21 March 2012

Price: **315.6p**
Market Cap: **£215.7m**
Yield: **5.7%**

RIC/BLBG: PHP.L / PHP LN

(Current share price timed at 13.00pm 21 March 2012)

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Primary Health Properties *

Asset-backed yield

Final results to 31 December 2011 highlighted solid growth in rental income, recurring profits, DPS and EPRA NAV. Moreover, the company secured £300m of debt in the year, largely removing near-term refinancing risk. Although rising debt costs have temporarily reduced dividend cover to c.77%, we believe that PHP can continue to grow dividends. We believe a return to full cover is possible by 2014 as the rent roll rises, perhaps sooner if the company completes more acquisitions. In our view, PHP offers a high quality, asset-backed dividend, generated from long-term government backed cash flow. With a prospective yield of 5.7%, we believe the shares remain attractive for income seekers.

- **Overview:** PHP listed in 1996 and converted to a REIT in 2007. The company seeks to generate rental income and capital growth from owning a portfolio of purpose-built, fully-let health care premises. Of the total rent roll, 90% comes from GPs and NHS occupiers who have their rents reimbursed by the government. This is a process which has been enshrined in law since 1948, and is a key driver of the investment case in our view. Since inception PHP has delivered annual shareholder returns of 12% including dividends of 178.25p; annual DPS has grown for 15 consecutive years.
- **Asset-backed income:** The portfolio comprises 161 assets with high visibility of cash flow resulting from long leases (average remaining term of 16.3 years) and a strong tenant covenant. The company is contracted to receive minimum lease payments of £526m (excl. rental growth), which we believe firmly underpins the portfolio value of £539.7m (inc commitments).
- **Defensive asset class:** Given the relative security of cash flows and positive rental growth drivers, property values have proven to be less volatile compared with commercial assets. Whilst this limits NAV upside from yield compression in a rising property investment market, the opposite is true in a falling market.
- **Improved financing position:** One year ahead of maturity, PHP has extended the average term of its debt to 5.6 years from 2.5 years, largely removing near term refinancing risk. Importantly, in our view, this was achieved without having to crystallise any significant mark to market losses from the interest rate swap portfolio, which carried an unrealised accounting loss of c.£49m at 31 December. Whilst the overall cost of debt has increased (230bps ave. margin from 70bps), we still anticipate further DPS growth. Our estimates assume that the higher finance costs are absorbed by growth in the rent roll from accretive acquisitions and positive rent reviews (+2.5% rental growth). PHP has c.£70m of firepower to add new stock to the portfolio in 2012. Encouragingly, the yield on new properties is currently 100-150bps higher than the combined finance and management cost.
- **Strong performance**: The attractive yield and defensive asset class have been key drivers of share price and property level outperformance versus the FTSE All-Share Real Estate and IPD All Property Indices over the past 1, 3 and 5 years.

Results Summary

Solid operational performance

In the 12 months to 31 December, PHP delivered a solid operational performance reflecting the strong income characteristics and defensive nature of the property portfolio. Key highlights included:

- 3% rental growth

Growing rent roll

Following successful lease reviews across the portfolio, average rental growth achieved was 3.0%. Combined with acquisitions and commitments this increased the annualised rent roll to £32.3m. The addition of eight properties during the year for £45.7m, added £2.9m of new rents and 18,996 square metres of fully let space. Looking forward, we believe annual growth of 2-3% is sustainable under the lease structure.

- 10% increase in recurring profits

Strong recurring profit growth

Profit increased 10% to £10m. This excludes a £10m increase in property values but includes the expensing of arrangement fees on debt that has been refinanced.

- 15 consecutive years of DPS growth

PHP will pay a dividend of 9.25p on 5 April having gone ex-dividend on 7 March. We expect a similar payment in October 2012 resulting in an annualised DPS of 18.5p reflecting a prospective 5.7% yield.

- 2% increase in EPRA NAV

Moderate EPRA NAV growth

Including commitments, the total portfolio was valued at £539.7m, incorporating a valuation uplift of £10.6m reflecting a positive shift in valuation yields to 5.74% from 5.79%. EPRA NAV increased 2% to 318.7p (311.5p 30 June), in line with our estimates. Basic NAV, which includes an unrealised mark to market impact of the interest rate swap portfolio, was 246.3p (275p as at 30 June).

- £300m of debt secured

Extended average debt maturity

PHP secured £300m of debt including two new facilities and refinancing of £175m of existing loans which were due to mature in 2013. As at 31 December, borrowings totalled £303m. LTV was 57.8%, comfortably below the banking covenants which range between 65% and 70%.

Balance sheet strengthened

Most short-term debt now extended albeit at increased cost

The new lines of credit and refinancing have strengthened the balance sheet and should give investors comfort over the sustainability of dividends in our view. The weighted average maturity of debt has increased to 5.6 years from 2.5 years leaving PHP with a broad mix of lenders and a mixture of maturity dates.

Table 1. Finance Facilities

Provider	Maturity	Facility (£m)	Drawn (£m)	Headroom (£m)
RBS	Jan-13	5	0	5
AIB	Jan-13	30	30	0
Clydesdale	Jul-14	50	14.2	35.8
RBS/Santander	Mar-16	175	156.5	18.5
Aviva	Nov-18	75	75	0
Aviva	Dec-20	25	0	25
Aviva	Jan-32	27.3	27.3	0
Total		387.3	303	84.3

Source: Company Data

The next tranche of debt to mature is a £30m facility with AIB which is due for renewal in 2013. We understand that PHP has a number of options to replace this funding by either repaying it using headroom on its existing debt facilities, extend with the current lender or replace through a new lender.

Higher cost of debt reflected in estimates

Whilst the cost of group debt has increased (as expected) with average margins rising from 70 to 230 bps over Libor this is reflected in our estimates. The swap portfolio was a constraining factor in the debt negotiations although importantly management was able to extend its largest existing facility with RBS and Santander without incurring any swap break costs. Overall we believe the company achieved the best possible balance between maturity and cost.

Refinance achieved without crystallising swap liability

Reflecting the long-term nature of its cash flows, PHP has built up a portfolio of interest rate swaps predominantly with RBS and AIB. These derivative contracts have a variety of expiry dates and will hedge interest rate exposure by fixing the cost of a maximum of c.£193m of its c.£300m debt at c.4.75%. Under IFRS accounting, these contracts must be marked to market. As the table below illustrates, money market rates are currently substantially below 4.75% creating a sizeable but unrealised liability on the balance sheet at the period end, in common with many other property companies.

Table 2. Money Market Rates

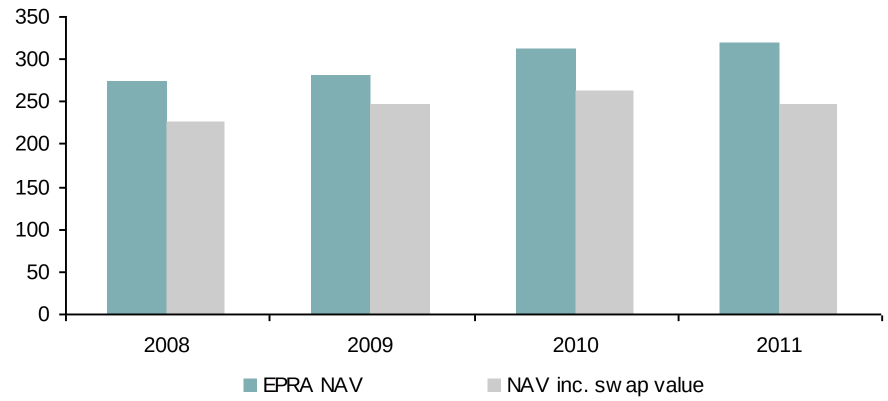
Instrument	Rate (%)	12 Mth Hi/Lo Rate (%)
5 Year Swap	1.76	3.0/1.4
10 Year Swap	2.63	3.9/2.2
5 Year Gilt Yield	1.25	1.7/0.9
10 Year Gilt Yield	2.44	3.9/2.0

Source: Bloomberg

EPRA NAV is the key measure of portfolio performance

As at 31 December, the mark to market valuation of the swap portfolio was £49.5m. While it reduced the basic NAV as at 31 December, as with other REITs we believe the key measure of portfolio performance is EPRA NAV. This strips out the impact of the swaps as these are likely to be held to maturity when their value will be zero. The mark to market value would only crystallise if PHP were to repay the related debt or cancel its swaps, we assume that neither scenario is likely in the near term. The chart below illustrates the NAV including and excluding the value of the swaps.

Figure 1. EPRA NAV (p) and NAV incl. mark to market of swaps (p)



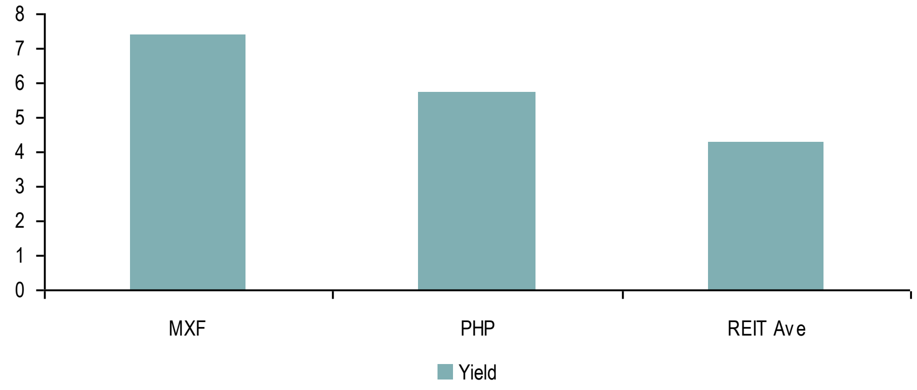
Source: Company Data

Attractive asset backed yield

PHP has a higher yield than commercial REITs and stronger dividend cover than MXF

The following chart looks at the yield from PHP relative to its closest healthcare peer and the broader commercial REITs sector.

Figure 2. Peer Yield Comparison (%)



Source: Numis Securities Investment Companies Research

The yield on PHP shares yield is higher than the commercial REIT peer group from a more defensive asset base in our view. While PHP's yield is lower than that of Medicx Fund (MXF), the closed-ended investment company, PHP has considerably higher dividend cover.

MXF currently targets a payment of 5.6p for 2012 (7.4% yield) which will cost c£13.7m in a full year, based on 245.35m shares in issue (before scrip) and following the recent share issue. Recurring net profit for the financial year to 30 September 2011 was £3.76m based on rent received of £11.7m. We expect this to rise to c£6m in the next 12-18 months as construction assets complete although this still leaves a sizeable shortfall to be paid out of capital.

As at 23 February 2012, the Medicx portfolio comprised 70 properties of which 61 are complete and nine are under construction. Rent received will rise to £17.1m once forward funded commitments complete over the next 12 months. However, assuming a full year of costs of £11.1m, we estimate that MXF needs to increase the rent roll 46% to c.£25m before it fully covers the dividend from recurring profits.

PHP dividend growth to continue

PHP has delivered 15 consecutive years of DPS growth

PHP has delivered 15 consecutive years of dividend growth and we expect further DPS progression even after factoring in the recently increased cost of group debt. Our estimates assume a prospective yield of 5.7% which remains highly attractive in the current low interest rate environment.

Table 3. Numis DPS Estimates

	DPS	Growth (%)	Div cover (%)
2012F	18.5	3	77
2013F	19.0	3	82

Source: Numis Securities Investment Companies Research

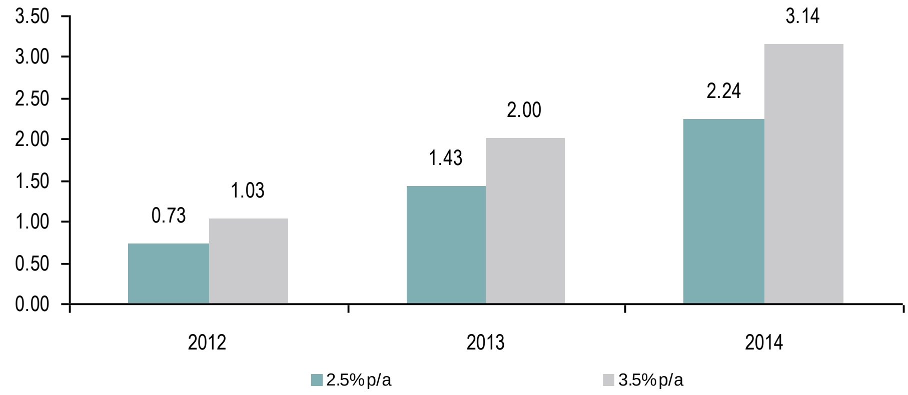
3% DPS growth in 2012 and 2013

We anticipate 3% DPS growth in 2012 and 2013 albeit resulting in a lower level of dividend cover than has been the case in recent years. However, we believe that cover will be restored in the relatively short-term as higher finance costs are absorbed by growth in the rent roll from accretive acquisitions and positive rent reviews (+2.5% rental growth).

Predictable increases in rental income

We believe PHP needs to generate c.£38.5m of rental income to pay a fully covered dividend. The following charts illustrate that this is achievable from existing resources The following chart illustrates the potential incremental cash flows in the event that rents increase in line with the long-term trend range of between 2.5% or 3.5% per annum at rent review.

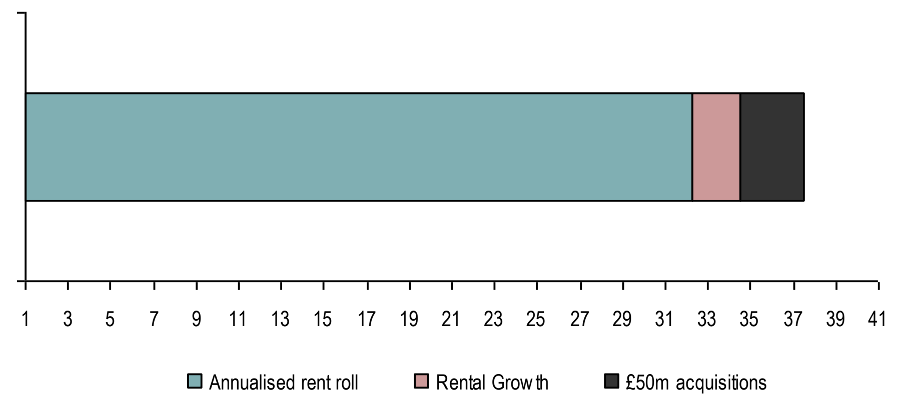
Figure 3. Potential Incremental Income on Rent Reviews



Source: Company Data

Factoring in rental growth at the lower end of this range at 2.5% pa would add £2.2m of incremental income by 2014. If rental growth were 3.5% this would add £3.14m. In addition, assuming PHP uses c£50m of its firepower to add new stock to the portfolio this could add a further £3m of rent assuming current market yields. Encouragingly, the yield on new properties is currently 100-150bps higher than total finance and management costs making each new purchase accretive to EPS.

Figure 4. Rental income by 2014 (£m)



Source: Numis Securities Research Department

Portfolio Summary

Long lease length

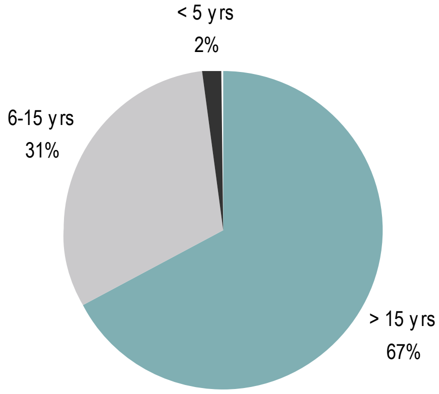
Ave unexpired lease term of 16.3 years

The average unexpired lease length of the portfolio is 16.3 years, which coupled with regular upward-only rent reviews, results in high visibility of cash flow, particularly compared with commercial real estate operators. PHP can expect to receive minimum future lease payments of at least £526m from its existing asset base excluding any future rental growth. This bodes well for future dividend payments and underpins the valuation of the portfolio in our view.

Asset management potential from shorter leases

Where leases are shorter than average, management undertakes asset management initiatives to enhance longevity of income. The team undertake between 5-10 projects per annum. Initiatives during 2011 included enhancements to eight sites which added rent of £82,000, generating a 35% valuation uplift on cost.

Figure 5. PHP Lease Lengths



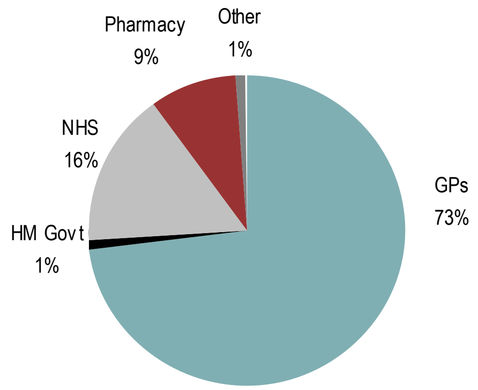
Source: Company Data

In stark contrast to PHP's portfolio, commercial property lease lengths have been falling for the past decade, and are now just over five years on average. Many are subject to break clauses and long rent-free periods. Moreover, the outlook for rental growth remains muted in all but a few pockets of the market. According to the British Property Foundation/IPD Annual Lease Review, 63% of new commercial leases signed in 20010/11 were for five years or less. The proportion of commercial leases with a break clause increased to 31.1% from 29.4% in 2009/10. Overall, commercial rent free periods increased to 13.4 months.

Strong covenant

Another comfort factor for dividends is the strength of the covenant. Of the total income, 90% is paid either directly or indirectly by the UK government.

Figure 6. Covenant Strength



Source: Company Data

Government reimburses GP rent costs

In the case of GP tenants, the typical payment structure is quarterly. The most common lease in the portfolio provides that the relevant government body (NHS or PCT) pays GPs the current market rent for their premises, plus an allowance of 5% for any repairs. In turn, GPs pay the current market rent to PHP and accept responsibility for all repairs and maintenance.

Pharmacy operators pay higher rents

Nine per cent of rents come from pharmacy operators including national players such as Lloyds, Rowlands and Boots. Their premises are usually next to GP surgeries, have co-terminus leases and command a higher rent per sq ft.

Table 4. Portfolio Rental Levels

Tenant	Area (sq m)	Area (sq ft)	Rent (£psm)	Rent (£psf)
NHS	160,842	1,721,009	175	16.17
Pharmacy	9,685	104,211	278	25.84
Other	3,910	42,072	110	10.22
Total	153,564	1,652,984	178	16.57

Source: Company Data

Regular, upward only rent reviews

GP rents are subject to triennial reviews which provide potential to increase revenue on a regular basis

Inflation Protected Revenues

11.53% index linked

The regular rent review process provides an element of inflation protection as 11.53% of total rent roll is index linked with a floor at 0%: 1.89% is subject to a fixed uplift, typically increasing 2-3% pa every three years.

Higher replacement costs will drive rental growth

The balance is subject to effective upwards only open market reviews, agreed with the District Valuers Office, a government agency. Key inputs into deciding a fair rent include the replacement cost of the asset, as well as general inflation and market evidence. In particular, replacement costs continue to rise, driven by tighter building regulation, higher specification requirements and increasing raw material prices. This should support rental growth across the portfolio.

Lower Volatility of Asset Values

Valuation yields less volatile than commercial property assets

Lambert Smith Hampton values PHPs portfolio every six months based on the individual value of each property. Given the favourable income characteristics, strong covenants and generally matched supply and demand of primary care assets, valuation yields have been less volatile compared with other commercial real estate assets. The following table illustrates the significant difference in yield shift over the past five years between the property sub-sectors.

Table 5. Yield Shift - Peak to Current

	PHP	Prime Retail	Prime Industrial	Prime Office
Valuation yield at cycle peak (%)	*5.2*	*4.3*	*5.3*	*4.5*
Valuation yield at cycle low (%)	*6.2*	*7.6*	*8.7*	*8.2*
Movement	100 bps	330 bps	340 bps	370 bps
5 Year average (%)	*5.7*	*5.6*	*6.5*	*5.9*

Source: Company Data/Numis Securities Investment Companies Research/ IPD

Valuation yield to remain stable

Looking forward, we expect the overall valuation yield on the portfolio to remain stable.

Growth Potential

The sector continues to benefit from a number of positive demographic and political drivers including an ageing population and cross-party commitment to the NHS. The market place for primary health assets in the UK is substantial, comprising 10,400 surgeries, 3,000 of which need to be replaced or substantially modified.

Putting this in context, PHP's portfolio comprises 161 assets. Providing access to funding remains available, we believe that PHP can continue to increase its market share. In particular, management believe the company is well positioned to benefit from the next phase of primary care premises development which should follow the passing of the Health and Social Care bill.

Financial Summary

Table 6. Income Summary

	Dec 2010	Dec 2011	Dec 2012F	Dec 2013F
Rent & Related Income (£m)	26.9	30.7	34.2	36.3
Admin Costs (£m)	(6.1)	(5.5)	(5.5)	(5.5)
Net Finance Costs (£m)	(12.6)	(15.4)	(19.0)	(20.2)
Recurring Profit/Loss Before Tax (£m)	8.2	9.8	9.7	10.6
EPS (p)	12.4	14.3	14.2	15.5
DPS (p)	17.5	18.0	18.5	19.0
Shares in issue (m)	62.6	68.2	68.2	68.2
Divi Cost (£m)	10.95	12.2	12.6	12.9

Source Numis Securities Investment Companies Research

Table 7. Balance Sheet Summary

	Dec 2010	Dec 2011A	Dec 2012F	Dec 2013F
Property (£m)	472.7	528.7	576.7	606.7
Total Assets (£m)	476.3	531.4	579.4	609.4
Debt (£m)	(264.4)	(300.7)	(346.7)	(366.7)
Total Liabilities (£m)	(311.5)	(363.3)	(409.3)	(429.2)
Net assets (£m)	164.8	168.1	170.2	180.2
NAV p	262	247	250	264
EPRA NAV (£m)	195.6	217.6	223.6	231.7
EPRA NAV p	311.5	319.0	322	337
LTV %	*56*	*57*	*60*	*60*

Source Numis Securities Investment Companies Research

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