

Primary Health Properties

Steady long-term income

AGM trading update

Primary Health Properties' (PHP) 26 April trading update demonstrated several positive developments in the year to date: continued portfolio and rental growth, new long-term financing, a revision of the advisory agreement with Nexus and a higher quarterly dividend (5.25p annualised vs 5.125p in FY16). Long-term demographic trends and broad political will for healthcare reform continue to support the outlook for primary care property in both the UK and Ireland, and PHP's long and largely government-backed leases underpin an attractive and fully covered dividend, which we expect to continue its 20-year growth trend.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	EPRA NAV/share (p)
12/15	63.1	21.7	4.9	5.000	4.4	87.7
12/16	67.4	26.7	4.8**	5.125	4.6	91.1
12/17e	72.6	32.2	5.4	5.250	4.7	92.9
12/18e	78.5	33.7	5.6	5.360	4.8	95.3

Note: *PBT and EPS are on an underlying EPRA basis, excluding valuation movements and other exceptional items. **Using weighted average shares for the year. The total cash dividend was fully covered by earnings.

Income and asset growth

PHP completed 48 rent reviews in Q117, increasing rents by £0.2m or an average of 1.6%, which is an encouraging increase over the 0.9% seen in 2016. PHP has also continued to add to its portfolio, with the acquisitions of two standing let properties near Aberdeen for £7.2m and a second Irish asset for €7.3m. The latter is a 2,900sqm Primary Care Centre in County Cork where the Health Service Executive comprises over 75% of the rent roll. PHP is funding the development, which is expected to be complete in Q317. PHP has one development asset in the UK, which is on track for completion in May, and 297 standing let properties.

Financing and advisory agreement

The issue of £100m of secured notes was PHP's first private debt placement, extending its already broad access to debt funding and increasing the weighted average maturity of debt to 6.1 years from 5.1 years at 31 December. The changes to the advisory agreement include further reductions in the incremental management fee and a change to the measurement criteria of the advisor's performance, to use EPRA rather than IFRS metrics. Neither of these has an effect on our estimates yet, although when the portfolio does exceed £1.5bn (which we expect to be beyond FY18 – the current limit of our forecast period), the EPRA cost ratio, which is already the lowest in the sector, should be reduced slightly.

Valuation: Secure income supports rising dividends

The primary care market in the UK and Ireland is inherently stable compared with other real estate subsectors; long leases, effectively full occupancy at all times and the presence of the NHS and HSE as major tenants mean that rents and valuations are less volatile than in other markets. The stable, long-term cash flows PHP's portfolio generates support an FY17e dividend yield of 4.7%, fully covered by EPRA earnings and which we expect to continue to grow, as it has for 20 years.

Real estate

16 May 2017

Price **112.50p**

Market cap **£673m**

€1.1762/£

Net debt (£m) at 31 March 2017 669.0

Shares in issue 598.3m

Free float 98%

Code PHP

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 4.2 4.2 7.1

Rel (local) 6.9 3.9 (4.4)

52-week high/low 440.0p 350.0p

Business description

Primary Health Properties is a long-term investor in primary healthcare property in the UK and, recently, Ireland. Assets are mainly long-let to GPs and the NHS or HSE, organisations backed by the UK and Irish governments, respectively. The tenant profile and long average lease duration provide an exceptionally secure rental income stream.

Next events

Q2 dividend paid 26 May 2017

Q3 dividend declared 6 July 2017

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Summary of the update

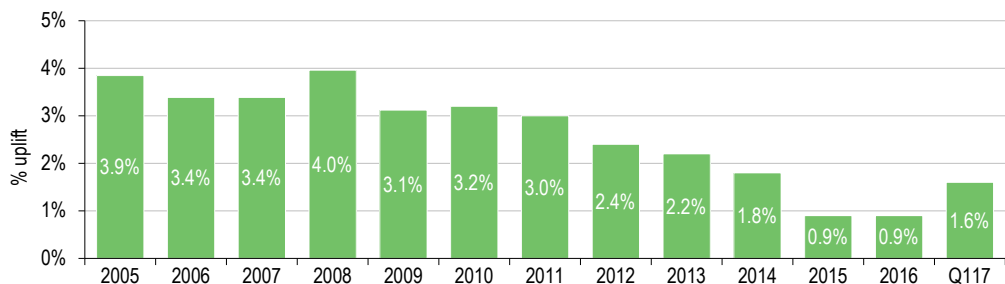
Portfolio growth

PHP bought two modern, purpose-built healthcare facilities near Aberdeen in January for £7.2m through the acquisition of Carden Medical Investments. These have unexpired leases of 15.3 and 13.0 years. The former is let to a GP practice and the Scottish Ministers and the latter to the Haddo Medical Group, another practice. In March, PHP contracted to provide development funding for the Carrigaline Primary Care Centre near Cork. This is PHP's second Irish acquisition and is expected to be completed in Q317. The portfolio now 299 assets valued at over £1.2bn and with a contracted rent roll of £68.8m.

Rental growth

While we note that on the 48 reviews completed in the quarter, the average increase of 1.6% is higher than in 2015 or 2016 (Exhibit 1). Our model assumes that annual rental growth is 1%, and one stronger quarter is not sufficient to change that assumption, but we note that higher inflation and any increase in new primary care construction could make our assumption appear conservative. An increase in our annual rent growth assumption would increase our forecasts of both EPRA earnings and EPRA NAV.

Exhibit 1: Average rental uplift



Source: Primary Health Properties data

New financing

The £100m 10-year senior secured note has a fixed coupon of 2.83%, similar to the club facility that it is partially being used to refinance, and we have not changed our debt cost assumptions. The £115m facility with RBS and Santander has been replaced with a bilateral loan for £50m from RBS, initially on a four-year term, which may be extended by a further year and to £100m with the approval of RBS. The refinancing adds further diversity to PHP's debt funding and a year to its average maturity. Net debt stood at £669.0m at 31 March for pro forma LTV of 54.3% (31 December: £655.7m and 53.7%; this differs from the IFRS calculation we show because of the marking to market of convertible bonds in the financial summary at Exhibit 3).

Advisory agreement

The changes affect both the management fee and the performance fee: the top band of the management fee was previously 0.3% of gross assets in the portfolio over £1.5bn; this has been replaced with 0.275% of assets between £1.5bn and £1.75bn and 0.25% between £1.75bn and £2.0bn. The portfolio was valued at £1.22bn at 31 December, and we do not expect it to reach £1.5bn before FY19, the current limit of our forecast period.

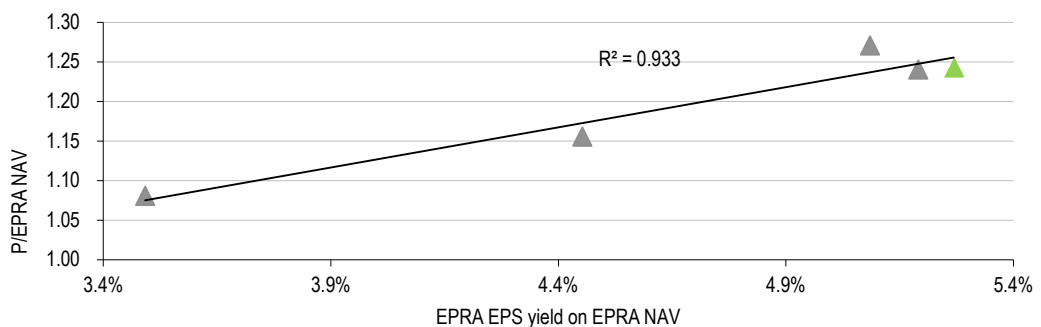
The terms of the performance incentive fee (PIF) have been amended to use EPRA rather than IFRS NAV. Nexus, the advisor, is still entitled to a fee of 11.25% of the NAV total return above a hurdle of 8%, but by using the EPRA rather than the IFRS metric, the impact of changes to the mark to market valuation of PHP's derivatives and convertible bonds will be excluded. These do not reflect the performance of the underlying property portfolio. New controls on the PIF have been introduced too: it is now capped at the lower of 20% of the management fee or £2m and payment of it is restricted if doing so would cause dividend cover to fall below 98%. No PIF has been paid since 2007 and the £12.1m cumulative PIF deficit at 31 December 2016, which was entirely attributable to IFRS mark-to-market adjustments, has been eliminated.

Valuation

We have not changed our estimates as a result of the update. The current pipeline of deals in solicitors' hands stands at £45m in the UK and €30m in Ireland, combined with acquisitions in the year to date, represents c 90% of our assumption that PHP will invest £95m in total in FY17.

The security and length of PHP's lease portfolio are attractive to investors, and have contributed to the c 24% price premium to the last reported EPRA NAV per share. This is in line with other stocks with similarly strong income characteristics: as Exhibit 3 shows, although the small sample size means we cannot draw strong conclusions, there appears to be a relationship between the earnings yield on NAV, and the price/NAV among listed UK healthcare property investors with long leases. In the current environment of low interest rates, PHP's fully covered prospective dividend yield of 4.7%, which is paid from cash earnings 90% backed by the UK and Irish governments, compares well with 10-year gilts (c 1.1%), 10-year Irish government bonds (c 0.9%) and the FTSE 100 (3.67%).

Exhibit 2: Price/EPRA NAV vs EPRA EPS yield on EPRA NAV



Source: Bloomberg, Edison Investment Research. Note: Companies: Primary Heath Properties (PHP, green marker), Assura Group (AGR), MedicX Fund (MXF), Secure Income REIT (SIR) and Target Healthcare REIT (THRL). Prices as at 15 May 2017.

Exhibit 3: Financial summary

Year end 31 December	2014	2015	2016	2017e	2018e
£000s	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	59,985	63,115	67,439	72,564	78,485
Cost of Sales	(723)	(852)	(868)	(953)	(1,031)
Gross Profit	59,262	62,263	66,571	71,611	77,454
Administrative expenses	(6,782)	(6,807)	(7,332)	(7,652)	(7,996)
EBITDA	52,480	55,456	59,239	63,959	69,457
Other income and expenses	0	0	0	0	0
Non-recurring items	(2,426)	0	0	0	0
Net valuation gain on property portfolio	29,204	39,767	20,686	9,872	12,331
Operating profit before financing costs	79,258	95,223	79,925	73,831	81,788
Net Interest	(34,275)	(33,727)	(32,490)	(31,795)	(35,788)
Non-recurring finance income/expense	0	0	0	0	0
Early loan repayment fees	(1,187)	0	(24)	0	0
Fair value gain/(loss) on interest rate derivatives and convertible bond, and swap amortisation	(6,916)	(5,464)	(3,710)	0	0
Profit Before Tax	36,880	56,032	43,701	42,036	46,001
Tax	0	0	0	0	0
Profit After Tax (FRS 3)	36,880	56,032	43,701	42,036	46,001
Adjusted for the following:					
Net gain/(loss) on revaluation	(29,204)	(39,767)	(20,686)	(9,872)	(12,331)
Fair value gain/(loss) on derivatives & convertible bond	6,916	5,464	3,710	0	0
Profit on termination of finance lease	0	0	0	0	0
Early loan repayment fees	1,187	0	24	0	0
Issue costs of convertible bond	2,426	0	0	0	0
EPRA basic earnings	18,205	21,729	26,749	32,164	33,670
Period end number of shares (m)	445.1	446.3	598.2	599.6	601.1
Average Number of Shares Outstanding (m)	444.2	445.5	560.0	598.8	600.5
Fully diluted average number of shares outstanding (m)	496.6	530.2	644.6	683.5	685.1
EPS - fully diluted (p)	7.9	11.2	7.3	6.4	7.0
EPRA EPS (p)	4.1	4.9	4.8	5.4	5.6
Dividend per share (p)	4.875	5.000	5.125	5.250	5.360
Dividend cover	84%	98%	100%	102%	105%
BALANCE SHEET					
Fixed Assets	1,026,232	1,100,621	1,220,155	1,321,277	1,442,358
Investment properties	1,026,207	1,100,612	1,220,155	1,321,277	1,442,358
Net investment in finance leases	0	0	0	0	0
Derivative interest rate swaps	25	9	0	0	0
Current Assets	17,740	7,034	8,442	7,282	5,880
Trade & other receivables	5,668	4,153	3,343	3,537	3,839
Net investment in finance leases	0	0	0	0	0
Cash & equivalents	12,072	2,881	5,099	3,746	2,041
Current Liabilities	(33,065)	(34,864)	(32,260)	(33,048)	(34,278)
Term loans	(711)	(862)	(803)	(803)	(803)
Trade & other payables	(14,244)	(16,099)	(13,600)	(14,388)	(15,618)
Derivative interest rate swaps	(5,802)	(4,734)	(3,795)	(3,795)	(3,795)
Deferred rental income	(12,308)	(13,169)	(14,062)	(14,062)	(14,062)
Other	0	0	0	0	0
Long Term Liabilities	(701,777)	(727,431)	(697,141)	(784,141)	(887,141)
Term loans	(437,022)	(460,550)	(429,433)	(516,433)	(619,433)
Bonds	(229,543)	(236,328)	(238,197)	(238,197)	(238,197)
Derivative interest rate swaps	(35,212)	(30,553)	(29,511)	(29,511)	(29,511)
Net Assets	309,130	345,360	499,196	511,370	526,818
Derivative interest rate swaps	40,989	35,278	33,306	33,306	33,306
Change in fair value of convertible bond	4,462	10,931	12,456	12,456	12,456
EPRA net assets	354,581	391,569	544,958	557,132	572,580
IFRS NAV per share (p)	69.5	77.4	83.5	85.3	87.6
EPRA NAV per share (p)	79.7	87.7	91.1	92.9	95.3
CASH FLOW					
Operating Cash Flow	49,020	57,145	56,838	64,553	70,385
Net Interest & other financing charges	(49,633)	(32,337)	(31,374)	(31,795)	(35,788)
Tax	(23)	0	(51)	0	0
Acquisitions/disposals	(54,396)	(29,477)	(97,359)	(91,250)	(108,750)
Net proceeds from issue of shares	17	(139)	145,232	0	0
Equity dividends paid (net of scrip)	(20,688)	(21,083)	(24,734)	(29,862)	(30,553)
Other (including debt assumed on acquisition)	7,647	(13,764)	(17,027)	0	0
Net Cash Flow	(68,056)	(39,655)	31,525	(88,353)	(104,705)
Opening net (debt)/cash	(587,148)	(655,204)	(694,859)	(663,334)	(751,687)
Closing net (debt)/cash	(655,204)	(694,859)	(663,334)	(751,687)	(856,392)

Source: Primary Health Properties accounts, Edison Investment Research

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