

Palace Capital

Net asset value growth

Portfolio update

Real estate

Palace Capital (Palace) has released a positive portfolio and trading update detailing disposals made in FY17, significant ongoing projects at ten properties and the possible acquisition of a fully let office building for c £20m, which would more than replace rents at properties sold in the year. These developments demonstrate Palace's ability to add shareholder value through active management and to recycle capital efficiently. We have revised our estimates and note that management expects the March 2017 NAV to beat market expectations.

| 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 | 4.5 |
| 03/17e | 14.0 | 5.0 | 21.0 | 431 | 18.0 | 5.1 |
| 03/18e | 13.7 | 5.6 | 22.2 | 437 | 18.0 | 5.1 |
| 03/19e | 14.7 | 6.9 | 27.5 | 447 | 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.

Asset management adding value

Thirteen disposals were made in the year to 31 March 2017 for a total consideration of £12.6m, which is a £3.4m (37%) gain on the book value of the properties (£9.2m), equivalent to c 13p per share before tax. These disposals have helped reduce net LTV to 39% of the September 2016 portfolio valuation. LTV may be lower still vs the March 2017 NAV, which Palace has stated is likely to beat market expectations. The portfolio update also detailed ten property management projects, most significantly one at Hudson House in York where a new planning application has been submitted to replace the existing building with 127 apartments, 34,000sqft of offices and 5,000sqft of commercial space. Full details of all the projects are available [here](#), and while we have increased our FY17 forecasts we expect these initiatives may still have contributed to a portfolio valuation in excess of our new EPRA NAV estimate of 431p per share (previously 430p).

Reinvestment to enhance income

Although the disposals have reduced the contracted rent roll to £12.8m pa at 31 March 2017 (£10.9m net of head rent and void costs), Palace has also agreed terms for the corporate acquisition of a fully let office building for c £20m. It is reported that if completed, this would more than replace income lost through disposals. We have assumed the acquisition is made with 5% purchaser's costs, at a 7.5% net initial yield and 50% LTV with debt costs in line with existing debt: our FY18 EPRA EPS forecasts have risen to 22.2p and to 27.5p in FY19.

Valuation: more NAV gains likely

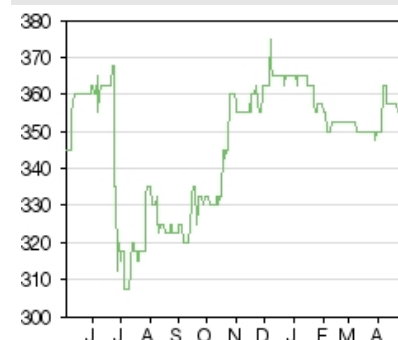
With the potential acquisition likely to mean that rental income levels are sustained and the probability of a NAV uplift beating market expectations, there is significant potential for the shares to appreciate. Regional peers tend to trade at premiums to reported EPRA NAV averaging c 4% and the completion of the acquisition and/or the FY17 results could be catalysts for Palace's c 18% discount to narrow.

2 May 2017

Price 355.00p
Market cap £89m

| | |
|------------------------------------|-------|
| Net debt at 30 September 2016 (£m) | 73.5 |
| Shares in issue | 25.2m |
| Free float | 94% |
| Code | PCA |
| Primary exchange | AIM |
| Secondary exchange | N/A |

Share price performance



| % | 1m | 3m | 12m |
|------------------|--------|--------|--------|
| Abs | 1.4 | 0.0 | 3.7 |
| Rel (local) | 2.3 | (2.3) | (10.0) |
| 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

| | |
|---------------------|-------------|
| FY17 results | 6 June 2017 |
| Final dividend paid | July 2017 |

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Changes to estimates

Exact details of the asset management initiatives and disposals undertaken in the period can be found in Palace's announcement [here](#). We have substantially revised our estimates as a result of the portfolio update and in light of the likely acquisition, and have taken into account mechanical changes to the model such as the recent share buyback, the exercise of options and passage of the 2014 LTIP deadline. The principal changes to our assumptions are listed below.

Rental income

- The change in contracted rental income falls less than previously assumed because the acquisition replaces income lost through disposals. Assuming a £20m consideration, costs of £1m and a 7.5% net initial yield, gives gross rental income of £1.6m per annum.
- We have also allowed for the new lettings at Ovest House in Brighton and the Copperfield Centre in Dartford, where annual rents are now £0.3m. We also note that letting recently refurbished space at Solaris House in Milton Keynes, Bank House in Leeds and Boulton House in Manchester could add a further c £0.8m of annual rent and reduce void costs. We have allowed for this to be achieved in FY18 so that all three make a full contribution in FY19. Fixed rental increases of £0.15m at Broad Street Plaza in Halifax and have also been taken into account.

Void costs

- The sales of vacant buildings in Maldon, Stoke and Stockport will reduce void costs sooner and therefore more than we had previously assumed.
- We have assumed that the Hudson House planning application will be successful, given the previous successful applications for variations of use and the close consultation with Historic England, York City Council and other stakeholders: so far there has been positive support of the plan submitted to the planning authority. We expect demolition of the existing building to occur in 2018, reducing void costs by £0.7m.

Finance costs and dividend

- We have assumed that the new acquisition will be 50% funded with debt at a similar rate to the existing weighted average cost. We have left our Libor assumption unchanged at 0.4%.
- We have assumed that the dividend will remain flat and forecast dividend cover of 1.48x in FY19, implying scope for a higher distribution or for further investment.

The effects of these changes on our estimates are summarised in Exhibit 1 below.

Exhibit 1: Changes to estimates

| | 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% | 20.4 | 20.4 | 0.5% | 430 | 431 | 0.2% | 18.0 | 18.0 | 0% |
| 03/18e | 13.5 | 13.7 | 1.6% | 21.2 | 21.4 | 1.0% | 433 | 437 | 0.9% | 18.0 | 18.0 | 0% |
| 03/19e | 13.1 | 14.7 | 12.5% | 22.4 | 26.7 | 19.2% | 439 | 447 | 1.9% | 18.0 | 18.0 | 0% |

Source: Edison Investment Research. *This is lower than the adjusted figure on page 1 because it includes share-based payments.

Valuation

Palace's shares trade at a discount of c 18% to our estimated FY17e EPRA NAV, and we note that management expects the 31 March portfolio valuation to exceed market expectations. In Exhibit 2 we show the last reported EPRA NAV per share and, where available, forecast EPRA NAV per share for a selection of investors in regional commercial and industrial property. This shows that

Palace trades at a considerable discount to peers, which trade at an average premium to last reported EPRA NAV of c 4%, as at the time of our initiation note in January. Regional property markets are less exposed to Brexit-related risks than London ones and occupier demand is reported to be robust in regional cities. The market appears to expect growth (although forecasts of EPRA NAV per share are only available for four companies) which may explain the premium. Palace's discount could narrow as the market recognises the company's ability to deliver returns by growing capital values as well as providing a stable and diversified income stream.

Exhibit 2: Peer comparison

| Company | Price (p) | Last reported EPRA NAV/share (p) | Price/reported EPRA NAV/share (x) | Prospective NAV/share | Price/prospective NAV/share |
|--------------------------|-----------|----------------------------------|-----------------------------------|-----------------------|-----------------------------|
| Palace | 355.5 | 419.0 | 0.85 | 431* | 0.82 |
| Custodian REIT | 111.8 | 101.5 | 1.10 | 103* | 1.08 |
| Mucklow | 493.8 | 448.0 | 1.10 | 455 | 1.09 |
| Picton Property Income | 84.0 | 81.8 | 1.03 | | |
| Real Estate Investors | 61.0 | 66.2 | 0.92 | | |
| Regional REIT | 106.8 | 106.9 | 1.00 | 110* | 0.98 |
| Schroders REIT | 65.0 | 61.1 | 1.06 | | |
| Average ex-Palace | | | 1.04 | | 1.05 |

Source: Company data, Bloomberg (prices at 26 April), Edison Investment Research. Note: *Edison estimates.

Sensitivities

As we have noted before, property markets are cyclical and capital values tend to be more volatile than rental income. Palace's policy of investing outside London may shield its portfolio to some extent from macroeconomic risks, and recent upgrades to the UK's GDP forecast by the Bank of England and the EC, among others, may give further confidence.

The sale of some vacant assets and further lettings in the retained portfolio have reduced vacancy risk and other asset management initiatives have also made Palace's properties more attractive to occupiers, further reducing that risk.

Palace's debt remains low cost (2.9%), has a weighted average term of 4.6 years and, as noted above, net LTV of 39% against the 30 September property valuations is likely to fall further when the portfolio is revalued.

For those reasons, we believe Palace's main sensitivities are to the upside: management appears confident of beating market expectations of EPRA NAV, we forecast that earnings will continue to rise and the full year results due to be announced on 6 June may be a catalyst for a re-rating.

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 | 13,687 | 14,712 |
| Cost of Sales | | (648) | (1,200) | (1,624) | (2,320) | (1,429) | (744) |
| Gross Profit | | 2,604 | 7,437 | 12,969 | 11,649 | 12,258 | 13,968 |
| Administrative expenses | | (649) | (1,439) | (2,048) | (2,626) | (3,028) | (3,037) |
| Operating Profit before revaluation | | 1,955 | 5,998 | 10,921 | 9,023 | 9,230 | 10,930 |
| Revaluation of investment properties | | 19,501 | 9,769 | 3,620 | 32 | 1,500 | 0 |
| Costs of acquisitions/profits on disposals | | 270 | (461) | (525) | 3,400 | (1,000) | 0 |
| Operating Profit | | 21,725 | 15,306 | 14,016 | 12,455 | 9,730 | 10,930 |
| Net Interest | | (573) | (1,398) | (2,264) | (2,794) | (3,009) | (3,037) |
| Profit Before Tax (norm) | | 1,652 | 4,139 | 8,132 | 9,629 | 6,221 | 7,893 |
| Profit Before Tax (FRS 3) | | 21,153 | 13,908 | 11,752 | 9,661 | 6,721 | 7,893 |
| Taxation | | 81 | 107 | (953) | (1,390) | (840) | (1,184) |
| Profit After Tax (norm) | | 1,733 | 4,246 | 7,179 | 8,239 | 5,381 | 6,709 |
| Profit After Tax (FRS 3) | | 21,234 | 14,015 | 10,799 | 8,271 | 5,881 | 6,709 |
| EPRA earnings | | 1,463 | 4,707 | 7,704 | 4,839 | 5,381 | 6,709 |
| Adjusted for: | | | | | | | |
| Surrender premium | | 0 | 0 | (3,172) | 0 | 0 | 0 |
| Share-based payments | | 0 | 114 | 110 | 145 | 200 | 200 |
| Adjusted EPRA earnings | | 1,463 | 4,821 | 4,642 | 4,984 | 5,581 | 6,909 |
| Company adjusted PBT | | 1,382 | 4,828 | 5,705 | 6,374 | 6,421 | 8,093 |
| Average undiluted number of shares outstanding (m) | | 5.3 | 17.1 | 24.6 | 25.7 | 25.2 | 25.2 |
| EPS - normalised (p) | | 32.9 | 24.8 | 29.2 | 32.1 | 21.4 | 26.7 |
| EPS - FRS 3 (p) | | 403.4 | 82.0 | 43.9 | 32.2 | 23.4 | 26.7 |
| Adjusted EPS | | 29.7 | 28.3 | 18.9 | 21.0 | 22.2 | 27.5 |
| EPRA EPS (p) | | 27.8 | 27.5 | 31.3 | 20.4 | 21.4 | 26.7 |
| 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 | 1.14 | 1.19 | 1.48 |
| BALANCE SHEET | | | | | | | |
| Fixed Assets | | 60,086 | 104,470 | 175,738 | 180,021 | 201,521 | 203,521 |
| Investment properties | | 59,440 | 102,988 | 174,542 | 179,011 | 200,511 | 202,511 |
| 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 | 16,475 | 3,792 | 6,138 |
| Debtors | | 1,937 | 3,375 | 3,327 | 3,170 | 3,170 | 3,170 |
| Cash | | 5,123 | 12,279 | 8,576 | 13,305 | 622 | 2,968 |
| 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) | (76,825) | (84,089) | (86,053) |
| Long term borrowings | | (17,384) | (35,407) | (69,711) | (74,759) | (82,023) | (83,987) |
| Other long term liabilities | | (1,215) | (1,214) | (2,067) | (2,066) | (2,066) | (2,066) |
| Net Assets | | 44,376 | 80,016 | 106,815 | 108,478 | 110,031 | 112,413 |
| Net Assets excluding goodwill and deferred tax | | 44,370 | 80,010 | 106,815 | 108,478 | 110,031 | 112,413 |
| Basic NAV/share (p) | | 219 | 395 | 414 | 431 | 437 | 447 |
| EPRA NAV/share (p) | | 219 | 396 | 414 | 431 | 437 | 447 |
| CASH FLOW | | | | | | | |
| Operating Cash Flow | | 1,297 | 4,388 | 12,287 | 9,664 | 8,450 | 11,150 |
| Net Interest | | (390) | (1,593) | (3,421) | (2,501) | (3,009) | (3,037) |
| Tax | | (13) | (15) | (158) | (916) | (840) | (1,184) |
| Preference share dividends paid | | (18) | 0 | 0 | 0 | 0 | 0 |
| Net cash from investing activities | | 2,532 | (2,922) | (50,012) | (1,055) | (20,020) | (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 | 6,291 | 7,264 | 1,964 |
| 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) | 4,729 | (12,682) | 2,346 |
| Opening cash | | 39 | 5,123 | 12,278 | 8,576 | 13,305 | 622 |
| Other items (including cash assumed on acquisition) | | 0 | 0 | 439 | 0 | 0 | 0 |
| Closing cash | | 5,123 | 12,278 | 8,576 | 13,305 | 622 | 2,969 |
| Opening net debt/(cash) | | 1,724 | 13,476 | 24,742 | 65,435 | 66,761 | 86,708 |
| Closing net debt/(cash) | | 13,476 | 24,742 | 65,435 | 66,761 | 86,708 | 86,326 |

Source: Company data, Edison Investment Research

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