Palace Capital

Interim results

Income and NAV growth in H1

Real estate

Palace Capital has announced its interim results for the six months ended 30 September 2017. These show good progress in income, earnings, and NAV. The interim dividend had been previously announced, showing growth of 5.6% to 9.5p per share. The significant acquisition of the RT Warren portfolio and accompanying capital increase came after the period under review and is not reflected in the results. Our forecasts reflect the near-term dilution from the acquisition but not the upside from asset management, due to uncertainty as to the timing and impact. Despite that, Palace offers a highly attractive yield and discount to NAV, while 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	0.81	16.0	4.8
03/17	12.2	5.7	22.2	443	0.76	18.5	5.5
03/18e	14.3	7.0	19.8	395	0.85	19.0	5.7
03/19e	17.9	9.5	20.6	396	0.85	19.5	5.8

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

Interim progress; yet to reflect RT Warren

Management remains very positive about prospects for Palace. While occupier and investor demand for commercial property outside of Central London remains good, the company cites progress with some of its strategic assets and the prospective upside from asset management of the recently acquired RT Warren assets. These have increased Palace's asset base by 35% since end-H118 but the potential is clear in the smaller immediate income uplift of c 26%. Management plans to increase income from the commercial assets acquired and recycle capital from the lower-yielding residential assets into further commercial investment.

Small changes to forecasts

The end-H118 gross rent roll increased to £14.1m (£12.7m at end-FY17), reflecting the £20m Newcastle acquisition on an 8.6% net initial yield, as well as rental growth and leasing initiatives, but was slightly below the level we had forecast. This feeds through into our H218/FY19 rental income forecast and together with an increased cost assumption generates a 0.7% reduction in our adjusted earnings forecast for FY18 and 3.7% in FY19. Our EPRA NAV per share forecasts rise slightly and forecast DPS is unchanged and remains fully covered.

Valuation: Attractively priced with upside potential

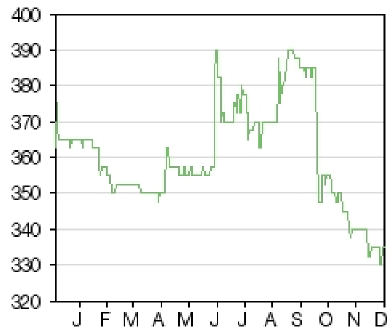
With a fully covered prospective yield of 5.7% and a 15% discount to FY18e NAV per share, Palace shares appear to have factored in the near-term dilution from the recent capital increase but not the potential benefits to emerge from the acquisition and increased scale.

4 December 2017

Price	**335p**
Market cap	**£154m**

Net debt (£m) as at 30 September 2017	86
Net LTV as at 30 September 2017	41.9%
Shares in issue	45.8m
Free float	94.5%
Code	PCA
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(1.5)	(12.5)	(7.1)
Rel (local)	1.0	(11.3)	(15.0)
52-week high/low		387.8p	330.0p

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

Payment of interim dividend	29 December

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Edison profile page

Palace Capital is a research client of Edison Investment Research Limited

Company description

Palace Capital is a property investment company listed on the Alternative Investment Market (AIM) of the London Stock Exchange (LSE) and registered in the UK. It focuses on commercial property, mainly outside London. 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, the most recent being the corporate acquisition of RT Warren, which completed in October and therefore does not have an impact on the interim results but is covered in detail in our last update note. The RT Warren portfolio was valued, on an open market and fair value basis, by Cushman & Wakefield at £71.8m and represents a substantial 35% increase on the £202.8m value of Palace's pre-acquisition portfolio value as at 30 September. It brings an immediate £3.7m in annual gross rental income, which also represents a significant, but smaller, 26% uplift on the pre-acquisition contracted gross rental income. The smaller contribution to income highlights the opportunity for Palace management to grow the newly acquired commercial rents over time through more active management, while most likely disposing of the residential assets, subject to price. The capital freed up will then be available for recycling into higher-yielding commercial property assets, which remain the company's focus.

Following the completion of this acquisition, Palace has commenced preparations to apply to join the Official List of the London Stock Exchange, a move that should broaden the appeal of its shares to a wider group of investors.

FY18 interim results

The interim results covering the six months that ended 30 September 2017 show continued growth in income, earnings, and net asset value. But importantly, the results do not reflect the impact of the recent significant RT Warren acquisition and accompanying capital increase. This was covered in detail in our last published note. We have made only small adjustments to our forecasts, increasing NAV per share, slightly reducing forecast earnings but with DPS unchanged and remaining fully covered.

Key features of the interim results were:

- IFRS net profit of £4.4m was up 26% on H117 but included £1.4m of revaluation gains, slightly offset by £0.2m of losses on disposal.
- Adjusted net earnings, which like EPRA earnings excludes revaluation movements and disposal gains/losses, and deferred tax expense on property revaluation but further adjusts for

share-based payment charges, increased 16% on H117 and 11% on H217. Diluted adjusted EPS per share was 12.8p.

- As previously announced, the interim dividend is up 5.6% to 9.5p per share and will be paid on 29 December to shareholders on the register as at 8 December. Quarterly dividend payments will commence in April.
- The external portfolio revaluation represents a 1.5% gain on a like for like basis and contributed to NAV per share growth of 1.8% compared with end-FY17, to 451p per share on an EPRA basis.
- The RT Warren acquisition completed shortly after the period under review, on 9 October, but is in our previously published forecasts.

Exhibit 1: Summary of H118 financials

£000s	H118	H117	FY17
Net rental income	6,463	5,936	12,211
Administrative expenses	(1,487)	(1,369)	(2,915)
Operating profit before gains on investment properties	**4,976**	**4,567**	**9,296**
Gain on revaluation	1,396	32	3,101
Gain/(loss) on disposal	(159)	873	3,191
Operating profit	**6,213**	**5,472**	**15,588**
Net finance expense	(1,354)	(1,562)	(3,011)
PBT	**4,859**	**3,910**	**12,577**
Tax	(507)	(464)	(3,191)
IFRS net profit	**4,352**	**3,446**	**9,386**
Adjusted earnings	**3,215**	**2,779**	**5,686**
Basic IFRS EPS (p)	17.3	13.4	36.6
Diluted EPRA EPS (p)	12.4	10.4	21.2
Diluted adjusted EPS (p)	12.8	10.8	22.1
DPS declared (p)	9.5	9.0	18.5
IFRS NAV per share (p)	442	419	436
EPRA NAV per share (p)	451	419	443
Net LTV	41.9%	39.5%	36.9%

Source: Palace Capital

Financials

Our existing forecasts were made at the completion of the RT Warren acquisition and accompanying capital increase and thus require only modest adjustment now. NAV per share is increased, despite a slight cut in earnings, while the DPS forecast is unchanged and remains fully covered.

Gross rental income was slightly ahead of where we expected it to be in H118 and void costs were lower. However, the period end gross contracted rent roll fell slightly short of our forecast with a knock-on into H218 and FY19. We continue to assume that the remaining c 44,000sq 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 5,200sq ft of space at the Manchester property (Boulton House), the positive impact on our gross rent roll going into FY19 is c £760k.

Recognising the expanded scale and continuing ambitions of the business, we have also slightly increased our expectations for administrative costs through H218 and FY19.

Our revised forecasts are shown in Exhibit 2.

Exhibit 2: Forecast changes

	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	14.4	14.3	-0.7	19.9	19.8	-0.7	392	395	0.8	19.0	19.0	0.0
03/19e	18.3	17.9	-2.2	21.5	20.6	-3.8	394	396	0.6	19.5	19.5	0.0

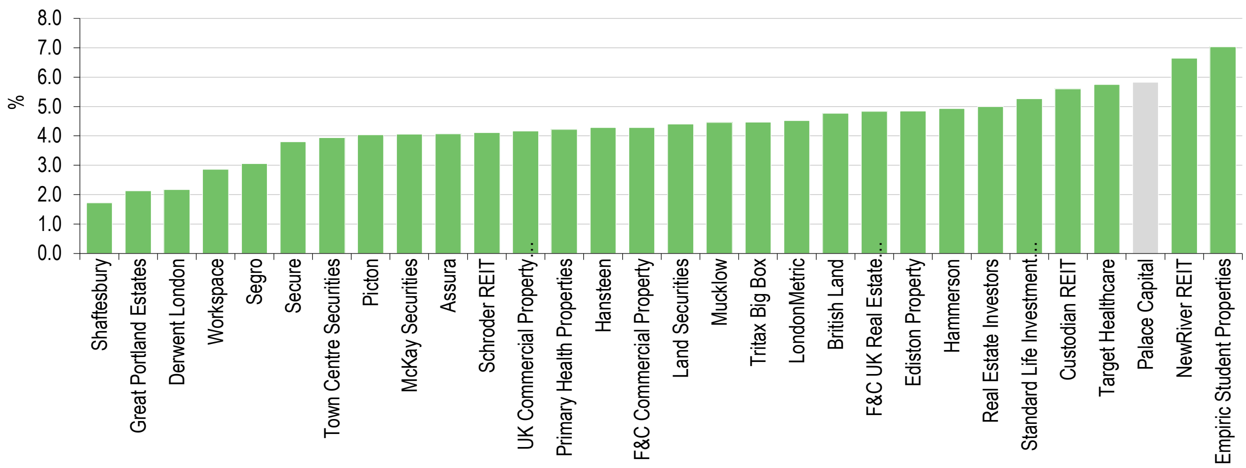
Source: Edison Investment Research

Valuation

We have noted above that strategically, Palace sits somewhere between the income-focused REITs and the more development-focused companies, giving it flexibility to invest earnings in capital-enhancing asset management projects. While our forecasting has built in c £5m pa of general capex spend we still expect the high payout ratio of the past two years (an average 84%) to continue over the next couple of years.

Hence, although Palace Capital 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 5.7% is towards the upper end of prospective yields offered by the broad universe of property investment companies and REITs shown in Exhibit 4, below. The 9.5p per share dividend, announced on 30 November 2017, will be paid on 29 December 2017 to shareholders on the register as at 8 December 2017. In combination with the move to quarterly dividend payments from April 2018, we estimate that shareholders entitled to this most recently announced dividend will see dividend payments of 24.125p over the next 12 months (9.5p plus the first three quarterly dividends in respect of FY19, which we estimate at 4.875p each), representing c 7% of the share price.

Exhibit 3: Universe by prospective dividend yield



Source: Bloomberg, Edison Investment Research. Note: Data as at 4 December 2017

But Palace's strategy is about more than income returns and the company 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 while still increasing dividends per share strongly: from the 4.5p per share declared in respect of the year ending 31 March 2014 to 19.0p declared for the current year.

To capture both income returns and capital returns we show the NAV total return since end-FY14 in Exhibit 3. Including the 4.1% NAV total return generated in the first six months of the current year (8.2% annualised), Palace has generated a 46.8% NAV total return over the entire 3.5 years shown. This represents a compound annual return of 11.6% pa.

Exhibit 4: NAV total return

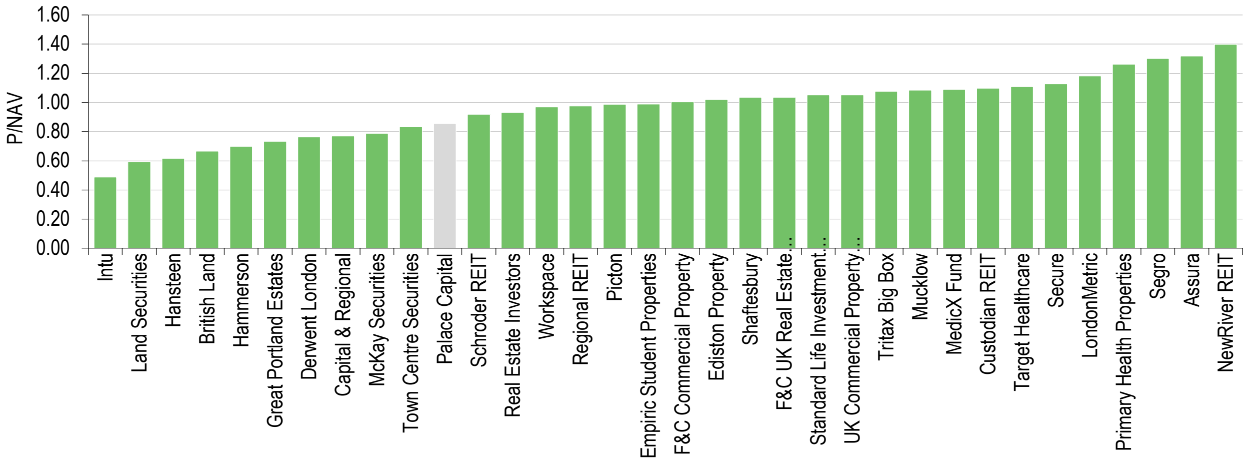
	FY15	FY16	FY17	H118	FY15-H118
Opening EPRA NAVPS (p)	341	388	414	443	341
Closing NAVPS (p)	388	414	443	451	451
Dividend per share paid (p)	8.5	14.0	18.0	9.5	50
NAV total return (p)	54.7	40.8	46.4	18.0	159.9
NAV total return (%)	16.0%	10.5%	11.2%	4.1%	46.8%

Source: Palace Capital, Edison Investment Research

The shares have retreated from a 12-month high of 395p before the announced RT Warren acquisition and capital increase, a downward move of c 10%, somewhat less than the 14% near-term dilution of our FY19 NAV per share forecast prior to the transaction. Our estimates imply that taking account of that near-term dilution, the four-year NAV total return to the end of FY18 will drop to a compound 7.4% pa but that is before taking account of any of the asset management upside that management anticipated from RT Warren. Given the difficulty in credibly forecasting this ahead of events, it is not reflected in our forecasts.

The 15% discount to our forecast end-FY18 NAV per share that Palace now trades on positions it in the lower half of the universe (Exhibit 5).

Exhibit 5: Universe by P/NAV



Source: Bloomberg, Edison Investment Research. Note: Data as at 4 December 2017

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 Palace Capital is now a larger and potentially more liquid company, we would expect the shares to appeal to a wider group of investors especially as Palace makes preparations to apply to join the Official List of the London Stock Exchange.

Exhibit 6: 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	16,055	18,898
Non-recoverable property costs		(648)	(1,200)	(1,624)	(2,055)	(1,715)	(1,000)
Net rental income		2,604	7,437	12,969	12,211	14,340	17,898
Administrative expenses		(649)	(1,439)	(2,048)	(2,915)	(3,187)	(3,400)
Operating Profit (before amort. and except).		1,955	5,998	10,921	9,296	11,153	14,498
Revaluation of investment properties		19,501	9,769	3,620	3,101	2,396	0
Costs of acquisitions/profits on disposals		270	(461)	(525)	3,191	(1,176)	0
Operating Profit		21,725	15,306	14,016	15,588	12,373	14,498
Net Interest expense		(573)	(1,398)	(2,264)	(3,011)	(3,175)	(3,600)
Profit Before Tax		21,153	13,909	11,752	12,577	9,198	10,898
Taxation		81	107	(953)	(3,191)	(1,158)	(1,635)
Profit After Tax (FRS 3)		21,234	14,015	10,799	9,386	8,040	9,263
EPRA adjustments:							
Revaluation of investment properties		(19,501)	(9,769)	(3,620)	(3,101)	(2,396)	0
Costs of acquisitions/profits on disposals		(270)	461	525	(3,191)	1,176	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	6,820	9,263
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	7,020	9,463
Company adjusted PBT		1,394	4,714	5,595	6,677	8,178	11,098
Average fully diluted number of shares outstanding (000s)		5,264.3	17,488.9	24,618.0	25,737.7	35,534.1	45,875.2
Basic EPS - FRS 3 (p)		403.4	80.1	43.9	36.5	22.6	20.2
Fully diluted normalised (p)		31.4	28.3	18.9	22.2	19.8	20.6
Fully diluted EPRA EPS (p)		29.1	26.9	31.3	21.2	19.2	20.2
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	1.01	1.04
BALANCE SHEET							
Fixed Assets		60,086	104,470	175,738	183,959	274,277	279,277
Investment properties		59,440	102,988	174,542	183,916	274,148	279,148
Goodwill		6	6	0	0	0	0
Other non-current assets		640	1,475	1,196	43	129	129
Current Assets		7,060	15,653	11,903	13,692	24,397	21,563
Debtors		1,937	3,375	3,327	2,511	4,726	5,396
Cash		5,123	12,279	8,576	11,181	19,670	16,167
Current Liabilities		(4,171)	(3,487)	(9,048)	(8,197)	(10,851)	(12,078)
Creditors		(2,971)	(3,087)	(6,815)	(6,161)	(8,665)	(9,892)
Short term borrowings		(1,200)	(400)	(2,233)	(2,036)	(2,186)	(2,186)
Long Term Liabilities		(18,599)	(36,620)	(71,778)	(79,895)	(109,217)	(109,517)
Long term borrowings		(17,384)	(35,407)	(69,711)	(75,758)	(105,130)	(105,430)
Deferred tax		0	0	0	(2,187)	(1,588)	(1,588)
Other long term liabilities		(1,215)	(1,214)	(2,067)	(1,950)	(2,499)	(2,499)
Net Assets		44,376	80,016	106,815	109,559	178,605	179,245
EPRA net assets		44,370	80,010	106,924	111,759	181,104	181,744
Basic NAV/share (p)		357	396	414	436	390	391
EPRA NAV/share (p)		341	388	414	443	395	396
CASH FLOW							
Operating Cash Flow		1,297	4,388	12,287	10,294	10,123	15,256
Net Interest		(390)	(1,593)	(3,421)	(2,516)	(2,584)	(3,300)
Tax		(13)	(15)	(158)	(1,047)	(762)	(1,635)
Preference share dividends paid		(18)	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(3,108)	(73,596)	(5,000)
Ordinary dividends paid		0	(1,766)	(3,221)	(4,617)	(6,744)	(8,824)
Debt drawn/(repaid)		(21,266)	(10,600)	21,272	5,861	14,863	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)	(361)	0
Net Cash Flow		5,085	7,155	(4,141)	2,605	8,489	(3,503)
Opening cash		39	5,123	12,278	8,576	11,181	19,670
Other items (including cash assumed on acquisition)		0	0	439	0	0	0
Closing cash		5,123	12,278	8,576	11,181	19,670	16,167
Closing debt		19,509	37,021	74,011	79,744	109,815	110,115
Closing net debt/(cash)		14,385	24,742	65,435	68,563	90,144	93,947
Net LTV		23.0%	23.3%	37.0%	36.9%	32.4%	33.1%

Source: Palace Capital accounts, Edison Investment Research

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