20 November 2019

HARDMAN & CO.

PRIMARY HEALTH PROPERTIES

Security of rising income; accelerating dividend growth

90% of PHP's income is backed by the UK or Republic of Ireland (RoI) governments. Occupancy consistently exceeds 99%. We are confident investors will continue to seek out REITs with a strong asset-class focus, particularly categories that provide security of rising income. PHP achieves all this, and its dividend per share growth rate is accelerating as a result. In total contrast to the wider real estate market, rent reviews on PHP assets are accelerating upwards. PHP's growth avenues are expanding. The March 2019 merger with MedicX Fund – as well as a £4m p.a. synergy efficiency and additional investment assets of more than £800m – has added complementary routes to purchase new assets.

- **What PHP invests in:** PHP purchases modern standing stock, and forward-funds repeat development partners. These assets are localised hubs, providing community-based GP surgeries and other closely-related medical services. The gross value is over £2.3bn, and the contracted rent roll now stands at £125.6m.
- **Growth in 2019 sees step-jump expansion**: The 14 March 2019 merger with complementary MedicX Fund effectively adds well over £800m of investment assets of as high a quality as PHP's, at nil stamp duty cost, bringing synergy efficiencies and taking PHP's investor offering to a new level.
- **Valuation:** The shares trade at a premium to EPRA NAV. Latest balance sheet assets were valued at a 4.85% (unchanged) net initial yield (NIY), but portfolios of this asset class consistently change hands at lower yields (higher prices). Investors in quoted real estate consistently favour focused investment strategies.
- **Risks:** No development risk is taken. Average cost of debt is 3.68%, down from 4.0% at the merger date and falling further on refinancings. Undrawn facilities exceed £200m. PHP states a 2.7% marginal interest cost, vs. a 3.9% average cost in 2018 – so yield pick-up continues to trend upwards.
- **Investment summary**: 23 years of unbroken dividend growth: expansion into higher cash-generating RoI assets and a falling debt cost support EPRA EPS and DPS growth. Incremental management fees are below existing averages. Given this, plus the enlargement through the merger and the asset yield, recent acquisitions have been EPS-accretive. The merger led to strong upgrades.

Financial summary and valuation

Year-end Dec (£m)	2016	2017	2018	2019E	2020E
Rental income	66.5	71.3	76.4	116.5	134.5
Net finance costs	-32.5	-31.6	-29.7	-43.7	-47.0
Declared profit	43.6	91.9	74.3	-52.5	114.5
EPRA PBT (operating)	26.7	31.0	36.8	60.2	74.5
EPS reported (p)	7.8	15.3	10.5	-5.1	9.4
EPRA EPS (diluted, p)	4.7	5.1	5.2	5.7	6.1
DPS (p)	5.12	5.25	5.40	5.60	5.85
Net debt	-663.2	-726.6	-670.2	-1,092.9	-1,222.9
Dividend yield	3.6%	3.6%	3.8%	3.9%	4.1%
Price/adj. EPRA NAV (x)	1.56	1.42	1.35	1.31	1.27
NAV per share (p)	83.5	94.7	102.5	103.0	105.8
Adj. EPRA NAV/share (p)	91.1	100.7	105.1	108.8	111.6

Source: Hardman & Co Research

Real Estate

Source: Refinitiv

Market data

EPIC/TKR	**PHP**
Price (p)	142
12m High (p)	142
12m Low (p)	106
Shares (m)	1,210
Mkt Cap (£m)	1,715
EV (£m)	2,770
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).

Company information

CEO	Harry Hyman
CFO	Richard Howell
Chairman	Steven Owen

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www.phpgroup.co.uk

Key shareholders

Directors	1.0%
Blackrock	6.9%
CCLA	5.3%
Investec Wealth	5.0%
Vanguard Group	2.7%
Troy Asset	2.4%

Diary

Feb'20	Final results
Apr'20	AGM

Analyst

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Investment objective

23 years of uninterrupted success

PHP has delivered an unbroken 23 years of dividend rises in each year since its flotation. The REIT's objective is to generate progressive dividends through investing in primary healthcare real estate, let on long-term leases.

Government-backed income

Company undertakes zero development

Important that PHP has access to two acquisition streams: standing assets and newly-developed stock

Rental income is funded directly or indirectly by a government body. The group leases medical centres to GPs, NHS organisations, the HSE in RoI and other healthcare users (e.g. pharmacies and family agencies). PHP makes no investment in hospitals, nor does it undertake developments. It acquires modern standing stock: typically of individual large assets (large in the context of this sector equates to ca.£10m or more consideration) or smaller portfolios of modern assets. 2019 notably comprised significant growth, acquiring over £800m assets through a merger with the very similar MedicX Fund. PHP's manager, Nexus, now manages the enlarged REIT.

2019 MedicX Fund merger a transformational quantum move

This is a growth company, and, to facilitate this growth, PHP has expanded its equity base, most recently confirmed on 24 September 2019, raising £100m in gross new equity at 128p – a premium to NAV. The company's investment objective is stated on its website: www.phpgroup.co.uk/investors/investment-case.

Investment case

- The REIT is dedicated entirely to a specific asset class – namely primary medical properties. Investor appetite for such a degree of focus is high. These are attractive, modern assets, with over 99% occupancy, on long upwards-only leases.

High covenant; upwards-only leases

Prospective rent rises – trend contrasting sharply with broader market

- Market rises in rents are set modestly to increase, after some years of low growth. Dividends have risen each year on the back of rent increases, which are now set to rise faster; thus dividend prospects are encouraging.

Rising margins from lower average fee costs and lower debt cost

- Dividends are also set to benefit from the rises in pre-tax profit margins. Marginal costs of management fees and the cost of debt are on long-established falling trends, with more to go. MedicX Fund did have a slightly higher cost of debt, but, since the merger, incremental part-refinancings and acquisitions, as well as new €- denominated debt, have reduced debt costs to 3.7%. The REIT's cost ratios have, in recent years, been at (or within striking distance of) their lowest levels across the whole sector, even prior to the further impetus afforded by the merger.

SWOT analysis	
Strengths	Long upwards-only leases and multiple sources of acquisitions
Weaknesses	Real estate sector out of favour with investors
Opportunities	Unlike broader market, rent growth set to accelerate
Threats	Rating above NAV but appears fully justified

Source: Hardman & Co Research

EPRA profit drivers

Future rental growth trends much more positive than broader market

Rental growth been modest across sector, but beginning to rise – with more to come

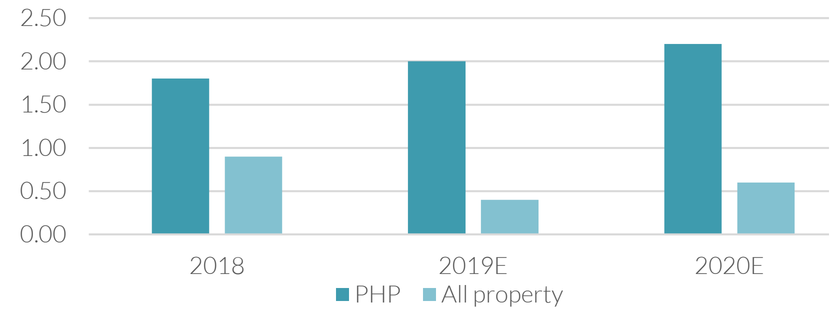
The sector has seen relatively modest rental growth, but this is accelerating, which is in marked contrast to the broader UK property market. Open market rent review assessments are based on local comparables. However, underlying all this, new development currently taking place (as the NHS steadily modernises its estate) needs to be remunerative. In addition, build (and land) costs are rising and are well ahead of pre-2008 levels.

Rents grew 1.8% in 2018 for PHP (pre MedicX Fund merger), including 2.7% on the 31% leases that are index-linked or fixed uplifts. For 1H'19, the average total figure was 1.9%. Open market rents (contractually upwards-only) increased slowly. The primary medical sector's rent growth history and prospects are diametrically opposed to the broader market. Growth has been held down in recent years, and is starting to accelerate.

We estimate that this 1.8% figure will rise in 2019 and accelerate in 2020. This is in marked contrast to the prospects for broader UK real estate, where several sectors are seeing negative numbers and the average has been progressively downgraded. The broader market currently is anticipated to grow by less than 1% this year and next.

PHP's rising trend contrasts sharply with the All-Property average

Rental growth (%) for PHP portfolio and for UK All-Property (IPF consensus)



Source: Historical PHP data provided by PHP; 2019, 2020 Hardman & Co Research estimates All-Property data source MSCI/IPF

Debt costs falling

There is clear scope for further reduction, with Sterling-based debt costing typically 2.7% (to include PHP's normal interest margin over 10-year swap rates) and the current average debt cost for PHP estimated at ca.3.7%.

Republic of Ireland (RoI)

Further high-quality acquisitions in RoI

PHP's portfolio is in the UK and RoI, with a current ceiling of 10% in RoI. RoI has been, and remains, a strong driver to expansion in the PHP balance sheet, and has a positively geared beneficial effect on profitability. The RoI asset NIYs are slightly higher than available, on average, in the UK, while € borrowing costs are below those of Sterling. Asset quality and balance of risks are similar between the UK and RoI. The RoI market is of a less historical long-standing nature, but significant new stock is being commissioned by RoI health authorities.

September 2019 £100m new equity raise

Equity raise at significant premium to NAV

The latest equity raise, as had been the case in earlier raises, was in response to investor demand. It has reduced LTV to around 44% (the same level as pre the MedicX Fund merger) and also provides substantial firepower for further growth. PHP is delivering its £150m pipeline, which includes £60m of forward-funded developments currently on site and £70m of new deals, with terms agreed and in solicitors' hands.

Risks and mitigation

Tenants may default; however, 90% of PHP income is state-backed, and the remainder derives from health services, which are of extremely high covenant. Rental contracts in the leases are upwards-only. Just under 70% are open-market rent reviews (upwards-only), and the remainder are fixed or index-linked.

Long leases, upwards-only

There is a risk at lease expiry, but the weighted average lease term to expiry (or break) stood at 13.0 years at end-June. PHP invests in modern, substantial local hub assets, and lease expiry usually brings upside (from small asset management projects).

Much of debt is fixed and average length to maturity nears eight years

93% of debt is fixed or hedged. LTV is slightly above that of many other UK REITs (many of which will be seen in the 30%-40% bracket); however, it is difficult to overstate the importance of the upwards-only rental clauses. Weighted average debt maturity is 7.6 years. PHP is refinancing debt at lower levels, and planning well for the relatively high levels of facility maturity in 2021 and 2022. Maturities to end-2022 now total £368m. Refinancing should be straightforward and at lower rates.

Positive income pick-up over cost of debt

Asset prices may rise too far, reducing NIYs and making future acquisitions less economically viable. There is still a useful yield gap between (post-cost) rent income of 5.0% and marginal cost of debt of 2.7%. PHP has strong connections and repeat business from a number of large developers, and so sourcing of assets does not rely at all on the second-hand market.

Financial analysis

Financial accounts

Year-end Dec (£m)	2014	2015	2016	2017	2018	2019E	2020E
Revenue account							
Rental income (net direct property expenses)	59.3	62.2	66.5	71.3	76.4	116.5	134.5
Total expenses	6.8	6.8	7.3	8.7	9.9	12.6	13.0
Operating profit	52.5	55.4	59.2	62.6	66.5	103.9	121.5
Net finance costs	-35.5	-33.7	-32.5	-31.6	-29.7	-43.7	-47.0
EPRA PBT (operating)	18.2	21.7	26.7	31.0	36.8	60.2	74.5
Net revaluation on portfolio	29.2	39.8	20.7	64.5	36.1	40.0	40.0
Fair value on convertible and derivatives	-7.0	-5.5	-3.8	-3.6	1.4	-4.1	0.0
MedicX Fund-related exceptionals	-2.4	0.0	0.0	0.0	0.0	-148.6	0.0
Reported PBT	36.9	56.0	43.6	91.9	74.3	-52.5	114.5
EPRA EPS (diluted, p)	4.10	4.77	4.69	5.07	5.16	5.70	6.08
DPS (p)	4.875	5.000	5.125	5.250	5.400	5.600	5.850
DPS cash cover	86%	97%	97%	97%	101%	102%	104%
Balance sheet							
Total assets	1,044.0	1,107.6	1,228.4	1,372.4	1,514.2	2,549.9	2,616.0
Total liabilities	734.8	762.2	729.2	785.6	726.4	1,293.6	1,318.0
Net debt	658.0	694.7	663.2	726.6	670.2	1,092.9	1,222.9
EPRA shareholders' funds	354.2	391.6	545.0	623.6	808.8	1,276.3	1,316.3
Adj. EPRA NAV per share (p)	79.6	87.5	91.1	100.7	105.1	108.8	111.6
LTV ratio	62.8%	62.7%	53.7%	52.9%	44.8%	43.0%	46.7%
No. of shares in issue at period-end (m)	445.1	446.3	598.2	619.4	769.1	1,220.0	1,225.0

Adjusted EPRA NAV excludes debt mark-to-market re MedicX Fund merger
Source: PHP report and accounts; Hardman & Co Research estimates

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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