Palace Capital

Interim results

Investing for growth

Real estate

During H120, Palace stepped up its refurbishment and development activity aimed at improving the quality of the portfolio and enhancing its income and valuation potential over the longer term. The flagship Hudson Quarter development is making good progress and the initial tranche of the apartments offered for sale in June has been well received. Although refurbishment and redevelopment activity is dampening current income, DPS is being maintained in anticipation of future income growth and represents an attractive yield.

Year end	Net rental income (£m)	Adj. PBT* (£m)	Adj. EPS* (p)	EPRA NAV/ share (p)**	P/NAV (x)	DPS (p)	Yield (%)
03/19	16.4	8.9	17.3	407	0.70	19.0	6.7
03/20e	18.3	8.0	16.7	391	0.73	19.0	6.7
03/21e	15.7	8.1	17.6	412	0.69	19.0	6.7
03/22e	16.8	9.0	19.5	416	0.68	19.0	6.7

Note: *Adjusted earnings – in addition to EPRA adjustments for revaluation gains, profits or losses on disposals of investment properties and surrender gains on early lease terminations, this adjusts for share-based payments and Main Market listing costs. **EPRA NAV is fully diluted.

Robust H120

The property portfolio produced an ungeared total return of 1.5% in H120 compared with 0.8% for the MSCI Quarterly Benchmark Index, benefiting from a focus on regional office and industrial assets. The Hudson Quarter (HQ) development remains on track and on budget and, after initial marketing of 20 apartments in June, 21 apartments have been sold with another seven under offer. Refurbishment and redevelopment are dampening current income and recurring earnings, but adjusted net earnings increased to £3.9m (H119: £3.6m) due to post-REIT conversion tax benefits. With capex yet to be reflected in property valuation EPRA NAV fell 3.9% to 391p. Gearing remained moderate at 34%. Mainly reflecting refurbishment plans our forecasts are reduced slightly (see page 7).

Significant income and value potential

End-H120 estimated rental value (ERV) of £21.2m pa, before the c £0.9m rent potential expected from the HQ commercial assets, is 30% ahead of passing rent of £16.3m pa. This represents a significant opportunity to increase recurring income and underpins the continuation of attractive dividend distributions. Relatively little of this income and value opportunity is reflected in our forecasts although we do include c £10m in development gains in respect of HQ. Similarly not factored into our forecasts, management continues to seek accretive acquisitions for which borrowing headroom exists.

Valuation: Attractive yield and discount to NAV

The dividend yield is attractive, more than 6%, and management has committed to the current level of DPS despite a near-term earnings cover shortfall. The discount to EPRA NAV is c 27%. Asset management initiatives to capture reversionary potential and progress with Hudson Quarter are potential triggers for a re-rating.

2 December 2019

Price	**284p**
Market cap	**£130m**

Net debt (£m) at 30 September 2019	94.1
Net LTV at 30 September 2019	34.1%
Shares in issue	46.0m
Free float	95%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.5)	2.9	(3.6)
Rel (local)	(1.6)	(0.3)	(8.6)
52-week high/low		328p	265p

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

Q2 DPS paid	December 2019

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Edison profile page

Palace Capital is a research client of Edison Investment Research Limited

Investing for future growth

During H120, Palace stepped up its refurbishment and development activity aimed at improving the quality of the portfolio, and enhancing its income and valuation potential over the longer term. The flagship Hudson Quarter development is making good progress and the initial tranche of the apartments offered for sale in June has been well received. The necessary increase in vacancy has dampened recurring income in the period, while capex is yet to be fully reflected in property revaluation. However, DPS has been maintained in anticipation of the future income growth that management expects and the solid financial position. Reported earnings included significant lease surrender income as well as positive current and deferred tax effects resulting from REIT conversion.

Exhibit 1: Summary of H120 financials

	H120			H119			H120/ H119	FY19		
£m unless stated otherwise	**IFRS**	**Adj.**	**Adj. earnings**	**IFRS**	**Adj.**	**Adj. earnings**	**Adj. earnings**	**IFRS**	**Adj.**	**Adj. earnings**
Rental & other income	11.9	(2.9)	9.1	9.2	0.0	9.2		18.8		18.8
Non-recoverable property costs	(1.2)		(1.2)	(1.1)		(1.1)		(2.3)		(2.3)
Net rental income	**10.7**	**(2.9)**	**7.9**	**8.1**	**0.0**	**8.1**	**-3.2%**	**16.4**	**0.0**	**16.4**
Dividend on listed equity investment	0.1		0.1	0.0		0.0		0.0		0.0
Share based payments	(0.1)	0.1	0.0	(0.1)	0.1	0.0		(0.3)	0.3	0.0
Other administrative expenses	(2.1)		(2.1)	(1.9)		(1.9)	10.9%	(3.8)		(3.8)
Operating profit before gains/(losses) on property assets	**8.6**	**(2.8)**	**5.8**	**6.1**	**0.1**	**6.2**	**-6.6%**	**12.4**	**0.3**	**12.7**
Unrealised gains/(loss) on revaluation of investment properties	(6.2)	6.2	0.0	3.9	(3.9)	0.0		(0.4)	0.4	0.0
Profit/(loss) on disposal of investment properties	(0.3)	0.3	0.0	0.2	(0.2)	0.0		(0.7)	0.7	0.0
Impairment of trading properties	(0.3)	0.3		0.0	0.0	0.0				
Unrealised gain/(loss) on listed investments	0.1	(0.1)	0.0	0.0	0.0	0.0		(0.2)	0.2	0.0
Operating profit	**1.9**	**3.9**	**5.8**	**10.2**	**(4.0)**	**6.2**	**-6.6%**	**11.1**	**1.6**	**12.7**
Net finance costs	(2.4)	0.5	(1.9)	(1.9)	0.0	(1.9)	-2.1%	(3.7)		(3.7)
Change in value of interest rate derivatives	(0.7)	0.7	0.0	0.1	(0.1)	0.0		(0.9)	0.9	0.0
Profit before tax	**(1.2)**	**5.1**	**3.9**	**8.3**	**(4.1)**	**4.3**	**-8.6%**	**6.4**	**2.5**	**8.9**
Taxation	3.7	(3.7)	0.0	(1.1)	0.4	(0.6)		(1.3)	0.2	(1.0)
Profit after tax	**2.6**	**1.4**	**3.9**	**7.3**	**(3.6)**	**3.6**	**7.4%**	**5.2**	**2.8**	**7.9**
OTHER DATA										
Basic EPS (p)			5.6			15.9				11.3
Fully diluted EPRA EPS (p)*			14.5			7.7	87.7%			16.5
Fully diluted adjusted EPS (p)			8.5			8.0	6.8%			17.3
DPS (p)			9.5			9.5	0.0%			19.0
EPRA NAV per share (p)			391			421	-7.2%			407
EPRA NAV total return			-1.4%			4.0%				2.8%
Fair value of investment properties			275.8			261.6				286.3
Net debt			94.1			85.4				96.5
Net LTV			34.1%			30.3%				33.7%

Source: Palace Capital data, Edison Investment Research

The key highlights of the H120 results were:

- The property portfolio produced an ungeared total return of 1.5% compared with 0.8% for the MSCI Quarterly Benchmark Index, benefiting from a focus on regional office and industrial assets.
- On an IFRS basis, net rental income included £2.9m of previously disclosed non-recurring lease surrender income. Excluding this, rental income was marginally lower, reflecting the current focus on strategic refurbishment and development. On an EPRA basis, occupancy was 84% at the end of the period compared with 87% at end-FY19.
- Adjusted profit before tax (excluding realised and unrealised valuation movements, share-based payments and non-recurring items, including the lease surrender premium) was £3.9m

(H119: £4.3m). As a result of REIT conversion, the tax charge has fallen away, and post-tax adjusted earnings were also £3.9m but ahead of H119 (£3.6m). Adjusted EPS was 8.5p and covered DPS (unchanged at 9.5p) by c 90%.

- Negative property revaluation was driven by the impact of the lease surrender on the carried value of the short leasehold asset value and the lack of recognition of refurbishment and redevelopment capex in the property valuation. This typically comes through with a lag as the projects complete and refurbished and developed space is re-let or sold. As a result, EPRA NAV per share reduced 3.9% to 391p compared with 407p at end-FY19.
- IFRS earnings and IFRS NAV benefited from the post-REIT conversion elimination of £3.7m of deferred tax liabilities in respect of unrealised property revaluation gains (EPRA NAV had previously adjusted for this).
- Gearing remained moderate, with a c 34% net LTV. The company had c £46m of undrawn debt facilities comprising the £26.5m development loan that will be used to fund continuing building costs at Hudson Quarter, and a £20m flexible revolving credit facility.

In a confident outlook statement management reiterates its confidence that the core income-producing properties, together with the development and refurbishment pipeline, including the ongoing progress at Hudson Quarter, will generate increasing income and significant value for shareholders over the long term.

Portfolio update

Palace's property portfolio performance continues to benefit from its sector positioning. The 1.5% property total return in H120 was ahead of the MSCI Quarterly Benchmark Index return of 0.8% and the Palace portfolio has now outperformed the index over three successive years. The portfolio also contains significant opportunities to enhance income and capital values, in many cases supported by identified asset management initiatives.

The Palace property portfolio was externally valued at £275.8m at 30 September 2019. This included an income-generating investment portfolio of 55 commercial assets (plus two car park assets) and the Hudson Quarter development asset, split on the balance sheet between investment properties under development (the office and other commercial) and trading properties (the residential space that will be sold). The balance sheet value differs slightly from the external valuation, primarily due to lease incentive and other adjustments. The standing commercial assets had a gross annualised contracted rental income of £16.3m with a weighted average unexpired lease term (WAULT) of 5.2 years to first break. On an EPRA basis, occupancy was 84%. The ERV of the portfolio of £21.2m represents a significant income opportunity, discussed below, and is expected to increase to c £22.2m on completion of the Hudson Quarter commercial space.

Exhibit 2: Portfolio summary

£m unless otherwise stated	30 September 2019	31 March 2019
	H120	FY19
Property valuation	275.8	286.3
Number of commercial properties*	55	59
Commercial GLA** (million square feet)	1.7	1.7
Contractual rental income	16.3	17.7
Net rental income	14.8	15.8
ERV (excluding Hudson Quarter)	21.2	22.4
WAULT (to first break)	5.2 years	4.5 years
EPRA occupancy rate	84%	87%

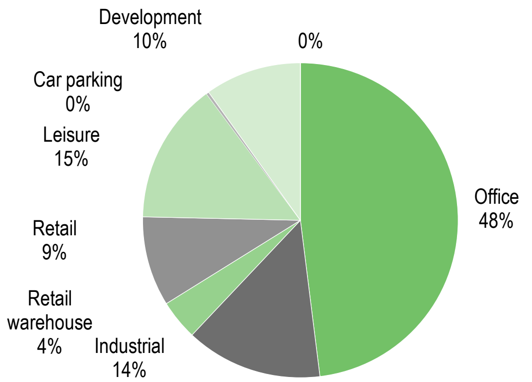
Source: Palace Capital. Note: *In addition there are two car parks. **GLA is gross lettable area.

Overweight in industrial and office assets

Although Palace is sector-agnostic in terms of its approach to asset selection, it nevertheless maintains a diversified portfolio by both sector and location. The portfolio is regional (ie not central London) and 62% (by value) is invested in offices and industrial assets, which continue to drive overall returns. The tenant base is also diversified in number and industry exposure, providing income security. The largest tenant (Vue) accounts for c £0.9m of contracted rents and the top 20 tenants account for c 45%.

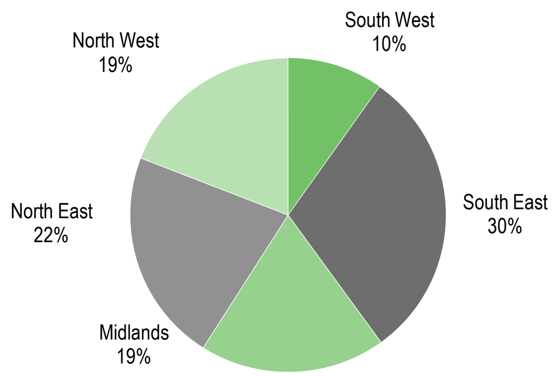
The largest sector exposure is to regional offices (48% by value) where growing tenant demand, including relocations away from London and limited new supply including conversion of office space to residential have all contributed to a generally positive demand-supply balance and continuing rental growth. Industrial property (14% by value) has similarly benefited from firm occupier demand, limited new supply and rental growth. The leisure portfolio comprises two large leisure assets, in Halifax and Northampton, accounting for 15% of the portfolio by value. The leisure sector has faced similar challenges to the retail sector, although recent letting success at Northampton has taken occupancy to 89% and management says interest in the remaining space is strong. The retail portfolio includes a number of strong tenants (eg Aldi on a secure and recently extended long lease) and has no exposure to problem areas like mid-market fashion or department stores.

Exhibit 3: Sector split by value



Source: Palace Capital, 30 September 2019

Exhibit 4: Geographic split by value



Source: Palace Capital, 30 September 2019

Portfolio activity

Palace invested £9.7m in H120 in refurbishment capex (£3.5m) and development spending (£6.2m). Acquisitions were sought, but none that met the group's strict acquisition criteria was identified. Disposals amounted to £13.2m, including the £11.5m sales of the remaining non-core residential units acquired with RT Warren and a small non-core commercial asset (Rathbone House, Weybridge). Palace continues to look for suitable, accretive acquisition opportunities and also plans further non-core disposals in H220. The company has identified four non-core assets and management estimates that disposal will increase the remaining portfolio occupancy by 3pp to 87%, reduce non-recoverable property costs by c £0.5m pa, and generate c £2.75m of equity for reinvestment.

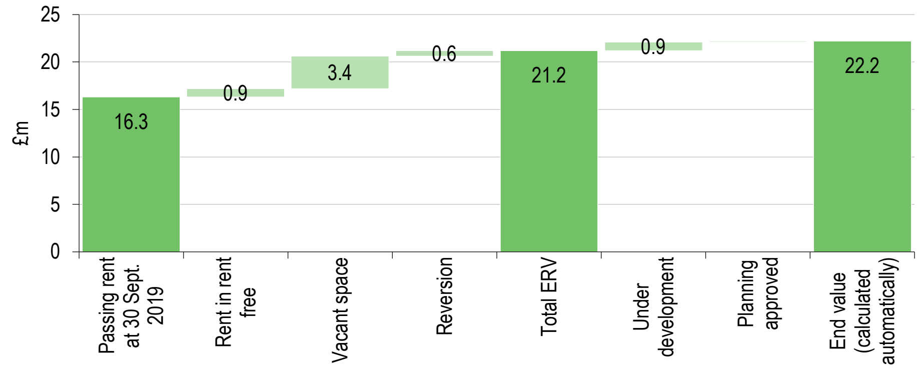
During H120, 12 lease renewals and five rent reviews were completed at an average of 3% above ERV, with a 25% uplift on previous rents, and creating c £0.4m of additional annual rental income. Nine lease reviews provided an additional £0.5m of annual income.

The reduction in H120 occupancy (EPRA basis) from 87% at end-FY19 to 84% additionally reflects the previously announced lease surrender at Priory House Birmingham (c £0.3m of annual rent) and other lease expiries. Palace says it has tactically reserved some of this freed space for refurbishment or redevelopment and in some instances the space has been let on a short-term basis.

Significant asset management opportunities

Significant opportunities exist in the current portfolio. The ERV of £21.2m is c 30% or £4.9m ahead of the end-H120 passing rent of £16.3m. Around £4.5m of the reversionary potential is within the regional office portfolio and £2.8m of this represents the upside from reducing voids.

Exhibit 5: Portfolio income opportunity to full occupancy estimated rental value (ERV)



Source: Palace Capital

The company continues to target void reduction alongside the programme of refurbishment and development opportunities that have been identified in the asset management plans of each individual property. These will be phased in over a number of years providing counter-cyclical opportunities to add value to the portfolio. Exhibit 6 provides a summary of the main upside opportunities. It is not possible to model all of these on an individual basis although, given its significance, we include detailed forecasts for Hudson Quarter within our overall group estimates.

Exhibit 6: Future upside within the portfolio

		Status	Historic Performance	Future Potential	Timing
	**Hudson Quarter, York**	Construction of new development of 127 apartments, 35,000 sq ft offices, 5,000 sq ft of commercial and car parking on time and budget	Acquired in 2013 for £3.8m. Uplift in value to date: £20.4m	GDV £69m Development profit £10m forecast +20pps to NAV	Forecast to complete during year end 31 March 2021
	**High Street, Weybridge**	Planning consent achieved for development of 28 residential units and 4,000 sq ft of retail space	Acquired in 2014 for £3.5m. 5 years of income, now predominantly vacant and being stripped out	GDV £13.5m	Forecast to complete during year end 31 March 2022
	**Boulton House, Manchester**	Centrally located office of 75,000 sq ft 18% vacant space refurbished available. Further common area upgrade to be carried out.	Acquired in 2016 for £10.6m +44% uplift in value to date	£1.36m ERV vs £0.87m passing net rent received showing +56% potential rental growth and positive impact on capital value	Within the next 18 months
	**249 Midsummer Boulevard, Milton Keynes**	City centre offices. Lease expiries in June 2020 provides opportunity for refurbishment and increasing ERV	Acquired Feb 2016 for £7.2m +6% uplift in value to date	£0.63m ERV vs £0.43m passing rent showing +47% potential rental growth and positive impact on capital value	Within the next 18 months
	**Sol, Northampton**	City centre leisure scheme of 190,000 sq ft	Acquired in 2015 for £20.7m. £4.0m surrender received, with current value of £16.5m	£1.65m ERV vs £1.34m passing rent. Occupancy up from 70% at the start of the year to 90% following new lettings in 2019. Transformational refurbishment plans being finalised to complete turnaround of asset	Within the next 18 months

Source: Palace Capital

Hudson House progressing and well received

We expect the Hudson Quarter development to be a key driver of income growth and value creation during the forecast period. We expect the fully let income benefit from the retained commercial assets (c £0.9m pa) at completion to make an important contribution to rental income, and our forecast development gain of c £10m adds more than 20p per share to NAV. For details of our Hudson Quarter forecast, please see our outlook note published on 15 July.

Hudson Quarter occupies a two-acre site in York, within the city walls and just a minute's walk from the York railway station. The scheme comprises three residential buildings and a commercial building. The 127 flats will be sold and the commercial development, comprising 35,000 sq ft of grade A offices and 5,000 sq ft of other commercial space and car parking, will be retained for income. Building work commenced in February 2019 and is expected to take around two years, with completion scheduled for January 2021. Management says that it is well ahead of the business plan and that marketing of the residential assets has been well received. An initial tranche of 20 apartments was offered for sale in June and demand has been such that pre-sales have been contracted on 21 apartments with another seven under offer. The York office market is strong and with the Hudson Quarter office development being the first within the city walls for more than a decade, the company anticipates strong interest from potential tenants with a view to pre-letting ahead of completion.

The commercial property market remains polarised

Amid some slowing of UK economic growth and continuing Brexit-related uncertainty, the UK commercial property market as a whole has entered a period of increased uncertainty, with sector performance remaining highly polarised. The industrial, warehouse and logistics sectors in particular, and also the office sector, are continuing to deliver positive returns, while the retail sector continues to suffer from weak occupational demand and the impact of CVAs and defaults, reflected in softer rental and capital values. Regional office returns continue to outperform central London office returns as they have done in every year since 2016. Research by Avison Young indicates that take-up of office space across the big nine regional office markets continued to be above the long-term average through Q219 and that against a backdrop of limited supply this has continued to put upward pressure on rents.

Looking forward, the most recent quarterly market forecasts by the Investment Property Forum (IPF, canvassing a group of fund managers and surveyors under the IPF Research Programme) were published in September and point to a deterioration in expectations for capital growth over the past quarter. This is focused on the retail sector, where the expectation of capital value decline has increased but also includes industrial, where expectations of capital value growth have been tempered. The consensus expectation for overall total property return remains positive despite weakness in retail.

Exhibit 7: Summary of IPF market consensus

	Rental growth value (%)				Capital value growth (%)				Total return (%)			
	2019	2020	2021	2019/23	2019	2020	2021	2019/23	2019	2020	2021	2019/23
Office	0.8	0.6	1.3	1.3	(1.1)	(1.1)	0.5	0.2	2.9	3.1	4.9	4.6
Industrial	3.0	2.0	1.7	2.0	2.1	1.1	1.5	1.5	6.6	5.7	6.1	6.1
Standard retail	(3.1)	(2.1)	(0.9)	(1.2)	(8.1)	(4.4)	(1.4)	(2.7)	(3.9)	0.1	3.3	1.9
Shopping centre	(4.7)	(3.3)	(1.8)	(2.3)	(13.8)	(7.2)	(3.7)	(5.7)	(8.8)	(1.5)	2.3	0.0
Retail warehouse	(3.8)	(2.5)	(1.0)	(1.5)	(10.8)	(5.7)	(1.9)	(3.9)	(5.2)	0.5	4.6	2.4
All property	**(0.2)**	**0.1**	**0.6**	**0.5**	**(3.6)**	**(1.8)**	**(0.2)**	**(0.8)**	**0.9**	**2.9**	**4.7**	**4.0**
Change since spring forecast												
	Rental growth value (%)				Capital value growth (%)				Total return (%)			
	2019	2020	2021	2019/23	2019	2020	2021	2019/23	2019	2020	2021	2019/23
Office	0.4	0.3	0.2	0.2	0.6	0.2	0.6	0.5	0.5	0.0	0.6	0.5
Industrial	0.0	(0.2)	(0.1)	(0.1)	(0.5)	0.1	1.0	0.5	(0.6)	0.0	0.9	0.4
Standard retail	(0.3)	(0.4)	(0.3)	(0.4)	(0.7)	0.1	(0.1)	(0.2)	(0.7)	0.1	(0.1)	(0.2)
Shopping centre	(0.8)	(0.7)	(0.5)	(0.6)	(3.1)	(1.0)	(0.6)	(1.1)	(3.0)	(0.8)	(0.4)	(1.0)
Retail warehouse	(0.7)	(0.4)	(0.1)	(0.5)	(1.9)	(0.8)	0.1	(0.7)	(2.0)	(0.7)	0.2	**(0.6)**
All property	**0.0**	**0.0**	**0.0**	**(0.1)**	**(0.8)**	**(0.1)**	**0.3**	**0.0**	**(0.9)**	**(0.2)**	**0.3**	**0.0**

Source: Investment Property Forum (IPF) UK consensus forecasts

We present the market consensus data as a guide to expected overall market direction and returns but would caution against a direct read across to Palace's, or any other, portfolio. The market consensus is formed of a wide range of differing expectations and, at the individual portfolio level, much depends on the performance of individual assets as well as the timing and effectiveness of asset management initiatives. For Palace, we expect the Hudson Quarter development to be a significant driver of return over the next two years.

Financials

Our forecasts are based on an unchanged portfolio, although management continues to seek accretive acquisitions and, as discussed above, has also highlighted non-core asset disposals that it expects will generate gross proceeds of c £2.75m in H220. Forecast rental income is slightly reduced, reflecting the ongoing refurbishment plans and additional deferment of income/higher void rate at H120. We have also increased our forecast for administrative costs, partly offset by lower net finance costs (lower debt).

Exhibit 8: Estimate revisions

	Net rental income (£m)			Adjusted PBT (£m)			Adjusted EPS* (p)			EPRA NAV* (p)			DPS (p)		
	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)
03/20e	18.6	18.3	(2.0)	8.2	8.0	(2.5)	17.1	16.7	(2.4)	411	391	(4.8)	19.0	19.0	0.0
03/21e	16.1	15.7	(2.1)	8.4	8.1	(2.7)	18.2	17.6	(3.1)	432	412	(4.4)	19.0	19.0	0.0
03/22e	17.0	16.8	(1.4)	9.0	9.0	(0.7)	19.7	19.5	(1.0)	435	416	(4.6)	19.0	19.0	0.0

Source: Edison Investment Research. Note: *Adjusted EPS and EPRA NAV are both fully diluted.

Key forecasting assumptions

- Our forecasts are based on an unchanged portfolio, although management continues to seek accretive acquisitions and, as discussed above, has also highlighted non-core asset disposals that it expects will generate gross proceeds of c £2.75m in H220.
- The increase in recurring earnings that we forecast is driven by our expectation of growth in passing rent from £16.3m at end-H120 (£17.7m at end-FY19) to £18.6m by end-FY22. We had previously forecast end-FY22 passing rent of £19.2m and the reduction reflects lower assumed occupancy. We had previously assumed that like-for-like occupancy would rise from 87% at end-FY19 to 91.5% at end-FY22 but, with H120 occupancy lower at 84%, we now assume an increase to 90% by FY22. We continue to assume reversionary rental growth of c 0.5% pa and a contribution of c £0.9m pa from FY22 in respect of the Hudson Quarter commercial assets. Given management's focus on void reduction and continuing rental growth in regional offices, our assumptions may prove conservative. Non-recoverable property costs are assumed to increase slightly in FY20 and then drop modestly with void reduction.
- We have increased our forecasts for administrative expenses in line with H120. H120 included some undisclosed REIT conversion costs and we also note that Palace has recently strengthened its property management team. We now look for £3.9m (before share-based payment costs) in FY20 (previously £3.4m), falling to £3.7m in FY21 (£3.5m previously) as FY20 one-off costs fall away.
- Our forecast for underlying net finance costs is reduced, although FY20 IFRS costs include the H120 c £0.7m of negative derivative fair value movements and c £0.5m of debt termination costs. These non-recurring costs are excluded from adjusted earnings. The reduction in underlying net interest cost is driven by lower average debt.
- We expect accounting earnings and NAV to benefit from modest underlying revaluation gains, in line with achieved rental growth, adding an aggregate c £3.2m from the beginning of H220 through to end-FY22 (c 7p per share), with a more significant impact from the development profits that we forecast in respect of Hudson Quarter (c £10.2m or 22p per share) in FY22.

Funding and debt

End-H120 gross outstanding debt was £108.1m (including unamortised debt facility fees) and the cash balance was £14.0m. Net debt of £94.1m represented a net loan to value ratio (LTV) of 34.1%, within the company's target range of 30–40%.

The debt was well spread across lenders with an average cost of 3.2% and an average maturity of 4.5 years. 63% of the debt was either fixed rate or hedged to mitigate interest rate risk. Undrawn facilities amounted to £46.5m comprising the £26.5m Barclays Bank development facility arranged to substantially fund the Hudson Quarter construction costs and a £20.0m revolving credit facility.

In our forecasts we do anticipate the need for further debt facilities but expect the development facility to be fully drawn during FY21, ahead of completion. We forecast the net LTV to peak at around 40% (net debt to peak at c £134m and gross debt at c £140m) as the Hudson Quarter nears completion and to then decline to c 30% as the residential asset sales complete.

This analysis suggests there is scope for Palace to bring forward acquisitions and/or other asset management and development projects during the period (not in our forecasts), especially as Hudson Quarter construction progresses and the residential pre-sales and commercial pre-letting position becomes clearer.

Valuation

Palace's total return strategy has generated cumulative EPRA NAV total returns of 123.8% measured since the end of H114, or a compound annual average return of 15.8%.

Exhibit 9: NAV total return track record

	H214	FY15	FY16	FY17	FY18	FY19	Cumulative return H214–FY19
Opening EPRA NAVPS	218	341	388	414	443	414	218
Closing NAVPS	341	388	414	443	414	407	407
Dividend per share paid	2.5	8.50	14.00	18.00	19.00	19.00	81
Income return (%)	1.1%	2.5%	3.6%	4.3%	4.3%	4.6%	37.2%
Capital return (%)	56.6%	13.5%	6.9%	6.9%	-6.4%	-1.8%	86.7%
NAV total return (%)	**57.8%**	**16.0%**	**10.5%**	**11.2%**	**-2.1%**	**2.8%**	**123.8%**
Average annual compound return							**15.8%**

Source: Palace Capital data, Edison Investment Research

As discussed above, we believe that our forward-looking estimates have been struck cautiously, reflecting a less benign external market environment than has been experienced over the past five years, while assuming a relatively modest capture of the upside potential within the portfolio. Total return was a negative 1.4% in H120, reflecting the reduction in EPRA NAV per share during the period, primarily as a result of capital expenditure not being fully reflected in valuation. As refurbished space is leased at completion, we would expect some catch-up and, over the forecast period as a whole (FY20–22), our estimates imply a cumulative total return of 16.1% or an annual average compound return of 5.1%. There remains considerable scope for Palace to do better than this if market conditions remain favourable, and it is successful in continuing to let remaining vacant refurbished space and capturing reversionary potential through lease renewals. Management also continues to seek accretive acquisitions, which are similarly not reflected in our forecasts. Almost 90% of our forecast return comes from DPS payments and we expect these to be fully covered by earnings in FY22 following a full year, post-completion contribution from the Hudson Quarter development. Even on what we believe to be a cautious basis of forecasting, there remains a material uplift compared with risk-free returns (the 10-year UK gilt yield is c 0.7%).

Exhibit 10: Peer comparison

	Price (p)	Market cap (£m)	P/NAV* (x)	Yield** (%)	Share price performance			
					1 month	3 months	12 months	From 12M high
Circle Property	205	58	0.74	3.1	2%	8%	3%	0%
Custodian	114	471	1.10	5.8	-1%	-2%	-1%	-5%
Picton	93	507	0.98	3.8	3%	7%	11%	-8%
Real Estate Investors	53	99	0.77	7.0	-2%	0%	-4%	-9%
Regional REIT	108	466	0.94	7.5	2%	3%	9%	-2%
Schroder REIT	54	280	0.79	4.8	-3%	2%	-2%	-9%
UK Commercial Property Trust	88	1140	0.97	4.2	1%	7%	7%	-6%
BMO Commercial Property Trust	119	948	0.89	5.1	1%	8%	-12%	-13%
BMO Real Estate Investments	86	206	0.82	5.8	0%	1%	-3%	-14%
Average			**0.89**	**5.2**	**1%**	**4%**	**1%**	**-7%**
Palace Capital	**284**	**131**	**0.73**	**6.7**	**-6%**	**3%**	**-4%**	**-14%**
UK property index	1,872			3.6	3%	14%	16%	-1%
FTSE All-Share Index	4,067			4.7	1%	2%	6%	-3%

Source: Company data, Refinitiv. Note: Prices at 29 November 2019. *Based on last reported EPRA NAV per share. **Based on trailing 12-month DPS declared.

In Exhibit 10, 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. Reflecting the balance sheet liquidity and a comfortable level of gearing, and the expectation of future recurring income growth, Palace has maintained its attractive dividend payout, which represents a yield of 6.7%, above the average for the peer group. The discount to NAV at which Palace shares trade (27%) is also noticeably larger than for the peer group average (c 11%). Within the peer group, the companies with the higher P/NAVs tend to be REITs with a strong focus on income returns (in contrast to Palace's total return strategy) and we believe that this higher rating results from investors' continuing search for sustainable income, and perhaps due to concerns about the maturity of the economic and commercial property cycle. REIT conversion may well underline Palace's strong commitment to attractive dividends, while investing to grow the portfolio and enhance capital values. Given the strong track record of total return generation and the potential to drive further returns from the existing portfolio, the Palace valuation continues to appear undemanding.

Exhibit 11: Financial summary

Year end 31 March (£000s)	2017	2018	2019	2020e	2021e	2022e
PROFIT & LOSS						
Rental & other income	14,266	16,733	18,750	20,722	18,074	19,056
Non-recoverable property costs	(2,055)	(1,824)	(2,318)	(2,464)	(2,350)	(2,250)
Net rental income	12,211	14,909	16,432	18,258	15,724	16,806
Dividend income from listed equity investments			43	53	0	0
Administrative expenses before share-based payments	(2,678)	(4,011)	(3,790)	(3,943)	(3,700)	(3,820)
Share-based payments	(237)	(174)	(332)	(250)	(300)	(300)
Operating Profit (before capital items)	9,296	10,724	12,353	14,118	11,724	12,686
Revaluation of investment properties	3,101	5,738	(382)	(5,552)	11,532	1,317
Gains/(losses) on disposals	3,191	274	(652)	(24)	0	0
Loss on revaluation of listed equity investments			(214)	101	0	0
Operating Profit	15,588	16,736	11,105	8,643	23,256	14,003
Net finance expense	(3,011)	(3,432)	(4,672)	(4,996)	(3,899)	(4,019)
Profit Before Tax	12,577	13,304	6,433	3,648	19,357	9,984
Taxation	(3,191)	(773)	(1,263)	3,729	0	0
Profit After Tax (FRS 3)	9,386	12,531	5,170	7,377	19,357	9,984
EPRA adjustments:						
Revaluation of investment properties	(3,101)	(5,738)	382	5,857	(11,532)	(1,317)
Gains/(losses) on disposals	(3,191)	(274)	652	24	0	0
Deferred tax charge	2,200	(299)	243	0	0	0
Other adjustments	155	308	1,143	1,063	0	0
EPRA earnings	5,449	6,528	7,590	14,320	7,825	8,667
Adjusted for:						
Non-recurring items	0	698	0	(2,850)	0	0
Share-based payments	237	174	332	250	300	300
Adjusted earnings	5,686	7,400	7,922	11,720	8,125	8,967
Company adjusted PBT	6,677	8,472	8,942	7,991	8,125	8,967
Average fully diluted number of shares outstanding (000s)	25,738	34,980	45,898	46,020	46,069	46,069
Basic EPS - FRS 3 (p)	36.5	35.8	11.3	14.8	42.0	21.7
Fully diluted EPRA EPS (p)	21.2	18.7	16.5	22.4	17.0	18.8
Fully diluted adjusted EPS (p)	22.2	21.2	17.3	16.7	17.6	19.5
Dividend per share declared (p)	18.5	19.0	19.0	19.0	19.0	19.0
EPRA dividend cover (x)	1.14	0.98	0.87	1.18	0.89	0.99
BALANCE SHEET						
Fixed Assets	183,959	253,984	261,064	266,691	279,194	284,511
Investment properties	183,916	253,863	258,331	263,139	275,642	280,959
Goodwill	0	0	0	0	0	0
Other non-current assets	43	121	2,733	3,552	3,552	3,552
Current Assets	13,692	46,292	55,256	40,136	63,354	29,781
Trading properties	0	0	14,367	27,137	52,250	0
Assets held for sale	0	21,708	11,756	0	0	0
Cash	11,181	19,033	22,890	7,710	5,540	23,761
Other current assets	2,511	5,551	6,243	5,288	5,564	6,021
Current Liabilities	(8,197)	(11,520)	(16,000)	(9,158)	(13,169)	(9,577)
Creditors	(6,161)	(8,834)	(10,001)	(7,322)	(11,333)	(7,741)
Short term borrowings	(2,036)	(2,686)	(5,999)	(1,836)	(1,836)	(1,836)
Long Term Liabilities	(79,895)	(105,457)	(119,997)	(119,005)	(139,905)	(113,805)
Long term borrowings	(75,758)	(97,157)	(112,017)	(115,226)	(137,126)	(111,026)
Deferred tax	(2,187)	(6,531)	(5,580)	(204)	796	796
Other long-term liabilities	(1,950)	(1,769)	(2,400)	(3,575)	(3,575)	(3,575)
Net Assets	109,559	183,299	180,323	178,664	189,474	190,911
EPRA net assets	111,759	190,011	186,968	180,203	190,013	191,450
Basic NAV/share (p)	436	400	393	388	412	415
Diluted EPRA NAV/share (p)	443	414	407	391	412	416
CASH FLOW						
Operating Cash Flow	10,294	9,899	11,920	12,551	15,661	8,836
Net Interest	(2,516)	(2,704)	(3,385)	(3,946)	(4,379)	(3,619)
Tax	(1,047)	(395)	(1,639)	(1,554)	(1,000)	0
Net cash from investing activities	(3,352)	(67,725)	(11,560)	(12,241)	(25,204)	48,250
Ordinary dividends paid	(4,617)	(6,744)	(8,718)	(8,737)	(8,747)	(8,747)
Debt drawn/(repaid)	6,467	8,151	17,954	(1,246)	21,500	(26,500)
Proceeds from shares issued	29	70,000	0	0	0	0
Other cash flow from financing activities	(2,897)	(3,434)	(162)	(627)	0	0
Net Cash Flow	2,361	7,048	4,410	(15,800)	(2,170)	18,220
Opening balance sheet cash	8,576	10,937	17,985	22,395	6,595	4,426
Restricted cash	244	1,048	495	1,115	1,115	1,115
Other items (including cash assumed on acquisition)	0	0	0	0	0	0
Closing balance sheet cash	11,181	19,033	22,890	7,710	5,541	23,761
Closing balance sheet debt	77,794	99,843	118,016	117,062	138,962	112,862
Unamortised debt costs	936	1,552	1,334	1,041	641	241
Closing net debt/(cash)	67,549	82,362	96,460	110,393	134,062	89,342
Net LTV (exc restricted cash & adjusted for unamortised debt costs)	36.9%	29.8%	33.7%	37.8%	40.7%	31.6%

Source: Palace Capital data, Edison Investment Research forecasts

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