semi-annually, in January and July. It is unsecured with no associated covenants, which gives PHP flexibility over the use of the proceeds.

The funds have immediately been used to pay down the revolving portion of group banking facilities and are available to be redrawn when required. Proceeds will be invested at the earliest opportunity, with part of these funds to be applied to recent acquisitions and others due to complete shortly.

The issue was a first retail bond issue by a UK REIT. It was interesting enough to fixed income investors that the group reached its £75m target and closed the offer period a week earlier than planned.

Sensitivities: Growth pivots on access to new assets and debt

We believe the main issue for investors hinges on how quickly the group will be able to grow earnings to restore dividend cover and potentially accelerate dividend distributions. Our projections assume cover will be 74% by end-FY13. PHP believes it can achieve it within three years via faster acquisitions, particularly in FY14.

£130m of headroom supports acquisitions over next two years

With finance in place, we have assumed that PHP will secure c £60m pa of additions to the portfolio this year, £50m next and achieve average 2.5% rent review increases. Recent fundraisings and debt refinancing provide c £130m of headroom for acquisitions and other capex; £84m undrawn debt; and the £75m retail bond, net of the £27m AIB debt due for repayment in January 2013. Management is in discussions with alternative sources of funding for the latter facility and future funding for expansion.

Although the first half saw £11.5m of acquisitions and £3.9m post the year end, the mid-year pipeline, with £49m of assets in solicitors' hands and others under negotiation, suggests that our target is readily achievable. Uplifts at review were 2.7% in H1 and 3% on average for the last three years.

New clinical commissioning groups to drive demand for new facilities

Availability of assets in the open market is difficult to ascertain, but the outlook for supply does appear to be improving. Uncertainty over NHS reform disrupted the market over the last few years and new commissions fell. However, the Health and Social Care Act entered into statute in March 2012 and its planned replacement of primary care trusts with CCGs from April 2013 is a possible catalyst for a pick-up in demand for new facilities that may drive market activity from 2014.

The Act transfers the commissioning of care to more localised CCGs, which supports plans to deliver increased healthcare services within local communities. If that is to be done efficiently, additional primary care facilities will be required. PHP is in a strong financial position to support this.

Quality of NHS tenant covenant remains as strong post reform

Details of the new legislation, particularly in relation to the establishment of an NHS property company and management of its primary care estate, have provided reassurance over ongoing stability and tenant quality. During the first six months of 2012, the NHS property company was also formed and will take over the NHS's primary care estate after PCTs are abolished.

In addition, management has ascertained that following the abolition of PCTs in April 2013 and their replacement by CCGs, with the latter expected to mainly be managed by GPs, there will be no change in the arrangements for reimbursement of GP rent and property costs.

This will become the responsibility of the newly-formed National Commissioning Board, a special health authority that provides continued strong backing for PHP's rental income.

Valuation: Steady dividend growth as cover is rebuilt

We believe that the dividend yield drives the shares, which makes restoration of full cover a strategic priority to prevent NAV/share dilution and provide potential for accelerated growth in distributions.

PHP has announced an intention to pay another 9.25p dividend in H2 – a 5.3% prospective FY12 yield – and we anticipate a further 0.5p/share increase in FY13 to 19p/share. Distributions in this period will not be fully covered, with the balance funded from retained earnings and cash/undrawn facilities that will have a direct, equivalent negative impact on NAV per share until EPS-accretive portfolio and rental growth restore cover.

The latter depends on a range of assumptions which include: (a) the rate of portfolio acquisitions; (b) annual rental growth at reviews; (c) margins on new debt facilities; (d) net initial yields available on asset acquisitions; (e) size and terms of any future equity issues; and (f) scrip dividend take-up rates. For the purposes of our forecasts, we have assumed that PHP will add £60m of net assets to its portfolio this year, £50m in FY13 and achieve 2.5% pa from rent reviews. We have not incorporated any new equity issues before FY14 and the other variables are in line with H112. On that basis, we calculate that dividend cover (full dividend cost, ignoring scrip take-up) will be 67% this year and 74% in FY13e, building incrementally thereafter.

There is potential for a faster rate of portfolio growth to bring this forward, but PHP will acquire only on terms that fit its criteria. We believe our forecasts are achievable and finance is already in place. However, the group has secured c £15.4m of additions so far this year, has another £49m in solicitors' hands and others in the pipeline, so it could beat our £60m forecast for the full year. Subject to progress on this, we will revise our forecasts over the course of H2.

NAV backing provided by DCF appraisal

The table below sets out recent portfolio growth and our NAV forecasts. We have assumed modest uplifts in portfolio valuations, fully underpinned by the 2.5% pa rental growth assumption.

Exhibit 7: Portfolio and NAV forecasts

	FY 2009	FY 2010	FY 2011	H1 2012	FY 2012e	FY 2013e
Investment portfolio incl. finance leases	£346.3m	£472.3m	£528.7m	£542.2m	£601.8m	£666.8m
Debt	£166.1m	£268.3m	£303.0m	£296.6m	£352.0m	£417.0m
Aggregate loan to value	48%	57%	57%	55%	58%	63%
Net assets per Group Balance Sheet	£151.9m	£164.7m	£168.1m	£188.0m	£187.8m	£189.7m
EPRA NAV	£172.0m	£195.6m	£217.3m	£216.6m	£230.4m	£249.7m
Shares in issue at period end	61.5m	62.8m	68.2m	74.6m	74.7m	75.0m
Basic net asset value per Share	247.2p	262.3p	246.3p	248.9p	251.3p	253.1p
EPRA NAV per Share	279.9p	311.5p	318.7p	314.9p	317.5p	319.1p

Source: Primary Health Properties results, Edison Investment Research forecasts

The manager provides a discounted cash flow valuation of the portfolio at the mid-year, appropriate for long-term cash flows from mainly UK-government leases. This produces a value of £595.1m vs £548.6m for the yield-based valuation by the external valuer, equivalent to a 63p/share addition to NAV. This DCF applies a 7% discount to cash flows from the assets, based on a 2.5% margin over an historic long-term gilt yield of 4.5% (currently c 4.7% above the 16-year gilt, equivalent to the portfolio's weighted average unexpired lease term). It assumes 2.5% pa rental growth and 1% pa growth in residual values. Approximately 65% of the DCF is derived from rents, and 35% from residual values.

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Exhibit 8: Financial summary

	£'000s	2008	2009	2010	2011	2012e	2013e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		19,691	21,332	26,915	30,676	34,200	38,055
Cost of Sales		0	0	0	0	0	0
Gross Profit		19,691	21,332	26,915	30,676	34,200	38,055
EBITDA		15,125	18,034	21,871	25,117	28,293	31,766
Operating Profit (before GW and except.)		15,125	18,034	21,871	25,117	28,293	31,766
Intangible Amortisation		0	0	0	0	0	0
Exceptionals		0	0	0	0	0	0
Other		0	0	0	312	0	0
Operating Profit		15,125	18,034	21,871	25,429	28,293	31,766
Net valuation gain on property portfolio		(17,707)	1,615	22,790	10,584	1,500	10,000
Mark to market loss on derivatives		(10,655)	1,318	(4,714)	(7,947)	0	0
Net Interest		(10,502)	(10,181)	(12,722)	(15,417)	(19,296)	(21,345)
Profit Before Tax (norm)		4,623	7,853	9,149	9,700	8,997	10,420
Profit Before Tax (FRS 3)		(23,739)	10,786	27,225	12,337	10,497	20,420
Tax		(160)	0	(1,550)	5	0	0
Profit After Tax (norm)		4,463	7,853	7,599	9,705	8,997	10,420
Profit After Tax (FRS 3)		(23,899)	10,786	25,675	12,342	10,497	20,420
Average Number of Shares Outstanding (m)		33.6	40.6	62.2	66.6	72.3	74.8
EPS - normalised (p)		13.3	18.4	14.7	14.6	12.5	13.9
EPS - FRS 3 (p)		(71.2)	26.6	41.3	18.5	14.5	27.3
Dividend per share (p)		16.5	17.0	17.5	18.0	18.5	19.0
Gross Margin (%)		100.0	100.0	100.0	100.0	100.0	100.0
EBITDA Margin (%)		76.8	84.5	81.3	81.9	82.7	83.5
Operating Margin (before GW and except.) (%)		76.8	84.5	81.3	81.9	82.7	83.5
BALANCE SHEET							
Fixed Assets		320,133	349,786	472,739	528,679	601,826	666,794
Investment properties		316,862	341,890	469,290	525,586	598,726	663,694
Development properties		282	3,496	0	0	0	0
Net inv. in fin leases/ deriv. int. Rate swaps		2,989	4,400	3,449	3,093	3,100	3,100
Current Assets		2,987	2,263	3,555	2,740	23,050	7,050
Other		454	63	555	0	0	0
Debtors		1,808	1,939	2,582	2,633	3,000	4,000
Cash		675	212	370	77	20,000	3,000
Current Liabilities		(23,597)	(20,321)	(33,241)	(36,913)	(50,100)	(26,100)
Creditors		(23,597)	(20,321)	(29,684)	(36,321)	(23,100)	(24,100)
Short term borrowings		0	0	(3,557)	(592)	(27,000)	(2,000)
Long Term Liabilities		(221,237)	(176,317)	(278,307)	(326,386)	(387,000)	(458,000)
Long term borrowings		(204,088)	(166,139)	(263,888)	(300,747)	(345,000)	(418,000)
Other long term liabilities		(17,149)	(10,178)	(14,419)	(25,639)	(42,000)	(40,000)
Net Assets		78,286	155,411	164,746	168,120	187,776	189,744
CASH FLOW							
Operating Cash Flow		15,799	15,951	22,801	24,025	21,794	18,078
Net Interest		(9,883)	(3,346)	(12,722)	(15,417)	(19,296)	(21,345)
Tax		0	0	0	0	0	0
Capex		0	0	0	0	0	0
Acquisitions/disposals		(49,311)	(23,413)	(70,761)	(44,589)	(60,000)	(50,000)
Financing		0	60,748	0	15,605	18,400	0
Dividends		(5,542)	(5,562)	(9,825)	(11,199)	(13,133)	(13,531)
Other (incl. non cash MTM shift in derivative vals)		0	(6,541)	0	(2,880)	1,500	1,800
Net Cash Flow		(48,937)	37,837	(70,507)	(34,455)	(50,735)	(64,999)
Opening net debt/(cash)		155,357	203,413	165,927	267,075	301,262	352,000
HP finance leases initiated		0	0	0	0	0	0
Other		881	(351)	(30,641)	268	(3)	(8)
Closing net debt/(cash)		203,413	165,927	267,075	301,262	352,000	417,007

Source: Company accounts, Edison Investment Research

Edison investment research

Contact details	Revenue by geography
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CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 2009-13e	(6.7)	ROCE 12e	5.6	Gearing 12e	188	Litigation/regulatory	◖
EPS 2011-13e	(2.2)	AvgROCE 2009-13e	5.5	Interest cover 12e	1.5	Pensions	○
EBITDA 2009-13e	15.2	ROE 12e	4.8	CA/CL 12e	0.5	Currency	○
EBITDA 2011-13e	12.5	Gross margin 12e	100	Stock turn 12e	N/A	Stock overhang	○
Sales 2009-13e	15.6	Operating margin 12e	82.7	Debtor days 12e	32.0	Interest rates	◖
Sales 2011-13e	11.4	Gr mgn / Op mgn 12e	1.2	Creditor days 12e	246	Oil/commodity prices	○

Management team

Managing Director: Harry Hyman

A chartered accountant and member of the Association of Corporate Treasurers, Harry Hyman has been PHP's MD since he founded the group in 1994. He was previously with Baltic, involved in property development and structuring mezzanine funding. He is founder and MD of Nexus Structured Group Holdings, of which Nexus PHP Management is a subsidiary. Also a non-executive director of General Medical Clinics and other companies.

Deputy MD: Phil Holland

Before joining Nexus in January 2011, Phil Holland held board positions with both public and private property investment, development and fund management companies. Positions held include FD of Natixis Capital Partners Limited and Atlas Estates Limited. Phil is a qualified chartered accountant (ACA) and holds an honours degree in accounting and finance from Lancaster University.

Chairman: Graeme Elliot

Appointed to the board in February 1996, Graeme Elliot was formerly executive vice chairman of Slough Estates. Previously, he held senior positions at Rio Tinto.

Principal shareholders	(%)
Nexus Group Holdings	5.35
Blackrock	4.07
BT Pension Scheme	2.61
Investec Wealth & Investment	2.49
Aberdeen Asset Management	1.50

Companies named in this report

MedicX; Assura

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