Palace Capital

Interim results

Poised to unlock value

Real estate

Palace Capital's (PCA) H122 results showed strong financial and operational improvement, including leasing progress, Hudson Quarter (HQ) apartment sales and strong rent collection. Q222 DPS was increased by 8.3% to 3.25p, the minimum that PCA expects going forward. We forecast strong returns from apartment sales gains, capital redeployment and reversionary income capture.

Year end	Net rental income (£m)	Adj PBT* (£m)	Adj EPS* (p)	EPRA NTA**/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
03/21	14.9	7.5	16.4	350	10.5	0.77	3.9
03/22e	14.1	6.9	15.1	370	12.8	0.72	4.8
03/23e	15.2	7.7	16.7	390	14.0	0.69	5.2
03/24e	17.5	10.0	21.6	404	18.0	0.66	6.7

Note: Adjusted for revaluation gains, share-based payments and non-recurring items.

Strong asset sales and operational progress

IFRS profits of £8.0m in H122 showed a strong rebound from the H121 loss and substantial progress on H221. Development profits, valuation increases and disposal gains drove the headline result, but recurring earnings were also robust. This included strong leasing activity (all above ERV) and an increase in underlying occupancy combined with continuing strong rent collection. Q222 DPS increased by 8.3% to 3.25p, the minimum that management expects for the rest of FY22. EPRA NTA per share increased by 3.4% in the period to 362p and including DPS paid the six-month accounting total return was 5.2%. Of the 127 HQ residential apartments, 72 are now sold, exchanged or under offer to a value of £24m. Non-core asset sales have reached £26.3m including those exchanged or under offer, all above book value. Net LTV has reduced to 36%, allowing PCA to pursue reinvestment opportunities.

Organic upside and capital redeployment

Organic income and capital growth potential within the existing portfolio is strong. The £20.0m end-H122 estimated rental value (ERV) of the portfolio was £3.1m (18%) ahead of contracted rent. Void reduction in office assets is the key opportunity, including £0.9m of recently completed high-quality HQ commercial space. Sales of the Hudson Quarter residential apartments is generating trading gains and freeing capital for redeployment in yielding assets. The £30m non-core asset disposal programme is well on track and redeployment of the proceeds should at least replace the income foregone and improve overall asset quality. Combined, we expect £50m of redeployment, adding c £3m pa to rent roll.

Valuation: Not reflecting company growth targets

A c 4.9% prospective yield, with DPS fully covered by cash earnings and an almost 30% discount to H122 EPRA NTA per share is undemanding relative to peers and does not appear to reflect the potential for income and capital growth embedded in the existing portfolio or the opportunities for accretive new investment.

1 December 2021

Price	**268p**
Market cap	**£124m**

Net debt (£m) at 30 September 2021	93.2
Net LTV at 30 September 2021	35.6%
Shares in issue	46.1m
Free float	95%
Code	PCA
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	11.0	7.2	19.6
Rel (local)	13.8	9.4	5.3
52-week high/low		273p	190p

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

Q222 DPS paid	31 December 2021

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Edison profile page

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Investment summary

Regional investor targeting total returns

Palace Capital (PCA) is an internally managed UK real estate investment trust (REIT), focused on commercial properties in major cities and university towns in the UK, outside London. It has an entrepreneurial approach to investment and operates a total return model, targeting attractive income returns and capital growth. PCA has a proven track record of acquiring properties where it can extract value by enhancing sustainable recurring income and generating capital growth through refurbishment and development and other asset management opportunities. Although currently focusing on regional office and industrial assets, over a longer time frame the investment strategy is sector-agnostic, adapting to shifting market opportunities. The existing portfolio contains strong reversionary potential and offers significant refurbishment and development opportunities. We expect the now completed flagship HQ development in York to significantly enhance income and capital values, while freeing capital for higher-yielding reinvestment.

Financials: Capital recycling will drive near-term returns

PCA expects completion of the sale of the HQ apartments (by end-FY23) and the £30m non-core asset disposal programme will free at least £50m for reinvestment, while maintaining net LTV at around the mid-30% level. The apartment sales will deliver trading gains (we estimate an additional £4.5m on top of the £2.8m reported in H122) and, with the assets non-yielding, redeployment of the proceeds (c £28m now that the development loan is effectively repaid) will be highly accretive. Letting the HQ office space should add c £0.9m to income and generate revaluation gains (we estimate c £3m), and PCA hopes to have let more than half the space by end-FY22. Redeployment of the proceeds of the non-core disposals should at least replace lost income and improve overall asset quality. Additionally, the portfolio includes c £2.2m of reversionary potential (excluding HQ), the majority of which represents the letting of vacant refurbished office space. Our forecasts imply NAV total returns of at least 9% pa for the next two years.

Valuation does not reflect the embedded potential

Based on the current quarterly rate of DPS (3.25p), the minimum payout that the company anticipates for the balance of FY22, the annualised yield is an attractive 4.9%. We forecast DPS to be fully covered by adjusted earnings. The yield compares favourably to the risk-free yield on offer (10-year UK gilt yields remain less than 1%) and the almost 30% discount to H122 EPRA NTA remains clearly below the peer average. The PCA valuation continues to appear undemanding, particularly in view of the significant asset management potential embedded in the portfolio. Letting existing refurbished or developed vacant space would lift current rent roll by up to £3.2m or c 20% and enhance capital values, while continuing residential and non-core asset sales will allow up to £50m capital to be recycled into accretive acquisition or asset management opportunities.

Sensitivities: Macro and sector

We review the main sensitivities on pages 12–13. We consider these to be related mainly to the broader macroeconomic background and the cyclical nature of the commercial property market. Commercial property has historically exhibited substantial swings in valuation through cycles. Income returns are significantly more stable, but still fluctuate according to tenant demand and rent terms. Development activity brings additional risks and PCA's exposure has been significantly reduced by completion of HQ. The pandemic continues to generate uncertainty, but rebounding GDP growth, currently low interest rates and lockdown easing are supporting strong commercial property returns, still led by industrials, but broadening across all sectors.

H122 results show increasing momentum

IFRS profits of £8.0m in H122 showed a strong rebound from the H121 loss and substantial progress on H221. Development profits, valuation increases and disposal gains drove the result, but leasing activity contributed towards an increase in underlying occupancy and rent roll since the start of the year, and supported a robust recurring earnings performance. With rent collection remaining strong (96% in H122 and 95% already for the September quarter[1]), quarterly DPS was increased from 3.0p to 3.25p for Q222, well covered by adjusted earnings and, more importantly, fully covered by cash. PCA says 3.25p is the minimum that it expects for the rest of FY22. With the Hudson Quarter development in York completed on 20 April 2021, sales of residential apartments and progress with the £30m non-core disposal programme saw net gearing reduce to 36% from 42% at end-FY21, allowing PCA to look at potential investment opportunities.

Exhibit 1: Summary of H122 financials

£m unless stated otherwise	H122	H121	H122/H121	H221
ADJUSTED EARNINGS				
Rental & other income	8.6	8.6	-0.2%	8.7
Movement in credit loss	0.0	(0.3)		(0.6)
Non-recoverable property costs	(1.2)	(1.0)		(0.5)
Net rental income	**7.4**	**7.3**	**2.2%**	**7.6**
Dividend on listed equity investment	0.1	0.0		0.1
Administrative expenses	(1.9)	(2.1)	-12.2%	(1.9)
Net finance expense	(1.6)	(1.8)	-9.9%	(1.6)
ADJUSTED PROFIT BEFORE TAX	**4.0**	**3.4**	**19.5%**	**4.2**
Surrender premium	0.0	0.0		0.0
Share based payments expense	(0.2)	(0.2)		(0.2)
Capitalised development loan interest	(0.2)			
EPRA EARNINGS	**3.7**	**3.2**	**15.0%**	**4.0**
Trading property revenue less cost of sales	2.8			
Unrealised gains/(loss) on revaluation of properties	1.3	(10.0)		(3.9)
Profit/(loss) on disposal of investment properties	0.4	0.3		0.6
Unrealised gain/(loss) on listed investments	(0.1)	(0.2)		0.9
Fair value loss on derivatives	(0.0)	(0.4)		0.1
Debt termination costs	(0.0)	0.0		(0.1)
IFRS PROFIT BEFORE TAX	**8.0**	**(7.2)**		**1.6**
Tax	0.0	0.000		0.000
IFRS NET PROFIT	**8.0**	**(7.2)**		**1.6**
Basic EPS (p)	17.4	(15.5)		3.5
Fully diluted EPRA EPS	**8.0**	**7.0**	**14.5%**	**8.8**
Fully diluted adjusted EPS (p)	**8.7**	**7.3**	**19.0%**	**9.1**
DPS declared (p)	**6.3**	**5.0**	**25.0%**	**5.5**
Dividend cover (Adjusted earnings)	1.39	1.46		1.65
EPRA NTA per share (p)	**362**	**347**		**350**
EPRA NTA total return	**5.2%**	**-4.1%**		**2.3%**
Investment properties (inc. trading assets)	256.8	279.8		278.6
Gross debt	(106.9)	(132.7)		(128.3)
Cash	13.7	14.3		9.4
Net LTV	35.6%	42.0%		42.0%

Source: Place Capital data, Edison Investment Research

Key highlights of H122 included:

- Rental and other income of £8.6m was at a similar level to H121 and slightly down on H221. Gross annualised contracted rent roll of £16.9m was up compared with £16.4m at end-FY21 (£15.6m net of property costs versus £14.9m), but income in H122 was affected by the timing of leasing events and disposals.

[1] The rent collection rate includes rents collected in full and rents being collected under agreed monthly collection. September quarter collection as at 16 November.

Exhibit 2: Strong rent collection continuing

	September 2021 quarter			H122
	Rent demanded	Cash collected*	Collection rate	Collection rate
Office	£2.08m	£2.05m	98%	98%
Industrial	£0.64m	£0.55m	87%	94%
Leisure	£0.83m	£0.76m	92%	94%
Retail warehouse	£0.15m	£0.15m	100%	100%
Retail	£0.42m	£0.39m	93%	96%
Portfolio total	**£4.12m**	**£3.90m**	**95%**	**96%**

Source: Palace Capital data. Note: *Cash collected in full and rent being collected monthly under agreed payment plans.

- Non-recoverable property costs increased, primarily due to vacant rates, prior to letting the office space and completing the disposal of the residential apartments at the completed HQ development. This was partly offset by a non-repeat of credit loss provisions.
- Administrative expenses were well controlled and underlying net interest expense (excluding fair value movements on interest rate derivatives and capitalised interest in respect of the HQ development loan) benefited from lower average borrowing in the period.
- Recurring earnings were well ahead of H121 and slightly below H221. Adjusted PBT was £4.0m and adjusted EPS of 8.7p covered DPS declared in the period by 1.39x. DPS was also fully covered by cash and the Q222 DPS was increased to 3.25p from 3.0p in Q122.
- IFRS earnings and net asset value benefited from net unrealised revaluation gains on investment properties of £1.3m, a like-for-like increase of 0.5%, net realised gains on non-core asset disposals of £0.4m and gross profits on the sale of trading properties (the HQ residential apartments) completed in the period.
- IFRS earnings also included a modest impact from a mark-to-market loss on interest rate derivatives, a realised loss versus book value on the sale of the Circle Property investment and debt termination costs. The sale of the Circle stake for £3.2m locked in an 8.6% total return.
- EPRA net tangible assets (NTA) per share increased 3.4% to 362p from 350p at end-FY21. Including DPS paid, the accounting total return in the six-month period was 5.2%.
- Liquidity remained good with £18.7m of cash and immediately available borrowing facilities, while the £26.5m Barclays development facility (HQ financing) was reduced to £4.6m at period end (and £1.6m at the date of reporting) and will be repaid in full by the end of November. Future sales proceeds will then be available for reinvestment.

Hudson Quarter update

The flagship HQ development in York[2] was completed on budget on 20 April 2021. In this report, we refer to the total development as HQ, although PCA has branded the residential development as Hudson Quarter and the office assets as HQ. HQ is a large project for PCA (the gross development value represents c two-thirds of market capitalisation) and completion has provided the potential to crystalise sales profits on the residential apartments, recognise development gains on the commercial space and earn recurring income as it is let, while significantly de-risking the portfolio. Including sales to date, our forecasts include c £10m of total development/trading gains from HQ (c £7.4m trading profit from the residential sales and the balance from revaluation of the office assets) by the end of FY23, c 20p per share. We expect the commercial space to add c £0.9m to rental income on an annualised basis, in line with ERV, once fully let.

[2] HQ occupies a two-acre site in York, within the city walls and just a minute's walk from York railway station, which is 105 minutes (non-stop) by rail from London. The scheme comprises three residential buildings and a commercial building. The 127 flats (c 95,000 sq ft of living space) are being sold and the commercial element, comprising 39,500 sq ft of grade A offices, will be retained for income.

The pace of residential sales has accelerated as lockdown restrictions have eased and at the time of reporting, sales had completed or exchanged on 64 of the 127 apartments for a total value of £21m. A further eight apartments were under offer with a value of £3m. Aggregate gross sales are expected to be c £52m and PCA is confident that this will be achieved by end-FY23 at the latest. With the Barclays development facility effectively repaid, the net (of sales costs) proceeds from the remaining £28m of expected sales will be fully available for redeployment into income-generating assets.

For the commercial space, although the pandemic slowed pre-letting activity, this too is picking up. Initially, 4,700 sq ft of office space, on the ground floor of one of the residential buildings, was pre-let to Knights, a quoted law firm, at a record rent for York of £25 per sq ft. Of the remaining 35,000 sq ft of standalone office space, 11,280 sq ft is under offer and PCA hopes the lease will be signed early in December. The letting of a further 3,500 sq ft has just been agreed and management hopes to have completed the letting of half the office space by end-FY22.

Strategy and portfolio

Total return strategy

PCA is an internally managed UK REIT, listed on the Main Market of the London Stock Exchange (LSE). It focuses on commercial property in major cities and university towns in the UK, outside London, and at 30 September 2021 had a property portfolio externally valued at £262m. It has an entrepreneurial approach to investment and operates a total return model, with a proven track record of acquiring properties where it can extract value by enhancing sustainable recurring income and generating capital growth through refurbishment and development opportunities. This strategy is aimed at providing both attractive income returns and exposure to capital growth from the repositioning of value-add properties. PCA is currently focused on regional office and industrial assets, where it has identified the most attractive opportunities, although the investment strategy is sector-agnostic. Over a longer time frame, we would expect the portfolio to adapt to shifting market conditions. The existing portfolio contains strong reversionary potential and offers significant refurbishment and development opportunities. We expect the now completed Hudson Quarter development in York to contribute materially to income and income capital growth.

The management team has considerable experience in the real estate sector, across cycles. Its extensive networks and strong industry relationships have been an advantage in sourcing opportunities to grow the business. Palace was established in its current form in July 2010 when Stanley Davis (the current non-executive chairman, due to step down at the end of 2021[3]) and Neil Sinclair (CEO) acquired board control of an AIM-listed vehicle for the purpose of property investment. The growth of the portfolio and the company's performance since then has been significantly driven by corporate acquisitions, including the £39.25m acquisition of a subsidiary of Quintain in 2013 and the £32.0m acquisition of Property Investment Holdings (PIH) in 2014. Both these transactions had the added attraction of being tax efficient with minimal purchase costs (stamp duty) to absorb and their availability was in part due to the high leverage of both companies.

Over the past year, PCA has been focused on rent collection and completion of the HQ development but, with market conditions improving, it remains keen to grow further. With gearing on a downward trajectory, PCA indicates, and we forecast, that capital will be redeployed into new investment opportunities including acquisitions from distressed vendors. Management is attuned to the need for consolidation in the sector and is very open to further growth via corporate acquisitions, although for now the share price discount to NAV is an obstacle. PCA says that

[3] In a recent update, the company said that the search process for a new chairman is progressing well with several strong candidates on the shortlist.

although it has not disregarded share buybacks as a way to manage the discount and deploy capital, its preference remains for accretive investment for as long as these can be identified.

Portfolio focus on regional property outside London

Exhibit 3 provides a summary of the PCA portfolio as at 30 September 2021 (H122).[4] The portfolio was externally valued at £262.0m and comprised 45 completed/standing commercial properties (which now include the HQ commercial space) and 'development properties', which represents the fair value of the yet to be sold HQ residential apartments.[5] The standing commercial assets had a gross annualised contracted rental income of £16.9m and, after non-recoverable property costs that mostly relate to voids, the net contracted rental income was £15.6m. The weighted average unexpired lease term (WAULT) was 4.9 years to first break and on an EPRA basis occupancy was 84.3%. This headline occupancy rate was affected by completion of the yet to be let HQ office space and adjusting for this (as presented in Exhibit 3) occupancy improved to 87.9% from 86.4% at end-FY21.

Exhibit 3: Portfolio summary

	H122	FY21	FY20
	30-Sep-21	31-Mar-21	31-Mar-20
External portfolio valuation	£262.0m	£282.8m	£277.8m
Net initial yield	6.1%	5.6%	6.0%
Reversionary yield	7.2%	7.3%	6.6%
Contractual rental income	£16.9m	£16.4m	£17.6m
Estimated rental value (ERV)	£20.0m	£20.6m	£20.6m
Properties	45	48	53
Tenants	186	182	204
WAULT to first break	4.9 years	4.8 years	4.8 years
Like-for-like EPRA basis occupancy*	87.9%	86.4%	87.3%

Source: Palace Capital data. Note *Adjusted to exclude the HQ office space that was classified as a development asset and therefore excluded in the prior periods. Including the HQ commercial space, now completed, the end-H122 occupancy rate was 84.3%.

Underlying occupancy and contracted rents both benefited from new lettings, lease renewals and rent reviews, all on average ahead of estimated rental value (ERV). In aggregate, 29 lease events provided £0.6m of additional income at a blended 3% premium to ERV. PCA reports strong letting activity since the end of H122.

The ERV of the portfolio of £20m represents a significant income opportunity, which we discuss below. The reduction in ERV during H122 reflects primarily the impact of non-core commercial asset disposals. As part of its £30m non-core asset disposal programme, discussed below, during H122 PCA exchanged or completed on £12.0m of asset sales [6], generating realised gains of £0.4m net of disposal costs. Year-to-date sales and completions have since reached £21.3m with another c £5m of sales under offer.

Regional offices and industrial assets account for 63% of the H122 portfolio by value and PCA indicates that this will increase further as it completes its divestments and recycles capital.

[4] The external fair value differs slightly from the balance sheet value primarily due to lease incentives and other adjustments.

[5] These are reflected in the balance sheet as 'trading properties' with a carried value of £27.2m.

[6] PCA completed on £10.3m of asset sales in H122 and exchanged on £1.7m.

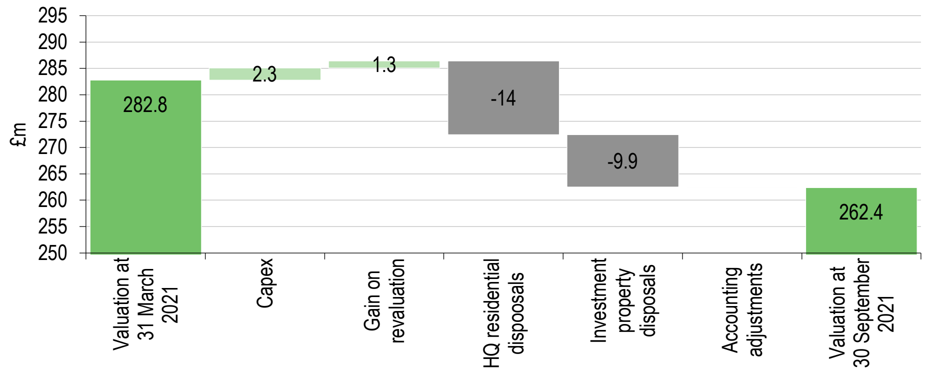
Exhibit 4: Portfolio summary by sector

	Market value (£m)	Portfolio split by value	Number of assets	WAULT to first break (years)	Contractual income (£m)	ERV (£m)	ERV of void (£m)	Void*
Office	122.5	46.7%	25	3.2	8.1	11.2	2.8	24.8%
Industrial	42.3	16.2%	9	3.2	2.8	2.9	0.0	0.2%
Leisure	36.1	13.8%	2	10.4	3.5	3.2	0.2	5.6%
Development	30.5	11.7%	-					
Retail	21.3	8.1%	7	8.0	1.8	2.1	0.2	8.5%
Retail warehouse	9.3	3.5%	2	5.2	0.8	0.6	0.0	0.0%
Total portfolio	**262.0**	**100.0%**	**45**	**4.9**	**16.9**	**20.0**	**3.1**	**15.7%**

Source: Palace Capital data as at 30 September 2021. Note: *Headline void rate including Hudson Quarter.

Exhibit 5 tracks the change in portfolio value during H122. Capital expenditure of £2.3m and the revaluation gain of £1.3m increased the portfolio but were more than offset by the £14.0m (book value) sale of HQ residential apartments and £9.9m (book value) sale of non-core investment property assets that were completed in the period. Those sales that were exchanged but not completed by end-H122 will affect the H222 portfolio valuation.

Exhibit 5: H122 property portfolio valuation bridge



Source: Palace Capital data

The like-for-like property revaluation increase of 0.5% was driven by industrial assets, following the market trend, but was nevertheless broadly spread across all sectors other than retail. Note that the £1.1m gain shown in Exhibit 6 differs from the £1.3m reported gain because it excludes assets disposed of during H122.

Exhibit 6: Analysis of H122 revaluation movement

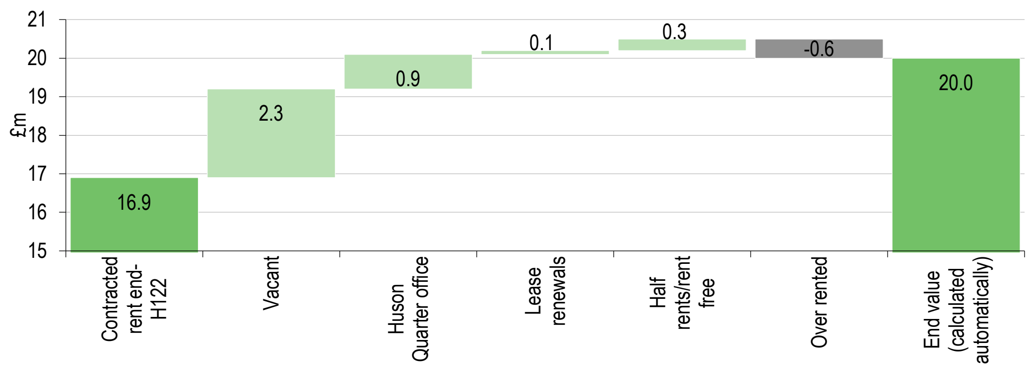
	Adjusted end-FY21 market value* (£m)	End-H122 market value (£m)	Gain/loss (£m)	Gain/loss	EPRA topped-up net initial yield**
Office	121.9	122.5	0.6	0.4%	5.7%
Industrial	39.9	42.3	2.4	6.1%	5.8%
Leisure	35.5	36.1	0.6	1.7%	8.4%
Retail	21.5	21.3	(0.2)	-1.0%	7.7%
Retail warehouse	9.2	9.3	0.1	1.1%	7.6%
Total completed portfolio	**228.0**	**231.5**	**3.5**	**1.5%**	
Capital expenditure		(2.4)			
Total like-for-like	**228.0**	**229.1**	**1.1**	**0.5%**	

Source: Palace Capital. Note: *FY21 adjusted for disposals in H122. **Net initial yield based on contracted rents before lease incentive impact.

Significant value embedded within the current portfolio

With an annualised contracted rent roll at H122 of £16.9m and an externally estimated market rental value of £20.0m there is significant income upside potential embedded in the portfolio, with capital values likely to follow. As can be seen from Exhibit 4 above, void reduction/letting vacant space in the office sector assets represents the single largest opportunity to increase portfolio income at £2.8m, including the HQ office assets (£0.9m). As a result of PCA's total return strategy, voids are inevitable in the portfolio as vacancy is deliberately targeted ahead of asset management projects. However, COVID-19 has slowed the letting of refurbished assets, primarily in the office sector, and available space has increased with the completion of HQ. At a portfolio level, the bridge from contracted rents to ERV is shown in Exhibit 7. There is a small amount of void reduction potential outside of the office assets and upside from lease incentives running off. The industrial assets are fully occupied with some small upside in rents to ERV, while the leisure assets, now effectively fully let, are 'over rented' with contractual rents above ERV. The retail assets also show upside to ERV, although across the sector ERVs remain under pressure.

Exhibit 7: Bridge from contracted rents to ERV



Source: Palace Capital data

Disposal programme and capital recycling

Having grown the portfolio primarily through portfolio acquisition, non-core disposals have been a regular feature, enabling capital deployment to be optimised and supporting operational efficiency. Disposals are typically driven by completion of the business plan for the asset or where the risk-return balance favours disposal, in some cases generating an immediate saving on property operating costs. PCA is targeting disposals with an aggregate value of at least £30m in the current year to reinvest in better quality assets. It is making good progress and says it is well on track to meet its target. Including the most recent sale of an industrial building in Aldershot for £2.4m, an aggregate £21.3m of transactions have completed or exchanged (of which £12.0m during H122 and the balance since), all at a premium to book value. A further c £5m is currently under offer. Allowing for repayment of the debt against which the assets are charged, the completed and exchanged sales to date have freed £10.4m of equity for reinvestment and PCA expects a further £5.6m will be freed by the end of the programme.

When completed, the sale of the HQ residential apartments should generate net proceeds of c £30m after repayment of the Barclays development facility. Repayment of the facility was substantially complete at end-H122 and it was fully repaid at the end of November. All proceeds from the remaining apartment sales will then be available for reinvestment. Including the £30m non-core asset sales, PCA estimates that it will be able to reinvest more than £50m into income-generating investments and new asset management opportunities, adding c £3.0m to annualised rental income at an expected yield of 6%. This will more than replace the net income forgone on the non-core disposals. A c £10m acquisition is currently in legals and is expected to complete by the end of FY22.

Rebalancing the portfolio

Management has indicated that it will take advantage of the capital recycling to further focus the portfolio on offices and industrial assets in line with its regional strategy, and to increase the weighting of core income-generating assets. Once all the HQ residential assets have been sold and the £30m disposal programme completed, PCA estimates that offices (32.3%) and industrials

(17.8%) will represent 70.1% of the portfolio total compared with 62.9% at end-H122. Reinvestment will increase this further.

Exhibit 8: Strategy rebalance

	Mar-21	Sep-21	Looking forward
Core	28%	30%	50%
Value add	51%	58%	40%
Development	21%	12%	10%
Total	**100%**	**100%**	**100%**

Source: Palace Capital data

While retaining its total return strategy, in tandem with the office/industrials focus, PCA intends to increase the weight of core income-generating assets within its portfolio while reducing the share of 'value-add' and development properties. To a large extent, this shift reflects the completion of the HQ development as well as management's expectations for rental growth in the regional office and industrial sectors.

Regional offices offer relatively high yields, which is a combination of low rents and low capital values. Capital values are well below new build cost and this has inhibited most new development in recent years. Meanwhile, re-purposing of existing space towards residential, student and hotel accommodation, has worked to reduce supply. Structural demand factors remain in place, such as office migration from (more expensive) London to the regions and the political goal of rebalancing economic activity from South England to the North likely to remain, possibly reinforced by a shift to 'localism' (smaller, regional offices located in towns and cities outside the capital).

PCA expects the return to the office to gather momentum, as evidenced by letting progress at HQ. A great many tenants may adopt a hybrid model of working, at least initially, whereby employees spend perhaps three days per week in the office and two days at home, but this seems unlikely in itself to materially affect space requirements which must cater for peak usage. As an alternative, hot desking is typically unpopular with staff, who value their own space, the certainty of being in proximity to close colleagues, and may stifle the collaboration and creativity required by many employers. Where changes in working practices do reduce demand for space, this is likely to be mitigated by a reduction in office density (the number of employees per square meter), accelerating a trend that was in place prior to the pandemic.

The industrial sector also benefits from good levels of occupier demand and a limited supply of space. The pandemic has accelerated the trend towards e-commerce and distribution, and consumer demand for swift delivery is leading to strong demand for distribution facilities close to city centres. Rents remain relatively low and typically below new build costs, providing scope for further growth.

PCA 's portfolio will continue to include several identified medium-term asset management opportunities that it plans to phase in over a number of years, potentially providing counter-cyclical opportunities to add value to the portfolio should market-wide rents and capital returns stall. However, it does not anticipate commencing any development projects during the next three years.

Improving environmental performance

As well as repositioning the portfolio, asset disposals in combination with a rolling capital expenditure programme (£2.3m in H122) will continue to support a needed improvement in the environmental performance of portfolio properties. By 2023 it will not be possible to let properties with an EPC[7] rating below E and by 2027 properties will need be C rated or better, increasing further to B or better in 2030. During H122, PCA removed all G-rated properties from the portfolio and reduced E-rated properties from 7.45% at end-FY21 to 2%. More details of the actions to be

[7] Energy Performance Certificate.

taken and the potential capex needs will be provided with the FY22 results, expected to be released in June next year.

Forecasts increased

Reflecting a stronger H122 than we had expected, we have increased our forecasts for FY22 adjusted PBT and adjusted EPS by c 5% with smaller increases for FY23 and FY24, driven by small changes to net rental income, administrative costs before share-based payment costs and net finance expense. The increase in Q222 DPS and PCA's forward guidance leads to an increase in FY22e DPS, but we maintain our expected increases for FY23 and FY24.

Exhibit 9: Forecast revisions

	Net rental income (£m)			Adjusted PBT (£m)			Adjusted EPS (p)			EPRA NTA (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
03/22e	14.2	14.1	(0.4)	6.6	6.9	5.2	14.3	15.1	5.0	366	370	1.0	12.0	12.8	6.3
03/23e	15.2	15.2	0.0	7.5	7.7	2.2	16.4	16.7	2.2	385	390	1.2	14.0	14.0	0.0
03/24e	17.6	17.5	(0.3)	9.8	10.0	1.6	21.3	21.6	1.6	401	404	0.6	18.0	18.0	0.0

Source: Edison Investment Research

The key component of our adjusted PBT forecast is net rental income, for which we assume:

- Completion of the £30m non-core asset sale programme by the end of FY22 (ie c £18m of H222 sales, of which c £7m already exchanged or completed).
- Completion of the sale of the HQ residential apartments by end-FY23.
- Reinvestment of c £50m, £10m during H222 and £40m during FY23, at a blended c 6% net initial yield, adding c £3.0m to annualised contracted rents.
- We forecast end-of-period annualised contracted rents of £16.9m pa at end-H122 to:
  - reduce to £15.4m at end-FY22 with net lease expiries (£0.5m) and disposals (£1.6m) partly offset by acquisitions (£0.6m). Given the progress with letting activity, including HQ, since H122, we believe our net leasing assumption to be conservative in respect of tenant retention on upcoming lease expiries;
  - increase to £19.1m at end-FY23, including c £2.4m from the acquisitions and the balance from leasing events including letting the remaining HQ office space with an ERV of c £0.8m;
  - increase to £19.3m at end-FY24, driven by leasing events; and
  - we estimate that these assumptions are consistent with an increase in EPRA occupancy from 84.3% at end-H122 to c 90% by end-FY24, including full letting of the HQ office space.
- Our net rental income forecast reflects:
  - the weighted impact of annual contracted rents and modest other rent related income; and
  - an increase in direct property costs in FY22, falling thereafter. The rise in FY22 costs is driven by the non-repeat of FY21 rates relief (c £0.4m) and costs related to HQ (empty rates etc) in the period between practical completion and letting/disposal, partly offset by savings generated by the disposal programme.

Our IFRS earnings and the change in NTA include the following capital valuation assumptions:

- A c £3m unrealised development gain/revaluation uplift on the HQ commercial space emerging over the next 18 months (from end-H122) as the space is let.
- Aggregate gross disposal gains on the HQ residential assets of c £8.7m or c £7.4m net trading gains after sales costs. The £7.4m includes the £2.8m of trading gains booked in H122 with £4.5m to follow.

- Like-for-like revaluation gains of c 1% pa through to end-FY23 and 1.5% in FY24, reflecting progress with void reduction. We believe these assumptions are consistent with a broadly stable net initial yield. We estimate that a 1% increase/decline in the FY22 property valuation compared with our forecasts would increase/reduce FY22e EPRA NTA by c 5p.

Our forecasts for DPS are consistent with adjusted earnings cover of c 1.2x. With the forecast proceeds of residential sales and non-core disposals exceeding our assumed reinvestment, our forecast net loan to value ratio (LTV) for end-FY24 is 33%.

Funding and gearing

PCA will have total borrowing facilities of c £118m on full repayment of the Barclays development loan facility by the end of November 2021. On a pro forma basis, adjusting for the Barclays repayment, end-H122 borrowings were c £102m. Around £16m remained undrawn from its revolving credit facility (RCF) with NatWest. Allowing for £13.7m of cash, the end-H122 net loan to value ratio was 36%. The average cost of debt was 3.0% with costs fixed by hedging on 58% of debt. Liquidity, comprising immediately available debt and cash resources, amounted to £18.7m.[8] The average term of PCA's debt was 2.3 years at end-H122, with the first maturity (other than the Barclays development loan) being the £25m Santander facility in August 2022, for which PCA has already agreed terms for a refinancing on what it says are competitive terms. PCA notes that across the market, the availability and cost of debt will increasingly become linked with progress on EPC ratings.

Our forecasts imply net LTV remaining slightly below the mid-30% level that PCA is targeting in the current market environment.

Exhibit 10: Debt portfolio summary

Lender	Facility (£m)	Drawn (£m)	Maturity	Fixed/floating
Barclays	37.5	37.5	Jun-24	£34.1m fixed
NatWest (RCF)	40.0	23.8	Aug-24	100% floating*
Santander	25.0	25.0	Aug-22	£18.8m fixed
Lloyds	6.8	6.8	Mar-23	100% floating
Scottish Widows	9.2	9.2	Jul-26	100% floating
Barclays (development facility)	4.6	4.6	Jul-22	100% floating**
Total	**123.1**	**106.9**	**2.3 years**	**58% fixed/42% floating**

Source: Palace Capital. Note: *Facility fee on undrawn balances 1.05%. **Facility fee on undrawn balances 1.3%

Valuation

Unlike REITs that focus wholly or predominantly on generating income returns, PCA's total return model relies significantly on generating capital growth from the repositioning of value-add properties, as well as seeking an attractive level of income. Capital returns do not emerge with the same regularity as contracted rental income but are targeted to enhance overall return. Since its first major post-IPO transaction in H214, PCA has built a proven track record of acquiring properties where it can extract value by enhancing sustainable recurring income and generating capital growth through refurbishment and development opportunities. During this period and up to end-H122, it has generated cumulative accounting/EPRA NTA total returns of 118.0% or a compound annual average return of 10.2%. This is a good level of return despite the negative impact of COVID-19 on late FY20 and FY21.

[8] PCA is able to draw £5m of its RCF immediately. To draw the balance of £11.2m requires properties to be charged to it.

Exhibit 11: NAV total return history

	H214	FY15	FY16	FY17	FY18	FY19	FY20	FY21	H122	Cumulative return H114–H122
Opening EPRA NTA per share (p)*	218	341	388	414	443	414	407	364	350	218
Closing EPRA NTA per share (p)*	341	388	414	443	414	407	364	350	362	362
DPS paid (p)	2.5	8.50	14.00	18.00	19.00	19.00	19.00	7.50	5.50	113
Income return (%)	1.1%	2.5%	3.6%	4.3%	4.3%	4.6%	4.7%	2.1%	1.6%	51.8%
Capital return (%)	56.6%	13.5%	6.9%	6.9%	-6.4%	-1.8%	-10.4%	-4.1%	3.6%	66.1%
NAV total return (%)	**57.8%**	**16.0%**	**10.5%**	**11.2%**	**-2.1%**	**2.8%**	**-5.8%**	**-2.0%**	**5.2%**	**118.0%**
Average annual compound return										**10.2%**

Source: Palace Capital data, Edison Investment Research. *Since FY20 EPRA net tangible assets per share and prior to FY20 the broadly equivalent EPRA net asset value per share.

Based on the minimum 3.25p quarterly DPS that PCA targets for the balance of FY22, the prospective yield is c 4.9%. We forecast FY22 DPS to be well covered by adjusted earnings and for DPS to increase further during FY23 and FY24. Meanwhile, the shares continue to trade at a significant discount of c 26% to H122 EPRA NTA per share of 362p.

In Exhibit 12 we show a summary performance and valuation comparison of PCA and a peer group of UK commercial real estate investment companies with a strong regional focus. For comparative purposes, the valuation data are based on last reported EPRA NTA/NAV and trailing 12-month DPS declared. On this basis, PCA trades at a clearly lower P/NTA than the group average and despite its total return focus its trailing dividend yield is only modestly below the average.

the Palace valuation continues to appear undemanding in view of:

- The strong long-term track record of total return generation.
- The significant income and capital return potential embedded within the existing portfolio.
- The opportunity to recycle capital accretively and/or maintain a somewhat lower gearing level than has historically been the case and/or return capital to shareholders if attractive investment opportunities fail to emerge.

Exhibit 8: Peer group valuation and performance comparison

	Price (p)	Market cap (£m)	P/NAV* (x)	Trailing Yield (%)**	Share price performance			
					1 month	3 months	12 months	From 12M high
Circle Property	206	59	0.75	1.7	-8%	0%	10%	-10%
Custodian	96	404	0.91	5.2	0%	-1%	9%	-10%
Picton	100	544	0.95	3.3	3%	1%	30%	-1%
Real Estate Investors	39	70	0.68	9.6	-1%	-6%	10%	-9%
Regional REIT	88	380	0.89	7.2	1%	-2%	15%	-6%
Schroder REIT	51	248	0.77	5.3	0%	-2%	37%	-5%
UK Commercial Property REIT	76	990	0.84	3.6	0%	-4%	7%	-10%
BMO Commercial Property Trust	101	809	0.78	4.2	-2%	1%	36%	-3%
BMO Real Estate Investments	84	203	0.76	4.2	-1%	13%	43%	-6%
Average			**0.81**	**4.9**	**-1%**	**0%**	**22%**	**-7%**
Palace Capital	**268**	**123**	**0.74**	**4.4**	**12%**	**3%**	**17%**	**-4%**
UK property sector index	1,933				3%	-2%	22%	-3%
UK equity market index	4,026				-3%	-2%	11%	-5%

Source: Company data, Refinitiv. Note: Prices at 18 November 2020. *Based on last reported EPRA NAV/NTA per share. **Based on trailing 12-month DPS declared.

Sensitivities

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

- The COVID-19 pandemic continues to create uncertainty, with the potential for further restrictive measure and/or lockdowns. Regarding the UK **economic outlook**, the HM Treasury comparison of independent forecasts for the UK economy published in September 2021 indicated a consensus UK GDP growth rate of 6.8% (6.0–8.2%) for 2021, followed by 5.5% (3.5–8.2%) in 2022. The consensus expectation is that inflation will moderate from current levels (CPIH[9] +3.8% over the 12 months to October 2021 and RPI +6.0%). The consensus forecast for the Consumer Prices Index (CPI) was 3.4% in Q421 and 2.4% in Q422 and for the Retail Prices Index (RPI) it was 4.8% in Q421 and 3.4% in Q422.
- **Sector risk:** some of the inherent cyclical risk to vacancy in commercial property can be mitigated by portfolio diversification. PCA has a diversified portfolio across property types, locations and tenants. While its focus on regional offices and industrials is increasing, its sector-agnostic approach to asset selection provides scope to adjust the portfolio to evolving market conditions. The portfolio contains significant reversionary potential and other asset management opportunities, providing scope for counter-cyclical income growth and value creation.
- **Development risk:** although we expect asset management projects to continue to be an important contributor to property income growth and capital returns, active projects normally represent a relatively low share of the overall portfolio at any point in time. The successful completion of the HQ development represents a significant de-risking.
- **Funding risks:** our estimates indicate that existing debt facilities are adequate to meet the company's funding needs over the forecast period. Almost 60% of borrowing costs are fixed or hedged, providing protection against an unexpected increase in market lending rates. However, on a long-term basis, interest rates remain historically low and any significant increase in long-term rates in particular may be expected to negatively affect market-wide property.

[9] Consumer price inflation including housing costs.

Exhibit 13: Financial summary

Year end 31 March (£m)	2018	2019	2020	2021	2022e	2023e	2024e
PROFIT & LOSS							
Rental & other income	16.7	18.8	21.1	17.3	16.8	17.3	19.4
Movement in credit loss		0.0	0.0	(0.9)	0.0	0.0	0.0
Non-recoverable property costs	(1.8)	(2.3)	(2.4)	(1.5)	(2.6)	(2.1)	(1.9)
Net rental income	14.9	16.4	18.8	14.9	14.1	15.2	17.5
Gross profit from trading properties					4.1	3.2	0.0
Dividend income from listed equity investments		0.0	0.1	0.1	0.1	0.0	0.0
Administrative expenses including share-based payments	(4.2)	(4.1)	(4.3)	(4.3)	(4.5)	(4.6)	(4.8)
Operating Profit (before capital items)	10.7	12.4	14.6	10.6	13.8	13.8	12.8
Realised & unrealised gains/(losses) on properties	6.0	(1.0)	(18.0)	(13.1)	3.9	4.5	3.9
Loss on revaluation of listed equity investments	0.0	(0.2)	(0.4)	0.7	(0.1)	0.0	0.0
Operating Profit	16.7	11.1	(3.9)	(1.8)	17.6	18.3	16.7
Net finance expense	(3.4)	(4.7)	(5.2)	(3.8)	(3.4)	(3.3)	(3.2)
Profit Before Tax	13.3	6.4	(9.1)	(5.5)	14.3	15.0	13.5
Taxation	(0.8)	(1.3)	3.6	(0.0)	0.0	0.0	0.0
Profit After Tax (FRS 3)	12.5	5.2	(5.4)	(5.5)	14.3	15.0	13.5
EPRA adjustments:							
Realised & unrealised gains/(losses) on properties	(6.0)	1.0	18.0	13.1	(3.9)	(4.5)	(3.9)
Deferred tax charge	(0.3)	0.2	0.0	0.0	0.0	0.0	0.0
Other adjustments	0.3	1.1	(1.8)	(0.3)	(4.0)	(3.2)	0.0
EPRA earnings	6.5	7.6	10.8	7.2	6.4	7.3	9.6
Share-based payments	0.2	0.3	0.1	0.3	0.4	0.4	0.4
Other adjustments	0.7	0.0	(2.9)	0.0	0.2	0.0	0.0
Adjusted earnings	7.4	7.9	8.1	7.5	6.9	7.7	10.0
Tax adjustments	1.1	1.0	(0.0)	(0.0)	0.0	0.0	0.0
Company adjusted PBT	8.5	8.9	8.0	7.5	6.9	7.7	10.0
Average fully diluted number of shares outstanding (m)	35.0	45.9	46.0	46.1	46.2	46.1	46.1
Basic EPS - FRS 3 (p)	35.8	11.3	(11.8)	(12.0)	30.9	32.6	29.2
Fully diluted EPRA EPS (p)	18.7	16.5	23.4	15.7	13.9	15.9	20.7
Fully diluted adjusted EPS (p)	21.2	17.3	17.5	16.4	15.1	16.7	21.6
Dividend per share declared (p)	19.0	19.0	12.0	10.5	12.8	14.0	18.0
Dividend cover by adjusted earnings (x)	1.11	0.91	1.46	1.56	1.18	1.20	1.20
NTA total return	-2.1%	2.8%	-5.8%	-2.0%	9.2%	9.0%	7.7%
BALANCE SHEET							
Fixed Assets	254.0	261.1	251.7	239.3	223.8	273.3	282.2
Investment properties	253.9	258.3	248.7	235.9	223.6	273.1	282.0
Other non-current assets	0.1	2.7	3.0	3.5	0.1	0.1	0.1
Current Assets	46.3	55.3	51.8	61.9	58.1	16.6	13.6
Trading properties	0.0	14.4	27.6	42.7	18.5	(.0)	(.0)
Assets held for sale	21.7	11.8	0.0	0.0	0.0	0.0	0.0
Cash	19.0	22.9	14.9	9.4	29.8	6.8	3.9
Other current assets	5.6	6.2	9.3	9.8	9.8	9.8	9.8
Current Liabilities	(11.5)	(16.0)	(16.1)	(34.9)	(42.0)	(42.2)	(43.2)
Creditors	(8.8)	(10.0)	(14.1)	(12.9)	(11.1)	(11.3)	(12.3)
Short term borrowings	(2.7)	(6.0)	(1.8)	(21.9)	(30.8)	(30.8)	(30.8)
Long Term Liabilities	(105.5)	(120.0)	(121.1)	(108.5)	(72.8)	(71.3)	(69.8)
Long term borrowings	(97.2)	(112.0)	(117.5)	(105.4)	(70.0)	(68.5)	(67.0)
Deferred tax & other long-term liabilities	(8.3)	(8.0)	(3.5)	(3.1)	(2.7)	(2.7)	(2.7)
Net Assets	183.3	180.3	166.3	157.8	167.1	176.3	182.8
EPRA net assets	0.0	0.0	167.9	161.3	171.3	180.5	187.0
Basic NAV/share (p)	400	393	361	343	361	381	395
Diluted EPRA NAV/share (p)	0	0	364	350	370	390	404
CASH FLOW							
Operating Cash Flow	9.9	11.9	15.7	11.3	37.3	33.0	14.2
Net Interest	(2.7)	(3.4)	(3.7)	(3.6)	(3.2)	(3.1)	(3.0)
Tax	(0.4)	(1.6)	(2.2)	(1.2)	(0.0)	0.0	0.0
Net cash from investing activities	(67.7)	(11.5)	(10.1)	(14.8)	16.6	(43.0)	(5.0)
Ordinary dividends paid	(6.7)	(8.7)	(8.7)	(3.5)	(5.4)	(6.2)	(7.4)
Debt drawn/(repaid)	8.2	18.0	1.4	7.6	(26.9)	(1.7)	(1.7)
Proceeds from shares issued (net)	67.7	(0.0)	0.0	0.0	0.0	0.0	0.0
Other cash flow from financing activities	(1.1)	(0.1)	(1.0)	(0.3)	(0.0)	0.0	0.0
Net Cash Flow	7.0	4.4	(8.5)	(4.5)	18.4	(21.0)	(2.9)
Opening cash	10.9	18.0	22.4	13.9	9.4	27.8	6.8
Closing cash	18.0	22.4	13.9	9.4	27.8	6.8	3.9
Restricted cash	1.0	0.5	1.0	0.0	2.0	0.0	0.0
Closing balance sheet cash	19.0	22.9	14.9	9.4	29.8	6.8	3.9
Closing balance sheet debt	(99.8)	(118.0)	(119.4)	(127.3)	(100.9)	(99.4)	(97.9)
Unamortised debt costs	(1.6)	(1.3)	(1.4)	(1.0)	(0.6)	(0.4)	(0.2)
Closing net (debt)/cash	(82.4)	(96.5)	(105.8)	(118.9)	(71.6)	(92.9)	(94.2)
Net LTV (excl. restricted cash & adjusted for unamortised debt costs)	29.8%	33.7%	38.1%	42.0%	29.0%	33.4%	32.8%

Source: Palace Capital historical data, Edison Investment Research forecasts

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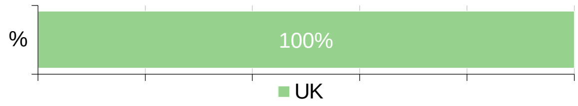
Revenue by geography



Leading team

Non-executive chairman (until 31 December 2021): Stanley Davis

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

CEO: Neil Sinclair

Neil Sinclair has over 50 years' experience in the property sector. He was a founder of Sinclair Goldsmith, chartered surveyors, which was admitted to the Official List in 1987 and subsequently merged with Conrad Ritblat in 1993, when he became executive deputy chairman. Neil was appointed non-executive chairman of surveyors Baker Lorenz in 1999, which was sold to Hercules Property Services in 2001. He was appointed a non-executive director of Tops Estates, a fully listed company, in 2003 and remained so until Tops Estates was sold to Land Securities in 2005. He was one of the founders of Mission Capital, now Watchstone Group, which was admitted to AIM in 2005, and was executive chairman until February 2008.

Executive director: Richard Starr

Richard has extensive experience of sourcing and managing commercial investments throughout the UK. After qualifying as a chartered surveyor in 2000, he developed his experience working as a fundamental team member of four Central London property firms including the corporate real estate division of what is now CBRE Global Investors. In 2011, Richard established his own boutique property consultancy, successfully negotiating sales and acquisitions on behalf of a wide variety of institutional and private clients before joining the board of Palace Capital in October 2013.

CFO: Matthew Simpson

Matthew is a chartered certified accountant with 15 years' experience and has been with the company since 2016. Previously holding the position of head of finance and operations, Matthew was appointed CFO with effect from 11 November 2021. He was previously part of the financial management team at Private Equity firm CIT Group Partners LLP, where he gained an extensive understanding in commercial property transactions in Central London and across Germany.

Principal shareholders as 14 July 2021 (source: Palace Capital)	(%)
Premier Miton	9.4
AXA Investment Managers	7.7
JO Hambro	7.3
Peter Gyllenhammar	6.0
Allianz	5.1
Stanley Davis	3.6

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