EDISON

Palace Capital

HQ completion opens strong growth opportunity

FY21 results update

Real estate

Palace Capital's (PCA) FY21 results were robust, with a clear improvement in the second half. With a good level of rent collection continuing, Q421 DPS was increased by 20%, to a level that management hopes to at least maintain through FY22. Importantly, the flagship Hudson Quarter (HQ) development in York completed in April, on budget. We expect HQ to be a significant driver of forecast increasing returns and deleveraging.

Year end	Net rental income (£m)	Adj PBT* (£m)	Adj EPS* (p)	EPRA NTA/ share (p)**	DPS (p)	P/NTA (x)	Yield (%)
03/21	14.9	7.5	16.4	350	10.5	0.74	4.0
03/22e	14.2	6.6	14.3	366	12.0	0.71	4.6
03/23e	15.2	7.5	16.4	385	14.0	0.68	5.4
03/24e	17.6	9.8	21.3	401	18.0	0.65	6.9

Note: *Adjusted for revaluation gains and non-recurring items. **EPRA NTA is fully diluted.

Robust earnings and DPS recovering

FY21 adjusted PBT of £7.5m, including a £0.9m receivables provision, exceeded our forecast, with H221 improving to £4.5m vs £3.1m in H121. With strong and consistent rent collection continuing, the Q421 DPS was increased to 3.0p, the minimum pay-out that management expects through FY22. End-FY21 EPRA NTA per share was 350p (end-FY20: 364p) but also improved in H221 (from 347p at end-H121) as the net like-for-like decrease in property valuations slowed from 3.5% to 0.5%. With HQ residential sales beginning to complete, and the £30m non-core asset disposal programme proceeding well, we expect the end-FY21 gearing (LTV of 42.0%) to represent the peak level; despite forecasting £40m of reinvestment, we forecast a prospective LTV of little more than 30%. Our FY22 adjusted PBT forecast is unchanged but increases for FY23 with further growth reflected in our tentative FY24 forecast. We expect DPS growth to follow earnings. Forecast EPRA NTA per share increases in each year, in part reflecting FY21 performance.

HQ completion to unlock embedded value

PCA has a range of opportunities to optimise both income and capital values in various market conditions over the medium term. The £20.6m end-FY21 estimated rental value (ERV) of the portfolio was £4.1m (25%) ahead of passing rent including £0.9m of high-quality HQ commercial space. The key opportunities are reversionary rent uplifts for the fully let industrial assets and void reduction in the office portfolio. We expect HQ to add c 19p to EPRA NTA through FY22–23 as the residential apartments are sold and the commercial space let. With management remaining very positive about the prospects for regional commercial property in its core office and industrial sectors, there is significant scope to reinvest the proceeds of the £30m non-core and residential asset sales in higher-return acquisitions and in a range of identified refurbishment and development initiatives.

Valuation: Not reflecting company growth targets

A 4.6% prospective yield and FY21 P/NTA of 0.74x is undemanding relative to peers and is yet to reflect the potential growth that management seeks from crystallisation of the HQ value and accretive reinvestment of sales proceeds.

17 June 2021

Price	**261p**
Market cap	**£120m**

Net debt (£m) as at 31 March 2021	118.9
Net LTV as at 31 March 2021	42.0%
Shares in issue	46.1m
Free float	95%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	6.3	13.7	50.0
Rel (local)	4.3	7.9	26.8
52-week high/low		268p	171p

Business description

Palace Capital is a UK property investment company listed on the Main Market of the LSE. It is not sector-specific and looks for opportunities where it can enhance the long-term income and capital value through asset management and strategic capital development in locations outside London.

Next events

Q421 DPS paid	5 August 2021

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Edison profile page

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Summary of FY21 results

The FY21 financial performance was robust with a clear improvement in the second half of the year (H221 adjusted PBT of £4.5m vs £3.1m in H121), and ahead of our forecast. For the year as a whole, COVID-19 had a negative impact on valuations and slowed leasing activity, but rent collection remained robust with 95% collection during the year. Quarterly DPS was reinstated at the beginning of the year and increased by 20% in Q421. Since end-FY21, HQ has been completed, to budget, and sales of residential apartments have accelerated as the lockdown has been eased.

Exhibit 1: Summary of FY21 financial performance

£m unless stated otherwise	FY21	FY20	FY21/FY20	H121	H221	Edison FY21e	Actual vs Forecast
Adjusted earnings							
Rental & other income	17.3	18.3		8.3	9.1	16.7	
Movement in credit loss	(0.9)	0.0		(0.3)	(0.6)	0.0	
Non-recoverable property costs	(1.5)	(2.4)		(1.0)	(0.5)	(2.2)	
Net rental income	**14.9**	**15.9**	**-6.5%**	**7.0**	**7.9**	14.5	2.6%
Dividend on listed equity investment	0.1	0.1		0.0	0.1	0.0	
Administrative expenses	(4.0)	(4.2)	-2.6%	(2.1)	(1.9)	(4.2)	-3.9%
Net finance expense	(3.3)	(3.8)	-12.6%	(1.8)	(1.6)	(3.6)	-7.4%
Adjusted profit before tax	**7.5**	**8.0**	**-6.0%**	**3.1**	**4.5**	6.7	13.2%
Surrender premium	0.0	2.9		0.0	0.0	0.0	
Share based payments expense	(0.3)	(0.1)		(0.2)	(0.2)	(0.3)	
EPRA earnings	**7.2**	**10.8**	**-32.9%**	**2.9**	**4.3**	6.4	13.8%
Unrealised gains/(loss) on revaluation	(14.0)	(17.9)		(10.0)	(3.9)	(14.5)	
Profit/(loss) on disposal of investment properties	0.9	(0.1)		0.3	0.6	0.9	
Unrealised gain/(loss) on listed investments	0.7	(0.4)		(0.2)	0.9	(0.2)	
Fair value loss on derivatives	(0.3)	(0.8)		(0.4)	0.1	(0.4)	
Debt termination costs	(0.1)	(0.5)		0.0	(0.1)	0.0	
IFRS profit before tax	**(5.5)**	**(9.1)**		**(7.5)**	**1.9**	(7.8)	
Tax	(0.0)	3.6		0.0	0.0	0.0	
IFRS net profit	**(5.5)**	**(5.4)**	**1.7%**	**(7.5)**	**1.9**	(7.8)	
Basic EPS (p)	(12.0)	(11.8)		(16.2)	4.2	(16.9)	
Fully diluted EPRA EPS	15.7	23.4		6.3	9.4	13.8	
Fully diluted adjusted EPS (p)	**16.4**	**17.5**	**-6.5%**	**6.6**	**9.7**	14.5	13.2%
DPS declared (p)	**10.5**	**12.0**	**-12.5%**	**5.0**	**5.5**	10.0	5.0%
EPRA NTA per share (p)	**350**	**364**	**-3.9%**	**347**	**350**	341.1	2.7%
EPRA NTA total return	-1.8%	-5.8%		-4.1%	2.3%	-4.4%	
Investment properties (inc. trading assets)	278.6	276.3		279.8	278.6	279.2	
Gross debt	(128.3)	(120.8)		(132.7)	(128.3)	(127.3)	
Cash	9.4	14.9		14.0	9.4	9.4	
Net LTV	42.0%	38.1%		42.1%	42.0%	41.9%	

Source: Palace Capital data, Edison Investment Research FY21 forecast

The key financial highlights include:

- Net rental income was £14.9m (FY20: £15.9m), primarily reflecting lower occupancy and disposals, partly offset by end-year rates relief that reduced direct property costs. Provisions against rent receivables were separately disclosed at £0.9m.
- Administrative expenses were well controlled and net finance expense charged to the income statement reduced due to a lower average cost of debt and lower average structural debt. Interest costs of c £0.9m (FY20: c £0.5m) in respect of the HQ development were capitalised.
- Adjusted PBT was £7.5m (FY20: £8.0m) or 16.4p per share. The greater decline in EPRA earnings (£7.2m vs £10.8m in FY20) reflects the inclusion in FY20 of £2.9m of non-recurring surrender premium, excluded from adjusted PBT.
- Including realised gains on disposal of investment property and unrealised valuation losses (4.0% like for like) the IFRS loss was £5.5m, while EPRA net tangible assets (NTA) per share was 350p (FY20: 364p).

- A DPS of 2.5p was declared in each of the first three quarters of the year and was increased by 20% to 3.0p in Q4. The aggregate 10.5p for the year was 1.56x covered by adjusted EPS and fully covered on a cash basis.
- Reflecting continuing development expenditure, net loan to value increased to 42.0%, which we expect to be the peak on an annual basis as HQ residential sales are completed and development borrowing is repaid.

The FY21 operational highlights include:

- 31 completed events providing additional income of £0.9m pa and reducing void costs by £0.1m, comprising:
  - 14 new leases at an average 16% uplift to ERV, providing £0.7m pa of additional income;
  - 11 lease renewals at an average 12% uplift to ERV, providing additional income of £0.1m pa;
  - and six rent reviews at an average 13% uplift to ERV, providing additional income of £0.1m pa.
  - On an EPRA basis, end-FY21 occupancy was 86.4% (FY20: 87.3%).
- PCA completed the sale of five non-core assets for an aggregate £5.4m at a blended 23% premium to book value.
- The property portfolio value increased by £5.0m to £282.8m (FY20: £277.8m) as a result of capital expenditure, primarily relating to the HQ development. On a like-for-like basis, valuations were 4.0% lower in the year but with a noticeable improvement in the second half of the year (-0.5% compared with -3.5% in H1). By sector, the annual movements broadly reflected market-wide trends with industrial assets showing the strongest gains and retail & leisure related assets, most affected by the pandemic, showing the weakest performance.

Exhibit 2: Like-for-like portfolio valuation movement – stronger H2

	Market value (£m) 31-Mar-20 FY20	H121 gain/(loss) %	Market value (£m) 30-Sep-20 H121	H221 gain/(loss) %	Market value (£m) 31-Mar-21 FY21
Offices*	124.4	(4.2)	119.2	(2.5)	116.3
Development	37.8	39.4	52.7	13.1	59.6
Industrial	38.8	2.1	39.6	2.8	40.7
Leisure	37.9	(7.4)	35.0	1.2	35.4
Retail*	23.6	(6.5)	22.1	(2.7)	21.5
Retail warehouse	10.5	(10.5)	9.4	(2.5)	9.2
Total market value	**273.1**	**1.9**	**278.2**	**1.7**	**282.8**
Capital expenditure**			(14.5)		(20.7)
Total like for like	**273.1**	**1.9**	**263.7**	**(0.5)**	**262.2**

Source: Palace Capital data. Note: *Excludes properties disposed in FY20. **Includes capital expenditure on developments and capitalised legal and letting fees incurred in FY21.

- On an ungeared basis the property portfolio total return, combining capital returns and income returns, was 1.0%, slightly behind the MSCI UK Quarterly Index benchmark. On a three-year basis PCA's total return remains 4% ahead of the benchmark.

95% of rents collected in FY21

FY21 rent collection was strong and PCA attributes its 95% collection rate (98% from the top-20 tenants that account for more than 40% of contracted rents) in part to its early and active outreach to its 182 tenants. This collection performance has continued into the current year, with 95% (including agreed monthly collections) collected to date[1] for the March 2021 rent quarter. Significant support was provided to tenants, amounting to £1.1m via rent concessions and rent deferrals,

1 At 8 June 2021.

regearing leases to provide rent-free periods, and payment plans to help tenants manage their cash flow.

Exhibit 3: Rent collection data

	FY21 rent demanded	FY21 rent concessions/deferrals	FY21 cash collected	FY21 collection rate	March 2021 collection rate*
Office	£8.6m	£0.1m	£8.0m	95%	96%
Industrial	£2.4m		£2.4m	98%	97%
Leisure	£3.3m	£0.9m	£2.2m	91%	91%
Retail warehouse	£0.8m		£0.8m	100%	100%
Retail	£2.0m	£0.1m	£1.8m	94%	89%
Portfolio total	**£17.1m**	**£1.1m**	**£15.2m**	**95%**	**95%**

Source: Palace Capital data. Note: *Data as at 8 June 2021. Rent collection is defined as cash rent collected in full and rent being collected monthly as per agreed payment plans.

Provisions against rent receivables held on the balance sheet were c £1.3m at end-FY21, of which 63% relates to the retail and leisure sectors, increasing by £0.9m during the year. PCA expects to recover some of the rents provided for as the lockdown restrictions eases.

Update on portfolio development and asset management

The portfolio was externally valued at £282.8m at end-FY21, comprising 48 assets let to 182 individual tenants. PCA's current and future focus is on the office (c 41%) and industrial (c 14%) sectors and management estimates that the combined total of these two sectors will increase from c 56% to more than 70% once the HQ residential apartments have been sold and the commercial space let. The contractual rent income of £16.4m pa at end-FY21 is reflected in a portfolio net initial yield of 5.6% and with an externally assessed estimated market rental value at full occupancy (ERV) of £20.6m the reversionary yield was 7.3%. The FY21 ERV includes £0.9m in respect of the HQ commercial space. The gap between ERV and contractual rent provides a significant opportunity for income and value generation, discussed below.

Exhibit 4: Portfolio summary

	FY21	FY20
	31-Mar-21	31-Mar-20
External portfolio valuation	£282.8m	£277.8m
Net initial yield	5.6%	6.0%
Reversionary yield	7.3%	6.6%
Contractual rental income	£16.4m	£17.6m
Estimated rental value (ERV)	£20.6m	£20.6m
Properties	48	53
Tenants	182	204
WAULT to first break	4.8 years	4.8 years
Void rate	13.6%	12.7%

Source: Palace Capital data

Hudson Quarter completion

The flagship HQ development in York[2] (HQ) was completed on budget on 20 April and the first occupiers, both residential and commercial, have already moved in. HQ is a large project for PCA (the gross development value represents c two-thirds of market capitalisation) and completion provides the potential to crystalise sales profits on the residential apartments, recognise development gains on the commercial space, and earn recurring income as it is let. Completion on budget also represents a significant de-risking, while the proceeds of residential sales can be used

[2] HQ occupies a two-acre site in York, within the city walls and just a minute's walk from York railway station, which is 105 minutes (non-stop) by rail from London. The scheme comprises three residential buildings and a commercial building. The 127 flats (c 95,000 sq ft of living space) are being sold and the commercial element, comprising 39,500 sq ft of grade A offices will be retained for income.

to de-gear and/or can be recycled, depending on market conditions and opportunities. Our forecasts include c £10m (gross) of development/disposal gains from HQ (c £8.8m net of residential disposal costs) over FY22 and FY23, c 20p per share, and for the commercial space to add c £0.9m to rental income on an annualised basis, in line with ERV, once fully let.

Although the pandemic slowed completion slightly (by about three months compared with the original schedule), forced the closure of the residential marketing suite for much of the past year, and slowed activity in the commercial letting market, underlying market conditions in York remain favourable for both the residential and commercial assets and the high quality and strong location of the scheme should appeal.

The pace of residential sales has accelerated as lockdown restrictions have eased. Sales have now been completed or contracts exchanged on 46 of the 127 residential apartments[3] with a sales value of £12.5m, with an additional four apartments under offer, with a sales value of £3.4m. At c £550 per sq ft, PCA expects the gross sales value of the residential assets to be c £52m and although most of the apartments sold to date have been lower-value studios and smaller one-bedroom apartments, the most recent sales show a noticeable increase in average sales value. Palace expects at least two-thirds of all apartments to be sold by the end of FY22, taking total sales proceeds (including the existing apartments where contracts have been exchanged) to at least £30m. Including existing financial resources, PCA expects to repay the Barclays development facility, utilised to part-fund the entire project, in full by the end of calendar 2021.

While the pandemic has also slowed pre-letting activity, 4,500 sq ft of office space, on the ground floor of one of the residential buildings, has been pre-let to Knights, a quoted law firm, at a record rent for York of £25 per sq ft, and PCA has seen strong interest in the 35,000 sq ft of self-contained commercial space, which it expects to be let or under offer by the end of FY22.

Disposal programme and capital recycling

Having grown the portfolio primarily through portfolio acquisition, non-core disposals have been a regular feature, enabling capital deployment to be optimised and supporting operational efficiency. Disposals are typically driven by the completion of the business plan for the asset or where the risk-return balance favours disposal, in some cases generating an immediate saving on property operating costs. PCA has identified and targets the disposal of at least 15 properties with an aggregate value of more than £30m in the current year and has already made good progress, with £9.4m of sales completed or exchanged at a premium to book value.

With up to £30m of net proceeds (net of repayment of the development loan) over the next two years and the £30m proceeds from the non-core disposal programme, PCA will have considerable capital to recycle into income generating investments and new asset management opportunities. Although we expect HQ to generate significant profits for PCA this is in the form of capital growth (at least until the commercial assets are let) rather than immediate income. We anticipate that the net income forgone on the non-core disposals will be below that achievable from reinvestment and in some cases will yield savings on vacant property costs.

Regional offices and industrials, particularly logistics, remain the core focus for reinvestment, while in time we expect PCA to divest of its two large leisure assets, valued at more than £35m, particularly if valuations improve as a result of recent asset management activity (including three new lettings in the past year) and a sector recovery, which would provide additional capital recycling opportunities.

The majority of PCA's portfolio has been assembled through cost-effective corporate acquisitions, which generate a considerable savings on stamp duty, and this continues to be its preferred method

[3] At 16 June 2021.

of acquisition. It expects corporate acquisition opportunities may emerge later this year or early next year as government support for companies is withdrawn.

Other asset management opportunities

In addition to capital recycling and HQ there is a broad range of additional asset management opportunities embedded within the PCA portfolio, including lease renewals, new lettings and regears, as well as refurbishment, and further development projects.

The most immediate opportunity is the reversionary potential within the existing portfolio. Exhibit 5 shows the ERV and vacant/void ERV by sector. Of the £4.2m difference to current contractual income, c £2.8m is accounted for by voids (including the opportunity to let the recently completed HQ commercial space) and the balance by lease incentive run-off and reversion to market rent levels.

Exhibit 5: Reversionary upside by sector

	Market value (£m)	Contractual rental income (£m)	ERV (£m)	ERV of void (£m)	WAULT to first break (years)
Offices	116.3	8.0	10.8	2.3	2.8
Industrial	40.7	2.5	2.9	0.1	3.5
Development	59.6	-	0.9	-	-
Leisure	35.5	3.4	3.2	0.2	10.8
Retail	21.5	1.9	2.1	0.2	8
Retail warehouses	9.2	0.8	0.6	-	5.7
Total portfolio	**282.8**	**16.4**	**20.6**	**2.8**	**4.8**

Source: Palace Capital data

Void reduction within the office assets, including several properties that have recently been refurbished or are currently being refurbished, and reversion to market rent in the effectively fully occupied industrial assets are the largest opportunities. During the past year, in response to the pandemic, PCA has prioritised those capital expenditure projects that are expected to have the most immediate impact on value or tenant use. This included the ongoing refurbishment of the c 99,000 sq ft office property at St James Gate in Newcastle, which is expected to complete in August 2021, and PCA says that it is confident that the c 20,000 sq ft of vacant space will be let before end-FY22.

There are several medium-term refurbishment and development opportunities for which detailed asset management plans have been identified, potentially providing further opportunities to add value to the portfolio, including:

- The office properties at Holly Walk in Leamington Spa, with potential to create a 70,000 sq ft mixed-use development, subject to planning consent, which is currently anticipated to commence around 2024.
- The office property Bank House in Leeds, which is currently c 85% occupied under short-term leases, pending a planned accretive refurbishment in 2025.

Forecast update

For FY22 a slight reduction in forecast net rental income is offset by slightly lower administrative expenses. In FY23 a combination of slightly higher forecast net rental income, lower administrative, and lower financing costs drives a c 6% increase in adjusted PBT and adjusted EPS. Our new FY24 forecast requires caution given the continuing economic uncertainty, but indicates further strong growth driven by net rental income. The growth in net rental income includes reversionary capture and a full period contribution from assumed FY23 acquisitions as detailed below. FY21 EPRA NTA was above our expectation and this feeds through into our forecasts, which also benefit from like-for-like growth including realised gains on sales of HQ residential assets, development gains on the HQ commercial space and reversionary capture/reduced voids.

Exhibit 6: Forecast revisions

	Net rental income (£m)			Adjusted PBT (3m)			Adjusted EPS (p)			EPRA NTA (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/22e	14.3	14.2	(0.9)	6.6	6.6	0.0	14.3	14.3	0.0	360	366	1.8	12.0	12.0	0.0
03/23e	15.0	15.2	0.9	7.1	7.5	6.0	15.5	16.4	5.9	369	385	4.5	14.0	14.0	0.0
03/24e	N/A	17.6	N/A	N/A	9.8	N/A	N/A	21.3	N/A	N/A	401	N/A	N/A	18.0	N/A

Source: Edison Investment Research

The key component of our adjusted PBT forecast is net rental income for which we assume:

- Completion of the £30m non-core asset sale programme in FY22, with £40m of reinvestment during FY23, less than the c £50m that management indicates.
- We forecast contracted rents of £16.4m pa at end FY21 to:
  - Reduce to £15.3m at end-FY22 due to the disposals (although we expect the net income effect to be offset by property cost and interest expense savings).
  - Increase to £18.7m at end-FY23, including £2.4m (6% net initial yield) from the acquisitions and c £1.0m from reversionary rent capture/void reduction (effectively equal to fully letting the HQ commercial space).
  - Increase to £19.7m at end-FY24 including a further £1.0m of reversionary capture/void reduction.
- Net rental income reflects:
  - the weighted impact of annual contracted rents.
  - Other income of c £0.5m pa.
  - An increase in direct property costs from c £1.5m in FY21 to c £2.5m in FY22, falling to c £2.2m thereafter. The rise in FY22 costs is driven by the non-repeat of FY21 rates relief (c £0.4m) and costs related to HQ (rates etc) in the period between practical completion and letting/disposal, partly offset by savings generated by the disposal programme.
- We do not forecast continuing charges in respect of concessions/rent receivables on a net basis.

Our IFRS earnings and the change in NTA include the following capital valuation assumptions:

- A c £2.0m unrealised development gain/revaluation uplift on the HQ commercial space upon letting (end-FY22).
- Aggregate gross disposal gains on the HQ residential assets of c £7.9m (£6.8m net of transaction costs at 2% on the gross sales value of c £52m), spread over FY22 and FY23.
- Like-for-like revaluation gains of c 2% pa in FY23 and FY24 (nil in FY22) reflecting progress with void reduction. We believe these assumptions are consistent with a c 0.3% increase in net initial yield (as contracted income increases) and a very slight reduction in the reversionary yield. We estimate that a 1% increase/decline in the FY22 property valuation compared with our forecasts would increase/reduce FY22e EPRA NTA by c 5p.

Our forecast for DPS increases in FY22 and FY23 are unchanged, and we expect continuing growth in FY24, with dividend cover consistently 1.5–1.2x. With the forecast proceeds of residential sales and non-core disposals exceeding our assumed reinvestment, our forecast net loan to value ratio (LTV) for end-FY24 is 32%.

Funding

End-FY21 debt facilities of £141.7m were diversified across several lenders. £128.3m had been drawn and adjusting for £9.4m of cash, net borrowing was £118.9m with an LTV of 42.0%. The average cost of debt was 3.0% (FY20: 3.1%) with costs fixed by hedging on 49% of debt. Immediately available debt and cash resources amounted to £14.4m at end-FY21.

At end-FY21 the average debt maturity was 2.6 years, but since then the maturity date of the Barclays development facility has been extended and repayments from the proceeds of completed residential asset sales have reduced the drawn balance to £11.6m. On an FY21 pro-forma basis, including the development loan part-repayment the group LTV has reduced from 42% to 40.[4] PCA expects continuing residential sales to enable a full repayment of the development facility before the end of 2021 and for LTV to reduce further.

Exhibit 7: Summary of debt portfolio as at 31 March 2021 (end-FY21)*

Lender	Facility (£m)	Drawn (£m)	Maturity	Hedging
Barclays	38.0	38.0	Jun-24	£34.3m fixed
NatWest (RCF)	40.0	28.6	Aug-24	100% floating*
Santander	25.3	25.3	Aug-22	£19.0m fixed
Lloyds	6.8	6.8	Mar-23	100% floating
Scottish Widows	9.3	9.3	Jul-26	100% floating
Barclays (development facility)	22.3	20.3	Jul-22*	100% floating
Total	**141.7**	**128.3**	**2.6 years**	**49% fixed/51% floating**

Source: Palace Capital data. Note: *Maturity extended from January 2022 since 31 March 201.

At the group level, interest cover was 2.7x at end-FY21 (end-FY20: 3.5%). Each debt facility is secured at a special purpose vehicle (SPV) level, each with its own interest cover and LTV covenants. In the past year the pandemic lockdowns have put pressure on facilities charged to the two leisure assets, requiring covenant waivers from the respective lenders during periods where concessions and rent deferrals have been agreed with tenants. Additionally, PCA reduced its loan balance with Scottish Widows by £4.1m to 'cure' the LTV covenant with an ongoing waiver of the interest cover covenant.

Valuation

Unlike many REITs, PCA operates a total return model, aiming to provide attractive income returns, as well as exposure to capital growth from the repositioning of value-add properties. Since its first major post-IPO transaction in H214, it has built a proven track record of acquiring properties where it can extract value by enhancing sustainable recurring income and generating capital growth through refurbishment and development opportunities. During this period, it has generated cumulative EPRA NTA total returns of 110.1% or a compound annual average return of 10.4%. This is a good level of return despite the negative impacts of COVID-19 on late FY20 and FY21. Our forecasts for FY22–24 indicate total returns of c 8% pa in each of the three years, driven by development gains/residential disposal profits on the completion of HQ and increased rental income through reversionary capture.

Exhibit 8: NAV total return history

	H214	FY15	FY16	FY17	FY18	FY19	FY20	FY21	Cumulative*
Opening EPRA NTA per share (p)**	218	341	388	414	443	414	407	364	218
Closing EPRA NTA per share (p)**	341	388	414	443	414	407	364	350	350
Dividend per share paid (p)	2.5	8.50	14.00	18.00	19.00	19.00	19.00	7.50	108
Income return (%)	1.1%	2.5%	3.6%	4.3%	4.3%	4.6%	4.7%	2.1%	49.3%
Capital return (%)	56.6%	13.5%	6.9%	6.9%	-6.4%	-1.8%	-10.4%	-3.9%	60.8%
EPRA NTA total return (%)	**57.8%**	**16.0%**	**10.5%**	**11.2%**	**-2.1%**	**2.8%**	**-5.8%**	**-1.8%**	**110.1%**
Average annual return									**10.4%**

Source: Palace Capital data, Edison Investment Research. *Cumulative returns from end-H114 to end-FY21. **FY20 and H121 are EPRA net tangible assets per share and previous years reflect the broadly equivalent EPRA net asset value per share.

Based on the minimum 3p quarterly DPS that PCA targets during FY22, the prospective yield is 4.6%. We forecast the annualised 12p DPS to be well covered (1.2x) by adjusted earnings. Meanwhile, the shares trade at a significant discount of c 26% to end-FY21 diluted EPRA NTA per share of 360p.

[4] As at 8 June 2021.

In Exhibit 9 we show a summary performance and valuation comparison of PCA and a peer group of UK commercial real estate investment companies with a strong regional focus. For comparative purposes, the valuation data is based on last reported EPRA NTA/NAV and trailing 12-month DPS declared. On this basis, PCA trades at a lower P/NTA than the group average and although its trailing dividend is lower, this is yet to reflect the recent 20% DPS increase.

Exhibit 9: Peer group performance and valuation comparison

	Price (p)	Market cap (£m)	P/NTA/NAV* (x)	Trailing yield (%)**	Share price performance			
					1 month	3 months	12 months	From 12M high
Circle Property	197	56	0.70	2.3	0%	9%	16%	-9%
Custodian	98	414	1.00	4.6	0%	5%	5%	-6%
Picton	88	482	0.91	3.3	2%	0%	33%	-4%
Real Estate Investors	40	71	0.72	7.6	5%	16%	20%	-6%
Regional REIT	86	373	0.84	7.1	4%	11%	10%	-7%
Schroder REIT	47	231	0.78	4.8	0%	15%	41%	-3%
UK Commercial Property REIT	79	1027	0.90	3.2	4%	9%	21%	-5%
BMO Commercial Property Trust	90	719	0.75	3.2	8%	20%	22%	-4%
BMO Real Estate Investments	72	174	0.73	4.4	-5%	1%	35%	-11%
Average			0.81	4.5	2%	10%	23%	-6%
Palace Capital	261	120	0.75	3.8	6%	13%	49%	-3%
UK property sector index	1,780				3%	9%	16%	-2%
UK equity market index	4,088				2%	6%	18%	0%

Source: Company data, Refinitiv. Note: Prices at 16 June 2021. *Based on last reported EPRA NAV per share. **Based on trailing 12-month DPS declared.

Exhibit 10: Financial summary

Year end 31 March (£m)	2018	2019	2020	2021	2022e	2023e	2024e
PROFIT & LOSS							
Rental & other income	16.7	18.8	21.1	17.3	16.7	17.4	19.7
Movement in credit loss		0.0	0.0	(0.9)	0.0	0.0	0.0
Non-recoverable property costs	(1.8)	(2.3)	(2.4)	(1.5)	(2.5)	(2.2)	(2.1)
Net rental income	14.9	16.4	18.8	14.9	14.2	15.2	17.6
Dividend income from listed equity investments		0.0	0.1	0.1	0.0	0.0	0.0
Administrative expenses including share based payments	(4.2)	(4.1)	(4.3)	(4.3)	(4.4)	(4.6)	(4.7)
Operating Profit (before capital items)	10.7	12.4	14.6	10.6	9.8	10.6	12.8
Unrealised gains/(losses) on properties	5.7	(0.7)	(17.9)	(14.0)	2.0	4.2	5.0
Realised gains/(losses) on properties	0.3	(0.4)	(0.1)	0.9	3.9	2.9	0.0
Loss on revaluation of listed equity investments		(0.2)	(0.4)	0.7	0.0	0.0	0.0
Operating Profit	16.7	11.1	(3.9)	(1.8)	15.7	17.7	17.9
Net finance expense	(3.4)	(4.7)	(5.2)	(3.8)	(3.5)	(3.3)	(3.3)
Profit Before Tax	13.3	6.4	(9.1)	(5.5)	12.2	14.4	14.5
Taxation	(0.8)	(1.3)	3.6	(0.0)	0.0	0.0	0.0
Profit After Tax (FRS 3)	12.5	5.2	(5.4)	(5.5)	12.2	14.4	14.5
EPRA adjustments:							
Unrealised gains/(losses) on properties	(5.7)	0.7	17.9	14.0	(2.0)	(4.2)	(5.0)
Realised gains/(losses) on properties	(0.3)	0.4	0.1	(0.9)	(3.9)	(2.9)	0.0
Deferred tax charge	(0.3)	0.2	0.0	0.0	0.0	0.0	0.0
Other adjustments	0.3	1.1	(1.8)	(0.3)	0.0	0.0	0.0
EPRA earnings	6.5	7.6	10.8	7.2	6.3	7.2	9.5
Non-recurring items	0.7	0.0	(2.9)	0.0	0.0	0.0	0.0
Share-based payments	0.2	0.3	0.1	0.3	0.3	0.3	0.3
Adjusted earnings	7.4	7.9	8.1	7.5	6.6	7.5	9.8
Tax adjustments	1.1	1.0	(0.0)	(0.0)	0.0	0.0	0.0
Company adjusted PBT	8.5	8.9	8.0	7.5	6.6	7.5	9.8
Average fully diluted number of shares outstanding (m)	35.0	45.9	46.0	46.1	46.1	46.1	46.1
Basic EPS - FRS 3 (p)	35.8	11.3	(11.8)	(12.0)	26.5	31.2	31.5
Fully diluted EPRA EPS (p)	18.7	16.5	23.4	15.7	13.7	15.7	20.6
Fully diluted adjusted EPS (p)	21.2	17.3	17.5	16.4	14.3	16.4	21.3
Dividend per share declared (p)	19.0	19.0	12.0	10.5	12.0	14.0	18.0
Dividend cover by adjusted earnings (x)	1.11	0.91	1.46	1.56	1.20	1.17	1.18
NTA total return	-2.1%	2.8%	-5.8%	-1.8%	7.8%	8.7%	8.4%
BALANCE SHEET							
Fixed Assets	254.0	261.1	251.7	239.3	217.5	266.7	276.7
Investment properties	253.9	258.3	248.7	235.9	214.0	263.2	273.2
Other non-current assets	0.1	2.7	3.0	3.5	3.5	3.5	3.5
Current Assets	46.3	55.3	51.8	61.9	64.6	23.5	22.0
Trading properties	0.0	14.4	27.6	42.7	18.9	0.0	0.0
Assets held for sale	21.7	11.8	0.0	0.0	0.0	0.0	0.0
Cash	19.0	22.9	14.9	9.4	35.9	13.7	12.2
Other current assets	5.6	6.2	9.3	9.8	9.8	9.8	9.8
Current Liabilities	(11.5)	(16.0)	(16.1)	(34.9)	(33.5)	(33.2)	(34.5)
Creditors	(8.8)	(10.0)	(14.1)	(12.9)	(11.5)	(11.2)	(12.5)
Short term borrowings	(2.7)	(6.0)	(1.8)	(21.9)	(21.9)	(21.9)	(21.9)
Long Term Liabilities	(105.5)	(120.0)	(121.1)	(108.5)	(83.4)	(83.2)	(83.0)
Long term borrowings	(97.2)	(112.0)	(117.5)	(105.4)	(80.4)	(80.2)	(80.0)
Deferred tax & other long-term liabilities	(8.3)	(8.0)	(3.5)	(3.1)	(3.1)	(3.1)	(3.1)
Net Assets	183.3	180.3	166.3	157.8	165.1	173.7	181.2
EPRA net assets	0.0	0.0	167.9	161.3	168.6	177.2	184.7
Basic NAV/share (p)	400	393	361	343	359	377	394
Diluted EPRA NAV/share (p)	0	0	364	350	366	385	401
CASH FLOW							
Operating Cash Flow	9.9	11.9	15.7	11.3	8.7	10.6	14.4
Net Interest	(2.7)	(3.4)	(3.7)	(3.6)	(3.2)	(3.0)	(3.0)
Tax	(0.4)	(1.6)	(2.2)	(1.2)	0.0	0.0	0.0
Net cash from investing activities	(67.7)	(11.5)	(10.1)	(14.8)	51.6	(23.2)	(5.0)
Ordinary dividends paid	(6.7)	(8.7)	(8.7)	(3.5)	(5.3)	(6.0)	(7.4)
Debt drawn/(repaid)	8.2	18.0	1.4	7.6	(25.4)	(0.5)	(0.5)
Proceeds from shares issued (net)	67.7	(0.0)	0.0	0.0	0.0	0.0	0.0
Other cash flow from financing activities	(1.1)	(0.1)	(1.0)	(0.3)	0.0	0.0	0.0
Net Cash Flow	7.0	4.4	(8.5)	(4.5)	26.5	(22.2)	(1.5)
Opening cash	10.9	18.0	22.4	13.9	9.4	35.9	13.7
Closing cash	18.0	22.4	13.9	9.4	35.9	13.7	12.2
Restricted cash	1.0	0.5	1.0	0.0	0.0	0.0	0.0
Closing balance sheet cash	19.0	22.9	14.9	9.4	35.9	13.7	12.2
Closing balance sheet debt	(99.8)	(118.0)	(119.4)	(127.3)	(102.2)	(102.0)	(101.8)
Unamortised debt costs	(1.6)	(1.3)	(1.4)	(1.0)	(0.7)	(0.4)	(0.1)
Closing net (debt)/cash	(82.4)	(96.5)	(105.8)	(118.9)	(67.1)	(88.7)	(89.7)
Net LTV (exc restricted cash & adjusted for unamortised debt costs)	29.8%	33.7%	38.1%	42.0%	28.3%	33.2%	32.3%

Source: Palace Capital historical data, Edison Investment Research forecasts