2nd March 2017

hardman&co

Primary Health Properties REIT

Clear road, full tank, strong dividend prospects

PHP reported final results 16th February. PHP has paid 20 years' unbroken dividend increases since first listed. Assets are all on long term leases, mostly upward only rents: a REIT with sustainable growth. At a relatively mature stage in the market cycle, this offers growth with resilience. With a successful £150m fund raise under its belt, visibility of steady expansion and re-gearing imparts upward momentum to EPS. We thus see scope for continuing further dividend growth. 2016 cash dividend cover was 100%. 2017 onwards we see growing, covered dividends.

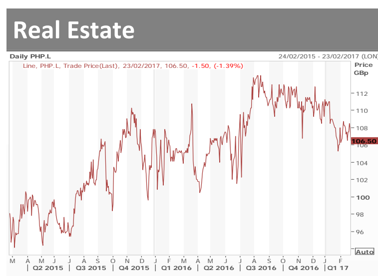
- **Strategy:** PHP grows its UK portfolio, now also entering Ireland, enhancing dividend growth. PHP's 2016 EPRA Cost Ratio (admin costs as a proportion of net rental income) of 11.5% (11.5% 2015), we believe ranks best in sector. We estimate falls in all future years. This is another support to future dividends.
- **Stability and growth:** Dividend cover is rising and set to rise further, underpinning good growth prospects. Post the £150m 2016 fund raise there is strong scope for re-gearing of the balance sheet which supports EPS enhancement. PHP has a good record of growth, having trebled its portfolio size in five years. PHP's reputation, partners and track record assist when securing both standing assets and new stock. We also anticipate a gradual lengthening of debt maturity profile, PHP having wisely managed the cycle of falling rates.
- **Valuation:** The healthcare real estate sub-sector trades at a premium to NAV. PHP's 'bond proxy' status is the right area to be in at this cycle stage. Indeed, PHP has been among the strongest REIT share price performers long term too.
- **Risks:** There is no rental income or void risk, but some exposure to interest rate trends circa five years from now. Addressing this, the average debt maturity is set to rise steadily. With incremental management costs which are below PHP's average, ongoing expansion enhances dividend cover.
- **Investment summary:** Total Shareholder Return (TSR) CAGR of well over 10% over the past five years. In 2016 TSR was 7.3%, 2015 23.5%.
- **2019E:** Estimates will be initiated shortly. We can confirm we estimate growth in NAV, EPS and DPS, assisted by modestly accelerating rental inflation. Note, in 2019 we anticipate the Convertible holders will elect to convert to equity.

Financial summary and valuation

Year end Dec (£m)	2013	2014	2015	2016	2017E	2018E
Income	42.0	60.0	63.1	67.4	73.8	80.5
Finance cost	(26.9)	(35.5)	(33.7)	(32.5)	(33.7)	(38.3)
Declared profit	20.2	36.9	56.0	43.7	43.6	46.4
EPRA PBT (Adj pre revln)	9.5	18.2	21.7	26.7	31.4	33.1
EPS Reported (p)	5.7	8.3	12.6	7.8	7.3	7.9
EPRA EPS (p)	2.7	4.1	4.8	4.7	5.3	5.5
DPS (p)	4.750	4.875	5.000	5.125	5.250	5.450
Net (Debt)	(587.2)	(655.2)	(694.7)	(663.2)	(758.1)	(851.8)
Dividend yield (%)	4.4	4.4	4.5	4.7	4.8	5.0
Price/EPRA NAV	1.43	1.37	1.24	1.20	1.17	1.13
NAV (p)	70.0	69.6	77.4	83.5	85.7	89.0
EPRA NAV (p)	76.1	79.6	87.5	91.1	93.2	96.4

Source: Hardman & Co Research

Real Estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	PHP
Price (p)	109
12m High (p)	114
12m Low (p)	101
Shares (m)	598
Mkt Cap (£m)	651
EV (£m)	1315
Free Float*	96%
Market	Main LSE

**As defined by AIM Rule 26*

Description

Acquisition and ownership of modern primary medical properties in UK; expanding into Republic of Ireland.

Company information

CEO	Harry Hyman
CFO	Phil Holland
Chairman	Alun Jones

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www.phpgroup.co.uk

Key shareholders

Directors	2.6%
Investec Wealth	5.2%
Blackrock	5.0%
Unicorn	4.5%
CCLA	3.9%
Troy	3.7%

Next event

Apr-17	AGM
Aug-17	Interim results
Nov-17	IMS

Analysts

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2016 results and future implications

Oversubscribed equity issue April 2016 to fund coming years' growth

In 2016, PHP raised net £143.5m in a new equity share issue enlarged due to oversubscription. This fuels several years' growth which would be fundable by debt and strongly EPS enhancing. We estimate that this fresh equity was 5% dilutive of historic, 2016 EPS. We estimate EPS to be up just over 10% for 2017E.

There was a 25% rise in shares in issue on average for 2016, so unsurprisingly EPS fell. For 2017E, the average shares in issue rise 7% (assuming no further issuance this year). Asset returns are higher than cost of debt, so the 2016 equity issue provides substantial financing for growth in earnings.

Share issuance has diluted 2016 EPS and also impacts 2017, providing significant upward momentum to future years

As this cash is re-invested, it will impart upward momentum to EPS. Despite the greater shares in issue, we anticipate EPRA diluted EPS to be up just over 10% for 2017E. This is a combination of deploying the funds and also a treasury management operation effective November 2016 which enhanced 2016 EPS by a de minimis amount and enhances 2017E (and future years) by near 8%. See summary table page 6.

14% EPRA EPS rise 2017E followed by 10% 2018E and good rises beyond that

On top of 10% EPRA EPS growth 2017E, we estimate an 8% rise in 2018E EPRA EPS. The 25% and 7% rise in average shares in issue for 2016 and 2017E mean earnings performance is significantly better than EPS. For 2018 when this 'mathematical' headwind is fully in the past, growth continues, fully reflected in EPS.

Progressive re-gearing of the balance sheet has a significant positive effect on net earnings, especially 2018 and 2019

Further deployment of funds leads to rising gearing as the 2016 equity issue proceeds are deployed further. This provides one of the avenues by which PHP grows earnings and enhances dividend cover. Loan to value (LTV), having been 62.7% end 2015, fell to 53.7% at end 2016. A rise to over 56% and then near 59% is anticipated for end 2017 and end 2018 respectively. We note the level of 60% is unlikely to be exceeded in the near future, for PHP-stated reasons of prudential strategy.

During 2016, £74.2m assets were acquired, including £5.7m in the Republic of Ireland (RoI). 2017 should see acceleration in investment. The UK 2016 tally, unusually, included no acquisitions of forward-development assets. This route will return – the dearth is indicative of a low level of development in the whole market and we do not see this lasting. The investment nonetheless is usefully up on 2015's £34.6m. The prior five years averaged £110m (enhanced by major portfolio acquisitions in 2013).

PHP's pipeline of forward-funding (with exclusive first refusal) and also acquisitions is robust, so we upgrade expectations here....

We increase our estimates for 2017E to £100m total acquisitions, from a former estimate of £65m. This is fortified by the good pipeline of opportunities and the anticipated return of new build in the market as a whole. Further, we estimate an annual average €20-30m RoI investment for a number of years – at acquisition prices set to remain attractive. PHP's track record on smaller portfolio acquisitions and its being a strong development partner are standing PHP in good stead. It may secure larger portfolios (as in 2013) but there is strong investor appetite for these currently and not a substantial cohort of large portfolios exist. We do not anticipate PHP wanting or needing to pay aggressive prices for these.

Low levels of development of new stock are ongoing but are likely to rise (and maybe significantly) at some stage. Overall, PHP is well placed to grow substantially.

.... and now includes ROI

Republic of Ireland (RoI). This is a significant market for new-build. During PHP's forward-funding, it receives income (as per its UK operations). The Irish government typically accounts for 60-75% of income, via 20+ years lease terms. The remainder of the tenants are primary health providers and pharmacies. The yield pickup in this

market should be up to 200bps higher than similar UK stock. Specialist knowledge and patience is required from the buyer (i.e. PHP). We consider the amount of new stock being developed to be sufficient to supply the appetite of buyers without significant rises in prices for some while.

Rental growth remains just under 1% pa. This low level is as a result of the technicalities of how the tenant (e.g. NHS England) negotiates and sets rents. A prospective rise in volume of new development will, we consider, underpin rising rents. This is the result of the cumulative rises in construction (and land) costs of recent years – rises which developers need to be covered by rents. This new-build driven re-assessment then filters through to lease renewals on standing stock. Our estimates are for 1.0% then 1.5% rent inflation in 2017E and 2018E respectively but we would hope to be raising estimates as 2018 proceeds. Note that 20% of PHP's rent is in leases indexed to RPI.

20% rent is indexed to RPI

Cost ratio will fall further

The EPRA cost ratio for 2016 was 11.5%, unchanged on 2015 and down on 2014's 12.0%. This is best in sector. Operating margins thus were maintained: at 87.8%. Five years ago, they were 83.9%. The trend is for further rises in margins, as a function of the tiered fee structure.

Excellent 7.9% total return on the assets and 7.3% TSR

Total property returns were 7.9% 2016. Whilst this is below the 2015 9.7%, it is well ahead of the 2016 IPD All Property of 3.6% total return (i.e. capital plus income).

Total shareholder returns were 7.3% in 2016 (23.5% 2015). NAV return was 3.9% (16.3% in 2015 and 12.8% in 2014). The share issue (which was at a premium to NAV) was a factor behind the NAV rise. There was only a modest revaluation driven by capitalisation rates tightening (reducing) slightly. Yield tightening and the 0.9% 2016 rent increase contributed to revaluation gains. These totalled £20.7m in 2016. We are happy to see the yield tightening (asset price rises) only being modest. PHP is a significant ongoing buyer, so rises in existing assets' values are a two-edged sword.

Cost of debt flattened out in 2016 but we see more falls for 2017E

Average cost of debt fell marginally to 4.65% compared to 4.67% in 2015, 5.15% in 2014 and 5.85% for 2013.

Term reduced to 5.1 years. We would confidently watch for a lengthening there: both this year and next

The average length to maturity of facility fell to 5.1 years (from 5.9 at end 2015). The convertible runs to 2019. In an environment of falling interest rates, PHP has been very wise to maintain debt of shorter duration than the long leases it owns. The current interest rate environment offers excellent re-financing opportunities, lengthening maturity and fixing rates. 5-year swap rates at under 0.9% and 15 or 20 year rates being only very modestly higher, the cost to the profit and loss account of incrementally lengthening the debt profile is extremely modest. We would anticipate PHP to be assessing opportunities here. Such lengthening would – if undertaken – fix in some attractively priced debt costing far less than the (progressive) rental yield. It would also remove the risk of rising debt eroding that yield pick-up from debt to rental income in the future – albeit that risk is, we consider, many years off.

Good treasury management - again

To give visibility on future interest rates, PHP enters into swap contracts. A number of these (on older higher rates) were retired in summer 2015. In May 2016, but effective from November 2016, the opportunity was taken to re-coupon some £88m of such swaps for a cost usefully below net present value of the cost of the swaps. As a result of the buy-out, the cost of those swaps in 2017E will fall circa £3m below the cost for 2016E. New swaps were arranged in 2015 on £100m debt, to become effective from 2018 and 2019, for five year periods at 2.47% and 2.65% respectively. Our estimate of the prospective swap interest rise reflects this.

Convertible issued 2014, matures 2019

There is currently a circa 3% EPS dilution from the 2014-issued Convertible maturing 2019. Our headline EPRA EPS figures are stated post this dilution. With an initial conversion price of 97.5 pence, the unsecured convertible bond issued by the Group on 20 May 2014, maturing 2019, is anti-dilutive to all measures of net asset value per share. We would anticipate a (near) full conversion of this stock into equity in 2019, given the current share price premium. Were this to take place, the resultant 2020 dividend payment would rise by more than the reduction in the interest charge payable currently to the convertible bond holders. The amount of dividend cover rising well each year from here forward, such a consideration is not too material and is some way off, contingent on a number of factors. In this regard, it is particularly relevant that the bond, of course, is included currently within the key LTV metric. Its presence does not restrict opportunities for good dividend growth at all.

Summary of key forward metrics

2017E, 2018E dividend cover 100%, 102% respectively

2017E and 2018E EPRA EPS growth momentum visibility is high – investing the proceeds of 2016 equity raise. 2018E dividend cover rises to 102%. 2019E growth is expected.

The major drivers to 2017 advance have all been put in place already:

1) *November 2016 swaps re-set*
2) *Equity fund raise to finance ongoing growth*
3) *Irish expansion*

The share issuance of 2016 has significant effects to the 2017E growth in a number of ratios. The average shares in issue for 2017 rise 6.8% (we assume no further 2017 issuance), but the re-gearing enables 10.0% rental growth. Within this 10.0% figure is a modest (well below 1%) element coming from the superior net initial yields derived from Irish developments). This RoI factor expands further in 2018E but remains relatively modest. In 2017E we anticipate modest 1.0% rental inflation. Further benefitting 2017 is the reduction in the swaps interest charge following a re-negotiation effective November 2016. This reduces total net finance charge by 10%. Our 2017E figure of 3.0% reduction (see below) allows for newer swaps in place to start. The +3.0% 2018E figure likewise is an allowance for the new swap arrangements already in place due to start. Our assumption on average interest on bank borrowings is for a small fall 2017E and a de minimis small rise in 2018E, whilst lengthening the maturity profile. Circa a third of interest is bond interest, 2017E.

Combined, these factors lead to our estimate of EPRA EPS (i.e. excluding revaluations) growth of 10.0% 2017E and 5.5% for 2018E.

Strong momentum behind 2017E EPS growth of 10%

Key financial metrics – 2017 and 2018 drivers to growth

Growth vs prior year %	2017E	2018E
Average shares in issue %	6.8	0.0
Revenue %	9.5	9.0
Revenue - of which asset acquisitions %	8.5	7.5
Net interest charge %	3.7	13.6
Interest – of which effect of swaps %	-3.0	3.0
EPRA profit %	17.6	5.5
EPRA EPS (diluted for convertible) %	10.0	5.5

Source: Hardman & Co Research

Debt headroom and ratios allows plenty of scope for growth. We anticipate 60% LTV as a medium-term level. The equity share issue has taken LTV down to just below 54%. Our estimate is 56.3% at end 2017E and 58.6% end 2018E. See table below.

The table below also shows trends in operating margins. The trend in years prior to 2016 has been for ongoing reductions in the ratio – a function of efficiencies garnered through size and also historically the fee structure has been changed for the benefit of shareholders. There was a particular reduction effective in 2015 and which has come to an end, hence the absence of the margin rise in 2016 is a one-off.

Note how the equity issue reduced LTV and the significant scope for re-gearing

Key financial metrics – 2017 and 2018 drivers

Metric	2015	2016	2017E	2018E
LTV	62.7%	53.7%	56.3%	58.6%
Operating margins	87.8%	87.8%	88.2%	88.7%

Source: Hardman & Co Research

2019E growth

For 2019E there is still scope for adding further gearing on the balance sheet as 60% LTV is the current management-stated ceiling. Facilities would enable significantly higher gearing. There is also scope for margin enhancement. 2019E should also witness a (modest) increase in the pace of rent rises.

20 years of dividend growth

Highly visible future growth

PHP's focus is creating sustainable growth in shareholders' assets and income. It has and will continue to achieve this. The statistics on page 5 we believe illustrate the reasons for confidence. With cover rising, we suspect there is good scope for the rate of dividend growth, which we estimate at 3.8% for 2018E, to be sustainable long term. To support our confidence, we now analyse the EPRA EPS momentum and the outlook. We analyse each in turn. We note the rent rises are likely to remain modest but not to reduce from the 0.9% pa historic level. Our confidence on dividend growth does not rely on a significant acceleration in rent rises, although we do anticipate a rise (assisted by the 20% of rents based on RPI).

Earnings set on a rising trend – income rising + costs falling

Strong situation on the positive 'yield gap'

Falling costs….

PHP's forward prospects in this regard are underpinned by growing earnings. In this segment, we look at EPS: the earnings themselves are driven by the positive and widening gap between the gross income yield of the assets and all-in cost of finance (which includes swap costs and fees). It also is underpinned and enhanced by the downward trend in costs as a proportion of gross investment assets, which is a function of increasing efficiencies driven by the growth in assets. Asset management fees taper as the portfolio is enlarged (and indeed the fee scale has reduced). Importantly, the asset yield in the chart below is calculated on continually revalued assets thus a flat trend in returns on assets and on debt would deliver a rise in earnings (given the yield being calculated on rising asset values).

…. high visibility on rental contracts and upward-only rents

PHP benefits from excellent forward visibility of rental income, being invested exclusively through long leases and predominantly upward only rental contracts.

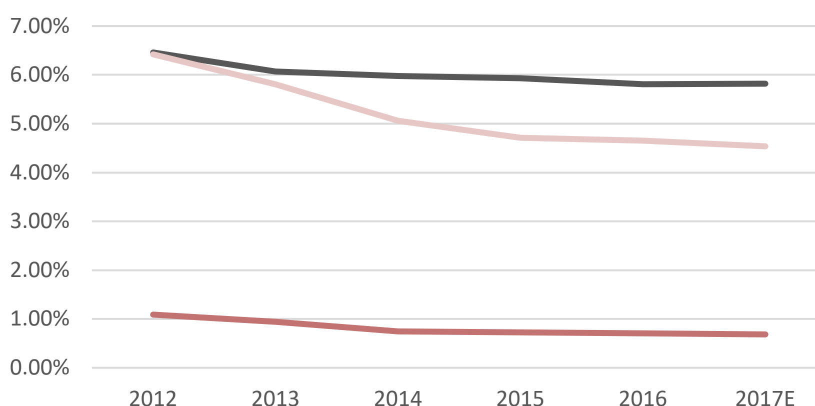
Whilst rents are mostly upwards only, the rises have been modest (1-2% range for past near 10 years) and – as asset prices have risen – the yield on mark-to-market values has reduced slightly over time. But costs of debt and cost of administration/ management have fallen much further. CHART BELOW HAS BEEN UPDATED

The positive and widened gap evident here is just ONE of the REIT earnings drivers

Although the yield on new acquisitions is falling slightly (the top line) as a result of with rising prices, administrative costs are falling too

The significant fall in interest costs lagged as a function of PHP's reduction in interest swaps

Earnings drivers – income and costs



Gross income as % ave gross assets
Finance costs as % ave debt
Operating, management costs as % ave gross assets

Source: PHP report accounts and estimates: Hardman & Co

Three major positive drivers for PHP cash based earnings – hence dividends

- A significant driver to PHP's earnings growth is that it is acquiring assets on a positive yield gap after all costs.
- The average cost of debt (chart above) was 4.65% 2016. The incremental cost of debt is some 3.0% on a circa 190bps margin over ten-year debt.
- Re-gearing the balance sheet enhances earnings materially.

This is the raw material for the 'clear road' we refer to in the title of this document. The chart above shows an ongoing, widening positive 'gap' in income and costs. So why do we see scope for (modest) acceleration in dividend paying ability? What is the second factor? The answer in short is the strong and significantly strengthened equity base.

EPS benefits from a 'following wind' – re-gearing financially

Growing dividends covered by EPS are set to continue from here.

We refer in the title of this document to 'full tank.' By this we look at the balance sheet's power to grow the asset base. It has been replenished following the £150m equity issuance earlier this year.

The table shows that in 2012, 2013 indeed, the dividends were materially un-covered, but growth continued without a problem

Dividend cover

Year Dec	2011	2012	2013	2014	2015	2016	2017E	2018E
EPRA EPS (p)*	4.114	2.510	2.666	4.095	4.870	4.767	5.250	5.540
DPS (p)	4.500	4.625	4.750	4.875	5.000	5.125	5.250	5.450

Source: PHP report accounts and estimates: Hardman & Co

* *EPS stated pre-revaluations – EPRA basis non diluted*

We have illustrated that the positive earnings gap has been significantly improving yet the table above shows EPRA EPS growth of 16% in 2015 turning negative in 2016.

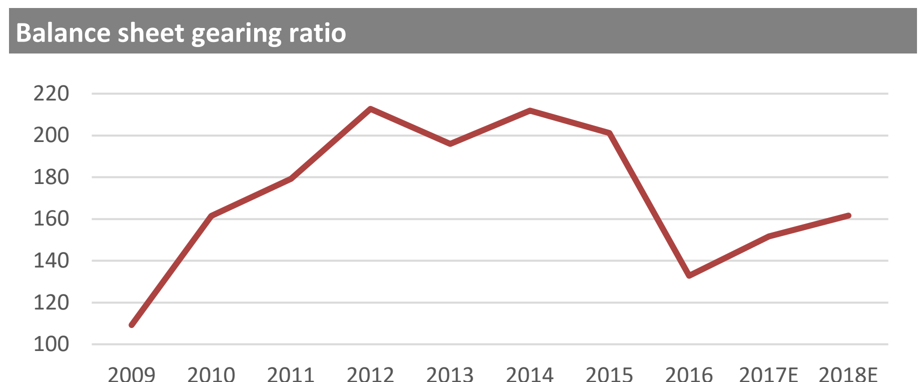
This slowing of EPS growth results from the significant rise in shares in issue. This dilutes EPS 'today' to facilitate growth and thus enhance them 'tomorrow'.

The chart below shows the significant effect of the 2016 equity raise on the financial gearing of PHP. It illustrates net debt as % shareholders' funds. In 2016 a start was made in investing those monies but the fuller gearing up comes as 2017 and 2018 progresses and sound investment opportunities grasped.

De-gearing is indicated by a falling line on the graph

1) *Driving a temporary dilution in EPS, 2016*
2) *Steady rise back up 2017E onwards, enhancing EPS*

Balance sheet gearing ratio



Source: PHP report accounts and estimates: Hardman & Co

As the gearing rises, so will EPS benefit from a 'following wind'….. There would appear to be substantial room here

Given the positive yield gap between assets and debt interest, re-gearing from here on will be EPS enhancing. Raising £150m earlier in 2016 is to fuel expansion, so re-

gearing will follow. The chart illustrates that we anticipate a modest re-gearing through deployment of investments in the current year. The pace of this will continue solidly for some years, enhancing EPS.

More details

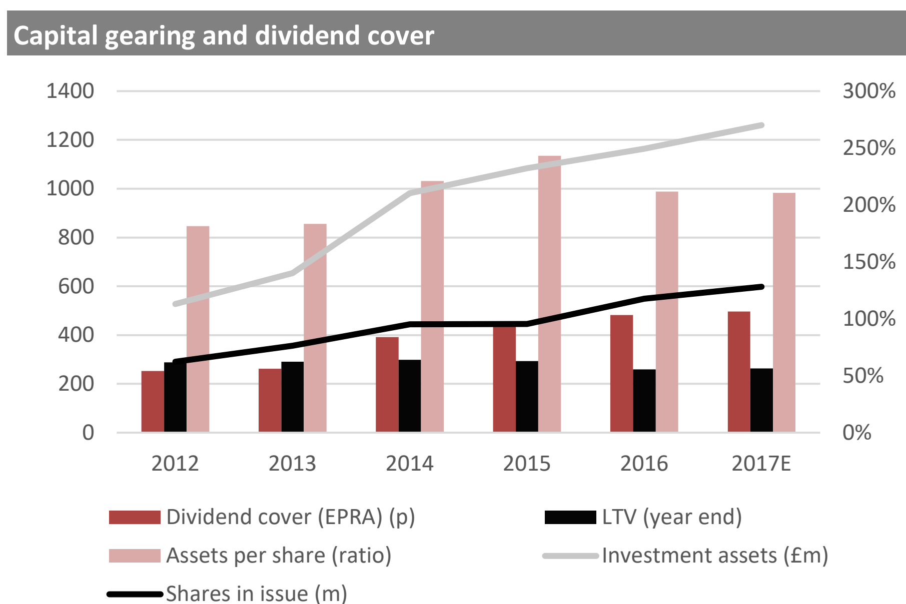
Scope to accelerate growth in Investment assets held, given the 2016 share issuance

For more 'granular' detail and a wider range of pertinent ratios, the chart overleaf illustrates how the shares in issue have risen in 2016, as a result of the major equity raise in April 2016. This has reduced the financial gearing (LTV, shown) and with shares issued rising faster than assets owned, the top bar (investment assets owned per share in issue) retraces somewhat in 2016. The move in 2017E is sideways as, though assets are being purchased, the average shares in issue are set to rise as a product mathematically of a full year of dilution in 2017 for shares issued during 2016.

We consider there is scope for the growth in investment assets held (the top line) to be maintained and accelerated. This in itself has a direct effect of growing EPS.

A significantly enlarged scope for further asset acquisition at current gearing ratios (the tallest bar series)

Capital gearing and dividend cover



Source: PHP report accounts and estimates: Hardman & Co

Note that the dividend cover is calculated on the weighted shares in issue on which the dividend is payable. The 2016 cash dividend cover therefore is 100% (as indicated in the chart) on the basis that the dividend was paid on the enlarged share capital for only the dividends pertaining to the latter part of 2016.

Our conclusion is that the share issuance of 2016 gives sufficient scope regarding the balance sheet's ability to re-gear to fund several years' expansion in gross investment assets held. 'Steady state' we would anticipate for every £1 raised circa £2.50 assets would be purchased. This would result in 60% LTV on those assets, with the resulting EPS uplift from the yield on the assets being above the cost of debt.

PHP target of 60% loan to value (i.e. net debt as % valuation of Investment assets) is not a firm ceiling, but rather a management tool. The history of loan to value is as below. The scope to rise is modest – to 60% and indeed maybe to slightly over 60% – but clear.

Fall in debt ratios because of 2016 equity raise (amongst others)

All reinvested promptly

Capital gearing measures

Year end December	Loan to value %
2010	56
2011	57
2012	58
2013	62
2014	63
2015	63
2016	54
2017E	56
2018E	59

Source: PHP report accounts and estimates: Hardman & Co

Swaps are now much reduced and outlook on interest rises muted

Treasury management has been excellent

Swaps had been a useful function to reduce volatility of interest payments

PHP has a policy of borrowing variable rate and fixed rate debt/ bonds but also using swaps to increase the element of fixed interest. In the aftermath of the GFC (general financial crisis) this led to the rates PHP was paying (effective including the swaps effect) being above the rates to which the interest rate environment had fallen. There was a lag. Through a combination of time passing and effective proactive treasury management, this effect has tapered to modest levels. In 2012 the cost of swaps was 31% the total finance cost, which was already well down on the 67% and 57% levels of the previous two years respectively. By 2015, the level was down further to 20% and 2016: 15%. We estimate 9% for 2017E.

We consider the global interest rate environment may well have turned indicating higher rates. We note:

Cost of debt fell in 2016 despite the gyrations

Macro trends are eminently manageable

- Rates have fallen through 2016, despite notable swings driven in part by UK and USA political events.
- The yield curve is rising but 10 and 15 year rates are only a fraction of a % above five year or shorter rates. This gives little cost to lengthen the maturity profile of debt, which PHP has indicated it is considering.
- The Governor of the Bank of England still maintains an outlook of UK rates going either up or down.

5-year Sterling swap rates are circa 0.9%, well below the recent peak of 2.1%. The 2014 and 2015 averages were 1.7%. The move is modest and still falling. The average maturity of PHP debt is over five years and, given this, the likely modest pace of market rises indicates a rise in PHP interest rate on its funding costs to be minimal for some years to come. Note a very small portion of its debt is € based matching € assets.

Conclusion

Dividend cover is clearly set to grow further – which might encourage a modest acceleration in rates of dividend growth

In the past seven years, PHP has paid some uncovered dividends. Through this period, dividends have grown each year – by a modest 2% or 3% pa. However, the two factors leading to this situation (uncovered dividends) will not be a feature of the coming years.

- PHP's (ERPA) operating margins are on a rising trend and this – supported by growth and the fee structure – is set to continue. Over the past five years the operating margin has risen 49 basis points. This feeds positively to EPS and hence dividend growth potential.

Historic operating margin rises – more to come

- LTV (loan to value of debt to assets) stood at 53.7% end 2016, having peaked at just under 64% end 2014. We anticipate this ratio rising over the coming several years to 60% or possibly slightly higher. This feeds positively to EPS and hence dividend growth potential.

Re-gearing boosts earnings – more to come

- This gearing (LTV) reduction is a function of the £150m equity raise in 2016. Enlarged equity dilutes EPS (and thus the dividend cover) until the monies raised are invested AND an element of gearing is added onto those newly acquired assets. This has been building in 2016 and the trend will continue.
- We anticipate strong EPS expansion in coming years, hence scope for dividend rises in due course to accelerate from recent historic rates of 2.5% to 3.0%.

PHP's earnings in 2016 were thus impacted by the raising of fresh equity. This, as outlined, is part of the planned growth model.

Dividend growth – more to come and eventually accelerating

With the dividend 100% covered in 2016 (allowing for shares on which it was paid) despite significant 'drag' from the equity raise undertaken to grow, PHP has (as per our headline) a 'full tank' for expansion. PHP has upward only rental rates with effectively no voids.

Risks, Investment case, Comparables

Risks

AAA strength in the portfolio for this bond proxy

We consider the economic and the real estate cycle to be nearing a mature stage, favouring stocks such as PHP which offer solid returns and dividends. Such a resilient portfolio has a 'low beta': real estate stocks whose income is more GDP-related or confidence driven will perform better in a recovery cycle and worse in the bear phase of the cycle. The PHP NAV valuation is driven by (upward only) rents and changes in capitalisation rates. The covenant is AAA, with effectively nil void.

PHP has benefitted from interest rates falling but reasonably secured against a rise – which we anticipate to remain muted

The main operational sensitivity is to changes in interest rates for longer term debt. Debt is fixed and floating, with Swaps. The average date to debt maturity is just a fraction over five years. This indicates that PHP has benefited from the recent trends in falling 5-10 year maturity interest rates and is 'rolling over' debt at rates which have tended to fall. There is a risk if rates rise significantly without PHP taking 'avoiding action.' There is thus a 're-banking' risk (and opportunity) which is very manageable because the assets are robust, LTV is manageable, sources of finance are varied and financial institutions willing lenders (even in the global financial crisis). The swaps in place give time to readjust facilities in the face of market rate rises.

Steady dividend growth – asset backed – continues to be in prospect after 20 years' unbroken advance

Dividends have grown continually. We touch on the dividend's foundations and growth prospects in the next segment of this research document. 2016 has seen cover over 100% and rising into 2017E. Asset exposure was 100% UK, but ROI assets are being purchased on good yields. ROI assets (which we anticipate not exceeding 10% total balance sheet) are valued in € with € income streams and debt. The ROI covenants are good, with c 70% rent from government and rest from the local providers such as GPs and pharmacies. ROI rents are typically CPI inflated.

Investment case

PHP's track record over the long term is excellent

We would highlight the long-term success of PHP. Original investors at PHP float have seen dividends of nearly 3x the share price being paid to them. Our positive view of the quantum (and sustainability) of dividends is absolutely crucial here.

The ideal macro economic mix is a GDP slowdown enhancing attractions of a safe haven, accompanied by interest rates rising only modestly if at all

PHP shares offer a growing and securely based dividend, at a yield premium to the market. Post the equity raise earlier in 2016, there is plenty of scope to re-gear the portfolio financially which would enhance EPS (dividend cover). Though PHP's real estate assets are low 'beta', it has kept pace in the 'risk-on' phase of the cycle. It is even better placed for a maturing economic cycle. Over the past five years, PHP's total shareholder return CAGR has been over 10%. For a REIT with a portfolio squarely aimed at lower risk spectrum of assets, this is a robust performance, we consider.

PHP is run efficiently, with regards administrative costs and treasury management. Its debt maturity profile is 5.1 years. There is a mix of fixed, swaps and floating rate debt. PHP has benefited from the recent trends in falling interest rates and as older debt matures there is still scope for the interest rate PHP pays to reduce further. There is some risk if rates rise without PHP taking 'avoiding action' and medium term rates have ticked up. We take the view that rate rises will be modest, particularly with a view to 5-10 year interest rates, there may well be no material rise at all in the coming years. Secondly, PHP actively and successfully manages treasury risk. We thus see a policy of funding with medium-term (as opposed to very long) maturity profile debt as being one which suits and benefits PHP and its shareholders. At this

stage in the interest rate cycle, PHP may lengthen its debt maturity profile, achieving this at rates virtually at the cycle low-point and reducing risk exposure with debt currently being much shorter than the 13.7-year weighted average unexpired lease term.

Investment case conclusion

PHP is delivering against its own strategic objectives: 1) resilient and strong progressive returns; 2) growth the portfolio. 3) It has continually increased its efficiencies (with an excellent EPRA cost ratio of 11.5% set to fall further). 4) Funding has been derived from a diversified range of providers. The interest rate/ economic cycle has been very well managed.

Valuation

We consider each of these as bond/equity proxies but each has distinctive characteristics

Not all REITS with their investment focus on long leases are truly comparable. We list a limited selection of REITS and other property stocks exposed to UK assets with long term income streams which are more or less secure. The dividend cover – as this document has sought to highlight – needs significant analysis albeit an excellent pointer is the length of the track record of uninterrupted dividend increases. None of the stock below has cut their dividend. None has a construction element of over 2% in their asset valuations. All bar HICL are UK or UK and a small amount in Republic of Ireland.

HICL is more international and has more demand based risk

HICL investments are located 80% UK, but also in Europe, Australia and North America. Demand based risk assets comprise a substantial part of the portfolio and include student accommodation and toll roads.

Length of lease/ concession is long. Civitas is building its portfolio but we anticipate circa 20 years to break (WAULT). HICL is over 20; MedicX 15.5 and PHP 13.7. Tritax exposure has more commercial risk but its long-term assets have 16.5 year WAULT.

Civitas and Tritax have shorter track records. PHP by far the longest

All bar Civitas Social Housing REIT (2016 float) and Tritax Big Box (2013) have been in existence over more than one economic cycle, growing their dividends each year.

Figures stated include NAV. This is not NNNAV, where the largest divergence is MedicX Fund (NNNAV 77% of NAV), due to its policy of fixing debt interest cost to a long date. Further, MedicX EPRA EPS (from which we exclude the performance fee) was 3.5p historic: an uncovered dividend. MedicX has successfully grown dividends long term whilst paying more than EPS at the pre-revaluation benefit level.

A selection of some property stocks with long term lease income

Tritax the exception: not regulated / government income

Valuation highlights

REIT	Main asset class	Price (p)	Historic EPRA NAV (p)	Historic div (p)	Historic div yield %
Civitas	Social housing	107	98	[1]	[1]
HICL Infrastructure	Regulated and demand based infrastructure	164	143	7.45	4.5
MedicX	Primary medical	88	73	5.95	6.8
PHP	**Primary medical**	**109**	**91**	**5.125**	**4.7**
Tritax Big Box	Distribution centres	145	125 [2]	6.0 [2]	4.2

Source: Hardman & Co Research

[1] Float November 2016. Hardman estimate for 2018, first year fully invested: 5.0p.

[2] Figure stated to December 2015. Latest is 129p NAV, 6.2p dividend.

Financial Analysis

Summary Financial

Profit & loss and balance sheet								
Year end December £m	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
Total Income	30.7	33.2	42.0	60.0	63.1	67.4	73.8	80.5
Rise in income %	*14.0*	*8.2*	*26.5*	*42.9*	*5.2*	*6.8*	*9.5*	*9.0*
Operating Profit	25.1	27.6	35.5	52.5	55.4	59.2	65.1	71.4
Operating profit margin %	*82.9*	*83.9*	*84.7*	*87.5*	*87.8*	*87.8*	*88.2*	*88.7*
Admin expenses as % net rental income	*17.1*	*16.0*	*14.7*	*11.5*	*10.9*	*11.0*	*10.4*	9.9
Net Finance Costs	-15.4	-21.8	-26.9	-35.5	-33.7	-32.5	-33.7	-38.3
EPRA Pre-tax Profit	**11.0**	**7.3**	**9.5**	**18.2**	**21.7**	**26.7**	**31.4**	**33.1**
Reported Pre-tax Profit	11.4	1.1	20.2	36.9	56.0	43.7	43.6	46.4
EPRA EPS (p) excludes all revaluation	**4.1**	**2.5**	**2.7**	**4.1**	**4.8**	**4.7**	**5.2**	**5.5**
Reported EPS (p)	4.8	0.5	5.7	8.3	12.6	7.8	7.3	7.8
Dividend Per Share (p)	**4.50**	**4.63**	**4.75**	**4.875**	**5.00**	**5.125**	**5.25**	**5.45**
Rise in dividend %	*2.9*	*2.8*	*2.7*	*2.6*	*2.6*	*2.5*	*2.4*	3.9
Dividend cover %	*91.4*	*54.3*	*56.1*	*84.0*	*98.0*	*93.0*	*100.0*	*101.7*
Shares in Issue, No., Average	266.9	290.8	356.4	444.4	445.6	560.1	598.2	598.2
EPRA Shareholders' Funds	217.5	230.4	330.9	354.2	391.6	545.0	557.2	576.9
Net debt	-301.2	-377.9	-587.2	-655.2	-694.7	-663.2	-758.1	-851.8
NAV (p)	**61.5**	**59.4**	**69.6**	**69.5**	**77.4**	**83.5**	**85.7**	**89.0**
EPRA NAV (p)	**79.6**	**75.7**	**76.1**	**79.6**	**87.5**	**91.1**	**93.2**	**96.4**
Rise in NAV %	*-6.2*	*-3.5*	*17.3*	*-0.2*	*11.4*	*7.8*	*2.7*	*3.8*
Rise in EPRA NAV %	*2.2*	*-4.9*	0.5	*4.6*	*9.9*	*4.2*	*2.2*	*3.5*
Debt LTV %	56.7	57.8	61.8	62.8	62.7	53.7	56.3	58.6

Source: PHP report accounts. Estimates: Hardman & Co

Dividends: Are paid quarterly from February 2016.

Debt: This is pre-mark- to- market of the convertible. For example, including this the end 2016 figure was £655m.

Convertible: Bonds carry a coupon of 4.25% and are convertible into preference shares of the Issuer which will be automatically be exchanged to ordinary shares of PHP. The initial conversion price was set at 97.5p, representing a premium of 16.0% above the volume weighted average price of the Company's Shares from launch to pricing. Under the terms of the Bonds, the Company will have the right to settle any conversion rights entirely in Shares, in cash or with a combination of Shares and cash.

The effect of the Convertible is enhancing to NAV (we do not adjust for this).

Profit & Loss

Profit & Loss account								
Year end December £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	73.8	80.5
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	**73.8**	**80.5**
Direct Property Expenses	0.4	0.4	0.4	0.7	0.9	0.9	1.0	1.1
Administrative Expenses	5.1	5.2	6.1	6.8	6.8	7.3	7.7	8.0
Total Expenses	5.5	5.6	6.5	7.5	7.7	8.2	8.7	9.1
Operating Profit	**25.1**	**27.6**	**35.5**	**52.5**	**55.4**	**59.2**	**65.1**	**71.4**
Operating margin %	*82.9*	*83.9*	*84.7*	*87.5*	*87.8*	*87.8*	*88.2*	*88.7*
Devt loan interest, other income	0.4	0.5	0.2	1.0	0.7	0.5	0.4	0.5
Swap interest paid	-8.8	-6.7	-7.7	-7.6	-6.7	-5.0	-4.0	-5.0
Bank, bond loan interest, fees	-5.8	-14.1	-18.5	-27.7	-27.7	-28.0	-30.1	-33.8
Break fees (excluded from Adj EPS fig.)	-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**	**-33.7**	**-38.3**
EPRA Pre-tax Profit	**11.0**	**7.3**	**9.5**	**18.2**	**21.7**	**26.7**	**31.4**	**33.1**
Net revaluation on portfolio	10.6	-1.8	2.9	29.2	39.8	20.7	12.2	13.3
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				-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	43.6	46.4
Tax Charge	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EPRA EPS (p) excludes all reval'n, diluted for conv	4.1	2.5	2.7	4.1	4.8	4.69	5.17	5.46
EPRA EPS (p) non diluted	**4.1**	**2.5**	**2.7**	**4.1**	**4.9**	**4.77**	**5.25**	**5.54**
Reported EPS (p)	4.8	0.5	5.7	8.3	12.6	7.80	7.29	7.76
Dividend Per Share (p)	**4.500**	**4.625**	**4.750**	**4.875**	**5.000**	**5.125**	**5.250**	**5.450**
Shares in Issue, No., Avge	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: PHP report accounts. Estimates: Hardman & Co

Rent rise estimates: These are driven by assumed 1% inflation and expansion in the physical portfolio. Expansion in ROI has a positive – but initially very minor – effect.

Rise in interest charge: Note this includes lower swaps 2016 and some new swaps being instigated.

Swaps: Some swaps were repaid in 2015 and we model new swaps being taken out in the near future. Note the very significant reduction in the proportion of the interest charge relating to swaps over the period shown above. Certain swaps are in place to commence 2018 and 2019.

Loan to value: Highlighted in the page 13 table, has scope to rise significantly further were management to wish. There is significant unsecured debt which would facilitate such a situation. Currently management has placed a 60% cap on the ratio.

Balance sheet

- Note, debt includes revaluation of convertible liability (as share price rises), thus change in debt does not match cash flow.
- By end 2017 we estimate c€20m debt, rising further beyond.

Some key numbers:

Portfolio additions rose well in 2016 and such levels will be sustained

Minimal current liabilities

NAV rise driven primarily by revaluations

Balance Sheet

Year end December £m	2014	2015	2016	2017E	2018E
Investment Properties - Start of Period	941.5	1026.2	1100.6	1220.1	1332.3
Currency translation effect	0.0	0.0	0.0	0.0	0.0
Additions to Portfolio	55.5	34.6	98.8	100.0	100.0
Revaluations	29.2	39.8	20.7	12.2	13.3
Non current assets					
Investment Properties - End of Period	1026.2	1100.6	1220.1	1332.3	1445.6
Interest rate swaps	0.0	0.0	0.0	0.0	0.0
Sub total: Non-Current Assets	1026.2	1100.6	1220.1	1332.3	1445.6
Current assets					
Receivables	5.7	4.1	3.3	3.0	3.0
Cash + Short Term Investments	12.1	2.9	5.1	11.2	7.9
Sub total: Current Assets	17.8	7.0	8.4	14.2	11.0
Total Assets	1044.0	1107.6	1228.5	1346.5	1456.6
Current liabilities					
Deferred Rental Income	12.3	13.2	14.1	15.0	15.0
Trade and Other Payables	14.2	16.1	13.6	16.0	16.0
Term loans	0.7	0.9	0.8	1.0	1.0
Interest Rate Swaps	5.8	4.7	3.8	3.8	3.8
Sub total: Current Liabilities	33.0	34.9	32.3	35.8	35.8
Non current liabilities					
Term Loan over 1 year, bond	666.6	696.7	667.5	768.3	858.7
Interest Rate Swaps	35.2	30.6	29.5	29.5	29.5
Sub total: Non-Current Liabilities	701.8	727.3	697.0	797.8	858.7
Total Liabilities	734.8	762.2	729.3	833.6	924.0
Shareholders' Funds	309.2	345.4	499.2	512.9	532.6
EPRA Shareholders' Funds	354.2	391.6	545.0	557.2	576.9
Shares in Issue at Period End, No, m.	445.1	446.3	598.2	598.2	598.2
NAV per Share p.	69	77	83	86	89
EPRA NAV per Share p.	80	87	91	93	96
Net debt	655.2	694.7	663.2	758.1	851.8
Investment Properties - Start of Period	941.5	1026.2	1100.6	1220.1	1332.3
Currency translation effect	0.0	0.0	0.0	0.0	0.0
Additions to Portfolio	55.5	34.6	98.8	100.0	100.0

Source: PHP report accounts and estimates: Hardman & Co

Cashflow

Some key numbers:

Our valuation rises are lower in future years – this may well prove conservative

Finance costs rise 10% over the period whilst assets rise 40%

Asset rise is almost wholly funded by long term borrowings rises in 2017E and 2018E

Cashflow					
Year end December £m	**2014**	**2015**	**2016**	**2017E**	**2018E**
Operating activities					
Profit before taxation (excl derivatives)	38.2	49.9	43.1	43.6	46.4
Adjustments for:					
Net valuation changes on investment property	-29.2	-39.8	-20.7	-12.2	-13.3
Fees early repayment and bond	3.6	0.0	0.0	0.0	0.0
Profit on disposal of property	0.0	0.0	0.0	0.0	0.0
Financial income receivable	-1.0	0.0	0.0	0.0	0.0
Finance costs payable	35.3	33.7	32.5	33.7	38.3
Sub-total	**46.9**	**43.8**	**54.9**	**65.1**	**71.4**
Increase in trade, other receivables	-0.5	1.0	0.6	0.5	1.0
Increase in trade, other payables	-2.0	2.1	-1.5	0.5	0.5
Interest paid	-35.9	-37.0	-46.0	-33.7	-38.3
Interest received	0.5	1.3	0.5	0.0	0.0
Taxation (& REIT) paid	0.0	0.0	-0.1	0.0	0.0
Net cash inflow from operating activities	**9.0**	**11.2**	**8.4**	**32.4**	**34.6**
Investing activities					
Acquisitions net of cash acquired	0.0	0.0	0.0	0.0	0.0
Additions to properties	-54.5	-29.5	-97.4	-100.0	-100.0
Net cash flow operating and investing	**-45.5**	**-18.3**	**-89.0**	**-67.6**	**-65.4**
Financing activities					
Net proceeds from equity issue	0.0	-0.1	145.2	0.0	0.0
Dividends paid	-20.7	-21.1	-24.7	-27.3	-28.5
Net cash flow (change in debt)	**-66.2**	**-39.5**	**31.5**	**-94.9**	**-93.9**
Net proceeds of long-term borrowings	69.0	30.3	-29.3	101.0	90.6
Net cash financing inflow	**48.3**	**9.1**	**91.2**	**73.7**	**61.1**
Net debt	**655.2**	**694.7**	**663.2**	**758.1**	**851.8**

Source: PHP report accounts and estimates: Hardman & Co

Notes

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