PALACE CAPITAL

Hudson Quarter, York, development commences

Palace Capital is a real estate investor. It has recently commenced construction of its mixed residential and commercial development at Hudson Quarter, having secured a new £26.5m debt facility and fixed price contract. Supply in this location is tight and the projected gross development value of £65m would thus appear robust. The current site book value is £16.8m. The building contract is £35m (part of a total projected cost of £37m, pre-interest). We note that the full benefit of Hudson Quarter is derived during FY22, when Palace Capital will receive significant free cash. This is one of several factors underpinning significant medium-term expansion in capacity to pay growing dividends.

- **Palace Capital's value optimisation has been made with care:** Palace Capital acquired the development site inside York city walls some years ago as part of a broader portfolio. It has worked up the planning and has now secured finance and, on 11 February selected a (fixed price) building contractor, post site clearance.
- **Across-the-board, good progress:** Results to end September saw total property return of 5.3%, outperforming the MSCI IPD Quarterly Benchmark of 3.3%. Progress in recycling capital is live: disposals of London residential purchased within a mixed portfolio; and December's acquisition of central Liverpool offices.
- **Yield, location and active asset management:** The yield on the assets is above market. Annualised contracted rental income is £17.4m pa, 6.2% of the book value of the real estate assets. 2H'19 gross rent income was £18.4m annualised. There is significant reversionary potential (ERV: £21.1m pa).
- **Risks:** The normal risks of real estate apply. Weighted average length of unexpired lease to break is ca. 5.4 years. Generally, covenants are good. Retail exposure (bar Wickes and Booker) is minimal. Gearing at 30% LTV (loan-to-value) is conservative, and although expected to increase as the York development progresses, Management have previously stated an intention to keep below 40%.
- **Investment case:** Running yield and upside potential in income and capital are attractive, as is sectoral (minimal retail bar Wickes and Booker) and geographic positioning. Although the dividend is uncovered, the York development site is well positioned for FY22 to deliver cash, capital- and income-uplift to more than cover a progressive dividend. We anticipate it will raise NAV by ca. 20p by FY22.

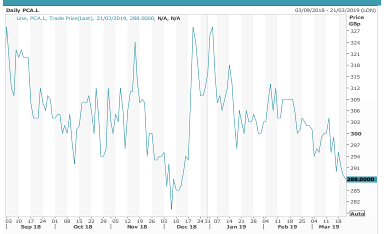
Financial summary and valuation

Year-end March (£m)	2017	2018	2019E	2020E
Income	14.3	16.7	18.0	18.7
Finance cost	-3.0	-3.4	-3.9	-4.1
Declared profit	12.6	13.3	10.7	9.4
EPRA PBT (adj. pre-revaluation)	6.3	7.3	9.2	9.4
EPS reported (p)	36.4	35.9	20.0	17.2
EPRA EPS (p) [note]	21.2	18.7	16.8	17.2
DPS (p)	18.5	19.0	19.0	19.0
Net cash (debt)	-68.6	-82.4	-87.2	-116.3
Dividend yield	6.3%	6.5%	6.5%	6.5%
Price/EPRA NAV	66.1%	70.6%	70.7%	70.2%
NAV (p)	434.2	400.2	407.7	410.5
EPRA NAV (p)	443.0	414.8	414.2	417.1

Diluted, pre share-based payments

Source: Hardman & Co Research

Real Estate



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**PCA**
Price (p)	293
12m High (p)	360
12m Low (p)	280
Shares (m)	45.9
Mkt Cap (£m)	135.0
EV (£m)	217.0
Market	Main, LSE

Description

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. The York development site comprises 6% of assets.

Company information

Chairman	Stanley Davis
CFO	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

3Q'19 div paid	April 2019
Final results	June 2019
4Q'19 div paid	July 2019

Analyst

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Investment case

Four drivers to shareholder value

Portfolio yield

1. Palace Capital has acquired portfolios with inherent opportunities for value creation through asset management. ERV is 16% ahead of contracted rent. Looking at the top 10 assets, the median net initial yield (NIY) is 5.3% but many assets are purchased with a view to optimising rental income (and hence valuation). It is important, therefore, to note that the median reversionary yield on these top 10 stands at 8.1%; see page 6.

Sector exposure fits well with the best strategic resilience

2. The company's largest asset class (just under 50% of the total) is regional city centre offices, which is expected to generate stronger growth than the majority of other UK sectors. Supply/demand here is relatively healthy, with both planning changes and market forces having a positive impact.

Major NAV uplift of 20p per share central estimate) from Hudson Quarter development

3. Palace Capital demonstrates significant near-term NAV upside potential, we believe. This stems from its development of Hudson Quarter in York, due to complete FY21. After securing and optimising planning permission, Palace Capital is starting construction of the project. This is a centrally located asset in York, a strong market for such a mixed residential and commercial scheme. We estimate development profits over £10m, adding approximately 20p NAV – or more, depending on market conditions. We expect Palace Capital will – over time – tend to maintain an element of its capital in development projects.

Asset management drives income expansion

4. The active asset management, coupled with acquisition principally of portfolios of assets, offers ongoing value-accretive opportunities. This has been through selective recycling of capital. For example, Palace Capital is disposing of most of the London residential assets bought within the RT Warren portfolio. It has also a programme of selective refurbishments, each directly linked to rent enhancement. A live example here is the Manchester office asset, purchased with significant void space, now being "worked up".

Hudson Quarter, York, goes live

Finances are conservative…

The York – Hudson Quarter – development is set to progress. A new debt facility has been put in place and construction is about to start. We assess its potential impact on the group and conclude that Palace Capital demonstrates:

- Low balance sheet risk, with LTV remaining below 40%: That estimate is based on Hardman's modelling of additional acquisition(s) on top of funding the Hudson Quarter development. Residential disposals amounting to £50m are modelled from this scheme, completing calendar 2021 (post March fiscal period end).

…. the development is done "in-house"

- Close monitoring of the risk of self-developing: Robustness of the York market, with strong demand and minimal supply anywhere near this attractive, landmark, central (just within the walls) location is important.
- Scope significantly to enhance NAV and ongoing earnings, based on recycling capital (i.e. not gearing up on LTV, but reinvesting cash post Hudson Quarter).

Positioned inside the city walls…

.... demolition is now complete

Hudson Quarter demolition is now finished – inside York city walls

Source: Hardman & Co Research – November capital markets visit

This picture shows the edge of the site in November 2018. Demolition is now completed. Construction started in early February. The site is located within the city walls. The railway station (frontage adjacent the exterior of the walls), makes this a strong location both for offices and residential (and allied commercial).

Residential and commercial

The 100% owned development will consist of 127 apartments totalling 95,000 square feet (748 each on average). Residential sales prices are expected at a little over £520 sq. ft. A marketing suite is projected to be opened on site in June this year. Note that any sales proceeds within the FY21 time horizon of our model would be held in solicitors' accounts so not with Palace Capital until, at earliest, practical completion. We expect the full proceeds of all residential units will fall within FY22. The development also comprises 34,500 sq ft of offices and 5,000 sq ft of commercial space, plus car parking.

The estimated £37m total construction cost (£35m being the building contract) is after extensive diligence on ground conditions in this central site, and is a fixed price contract, awarded to Yorkshire-based Caddick Group. FY22 will see full repayment of the new £26.5m Barclays loan. Development loan interest is capitalised. For cash flow purposes we model 4%, a Hardman estimate. Development cash investment will gradually grow, as the build progresses. We anticipate £2.8m by end March this year and a further £20m progressively in FY20.

Ca. 20p anticipated NAV uplift from Hudson Quarter

Hudson Quarter metrics

Current book value of site	£16.8m
All development costs [1]	£38.0m
Gross development value (GDV) anticipated	£65.0m
Anticipated uplift pre tax - approximate	£10.2m

[1] Assumed cost. This includes the fixed price contract and other costs including finance
Source: Palace Capital

Post tax, the NAV uplift indicated above is ca. 20p per share.

Optimisation of the York development upside requires tying up £16.8m bare site value, yielding nil. Further, there are progressive construction costs of £35m, with fees and interest in addition. So, pre-completion, York ties up capital and, importantly, post completion, it adds capital enhancing future group-wide rental income streams.

Valuation

DPS: scope for rises post Hudson Quarter completion

We outline in the following paragraph the drivers to an illustrative potential of EPRA EPS of over 23p, which is post an illustrative 10% tax rate. On this basis, we see significant medium term potential for progression in the dividend. Note (page 1) the dividend yield on Palace Capital shares.

Illustrating EPRA EPS of over 23p

Taking the three figures of £17.4m rent run rate, £21.1m ERV reversionary, £2.9m potential extra EPRA PBT from disposing of residential but retaining the allied commercial property post the completion of Hudson Quarter, the illustrative potential equates to over 23p annual EPS. This is post an element of share-based payments and also post an illustrative 10% tax rate (Palace Capital is not a REIT).

NAV has already doubled – plenty in the tank for future rises

Illustrating over 440p EPRA NAV

Palace Capital has virtually doubled its NAV since listing five years ago and has outperformed the sector in NAV terms over that period, on a total accounting return basis of 128%. With a strong sector and geographic positioning, we see good potential for NAV progression. We also illustrate a potential 20p NAV uplift, per share, post a successful Hudson Quarter development, expected to complete early in FY22. EPRA NAV was 421p as of September 2018.

Background and illustration

The most recent results statement (period ended September 2018) stated:

- Annualised contracted rental income of £17.4m pa, with significant reversionary potential (ERV: £21.1m). Note, gross income refers to income pre incentives etc.

- Overall, the portfolio offers an NIY of 6.2%; reversionary yield 6.9%.

Five of top 10 assets have average NIY of 4.4% and average reversionary 8.1%

- By valuation, assets 5, 6, 7, 9, 10 (see page 6) have an average NIY of 4.4% and a reversionary yield of 8.1%. With a combined valuation of £49.7m, this indicated rental uplift is ca. £1.7m on those five assets alone. Many have short leases. Manchester in particular (£14.4m valuation) is achieving significant new lettings on void space, with momentum provided by refurbishment and a strong market.

Fourth largest asset is the development site

- Hudson Quarter, York, is valued at £16.8m and is a bare site for development (construction commencing last month). On our assumptions, we expect debt could be as low as £60m post this development if all Hudson Quarter is sold.

Debt and LTV post Hudson Quarter development assuming no acquisitions

	Mar 2021E £m debt	Mar 2021E LTV	Mar 2022E £m debt	Mar 2022E LTV
Nil acquisitions, Hudson commercial assets not retained, Hudson residential sold FY22E for £50m, £6m initial Hudson Quarter revaluation	124.5	38.4%	59.5	22.5%

Source: Hardman & Co Research estimates

- On this basis, we see significant medium-term potential for progression in the dividend and;

- in the NAV per share, Hudson Quarter adding an illustrative 20p NAV in FY22E.

Targeting an attractive income return and strong capital growth

We briefly outline the broader positioning of the Palace Capital group.

Where

All is (and will remain) outside M25, bias tending to "Northern Powerhouse"

Palace Capital invests in commercial property assets, predominantly excluding Greater London, currently with a bias towards regional offices. Strategy focuses on city centre locations in thriving university towns and regional cities. The sector's range includes leisure, and minimal retail and weighting is strongly towards town and city centre offices. Investment is particularly where permitted development and a lack of speculative development has reduced the office stock by 48% south east; 15% Midlands; and 21% north west.

How

Large majority is bought off-market

The majority of assets has been acquired off-market through portfolio acquisitions. For example, in September 2017, the company invested £68m, acquiring the RT Warren portfolio. This had been built-up over many years. It has provided opportunities for site assembly (Fareham, Hampshire) and for optimising dilapidations and rent; e.g. Southampton's central business district (Kings Park House) refurbishment pre-acquisition with rent for vacant floors guaranteed by the vendor for many months. The RT Warren portfolio included an office in Winchester. Here, an outgoing tenant assisted with dilapidations payments thus enabling Palace Capital to refurbish and enhance the attraction of the letting space.

What

50% regional offices, mostly in north of England

50% of assets are regional offices. As an overview, among the top five assets in Palace Capital's portfolio are two offices, two leisure assets and a development site. The top 10 (table below) comprise 48% of the total. Top tenants are Vue, National Lottery, Walker Morris*, Accor, Eldon*, Wickes, Rockwell Automation, Blake Morgan*. (* denotes legal and insurance sectors).

Among the top five assets in Palace Capital's portfolio are two offices, two leisure assets and a development site

Note that a number of assets were bought significantly under-rented on short WAULTS – Palace Capital steadily "working up" the asset

Largest assets

	Market value (£m)	NIY	Reversionary yield	WAULT to break
Broad Street Plaza, Halifax	23.2	6.17%	7.11%	12.7
2&3 St James Gate, Newcastle	20.0	8.17%	8.13%	3.4
Sol Central, Mare Fair, Northampton	18.9	7.43%	7.74%	7.6
Hudson House, York	16.8	0.00%	N/A	N/A
Boulton House, 17-21 Chorlton Street, Manchester	14.4	2.49%	7.98%	1.5
Bank House, 27 King Street, Leeds	10.9	5.68%	9.34%	1.8
Kiln Farm, 2-4 Pitfield, Milton Keynes	9.2	5.26%	8.26%	8.5
Units A & B, Imberhorne Lane, East Grinstead	8.4	5.70%	5.39%	8.8
249 Midsummer Boulevard, Milton Keynes	7.9	3.42%	8.16%	2.0
Black Moor Road, Verwood	7.3	3.76%	5.87%	3.1

Source: Palace Capital

Results for 1H'19 stated a total property return of 5.3%, outperforming the MSCI IPD Quarterly Benchmark of 3.3%.

Risks

LTV ratios stand at 29.9% (end-2018), down from a sustainable historical level of 37.3% end-2017. We believe the broad target LTV is 35-40%, but assuming York's Hudson Quarter proceeds to plan, the LTV on exit will be 30% or less.

During development of Hudson Quarter, LTV is expected to rise to manageable levels (40%) and will ultimately reduce LTV, through the value uplift and residential sales.

York's mixed-use development (the majority of which is apartments) is being commenced without residential pre-sales or pre-letting of the relatively modest commercial element. The residential market here is currently strong and marketing commences shortly.

The Hudson Quarter construction is being undertaken at a fixed-price contract, however it is not pre-sold at this stage, namely start of construction.

All real estate sector investment is at risk as regards location. Palace Capital mitigates this by excluding London and choosing central, accessible locations with good underlying demand.

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 or external). This is the nature of the value-adding asset management policy. To fund this, however, the group requires either dilapidations to be deployed, or an element of Palace Capital 'maintenance' capital or a mix of both. Our cashflow and asset forecasts include an element of this, itemised.

A number of leases are of short duration. The overall WAULT number is not relevant as this is a granular investment portfolio. Assets which have reversionary potential indeed, by definition, benefit from shorter WAULTs.

Leisure might be considered a sector under pressure and here the leases are mostly of long duration (see our analysis of top 10 assets), anticipating and mitigating that risk.

Sector exposure is weighted to regional offices – a segment we consider to be robust, with good supply/demand balance favouring the investor.

The dividend cover reduces this year and is not 100%-covered next year, according to Hardman estimates. This will constrain DPS growth, we estimate, until the NAV and, importantly, income step-uplift upon completion of the development. So, the DPS is 'cake today', 'cake and jam' in a short number of years, post the delivery of the highly visible York development. Therefore, DPS cover will rise substantially 'post York's Hudson Quarter', giving opportunities for DPS sustainable growth.

Financial analysis

Summary and quantified illustration of potential

There is strong momentum in raising rent to the current market value, in our view. The process does not happen overnight. The Hudson Quarter, York, development is in addition to this. We emphasise that FY22E will be the year Hudson Quarter's full benefits should be felt. In summary:

- £16.8m book value of Hudson Quarter: nil income currently.
- Development finance in place, construction started last month, LTV remains below 40%, then reduces significantly prior to any choice regarding further asset acquisition.
- This potential to recycle capital will bring progressive EPS uplifts.

Potential of 23p EPS – Hardman illustration quantified

- Moving rents to market levels and recycling the Hudson Quarter capital could combined achieve 23p EPRA EPS for Palace Capital. Currently, the rent run rate is £17.4m per annum, with £21.1m per annum as stated ERV (reversionary). We calculate £3m potential extra PBT from re-gearing to 30% LTV post the completion of Hudson Quarter.

Revenue account

Revenues, year-end March (£m)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019E	FY 2020E
Rental, other income	8.64	14.59	14.27	16.73	18.00	18.70
Direct property costs	-1.20	-1.62	-2.06	-1.82	-1.55	-1.60
Net income	7.44	12.97	12.21	14.91	16.45	17.10
Administrative expenses	-1.44	-2.05	-2.91	-4.18	-3.40	-3.60
EPRA operating profit	6.00	10.92	9.30	10.73	13.05	13.50
Property revaluation	9.77	3.62	3.10	5.74	2.00	0.00
Profit on disposal, transaction costs	-0.46	-0.52	3.19	0.27	-0.50	0.00
Share based payments	-0.11	-0.11	-0.24	-0.17	-0.20	-0.20
Operating profit	15.20	13.91	15.35	16.57	14.35	13.30
Interest	-1.40	-2.26	-3.01	-3.43	-3.85	-4.10
EPRA PBT (pre-revaluation, etc.)	4.60	8.66	6.45	7.30	9.20	9.40
PBT as declared (pre share-based)	13.91	11.76	12.58	13.31	10.70	9.40
Tax	0.00	-0.95	-3.19	-0.77	-1.50	-1.50
Deferred tax on revaluations, capital allowances	0.10	0.00	2.20	0.00	0.00	0.00
EPRA PAT	4.70	7.71	5.46	6.53	7.70	7.90
Company adjusted EPS (p)	26.87	31.32	21.21	18.67	16.78	17.21
EPRA EPS (post share-based) (p)	26.24	30.87	20.28	18.18	16.34	16.78
EPS (p) Reported	80.00	43.90	36.50	35.85	20.04	17.21
DPS (p)	13.00	16.00	18.50	19.00	19.00	19.00
Average shares issue (m)	17.49	24.62	25.74	34.98	45.90	45.90
Year-end shares issue (m)	20.23	25.78	25.23	45.80	45.90	45.90

NB All EPS figures are on diluted shares.
Source: Palace Capital accounts; Hardman & Co Research estimates

Income

By definition, none on a development site

Rental income – the development site's material influence

The rental line, it should be noted, currently receives nil from Hudson Quarter at York, in the books at £16.8m. We expect no rental income from York in the time horizon of this document. We anticipate that Palace Capital might choose to retain some or all the commercial assets developed at York during the course of the next two years. This would only have an impact on FY22 rental income and Palace Capital may choose to dispose or retain these.

No other assets are development assets, although some, in particular the Manchester office asset, have some portions undergoing refurbishment and off-rent while others in the normal course of events are also off-rent.

Rental income – acquisitions and disposals

Regarding rental evolution, above, it is important to note that it includes some disposals and acquisitions as well as the portfolio's natural rental income movements.

Rental income - inflation

Expecting modest outperformance in a difficult UK market

We expect very modest like-for-like rent inflation at Palace Capital in our model timeframe. It should be noted that market consensus IPF estimates for the whole UK office market are for 0.3% rent reductions in calendar 2019 like-for-like and 0.3% growth in 2020. Some Palace Capital assets are seeing significant rent rises per square foot (e.g. Manchester, Milton Keynes and others).

Manchester – "working-up" the income

We also note the progressive letting of the Manchester (Boulton House) asset on significantly higher rents per sq. ft., purchased with significant voids pending the now ongoing internal refurbishment. In 2016, the building was commanding rents at £12.50-£13.00 per sq. ft. Recent lets of 2,120 sq. ft. at £18.95 per sq. ft. and (earlier) 6,500 sq. ft. at £17.25 demonstrate benefits of £0.8m refurbishment (ongoing).

Additionally, some very modest rises assumed in our model

Setting aside the acquisitions and disposals and the "structural" increase in on-rent space in Manchester, we estimate a small (ca. £0.2m) rise in rental income like-for-like in both FY20 and FY21. Naturally, this is made up of a large number of plusses and minuses, however, overall we consider the bias towards regional offices and the focus on active asset management and the element of refurbishment all combine to see rental income modestly outperform the UK market. They did in FY18. Note that – as is normal for real estate – some new leases offer initial rent-free periods. The impact of these, for accounting purposes, is spread across the lease.

Recycling capital

Recycling capital boosts income. We estimate Palace Capital undertakes disposals and acquisitions during the time-frame of the estimates in the table above. End-2018 fiscal period, Palace Capital held £21.7m assets for sale – a specific item. This refers to the 65 north London residential assets acquired as part of the RT Warren portfolio acquisition. 50 have been sold for £18.2m to London Borough of Barnet, in the process of completing 35 prior to end March 2019 with 15 having been completed to date. All remaining such assets are expected to be sold in the course of FY20. In December 2018, a commercial asset in central Liverpool was acquired, with a rental income of just over £1.0m.

We estimate that Palace Capital will make additional (unspecified) acquisitions in FY20. This estimate is comprised of a total net £5m,(gross £8m plus and the disposal of the 10 remaining residential assets, which are stated as "for sale"). For the purposes of the modelling (solely illustrative), we assume £0.2m rental income FY20 from this gross £8m acquisition which we model as being into 2H. This is solely for the purposes of modelling. Incrementally in FY21, such a quantum of acquisition, were it to be of yielding commercial assets, might be expected to yield ca. £0.5m, or an incremental £0.3m over and above the part year FY20's £0.2m estimate.

Costs

Direct property costs include an element of uncovered expenses such as the rates bills or service charges on void assets. This is a normal function of the investment strategy.

Administrative costs include finance re move to main market

Administrative expenses in 2018 included £0.7m one-off costs of Palace Capital moving to the main market (from AIM). We model for a fall, going forward.

We estimate interest costs of sub 4% with £0.4m p.a. amortisation of fees. Interest costs on development of Hudson Quarter are capitalised. Development debt is on balance sheet. Finance costs include ca.£0.1m head lease costs.

Tax: Palace Capital chooses not to convert to a REIT so allows for a £6.6m deferred tax liability (falling to £3.6m now that the residential disposal crystallises £3.0m). The table above shows total tax and also, *in italics*, the line for the element of tax which is excluded for the purposes of calculating EPRA profits.

Balance sheet

Balance sheet

@ year-end March (£m)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019E	FY 2020E
Investment properties	103.0	174.5	183.9	253.9	280.0	310.7
Long-term liabilities (deferred tax)	1.5	1.2	-2.1	-6.6	-3.0	-3.0
Long-term debt	-36.6	-71.8	-77.7	-98.8	-98.8	-123.3
Net current assets, excluding financial	0.3	-3.5	-3.7	-3.3	-6.0	-3.0
Assets held for sale	0.0	0.0	0.0	21.7	3.7	0.0
Cash, deposits, short-term debt	11.9	6.3	9.1	16.3	11.6	7.0
Net cash (debt/finance lease)	-24.7	-65.4	-68.6	-82.4	-87.1	-116.3
Net assets (NNNAV)	80.0	106.8	109.6	183.3	187.6	188.4
EPRA net assets	80.0	106.8	111.8	190.0	190.6	191.4
NAV/share (p)	395.6	414.3	434.2	400.2	407.7	410.5
EPRA NAV/share (p)	395.6	414.3	443.0	414.8	414.2	417.1

Source: Palace Capital accounts; Hardman & Co Research estimates

Plenty of fire-power for a £37m cost development project

► A new bank facility has been put in place: a £26.5m facility with Barclays Bank.

Palace Capital has concluded a new facility to fund 72% of our estimate of the Hudson Quarter development where build is now commencing. As of end-September 2018, Palace Capital held £13.8m cash. As of end-September 2018, Palace Capital held unused loan facilities amounting to £15.0m (31 March 2018: £14.15m). Interest is charged on this facility at a rate of 1.25%, payable quarterly. This facility is secured on investment properties held. The new Barclays facility is at a rate of interest unspecified by Palace Capital in its announcement (of 11 February 2019).

Here, we model scenarios regarding recycling the Hudson Quarter capital

Conservative LTV; with development bringing in significant cash

LTV stood at 29.9% at the end of fiscal 2018, down from 37.3% 2017. If no further acquisitions are made and the development concluded and liquidated, we estimate LTV reduces to 23.1%, see page 12, at end fiscal 2022. Development will bring significant cash as well as projected value uplift.

The rise in LTV is driven by investment, predominantly in the Hudson Quarter development.

Balance sheet

@ year-end March (£m)	FY 2017	FY 2017	FY 2018	FY 2019E	FY 2020E
Investment properties	183.9	183.9	253.9	280.0	310.7
Hardman estimate Hudson Quarter revaluation included above	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Acquisitions net of Disposals [1]	-1.2	-1.2	65.0	-4.2	4.5
Included in above: gross acquisitions	14.4	14.4	71.0	14.0	7.5
Hudson House development cash spend in year	0.0	0.0	0.0	2.8	20.0
Net debt	68.6	68.6	82.4	87.1	116.3
LTV	37.3%	37.3%	29.9%	30.7%	37.4%

[1] Excludes a modest ongoing capitalisation of refurbishments. Cash based figures
Source: Palace Capital accounts; Hardman & Co Research estimates

For 2019E, the small rise in debt represents our estimate for £2.8m spend on York (Hudson Quarter development including fees and other build costs), £3.5m major refurbishment projects; and £4.2m net proceeds of disposals and acquisitions, notably the Barnet residential disposals and central Liverpool office acquisition.

Peak estimated LTV assumes other off-market or market acquisitions, totalling £7.5m gross, in addition to the development spend. Our estimate for LTV at March 2021 is 39.9%. Note that this includes 100% of the Hudson Quarter development costs, scheduled for completion at March 2021. It takes no disposal proceeds into account and also includes a Hardman estimate of £7.5m acquisitions and £3.0m disposals in FY20 (nil FY21). These Hardman estimates are illustrations of a possible scenario, but are based on the prudent opportunistic deployment of capital.

38.4% would be the LTV peak ratio before any discretionary other acquisitions

38.4% is the end-March 2021 LTV figure pre acquisitions. See the table on page 12.

At end-March 2021, we would expect a completed construction and active marketing of the residential element to have generated significant pre-sales. Our sales complete post the March 2021 balance sheet so none are registered on the balance sheet. Any deposits received would be in blocked accounts in solicitors' hands pending legal completion. We estimate the residential element to be sold in full during calendar 2021 and materially, all to complete in calendar 2021.

77% Hudson Quarter GDV from residential

At just under an estimated £0.4m per apartment and 127 apartments, we model just under £50m gross disposal proceeds. Nonetheless, this is only part of the story as Hudson Quarter comprises commercial assets which should be worth ca. £15m (a Hardman initial estimate). These are all estimates, and no pre-sales have been sought.

Balance sheet evolution with ILLUSTRATION of FY21 and FY22						
@ March year-end (£m)	FY 2017	FY 2018	FY 2019E	FY 2020E	FY 2021E	FY 2022E
Investment properties includes Hudson Quarter (sold FY22)	183.9	253.9	280.0	310.7	331.2	273.3
Acquisitions net of disposals during the year [1]	-1.2	65.0	-4.2	4.5	0.0	0.0 [2]
Included in above: gross acquisitions	14.4	71.0	14.0	7.5	0.0	0.0 [2]
Hudson Quarter development cost during the year	0.0	0.0	2.8	20.0	14.0	0.2
Net cash (debt/finance lease)	-68.6	-82.4	-87.1	-116.3	-132.0	-67.0
LTV	37.3%	29.9%	30.7%	37.4%	39.9%	24.5%

[1] Excludes a modest ongoing capitalisation of refurbishments. Cash based figures
[2] Also excludes an assumed £15.0m worth of commercial assets developed by Palace Capital at Hudson Quarter and potentially retained by Palace Capital
Source: Palace Capital accounts; Hardman & Co Research estimates

We find it notable that under a scenario of working out and selling the Hudson Quarter development, LTV would reduce to 24.8%. This includes our estimated £7.5m acquisitions of property FY20E. Such a level indicates re-gearing financing upside for acquisitions.

The background detail – a significant LTV reduction

The calculations to reach the 24.5% LTV in the table above are as follows. We assume valuations uplift of £6m (initially) at Hudson Quarter upon practical completion and £3m further, in FY22 on completion of sales. So, on the modelling above, FY22E vs FY21E shows a £3m uplift for Hudson Quarter, minus £63m. £63m is the then book value of Hudson Quarter comprising initial book cost, development expenditure and initial revaluation profits taken. Effectively, as a cross-check, investment property book value end FY19E is £264.1m including £3.7m of assets for sale (residential) but excluding all Hudson Quarter valuation. FY22E would include our estimated £4.5m net acquisitions (FY20E) and ongoing capitalised refurbishments but, under this scenario, above, nil for Hudson Quarter as this would be all disposed.

We model various scenarios, below. The main conclusion we reach is that Palace Capital has significant scope and choice regarding recycling the development capital.

A range of scenarios with Palace Capital in the driving seat as to which to target

Minimising acquisitions would lead to just under 23% LTV post successful completion

Debt and LTV illustrations under various scenarios post Hudson Quarter				
	Mar 2021E £m debt	Mar 2021E LTV	Mar 2022E £m debt	Mar 2022E LTV
Core assumption: FY20E £7.5m (gross) acquisitions, Hudson commercial assets retained, Hudson residential sold FY22E £50m, £6m revaluation uplift	132.0	39.9%	82.0	28.4%
Nil acquisitions, Hudson commercial assets retained, Hudson residential sold FY22E £50m, £6m revaluation uplift	124.5	38.4%	74.5	26.0%
£7.5m gross acquisitions, Hudson commercial assets not retained, Hudson residential sold FY22E £50m, £6m revaluation uplift	132.0	39.9%	67.0	24.8%
Nil acquisitions, Hudson commercial assets not retained, Hudson residential sold FY22E £50m, £6m revaluation	124.5	38.4%	59.5	22.5%

Source: Hardman & Co Research estimates

If LTV is targeted at a level similar to end March 2019E.....

..... the EPS uplift would be attractive

Modelling the Hudson Quarter quantum of EPS enhancement

On the first assumption in the table above, Palace Capital retains the commercial element of the Hudson Quarter development, valued at £15m and generating rental income, we model, at £0.9m (a 6.0% NIY). This leaves FY22E LTV at 28.4%, which we consider a conservative level and is below historic levels. Adding this income to our FY21E operating profit and also adding the finance cost benefit of reducing debt by £50m (the residential, sold), namely £2m, adds £2.9m to EPRA profits for FY22E vs FY21E. This takes the EPRA EPS illustratively to 23.4p.

Hudson Quarter NAV enhancement

FY21E value uplift £6.0m is only a part of the value uplift estimated

We model £6.0m valuation uplift on the Hudson Quarter development taken at the time of practical completion, fiscal year end 2021, based on physical practical completion and a portion of the achieved residential sales prices. We estimate a further £3m uplift potential on residential assets created (this figure is naturally market dependent), or more, in FY22. We also expect an additional uplift regarding the commercial assets. We model Palace Capital retaining much or all of the commercial assets. Illustratively Hudson Quarter should generate £10m or greater development profits, a 20p or greater uplift to EPRA NAV at mid range (see also pages 4 and 5).

Possible ca. 20p EPRA NAV uplift

Cashflow

Cashflow						
Revenues, March year-end (£m)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019E	FY 2020E
Cash from operations	4.4	12.3	10.3	9.9	13.1	13.5
Finance	-1.6	-3.4	-2.5	-2.7	-3.9	-4.1
Tax	0.0	-0.2	-1.1	-0.4	-2.0	-2.0
Net cash flow from op. activities	2.8	8.7	6.7	6.8	7.2	7.4
Acquisitions/disposals	-0.4	-48.4	1.2	-65.0	4.2	-4.5
Refurbishment (capitalised)	-2.5	-1.2	-4.6	-2.8	-3.5	-3.5
Major development (Hudson)	0.0	0.0	0.0	0.0	-2.8	-20.0
Free cashflow operation and investment	-0.1	-40.9	3.4	-60.9	5.1	-20.6
Share issue	19.7	19.1	-2.2	67.7	0.0	0.0
Shares to fund asset purchases	-29.0	-15.7	0.2	-13.7	0.0	0.0
Dividends	-1.8	-3.2	-4.6	-6.7	-7.0	-8.6
Other	0.0	0.0	0.0	0.0	-2.8	0.0
Net cash change	-11.2	-40.7	-3.3	-13.7	-4.7	-29.2
Net financial position	-24.7	-65.4	-68.6	-82.4	-87.2	-116.3

Source: Palace Capital accounts; Hardman & Co Research estimates

- Our conclusion is that, assuming construction proceeds as anticipated and residential sales achieve estimates, the Palace Capital balance sheet and its long term earnings both benefit materially. Palace Capital has the option to direct the benefit (balance sheet finances and revenue account) as it deems fit: either way, significantly supportive to a progressive and sustainable dividend growth outlook.

Notes

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