EDISON

Palace Capital

Trading update

Hudson Quarter completion

Real estate

Ahead of results for the year ended 31 March 2021 (FY21), due in June, Palace Capital (PCA) issued a trading update on continuing robust rent collection, further disposals of non-core assets, and perhaps most important of all, the completion of the flagship Hudson Quarter (HQ) development in York, on budget, later this month. We expect HQ to be a significant driver of returns and deleveraging over the next two years.

Year end	Net rental income (£m)	Adj PBT* (£m)	Adj EPS* (p)	EPRA NTA/ share (p)**	DPS (p)	P/NTA (x)	Yield (%)
03/20	18.8	8.0	17.5	364	12.0	0.64	5.1
03/21e	14.5	6.7	14.5	341	10.0	0.69	4.3
03/22e	14.3	6.6	14.3	359	12.0	0.65	5.1
03/23e	15.0	7.1	15.5	368	14.0	0.64	6.0

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

HQ to drive returns and de-gearing

We forecast development gains of c 20p per share and recurring income of c £0.9m over the next two years as the HQ residential apartments are sold and the commercial space let. Despite the marketing suite being closed for much of the past year by lockdowns, contracts have been exchanged on 40 (of a total 127) apartments for an aggregate value of £10.8m with six further apartments under offer (£1.8m value). PCA now expects at least half of the remaining apartments to be sold by end-FY22, generating sufficient cash to repay the development funding in full by the end of calendar 2021. Given supply constraints in the local market, PCA expects the high-quality commercial space to be let or under offer by end-FY22. Completion of HQ represents a significant de-risking and an opportunity to de-gear. We an estimate peak year-end LTV of just over 40% at FY21, falling to c 30% as apartment sales complete, and assuming no reinvestment.

Adjusting future year forecasts for more cautious outlook

PCA collected 94% of rents for the year ended 31 March 2021 and at the date of the announcement, 82% of the March quarter rents had been collected (69% in cash, 3% lease amendments and 10% agreed payment plans and monthly collection); PCA expects this to increase to more than 90%. Our previously above-consensus forecasts are adjusted to take account of recent disposals (for which we assume no reinvestment) and a more cautious view on the pace at which strong reversionary potential can be captured over the next two years. FY21 earnings are unchanged but we have deferred an increase in quarterly DPS to FY22. We expect a slower rate of earnings growth in FY22 and FY23 but continuing DPS growth, fully covered by earnings and growth in EPRA NTA, driven by HQ.

Valuation: Attractive yield and wide discount to NAV

The PCA valuation remains undemanding set against the value embedded in the portfolio (see below). Our FY22e DPS forecast represents a well-covered dividend yield of 5.1%, while the shares continue to trade at a significant discount of c 30% to EPRA NTA.

20 April 2021

Price	**235p**
Market cap	**£108m**

Net debt (£m) at 31 March 2021	117.9
Edison est. net LTV at 31 March 2021	41.9%
Shares in issue	46.1m
Free float	95%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.2	22.2	16.9
Rel (local)	(2.2)	16.0	(6.7)
52-week high/low		239p	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

FY21 results	Expected June 2021

Analyst

Martyn King +44 (0)20 3077 5745

financials@edisongroup.com

Edison profile page

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Regional investor targeting total returns

In this note we provide an update on our November Outlook note and revisions to our forecasts ahead of PCA's release of results for the year to 31 March 2021 (FY21) that we expect in June. PCA is an internally managed UK real estate investment trust (REIT), focused on commercial properties in major cities and university towns in the UK, outside London. It has an entrepreneurial approach to investment and unlike many REITs operates a total return model. Since IPO in 2013 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. This strategy aims to provide attractive income returns, as well as exposure to capital growth from the repositioning of value-add properties. PCA is sector-agnostic over the medium term, adapting to shifting market opportunities, but is currently focused on regional office and industrial assets, 43% and 14% of portfolio value respectively at end-H121. We expect this focus to further increase through the company's capital recycling plans. Although rent collection has remained strong, the market conditions created by the pandemic over the past year have limited the opportunity to deliver value creation by slowing letting activity and weakening capital values across much of the UK commercial property market. Nevertheless, the existing portfolio contains strong reversionary potential and offers significant refurbishment and development opportunities as and when conditions improve. Meanwhile, we expect completion of the flagship HQ development in York to materially drive returns in the next two years.

Flagship Hudson Quarter development approaches completion

The HQ development in York promises to be a significant driver of returns for PCA over the next two years. Despite pandemic-driven delays of around three months in total it is due to complete by the end of April 2021, on budget.

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. The underlying market conditions in York remain favourable for both the residential and commercial assets.

Although the marketing suite has been closed for much of the past year by the lockdowns, it has now re-opened. Contracts have been exchanged on 40 of the 127 apartments, up from 36 in November 2020 and 28 in March 2020, with a value of £10.77m. An additional six apartments are under offer with a total consideration of £1.75m. At £550 per sq ft, PCA expects the gross sales value of the residential assets to be c £52m. Most of the apartments sold to date have been studios and one-bedroom apartments rather than the higher value, larger apartments and hence the average sales value has been below the overall expected value. The scheme is of high quality and PCA is encouraged by a significant increase in enquiries and reservations since the government published its roadmap out of lockdown on 23 February. It expects at least half of the remaining 81 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 £20m. Including existing financial resources, PCA expects to repay the c £26m Barclays development facility, utilised to part-fund the entire project, in full by the end of calendar 2021.

The pandemic has also slowed pre-letting activity for the 35,000 sq ft of self-contained commercial space at HQ. However, given the quality of the space (grade-A standard) and supply constraints in the local market PCA expects it to be let or under offer by the end of FY22. As has been previously reported, in February, 4,500 sq ft of office space, on the ground floor of one of the residential buildings was pre-let to Knights, a quoted law firm, at a record rent for York of £25 per sq ft.

HQ is one of many opportunities embedded in the portfolio

HQ provides a significant upside opportunity for PCA. It is a large project for PCA, with a gross development value that represents c two-thirds of market capitalisation. Completion on budget represents a significant de-risking, as does the opportunity to de-gear as the residential assets are sold. In terms of income and capital returns, HQ completion provides the potential to crystalise sales profits on the residential apartments, recognise development gains on the commercial space and recurring income as it is let. For HQ, our forecasts include c £10m of development/disposal gains over FY22 and FY23, more than 20p per share, and for the commercial space to add c £0.9m to rental income on an annualised basis once fully let. We expect gearing (LTV) to peak at a little over 40% in FY21, ahead of HQ completion, falling to around 30% as the residential apartment sales are completed in full (c £50m net proceeds).

Individually on a smaller scale than HQ there is a broad range of additional opportunities embedded within the PCA portfolio.

The H121 externally estimated rental value (ERV) of the portfolio, excluding the c £0.9m of additional rent uplift that management expects from the completion and letting of HQ, was £3.3m or 20% ahead of the contracted gross income. Although both ERV and contracted rents will have shifted during H221 with disposals, leasing events and market rental changes, the scale of the potential is clear. Void reduction represents the largest share of this (£3.1m at end-H121), including vacant properties, in many cases recently refurbished, that are immediately available to let as well as properties where vacant possession has been strategically obtained with a view to refurbishment or development activity. Some of these could meanwhile be offered on short lets. Several additional medium-term refurbishment and development opportunities for which detailed asset management plans have been identified, potentially providing counter-cyclical opportunities to add value to the portfolio should market-wide rents and capital returns stall.

Continuing asset management

The pandemic has slowed leasing activity across much of the portfolio, not least because of the difficulty in viewing properties but also because many potential tenants have been unwilling to commit to long-term plans until uncertainty has eased. Encouragingly, four lettings have recently been agreed at the company's two leisure assets in Northampton and Halifax in addition to an office property in Leeds. Unsurprisingly the leisure assets were badly affected by the lockdown and in H121 PCA focused on securing longer-term occupancy and protecting valuation, in some cases by providing immediate pandemic support to the tenants through rental concessions in return for lease extensions and lease break removal. As the lockdown is eased PCA continues to anticipate a recovery in investment market activity in the sector which it hopes will provide an opportunity to recycle capital towards the office and industrial sectors that form the core of its portfolio.

Further non-core disposals identified

Since the end of H121 PCA has reported on the disposed of four properties as part of its ongoing disposal programme, focused on non-core properties, largely where it has completed 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. With the interim results in November PCA reported the sale of two non-core office assets for a combined c £2.7m, an average c 23% above the H121 book value. Meadow Court, a partially let office in Sheffield, was sold for £1.25m, 30% above book value, and the vacant Hyde Abbey House, in Winchester, with its historic Georgian façade was sold for £1.46m, 17% above book value with planning consent for a change of use to residential. PCA has also disclosed the sale of two further asset during H221 (Harbour Court in Portsmouth and 124–126 Upper Bar Street in Southampton), also at an undisclosed premium to book value, for a combined £2.45m. At least another 15 properties with an aggregate value more than £30m have been identified for disposal during the current year. The properties that have been sold or may be sold are relatively small. The average lot size of the four properties sold in H221 was £1.3m and the average lot size of the additional properties identified for sale is c £2m. Across the entire portfolio, with a H121 value of £281.6m the average lot size of the 52 properties owned at the time was c £5.4m. 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.

Forecast revisions

Our previously above consensus forecasts are adjusted to take account of recent disposals (for which we do not assume reinvestment) and build in a more cautious view on reversionary capture going forward. Although we have not specifically included the further disposals planned by the company, we would expect the proceeds of these to be substantially recycled to maintain the income base as well as providing new asset management opportunities. However, there may well be a timing gap between sales and purchases, and this contributes to the more cautious view. Our FY21 forecasts are unchanged other than to defer any increase in the quarterly rate of DPS until FY22. However, our FY22 forecasts are lower and the impact builds in FY23 with a material reduction in the rate of earnings growth compared with that previously forecast.

Despite a consistent rent collection performance we have therefore deferred any increase in the level of quarterly DPS until FY22.

Exhibit 1: 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 (%)
03/21e	14.5	14.5	0.0	6.7	6.7	0.0	14.5	14.5	0.0	341	341	0.0	12.0	10.0	(16.7)
03/22e	14.9	14.3	(4.1)	6.9	6.6	(4.6)	14.9	14.3	(4.6)	364	359	(1.4)	12.0	12.0	0.0
03/23e	16.6	15.0	(9.6)	8.4	7.1	(15.2)	18.2	15.5	(15.2)	378	368	(2.5)	16.0	14.0	(12.5)

Source: Edison Investment Research

The changes to our adjusted profit before tax (adjusted PBT) are driven by lower net rental income, partly offset by lower net finance expense (lower debt). We estimate that recent disposals reduce gross contracted rent roll (£16.9m at end-H121) by c £0.4m. Including this, our forecasts are based on expected gross contracted rent roll of £16.3m (previously £16.7m) at end-FY21, £15.9m at end-FY22 (previously £16.8m, both before any impact from the HQ commercial assets), and £17.3m at end-FY23 (previously £17.3m, both including c £0.9m from HQ).

In line with company guidance, we have extended the sales period for the HQ residential apartments to the end of calendar 2022, having previously assumed this would be completed by 31 March 2022 (end-FY22). In our forecasts this is primarily a cash flow item although by tying development gains on the apartments to completed sales it has the effect of deferring c £3.0m of gains from FY22e to FY23e. Other than the HQ development gains (now c £7m in FY22 and c £3m in FY23) we continue to allow for additional negative revaluation effects in H221 of c £4.5m (c 1.9% of the end-H121 value of the completed portfolio or c 1.5% adjusting for assumed capex). For FY22 and FY23 we assume no change in values, adjusted for capex. Each 1% increase/decrease in the value of the overall portfolio (including HQ) is equivalent to an increase/decrease in FY21e EPRA net tangible assets per share (NTA) of c 6p.

Valuation

Since its first major post-IPO transaction in H214 until end-H121 PCA's total return strategy has generated cumulative EPRA NAV total returns of 106.1% or a compound annual average return of 10.9%. This is a good level of return despite the negative impacts of COVID-19 on late FY20 and H121 property valuations. Our forecasts indicate a negative (4.4%) total return for FY21 but positive returns in FY22 (8.6%) and FY23 (6.1%), driven by development gains/residential disposal profits on the completion of HQ) and increased rental income through reversionary capture.

Exhibit 2: NAV total return history

	H214	FY15	FY16	FY17	FY18	FY19	FY20	H121	Cumulative return H214–H121
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	347	347
DPS paid (p)	2.5	8.50	14.00	18.00	19.00	19.00	19.00	2.5	103
Income return (%)	1.1%	2.5%	3.6%	4.3%	4.3%	4.6%	4.7%	0.7%	47.0%
Capital return (%)	56.6%	13.5%	6.9%	6.9%	-6.4%	-1.8%	-10.4%	-4.8%	59.1%
NAV total return (%)	**57.8%**	**16.0%**	**10.5%**	**11.2%**	**-2.1%**	**2.8%**	**-5.8%**	**-4.1%**	**106.1%**
Ave, annual compound return									**10.9%**

Source: Palace Capital data, Edison Investment Research. *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 current rate of quarterly DPS (an annualised 10p per share) the yield is 4.3% and based on our forecast FY22 DPS of 12p per share the prospective yield is 5.1%. We forecast DPS to continue to be fully covered by adjusted earnings. Meanwhile, the shares trade at a significant discount of c 30% to both H121 EPRA NTA per share of 347p and our forecast end-FY21 diluted EPRA NTA per share of 341p.

In Exhibit 3 we show a summary performance and valuation comparison of Palace and a peer group of UK commercial real estate investment companies with a strong regional focus. PCA's current annualised DPS of 10p, fully covered by adjusted earnings, represents a yield of 4.3% which represents an attractive income return within PCA's total return strategy. In combination with the more than 30% discount to NAV and strong reversionary potential within the portfolio there appears to be significant unrecognised value in the shares. HQ completion is a potential trigger for a re-rating by significantly reducing development risk, which we expect to be followed by financial de-leveraging as the residential assets are sold, recognition of development/sale profits and enhancement of long-term income.

Exhibit 3: 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	205	59	0.72	2.2	15%	15%	12%	-6%
Custodian	97	408	1.01	5.1	10%	9%	3%	-1%
Picton	91	496	0.95	3.0	4%	11%	29%	-1%
Real Estate Investors	38	68	0.69	7.9	13%	7%	-11%	-13%
Regional REIT	84	364	0.82	7.6	10%	9%	12%	-4%
Schroder REIT	41	211	0.69	3.9	2%	3%	2%	-4%
UK Commercial Property REIT	76	988	0.91	2.4	4%	15%	16%	-3%
BMO Commercial Property Trust	78	620	0.66	2.3	9%	-2%	13%	-10%
BMO Real Estate Investments	80	192	0.81	4.5	9%	24%	57%	-2%
Average			**0.81**	**4.3**	**8%**	**10%**	**15%**	**-5%**
Palace Capital	**235**	**108**	**0.68**	**4.3**	**2%**	**18%**	**16%**	**-2%**
UK property sector index	1,721				6%	8%	20%	0%
UK equity market index	3,997				4%	5%	25%	-1%

Source: Company data, Refinitiv. Note: Prices as at 20 April 2021. *Based on last reported EPRA NAV per share. **Based on trailing 12-month DPS declared.

Exhibit 4: Financial summary

Year end 31 March (£m)	2017	2018	2019	2020	2021e	2022e	2023e
PROFIT & LOSS							
Rental & other income	14.3	16.7	18.8	21.1	16.7	16.5	17.1
Non-recoverable property costs	(2.1)	(1.8)	(2.3)	(2.4)	(2.2)	(2.2)	(2.1)
Net rental income	12.2	14.9	16.4	18.8	14.5	14.3	15.0
Dividend income from listed equity investments			0.0	0.1	0.0	0.0	0.0
Administrative expenses before share based payments	(2.7)	(4.0)	(3.8)	(4.2)	(4.2)	(4.3)	(4.4)
Share-based payments	(0.2)	(0.2)	(0.3)	(0.1)	(0.3)	(0.3)	(0.3)
Operating Profit (before capital items)	9.3	10.7	12.4	14.6	10.0	9.7	10.3
Unrealised gains/(losses) on properties	3.1	5.7	(0.7)	(17.9)	(14.5)	7.0	3.0
Realised gains/(losses) on properties	3.2	0.3	(0.4)	(0.1)	0.9	0.0	0.0
Loss on revaluation of listed equity investments			(0.2)	(0.4)	(0.2)	0.0	0.0
Operating Profit	15.6	16.7	11.1	(3.9)	(3.8)	16.7	13.3
Net finance expense	(3.0)	(3.4)	(4.7)	(5.2)	(4.0)	(3.5)	(3.5)
Profit Before Tax	12.6	13.3	6.4	(9.1)	(7.8)	13.3	9.8
Taxation	(3.2)	(0.8)	(1.3)	3.6	0.0	0.0	0.0
Profit After Tax (FRS 3)	9.4	12.5	5.2	(5.4)	(7.8)	13.3	9.8
EPRA adjustments:							
Unrealised gains/(losses) on properties	(3.1)	(5.7)	0.7	17.9	14.5	(7.0)	(3.0)
Realised gains/(losses) on properties	(3.2)	(0.3)	0.4	0.1	(0.9)	0.0	0.0
Deferred tax charge	2.2	(0.3)	0.2	0.0	0.0	0.0	0.0
Other adjustments	0.2	0.3	1.1	(1.8)	0.6	0.0	0.0
EPRA earnings	5.4	6.5	7.6	10.8	6.4	6.3	6.8
Non-recurring items	0.0	0.7	0.0	(2.9)	0.0	0.0	0.0
Share-based payments	0.2	0.2	0.3	0.1	0.3	0.3	0.3
Adjusted earnings	5.7	7.4	7.9	8.1	6.7	6.6	7.1
Tax adjustments	1.0	1.1	1.0	(0.0)	0.0	0.0	0.0
Company adjusted PBT	6.7	8.5	8.9	8.0	6.7	6.6	7.1
Average fully diluted number of shares outstanding (m)	25.7	35.0	45.9	46.0	46.1	46.1	46.1
Basic EPS - FRS 3 (p)	36.5	35.8	11.3	(11.8)	(16.9)	28.8	21.3
Fully diluted EPRA EPS (p)	21.2	18.7	16.5	23.4	13.8	13.6	14.8
Fully diluted adjusted EPS (p)	22.2	21.2	17.3	17.5	14.5	14.3	15.5
Dividend per share declared (p)	18.5	19.0	19.0	12.0	10.0	12.0	14.0
Dividend cover by adjusted earnings (x)	1.20	1.11	1.10	1.10	1.45	1.19	1.10
BALANCE SHEET							
Fixed Assets	184.0	254.0	261.1	251.7	237.0	243.5	248.5
Investment properties	183.9	253.9	258.3	248.7	234.3	240.8	245.8
Other non-current assets	0.0	0.1	2.7	3.0	2.7	2.7	2.7
Current Assets	13.7	46.3	55.3	51.8	61.9	38.7	37.3
Trading properties	0.0	0.0	14.4	27.6	44.9	22.0	1.0
Assets held for sale	0.0	21.7	11.8	0.0	0.0	0.0	0.0
Cash	11.2	19.0	22.9	14.9	6.9	6.7	26.3
Other current assets	2.5	5.6	6.2	9.3	10.0	10.0	10.0
Current Liabilities	(8.2)	(11.5)	(16.0)	(16.1)	(17.7)	(13.7)	(12.8)
Creditors	(6.2)	(8.8)	(10.0)	(14.1)	(15.7)	(11.7)	(10.7)
Short term borrowings	(2.0)	(2.7)	(6.0)	(1.8)	(1.8)	(1.8)	(1.8)
Long Term Liabilities	(79.9)	(105.5)	(120.0)	(121.1)	(128.1)	(104.5)	(104.9)
Long term borrowings	(75.8)	(97.2)	(112.0)	(117.5)	(124.4)	(100.9)	(101.3)
Deferred tax	(2.2)	(6.5)	(5.6)	(.2)	(.2)	(.2)	(.2)
Other long-term liabilities	(2.0)	(1.8)	(2.4)	(3.3)	(3.4)	(3.4)	(3.4)
Net Assets	109.6	183.3	180.3	166.3	155.5	164.0	168.1
EPRA net assets	111.8	190.0	187.0	167.9	157.3	165.7	169.9
Basic NAV/share (p)	436	400	393	361	338	356	365
Diluted EPRA NAV/share (p)	443	414	407	364	341	359	368
CASH FLOW							
Operating Cash Flow	10.3	9.9	11.9	15.7	11.9	6.0	9.7
Net Interest	(2.5)	(2.7)	(3.4)	(3.7)	(3.5)	(3.0)	(3.0)
Tax	(1.0)	(0.4)	(1.6)	(2.2)	(1.1)	0.0	0.0
Net cash from investing activities	(3.4)	(67.7)	(11.5)	(10.1)	(15.7)	23.4	19.0
Ordinary dividends paid	(4.6)	(6.7)	(8.7)	(8.7)	(3.5)	(5.1)	(6.0)
Debt drawn/(repaid)	6.5	8.2	18.0	1.4	6.5	(24.0)	0.0
Proceeds from shares issued (net)	0.0	67.7	(0.0)	0.0	0.0	0.0	0.0
Other cash flow from financing activities	(2.9)	(1.1)	(0.1)	(1.0)	0.0	0.0	0.0
Net Cash Flow	2.4	7.0	4.4	(8.5)	(5.3)	(2.7)	19.6
Opening cash	8.6	10.9	18.0	22.4	13.9	8.6	5.9
Closing cash	10.9	18.0	22.4	13.9	8.6	5.9	25.5
Restricted cash	0.2	1.0	0.5	1.0	0.8	0.8	0.8
Closing balance sheet cash	11.2	19.0	22.9	14.9	9.4	6.7	26.4
Closing balance sheet debt	(77.8)	(99.8)	(118.0)	(119.4)	(126.3)	(102.7)	(103.1)
Unamortised debt costs	(0.9)	(1.6)	(1.3)	(1.4)	(1.0)	(0.5)	(0.1)
Closing net (debt)/cash	(67.5)	(82.4)	(96.5)	(105.8)	(117.9)	(96.5)	(76.9)
Net LTV (exc restricted cash & adjusted for unamortised debt costs)	36.9%	29.8%	33.7%	38.1%	41.9%	36.5%	30.9%

Source: Company data, Edison Investment Research

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