Primary Health Properties

2014 full year results

Profit growth delivering dividend cover progress

Real estate

Primary Health Properties (PHP) provides growing dividends and an attractive 5.2% prospective yield. Cash flows are generated from a broad portfolio of government-backed healthcare facilities on long leases. Strong earnings growth in 2014, resulting from portfolio growth, lower funding costs and a lower expense ratio restored dividend cover to 84%. We expect a full contribution from funding and expense benefits in 2015. While portfolio growth is ongoing, it is currently subdued by the slow pace of new development approvals and competition for assets in this class. We have tempered our forecast asset growth, but still see full dividend cover by the end of FY16.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	Yield (%)	EPRA NAV/ share (p)
12/13	42.0	6.8	7.6	19.0	4.9	300
12/14	60.0	18.2	16.4	19.5	5.1	319
12/15e	63.1	20.2	18.1	20.0	5.2	328
12/16e	68.2	22.4	19.9	20.5	5.3	341

Note: *PBT and EPS are on an underlying EPRA basis, excluding valuation movements and other exceptional items. 2013 was previously shown additionally adjusted for £2.6m of other non-recurring costs, mainly the restructuring of management contracts.

Primary care growth prospects remain strong

We believe PHP operates in a very attractive market with good growth prospects over the medium term. Tenant quality is excellent, being largely government risk or pharmacies with a natural flow of business as a result of co-location with GP practices. Leases are long and with upward-only rent revisions. Demand is set to grow over the long term even though the process of approval by the NHS for new development projects remains frustratingly slow at present. Ahead of the general election, the NHS is centre stage with all main parties agreed on the central role of the GP. The NHS five-year plan acknowledges the need for significant change and seeks to deliver additional and more integrated services in the community.

Key messages from the FY14 results

Acquisitions and new commitments (including the PPP acquisition in December 2013) drove asset growth and rental income. Refinancing and improved financing conditions drove down funding costs, supported by PHP's growing scale. A renegotiated management fee structure reduced costs from 1 May 2014 and increases ongoing operational gearing. Competition for available properties is strong, evidenced by the marginal lowering of yields that contributed to £29.2m of net valuation gains. Management intends to maintain a disciplined approach to asset selection, but still expects near-term asset growth. As new development activity picks up (our estimates imply this should become apparent during FY16), PHP is very well placed to be a major participant.

Valuation: Growing dividends and cover

PHP's assets deliver secure cash flows from mainly government-backed revenues, supporting a high payout and growing dividends. Healthcare property values (and PHP NAV) are also benefiting from mild yield compression, but historical performance has shown much less volatility than the broad commercial sector.

2 March 2015

Price	**385.0p**
Market cap	**£428m**

Net debt (£m) as at 31 December 2014	655.2
Shares in issue	111.3m
Free float	96%
Code	PHP
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	4.1	8.6	7.0
Rel (local)	1.5	4.3	4.6
52-week high/low		395.8p	327.8p

Business description

Primary Health Properties is a long-term investor in primary healthcare property in the UK, principally let long term to GPs and NHS organisations backed by the UK government. The tenant profile and long average lease duration provide an exceptionally secure rental outlook.

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Profit growth delivering dividend cover progress

For the year to 31 December 2014 PHP delivered strong earnings growth and significant progress towards management's target of fully restoring dividend cover, despite a higher dividend per share and increased number of shares in issue. On a statutory IFRS basis, PBT grew 83% to £36.9m, while underlying (EPRA basis) earnings grew by 168% to £18.2m. EPRA earnings exclude valuation movements, as well as other non-recurring/non-cash items. 19.5p of dividend payments were made during the year (FY13 19.0p), marking the 18th successive year of growth, and dividend cover continued the increase reported at H1, rising to 84% for the year compared with the 57% reported in 2013. Growth in profitability was driven by substantially higher rental income (particularly reflecting a full year contribution from the PPP acquisition in December 2013), a lower average cost of debt (including significant refinancing activity during the year), and a lower expense ratio resulting from the restructured administration structure. The current year (FY15) should also see further benefit from the FY14 expense and refinancing activity, while asset/rent growth should be a continuing factor (although we have reduced our expected additions to the investment portfolio in 2015). With ongoing asset growth, we still expect full dividend cover in H216 on an increasing dividend per share.

Highlights of the 2014 full year results

- The total portfolio, including development properties, ended the year at £1,026.3m (a 10.4% increase on the year). Including £11.2m of contracted cost to complete development commitments, the total completed and committed portfolio was £1,037.5m (+8.2%). Seven new properties were acquired (of which three were standing let and four were in the course of development), representing £43m of new investment. Net revaluation gains of £29.2m were achieved (representing underlying like-for-like growth of 3.2%).
- At 31 December 2014, the portfolio consisted of 265 assets (of which 260 were completed and rent producing). Effectively full occupancy continued, at 99.8% let with a weighted average unexpired lease term (including commitments) of 15.3 years (FY13 15.7).The total contracted rent roll was £60.9m (FY13 £57.6m). A further three properties (including one let standing and two forward funding commitments) have been acquired at a cost of £15.8m.
- The independent year-end valuation of the portfolio was undertaken by Lambert Smith Hampton. The £29.2m gain is net of acquisition expenses and reflects a continued tightening in sector yields during the year, as well as ongoing asset management initiatives that support valuation through rental uplifts and lease extensions. The year-end valuation represents a net initial yield on PHP's portfolio of 5.52% compared with 5.65% in the previous year.
- Rental income receivable during the year increased by 43% to £60.0m, reflecting portfolio growth as well as continued rental growth. The average annualised uplift on the 135 rent reviews completed during the year was 1.8% (FY13 was 2.2% and H114 was 1.9%). Management expects no near-term change in trend of muted open market rent growth (77% of the rent roll, with the balance in leases with fixed or inflation-indexed uplifts) and expects the average overall portfolio uplift to be slightly down again in FY15 (we assume 1.6%). However, it also expects open market rents to eventually benefit from an increased number of newly approved developments that should highlight the increase that has occurred in building costs and help to establish a new rental level.
- As part of the acquisition of the PPP portfolio in December 2013, PHP assumed £178m of expensive existing debt at a rate of 5.9%. During the year, all of this debt has been refinanced, saving in excess of 100bp pa. PHP has completed a number of different financing transactions, including arranging new bank facilities and issuing (in May) an £82.5m 4.25% unsecured convertible bond, further diversifying its sources of finance. £235m of bank facilities were

restructured in August, with lending margins reduced by an average of 0.55%. Year-end debt facilities, including bank facilities (£558m), secured bonds (£70m), unsecured retail bonds (£75m) and unsecured convertible bonds (a nominal £82.5m) totalled £785m, of which £670m had been drawn. Allowing for cash balances as well as future funding costs to complete committed investments (£11.2m), the headroom on existing facilities was £116.7m. The balance sheet remains conservatively positioned with 92% of all drawn debt either fixed rate or hedged with swaps or caps, with an average maturity of 6.2 years (excluding the PPP loans refinanced through 2014, FY13 was 5.8 years). The group loan-to-value ratio was 64.1% compared with 61.6% at the end of FY13, while interest cover increased to 1.73x (FY13 1.60x). Unsecured debt facilities have increased to 24% of the total, a function of the increased size of the group, providing it with the flexibility to optimise collateral cover within its secured facilities and improve its funding terms.

- During FY14 the consolidation of accounting and secretarial services within Nexus became effective. Importantly, this broke the link between administration expenses and gross assets with a benefit to PHP's overhead costs. Based on gross assets at 1 May 2014, when the new arrangement became effective, management estimates the annualised saving at £1.2m compared with fees under the old arrangement. During FY14 the total expense ratio based on administrative expenses as a percentage of gross property assets reduced from 0.88% to 0.69%, and with a full year contribution from the new arrangement in 2015, as well as further asset growth, we forecast a further reduction to 0.61%.
- Statutory IFRS profit before tax increased 83% to £36.9m (FY13 £20.2m) while underlying PBT on an EPRA basis increased by 168% to £18.2m (FY13 £6.8m). PHP's historical adjusted earnings in FY13, on which the 57% FY13 dividend cover is calculated, adjusted for an additional £2.7m of one-off expenses (for which EPRA does not adjust), of which £2.5m was the contractual termination cost associated with implementing the new management structure. Factoring in the increased number of shares in issue, EPRA EPS increased by 116% to 16.4p. 19.5p per share of dividends were paid during FY14 (FY13 19.0p) and a second FY14 interim dividend of 10p per share has been declared for payment on 1 April 2015. The board is committed to maintaining a progressive dividend policy while growing dividend cover and, barring unforeseen circumstances, we expect PHP to pay 20.0p per share in dividends during FY15. EPRA NAV per share increased from 300p per share at the end FY13 year-end to 319p.

New portfolio commitment currently below the expected trend

Exhibit 1: Portfolio overview as of 31 December 2014

Number of completed investment properties	260
Number of properties in the course of development	5
Total number of properties at completion	**265**
Carried value of investment properties (£m)	1,002.4
Carried value of development properties (£m)	23.9
Total carried value of properties (£m)	**1,026.3**
Balance to complete committed investments (£m)	11.2
Total committed portfolio (£m)	**1,037.5**

Source: Company data

The seven new property transactions completed in FY14 saw PHP commit £43m in a mix of let standing acquisitions (three) and properties in the course of development (four). In addition, PHP continues to invest in its existing portfolio, to ensure that over the longer term the properties remain fit for purpose, with the flexibility to meet changing needs. In FY14, eight such projects were completed and £4.4m invested, adding to rents (£0.3m), extending average unexpired lease length (by an average 15.7 years) and producing an aggregate 42% valuation gain on the capital spent.

However, new portfolio commitments were below the c £100m pa that management believes to be a reasonable target over the medium term, and reflected in our previous forecasts. Moreover, transaction activity did not accelerate in H2 as we thought was possible (£29m committed in H1) given the mid-year strength of the pipeline of acquisition opportunities. At the H114 interims management reported an overall strong pipeline with c £85m either in solicitors' hands or at an advanced stage of negotiation. Despite this apparent delay, management indicated with the full year results that a number of transactions are nearing completion, and has subsequently announced that it has contracted to fund the development of two new properties and acquire one new standing property, all on long leases. Despite this recent progress, we have based our revised forecasts on £60m of commitments in FY15 (was £100m), increasing to £97m in FY16. We believe that the medium-term growth outlook remains strong, driven by an ageing population with growing healthcare needs, an underinvested primary healthcare estate and a general acceptance of the need for more integrated primary care services in the community. The short-term obstacles to faster portfolio commitments include the following:

- Despite falling yields, favourable debt funding conditions have maintained an attractive spread between rental yields and financing costs. However, increased investor interest in the attractive long-term yields that are still available in healthcare properties has increased competition for assets (particularly larger properties valued in excess of £10m). PHP says that while it expects to continue to add assets, it will remain disciplined and do so only where the underlying fundamentals are strong. In many cases this refers to properties that have the ability to expand and adapt to constantly changing medical needs, and can therefore provide the potential for long-term income and capital growth.
- The process of approval by the NHS for new development projects remains frustratingly slow, but PHP and other participants say they seeing some positive signals. The run up to the general election in May 2015 will have done little to speed things up, but has at least put the future of the NHS at the centre of political debate. All the main parties continue to support general practice as the key resource and patient gateway for state healthcare in the UK. The NHS five-year plan acknowledges the need for significant change and seeks to deliver additional and more integrated services in the community, with extended opening hours to improve access. The autumn statement recently announced £1bn of additional funding over four years, for investment in primary care infrastructure.
- The anticipated changes in healthcare delivery require modern, purpose-built, flexible premises (of the type in which PHP invests), in contrast to a significant proportion of the existing estate that is comprised of ageing, converted, residential properties. The BMA GP Committee Premises Survey reported that 40% of GPs see their premises as inadequate for the provision of general practice services. When new development activity does picks up (our estimates for new commitments imply that this may become evident during 2016), PHP should be well placed to be a major participant in the ongoing development and modernisation of the primary care estate.

Valuation

Yield

As a REIT, yield is obviously a key attraction of PHP shares. A high payout ratio and growing dividend per share are supported by the long-term predictable cash flows available to PHP on its portfolio of assets. Dividends per share totalling 19.5p were paid in FY14 and barring unforeseen circumstances, we expect the fund to pay out 20.0p per share of dividends in FY14, representing a prospective yield of 5.2%.

Management's key short-term priority of restoring dividend cover made significant progress in FY14, with cover increasing to 84% compared with the 57% reported in FY13. In FY15 there will still be some positive effect from the debt refinancing undertaken in FY14 and a full year impact of the management fee restructuring. Additionally, ongoing portfolio growth, locking in the spread between available asset yields of c 5.25-5.75% and an all-in marginal cost of debt of c 3.25% (assuming five-year swap rates of 1.4%), in combination with operational gearing, should generate ongoing cash flow growth. The marginal management fee on assets under management between £1,000m and £1,250m is 0.325%, declining to 0.30% above £1,250m.

Despite our reduced expectation for asset growth in FY15, we continue to forecast full dividend cover being achieved during H216.

NAV

IFRS net asset value per share was 278p at 31 December 2014 (2013: 274p) while on an EPRA basis it was 319p per share (2013: 300p). EPRA adjusts for the fair value liability of interest rate swaps and fair value movements on the recently issued convertible bond. On an EPRA basis, the shares trade on a P/NAV of 1.21x.

Increased interest in the attractive and secure long-term yields still available on primary healthcare properties, from institutional investors in particular, has driven a marginal tightening of valuation yields. We estimate that if the valuation yield on PHP's existing portfolio were to reduce by 0.1% (to an equivalent yield of 5.42%) the EPRA NAV per share would increase by c 17p to 336p.

During calendar year 2014, the yield contraction seen in the primary care real estate sector was eclipsed by that in the historically more volatile commercial property sector as a whole. Exhibit 2 shows the total property returns (net rental income plus valuation movements) for various periods to 31 December 2014 for PHP and for the overall commercial property sector. IPD's UK Healthcare Property Index returns will be available in March 2015. In the five years to 31 December 2013, PHP had shown a total return of 14.0% compared with 8.7% for the healthcare index.

Exhibit 2: Performance versus IPD Healthcare Property Index (total return)

To 31 December 2014	One year	Three years	Five years
PHP	8.9%	7.1%	8.3%
IPD All Property Index	18.6%	7.3%	8.0%

Source: PHP, IPD

Net rental income is a significant element of commercial (and healthcare) property returns over time. Because healthcare property is less economically sensitive, displays consistently high levels of occupancy and is less susceptible to speculative development, returns tend to show much less volatility over time than for the commercial sector as a whole.

Financial summary and estimate revisions

We believe the prospects for medium-term asset growth are strong. However, as discussed above, new portfolio commitments in 2014 were below our forecast level. While it is difficult to predict how much of the pipeline of investment opportunities may be converted in any given period, near-term market conditions (continued subdued new development and PHP's determination to maintain investment discipline amid greater competition for available assets) suggests to us that 2015 commitments will similarly be below the medium-term target of c £100m pa that we had assumed previously. In our revised forecasts, lower average assets and hence rental income is partly offset by lower funding costs and administrative expenses. Full dividend cover is still forecast for H216. EPRA NAV per share benefits from anticipated valuation gains.

Exhibit 3: Estimate revisions

	Revenue (£m)			EBITDA (£m)			EPRA EPS (p)			DPS (p)			Dividend cover			EPRA NAVPS (p)		
	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff	Old	New	% diff
12/15e	66.7	63.1	(5.4)	58.36	55.73	(4.5)	18.3	18.1	(1.6)	20.0	20.0	0.0	92.2%	90.3%	N/M	309	328	6.1
12/16e	73.9	68.2	(7.7)	64.77	60.36	(6.8)	21.2	19.9	(6.3)	20.5	20.5	0.0	104.7%	97.2%	N/M	316	341	8.0

Source: Company data, Edison Investment Research

For FY15 we assume £60m of new portfolio commitments (FY14 £43m), increasing to £97m in FY16. The increase in FY16 assumes a thawing of the logjam of new development approvals by the NHS, particularly after the general election. For FY15 we assume that the majority of new commitments are to forward-fund properties under development (£38m), with the balance to immediately income-producing assets. Additionally, we assume £40m of development assets transfer to income-producing assets during the year. All of the development assets are pre-let and PHP does not undertake speculative development.

In addition to the known positive effects of the management fee restructuring that became effective on 1 May 2014, administrative expenses have been well contained and we assume this will continue. FY14 refinancing activity continues to reduce the average cost of funding.

Valuation gains of an assumed £12.7m in FY15 and £15.4 in FY16 reflect estimated rental growth of 1.6% and 2.0% respectively with no potential decrease in valuation yields factored in.

Our forecasts continue to show dividend cover progress despite increasing dividends per share. Although not fully covered for FY16 as a whole (forecast 97.2%), we do expect full dividend cover in H216 (102.0%).

Our investment portfolio growth forecasts imply an increase in debt during FY15 and FY16 with net debt as a percent of the portfolio value ending the period at 66.9%. This is towards the higher end of the range with which we believe management would be comfortable and faster than forecast asset growth raises the prospect of additional equity funding, not included in our forecasts.

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Exhibit 4: Financial summary

	£'000s	2012	2013	2014	2015e	2016e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		33,151	41,982	59,985	63,061	68,202
Cost of Sales		(402)	(398)	(723)	(877)	(949)
Gross Profit		32,749	41,584	59,262	62,184	67,254
Administrative expenses		(5,124)	(6,080)	(6,782)	(6,450)	(6,892)
EBITDA		27,625	35,504	52,480	55,734	60,362
Other income and expenses		0	638	0	0	0
Non-recurring items		0	(2,702)	(2,426)	0	0
Net valuation gain on property portfolio		(1,768)	2,313	29,204	12,718	15,360
Operating profit before financing costs		25,857	35,753	79,258	68,451	75,721
Net Interest		(20,242)	(26,016)	(34,275)	(35,496)	(38,004)
Non-recurring finance income/expense		0	0	0	0	0
Early loan repayment fees		(1,564)	(950)	(1,187)	0	0
Fair value gain/(loss) on interest rate derivatives and convertible bond, and swap amortisation		(2,922)	11,432	(6,916)	0	0
Profit Before Tax (FRS 3)		1,129	20,219	36,880	32,956	37,717
Tax		1	1	0	0	0
Profit After Tax (FRS 3)		1,130	20,220	36,880	32,956	37,717
Adjusted for the following:						
Net gain/(loss) on revaluation		1,768	(2,313)	(29,204)	(12,718)	(15,360)
Fair value gain/(loss) on derivatives & convertible bond		2,922	(11,432)	6,916	0	0
Profit on termination of finance lease		0	(638)	0	0	0
Early loan repayment fees		1,564	950	1,187	0	0
Issue costs of convertible bond		0	0	2,426	0	0
EPRA basic earnings		7,384	6,787	18,205	20,238	22,358
Period end number of shares (m)		76.0	110.5	111.3	111.4	111.6
Average Number of Shares Outstanding (m)		72.7	89.1	111.0	112.1	112.3
Fully diluted average number of shares outstanding (m)		72.7	89.1	124.1	117.0	117.2
EPS - basic (p)		1.6	22.7	33.2	29.4	33.6
EPS - fully diluted (p)		1.6	22.7	31.5	31.2	35.2
EPRA EPS (p)		10.2	7.6	16.4	18.1	19.9
Dividend per share (p)		18.5	19.0	19.5	20.0	20.5
Dividend cover		56%	41%	84%	90%	97%
BALANCE SHEET						
Fixed Assets		625,547	942,020	1,026,232	1,098,950	1,211,309
Investment properties		622,447	941,548	1,026,207	1,098,925	1,211,284
Net investment in finance leases		3,100	0	0	0	0
Derivative interest rate swaps		0	472	25	25	25
Current Assets		28,033	14,052	17,740	13,125	13,597
Trade & other receivables		2,916	4,764	5,668	5,125	5,597
Net investment in finance leases		21	0	0	0	0
Cash & equivalents		25,096	9,288	12,072	8,000	8,000
Current Liabilities		(107,519)	(39,635)	(33,065)	(37,637)	(39,113)
Term loans		(79,934)	(3,843)	(711)	(3,513)	(3,513)
Trade & other payables		(10,687)	(16,269)	(14,244)	(16,014)	(17,490)
Derivative interest rate swaps		(7,523)	(7,566)	(5,802)	(5,802)	(5,802)
Deferred rental income		(7,811)	(11,934)	(12,308)	(12,308)	(12,308)
Other		(1,564)	(23)	0	0	0
Long Term Liabilities		(366,971)	(614,052)	(701,777)	(754,090)	(850,045)
Term loans		(247,905)	(460,185)	(437,022)	(489,335)	(585,290)
Bonds		(73,755)	(132,408)	(229,543)	(229,543)	(229,543)
Derivative interest rate swaps		(45,311)	(21,459)	(35,212)	(35,212)	(35,212)
Net Assets		179,090	302,385	309,130	320,347	335,748
Derivative interest rate swaps		52,834	28,553	40,989	40,989	40,989
Change in fair value of convertible bond		0	0	4,462	4,462	4,462
EPRA net assets		231,924	330,938	354,581	365,798	381,199
IFRS NAV per share (p)		236	274	278	287	301
EPRA NAV per share (p)		305	300	319	328	341
CASH FLOW						
Operating Cash Flow		35,432	36,682	49,020	58,047	61,365
Net Interest & other financing charges		(20,339)	(30,430)	(49,633)	(35,496)	(38,004)
Tax		0	0	(23)	0	0
Acquisitions/disposals		(45,519)	(54,731)	(54,396)	(60,000)	(97,000)
Net proceeds from issue of shares		18,399	65,232	17	0	0
Equity dividends paid (net of scrip)		(12,209)	(16,130)	(20,688)	(21,738)	(22,316)
Other (including debt assumed on acquisition)		(51,000)	(211,273)	7,647	0	0
Net Cash Flow		(75,236)	(210,650)	(68,056)	(59,187)	(95,955)
Opening net debt/(cash)		(301,262)	(376,498)	(587,148)	(655,204)	(714,391)
Closing net debt/(cash)		(376,498)	(587,148)	(655,204)	(714,391)	(810,346)

Source: Company data, Edison Investment Research