PALACE CAPITAL

Conversion to REIT status; FY19 results announced

Palace Capital's results (4 June) show 37 new leases were completed. Most importantly, these were 14% above ERV (i.e. the level which previous valuers had estimated). This is one of several factors underpinning significant medium-term expansion in capacity to pay growing dividends. Further, the REIT status enhances the capacity for investment and for dividend payment, through the elimination of corporation tax payable. Total property return was 7.1%, ahead of the MSCI UK Index figure of 4.6%. Like-for-like valuations edged ahead by 0.5%, compared with MSCI UK index capital growth at 0.1%. Cost of debt fell to a competitive 3.3%.

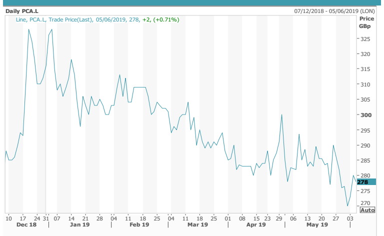
- **REIT status and FY'19 results:** Both items are of great significance for Palace Capital shareholders. REIT status brings a rise in earnings as a function of the REIT nil tax regime. The results confirm the company's continued outperformance – which we quantify in this report. We initiate FY21 estimates.
- **Results and prospects:** Property return was strong – beating the benchmark; as did rents. NAV, though, fell 2%, primarily due to tax and a modest loss on part-disposal of the RT Warren portfolio. We expect a covered dividend next year, ahead of the large benefits from the York development in FY22.
- **Cash paid by tenant for early lease surrender a further positive:** A lease event, announced on 7 May, saw an FY20 profit and cash upgrade. A £2.85m cash premium has been agreed with the tenant. We note the most recent valuation of this asset was only £2.2m. Economic value has been created.
- **A track record of outperformance:** In the five years to 2018, 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 4.5 years. Generally, covenants are good. Retail exposure (bar Wickes and Booker) is minimal. Gearing, at 34% LTV, is conservative and, although expected to rise as the York development progresses, management has previously stated an intention to keep it below 40%.

Financial summary and valuation

Year-end Mar (£m)	FY17	FY18	FY19	FY20E	FY21E
Net income [1]	12.2	14.9	16.4	19.2	16.8
Finance cost	-3.0	-3.4	-4.6	-4.0	-4.0
Declared profit	12.6	13.3	6.4	11.2	14.8
EPRA PBT (adj. pre-revaluation)	6.4	7.5	8.6	11.2	8.8
EPS reported (diluted, p)	36.5	35.8	11.3	25.4	33.3
EPRA EPS (p) [2]	21.2	18.7	16.5	23.6	19.1
DPS (p)	18.5	19.0	19.0	19.0	19.0
Net cash/debt	-68.6	-82.4	-96.5	-108.6	-123.1
Dividend yield	6.7	6.9	6.9	6.9	6.9
Price/EPRA NAV	62.0%	66.2%	67.6%	66.8%	64.7%
EPRA NAV (p)	443.0	414.8	406.6	411.8	425.0
LTV (loan-to-value)	37.3%	29.9%	33.8%	36.3%	38.5%

[1] Post direct costs [2] Diluted, pre-share-based payments; *Source: Hardman & Co Research*

Real Estate



Source: Refinitiv

Market data

EPIC/TKR	**PCA**
Price (p)	275
12m High (p)	360
12m Low (p)	265
Shares (m)	45.9
Mkt Cap (£m)	126.2
EV (£m)	222.7
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

Jul'19	4Q'19 div. paid
Jul'19	AGM
1 Aug	Anticipated REIT status

Analyst

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FY19 results

Throughout, Palace Capital adds value through active asset management:

Property return ahead of benchmark

Good property returns

- Total property return was 7.1%, well ahead of the MSCI UK Quarterly Index figure of 4.6%.
- Like-for-like valuation increased by 0.5%, compared with MSCI growth in UK capital values of 0.1%.
- Palace Capital has a policy of purchasing portfolios which fit its criteria and disposing of the minority segments which do not fit. The RT Warren acquisition included some London residential assets. These have virtually all been sold – some in FY19 and some since year-end. There was a budgeted minor loss on the part-disposal of the RT Warren portfolio. As confirmed by Palace Capital with the results announcement: "We have achieved 98% of book value so far, which is well ahead of the business plan on acquisition."
- The like-for-like rental value rose 1.1% to £16.4m (the contracted rent roll was £17.7m before allowing for head rents, service charge shortfalls and empty rates).

The most important aspect, in our view, is that new leases signed were 14% above ERV

- 37 new leases were completed, at 14% above ERV (the anticipated rental value).
- FY19 saw the Acquisition of One Derby Square, Liverpool for £14.0m and Palace Capital states this comes "with considerable asset management opportunities."

Balance sheet and cashflow

- EPRA NAV of 407p was down from 415p, which takes into account the Stamp Duty Land Tax on the Liverpool acquisition as well as the reduction in the share price of the small listed investment and the loss on RT Warren non-core disposals (see above).

NAV down 2%

- Debt facilities total £145.9m, with £22.9m of cash available for investment. Hardman & Co models £5.0m gross acquisitions this fiscal year.
- The year-end loan-to-value ratio (LTV) stood at 34%.
- The average cost of debt declined to 3.3%.

Leases

Aldi showed a strong uplift

- A 17.4% uplift in rental income was secured through the re-gearing 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.

Good leases in leisure – but this remains a difficult segment

- 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; however, 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.

Recycling capital

- 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. Within the RT Warren portfolio acquired were fully let residential assets in north west London. The large majority have been sold to Barnet Council. The remainder are all expected to be sold by the end of this month. Disposals to date have been at or very near valuation and above the business plan at the time the RT Warren portfolio was acquired.

- In FY19, the major acquisition was an asset in the centre of Liverpool, bought on a net initial yield approaching 6.8%, with medium-term enhancement prospects.

- Current progress at the mixed-use scheme Hudson Quarter, York is that construction has commenced and a residential sales centre will launch in June.

- Palace Capital stated that: "As a result of the limited opportunities to acquire properties that meet our strict criteria, we held surplus cash in the year. Management took the decision to acquire a 5% holding in a listed equity investment with a strategy focussed on the regional office sector, consistent with our own."

Post year-end

REIT conversion

This is an upgrade to EPS and NAV going forward

It has been announced that REIT conversion has been recommended by the Board, following extensive professional, independent advice.

Conversion – subject to shareholder approval – is expected on 1 August 2019.

As Palace Capital states: "Conversion supports our Total Return Strategy, harnessing the core income-producing portfolio for income growth, whilst exploiting value-add and development opportunities for capital growth."

Property/lease events already achieved

FY20 already has strong financial momentum (to cash and to NAV)

- 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 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. As of 1 June, Palace Capital will bear the void costs, including business rates.

- 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.

- Asset-by-asset business plans are 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.). For FY20, we expect asset management input across the portfolio with a particular emphasis on various offices sites, including Manchester, but elsewhere too, and further at the Northampton leisure asset.

- The marketing suite for the apartments in Hudson Quarter, York, is almost complete and June will see the first batch of apartments launched for sale.

Achievements since flotation

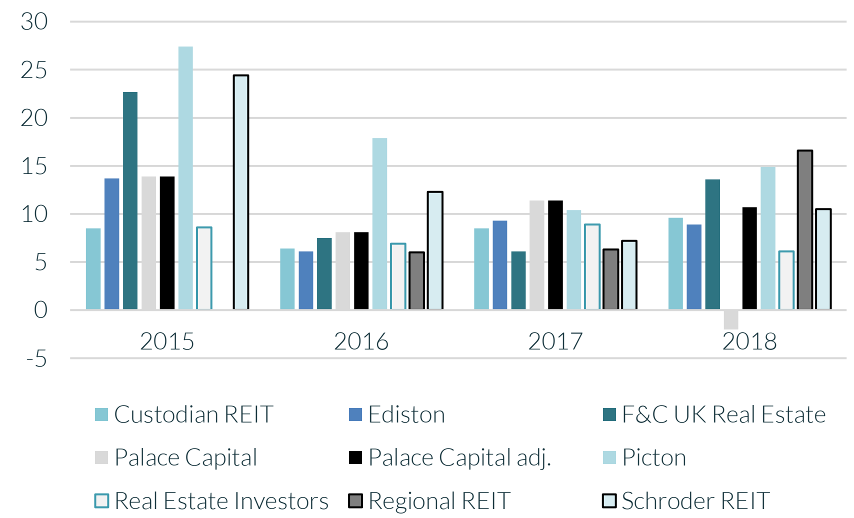
Sector-premium performance

- 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 total accounting return (TAR) has been in first or second quartile vs. our small basket of six most comparable regional UK REITs. TAR is calculated as EPRA NAV plus dividend per share. (Note that, in FY18, this excluded the distorting effect of Palace Capital equity issuance.) Not all of the 2019 sector results are in yet.
- FY19 results register a TAR of 3% for Palace Capital – slightly affected by the accounting for a significant purchase (Liverpool). Two out of the eight REITs we track as the Palace Capital peer group (to greater or lesser extents) have reported fiscal 2019 results to date. Both Picton and Schroder REIT have March year-ends. They have reported TARs, respectively, of 6.5% and 4.5%.

For 2019, Palace Capital has just reported 3% TAR

Consistently outperforming subsector

Total accounting return for comparable REITs



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

Palace Capital is 47%-invested in city-centre regional offices. This asset class has, we believe, a strong strategic upside. Regional offices' rental drivers comprise:

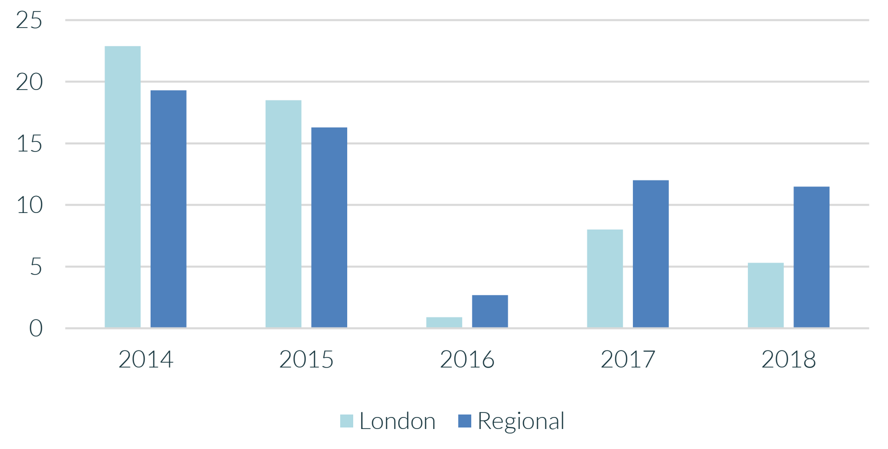
- a ca.30% reduction in real rents since 2008;
- continuing growth of regional hubs' demand, driven by value-adding employment and population emigration from London;
- reduction in supply (from permitted development, and obsolescence); and
- valuation levels remaining – location-dependent – at insufficient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

Drivers for future performance

47% of Palace Capital's assets are in regional offices. The positive absolute and relative outperformance of these assets in the past three years is set to continue. We have touched on the reduction in supply. 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/

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



Source: MSCI

FY20 onwards – good recurring earnings, driven by:

Regional office

- under-supply of regional offices;

Good geography

- underlying positive market trends in its geographical areas of major exposure;
- execution of asset management business plans;

Hudson Quarter

- execution of the Hudson Quarter, York development, which we estimate will add 20p NAV; 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.

Minimal "bad stuff"

We consider the potential in regional city-centre offices to be strong. It is noteworthy that Palace Capital has a range of assets. None are in high street or out-of-town retail apart from modest assets included as part of mixed-use assets.

Industrial holdings represent 13.1% of the total value of the portfolio. The highest rental increase Palace Capital achieved in FY19 was in Coventry where a new five-year lease saw an uplift of 32.8%. We mention this with regard to FY20 earnings drivers in the context of the forward momentum being broader than the major exposure to regional offices. Of course, rent rises in FY19 have a partial impact on FY19 full-year profits but benefit the whole of FY20. Interestingly, the Coventry tenant is a German car parts manufacturer. As Palace Capital states this "is evidence that leaving the EU is potentially not all doom and gloom." At the industrial estate in Verwood, following a refurbishment, Palace Capital completed a new letting at a rent 22.3% higher than at the time of purchase.

Palace Capital's attention to important detail is a key attribute. Office occupiers require connectivity. Palace Capital has instructed WiredScore (the market-leading trusted assessor) to assess this in all major office buildings. In Leeds, Manchester and Newcastle they are all rated Gold or better.

More on Hudson Quarter

Further detail on our estimates for the Hudson Quarter development in York are contained in our research document, *Hudson Quarter, York development commences*, published on 21 March 2019 Palace Capital demonstrates significant near-term NAV upside potential, we believe. This stems from its development of Hudson Quarter in York, due to complete in FY21. After securing and optimising planning permission, Palace Capital has started construction of the project. This is a centrally located asset in York, a strong market for such a mixed residential and commercial scheme. We estimate development profits of more than £10m, adding approximately 20p NAV, or more, depending on market conditions.

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 of Palace Capital's major retail tenants 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 stood at 34% at the end of fiscal 2019. 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. During the development of Hudson Quarter, LTV is expected to rise to manageable levels (40%), and it will ultimately reduce, 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 begins 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 – weighted average unexpired lease term – is not particularly relevant, as this is a granular investment portfolio. Assets that have reversionary potential, indeed, by definition, benefit from shorter WAULTs. Palace Capital's WAULT happens to be 4.5 years (at year-end).

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), thus 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

Revenue account

FY20E

FY20 includes the completion of London residential asset disposals. We also estimate £5m of further acquisitions. The early lease termination at Priory House, Birmingham leads to a £2.85m surrender premium added to FY20E income. 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. Apart from this, we see overall ca.2% negative like-for-like rental income, assuming a relatively unhelpful UK macroeconomic background. This includes some rises, coming from assets such as Manchester's Boulton House offices and offices in Milton Keynes, with a mix of relatively small positives and negatives elsewhere.

FY21E

The "headline" fall of £2.40m in total income includes a £2.85m reduction vs. FY20E, which received a one-off income from Priory House. We initiate estimates for FY21, today. We assume nil investment property acquisitions or disposals in this year. Note the tax charge post the REIT-conversion is nil.

FY22E

We are not currently forecasting to FY22. It is also important to note that the development of Hudson Quarter, York, is ongoing and that we fully expect first profits being taken in FY22E from disposals of residential units developed.

Finance cost: note that the York development cost is capitalised.

Revenue account

Year-end Mar (£m)	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
Rental, other income	8.64	14.59	14.27	16.73	18.75	21.00	18.60
Direct property costs	-1.20	-1.62	-2.06	-1.82	-2.32	-1.85	-1.85
Net income	7.44	12.97	12.21	14.91	16.43	19.15	16.75
Administrative expenses	-1.44	-2.05	-2.91	-4.18	-4.08	-4.00	-4.00
EPRA operating profit	6.00	10.92	9.30	10.73	12.35	15.15	12.75
Property revaluation	9.77	3.62	3.10	5.74	-0.89	0.00	6.00
Profit on disposal, transaction costs	-0.46	-0.52	3.19	0.27	-0.36	0.00	0.00
Share based payments	-0.11	-0.11	-0.24	-0.17	-0.33	-0.20	-0.20
Other income/costs	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Operating profit	15.20	13.91	15.35	16.57	10.77	14.95	18.55
Finance	-1.40	-2.26	-3.01	-3.43	-3.74	-4.00	-4.00
EPRA PBT (pre-revaluation, etc.)	4.60	8.66	6.45	7.30	8.61	11.15	8.75
Financial derivatives: change in fair value	0.00	0.00	0.00	0.00	-0.93	0.00	0.00
PBT as declared (pre-share-based)	13.91	11.76	12.58	13.31	6.43	11.15	14.75
Tax	0.00	-0.95	-3.19	-0.77	-1.26	-0.30	0.00
Deferred tax revaluations, capital allowances	0.10	0.00	2.20	0.00	0.00	0.00	0.00
EPRA PAT	4.70	7.71	5.46	6.53	7.35	10.85	8.75
EPRA EPS (p) (diluted)	26.87	31.32	21.21	18.67	16.54	23.64	19.06
EPRA EPS (p) adj. post share-based payments	26.24	30.87	20.28	18.18	15.82	23.20	18.63
EPS (p) (diluted) reported	80.00	43.90	36.50	35.85	11.26	23.64	32.14
DPS (p)	13.00	16.00	18.50	19.00	19.00	19.00	19.00
Average shares issue (m)	17.49	24.62	25.74	34.98	45.90	45.90	45.90
Year-end shares issue (m)	20.23	25.78	25.23	45.80	45.90	45.90	45.90

All EPS figures are on diluted shares. *Source: Palace Capital accounts; Hardman & Co Research estimates*

Balance sheet

Balance sheet							
As at 31 March (£m)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**	**FY20E**	**FY21E**
Investment properties	103.0	174.5	183.9	253.9	273.4	299.4	319.9
Long-term liabilities (deferred tax)	1.5	1.2	-2.1	-6.6	-5.6	0.0	0.0
Long-term debt	-36.6	-71.8	-77.7	-98.8	-119.4	-128.4	-142.4
Net current assets, excluding financial	0.3	-3.5	-3.7	-3.3	-2.7	-3.0	-3.0
Assets held for sale	0.0	0.0	0.0	21.7	11.7	0.0	0.0
Cash, deposits, short-term debt	11.9	6.3	9.1	16.3	22.9	19.8	19.4
Net cash (debt/finance lease)	-24.7	-65.4	-68.6	-82.4	-96.5	-108.6	-123.0
Net assets (NNNAV)	80.0	106.8	109.6	183.3	180.3	187.8	193.9
EPRA net assets	80.0	106.8	111.8	190.0	187.1	189.0	195.1
NAV/share (p)	395.6	414.3	434.2	400.2	392.8	409.2	422.3
EPRA NAV/share (p)	395.6	414.3	443.0	414.8	406.6	411.8	425.0
LTV	24.0%	37.5%	37.3%	29.9%	33.8%	36.3%	38.5%

Source: Palace Capital accounts; Hardman & Co Research estimates

Potential, deferred corporation tax liabilities for potential capital gains tax have now – subject to shareholder approval – been extinguished under the REIT regime status.

Cashflow

Cashflow							
Year-end Mar (£m)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**	**FY20E**	**FY21E**
Cash from operations	4.4	12.3	10.3	9.9	13.6	15.2	12.8
Finance	-1.6	-3.4	-2.5	-2.7	-4.6	-4.0	-4.0
Tax	0.0	-0.2	-1.1	-0.4	-2.0	-2.0	0.0
Net cash flow from op. activities	2.8	8.7	6.7	6.8	6.9	9.2	8.8
Acquisitions/disposals/lease break premiums	-0.4	-48.4	1.2	-65.0	-4.6	11.0	0.0
Refurbishment (capitalised)	-2.5	-1.2	-4.6	-2.8	-3.0	-3.5	-0.5
Major development (Hudson)	0.0	0.0	0.0	0.0	-1.9	-20.0	-14.0
Free cashflow operation and investment	-0.1	-40.9	3.4	-60.9	-2.6	-3.4	-5.8
Share issue	19.7	19.1	-2.2	67.7	0.0	0.0	0.0
Shares to fund asset purchases	-29.0	-15.7	0.2	-13.7	0.0	0.0	0.0
Dividends	-1.8	-3.2	-4.6	-6.7	-8.7	-8.7	-8.7
Other	0.0	0.0	0.0	0.0	-2.8	0.0	0.0
Net cash change	-11.2	-40.7	-3.3	-13.7	-14.1	-12.1	-14.5
Net financial position	-24.7	-65.4	-68.6	-82.4	-96.5	-108.6	-123.0

Source: Palace Capital accounts; Hardman & Co Research estimates

FY20E

No acquisitions assumed – disposals made since year end

Note the £11.0m disposals cash inflow is largely achieved already, namely the balance of the RT Warren residential asset disposals. Headroom is available for acquisitions.

FY21E

Note, with regard our cashflow estimates, that FY21 assumes significant further investment into the development at the Hudson Quarter, York site. Some forward sales are anticipated to be taken in FY21. Any cash received from such transactions is not taken into account in our estimates – as we expect it would be retained in blocked accounts by solicitors pending completion. Completion is anticipated from early FY22.

FY21E includes £14m outflow for the York development and we estimate this is the total (gross) outflow on this project to completion.

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(Disclaimer Version 8 – Effective from August 2018)

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