Palace Capital

Income and capital growth outside London

Initiation of coverage

Real estate

Palace Capital (Palace) invests in commercial real estate outside London, mainly through corporate acquisitions. Palace has more capital flexibility to reinvest in its portfolio than many REITs and has successfully provided capital growth plus a comparable yield by recycling capital and improving its properties through active asset management. Palace selects properties in good locations near public transport, typically with scope for physical improvement, possibly including redevelopment, change of use or active management. In this way it gains access to higher yields than are available in London, while providing tenants with good accommodation at reasonable rents, and investors with sustainable income and value growth.

Year end	Revenue (£m)	Adjusted EPRA earnings (£m)	Adjusted EPRA EPS* (p)	EPRA NAV/ share (p)	DPS (p)	Yield (%)
03/15	8.6	4.8	28.3	396	13.0	3.6
03/16	14.6	4.6	18.9	414	16.0	4.4
03/17e	14.0	5.6	21.8	422	18.0	5.0
03/18e	13.9	5.8	22.5	426	18.0	5.0
03/19e	13.6	6.2	24.0	431	18.0	5.0

Note: *Adjusted EPRA earnings exclude revaluation gains, profits or losses on disposals of investment properties and surrender premiums on early lease terminations.

Active asset management

Palace's selective acquisition and asset management has let it increase NAV per share by over 90% since September 2013 from 218p to 419p at 30 September 2016. Three properties have recently been refurbished and are expected to benefit from reversion to market rent, which should result in capital growth. Two other assets are held for sale to owner-occupiers, which can result in a premium to investment value, and there is one in York that is largely vacant pending redevelopment. Management aims for 90% long-term occupancy vs 83% currently (89% excluding the possible redevelopment), which our forecasts indicate should support continued value and earnings growth, based on conservative assumptions.

Taking advantage of uncertainty

Last year Palace was able to acquire its Manchester property following the withdrawal of other bidders when the EU referendum was announced and has seen occupier demand remain strong as the supply of new developments has been restricted by political and economic uncertainty, but the UK economy has continued to perform. In this climate, occupiers are encouraged to take up new space and may choose accommodation at a discount to rents on prime assets. Regional and secondary yields remain higher than London and prime yields, providing scope for gains and possible protection against cyclical change.

Valuation: Unrecognised strength

Given the potential to beat our estimates and to deliver both solid earnings and NAV growth, we believe Palace's discount to EPRA NAV (c 15%) is high, especially compared with a regional peer group that trades at a premium to NAV on average. The 6.3% portfolio net initial yield and low cost of debt support a dividend yield of c 5%, similar to REIT peers, with the added prospect of NAV growth.

31 January 2017

Price	**357.5p**
Market cap	**£92m**

Net debt (£m) at 30 September 2016	73.5
Shares in issue	25.7m
Free float	94%
Code	PCA
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(2.1)	(0.7)	7.5
Rel (local)	(1.8)	(2.6)	(7.2)
52-week high/low		375p	308p

Business description

Palace Capital is an AIM-quoted property investment company focused on commercial real estate in the UK outside London. The portfolio is diverse, with the largest weighting in offices. Management aims to increase capital value and provide a sustainable and growing income stream.

Next events

Financial year-end	31 March 2017
FY17 results	June 2017

Analysts

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Edison profile page

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Investment summary

Asset management for higher value and income

Palace is building a diversified and well-located commercial property portfolio let to financially sound tenants with the aim of providing investors with attractive income and capital returns. The portfolio's diversity helps mitigate sector-specific risks and the regional focus brings higher yields and less exposure to Brexit-related risks than investment in London. The policy of investing outside London can provide opportunities overlooked by other investors. Palace has an active asset management strategy with specific plans for each property, which may include full redevelopment. Asset management plans for each unit are developed by an experienced in-house team, which aims to acquire assets in good locations near transport hubs, enabling them to refurbish or redevelop them to provide high-quality alternatives to prime commercial real estate. In this way Palace seeks to increase rents and capital values while still offering an economic alternative to its tenants; examples are given in the portfolio section (page 8).

Financials: Growth on conservative assumptions

We forecast steady NAV per share growth from 419p at 30 September 2016 to 429p at the end of FY19, without building any structural valuation uplift into our model and only accounting for higher rents at two properties where refurbishment is complete and there is reasonable expectation that these increases will lead to capital value growth in the near term. We similarly forecast modest EPRA earnings growth as new leases begin with rent holidays and some leases at properties that may be refurbished or redeveloped are not immediately replaced, taking occupancy from 89% at 30 September 2016 to 88% in FY18, before rising again to a long-term rate of 90%. While these effects reduce rental income slightly from £13.8m forecast in FY17 to £13.4m in FY18 and £13.5m in FY19, we also expect direct property costs to fall from £2.3m in FY17 to £1.5m in FY19 with disposals of vacant properties and as asset management initiatives mitigate other vacancy costs.

We have not allowed for any new acquisitions or borrowings, which means our revenue and earnings forecasts are sensitive to the upside should Palace invest further, and also that we forecast debt reduction in line with the existing maturity schedule. As a result, finance costs are reduced in our forecast period, and EPRA earnings rise on a per share basis from 18.4p (net of a one-off gain from a lease surrender) in FY16 to 20.0p in FY17, 20.8p in FY18 and 23.1p in FY19. Assuming the dividend remains at 9p every half-year, we forecast that cover will rise from 1.2x to 1.3x over the forecast period. Further detail is given in the financials section on page 10.

Valuation: Above average discount

Palace aims to increase capital values as well as earnings and we consider our forecasts to be conservative, with only two specific valuation gains expected in the forecast period, a slight decline in occupancy and no rental growth assumed elsewhere. The company also has the least expensive debt portfolio of its peers and a 5% prospective dividend yield. In that context, the c 15% discount to NAV appears high compared with an average of c 3% for the peer group of diversified regional property companies.

Sensitivities: Regional protection from macro headwinds

Occupier demand is sensitive to wider economic conditions and capital values are affected by investment flows and macroeconomic factors such as the value of sterling. Regional properties are likely to be less sensitive to these than London ones. Palace has relatively high-yielding assets with scope for rent growth, low-cost debt, a well-covered dividend and capacity to make further acquisitions of a similar scale to other recent ones.

Company description: Regional specialist

Palace Capital is a property investment company listed on the Alternative Investment Market (AIM) of the London Stock Exchange (LSE) and registered in the UK. The company invests in UK commercial property outside London and is sector agnostic, with offices making up the largest portion of the portfolio at 42%, followed by leisure at 24%. The current portfolio of 50 assets is valued at £184.8m (30 September 2016) and has net annual rents of £11.7m. Further detail is on page 8. Palace seeks to enhance capital values and provide a sustainable and growing income stream by acquiring assets with potential for rent increases through the reduction of void costs, refurbishment and in some cases redevelopment or refurbishment. Most properties are held for long-term rental income, but the company also realises capital value through selective disposals where opportunities arise.

Income and capital growth

On a spectrum with very low-risk, buy-and-hold REITs at one end and speculative developers at the other, Palace is in the middle: it has the flexibility to invest earnings in capital-enhancing asset management projects, unconstrained by the REIT property income distribution requirement (albeit the payout ratio is currently similar to a REIT's), and is willing to assume some development risk where the potential returns are attractive, but also has a stable core portfolio producing sustainable rental income as well as providing opportunities for capital growth.

History

The company was given its current form in July 2010 when Neil Sinclair (the current CEO), Stanley Davis (non-executive chairman) and Andrew Perloff acquired 29.9% of AIM-quoted Leo Insurance Services. Leo's insurance interests were sold to Safeland as part of the deal, and the company's investment policy was changed to take advantage of a regional property market which the new management and directors believed was significantly undervalued following the financial crisis. The crisis left many landlords with distressed assets and without the resources, or access to funding, to invest in them as a means to enhance income. It had also increased the number of private landlords seeking to sell assets.

The portfolio has been built since October 2011 through the acquisitions shown in Exhibit 1 below.

Exhibit 1: Acquisition history

Date	Asset/portfolio	Vendor	Price (£m)	Funding	Notes
October 2011	Hockenhull portfolio	Local investor	1.8	Small equity raise	Corporate deal, off-market
October 2013	Sequel Portfolio	Quintain	39.2	£20m debt, £23.5m of equity at £2.00	Corporate deal
August 2014	PIH Portfolio	Private investors	32	Debt and £20m equity at £3.10	Corporate deal, off-market
April 2015	Bank House, Leeds	Pension fund	10.0	Cash	
June 2015	Sol Central, Northampton	O&H Northampton	20.7	Debt and £20m of equity at £3.60	Corporate deal, off-market
August 2015	46-54 High Street, Sutton	Dering Properties	3.9	Cash	Corporate deal, off-market
February 2016	249 Midsummer Boulevard, MK	Not disclosed	7.2	Cash	Off-market
March 2016	Broad Street Plaza, Halifax	Not disclosed	24.2	Cash and assumption of SPV's debt	Corporate deal, off-market
August 2016	Boulton House, Manchester	Not disclosed	10.6	Cash and debt	Other bids withdrawn post-referendum

Source: Palace Capital data

The first acquisition was the Hockenhull Estates portfolio of nine properties in Cheshire in September 2011 for £1.8m at a net initial yield of 10%. Funding came from a small equity issue and a debt facility from Close Brothers. This was followed in October 2013 by the acquisition of the Sequel Portfolio from Quintain plc and Buckingham Properties. The latter was a more significant investment of £39.25m and added 24 office, industrial and retail properties generating net rents of £5.2m for a net initial yield of 13.2%. This was funded by a larger equity fund raise of £23.5m and a £20m facility from Nationwide. Not only did Sequel substantially increase the scale of the portfolio, but it also added opportunities to increase capital value through active management of properties in a variety of regional hubs with attractive growth prospects. Since then the company has continued to grow the portfolio with a focus on the potential for value growth through active asset management and the aim of building stable and sustainable long-term income streams.

Board and management

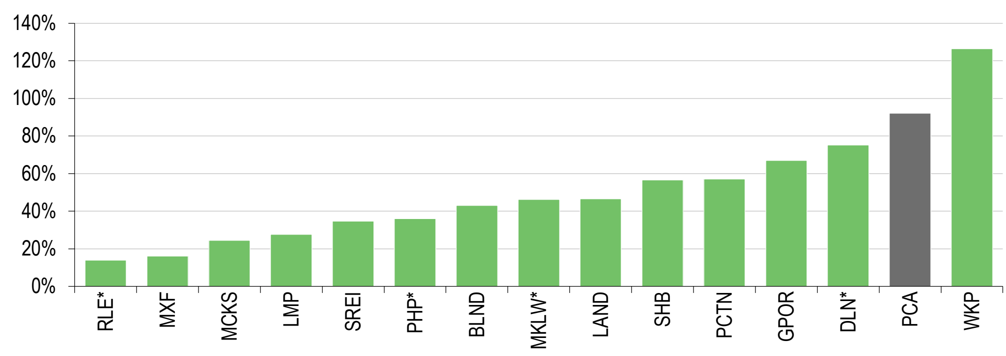
The six-member board is chaired by Stanley Davis, who holds 6.07% of Palace's shares and was a founding shareholder, as noted above. The two non-executive directors, Anthony Dove and Kim Taylor-Smith, are both independent and chair the remuneration and audit committees respectively.

The executive management team is led by Neil Sinclair, a chartered surveyor, as CEO, bringing over 50 years' experience in the UK property market to the executive team. The company has recently been adding depth to the team, with the CFO, Stephen Silvester, joining in July 2015, and executive director Richard Starr becoming a full-time executive in July 2016, having joined the board in 2013. A new investment manager, Andrew Thomas, also joined in 2016. Mr Starr and Mr Thomas are chartered surveyors and Mr Silvester is a chartered accountant. The team has considerable experience in the commercial property sector. Palace outsources day-to-day project and property management, saving costs and freeing its own team to concentrate on asset management. Including the directors and company secretary, it has 11 members of staff. Brief biographies of the board members are on page 16.

Business model

Palace is not a REIT, meaning that although it has to pay corporation tax (see page 11) it does not have to pay out 90% of rental income as Property Income Distributions (PIDs) (there are also differences in the tax implications for shareholders, who will typically pay less tax on company dividends than on PIDs from REITs). Because it can retain more of its earnings, the company is better able to recycle capital. Partly for that reason, Palace has been able to increase NAV per share by over 90% in the three years to 30 September 2016 (Exhibit 2).

Exhibit 2: EPRA NAV/share increase in the three years to September 2016



Source: Edison Investment Research. Note: *Three years to June 2016.

The management team's experience is central to establishing a pipeline of potential acquisitions on which it can bring its asset management expertise to bear. Acquisitions are generally opportunistic and the company aims to make them off-market to achieve the best price. The company's first major deal, the acquisition of the Sequel Portfolio from Quintain in 2013, is a good example: the portfolio had fallen over 16% in value in the year to March 2013, when a price was agreed with Quintain, and was weighing on the company's overall performance. Quintain wanted to reduce debt levels and refocus on London. The lender, Nationwide, was also keen to reduce its exposure from 71% LTV to nearer 50%. With £23.5m of equity and £20m of debt from Nationwide, Palace was able to acquire the portfolio at a 13.2% yield with the prospect of being able to reduce vacancy from the 14% at which it had been running. Having acquired the Sequel Portfolio for £39.25m in October 2013 and disposed of £7.7m of properties, the rest of this portfolio was most recently valued at £70m on 30 September 2016.

Disposals are also opportunistic and may be of non-core assets acquired as part of a portfolio, or because management can crystallise a return. In several cases occupiers have bought premises they were renting. Often these are high-yielding assets where a price above book value can be achieved. In other cases, Palace's willingness and ability to take some redevelopment risk enables it to improve the quality and rent potential of an asset to the point where larger institutional investors may be willing to invest, again at lower yields than Palace did originally.

Regional commercial real estate

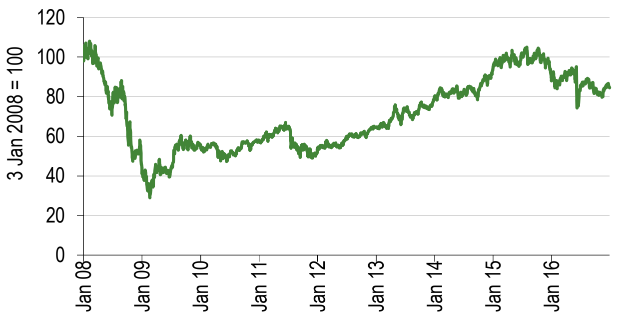
The regional commercial real estate market differs from the more closely followed London market in several ways, which may make it attractive to investors:

- It is characterised by higher-yielding properties, offering higher income returns on investment and potentially greater scope for capital growth.
- Yield movements tend to lag the London market and to be less volatile, meaning that while London may be in the later stages of the cycle, the regions may continue to perform and to outperform if indeed the cycle turns.
- Individual assets, especially secondary ones, tend to attract less attention from institutions. This reduces competition for purely income-generating investments and may leave more opportunity for specialists.
- It is less exposed to national and international factors such as the business rate changes coming into effect in April, the financial services industry and the reaction to the EU referendum.

We examine the regional market in more detail below and start by discussing how its performance has differed from the London market.

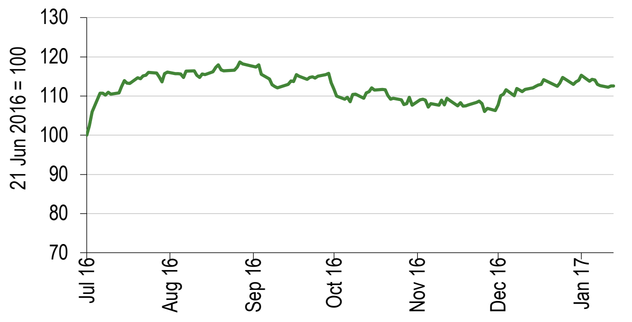
Following several years of strong share price performance after the low point reached in March 2009, the UK's commercial property market, as measured by an index of listed property companies, was sharply affected by the EU referendum on 23 June 2016 (Exhibit 3) before recovering to some extent in the rest of the year (Exhibit 4).

Exhibit 3: EPRA NAREIT UK Index since 3 Jan 2008



Source: Bloomberg

Exhibit 4: EPRA NAREIT UK Index since 21 Jun 2016



Source: Bloomberg

However, the recovery in the share prices of these companies has not been even. In Exhibit 5 we show the share price performance of a basket of REITs that invest in the regional UK vs a basket of larger UK REITs with significant exposure to London. This shows that companies most exposed to London underperformed the regional basket by 16% between 21 June and 31 December 2016. A further comparison with another basket of companies that have average lease lengths over 10 years implies that the perceived security of income associated with long leases has been particularly highly valued since the referendum, outperforming the London basket by 22%. Although the basket of long lease companies has therefore outperformed the regional one over the same period, almost all of its gains occurred immediately after the referendum; in H216, regionally focused property companies outperformed both of the other baskets.

Exhibit 5: Regional vs London-exposed REITs

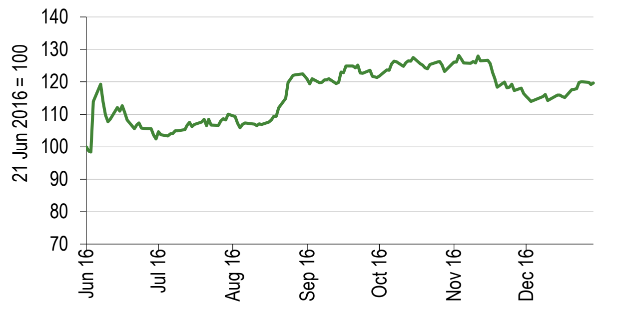
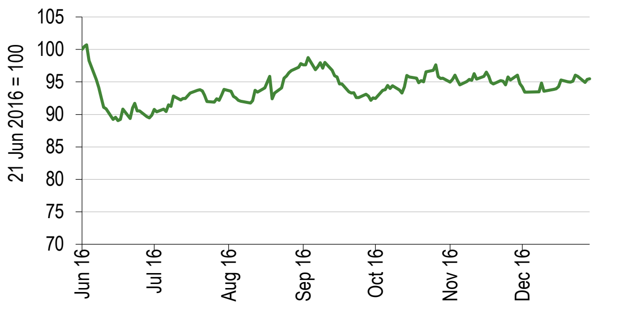


Exhibit 6: Regional REITs vs long-lease



Source: Bloomberg. Note: **Regional basket**: Palace Capital, Custodian REIT, Mucklow, Real Estate Investors, Regional REIT. **London**: Land Securities, British Land, Workspace, Derwent London, Shaftesbury, Great Portland Estates, LondonMetric. **Long leases**: Assura, MedicX Fund, Primary Health Properties, Secure Income REIT, Target Healthcare REIT, Tritax Big Box.

The shape of the referendum's aftermath reflects the uncertainty cast over the property market by the Brexit vote, hence the attraction of longer leases and the regions. Part of the attraction of regional investment is its lower volatility compared with London. To illustrate this, in Exhibit 7 we compare the average reported portfolio equivalent yields for five members of our basket of London property investors and those of Schroders REIT and Mucklow (net initial yield), which are the only two regional investors to have reported portfolio yields since before the financial crisis. While individual portfolio changes and the small size of the regional basket should be borne in mind, regional yields appear to have been slower to fall than London yields and the spread between the two remains wide. There may be scope for further compression in the regions or protection from a cyclical change should London yields widen again, as they have in the last six to 12 months.

Exhibit 7: Regional vs London equivalent yields

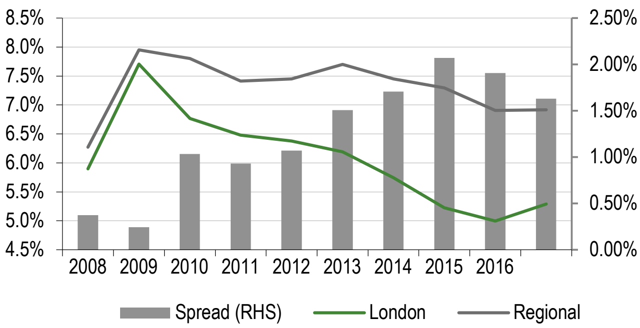
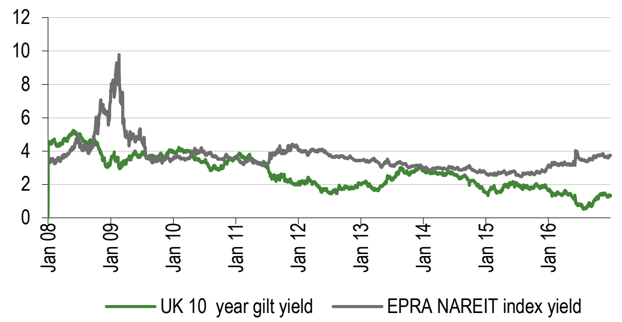


Exhibit 8: UK 10-year gilt and NAREIT index yields



Source: Palace Capital data, Edison Investment Research. Note: The last column shows the most recently reported portfolio yields.

Source: Bloomberg

The yield gap between London and the regions, between prime and secondary and the historically low yield on government debt all make regional property relatively attractive. Because of the diversity and specialist nature of the regional markets, they also provide opportunities for companies with the right asset management skills to acquire assets at attractive prices, increase their rental value by improving the premises, and thus their attractiveness to other investors and capital value.

We would highlight several other factors which support the view that the regions are likely to outperform the capital, and potentially other subsectors, over the next one to two years while uncertainty persists:

- The UK's regional commercial real estate market is less sensitive to the direct effects of the EU referendum than London, with less dependence on international financial services, tourism and international investment. Several major financial services companies with London offices have announced intentions to relocate some staff overseas since the referendum, whereas several major manufacturers have indicated their intention not to move their regional UK operations abroad.
- Regional cities continue to attract occupiers from London, particularly the back office divisions of large organisations. Combined with limited new supply and the broad UK economic recovery, tenant demand has been rising and increasing rents for regional offices and industrial sites.
- The business rate changes due to be introduced on 1 April 2017 are likely to raise costs significantly for tenants in parts of London and South-East England, whereas much of the rest of the country will likely see business rates remain flat or decline. Although it is expected that a transition scheme will be put in place to cushion the effect on businesses, this will be the first business rate change for seven years, during which time there has been a property boom led by the South-East and London. Some retail properties in London are expected to see rates rise by c 60%, whereas occupants of Boulton House in Manchester are likely to see changes of less than 2% and some of Palace's other tenants can expect their business rates to fall.
- The December 2016 manufacturing PMI measure reported by Markit/CIPS was at its highest level for over two years, implying that demand for industrial space, which is mainly regional, will remain strong, while we expect that uncertainty over Brexit may continue to inhibit new developments, which have not recovered to pre-2009 levels.
- These trends may be expected to support rental values, particularly outside London. The RICS October 2016 UK Property Market Chart Book appears to show evidence of the market anticipating that: there was a positive investor-demand balance of 30% in favour of ex-London versus London offices and over 70% of all office deals in the quarter to the end of October involved regional properties.
- Foreign investment accounted for 75% of purchases of commercial real estate in London in 2016 (source: Savills) and sterling weakness is expected to encourage further non-domestic investment in future. Given the higher yields available outside London and the higher occupier risk in London following Brexit, more foreign investment may be directed beyond London.
- The flight to long leases appears to have been quite sudden and to be unwinding, hence regional property investors' outperformance in H216. Although initial fears over Brexit may abate, some risk aversion is likely to remain and the higher yields available on regional property portfolios (and the fact that they tend not to trade at premiums to NAV as some long-lease companies do) may provide a measure of risk protection.

In the longer term, devolution of some powers to city mayors, as well as infrastructure projects including HS2, are likely to be of benefit to the non-London economy as well.

However, the effects of the referendum will not be limited to London and the current positive PMI reading could be threatened if uncertainty causes companies to defer some strategic investment decisions and to exercise caution more generally. Cushman & Wakefield (one of Palace's valuers) expects regional office and industrial yields to remain fairly steady over the next year, a view echoed by several other market participants.

The caution engendered by Brexit appears so far to have been beneficial to Palace, which has seen companies take leases in its properties such as The Forum, Exeter, rather than pay a premium to be in grade A buildings. They have also seen demand from smaller occupiers to buy industrial units (as has recently happened in Stoke-on-Trent). While the yield gap between London and regional rents remains historically high at c 1.5-2% and bond yields are historically low, opportunities to acquire regional assets with considerable scope for rental and valuation increases will remain.

Portfolio

Here we provide an overview of the portfolio as well as more detail on several major properties that illustrate aspects of Palace's strategy. The charts below show the portfolio's distribution by sector, geography, tenant and lease (Exhibits 9 to 12). The predominance of office and leisure property will be diluted to some extent as office space will be converted to residential use at two properties (York and Dartford), further enhancing the portfolio's diversity.

The portfolio is also well-diversified by sector and location, and although Palace bears diversity in mind, it is sector agnostic. Acquisitions are chosen based on their individual merits and applications may be made for change of use in respect of existing assets (as in the case of Hudson House, page 9). Palace also has a diverse tenant base, with the biggest tenant by rent only accounting for 6.3% of net rent and the top 10 paying less than one-third of the total rent roll.

Exhibit 9: Portfolio sector analysis by value

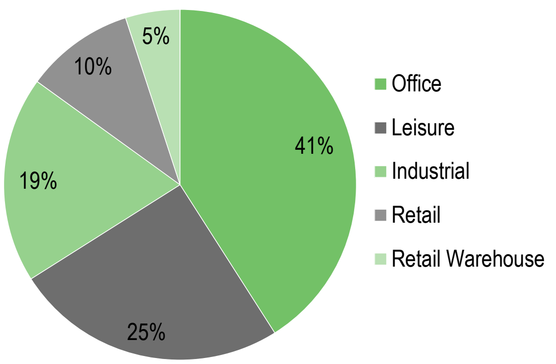
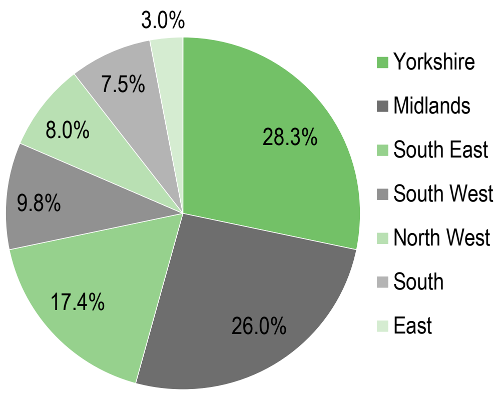
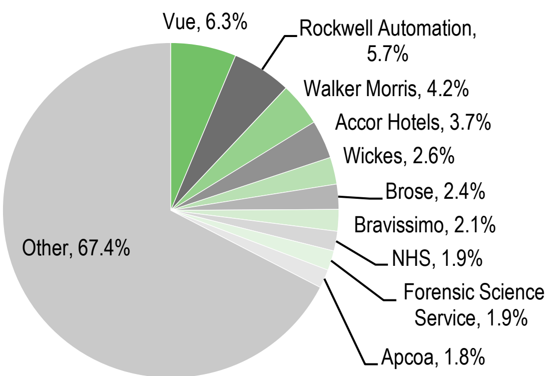


Exhibit 10: Portfolio location analysis by rent



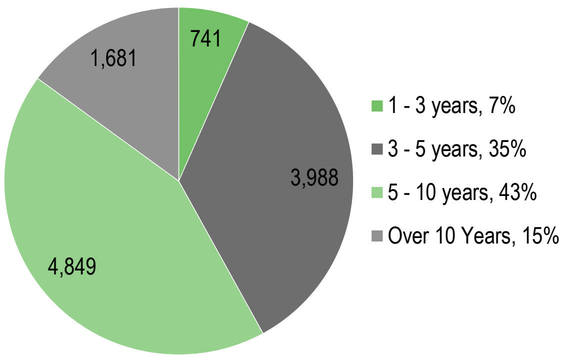
Source: Palace Capital data as at 30 September 2016

Exhibit 11: Tenants by contribution to total net rent



Source: Palace Capital data as at 30 September 2016

Exhibit 12: Net rent by WAULT, 1 January 2017, £000s



Source: Palace Capital data

The FY17 interim results showed that the portfolio contained 50 properties totalling 1.8m sqft. Of this, excluding Hudson House in York, 89% was let through 210 leases to 160 tenants for a total gross contracted rental income of £13.7m (£11.7m net). The leases had a weighted average unexpired lease term (WAULT) to first break of 5.8 years. Exhibit 13 shows the top 12 properties by rent/area to illustrate the composition of the portfolio.

Exhibit 13: Top 12 properties by area/rent

Asset	Location	Size (sqft)	Tenant(s)	Sector	Notes
Point Four Ind. Estate	Avonmouth	84,748	Eurocarb, Walkers	Industrial	Lease extensions
Copperfield Centre	Dartford	24,271	RBS, Dartford Borough Council	Retail/residential	Part of the Sequel Portfolio, conversion of top floor from office to residential successfully let.
A&B Bridge Retail Park	East Grinstead	30,761	Wickes, Pets at Home	Retail warehouse	Part of PIH portfolio
BPC Building	Exeter	113,106	Wheatons	Industrial	Newly let to the buyer of the previous tenant.
Broad Street Plaza	Halifax	117,767	JD Wetherspoon, Pizza Express, TGI Friday, PureGym, Vue	Leisure	Bought in FY16 for £24.2m.
Imperial Court	Leamington Spa	38,004	Bravissimo, Freestyle Games, Altair Engineering	Office	Medium-term development opportunity.
Bank House	Leeds	88,036	Bank of England, Walker Morris	Office	Bought in FY16 for £10m.
Boulton House	Manchester	76,918	Learn Direct, Northern Rail	Office	Recently refurbished
Pitfields	Milton Keynes	52,819	Rockwell Automation	Office	Refurbished and let in 2014
249 Midsummer Blvd	Milton Keynes	49,000	Crawford, Matrix, DHL	Office	Bought in FY16 for £7.2m.
Sol Central	Northampton	189,298	Accor, Marstons, Vue	Leisure	Bought in FY16 for £20.7m. Tenants being sought for former Gala Casino space.
Hudson House	York	101,686	AMEY, Thales	Office	Prospective redevelopment.

Source: Palace Capital data

Several asset management initiatives are underway:

- A lease on the recently completed conversion of the top floor of the Copperfield Centre in Dartford has been signed with the local council for 10 years with no break and annual increases.
- Palace is in discussion with possible tenants for two floors of Boulton House in Manchester.
- Sol Central, a leisure asset in Northampton, contains a cinema, hotel, gym and car park. Gala Casino vacated its space there in 2015, paying £4m in lease surrender and dilapidations, and tenants including food outlets are being sought before the space is reconfigured.
- Refurbishments of vacant space in Leeds and Milton Keynes are ongoing and potential future tenants sought.
- Leases to existing occupiers have recently been extended at properties in Leamington Spa, Leeds and Milton Keynes. Not only do these increase Palace's income, but also reduce outgoings through vacancy rates and other direct property costs such as insurance.
- Two vacant properties in Stockport and Coventry are on the market and are expected to be sold by H218, saving c £0.4m in annual costs as well as realising capital value.

We examine three assets in more detail to show Palace's asset management approach:

Hudson House, Toft Green, York

Hudson House was acquired as an office property in October 2013 for £3.8m and has lettable area of 103,000sqft. It is opposite York Station, near the City Council building and within the Roman walls. The council and Network Rail have plans to redevelop surplus railway land around the station over the next 20 years including commercial and residential elements, which will complement the plan proposed at Hudson House. Although the building is within a protected area, the planned redevelopment nearby gives management confidence that more efficient use of the space with a wholly new building would be possible and permissible and is therefore bearing vacancy costs of a net £0.4m pa while working on redevelopment plans. Palace has already secured permission for change of use to 139 apartments or to 82 apartments and 37,000sqft of offices, which has increased the asset's valuation to £14.9m as at 30 September 2016.

Boulton House, Chorlton Street, Manchester

Boulton House was bought in August 2016 for £10.6m. It is a 75,000sqft grade B office building between Manchester Piccadilly Station and the city centre and close to both. At acquisition the property generated £0.625m of rent, a yield of 5.9%, rising to £0.775m after rent-free periods come to an end, but with around 25% of the space unlet. This vacant space and the reception area have been refurbished and the company has been encouraged by interest in the space which, when fully let, would take the rent to £0.9m reflecting a yield of c 8.5%. Given the excellent location, management believes there is scope for further rental growth towards £17.25 per sqft available in Manchester from the current level of £13-15/sqft.

Copperfields, Dartford

This was acquired as part of the Sequel portfolio as a mixed-use retail and office property and is in the centre of a major commuter town in Kent, within walking distance of the station and opposite the Priory Shopping Centre. Post-acquisition, Palace obtained permission to convert the office space to residential use in a £2.25m scheme, which was completed in December 2016. Dartford Council has recently signed a 10-year lease without breaks at an initial annual rent of £146,500 rising at a fixed rate of 2.5% a year. The lease starts with a rent-free period until April 2017 in lieu of work the tenant will carry out on the flats. The value of the asset had grown from £1.1m as a tertiary retail/office property to £4.05m as at 30 September 2016.

Financials

This section sets out the basis for our forecasts and the valuation (page 12). We have used conservative assumptions and highlight the major sensitivities at the end of each subsection.

Earnings

Exhibit 14: Earnings estimates adjusted for 2016 surrender premium

£000s	Rental income	Property and admin costs	Revaluation gain	Disposal/acquisition profits/costs	Finance and tax costs	Profit after tax	EPRA earnings	EPRA EPS (p)
03/16*	11,421	(3,672)	3,620	(525)	(3,217)	7,627	4,532	18.4
03/17e	13,969	(4,834)	32	873	(3,683)	6,356	5,451	21.2
03/18e	13,878	(4,510)	1,500	0	(3,693)	7,175	5,675	21.8
03/19e	13,603	(4,138)	0	0	(3,399)	6,066	6,066	23.3

Source: Edison Investment Research. Note: *FY16 figures adjusted for one-off surrender premium of £3.172m from Gala Casinos. EPRA earnings exclude revaluation gains and profits on disposals of property.

2016 revenues were £11.4m excluding a £3.2m surrender premium from Gala Casinos for vacating Sol Central in Northampton early. We forecast £14.0m in FY17, falling slightly in FY18 as new leases we expect to be signed at Boulton House, Milton Keynes and potentially Sol Central are assumed to begin with rent-free periods and including the recent new lease at Copperfields in Dartford, and leases at Hudson House run out prior to the redevelopment of the site. We have not included any rental growth at let properties before 2019, from which time we assume that 10% of rents come up for review or re-leasing every six months (meaning that the whole portfolio will have a rent review every five years, roughly in line with the WAULT). On review we assume that the estimated rental value (ERV) can be achieved and we use a long-term occupancy rate of 90%, achieved in 2020 after a slight decrease in FY17 and FY18. We have not included Hudson House in our occupancy estimate, but do account for loss of rents and costs there.

We expect vacancy costs to fall by c £0.8m over the next two years as two vacant properties in Coventry and Stockport are sold (we assume at book value of c £3m in H217), a planning decision at Hudson House is made and asset management initiatives partially offset vacancy costs at Boulton House, Sol Central and Milton Keynes by the end of FY18. We assume head rents across the portfolio remain flat at £0.16m and that administrative costs fall to 20% of net income by FY19 from 23% in H117, in line with the three-year average.

We have not built any change in valuation yield into our model, but we have estimated the valuation uplift from new leases being signed at Boulton House and Pitfields in H118. We expect that Palace can let the vacant space at Boulton House for c £0.275m, giving headline rental income for the building of £0.9m. At a flat equivalent yield, we estimate that the uplift would be c £1m. At Solaris House we expect an uplift of c £0.5m, bringing the value per square metre in line with the adjacent Pitfields properties let to Rockwell. The revaluation characteristics of Sol Central are less certain and reconfiguration is likely to last beyond FY18, so we have not made any revaluation assumption regarding that asset beyond capitalisation of the expenditure on it. We do not assume any further valuation uplift at Hudson House within our forecast period.

Debt is covered in more detail on page 12, but we forecast a modest decrease in finance costs as some more expensive debt funding matures in H118. Palace has recently paid effective tax of c 12%, which we forecast to rise to 15% in future years as former losses are used up but capital allowances and other relief and a reduction in corporation tax rates keep the effective rate below 20%.

These assumptions mean that forecast profit after tax is sensitive to the timing and quantum of disposals and revaluation gains, which we have been conservative in modelling, but that our EPRA earnings forecast reflects the underlying progress we expect the company to make in reducing costs and managing the properties to maximise rental value. The EPS figures allow for outstanding options to be fully exercised (0.4m in FY18 and 0.12m in FY19).

Our estimates are sensitive to any change in rents on assets other than those mentioned above, either through rent reviews or new leases and, given the level of asset management ongoing, it would be unsurprising to see some rental growth ahead of our forecasts. A 1% rise in annual net rent would add 0.5p per share to EPRA earnings. Our revaluation and disposal forecasts are also conservative and we have not included any new acquisitions in the period.

Cash flow

Our only significant cash flow assumption, beyond those described above, is that dividends will be maintained at 9p every half-year over the forecast period. This gives a yield of c 5% on the current share price, covered 1.2x by EPRA earnings (which exclude revaluation gains) in FY17, rising to 1.3x by FY19. The company has a progressive dividend policy, so we consider this to be the most conservative reasonable assumption.

Balance sheet

Exhibit 15: Balance sheet forecasts

£000s	Investment properties b/f	Additions/ refurbishment	Revaluation	Disposals	Investment properties c/f	Other assets	Total liabilities	EPRA net assets	EPRA NAV/share (p)
03/16	102,988	69,601	3,620	(1,667)	174,542	13,099	(80,826)	106,924	414
03/17e	174,542	13,637	32	(3,924)	184,287	13,869	(89,967)	108,189	422
03/18e	184,287	2,000	1,500	(2,000)	185,787	11,790	(86,731)	110,846	426
03/19e	185,787	2,000	0	0	187,787	9,304	(84,695)	112,396	431

Source: Edison Investment Research

We have not assumed any new acquisitions are made, but we do allow for £2m pa of capitalised expenditure on existing properties funded from earnings. We have also assumed that the sales of the Coventry and Stockport assets will be at their current valuation, net of any disposal costs. As mentioned in the previous subsection, our forecasts include no valuation uplift except in FY18 on Boulton House in Manchester and Pitfields in Milton Keynes. This is a conservative stance given that asset management initiatives helped add £3.6m of value in FY16 and that management has completed refurbishing Copperfields, Solaris House and Boulton House and expects to let several vacant units in the current financial year. Without further major investment in our model we have also not assumed any change in borrowings other than scheduled debt repayments, although we note that Palace has £3.5m of undrawn facilities, which at 40% LTV would allow £8.75m of spending power.

Palace is moderately geared with 39.5% net LTV at 30 September 2016. We forecast this to be 40% at year end, falling to 38.3% at the end of FY18 as some debt matures and is repaid from earnings. A summary of Palace's debt is given in Exhibit 16. Apart from a £20m revolving credit facility with NatWest (which can be extended to £30m), it is largely secured against investment properties; however, £19m of properties are unencumbered. In all cases there is ample headroom before the LTV or rental cover covenants are reached. £10m of the Nationwide loan is hedged at a margin of 0.95% and all of the debt against Broad Street Plaza is hedged at 0.7%. We have assumed three-month Libor of 0.4% throughout our forecast period. The loan from Scottish Widows replaces one from Barclays and has reduced Palace's average cost of debt to 3%; it now has the lowest average cost of debt of its peers.

Exhibit 16: Debt profile at 31 December 2016

Lender	Facility (£000s)	Drawn (£000s)	Interest margin (%)	Maturity	Drawn against
NatWest	29,750	25,918	2.50	Mar 2021	PIH portfolio and revolving credit
Nationwide	18,920	18,920	2.45	Sep 2020	Sequel portfolio
Santander	15,800	15,800	2.25	Jun 2020	Sol Central, Northampton; Boulton House, Manchester
Scottish Widows	15,141	15,141	2.20	Jul 2026	Broad Street Plaza, Halifax
Lloyds	4,125	4,125	2.10	Apr 2019	Bank House, Leeds
Close Brothers	1,200	1,200	5.00	Sep 2017	Hockenhull portfolio, Cheshire
Total/average	**84,936**	**81,104**	**2.98**	**4.8 years**	

Source: Palace Capital data

As interest costs decline with the reduction in debt and earnings are retained or paid out rather than invested, we forecast gradual NAV per share growth. We would emphasise that this is a conservative approach given the company's strategy of recycling capital and increasing asset values. A change in valuation yields could have a substantial impact on our estimates: a yield movement of 10 basis points would alter the portfolio value by c £2.1m or 8p per share.

Valuation

As well as paying dividends at a level which gives a similar payout ratio to a REIT and a yield of 5%, Palace aims to provide NAV growth. We believe our estimates of NAV are conservative as explained above, and our forecast NAV growth is largely due to likely valuation uplifts on only two assets and to earnings retention. Given the potential to beat our estimates and to deliver solid earnings and NAV growth supported by the historic performance, we believe Palace's current discount to EPRA NAV is high, especially with higher regional yields providing a possible cushion were property yields to rise, as the market appears to expect will happen in London.

In Exhibit 17 we show Palace and 11 other regional and London-focused property investors' prices to EPRA NAV, FY18e EPRA earnings and some risk indicators that may affect their valuation. We have excluded Shaftesbury and Town Centre Securities because of their retail focus and the fact that they were outliers from the rest of the group. All data are taken from the last trading update, interim or annual report except the share price, which is as of 26 January 2017. The table shows that while Palace ranks relatively lowly in terms of WAULT, LTV and occupancy, it has the least expensive debt and its net initial yield is middling (and could be expected to improve as asset management initiatives take effect). We have also calculated the correlation between each of the risk indicators and the current price to EPRA NAV ratio (using our own estimates for Palace and Regional REIT). Interestingly, there does appear to be a strong positive correlation between the yield-debt spread and P/NAV. This bodes well for Palace, which has a higher spread than the peer group average.

It appears that while Palace is in the middle of the pack in terms of P/E (on our conservative estimates of FY18 [not calendarised] earnings), it is undervalued compared to peers on a NAV basis. Given the business model of significantly enhancing value, we would argue that a lower discount to NAV would be justified. We would also note the sensitivity of our forecast earnings to rental growth, which we have not modelled: if we assume rental growth across the portfolio of 2% pa over the forecast period, roughly in line with inflation, our FY18 EPS forecast rises to 22.8p, reducing the earnings multiple to below 16x.

If Palace's shares traded at the overall group average of 92.5% of NAV, the price would be 388p, and at 20x our FY18 earnings estimate they would be at 436p (ahead of H117 NAV of 419p). The same exercise using only the smaller regional sample gives a wider spread of 438p to 338p (noting that only three of those companies have FY18 estimates available). In either case, a share price closer to 400p would appear justified.

Exhibit 17: Peer comparison

%	P/NAV	Price/FY18e EPRA EPS (x)	Cost of debt	Net initial yield	Yield – debt spread	WAULT (years)	Occupancy	LTV
Palace	**85.9%**	**17.2**	**2.98%**	**6.3%**	**3.29%**	**5.8**	**89.0%**	**39.0%**
Regional average	**104.6%**	**15.5**	**3.94%**	**6.6%**	**2.65%**	**5.6**	**92.2%**	**31.7%**
Custodian	138.3%	-	3.13%	7.0%	3.82%	6.2	97.8%	19.6%
Mucklow	104.0%	18.3	4.10%	6.4%	2.30%	6.0	96.8%	20.0%
Regional	99.3%	11.0	3.70%	7.1%	3.40%	3.6	81.8%	40.0%
Picton	98.6%	-	4.20%	5.8%	1.60%	5.7	93.0%	37.8%
REI	96.0%	17.4	4.10%	7.7%	3.60%	4.8	92.6%	42.8%
Schroders	91.6%	-	4.40%	5.6%	1.20%	7.2	91.0%	30.0%
London average	**78.5%**	**22.1**	**4.26%**	**3.82%**	**-0.44%**	**8.7**	**95.6%**	**22.7%**
LondonMetric	103.3%	16.8	3.30%	4.8%	1.50%	12.6	98.5%	36.0%
Workspace	80.5%	19.9	5.50%	4.8%	-0.70%	8.5	90.6%	14.0%
Great P	72.9%	29.2	3.90%	2.8%	-1.10%	6.9	93.8%	21.7%
Derwent	68.7%	25.2	3.88%	3.1%	-0.78%	6.8	98.0%	19.1%
LandSecs	67.2%	19.4	4.70%	3.6%	-1.10%	8.9	97.3%	22.6%
Overall average	**92.5%**	**19.6**	**4.1%**	**5.3%**	**1.22%**	**7.0**	**93.7%**	**27.7%**
Rank	**8**	**7**	**1**	**5**	**4**	**9**	**11**	**10**
Correlation with P/NAV	**100%**	**-67.7%**	**-47.1%**	**71.4%**	**76.7%**	**-14.3%**	**8.2%**	**15.9%**

Source: Company data, Bloomberg, Edison Investment Research. Note: NAV and EPS estimates are not calendarised. Prices as at 26 January 2017.

Sensitivities

The property market is cyclical and, while the regions may be less sensitive than London, occupier demand is influenced by economic growth. Similarly, the supply of new developments is affected by the economic outlook and may be more sensitive to Brexit than demand. Positively, the UK economic recovery has so far exceeded the expectations of many commentators, especially since the referendum. Unemployment is at its lowest rate since 2005 and employment is near its highest level since records began. The Bank of England raised its GDP projections in November from 0.8% GDP growth for 2017 to 1.4%. Both the Bank and the Office for Budget Responsibility forecast growth every year to 2021. As noted above, devolution of powers to city mayors and national infrastructure projects may support regional economic growth.

A key part of Palace's investment case is its ability to enhance capital value by improving its assets. While refurbishments are relatively straightforward, the potential replacement of Hudson House with a new building would incur some development risk. This is mitigated by the city council's intention to undertake development itself in the same area, the Palace team's experience of similar projects and the existing permissions for different uses of the property.

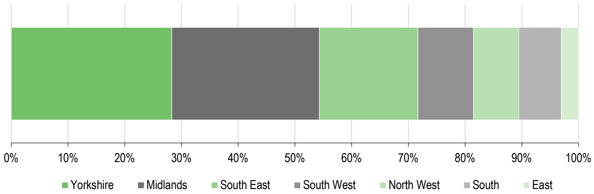
Tenant risk and vacancy risk are both inherent in the business model and mitigated by maintaining a close relationship with tenants, planning for potential vacancy and making judicious acquisitions and disposals. For example, the tenant at one of the Exeter properties went into administration in H117 and was acquired by a PE firm. By the time the half-year results were announced, the building had been re-let to the buyer on a 10-year lease, without a break and with a fixed rental uplift programme, avoiding vacancy costs and extending the income stream, albeit at a lower level.

Palace has c £3.5m of undrawn debt, which at 40% LTV would enable it to acquire assets worth £8.75m assuming equity funding was available (it had cash of £9.3m at the half-year). At an 8% net initial yield, assuming costs of 6%, this would generate £0.658m of rental income on annual interest costs of £86k for net rental income of around £0.57m or 1.7p per share of earnings, allowing for additional administrative costs. At the FY18e EPRA EPS multiple of c 17x, that could be worth 30p per share.

Exhibit 18: Financial summary

Year end 31 March	£000s	2014	2015	2016	2017e	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue		**3,252**	**8,637**	**14,593**	13,969	13,878	13,603
Cost of Sales		(648)	(1,200)	(1,624)	(2,423)	(2,323)	(1,868)
Gross Profit		2,604	7,437	12,969	11,646	12,010	11,832
Administrative expenses		(649)	(1,439)	(2,048)	(2,626)	(2,511)	(2,642)
Operating Profit before revaluation		1,955	5,998	10,921	8,776	9,053	9,135
Revaluation of investment properties		19,501	9,769	3,620	32	1,500	0
Costs of acquisitions/profits on disposals		270	(461)	(525)	873	0	0
Operating Profit		21,725	15,306	14,016	9,681	10,040	10,868
Net Interest		(573)	(1,398)	(2,264)	(2,822)	(2,427)	(2,328)
Profit Before Tax (norm)		1,652	4,139	8,132	6,826	6,626	7,185
Profit Before Tax (FRS 3)		21,153	13,908	11,752	6,858	8,126	7,217
Taxation		81	107	(953)	(861)	(1,266)	(1,071)
Profit After Tax (norm)		1,733	4,246	7,179	6,008	5,408	6,324
Profit After Tax (FRS 3)		21,234	14,015	10,799	6,040	6,908	6,356
Less:							
Revaluation of investment properties		(19,501)	(9,679)	(3,620)	(32)	(1,500)	0
Costs of acquisitions/profits on disposals		(270)	461	525	(873)	0	0
EPRA earnings		**1,463**	**4,707**	**7,704**	**5,451**	**5,675**	**6,066**
Adjusted for:							
Surrender premium		0	0	(3,172)	0	0	0
Share-based payments		0	114	110	145	100	100
Adjusted earnings		**1,463**	**4,821**	**4,642**	**5,596**	**5,775**	**6,166**
Average Number of Shares Outstanding (m)		5.3	17.1	24.6	25.7	26.0	26.0
EPS - normalised (p)		32.9	24.8	29.2	24.6	21.8	23.3
EPS - FRS 3 (p)		403.4	82.0	43.9	24.8	27.5	23.3
EPRA EPS (p)		**27.8**	**27.5**	**31.1**	**21.2**	**21.8**	**23.3**
Adjusted EPS (p)			28.3	18.9	21.8	22.5	24.0
Dividend per share (p)		**0.0**	**13.0**	**16.0**	**18.0**	**18.0**	**18.0**
Dividend cover (x)		N/A	2.12	1.96	1.18	1.21	1.29
BALANCE SHEET							
Fixed Assets		60,086	104,470	175,738	185,297	186,797	188,797
Investment properties		59,440	102,988	174,542	184,287	185,787	187,787
Goodwill		6	6	0	0	0	0
Other non-current assets		640	1,475	1,196	1,010	1,010	1,010
Current Assets		7,060	15,653	11,903	12,859	10,780	8,294
Debtors		1,937	3,375	3,170	3,170	3,170	3,170
Cash		5,123	12,279	9,689	7,610	5,124	4,502
Current Liabilities		(4,171)	(3,487)	(9,048)	(11,193)	(11,193)	(11,193)
Creditors		(2,971)	(3,087)	(7,952)	(7,952)	(7,952)	(7,952)
Short term borrowings		(1,200)	(400)	(2,233)	(3,241)	(3,241)	(3,241)
Long Term Liabilities		(18,599)	(36,620)	(71,778)	(78,774)	(75,538)	(73,502)
Long term borrowings		(17,384)	(35,407)	(69,711)	(76,709)	(73,473)	(71,437)
Other long term liabilities		(1,215)	(1,214)	(2,067)	(2,065)	(2,065)	(2,065)
Net Assets		44,376	80,016	106,815	108,189	110,846	112,396
Net Assets excluding goodwill and deferred tax		44,370	80,010	106,815	107,873	108,189	110,846
NAV/share (p)		219	395	414	422	426	431
EPRA NAV/share (p)		**219**	**396**	**414**	**422**	**426**	**431**
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	9,776	9,488	9,585
Net Interest		(390)	(1,593)	(2,529)	(2,427)	(2,328)	(2,328)
Tax		(13)	(15)	(387)	(1,266)	(1,071)	(1,235)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(8,858)	(8,858)	(20)
Ordinary dividends paid		0	(1,766)	(3,221)	(4,617)	(4,617)	(4,617)
Debt drawn/(repaid)		(21,266)	(10,600)	21,272	8,241	(3,236)	(2,036)
Proceeds from shares issued		23,009	19,664	19,114	38	38	0
Other cash flow from financing activities		(66)	(2)	(2)	(551)	(551)	0
Net Cash Flow		5,085	7,155	(4,141)	1,113	(2,078)	(2,487)
Opening cash		39	5,123	12,278	8,576	9,689	7,611
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	9,689	7,611	5,124
Opening net debt/(cash)		**1,724***	**13,476**	**24,742**	**65,435**	**72,326**	**71,169**
Closing net debt/(cash)		**13,476**	**24,742**	**65,435**	**72,326**	**71,169**	**71,619**

Source: Palace Capital data, Edison Investment Research. Note: *Net debt at 31 January 2013

Contact details	Revenue by geography
Malta House, 36-38 Piccadilly London W1J 0DP United Kingdom +44 (0) 20 3301 8335 www.palacecapitalplc.com	

Management team	
Chairman: Stanley Davis	**Non-executive director: Anthony Dove**
Mr Davis is the founder and chairman of Stanley Davis Group, a corporate services provider. He was the CEO of IRG, which was sold to Capita in 2000. He has extensive experience administering listed companies.	Mr Dove has a law degree from Cambridge and was a partner at Simmons & Simmons from 1977 to 1999. He was a director of listed property company Tops Estates until its sale to Land Securities in 2005.
Non-executive director: Kim Taylor-Smith	**CEO: Neil Sinclair**
Mr Taylor-Smith is a chartered accountant with 30 years' experience as a company director with particular knowledge of the property investment, management and development business. He was FD and then CEO of Birkby and continued as CEO after the takeover by Mentmore until 2001.	Mr Sinclair has over 50 years' experience in UK commercial property. He was a founder of Sinclair Goldsmith Chartered Surveyors, which was listed in 1987, and he became deputy chairman when it merged with Conrad Ritblat in 1993. He was a non-executive director of Baker Lorenz (sold to Hercules Property Services) and of Tops Estates. He also founded Mission Capital, now Watchstone Group, which was admitted to AIM in 2005.
Executive Director: Richard Starr	**CFO: Stephen Silvester**
Mr Starr is a chartered surveyor and worked as a senior member of three established London surveying firms before founding his own property consultancy, which advised on the Sequel Portfolio acquisition in 2013. He was a consultant to Palace until July 2016 when he became full-time executive director.	Mr Silvester is a chartered accountant, having begun his career at Menzies Chartered Accountants in the UK and later Australia. He became group financial controller for St Hilliers Pty, a large property company headquartered in Sydney, before returning to the UK and joining the finance team of NewRiver REIT. He joined Palace in 2015.

Principal shareholders	(%)
Schroders	14.06
Polar Capital European Forager Fund	12.71
Henderson Global Investors	9.91
Quantum Partners	9.90
Stanley Davis	6.07
Unicorn Asset Management	5.04
Hargreave Hale	5.02
AXA Investment Managers	4.82

Companies named in this report

Palace Capital (PCA), Assura (AGR), British Land (BLND), Custodian REIT (CREI), Derwent London (DLN), Great Portland Estates (GPOR), Land Securities (LAND), LondonMetric (LMP), MacKay Securities (MCKS), MedicX Fund (MXF), Mucklow (MKLW), Primary Health Properties (PHP), Real Estate Investors (RLE), Regional REIT (RGL), Secure Income REIT (SIR), Shaftesbury (SHB), Target Healthcare REIT (THRL), Tritax BigBox (BBOX), Workspace (WKP).