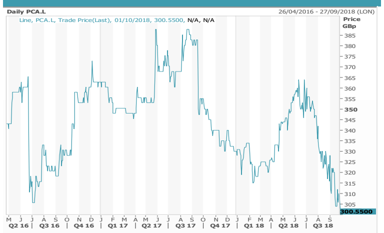
Real Estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**PCA**
Price (p)	293
12m High (p)	365
12m Low (p)	290
Shares (m)	45.9
Mkt Cap (£m)	135
EV (£m)	217
Market	Main, LSE

Description

A real estate investor, diversified by sector (office, industrial predominate) and location, but not in London and minimal exposure to retail. There is an emphasis on city centres. The York development site comprises 6% of assets.

Company information

Chairman	Stanley Davis
CFO	Neil Sinclair
CFO	Stephen Silvester
Executive director	Richard Starr

+44 20 3301 8330
www.palacecapitalplc.com

Key shareholders

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

Diary

December 2018	Q2 div paid
April 2019	Q3 div paid
June 2019	Final results
July 2019	Q4 div paid

Analyst

Mike Foster 020 7194 7633
mf@hardmanandco.com

PALACE CAPITAL

Interim results to September 2018 reported

Palace Capital reported 1H'19 (six months to September 2018) results on 26 November, in line with expectations. We reduce our forward estimates due to disposal and minor trimming of some 2020 income. The strategy of being overweight offices (48% assets in offices in regional hub locations), well underweight retail continues to deliver, with total returns (5.3%) once again ahead of market benchmarks (of 3.3%). Palace Capital is an active manager: in the six months there were 22 lease events, 9% ahead of ERV (estimated rental value). Since period-end, further capital has been recycled out of assets purchased as part of the 2017 RT Warren acquisition, creating value going forward and capturing a modest value uplift.

- **Results:** Portfolio valuation rose 2.4% in the six months; EPRA NAV per share grew 1.4%. 30.3% LTV maintains 'fire power' for attractive investment opportunities being seen and the pending investment into the York development asset. This will deliver a useful income increase and should enhance NAV.
- **1H'19 (six months to September 2018) total property return of 5.3%:** The company once again outpaced the MSCI IPD benchmark, at 3.3%. Strong income supports the dividend payout, the reversion within the current portfolio along with potential accretive acquisitions should take dividend per share cover back usefully above 100% in the medium term.
- **Capital and income focus:** These are important elements of Palace Capital's philosophy. Assets with strong long-term prospects are held, and reversionary yield stands at 7.6% compared to 5.8% NIY. Also, value-creating (large-scale York development) and occupier-focused enhancements crystallise higher rents and asset revaluation.
- **Exchange of contracts to sell 50 residential assets in outer London:** Cash from the assets, acquired with the RT Warren portfolio and always listed as "assets held for sale", arrives at an opportune time. Divestment reduces income and recycling of the capital, at Palace Capital's choice of asset and timing, will raise it again.
- **Risks:** The short-term acquisition opportunities being offered to such an experienced team, amid the current political uncertainty, are good. Palace Capital has been holding back, optimising its upside, which could lead to minor erosion of operating profits given it has successfully exchanged on a meaningful disposal.

Financial summary and valuation

Year-end March (£m)	2016	2017	2018	2019E	2020E
Income	14.6	14.3	16.7	18.0	18.9
Finance cost	-2.3	-3.0	-3.4	-3.9	-4.2
Declared profit	11.8	12.6	13.3	13.8	9.5
EPRA PBT (adj. pre-revaluation)	8.7	6.3	7.3	9.2	9.5
EPS reported (p)	43.9	36.4	35.9	26.9	17.5
EPRA EPS (p) [note]	31.3	21.2	18.7	16.8	17.5
DPS (p)	16.0	18.5	19.0	19.0	19.2
Net debt	-65.4	-68.6	-82.4	-66.8	-130.1
Dividend yield	5.5%	6.3%	6.5%	6.5%	6.6%
Price/EPRA NAV	70.7%	66.1%	70.6%	70.4%	70.4%
NAV (p)	414.3	434.2	400.2	407.4	407.7
EPRA NAV (p)	414.3	443.0	414.8	415.2	415.6

Diluted, pre share-based payments *Source: Hardman & Co Research*

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Executive summary

On track …. A post-period disposal does affect short-term income until re-deployed

Interim results

On track: we assess the results reported on 26 November 2018, which demonstrate all is on track, although – as anticipated – the dividend is not fully covered. See below, we have reduced forward estimates.

Beating the market again

Beating the market again: the company delivered 1H'19 (six months to September 2018) total property return of 5.3%, once again outpacing the MSCI IPD benchmark, at 3.3%.

Fire power at just the right time

Balance sheet strength

Fire power at just the right time: LTV at end-September stood at 30.3%, maintaining 'fire power' for the attractive investment opportunities being seen. We had anticipated nil purchases this year (to March 2019). In fact, 50 residential assets have just been exchanged for disposal, generating significant cash proceeds. This adds to the 'fire power' and the current political uncertainty is a positive for a lowly-geared buyer such as Palace Capital seeking attractive investment opportunities.

Further 'fire-power' from disposal

An asset disposal – by definition this reduces rent and operating profits in the short term. Currently, we do not adjust estimates for this.

Palace Capital has just exchanged contracts on a disposal, directly in line with this theme of being well financed and well placed to grow into the current difficult times. These assets had been categorised as for sale, bought as part of a portfolio. In the short term, this is therefore dilutive to cash flow and profits. It provides excellent options for re-investment of the cash into assets, which may well be both strategically attractive and modestly priced – amid the current political uncertainty.

Forward estimate reductions

We are downgrading profits for 2019E and 2020E. We reduce dividend estimates for 2019E by 0.25p and 2020E (growth vs 2019) is cut by a similar figure. In 2019E we estimate maintained dividends per share.

This £18.2m asset disposal is good strategically. Ultimately, both the running yield and the capital upside will be enhanced when proceeds are re-deployed. Investors need to be prepared that tactics might result in modest operating profit downgrades if such tactics dictate divestment proceeds remain longer in cash.

25.5% LTV

The disposal results in an estimated £66.8m net debt for March 2019 – a loan-to-value ratio of 25.5%. Such a level gives plenty of financial 'fire power' for expenditure on the development asset in York and net property acquisition investment.

2019E PBT reduced £0.2m; 2020E reduced £1.0m

We reduce 2019E profits by £0.2m as a direct result of the disposal and the income (net of interest) reduction which ensues. The 2020E assumption is affected by a full year of this disposal and we assume re-investment to take place beyond the timeframe, while also noting that a small amount of such outer-London residential assets remain and are likely to be sold. This full-year effect reduces PBT by £0.6m. We had already taken part of this into account, so we lower our previous 2020E EPRA PBT of £10.5m to £9.5m. There is a cut to £10.1m as a result of this disposal announcement. We reduce to £9.5m as we update for a number of vacancies coming through to the portfolio. Macro uncertainty leads us to take a view that Palace Capital might choose to wait to fill some of these unless terms offered are strong.

Building strongly for the (near) future

NAV enhancement projects

Building strongly for the (near) future: As a result of the exposure to non-yielding development assets at York, not all assets are currently income-generating. The future dividends and the NAV prospects are enhanced by the fact that: 1) Palace Capital holds development assets (16% of the total and set to rise); and 2) the LTV is 30.3% (pre the residential disposal) and falling, thus providing it with optionality. Palace Capital is well positioned to acquire positively in difficult markets.

In this document, we highlight two types of example of the maximisation of asset values, in what we consider to be good illustrations of the broader advances of the whole company. One way to assess this is to touch on the most recent portfolio acquisition, RT Warren. What has Palace Capital been doing to optimise value of this 14-month old acquisition? We like what we see – steady capital recycling and low-risk site-assembly. This document provides specific examples. We also look at the good asset management at its Newcastle property, its second largest, which is yielding over 8% and seeing rent increases.

1H'19 (September 2018) results reported

- EPRA NAV per share up 1.4% to 421p (March 2018: 415p)
- EPRA NNNAV per share 406p (vs. March 2018 400p)
- Total accounting return for the period of 4.0% (NAV growth plus dividends paid)
- Gross rental income £9.2m, up 29.0% (September 2017: £7.1m)
- IFRS profit after tax of £7.3m, up 67.1% (September 2017: £4.4m)
- 9.5p half yearly dividends (paid quarterly, maintained at 4.75p per quarter)
- EPRA EPS 7.7p (vs. 12.4p 1H'18 to September 2017 and 6.3p 2H'18, to March 2018)
- Adjusted EPS of 8.0p, 0.84x covering dividends of 9.5p for the six months (uncovered due to increased equity base following £70m raise in October 2017 and patient strategy on acquisitions)
- Average number of shares in issue 45.9m (vs. 25.2m 1H'18 and 44.8m 2H'18)
- Net debt £84.0m, maintaining conservative net LTV of 30.3% (March 2018: 29.9%)

Rental and other income increased 29% vs. 1H'19. Administrative costs were well down on 2H'18 and also below half the previous full year.

The portfolio

- Annualised contracted rental income £17.4m per annum with significant reversionary potential (ERV: £21.1m per annum)
- Total property return of 5.3%, outperforming the MSCI IPD Quarterly Benchmark of 3.3%
- Like-for-like valuation increase of 1.7%, driven by industrial and office sectors
- Portfolio valuation £283.3m, up 2.4% from 31 March 2018 (March 2018: £276.7m)
- Demolition due to be completed next month of 2-acre Hudson Quarter site in York, ready for construction to start in first quarter of 2019
- One £0.95m disposal completed, 30.1% above 31 March 2018 book valuation
- 22 lease events took place in the period across 140,000 sq ft, 9% ahead of ERV
- Overall EPRA occupancy remains high at 88% (March 2018: 90%) to a sustainable tenant base
- WAULT (weighted average unexpired lease term) of 5.5 years to break and 7.3 years to expiry

Full year 2019 is on track, but profits trimmed

2019E underlying is on track but the disposal of 50 residential assets could lead to modest short-term profit dilution: we estimate £0.2m

£13.05m EPRA (operating) profits are estimated for the full year to March 2019, an estimated cut of £0.3m. £6.12m were booked for the first half year. This reduction is a direct result of the disposal (below) and the income (net of interest) reduction, which ensues.

Palace Capital has just exchanged contracts to dispose, for £18.2m gross, 50 residential assets out of the former RT Warren portfolio. Cash from this arrives at an opportune time. Short term, the reduction in interest cost on debt (cash received from the disposal) is lower than the reduction in rental income.

Timing is excellent - re-investment opportunities should prove particularly attractive given current macro uncertainties

The risks thus comprise principally an anticipated further reduction in the administrative overheads and the timing of cashflow from the pending investment of proceeds from the recently exchanged disposal of 50 houses. This reduces rents and debt but, at the margin, reduces operating profits until re-invested. Palace Capital is assessing multiple opportunities at any time and – as is clear – the opportunities may become more attractive given current market-wide uncertainties over the prospects of the form of exit Britain negotiates from the EU. Delay in investment by Palace Capital amid such macroeconomic uncertainty might prove beneficial but it would also marginally delay the concomitant rise in rental income.

2020E profit trimmed – modest PBT growth in 2019E

2019E PBT reduced by £0.2m; 2020Eshows growth vs. 2019E but estimates reduced by £1.0m

We reduce 2020E PBT by £1.0m to £9.5m pre revaluations. The 2020E assumption is affected by a full year of this disposal we update for certain vacancies coming through to the portfolio. Macro uncertainty leads us to take a view that Palace Capital might choose to wait to fill some of these unless terms offered are strong.

We trim dividend estimates, from modest growth in both forecast years to flat this year (as is the declared interim dividend per share) and a modest rise for 2020E.

Near-term prospects

York, Hudson Quarter: development asset

Going forward, the most material factor in cashflow is the York development. This was bought as part of a portfolio from Quintain some years ago and planning has been optimised. Demolition of the site is nearly complete and project managers are in discussion with a major contractor who has submitted the most favourable tender with a view to work starting in February of next year. As stated by Palace Capital with the results, "We have agreed Heads of Terms with a leading bank to finance the construction element. We will be making a relatively small contribution to this element and we have the necessary cash resources to do so. We do not intend to offer any of the residential units until the marketing suite has been completed in early June 2019. However, we formally launched the scheme as "Hudson Quarter" in October and we are already receiving strong interest through the website www.hudsonquarteryork.com."

2 / 3 St James Gate, Newcastle upon Tyne

"We will shortly commence a limited refurbishment of this property involving an outlay of £2m, which includes giving it a more prominent identity and improving a 11,000 sq ft office floor which has become vacant. Comparable properties in the area are letting at 15-20% more than what we are currently securing and with very limited development and shrinking office supply in Newcastle, we are optimistic about the prospects for this asset."

Aldi Supermarket, Mumby Road, Gosport, Hants

"Post the end of the half year we announced that we had concluded a letting to Aldi on our Gosport property and to include a small adjoining site for a term of 20 years at an increased rental of £291,000 per annum with annual increases."

A number of other near-term opportunities are referred to in the announcement, namely in Northampton, Manchester, Milton Keynes, Weybridge, York and Winchester.

FTSE SmallCap index

It is relevant to note than Palace Capital joined the FTSE SmallCap and FTSE All-Share indices in May 2018 following the premium listing on the Main Market in March 2018. Palace Capital is a property investment company which also undertakes some development activity. It is not a REIT.

Targeting an attractive income return and strong capital growth.

We point to two types of example of the maximisation of asset values, in what we consider to be good illustrations of the broader advances of the whole company. One way to assess this is to touch on the most recent portfolio acquisition. What has Palace Capital been doing to optimise value at its 14-month old £68m acquisition of the RT Warren portfolio? We like what we see – steady capital recycling and low-risk site-assembly. A couple of details on the RT Warren assets illustrate this, we consider.

Incremental capital recycling – the RT Warren example

In September 2017, the company invested £68m, acquiring the RT Warren portfolio. This had been built-up over many years and, in a short space of time, before the six months under review in 1H'19, 10 assets with limited growth prospects were sold for £9m. Post period-end, further assets have been sold, with exactly the same driving rationale. RT Warren included 65 outer-London residential assets and contracts for sale have been exchanged on 50 of these in November this year.

Incremental site-assembly – an example within RT Warren

In Spring 2018, Palace Capital acquired, for £0.75m, Nicholson Gate Fareham, a 5,500 sq ft office building with vacant possession. This adjoins Admiral House, High Street, which was part of the RT Warren portfolio. Collectively, these two properties stand in approximately 1.3 acres and, based on planning advice, have the medium-term potential for development. We would highlight the modest size of the acquisition consideration but the incremental value-creation over time. We also highlight that the acquisition is vacant possession. This shows that Palace Capital seeks a strong overall income for the total portfolio but is not driven by this to overlook value-adding opportunities, which might not produce for a few months.

Optimising dilapidations and rent

The RT Warren portfolio included an office asset in Southampton's central business district (Kings Park House). This was fully refurbished just prior to the purchase and the property benefits from rents, rates and service changes being paid by the vendor up to March 2019. One floor remains vacant, as the vendor guarantee supplied Palace Capital with leeway as regards timing. RT Warren's Southampton, London Court asset benefitted from a new tenant from a month or so post purchase, let at a rent which we consider to be sub-market as no refurbishment took place. For a subsequent lease period, refurbishment could well take place, enhancing income potential, thus making the asset reversionary.

The RT Warren portfolio included an office in Winchester. Here, an outgoing tenant assisted with dilapidations payments thus enabling Palace Capital to refurbish and enhance the attraction of the letting space.

Asset management examples in the largest group assets

In this results assessment, we think it is worthwhile to illustrate recent events, which might give a good breadth of insight into how the half year outperformance was achieved. We point to two types of example, so we have looked, above, at progress on the RT Warren portfolio. Below, we turn to the largest assets by individual value.

Overleaf, we provide a summary of the largest assets in the portfolio.

In the next section of this report, we focus on one of these assets, as part of a planned series of Hardman reports on the larger assets Palace Capital holds.

As an overview, among the top five assets in Palace Capital's portfolio are two offices, two leisure assets and a development site.

Among the top five assets in Palace Capital's portfolio are two offices, two leisure assets and a development site....

Largest assets

	Market value (£m)	NIY (%)	Reversionary yield (%)	WAULT to break
Broad Street Plaza, Halifax	23.2	6.15	7.11	13.2
2&3 St James Gate, Newcastle	20.0	8.05	8.10	3.9
Sol Central, Mare Fair, Northampton	18.9	7.45	7.69	7.9
Hudson House, York	16.0	0.00	N/A	N/A
Boulton House, 17-21 Chorlton Street, Manchester	14.3	2.87	8.04	1.3
Bank House, 27 King Street, Leeds	10.9	5.26	9.34	2.3
Kiln Farm, 2-4 Pitfield, Milton Keynes	8.4	3.73	8.39	8.7
Units A & B, Imberhorne Lane, East Grinstead	8.1	5.95	5.62	9.3
249 Midsummer Boulevard, Milton Keynes	8.0	5.32	8.06	1.5
Point Four Industrial Estate, Avonmouth, Bristol	7.0	4.73	6.54	4.2

Source: Palace Capital

.... the asset in Manchester is seeing rising rents, as is the larger Newcastle office asset

St James Gate, Newcastle, is Palace Capital's second-largest asset. In Hardman's next publication on Palace Capital, in 2019, we hope to provide more background information on the largest (by valuation) asset, Halifax, and also the fourth-biggest investment asset, the Manchester asset, which is an office building located in the city centre. This was acquired in August 2016, with substantial void space and presenting itself as in need of a 'refresh'. 24% of the space has now been refurbished and there have been significant lettings at rising prices, the latest being at £18.95 sq. ft. Older office buildings in not dis-similar locations are renting at consistently £20 sq. ft. or more. Prime is now approaching £40 per sq. ft. in Manchester. A positive momentum continues to be in place, therefore, for the lettings and valuations on Boulton House, Chorlton Street, Manchester, M1.

In this following section, we concentrate on the second-largest investment asset, offices in Newcastle city centre. Asset improvement programmes are a key plank to the Palace Capital strategy. Another is the centrality of location.

As a result of modest but strategic investment into the common parts of the asset, rents in the Newcastle office are rising.

The Newcastle asset

St James Gate Newcastle office asset – fully let

St James Gate, Newcastle, was purchased in August 2017

Among Palace Capital's portfolio, the Newcastle asset at St James Gate is of greater size and higher valuation, so it is for this asset that we focus on, here.

- St James Gate, Newcastle, was bought in August 2017 for £20.0m and valued at latest balance sheet at £20.0m.

St James Gate is fully let, with recent renewals at higher rents

The valuation equates to £204 per sq. foot. Serco recently extended its lease until June 2019, at 10% higher rent. This is a multi-let, modern city centre office, fully let.

The average is £18 sq. ft – offering good value for quality central assets

It comprises 82,500 sq. ft. of offices and 16,500 sq. ft. of retail space, producing £1.8m rental income, just over £18 per annum per sq. ft.

St James Gate, Newcastle

Source: Palace Capital

NIY 8.1%

The net initial yield valuation is 8.1%. WAULT (weighted average unexpired lease term) is 3.9 years and valuers see the reversionary yield as 8.1%, indicating that the current rent level is likely to be achievable on re-letting under current conditions. We consider this conservative and see scope for a further element of rent increase.

A well-presented courtyard less than five minutes from station

The central business district of Newcastle is relatively compact and this site was developed as a courtyard-style mixed-use scheme, with offices, a hotel, gym and a small number of residential apartments. It is located on the western side of the central business district. Palace Capital owns the freehold for the whole courtyard, but the only material asset is the office block held on the long lease off the Palace Capital-owned freehold. Ownership of the freehold is of significant benefit in enabling 'kerb-appeal' through inexpensive redesign of the public realm to attract footfall to the office reception. This will increase its attraction as a destination compared with new developments.

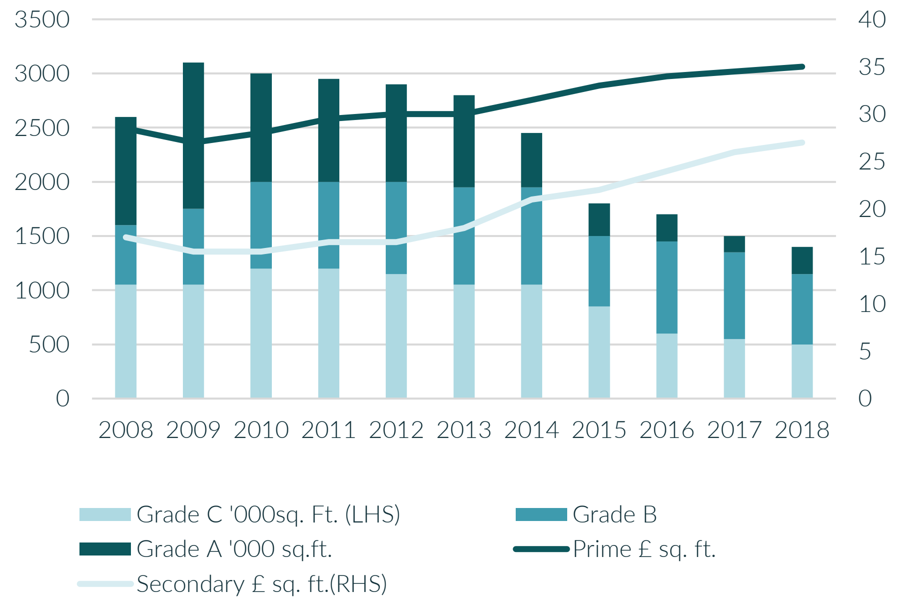
Some spending to modernise the reception and pathway/footfall attraction of the location

The building itself has an attractively large 11,500 sq. ft. footprint per floor. With modest-cost improvements to the reception area (greater area of double-height ceilings and a more attractive vista to the lifts) and the public realm (a better portal from the street into this pedestrianised courtyard), tenant-attraction will be raised further, imminently. The location is less than five minutes' walk from the railway station, also adjacent to a Metro station and is in the quarter which is seeing a planning-led expansion from the very centre (see the following segment, on the Newcastle office market). This is the so called 'Stephenson quarter' featuring leisure, offices and residential apartments. Palace Capital specifically reviewed and assessed the City Council's strategic plan for the centre zone before the St James Gate acquisition.

The Newcastle office market

Grade A availability has fallen significantly in Newcastle

Newcastle city centre office availability



Source: Colliers

The chart above illustrates the reduction in availability of space – Grade A being the segment relevant to Palace Capital's asset. Other agents (e.g. LSH) state very similar data to Colliers for Grade A since 2015, albeit LSH's pre-2015 figures show lower availability of Grade A than do Colliers. Both agents show the same trend. Since 2011 Grade A has fallen by ca.75%.

3Q take-up is as much as 1H

The market is buoyant. City centre take-up for calendar 1H'18 was just over 90,000 sq. ft. 3Q'18 alone saw 110,000 sq. ft, twice the rate of 1H. In recent years, the typical annual take-up has been ca.220,000 sq. ft. The local economy is witnessing inward re-location of large names and also a healthy tone deriving from start-ups and spin-offs from the Universities.

New development pipeline is modest

Much of the traditional core area is constrained by being Grade II

The central area tenant sectoral splits comprise some 35% professional services, 30% TMT, 20% finance. Current available supply is 193,000 sq. ft of Grade A. Only one such type of building – Helix, of 107,000 sq. ft size, due for completion 1Q'20 – is under construction. Helix is the product of investment collaboration by the University, L&G and the City Council, enhancing the staff retention/appeal of an area adjacent to the centre, expanding for knowledge-based tenants. Further schemes are in planning and thus might complete in 2021 and beyond. The 'traditional' office core segment of the central business district comprises extensive amounts of Grade II listed buildings, so, around 2004, new development was planned and taken on market on the Quayside area (to the east). Now, the planning is for extension to the west and north west, towards the St James Gate location in general terms (again, emphasising the generally compact nature of Newcastle's central district).

Recent transactions - rents

Recent transactions ca.£21.50 per sq. ft. plus for Grade A – vs. ca. £18/sq. ft. for St James' average

Recent transactions have been at ca.£21.50 to £24 per sq. ft. and we understand these re-lettings represented rent uplifts of ca.20% above prior levels. We would consider this to be the range that St James Gate would aspire to once the refurbishments (reception area, external paving and landscaping) are completed and the scheme to benefit from the momentum in the central office market. The current ca.£18 per sq. ft. is at the least defensively attractive, and should provide reversionary uplift in due course.

Four drivers to shareholder value

1. Palace Capital NAV growth has been sector-leading and clarity of future potential is high. It has acquired portfolios with inherent opportunities for value creation. It has delivered significant and progressive dividends, incremental revaluations, with continuing reversionary potential being steadily secured. ERV is 16% ahead of contracted rent.

2. As significant – and something we consider the market has missed – is the planning permission secured on a centrally located asset in York, a strong market for such a mixed residential and commercial scheme. The York asset was acquired as part of a portfolio, without planning permissions in place and no material premium paid for the 'hope-value',

3. Optimisation of the York development upside requires tying up of an asset valued at £16m yielding nil. Further, there are progressive development construction costs of more than £30m. This leads to significant capital allocation in both elements – the asset and the construction cost. This capital is earning nil reported profits in the timeframe of our model, so there is a major step up in ongoing profits once that capital is put to work into yielding assets post completion. So, pre-completion, York ties up capital; post completion, it adds capital enhancing future group-wide rental income streams. We expect Palace Capital will – over time – tend to maintain an element of its capital in development projects.

4. The company's largest asset class is regional city centre offices, which is expected to generate stronger growth than the majority of other sectors. The largest weight of asset allocation (48% of total, the largest segment by far) is in well located large town/city centre offices. Supply here has been depleted by the planning regime's permitted development conversion to residential. In our view, this segment has a positive medium-term investment case – even ahead of individual asset enhancement programmes.

This adds up to an investment company deploying capital to support revaluation of its standing assets as well as NAV growth through a measured development pipeline. It also supports a dividend, which is attractive at the current share price, in the top decile of dividend yields available to investors in the sector.

Risks

We have pointed (page 6) to the risks to the operating profit line from potentially holding back on investment. Palace Capital is assessing opportunities and with low LTV, the macroeconomic uncertainty could prove beneficial, but recycling the capital is what triggers the concomitant rise in rental income. Disposal proceeds on 50 residential properties will be received by the end of March and our model assumes modest recycling of that into yielding assets, at least in the short term.

The assets owned offer value-for-money to occupiers and as such there is often tight emphasis by the tenant on the rental levels. Mitigating this is the fact that the rent level will be a more modest part of total operating costs (be it offices or leisure, etc.) than would be the case for prime assets.

Assets purchased sometimes require areas of refurbishment (e.g. reception area or external). This the nature of the value-adding asset management policy. To fund this, however, the group requires either dilapidations to be deployed, or an element of Palace Capital 'maintenance' capital or a mix of both. Our cashflow and asset forecasts include an element of this, itemised.

LTV ratios stand at 30%, (falling below 26% post the current disposal) down from a sustainable historical level of 37%. We believe the broad target LTV is 40%.

The other asset type is the development assets class. Currently this comprises one asset, Hudson Quarter, 6% of the total portfolio value. We expect this type will always comprise a modest portion. This is because development in itself brings inherent risks and because it creates a drag on income stream related cash income.

During development of Hudson Quarter, LTV is expected to rise to manageable levels and will ultimately reduce LTV through the value uplift and residential sales.

York's mixed-use development (the majority of which is apartments) is being developed without pre-letting, including on the relatively modest commercial element. The residential market here is currently strong.

All real estate is at risk as regards location. Palace Capital mitigates this by excluding London and choosing central, accessible locations with good underlying demand.

A number of leases are of short duration. The overall WAULT number is not relevant as this is a granular investment portfolio. Leisure might be considered a sector under pressure and here the leases are mostly of long duration (see our analysis of top 10 assets), anticipating and mitigating that risk.

Sector exposure is weighted to regional offices – a segment we consider to be robust, with good supply/demand balance favouring the investor.

The dividend cover reduces this year and is not 100% covered next year, by Hardman estimates. This will constrain DPS growth, we estimate, until the NAV and, importantly, income step-uplift upon completion of the development. So, the DPS is 'cake today', 'cake and jam' shortly, post the highly visible York development delivery. Therefore, DPS remains progressive but the cover will rise substantially 'post York', giving opportunities for DPS growth acceleration.

Financial analysis

Revenue account							
Revenues, March year-end (£m)	**FY 2014**	**FY 2015**	**FY 2016**	**FY 2017**	**FY 2018**	**FY 2019E**	**FY 2020E**
Rental, other income	3.25	8.64	14.59	14.27	16.73	18.00	18.90
Direct property costs	-0.65	-1.20	-1.62	-2.06	-1.82	-1.55	-1.60
Net income	2.60	7.44	12.97	12.21	14.91	16.45	17.30
Administrative expenses	-0.65	-1.44	-2.05	-2.92	-4.18	-3.40	-3.60
EPRA operating profit	**1.95**	**6.00**	**10.92**	**9.29**	**10.73**	**13.05**	**13.70**
Property revaluation	19.50	9.77	3.62	3.10	5.74	4.60	0.00
Profit on disposal, transaction costs	0.27	-0.46	-0.52	3.19	0.27	0.00	0.00
Share based payments	-0.01	-0.11	-0.11	-0.24	-0.17	-0.20	-0.20
Operating profit	**21.71**	**15.20**	**13.91**	**15.34**	**16.57**	**17.45**	**13.50**
Interest	-0.57	-1.40	-2.26	-3.01	-3.43	-3.85	-4.20
EPRA PBT (pre-revaluation, etc.)	**1.38**	**4.60**	**8.66**	**6.45**	**7.30**	**9.20**	**9.50**
PBT as declared (pre share-based)	**21.15**	**13.91**	**11.76**	**12.57**	**13.31**	**13.80**	**9.50**
Tax	0.00	0.00	-0.95	-3.19	-0.77	-1.50	-1.50
Deferred tax on revaluations, capital allowances	*0.08*	*0.11*	*0.00*	*2.20*	*0.00*	0.00	0.00
EPRA PAT	**1.46**	**4.71**	**7.71**	**5.46**	**6.53**	**7.70**	**8.00**
Company adjusted EPS (p)	n/a	28.30	18.90	22.20	21.20	16.81	17.47
EPRA EPS (post share-based) (p)	**27.60**	**26.20**	**30.90**	**20.30**	**18.18**	**16.38**	**17.03**
EPS (p) Reported	403.61	80.00	43.90	36.50	35.85	26.86	17.47
DPS (p)	**4.50**	**13.00**	**16.00**	**18.50**	**19.00**	**19.00**	**19.25**
Average shares issue (m)	5.29	17.49	24.62	25.74	34.98	45.90	45.90
Year-end shares issue (m)	12.44	20.23	25.78	25.20	45.80	45.90	45.90

Note: 2014 comprises a 14-month reporting period. All EPS figures are on diluted shares
Source: Palace Capital accounts; Hardman & Co Research estimates

Rental income

The rental line, it should be noted, currently receives nil from Hudson Quarter at York, in the books at £16.8m and – since March 2018 – being demolished and redeveloped. No development profits are assumed in the model's time horizon. Note that Palace Capital may choose to delay timing of new investments in the current time of uncertainty over Brexit. We assume nil for the current year. This is no change from our previous estimates. However, there is a divestment of 50 houses, so our new estimate is for £18m divestment. We estimate a re-investment of these proceeds later in fiscal 2020, calendar 2019, but value maximisation could delay this.

Direct property costs

Note that – as is normal for real estate – some new leases offer initial rent-free periods. The impact of these, for accounting purposes, is spread across the lease.

Direct property costs include an element of uncovered expenses such as the rates bills or service charges on void assets. This is a normal function of the investment strategy.

Admin expenses

Administrative expenses in 2018 included £0.7m one-off costs of Palace Capital moving to the main market (from AIM). We model for a significant fall going forward.

Revaluation

We expect modest like-for-like rent inflation, which would lead to a small positive revaluation each year, assuming stable valuation yields. This element of revaluation is excluded from our 2020 estimates. Some assets are seeing significant rent rises per square foot (e.g. Milton Keynes and others). We consider this and certain void reductions would impart upwards pressure on 2019 valuations. The new Hudson Quarter development sees construction commencing early calendar 2019. We model significant development surplus but make no assumption of revaluation in 2020.

Finance costs

We estimate interest costs of ca.3.5% with £0.4m p.a. amortisation of fees. Interest costs on development of Hudson House are capitalised. Development debt is on balance sheet. Finance costs include ca.£0.1m head lease costs.

Tax strategy

Tax: Palace Capital chooses not to convert to a REIT so allows for a £6.6m deferred tax liability (falling to £3.6m now that the residential disposal crystallises £3.0m). The table above shows total tax and also, *in italics*, the line for the element of tax which is excluded for the purposes of calculating EPRA profits.

Balance sheet

@ March year-end (£m)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019E	FY 2020E
Investment properties	59.4	103.0	174.5	183.9	253.9	260.0	323.7
Long-term liabilities (deferred tax)	-1.2	1.5	1.2	-2.1	-6.6	-3.6	-3.6
Long-term debt	-18.6	-36.6	-71.8	-77.7	-98.8	-98.8	-156.8
Net current assets, excluding financial	0.8	0.3	-3.5	-3.7	-3.3	-6.3	-3.3
Assets held for sale	0.0	0.0	0.0	0.0	21.7	3.7	0.0
Cash, deposits, short-term debt	3.9	11.9	6.3	9.1	16.3	32.0	26.7
Net cash (debt/finance lease)	-14.7	-24.7	-65.4	-68.6	-82.4	-66.8	-130.1
Net assets (NNNAV)	44.4	80.0	106.8	109.6	183.3	187.1	186.7
EPRA net assets	44.4	80.0	106.8	111.8	190.0	190.6	190.3
NAV/share (p)	356.6	395.6	414.3	434.2	400.2	407.4	407.7
EPRA NAV/share (p)	356.6	395.6	414.3	443.0	414.8	415.2	415.6

Source: Palace Capital accounts; Hardman & Co Research estimates

For the current year, we estimate a revaluation gain of £4.6m, an estimate unchanged from our initiation research published last month. Revaluation gains of £3.88m were posted in the recent half year results.

The assets held for sale comprise residential acquired as part of the RT Warren portfolio. Note the recent exchange of contracts to sell 50 out of the 65 properties.

As of end-September 2018, Palace Capital held unused loan facilities amounting to £15.0m (31 March 2018: £14.15m). Interest is charged on this facility at a rate of 1.25%, payable quarterly. This facility is secured on investment properties held.

Loan to value stood at 29.9% end fiscal 2018; 25.5% 2019E; 40.2% 2020E (rising as a result of the expenditure on the York development asset). Note, for 2020E a £3m tax payment arising from the disposal of the residential assets from the RT Warren portfolio is within our total tax estimated payable of £4m that year (a short term creditor at March 2019 balance sheet). This £3m sum has already been provided so has no P&L impact.

Cashflow

Revenues, March year-end (£m)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019E	FY 2020E
Cash from operations	1.3	4.4	12.3	10.3	9.9	13.1	13.7
Finance	-0.4	-1.6	-3.4	-2.5	-2.7	-3.9	-4.2
Tax	0.0	0.0	-0.2	-1.1	-0.4	-1.0	-4.0
Net cash flow from op. activities	0.9	2.8	8.7	6.7	6.8	8.2	8.5
Acquisitions/disposals	-2.7	-0.4	-48.4	1.2	-65.0	18.0	-38.0
Refurbishment (capitalised)	0.0	-2.5	-1.2	-4.6	-2.8	-2.5	-2.0
Major development (Hudson)	0.0	0.0	0.0	0.0	0.0	0.0	-20.0
Free cashflow operation and investment	-1.8	-0.1	-40.9	3.4	-60.9	23.7	-54.5
Share issue	23.0	19.7	19.1	-2.2	67.7	0.0	0.0
Shares to fund asset purchases	0.0	-29.0	-15.7	0.2	-13.7	0.0	0.0
Dividends	0.0	-1.8	-3.2	-4.6	-6.7	-8.0	-8.8
Other	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net cash change	21.1	-11.2	-40.7	-3.3	-13.7	15.7	-63.3
Net financial position	-13.5	-24.7	-65.4	-68.6	-82.4	-66.8	-130.1

Source: Palace Capital accounts; Hardman & Co Research estimates

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The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com