Edison investment research

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Primary Health Properties

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	Basic NAV/ share (p)	EPRA NAV/ share (p)
12/10	26.9	9.1	14.7	17.5	5.3	262	311
12/11	30.7	9.7	14.6	18.0	5.4	247	319
12/12e	34.7	9.8	13.9	18.5	5.6	262	321
12/13e	38.0	10.8	14.5	19.0	5.7	267	324

Note: *PBT and EPS are normalised, excluding intangible amortisation, unrealised valuation gains or losses and mark-to-market changes in swaps.

Investment summary: Resourced for growth

The group achieved 3% annualised increases on rent reviews concluded in FY11, supplemented by net contributions from recent property acquisitions. A number of concerns fell away as it refinanced short-term debt and secured new facilities to fund earnings-enhancing portfolio growth this year, as net initial yields of c 6% remain above all-in debt and asset management costs. Industry drivers are positive, despite ongoing debate over NHS reform, with considerable unmet demand for modern specialist primary care premises. We will produce a full Outlook after implementation of the Health & Social Care Bill in the next few months, legislation that seeks to enhance the GP's role and should in due course unlock demand for new facilities.

Growth outlook underpinned by acquisition pipeline

The £3.8m increase in FY11 revenues reflected reviews, full-year contributions from FY10 acquisitions and the initial benefit of eight assets purchased in FY11 for £45.7m, which added £2.9m pa to the rent roll. The portfolio was valued at £539.7m at end FY11, 7% ahead at a 5.74% NIY.

Finances: £300m of new and refinanced debt facilities

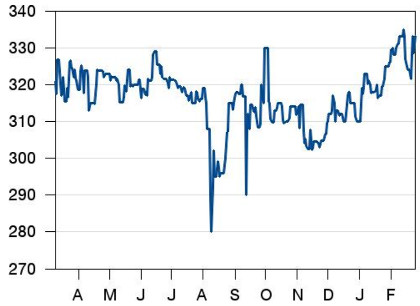
The group secured £300m of banking facilities during FY11 with £125m of new debt, and credit approval from RBS/Santander to refinance an existing £175m club facility, for a new four-year term. The terms of the latter included tighter LTV/ICR covenants and higher margins, but even less attractive all-in debt costs are conducive to EPS accretive portfolio growth and restoration of dividend cover in the next few years.

Valuation: 5.7% prospective yield and asset backing

Our forecast 3% dividend increase was confirmed. That underlines confidence in the cashflow outlook, with finance in place, a visible pipeline of acquisition and asset management opportunities and the prospect of accelerated demand from NHS-/GP-backed clients when healthcare reforms are complete. The shares yield a prospective 5.6%, backed by 319p EPRA NAV/share (246.3p/share basic), or c 393p/share DCF appraisal. Rents are secured by a fully let portfolio, long-term leases, three-yearly review cycles and potential for earnings enhancing additions over the next few years.

Price	333p
Market Cap	£227m

Share price graph



Share details

Code	PHP
Listing	FULL
Sector	Real Estate (UK-REIT)
Shares in issue	68.18m

Price

52 week	High	Low
	337p	280p

Balance Sheet as at 31 December 2011

Net debt/equity (%)	179
Net debt (£m)	301

Business

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

Valuation

	2011	2012e	2013e
P/E relative	216%	236%	250%
P/CF	9.2	7.1	9.3
EV/Sales	17.0	16.6	16.2
ROE	6%	5%	5%

Geography based on revenues (2011)

UK	Europe	US	Other
100%	0%	0%	0%

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

Investment summary: Resources in place for growth

The group extracted further performance from a low-risk business model in FY11, ending the year with a fully-occupied investment portfolio, let on long-term leases to strong tenants, 90% of rent underpinned by UK government (NHS). Consistent application of that strategy has been reflected in attractive long-term performance relative to other classes of UK commercial property.

Exhibit 1: Relative performance

Note: (1) PHP share price and dividends (2) Investment portfolio total return (capital value and rent).

Annualised total return (1)	1 year %	3 years %	5 years %
Primary Health Properties	0.45	2.77	(0.37)
FTSE All-Share Real Estate Index	(8.80)	5.00	(17.10)
FTSE All-Share Index	(3.50)	12.90	1.20
Annualised property portfolio return (2)			
PHP property portfolio	8.24	7.13	4.68
IPD All Property Index	8.10	(2.50)	1.10

Source: IPD/PHP

The portfolio performed steadily in FY11, generating growth in aggregate value and rents. Eight properties were acquired with total £45.7m investment. The year-end portfolio comprised 156 completed assets and another five forward-funding commitments/conditional purchase contracts. The year-end portfolio appraisal put the aggregate valuation at £539.7m including commitments, an uplift of £10.6m y-o-y. Revenues increased by 14% to £30.7m and including committed purchases, contracted annual rent roll at the year-end was £32.3m (FY10: £30.4m). Of that, reviews agreed during the year produced c 3% pa rental growth (FY10: 3.2%).

Our forecasts assume a further £50m of acquisitions this year, £35m in FY13 and underlying 3% rent increases on reviews. For NAV/EPS calculations, we have assumed that Primary Health Properties (PHP) will issue £25m of new equity in total over the next two years and that scrip dividend take-up will be steady at 5% (both at 325p/share; resultant growth in shares in issue is shown in Exhibit 2). Portfolio growth will be derived from a ready acquisition pipeline, on terms that should provide an immediate positive contribution to profitability, as net initial yields are above funding and asset management costs.

Exhibit 2: Portfolio growth and NAV/share performance

	31 Dec 2009	31 Dec 2010	31 Dec 2011	31 Dec 2012e	31 Dec 2013e
Investment portfolio incl. finance leases	£346.3m	£472.3m	£528.7m	£583.1m	£623.1m
Debt	£166.1m	£268.3m	£303.0m	£341.0m	£369.3m
Aggregate loan to value	48%	57%	57%	58%	59%
Net assets per group balance sheet	£151.9m	£164.7m	£168.1m	£188.1m	£206.1m
EPRA NAV	£172.0m	£195.6m	£217.3m	£230.7m	£250.0m
Shares in issue at period end	61.5m	62.8m	68.2m	71.9m	77.3m
Basic net asset value per share	247.2p	262.3p	246.6p	261.7p	266.6p
EPRA NAV per share	279.9p	311.5p	318.7p	321.0p	323.4p

Source: PHP full year results / Edison Investment Research forecasts

Well funded post £300m of new and refinanced debt

Recent refinance of short-term debt has removed a source of uncertainty. PHP secured £125m of new banking facilities in the last 12 months from Clydesdale and Aviva. It also obtained continuing support from Royal Bank of Scotland and Santander, which agreed to extend the existing loan facilities due to expire in January 2013, with a four-year interest-only facility starting in March 2012.

That provides headroom for further asset acquisitions and despite materially tighter terms for new debt agreed over the last few years – average debt margin of 230 bp (2010: 70 bp) – initial yields on acquisitions should still be sufficient provide an immediate positive net margin, so we see additional portfolio scale as EPS accretive. The terms of loan covenants also tightened, ie maximum LTV reduced from 70% to 65% and minimum interest cover raised from 1.3 to 1.4 times.

Exhibit 3: Debt profile

Provider	Maturity	Facility (£m)	Drawn (£m)	Headroom (£m)
Royal Bank of Scotland	January 2013	5.0	0.0	5.0
Allied Irish Banks	January 2013	30.0	30.0	0.0
Clydesdale Bank	July 2014	50.0	14.2	35.8
RBS/Santander/AIB	March 2016	175.0	156.5	18.5
Aviva	November 2018	75.0	75.0	0.0
Aviva	December 2020	25.0	0.0	25.0
Aviva	January 2032	27.3	27.3	0.0
Total		387.3	303.0	84.3

Source: PHP full year results / Edison Investment Research forecasts

Group finances were also supplemented via an equity issue in April 2011 of 5.3m shares at 305p, a modest 2.5% discount to the prevailing share price. Despite the small dilution resulting from the issue and part uncovered dividends, EPRA NAV/share was 318.7p at the year-end, 2.3% ahead. That measure ignores changes in the fair value of the group derivative portfolio.

Outlook: Further growth in rents and EPS over next two years

Underlying profit (before property revaluations and mark-to-market changes in derivatives increased by 8% to £9.7m (2010 £9.1m), including the costs of arrangement fees on refinanced debt.

Exhibit 4: Results summary

£m	FY10	FY11	FY12e	FY13e
Rent & related income	26.9	30.7	34.7	38.0
Expenses	(5.0)	(5.6)	(5.9)	(6.2)
Operating profit before revaluation gain and financing	21.9	25.1	28.8	31.8
Net financing costs	(12.8)	(15.4)	(19.0)	(21.0)
Normalised pre-tax profit	9.1	9.7	9.8	10.8
Fair value gain/(loss) on derivatives	(4.7)	(7.9)	0.0	0.0
Profit on sale of AHMP shares	0.0	0.3	0.0	0.0
Property revaluation gain	22.8	10.6	5.0	5.0
Pre-tax profit	27.1	12.7	14.8	15.8
Dividend cost	(10.9)	(11.8)	(13.1)	(14.2)
Dividend cost (cash - net of scrip)	(9.8)	(11.2)	(12.4)	(13.5)
Dividend cover	0.83x	0.82x	0.75x	0.76x
Dividend cover (cash cost, net of scrip)	0.92x	0.87x	0.79x	0.80x

Source: PHP full year results / Edison Investment Research forecasts

The increased margin on group debt is reflected in P&L forecasts from the current year. We have also increased the investment portfolio to reflect a pipeline of potential acquisitions with £50m this year and £35m in FY13 into our forecasts. There is also potential growth from reviews on an enlarged portfolio – we have assumed 3% pa uplifts – and contributions from asset management opportunities, typically extensions to existing properties, carried out on a pre-let basis. Eight projects completed in FY11 added £82,000 to the rent roll and generated 35% average valuation uplifts on capex cost. Seven further projects – total £3.5m projected capex – have already been approved for FY12, with two already on site. These include additional pharmacies, minor refurbishment programmes and extensions to GP practices. PHP forecasts enhancements to the values of refurbished assets equivalent to 34% of capex.

Exhibit 5: 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	34,700	38,044
Cost of Sales	0	0	0	0	0	0
Gross Profit	19,691	21,332	26,915	30,676	34,700	38,044
EBITDA	15,125	18,034	21,871	25,117	28,793	31,803
Operating Profit (before GW and except.)	15,125	18,034	21,871	25,117	28,793	31,803
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	28,793	31,803
Net valuation gain on property portfolio	(17,707)	1,615	22,790	10,584	5,000	5,000
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)	(19,000)	(21,000)
Profit Before Tax (norm)	4,623	7,853	9,149	9,700	9,793	10,803
Profit Before Tax (FRS 3)	(23,739)	10,786	27,225	12,337	14,793	15,803
Tax	(160)	0	(1,550)	5	0	0
Profit After Tax (norm)	4,463	7,853	7,599	9,705	9,793	10,803
Profit After Tax (FRS 3)	(23,899)	10,786	25,675	12,342	14,793	15,803
Average Number of Shares Outstanding (m)	33.6	40.6	62.2	66.6	70.7	74.5
EPS - normalised (p)	13.3	18.4	14.7	14.6	13.9	14.5
EPS - FRS 3 (p)	(71.2)	26.6	41.3	18.5	20.9	21.2
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	83.0	83.6
Operating Margin (before GW and except.) (%)	76.8	84.5	81.3	81.9	83.0	83.6
BALANCE SHEET						
Fixed Assets	320,133	349,786	472,739	528,679	583,100	623,100
Investment properties	316,862	341,890	469,290	525,586	580,000	620,000
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	4,050	6,350
Derivative interest rate swaps	454	63	555	0	0	0
Debtors	1,808	1,939	2,582	2,633	3,000	3,300
Cash	675	212	370	77	1,000	3,000
Current Liabilities	(23,597)	(20,321)	(33,241)	(36,913)	(35,100)	(33,350)
Creditors	(23,597)	(20,321)	(29,684)	(36,321)	(34,100)	(32,100)
Short term borrowings	0	0	(3,557)	(592)	(1,000)	(1,250)
Long Term Liabilities	(221,237)	(176,317)	(278,307)	(326,386)	(364,000)	(390,000)
Long term borrowings	(204,088)	(166,139)	(263,888)	(300,747)	(340,000)	(368,000)
Other long term liabilities	(17,149)	(10,178)	(14,419)	(25,639)	(24,000)	(22,000)
Net Assets	78,286	155,411	164,746	168,120	188,050	206,100
CASH FLOW						
Operating Cash Flow	15,799	15,951	22,801	24,025	33,294	26,815
Net Interest	(9,883)	(3,346)	(12,722)	(15,417)	(19,000)	(21,000)
Tax	0	0	0	0	0	0
Capex	0	0	0	0	(1,500)	0
Acquisitions/disposals	(49,311)	(23,413)	(70,761)	(44,589)	(50,000)	(35,000)
Financing	0	60,748	0	15,605	11,000	17,000
Dividends	(5,542)	(5,562)	(9,825)	(11,199)	(12,629)	(13,952)
Other (incl. non cash MTM shift in derivative vals)	0	(6,541)	0	(2,880)	0	0
Net Cash Flow	(48,937)	37,837	(70,507)	(34,455)	(38,835)	(26,137)
Opening net debt/(cash)	155,357	203,413	165,927	267,075	301,262	340,000
HP finance leases initiated	0	0	0	0	0	0
Other	881	(351)	(30,641)	268	97	(113)
Closing net debt/(cash)	203,413	165,927	267,075	301,262	340,000	366,250

Source: Company accounts/Edison Investment Research

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