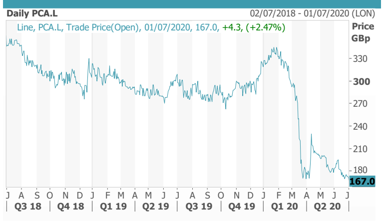
## Real Estate




*Source: Refinitiv*

## Market data

| | |
|---|---|
| EPIC/TKR | **PCA** |
| Price (p) | **170** |
| 12m High (p) | 350 |
| 12m Low (p) | 170 |
| Shares (m) | 45.9 |
| Mkt Cap (£m) | 80 |
| EV (£m) | 188 |
| Market | Main, LSE |

## Description

Palace Capital is a real estate investor, diversified by location, but with no London exposure and with minimal exposure to retail. There is an emphasis on city-centre locations. The York development site comprises 6% of assets.

## Company information

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

+44 20 3301 8330
www.palacecapitalplc.com

## Key shareholders

| | |
|---|---|
| Directors | 5.0% |
| AXA | 7.7% |
| Miton | 7.4% |
| J.O. Hambro | 7.3% |
| Stanley Davis (Chairman) | 3.6% |

## Diary

| | |
|---|---|
| 7 Jul | Final results |
| Aug'20 | AGM |
| Nov'20 | Interim results |

## Analyst

Mike Foster 020 7194 7622
mf@hardmanandco.com

# PALACE CAPITAL

## A strong hand, attractively priced

**Palace Capital's healthy liquidity position takes risks down to a modest level, as does its overweight position to regional offices and the broader asset-class balance. The risk on the Hudson Quarter development site is also low and places Palace Capital among the sector's robust segments. Hudson Quarter, within the York city walls, has been selling well. This provides upside – with risks tightly controlled and manageable – to NAV from developments and medium-term asset management plans. Pre and post COVID-19, the income yield is above the market average, and with below-market risk.**

- **Strategy:** Palace Capital REIT invests in and also, in a measured way, develops commercial real estate. While its mandate is not sector-specific, it does exclude central London locations, and ca.48% of assets are offices. It also has exposure to industrial and is well underweight in retail, with no shopping centres.
- **Four pillars:** Palace Capital has four strategic benefits: i) strong sectoral and regional exposure; ii) development opportunities to optimise income and capital values; iii) a strong balance sheet, strengthening further via development sales; and iv) evident medium-term, value-creating opportunities.
- **Valuation:** This is a strongly positioned regional REIT. The regional peer group tends not to undertake development, which we see as an upside for the company, but the market does not price as such. Price to historical NAV for Palace Capital is 31ppts below the (unweighted) average for the regional REIT universe.
- **Risks:** LTV is set for ca.40% at the peak of the apartment and office development project within the York city walls. The latter can be retained or sold, thereby ensuring enhanced income, as well as reduced debt. Current markets are uncertain, and Palace Capital has not commented on calendar 2020.
- **Investment summary:** A comparison with the sector is straightforward. The sectoral and regional exposures point to outperformance in capital values, rental change and total returns. While markets all present challenges and reduced clarity, this positioning and the embedded value-adding, specific future events are major positives. In current markets, short-term NAV prospects are volatile.

## Financial summary and valuation

| Year-end Mar (£m) | 2017 | 2018 | 2019 | 2020E |
|---|---|---|---|---|
| Net income | 12.2 | 14.9 | 16.4 | 19.0 |
| Finance cost | -3.0 | -3.4 | -3.6 | -4.0 |
| Declared profit | 12.6 | 13.3 | 6.4 | -12.6 |
| EPRA PBT* | 6.4 | 7.3 | 8.6 | 11.0 |
| EPS reported (diluted, p) | 36.5 | 35.8 | 11.3 | -13.1 |
| EPRA EPS (p) | 21.2 | 18.7 | 16.5 | 23.2 |
| DPS (p) | 18.5 | 19.0 | 19.0 | 14.3 |
| Net cash/debt | -68.6 | -82.4 | -96.5 | -108.6 |
| Dividend yield | 10.7% | 11.0% | 11.0% | 8.2% |
| Price/EPRA NAV | 39.1% | 41.8% | 42.6% | 46.2% |
| EPRA NAV (p) | 443.0 | 414.8 | 406.6 | 375.0 |
| LTV | 37.3% | 29.9% | 33.8% | 38.7% |

**Pre share-based payments. Source: Hardman & Co Research*

# A regional property REIT

*Strategy: achieve good rental yields, weighted to robust asset classes; enhance NAV through asset management and development*

## Strategy and current positioning

Palace Capital invests and develops commercial real estate in the UK regions, with a preponderance in the north of England, and to the south west of London and Milton Keynes. Its mandate excludes central London locations. With higher-than-market income yields and strong reversionary potential, there is a strong base from which to allocate some assets to development and undertake asset-enhancement projects.

*Half in offices; 62% in offices and industrial*

*Strong development under way…*

*…and more to come at management's choice*

### *Asset positioning better than average market mix*

74% of assets are office, industrial or under development. Leisure, at 13.6%, comprises two large assets. 3.8% of assets are in retail warehouse and 8.6% in retail. Much of retail comprises the ground floor part of mixed-use assets. The development site at York Hudson Quarter makes up a significant proportion of the company's development properties, and there are other assets, which either have significant future development potential (the 75,000 sq. ft. central Manchester office) or are smaller sites set to receive redevelopment go-ahead at the appropriate time, e.g. Weybridge High Street redevelopment to residential. The portfolio is laid out *here*.

*Hudson Quarter, within York city walls*

*£20m cash-on-cash returns realistic to anticipate from acquisition cost; completion likely summer 2021*

### *Developments and potential developments: in control*

Developments constitute 13.6% of the portfolio and are well placed. The prestigious mixed-use development at Hudson Quarter, inside the York city walls, comprises 35,000 sq. ft. of offices, 5,000 sq. ft. of commercial space and 127 apartments. Marketing and sales launched in June 2019. As at 30 June, sales contracts had been exchanged on 32 apartments, with a further six under offer. The original cost, several years ago, was £3.8m, as part of a non-core Quintain portfolio. The value of the site, once planning consent was granted, totalled £16m. Gross development value is assessed at £69m, and there is strong potential for a £20m cash-on-cash return to exit. Palace Capital is likely to choose to retain the office element, thus enhancing ongoing income and significantly improving dividend cover, as well as NAV. The site's location means there is no comparable competition. Early office lettings, plus residential sales, indicate as much.

*Manchester office: to date, 44% rise in valuation been achieved*

*2024 could see continuing use as is, or a possible doubling in floorspace*

The Manchester office is an interesting case study, highlighting three aspects of the REIT's investment style. The acquisition price, at £150 sq. ft., reflected underinvestment by the previous owner and significant voids. Steady progress has been made on occupancy at this very central site, at rents that have risen steadily, but still offer strong value for the location: at up to £20 sq. ft. It comprises 75,000 sq. ft., and Palace Capital has arranged leases to look to get possession in 2024, with an eye on potentially re-developing. The car park is hardly used, so could either add to tenant attraction – in a "new normal" if car commuting rises – or it could be space for building on, doubling the floorspace. Palace Capital has plenty of options to add to value, and is in control of timings, having already created value.

*At Manchester and Weybridge, timing in Palace Capital's hands and prospects encouraging*

The Weybridge High Street asset has achieved consent for 28 apartments, with a potential 2021 start, and £13.5m gross development value. As with Manchester, the REIT has "optionality" in its tactics. It can wait, or it can press ahead once markets settle. Neither of these upsides is reflected in valuations.

*March quarter income: now 95% covered*

## COVID-19

While we believe it is important to assess the development potential carefully, and properly balance reward and risk, the weight of assets – as a REIT – is in long-term investments. Currently, 95% of rent due end-March 2020 has been collected, or is being paid on time under freshly agreed deferral schedules. On 1 April, 70% of rents had been collected, which increased by 20 April to 80% collected. These figures make allowance for some rent agreed as monthly payment.

*Clearly, June quarter day payment will also be hard work in places*

Clearly, current market conditions are uncertain, and Palace Capital has not commented on calendar 2020. An overweight position to offices provides relative resilience. Retail exposure – other than as a mixed component – is limited, and shops are let at low rents, and thus sustainable. Retail parks' tenants are Booker, Pets at Home and Wickes. The 13.6% leisure exposure is more significant, with values currently under pressure as a result of COVID-19, and tenants not being able to operate. The main tenants are Vue and Wetherspoons. The covenant is strong for both, and we consider the interaction positive. Cinemas and restaurants will re-open on 4 July. There are some smaller tenants, and the sector has risk, but these are destination locations.

## Regional offices are by far the largest component

*More detailed projections (consensus) on offices and regional, in particular*

Palace Capital's sectoral and regional exposure, headed up by regional offices, points to potential market outperformance in capital values, rents and total returns. The office property yield differential between London and the regions remains above average and regional supply is diminishing. As just one example on supply reduction, Liverpool alone (the location of one of Palace Capital's top 10 assets) has seen 1m sq. ft. of offices converted to residential (including student) in the past five years.

Office markets in 2019 saw non-London total returns outperform both London West End and London City. A year ago, IPF consensus was for a 2020 total return of 3.1% non-London and 2.7% London – not a great difference, but still one where regional growth outpaces London. The latest IPF data (collected from March to May this year) sees a regional 5.5% fall vs. a 6.5% average London decline. Although these are negative numbers, again the regional outlook outpaces London.

*Outperforming in all years – up or down*

**IPF consensus forward valuations – May 2020 basis**

| | Rental value growth (%) | | | Capital value growth (%) | | | Total returns (%) | | |
|---|---|---|---|---|---|---|---|---|---|
| Sector | 2020 | 2021 | 2022 | 2020 | 2021 | 2022 | 2020 | 2021 | 2022 |
| Office | -5.4 | 0.3 | 2.3 | -9.5 | 1.4 | 4.9 | -5.5 | 5.9 | 9.3 |
| Industrial | -2.9 | 1.1 | 2.4 | -7.1 | 2.9 | 4.7 | -3.0 | 7.7 | 9.4 |
| Standard retail | -10.7 | -3.4 | -1.4 | -19.8 | -1.8 | 1.2 | -15.5 | 3.8 | 6.6 |
| Shopping centre | -12.0 | -5.0 | -3.0 | -24.7 | -4.6 | -2.7 | -19.7 | 2.2 | 4.1 |
| Retail warehouse | -9.6 | -2.7 | -0.5 | -20.2 | -1.1 | 1.1 | -14.6 | 6.1 | 8.3 |
| All property | -6.3 | -1.3 | 0.8 | -12.4 | 0.2 | 2.9 | -8.1 | 5.3 | 7.9 |
| London West End office | -5.9 | 0.7 | 3.3 | -10.2 | 2.3 | 8.2 | -7.1 | 5.9 | 11.8 |
| London City office | -6.6 | 0.2 | 3.7 | -9.9 | 2.0 | 7.5 | -5.9 | 6.3 | 12.1 |

*Source: IPF: Investment Property Forum*

## The risk and reward

**SWOT analysis**

| | |
|---|---|
| **Strengths** | Asset management plans bring NAV upside potential, as well as sectoral and geographical strength on income front. |
| **Weaknesses** | 2020 outlook unclear. Estimates withdrawn (written pre-results). |
| **Opportunities** | Upon completion, Hudson Quarter will benefit NAV and net debt and income line. Estimated rental value (ERV) is 30% above passing rents. |
| **Threats** | 2020 cashflow is under pressure from COVID-19-related issues. Debates about "death of the office" ignore the possibility of moves into lower-cost, well-connected, lower-rise, lower-density city-centre regional assets. |

*Source: Hardman & Co Research*

As to loan covenants, a 20% valuation fall would have to take place before "repairs" to any covenants would be needed. Palace Capital has £20m gross cash available.

## Investment conclusions

*Rent collection: successful focus*

- 2020 is a difficult year for the sector and, although Palace Capital cut its 3Q'20 interim dividend, 91% of rentals due end-March 2020 are either paid or on agreed schedules. As this document goes to press, the results for the year to March 2020 are set to be announced. The scheduled date is 7 July 2020.

*Risk:reward balance was, and very much remains, significantly ahead of the sector*

- Pre and post COVID-19, the income yield is above the market average, and with below-market risk. This reversionary yield potential will, of course, be reviewed at the imminent results (announced post this note but pre the Hardman & Co *Investor Forum*). The risk is below market because of the macro-sector positioning, but also because care has been taken to secure sites in the right micro-location. The balance is towards city-centre, well-connected sites in cities with above-average graduate employment profiles.

- The positioning is significantly overweight to offices and also industrial. Both sectors are set to outperform the wider market in the next two forecast years, as they did in 2019 (*Investment Property Forum* consensus).

*Northern powerhouse*

- Not only are sectoral weightings propitious, but the exposure to the regions – particularly the north of England – is a positive, we believe.

*Outperformed long term*

- Management has created value, with total accounting returns since the 2013 launch outperforming the sector average. In this document, we have touched, in a limited way, on some of the development projects, and all reduce risk and add value, in our view. Hudson Quarter has been selling well, and the location alone means there is no comparable competing site. The share price reflects more on the risk than the reward of development.

*In control of events*

- On other potential development sites, Palace Capital is in control of the timing, configuration and decisions of how best to adapt to future market conditions.

*"Working" the portfolio*

- Part of value creation is asset management, which includes the optimisation of rent and, at times, this means deliberately holding back space. This space is readily lettable, providing upside, in due course, to the income stream. Typical is a city-centre Leeds office, with the Bank of England as one of the tenants. Management is taking care to optimise the reversionary potential in the portfolio, identified by the valuers at the last results (to September 2019).

### Financial summary and valuation

| Year-end Mar (£m) | 2015 | 2016 | 2017 | 2018 | 2019 | 2020E |
|---|---|---|---|---|---|---|
| Net income (after direct costs) | 7.44 | 12.97 | 12.21 | 14.91 | 16.43 | 18.95 |
| EPRA operating profit | 6.00 | 10.92 | 9.30 | 10.73 | 12.35 | 14.95 |
| Property revaluation, transaction cost and disposal profit | 9.31 | 3.10 | 6.29 | 6.01 | -1.25 | -16.70 |
| Profit on disposal, transaction costs | -0.46 | -0.52 | 3.19 | 0.27 | -0.36 | 0.00 |
| Operating profit (post share-based payments) | 15.20 | 13.91 | 15.35 | 16.57 | 10.77 | -7.95 |
| Finance | -1.40 | -2.26 | -3.01 | -3.43 | -3.74 | -4.00 |
| EPRA PBT (pre-revaluation, etc.) | 4.60 | 8.66 | 6.45 | 7.30 | 8.61 | 10.95 |
| Financial derivatives: change in fair value | 0.00 | 0.00 | 0.00 | 0.00 | -0.93 | -0.70 |
| PBT, as declared (pre share-based) | 13.91 | 11.76 | 12.58 | 13.31 | 6.43 | -6.55 |
| Tax including deferred tax and capital allowances | 0.10 | -0.95 | -0.99 | -0.77 | -1.26 | -0.30 |
| EPRA PAT | 4.70 | 7.71 | 5.46 | 6.53 | 7.35 | 10.65 |
| EPRA EPS (diluted, pre share based payments, p) | 26.87 | 31.32 | 21.21 | 18.67 | 16.54 | 23.20 |
| EPS reported (diluted, p) | 80.00 | 43.90 | 36.50 | 35.85 | 11.26 | -13.06 |
| DPS (p) | 13.00 | 16.00 | 18.50 | 19.00 | 19.00 | 14.25 |
| EPRA net assets | 80.0 | 106.8 | 111.8 | 190.0 | 187.1 | 172.1 |
| Net cash (debt/finance lease) | -24.7 | -65.4 | -68.6 | -82.4 | -96.5 | -108.8 |
| EPRA NAV/share (p) | 395.6 | 414.3 | 443.0 | 414.8 | 406.6 | 375.0 |
| LTV | 24.0% | 37.5% | 37.3% | 29.9% | 33.8% | 38.7% |

*Source: Hardman & Co Research*

# Disclaimer

*Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.*

*This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.*

*Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.*

*Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.*

*The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.*

*Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.*

*This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).*



*(Disclaimer Version 8 – Effective from August 2018)*

# Status of Hardman & Co's research under MiFID II

*Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.*

*In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'*

*The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.*

*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*

*In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.*

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com