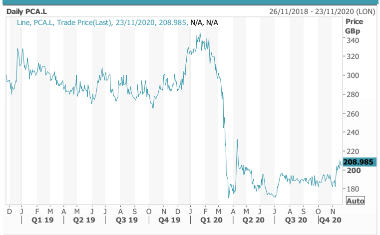
HARDMAN & CO.

24 November 2020

PALACE CAPITAL

Interim results on track – upside clear in FY'22

Real Estate



Source: Refinitiv

Market data

EPIC/TKR	**PCA**
Price (p)	206
12m High (p)	345
12m Low (p)	172
Shares (m)	45.9
Mkt Cap (£m)	94.6
EV (£m)	204.0
Market	Main, LSE

Description

Palace Capital (PCA) is a real estate investor, diversified by sector (office, industrial) and location, excluding London and with minimal exposure to retail. There is an emphasis on city-centre locations. Development assets comprise 18.7% of assets.

Company information

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

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Key shareholders

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

Diary

Jun'21	Final results
Jul'21	AGM

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1H'21 results cover the depths of the initial market impact of COVID-19. We note the 4.7% fall in EPRA NTA and the effect of the dividend rebasing announced some months prior. There are no negative surprises. The focus on regional offices is a positive. There are other positives that we consider to be important, namely the ongoing contractual performance of the leisure asset tenants and lengthening of leases there, and the continuing encouraging residential sales (and small letting) at the mixed-use development of PCA's newly created Hudson Quarter, York. Here, we see just one of PCA's initiatives to unlock value and deliver attractive returns.

- **1H'21 results:** Rental income fell 7% (vs. 1H'20) – a level we see as the low point. There was a £7.2m IFRS loss, taking EPRA NTA/share to 347p. Adjusted EPS fell to 7.3%, down 14% vs. 1H'20. This excludes both the one-off £2.85m early lease surrender cash income in 1H'20 and modest share scheme impact.
- **Robust strategy:** Regional offices' (43% of assets) returns have exceeded London's in every year since 2016, and are clearly set to continue to do so. The development assets are set to show a 50% cash-on-cash return in calendar 2021. PCA's asset management and capital recycling strategy work.
- **Valuation reflects short-term problems:** We do not expect the balance sheet to have difficulties weathering storms, particularly as a result of proven strong tenant performance in 1H'21 and the £60m Hudson Quarter WIP unwind. These illustrate the strong underpinning and the near-term valuation upside.
- **Risks and upside:** COVID-19 has fully demonstrated the market difficulties and, indeed, many assets have short WAULTs. The regional office sector has good prospects, notwithstanding the short-term turbulence. The leisure assets have long WAULTs, and good tenants in close touch and up to date on rent.
- **Investment case**: Major NAV and profit advances are highly visible for FY'22. With the completion of the Hudson Quarter, York development, significant profits are generated in apartment sales. These are cash-backed, but – standard accounting practice – not included in EPRA profits. For this reason, NAV per share jumps nearly 20p. Regional offices and industrial are good sectors.

Financial summary and valuation

Year-end Mar (£m)	FY'19	FY'20	FY'21E	FY'22E	FY'23E
Net income*	16.43	18.76	14.40	14.10	15.30
Finance cost	-3.74	-4.34	-3.60	-3.40	-3.30
Declared profit	6.43	-9.07	-1.84	12.20	8.00
EPRA PBT (adj. pre-reval'n.)	8.61	10.14	6.80	6.70	8.00
EPS reported (diluted, p)	11.26	-11.85	-4.01	26.58	17.43
EPRA EPS (diluted, p)**	16.54	30.24	14.81	14.60	17.43
DPS (p)	19.00	12.00	10.00	11.00	13.00
Net cash/(debt)	-96.50	-105.90	-113.20	-81.60	-80.70
Dividend yield	9.2%	5.8%	4.8%	5.3%	6.3%
Price/EPRA NAV	49.5%	54.0%	57.7%	54.5%	53.3%
EPRA NAV/share (p)	406.60	372.50	348.60	367.40	376.00
LTV (loan to value)	33.85%	37.41%	40.26%	31.60%	31.00%

**Post direct costs, **Pre share-based payments*
Source: Hardman & Co Research

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Investment case

A major consideration benefits future numbers

18.7% of assets in development generate major FY'22 and FY'23 profits but, at the moment, Revenue Account just shows costs

Development assets of £52.7m comprise 18.7% of the portfolio, by value. This is a major commitment. Happily, it is progressing very well, as PCA took great care to select an asset where competition is effectively non-existent locally, and this shows; yet this £52.7m (some funded by development debt) is returning zero to the revenue account. A 50%-plus cash-on-cash is set to be achieved, as well as the working capital unwind, so current profits are achieved after the burden of funding a major project, which is accruing significant profits for the imminent future.

Current position is supportive

Outperformance amid NAV declines

94%-96% of rent collected or secured

Rents are being collected. 96% of the March 2020 rent due is now collected. 94% of the June 2020 rent and only 82% of the September 2020 rent have been collected to date, with a further 13% of the rents being collected monthly.

While asset values fell and EPRA (still in profit) reduced, the lease momentum was excellent.

New rent levels increased

- Seven lease renewals and two rent reviews were completed at an average of 11% above ERV and a 9% uplift on previous passing rent.
- For the fourth year in a row, PCA (modestly) outperformed the market valuation benchmark.

NAV fall, but actually fourth consecutive year of outperformance on values

1H'21 reported a 3.5% like-for-like reduction in property valuations in the period, compared with the MSCI UK quarterly property index, which reported capital values down 3.7% in the same period.

Regional offices a sound investment proposition

The mix is biased to regional offices (43.4%) and, to a lesser degree, industrial (14.1%) and leisure (12.4%). We are sanguine about the investment value (and rental prospects) underpinning the regional city-centre office assets. Industrial is a strong market. The leisure assets are concentrated in two large properties, and all leases are conforming to contract with high-covenant tenants. Leases have some years to run in these leisure assets and, indeed, we see the balance of likelihood as being PCA filling some of the modest voids in these two assets.

No high street or mall retail

PCA does not own any high street or mall retail assets, and the modest retail park exposure is to strong covenants, which have remained open during the COVID-19 pandemic.

The balance sheet is strong, with 42% LTV and a clear path to it falling to near 30% by end-March 2022 fiscal period.

Clear sight to LTV reductions towards 31%

Gearing is rising, specifically due to expenditure on the HQ (Hudson Quarter, York) mixed residential office development. This is on budget, and residential sales (due to complete from early March 2021 onwards) reduce the LTV towards 31%.

Upside visibility, in both FY'22 (to March) and further to FY'23

Lots of profit "in the tank"

- A number of clear value-uplift opportunities present themselves. To list just five: i) HQ; ii) a small office to residential redevelopment in Weybridge, which has planning and is currently being marketed for sale; iii) a future development in Leamington Spa (the building's current lease ends in 2022); iv) Manchester office potential for redevelopment; and v) Milton Keynes redevelopment. None of these strains the balance sheet in the short term – and, in the meantime, the majority are income-producing and cash-generative.

Dividend passed, then a cut; painful but necessary

- Although the dividend has been cut significantly, we model a clear path to full restoration, albeit this Hardman & Co illustration takes us through to 2023, as we model a major letting to take place in late FY'22 or at the start of FY'23.

In summary

This actively-run, multi-let regional real estate REIT has a robust tenant base, and exposure risks to the more difficult segments of UK real estate should not concern investors, in our view. Retail exposure (other than grocers and the likes of Wickes) is *de minimis*. Leisure weighting is broadly in line with MSCI, but this is with good tenants who are paying their rent, and several have lengthened their leases.

The track record is good. The seven-year track record is of total accounting return (NAV plus dividend) of 114% – investors more than doubling returns.

On balance, we see no major underlying rent reduction risk from here and, indeed, £1.0m additional to come from letting newly developed space

In our view, prospects for regional offices are encouraging and distinctly better than for City/Docklands. In addition, the yields generated are attractive and, although there is now a question mark about the reversionary upside, we expect no major rental falls.

Our calculations lead us to conclude that there is a clear path to dividends, in due course, being reinstated to match the peak payout achieved by PCA pre COVID-19, although this would require some (modest) rent rises.

Taking these points into account, the current discount to NAV offers plenty of leeway for unexpected macro events. The dividend yield on the shares balances the perceived risks with the undoubted potential for dividends to recover and, again, this should offer plenty of leeway.

First-half results

- Rent collection has been strong – more than 90% since lockdown. 82% of all rents due on, and since, the September quarter day have been collected – a higher percentage than at the equivalent stage in the previous two quarters. December monthly payments are still to come, when collection is expected to exceed 90%.
- 94% of rent due on the June quarter day was collected, compared with 96% on the March quarter day (excludes deferred rent).
- EPRA NTA per share of 347p reduced by 4.7%. This was predominantly the result of reductions on the two major leisure assets held. Rent payments on both are fully up to date.
- Like-for-like property valuations saw a 3.5% reduction in the period, compared with the MSCI UK quarterly property index, which reported capital values down 3.7% in the same period.
- EPRA earnings were £3.2m.
- LTV of 42% reflected drawdowns on the development loan at HQ, due to complete in March 2021.
- Two sets of dividends of 2.5p each were declared.
- The HQ development is on track for completion in March 2021, with more than 28% of 127 apartments already sold.
- Seven lease renewals and two rent reviews were completed at an average of 11% above ERV and a 9% uplift on previous passing rent.
- All debt covenants over the past two quarters were compliant.

Balance sheet position strong, and COVID-19 has added ca.3% points to our peak LTV estimates

The weighted average cost of debt reduced from 3.1% to 2.9%. See our estimates for year-end on page 1. LTV is set to fall materially just before this full year-end (March 2021), as 36 pre-sold apartments at HQ complete when the project reaches practical (physical) completion, with sales ongoing. This is due before the fiscal year-end. Note that we expect LTV to fall towards ca.31% in our forecast horizon.

The balance sheet is solid, with cash reserves and immediately available facilities of £26.3m as at 30 September 2020, to handle any unforeseen circumstances and to take advantage of potential opportunities in the short to medium term.

A modest disposal was made in 1H'21 and another post period-end – both at above book value.

WAULT (weighted average lease term) to break is 4.9 years.

Encouragingly robust performance at leisure tenants

Worth noting robust outcome in leisure assets

Only £0.2m income was lost to Company Voluntary Arrangements (CVAs) in the period 1H'21. "Cash flow remains robust", according to PCA.

Attention was paid to all tenants, and it is especially pleasing to Hardman & Co to see leisure sectors achieving good outcomes, suiting both parties to the leases. Rental concessions were granted at Sol Northampton with Accor Hotels in return for a five-year lease extension until 2032 and with Gravity Fitness in return for removal of the break clause, securing the lease until 2034. Rental concession was granted post the half-year-end at Broad Street Plaza, Halifax with TGI Friday's in return for a three-year lease extension until 2030.

Sector split and top 10 assets

The table below is important, and is based on the regular third-party valuation. It illustrates the sector split, and we consider it worth emphasising that it highlights that a substantial portion is in Development, which naturally has no yield. There are some voids. It also shows where the aggregate for a sector is over-rented (vs. current market, as assessed by Cushman & Wakefield) or under-rented (i.e. with reversionary potential). Note the long WAULT for leisure and short for offices.

- 52 properties with 227 leases
- 4.9 years' WAULT
- 1.61m sq. ft. area (0.84m sq. ft. in top 10 assets)
- £16.92m contracted income (£8.50m in top 10 assets)
- £20.23m ERV
- 60% of portfolio by value is the top 10 assets

Portfolio – asset types

@ end-September 2020	Market value (£m)	Number of properties	Number of leases	Contracted income (£m)	ERV* (£m)	WAULT to break (years)	ERV* of void (£m)
Offices	122.25	27	117	8.46	11.28	2.8	2.35
Development	52.75	2	0	0.00	n/a	n/a	n/a
Industrial	39.62	10	38	2.44	2.84	3.7	0.12
Leisure	35.04	2	20	3.20	3.20	11.3	0.37
Retail	22.32	8	49	1.94	2.18	7.7	0.21
Retail warehouse	9.44	2	2	0.76	0.60	6.2	0.00
Other	0.20	1	1	0.11	0.13	2.8	0.00

**ERV estimated rental value in open market; Source: Palace Capital*

Naturally, the difference between contracted and ERV is the difference in market values of rent achievable and the current rent on the existing leases, plus the rent that could theoretically be achieved were all voids to be let. Valuations are by Cushman & Wakefield. Under an asset management regime, some voids are necessary.

Top 10 assets by value

@ end-September 2020	Area (m sq. ft.)	Gross rental income pa (£m)	Reversionary yield (%)	WAULT to break (years)
Hudson Quarter, York development	n/a	0.00	n/a	n/a
St James Gate, Newcastle, offices	0.10	1.24	8.8	3.8
Broad Street Plaza, Halifax, leisure	0.12	1.63	7.6	11.5
Sol, Northampton, leisure	0.19	1.57	8.5	11.2
Boulton House, Manchester, offices	0.07	0.93	7.9	2.2
Derby Square, Liverpool, offices	0.07	1.06	7.9	3.0
Bank House, Leeds, offices	0.09	0.62	9.2	2.7
Kiln Farm, Milton Keynes, offices	0.05	0.66	7.4	6.5
Black Moor Road, Verwood, industrial	0.07	0.35	5.9	2.7
Point Four Estate, Avonmouth, industrial	0.08	0.43	7.1	3.5

Source: Palace Capital

Leisure assets

The leisure sector is one that is under pressure.

PCA's position is strong, we believe:

In detail: PCA's position is strong

- WAULT to break is 11.3 years and – importantly – lengthened during 1H'21, following constructive tenant interaction>
- Two properties (20 tenants), so opportunities to be deeply committed on asset management projects are being undertaken, specifically to enhance existing and potential tenant engagement.
- Valued on 9.1% of contracted rental income, with ERV in line with current rents and, indeed, several leases extended, thus proving-up the current market.
- Scope for voids to be filled, existing tenancies secured on the long WAULT, and rents being paid up to date.

Overall – some difficulties in rear-view mirror, but strong tenants and long leases underpin future in difficult times

We reproduce PCA's announcement in the 1H'21 results announcement of 16 November.

"The reduction in NAV reported today is impacted by our two leisure assets, Sol Northampton and Broad Street Plaza in Halifax, which have been mostly affected by the lockdown closures and the prevailing sentiment towards the leisure industry. However, news of a potential vaccine has improved the outlook for the industry and these assets are well placed to bounce back post pandemic. We have strong covenants in both schemes and rent payments across both assets are up to date. Moreover, we are in discussion with a number of potential tenants regarding the vacant space in these properties as parties start focusing on the recovery in the economy." (PCA)

Only two small units at Broad Street Plaza, Halifax, have been left void, with rent owing through COVID-19 due to CVAs at the Restaurant Group and Pizza Express. Naturally, some lease extensions included contractual rent-free periods.

"However, we think we've reached the bottom of the market for leisure and we have a £1m refurbishment programme planned at Sol [Northampton] for 2021 and lettings under offer at both schemes will improve rental income longer-term." (PCA presentation)

The estimated rental value of void assets is £0.37m p.a.

Progress at the York site, Hudson Quarter (HQ)

HQ provides profitability and significant cash

Why and how development reduces risk

The HQ development has significantly reduced the financial risk for PCA. Not only has it brought high visibility of major cash profits, but it has also worked to strengthen the PCA strategy of recycling capital. Each time capital is recycled, a liquidity event is achieved and, at each such event, Palace Capital can exercise choice. It can reinvest to enhance income, or it can pay down debt.

Site progress

The site launch took place in June 2019 for 127 apartments and 39,000 sq. ft. of highest-quality office space. Sales have progressed at a rate of one apartment per week, and a record £25 sq. ft. rent was agreed on part of the office space.

Residential prices achieved are a little above original budget, and the office lease was at a record for the strong location, which is inside York's city walls. There are no similar competing residential sites. Albeit different circumstances, the housing market was strong in the year post the 1987 stock market crash and also post the 2000 dotcom crash.

Our numbers remain firm

We had anticipated total profits of ca.£9.5m for HQ. We maintain these estimates. Our numbers are £7.0m residential sales cash-backed profits and £2.5m commercial revaluation.

Near £60m peak capital employed will then unwind and be deployable on new schemes, or be utilised to reduce REIT LTV to low levels

HQ benefits group prospects, not only through its latent profits but also through subsequently reinvesting the significant capital being employed. At peak, nearly £60m capital will be employed, comprising the book cost of the site and total construction costs.

Illustration towards fully covered peak-market dividends

Our short-term confidence on finances underpins current dividend levels

Short term, financing is robust. On average, rents would have to fall by 40% for ICR loan covenant "curing" to take place. Longer term, the residential gross development value (GDV) of £53m comes back as cash, net of development debt, but this still leaves an estimated £27m net cash out of the development to PCA to reinvest. It is due to retain the commercial assets (generating an estimated £1.0m rent p.a.)

Strategy firmly in place

PCA is positioned such that it can rapidly resume its strategy to optimise real estate assets, which combine strong tenants, good locations and the scope to add value (by improving the asset and hence tenant desirability). This then gives the opportunity to recycle capital. It is worth noting that our estimates are for £9.5m HQ profits and, along with planning gains already achieved, almost a 50% cash-on-cash return on PCA equity.

50% cash-on-cash returns from capital recycling and more recycling opportunities are clear

We believe the broad target PCA LTV is 35%-40% but, assuming York's HQ proceeds to plan with a physical build completion in spring 2021, the LTV post completion and exit of the York development will be not far above 30%.

1.5p EPS enhancement from an element of re-gearing post HQ cash release

Drivers to the net rental income line estimates

Element of illustration	Palace Capital EPRA EPS
Hardman & Co FY'23 estimate	17.4p
Recycling part of the HQ capital	1.5p
Rents and voids unwinding a quarter of ground lost since FY'20	0.2p
Realistic potential FY'24	19.1p

Source: CBRE

Our FY'23 estimates assume no net real estate acquisitions. Illustratively, were PCA to reinvest only part of the HQ cash generated and raise LTV by an illustrative 5% points, plus reinvest the profit, then further assets could be acquired. Were these to yield 6% net and financed at 3% (we would hope lower), then the boost to net profits would be £0.6m. Again, for illustration and with round numbers, this is comprised of £25m assets purchased funded by debt, yielding £1.5m and costing £0.8m interest. This raises EPS by 1.5p.

19.0p peak dividend payout of FY'19 still achievable from current capital base

Our new FY'23 ERA EPS is 17.4p. It would take very little further upside beyond the illustrative capital recycling to take EPRA EPS to above the peak dividend payout of 19.0p per share of FY'19.

The office market

How does the office market affect PCA, relatively?

PCA is an investor in offices in the centre of regional cities, excluding London.

Summary points – regions remain well-placed for market trends

Lower densities and affordable rents vs. proximate competition

There is no "average office", so it is a case-by-case assessment, but we are confident that PCA's office assets will outperform the "average/market". PCA assets offer:

- Lower storey height than prime newly developed space. This adds to their relative advantage.
- Lower rents than prime newly developed space, with PCA's central Manchester office rents being ca.£20 sq. ft; this illustrates a significant discount to central Manchester newly developed space, asking ca.£28 sq. ft. rent.

For occupiers, there will be a short-term but, distinctly, also a medium-term desire for lower density. It is not fixed how this will play out, but logic would indicate that convenient central locations, which are somewhat cheaper to rent, will be revalued, especially if the fit-out is modern and the density of lift-usage is less. This benefits assets such as PCA's central Manchester and central Liverpool. Newcastle should benefit too, but it has slightly higher lift density, we believe.

In London, the availability ratio (available-to-let space vs. total rented floorspace) would indicate a greater London risk, but PCA has no London offices.

Availability in regional market is lower – competition less compared with London

Regional availability remains relatively constrained

Availability ratio for offices, 3Q'20

Location	Availability vs. total floorspace
Central London (West End, City, Docklands)	12.0%
Manchester*	10.0%
Liverpool*	6.4%

**PCA location; Source: CBRE*

In the regions, just over 3m sq. ft. of Grade A is available to rent (Savills, August 2020 report), reflecting a 4% decrease since the end of 2019.

The total available office supply of all grades is 11.3m sq. ft. in the UK regional office markets, reflecting a 17% decrease since the end of 2019 (Savills, August 2020 report).

Hub and spoke model would be of additional benefit to PCA above these other factors – maybe too early to tell

Availability is far from the only assessment criterion, but it at least indicates reasonable underpinning of the regions as to supply. Only 2021 will tell whether the shift in the areas of greater demand continues to expand to regional centres out of London. We surmise it will, for reasons of density (both of offices and of the housing for the office workers), cost (especially with lower densities), fewer crowded lifts, and the possible "hub and spoke" occupier model (which was a minor trend ahead of COVID-19).

Savills, in August of this year, published a report that compared the current supply/demand dynamics in the regional office market with 2009. The report estimated that, since 2015, excluding London, 31m sq. ft. of office space has been converted to residential under Permitted Development Rights in England. Current availability of Grade B and C space across the regional markets in England has fallen by 45% since 2015. In parallel to this, there has been limited speculative office development in the regions in recent years. Savills further reported, in August, that there was a total available office supply of 11.3m sq. ft. in the UK regional office

Reduction in supply quantified…

markets, reflecting a 17% decrease since the end of 2019. However, of that, just over 3m sq. ft. is Grade A, reflecting a 4% decrease since the end of 2019. When this is compared with average annual take-up levels, it reflects only enough supply to meet the demand for 11 months of take-up.

When exogenous negative demand shocks hit, London typically would benefit. This time, there is such a hit, but the way of occupying offices has changed. Interestingly, typically in such a sudden recession, London house prices have tended to fall first (e.g. 1988 and, to a lesser extent, 2008). The same has happened this time (relatively, anyway). Maybe regions will fall, but for the reasons given in this section, we consider it to be different this time. While we acknowledge these are sometimes seen as dangerous words, the evidence is strong, and logic supports in a manner totally absent in 1988 and 2008.

…potential other broader factors to consider: too early to tell

The market lives on, and significant pre-lettings in excess of 80,000 sq. ft. have recently been announced in the city centres of Edinburgh, Manchester and Leeds (Source: PCA interim results).

What market-wide trends seem to be emerging during 2020?

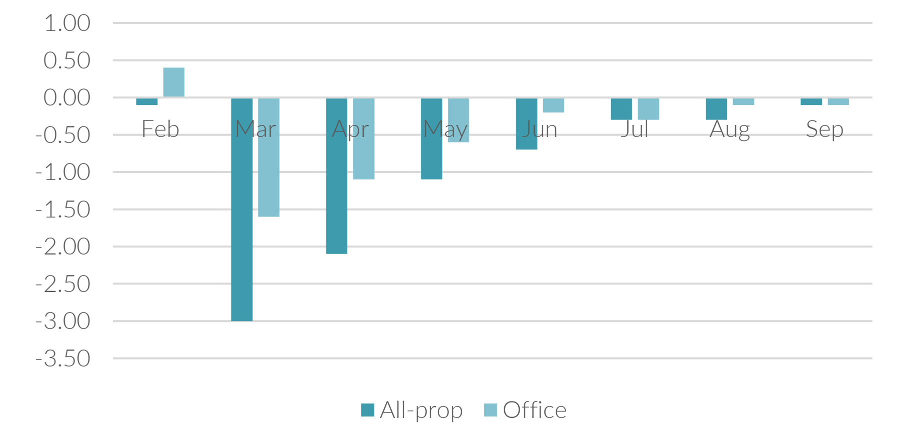
Office values are falling, but by less than the all-property market.

Valuations are starting to become clearer, as transactions tentatively recommence. While this is very tentative regarding volume, the "pecking order" is clear, with offices not caught in some greater COVID-19-inspired down-valuation relative to many other asset classes. Valuers' official "Material Uncertainty" clauses have been lifted in nearly all sectors, but investors naturally are sceptical. There is clear differentiation between sectors. The "direction of movement", for example, for logistics is clearly upwards, and for retail and leisure clearly downward. Offices have likely been unable to escape the value reduction in real estate but, regarding the quantum, we would not wish to pretend to be totally sure. Yet there are value-based facts, to which we are clear and confident to commit.

Offices: down, but not by as much as UK all-property

Mean office values have reduced, but not by as much as the UK all-property valuations.

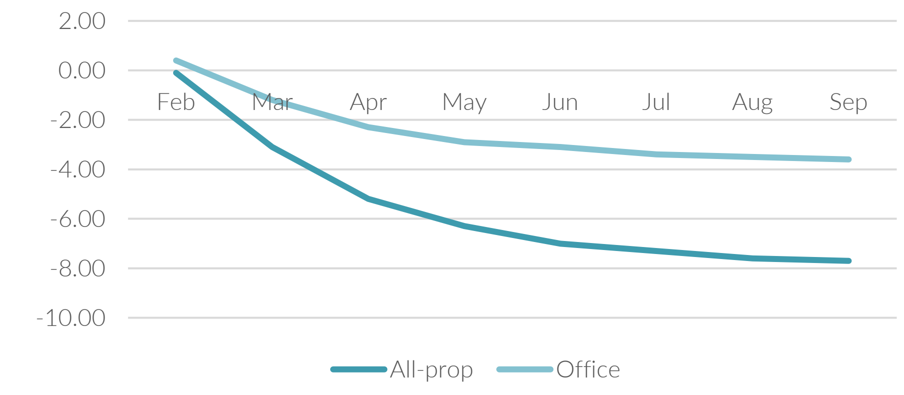
Monthly movements in UK market capital values through 2020 (%)



Source: CBRE "Monthly Snapshots"

The same data can be presented as a cumulative figure from the start of the global pandemic.

Cumulative monthly movements in capital values through 2020 (%)



Source: CBRE "Monthly Snapshots"

Offices have a core role in the prosperity of their occupiers

Offices have a role to play in growth and survival of businesses – role may change but not go away

This is not entirely without cost – rents are, after all, what the investment is about – but those costs range typically between 4% and 10% of total employment costs. Occupiers can work from home and, clearly, have done so, partly because of government mandating, but also through choice.

Office physical occupancy densities have changed forever, with fewer desks per area. On return towards (not to) normality, the "feel" of the office will be totally different. Many lifts are useable by one person at a time, one-way systems have been rolled out, and recommended office densities have reduced.

Mixed home-office working is here to stay, as illustrated in the British Council for Offices (BCO) survey: *http://www.bco.org.uk/News/News46982.aspx*. The survey indicated that 30% expect a full week of working in the office to be the outcome during the next six months. But, crucially, respondents also highlighted the importance of the office to career development, with 71% stating that the office is important for developing networks and learning. Meanwhile, 65% said their career had been helped by relationships forged in the office, and 71% agreed that the office was important for forming connections with colleagues.

There is not yet sufficient market evidence of how the operations of tenants will be rebalanced between hub and spoke office space; however, accessible, decentralised space may well be in demand.

Office occupier densities have reduced

Density of occupation set to reduce – a good thing for PCA's competitive position

There is plenty of third-party evidence that office occupation density has reduced. For example, the recent results from McKay Securities indicated that former fit-out designs at one person to 80 sq. ft. compare now with several other newer fit-outs, which have been noted more recently at 200 sq. ft. It may be that this expansion of densities may overshoot and then tighten again as costs become clearer. Time is needed for client requirements to evolve and clarify. Currently, density of lift-usage has to be lower. Unless there is a permanent eradication of COVID-19 by vaccines, it may well be that occupiers are wary of lift over-crowding, as they might be now in the 'flu season. If low-level COVID-19 becomes established, densities are likely to reduce permanently, in our view. After all, it has only been in recent years that densities have risen, but that rise is essential to the economics of modern, expensive high-rise development.

Risks and mitigation – sector exposure

Banking position robust

Cash and the unused revolving credit facility totalled £19.7m at end-March 2020. This is slightly in excess of 12 months' income. No bank or other debt is due to mature within the next two years, other than the development facility on HQ. The HQ financing is ring-fenced and all securely in place with a fixed-price construction contract. Strong sales – one per week since launch – and lettings have been achieved to date.

No bank facilities will mature in the coming year.

Debt facilities have 225%-250% interest cover covenants, which would, on average, only be breached if rents fell by 40%. On an asset-by-asset basis, there are a variety of LTV covenants. PCA has deposited £0.8m in a lock-up account to cure the LTV for Broad Street Plaza. Significant value falls would take place before any loan advances would have to begin to see PCA reducing loans on the particular asset. The large Sol Leisure asset, we estimate, has the most exposure in the group to tenants such as gyms, and we understand this is cross-collateralised with two non-leisure assets.

HQ set to generate significant cash at just the right time (calendar 2021)

All HQ development finance has been fully in place from the commencement of construction. This development was "on-risk", but the risk on the commercial side was a letting risk, not a sales risk, as the REIT was always going to retain it. Residential was on-risk, but there have been no competing projects.

High regional office exposure…

PCA's exposure to offices stands at near-50% (MSCI index weight 29.5%).

…but some leisure too

There is exposure (12.4% of the portfolio) to leisure via two large assets: Halifax and Northampton. Halifax is nearly fully let, with well more than half its value in Vue Cinema, Mitchells & Butlers and larger restaurant chains. Vue ticket prices, at typically under £10, drive excellent footfall. Sol Northampton is being progressively repositioned whilst occupied. The majority is occupied in fitness and wellbeing, as well as a cinema and a budget hotel as a destination attraction. We note the loan onto this asset is collateralised on three assets in total.

No individual tenant exceeds 6% of the total. The largest retail tenants comprise Wickes, Pets at Home, Aldi, Booker and Tesco. No shopping centres are owned.

Leisure tenants in portfolio are strong counterparts

We consider all of PCA's major leisure and retail (park) tenants to be solid. In terms of background, Bravissimo (an office tenant, albeit with a retail business) currently has 29 stores across the UK, and also sells via mail order, online and via a US website.

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

Assets purchased sometimes require areas of refurbishment (e.g. reception area). This is the nature of the value-adding asset management policy. At times of market disruption, as per 2020, "freshening" of assets is particularly important. The process itself is, at times, disruptive, so a careful balance has to be kept, as well as a close eye on cash management.

A number of leases are of short duration. The overall WAULT is not particularly relevant, as this is a granular investment portfolio. Assets that have reversionary potential, indeed, by definition, benefit from shorter WAULTs. PCA's WAULT happens to be 4.9 years to tenant break option (at period-end). It is important that the leisure sector WAULT is much longer, at 11.3 years, and, indeed, has been lengthened. This segment really benefits from visibility of income.

Borrowings

The group has unused loan facilities amounting to £19.3m (31 March 2020: £32.9m).

The six secured loan facilities comprise:

- Barclays development loan, maturity January 2022, 100% drawn, 3.30% all-in interest cost;
- Santander, maturity August 2022, 100% drawn, 3.56% all-in interest cost;
- Lloyds, maturity March 2023, 100% drawn, 2.01% all-in interest cost;
- Barclays, maturity June 2024, 100% drawn, 3.12% all-in interest cost;
- NatWest, maturity August 2024, 100% drawn, 2.16% all-in interest cost; and
- Scottish Widows, maturity July 2026, 100% drawn, 2.90% all-in interest cost.

A number of these facilities' all-in cost has been reduced in the past 18 months.

HQ is funded by the Barclays development loan. For accounting purposes, the interest cost on this one facility is capitalised.

Future financial performance and estimates

Rents

Overview – £1.0m rent estimated rise by FY'23

Strong covenants in more exposed sectors

While we are in the midst, still, of a difficult period for global real estate, we can make some strategic comments as regards PCA's position.

Lease extensions – all positive discussions

Effectively, 1H'21 has seen rental income fall: £8.3m rental income was reported, minus £1.0m direct property costs. For FY'20, it should be remembered that there was the benefit of a £2.85m lease surrender premium.

Excluding this, 1H'21 rent income fell nearly 9% vs. 1H'20. Our estimate is for stable rent income 2H'21 vs. 1H'21 (reported, to September 2020).

These strategic assumptions drive our forward estimates. To date, PCA's tenants have entered into positive dialogue where COVID-19 has hit them and, so far, those in the most exposed areas have performed contractually, e.g. Vue Cinema and Wetherspoons pubs and (multi-branch) gym tenants. The extensions have been agreed. Rent performance stays resilient. PCA's good fortune has been designed-in, we consider. It is also far better positioned for the future – in our view – by having regional (and relatively low-rise) office exposure.

Medium-term benefits of active asset management model have not gone away

Soon, the asset management features across the estate will pay off incrementally. For the moment, this adds to resilience, rather than monetary income.

What does add to the monetary income in a major way is the well-positioned HQ development. The majority of this is residential (over 70% of the capital employed), and the table below excludes disposal profits, so it excludes all this residential upside. Readers will note the £1.0m p.a. rent potential for the offices being developed, which we always anticipated PCA would retain.

Development model set to pay off – very visibly

Drivers to the net rental income line estimates

Asset class	Income impact (change) in the period (£m)
2H'21	
Offices, 2% fall (rent pricing' plus voids)	-0.1
Combined disparate leisure, industrial, grocer	-0.0
FY'22	
Offices, 2% fall balanced by new lettings	-0.1
Combined disparate leisure, industrial, grocer	-0.2
FY'23	
Offices, flat rent like-for-like, some lower void costs	+0.2
Offices, new let of HQ developed space	+1.0
Combined disparate leisure, industrial, grocer	0.0

Source: Hardman & Co estimates

Possible £0.3m cumulative run rate fall prior to £1.0m run rate jump

Regional office: very modest fall, then step-up from end-FY'22

In summary, we expect the market for regional office to be flat to -2% rent until our anticipated end-FY'22 letting of 35,000 sq. ft. new space in HQ adds £1.0m p.a. to the rent roll. So, this is a possible £0.2m run rate fall prior to a £1.0m run rate jump.

Half of assets are in regional offices: market consensus for this market is for rents to fall 1% over this difficult year, compared with ca.3% for the all-property (CBRE).

Either way, there is a pretty resilient basis underlying this half of PCA's assets. It would be imprudent not to assume voids drift up – as fresh tenants may take longer to make up their minds, and PCA has no need to let space go at the wrong price. So, we assume direct property costs rise slightly in FY'22. Overall, in the offices segment in FY'22, a 2% rent fall would equate to a little under a £0.2m reduction; however, we expect a small net amount of new lettings. Indeed, new space has already been let at HQ to Knights; there is a good uplift due in assets in Milton Keynes, and there could well be news of modestly net positive lettings of voids that have been refurbished in Manchester.

Industrial markets are firm, but the leisure sector is weak. It may well be – given the long leases – that leisure segment rents mark time, but we aim to be conservative, at a £0.2m reduction.

Leisure, industrial, supermarket earnings estimates to FY'23

Important to put leisure in context, as all tenants have communicated positively, and several leases have been lengthened (with rent-free periods agreed)

Half of the assets are split between leisure, industrial, retail parks, supermarket grocery and development, principally (but not entirely) HQ. We broadly consider the positives in industrial to balance the negatives in leisure and retail parks. Leisure is a mix, and includes a range of tenants, all of which are conforming to contract, although some is on the basis of rent-free periods to extend leases, for example.

Good tenants

Long Aldi lease

Not all covenants are "bomb-proof" but, at this stage, after the extreme tests to date, only two (relatively modest) units have been hit by a restaurant CVA. The exposure to hospitality is Wetherspoons. There remains some void space, which could be filled, but there is current interest in these. Retail parks are strong tenants (principally Wickes), and the Aldi supermarket lease is large and long, secure income. Overall, we believe it prudent to factor in a 3% contractual income fall (rents and voids) through 2H'21 vs. 1H'21 run rates. Note that rent-free incentives have been agreed, and this affects cash, but the effect is smoothed over the length of the (extended) lease. We then – to be prudent – factor in a further 2% fall in FY'22, and then stasis after that, but with the likelihood of increases. Industrial is a relatively easy story to tell. Rents are rising and set firm.

Background detail

FY'22 rent income benefits from a full year of HQ commercial, which has been let to Knights; there should also be a modest uplift from assets in Milton Keynes and from letting more space in Manchester progressively through the year. For FY'23, we assume further effects of market headwinds, but there remain a number of locations where local rents prove still to be reversionary. We think the opportunity remains to raise rents to nearer market ERVs. Thus, for FY'23, we take a view that this reversionary potential and the negative headwinds balance imply a very small rise in rental income, and also a minimal reduction in void costs.

FY'23 income is expected to benefit from the letting of the 35,000 sq. ft. of HQ office blocks during FY'22. This should equate to £1.0m (or slightly more) p.a. We assume no income from this in FY'22.

On balance, for the leisure assets, we see as much upside from filling voids maybe at initially attractive rents, versus the risk of new voids. The overwhelming majority of leisure segment leases are long, and the position, as of publication, is that all tenants are complying with contracts – after certain incentives agreed during 1H'21 – and are in good communication. We may be overly conservative for FY'23, with the ongoing rises in industrial, but we think it is best to leave leeway at this stage.

Revaluations

No material further market-related move post reported 1H'21

Overall – no meaningful change in asset valuations from here

Turning to revaluations and profits/losses from disposals, we assume that the negative revaluations of FY'21 and 1H'22 pretty much mark the low water position.

£2.5m commercial development (HQ) revaluation FY'21

We turn now to development assets, namely HQ, which is being developed for residential and office. We estimate a £53m GDV for the former, which is in line with the original assessment.

Residential development (HQ)

Going to budget and timing has been only moderately disrupted by physical constraints of COVID-19

This robust anticipated outcome of values in line with original budgets is not dependent – we consider – on the government's stamp duty holiday, although it, of course, helped. Sales were progressing well (under the circumstances) between the start of the March lockdown and pre the stamp duty announcement. We estimate 20% of the residential flats will be completed as sales by end-FY'21 (end-March). Practical completion is estimated for the second week of March, triggering completion of the exchanged backlog.

With prices for these contractually set already and substantial deposits taken, our anticipated £1.5m residential sales profit for FY'21 should be secure, bar any delay to physical completion. Note, in our tables, this is collated with a small commercial property disposal not associated with HQ.

All hallmarks of successful (and major) strategic move –50%-plus cash-on-cash return and excellent cash returns at just right time

For HQ residential sales, the majority will take place in FY'22. Sales rates are continuing (as per the results announcement, which we update in this document), and there is every likelihood that the development will be sold and completed well before end-March 2022. We anticipate £5.5m residential sales profits in FY'22, completing the development (with PCA set to retain the whole of the commercial asset).

Future development

Plenty of potential "in the tank"

Development and also refurbishment

18.7% of the assets are categorised by PCA as having development potential. A greater portion (33.0%) has value-add potential through refurbishment. We expect PCA to commence other developments in the future on a cautious, but proactive, basis.

High Street Weybridge is a PCA building (unencumbered), recently empty for redevelopment into 28 residential units over small retail – planning permission having been granted. The PCA forecast for cash-on-cash return is over 30%. It is currently being marketed for sale, with the benefit of planning.

All timings under PCA's control

PCA has listed five further developments, each with build costs of between £2.0m and £45.0m and totalling £100.0m. They principally comprise offices, but also residential. The timing on this pipeline is entirely in PCA's hands. It may undertake the development itself, or with a JV, or a sale. It may, indeed, choose to hold the assets and defer development. It is in control. The smaller development has planning permission.

Financial estimates

Revenue account							
Year-end Mar (£m)	**FY'17**	**FY'18**	**FY'19**	**FY'20**	**FY'21E**	**FY'22E**	**FY'23E**
Rental, other income	14.27	16.73	18.75	21.15	16.40	16.30	17.40
Direct property costs	-2.06	-1.82	-2.32	-2.39	-2.00	-2.20	-2.10
Net income	12.21	14.91	16.43	18.76	14.40	14.10	15.30
Administrative expenses	-2.91	-4.18	-4.08	-4.28	-4.00	-4.00	-4.00
EPRA operating profit	9.30	10.73	12.35	14.48	10.40	10.10	11.30
Property revaluation	3.10	5.74	-0.89	-18.34	-10.00	0.00	0.00
Profit on disposal, transaction costs	3.19	0.27	-0.36	-0.13	1.76	5.50	0.00
Share-based payments	-0.24	-0.17	-0.33	-0.20	-0.20	-0.20	-0.20
Other income/costs	0.00	0.00	0.00	0.10	0.00	0.00	0.00
Operating profit	15.35	16.57	10.77	-4.09	1.96	15.40	11.10
Finance cost	-3.01	-3.26	-3.74	-4.34	-3.60	-3.40	-3.30
EPRA PBT (pre-revaluation, etc.)	6.45	7.47	8.61	10.14	6.80	6.70	8.00
Financial derivatives: change in fair value	0.00	-0.18	-0.93	-0.85	-0.40	0.00	0.00
PBT, as declared (pre share-based)	12.58	13.30	6.43	-9.07	-1.84	12.20	8.00
Tax	-3.19	-0.77	-1.26	3.63	0.00	0.00	0.00
Deferred tax revaluations, capital allowances	2.20	0.00	0.00	0.00	0.00	0.00	0.00
EPRA PAT	5.46	6.70	7.35	13.77	6.80	6.70	8.00
EPRA EPS (diluted, p)	21.21	18.67	16.54	30.24	14.81	14.60	17.43
EPRA EPS (adj. post share-based payments, p)	20.28	18.18	15.82	29.80	14.38	14.16	16.99
EPRA plus cash profit on disposals: EPS (p)*	31.70	19.34	15.84	29.85	18.65	26.58	17.43
EPS reported (diluted, p)	36.50	35.87	11.26	-11.85	-4.01	26.58	17.43
DPS (p)	18.50	19.00	19.00	12.00	10.00	11.00	13.00
Average shares issue (m)	25.74	34.98	45.90	45.90	45.90	45.90	45.90
Year-end shares issue (m)	25.23	45.80	45.90	45.90	45.90	45.90	45.90

**This figure is a Hardman & Co calculation, and assumes the same tax rate on disposals as on the rest of the business – which does not necessarily reflect actual tax splits. This figure also is stated pre share-based payments.*

Source: Palace Capital accounts, Hardman & Co Research estimates

Balance sheet

Balance sheet							
@ 31 March (£m)	FY'17	FY'18	FY'19	FY'20	FY'21E	FY'22E	FY'23E
Investment properties	183.9	253.9	273.4	251.6	277.6	253.6	255.6
Long-term liabilities (deferred tax)	-2.1	-6.6	-5.6	-3.5	-2.0	-2.0	-2.0
Long-term debt	-77.7	-98.8	-119.4	-117.5	-117.4	-100.0	-93.9
Net current assets, excluding financial	-3.7	-3.3	-2.7	-4.9	-7.0	-6.0	-5.0
Assets held for sale	0.0	21.7	11.7	27.5	0.0	0.0	0.0
Cash, deposits, short-term debt	9.1	16.3	22.9	13.1	5.6	19.9	14.7
Net cash (debt/finance lease)	-68.6	-82.4	-96.5	-104.4	-111.8	-80.1	-79.2
Net assets (NNNAV)	109.6	183.3	180.3	166.3	156.8	165.4	169.4
EPRA net assets	111.8	190.0	187.1	171.0	160.0	168.6	172.6
NAV/share (p)	434.2	400.2	392.8	362.2	341.6	360.4	369.0
EPRA NAV/share (p)	443.0	414.8	406.6	372.5	348.6	367.4	376.0
LTV	37.3%	29.9%	33.8%	37.4%	40.3%	31.6%	31.0%

Source: Palace Capital accounts, Hardman & Co Research estimates

Potential, deferred corporation tax liabilities on capital gains have been extinguished following the conversion to REIT regime status.

Cashflow

Cashflow							
Year-end Mar (£m)	FY'17	FY'18	FY'19	FY'20	FY'21E	FY'22E	FY'23E
Cash from operations	10.3	9.9	13.6	14.9	9.2	15.6	11.3
Finance	-2.5	-2.7	-4.6	-4.7	-3.6	-3.4	-3.3
Tax	-1.1	-0.4	-2.0	-2.2	0.0	0.0	0.0
Net cash flow from op. activities	6.7	6.8	6.9	8.0	5.6	12.2	8.0
Acquisitions/disposals/lease break premiums	1.2	-65.0	-4.6	13.9	2.0	0.0	0.0
Refurbishment (capitalised)	-4.6	-2.8	-3.0	-5.7	-3.5	-2.0	-2.0
Major development (Hudson)	0.0	0.0	-1.9	-18.2	-8.0	26.0	0.0
Free cashflow operation and investment	3.4	-60.9	-2.6	-2.0	-3.9	36.2	6.0
Share issue	-2.2	67.7	0.0	0.0	0.0	0.0	0.0
Shares to fund asset purchases	0.2	-13.7	0.0	0.0	0.0	0.0	0.0
Dividends	-4.6	-6.7	-8.7	-8.7	-3.4	-4.6	-5.0
Other	0.0	0.0	-2.8	1.4	0.0	0.0	0.0
Net cash change	-3.3	-13.7	-14.1	-9.3	-7.4	31.6	1.0
Net financial position	-68.6	-82.4	-96.5	-105.9	-113.2	-81.6	-80.7

Source: Palace Capital accounts, Hardman & Co Research estimates

Note cash inflow from HQ, which we expect to accrue from sales, progressively throughout the year. The development facility will be paid off, and long-term debt can be secured on the commercial asset, which physically completes in a matter of months from now.

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