

Palace Capital

Another NAV-accretive disposal

Palace continues to demonstrate its ability to grow NAV per share through its strategic recycling of assets. The disposal of a property in Maldon has realised value created through recent asset management initiatives. As with two other recent sales, this is in line with the company's strategy to increase shareholder value through active management of the investment portfolio. We have adjusted our forecasts for the £1.56m gain in value and, although we have not assumed any additional acquisitions, would expect Palace to reinvest the proceeds in other regional property assets at attractive yields and with further scope for capital gains.

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	3.7
03/16	14.6	4.6	18.9	414	16.0	4.6
03/17e	14.0	5.0	20.9	430	18.0	5.1
03/18e	13.5	5.5	21.9	433	18.0	5.1
03/19e	13.1	5.8	23.1	439	18.0	5.1

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

Value-added through asset management

The ICS building in Maldon is let to Rockwell Automation (which remains a tenant of Palace in Milton Keynes) and following the recent extension of the lease, has little further scope for active asset management to add value in the near term. The gain on the carried value of the property equates to c 6p per share and crystallises the value of the property management team's work to date. It follows the disposal of two adjacent properties in September 2016 and two further disposals in February, all at significant premiums to book value and thus all NAV-accretive.

Reinvestment to come

Palace has now sold properties for a total of £7.6m in the last month, giving the company enough funds to make an acquisition of the scale of Boulton House in Manchester (its most recent purchase). While we have not allowed for further investment in our modelling assumptions, we believe that the company has a healthy pipeline of opportunities for new investment beyond improvement of its existing portfolio and we would expect management to deploy the funds in FY18 and continue to grow its income.

Valuation: Significant unrecognised value

Palace's shares trade at c 16% below last reported EPRA NAV per share of 419p, and the company has made disposals in the last month at c 9p per share above the book value of the assets in total. With some earnings being retained and allowing for the share buyback [announced](#) on 13 March, we forecast EPRA NAV of 430p per share at 31 March 2017, the financial year-end, implying that the shares trade at a discount of 19%. This is well above the average of regional property investment peers, which trade at close to or above EPRA NAV. As illustrated on page 2, there appears to be scope for this gap to close, supported by the earnings yield. Possible catalysts include the full-year results and reinvestment of capital.

Property disposal

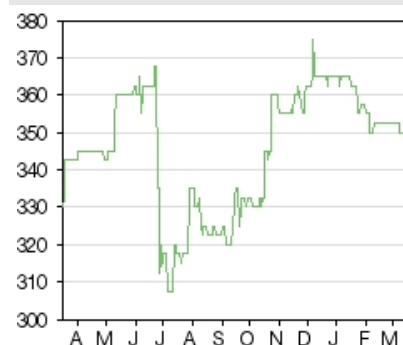
Real estate

14 March 2017

Price 350p
Market cap £89m

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	(0.7)	(4.1)	5.3
Rel (local)	(1.9)	(9.6)	(11.6)
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 disposal

The property which has been sold is currently let to Rockwell Automation. The existing lease runs out in June 2017 and is for £375k per annum. Palace announced in December 2016 that a ten-year lease extension had been signed with mutual breaks in June 2020 and June 2024 (at three and seven years) and an agreed rent review to not less than £394,128 in June 2022. The adjacent properties, 4 and 5 Hall Road, were sold by Palace for £1.03m in September: No 4 was let on a rolling annual lease and No 5 was vacant. The ICS building has been sold for £3.9m, equating to c £52 per sq ft and a 66% premium to the £2.34m valuation as of 30 September 2016. The £1.56m gain on the book value is equivalent to 6p per share before tax.

As with the disposals announced in February, this gain was not included in our forecasts (see our [note](#) of 28 February). As with the earlier disposals, the rationale for this sale is clear; it crystallises considerable value from asset management initiatives including the lease extension, and allows Palace to recycle capital into other investments.

Adjusting for the 0.5m share buyback (at 340p, and therefore NAV accretive on a per-share basis) and without assuming further asset acquisitions, the disposal reduces our rental income and EPS forecasts from FY18, although we would expect Palace to invest the capital. We have also not assumed that any additional debt will be repaid to save finance costs, and note that our forecasts now indicate a cash balance of c £14m in March 2017, up from £9.3m at September 2016. This represents a cash drag and we therefore view our forecasts as conservative. For illustration, if we assumed that £10m could be invested in H118, with 5% purchaser's costs and at a 7% net initial yield, our FY18 EPRA EPS forecast would rise to 22.7p and 24.0p in FY19.

Exhibit 1: Estimate changes

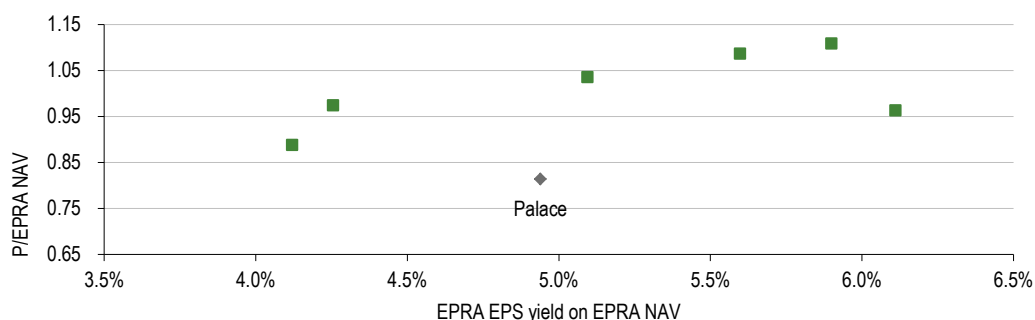
	Rental income (£m)			EPRA EPS (p)			EPRA NAV per share (p)			Dividend per share (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/17e	14.0	14.0	0.0%	21.2	20.4	-4.1%	424	430	1.4%	18.0	18.0	0%
03/18e	13.7	13.5	-2.0%	21.5	21.2	-1.4%	428	433	1.3%	18.0	18.0	0%
03/19e	13.4	13.1	-2.7%	22.9	22.4	-2.1%	433	439	1.2%	18.0	18.0	0%

Source: Edison Investment Research

Valuation: Further NAV gains

This additional NAV increase means that the shares now trade at a 21% discount to our FY17e EPRA NAV. This seems high compared with the peer group (Exhibit 2) and we would expect the shares to move closer to the peer average as the capital is redeployed.

Exhibit 2: P/EPRA NAV vs EPRA EPS yield on EPRA NAV



Source: Company data, Bloomberg, Edison Investment Research. Peers are Custodian REIT (CREI), Mucklow (MKLW), Picton Property Income (PCTN), Real Estate Investors (RLE), Regional REIT (RGL) and Schroder REIT (SREI).

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	13,468	13,073
Cost of Sales		(648)	(1,200)	(1,624)	(2,321)	(1,858)	(1,392)
Gross Profit		2,604	7,437	12,969	11,648	11,610	11,681
Administrative expenses		(649)	(1,439)	(2,048)	(2,626)	(2,554)	(2,628)
Operating Profit before revaluation		1,955	5,998	10,921	9,022	9,056	9,053
Revaluation of investment properties		19,501	9,769	3,620	32	1,500	0
Costs of acquisitions/profits on disposals		270	(461)	(525)	3,183	0	0
Operating Profit		21,725	15,306	14,016	12,237	10,556	9,053
Net Interest		(573)	(1,398)	(2,264)	(2,822)	(2,427)	(2,328)
Profit Before Tax (norm)		1,652	4,139	8,132	9,383	6,629	6,724
Profit Before Tax (FRS 3)		21,153	13,908	11,752	9,415	8,129	6,724
Taxation		81	107	(953)	(1,350)	(1,219)	(1,009)
Profit After Tax (norm)		1,733	4,246	7,179	8,033	5,410	5,716
Profit After Tax (FRS 3)		21,234	14,015	10,799	8,065	6,910	5,716
EPRA earnings		1,463	4,707	7,704	4,850	5,410	5,716
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	4,995	5,510	5,816
Average Number of Shares Outstanding (m)		5.3	17.1	24.6	25.7	25.5	25.5
EPS - normalised (p)		32.9	24.8	29.2	31.3	21.2	22.4
EPS - FRS 3 (p)		403.4	82.0	43.9	31.4	27.0	22.4
Adjusted EPS		29.7	28.3	18.9	20.9	21.9	23.1
EPRA EPS (p)		27.8	27.5	31.3	20.4	21.2	22.4
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	1.13	1.18	1.24
BALANCE SHEET							
Fixed Assets		60,086	104,470	175,738	181,007	182,507	184,507
Investment properties		59,440	102,988	174,542	179,997	181,497	183,497
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	17,232	14,979	12,232
Debtors		1,937	3,375	3,327	3,170	3,170	3,170
Cash		5,123	12,279	8,576	14,062	11,809	9,062
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)	(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)	(78,775)	(75,539)	(73,503)
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)	(2,066)	(2,066)	(2,066)
Net Assets		44,376	80,016	106,815	108,271	110,754	112,043
Net Assets excluding goodwill and deferred tax		44,370	80,010	106,815	108,271	110,754	112,043
Basic NAV/share (p)		219	395	414	430	433	439
EPRA NAV/share (p)		219	396	414	430	433	439
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	9,663	9,176	9,173
Net Interest		(390)	(1,593)	(3,421)	(2,529)	(2,427)	(2,328)
Tax		(13)	(15)	(158)	(876)	(1,219)	(1,009)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(2,258)	(20)	(2,020)
Ordinary dividends paid		0	(1,766)	(3,221)	(4,612)	(4,527)	(4,527)
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)	(2,180)	0	0
Net Cash Flow		5,085	7,155	(4,141)	5,487	(2,253)	(2,747)
Opening cash		39	5,123	12,278	8,576	14,063	11,809
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	14,063	11,809	9,062
Opening net debt/(cash)		1,724	13,476	24,742	65,435	67,954	66,971
Closing net debt/(cash)		13,476	24,742	65,435	67,954	66,971	67,682

Source: Company data, Edison Investment Research

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