Allenby CAPITAL

COMPANY NOTE

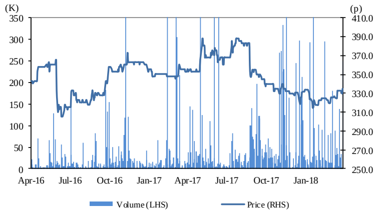
Portfolio & trading updates

25 April 2018

CORPORATE

Current price	336.0p
Sector	Real Estate Investment
Code	(PCA.L)
Listing	AIM

SHARE PERFORMANCE



	1m	3m	12m
— PCA.L	+4.7%	+0.9%	-5.1%

Source: Fidessa, Allenby Capital

SHARE DATA

Market cap		£153.6m
Shares in issue		45.8m
52 weeks	High	Low
	391p	315p
Financial year end		31 March

Source: Company Data, Allenby Capital

KEY SHAREHOLDERS

Axa Investment Managers	7.7%
Miton Group Plc	7.4%
J O Hambro	7.3%
Polar Capital Euro Forager	5.0%
Stanley Davis	3.6%

Source: Company Data, Allenby Capital

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PALACE CAPITAL PLC (PCA.L)

Asset management, refinancing driving result

The group's portfolio and trading update confirmed that FY17/18 results will be slightly ahead of expectations. The statement illustrates how effectively intensive asset management continues to drive underlying rent and asset values, with margins also enhanced by recent debt refinance on improved terms.

- **Despite the statement, we have held our FY17/18 forecasts pending the results** which are due to be announced on 11 June. We have however, reduced FY18/19e to incorporate more conservative assumptions on the timing and terms of asset sales and acquisitions, and expenditure related to the major development in York. With multiple moving parts, our projections disregard the potential for short-term acquisitions which should immediately benefit net income/EPS. Discussions are, however, well underway in respect of both major asset disposals and acquisitions, and transactions over the next few months could have a material impact on the result for this and future financial years

- **Redevelopment of Hudson House, York scheduled to get underway in early 2019.** We expect more detail regarding this project at the results in June. This substantial office and residential scheme has planning consent and demolition of existing properties, now underway, will save around £0.75m pa of expenses related to empty building liabilities. PCA now plans to carry out this project on its own.

- **Valuation: underpinned by move to Official List, 16% discount to FY18e NAV, 5.7% prospective yield** In March PCA completed its anticipated move from AIM to the LSE Official List. That should benefit equity liquidity and potentially attract new investors, particularly as the shares join the FTSE All-Share Index.

- **Catalysts for reappraisal over next few months** Acquisition of RT Warren in October provided £48.5m of commercial assets to 'work', but the main catalysts for outperformance over the next 18 months appear to be (a) disposal of the c £20m RT Warren residential portfolio and (b) investment of up to c £60m including sales proceeds and debt. That could add another £3m to group income, net of debt service costs and the 3.4% net rental yield on the residential portfolio. The dividend would thus be fully covered by recurring rental revenues once available cash is reinvested in rented commercial assets at a c 7% NIY.

EXHIBIT 1: SUMMARY FINANCIALS

Y/E March	2016A	2017A	2018E	2019E
NET REVENUE	**9.8**	**12.2**	**16.2**	**18.6**
ADJ. PRE-TAX PROFIT	**5.5**	**6.3**	**8.4**	**10.0**
REVALUATION GAINS	3.6	3.1	0.0	0.0
PRE-TAX	**11.8**	**12.6**	**8.5**	**10.0**
ADJ. EPS (DILUTED).	*18.4*	*22.2*	*20.1*	*18.5*
DIVIDEND/SHARE (P)	**16.0**	**18.5**	**19.0**	**19.5**
DIVIDEND YIELD	*4.8%*	*5.5%*	*5.7%*	*5.8%*
EPRA NAV/SHARE (P)	**414**	**443**	**400**	**403**

Source: Company data, Allenby Capital (Adj. PTP incl. profit from asset sales, excludes acq. Costs)

EQUITY RESEARCH

TRADING UPDATE - FY17/18 AHEAD OF FORECAST

The portfolio and trading update covers the period since PCA's interim announcement in December. The key event during the intervening period was the group's move from AIM to the LSE Main Market (March 2018), which we expect to progressively increase its profile and build equity liquidity. It will now pay dividends quarterly.

The underlying result for the year to 31 March 2018 is likely to be slightly ahead of expectations. That excludes profit on disposals, any revaluation gains and allows for the major acquisition in October and the fundraise. The results are due to be announced on 11 June.

We have held our FY17/18e forecasts pending the results but adjusted our previous FY18/19e projections to reflect more cautious assumptions related to the timing of acquisitions and sales, and other portfolio expenses.

The outlook is underpinned by the cash position and potential acquisitions, which would boost rental income and EPS. The group's contracted rent roll is currently £18.1m pa, or £16.88m pa net of £1.22m pa of costs related to empty rates, service charge shortfalls and head rents. We estimate that full investment of available resources - cash and debt – would push the contracted rent roll to c £21.5m pa.

The focus on active asset management to grow rental and NAV/share is supported by the recent appointment of two senior asset managers.

PORTFOLIO AND TRADING UPDATE

The update confirmed that trading remains on track:

- Terms achieved at lease renewals/new lettings have been in line with forecasts. The performance justifies recent investment in asset refurbishment and provides useful precedent for upcoming lease negotiations. Examples of strong performances by specific assets are set out below.

- Intensive asset management has ensured that rental income continues to offset any shortfalls attributable to a relatively challenging retail and leisure environment. PCA discusses this in its statement (we comment below) and we have incorporated pressure on this part of the portfolio in our forecasts. Net performance is however, reported to be relatively stable.

- The site for the group's major development in York is currently being cleared, with construction scheduled to get underway in early 2019. The demolition of existing lettable space will reduce empty property related outgoings by c £0.75m pa. We expect PCA to provide more detail on this proposed project with the result in June. It has decided to retain 100% of the scheme and initial discussions with lenders regarding provision of construction finance have been positive.

- PCA reports that discussions are underway with prospective purchasers for most of the residential assets acquired with RT Warren portfolio in October 2017 (discussed below). It plans to reinvest the expected c £20m (book value) proceeds in income producing commercial assets, some of which are currently under consideration.

- We estimate that with the above sales proceeds, PCA will have c £60m available to invest, including debt. Full investment could add c £3m pa to profit, net of debt service costs and income currently received from the non-core residential assets.

PORTFOLIO ACTIVITY

FY17/18's most material transaction was the acquisition of RT Warren (Investments) Ltd in October 2017. To recap, PCA paid £53.4m plus £14.5m retained debt. That added a £71.8m portfolio of 21 commercial buildings and 65 residential units at a price below the independent valuation carried out by Cushman and Wakefield.

The transaction was financed by a £70m share issue, with £14m surplus cash net of expenses held to finance further expansion. PCA has since sold three of the residential units at prices 14% above book value and reports ongoing discussions to dispose of another 60 units. The other two will be retained for strategic reasons.

This acquisition provides a raft of opportunities to seek to enhance revenues and capital values by application of its brand of 'hands on' asset management to the commercial component.

Post the RT Warren acquisition the group portfolio was valued at £274.6m, diversified by commercial sector and geographically.

EXHIBIT 2: PORTFOLIO (% OF VALUATION)

Offices	48.8%	South East	28.5%
Leisure	15.4%	Yorkshire	20.6%
Industrial	13.9%	Midlands	18.0%
Residential	10.2%	South West	10.1%
Retail	7.5%	London	9.7%
Warehouses	4.0%	North East	7.3%
Car Parking	0.2%	North West	4.8%
		East	1.1%
	100.0%		100.0%

Source: Company

Other activity

- On 4 April 2018 PCA paid £0.75m for Nicholson Gate Fareham, a 5,500 sq ft office building acquired with vacant possession. This property has specific strategic value as it adjoins Admiral House, High Street, Fareham, part of the RT Warren portfolio. The two properties stand in a c. 1.3-acre site and PCA has obtained planning advice that identifies medium term development potential.

- The sale of three properties (Exeter, Coventry and West Molesey) raised £4.76m, above book value. All assets were either vacant or had limited/no growth potential.

PCA provided other updates on several existing portfolio properties:

Hudson House, York

Demolition of existing buildings is now underway to create a site for a prospective development. PCA has planning consent for a scheme which comprises 127 apartments, 35,000 sq ft offices, 5,000 sq ft of commercial and car parking.

PCA has decided to proceed with this development on its own, rather than with a joint venture partner. That decision reflects the demand for other schemes in York. It has appointed agents for both the commercial and residential elements and discussions commenced with potential providers of construction finance.

The existing property is not charged. PCA expects to commit limited cash during the construction phase expected to start in early 2019.

Sol Central, Northampton	The group's plans for this leisure asset have been affected by publicised pressure on the UK casual dining sector. It has however carried out improvements including repairs to external lighting and a new roof. New agents have been appointed to market the vacant space and external managers to focus on increased car park income. The return from this asset is underpinned by a turnover rent paid by Accor Hotels in respect of trading by The Ibis Hotel.
Broad Street Plaza, Halifax	There is potential for interruption in rental income due to the liquidation of a small restaurant tenant and Prezzo's recently announced Company Voluntary Arrangement. PCA will undertake ongoing marketing initiatives to boost footfall and let vacant space. New agents have been appointed.
St James, Newcastle-Upon-Tyne	PCA plans to upgrade this property to enhance its visual impact. Serco has extended its lease to May 2019 and agreed a 10% increase in rent to £0.222m pa from June 2018.
Solaris House, Pitfields, Milton Keynes	This 14,500 sq ft refurbished office building (Unit 2) was recently let to Monier Redland (part of the BMI Group) for ten years without a break and provision for rent review at the end of the 5th year. Headline rent is £0.24m pa (£16.55 psf) with a 50% reduction until August 2021 in lieu of a rent-free period. PCA's adjoining 38,300 sq ft office buildings are let until December 2026 at £0.4m p a (10.40 psf). A rent review is due this December.
249 Midsummer Boulevard, Milton Keynes	PCA has carried out refurbishment, including the vacant 5,300 sq ft second floor and 8,600 sq ft which becomes vacant this month. When acquired most leases were between £12.50 and £13.50 psf; none above £14.90 psf. Milton Keynes's office market has picked up this year and agents advise that it is likely to achieve 20% rental growth.
High Street, Weybridge	This three storey 12,000 sq ft property; ground floor retail and offices on upper floors plus car parking, is due to become vacant in early 2019. PCA has instructed a professional team and expects to submit a planning application to redevelop the site for commercial or residential purposes.
Priory House, Gooch Street, Nth. Birmingham	A 60,000 sq ft office building let to Forensic Science Ltd to December 2027, with the next rent review due in December 2022. Rent payable increased from £0.26m pa to £0.32m pa exclusive, from December 2017.
Boulton House, Chorlton Street, Manchester	Passing rent was £12-£13 psf at this asset's acquisition in June 2016. PCA carried out a limited refurbishment and secured a tenant for 5,500 sq ft in August 2017 at £17.25 psf.

REFINANCING: AVERAGE INTEREST COST 3.4%, MAJORITY (70%) HEDGED

Current debt facilities are £115m (H117/18: £95.3m), with £101m drawn, equivalent to a 31% LTV on interim valuations. Average debt maturity is 4.7 years, average cost 3.4% and 70% of aggregate debt is hedged.

EXHIBIT 3: DEBT FACILITIES AND TERMS

Lender	Balance drawn	Maturity date	LTV Covenant	LTV Actual	Interest cover covenant	Interest cover actual
NatWest	£20.39m	Mar 2021	60%	33%	2.25x	6.47x
Santander	£26.75m	Aug 2022	60%	52%	2.50x	4.04x
Lloyds	£3.81m	Apr 2019	55%	36%	2.00x	5.55x
Scottish Widows	£14.41m	Jul 2026	68%	60%	2.00x	4.06x
Barclays	£35.85m	Jan 2023	60%	43%	2.50x	4.66x
	£101.20m					

Source: Company

Full investment of the £60m (50:50 cash and debt) of resources available would increase aggregate group LTV to c 40%. The major development in York would largely be funded by a development facility and with no further acquisitions, PCA expects that LTV would peak by end of calendar 2021 and gradually reduce as it sold the residential component.

PCA has recently improved financing terms as follows:

- In January it refinanced existing facilities provided by Nationwide and Barclays. It replaced both with a new five-year £40m Barclays facility.
- The Santander and Barclays facilities were hedged in March 2018.

PCA reports that its bank lenders have all indicated an appetite to provide increased facilities where appropriate.

VALUATION: 5.7% PROSPECTIVE YIELD, 16% DISCOUNT TO EPRA NAV

The yield is attractive at 5.7% (FY18e). Although our current FY19e adjusted EPS forecast does not fully cover distributions, that gap should close as PCA invests spare cash in acquisitions at a 7-8% NIY. **The group has c £60m to invest, including debt and the proceeds of the potential sale of non-core and low yielding residential assets.**

However, with multiple moving parts including a possible equity commitment to a substantial development in York, we have not incorporated any further acquisitions into our forecasts. Consequently, substantial cash holdings and lower yield residential assets will act as a drag on earnings growth, relative to a prospective c £3.0m pa boost if PCA was fully invested in commercial property. That figure is net of debt service cost and income on the residential portfolio.

The current share price is 16% below 400p end FY18e NAV/share. The trading update supports our belief that ongoing asset management will be reflected in external valuations, but that is not reflected in FY19e NAV/share.

Neither does it incorporate the potential for the group to work its latest portfolio and ratchet up asset performance. PCA regarded the RT Warren portfolio as undermanaged by its standards, with components let at passing rents below open market. We expect the next 18 months to be particularly active, as it works its way through opportunities to improve and upgrade assets, leases and letting terms.

EXHIBIT 4: INCOME STATEMENT

Year to 31 March	2016	2017	2018e	2019e
Rents received from investment properties	11,375	13,809	16,200	18,600
Management fees & other income	46	457	0	0
Surrender premium	3,172	0	0	0
Total Revenue	**14,593**	**14,266**	**16,200**	**18,600**
Non-recoverable property costs	-1,624	-2,055	-1,350	-1,400
Net property income	**12,969**	**12,211**	**14,850**	**17,200**
Administrative expenses	-2,048	-2,915	-3,000	-3,400
Operating profit before gains and losses on property assets and cost of acquisitions	**10,921**	**9,296**	**11,850**	**13,800**
Gains on revaluation of inv. portfolios	3,620	3,101	3,800	0
Profit on disposal of inv. properties	290	3,191	-159	0
Cost of acquisitions	-815	0	-3,500	0
Operating profit	**14,016**	**15,588**	**11,991**	**13,800**
Finance income	34	3	0	0
Finance expense	-2,298	-3,014	-3,451	-3,800
Pre-tax profit	**11,752**	**12,577**	**8,540**	**10,000**
Adjusted pre-tax profit	**5,485**	**6,689**	**8,399**	**10,000**
Taxation	-953	-3,191	-1,344	-1,500
	17%	25%	16%	15%
Net profit after tax	**10,799**	**9,386**	**7,196**	**8,500**
Underlying PAT	**4,532**	**3,498**	**7,055**	**8,500**
Earnings per share				
Basic	43.9	36.6	20.5	18.5
Diluted	43.9	36.5	20.5	18.5
Adjusted cash EPS	18.4	22.2	20.1	18.5
Dividend per share	16.0	18.5	19.0	19.5
Dividend cover	1.15x	1.20x	1.06x	0.95x

Source: Company data, Allenby Capital

EXHIBIT 5: BALANCE SHEET

Year to 31 March	2016	2017	2018e	2019e
Non-current assets				
Goodwill	0	0	0	0
Investment properties	174,542	183,916	270,178	271,178
Property, plant and equipment	37	43	120	110
Deferred tax	334	0	0	0
Trade and other receivables	825	0	0	0
	175,738	**183,959**	**270,298**	**271,288**
Current assets				
Trade and other receivables	3,327	2,511	6,000	6,000
Cash at bank and in hand	8,576	11,181	24,894	25,065
	11,903	**13,692**	**30,894**	**31,065**
Current liabilities				
Trade and other payables	-6,815	-6,161	-8,350	-8,350
Borrowings	-2,233	-2,036	-3,000	-3,000
Creditors: amounts falling due within one year	**-9,048**	**-8,197**	**-11,350**	**-11,350**
Net current assets	**2,855**	**5,495**	**19,544**	**19,715**
Non-current liabilities				
Borrowings	-69,711	-75,758	-100,500	-100,500
Deferred tax liability		-2,187	-6,500	-6,500
Obligations under finance leases	-2,067	-1,950	-1,588	-1,588
Net assets	**106,815**	**109,559**	**181,253**	**182,414**
EPRA NAV/share - Basic	**414p**	**443p**	**400p**	**403p**

Source: Company data, Allenby Capital

EXHIBIT 6: CASHFLOW STATEMENT

Year to 31 March	2016	2017	2018e	2019e
Operating Activities				
Net cash generated in operations	12,287	10,294	14,048	13,820
Interest received	34	0	0	0
Interest and other finance charges paid	-3,455	-2,516	-3,451	-3,800
Corporation tax paid in respect of operating activities	-158	-1,047	-1,000	-1,000
Net cash flows from operating activities	**8,708**	**6,731**	**9,597**	**9,020**
Investing Activities				
Purchase of investment property	-21,689	-10,950	-91,808	0
Payments to acquire subsidiary undertakings	-29,095	0	0	0
Capital expenditure on refurbishment of investment property	-1,182	-4,579	-2,500	-2,500
Deposit paid on purchase of investment property	0	0	0	0
Proceeds from disposal of investment property	1,957	12,447	3,246	0
Purchases of property, plant and equipment	-3	-26	-25	-25
Net cash flow (used in)/from investment activities	**-50,012**	**-3,108**	**-91,087**	**-2,525**
Financing Activities				
Other loans repaid	0	0	0	0
Bank loans repaid	-17,010	-19,952	0	0
Proceeds from new bank loans	38,282	25,813	32,500	2,500
Issue of new share capital	19,114	29	67,500	0
Purchase of treasury shares	0	-2,250	0	0
Fees relating to cancellation of deferred shares	0	0	0	0
Dividends paid	-3,221	-4,617	-4,798	-8,824
Capital element of finance lease rental payments	-2	0	0	0
Net cash flow from financing activities	**37,163**	**-1,018**	**95,202**	**-6,324**
Net Increase in Cash and Cash Equivalents	**-4,141**	**2,605**	**13,713**	**171**
Cash and cash equivalents at beginning of the year	**12,278**	**8,576**	**11,181**	**24,894**
Cash acquired	**439**	**0**	**0**	**0**
Cash and cash equivalents at the end of the year	**8,576**	**11,181**	**24,894**	**25,065**

Source: Company data, Allenby Capital

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