16 May 2019

HARDMAN & CO.

PALACE CAPITAL

Portfolio and trading update

Palace Capital's portfolio and trading update of 2 May showed underlying values up year- on-year. A lease event, resulting in a profit and cash upgrade, was announced on 7 May. This showed a cash premium being agreed to be paid by the tenant. The loan-to-value (LTV) stood at 33%. Palace Capital took the "strategic decision to hold back on letting some of our vacant space where we see the opportunity to drive value and income potential." Construction has recently commenced for the Hudson Quarter, York, mixed residential-commercial development inside the city walls. This is one of several factors underpinning significant medium-term expansion in capacity to pay growing dividends.

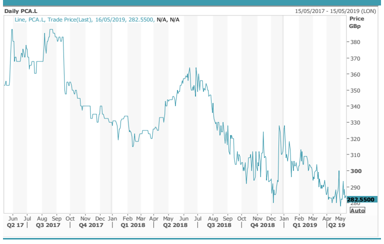
- **Update from 2 May: "Palace Capital is making substantial progress** across the portfolio, notwithstanding the uncertain environment. During the year we took the strategic decision to hold back on letting some of our vacant space where we see the opportunity to drive value and income potential."
- **Minor estimate changes:** We reduce FY19E revenue and profit by £0.5m, as Palace Capital points to increased opportunities for lease renewals into FY20. As to FY20E, we raise our revenue and profit figures by £2.3m as a result of the tenant-requested lease surrender at the Birmingham office, net of costs.
- **Location and active asset management:** Many of the top 10 assets (by value and rental income) are along the M62 corridor. A recent (5 April) Property Week survey placed 10 of the top 20 UK non-London office "hotspots" in that M62 corridor. "Northern Powerhouse" commercial real estate opportunities grow.
- **A track record of outperformance:** In each of the past five years, Palace Capital's accounting return has been in the first or second quartile vs. our small basket of six most comparable regional UK REITs. (Note that, in FY18, this excluded the distorting effect of equity.) Since 2013, NAV has more than doubled.
- **Risks:** The normal risks of real estate apply. The weighted average length of unexpired lease to break is ca.5.4 years. Generally, covenants are good. Retail exposure (bar Wickes and Booker) is minimal. Gearing, at 33% LTV, is conservative and, although expected to increase as the York development progresses, management has previously stated an intention to keep it below 40%.

Financial summary and valuation

Year-end Mar (£m)	FY2016	FY2017	FY2018	FY2019E	FY2020E
Income	14.6	14.3	16.7	17.5	21.2
Finance cost	-2.3	-3.0	-3.4	-3.9	-4.1
Declared profit	11.8	12.6	13.3	10.2	12.0
EPRA PBT (adj. pre-revaluation)	8.7	6.4	7.3	8.7	12.0
EPS reported (p)	43.9	36.5	35.9	19.0	22.1
EPRA EPS (p)*	31.3	21.2	18.7	15.7	22.1
DPS (p)	16.0	18.5	19.0	19.0	19.0
Net cash (debt)	-65.4	-68.6	-82.4	-94.6	-111.4
Dividend yield	5.6%	6.4%	6.6%	6.6%	6.6%
Price/EPRA NAV	70%	65%	69%	70%	67%
NAV (p)	414.3	434.2	400.2	406.6	421.1
EPRA NAV (p)	414.3	443.0	414.8	413.1	427.6

**Diluted, pre share-based payments; Source: Hardman & Co Research*

Real Estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**PCA**
Price (p)	288
12m High (p)	360
12m Low (p)	280
Shares (m)	45.9
Mkt Cap (£m)	133.0
EV (£m)	215.0
Market	Main, LSE

Description

Palace Capital is a real estate investor, diversified by sector (office, industrial) and location, excluding London and with minimal exposure to retail. There is an emphasis on city-centre locations. The York development site comprises 6% of assets.

Company information

Chairman	Stanley Davis
CEO	Neil Sinclair
CFO	Stephen Silvester
Executive director	Richard Starr

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Key shareholders

AXA	7.7%
Miton	7.4%
J.O.Hambro	7.3%
Stanley Davis (Chairman)	3.6%

Diary

Jun'19	Final results
Jul'19	4Q'19 div. paid

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Achievements since flotation

Sector-premium performance

- From its inception in 2013, the total accounting return for Palace Capital stands at 130%, NAV more than doubling.
- In each of the past five years, Palace Capital's accounting return has been in first or second quartile vs. our small basket of six most comparable regional UK REITs. (Note that, in FY18, this excluded the distorting effect of Palace Capital equity issuance.)

Consistently outperforming subsector

Accounting return is the NAV movement plus dividends paid. Over the period, this is higher than any in a basket of six comparable REITs we track (see page 4). The cumulative effect of strong performance has resulted in this significant positive historical outcome. The table below lists the Palace Capital accounting return in first or second quarters vs. comparables. Note, in FY18, Palace Capital issued new equity at a discount to NAV. The right-hand column excludes the distorting effect of this non-real estate-related event.

Palace Capital accounting returns ranked vs. comparable regional UK REITs

Accounting return rank	Quartile rank	Adjusted to exclude equity issuance effect on NAV
FY15	2Q	2Q
FY16	2Q	2Q
FY17	1Q	1Q
FY18	4Q	2Q

Source: Hardman & Co Research estimates

The performance of Palace Capital, as tracked by NAV increase added to dividends paid (the total accounting return), is consistently robust. We compare this with a small basket of regional REITs, namely Custodian REIT, Ediston, F&C UK Real Estate, Real Estate Investors, Regional REIT and Schroder REIT.

A scrip-equivalent issue, historically

Palace Capital has demonstrated consistently attractive accounting returns (NAV growth plus dividend per share). For the accounting period 2018, the issue of new shares, at 340p, allied to the RT Warren portfolio, had a diluting effect on NAV. The chart below presents the accounting return adjusted to exclude this scrip dilution effect specific to 2018. Unadjusted, we calculate Palace Capital's accounting return in 2018 at minus 2%. Note, Regional REIT was admitted to the stock market in November 2015; thus no performance data for 2015 for Regional REIT is stated below.

Successful strategic positioning for the future

Positioned to regional offices

This has been achieved through a focus on the correct subsectors. Just under 50% of assets are in regional offices and, since 2016 in particular, this segment has outperformed all-property (MSCI) – see page 9. Early strong performance was the result of initial returns from newly acquired assets, indicating value-added from the point of the acquisition.

Throughout, Palace Capital adds value through active asset management:

Matching assets to tenants

- Suiting the assets to tenant needs (refurbishing, reconfiguring, being flexible to optimise tenant returns) and capturing that value.

Early lease surrender benefits shareholders and also tenant

- All rent due through to the December 2027 end of the lease has been paid by the tenant of the Birmingham office asset. Palace Capital has agreed a May 2019 lease termination for the tenant, which saves the tenant costs and also enables a combination of an asset optimisation plan, giving a number of clear options to create shareholder value.

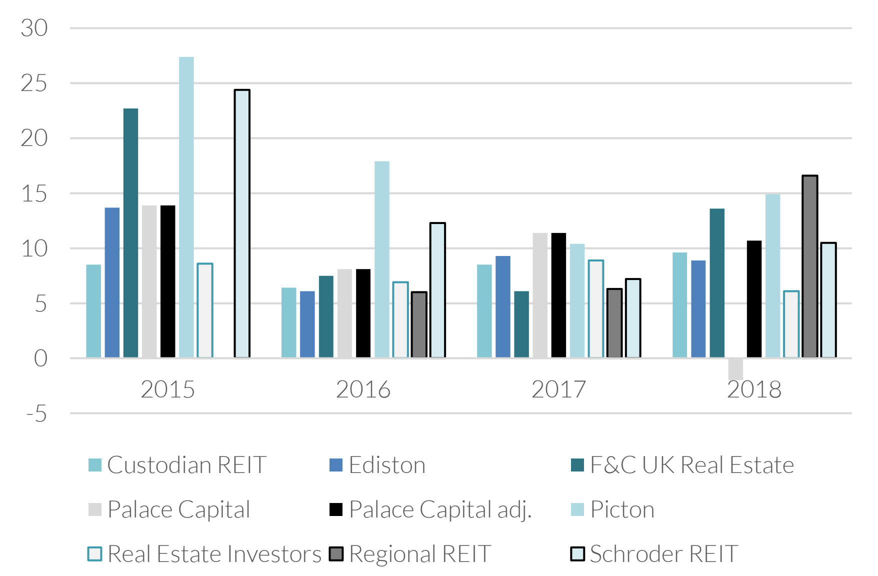
17.4% uplift in Aldi rent – negotiated 10 years ahead of expiry

- Re-gearing of leases (e.g. Aldi in FY19): 17.4% uplift in rent.
- Asset-by-asset business plans executed progressively over a period of years (numerous plans executed in FY19, notably on the Manchester office, the York development site, the Northampton leisure asset, the Milton Keynes offices, etc).
- Recycling capital: from portfolio acquisitions and ultimately once the asset's business plan's completion coincides with effective purchaser demand. The notable example here in FY19 is the disposal of residential assets purchased via the RT Warren portfolio.

This can be summarised and quantified in the chart below.

An encouraging history of performance

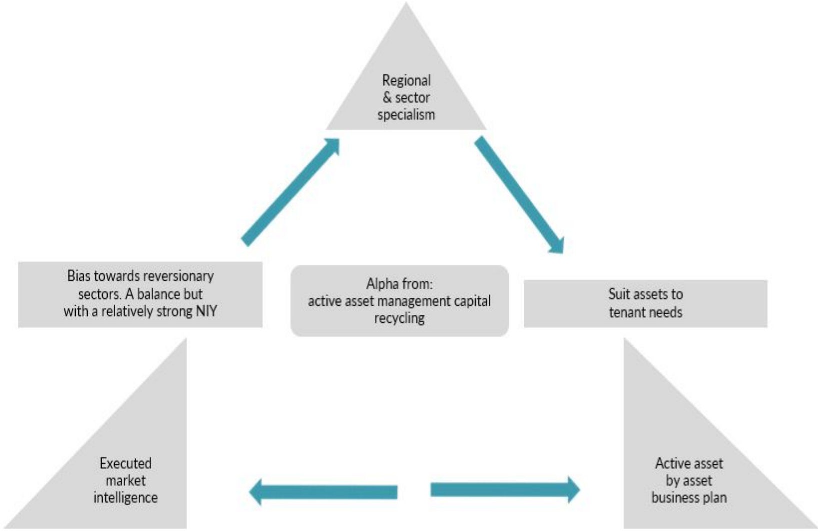
Accounting return (NAV plus dividend per share) for comparable REITs



Palace Capital adjusted excludes impact of equity issuance on NAV
Source: Company accounts

Palace Capital has produced consistent second-quartile returns vs. the regional real estate REITs. Consistent second-quartile returns add to category-beating total returns.

Value creation by Palace Capital



Source: Hardman & Co Research

FY19 update highlights

Current macro uncertainties from politics…

Operationally, the positioning is successfully designed and positioned to deliver returns and drive value, despite current political uncertainties. Underlying all this is the strong macroeconomic dynamic in regional offices. We explore this on pages 8 and 9. There is a patient approach to investment, in order to maximise £ sq. ft. and ultimate income and capital value. Time and again, the detail of the business plan secures positive results and illustrates valuations as being conservative. It also illustrates how – in detail – the close attention to assets and tenants creates value when acquiring portfolios of assets.

Notably:

…with a stream of value-adding interactions with tenants

Early and active tenant engagement

- A 17.4% uplift in rental income was secured through the re-gear of the Aldi, Gosport lease. On 2 October 2018, Palace Capital agreed a new 20-year RPI-linked lease with the existing tenant Aldi. Again, this is an example of i) acting ahead of events (the 2030 expiry) and ii) working the relationship with tenants, post-acquisition of a portfolio. Aldi previously leased this 16,500 sq. ft. supermarket from RT Warren on a lease expiring in August 2030.

The "portfolio effect"

- Within the RT Warren portfolio acquired were fully let residential assets in north London. The large majority have been sold to L. B. Barnet. Two have been sold since end-March 2019 (fiscal year-end). We understand that, of the original 65 houses, eight now remain and are expected to be sold in the next few months. Disposals to date have been at or very near valuation and above the business plan at the time the RT Warren portfolio was acquired.

Positive momentum

- Hudson Quarter, York. Again, this has been a transformative and value-creating journey for the asset, securing change of use planning permission and commencing construction. A sales centre opens in just over a month, we understand.

Steady asset-uplift programme

- Boulton House, Chorlton Street Manchester. A steady process of refurbishment and raised letting values (£ per sq. ft. typically up 25% or more) is under way. This is "patient capital", with the upwards momentum in rents and valuation clearly demonstrated.

Benefits of steady asset-uplift programme

- Sol Northampton, on 19 February, completed a 15-year lease for 12,800 sq. ft. with Soo Yoga Group. This is for £85,000 p.a., with RPI-linked uplifts and a minimum uplift at first review to £100,000 p.a. (£7.80 sq. ft.). The lease terms include a nine-month rent-free period and a break at 10 years. As stated at the time by Palace Capital, this is all in line with the strategy to "improve the offering so that it holds greater appeal to a wider catchment that includes the affluent surrounds of the town. While the leisure sector has gone through somewhat of a difficult period of late, we are very pleased with our latest signing, which is fully in line with our strategy, and there has been encouraging interest in the remaining space which gives us confidence for the future of the asset." Raising the asset's income and achieving a good, long lease is important, but it is also crucial to secure the kind of tenants that help reposition the asset as a whole to enhance future leases, and hence its present and future value.

- All rent due through to the December 2027 end of the lease has been paid by the tenant of the Priory House office, Gooch Street North, in Birmingham. The tenant vacated the building in 2012, and it has remained unoccupied since then, incurring costs to the tenant. Palace Capital has agreed an end-May 2019 lease termination for the tenant, which saves the tenant costs from end-May, and also enables a combination of asset-optimisation plans, which gives a number of clear options to create shareholder value. Receiving the whole of the rent to 2027 is a successful outcome for all parties. The money enables potential refurbishment or redevelopment in conjunction with the freeholder, or alternatively the sale of its leasehold interest.

In one asset, example of i) value creation, ii) conservative valuation and iii) the route from acquisition, as part of a portfolio

Priory House is a good example of i) value creation, ii) conservative valuation and iii) the route from acquisition, as part of a portfolio being disposed of. The asset was purchased from Quintain in October 2013 as part of the Sequel Portfolio. As at 30 September 2018, the company's interest in Priory House was valued at £2.2m, an interesting figure given the £2.85m cash being received. The £2.2m latest valuation was the equivalent of £35 per sq. ft.

This places Palace Capital in a strong position for continued growth – not solely in FY20 – in recurring earnings, driven by:

- underlying positive market trends in its areas of major exposure (not only regional offices);
- execution of asset management business plans;
- execution of the Hudson Quarter, York development; and
- recycling capital (from Hudson Quarter and other optimised assets).

Clearly, there are some current political uncertainties that affect the whole of the UK outlook. These have been referred to above and were already, in large part, in our estimates.

It should be noted that FY20E includes £2.85m income for the lease surrender of Priory House, Birmingham. By definition, lease surrender premiums are not recurring items. It is interesting to note that this asset had a valuation of £35 per sq. ft., and there should be an opportunity to raise that (in addition to the cash benefit of the substantially early surrender). As illustrated with a number of examples (including some on pages 1 and 5), there is a time for all things, and it may be best to take the proper time to "work-up" value. As of 1 June, Palace Capital will bear the void costs, including business rates.

2021 estimates

We plan to initiate FY21 estimates later this year.

High exposure to strong, lower-risk sectors

An important and a well-placed sector

Palace Capital is ca.50% invested in regional offices.

Its current positioning is in sectors with the strongest prospects. Not only that, we consider the main sector exposure to be the strongest, risk-adjusted.

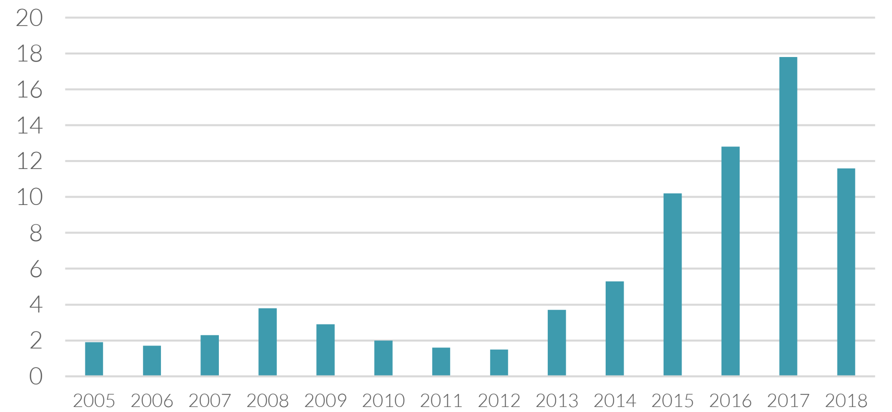
Regional offices' rental drivers comprise:

- a ca.30% reduction in real rents since 2008;
- continuing growth of regional hubs' demand, driven by value-adding employment and population emigration from London;
- reduction in supply (from permitted development, as well as some obsolescence); and
- valuation levels remaining – location-dependent – at insufficient levels to trigger significant development, apart from grade A space at rent premiums.

A shrinking sector – regarding competition

Cause: reduction in office stock

Office conversion to residential (England) (m. sq. ft.)



Source: Ministry of Housing, Communities, Local Government

Source: *https://www.gov.uk/government/statistical-data-sets/live-tables-on-net-supply-of-housing*

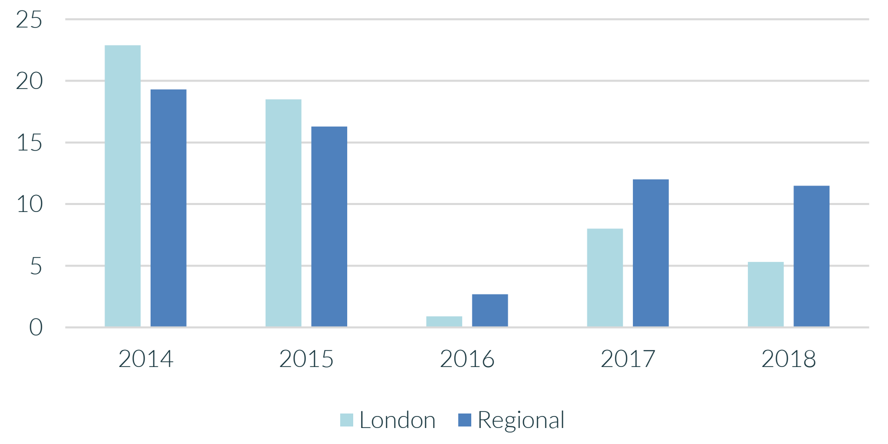
In the mere three-year period to 2017, between 1% and 2% of total office space was converted to residential in most cities in the north of England: Manchester, Leeds, Newcastle, for example. In the south of England, percentages typically were 2% to 5%, or higher still, as capital values justify the conversion costs (Source, Centre for Cities).

https://www.centreforcities.org/reader/building-blocks-role-commercial-space-local-industrial-strategies/supply-commercial-property-vary-across-cities/

Effect

In 2016, and in each subsequent year, regional office returns have exceeded those generated by London.

London vs. regional UK offices (% p.a. total returns)



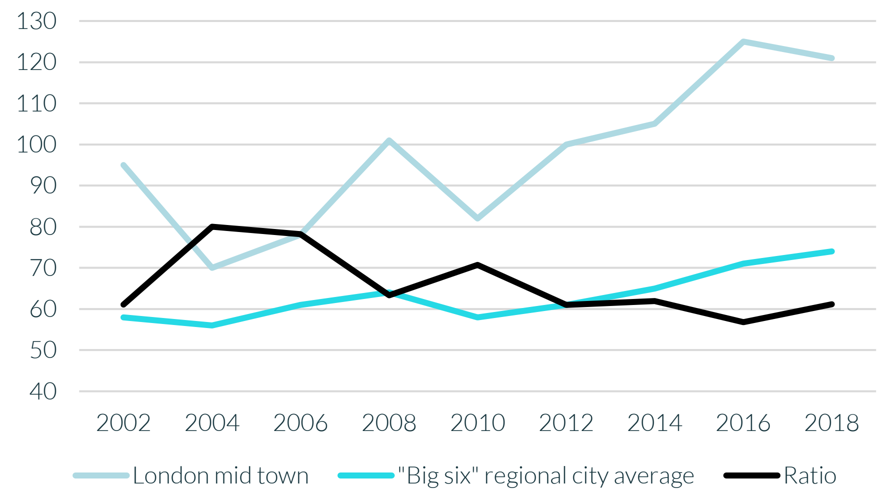
Source: MSCI

Rents rising in the sector

The total occupier costs (of which typically under 40% is rent) of major regional modern office space remain near their low point as a ratio vs. London. However, this ratio is rising as occupier costs and rents start the long journey to reverse at least part of the ground lost.

Regions well placed for more rent growth to come

Occupier costs – regions vs. London (£ sq. ft.)



Source: LSH, Ministry of Housing, Communities, Local Government

The Manchester asset

For a more detailed analysis of the Palace Capital Newcastle asset, *click here.* For the Palace Capital York asset, *click here.*

A number of value drivers…

Boulton House

Investment summary

Among Palace Capital's portfolio, the Manchester asset is a useful asset management opportunity.

- New level of rents captured at ca.£17.50 to £19.00 sq. ft., vs. £14.00 sq. ft rental levels on acquisition.
- Going through the cycles of refurbishment and re-letting on an incremental basis.
- Initial cost £10.6m. Total (incremental) refurbishment costs estimated (Hardman & Co) in the region of 20% of acquisition cost, with estimated gross incremental rental yield over 10% on the refurbishment expenditure.
- Revaluation already booked.
- Hardman & Co estimates further revaluation (before any underlying market change).

…deployed progressively over time

- Our view is that the asset might attract a valuation at a capitalisation rate of 7%, once income has been stabilised, thus giving an eventual value of £18m (pre any moves in the broader, central-Manchester office market pricing). We do not expect this value to be captured for some years, but believe this illustration is of some merit in assessing the business case for the asset.
- Hardman & Co expects the trend for the firming central Manchester office lettings market to continue – thus supporting a policy of progressive refurbishment to maximise rental income and ride a positively underpinned occupier market.

Asset description

The asset is well along the path of being optimised. It was purchased with high voids and achieving sub-market rents. A large factor was the prior under-investment. This is a CBD prime site, M1 postcode. Palace Capital took the decision to undertake a rolling refurbishment programme in order to optimise rental levels and occupancy, around the break dates for leases in place at time of purchase. Delivering this over the optimal time scale and at optimal cost is a judgement, and a steady rise in both rents per sq. ft. and in occupancy has flowed from the capital invested. Value has already been created, and we consider (see calculations and projections, below) that some further value gain appears deliverable, over time.

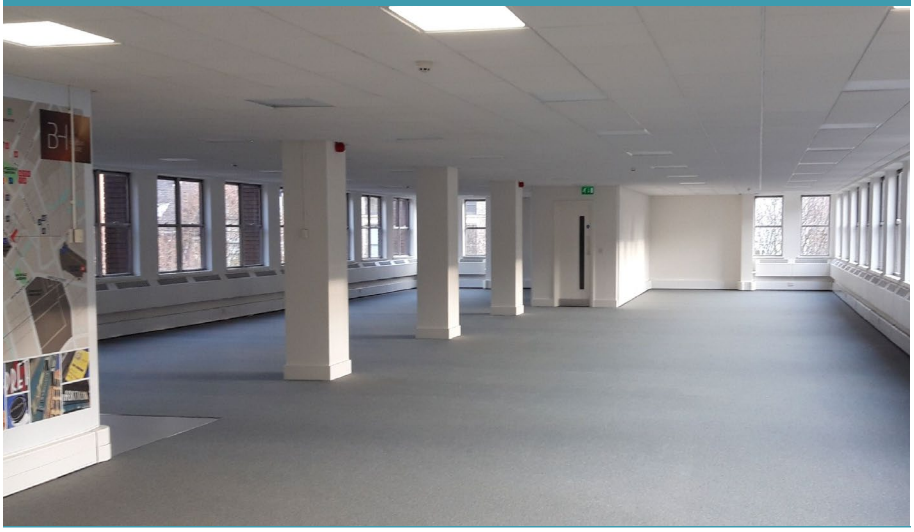
Flexible configuration – progressive refurbishment

The asset is ca.150m from Piccadilly Gardens, in the centre of the city, laid out over eight storeys, totalling 75,000 sq. ft., on floorplates between 6,000 and 11,000 sq. ft each; the large majority of space is double-aspect. Refurbishment is being progressively carried out, principally when tenants vacate. Configuration post the Palace Capital acquisition has been made flexible to prospective new tenants, offering individual floorplates from 2,000 sq. ft. up to 6,000 sq. ft. or more.

Rents at Boulton House averaged ca.£14 sq. ft. on acquisition, in August 2016, and the level of rents achieved in the more recent new leases is £19 sq. ft. We consider that the bulk of the market for this location and specification is around £17.50 sq. ft.; naturally, the correct pricing within the Boulton House asset varies depends on precise layout and position within the building. Were such levels to be repeated, the building in due course would achieve income of ca.£1.3m.

Boulton House was purchased for £10.6m in August 2016. Most leases were at below market levels, but reflecting how the pre-Palace Capital asset was presented to potential occupiers, and relatively short (many shorter than two years to break). There is some parking, and also a basement. This acquisition was achieved at a price of £150 per sq. ft.

Most Boulton House floorplate is double-aspect or more



Source: Hardman & Co Research

Rationale for acquisition and ownership

The asset is in the sector of non-London offices located in the centre of major regional hubs. We consider this sector attractive, as investment turns increasingly to "connected" cities such as Manchester, and relevant real estate supply balance is attractive. Supply/demand in this sector is strong, and Manchester specifically has strong ratios. Oxford Econometrics forecasts (October 2018) Manchester GDP to grow at compound 0.3% p.a., faster than the UK as a whole. Further sub-market detail is provided below.

A journey from £14 sq. ft. to £19 sq. ft.

2016 achieved rents of ca.£14 sq. ft. were notably below the levels at which the market would absorb good-quality refurbished space in such a strong central location. The asset, at that stage, was ca.65% let, on a number of leases, and required refurbishment to achieve market rents. Many leases were (and a number remain) relatively short-dated. This has enabled a progressive rollout of refurbishment floor-by-floor. New rentals have been achieved at just under £19 sq. ft. This is an attractive price to tenants, compared with Grade A prime new build, at ca.£35, and with the majority of the available "ready to occupy" Grade A market (Source Schroders/Sixteen Real Estate, September 2018) standing at £23.50 to £29.50 per sq. ft. Such rent uplifts create value at the cost of refurbishment, despite the inevitable void periods all professional asset managers experience in such a type of investment programme.

Value to Palace Capital

Comparable data indicate to us that, let on long leases at the higher rents being achieved, the asset should achieve valuation levels of 7% NIY on a stabilised income. A not-dissimilar asset (undergoing refurbishment and hence only currently part-let) is valued at a 7.2% reversionary yield. £10.6m was the cost of the Boulton House acquisition in August 2016. That equates to a 10.8% reversionary yield on the most recent stated, improved, reversionary potential. This 2016 acquisition cost was £150 sq. ft. The asset was valued at £11.1m in September 2016, so there was some modest initial uplift.

Boulton House is now (September 2018), valued at £14.5m, vs. £10.6m cost; more to come

Boulton House is now (September 2018) valued at £14.5m, vs. £10.6m cost. How has that happened? In the past near three years, there has been some modest rental inflation in the central Manchester market, but only ca.10%. In addition, over £1m has been invested in refurbishment. These two factors combined take the £11.1m September 2016 (itself a modest premium to the acquisition cost) valuation to ca.£13.2m, mathematically. How has the current valuation of £14.5m been arrived at? Just over 10% of floor space has been newly let since acquisition. Re-letting was held back initially for rolling refurbishment. This newly let refurbished space achieved ca.30%+ rent premium over the price of space let prior to acquisition. This 30%+ rent premium is a result of the refurbishment, the cost of which has been paid, in modest part, by dilapidations.

Taking the improved, current estimated reversionary income, this £10.6m purchase price equates to a reversionary yield now at 10.8%. The most recent reversionary yield valuation is 7.98%, and the current value stands at £14.45m (Cushman & Wakefield). Rents have been supported by modest ongoing market rises, but the driving force is the programme of refurbishment. Approximately 20% of the space has been refurbished to date; 8,620 sq. ft. has been re-let since acquisition, at an average of £17.60 sq. ft., the latest at £18.95. Hardman & Co estimates that there is further valuation movement to be derived from ongoing new rentals at these higher levels. Indicatively, were Boulton House to be at a current £16m valuation (Hardman & Co estimate potential valuation at £18m post £2m further refurbishment), the pro-forma further uplift to Palace Capital NAV would be £1.5m, or 3.3p per share.

We thereby estimate that around half the valuation shift justified by achieving the significantly higher headline rents has been achieved to date. Based on a valuation at a "headline" rent of £17.50 sq. ft. (a Hardman & Co estimate of the appropriate level of rents that investors might conservatively anticipate from this building once refurbished) and on a 7% NIY, the valuation would be now illustratively £16m, i.e. £18m fully refurbished minus the figure of up to £2m to complete the (rolling) refurbishment. A £16m valuation (Hardman & Co estimates potential valuation at £18m post £2m estimated further refurbishment), the pro-forma uplift to Palace Capital NAV of £1.5m leads us to conclude that the current valuation is conservative. Of course, there is substantial further work to do in terms of delivering the rent levels being achieved into a greater number of new lets, filling voids and re-letting.

The central Manchester office market

Strong local market

We consider Manchester to offer strong prospects for supply/demand in the upcoming medium term. We also consider the central Manchester rental levels to be well underpinned, notwithstanding current UK-wide macroeconomic and political issues.

Manchester has seen a 17% rise in prime rents for offices in total since 2012, barely keeping pace with inflation, after a period of downward pressure on rents prior to 2012. Yet, supply appears modest and below demand. Prime rents stand at £35 sq. ft.

Grade A supply stood at 210,000 sq. ft. at end-2018 (Knight Frank), down from 305,000 sq. ft., and compared with a 10-year average of 345,000. Prime rent is stated at £34 sq. ft. "In 2018, leasing activity increased by 44% year on £36.00 year, with office take-up reaching 1.7m sq. ft. by year-end. This is not only 52% above the 10-year average, but also represents the highest total on record for the city." (Source: Knight Frank.) Knight Frank states that 38% of office take-up in the centre was from TMT in 2018. Office investment volumes reached £989m in 2018 (Knight Frank), the highest of any of the regional cities and 81% ahead of the 10-year average for the city.

Total take-up in 1H'18 stood at 769,119 sq. ft., vs. 1H'17's 487,000 sq. ft.

The majority of the available "ready to occupy" Grade A market (Source Schroders/ Sixteen Real Estate, September 2018) stands between £23.50 and £29.50 per sq. ft.

Manchester has 30,000 jobs in the tech sector; this is third in the UK behind London and Reading, and ahead of Bristol at 25,000, Birmingham at 17,000 and Cambridge at 15,000 (Source: Tech Nation 2018 Report, Oxford Economics 2018). This, among other matters, is driving demand, and Manchester office vacancy rates stand at 10.5%, only 1% point higher than at the low point of 2007.

Recent data (Schroders/Sixteen Real Estate) indicate average rents on Manchester city centre take-up at £17.60 sq. ft. (average of new, refurbished and un-refurbished space). "Occupiers are becoming more experimental with office designs and layouts and require flexible M&E systems and digital connectivity solutions." Hence, significantly refurbished space commands an increasing premium. The Boulton House asset's refurbishment cost per sq. ft. is, we believe, ca.25%+ of the original capital cost and includes extensive refurbishment of common parts.

Past oversupply has been a feature across the regional UK office market. IPD/Schroders data show regional office capital values as being the worst performer on any timescale up to 2015 (compared with all commercial property, central London office, retail and industrial). 2015-18 regional office asset values have matched all property. IPD/Schroders projections are for capital values on all commercial property to fall a total of 8% by 2021, with regional office values moving sideways. With the supply/demand being exacerbated by the near 40m sq. ft. office space converted to residential in the 10 years to end-2016 (and significantly more since), there are a number of factors supporting the sector valuation.

The "northern powerhouse"

Attractions in well-located northern office markets

Further, to place Manchester in a UK context, we note with interest the recent survey and analysis by Property Week, assessing the top 20 UK locations for offices, based on a basket of criteria that appeal to occupiers. We present the Property Week location findings, ranked, in the map below. Each number represents the rank (1 being the best outside London).

In our view, this illustrates that half of the UK's top 20 non-London locations for offices, ranked by attractiveness to occupiers, stand in the broad M62 or "northern powerhouse" corridor.

UK's top 20 (occupier-criteria ranked) office locations, excluding London

Source: Property Week

Each number represents the rank (1 being the best outside London).

Risks and mitigation – sector exposure

No industrial tenant exceeds 2% of the total. The largest retail tenants comprise Wickes, Bravissimo, Aldi, Booker and Tesco. No shopping centres are owned.

We consider all major retail tenants of Palace Capital to be solid. In terms of background, Bravissimo (an office tenant, albeit with a retail business) currently has 29 stores across the UK, and also sells via mail order, online and via a US website.

LTV ratios stand at 29.9% (end-2018), down from a sustainable historical level of 37.3% at end-2017. We believe the broad target LTV is 35%-40%, but assuming York's Hudson Quarter proceeds to plan, the LTV on completion and exit of the York development will be 30% or less. It is stated at 33% LTV currently.

During the development of Hudson Quarter, LTV is expected to rise to manageable levels (40%), and will ultimately reduce LTV, through the value uplift and residential sales.

York's mixed-use development (the majority of which is apartments) is being commenced without residential pre-sales or pre-letting of the relatively modest commercial element. The residential market here is currently strong, and marketing commences shortly.

The Hudson Quarter construction is being undertaken at a fixed-price contract; however, it is not pre-sold at this stage.

All real estate sector investment is at risk as regards location. Palace Capital mitigates this by excluding London and choosing central, accessible locations with good underlying demand.

The assets owned offer value-for-money to occupiers and, as such, there is often tight emphasis by the tenant on the rental levels. Mitigating this is the fact that the rent level will be a more modest part of total operating costs (be it offices or leisure, etc.) than would be the case for prime assets.

Assets purchased sometimes require areas of refurbishment (e.g. reception area or external). This is the nature of the value-adding asset management policy. To fund this, however, the group requires either dilapidations to be deployed, or an element of Palace Capital 'maintenance' capital, or a mix of both. Our cashflow and asset forecasts include an element of this, itemised.

A number of leases are of short duration. The overall WAULT number is not relevant, as this is a granular investment portfolio. Assets that have reversionary potential, indeed, by definition, benefit from shorter WAULTs.

Leisure might be considered a sector under pressure, and here the leases are mostly of long duration (see our analysis of top 10 assets in our previous research documents), anticipating and mitigating that risk.

Sector exposure is weighted to regional offices – a segment we consider to be robust, with good supply/demand balance favouring the investor.

The dividend cover reduces this year but, on the basis of EPRA earnings, will return to being fully covered next year, according to Hardman & Co estimates. DPS growth will be constrained, we estimate, until the NAV and, importantly, income step-uplift upon completion of the York development. So, the DPS is 'cake today', 'cake and jam' in a short number of years, post the delivery of the highly visible York development. Therefore, DPS cover will rise substantially 'post York's Hudson Quarter', giving opportunities for sustainable DPS growth.

Financial performance

Our estimates assume, for FY19 (year now ended), £4.2m net asset acquisitions, with significant purchases (notably the Liverpool office asset) and disposals (notably London residential assets acquired within a portfolio). FY20E assumes further modest disposals within the London residential assets, but also further acquisitions are estimated to be made. Note also that – as recently announced – Palace Capital has taken advantage of the tenant offer for an early termination of the lease at Priory House, Birmingham. This leads to a surrender premium – a £2.8m credit to FY20E income – but the rental income ends, thus reducing ongoing profits until the asset is re-let, or other action of Palace Capital choice is taken. This early surrender has created economic value for Palace Capital; however, in our assuming nil income and void costs for FY20, we have reduced our forward estimates appropriately.

It is also important to note that the development of Hudson Quarter, York, is ongoing. We assume first profits being taken in FY22E from disposals of residential units developed.

Revenue account

Revenue account						
Year-end Mar (£m)	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019E**	**FY2020E**
Rental, other income	8.64	14.59	14.27	16.73	17.50	21.25
Direct property costs	-1.20	-1.62	-2.06	-1.82	-1.55	-1.60
Net income	7.44	12.97	12.21	14.91	15.95	19.65
Administrative expenses	-1.44	-2.05	-2.91	-4.18	-3.40	-3.60
EPRA operating profit	6.00	10.92	9.30	10.73	12.55	16.05
Property revaluation	9.77	3.62	3.10	5.74	2.00	0.00
Profit on disposal, transaction costs	-0.46	-0.52	3.19	0.27	-0.50	0.00
Share-based payments	-0.11	-0.11	-0.24	-0.17	-0.20	-0.20
Operating profit	15.20	13.91	15.35	16.57	13.85	15.85
Interest	-1.40	-2.26	-3.01	-3.43	-3.85	-4.10
EPRA PBT (pre-revaluation, etc.)	4.60	8.66	6.45	7.30	8.70	11.95
PBT (as declared, pre share-based)	13.91	11.76	12.58	13.31	10.20	11.95
Tax	0.00	-0.95	-3.19	-0.77	-1.50	-1.80
Deferred tax on revaluations, capital allowances	0.10	0.00	2.20	0.00	0.00	0.00
EPRA PAT	4.70	7.71	5.46	6.53	7.20	10.15
Company-adjusted EPS (p)	26.87	31.32	21.21	18.67	15.69	22.11
EPRA EPS (post share-based, p)	26.24	30.87	20.28	18.18	15.25	21.68
EPS (reported, p)	80.00	43.90	36.50	35.85	18.95	22.11
DPS (p)	13.00	16.00	18.50	19.00	19.00	19.00
Average shares in issue (m)	17.49	24.62	25.74	34.98	45.90	45.90
Year-end shares in issue (m)	20.23	25.78	25.23	45.80	45.90	45.90

Hardman & Co assumes yielding-asset acquisitions are made; all EPS figures are on diluted shares.
Source: Palace Capital accounts, Hardman & Co Research estimates

Balance sheet

Balance sheet						
@ year-end Mar (£m)	FY2015	FY2016	FY2017	FY2018	FY2019E	FY2020E
Investment properties	103.0	174.5	183.9	253.9	287.0	310.7
Long-term liabilities (deferred tax)	1.5	1.2	-2.1	-6.6	-3.0	-3.0
Long-term debt	-36.6	-71.8	-77.7	-98.8	-98.8	-113.4
Net current assets, excluding financial	0.3	-3.5	-3.7	-3.3	-6.0	-3.0
Assets held for sale	0.0	0.0	0.0	21.7	3.7	0.0
Cash, deposits, short-term debt	11.9	6.3	9.1	16.3	4.1	2.0
Net cash (debt/finance lease)	-24.7	-65.4	-68.6	-82.4	-94.6	-111.4
Net assets (NNNAV)	80.0	106.8	109.6	183.3	187.1	193.3
EPRA net assets	80.0	106.8	111.8	190.0	190.1	196.3
NAV/share (p)	395.6	414.3	434.2	400.2	406.6	421.1
EPRA NAV/share (p)	395.6	414.3	443.0	414.8	413.1	427.6
LTV	24.0%	37.5%	37.3%	29.9%	32.5%	35.7%

Source: Palace Capital accounts, Hardman & Co Research estimates

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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