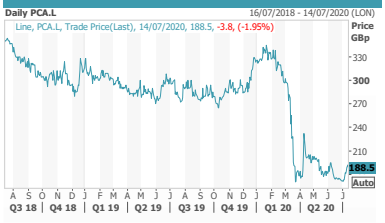
Real Estate



Source: Refinitiv

Market data

EPIC/TKR	**PCA**
Price (p)	**181**
12m High (p)	350
12m Low (p)	165
Shares (m)	46
Mkt Cap (£m)	83
EV (£m)	187
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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www.palacecapitalplc.com

Key shareholders

Directors	5.0%
AXA	7.7%
Miton	7.4%
J.O. Hambro	7.3%
Stanley Davis (Chairman)	3.6%

Diary

Aug'20	AGM
Nov'20	Interim results

Analyst

Mike Foster 020 7194 7622
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PALACE CAPITAL

Encouraging full-year results

The healthy liquidity position of Palace Capital takes risks down to a modest level, as does the overweight to regional offices and minimal shops. The Hudson Quarter mixed-development site is selling well, and profitability remains at appraisal levels. Hudson Quarter is within the York city walls, has been selling well and is a material positive, set to generate approaching £70m cash for recycling investment. The current returns from this count for zero in reported numbers or forward estimates this year. Even after having devoted significant resource to this successful site, the income yield is above the market average, and with below-market risk.

- **FY'20 results:** 84% of rents due end-June are paid (or being paid monthly), on time. 93% of March rents are now in. Unsurprisingly, asset values are down but, from here, we expect stable valuations at Palace Capital's office assets. Some new lettings are taking place. Asset total return outperformed the benchmark.
- **Robust balance sheet:** Year-end loan to value (LTV) stood at 38%. Loan covenants are fully compliant. £20m gross cash is held, with no facilities maturing until 2022. By that point, Hudson Quarter will have generated significant cash for reinvestment, thereby enhancing ongoing income.
- **Valuation:** This is a strongly positioned regional REIT. The regional peer group tends not to undertake development, which we see as a Palace Capital upside, but the market does not price as such. Price to historical NAV for Palace Capital is 31ppts below the (unweighted) average for the regional REIT universe.
- **Risks:** LTV is set for ca.40% at the peak of the apartment and office development project within York city walls. The latter can be retained or sold, thereby ensuring enhanced income, as well as reduced debt. Current markets are uncertain, and Palace Capital has not commented on calendar 2020.
- **Investment summary:** A comparison with the sector is straightforward. The sectoral and regional exposures point to outperformance in capital values, rental change and total returns. The value uplift and cash-generation benefits from the 13.6% of the portfolio in development assets are clearly visible, but not reflected in the accounts. The balance sheet remains robust.

Financial summary and valuation

Year-end Mar (£m)	2017	2018	2019	2020	2021E
Net income*	12.2	14.9	16.4	18.8	14.9
Finance cost**	-3.0	-3.4	-3.7	-4.3	-3.8
Declared profit	12.6	13.3	6.4	-9.1	6.6
EPRA PBT (adj. pre-reval'n.)	6.4	7.3	8.6	10.2	7.1
EPS reported (diluted, p)	36.5	35.8	11.3	-11.8	14.3
EPRA EPS (p)***	21.2	18.7	16.5	23.4	15.4
DPS (p)	18.5	19.0	19.0	12.0	10.5
Net cash/debt	-68.6	-82.4	-96.5	-104.4	-123.8
Dividend yield	10.2%	10.5%	10.5%	6.6%	5.8%
Price/EPRA NAV	40.8%	43.7%	44.5%	49.7%	49.1%
EPRA NAV (p)	443.0	414.8	406.6	364.2	368.9
LTV	37.3%	29.9%	33.8%	37.9%	41.6%

**Post direct costs, **Excluding fair value changes, ***Diluted, pre share-based payments*
Source: Hardman & Co Research

Table of contents

Financial results

Year to March 2020

Earnings growth last year

The company achieved a 41% uplift in EPRA EPS to 23.4p in the year to March 2020 (March 2019: 16.6p). This included a £2.9m one-off credit due to an early lease termination (pre COVID-19). It reflects 195% cover of 12.0p dividends announced and paid for the full year.

Rent collection good, under COVID-19 circumstances

Currently, 93% of rent due end-March 2020 has been collected, or is being paid on time under freshly agreed deferral schedules. 84% due end-June is collected or being paid on time, monthly.

The 3Q'20 dividend was cancelled to manage liquidity at the height of lockdown, but a 4Q'20 final dividend of 2.5p is proposed.

Three years' running total property return ahead of MSCI benchmark

Assets outperformed. Although valuations across the industry were hit as a result of COVID-19, total property return, at 1.1%, remained ahead of the benchmark, which was -0.5%. Therefore, on a relative basis, the REIT has outperformed for three successive years now. Nonetheless, EPRA NAV reduced to 364p from 407p at the previous year-end. The portfolio like-for-like value fell 5.7%.

Important Hudson Quarter mixed development selling well, and at 100% budgeted asking prices

The sales rate at Hudson Quarter has slowed, but prices are running at launch-date appraisal levels. As at 30 June (i.e. into the current fiscal period), 25% of the 127 apartments are sold. A further five are under offer. We are minded to maintain estimated profits on this development at £10m. This is ca.60% of the value of the site before construction commenced, and is ca.15% of the profit margin on GDV (gross development value).

Balance sheet leeway

There is a stable balance sheet, with cash and debt facilities totalling £153.7m: £120.8m of debt drawn at year-end, with a further £32.9m available and undrawn. The July covenant tests are set to be confirmed too, with no adjustments or discussions needed. Cash and available facilities total £42.7m, with capital commitments of £15.8m, so net liquidity stands at £26.9m, which is 3.8 years' interest plus overheads.

The revolving credit facility with NatWest increased to £40.0m in August 2019, and extended for a further five years at a lower margin, providing additional flexibility.

LTV was 38% (March 2019: 34%), and the weighted average interest rate reduced from 3.3% to 3.1%.

The company achieved 18 lease renewals, and completed seven rent reviews at an average of 4% above estimated rental value (ERV) and a 25% uplift on previous passing rents. There were 22 new leases, providing £1.2m of additional annual income, including 23,500 sq. ft. at Sol, the leisure scheme in Northampton, to Gravity Fitness for a minimum term of 10 years, at a 20% premium to ERV.

Major institutional shareholders have been adding to holdings in recent weeks.

Financial prospects

The year to March 2021

Overview

Very importantly, we exclude significant latent Hudson Quarter profit from our FY'21 estimates

For the purpose of taking a conservative view, we exclude the significant latent Hudson Quarter profit from our FY'21 estimates. This is anticipated at £10m or more. Further, it releases cash and enhances ongoing future earnings.

This year will see some filling of recently refurbished space, and strong progress at Hudson Quarter will continue. The former will underpin the FY'21 numbers, and the latter will progressively evolve in FY'21 to becoming a done deal by 1Q'22. This would be expected to materially underwrite an improvement in investor sentiment as calendar 2020 progresses, with the Hudson Quarter development being the key to taking EPRA EPS sustainably over the historical 19p per share dividend levels achieved.

New lettings already have been achieved

- New letting has already occurred this fiscal year, albeit on a modest scale. An active year of new lettings of recently refurbished space is in prospect, which will grow income. Our estimates take account of the negative effects of COVID-19, but make no material assumptions on further net new letting. Our net rental income estimate includes more than £2.0m in void costs.

Other potential development...

- There is a development pipeline within the portfolio, which Palace Capital is looking to tap into over the next few years. There is no benefit on the face of the accounts until FY'22. This includes Weybridge High Street, where planning is in place for 28 residential units on an asset currently held vacant. We expect commencement next year, but timing is under Palace Capital's control.

...on top of successes at Hudson Quarter

- Spring 2021 remains the anticipated practical completion date for the Hudson Quarter York development. This will trigger the completion of sales of apartments on which contracts are exchanging, bringing substantial cash onto the balance sheet. Our estimates assume this takes place in the weeks after the March 2021 year-end; thus end-March 2021 is peak debt on the balance sheet.
- Palace Capital is expecting to continue at or above the 2.5p (4Q'20) quarterly level for FY'21. We therefore estimate 10.0p for FY'21, but see scope for slightly more, particularly as Hudson Quarter prospects continue to roll out.

Detail components to our estimates

COVID-19 impact

We are reducing income expectations this year by £1.0m, which is 5.7% of the historical rental income. This reduction includes a £0.15m rise in general bad and doubtful debt provision. £0.55m of the £1.0m pertains to FY'21 only (indeed, it pertains to the period from end-March 2020 to end-calendar 2020 only).

With around 200 tenants, there are a range of discussions, but the half of the portfolio in offices is well placed in a sector outperforming the average for real estate and also in terms of the actual office assets held. These are city central and at affordable rents. Several have alternative uses or development potential. The position in industrial is strong. Retail exposure is particularly low – apart from a small number of retail parks with tenants such as Booker, Pets at Home and Wickes. There are two significant leisure assets and, here, the macroeconomic background challenges more.

There have been two tenants vacating, one (a restaurant) into a company voluntary arrangement (CVA), and one a new letting. The net effect of this is a ca.£0.4m p.a. income reduction, a notable element of which is void costs, such as rates and service charges. We discuss temporary rent reductions and temporary deferrals below, but

Hardman & Co estimates include a loss of 5% of rent for half a year as a conservative take on the likely outcome. This equates to £0.45m, and is in addition to the figure of £0.4m for additions to voids and the one CVA. In addition to these figures, we note that there is a one-off increase on a bad debt provision of £0.15m.

Sectoral prospects

Office assets well placed geographically and regarding price points

The company's office assets are well placed. It is too early to tell regarding the level of the market for new lettings in offices owned by Palace Capital, but the space is well located, typically around £20 sq. ft. (vs. up to and over £30 sq. ft. for newest class A space in these locations), and is appraised by external valuers as having reversionary potential. The "big picture" is of well-located assets letting well in the pre-COVID-19 environment, and well placed to maintain this, particularly in a world where tenants may want a good location but also the affordability to take lower-density desk space at affordable rates. This is assisted by a general economic policy aimed at fostering growth outside London, which plays exactly to Palace Capital's strengths.

Large industrial exposure

Industrial assets are well placed, and the market is seeing rent increases here.

Leisure more problematic but far less than other REITs' experiences here

Leisure calls for a detailed assessment, and we attempt to provide this below.

Exposure to retail is limited to two retail warehouses, an Aldi supermarket and small retail units as part of mixed assets. The retail shops, of which there are few, are generally let at very modest levels.

There is one live development asset – Hudson Quarter, inside the York city walls – but there are others to come shortly, when Palace Capital deems the moment right.

COVID-19

84% rent collection from end-June

Currently, 84% of the end-June 2020 rent due is paid, including payments being made under monthly (as opposed to quarterly) schedules. This is a better performance than the end-March quarter rent payment, although rents have now come in to a most satisfactory degree. As noted, 93% of rent due end-March 2020 has been accounted for. On 1 April, 70% of those rents had been collected (including monthly arrangements), which rose to 80% collected by 20 April.

One CVA of note

There has been one notable CVA, namely The Restaurant Group, affecting one location. This costs ca.0.8% of annual rental income, which is a figure including the cost to Palace Capital of the void in terms of business rates and service charges. There are no meaningfully sized tenants that are not engaging with Palace Capital, and there have been examples of lease extensions taking place.

Leisure is a presence but not a dominant driver to prospects. We would categorise about two thirds of tenants within this segment as fully on schedule, a tenth either CVA or in an uncertain position regarding rent from end-March to the early-July opening up, and the remainder all in good discussions – and either deferring or paying at reduced amounts. With the exception of the need to fill the space left by the demise of The Restaurant Group, there is every indication that leisure will be fully back on rent income track by this autumn. Naturally, there has been an element of rent-free periods, and possible assistance to enhance the physical asset for some occupiers, but the majority of rent affected is deferred, and ultimately likely and anticipated to be paid in full.

Strong roster of leisure tenants (bar one CVA)

Leisure tenants include Vue cinemas, Accor hotels, associated car parking, Wetherspoons, and various gym and restaurant assets, as well as the NHS. Vue is paying consistently and anchors both assets. Accor is also paying well, and we believe the group has been maintaining plans to expand in the UK. Wetherspoons is a good payer, and the NHS is strongly placed. The car park (Apcoa) is paying, but at a reduced level. This reduced level is specific to the closed assets and, as of the start of July, the position has changed for the better across England in that regard. Around a third of leisure assets are restaurants and gyms. The significant fitness centre is Gravity Fitness, a recent tenant that was already enjoying an initial rent-free period, which, as it turns out, has benefited both parties to the lease through this difficult time. We understand that Gravity was achieving good traction in terms of members in the two weeks it was open as a tenant pre lockdown – so it is in a strong position.

Clearly, the current markets are uncertain, and Palace Capital has not commented on calendar 2020. Being overweight to offices provides relative resilience. Retail exposure – other than as a mixed component – is limited, and shops are let at low rents, and so sustainable. Retail parks' tenants are Booker, Pets at Home and Wickes. The 13.6% leisure exposure is more significant, and values are currently under pressure as a result of COVID-19 and tenants not being able to operate. The main tenants comprise Vue and Wetherspoons, both whereby the covenant is strong and we consider the interaction positive.

Top 10 occupiers

Top 10 occupiers

Occupier	Annual rent
Vue	£913,104
Rockwell Automation	£543,617
Accor Hotels	£510,000
National Lottery	£444,413
Brose	£431,500
Eldon	£408,978
Wickes	£401,405
Blake Morgan	£360,000
Exela	£355,363
Apcoa (car park)	£345,000

Source: Hardman & Co Research

Apcoa is part of the Palace Capital 100%-owned central Halifax leisure asset.

The year to March 2022

FY'22 shaping up to be major positive, but we hold our fire on quantification

We are not, at this point, reinstating estimates for FY'22. We would confidently summarise a number of points, however.

- FY'22 rental net income should exceed FY'21 by some margin.
- FY'22 will see the financial benefit of the successful (i.e. profitable) completion of Hudson Quarter at the start of the fiscal period.
- Completion of Hudson Quarter brings cash, profit and "optionality". Palace Capital has options open to it, including paying down debt to the tune of reducing net debt to broadly half historical levels, but more likely a mix of debt reduction and recycling of capital, which enhances the income line.
- This puts Palace Capital on the path to achieving ongoing earnings per share in the following year – March 2023 – exceeding the 19p per share level of the historical dividend.

As we wrote in our 6 April 2020 research report, *Trading update and COVID-related dividend cut*, there is a "clear map back towards fully covered dividends" and this represents full cover on the 19p historical level. It is clear that 19p will not be

achieved this year or next. As to 2023, 19p is not a dividend aspiration we would care to state. What we would state, however, is that two clearly visible factors combine to bring 19p EPRA EPS into view as a more-than-plausible aim. The two factors are an anticipated rental income no lower than our confident FY'21 level, combined with the benefits of recycling capital from the confidently anticipated completion of Hudson Quarter. If only a portion of this development's free cash is reinvested on 6% NIY (net initial yield) with a modest element of gearing, ca.£2.0m additional ongoing rental income is generated after interest costs.

Beyond that – visible path to 20p EPRA EPS and more

This would take Palace Capital comfortably to above its previous all-time high of EPRA post-interest profits, equating to – in round terms – 20p EPRA EPS on a sustainable, progressive basis, we estimate.

A regional property REIT

The total return strategy at Palace Capital is supported by a balanced portfolio, in terms of both income-producing assets and opportunities for capital growth through refurbishment and redevelopments. There is a significant regional weighting to the north of England, with a presence also in the Midlands and southern locations. The government's "levelling up" agenda will only benefit the company's tenants and portfolio as a result.

Strategic capital expenditure is not necessarily reflected in increased values until the properties are completed and let or sold. The developments are set to achieve strong profitability at current prices and sales rates, but this is reflected in the accounts only from FY'22 onwards, we estimate.

Strategy and current positioning

Regional assets

Strategy to achieve good rental yields, weighted to robust asset classes, and also enhance NAV through asset management and development

Palace Capital invests and develops commercial real estate in the UK regions, with a preponderance in the north of England, and to the south west of London and Milton Keynes. While its mandate is not sector-specific, it does exclude central London locations, and 46% of assets are offices, with industrial as the second-largest segment, at 14%. Leisure also stands at ca.14%. It is well underweight in retail, with no shopping centres. With higher-than-market income yields and a strong reversionary potential, they provide a strong base to allocate some assets to development.

Asset positioning better than average market mix

Just under half in offices; 62% in offices and industrial

Strong development under way...

...and more to come at management's choice

74% of assets are office, industrial or under development. Leisure, at 13.6%, comprises two large assets; 3.8% retail warehouse and 8.6% retail. Much of retail is the ground-floor part of mixed-use assets. The development site at York Hudson Quarter is a significant proportion of development properties, and there are other assets, which have either significant future development potential (the 75,000 sq. ft. central Manchester office) or are smaller sites set to receive redevelopment go-ahead at the appropriate time, e.g. Weybridge High Street redevelopment to residential (www.palacecapitalplc.com/portfolio).

Four strategic pillars

Palace Capital has four strategic benefits: i) sectoral and regional exposure is strong; ii) there are development opportunities to optimise income and capital values; iii) the balance sheet is strong and strengthening further via development sales; and iv) in the medium term, value-creating opportunities are evident.

Regional offices are by far the largest component

More detailed projections (consensus) on offices and regional, in particular

Palace Capital's sectoral and regional exposure, headed up by regional offices, points to potential market outperformance in capital values, rents and total returns. The office property yield differential between London and the regions remains above average, and regional supply is diminishing. As just one example on supply reduction, Liverpool alone (one of Palace Capital's top 10 asset locations) has seen 1m sq. ft. of offices converted to residential (including student) in the past five years.

Office markets in 2019 saw non-London total returns outperform both London West End and London City. A year ago, the Investment Property Forum (IPF) consensus was a 2020 total return of 3.1% non-London and 2.7% London – not a great difference, but still one where regional growth outpaces London.

Outperforming in all years – up or down

IPF consensus forward valuations – May 2020 basis

(%)	Rental value growth			Capital value growth			Total returns		
Sector	2020	2021	2022	2020	2021	2022	2020	2021	2022
Office	-5.4	0.3	2.3	-9.5	1.4	4.9	-5.5	5.9	9.3
Industrial	-2.9	1.1	2.4	-7.1	2.9	4.7	-3.0	7.7	9.4
Standard retail	-10.7	-3.4	-1.4	-19.8	-1.8	1.2	-15.5	3.8	6.6
Shopping centre	-12.0	-5.0	-3.0	-24.7	-4.6	-2.7	-19.7	2.2	4.1
Retail warehouse	-9.6	-2.7	-0.5	-20.2	-1.1	1.1	-14.6	6.1	8.3
All property	-6.3	-1.3	0.8	-12.4	0.2	2.9	-8.1	5.3	7.9
London West End office	-5.9	0.7	3.3	-10.2	2.3	8.2	-7.1	5.9	11.8
London City office	-6.6	0.2	3.7	-9.9	2.0	7.5	-5.9	6.3	12.1

Source: IPF

The latest IPF data (collected from March to May this year) sees a regional 5.5% fall vs. a 6.5% average London decline. Although these are negative numbers, again the regional outlook outpaces London.

Developments and potential developments: in control

Hudson Quarter, within York city walls

Developments constitute 13.6% of the portfolio and are well placed. The prestigious mixed-use development at Hudson Quarter, inside the York city walls, comprises 35,000 sq. ft. of offices, 5,000 sq. ft. of commercial space and 127 apartments. Marketing and sales launched in June 2019. As at 30 June, sales contracts had been exchanged on 32, with a further six under offer. The original cost, several years ago, was £3.8m, as part of a non-core Quintain portfolio. The value of the site, once planning consent was granted, totalled £16m. GDV is assessed at £69m, and there is strong potential for a £20m cash-on-cash return to exit. Palace Capital is likely to choose to retain the office element – thus enhancing ongoing income significantly, and improving dividend cover and NAV. The site's location means that there is no comparable competition. Early office lettings, plus residential sales, indicate as much.

£20m cash-on-cash returns realistic to anticipate from acquisition cost. Completion likely summer 2021.

Manchester office: to date, 44% rise in valuation been achieved

2024 could see continuing use as is, or possible doubling in floorspace

The Manchester office is an interesting case study, highlighting three aspects of the REIT's investment style. The acquisition price, at £150 sq. ft., reflected the previous owner under-investing and significant voids. Steady progress has been made on occupancy at this very central site, at rents that have risen steadily but still offer strong value for the location: at up to £20 sq. ft. It comprises 75,000 sq. ft., and Palace Capital has arranged leases to look to get possession in 2024, with an eye to potentially redevelop. The car park is hardly used, so could either add to tenant attraction – in a "new normal" if car commuting rises – or could be a space for building on, doubling the floorspace. Palace Capital has plenty of options to add to value, and is in control of timings, having already created value.

At Manchester and Weybridge, timing in Palace Capital's hands, and prospects encouraging

The Weybridge High Street asset has achieved consent for 28 apartments, with a potential 2021 start and £13.5m GDV. As with Manchester, the REIT has "optionality" in its tactics. It can wait, or it can press ahead once markets settle. Neither of these upsides is reflected in valuations.

As to loan covenants, a 20% valuation fall would have to take place before "repairs" to any covenants would be needed. Palace Capital has £20m gross cash available.

Investment conclusions

Rent collection: successful focus

- 2020 is a difficult year for the sector and, although Palace Capital cut its 3Q'20 interim dividend, 93% of rentals due end-March 2020 are either paid or on agreed schedules.

Risk/reward balance was, and very much remains, significantly ahead of that of sector

- Pre and post COVID-19, the income yield is above the market average, and with below-market risk. The risk is below-market because of the macro-sector positioning but also because care has been taken to secure sites in the right micro-location. The balance is city-centre, well-connected sites in cities with above-average graduate employment profiles.
- The positioning is significantly overweight to offices and also industrial. Both sectors are set to outperform the wider market in each of the coming years, as they did in 2019 (IPF consensus).

Northern powerhouse

- Not only are sectoral weightings propitious, but the exposure to the regions – particularly north of England – is a positive, we believe.

Outperformed long term

- Management has created value, with total accounting returns since the 2013 launch outperforming the sector average. In this report, we have touched, in a limited way, on some of the development projects, and all reduce risk and add value, we consider. Hudson Quarter has been selling well, and the location alone means that there is no comparable competing site. The share price reflects more on the risk than the reward of development.

In control of events

- On other potential development sites, Palace Capital is in control of the timing, configuration and decisions of how best to adapt to future market conditions.

"Working" the portfolio

- Part of value creation is asset management, which includes the optimisation of rent, and, at times, this means deliberately holding back space. This space is readily lettable, providing upside in due course to the income stream. Typical is a city-centre Leeds office, with the Bank of England as one of the tenants. Management is taking care to optimise the reversionary potential in the portfolio, identified by the valuers at the previous results (to September 2019).

Risks and mitigation – sector exposure

The risk and reward

SWOT analysis	
Strengths:	The asset management plans bring NAV upside potential, as well as the sectoral and geographical strength on the income front.
Weaknesses:	The 2020 outlook is unclear; estimates are withdrawn (written pre-results).
Opportunities:	Upon completion, Hudson Quarter will benefit NAV, and the net debt and income line.
Threats:	2020 cashflow is under pressure from COVID-19-related issues. Debates about "death of the office" ignore the possibility of moves into lower-cost, well-connected, lower-rise, lower-density city-centre regional assets.

Source: Hardman & Co Research

COVID-19 pandemic problems main current risk

COVID-19 pandemic problems are the main current risk. This has led to cashflow delays – smaller or larger – at effectively all tenants. We have discussed this in a number of aspects of this research, so all we point to here is our twofold strong expectation. First, covenant tests are unlikely to be enforced to the letter across the sector this year. Secondly, a 40% rent fall, on average, would be required to cause material breaches.

Palace Capital's exposure to offices stands at over 46% (MSCI index weight 29.5%).

No individual 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.

The LTV ratio stood at 38% at the end of fiscal 2020. We believe the broad target LTV is 35%-40%, but assuming that York's HQ proceeds to plan with a physical build completion in spring 2021, the LTV on completion and exit of the York development will be ca.30%. During the development of HQ, LTV is expected to rise to manageable levels (40%), and it will ultimately reduce, through the value uplift and residential sales.

All real estate sector investment brings location risk. Palace Capital mitigates this. It excludes London, and chooses central, accessible locations with good underlying demand. We view these as assets with robust residual values, not simply good leases.

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). This is the nature of the value-adding asset management policy. At times of market

disruption, as per 2020, “freshening" of assets is particularly important. The process itself is, at times, disruptive – so a careful balance has to be kept, as well as a close eye on cash management.

In the next two years, no bank facilities will mature.

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 5.2 years to tenant break option (at period-end). Leases coming to an end in 2020, however, may well prove a risk on timing. As a matter of negotiation, FY’21 may well see voids drift slightly up.

Leisure might be considered a sector under pressure, and here the leases are mostly of long duration. The Northampton asset, in particular, has asset enhancement programme plans, to widen the catchment area. Its WAULT is longer than the group average. Notably, in February, a 15-year lease was signed by a new yoga fitness tenant. It has a 10-year term to first-break option, with 10 months rent-free.

Financial performance and estimates

Revenue account							
Year-end Mar (£m)	2015	2016	2017	2018	2019	2020	2021E
Rental, other income	8.64	14.59	14.27	16.73	18.75	21.15	17.60
Direct property costs	-1.20	-1.62	-2.06	-1.82	-2.32	-2.39	-2.70
Net income	7.44	12.97	12.21	14.91	16.43	18.76	14.90
Administrative expenses	-1.44	-2.05	-2.91	-4.18	-4.08	-4.18	-4.00
EPRA operating profit	6.00	10.92	9.30	10.73	12.35	14.58	10.90
Property revaluation	9.77	3.62	3.10	5.74	-0.89	-18.33	0.00
Profit on disposal, transaction costs	-0.46	-0.52	3.19	0.27	-0.36	-0.14	0.00
Share based payments	-0.11	-0.11	-0.24	-0.17	-0.33	-0.13	-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	-4.02	10.70
Finance cost	-1.40	-2.26	-3.01	-3.43	-3.74	-4.34	-3.80
EPRA PBT (pre-revaluation, etc.)	4.60	8.66	6.45	7.30	8.61	10.24	7.10
Financial derivatives: change in fair value	0.00	0.00	0.00	0.00	-0.93	-0.84	-0.50
PBT, as declared (pre share-based)	13.91	11.76	12.58	13.31	6.43	-9.07	6.60
Tax	0.00	-0.95	-3.19	-0.77	-1.26	3.63	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	13.87	7.10
EPRA EPS (p) (diluted)	26.87	31.32	21.21	18.67	16.54	23.40	15.41
EPRA EPS (p) adj. post share-based payments	26.24	30.87	20.28	18.18	15.82	23.12	14.98
EPS (p) (diluted) reported	80.00	43.90	36.50	35.85	11.26	-11.84	14.33
DPS (p)	13.00	16.00	18.50	19.00	19.00	12.00	10.50
Average shares issue (m)	17.49	24.62	25.74	34.98	45.90	45.95	46.07
Year-end shares issue (m)	20.23	25.78	25.23	45.80	45.90	46.07	46.07

Note: all EPS figures are on diluted shares
Source: Palace Capital accounts, Hardman & Co Research estimates

Our 2021 estimates comprise a reduction in net rental income (post direct costs, such as voids and service charges) to £15.0m, from £18.76m in 2020. The reduction includes the absence in 2021 of the one-off 2020 lease surrender premium received of £2.85m. It also includes a further reduction of £1.0m from COVID-19 and market movements, which we analyse in the body of this report. COVID-19 included a CVA, and market movements include a rise in net voids. In 2022, we expect the rise in voids to reverse, as well as significant profits from the Hudson Quarter completion, which is expected for 1Q'22.

The 3Q'20 dividend was not paid, and 4Q'20 saw a reduction to 2.5p. For 2021, we expect three dividends at 2.5p and – a Hardman & Co estimated – 4Q'21 at 3.0p. By that point, the outcome at Hudson Quarter will be, to all intents and purposes, already achieved, and we predict continued success.

Balance sheet

Balance sheet							
@ 31 Mar (£m)	2015	2016	2017	2018	2019	2020	2021E
Investment properties	103.0	174.5	183.9	253.9	273.4	275.6	297.6
Long-term liabilities (deferred tax)	1.5	1.2	-2.1	-6.6	-5.6	-0.3	0.0
Long-term debt	-36.6	-71.8	-77.7	-98.8	-119.4	-117.5	-137.5
Net current assets, excluding financial	0.3	-3.5	-3.7	-3.3	-2.7	-4.6	-5.0
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	13.1	13.7
Net cash (debt/finance lease)	-24.7	-65.4	-68.6	-82.4	-96.5	-104.4	-123.8
Net assets (NNNAV)	80.0	106.8	109.6	183.3	180.3	166.3	168.8
EPRA net assets	80.0	106.8	111.8	190.0	187.1	167.8	170.0
NAV/share (p)	395.6	414.3	434.2	400.2	392.8	360.9	366.3
EPRA NAV/share (p)	395.6	414.3	443.0	414.8	406.6	364.2	368.9
LTV	24.0%	37.5%	37.3%	29.9%	33.8%	37.9%	41.6%

Source: Palace Capital accounts, Hardman & Co Research estimates

Potential, long-term deferred corporation tax liabilities on capital gains have been extinguished, following the conversion to REIT regime status last year.

Finances – balance sheet and cashflow

Finance for HQ is ringfenced, and it will generate significant cash in FY'22 (start FY'22, we estimate). We understand that peak capital employed exceeds £65m. This all unwinds on practical completion, which we expect at April 2021. The construction completion was due in January 2021, and delays are specifically COVID-19-related. Work on site has continued – following all guidelines. Our estimate is for completion in April 2021.

The LTV, which we estimate at 41.6% end-March 2021, should therefore be the peak level. Sales completions take place once the practical completion is achieved. It should be noted that cashflow is neutral, other than this HQ outflow, and that HQ is fully financed by the Barclays development facility. Thus, the cash held (i.e. excluding long-term funded debt) stays broadly unchanged. We do not expect any facilities' covenants having to be addressed. Were the need to arise, there are substantial resources held to effectuate this. Note that the net cash figure quoted in the balance sheet table above is exactly that. That is to say, there is a higher level of gross cash, but there are also some short-term financial debts, leaving net cash as stated.

The NAV is estimated to rise modestly, as a function of earnings being somewhat ahead of dividends paid.

For cashflow, see overleaf.

Cashflow

Cashflow							
Year-end Mar (£m)	2015	2016	2017	2018	2019	2020	2021E
Cash from operations	4.4	12.3	10.3	9.9	13.6	15.7	11.9
Finance	-1.6	-3.4	-2.5	-2.7	-4.6	-3.6	-3.8
Tax	0.0	-0.2	-1.1	-0.4	-2.0	-2.2	0.0
Net cash flow from op. activities	2.8	8.7	6.7	6.8	6.9	9.9	8.1
Acquisitions/disposals/lease break premiums	-0.4	-48.4	1.2	-65.0	-4.6	1.2	0.0
Refurbishment (capitalised)	-2.5	-1.2	-4.6	-2.8	-3.0	-6.1	-2.0
Major development (Hudson)	0.0	0.0	0.0	0.0	-1.9	-3.9	-20.0
Free cashflow operation and investment	-0.1	-40.9	3.4	-60.9	-2.6	1.1	-13.9
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	-5.5
Other	0.0	0.0	0.0	0.0	-2.8	-0.3	0.0
Net cash change	-11.2	-40.7	-3.3	-13.7	-14.1	-7.9	-19.4
Net financial position	-24.7	-65.4	-68.6	-82.4	-96.5	-104.4	-123.8

Source: Palace Capital accounts, Hardman & Co Research estimates

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