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Primary Health Properties

Gilt edged rent collector – accelerating dividends

PHP rental income is effectively entirely HM Government underwritten and PHP's unbroken dividend growth is in its 21st year. In May 2017, PHP acquired its 300th primary care centre and now has 305. In 2018E, debt-financed investment continues in UK and Republic of Ireland (the latter on yields well above 6%). Interim results announced 27th July showed an acceleration in the rate of rent rises agreed (with more to come) and reduced cost of debt . We see good scope for acceleration in dividend growth, albeit 2018E may focus also on raising its cover.

- **Rental growth**: PHP's recent +1.6% rent reviews (up from 0.9%), with indications of further acceleration. Rising build costs drive this. These are important as there is a strong need for an expansion of the national stock of this asset type. For these to be brought into commission, rents need to drive adequate returns. This has knock-on benefits to PHP's modern, standing stock.

- **Asset growth**: Gross assets should rise by over 8% this year and similar next. Investment post the 2016 equity fund-raise remains an important feature, which re-gears EPS. Investment yields are particularly strong in Republic of Ireland and this has added a major ongoing new region for expansion in the past two years.

- **Valuation**: After a number of successful other REIT flotations, there is an increasing number of 'single asset class' REITs quoted, particularly since the past year. The flow of funds to these, typically low-to-moderate risk assets, illustrates the sustained interest in the sub-sector, which trades at a premium to NAV.

- **Risks**: There is no rental-income or void risk. With debt costs so low (5 year swaps under 1%, 10 year swaps 1.3%), we understand the policy is to lengthen the debt profile, thereby reducing risk, whilst also still lowering cost of debt.

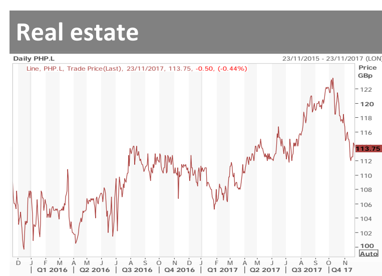
- **Investment summary:** Total Shareholder Return (TSR) CAGR is well over 10% over the past five years. In 2016 TSR was 7.3%, 2015 23.5%. In the past ten years, UK primary healthcare assets have returned a CAGR just over 7%, vs all property some 4.5%. PHP has fully kept up with this rise.

Financial summary and valuation

Year end Dec (£m)	2014	2015	2016	2017E	2018E
Income	60.0	63.1	67.4	72.5	78.8
Finance cost	(35.5)	(33.7)	(32.5)	(32.0)	(35.8)
Declared profit	36.9	56.0	43.7	68.9	47.4
EPRA PBT (Adj pre revaluation)	18.2	21.7	26.7	31.9	33.9
EPS Reported (p)	8.3	12.6	7.8	11.5	7.9
EPRA EPS (Diluted for conv) (p)	4.1	4.8	4.7	5.3	5.5
DPS (p)	4.875	5.000	5.125	5.250	5.400
Net (Debt)	(658.0)	(694.7)	(663.2)	(758.1)	(851.8)
Dividend yield (%)	4.1	4.2	4.3	4.4	4.5
Price/EPRA NAV	1.42	1.29	1.24	1.16	1.12
NAV (p)	69.6	77.4	83.5	89.9	93.2
EPRA NAV (p)	79.6	87.5	91.1	97.3	100.6

Source: Hardman & Co Research

Real estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	PHP
Price (p)	113
12m High (p)	121
12m Low (p)	105
Shares (m)	598
Mkt Cap (£m)	676
EV (£m)	1434
Free Float	97%
Market	Main, LSE

Description

A REIT acquiring and owning modern primary medical properties in UK; expanding into Republic of Ireland.

Company information

CEO	Harry Hyman
CFO	Richard Howell
Chairman	Alun Jones

020 7451 7050
www.phpgroup.co.uk

Key shareholders

Directors	2.6%
Investec Wealth	5.2%
Blackrock	5.0%
Unicorn Asset Mgt.	4.5%
CCLA	3.9%

Next event

February 2018	Final results
Late April 2018	AGM

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Disclaimer: Attention of readers is drawn to important disclaimers printed at the end of this document

Table of Contents

Executive summary **3**
Financial estimates **5**
- Dividend growth analysis 5
- Rental growth 6
- Interest cost 10
- Medium term impact of interest rate cycle on dividend growth potential 11

Investment case **13**
- Operational investment case 13
- Financial investment case 13

Risks **15**
Financial Analysis **16**
Disclaimer **21**
Hardman Team **22**

Executive summary

A strategic opportunity for PHP and for investors

Strong effective demand from significant expansion of modern primary medical assets

The NHS estate needs significant modernisation to deliver better patient outcomes efficiently. New developers (PHP undertakes zero development itself) require target returns. After seven years' rising build-costs, a (modest) head of steam has built up on new leases' rental levels. This is now starting to translate to higher tri-annual rent reviews on existing leases. Note, HM Government pays 91% and effectively backs 100% of rents. Occupancy is either side of 99%, ongoing. Lease lengths typically are 20+ years (average to expiry at last half year 13.3 years, currently longer). (See p.13) for further details on lease expiry. Only 2.3% of leases expire in under five years.

Low risk characteristics appeal to investors..........

.... who have been favouring new equity issuance in the sub-sector

PHP's yield is just above the FTSE100's. The past year has over £1.5bn invested in REITs (Tritax Big Box, social housing and other REITs). New funds' focus is on the secure end of the asset spectrum and PHP is thus an attractive proposition. Secondary raises have been at NAV premiums and all new issues trade at premiums.

PHP's rising dividend growth

3% CAGR of DPS achievable

Dividend (DPS) and EPRA EPS growth (y-o-y) %

	2015A	2016A	2017E	2018E	Long term assuming rate rises
Dividend	2.6	2.5	2.4	2.9	3.0+
EPRA EPS	18.8	-2.1	11.5	6.3	3.0+

Source: Company accounts and Hardman estimates

Rising DPS growth rates are sustainable. The main attraction is a 21-year unbroken record of DPS growth each year since float. But a major added attraction is the rising rent inflation which, even if modest, drives DPS growth – even factoring in rising debt market costs. PHP's debt costs are 4.26%, with some more expensive debt maturing in the next couple of years or so. Thus, even if 10-year swap rates rise, our model indicates a long term 3% DPS growth rate would still allow cover (ratio to EPS) to rise.

Growing the portfolio

In past ten years, portfolio growth from 99 to 305 assets. £1.27bn investment assets end June 2017

Ten years ago, PHP owned 99 properties, plus eight under development. Today the figure is 305. At end 2007 the annualised rent roll was £16.2m (vs £14.5m six months before), pre-tax EPRA profit £2.7m (i.e. pre-revaluations, mark-to-market, etc). Our estimate is for a rent roll of £71m by end 2017. Rent per property in the ten years has risen 43%. This rise is due equally to inflation and a rise in lot sizes, which averages £4.2m. The emphasis on growth is on properties of at least that size. Whilst larger properties are more competitively in demand, they do exhibit better investment characteristics. In the past year, PHP expanded into the Republic of Ireland (RoI).

Enlarging the portfolio enhances efficiencies and attracts investors to a sector where the 'lot size' of a GP surgery is too small for individual direct investment

Investors pay a share price premium for which we consider the rationale to be the dividend quantum, track record and visibility. It is also, we consider, a function of the difficulty investors have in executing the alternative strategy of buying the assets directly themselves. PHP's portfolio size (and strong, long track record) adds value of itself. Both the UK and the younger RoI markets require deep knowledge but the lot size tends to be seen as small by larger institutional investors, used to much larger individual real estate assets. Tritax Big Box REIT's last two properties have been bought at a cost of £78m and £44m. We would back PHP to continue its growth, even though large investors are competing actively for the larger individual assets.

Deep specialism required

Rent rises of 1.6% in the pipeline and greater rises likely

There are lags, so this benefits 2018E and particularly 2019E onwards, giving good forward visibility to cash-backed profit drivers to dividend growth

Rising rental inflation

Our 7.6% 2017 total income growth estimate would have been higher, but for the H2 asset investment weighting. We estimate rental growth of 8.7% in 2018E. Turning to *inflation*, the driver is first of all the developers' requirements (PHP is not a developer and never will be - and all developments are fully pre-let and de-risked, non-speculative) to achieve the right returns. These require a degree of higher rents (UK construction tender prices are now up nearly 50% since 2010). This feeds to higher agreed rents for standing stock (based on the comparables with the new stock coming through). The third differential is the rent then received by PHP and its peer group. With these lags in the lease changes, there is a two or three year visibility to these (modest) rises becoming effective. Note: all leases are on upwards-only rents.

The *Agreed* uplift translates to *Achieved* rate with a lag - the table below highlights this leading indicator. 1H17, for the first time in a while, saw increases in agreed rents on lease reviews (at 1.6%). 2019E *Achieved* will very likely rise, therefore.

Income y-o-y growth components per annum (%)

	2015	2016	2017E	2018E
Growth of portfolio and currency	3.2	5.0	6.6	7.7
Headline uplift on ***agreed*** reviews	0.9	0.9	1.7	2.0
Achieved rental increases, average	2.0	1.8	1.0	1.0
Total income increase	5.2	6.8	7.6	8.7

Source: Hardman & Co Research

Cost of debt reducing – with more to come

With 4.26% average cost of debt (August 2017), we see scope for interest cost to fall.

At end 2016 average cost was 4.65%. Since then a £20m, 4.76% fixed rate swap was cancelled. New revolving debt lines have been put in place H1: one being at 2.83%.We therefore see a minimal rise in interest payable in 2017. Termination of swaps has continued this year, with ongoing £0.8m p.a. benefits, fully effective 2018. Estimating a 3% cost of new funds leads to a £3m rise in interest payable 2018 vs 2017. But taking into account the H2 bias of 2017 spend and hence debt profile, the figure rises to £3.8m interest increase in 2018 vs 2017. We currently have no 2019 estimates but there still is an element of older more expensive debt maturing. Not least is the 5.375% £75m unsecured retail bond maturing July 2019 as well as the 4.25% coupon convertible.

Investors rightly like the sector and pay premiums to NAV for well-founded reasons

A premium would be warranted, for size of portfolio

Valuation

The sub-sector of lower volatility REITs remains in favour and we consider the broad asset class to be attractive. PHP's added advantage, we consider is threefold: 1) The potential for a rising level of dividend increases is clear. 2) The assets being purchased tend to be of a smaller size than appeal to the largest institutional or corporate investors in real estate, generally. 3) Longer term, NHS efficiencies do indicate a much greater role for primary medical real estate. External valuers to Civitas (a residential REIT) have established the criterion for a premium for size.

Tritax Big Box (BBOX), as an example, on a 146p share price, trades on a 4.3% historic dividend yield, dividend (historic) growth of 3.2%, dividend (historic) cover 104.8%, share price 8% premium to EPRA NAV, EPRA EPS historic (growth was 16% y-o-y for 1H17). PHP's current dividend cover is slightly less than Tritax, but we like the growth prospects within a niche, i.e. the strategic area of lower risk real estate. The dividend yields of both stocks are virtually identical.

Financial estimates

Dividend per share (DPS) growth analysis

Even assuming a rising cost-of-debt environment, 3% DPS rises are sustainable

- We anticipate rental inflation returning to the average of the past 10 years, namely 2.3%. This would result in operating profits growth of 2.5% pa (see page 11 for calculation)
- Finance costs are falling, as older, more expensive debt matures
- Our core estimate is a 3.3% rise in EPS long term, even if finance costs (see bullet above) fall only 1% pa as a function of general market-led rate rises.

The recent debt line has cost 2.83%. Were 10 year swaps to double (from 1.3% to 2.5%), long debt might cost PHP 4% maximum. This is below the 4.26% historic (and swap cost reductions are in addition to this). Hence, we model for PHP's cost of funds falling slightly (i.e. by 1% pa). This supports the 3.3% figure, above. We consider 3+% to be sustainable.

Long term EPS and DPS growth of 3%+ is based on rent inflation of 2% and a rise in cost of money, so we consider upside to this to be possible

Over and above this, we anticipate portfolio expansion, which enhances EPS.

The drivers to our DPS forecasts are explored in the next section. Pages 11 and 12 explore the impact of rising market-related costs to debt. For 2019E and beyond, 5% dividend growth rises are realistic to anticipate before market rates rise, but with near-inevitable rises factored in, a 3%+ DPS growth rate over the medium-long term is eminently achievable.

The major investment case, beyond the low risk pertaining to the asset class, is that an acceleration in tri-annually reviewed rental growth is happening now. Whilst the acceleration which we anticipate is modest and progressive, we consider this to be an important attraction for investors 1H17 EPRA earnings grew 22% y-o-y and with shares in issue up due to last April's capital increase, EPRA EPS by 8%. Full year 2017 EPRA EPS is estimated to grow 11.5%, taking dividend cover to 101.7%.

For 2018E we model 6.3% EPRA EPS growth, which looks indicative of the medium term potential before finance costs rise

2018E DPS growth could be faster than we anticipate, as we see 6.3% EPRA EPS growth that year. We assume, however, that PHP wishes to build cover further, principally to allow for the near-certainty that at some stage funding costs will rise. Given accelerating momentum in rent inflation, efficient operating costs and more finance cost savings still to be won, there is clear scope short term to raise DPS faster.

Rates will rise, but remember PHP has substantial fixed rate debt and is lengthening its maturities

Our 2018E dividend growth allows for some further expansion of earnings cover.

Dividend growth set to accelerate: a sustainable trend

Dividend and EPRA EPS growth (y-o-y) %

	2015A	2016A	2017E	2018E	Long term [1]
Dividend	2.6	2.5	2.4	2.9	3.0+
EPRA EPS	18.8	-2.1	11.9	6.0	3.0+

Source: Company accounts and Hardman estimates
Note [1] assumes market-costs of funds rises medium term

Beyond 2018E, we have no formal estimates. Our 2.9% estimated DPS rise for 2018E is driven by the fundamentals of that year (including rent inflation), rebuild of earnings cover, and also our assessment of the medium-term potential. The rise we estimate for 2018 leaves room for further sustainable acceleration in growth.

Rental growth

2017E Rental growth

Rental growth through acquiring more assets and through upwards only reviews

With a H2 weighting to investment into new assets, we estimate 7.6% annual growth.

In 2015, £29m properties were acquired, a figure which rose substantially in 2016: to £97m – an 8.0% rise (impacting 2017). This, added to rent increases projected at 1.0%, leads us to estimate a 2017 total rent increase of 7.6% to £72.5m (albeit there are timing effects and a de minimis but growing currency impact). Note that rents agreed on renewed leases rose by 1.6% in 1H17 and we anticipate 1.8% for 2H17 agreements. There is a lag in the rent being applied, and our 0.9% reflects the rises *agreed* in each of the *previous* couple of years.

PHP has track record of physical growth.........

...... assisted by expansion in Republic of Ireland, which assets are acquired on a higher yield than UK

In 2017 we estimate a growth in rent roll from expansion of the portfolio, totalling 6.6%. Note that the increase in rental assets from start to end of the year is £100m (pre revaluation) which is 8.1% of the start-year position, but the average is lower as purchases are H2 weighted this year.

Our 2H17E rental income is £37.3m, £72.5m for full year 2017. 2017 has seen portfolio expansion at the rate we had expected, albeit there is a greater bias to the current, second, half. Naturally, this timing is a 2017 impact, not 2018.

2018E Rental growth

Agreements made in 2017 underpin good rent roll inflation in later 2018 and 2019 onwards

Asset investment is coming through strongly and drives income growth, with rent inflation rises remaining modest. There is a significantly higher rental inflation rate for new leases being agreed as of 1H17. This acceleration fuels inflation on rents received progressively and principally impacts 2019E onwards.

Our 8.7% 2018E rise comprises 7.7% from growth in the portfolio and 1.0% from inflation. PHP has demonstrated its ability to secure physical growth in recent years when the asset class has been in demand. PHP's development partnerships and its expansion in Republic of Ireland underpin this ability.

In the table below, the following important points of detail should be born in mind:

Currency effects are de minimis. There is a growing € income stream from 2016 but the £ exchange rate fall's effect on a small sum of € income is modest.

The growth in the portfolio is not the same exactly as the growth in the balance sheet (ex-revaluations) as assets' income comes onstream at various times through the year.

Rent rising circa 1%, but 1H17 saw rent rises agreed at 1.6% and management indicates this should rise further.....

Leases are upward only rent reviews, but implementation is on a three-year rolling basis. We state the uplift % agreed (in the table below in italics), as stated by PHP. For example, the rises agreed 1H17 were 1.6% and we anticipated a modest H2 rise.

.... the uplift agreed impacts rent received with a lag, thereby raising visibility of future rent-received rises

Income y-o-y growth components (%)

	2015	2016	2017E	2018E
Growth of portfolio and currency	3.2	5.0	6.6	7.7
Rental increases, average	2.0	1.8	1.0	1.0
Headline uplift on agreed reviews	*0.9*	*0.9*	*1.7*	*2.0*
Total income increase	5.2	6.8	7.6	8.7

Source: Hardman & Co Research

2016A: 6.8% total rise: (85% from physical expansion of portfolio)

2017E: 6.6% income increase from additions + 1% rent inflation

2018E: 7.7% income increase from additions + 1% rent inflation

Loan to value (LTV) ratio reduced to 53.0% in June from 53.7% end December 2016. The rate of purchase of new assets in 2017 is skewed to H2 but is proceeded well, as anticipated, in 2H17. There is scope for the LTV to rise further (i.e. funding purchases with debt), with Hardman estimating 54.4% end 2017 and 56.6% end 2018E. This assumes no revaluation of the portfolio from any prospective yield shift, which we see as conservative.

Next couple of years sees 're-gearing' of the balance sheet continuing

The balance sheet enables a multi-year period of expansion, before debt constraints. We note the 2019 convertible is near-certain to convert to equity. See page 19. This is a conservatively financed portfolio (with upward only rent reviews and near 100% occupancy), so we see scope for LTV to rise modestly and incrementally to 60%, which, we estimate, indicates over £400m acquisitions over time, funded by debt without placing undue strain on the balance sheet. Acquisitions using debt are accretive to EPS. This 'following wind' to EPRA EPS is over and above the calculations we have outlined which support our estimate of over 3% DPS rise in the medium term.

Rent inflation will be accelerating

The drivers for rent income growth beyond 2018E are multiples of:

- Continuing expansion of the portfolio, re-gearing LTV (which enhances EPS);
- accelerating rises in rent on new leases agreed (0.9% a year ago, c.2% 2018 estimate, rising further);
- increase in rents received stemming from earlier uplift lease agreements;
- increasing investment in the (somewhat) higher yielding Republic of Ireland.

Rent rises are running at circa 1%, but 1H17 saw rent rises agreed at 1.6% and management indicate this 1.6% figure should (modestly) trend further upwards from here.

Market pressures for rents to rise

The NHS estate of GP surgeries is being replaced and renewed

The NHS estate of GP surgeries is being replaced and renewed by substituting modern facilities for – frequently – premises which are non-purpose built and not fit-for-purpose. New developers need to achieve hurdle returns, which are generated by the rental stream and the costs of development (including land).

Rents agreed are already rising and that rise is accelerating

Rents agreed are already rising and these benefit rent roll inflation, after a lag (i.e. more fully benefiting 2019). Added to that, the inflation in rents agreed (which has accelerated) is set to accelerate further.

Build costs are up 35% from the bottom. It is this which builds a 'head of steam' for rent increases

- With a 35% rise in tender price-levels (general UK construction index from 2010 low point) and a rise of 15% from the 2008 high-point, rents would seem to need to rise further and slightly faster, compared to the recent 1.6% annual rise. Cumulatively since 2008, PHP has reported that its rents have risen 12.0% since the end of 2010 and 18.4% since the end of 2008, which lags the build cost rises.
- The element of 'catch-up' required varies, depending on whether analysis is based on catch-up from the 2008 high point or the 2010 low point.
- This is an active area of investment as there is a requirement to build further modern primary clinical buildings. These are indeed being created by developers, but only as and where hurdle rates of return are achieved.

- There is a lag between build costs (as evidenced by the tender prices) rise and rents on the new developments become effective – rent rises are yet to come.

- Inevitably there is a further lag before these rises are assessed by the appointed surveyor (for the client, NHS England) and inevitably also there is a third lag in these assessments coming to effect. Typically, the portfolio is assessed for rent every three years. Only where there is a clear demonstration that rents on new build 'in the geographical vicinity' take the market to levels higher than existing rents for modern comparable stock (such as that owned by PHP), does the next assessment start to reflect those rises.

BCIS sees construction materials prices rising by 3.5%–4.0% per annum

As build costs rise, in order to secure new development, rents would need to rise.

New rents must achieve target hurdle returns for developers to proceed – an interaction between rental returns and costs. Build costs have risen, so the hurdle rises. BCIS 'all-in' (source RICS, Gardiner & Theobald) Tender Price Index (100 in 2008) fell to 85 in 2010, stood at 90 in 2013 then rose steadily to 115 by early 2017.

- The following was headlined in the BCIS Q3 2016 Construction Briefing: "Overall construction materials prices are expected to rise by 3.5%–4.0% per annum over each year of the forecast period.*"* The fuller context is below:

"Overall construction materials prices are expected to rise by 3.5%–4.0% per annum over each year of the forecast period. The price of imported materials will be affected by the fall in exchange rates. It is anticipated that oil prices will bounce back somewhat over the forecast period, affecting the price of oil derivatives, albeit from a low base."

Weekly earnings in construction rose 2.5% annual to end 2Q17 (Gardiner & Theobald 2Q17 Tender Price Indicator). Furthermore, the RICS estimates (2Q17) that UK construction could lose 8% of its workforce if a hard Brexit results in no access to the single market.

These trends have been noted across the sector, not just by PHP.

In the past recent years all quoted participants investing in this sector have outlined similar dynamics as regards rental growth and its prospects. This is a sector where significant modernisation of the estate needs to be delivered. The need is a combination of 1) population growth; 2) the NHS stated desire to expand larger surgeries (as part of clinics maybe offering a broader range of clinical services) at the expense of smaller surgeries and particularly one-person practice; 3) the demonstrable significant savings achievable by expanding primary care at modern premises (e.g. for test or extending into recuperative stays) as opposed to hospital (secondary care) beds.

Medium term projected rental growth estimates

2.3% is the past 10-year average rise and we see no constraint to this being achieved (or bettered) over the next ten years.

Dividend rises are geared some 2.5x to income rises.

Top line inflation rising 1% would boost dividend growth 2.5% each year incrementally

Income y-o-y growth components (%)

	2016	2017E	2018E	Longer term thereafter
Rental increases, as per rent received	1.8	1.0	1.0	2.3
Headline uplift on agreed reviews	0.9	1.7	2.0	2.3

Source: Hardman & Co Research

Two operational gearing benefits:

Republic of Ireland premium return on equity is material

- The Republic of Ireland aspect is material. It offers wider scope to expand, risks are low and competition, though rising, is less than UK. Net initial yields are higher whilst operational and financial (debt) costs are very similar. Return on equity gears up this differential and is thus some 30% greater. We emphasise this is a Hardman estimate.

- Though a rise in rent-roll inflation from 1% to over 2% may seem modest, the effect on the dividend paying ability is significant as it flows straight to the bottom line. 2016 EPRA profit was £26.7m pretax compared to income of £67.4m, a gearing factor of 2.5x.

The acceleration has started and will rise further – albeit modestly

Headline rent increases rose to 1.6% 1H17, which is up from 0.9% for 2016 – and higher levels are on the way. This is confirmed by management and we see it underpinned by construction tender price rises both historic and prospective.

It is becoming increasingly clear that valuers are now taking on board the strong cost rises since the low point…….

It is becoming increasingly clear that valuers are now taking on board the strong cost rises since the low point – the general market downturn has 'worked through'. The benefits of rent assessments being upwards-only are clear, in that investors and indeed occupiers are given high visibility and certainty around which to plan. In a period including a significant real-estate downturn (2008-2011), there is a gap which builds up between the upwards-only and more general rents which are affected by the economic downturn directly.

……. there is always a lag so the visibility for slight acceleration is high

Further, we would therefore extrapolate from this. As BCIS forecast (a year ago) "Overall construction materials prices are expected to rise by 3.5%–4.0% per annum over each year of the forecast period." We do not believe this has changed. A weak currency and robust energy costs are factors fuelling continued upward pressure. Labour shortages are more likely than surpluses given the threat of 'hard Brexit' (and the actuality of the uncertainty), the lack of new skilled trades coming through the system and the general low unemployment. RPI inflation has risen.

Annual rent rises should be at least at the past ten year average of 2.3%

We do not make explicit forecasts of PHP rents beyond 2018. We do however find it difficult to conclude that annual rises could be below the past ten year average of 2.3%, given 1) the rises already being agreed, 2) the fundamentals of the build costs having caught up with and overtaken the rent rises of the past ten years.

Interest cost

Plenty of scope for PHP to reduce its 4.26% cost of finance further than might be expected

The most important investment driver, we consider, is that PHP has kept the flexibility to lock in cheaper long-term money. Our 'medium-term' estimates of 3+% EPS and DPs rises are based on cost of money at around 4% for PHP. This assumes a doubling of 10 year swap rates. PHP is already locking in rates of well below that and we would not expect it to let the grass grow beneath its feet were expectations of rises in long term rates to become more marked.

- End 1H17, the debt maturity averaged 5.8 years and so the majority should mature before long term rates rise significantly.
- We model for 4% cost of money to PHP. But. for illustration only, on 2.83% average cost of money (the same level as the recent private placement), 2017E EPRA EPS would not be 5.34p. It would be 7.35p. This is on the basis of making no change to estimates, bar reducing the interest cost from £32.0m to £20.0m.
- That, an illustration only, would take dividend cover to 140%.
- This is not an illustration of an outcome (the 2.83% cost of money) which we expect – but it may be of use to put in context how conservative are the medium term illustrations which we do make.

2017E

Beneficial treasury management in 2016 reduces 2017 cost of money

PHP's average cost of debt as of August 2017 reduced by 39bp to 4.26% (end December 2016: 4.65%) including the impact of a £20m, 4.76% fixed rate swap cancelled, post period end, for a one-off payment of £6.2m.

Swap costs cut and new money costing 2.83%

For 2017E, swap interest costs reduce, due to significant swaps maturing in November 2016 and the impact of the £20m June 2017 cancellation noted above. New revolving debt lines have been put in place H1, reducing effective interest rates and a private placement of £100m ten-year senior secured notes was achieved at 2.83% fixed coupon, in March 2017. We therefore see a minimal rise in 2017 interest costs vs 2016 and indeed consider this a conservative estimate.

2018E

Fuller benefits of positive 2017 treasury management is delivered in 2018

Further swaps have been terminated this year, with an ongoing £0.8m benefit to interest costs, fully effective 2018.

For 2017, we estimate a £100m net new investment in real estate (with an H2 bias), funded entirely by debt (as the proceeds of the 2016 equity raise are deployed). We anticipate a similar rate of deployment in 2018. Estimating 3% cost of funds, interest payable would rise £3m in 2018 vs 2017, but taking into account the H2 bias of 2017 spend and hence debt profile, we estimate a £3.8m rise. Swaps (to synthetically fix interest rates) have been reducing but we assume a flat position in 2018E. New swaps may be taken out.

2019E

Trend of lengthening maturities on equal or (more commonly) lower coupons set to continue

We currently have no 2019 estimates, but we anticipate a further incremental lengthening of the maturity profile at attractive rates and there still is an element of older more expensive debt maturing. Not least is the 5.375% £75m unsecured retail bond maturing July 2019 as well as the 4.25% coupon convertible.

Medium term impact of interest rate cycle on dividend growth potential

After allowing for market-based interest rate rises, our estimate for medium-term EPRA EPS growth is 3.2%, as calculated below. It is worth noting this 3.2% estimate does not make allowance for the fact PHP is already lengthening its maturity profile and is likely to continue to manage its affairs well, thereby avoiding significant (or any) rise in debt cost. In that case, the 3.2% figure would be prone to upward revision in the future, even in the face of market rate rises.

Dividend rises are geared some 2.5x to income rises, treasury management cutting costs but eventually market rates will rise

After these factors, DPS still rises usefully more than the rate of rent inflation

Illustrative drivers to long term future dividend growth [1]

	% annual rise
Rental increases, as per rent received [2]	2.3
Operating cost increase	0.7
Operating profit rise	2.5
Finance cost at constant market-based interest rates	-1.0
Finance cost on market rates rising 0.3% points pa	1.8
Rise in EPRA EPS assuming rises in market-based rates [3]	**3.2**

Source: Hardman & Co Research
Note: [1] This model assumes constant EPS dividend cover
Note: [2] equating to the past 10 year average
Note: [3] See commentary and calculation, below. 2.5% EBITA rise, 1.8% finance cost rise = 3.2% PBT rise

Operating cost inflation increase 0.7% pa, vs estimated 2.3% income rise from rental inflation

Referring to the table above, we model operating cost increases of 0.7% pa. We assume a nil-growth-portfolio model: purely for ease of modelling.

Growth enhances earnings and it is especially accretive when that growth is debt funded. We have referred to the fact that the LTV end 2018E (we estimate 56.6%) is below the likely long term level, thereby adding fuel to DPS growth over and above our 3.2% pa model.

Circa 70% costs are the Advisory Fee which, under our nil-investment model rises 1% due to valuation rises of 2.3% in line with the rent rises. Note that we model no Performance Fees on that basis.

Our model for PHP borrowing costs is to fall from current 4.26% by 10% to 3.83%. This is before the effect of a rising market-rate environment

PHP still retains some debt struck at former slightly higher market rates. On an unchanged market-rates background, we assume a 10% fall in finance costs over time (i.e. to 3.83%). We 'amortise' this over a notional conservative 10 year basis, hence the 1.0% pa finance cost *reduction* on the fourth line of the table above. This is before taking into account changes in market costs of funds.

We consider this 10% fall to 3.83% (from 4.26% 1H17) to be particularly conservative as new debt was taken at 2.83% last year.

Market-based rates will rise. However, PHP has much of its debt fixed and would take action to mitigate market moves

Nonetheless, long term market rates are very low currently. 10 year swaps were 2.9% early 2014 (the recent peak) and are now c. 1.2%. Our model (line 5 table above) bases its illustration on a market rise averaging 0.3% pa, which would take swaps back to the 2014 peak by early 2023.

Our model appears particularly conservative

Our model takes no account of the fixing of rates PHP is undertaking right now, so in practice we consider it likely that PHP's interest rate cost will not rise at all. That said, at the September MPC meeting, the Bank of England stated it now judges that inflation will peak above 3%. Greater rent rises (boosting PHP EPS) might come hand

in hand with higher market-based cost of money, a factor reducing volatility in trends.

Our 3.2% estimated medium term DPS rise would be enhanced by management actions fixing rates....

Looking at the fifth line in the table above, if market rates rise at 0.3% points p.a., that would equate to an annual 2.8% rise in interest paid. From this is deducted the 1% fall stemming from unwind of older higher-coupon debt (line four), hence the +1.8% figure in the fifth line of the table above. Again, there is a strong possibility PHP would take avoiding action and its costs would not rise at all.

- This rise of 2.5% pa in operating profits and 1.8% rise in interest costs equates to 3.2% rise in EPRA EPS, which supports the dividend increase.

.... Also enhanced by likely re-gearing....

- On top of this are the benefits of re-gearing the balance sheet (with debt headroom and the convertible likely being converted to equity).
- Furthermore, whilst we model the 3.2% based on a small effective rise in PHP interest costs, we emphasise that this is a particularly conservative view and in all likelihood the effective interest rate will reduce. Our assumption for 2018E is indeed a fall.

.... clearly DPS cover will rise significantly

- As dividend cover rises further and towards 110% maybe as soon as 2020 (we currently make no estimates beyond 2018), investors will be further attracted to this strong cash-backed dividend pay-out.

Illustrations

Given recent new debt was secured at under 3%, we believe medium term, cost of debt could FALL from the current 4.26% whereas our model assumes a rise

We anticipate the 4.26% average cost of PHP debt to decline further as recent debt has been added at under 3% and significant amounts can be re-financed through maturities in the next couple of years in facilities costing above average.

- Calculating 2018E pro-forma EPRA EPS using 3% interest cost as opposed to our 4.0% estimate, EPS would be 6.93p pro forma (vs our 5.66p estimate).

Pro-forma, EPS of 6.9p 2018E illustratively at current market interest rates

- Conversely, calculating 2018E pro-forma EPRA EPS using 4.8% interest cost (but no cost of swaps) as opposed to our 4.0% estimate, EPS would be 5.16p pro forma (vs our 5.66p estimate).
- 10 year Sterling swaps peaked in this cycle at 2.9% in early 2014 vs c.1.2% currently, i.e. 1.8% points higher than current. Recent PHP debt facilities were negotiated at 2.83% and we adjust this to 3.0% to be conservative allowing for longer maturity profiles. So, to the 3.0% adjusted recent PHP rate we add 1.8% as the rise implied were swap rates to rise from current levels back to the 2014 peak. 3.0% plus 1.8% = 4.8%, the illustrative rate we use above.

In conclusion:

On balance, we consider the probability of PHP's debt cost rising in the next five years as very low

Cost of debt is 4.26%, down from 4.65% December 2016. It has clear scope to fall further, through old debt maturing and also being diluted by expansion using new, cheaper debt. An illustration shows material EPS enhancement (spread over several years) through lowering debt cost. This puts into perspective the core assumptions we have on the page 11 table, which should prove conservative. An illustration looking at debt cost to PHP in an environment matching the 2014 interest rate peak shows the cost of debt at 4.8%. This would be a number of years away and, as PHP is already lengthening its maturity profile, it is most unlikely, in our estimation, that PHP's cost of debt will rise at all.

Investment case, valuation

Operational investment case

Clear cross-party and operational benefits from modern assets

The NHS estate needs significant modernisation to deliver better patient outcomes efficiently. Thus, new developers require appropriate rental returns. PHP undertakes zero development risk, funding forward developments of trusted partners.

Construction cost rises lead to the need for higher rents and in 1H17 began to translate to agreed higher rents

After seven years of rises in construction tender prices, a (modest) head of steam has built up on new leases' rental levels which is now just starting to translate to higher tri-annual rent reviews on existing leases. Note that rents are 91% paid by the Government and effectively 100% governmental backed, in addition to which occupancy is effectively over 99% ongoing, with lease lengths typically 20+ years (average to expiry at last half year 13.3 years).

More on the Government's applied strategic vision

NHS England's primary care provision strategic plans were published in its 2014 Five-Year Forward View. More local detail has been set out. This was through the Sustainability and Transformation Plans (STPs), published by all 44 STP geographic areas in England. March 2017 saw a further independent overview on NHS Property and Estates. Slow as it is, the strategy is being implemented, with some areas seeing the benefit of modest additional capital funding from various Governmental funds.

The Republic of Ireland opportunity just begins. PHP is a strongly placed early mover.

Financial investment case

Long leases

Long leases with upward only rents

Income subject to expiry

Length years	£m	% of total
< 3 years	0.3	0.4
3 – 5 years	1.3	1.9
5 – 10 years	17.6	25.4
10 – 15 years	27.9	40.3
15 – 20 years	14.7	21.2
20 + years	7.5	10.8

Source: Hardman & Co Research

Only 2.3% of leases expire in next 5 years

Strong positive cash flow from investment

Assets' initial yield is 5%, recent borrowing at 2.8% - excellent 'arbitrage'

PHP assets' net initial yield is 5%, recent borrowing at 2.8%. Operating margins are 88%. With scope to increase borrowings, new acquisitions for debt enhance EPS.

Strong TSRs in addition to the lower risk and volatility

The past five-year total Shareholder Return (TSR) CAGR is well over 10%. In 2016 TSR was 7.3%, 2015 23.5%. In the past ten years, UK primary healthcare assets have returned CAGR just over 7%, vs all property 4.5%. PHP has fully kept up with this rise.

Investors look for vehicles in this category

Turning to the strong investor appetite, there is an increasing number of 'single asset class' real estate REITs in existence after a number of successful flotations, particularly in the past year. The flow of new funds to these (some £1bn in the past year), invested in low-to-moderate risk assets, illustrates the sustained interest in this area, which trades at a premium to NAV Strategic investment case.

Valuation comparisons

PHP has demonstrated its ability to execute a multi-decade growth strategy, into attractive modern assets. Its 21 year track record and the fact this comprises dividend rises each year are important valuation considerations. Investors seek lower risk REITs, with good yields.

Primary medical property funds / REITs comprise these three stocks

Rating on historic performance ratios (pence per share)

Fund	Share price	EPRA NAV	Multiple NAV (x)	EPRA EPS	PE (x)
Assura (AGR)	58	49.3	1.17	2.4	24.2
PHP (PHP)	**113**	**96.1**	**1.18**	**4.7** [1]	**24.0**
MedicX (MXF)	86	74.4	1.16	3.8	22.6

Source: Company accounts and Hardman estimates
Note [1] dilutes for Convertible

In a broader context, see our page 4 comments on Tritax Big Box (BBOX) and lower risk REITs.

Risks

Upward only rents, 99% occupancy, A1 covenant

There is no rental income or void risk. The average lease length is 13.3 years with a minimal amount ending within five years. Now that debt cost is so low (5 year swaps are well under 1%, 10 year swaps c. 1.2%) the policy is to lengthen the debt profile, we understand, thereby reducing risk whilst still lowering cost of debt.

Modest re-finance risk

There is market risk with regards to interest rate exposure. Interest rate 'swaps' are in place, which are all risk-reducing, covered positions. The average length of debt facility is 5.8 years (as of June 2017 results) and the large majority of this is fixed rate (including the swaps contracts). Bearing in mind the long leases, clearly, with hindsight, PHP has been entirely correct to wait until market rates fell, in order to lengthen its fixed rate exposure. As facilities mature, they need to be replaced and there is risk as to the cost of funds. This risk relates to fluctuation in market interest rates. With LTV at 54.4% and leases' weighted length to expiry some 13.3 years, we consider the availability of funding at attractive rates to be high.

Good cash-flow

The assets' net initial yield (NIY) at end June 2017 was assessed by LSH (the external valuers) at 5.04% (5.17%, end 2016). NIY on assets are usefully ahead of costs of debt and, with efficient cost base (under 12% EPRA cost ratio), acquisitions are cash flow positive, even if fully debt-funded. The current loan to value (LTV) stands at 54.4% with an internally-imposed ceiling around 60%. PHP can re-gear its balance sheet on a conservative LTV with interest cover at exactly 2.0x being no constraint either.

Dividend has been uncovered

Dividend cover has been below 100% recently, but this was a function principally of the dilutive effects of a large (£150m) oversubscribed 2016 equity issue. This issue was solely to accelerate growth.

Interest cover considerations

Interest cover (operating profits as multiple of total finance costs) fell to 1.7x in 2009, illustrating the strength of a business invested in rental streams which are upwards only. The cover fell to a low point of 1.3x in 2012, but this was function of a 19% expansion in the portfolio that year, funded by debt, itself a function of well-placed commitment to growth on attractive net initial yields on the assets. Cover is 2.0x 2017E (1.8x 2016). All these figures are cash cover excluding revaluations.

Stress-test on interest rates and costs

As with any real estate investment – funded by debt – there is a combination of risks based on levels of financial gearing and due diligence on assets acquired. Even if the average cost of PHP's debt rose to 5.0% five years from now, the PHP dividend would be over 100% covered (and this is without re-gearing the balance sheet). With PHP borrowing recently at 2.83%, we consider this risk to be distinctly modest. Note that the trend is still for PHP's specific costs to reduce as older debt matures. PHP's ability to secure finance through a range of different markets (banks, institutions, private placement, retail bonds and others) and its particular attraction in bear markets, reassures us that the right level of risk is being taken.

Brexit is seen by us, on balance, as a positive. Any changes to labour availability are likely to be in the nature of tightening. We are seeing a reduction in confidence and a likely construction slowdown, but immigration of skilled labour is a material issue. Currency falls would on balance lead to materials and energy cost rises. Construction tender prices are set to keep rising. Occupancy (as in GP surgery usage) is not in any way GDP or confidence related and of course the leases are long term. Rental growth rates under these circumstances are unlikely to slow. The attractions of full tenancy occupation on long term A1 covenant leases is all the stronger.

Financial Analysis

Revenue account (£m)	2011	2012	2013	2014	2015	2016	2017E	2018E
Rental income total received	30.3	32.9	41.9	60.0	63.1	67.4	72.5	78.8
Finance Lease Income	0.3	0.3	0.1	0.0	0.0	0.0	0.0	0.0
Total Income	30.7	33.2	42.0	60.0	63.1	67.4	72.5	78.8
Direct Property Expenses	0.4	0.4	0.4	0.7	0.9	0.9	0.9	1.0
Administrative Expenses	5.1	5.2	6.1	6.8	6.8	7.3	7.7	8.1
Total Expenses	5.5	5.6	6.5	7.5	7.7	8.2	8.6	9.1
Operating Profit	25.1	27.6	35.5	52.5	55.4	59.2	63.9	69.7
Operating margin %	*82.9*	*83.9*	*84.7*	*87.5*	*87.8*	*87.8*	*88.1*	*88.4*
Devt loan interest, other income	0.4	0.5	0.2	1.0	0.7	0.5	0.5	0.5
Swap interest paid	-8.8	-6.7	-7.7	-7.6	-6.0	-5.0	-4.0	-4.0
Bank, bond loan interest, fees	-5.8	-14.1	-18.5	-27.7	-28.4	-28.0	-28.5	-32.3
Break fees [1]	-1.3	-1.5	-0.9	-1.2	0.0	0.0	0.0	0.0
Net Finance Costs	-15.4	-21.8	-26.9	-35.5	-33.7	-32.5	-32.0	-35.8
EPRA Pre-tax Profit	11.0	7.3	9.5	18.2	21.7	26.7	31.9	33.9
Net revaluation on portfolio	10.6	-1.8	2.9	29.2	39.8	20.7	37.0	13.6
Fair value gain on derivatives	-8.0	-2.9	11.4	-2.5	1.0	-2.2	0.0	0.0
Fair value on Convertible	n.a.	n.a.	n.a.	-4.5	-6.5	-1.5	0.0	0.0
Non recurring expenses	0.3	0.0	-2.7	-2.4	0.0	0.0	0.0	0.0
Reported Pre-tax Profit	11.4	1.1	20.2	36.9	56.0	43.7	68.9	47.4
Tax Charge	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EPRA EPS (p) (dil) excludes all reval'n	4.11	2.51	2.67	4.10	4.77	4.69	5.25	5.48
EPRA EPS (p) as above, excluding Convertible	4.11	2.51	2.67	4.10	4.87	4.77	5.34	5.66
Reported EPS (p)	4.75	0.48	5.67	8.30	12.57	7.80	11.52	7.93
Dividend Per Share (p)	4.500	4.625	4.750	4.875	5.000	5.125	5.250	5.400
Shares in Issue, No., Average	266.9	290.8	356.4	444.4	445.6	560.1	598.2	598.2
Fully diluted shares (convertible)				496.0	530.8	644.7	682.8	682.8

Source: Hardman & Co Research

Note [1] Such break fees excluded from Hardman Adjusted EPS figures

- PHP assets' net initial yield is 5%, recent borrowing at 2.8%.
- Average borrowing costs are 4.26% thus further opportunities to reduce borrowing costs remain.
- Page 19 we submit our calculations regarding the convertible – our summary table is reproduced here. With re-investment of the debt retired when the convertible is converted (at PHP's option), any EPS dilution effectively is reversed.

DPS and EPS (p) - cover	2015	2016	2017E	2018E
EPRA EPS pre Convertible dilution	4.870	4.770	5.340	5.660
Dividend per share	5.000	5.125	5.250	5.400
Cover (%)	97.4	93.0	101.7	104.8

Source: Hardman & Co Research

Balance sheet (£m)

	2011	2012	2013	2014	2015	2016	2017E	2018E
Investment Properties - Start of Period	469.3	525.6	622.4	941.5	1026.2	1100.6	1220.1	1357.1
Currency translation effect	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Additions to Portfolio	45.7	98.6	316.2	55.5	34.6	98.8	100.0	100.0
Revaluations	10.6	-1.8	2.9	29.2	39.8	20.7	37.0	13.6
Non current assets								
Investment Properties - End of Period	525.6	622.4	941.5	1026.2	1100.6	1220.1	1357.1	1470.7
Finance Leases	3.0	3.1	0.5	0.0	0.0	0.0	0.0	0.0
Interest rate swaps	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Sub total: Non-Current Assets	528.7	625.5	942.0	1026.2	1100.6	1220.1	1357.1	1470.7
Current assets								
Receivables	2.6	2.9	4.8	5.7	4.1	3.3	3.0	3.0
Finance Leases etc	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash + Short Term Investments	0.1	25.1	5.5	12.1	2.9	5.1	33.5	30.6
Sub total: Current Assets	2.7	28.0	10.3	17.8	7.0	8.4	36.6	33.7
Total Assets	531.4	653.5	952.3	1044.0	1107.6	1228.5	1393.7	1504.4
Current liabilities								
Deferred Rental Income	6.6	7.8	11.9	12.3	13.2	14.1	15.0	15.0
Trade and Other Payables	5.8	12.3	16.3	14.2	16.1	13.6	16.0	16.0
Term loans	0.6	79.9	1.9	0.7	0.9	0.8	1.0	1.0
Interest Rate Swaps	24.0	7.5	7.6	5.8	4.7	3.8	3.8	3.8
Sub total: Current Liabilities	37.0	107.5	37.7	33.0	34.9	32.3	35.8	35.8
Non current liabilities								
Term Loan over 1 year, bond	300.7	323.1	592.6	666.6	696.7	667.5	790.6	881.5
Interest Rate Swaps	25.6	45.3	21.5	35.2	30.6	29.5	29.5	29.5
Sub total: Non-Current Liabilities	326.3	368.4	614.1	701.8	727.3	697.0	820.1	910.9
Total Liabilities	363.3	475.9	651.8	734.8	762.2	729.3	855.9	946.7
Shareholders' Funds	168.0	177.6	300.5	309.2	345.4	499.2	537.7	557.6
EPRA Shareholders' Funds	217.5	230.4	329.1	354.2	391.6	545.0	582.0	601.9
Shares in Issue at Period End, No, m.	273.2	304.4	444.4	445.1	446.3	598.2	598.2	598.2
NAV per Share pence	61.5	59.4	69.6	69.5	77.4	83.5	89.9	93.2
EPRA NAV per Share pence	79.6	75.7	76.1	79.6	87.5	91.1	97.3	100.6
Net Debt	301.2	377.9	589.0	655.2	694.7	663.2	758.1	851.8
Debt % NAV	179.2	212.7	196.0	211.9	201.1	132.8	141.0	152.8
Change in Term Loan	31.8	53.1	269.5	74.0	30.1	-29.2	123.1	90.8
Loan To Value Ratio	56.7%	57.8%	61.8%	62.8%	62.7%	53.7%	54.4%	56.6%
Net debt [1]	301.2	377.9	579.7	658.0	694.7	663.2	758.1	851.8

Source: Hardman & Co Research

Note [1] Measure of net debt including fair value, carrying value, unamortised borrowing costs

- With LTV of 54.4%, there is scope to purchase further assets entirely for debt. LTV of over 60% is not anticipated but a rise towards that level is likely.
- LTV of 60% would indicate a further £85m asset purchases. Illustratively this would add operating profits of £3.8m or more, with interest costs of £2.5m (at 3% which is higher than the recent debt raise), annualised this enhances pro forma 2017 EPS by 3.8%.

Investment and development properties (June 2017 £m)	UK	RoI	Total
Investment	1255.5	6.2	1261.7
Development	0.9	3.3	4.2
TOTAL	1256.4	9.5	1265.9

Source: Hardman & Co Research

Cash flow (£m)	2011	2012	2013	2014	2015	2016	2017E	2018E
Operating activities								
Profit before taxation (adj for fair value)	20.6	5.6	6.0	38.2	49.9	43.1	68.9	47.4
Adjustments for:								
Net valuation changes on investment property	-10.6	1.8	-2.9	-29.2	-39.8	-20.7	-37.0	-13.6
Early repayment fees and bond issue	0.0	0.0	0.0	3.60.0	0.0	0.0	0.0	0.0
Profit on disposal of investment property	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial income receivable	-0.4	-0.5	0.0	-1.0	0.0	0.0	0.0	0.0
Finance costs payable	15.8	20.8	23.3	35.3	33.7	32.5	32.0	35.8
Sub-total	**25.1**	**27.7**	**26.4**	**46.9**	**43.8**	**54.9**	**63.9**	**69.7**
Increase in trade and other receivables	-0.2	-0.1	4.4	-0.5	1.0	0.6	0.5	0.5
Increase in trade and other payables	1.1	7.9	0.4	-2.0	2.1	-1.5	0.0	0.0
Interest, fees paid	-19.0	-20.7	-26.9	-35.9	-37.0	-46.0	-32.0	-35.8
Interest received	0.3	0.4	0.0	0.5	1.3	0.5	0.0	0.0
Taxation (& REIT) paid	-2.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
Net cash inflow from operating activities	**5.4**	**15.2**	**4.3**	**9.0**	**11.2**	**8.4**	**32.4**	**34.3**
Investing activities								
Acquisitions net of cash acquired, other	0.0	-55.5	-232.5	0.0	0.0	0.0	0.0	0.0
Proceeds from sale of investment properties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Additions to investment properties	-45.0	-45.3	-58.6	-54.5	-29.5	-97.4	-100.0	-100.0
Net cash flow operating and investing	**-39.6**	**-85.6**	**-286.8**	**-45.5**	**-18.3**	**-89.0**	**-67.6**	**-65.8**
Financing activities								
Net proceeds from issue of share capital	15.6	21.0	91.8	0.0	-0.1	145.2	0.0	0.0
Dividends paid	-11.2	-12.2	-16.1	-20.7	-21.1	-24.7	-27.3	-28.0
Net cash flow (change in debt)	**-35.2**	**-76.8**	**-211.1**	**-66.2**	**-39.5**	**31.5**	**-94.9**	**-93.8**
Net proceeds of long-term borrowings	35.0	49.3	-16.3	69.0	30.3	-29.3	123.3	90.9
Net cash inflow from financing activities	**39.4**	**58.1**	**59.4**	**48.3**	**9.1**	**91.2**	**96.0**	**62.9**
Net debt	**301.2**	**377.9**	**589.0**	**655.2**	**694.7**	**663.2**	**758.1**	**851.8**
Increase in cash and cash equivalents	-0.3	25.0	-15.8	1.6	-9.4	2.2	28.4	-2.9
Opening cash and cash equivalents	0.4	0.1	25.1	9.3	12.1	2.9	5.1	33.5
Closing cash and cash equivalents	**0.1**	**25.1**	**9.3**	**12.1**	**2.9**	**5.1**	**33.9**	**30.6**

Source: Hardman & Co Research

Convertible Bond

On 20 May 2014, PHP (through a subsidiary) issued £82.5m of 4.25% Convertible Bonds due 2019 at par. Bonds are convertible into preference shares of the Issuer which will be automatically and mandatorily exchangeable into Ordinary Shares. The conversion price is 97.5 pence, thus up to 84.6m shares are liable to be issued (82.5m / 97.5%). The bondholders had the right to convert the Bonds up until 20th May 2017 only where the Parity Value (as defined in the Bond's terms) was greater than the Exchange Price. *After 20th May 2017*, the Bonds may be redeemed at par *at the Company's option* subject to the Parity Value equalling or exceeding £130,000, for Bonds with a nominal value of £100,000. If not previously converted, redeemed or purchased and cancelled, the Bonds will be redeemed at par on the maturity date.

The convertible dilutes EPS 2018E from 5.66p to 5.48p

Effect of convertible on EPRA EPS 2018E pro forma

	Convert Debt	Convert Interest	Shares (m)	PBT	EPS (p)
Convertible as stands	82.5	3.5			
Shares currently			598.2		
2018E current estimate EPRA PBT, EPS				33.9	5.66
Full conversion: 84.6m new shares [1]	0.0	0.0	682.8	37.4	5.48

Source: Company accounts and Hardman estimates

Note [1] dilutes for Convertible at £82.5m convertible divided by 97.5 pence

By extinguishing the Convertible, the new equity created by conversion gives PHP the potential to re-gear the balance sheet. PHP's managers target a loan to value (LTV) ratio, therefore the additional equity (i.e. a change of debt into new shares upon conversion) from a putative conversion would enable greater debt to be taken on. This assertion is on the basis that the conversion would reduce the existing LTV ratio by c.6% points.

This in itself would enable PHP to re-gear (take on new additional debt) but still remain with an LTV ratio band PHP management is comfortable with. Simply investing £82.5m of convertible (which would at this illustrative stage no longer be debt), assuming net initial yields of 5.0%, assuming 92% operating margins (incremental fees being below average fees on existing portfolio) and assuming a 3% cost of money, generates £3.80m operating profit and £2.48m interest cost.

Reinvestment takes the 5.48p EPRA EPS (diluted for convertible) back up to 5.67p

Effect of re-investment post conversion

	£m	EPS
2018E Pro forma EPRA PBT post conversion pre, re-investment	37.40	5.48
Assumed operating profit [1]	3.80	
Assumed interest at 3.0% [1]	-2.48	
2018E Pro forma EPRA PBT post conversion and re-investment	38.72	5.67

Source: Hardman & Co Research

[1] Based on £82.5m incremental investment at 5.0% net yields and 92% operating margins

Investors are safe to ignore the dilution from the convertible

In summary – whilst the convertible is dilutive to EPS and the extent for 2018E is 3.2% (i.e. 5.48p diluted EPS vs 5.66p undiluted EPS) – we consider investors should ignore this dilution and assume proceeds of the debt extinguished when PHP choses to convert are efficiently re-invested in accretive asset acquisitions.

See table overleaf.

DPS and EPS (p) - cover

	2015	2016	2017E	2018E
EPRA EPS pre Convertible dilution	4.870	4.770	5.340	5.660
Dividend per share	5.000	5.125	5.250	5.400
Cover (%)	97.4	93.0	101.7	104.8

Source: Hardman & Co Research

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