

# Palace Capital

Full year results

Income and capital growth beat estimates

Palace Capital has published strong FY17 results, with rental income of £14.3m feeding through to adjusted EPRA earnings of 22.2p per share (FY16: 18.9p). EPRA NAV of 443p per share was 3.5% ahead of our forecast (431p) and 7% higher than at 31 March 2016 (414p), driven by asset management initiatives, selective disposals at above book value and modest yield contraction. The regional occupier market is reported to be healthy and we continue to expect Palace's geographic and sector focus, as well as the relatively high yields on the portfolio, to provide some protection from macroeconomic headwinds, including the effects of Brexit, when compared with property in London.

Year end	Revenue (£m)	Adj. EPRA earnings* (£m)	Adj. EPRA EPS* (p)	EPRA NAV/ share (p)	P/EPRA NAV (x)	DPS (p)	Yield (%)
03/15	8.6	4.8	27.7	396	0.94	13.0	3.5
03/16	14.6	4.6	18.9	414	0.90	16.0	4.3
03/17	14.3	5.7	22.2	443	0.84	18.5	5.0
03/18e	14.0	5.4	21.4	449	0.83	19.0	5.1
03/19e	14.7	6.7	26.6	456	0.82	19.0	5.1

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## Active management for income and capital

As explained in our previous [notes](#), management has taken steps to add value by refurbishing, releasing and in some cases repositioning assets in the portfolio, and by disposing of non-core properties where an attractive price can be struck. The success of this strategy is evident in the results: property sales have generated a gross uplift in value of c 14p per share, while revaluation gains on the retained portfolio have added another c 12p per share. At the same time, Palace has assembled a stable core portfolio generating recurring rental income of £12.7m, expected to rise as new acquisitions are made and new leases signed for the existing portfolio.

## Dividend raised

The board proposes to pay a final dividend for FY17 of 9.5p, taking the total for the year to 18.5p, a 5.0% yield on the current price and equivalent to 87% of EPRA earnings, a similar payout ratio to a REIT. Allowing for a slight dip in rents as Hudson House in York is redeveloped and for a lag before a new acquisition replaces income from properties sold in FY17, we forecast that the higher dividend will be sustained and remain fully covered in FY18 and FY19.

## Valuation: Significant discount to NAV

As the company had indicated in its update in May, reported NAV is well above market expectations and means that Palace now trades at a discount of c 16% to EPRA NAV, despite having recurring rental income expected to rise to c £13.5m once the announced acquisition of a £20m asset is complete. Our forecast EPRA EPS fully cover a prospective dividend yield of c 5%, which we would argue justifies a narrower discount, in line with regional property peers, averaging close to NAV.

Real estate

7 June 2017

**Price** 370p  
**Market cap** £93m

Net debt (£m) at 31 March 2017	68.6
Shares in issue	25.2m
Free float	94%
Code	PCA
Primary exchange	AIM
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	4.2	5.0	1.4
Rel (local)	1.7	2.2	(14.9)
52-week high/low	390.0p	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

Final dividend paid	28 July 2017
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## Summary of results

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Palace's FY17 results were ahead of our estimates, with rental and other income of £14.3m and a £3.1m revaluation gain, taking EPRA NAV per share up 7% to 443p, from 414p at 31 March 2016. Operating profit was £15.6m and EPRA earnings (net of revaluation gains and share-based payments) of £5.4m equated to 21.2p per share (EPRA EPS in FY16 of 31.3p included a surrender premium of £3.2m). Palace reports an adjusted earnings figure, which tracks profits from recurring revenue: this came to £6.7m or 22.2p per share, up 20% from £5.6m (18.9p) in FY16. The board has proposed a dividend of 9.5p in respect of H2, taking the annual dividend to 18.5p, a 16% increase on the 2016 dividend of 16p and covered 1.2x by adjusted earnings.

These results were driven by Palace's active management of the investment portfolio, including the conversion of offices in Dartford to residential use, and their subsequent leasing, increased occupancy from 89% to 91% (excluding Hudson House in York, which is held for development) and sales of 13 non-core properties for a total of £12.6m, 37% above their book value of £9.2m. These and other initiatives contributed to the £3.1m revaluation gain (up 5.7% or 4.5% on a like-for-like basis), along with a slight contraction in yields from c 7.8% to 7.6% (weighted average net equivalent yield). The reduction in contracted rental income due to the disposals should be more than offset on completion of a £20m acquisition, which is expected to be finalised soon.

Administrative expenses were £2.9m (FY16: £2.0m) mainly due to higher headcount (11, including the board, up from nine a year earlier), and the company now has the resources to manage and deliver returns from a larger portfolio, providing scalability for the future. Finance costs were £3.0m, including £0.2m charged for early termination of debt. Palace has refinanced one facility and repaid two others in the year and now has total debt facilities of £82.3m, of which £78.7m is drawn. Palace's bank debt has an average margin of 2.35% over Libor. 30% of debt is fixed and the average maturity is 4.6 years (similar to the portfolio WAULT of 5.8 years).

Palace has over £15m of unencumbered properties and £11.2m in cash, which will allow the company to make the announced £20m acquisition using existing resources and facilities. Net loan to value of 37% is in line with expectations; we assume the acquisition is made with 50% gearing, which would raise net LTV to 42% by the end of 2018. The average cost of debt was reduced from 3.1% to 2.9% over the year, while the average maturity was extended from 3.9 to 4.6 years.

The effective tax rate of 5.4% was controlled using brought-forward losses and capital allowances. The charge of £3.2m in the year included £0.7m of tax payable on the profits in the year and a £2.5m deferred tax charge reflecting capital allowances in excess of depreciation and losses used in the year.

The 29p increase in EPRA NAV per share, combined with the 18p paid in dividends in the year, represents a total accounting return of 11.4% on NAV at the start of the year, 34% higher than our estimate.

Palace also provided an update on asset management progress, and we list the salient points below:

- Boulton House in Manchester was the only acquisition during the year, bought for £10.6m on a net initial yield of 5.5%, expected to rise to 6.9% on a conservative rental value of £12 per sq ft. The vacant space in the building, as well as the ground floor reception area, has now been refurbished at a cost of £0.7m and Palace is negotiating with potential tenants over rents ahead of expectations at the time of purchase.
- As noted above, 13 assets were sold in FY17 for £12.6m, generating disposal gains of £3.2m having been held at a book value of £9.2m. Among these was an asset on Hall Road in Maldon

where the lease was extended to 10 years from 3.5 and enabled Palace to sell the asset for £3.9m, having established that the local planning authority would resist any change of use for the site.

- A new planning application has been submitted for Hudson House in York, where permission for a change of use had already been granted. The new application is for 127 residential apartments, 34,000sqft of offices and 5,000sqft of commercial space on the ground floor. Discussions with the city council are underway.
- Broad Street Plaza in Halifax continues to trade well. 40% of leases in the property have minimum rental uplifts, which will increase net initial yield to over 8% by August 2017, from 7.25% at acquisition in March 2016. The weighted average unexpired lease term of the scheme is 13 years.
- The Copperfields in Dartford was previously an office and commercial building, but the offices became vacant due to lack of demand. The Permitted Development Rights legislation introduced in 2013 allowed Palace to convert these into 13 apartments, which have now all been let to the council for 10 years with annual 2.5% rent increases, converting the property into a core, income-producing asset.
- Two leases have been renewed at Point Four Industrial Estate, Avonmouth, and two more have had rent reviews that removed forthcoming breaks from the contracts. The one vacant unit is being refurbished and rents in the estate have risen 10% over the year.
- The Bank of England's lease at Bank House in Leeds has been extended to July 2023 with a minimum increase from the current level of £117,300 pa to £232,000 pa at the review in 2020, reflecting a modest £7.50 per sq ft. The vacant first floor has been refurbished and tenants are being sought who want to pay less than the £28 per sq ft, which is common for prime rents in the area. Redevelopment and refurbishment plans for the building are being considered in the medium term.
- The tenant at Marsh Barton Trading Estate in Exeter has gone into administration, as was the case with the previous tenant in March 2016 (which the current tenant bought out of administration). At the time of the previous tenant's administration, Palace instructed architects to draw up redevelopment plans for the site. These are at an advanced stage and Palace hopes to submit a planning application in H118 for a new building of c 100,000sqft.
- The occupier of Unit 2 of Kiln Farm, Milton Keynes, exercised their option to terminate in March 2016. Palace negotiated a dilapidation settlement and has refurbished it to the same standard as the adjacent unit. Tenants are now being sought, at a higher rent than next door, which should provide useful evidence for the rent review there in December 2018.
- Sol Central in Northampton will shortly undergo repairs to the roof and external lighting and a new pre-let is being sought before Palace commits funds to fully transform the space, introducing restaurants to a scheme that currently has a 10-screen cinema, a 151-room hotel, a gym and 375 car parking spaces.
- A lease expiry in June 2017 on the second floor of 249 Midsummer Boulevard in Milton Keynes will allow Palace to upgrade that space and the common areas for c £450k, with the aim of increasing rental tone. The large site has potential for significant development in the medium term.

Palace's active management strategy has contributed to the increase in EPRA NAV, and the geographic focus outside London has also been of benefit since year-end: the new UK business rates introduced in April 2017 actually reduced aggregate rates on the portfolio, ensuring continued affordability for tenants, while many rates in London rose significantly, potentially weighing on future rent increases.

The outlook for Palace remains positive: in the near term, irrecoverable costs related to development projects are likely to fall, which will help improve profitability further. We expect the company to complete the announced potential acquisition soon and, although other buying opportunities have been limited, they do exist and Palace continues to seek portfolios near public transport hubs, which offer a chance to improve rental values and are of a size that will help the company fulfil its aspiration to join the main market.

## Changes to estimates

The measures described above had already been taken into account in our previous estimates, so the main changes below are largely a result of FY17 numbers coming in above our previous forecasts and are to our NAV estimates. Our FY18 rental income forecast is also up, with the higher rental income reported for FY17 than we had forecast feeding through to future periods. Apart from a rise in the assumed dividend, in line with the 9.5p payout proposed in respect of H217, there are no other material changes to our assumptions. We continue not to assume any change in valuation yields, we assume only a small increase in occupancy in 2019 (with the vacation of Hudson House counterbalancing new leases elsewhere in the portfolio) and assume (conservatively, we believe) that estimated rental values (ERVs) will rise at 2% pa, below the current rate of inflation with 10% of rents reviewed in 2018 and 20% in 2019. We have allowed for the completion of the announced £20m acquisition in H118 at an initial yield of 7.5% net of 5% purchaser's costs.

**Exhibit 1: Estimate changes**

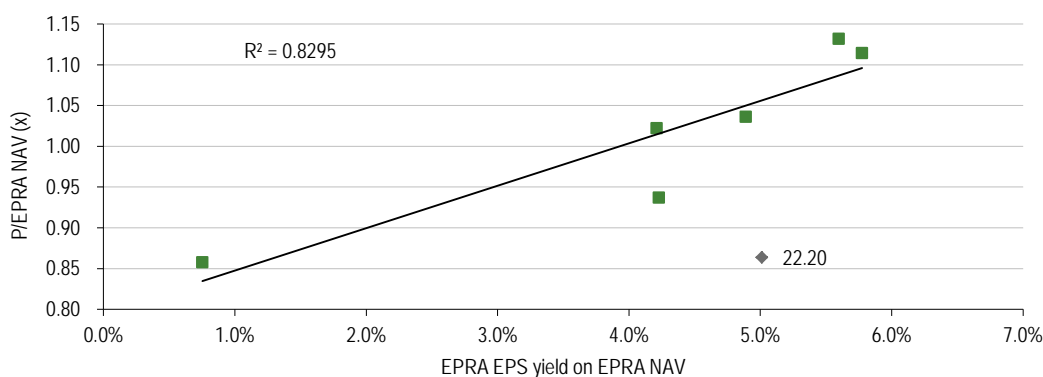
	Rental income (£m)			Adjusted EPRA EPS (p)			EPRA NAV per share (p)			Dividend per share (p)		
	Old	New/actual	Change (%)	Old	New/actual	Change (%)	Old	New/actual	Change (%)	Old	New/actual	Change (%)
03/17	14.0	14.3	2.1%	21.0	22.2	5.5%	431	443	2.7%	18.0	18.5	2.8%
03/18e	13.7	14.0	2.4%	22.2	21.4	-3.6%	437	449	2.6%	18.0	19.0	5.6%
03/19e	14.7	14.7	0.0%	27.5	26.6	-3.2%	447	456	2.1%	18.0	19.0	5.6%

Source: Company data, Edison Investment Research

## Valuation

We compare Palace with other listed investors in regional UK property and look at the relationship between their recurring EPRA earnings yield and the share price premium or discount to reported NAV. It appears that there is a fairly strong relationship between the two measures (Exhibit 2). If Palace were to trade in line with the peers in the chart, the shares would be at a premium to NAV of c 5%; we would argue that a reduction in the share price discount to EPRA NAV would be justified.

**Exhibit 2: Regional property companies' EPRA EPS yield and P/EPRA NAV**



Source: Bloomberg, Edison Investment Research, company data. Note: Peers are Circle Property, Custodian REIT, Mucklow, Picton Property Income, Real Estate Investors, Schroder REIT. R<sup>2</sup> is calculated excluding Palace.



## Sensitivities

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Our estimates are sensitive to movements in valuation yields, new leases being signed and to Palace's average cost of debt. Property markets are cyclical and capital returns tend to be more volatile than rental income. Palace's focus outside London may be expected to provide some protection from market cycles and from macroeconomic effects to which the capital is more exposed. We note that our model forecasts dividend cover from EPRA earnings rising to 1.4x in 2019, which may leave room for a further increase in the dividend from our forecast level of 19p.

**Exhibit 3: Financial summary**

Year end 31 March	£'000s	2014	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>							
Revenue		3,252	8,637	14,593	14,266	14,011	14,709
Cost of Sales		(648)	(1,200)	(1,624)	(2,055)	(1,640)	(755)
Gross Profit		2,604	7,437	12,969	12,211	12,371	13,954
Administrative expenses		(649)	(1,439)	(2,048)	(2,915)	(3,142)	(3,209)
Operating Profit before revaluation		1,955	5,998	10,921	9,296	9,229	10,745
Revaluation of investment properties		19,501	9,769	3,620	3,101	1,500	0
Costs of acquisitions/profits on disposals		270	(461)	(525)	3,191	(1,000)	0
Operating Profit		21,725	15,306	14,016	15,588	9,729	10,745
Net Interest		(573)	(1,398)	(2,264)	(3,011)	(3,045)	(3,110)
Profit Before Tax (norm)		1,652	4,139	8,132	9,476	6,184	7,635
Profit Before Tax (FRS 3)		21,153	13,908	11,752	12,577	6,684	7,635
Taxation		81	107	(953)	(3,191)	(1,003)	(1,145)
Profit After Tax (norm)		1,733	4,246	7,179	6,285	5,181	6,490
Profit After Tax (FRS 3)		21,234	14,015	10,799	9,386	5,681	6,490
Deferred tax charge		0	0	0	2,200	0	0
Debt termination cost		0	0	0	155	0	0
EPRA earnings		1,463	4,707	7,704	5,449	5,181	6,490
Adjusted for:							
Surrender premium		0	0	(3,172)	237	0	0
Share-based payments		0	114	110	0	200	200
Adjusted EPRA earnings		1,463	4,821	4,642	5,686	5,381	6,690
Company adjusted PBT		1,382	4,828	5,595	6,677	6,384	7,835
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	24.4	20.6	25.8
EPS - FRS 3 (p)		403.4	82.0	43.9	36.5	22.6	25.8
Adjusted EPS		29.7	27.7	18.9	22.2	21.4	26.6
EPRA EPS (p)		27.8	27.5	31.3	21.2	21.4	26.6
Dividend per share (p)		0.0	13.0	16.0	18.5	19.0	19.0
Dividend cover (x)		N/A	2.12	1.96	1.14	1.13	1.40
<b>BALANCE SHEET</b>							
Fixed Assets		60,086	104,470	175,738	183,959	205,459	207,459
Investment properties		59,440	102,988	174,542	183,916	205,416	207,416
Goodwill		6	6	0	0	0	0
Other non-current assets		640	1,475	1,196	43	43	43
Current Assets		7,060	15,653	11,903	13,692	3,264	5,139
Debtors		1,937	3,375	3,327	2,511	2,511	2,511
Cash		5,123	12,279	8,576	11,181	753	2,628
Current Liabilities		(4,171)	(3,487)	(9,048)	(8,197)	(8,197)	(8,197)
Creditors		(2,971)	(3,087)	(6,815)	(6,161)	(6,161)	(6,161)
Short term borrowings		(1,200)	(400)	(2,233)	(2,036)	(2,036)	(2,036)
Long Term Liabilities		(18,599)	(36,620)	(71,778)	(77,708)	(87,678)	(89,642)
Long term borrowings		(17,384)	(35,407)	(69,711)	(75,758)	(85,728)	(87,692)
Other long term liabilities		(1,215)	(1,214)	(2,067)	(1,950)	(1,950)	(1,950)
Net Assets		44,376	80,016	106,815	111,746	112,848	114,759
Net Assets excluding goodwill and deferred tax		44,370	80,010	106,815	111,746	112,848	114,759
Basic NAV/share (p)		219	395	414	434	440	448
EPRA NAV/share (p)		219	396	414	443	449	456
<b>CASH FLOW</b>							
Operating Cash Flow		1,297	4,388	12,287	10,294	8,449	10,965
Net Interest		(390)	(1,593)	(3,421)	(2,516)	(3,045)	(3,110)
Tax		(13)	(15)	(158)	(1,047)	(1,003)	(1,145)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(3,108)	(20,020)	(2,020)
Ordinary dividends paid		0	(1,766)	(3,221)	(4,617)	(4,779)	(4,779)
Debt drawn/(repaid)		(21,266)	(10,600)	21,272	5,861	9,970	1,964
Proceeds from shares issued		23,009	19,664	19,114	29	0	0
Other cash flow from financing activities		(66)	(2)	(2)	(2,291)	0	0
Net Cash Flow		5,085	7,155	(4,141)	2,605	(10,428)	1,875
Opening cash		39	5,123	12,278	8,576	11,181	754
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	11,181	754	2,629
Opening net debt/(cash)		1,724	13,476	24,742	65,435	68,563	88,961
Closing net debt/(cash)		13,476	24,742	65,435	68,563	88,961	89,050

Source: Company data, Edison Investment Research

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