Palace Capital

Portfolio growth

Acquisition

Real estate

Palace Capital has completed the previously announced £20m acquisition via a corporate deal, more than replacing rental income from disposals made in FY17. The new assets are fully let at a higher yield than our previous estimates. This leads us to raise our forecasts slightly and provides scope for rental and valuation uplifts in future, in line with Palace's strategy of providing capital growth as well as stable income.

Year end	Revenue (£m)	Adj. EPRA earnings* (£m)	Adj. EPRA EPS* (p)	EPRA NAV/ share (p)	P/EPRA NAV/ share (x)	DPS (p)	Yield (%)
03/16	14.6	4.6	18.9	414	0.89	16.0	4.3
03/17	14.3	5.7	22.2	443	0.84	18.5	5.0
03/18e	14.1	5.5	21.7	449	0.82	19.0	5.1
03/19e	14.8	6.3	24.9	455	0.81	19.5	5.3

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

High-quality assets at an attractive price

The company Palace has acquired owns a mixed-use, modern, office, residential, hotel and retail development in central Newcastle, with two floors of a multi-storey car park as well. The new assets' annual rental income of £1.765m represents a net initial yield of 8.6% on the £20m acquisition price after costs, which compares well with the rest of the portfolio at c 7.5% on average. It is expected that the next speculative office development in Newcastle will not be ready for two years, and occupier demand has been strong in recent months – favourable dynamics for rental markets in the area.

Executing the investment strategy

The acquisition aims to fulfil both Palace's aims of providing capital value increases and a rising dividend supported by a stable rental portfolio. There is potential for increased rents, with current rates c 15% below prime rates for Newcastle offices according to local property consultants, which, if achieved, could lead to higher valuations too. The 8.6% yield may also come down if investor demand in the regions rises; London offices are widely expected to lose value over the next two to three years and investors may seek income-producing assets in areas where higher yields provide attractive returns, protection from cyclical changes in the property market and less exposure to Brexit-related risks. Finally, following the disposal of £12.6m of assets in FY17 (including a £3.4m valuation gain), the new investment also shows Palace's ability to recycle capital efficiently, with the new income more than offsetting rent on the properties sold.

Valuation: Unrecognised value

Palace's 17% discount to 31 March 2017 EPRA NAV of 443p is well above the peer average (4% discount) and seems high even allowing for development risk on some of its assets. High yields and the regional focus provide some risk protection and the 19p FY18e dividend (5.1% yield) may add to the shares' attraction. Our forecasts indicate 1.28x cover in FY19, or possible scope for a higher distribution.

7 August 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	(0.7)	3.5	12.1
Rel (local)	(3.0)	0.2	(0.3)
52-week high/low		390p	320p

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

Half year end	30 September 2017
Half year results	November 2017

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Acquisition summary

Palace had already announced in its update on 2 May 2017 that it was negotiating a £20m acquisition and the news released today adds further detail. Palace has bought the entire share capital of SM Newcastle OB, a company that owns the freeholds of 1, 2 and 3 St James's Gate, the adjacent Jury's Inn (and a 125-year lease from October 2002 on the fourth and fifth floors of the Times Square Car Park), all near Newcastle Railway Station. The acquisition has been funded by a new loan from Santander of £11.5m and from the company's existing cash resources.

The properties were developed by McAleer & Rushe from 2003 to 2006, which owns the company being acquired. They comprise a 274-bed hotel (the Jury's Inn); 143,000 sqft of modern office space (1 and 2 St James's Gate) and 145 apartments (3 St James's Gate) above 16,500 sqft of commercial retail space, as well as a 635-space multi-storey car park on the other side of Railway Street, of which Palace has acquired the top two floors.

The hotel, the 61,000 sqft of offices in 1 St James's Place and the residential element of 3 St James's Place were already sold on 999-year leases when Palace bought SM Newcastle, but it still owns the freehold. Palace will receive rents from 2 St James's Place and from the retail part of 3 St James's Place. The former contains 82,500 sqft of offices, which are fully let to tenants including the National Lottery Charities Board, Eldon Insurance Services, Serco and UBS, for net income of £1.605m per annum. The retail space produces £0.16m of rent per annum, for total net rental income of £1.765m, a net initial yield of 8.6%.

The office rents equate to £19.45 per sqft, while Lambert Smith Hampton, a commercial property consultant, reports that prime office rents in Newcastle were £23 in Q217 and are expected to rise in 2017 due to a shortage of grade A supply. At full occupancy and with positive rental dynamics in Newcastle, the valuation outlook is also positive. While we have not assumed any yield contraction in our estimates, if the new assets were valued at a net initial yield of 7.5%, the valuation would rise by c £3m, or 11p a share.

Effects on estimates

We had already allowed for a £20m acquisition in our estimates but had only assumed a 7.5% net initial yield and 5% costs, so our net rental income figure has been adjusted upwards. We had assumed that the deal would be funded with £10m of new debt at Palace's average cost of debt of 2.9% margin above Libor. We now assume that the new loan (£11.5m) is at 2.5% above Libor. As a result, our estimated interest expense is slightly increased, with an impact on earnings. We have also increased our 2019e dividend assumption in line with Palace's progressive dividend policy which slightly affects NAV in that year.

Exhibit 1: Changes to estimates

	Rental income (£m)			Adjusted EPRA EPS (p)			EPRA NAV per share (p)			Dividend per share (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/18e	14.0	14.1	0.5	21.4	21.7	3.2	449	449	0.2	19.0	19.0	0.0
03/19e	14.7	14.8	0.3	26.6	24.9	(6.3)	456	455	(0.3)	19.0	19.5	2.6

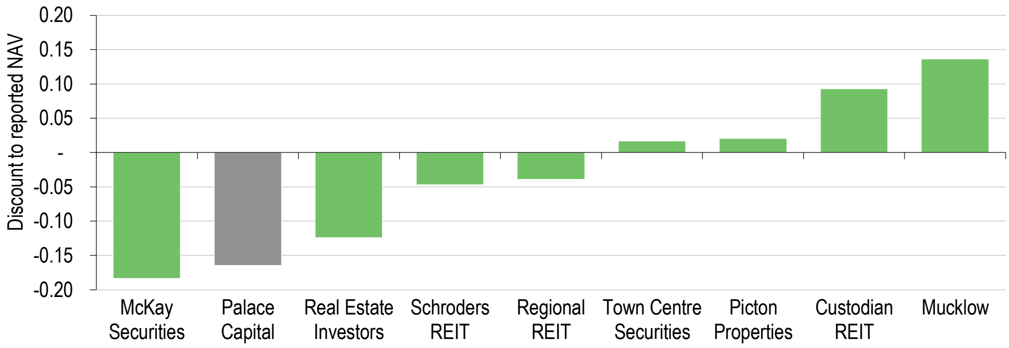
Source: Edison Investment Research

The effects on our estimates can be seen in Exhibit 1. The increase in income flows through to higher earnings, which in turn have a small effect on NAV. We have not changed our dividend assumptions, but note that dividend cover has risen to 1.16x in FY18 and 1.45x in FY19, from 1.13x and 1.40x, respectively.

Valuation

Palace continues to trade at a discount to last reported EPRA NAV (443p) of c 17%, higher than most other investors in regional real estate. The average for the peer group is a 2% discount, which would put Palace at 436p per share, 18% above the current price. At that level the prospective dividend yield would still be an attractive 4.4% (currently 5.1%). This acquisition provides further evidence of management's ability to find favourably-priced assets in good locations in the UK's regional cities. As Palace's track record extends and the portfolio grows, we would look for the discount to diminish to at least the peer average, and we would point to possible valuation gains from yield contraction, which is not included in our forecasts.

Exhibit 2: Listed regional property investors' discounts to last reported NAV



Source: Company data, Bloomberg. Prices at 2 August 2017

Exhibit 3: Financial summary

Year end 31 March	£'000s	2014	2015	2016	2017	2018e	2019e
PROFIT & LOSS		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Revenue		3,252	8,637	14,593	14,266	14,082	14,755
Cost of Sales		(648)	(1,200)	(1,624)	(2,055)	(1,540)	(1,055)
Gross Profit		2,604	7,437	12,969	12,211	12,542	13,700
Administrative expenses		(649)	(1,439)	(2,048)	(2,915)	(3,186)	(3,425)
Operating Profit before revaluation		1,955	5,998	10,921	9,296	9,357	10,275
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	9,857	10,275
Net Interest		(573)	(1,398)	(2,264)	(3,011)	(3,074)	(3,139)
Profit Before Tax (norm)		1,652	4,139	8,132	9,476	6,282	7,136
Profit Before Tax (FRS 3)		21,153	13,908	11,752	12,577	6,782	7,136
Taxation		81	107	(953)	(3,191)	(1,017)	(1,070)
Profit After Tax (norm)		1,733	4,246	7,179	6,285	5,265	6,066
Profit After Tax (FRS 3)		21,234	14,015	10,799	9,386	5,765	6,066
Deferred tax charge					2,200		
Debt termination cost					155		
EPRA earnings		1,463	4,707	7,704	5,449	5,265	6,066
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	5,465	6,266
Company adjusted PBT		1,382	4,828	5,595	6,677	6,482	7,336
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	20.9	24.1
EPS - FRS 3 (p)		403.4	82.0	43.9	36.5	22.9	24.1
Adjusted EPS		29.7	27.7	18.9	22.2	21.7	24.9
EPRA EPS (p)		27.8	27.5	31.3	21.2	21.7	24.9
Dividend per share (p)		0.0	13.0	16.0	18.5	19.0	19.5
Dividend cover (x)		N/A	2.12	1.96	1.14	1.14	1.28
BALANCE SHEET							
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	4,348	5,799
Debtors		1,937	3,375	3,327	2,511	2,511	2,511
Cash		5,123	12,279	8,576	11,181	1,837	3,288
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)	(88,678)	(90,642)
Long term borrowings		(17,384)	(35,407)	(69,711)	(75,758)	(86,728)	(88,692)
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	112,932	114,419
Net Assets excluding goodwill and deferred tax		44,370	80,010	106,815	111,746	112,932	114,419
Basic NAV/share (p)		219	395	414	434	440	446
EPRA NAV/share (p)		219	396	414	443	449	455
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	10,294	8,577	10,495
Net Interest		(390)	(1,593)	(3,421)	(2,516)	(3,074)	(3,139)
Tax		(13)	(15)	(158)	(1,047)	(1,017)	(1,070)
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	10,970	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	(9,344)	1,451
Opening cash		39	5,123	12,278	8,576	11,181	1,837
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	11,181	1,837	3,289
Opening net debt/(cash)		1,724	13,476	24,742	65,435	68,563	88,877
Closing net debt/(cash)		13,476	24,742	65,435	68,563	88,877	89,390

Source: Palace Capital data, Edison Investment research

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