PRIMARY HEALTH PROPERTIES

Strong set of results, confirming ongoing rent rises

29 July interims showed a 7.1% EPRA EPS increase, rising NAV and a continued rise in DPS. Illustrating the growth, rents rose 20.4%, and adjusted EPRA earnings rose 29.0%. On 9 July, PHP launched a £120m proposed placing, at a point in the REIT's development that is underpinned by a strong and broad pipeline. The placing was expanded to £140m as a result of investor appetite. The short-term pipeline stands at £128m, and there is also growth from active management of existing assets. We consider this REIT has significant per share value growth potential, through capital deployment, rent rises and financing cost efficiencies.

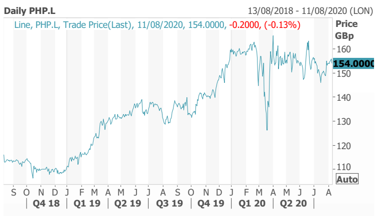
- **A stand-out performer**: Adjusted EPRA earnings rose 29%, or £8.1m. with £4.1m deriving from a full six months of the MedicX merger benefits, £2.2m from rental growth and reviews, and £1.8m from the reduced interest rate vs. the prior year. COVID-19 financial resilience illustrated PHP's index-linked, gilt-style character.
- **Investment summary:** 25% of leases being index-linked and 6% on fixed uplifts enhance even further the attractions of the AAA covenant, we believe. Also, the deployment success of the September 2019 equity raise is highly likely to be replicated on the latest oversubscribed raise, enhancing long-term dividends.
- **Expansion**: PHP deploys into new development funding, but also secures opportunities to buy standing assets. This is a growing sector. Last September, PHP raised growth equity at 128p; all of this has been deployed. With assets yielding 4.9% and new debt costing ca.2% or less, expansion is accretive.
- **Valuation:** The rating reacted positively to 2019 strategy execution, including the MedicX merger and the reduction in debt costs. The progressive dividends are – and will remain, we estimate – fully covered by earnings. This is not the first time investor appetite has exceeded initial targets for equity issuance.
- **Risks:** The recent placing helps to maintain an appropriate loan to value (LTV) in the short term, reducing the 30 June 2020 ratio by around 5.0ppts, from 45.8% to 40.3% on a pro-forma basis. Interest cover is over 2.9x. No direct development risk is taken, and the long leases are upwards-only rents.

Financial summary and valuation

Year-end Dec (£m)	2017	2018	2019	2020E	2021E
Rental income	71.3	76.4	115.7	133.0	142.0
Finance costs	-31.6	-29.7	-43.7	-46.3	-48.5
Declared profit	91.9	74.3	-70.2	112.8	133.7
EPRA PBT	31.0	36.8	59.7	72.8	78.7
EPS reported (p)	15.3	10.5	-6.4	9.0	10.2
EPRA EPS (diluted, p)	5.1	5.2	5.4	5.8	6.0
DPS (p)	5.25	5.40	5.60	5.90	6.12
Net cash/(debt) per balance sheet	-726.6	-670.2	-1,120.8	-1,110.9	-1,251.2
Dividend yield	3.4%	3.5%	3.6%	3.7%	3.9%
Price/EPRA NAV (x)	1.56	1.50	1.44	1.37	1.32
IFRS NAV per share (p)	94.7	102.6	101.0	106.7	110.8
EPRA NAV per share (adjusted, p)	100.7	105.1	107.9	113.3	117.5

Debt figure includes mark-to-market
Source: Hardman & Co Research

Real Estate



Source: Refinitv

Market data

EPIC/TKR	**PHP**
Price (p)	**156**
12m High (p)	161
12m Low (p)	115
Shares (m)	1,314
Mkt Cap (£m)	2,050
EV (£m)	3,020
Market	Premium, LSE

Description

Primary Health Properties (PHP) is a REIT acquiring and owning modern primary medical properties in the UK, and is expanding into the Republic of Ireland (RoI), now 7% of assets.

Company information

CEO	Harry Hyman
CFO	Richard Howell
Chairman	Steven Owen

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www.phpgroup.co.uk

Key shareholders (pre fund raise)

Directors	1.0%
Blackrock	6.7%
CCLA	5.3%
Investec Wealth	5.0%
Vanguard Group	2.7%
Troy Asset	2.3%

Diary

Feb'21	Final results
Apr'21	AGM

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Results

Summary of current position

PHP owns 510 assets, all primary medical assets, bar a very small exposure to nurse accommodation. All are held on very similar leases, which are upwards-only in rents and of long duration. The weighted average unexpired lease term (WAULT) stands at 12.5 years. 12.5 years is the weighted average length of lease to expiry. 90% of income is funded by government bodies, 7% in the Republic of Ireland (RoI), and the rest in the UK. These are all modern and relatively large (for the asset class) assets. Only 17% of the portfolio by value is in assets, which are valued at £3m or less, with 0.3% under £1m. This is important for sustainable long-term use.

Operating profits advance; accelerating rent growth

The interim results of 29 July were positive, seeing 2.2% annualised rent increases. Debt cost remained at 3.5%, but 1H'20 benefited from the 50bp reduction negotiated in 2019. PHP is set to benefit from a falling debt cost and earnings-accretive expansion. PHP remains in expansion mode and, during 1H'20, several development-partner projects were successfully delivered. We have noted the MedicX merger benefits. These have proven – as anticipated – to be two entirely complementary businesses. MedicX has widened the enlarged group's roster of development partners. See page 4 of this note for the immediate benefit to 1H'20.

Adjusted EPRA stood at £36.0m in 1H'20. In addition, there was a positive asset revaluation of £10.5m, but this stemmed from rent rises, rather than changes in the valuation yield basis. The net initial yield (NIY) was 4.86%. There was an (accounting only) £8.4m negative valuation on derivatives/convertible.

EPRA EPS stood at 3.0p in 1H'20, up 7.1% on 1H'19.

The main driver of the increase was underlying rental growth but, in the more immediate term, the deployment of capital should enhance earnings. Equity raises have lowered gearing, but this is being deployed promptly. Within the nine months since the previous equity raise, gearing has been fully deployed (leaving scope to gear up further, financially, we believe).

1H'20 net rental income grew 20.4%, and operating profit rose 21.7%, illustrating the deployment, some rent inflation and raised operating margins, driven by tight control on administrative costs (the fee structure).

PHP is into the fifth year in a row where rent inflation has risen. There has been (as per the contractual position) no year when rent has fallen, nor will there be. Rental growth from rent reviews continued its positive trend in 1H'20 – at £0.8m, equating to 2.2%. For the full years 2018 and 2019, the figures were 1.4% and 1.9%, respectively.

COVID-19

Investors will be well aware that the rents have been received as normal and the forward development new build sites have been physically progressing through the lockdown. Long term, it may be the case that patients interact in a slightly modified way with their GPs. The population is ageing. In addition, hospital costs are higher than the primary health asset delivery of certain services. This includes testing and recuperation, and, indeed, concerns over cross-infection in a hospital may cause a general review of health delivery to the benefit of expansion in primary medical facilities.

Debt financing and prospects

As noted, cost of debt remained stable, at 3.5%. This has been on a falling trend in recent years and – while it is now at low levels – we anticipate further reductions, as facilities at higher-than-average rates mature in the near future. New facilities at attractive terms have been put in place. We note that swap costs are now near *de-minimis*, and the maximum targeted LTV ratio has been lowered from 55% to 50%. There is excellent headroom, we believe, with over £400m of undrawn loan facilities and cash post all capital commitments.

LTV was 44.2% at end-2019, with the 2019 equity raise well invested. It stood at 40.3% at end-June 2020, if the July fund raise is adjusted pro-forma onto the actual end-June number. We model 41.5% at end-2020 – the reduction stemming from the equity raise this year, matched by net new investment – and 43.6% by end-2021.

Quarterly dividends showing healthy progression

Dividends are 5.4% higher than a year ago on a per share basis and 34.5% up in money terms. Our estimates for continuing growth are unchanged, as there has been consistent and highly visible growth in the dividend payout per share. Note that our estimates are for dividends being more than fully covered by EPRA earnings. 1H'20 dividend cover was 100%.

Fund raise

The equity raise of 9 July 2020

The £120m proposed placing was expanded to £140m as a result of investor appetite. A short-term pipeline stands at £92m from development projects and, in addition, there are substantial asset-enhancement projects. Taking the two together, the pipeline stands at £128m. Taking the development aspect of the pipeline, PHP's is effectively entirely partners' new developments, thereby providing visibility without having to compete for existing "standing stock" in the marketplace against other bidders. This is more than helpful, not least because of the active market for such second-hand modern stock bidding up valuations. Nonetheless, PHP has a good track record and solid prospects for purchasing standing stock, in addition to its forward funding with partners for new building of assets.

We have not raised our numbers for asset acquisition as a result of the fund raise, but anticipate opportunities that could lead to outperformance here. We model £130m acquisitions this year, followed by £140m in 2021. As with recent years, the majority will be in the UK, but RoI will contribute a share much greater than the RoI proportion of assets currently.

Indeed, the acquisitions, which generate investment running returns well ahead of cost of debt, and the relative skew to the RoI, which generates returns slightly above the UK, are an important plank to earnings growth.

Deployment on the 2019 raise

It is worth touching on the September 2019 £100m equity raise. This was successfully deployed across 23 standing investments, six forward-funded developments and 12 asset management projects totalling ca.£107m. This highlights that PHP does secure attractive standing asset portfolios and individual assets.

Turning to the development projects, there was the normal seamless and successful delivery at Athy, Bray and Rialto in RoI. These had a total development cost of £43.8m (€48.3m).

Risks

The contracts are for upwards-only rental revaluations (every three years), and the counterparts are effectively government-backed.

Equity raises do lead to initial reduced financial gearing – which de-risks – but are initially EPS-dilutive. Even in the light of the September 2019 equity raise, the recent dividends remain fully covered by earnings.

LTV stands at over 40%. Nonetheless, given the demonstrably robust characteristics of the assets, we see this as conservative. The target LTV is higher, but the target has recently been reined back slightly.

Undrawn facilities are substantial, and PHP demonstrably has access to a variety of sources of debt (bank, bond, placements) and equity (straight equity and convertible).

Currency risk to the Euro is negligible, and some Euro debt has been taken on, while remaining below levels of Euro asset valuations.

All development projects are forward-funding only. Delivery at Athy, Bray and Rialto in RoI substantially de-risks the forward-funded development exposure. Exposure is taken through low-risk contracts with known partners who undertake to deliver the developments. PHP's expertise is important, however, in this regard, as the company takes an active, supportive role at every stage.

Financial analysis

Revenue account summary							
Year-end Dec (£m)	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2021E**
Rental income (net direct property expenses)	62.2	66.5	71.3	76.4	115.7	133.0	142.0
Admin. expenses	6.8	7.3	8.2	8.6	10.5	12.0	12.7
Performance incentive fee (PIF)	0.0	0.0	0.5	1.3	1.8	1.9	2.1
Total expenses	6.8	7.3	8.7	9.9	12.3	13.9	14.8
Operating profit	55.4	59.2	62.6	66.5	103.4	119.1	127.2
Net finance costs	-33.7	-32.5	-31.6	-29.7	-43.7	-46.3	-48.5
EPRA PBT	21.7	26.7	31.0	36.8	59.7	72.8	78.7
Net revaluation and gain on portfolio	39.8	20.7	64.5	36.0	48.4	40.0	55.0
Gain on disposal	0.0	0.0	0.0	0.1	1.4	0.0	0.0
Fair value gain on derivatives	1.0	-2.2	-0.3	-1.8	-5.4	0.0	0.0
Fair value on convertible	-6.5	-1.6	-3.3	3.2	-28.2	0.0	0.0
MedicX-related exceptionals*	0.0	0.0	0.0	0.0	-146.1	0.0	0.0
Reported PBT	56.0	43.6	91.9	74.3	-70.2	112.8	133.7
EPRA EPS (diluted, post-performance fee, p)	4.77	4.69	5.07	5.16	5.42	5.79	5.99
Reported basic EPS (p)	12.57	7.78	15.30	10.48	-6.43	8.94	10.17
DPS (p)	5.000	5.125	5.250	5.400	5.600	5.900	6.125

**Including mark-to-market of debt acquired and costs of management contract termination*
Source: PHP Report and Accounts, Hardman & Co Research estimates

Note that 1H'20 dividend cover stood at 100%, but the equity raise is anticipated to result in only a minimal reduction in the interest charge for 2020, hence 2H'20 per share dilution will be a consequence.

With high visibility towards progressive deployment, a trend ongoing for interest rate reductions and the deployment of cash, we have every confidence in good DPS growth.

Balance sheet							
@ 31 Dec (£m)	2015	2016	2017	2018	2019	2020E	2021E
Investment properties, start of period	1,026.2	1,100.6	1,220.1	1,361.9	1,503.5	2,413.6	2,583.6
Currency translation effect	0.0	0.0	1.8	3.7	0.0	0.0	0.0
Additions to portfolio	34.6	98.8	75.5	101.9	855.3*	130.0	140.0
Revaluations	39.8	20.7	64.5	36.0	48.4	40.0	55.0
Non-current assets							
Investment properties, end of period	1,100.6	1220.1	1,361.9	1,503.5	2,413.6	2,583.6	2,778.6
Finance leases	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Sub-total: non-current assets	1,100.6	1220.1	1,361.9	1,503.8	2,413.6	2,583.6	2,778.6
Current assets							
Receivables	4.1	3.3	6.4	4.6	16.7	6.0	6.0
Other	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Net cash + short-term investments	2.9	5.0	3.8	5.9	143.1	104.0	11.2
Sub-total: current assets	7.0	8.3	10.5	10.4	159.8	110.0	17.2
Total assets	1,107.6	1,228.4	1,372.4	1,514.2	2,573.4	2,693.6	2,795.8
Current liabilities							
Deferred rental income	13.2	14.1	15.0	16.0	25.2	25.0	25.0
Trade and other payables	16.1	13.6	15.4	16.1	34.7	25.0	25.0
Term loans	0.9	0.8	0.8	0.9	6.1	31.0	1.0
Interest rate swaps	4.7	3.8	2.7	0.0	0.0	0.0	0.0
Bond	0.0	0.0	0.0	101.5	0.0	0.0	0.0
Sub-total: current liabilities	34.9	32.3	33.9	134.5	66.0	81.0	51.0
Non-current liabilities							
Term loan over one year, bond	696.7	667.4	729.6	573.7	1,257.8	1,183.9	1,261.4
Interest rate swaps	30.6	29.5	22.1	17.8	13.5	19.5	19.5
Other (head leases and deferred tax)	0.0	0.0	0.0	0.0	7.6	7.6	7.6
Sub-total: non-current liabilities	727.3	696.9	751.7	591.5	1,278.9	1,211.0	1,288.5
Total liabilities	762.2	729.2	785.6	726.0	1,344.9	1,292.0	1,339.5
Shareholders' funds	345.4	499.2	586.8	788.3	1,228.5	1,401.6	1,456.3
EPRA shareholders' funds	391.6	545.0	623.6	808.9	1,312.8	1,489.3	1,544.0
Shares in issue at period-end, No. (m)	446.3	598.2	619.4	769.1	1,216.3	1,314.2	1,314.2
NAV per share (p)	77.4	83.5	94.7	102.6	101.0	106.7	110.8
EPRA NAV per share (p)	87.7	91.1	100.7	105.1	104.2	109.9	114.0
Adjusted EPRA NAV per share (p)**	87.7	91.1	100.7	105.1	107.9	113.3	117.5
Net cash/(debt) per balance sheet	-694.7	-663.2	-726.6	-670.2	-1,120.8	-1,110.9	-1,251.2
Net cash/(debt)***	-694.7	-663.2	-726.6	-670.2	-1,081.9	-1,072.0	-1,212.3
LTV	62.7%	53.7%	52.9%	44.8%	44.2%	41.5%	43.6%

**Includes MedicX and other acquisitions of assets*
***Excludes mark-to-market of the former MedicX debt*
****Excludes mark-to-market on loans acquired*
Source: PHP Report and Accounts, Hardman & Co Research estimates

Note that the equity raise of 2020 is unlikely to be used to reduce the quantum of term loans during the remainder of the year, as very few such loans mature in 2020, as opposed to 2021. At the end-2020 balance sheet date, however, certain debt facilities, which were over one-year duration at end-2019, are in the sub one-year categorisation as at end-2020.

Hardman & Co also calculates LTV after a relatively minor adjustment related to mark-to-market, as compared with the face of the balance sheet.

Cashflow

Year-end Dec (£m)	2015	2016	2017	2018	2019	2020E	2021E
Operating activities							
Profit before taxation (adjusted for fair value)	49.9	43.0	91.9	73.4	100.1	112.8	133.7
Adjustments for:							
Net valuation changes on investment property	-39.8	-20.7	-64.5	-36.0	-48.4	-40.0	-55.0
Profit on disposals	0.0	0.0	0.0	0.1	1.4	0.0	0.0
Finance costs payable	33.7	32.5	32.2	29.7	43.7	46.3	48.5
Sub-total	43.8	54.8	59.6	67.2	96.8	119.1	127.2
Net (post-finance) cash inflow from operating activities	11.2	8.3	22.6	35.6	55.5	72.6	78.6
Investing activities							
Additions to investment assets	-29.5	-97.4	-75.4	-102.0	-47.4	-130.0	-140.0
Debt acquired	0.0	0.0	0.0	0.0	-476.6	0.0	0.0
Corporate transaction costs	0.0	0.0	0.0	0.0	-14.5	0.0	0.0
Net cashflow, operating and investing	-18.3	-89.1	-52.8	-65.6	-483.0	-57.4	-61.4
Financing activities							
Net proceeds from issue of share capital/conversion	-0.1	145.2	0.0	108.1	99.0	139.0	0.0
Dividends paid	-21.1	-24.7	-29.8	-34.7	-54.4	-71.7	-78.9
FX	0.0	0.0	0.5	0.7	-1.7	0.0	0.0
Net cashflow (change in debt)	-39.5	31.4	-82.6	7.8	-438.4	9.9	-140.3
Net proceeds of long-term borrowings	30.3	-29.3	62.1	-55.3	72.3	-49.0	47.5
Convertible redemption for shares	9.1	91.2	32.8	48.9	591.8	18.3	-31.4
Net cash inflow from financing activities	0.0	0.0	19.3	67.7	28.4	0.0	0.0
Net cash/(debt)	-694.7	-663.3	-726.6	-670.2	-1,081.9	-1,072.0	-1,212.3
Increase in cash and cash equivalents	-9.4	2.1	-1.2	2.1	137.2	-39.1	-92.8
Opening cash and cash equivalents	12.1	2.9	5.0	3.8	5.9	143.1	104.0
Closing cash and cash equivalents	2.9	5.0	3.8	5.9	143.1	104.0	11.2

Source: PHP Report and Accounts, Hardman & Co Research estimates

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