Palace Capital

Pre-results update

Continuing to move ahead

Real estate

With its move to the Main Market of the LSE completed, Palace recently provided an update on trading for the year to March 2018, ahead of preliminary results on 11 June. Management expects to report adjusted earnings (excluding revaluation movements and other one-offs) ahead of market expectations. Looking forward, the portfolio, enlarged by the RT Warren acquisition, offers significant asset management opportunities, while management seeks further accretive acquisitions, neither of which is reflected in our estimates. The shares offer an attractive yield and trade at a significant discount to NAV.

Year end	Net rental income (£m)	Adj. EPRA earnings* (£m)	Adj. EPRA EPS* (p)	EPRA NAV/ share (p)	Price/EPRA NAV/share (x)	DPS (p)	Yield (%)
03/16	13.0	4.6	18.9	414	0.83	16.0	4.6
03/17	12.2	5.7	22.2	443	0.78	18.5	5.3
03/18e	14.3	7.0	19.8	395	0.88	19.0	5.5
03/19e	17.2	8.6	18.7	394	0.88	19.5	5.6

Note: *Adjusted EPRA earnings exclude share-based payment costs in addition to revaluation gains, profits or losses on disposals of investment properties and surrender gains on early lease terminations.

FY18 was another significant year of growth

The October 2017 £67.9m acquisition of RT Warren increased the portfolio value by around a third to c £270m. The acquisition was conservatively funded, with £70m (gross) of new equity and an 81% increase in the share count, significantly increasing the market capitalisation and setting the scene for the move to the Main Market of the LSE. With regional commercial property markets remaining firm and rents generally benefiting from a positive demand–supply balance, Palace has significant asset management and further acquisition opportunities to pursue, supported by a robust balance sheet position (LTV 31%).

Significant potential not reflected in estimates

Our estimates may prove conservative; they allow nothing for the accretive acquisitions that management seeks or asset management gains from RT Warren and other projects due to the difficulty in credibly forecasting these. Our FY18 forecast is for now unchanged, pending details of the expected earnings beat. Although a recent significant letting of refurbished space took contracted rent roll to £18.1m, letting of refurbished space in Leeds and Manchester is taking longer than we had assumed and is unlikely to materially benefit FY19. We have trimmed FY19 net rental income by c 4% and adjusted EPS from 20.6p to 18.7p.

Valuation: Attractively priced with upside potential

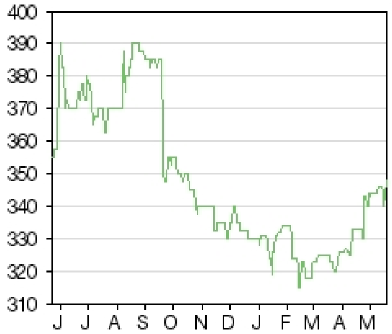
Without building in any potential upside from accretive acquisitions or asset management of the recently acquired RT Warren assets, the shares offer an attractive prospective yield of 5.6% and a 14% discount to FY18e NAV per share.

21 May 2018

Price	**346p**
Market cap	**£158m**

Net balance sheet debt (£m) at 30 September 2017 (including finance lease obligations)	86.4
Shares in issue	45.8m
Free float	95%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.5	7.7	(1.4)
Rel (local)	(1.4)	1.2	(6.2)
52-week high/low		387.8p	315.0p

Business description

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

Next event

FY18 preliminary results 11 June 2018

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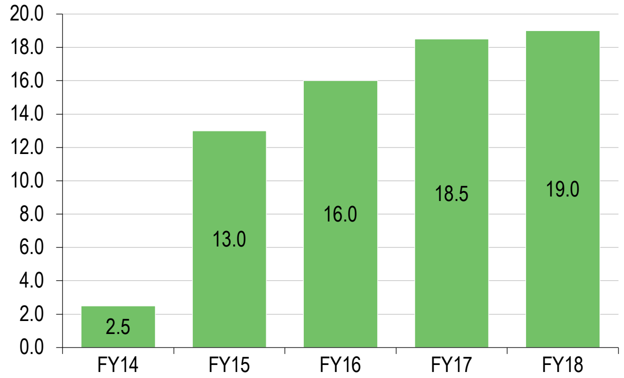
Edison profile page

Palace Capital is a research client of Edison Investment Research Limited

Growing with an income focus

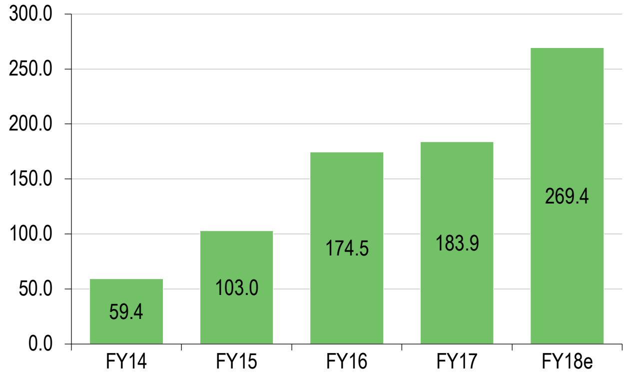
Palace Capital is an internally managed property investment company that focuses on commercial property in major cities and university towns in the UK, outside London, with a c £270m portfolio value. It operates a total return model, seeking to enhance capital values and to provide a sustainable and growing income stream, applying active asset management strategies in order to unlock potential and grow sustainable cash returns. Management seeks to be entrepreneurial and opportunistic in its approach to asset selection, which is sector-agnostic and allows for each potential investment to be evaluated on its own merits, subject to limits on the exposure to market fluctuations in any one sector. As we show in a later section of this note, the approach has not precluded the growth of a diversified portfolio, principally invested in office, industrial, and leisure assets. A core portfolio of sustainable income-producing assets has supported the progressive dividend policy. Meanwhile, as a non-REIT and unconstrained by REIT property income distribution requirements, Palace has the flexibility to reinvest surplus cash to refurbish, reposition and recycle property in order to grow the underlying capital values. This includes a willingness to assume some development risk where the potential returns are attractive.

Exhibit 1: Strong income focus. Growing dividends per share (p)



Source: Palace Capital data

Exhibit 2: Fast-growing portfolio of investment property (£m)



Source: Palace Capital data, Edison Investment Research

History

The company was given its current form in July 2010 when Stanley Davis (the current chairman) and Neil Sinclair (the current CEO) acquired board control of an AIM-listed vehicle for the purpose of property investment. The current portfolio has been built by acquisition since late 2011, mostly off-market corporate acquisitions that are tax efficient and have minimal purchase costs to absorb. Recognising the growth of the company, it transferred to the Main Market of the LSE in March 2018.

The first transformational acquisition came in October 2013 when a portfolio of 24 properties from around the UK, known as the Sequel portfolio, was acquired from Quintain and Buckingham Properties. Palace paid £39.25m for the properties which were valued individually at the time at £44.2m with a net rent receivable of £5.25m pa. Active asset management since acquisition has seen the disposal of several properties, with an aggregate value of £17.53m up to 30 September 2017. The remaining portfolio was independently valued at that date at £65.4m, representing an overall increase of 111.3%, adjusted for acquisitions, compared with the acquisition purchase price. Two further properties from the Sequel Portfolio have since been sold, for an aggregate consideration of £4.16m.

The August 2014 acquisition of the PIH portfolio, comprising 17 properties split into 55 individual tenancies, for £32.0m was a further significant step. Two of the properties have since been sold for

£2.58m, either at or above book value. At 30 September 2017, the remaining properties were independently valued at £39.54m, representing an overall increase in value of 31.6%, adjusted for disposals.

Outside of these notable portfolio acquisitions, Palace has been active with numerous smaller acquisitions, investing almost £100m in a number of transactions in the three years since the PIH acquisition (excluding RT Warren).

In terms of scale, the £67.9m October 2017 acquisition of RT Warren (Investments) represents the most significant move to date, albeit off a larger base, and provides significant potential asset management upside. RT Warren brought a portfolio, externally valued at £71.8m, comprising 21 commercial properties, mostly located in the Home Counties that surround London, and a number of residential assets. Palace expects to be able to increase the rental income on the commercial assets over time while the residential assets are targeted for disposal with the capital recycled into higher yielding commercial assets.

Portfolio overview

The acquisition of the RT Warren portfolio significantly increased the value of the investment portfolio, by £71.8m or 35%, to £274.6m from the £202.8m that was reported with the FY18 interim results to 30 September 2017. The lesser increase in contractual rental income resulting from the acquisition, c 26% to £17.8m, provides an insight into the asset management potential that the acquisition provides, including measures to increase income from the commercial property assets acquired and the recycling of capital from lower yielding residential property assets acquired into additional commercial assets. RT Warren took the total number of commercial properties from 41 to 62, increasing the gross lettable floor area (GLA) from c 1.6m sq ft to c 1.8m sq ft. The residential assets included within the RT Warren portfolio comprised 65 (now 62) residential units located around the London Borough of Hillingdon, valued at £23.3m.

Exhibit 3: Portfolio summary

£m unless otherwise stated	Including RT Warren	As at 30 September 2017
Property valuation	274.6	202.8
Number of commercial properties	62	41
Commercial GLA (million square feet)	1.8	1.6
Contractual rental income	17.8	14.1
Net rental income	15.8	12.4
ERV (excluding Hudson House)*	20.7	16.1
WAULT (to first break)**	4.8 years	5.2 years

Source: Company data. Note: *ERV is estimated rental value. **WAULT is weighted average unexpired lease term.

Despite Palace's sector-agnostic approach to asset selection, the company nevertheless has a diversified portfolio by both sector and location. The London weighting of 10% overwhelmingly represents the RT Warren residential assets, with the group commercial property assets exclusively situated outside of Central London. The 21 RT Warren commercial assets are predominantly located in the south-east of England, apart from one mixed retail and office building in the centre of York. By sector, the RT Warren commercial assets are mostly office, but also include one supermarket on a long lease with minimum rental growth built in, as well as some retail assets in affluent locations and a multi-let industrial estate.

Exhibit 4: Portfolio sector analysis by value

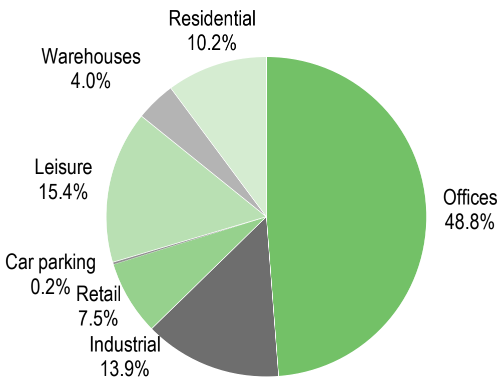
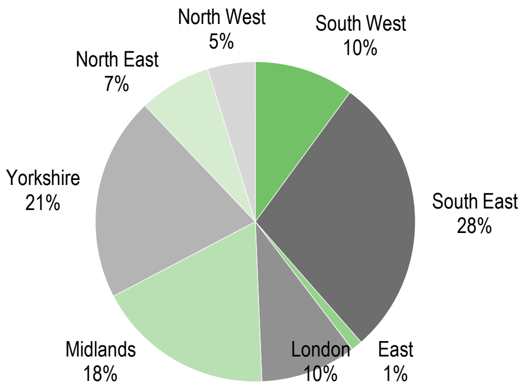


Exhibit 5: Portfolio location analysis by value



Source: Company data as per Prospectus dated 27 February 2018, including RT Warren

The tenant base is also diversified, with the largest accounting for 5.4% of contracted rents, and the top 15 tenants accounting for c 38%.

Exhibit 6: Top 15 tenants (as at 30 September 2017, adjusted for RT Warren)

Tenant	Contracted rent (£)	% of total contracted rent	Properties
Vue Entertainment	913,105	5.4%	Broad Street Plaza, Halifax; Sol Central, Northampton
ACCOR UK Economy Hotels*	599,059	3.6%	Sol Central, Northampton
National Lottery Charities Board	595,397	3.5%	2 & 3 St James Gate, Newcastle
Eldon Insurance Services	586,440	3.5%	2 & 3 St James Gate, Newcastle
Walker Morris Solicitors	567,998	3.4%	Bank House, Leeds
Wickes	401,405	2.4%	Unit A, East Grinstead
Rockwell International	398,916	2.4%	Kiln Farm, Milton Keynes
Blake Morgan	360,000	2.1%	Harbour Court, Portsmouth
Apcoa Parking (UK)	345,000	2.0%	Broad Street Plaza, Halifax
Brose	325,000	1.9%	Courtauld House, Coventry
D Young & Co	310,000	1.8%	Briton House, Southampton
Just Park car parking	295,000	1.7%	Sol Central, Northampton
Calderdale and Huddersfield NHS	261,500	1.5%	Broad Street Plaza, Halifax
Forensic Science Service	260,000	1.5%	Priory House, Birmingham
Aldi Stores	247,680	1.5%	Aldi Supermarket, Gosport
Total top 15	**6,466,500**	**38.3%**	
Others	10,417,312	61.7%	
Total portfolio	**16,883,812**	**100.0%**	

Source: Company data. Note: *includes £89,059 of rent linked to tenant turnover.

RT Warren

The RT Warren assets represent a little more than 25% of the total. The key attraction to Palace was the potential for rental growth that management sees in the commercial assets, from rent increases and from increased occupancy. By area, 14.7% of the RT Warren commercial space was vacant at acquisition, and early progress has seen the vacant office building in London Court, Southampton, let on a 10-year lease. In addition to increasing income on the commercial assets, the sale of the residential assets will allow capital to be recycled into higher yielding additional commercial assets. The residential assets were valued at £23.34m at acquisition, with gross rental income of c £0.9m pa (a yield of less than 4% compared with a net yield of c 6% of the group portfolio as a whole). Three of the 65 residential properties acquired with the RT Warren portfolio, generating combined income of £40,800 pa, have already been sold for an aggregate £1.23m, or 14% above book value. There are ongoing discussions for the sale of 60 of the remaining units while two units will be retained for strategic purposes.

Update on current asset management initiatives

As noted above, active asset management is a key element of Palace's strategy, reinvesting surplus cash to refurbish, reposition and recycle property in order to grow the underlying capital values. Recent and current initiatives include:

- **Hudson House, York.** Demolition of the 1960s office building, within the city walls and close to the railway station, is well underway. Palace has planning consent for new buildings comprising 127 apartments, 34,000 sq ft of office space, and 5,000 sq ft of other commercial space/restaurant space and parking. Demolition will save c £750,000 pa in property expenses, primarily by eliminating empty rates and service charges, or c £500,000 net of residual income. Palace is no longer seeking to develop the site with a joint venture partner, with the board taking the decision that it is in the company's best interest to proceed alone with the development, which it believes is backed by strong fundamentals, including a lack of Grade A office accommodation in York and strong residential demand. Agents have been appointed for both the commercial and residential space, and discussions have commenced with potential lenders to finance the construction.
- **St James' Gate, Newcastle**. The asset, acquired in August 2017, comprises four properties situated close to the railway station, mainly office space at 1, 2, and 3 St James' Gate and Jury's Inn. Palace is planning an upgrade to the property intended to enhance its visual impact. Meanwhile, a lease with Serco that was due to expire in May 2018 has been extended to May 2019 at a 10% higher rent.
- **Sol Central, Marefair, Northampton**. The prominent city-centre leisure scheme was acquired in May 2015 and comprised a 10-screen cinema, casino, 151-room hotel, gym, and 375-space car park. The vacated casino was refurbished to allow for needed restaurant space on the site, although the weakness of the casual dining sector has delayed letting. New agents have been appointed, but meanwhile the Ibis Hotel is trading well and Palace is seeking to increase car parking revenues. The opening of new council offices and a new university campus due for completion in June should both provide additional support.
- **Midsummer Boulevard, Milton Keynes.** Some refurbishment of vacant space is being carried out with a view to re-letting into a firmer market than when the property was acquired in February 2016. The company hopes to achieve £18 per sq ft compared with existing rentals that are mostly in the range of £12.50–£13.50, with none above £14.90.
- **Solaris House, Pitfields, Milton Keynes**. 14,500 sq ft of recently refurbished vacant space has been let for 10 years without break but with provision for rent review in the fifth year, at a headline rent of £240k pa (£16.55 per sq ft), with £120k pa payable until September 2021 in lieu of a rent-free period. Adjusting for reduced starting rent, the average over the 10 years is c £14 per sq ft, well above the rent equivalent of £10.40 per sq ft that Palace is receiving on two adjoining buildings, comprising 38,300 sq ft of space refurbished to a similar standard in 2014. The buildings are fully let until December 2026 but have provision for upward-only review in December 2018 and December 2022.
- **Bridge House, 41–45 High Street, Weybridge**. This property, comprising 12,000 sq ft of shops, offices and car parking on three storeys, will become vacant in early 2019. Palace is drawing up plans with a view to submitting a planning application to redevelop the site for either commercial or residential purposes.
- **Priory House, Gooch Street North, Birmingham**. The rent on this 60,000 sq ft office building has increased from £260k pa to £322k pa, payable from December 2016 following the completion of an outstanding rent review.

Regional markets continue to offer value

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

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

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

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

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

Management

Board and management

The six-member board is chaired by Stanley Davis, who holds 3.6% of Palace's shares and was a founding shareholder. The two independent non-executive directors, Anthony Dove and Kim Taylor-Smith, are both independent and chair the remuneration and audit committees, respectively. Stanley Davis was closely involved with the formation of the group's business and has been an important supporter of its early fundraisings. According to the UK Corporate Governance Code, he cannot be treated as independent and therefore the board has appointed Anthony Dove to the position of senior independent director.

The executive directors, Neil Sinclair, Stephen Silvester and Richard Starr have over 100 years of collective experience in the real estate market, as well as having management experience in public property companies. The non-executive directors have broad commercial and property experience: the chairman built up and sold a significant share registration business; Anthony Dove was a partner at law firm Simmons & Simmons; and Kim Taylor-Smith was chief executive at Birkby and, following its takeover, at Mentmore.

Palace outsources day-to-day project and property management and concentrates internally on asset management. In step with the growth of the portfolio, the internal management team has been increasing and now numbers 12, including two recently appointed senior asset managers.

A brief update on recent developments

We have previously published updates on the interim results to 30 September 2017 that were published on 4 December 2017, and separately on the RT Warren acquisition that completed in October 2017. There have since been a number of further developments in relation to asset management initiatives and funding, as well as completion of the move to the Main Market of the LSE (on 28 March 2018), and a trading update. Full-year results to 31 March 2018 will be published on 11 June 2018. We list the main developments, including the information from the trading update, which covers the period to 24 April 2018, below:

- **Letting**. The key recent development is at Solaris House, Kiln Farm, Milton Keynes, where 14,500 sq ft of recently refurbished vacant space has been let for 10 years without break but with provision for rent review in the fifth year, at a headline rent of £240k pa (£16.55 per sq ft), with £120k pa payable until September 2021 in lieu of a rent-free period.
- **Capital recycling**. Three non-core commercial properties have been sold, two of which were vacant with no impact on rental income, for an aggregate £4.8m, which is above book value, we believe modestly so. The three RT Warren residential assets sold to date generated an aggregate £1.23m of proceeds, 14% above book value. There are ongoing discussions for the sale of 60 of the remaining units while two units will be retained for strategic purposes.

  A 5,500 sq ft office building with vacant possession (Nicholson Gate, Fareham) has been acquired for £750,000. It adjoins Admiral House, High Street Fareham, which was acquired as part of RT Warren and collectively the properties provide medium-term development potential.
- **Asset management**. Demolition has commenced at Hudson House in York, a 1960s office building within the city walls and close to the railway station where Palace has planning consent for new buildings comprising 127 apartments, 34,000 sq ft of office space, and 5,000 sq ft of other commercial space/restaurant space and parking. Demolition will save c £750,000 pa in property expenses, primarily by eliminating empty rates and service charges, or c £500,000 net of residual income.
- **Funding**. In January 2018, Palace announced that it had entered a new five-year £40m bank facility with Barclays Bank, secured on the commercial assets of the RT Warren portfolio. The loan increased total borrowing facilities to c £115m, replacing the £14.5m loan acquired with RT Warren, and due to expire 31 January 2018, and allowing for a small £12.7m loan with Nationwide, to also be repaid. The new loan was agreed at a margin of 1.95% over LIBOR, making a positive contribution to the average cost of debt. In March, the company entered into new interest rate swaps covering £55.8m in order to mitigate future interest rate risk, taking the total amount of debt covered by swaps to £70.3m and adding c 0.5% to average debt cost. At the time of the trading update, c £101m had been drawn and after allowing for cash balances, the net LTV was c 31%. The average debt maturity was 4.7 years at an average interest cost of 3.4%, 70% hedged.

FY18 adjusted profits to exceed market consensus

In the trading update management guides that adjusted profit before tax for the year-ended 31 March 2018, allowing for the major acquisitions and fundraise, is likely to be ahead of market expectations (before profits on disposal and any revaluation gains). We have not yet made adjustment to our FY18 estimates, awaiting further details with the full-year earnings release on 11 June 2018.

Taking into account the recent letting at Milton Keynes, the contracted rent roll has increased to £18.1m from £17.8m at H118, adjusted to include the subsequent completion of the RT Warren acquisition. Allowing for empty property rates, uncovered service charges and head rents, the effective net rental income is now £16.88m.

Looking beyond FY18, we had previously assumed that the letting of the remaining c 44,000 sq ft of recently refurbished office space at Boulton House in Manchester, Bank House in Leeds and Solaris House in Milton Keynes would have a positive impact on FY19 gross rental income. While this is true in the case of Solaris House, the lettings at Manchester and Leeds are taking longer than we had assumed, and although we anticipate contracted rental income increasing to c £18.6m pa by end-FY19 there will be little benefit to forecast earned FY19 net rental income. The expected rental value (ERV) at H118, adjusted to include RT Warren, was £20.7m pa, demonstrating further significant upside from lettings and rental uplifts. The ERV includes nothing for Hudson House.

Our net interest expense forecasts also now allow for the additional cost of hedging interest rate exposure. In combination, these two factors, before any potential acquisition offsets, reduce our expected adjusted EPRA EPS to 18.7p from 20.6p. On the basis that management remains committed to a progressive dividend policy, our forecast for the FY19 DPS remains unchanged at 19.5p, not quite fully coved by our current forecast for adjusted earnings.

Exhibit 7: Estimate revision summary

	Net rental income (£m)			Adjusted EPRA EPS (p)			EPRA NAV per share (p)			Dividend per share (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/18e	14.3	14.3	0.0	19.8	19.8	0.0	395	395	0.0	19.0	19.0	0.0
03/19e	17.9	17.2	(4.1)	20.6	18.7	(9.2)	396	395	(0.4)	19.5	19.5	0.0

Source: Edison Investment Research

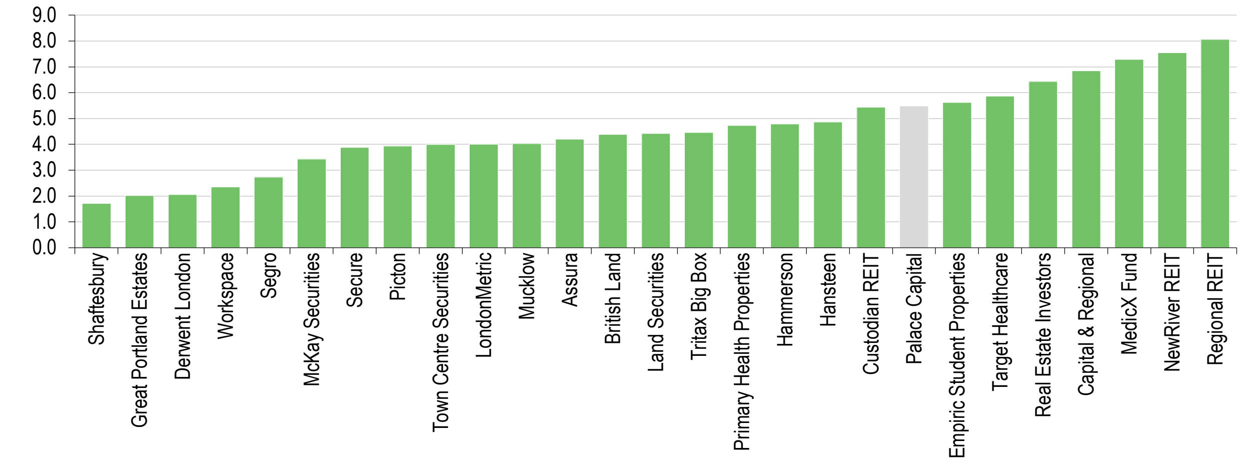
Potential for accretive acquisitions

Following the recent refinancing, Palace has additional borrowing headroom of c £14m, as well as cash resources, providing what management describes as considerable firepower to make significant acquisitions and boost returns. The H118 cash balance was £8.7m and including H218 disposals we estimate this may have increased to c £17.0m. None of this potential income upside is currently reflected in our forecasts. By way of example, £25m invested at a net initial yield of 7% would add c £1.75m to net rental income (c 10% of the FY19 forecast) or c £1.0m to adjusted earnings (c 10%) after financing costs and tax (at an assumed 15%). The FY19e LTV would increase from c 33% to c 39%.

Valuation

Although PCA is not a REIT, this current level of payout is at a similar level to the UK REIT sector and the prospective (FY19e) dividend yield of 5.6% is towards the upper end of prospective yields offered by the broad sector (Exhibit 8). Our forecasts show FY19e dividends covered 96% by adjusted earnings and 94% by diluted EPRA earnings (the difference between adjusted earnings and EPRA earnings is non-cash share based payments charges). As noted above, this may prove conservative as we included nothing in the forecast for potentially accretive acquisitions.

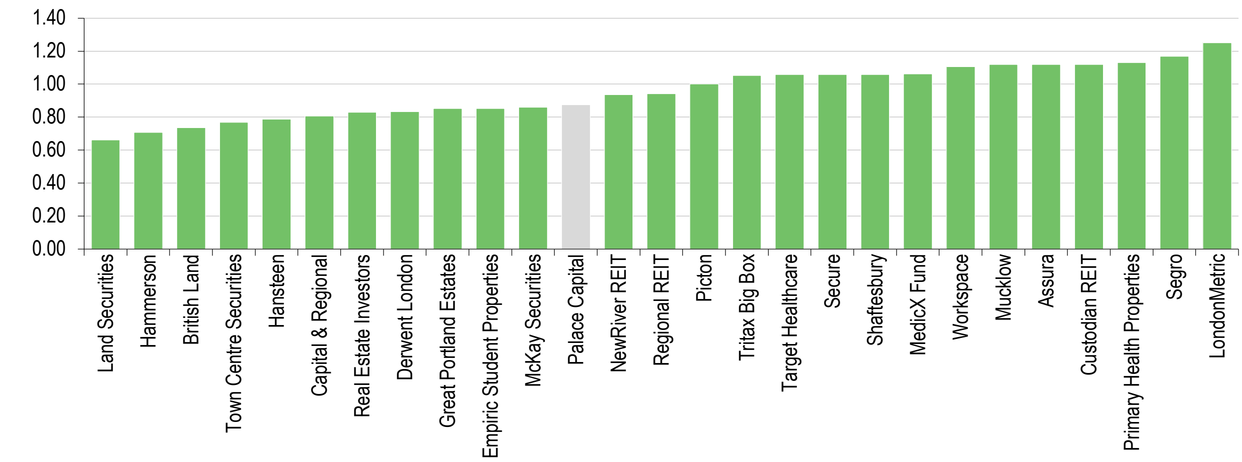
Exhibit 8: Peer prospective yield comparison



Source: Company data, Edison Investment Research, Bloomberg data as at 15 May 2018.

The c 20% discount to the FY18e EPRA NAV on which Palace shares trades positions it in the lower half of the sector (Exhibit 9).

Exhibit 9: Peer prospective trailing P/NAV comparison



Source: Company data, Edison Investment Research, Bloomberg data as at 15 May 2018.

Palace has built a strong track record of value creation over a number of years. Using our forecast end-FY18 EPRA NAV per estimate of 395p, but noting that management is indicating an above-consensus result for the year, the NAV total return in the four years and six months, from September 2013 (H114) is 109.6% or a compound 17.9% pa. We have begun the analysis at H114 because this corresponds to the acquisition of the Sequel portfolio, Palace's first transformational acquisition. The negative total return that we expect in FY18 is the result of the share issuance to fund the RT Warren portfolio, and captures none of the future asset management driven value creation that management targets.

Exhibit 10: NAV total returns (since the acquisition of the Sequel portfolio)

	H214	FY15	FY16	FY17	FY18e	H214–FY18
Opening EPRA NAV per share (p)	218	341	388	414	443	218
Closing EPRA NAV per share (p)	341	388	414	443	395	395
Dividend per share paid (p)	2.5	8.50	14.00	18.00	19.00	62
NAV total return (p)	126	55	41	46	(29)	239
NAV total return (%)	57.8%	16.0%	10.5%	11.2%	(6.5%)	109.6%
Compound annual total return						**17.9%**

Source: Palace Capital, Edison Investment Research

As noted above, our forecasts have built in no upside from asset management on the newly acquired assets because there is no convincing way that this can be prospectively modelled. But that is not to say that we do not expect such action. Meanwhile, we would argue that the current valuation has built in no anticipation of such progress from the newly acquired assets or ongoing portfolio initiatives, including potential further accretive acquisitions from deploying the strong cash position, and the Hudson House development in York.

The recent move to the Main Market of the London Stock Exchange should broaden the appeal of the shares to a wider group of investors.

Sensitivities

The commercial property market is cyclical, historically exhibiting substantial swings in valuation through cycles. Income returns are significantly more stable, but fluctuating with tenant demand and rent terms. We would also highlight the increased risks and uncertainties that attach to development activity, including planning consents, timing, construction risks and the long lead times to completion and eventual occupation. We consider the main sensitivities include:

- Sector risk: some of the inherent cyclical risk to vacancy in commercial property can be mitigated by portfolio diversification. As noted above, despite having a sector-agnostic approach to asset selection, Palace has a diversified portfolio across property types, locations and tenants, and this was further increased by the RT Warren acquisition.
- Development risk: although we expect asset management projects to continue to be a key contributor to property income growth and capital returns, active projects normally represent a relatively low share of the overall portfolio at any point in time. The Hudson House development is significant in relation to the overall group, although we note that detailed planning consent has already been granted. We anticipate that management will seek to manage risks by securing pre-lets for the commercial space and seeking to pre-sell the residential space.
- Macro risk:
  - Although growing by c 1.7% in 2017, UK GDP growth was weak in Q4, with slowing investment and construction, and low wage growth curbing consumption. The Bank of England forecasts a similar rate of growth in 2018 compared with 2017, although Brexit uncertainty remains high.
  - With inflation already rising, partly due to sterling depreciation and rising oil prices, the prospect of higher interest rates becomes more imminent. Around 70% of Palace's debt is now covered by interest rate swaps, significantly mitigating future interest rate risk. An increase in longer-term rates is likely to have a knock-on effect on NAV over time, through increased property yields.

Exhibit 11: Financial summary

Year end 31 March (£000s)	2014	2015	2016	2017	2018e	2019e
	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Rental & other income	3,252	8,637	14,593	14,266	16,055	18,566
Non-recoverable property costs	(648)	(1,200)	(1,624)	(2,055)	(1,715)	(1,396)
Net rental income	2,604	7,437	12,969	12,211	14,340	17,170
Administrative expenses	(649)	(1,439)	(2,048)	(2,915)	(3,187)	(3,400)
Operating Profit (before amort. and except).	1,955	5,998	10,921	9,296	11,153	13,770
Revaluation of investment properties	19,501	9,769	3,620	3,101	2,396	0
Costs of acquisitions/profits on disposals	270	(461)	(525)	3,191	(1,176)	0
Operating Profit	21,725	15,306	14,016	15,588	12,373	13,770
Net Interest expense	(573)	(1,398)	(2,264)	(3,011)	(3,175)	(3,896)
Profit Before Tax	21,153	13,909	11,752	12,577	9,198	9,873
Taxation	81	107	(953)	(3,191)	(1,158)	(1,481)
Profit After Tax (FRS 3)	21,234	14,015	10,799	9,386	8,040	8,392
EPRA adjustments:						
Revaluation of investment properties	(19,501)	(9,769)	(3,620)	(3,101)	(2,396)	0
Costs of acquisitions/profits on disposals	(-270)	461	525	(3,191)	1,176	0
Deferred tax charge	0	0	0	2,200	0	0
Debt termination cost	0	0	0	155	0	0
EPRA earnings	1,463	4,707	7,704	5,449	6,820	8,392
Adjusted for:						
Surrender premium	0	0	(3,172)	0	0	0
Share-based payments	12	114	110	237	200	200
Adjusted EPRA earnings	1,475	4,821	4,642	5,686	7,020	8,592
Company adjusted PBT	1,394	4,714	5,595	6,677	8,178	10,073
Average fully diluted number of shares outstanding (000s)	5,264	17,489	24,618	25,738	35,534	45,875
Basic EPS - FRS 3 (p)	403.4	80.1	43.9	36.5	22.6	18.3
Fully diluted EPRA EPS (p)	31.4	28.3	18.9	22.2	19.8	18.7
Fully diluted EPRA EPS (p)	29.1	26.9	31.3	21.2	19.2	18.3
Dividend per share declared (p)	4.5	13.0	16.0	18.5	19.0	19.5
EPRA dividend cover (x)	6.47	2.07	1.96	1.14	1.01	0.94
BALANCE SHEET						
Fixed Assets	60,086	104,470	175,738	183,959	269,515	275,265
Investment properties	59,440	102,988	174,542	183,916	269,386	275,136
Goodwill	6	6	0	0	0	0
Other non-current assets	640	1,475	1,196	43	129	129
Current Assets	7,060	15,653	11,903	13,692	22,003	17,181
Debtors	1,937	3,375	3,327	2,511	4,726	5,195
Cash	5,123	12,279	8,576	11,181	17,277	11,985
Current Liabilities	(4,171)	(3,487)	(9,048)	(8,197)	(10,851)	(11,711)
Creditors	(2,971)	(3,087)	(6,815)	(6,161)	(8,665)	(9,525)
Short term borrowings	(1,200)	(400)	(2,233)	(2,036)	(2,186)	(2,186)
Long Term Liabilities	(18,599)	(36,620)	(71,778)	(79,895)	(102,017)	(102,317)
Long term borrowings	(17,384)	(35,407)	(69,711)	(75,758)	(97,930)	(98,230)
Deferred tax	0	0	0	(2,187)	(1,588)	(1,588)
Other long term liabilities	(1,215)	(1,214)	(2,067)	(1,950)	(2,499)	(2,499)
Net Assets	44,376	80,016	106,815	109,559	178,650	178,418
EPRA net assets	44,370	80,010	106,924	111,759	181,149	180,917
Basic NAV/share (p)	357	396	414	436	390	389
EPRA NAV/share (p)	341	388	414	443	395	394
CASH FLOW						
Operating Cash Flow	1,297	4,388	12,287	10,294	10,071	14,360
Net Interest	(390)	(1,593)	(3,421)	(2,516)	(2,532)	(3,596)
Tax	(13)	(15)	(158)	(1,047)	(770)	(1,481)
Preference share dividends paid	(18)	0	0	0	0	0
Net cash from investing activities	2,532	(2,922)	(50,012)	(3,108)	(68,834)	(5,750)
Ordinary dividends paid	0	(1,766)	(3,221)	(4,617)	(6,744)	(8,824)
Debt drawn/(repaid)	(21,266)	(10,600)	21,272	5,861	7,663	0
Proceeds from shares issued	23,009	19,664	19,114	29	67,550	0
Other cash flow from financing activities	(66)	(2)	(2)	(2,291)	(361)	0
Net Cash Flow	5,085	7,155	(4,141)	2,605	6,044	(5,291)
Opening cash	39	5,123	12,278	8,576	11,181	17,225
Other items (including cash assumed on acquisition)	0	0	439	0	0	0
Closing cash	5,123	12,278	8,576	11,181	17,225	11,934
Closing debt	19,509	37,021	74,011	79,744	102,615	102,915
Closing net debt/(cash)	14,385	24,742	65,435	68,563	85,390	90,981
Net LTV	23.0%	23.3%	37.0%	36.9%	31.2%	32.5%

Source: Palace Capital, Edison Investment Research

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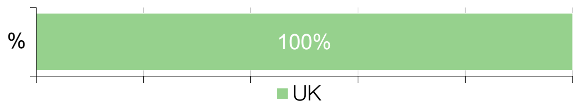
Revenue by geography



Leadership team

Chairman: Stanley Davis

Stanley Davis is a successful entrepreneur who has been involved in the City of London since 1977. He founded company registration agents, Stanley Davis Company Services, which he sold in 1988. In 1990 he became chief executive of a small share registration company which became known as IRG and acquired a number of businesses including Barclays Bank Registrars and was sold for a substantial sum to The Capita Group. He is chairman of Stanley Davis Group specialising in company formations, property and company searches.

CEO: Neil Sinclair

Neil Sinclair has over 55 years' experience in the property sector. He was a founder of Sinclair Goldsmith, chartered surveyors, which was admitted to the Official List in 1987 and subsequently merged with Conrad Ritblat in 1993, when he became executive deputy chairman. Neil was appointed non-executive chairman of Baker Lorenz, surveyors in 1999, which was sold to Hercules Property Services in 2001. He was appointed a non-executive director of Tops Estates, a fully listed company, in 2003 and remained so until Tops Estates was sold to Land Securities in 2005.

Executive Director: Richard Starr

Richard is a chartered surveyor and has over 20 years' experience working in the property industry. He was appointed to the board in October 2013. Prior to this appointment, he had founded his own boutique consultancy, having qualified as a chartered surveyor in 2000, and subsequently gaining a wide range of experience at three advisory firms. His extensive property knowledge allows him to identify and subsequently implement asset management initiatives to enhance value across all sectors.

CFO: Stephen Silvester

Stephen Silvester, a chartered accountant, joined Palace Capital in 2015 and brings over 10 years' experience as a finance professional, with a background across a range of markets, including real estate. Prior to joining Palace Capital he served for three years as group financial controller at NewRiver REIT and before that was financial controller at St Hilliers, a private construction and property development business in Sydney, Australia. He has been involved in debt restructuring, numerous property portfolio acquisitions across the UK, capital raising and securing credit facilities from major institutions.

Principal shareholders	(%)
AXA Investment Managers	7.73
Miton Group plc	7.41
J.O. Hambro	7.32
Polar Capital European Forager Fund Ltd	4.97
Stanley Harold Davis	3.63

Companies named in this report

Custodian REIR (CREI), Great Portland Estates (GPOR), Hammerson (HMSO), Picton Property (PCTN), Regional REIT (RGL), Land Securities (LAND), Town Centre Securities (TOWN)