

Palace Capital

Aiming high with acquisition and placing

Palace Capital shareholders have approved the significant acquisition of RT Warren, with a mixed use investment portfolio valued at £71.8m, and the issue of shares to fund it. Management has built a strong track record of value creation from previous acquisitions and expects its management of these newly acquired assets to yield similar results. That potential is not reflected in our revised estimates with the effect that earnings and NAV are diluted. Our dividend forecasts remain the same, and fully covered, such that Palace retains a highly attractive yield and discount to NAV. The increased market capitalisation and intention to seek a Main Market listing are likely to broaden Palace's appeal to a wider investor base.

Year end	Net rental income (£m)	Adj. EPRA earnings* (£m)	Adj. EPRA EPS* (p)	EPRA NAV/share (p)	Price/EPRA NAV/share (x)	DPS (p)	Yield (%)
03/16	13.0	4.6	18.9	414	0.84	16.0	4.6
03/17	12.2	5.7	22.2	443	0.78	18.5	5.3
03/18e	14.4	7.1	19.9	392	0.89	19.0	5.5
03/19e	18.3	9.8	21.5	394	0.88	19.5	5.6

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

Asset management opportunity

The acquired portfolio consists of mixed commercial properties, mostly located in the Home Counties that surround London, and 65 residential properties that are predominantly located around the London Borough of Hillingdon. It has been valued, on an open market and fair value basis, by Cushman & Wakefield at £71.8m with current annual gross income of c £3.7m, of which c 80% relates to the commercial assets. Management expects to grow the commercial rents over time through more active management, while the residential assets are likely to be disposed of, subject to price, freeing up capital for recycling into higher yielding commercial property assets, which remain the focus.

But initial dilution

The acquisition was settled for £53.3m in cash with £14.5m of debt assumed. It has been funded by the issue of £70m of new equity, before costs, at a price of 340p per share. The amount raised reduces net LTV below 35% and provides PCA with sufficient headroom should the existing RT Warren banking facility be repaid at expiry at the end of January 2018. The asset management upside from the acquired assets, including capital recycling, is not reflected in our revised forecasts, or the potential for further acquisitions given the increased balance sheet flexibility. Without building this in, our pre-acquisition adjusted EPRA EPS is diluted by 25% and EPRA NAV by 14%.

Valuation: Upside not reflected in price

Palace emerges from the acquisition and placing with an 11% discount to the end-FY18e EPRA NAV and fully covered 5.5% prospective yield. As we show on page 6, this is attractive in a sector context and does not obviously reflect anticipation of upside from the acquired assets or ongoing portfolio initiatives.

Acquisition and placing

Real estate

11 October 2017

Price **347.5p**
Market cap **£159m**

Net debt (£m) at 31 March 2017	68.6
Shares in issue (inc. 20.6m shares issued under placing and open offer)	45.8m
Free float	95%
Code	PCA
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



Business description

Palace Capital is an AIM-listed UK property investment company. It is not sector-specific and looks for opportunities where it can enhance the long-term income and capital value through asset management and strategic capital development in locations outside London.

Next events

Interim results	November 2017
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Aiming high with acquisition and placing

Palace has built a strong track record of value creation since its first portfolio acquisition, the Sequel portfolio, in October 2013. In the three and a half years to the end of the last financial year (31 March 2017), NAV per share increased by 103% while dividends per share grew strongly. The portfolio acquired through the corporate acquisition of RT Warren (Investments) is significant in terms of size, adding one-third to investment portfolio assets, while the new equity capital issued in the process substantially increases the market capitalisation and potential liquidity of the group's shares. Palace is an active manager of its assets and fully expects to be able to increase rental income on the acquired commercial assets, which it feels have historically been under-managed. The residential assets (c 20% of the acquired rental income) will potentially be sold and the capital recycled into higher yielding commercial assets. There is room to further gear the balance sheet should attractive acquisition opportunities present themselves, with a post-transaction net loan to value ratio (LTV) of less than 35%. None of this potential can be credibly captured in our revised estimates, which treat the acquired assets on an 'as is' basis. On this basis, in the first full year post-acquisition (FY19), our adjusted EPRA EPS forecast is diluted by 25% and EPRA NAV per share by 14%. Our dividend per share forecasts are unchanged and remain fully covered, albeit at a lower level of cover, despite the increased number of shares. The share price has fallen by c 12% from a year high of 395p before the transaction was announced, and the discount to prospective NAV has narrowed slightly in consequence, but remains relatively wide. This seems particularly so, when considering the attractive 5.5% dividend yield, the track record of value creation from active asset management of acquired assets, and the increased scale of the group. The move to quarterly dividend payments from April 2018 will see dividend payments representing c 7% of the share price over the next 12 months. Following the completion of this acquisition, Palace intends to commence preparations to apply to join the Official List of the London Stock Exchange.

The RT Warren transaction

The RT Warren portfolio has been acquired through the corporate acquisition of RT Warren (Investments) for a cash consideration of £53.3m plus retained debt of £14.5m, in aggregate representing the expected net assets of RT Warren at completion. The portfolio consists of mixed commercial properties, including offices, retail units, and industrial units, the majority of which (more than 90%) are located in the Home Counties that surround London, and 65 residential properties that are predominantly located around the London Borough of Hillingdon. It has been valued, on an open market and fair value basis, by Cushman & Wakefield at £71.8m with current annual gross income of c £3.7m.

The acquisition has been funded by the issue of £70m of new equity, before costs, at a price of 340p per share, £66.2m in a placing and £3.8m in an open offer to qualifying existing shareholders. The amount raised provides Palace with sufficient headroom should the existing RT Warren banking facility be repaid at expiry at the end of January 2018.

The new assets acquired

Twenty-one commercial properties have been acquired, including 15 office buildings, four predominantly retail properties, and two industrial units, all freehold and spread over 14 different locations. With its Home Counties focus, management considers these assets to be geographically complementary to the existing Palace portfolio. The total acquired floor area is c 255,000 sq ft, 85.3% let, to 58 lessees, with a weighted average unexpired lease term of 4.5 years to first lease break and 6.1 years to expiry. The commercial properties account for c £2.9m of the total portfolio gross rent roll, an average of £11.45 per sq ft, which Palace management believes offers significant

growth potential over time through more active management. Management also believes that there may be opportunities to enhance certain of the assets within the portfolio by applying for planning permission for a change of use.

The residential assets comprise 61 houses and four flats in nine locations, and are close to being fully occupied, generating a current gross rental income of £0.8 million pa. Palace management is reviewing the strategy for the residential assets and has indicated that, subject to a satisfactory price being achievable, these are likely to be disposed of, freeing up capital for recycling into commercial property assets, which remains Palace's focus. We would expect a sale value, in current market conditions, to be in the region of £20m, and recycling into commercial property assets at c 7% would significantly improve the return on this capital.

Successful track record of value-creating acquisitions

The RT Warren transaction is notable for its scale but is consistent with the strategy that Palace has successfully pursued in recent years. The company invests in UK commercial property outside London and is sector-agnostic, with offices making up the largest portion of the portfolio both before and after the RT Warren acquisition. Its strategy seeks to enhance capital values and provide a sustainable and growing income stream by acquiring assets with potential for rent increases through the reduction of void costs, refurbishment and, in some cases, redevelopment or refurbishment. Most properties are held for long-term rental income, but the company also realises capital value through selective disposals where opportunities arise.

On a spectrum with very low-risk, buy-and-hold REITs at one end and speculative developers at the other, Palace is in the middle: it has the flexibility to invest earnings in capital-enhancing asset management projects, unconstrained by the REIT property income distribution requirement (albeit the payout ratio is currently similar to a REIT's), and is willing to assume some development risk where the potential returns are attractive, but also has a stable core portfolio producing sustainable rental income as well as providing opportunities for capital growth.

The company was given its current form in 2010 when Neil Sinclair (the current CEO) and others acquired an AIM-listed vehicle for the purpose of property investment. The current portfolio has been built by acquisition since late 2011, but the first transformational acquisition came in October 2013 when a portfolio (the Sequel portfolio) of 24 properties from around the UK was acquired from Quintain and Buckingham Properties. Palace paid £39.25m for the properties, which were valued at the time at £44.2m with a net rent receivable of £5.2m pa. Active asset management since has seen seven properties disposed of by 31 March 2017, at prices either at or above book value. The remaining portfolio was independently valued at 31 March 2017 at £66.9m. Net rent receivables had fallen to £3.98m with disposals but also with the planned vacancy at Hudson House in York, a major redevelopment opportunity that recently received planning consent.

The August 2014 acquisition of the PIH portfolio, comprising 17 properties split into 55 individual units, for £32.0m was a further significant step. Two of the properties have since been sold for £2.58m, either at or above book value. At 31 March 2017, the remaining properties were independently valued at £37.8m with net rent receivables of £2.62m.

Outside of these notable portfolio acquisitions, Palace has been active with numerous smaller acquisitions, investing £97m in seven transactions in the three years since the PIH acquisition (excluding RT Warren).

Financials

The main purpose of this section is to explain the impact of the RT Warren acquisition and related capital increase on our forecasts. To do so we provide a detailed comparison of our forecasts for Palace, prior to the RT Warren acquisition and capital increase, and our new forecasts for the enlarged group. However, as a starting point our forecasts for Palace pre-RT Warren/capital increase are slightly revised compared with those last published, now allowing for the potential letting of recently refurbished office space in Manchester, Leeds, and Milton Keynes and lower than previously assumed acquisition costs on the corporate acquisition of the SM Newcastle acquisition.

Adjustments to pre-acquisition estimates

For the current year, we have reduced our estimate of the acquisition costs relating to the £20m acquisition in August of the entire share capital of SM Newcastle OB (SM Newcastle), which owns a mixed-use, modern, office, residential, hotel and retail development in central Newcastle. As a corporate acquisition, there will be a significantly lower stamp duty payable than previously allowed for. We have also now assumed that the remaining c 44,000 sq ft of refurbished office space in Manchester, Leeds, and Milton Keynes will be let over the next year, with a positive impact on FY19 rental income. At an assumed £17.25 per sq ft (similar to the recently agreed let on 5,200 sq ft of space at the Manchester property (Boulton House), the positive impact on our gross rent roll going into FY19 is c £760k.

Acquisition and capital raising impact

In Exhibit 2 we set out our revised estimates for PCA's pre-acquisition/capital increase, the impact of RT Warren and the capital increase, and our revised estimates for the group for FY19. We show FY19 as this captures a full-year impact. There will obviously be a part-year impact in the current year, which is included in our group estimates (Exhibit 7). It is important to note that we have modelled the RT Warren assets as acquired, with no assumptions about the impact of asset management initiatives or recycling of capital from the residential assets or other parts of the portfolio.

We have noted above how the acquisition and capital increase has significantly increased the size of Palace in terms of market capitalisation. That same increase in scale can be seen in the one-third increase in investment property value shown in Exhibit 1. There is less of an impact on rental income, primarily reflecting the lower yield residential assets within those acquired, but profits benefit from efficiency gains and lower average gearing.

Exhibit 1: Impact of RT Warren acquisition on key financial items

£m unless otherwise stated	PCA excl. RT Warren	RT Warren/capital increase	FY19 combined forecast	% change
Income statement				
Gross rental income	15.7	3.7	19.4	24%
Net rental income	15.0	3.3	18.3	22%
Operating profit	11.7	3.3	15.0	29%
Interest expense	(3.3)	(0.3)	(3.7)	10%
PBT	8.3	3.0	11.3	36%
Adjusted EPRA earnings	7.3	2.6	9.8	35%
Adjusted EPRA EPS (p)	28.7	(7.2)	21.5	-25%
DPS (p)	19.5	N/A	19.5	0%
Dividends	4.9	N/A	9.0	86%
Balance sheet				
Investment properties	204.6	67.8	272.4	33%
Borrowings	97.3	14.5	111.9	15%
Net assets*	113.7	67.6	178.6	57%
EPRA net assets*	115.9	67.6	180.8	56%
EPRA NAV per share (p)	457	N/A	393.7	-14%
Number of shares (m)	25.3	20.6	45.9	81%
Net LTV	40.9%		31.9%	

Source: Edison Investment Research. Note: *The difference between net assets and EPRA net assets including and excluding RT Warren includes a dividends paid effect in addition to the new equity raised.

However, with the number of shares in issue increased by 81%, initial earnings per share and NAV per share are diluted. Our adjusted EPRA EPS per share declines by 25% and EPRA NAV by 14%. The larger dilution of EPS again partly reflects the lower yield on the assets acquired, particularly the residential assets, and the recycling of capital from these to higher yielding commercial assets is an obvious potential source of uplift. Our new forecasts put the net LTV ratio at 31.8% at end-FY19 compared with a forecast 40.9% at end-FY19 before the transaction. We assume that the bank facility acquired with RT Warren will be refinanced/replaced with similar debt; if this is the case, then having raised additional equity capital for the potential repayment of the acquired debt, Palace would be in a position where it could re-gear the balance sheet by acquiring additional yielding assets, irrespective of recycling capital. This represents a further potential source of upside to our forecasts.

Forecast changes

Bringing together our estimate changes for the pre-acquisition business with the impacts of the acquisition/capital increase, we show the change in estimates compared with those last published in Exhibit 2. Importantly, there is no change to our dividend per share forecasts and management has indicated that the company intends to pay an interim dividend of 9.5p on 29 December 2017, before moving to a quarterly dividend payment commencing April 2018. The change means that over the next 12 months, shareholders will be entitled to the December 2017 payment as well the first three quarterly dividends in respect of FY19, which on our forecasts represents a yield of 7% over the period.

Exhibit 2: Estimate revisions

	Net 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	12.5	14.4	15.9	21.7	19.9	(8.2)	449	392	(12.9)	19.0	19.0	0.0
03/19e	14.0	18.3	30.3	24.9	21.5	(13.8)	458	394	(14.0)	19.5	19.5	0.0

Source: Edison Investment Research

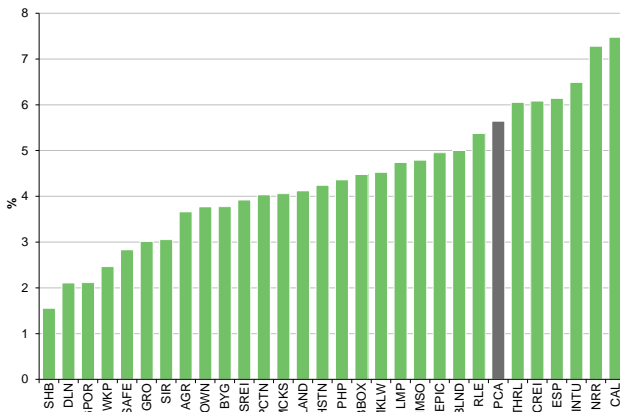
Valuation

Dividends declared have averaged 84% of adjusted EPRA EPS in the past two years and our estimates suggest an average 93% payout over the next two years. Although PCA is not a REIT,

this current level of payout is at a similar level to the UK REIT sector and the prospective dividend yield of 5.4% is towards the upper end of prospective yields offered by the broad sector (Exhibit 4).

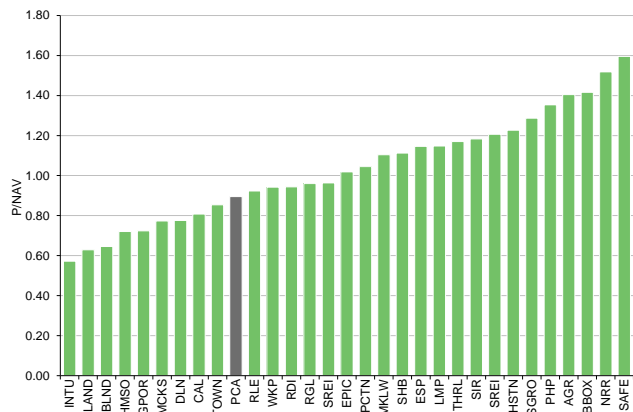
The shares have retreated from a 12 month high of 395p before the announced acquisition and capital increase, a downward move of c 10%, somewhat less than the 14% dilution of our FY19 NAV per share forecast. The 11% discount to trailing NAV (the stated 31 March 2017 NAV per share adjusted for the capital increase) on which Palace now trades, positions it in the lower half of the sector (Exhibit 5).

Exhibit 3: Peer group prospective dividend yields



Source: Bloomberg, data as at 5 October 2017. Edison Investment Research.

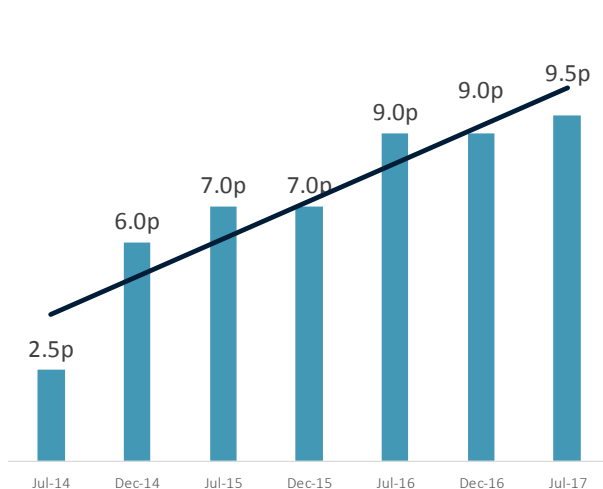
Exhibit 4: Peer group historical P/NAV



Source: Bloomberg, data as at 5 October 2017. Edison Investment Research.

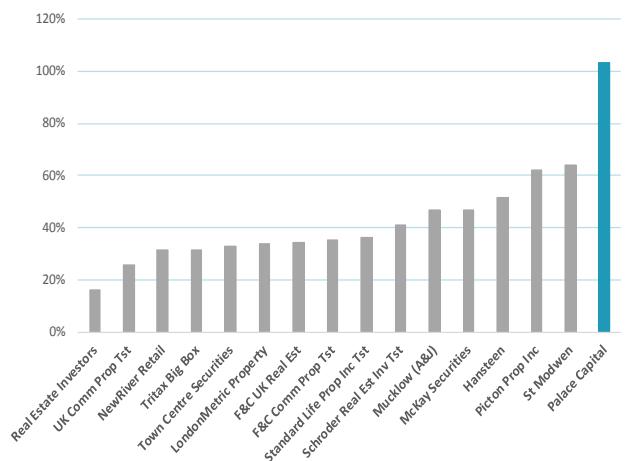
As noted above, Palace has built a strong track record of value creation since its first major portfolio acquisition, the Sequel portfolio, in October 2013. In the three and a half years to the end of the last financial year (March 2017) it grew NAV per share by 103% and increased dividends per share strongly.

Exhibit 5: Progressive dividends per share



Source: Palace Capital June 2017 investor presentation

Exhibit 6: NAV growth since Signal acquisition vs peers



Source: Palace Capital June 2017 investor presentation, Arden Partners. Note: 3.5 years to 31 March 2017.

As noted above, our forecasts have built in no upside from asset management on the newly acquired assets because there is no convincing way that this can be prospectively modelled. But that is not to say that we do not expect such action. Meanwhile, we would argue that the current valuation has built in no anticipation of such progress from the newly acquired assets or ongoing portfolio initiatives, particularly the Hudson House development in York. Furthermore, as a larger

and potentially more liquid company we would expect the shares to appeal to a wider group of investors and this could be the case especially as Palace makes preparations to apply to join the Official List of the London Stock Exchange.

Exhibit 7: Financial summary							
Year end 31 March	£000s	2014	2015	2016	2017	2018e	2019e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Rental & other income		3,252	8,637	14,593	14,266	16,093	19,418
Non-recoverable property costs		(648)	(1,200)	(1,624)	(2,055)	(1,655)	(1,124)
Net rental income		2,604	7,437	12,969	12,211	14,438	18,294
Administrative expenses		(649)	(1,439)	(2,048)	(2,915)	(3,100)	(3,300)
Operating Profit (before amort. and except).		1,955	5,998	10,921	9,296	11,338	14,994
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	(1,317)	0
Operating Profit		21,725	15,306	14,016	15,588	11,520	14,994
Net Interest expense		(573)	(1,398)	(2,264)	(3,011)	(3,220)	(3,660)
Profit Before Tax		21,153	13,909	11,752	12,577	8,300	11,334
Taxation		81	107	(953)	(3,191)	(1,245)	(1,700)
Profit After Tax (FRS 3)		21,234	14,015	10,799	9,386	7,055	9,634
EPRA adjustments:							
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)	1,317	0
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	6,872	9,634
Adjusted for:							
Surrender premium		0	0	(-3,172)	0	0	0
Share-based payments		12	114	110	237	200	200
Adjusted EPRA earnings		1,475	4,821	4,642	5,686	7,072	9,834
Company adjusted PBT		1,394	4,714	5,595	6,677	8,317	11,534
Average fully diluted number of shares outstanding (000s)		5,264.3	17,488.9	24,618.0	25,737.7	35,607.4	45,926.5
Basic EPS - FRS 3 (p)		403.4	80.1	43.9	36.5	19.8	21.0
Fully diluted normalised (p)		31.4	28.3	18.9	22.2	19.9	21.5
Fully diluted EPRA EPS (p)		29.1	26.9	31.3	21.2	19.3	21.0
Dividend per share declared (p)		4.5	13.0	16.0	18.5	19.0	19.5
Dividend cover (x)		6.47	2.07	1.96	1.14	1.02	1.08
BALANCE SHEET							
Fixed Assets		60,086	104,470	175,738	183,959	272,475	272,475
Investment properties		59,440	102,988	174,542	183,916	272,432	272,432
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	25,048	26,358
Debtors		1,937	3,375	3,327	2,511	2,511	2,511
Cash		5,123	12,279	8,576	11,181	22,537	23,847
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)	(79,895)	(111,711)	(112,011)
Long term borrowings		(17,384)	(35,407)	(69,711)	(75,758)	(107,574)	(107,874)
Deferred tax		0	0	0	(2,187)	(2,187)	(2,187)
Other long term liabilities		(1,215)	(1,214)	(2,067)	(1,950)	(1,950)	(1,950)
Net Assets		44,376	80,016	106,815	109,559	177,615	178,625
EPRA net assets		44,370	80,010	106,924	111,759	179,815	180,825
Basic NAV/share (p)		357	396	414	436	387	390
EPRA NAV/share (p)		219	396	414	443	392	394
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	10,294	10,220	15,194
Net Interest		(390)	(1,593)	(3,421)	(2,516)	(2,920)	(3,360)
Tax		(13)	(15)	(158)	(1,047)	(1,245)	(1,700)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(3,108)	(72,500)	0
Ordinary dividends paid		0	(1,766)	(3,221)	(4,617)	(6,749)	(8,824)
Debt drawn/(repaid)		(21,266)	(10,600)	21,272	5,861	17,000	0
Proceeds from shares issued		23,009	19,664	19,114	29	67,550	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	11,356	1,310
Opening cash		39	5,123	12,278	8,576	11,181	22,537
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	11,181	22,537	23,847
Closing debt		19,509	37,021	74,011	79,744	111,560	111,860
Closing net debt/(cash)		14,385	24,742	65,435	68,563	89,022	88,012

Source: Company data, Edison Investment Research

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