Investors' Chronicle | Alpha

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Alpha small company research

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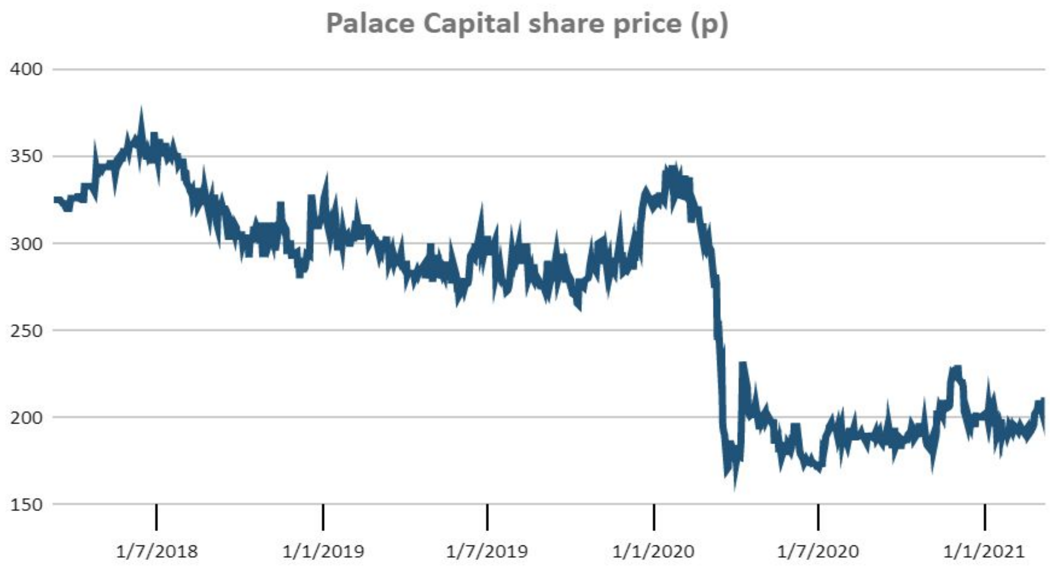
A Reit royal value play

It's not often a property company that offers strong prospects of capital growth is priced on a 37 per cent discount to spot NAV, but that's what's on offer at this regional commercial real estate investment trust. Moreover, the shares offer an attractive 5 per cent dividend yield and prospects for decent growth in the pay-out,

Simon Thompson's view:

Investors are being overly cautious in their valuation of **Palace Capital (PCA)**. For starters, borrowings are set to plunge over the next two years as the real-estate investment trust (Reit) is set to realise £52m of cash, and possibly far more, from the sale of flats at its flagship Hudson House residential scheme in York. Development profits from those sales is one reason why net asset value (NAV) is set to reverse the declines seen in recent years. It's not the only opportunity as high collection rates across the portfolio support a reversal of Covid-19 induced asset write-downs taken last year. The high yielding shares are firmly in bargain basement territory.



Source: FactSet

Bull points

1. 37 per cent discount to spot NAV despite catalysts for asset growth.
2. Attractive estimated reversionary yield of 7.3 per cent.
3. 92 per cent of rent collected in 2020.
4. 85 per cent occupancy rates.
5. Portfolio weighting to undersupplied regional offices and industrial property.
6. Minimal exposure to retail assets, and no London office exposure.
7. Modest balance sheet gearing and ample headroom on debt facilities.
8. Upside to dividend estimates.
9. Highly experienced management team owns 4.9 per cent of equity.
10. Contracted rental income covers all operating costs and dividends.
11. Residential sales at Hudson Quarter to deleverage balance sheet.
12. Stamp Duty holiday extension positive for housing market.

Bear points

1. Lacklustre NAV total return in the past three financial years.
2. Deleveraging of the balance sheet dependent on sales being achieved in York.
3. Quarterly dividend re-based to 2.5p a share.

Palace Capital (PCA)	
Ticker	PCA
Current price	216p
Target price	280p
Market cap	£100m
52 week high	310p
52 week low	158p
Net cash	£117m
Shares in issue	46.1m
Financial year end	31 March
Next event	Pre-close trading update, April 2021
Website	palacecapitalplc.com

Palace Capital's aim is to be the leading investor in regional commercial property, generating sector-leading total returns, while growing a sustainable portfolio of assets that adapts to changing occupier demands.

For the past decade, the company has been led by chief executive Neil Sinclair, a property sector stalwart with over 50 years' experience, during which time the board has built up a balanced portfolio of 52 properties through opportunistic acquisitions. Including £53m of development properties, the portfolio was last valued at £281.6m and produces annual contracted rental income of £16.9m (£14.9m after property costs). Occupancy rates are around 85 per cent, one reason why the rent roll is shy of estimated rental value (ERV) of £20.2m (potential ERV is £21.2m, including property under development).

Palace Capital portfolio summary

Portfolio valuation	£281m
Net initial yield	5.9%
Reversionary yield	7.3%
Number of properties	52
Average lot size	£5.4m
Gross lettable area	1.6m sq ft
Number of tenants	227
Annualised contracted rental income	£16.9m
Estimated rental value (ERV) at full occupancy	£20.2m
Estimated rental value (ERV) of void space	£3m
Weighted average unexpired lease term (WAULT) to first break	4.9 years
Occupancy by area	84.9%

Source: Palace Capital interim results (November 2020)

The income from 227 leases on 52 properties covers both the company's annual administration costs of £4.3m and interest charges of around £3m on low-cost net borrowings of £117m. Surplus profits are recycled back into new investments while at the same time rewarding shareholders with a chunky dividend. Since 2016, Palace has paid out £36m of cash dividends, a healthy sum in relation to the company's depressed market capitalisation of £100m. The company adopted Reit status in August 2019, so is no longer required to pay UK corporation tax in respect of property rental income and capital gains relating to its property rental business.

Admittedly, Palace's European Public Real Estate Association net asset value (Epra NAV) has fallen from 451p a share in September 2017 to a low of 347p at the 2020 September 2020 half-year end. However, more than half of the decline was due to Palace funding the £70m acquisition of a portfolio of commercial buildings. The deal in September 2017 was through a dilutive placing and open offer that was priced at 340p (cum 9.5p a share dividend), so well below the company's Epra NAV at the time.

Effectively, the impact of that transaction was to immediately reduce Epra NAV per share to 397p once the transaction completed. This means that the NAV reversal is not half as bad as it first appears. Importantly, management has taken on board the adverse impact to investor sentiment that has contributed to a wider share price discount to Epra NAV than was previously the case. Palace has not issued any equity for acquisitions since.

Palace Capital (PCA)

Order price:	216p	**Market value:**	£ 100m	
Touch:	214-218p	**12-month high/low:**	310p	158p
Discount to 2023 NAV:**	42%	**Dividend yield:**	5.6%	
Investment properties:	£281m	**Net debt:**	74%	

Year to 31 Mar	Epra Net asset value (p)	Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2017	443	12.6	22.2	18.5
2018	415	13.3	21.2	19.0
2019	407	6.4	17.3	19.0
2020	364	-9.1	17.5	12.0
2021**	341	-7.3	15.2	10.0
2022**	346	7.1	14.5	11.0
2023**	370	16.4	18.2	12.1
% change	**+7**	**+131**	**+25**	**+10**

Main market. SETS trading.

Source: Palace Capital annual report and London Stock Exchange

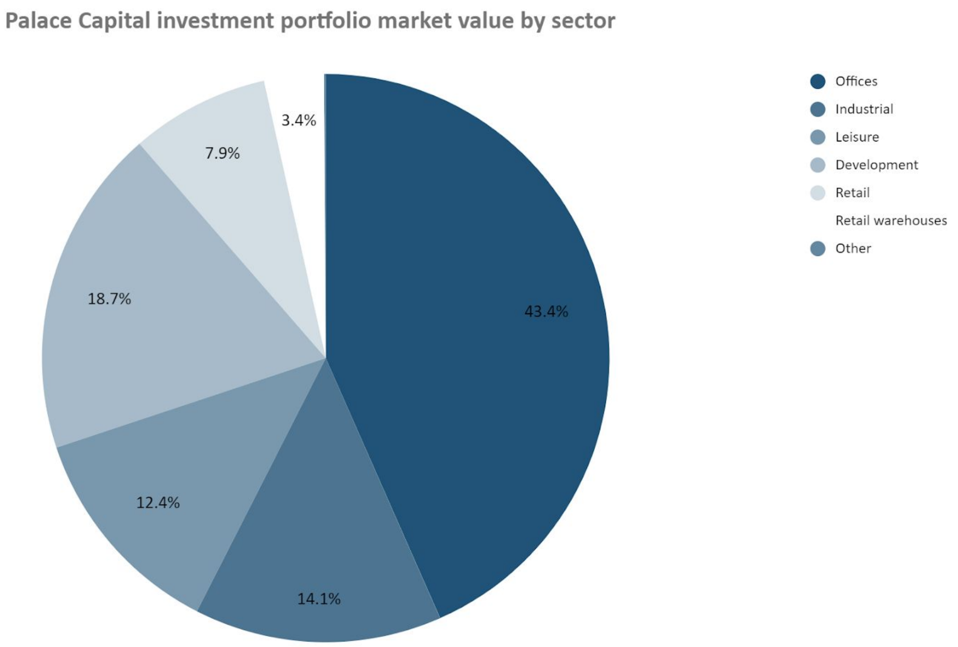
** Arden Partners pre-tax profit estimates stated after estimated revaluation gains/losses and prior year pre-tax profit also stated on reported basis. EPS stated on adjusted basis to reflect recurring net profit per share as this is relevant to Palace Capital's ability to pay a covered dividend.

Despite this, Palace's share price discount to Epra NAV has diverged materially from peers since the outbreak of the Covid-19 pandemic. The shares are trading on a 37 per cent discount to analysts' March 2021 year-end Epra NAV estimate of 341p. By comparison, Liberum Capital's peer group of UK commercial property companies trade on an average discount of only 14.7 per cent. The magnitude of the discount seems harsh given the management team more than doubled the company's Epra NAV per share from 218p to 451p in the 47-month period from the company's first significant acquisition (Signal Portfolio in October 2013) to the high-water mark in September 2017. This was achieved through a regional focus, active portfolio management and an innovative acquisition strategy to create shareholder value.

Of course, you need catalysts to entice investors to bargain hunt and narrow the glaring ratings anomaly. Palace offers several that should significantly improve sentiment in the coming months as it becomes abundantly clear that Palace is in a far better financial and operational position than the huge share price discount to NAV would suggest. It's also timely for bargain hunters to bottom fish right now because the reversal in the company's NAV per share looks to have troughed out, thus offering scope for asset growth to drive a significant narrowing of the share price discount.

High rent collection rates

Importantly, Palace has minimal exposure to retail property with the sector accounting for only 7.9 per cent of the portfolio's £281m valuation.



Source: Palace Capital annual report, London Stock Exchange

Palace's total rental income of £1.9m from retail tenants accounts for 11.5 per cent of its total contractual rental income of £16.9m. The company doesn't have high street retail exposure, but owns retail park properties which have strong covenants. For instance, food retailer Aldi, building supply group Wickes and cash-and-carry retailing group Booker account for a combined £950,000 of annual rental income.

Palace Capital top 20 tenant rent collection

Tenant	Sector	Contracted rental income p.a.	Q1 2020/21 rent collection	Q2 2020/21 rent collection	Q3 2020/21 rent collection
Vue Cinemas	Leisure	£0.91m	100%	100%	100%
Rockwell Automation	Automotive	£0.54m	100%	100%	100%
Accor Hotels	Hotel	£0.51m	Rent free	Rent free	100%
National Lottery	Charity	£0.44m	100%	100%	100%
Browse Technik fur Automobile	Automotive	£0.43m	100%	100%	100%
Somerset Bridge	Insurance	£0.41m	100%	100%	100%
Wickes	Retail	£0.40m	100%	100%	100%
Blake Morgan	Legal	£0.36m	100%	100%	100%
Exela Technologies	Technology	£0.36m	100%	100%	100%
Apcoa Parking	Car Parking	£0.35m	100%	100%	100%
D Young & Co Intellectual Property	Legal	£0.31m	100%	100%	100%
Bravissimo	Retail	£0.29m	0%**	0%**	100%
Aldi	Retail	£0.29m	100%	100%	100%
Sutton Local Authority	Local Authority	£0.28m	100%	100%	100%
Quadrant Systems	Aviation	£0.28m	100%	100%	100%
NHS Calderdale and Huddersfield	Health	£0.26m	100%	100%	100%
Booker	Retail	£0.25m	100%	100%	100%
Serco	Public services	£0.25m	100%	100%	100%
Redland	Construction	£0.24m	100%	100%	100%
Bank of England	Central Bank	£0.23m	100%	100%	100%

Source: Palace Capital corporate presentation (November 2020). Rent collection is rent collected in full and/or being collected monthly as per the payment plan agreed with the tenant. ** Non-collection to date as retail operations shut during lockdown.

A portfolio bias towards regional offices (43.4 per cent), industrial warehouses (14.1 per cent) and retail warehouses (3.4 per cent) supports robust rent collection rates.

It's worth noting that Palace Capital's top 20 tenants account for 44 per cent of passing rents and all but two paid up in full for the first three rent quarters in the 2020/21 financial year. A rent-free period was given to Accor Hotels (Sol Central development in Northampton) for two quarters last year in return for a lease extension to 2032. Lingerie retailer Bravissimo's operations were shut down due to the lockdown, hence its concession. All 20 tenants paid their third quarter rents in full.

Furthermore, Palace's management have been proactive with the 20 tenants at its two leisure assets: 189,000 sq ft Sol Central development in Northampton (acquired in May 2015); and Broad Street Plaza, a 118,000 sq ft development in the centre of Halifax, West Yorkshire (acquired in March 2016).

A rent-free period was given to Gravity Fitness at Sol Central in exchange for the removal of a break clause, thus securing the lease until 2034; and a rent concession was given to restaurant chain TGI Friday's at Broad Street Plaza in return for a three-year lease extension until 2030. The two leisure developments generate annual rents of £3.2m and the ERV of the voids is £370,000.

Prospects for filling those voids is positive given the UK Covid-19 vaccination programme is well on track and the UK government has signposted a complete lifting of the national lockdown by early June. Palace's management have been engaging in discussions with potential new tenants. They are also calling the bottom of the market for leisure assets and note that lettings under offer at both schemes will improve rental income longer term. That should be good for valuations, given that Sol Central and Broad Street Plaza are valued at £35m, and the £3.2m annual contracted rental income already represents a hefty 9.1 per cent yield. The weighted average unexpired lease term (Wault) to break is 11.3 years.

The bottom line is that Palace collected 92 per cent of rents due across the portfolio in the 12 months to 31 December 2020 (96 per cent excluding leisure assets) and agreed concessions representing 4 per cent of the rent roll. The directors envisage collecting the balance of the 4 per cent outstanding in due course. For the current quarter, the company has guided shareholders to expect 94 per cent rent collection (excluding leisure), a healthy outcome given the UK has been back in lockdown since the start of 2021. Expect collection rates to improve further as lockdown measures are eased and Palace's tenants are allowed to trade normally again.

Palace Capital Top 10 assets by value

Property	Sector	Area (sq ft)	Gross rental income p.a.	Reversionary yield	Wault* (years)
Hudson Quarter, York	Development	na	na	na	na
2 & 3 St James Gate, Newcastle	Offices	99,125	£1.24m	8.80%	3.8
Broad Street Plaza, Halifax	Leisure	117,767	£1.63m	7.56%	11.5
Sol, Northampton	Leisure	189,203	£1.57m	8.53%	11.2
Boulton House, 17-21 Chorley Street, Manchester	Offices	74,653	£0.93m	7.92%	2.2
One Derby Square, Liverpool	Offices	70,161	£1.06m	7.94%	3.0
Bank House, 27 Kings Street, Leeds	Offices	88,036	£0.62m	9.19%	2.7
Kiln Farm, 2-4 Pitfield, Milton Keynes	Offices	52,818	£0.66m	7.37%	6.5
25 & 27 Black Moor Road, Liverpool	Industrial	65,765	£0.35m	5.87%	2.7
Point Four Industrial Estate, Avonmouth	Industrial	84,748	£0.43m	7.13%	3.3
Total		**842,276**	**£8.49m**		

Source: Palace Capital corporate presentation (November 2020). * Weighted average unexpired lease term to break.

Completion of Hudson Quarter development to deleverage balance sheet

Palace Capital's management team have proved adept at making shrewd off-market property purchases with a view to boosting rental returns and reducing voids through active asset management. They have also worked to generate valuation uplifts through refurbishment and development initiatives. Capital is then recycled through profitable disposals and the release of equity in current developments for further investment.

For instance, Palace acquired the Signal Portfolio of 24 mixed-use commercial properties from Quintain Estates & Development for £39.25m in October 2013. The purchase price was based on an 11.7 per cent net initial yield and was funded by a £23.5m equity raise at 200p a share, and a three-year debt facility with Nationwide. Three years later the portfolio was valued at £71m and Palace Capital disposed of £3.9m worth of Sigma assets.

Around £3.8m of the purchase price for the Signal Portfolio was accounted for by Hudson House, a 1960s 103,000 sq ft office building directly opposite York Railway

Station. Transport links are excellent. York is on a 105-minute direct rail service to London, and a 144-minute service to Edinburgh.

Hudson Quarter development in York completes first sales this month

The company subsequently obtained planning consent to convert the property into a 170,000 sq ft mixed-use scheme encompassing 127 residential apartments, and 39,500 sq. ft. of grade 'A' office space. The planning consent generated an immediate £10m valuation uplift for Palace. Construction completes on the development later this month and has been largely funded from a £25.6m development finance facility with Barclays.

To date, 36 of the 127 apartments have been pre-sold, which will bring in £9.6m of sale proceeds. Analysts at house broker Arden Partners expect the remaining 91 apartments to be sold for £41.9m, based on an average sale price of £550 per sq ft. The prices range from £250,000 to £1.75m for a penthouse. The residential element of the development has a current book value of £38.4m, so there is scope for Palace to make an additional £7.3m (16p a share) development surplus if all remaining 91 units are sold at prices in line with these forecasts.

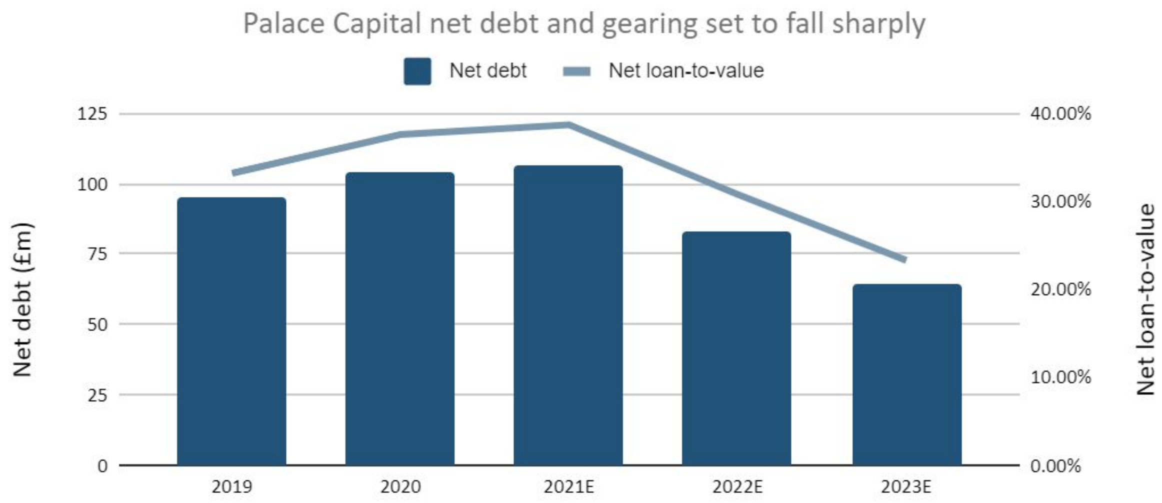
Hudson Quarter development surplus sensitivity to residential sales price

	Development surplus per sq ft on unsold residential units						
	£440	£495	£523	£550	£578	£605	£660
Development surplus to come (per share)	3.4p	12.5p	17.0p	21.6p	26.1p	30.7p	39.7p
Percentage of last reported NAV	1.0%	3.6%	4.9%	6.2%	7.5%	8.8%	11.5%

Source: Arden Partners (November 2020)

Moreover, the 39,500 sq ft office space at Hudson Quarter has a book value of £10.8m. Palace has already pre-let 4,500 sq ft of ground floor space at £25 per sq ft to **Knights Group (KGH)**, the listed law firm. Once fully let the office block should deliver a £2.6m (5.6p a share) development surplus for the company based on ERV of around £0.9m. This means that Palace is on course to generate a £20m cash-on-cash return on its total investment in the Hudson Quarter development. That represents a 17 per cent internal rate of return on the scheme since purchase in October 2013.

The proceeds from the Hudson Quarter sales will have a dramatic effect on Palace's balance sheet. Net debt of £117m at the 30 September 2020 half-year end should be cut to £107m at the 31 March 2021 financial year-end after taking account the £9.6m proceeds from this month's completions of the 27 pre-sold flats. Factoring in £24m of apartment sales at Hudson Quarter in the 2021/22 financial year, and a further £18m in the following year, Arden expects net debt to be slashed to £82.5m by 31 March 2022, dropping to £64m in 31 March 2023. There is even scope to offload the office space, assuming it can be fully let.



Source: Palace Capital and Arden Partners estimates (March 2021)

But, even if the company holds onto the office assets, the loan to value ratio on the investment portfolio is set to drop dramatically and could be well below 30 per cent within two years. I don't think investors have realised the scale of this liquidity event, nor the fact that Palace's Epra NAV per share is set to get a 21p a share boost from the sale of the residential flats at Hudson Quarter.

Regional office market prospects

The Covid-19 pandemic and the UK government's working from home guidance has of course influenced office occupation and fundamentally changed how companies will operate longer term. However, trends towards flexible and home working were already underway pre Covid-19, and the enforced move to remote working has simply accelerated this momentum.

Palace's management firmly believe that the shift in working patterns will benefit the regions as companies reflect on the requirement for expensive Central London offices, a segment of the market to which Palace is completely unexposed. They also point out that debate around the demise of the office is premature and recent lettings activity shows that employers remain convinced of the role of the workplace. Furthermore, previous forecasts of the demise of the office – in the early 1980s with the advancement of computer technology and again in the early 2000s during the dotcom era – proved unfounded.

The company's disciplined acquisition strategy, which has focused on good quality assets in town centres and close to transport hubs, including major railway stations, is likely to support continued demand for its regional offices, particularly in Manchester, Leeds, York, Newcastle-upon-Tyne and Liverpool. That's because Palace's newly refurbished offices offer lower rents than rivals' newly developed space, and are lower density. For instance, Palace's central Manchester refurbished office blocks are being offered to occupiers at £20 per sq ft, a hefty discount to the headline £28 per sq ft rents at new builds. Across its office portfolio of 698,946 sq ft, the average rent is £15.64 per sq ft.

The density of lift usage on Palace's office properties is also far less, enabling tenants to get their employees back to work in a socially distanced and safe environment. Unless vaccines eradicate Covid-19 permanently, increasing numbers of companies will look to rent low-level density buildings to avoid the lift overcrowding that has become a feature of high-rise blocks, and which makes the return to work for all their employees impossible if lifts can only be used by one person at a time. The fact that over two-thirds of respondents to a British Council for Offices survey stated that the office is important for developing networks, forming connections with other employees and their own career developments, highlights that office culture is far from dead.

Property consultancy Savills published a report late last summer that compared the current supply/demand dynamics in the regional office market with the last recession in 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 per cent since 2015.

At the same time, there has been limited speculative office development in the regions in recent years, one reason why the total available office supply of 11.3m sq ft in the UK regional office markets has declined 17 per cent since the end of 2019. Of that, just over 3m sq ft is Grade A reflecting a 4 per cent decrease since the end of 2019. Effectively this means that there is only enough supply to meet demand for 11 months based on average take-up levels.

This is clearly good news for Palace given its strong regional bias at a time when more London and South East-based businesses will be considering the relocation of at least some of their operations to generate cost savings, or implementing a 'hub and spoke' model with a greater regional presence to meet the demands of employees in an environment where competition for talent is strong. The UK Government's recently announced Levelling-Up Fund is another positive for economic activity in the regions. Around £4.8bn has been earmarked for town centre and high street regeneration, local transport, cultural and heritage projects.

Palace's £122m office portfolio (117 tenant leases across 27 properties) accounts for 43.4 per cent of the total portfolio by value and generates £8.5m of the total £16.9m contracted rental income. The office portfolio has an ERV of £11.3m, so is under-rented, with void space accounting for ERV of £2.3m, thus offering scope to not only improve the rent roll through new lettings but to also drive property valuation higher.

Future development potential

The short-term potential to attract new tenants to its newly refurbished office space aside, Palace has three other exciting city centre schemes which Arden believe could generate £19m (41p a share) of development surplus for shareholders in due course: 100,000 sq ft of offices or residential at Midsummer Boulevard, Milton Keynes; 70,000 sq ft of offices at Holly Walk, Leamington Spa; and 150,000 sq ft of offices at Boulton House, Manchester.

Boulton House is an eight-storey office block, walking distance from Manchester Piccadilly train station

Although there isn't any significant expenditure planned at these properties in the next 12 months, Palace could unlock further capital appreciation through the planning process in the interim. It's worth noting that Milton Keynes and Leamington Spa are respectively only 30 and 65 minutes by train into London.

In addition, Palace owns an unencumbered office building on Weybridge High Street, Surrey. It was acquired for £3.5m in 2014 and has planning consent for 28 residential flats and 4,000 sq ft of retail space. The building generated five years of income from acquisition to when the main office tenant vacated and is currently being marketed for sale with planning consent. It is expected to generate a cash-on-cash return of 34 per cent for Palace. Proceeds from any sale will further reduce debt. The company is also developing eight flats in a building on Uxbridge High Street. The property is held in the accounts at £1.7m and is expected to realise a development surplus of £600,000 after £2m development costs.

Strong funding in place

Palace Capital is well funded. At the half-year-end (30 September 2020), gross borrowings of £132.7m were well within total credit facilities of £151.9m. The company also had cash of £14.3m on its balance sheet to provide £33m of headroom. All-in cost of borrowings is 2.9 per cent and debt facilities have an average maturity of 3.9 years to run.

The £9.6m cash flow from the imminent completion of the Hudson Quarter pre-sales, and £2.7m received from property disposals since the interim results were announced have increased headroom. It's worth pointing out that the two property disposals were both priced at premiums to book value: Meadow Court, Sheffield, sold for £1.25m (30 per cent above book value); and Abbey House, Winchester, sold for £1.46m (a 17 per cent premium to book value). Palace has also instructed agents on four further sales of non-core assets (including the Weybridge High Street property) which have a combined book value of £8.3m.

If anything, the risk is skewed to Palace paying down debt even faster than analysts predict. This not only frees up cash to recycle into new investments, but mitigates financial risk.

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Palace Capital debt facilities

	Scottish Widows	Nat West	Barclays	Santander	Lloyds	Barclays (dev facility)	**Total**
All in cost	2.90%	2.16%	3.12%	3.56%	2.01%	2.01%	**2.90%**
Maturity	Jul-26	Aug-24	Jun-24	Aug-22	Mar-23	Jan-22	**3.9 years**
Loan balance	£13.5m	£28.6m	£40.5m	£25.5m	£6.8m	£17.8m	**£132.7m**
Debt facility	£13.5m	£40.0m	£40.5m	£25.5m	£6.8m	£25.6m	**£151.9m**
Hedging	100% floating	100% floating	£34.6m fixed	£19.2m fixed	100% floating	100% floating	**51% hedged**

Source: Palace Capital presentation and interim results November 2020

Property valuations

In the six months to 30 September 2020, Palace's like-for-like valuations declined 3.5 per cent, marginally better than the 3.7 per cent fall in the MSCI UK quarterly property index in the same period. The performance reflects a reduction in rental income from £8.8m to £8.2m due to higher vacancy rates, but also a £0.3m bad debt provision due to Covid-19 related rent arrears.

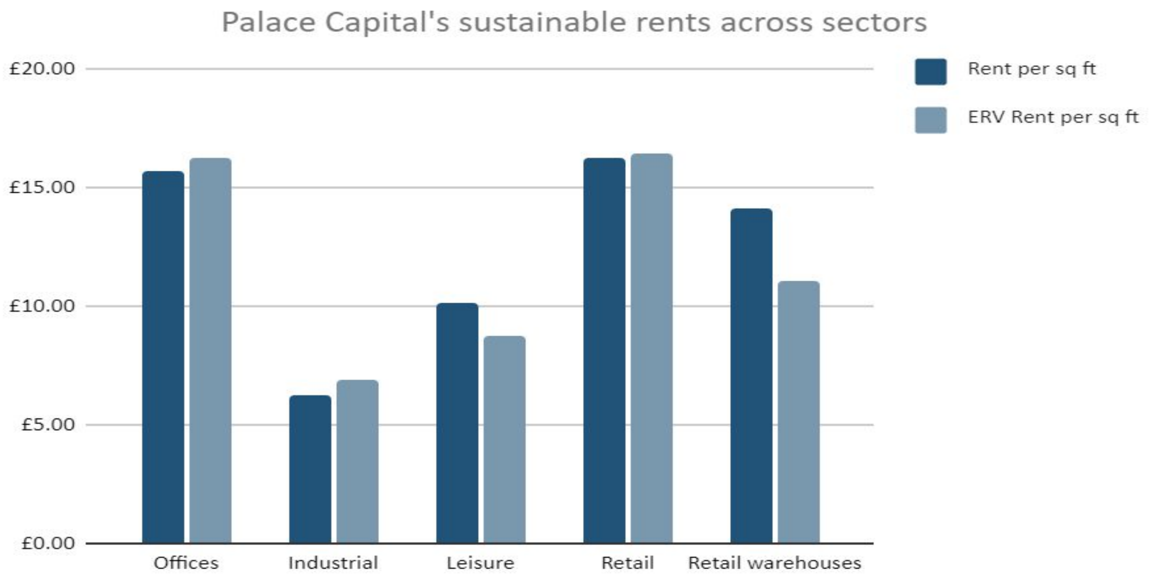
Palace Capital portfolio performance

Sector	Market value 30 September 2020	Market value 31 March 2020	Gain/ Loss	Gain/ Loss	Epra topped-up net initial yield
Offices	£122.3m	£127.5m	-£5.3m	-4.1%	**5.7**
Development	£52.7m	£37.8m	£14.9m	39.4%	**na**
Industrial	£39.6m	£38.8m	£0.8m	2.1%	**5.7**
Leisure	£35.0m	£37.9m	-£2.8m	-7.4%	**7.5**
Retail	£22.3m	£23.9m	-£1.6m	-6.5%	**7.7**
Retail warehouses	£9.4m	£10.5m	-£1.1m	-10.5%	**7.6**
Other	£0.2m	£0.4m	-£0.2m	-44.4%	**na**
Total market value	£281.6m	£276.8m	£4.8m	1.7%	
Capital expenditure	£14.5m		£14.5m		
Total like-for-like	**£267.1m**	**£276.8m**	**-£9.7m**	**-3.5%**	

Source: Palace Capital interim reports and presentation (November 2020)

It's worth noting that part of the £5.8m decline in the office valuation will reverse in the forthcoming annual results. That's because valuers had assumed the tenant (a firm of solicitors) at Britton House, Southampton would exercise a break-clause, but that hasn't happened.

Furthermore, Palace Capital's average rent of £15.64 per sq ft across its office portfolio is still below ERV of £16.22 per sq ft, so there is scope for rental uplifts on renewals. In the first half to end-September 2020, Palace signed three new leases 5 per cent ahead of ERV, entered seven lease renewals 12 per cent ahead of ERV, and had three rent reviews 8 per cent ahead of ERV across the whole portfolio.



Source: Palace Capital interim reports and presentation (November 2020)

It's also worth pointing out that the £2.8m write-down on Palace's two leisure assets was impacted by negative sentiment towards the leisure industry, even though the company's properties have strong covenants and rent collections were up to date at the time of the valuations. Sol Central and Broad Street Plaza's total contracted annual income of £3.2m equates to 9.1 per cent of their combined £35m valuation. Valuers based their valuation on an Epra topped-up net initial yield of 7.5 per cent and may have been overly cautious during last year's pandemic.

Although Palace's leisure assets produce an average rent of £10.14 per sq ft, so above ERV of £8.73 per sq ft, both properties have a weighted average unexpired lease term (Wault) of over 11 years to first break, so there is scope for the rental gap to narrow assuming consumer demand for leisure activities return to pre-Covid-19 levels. Moreover, management have been engaging with several tenants with regards to taking up the remaining space (ERV voids of £370,000). In the circumstances, it's realistic to expect the ultra-cautious down valuations to reverse in due course.

Palace Capital rental reversion

Year to 31 Mar	Gross contracted rent	Estimated rental value (ERV)
2016	£14m	£15m
2017	£13m	£16m
2018	£18m	£20m
2019	£18m	£22m
2020	£18m	£21m
H1 2020/21	£17m	£20m

Source: Palace Capital half-year reports and presentation (November 2020)

Finally, Palace's industrial property (14.1 per cent of portfolio by market value and 17.3 per cent, excluding development assets) continues to perform well (2.1 per cent like-for-like growth in the first half to 30 September 2020). It is still under-rented with the average rent of £6.20 per sq ft around 10 per cent below ERV of £6.85 per sq ft.

The upshot is that I would expect a reversal of the down valuations of Palace's office portfolio to be supported by new lettings as corporates look to lower cost regional office space close by transport links. Industrial warehouses should continue to perform well and the two leisure assets could rebound in value. Add in a potential 21p a share development surplus from Palace's Hudson Quarter scheme and it's not unreasonable to expect Palace to deliver healthy NAV per share growth in the next 12 to 24 months.

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Management team

Chief executive **Neil Sinclair** co-founded Palace in 2010 with non-executive chairman Stanley Davis. He 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.

Subsequently, Sinclair was appointed non-executive chairman of Baker Lorenz surveyors in 1999, a position he held when that company was sold to Hercules Property Services plc in 2001. Two years later, he was appointed a non-executive director of Tops Estates plc, a fully listed company, and remained in that position until Land Securities acquired Tops in 2005. Sinclair has overall responsibility for implementing strategy and day-to-day operations.

Chairman **Stanley Davis** is a successful entrepreneur who has been involved in financial services and property businesses since 1977. In 1990 he became chief executive of a small share registration company, which became known as IRG plc, and acquired several businesses, including Barclays Bank Registrars before the company was acquired itself by Capita Group for £100m.

Finance director **Stephen Silvester** joined Palace in 2015 and is a chartered accountant. He has over 10 years experience in the real estate sector, having previously served as group financial controller at NewRiver Reit.

Executive property director **Richard Starr** is a member of the Royal Institute of Chartered Surveyors and joined Palace in 2013 on the back of the company's Sequel acquisition and related equity raise.

Palace has four independent non-executive directors. **Anthony Dove** has over 30 years' experience in the corporate sector.

Chartered accountant and non-executive director **Kim Taylor-Smith** also has over 30 years' experience as a company director. He was finance director and latterly chief executive of Birkby plc, a manager of serviced workspace and indoor markets.

Non-executive director **Mickola Wilson** is a chartered surveyor with more than 30 years' experience in the real estate market, providing consultancy, research and investment management advice to the property fund management industry. She currently advises a number of overseas investors on their investment strategy and is responsible for their compliance and regulatory administration.

Non-executive director **Paula Dillon** is a qualified lawyer who specialised in the real estate sector for more than 30 years.

In total, the board directors were paid £1.6m in total remuneration in the 2020 financial year, a sum that is less than 30 per cent of the £5.5m dividend the board declared. The directors also own 4.9 per cent of the 46.09m shares in issue, so have skin in the game.

Peer group comparison

Company	Market cap	Premium/discount	Dividend yield	Percentage NAV total return	
				1-year	3-year
AEW UK Reit	£129m	-13.3%	9.8%	7.4%	25.8%
Alternative Income Reit	£50m	-26.5%	7.3%	-5.3%	7.6%
Conygar Investment Co	£57m	-35.8%	0.0%	na	na
Custodian Reit	£389m	-2.7%	4.3%	-2.6%	8.5%
Drum Income Plus Reit	£11m	-59.3%	7.5%	-11.9%	-10.4%
Ediston Property Investment Co	£145m	-18.3%	5.8%	-14.3%	-11.3%
BMO Commercial Property	£566m	-39.4%	5.9%	-8.2%	-7.2%
BMO Real Estate Investment	£184m	-22.1%	3.3%	-1.1%	6.4%
LXI Reit	£656m	3.2%	4.8%	9.2%	37.4%
Picton Property Income	£481m	-8.1%	3.1%	3.3%	20.2%
Regional Reit	£341m	-19.1%	8.1%	-7.0%	14.8%
Schroders Reit	£203m	-29.4%	5.6%	-2.4%	-2.0%
Standard Life Investment Property Income	£251m	-23.0%	5.3%	-4.5%	8.9%
Stenprop	£395m	-3.1%	4.8%	na	na
Supermarket Income Reit	£729m	6.8%	5.4%	13.8%	32.2%
Tritax Big Box Reit	£3,077m	18.0%	3.6%	4.8%	22.0%
UK Commercial Property Trust	£904m	-19.3%	2.6%	-0.8%	3.9%
Urban Logistics	£374m	3.5%	5.3%	5.2%	44.0%
Warehouse Reit	£529m	8.0%	5.0%	17.8%	39.8%
Average		**-14.7%**	**5.1%**	**0.2%**	**14.2%**
Palace Capital	**£100m**	**-36.7%**	**4.9%**	**-3.5%**	**-8.0%**

Source: Liberum Capital UK commercial property sector data (2 March 2021). Palace Capital calculations based on 31 March 2021 Arden Partners Epra NAV estimates.

Palace Capital is a small-cap company so you need to factor in a liquidity discount into its rating. However, the current share price discount to NAV is extreme.

Based on the 19 UK commercial real estate companies covered by brokerage Liberum Capital, the average share price discount to NAV is 14.7 per cent. That ranges from a premium of 18 per cent for Tritax Big Box Reit (market capitalisation of £3bn), to a discount of 59 per cent for Drum Income Plus Reit. However, that company only has a market capitalisation of £11m and the shares are untradable on a bid-offer spread of 20p to 40p.

Palace Capital is priced on a 37 per cent discount to analysts' NAV estimates for the March 2021 financial year-end, or 26 percentage points deeper than for peers, even though Palace's dividend yield is close to the peer group average of 5.1 per cent. Please note that the directors rebased the dividend in March 2020 in order to preserve liquidity given the economic uncertainty caused by the Covid-19 pandemic and have committed to a minimum 2.5p a share quarterly payout.

Admittedly, Palace Capital's total NAV return over the past 12 months and three years lags its peers, but as I have noted there are sound reasons to expect NAV to rebound over the next two financial years and shareholder returns to be enhanced further by the board's progressive dividend policy. In fact, based on Arden's conservative looking forecasts for the 2021/22 and 2022/23 financial years, Palace should deliver a two-year total NAV return of 15 per cent assuming valuations remain unchanged. However, there is clear potential for previous valuation downgrades to reverse and for new lettings to drive uplifts. This is not priced in.

Major shareholders

Name	Percentage
Axa Investment Managers	7.7%
Miton Asset Management	7.4%
JO Hambro	7.3%
Allianz	5.1%
Stanley Davis (chairman)	3.6%
Total	**31.2%**

Source: Palace Capital 2020 Annual Report, London Stock Exchange RNS

Four fund managers control more than a quarter of the shares in issue and chairman and co-founder Davis has a 3.6 per cent stake. This means Palace's five largest shareholders control 31 per cent of the 46.09m shares, so the free float is well above average.

The shares can readily be traded on a bid-offer spread of 4p with market makers offering to sell in bargain sizes of at least 2,000 shares, although trades as large as 10,000 shares have gone through the market between the spread recently.

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Target price

Taking into account likely disposals of commercial property and cash inflows from apartment sales at Hudson Quarter, it's realistic to expect Palace Capital to deleverage its balance sheet materially in the next 12 months. This mitigates financial risk and means that the company can recycle interest savings back to shareholders through higher dividends. It's worth noting that the company has been successful at achieving premiums on asset disposals, and managed to secure 13 lease renewals at rents ahead of ERV in the first half of the 2020/21 financial year.

The company's valuers look to have been too cautious in their property valuations last autumn, albeit Covid-19 uncertainty and lack of a vaccination programme were good enough reasons to be so at the time. This is no longer the case. So, with the dividend well covered by contracted rental income, and the high-yielding shares trading on a deep 37 per cent discount to spot Epra NAV, the investment risk looks heavily skewed to the upside.

On a 12-month basis, my 280p target price and a minimum of 10p a share of dividend income has potential to deliver 34 per cent total return. **Buy.**

Risk assessment

There are several risks to take into account when considering an investment.

■ **Degearing of balance sheet**. The reduction in Palace's borrowings is highly dependent on residential sales at Hudson House, York. The pre-sale of more than a quarter of the 127 apartments will deliver an immediate cash inflow of £9.6m as those sales complete in the coming weeks.

■ **Debt covenant risk**. Debt facilities have 225 to 250 per cent interest cover covenants which would only be breached if rents fall by 40 per cent. This is highly unlikely.

In the six months to 30 September 2020, property values fell 3.5 per cent on a like-for-like basis mainly due to Covid-19 induced down valuations, which are unlikely to be repeated. Although the Scottish Widows credit facility is being revalued by the bank, any curing can easily be satisfied from Palace's own cash reserves. In addition, valuations secured by the remaining facilities would on average need to fall a further 15 per cent to require curing.

■ **Tenant concentration risk**. No tenant exceeds 6 per cent of the total contracted rent roll and the largest tenants are all blue-chip covenants (Aldi, Booker, Tesco, Pets at Home, Wickes). Importantly, the company doesn't own any shopping centres.

■ Short duration leases. The portfolio has a relatively short weighted average unexpired lease term (Wault) to first break of 4.9 years. This is positive as the assets with the greatest reversionary upside have the shortest leases, so offer the greatest potential for higher rents to be achieved on any new lettings or rent renewals. This was the case in the first half of the 2020/21 financial year. More relevant is that leisure sector assets – the segment that suffered the deepest asset write-downs – have Wault of 11.3 years, so offer strong rental income visibility from a high quality tenant mix.

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