EDISON

Palace Capital

Full year results

A year of significant development and growth

Real estate

The year ended 31 March 2018 was one of significant development and growth for Palace, including the £68m acquisition of RT Warren, its largest acquisition to date, a £70m capital raise, and a move to trading on the Main Market of the LSE. The shares will join the FTSE Small Cap Index and FTSE All Share Index on 18 June. The portfolio, enlarged by the RT Warren acquisition, offers significant asset management opportunities, while management seeks further accretive acquisitions, neither of which is reflected in our estimates. The shares offer an attractive yield and trade at a significant discount to NAV.

Year end	Net rental income (£m)	Adj. earnings* (£m)	Adj. EPS* (p)	F.d. EPRA NAV per share (p)**	Price/EPRA NAV/share (x)	DPS (p)	Yield (%)
03/17	12.2	5.7	22.2	443	0.81	18.5	5.2
03/18	14.9	7.4	21.2	414	0.86	19.0	5.3
03/19e	16.9	7.9	17.2	418	0.86	19.5	5.4
03/20e	17.5	8.3	18.1	422	0.85	19.5	5.4

Note: *Adjusted earnings: in addition to EPRA adjustments for revaluation gains, profits or losses on disposals of investment properties and surrender gains on early lease terminations, this adjusts for share based payments and Main Market listing costs. **EPRA NAV is fully diluted.

FY18 earnings and NAV ahead of our forecasts

Net rental income increased by 22% to £14.9m, with RT Warren consolidated for a little under six months. Contracted net rents of £16.8m at end FY18 point to further rent growth before the impact of leasing. Adjusted earnings, which exclude c £700k of one-off Main Market listing costs, increased 30% to £7.4m, ahead of our £7.0m forecast, and significantly offset the 36% increase in average share count. Adjusted EPS was 21.2p (FY17: 22.2p), providing 1.1x cover of the increased DPS of 19.0p (FY17: 18.5p). Diluted EPRA NAV per share of 414p benefitted from valuation gains, and while it was lower y-o-y as a result of the dilution related to the capital raise, it was ahead of our forecast of 395p, LTV reduced to 30% (FY17: 37%), with cash and unutilised debt facilities providing headroom for accretive acquisitions.

Acquisition upside to forecasts

We have trimmed our FY19 adjusted PBT estimate by c 4% but management has reiterated its aim to further grow DPS, and we continue to forecast 19.5p, 93% covered. Our estimates may prove conservative as they allow nothing for the accretive acquisitions that management seeks or asset management gains from RT Warren and other projects due to the difficulty in credibly forecasting these. We estimate that a £25m cash acquisition at a 7% yield would increase our forecast adjusted earnings by c 12% on an annualised basis.

Valuation: Attractively priced with upside potential

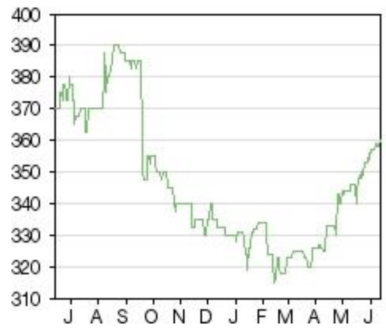
Without building in any potential upside from accretive acquisitions or asset management of the recently acquired RT Warren assets, the shares offer an attractive prospective yield of 5.4%. In addition, increased EPRA NAV forecasts maintain a 14% P/NAV (FY19e) discount despite the recent upward move in the share price.

12 June 2018

Price	**358p**
Market cap	**£164m**

Net balance sheet debt (£m) as at 31 March 2018	82.4
Net LTV as at 31 March 2018	30%
Shares in issue	45.8m
Free float	95.5%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.1	10.8	(2.2)
Rel (local)	3.5	3.7	(5.7)
52-week high/low		387.8p	315.0p

Business description

Palace Capital is a UK property investment company listed on the Main Market of the LSE. 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

AGM	July 2018

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Edison profile page

Palace Capital is a research client of Edison Investment Research Limited

A year of significant development and growth

The year ended 31 March 2018 was one of significant development and growth for Palace, including the £68m acquisition of RT Warren, its largest acquisition to date, a £70m capital raise and a move to trading on the Main Market of the LSE. We reviewed these developments in detail in our recent Outlook note and this update focuses on the publication of the FY18 results. These need to be viewed in the context of the RT Warren acquisition, which added 35% to the investment portfolio and 26% to contracted rent roll at completion on 9 October 2017.

Exhibit 1: Summary of FY18 results

Year end March (£000s)	2018	2017	% change
Adjusted earnings:			
Rental & other income	16,733	14,266	17.3%
Non-recoverable property costs	(1,824)	(2,055)	(11.2%)
Net rental income	**14,909**	**12,211**	**22.1%**
Administrative expenses	(3,313)	(2,678)	23.7%
Operating profit before gains/(losses) on property assets	**11,596**	**9,533**	**21.6%**
Finance costs	(3,124)	(2,856)	9.4%
Adjusted PBT	**8,472**	**6,677**	**26.9%**
Taxation	(1,072)	(991)	
Adjusted net profit	**7,400**	**5,686**	**30.1%**
Share based payments	(174)	(237)	
Costs in respect of move to main market	(698)	0	
EPRA earnings	**6,528**	**5,449**	**19.8%**
Gains on revaluation of investment properties	5,738	3,101	
Profit/(loss) on disposal on non-current assets	274	3,191	
Debt termination costs	(127)	(155)	
Fair value loss on derivatives	(181)	0	
Deferred tax relating to EPRA adjustments	299	(2,200)	
IFRS net profit	**12,531**	**9,386**	**33.5%**
Diluted adjusted EPS (p)	**21.2**	**22.2**	**(4.5%)**
Diluted EPRA EPS (p)	18.7	21.2	
IFRS EPS (p)	35.8	36.5	
DPS declared (p)	**19.0**	**18.5**	**2.7%**
Dividend cover (adjusted earnings) (x)	1.11	1.20	
Diluted EPRA NAV per share (p)	**414**	**443**	**(6.5%)**
IFRS NAV per share (p)	400	436	
NAV total return (%)	(2.1%)	11.2%	
Net LTV (%)	30.0%	36.9%	

Source: Palace Capital, Edison Investment Research

- Net rental income increased by 22.1% to £14.9m (FY17: £12.2m). The gross contracted rent roll at 31 March was an annualised £17.9m and the annualised net contracted rent roll was £16.8m, pointing to further growth in net rental income. Occupancy was 90%.
- Adjusted administrative expenses (excluding the £698k one-off costs associated with the move to the Main Market of the LSE and share-based payment charges) were 23.7% higher, mainly as a result of higher staff costs that include additions to the property management team.
- Adjusted net finance costs (excluding £127k of debt termination costs and £181k of unrealised negative fair value movements on interest rate derivatives) were 9.4% higher as a result of an increase in average debt. Net loan to value reduced however, from c 37% to c 30%.
- Adjusted PBT was 26.9% ahead at £8.5m, while adjusted net profit grew at a faster rate, 30.1%, due to a reduction in tax. The September capital raise increased the share count by 81% and the average share count for the year increased by 36%. As a result, diluted adjusted EPS reduced slightly to 21.2p (FY17: 22.2p).
- The investment portfolio value at 31 March 2018 was £275.6m, 50% higher than a year earlier (£183.9m). Net additions/disposals were £83.1m, including the £72.0m from RT Warren, while

net revaluation added £5.7m with a 3.5% like-for-like increase. Refurbishment capex added a little under £3m. 60 of the 65 residential properties acquired with RT Warren (three have already been sold and two will be retained), with a value of £21.7m, have now been classified as held for sale, reflecting management's intentions. The three sales already completed were at an average 14% premium to the carried value.

- Adding back the various adjustments, and including revaluation gains and gains on disposal, IFRS net earnings increased by 33.5% to £12.5m.
- Diluted EPRA NAV was 6.5% lower, primarily as a result of the capital raise which saw shares issued at 340p, but was ahead of our 395p forecast.
- As expected, a final quarterly DPS of 4.75p has been proposed, which brings the total for the year to 19.0p (FY17: 18.5p), 1.11x covered by adjusted EPS.

Regional markets continue to offer value

Despite some slowing of UK economic growth, continuing Brexit uncertainty and a significant retracement of the boost to export competiveness that resulted from post EU-referendum sterling weakness, regional property markets have remained in good health over recent months. In general, across the regional markets, a positive occupational demand–supply balance continues, although some participants have indicated that in some instances letting decisions are taking longer to execute. Investor demand has also remained robust, with regional markets taking a larger share. Overall investment volumes in the broad UK commercial market rose 26% in 2017.

Regional markets continue to benefit from structural factors such as business relocation away from London, office conversion to residential use and a relative lack of new development in the years following the financial crisis.

Office supply in regional markets remains low, with occupier take-up continuing to reduce availability, particularly of Grade A space, which should be a positive for occupier demand and rental growth in good quality secondary space. In industrial, continued occupier demand and constrained supply resulted in a 4.9% increase in industrial rents in 2017, according to IPD.

Data for the office market suggest that regional offices continue to represent attractive yields compared with London and that regional secondary office yields have room to tighten further versus prime. As a result of the continuing investor demand, the average yield spreads between regional and London offices has continued to narrow, but remain noticeably wider than it was before recovery took hold in the London market in 2009. As London recovered, and yields tightened, the gap between regional and London yields widened significantly, peaking around 2015. As the market recovery broadened to the regions, this spread has narrowed but not fully unwound.

The recovery in the London market also saw the yield spread between secondary over prime properties narrow. A similar pattern followed later in regional assets as recovery reached those markets and here the spread of secondary over prime yields remains wide despite more recent tightening.

Financials and valuation

In the trading update on 24 April 2018, management guided that adjusted profit before tax (before profits on disposal and any revaluation gains) for the year ended 31 March 2018 was expected to be ahead of market expectations. In our Outlook note published in May we adjusted our FY18 estimates for the recent acquisition and for the impact of interest rate hedging on finance costs, but left our FY19 estimates unchanged, pending the details that have now been published.

FY18 adjusted earnings of £7.4m are c 5% ahead of our estimate of £7.0m, driven by rental income and slightly offset by higher costs. The average share count was also a little lower than we had allowed for, giving an additional boost to adjusted EPS, c 7% ahead of our estimate.

Diluted EPRA NAV per share was also c 5%, or 19p per share, ahead of our forecast at 414p, in part resulting from higher revaluation movements than we had allowed for, as well as the higher earnings, but also reflecting the impact of the RT Warren corporate acquisition. Palace acquired RT Warren for £67.9m, including investment properties valued at £71.8m. The c £4m difference reflects deferred tax liabilities on the assets acquired, added back to EPRA NAV, providing an additional uplift versus our EPRA NAV forecast. We would expect at least some of the deferred tax to relate to the RT Warren residential assets that are likely to be sold. This will crystallise any deferred tax although the exact impact on NAV will depend on the prices achieved.

Exhibit 2: FY18 versus estimates, and estimate revisions

	Net rental income (£m)			Fully diluted adjusted EPS			EPRA NAV per share			Dividend per share		
						FY18 reported versus estimate						
	Est	Actual	Diff (%)	ESt	Actual	Diff (%)	Est	Actual	Diff (%)	Est	Actual	Diff (%)
03/18e	14.3	14.9	4.0	19.8	21.2	7.2	395	414	5.0	19.0	19.0	0.0
						FY19-20 estimates						
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
03/19e	17.2	16.9	(1.8)	18.7	17.2	(8.1)	394	418	6.0	19.5	19.5	0.0
03/20e	N/A	17.5	N/A	N/A	18.1	N/A	N/A	422	N/A	N/A	19.5	N/A

Source: Palace Capital, Edison Investment Research

Reflecting on recent UK macroeconomic newsflow, we have slightly reduced our net rental income expectations for FY19, although we continue to anticipate further letting progress over the course of the year, including refurbished assets. Our adjusted EPS estimate is also affected by a slightly higher tax burden (assumed effective tax rate 15% versus 6% in FY18). Our newly introduced FY20 forecast benefits from a full year contribution from FY19 void reduction and the 1% pa rental growth that we have assumed across the forecast period, partly offset by inflationary cost growth. We have assumed valuation growth in line with rental growth, although the letting progress that we assume has the potential to further support valuations.

Management has re-asserted its commitment to a progressive dividend policy and we continue to forecast an increase to 19.5p per share in respect of FY19 (FY18: 19.0p). However, the pace of adjusted earnings growth reflected in our forecasts for FY19 will not keep pace with the increase in average share count (following the September 2017 equity raise), with our forecast for adjusted EPS now at 18.1p, representing dividend cover of 93%. Although we forecast growth in FY20 adjusted EPS, we have for now assumed an unchanged FY20 DPS of 19.5p. However, our forecasts do not reflect the potential for earnings to benefit from accretive acquisition, which we discuss in more detail below.

Potential for accretive acquisitions

Management continues to target earnings-accretive acquisitions. The end-FY18 loan to value (LTV) ratio was 30.0% and the cash balance, excluding restricted cash relating to tenant deposits, was £18.0m, with unutilised borrowing facilities at £14.2m. £40m of property assets were uncharged, remaining available to provide security for additional bank borrowing. For example, £25m invested at a net initial yield of 7% would add an annualised c £1.75m to net rental income (c 10% of the FY19 forecast) or c £1.0m to adjusted earnings (c 12%) after financing costs and tax (at an assumed 15%). The FY19e LTV would increase from c 31% to c 37%. None of this potential income upside is currently reflected in our forecasts.

Nor do our forecasts make any assumptions about the development of Hudson House in York, where Palace has planning consent for new buildings comprising 127 apartments, 34,000 sq ft of office space and 5,000 sq ft of other commercial space/restaurant space and parking. Demolition of the 1960s office building, within the city walls and close to the railway station, is well underway and will save c £750,000 pa in property expenses, primarily by eliminating empty rates and service charges, or c £500,000 net of residual income. Palace is no longer seeking to develop the site with a joint venture partner, with the board taking the decision that it is in the company's best interest to proceed alone with the development, which it believes is backed by strong fundamentals, including a lack of Grade A office accommodation in York and strong residential demand. Agents have been appointed for both the commercial and residential space and discussions have commenced with potential lenders to finance the construction. The property is not charged and is valued at £16.0m.

Valuation

With a prospective yield of 5.4%, Palace is positioned above the median for the broader UK real estate sector, while its P/EPRA NAV is below the median. Our forecasts show the FY19e dividends covered 93% by adjusted earnings with cover increasing to 97% in FY20, although as noted above, this may prove conservative as we included nothing in the forecast for potentially accretive acquisitions.

Palace has built a strong track record of value creation over a number of years. NAV total return in the four years and six months, from September 2013 (H114) to end-FY18 is 118.6% or a compound 19.0% pa. We have begun the analysis at H114 because this corresponds to the acquisition of the Sequel portfolio, Palace's first transformational acquisition. The negative total return in FY18 was less than we had forecast and results from the share issuance to fund the RT Warren portfolio and captures none of the future asset management-driven value creation that management hopes to achieve from this, its largest portfolio acquisition to date.

Exhibit 3: NAV total returns (since the acquisition of the Sequel portfolio)

(p)	H214	FY15	FY16	FY17	FY18	H214-FY18
Opening EPRA NAV per share	218	341	388	414	443	218
Closing NAV per share	341	388	414	443	414	414
Dividend per share paid	2.5	8.50	14.00	18.00	19.00	62
NAV total return	126	55	41	46	(9)	258
NAV total return (%)	57.8%	16.0%	10.5%	11.2%	-2.1%	118.6%
Compound annual return (%)						**19.0%**

Source: Palace Capital, Edison Investment Research

Exhibit 4: Financial summary

Year end 31 March	£'000s	2014	2015	2016	2017	2018	2019e	2020e
		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS								
Rental & other income		3,252	8,637	14,593	14,266	16,733	18,239	18,480
Non-recoverable property costs		(648)	(1,200)	(1,624)	(2,055)	(1,824)	(1,376)	(1,016)
Net rental income		2,604	7,437	12,969	12,211	14,909	16,863	17,463
Administrative expenses		(649)	(1,439)	(2,048)	(2,915)	(4,185)	(3,400)	(3,502)
Operating Profit (before capital items)		1,955	5,998	10,921	9,296	10,724	13,463	13,961
Revaluation of investment properties		19,501	9,769	3,620	3,101	5,738	2,559	2,628
Costs of acquisitions/profits on disposals		270	(461)	(525)	3,191	274	0	0
Operating Profit		21,725	15,306	14,016	15,588	16,736	16,022	16,590
Net Interest expense		(573)	(1,398)	(2,264)	(3,011)	(3,432)	(3,907)	(3,907)
Profit Before Tax		21,153	13,909	11,752	12,577	13,304	12,115	12,682
Taxation		81	107	(953)	(3,191)	(773)	(1,817)	(1,902)
Profit After Tax (FRS 3)		21,234	14,015	10,799	9,386	12,531	10,297	10,780
EPRA adjustments:								
Revaluation of investment properties		(19,501)	(9,769)	(3,620)	(3,101)	(5,738)	(2,559)	(2,628)
Costs of acquisitions/profits on disposals		(270)	461	525	(3,191)	(274)	0	0
Deferred tax charge		0	0	0	2,200	(299)	0	0
Other adjustments		0	0	0	155	308	0	0
EPRA earnings		1,463	4,707	7,704	5,449	6,528	7,739	8,152
Adjusted for:								
Non-recurring items		0	0	(3,172)	0	698	0	0
Share-based payments		12	114	110	237	174	148	148
Adjusted earnings		1,475	4,821	4,642	5,686	7,400	7,887	8,300
Company adjusted PBT		1,394	4,714	5,595	6,677	8,472	9,704	10,202
Average fully diluted number of shares outstanding (000s)		5,264	17,489	24,618	25,738	34,980	45,842	45,842
Basic EPS - FRS 3 (p)		403.4	80.1	43.9	36.5	35.8	22.5	23.5
Fully diluted EPRA EPS (p)		29.1	26.9	31.3	21.2	18.7	16.9	17.8
Fully diluted adjusted EPRA EPS (p)		31.4	28.3	18.9	22.2	21.2	17.2	18.1
Dividend per share declared (p)		4.5	13.0	16.0	18.5	19.0	19.5	19.5
EPRA dividend cover (x)		6.47	2.07	1.96	1.14	0.98	0.87	0.91
BALANCE SHEET								
Fixed Assets		60,086	104,470	175,738	183,959	253,984	261,293	267,921
Investment properties		59,440	102,988	174,542	183,916	253,863	261,172	267,800
Goodwill		6	6	0	0	0	0	0
Other non-current assets		640	1,475	1,196	43	121	121	121
Current Assets		7,060	15,653	11,903	13,692	24,584	19,729	15,641
Debtors		1,937	3,375	3,327	2,511	5,551	5,105	5,239
Cash		5,123	12,279	8,576	11,181	19,033	14,624	10,402
Current Liabilities		(4,171)	(3,487)	(9,048)	(8,197)	(11,520)	(12,046)	(12,291)
Creditors		(2,971)	(3,087)	(6,815)	(6,161)	(8,834)	(9,360)	(9,605)
Short term borrowings		(1,200)	(400)	(2,233)	(2,036)	(2,686)	(2,686)	(2,686)
Long Term Liabilities		(18,599)	(36,620)	(71,778)	(79,895)	(105,276)	(105,576)	(105,876)
Long term borrowings		(17,384)	(35,407)	(69,711)	(75,758)	(97,157)	(97,457)	(97,757)
Deferred tax		0	0	0	(2,187)	(6,531)	(6,531)	(6,531)
Other long term liabilities		(1,215)	(1,214)	(2,067)	(1,950)	(1,588)	(1,588)	(1,588)
Net Assets		44,376	80,016	106,815	109,559	161,772	163,400	165,396
EPRA net assets		44,370	80,010	106,924	111,759	190,011	191,639	193,635
Basic NAV/share (p)		357	396	414	436	400	404	408
Diluted EPRA NAV/share (p)		341	388	414	443	414	418	422
CASH FLOW								
Operating Cash Flow		1,297	4,388	12,287	10,294	9,899	14,583	14,221
Net Interest		(390)	(1,593)	(3,421)	(2,516)	(2,704)	(3,607)	(3,607)
Tax		(13)	(15)	(158)	(1,047)	(395)	(1,817)	(1,902)
Preference share dividends paid		(18)	0	0	0	0	0	0
Net cash from investing activities		2,532	(2,922)	(50,012)	(3,352)	(67,725)	(4,750)	(4,000)
Ordinary dividends paid		0	(1,766)	(3,221)	(4,617)	(6,744)	(8,818)	(8,932)
Debt drawn/(repaid)		(21,266)	(10,600)	21,272	6,467	8,151	0	0
Proceeds from shares issued		23,009	19,664	19,114	29	67,651	0	0
Other cash flow from financing activities		(66)	(2)	(2)	(2,897)	(1,085)	0	0
Net Cash Flow		5,085	7,155	(4,141)	2,361	7,048	(4,409)	(4,221)
Opening balance sheet cash		39	5,123	12,278	8,576	10,937	17,985	13,576
Restricted cash		0	0	0	244	1,048	1,048	1,048
Other items (including cash assumed on acquisition)		0	0	439	0	0	0	0
Closing balance sheet cash		5,123	12,278	8,576	11,181	19,033	14,624	10,403
Closing balance sheet debt		19,509	37,021	74,011	79,744	101,431	101,731	102,031
Closing net debt/(cash) as per balance sheet		14,385	24,742	65,435	68,563	82,398	87,107	91,628
Net LTV (exc restricted cash & adjusted for unamortised debt costs)		23.0%	23.3%	37.0%	36.9%	30.0%	31.0%	31.8%

Source: Palace Capital, Edison Investment Research

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