Palace Capital

Disposals of assets

NAV-accretive disposals

Real estate

Palace Capital (Palace) has announced the disposals of two properties: one in Leeds and one in Stockport. The rationale for each is clear and in line with the company's strategy to deliver shareholder value through capital and income growth. The disposals, totalling £3.7m, will crystallise value from active asset management, free capital to be recycled, increase the portfolio's average unexpired lease term to first break and reduce void costs. We have adjusted our forecasts accordingly and expect Palace will reinvest the proceeds in other regional property assets in due course.

Year end	Revenue (£m)	Adjusted EPRA earnings* (£m)	Adjusted EPRA EPS (p)	EPRA NAV/share (x)	DPS (p)	Yield (%)
03/15	8.6	4.8	28.3	396	13.0	3.7
03/16	14.6	4.6	18.9	414	16.0	4.5
03/17e	14.0	5.5	21.8	424	18.0	5.1
03/18e	13.7	5.7	22.2	428	18.0	5.1
03/19e	13.4	6.1	23.6	433	18.0	5.1

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

One disposal increases value…

The sale of the long leasehold at Warwick House in Leeds for £2.15m is well above the carrying value of £1.4m, representing a 54% gain before expenses. The tenant, Interserve, pays rent of £196.3k a year, or £172.5k after ground rent due to the freeholder, Leeds City Council, and has an option to break the lease in August 2017. Palace has been able to reduce the risk of vacancy and make a disposal well above the price paid when the property was bought from Quintain in 2013 as part of the Sequel portfolio. The uplift to the carrying value is significant and shows Palace's ability to generate capital value growth through active asset management.

…the other reduces costs

Allen House in Stockport was also bought as part of the Sequel portfolio and has been vacant since the occupier surrendered the lease in September 2015. The price of the sale (£1.55m) is slightly above the most recent valuation, but perhaps more significantly, it removes the c £185k of annual vacancy costs associated with the building. Palace has previously stated it intended to sell the property and the effect of the sale was included in our earlier forecast assumptions. The disposal frees capital for reinvestment, as does Warwick House, and is another example of the effective implementation of Palace's strategy.

Valuation: Still at a discount to peers

Palace's c 18% discount to our FY17 EPRA NAV forecast seems high compared with a basket of regional property investor peers, which trade at c 98% of EPRA NAV on average. As the announcements demonstrate, Palace can deliver capital value growth as well as pay a dividend yield of c 5%, comparable to REIT peers, underpinned by stable income from its portfolio. As Palace extends its track record, its investor audience is likely to broaden and the discount may narrow.

28 February 2017

Price	**352p**
Market cap	**£90m**

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	(1.4)	(0.7)	6.0
Rel (local)	(2.6)	(6.4)	(10.2)
52-week high/low		375.0p	307.5p

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

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Details of the disposals and their effect on forecasts

The announced disposals of assets in Stockport and Leeds, acquired from Quintain in 2013 as part of the Sequel portfolio, are in line with Palace's active approach to asset management and we expect them to be NAV accretive. Exhibit 1 shows details of each disposal.

Exhibit 1: Disposals

Property name	Location	Sector	Size (sqft)	Book value (£m)	Sale price (£m)	Net rent (£000s)	Buyer
Warwick House	Leeds	Office	14,818	1.40	2.15	172.5	Private group
Allen House	Stockport	Industrial	68,000	1.55	1.55	(185.0)	Not disclosed

Source: Palace Capital

Warwick House in Leeds has been sold at a premium of 54% to its book value, or £0.75m, equivalent to c 2.9p per share before tax. This gain was not included in our forecasts for FY17 and is equal to half of our estimated valuation uplift in FY18, which we still expect to be generated by gains at Boulton House in Manchester and Solaris House in Milton Keynes (see our initiation note). the attractive price, the lease break coming up in August 2017 and the secondary location of the property motivated the sale. It will allow Palace to crystallise a gain on the property and recycle capital, in line with its investment strategy. The reduction in annual rent is offset by the reduction in void costs from selling Allen House in Stockport. This vacant asset, which the company had previously announced its intention to sell, had annual void costs of c £185k,. This cost reduction was already included in our forecasts, and we have now allowed for the reduction in rent from the disposal of Warwick House. This reduction in rental income reduces forecast EPRA EPS slightly and we have not allowed for any new investment. The changes to our forecasts are set out in Exhibit 2.

Exhibit 2: Estimate changes

Year end	Rental income (£m)			EPRA EPS (p)			EPRA NAV per share (p)			Dividend per share (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/17e	14.0	14.0	0.0	21.2	21.2	0.0	422	424	0.6	18.0	18.0	0
03/18e	13.9	13.7	-0.9	21.8	21.5	-1.5	426	428	0.4	18.0	18.0	0
03/19e	13.6	13.4	-1.2	23.3	22.9	-1.9	431	433	0.5	18.0	18.0	0

Source: Edison Investment Research

We note that management's strategy is to recycle capital, so we expect the proceeds of the disposals to be reinvested in income-producing assets. If all £3.7m of sale proceeds were reinvested at a yield of 7% and assuming purchaser's costs of 6%, they would generate a rental income of c £240k. If the funds were invested in the middle of FY18, our model indicates they would feed through to EPRA EPS of 21.6p per share in FY18 and 23.5p in FY19.

Valuation: NAV accretive and EPS neutral

The disposals are NAV accretive, and we continue to view Palace's discount to NAV (currently c 18% vs our new FY17 forecast) as high compared with regional peers, which trade at around a 2% discount to stated EPRA NAV on average. This may be because of Palace's relatively short time as a listed company, and we would expect it to move closer to the peer average as it establishes a longer track record of delivering value and income growth.

Exhibit 3: 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	13,748	13,436
Cost of Sales		(648)	(1,200)	(1,624)	(2,322)	(1,862)	(1,396)
Gross Profit		2,604	7,437	12,969	11,647	11,887	12,040
Administrative expenses		(649)	(1,439)	(2,048)	(2,511)	(2,615)	(2,079)
Operating Profit before revaluation		1,955	5,998	10,921	9,136	9,272	9,331
Revaluation of investment properties		19,501	9,769	3,620	32	1,500	0
Costs of acquisitions/profits on disposals		270	(461)	(525)	1,623	0	0
Operating Profit		21,725	15,306	14,016	10,791	10,772	9,331
Net Interest		(573)	(1,398)	(2,264)	(2,822)	(2,427)	(2,328)
Profit Before Tax (norm)		1,652	4,139	8,132	7,936	6,845	7,003
Profit Before Tax (FRS 3)		21,153	13,908	11,752	7,968	8,345	7,003
Taxation		81	107	(953)	(951)	(1,252)	(1,050)
Profit After Tax (norm)		1,733	4,246	7,179	6,985	5,593	5,952
Profit After Tax (FRS 3)		21,234	14,015	10,799	7,017	7,093	5,952
EPRA earnings		1,463	4,707	7,704	5,362	5,593	5,952
Adjusted for:							
Surrender premium		0	0	(3,172)	0	0	0
Share-based payments		0	114	110	145	100	100
Adjusted EPRA earnings		1,463	4,821	4,642	5,507	5,693	6,052
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	27.2	21.5	22.9
EPS - FRS 3 (p)		403.4	82.0	43.9	27.3	27.2	22.9
Adjusted EPRA EPS (p)		29.7	28.3	18.9	21.8	22.2	23.6
EPRA EPS (p)		27.8	27.5	31.3	21.2	21.5	22..9
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	1.19	1.27
BALANCE SHEET							
Fixed Assets		60,086	104,470	175,738	182,597	184,097	186,097
Investment properties		59,440	102,988	174,542	181,587	183,087	185,087
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	16,220	14,060	11,459
Debtors		1,937	3,375	3,327	3,170	3,170	3,170
Cash		5,123	12,279	8,576	13,050	10,890	8,289
Current Liabilities		(4,171)	(3,487)	(9,048)	(11,193)	(11,193)	(11,193)
Creditors		(2,971)	(3,087)	(6,815)	(7,952)	(7,952)	(7952)
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	108,850	111,426	112,861
Net Assets excluding goodwill and deferred tax		44,370	80,010	106,815	108,850	111,426	112,861
Basic NAV/share (p)		219	395	414	424	428	433
EPRA NAV/share (p)		219	396	414	424	428	433
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	9,777	9,392	9,451
Net Interest		(390)	(1,593)	(3,421)	(2,529)	(2,427)	(2,328)
Tax		(13)	(15)	(158)	(477)	(1,252)	(1,050)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(5,408)	(20)	(2,020)
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	0	0
Other cash flow from financing activities		(66)	(2)	(2)	(551)	0	0
Net Cash Flow		5,085	7,155	(4,141)	4,474	(2,160)	(2,601)
Opening cash		39	5,123	12,278	8,576	13,050	10,890
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	13,050	10,890	8,289
Opening net debt/(cash)		1,724	13,476	24,742	65,435	68,965	67,887
Closing net debt/(cash)		13,476	24,742	65,435	68,965	67,889	68,454

Source: Palace Capital, Edison Investment Research

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