FINANCE REVIEW

2015 was another strong year for Derwent London with substantially improved financial results across the board and further refinancing activity too.

DAMIAN WISNIEWSKI
FINANCE DIRECTOR

Financial overview

Derwent London has reported another very strong combination of NAV and earnings growth for the year ended 31 December 2015 and, as explained below, has also taken a number of steps during the year to further strengthen its financial position and de-risk its pipeline.

Helped by the issue of shares in January 2015 in connection with our call for early redemption of the 2016 convertible bonds, the Group's net asset value (NAV) rose by £919.7m to £4.0bn through 2015, an increase substantially higher than the £705.2m recorded in 2014. After allowing for the new shares issued, diluted EPRA NAV per share was 21.6% higher than the year before, giving a total return for 2015 of 23.0% (2014: 30.1%).

The benefits of consistently good lettings and asset management over the last year or so, as well as the refinancing activity in 2015 which substantially reduced our interest charge, have been reflected in a 31.0% increase in EPRA profit before tax and a 25.0% increase in EPRA recurring earnings per share to 71.34p compared to the previous year. Backed up by a 5.2% increase in like-for-like net rents in 2015 and positive lettings continuing into 2016, this has encouraged us to raise the final dividend by 10.0% to 30.8p per share. The total dividend for the year remains well covered at 1.6 times recurring earnings.

Our financing ratios have all improved again, with the loan-to-value ratio reduced from 24.0% at December 2014 to 17.8% in December 2015 and net interest cover up from 286% in 2014 to 362% for 2015. We have also been able to reduce the average IFRS interest rate on debt from 4.22% to 3.93% at December 2015, or down from 3.78% to 3.68% on a cash basis, while paying down net debt by £101.6m during the year and usefully increasing the weighted average unexpired length of our debt facilities.

	2015	2014
EPRA NAV per share	**3,535p**	2,908p
EPRA NNNAV per share	**3,463p**	2,800p
Property portfolio at fair value	**£4,954.5m**	£4,168.1m
Gross property income	**£152.0m**	£138.4m
EPRA profit before tax	**£81.6m**	£62.3m
Profit before tax	**£779.5m**	£753.7m
Dividend per share	**43.40p**	39.65p
NAV gearing	**22.8%**	32.9%
Net interest cover ratio	**362%**	286%

Keeping to our long-established business model, the short-term project pipeline is now substantially de-risked following lettings at the White Collar Factory and The Copyright Building and, as reported elsewhere, we are seeing good enquiries for The White Chapel Building and the space which we are creating for delivery in 2019. With a further £105m of long-term financing arranged in February 2016, we have the financial confidence to comfortably build out the committed pipeline, which continues to produce a significant level of development profit, while retaining our financial ratios at attractive levels.

Net asset value growth

The overall 627p increase in EPRA NAV per share can be summarised as follows:

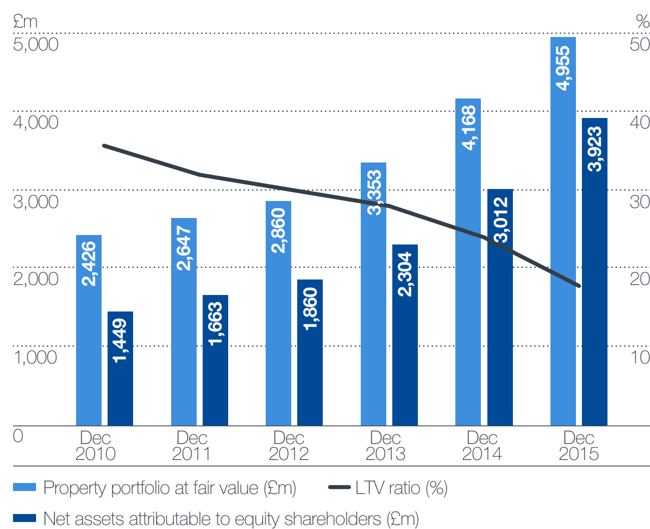
	2015 p	2014 p
Revaluation surplus	**581**	654
Profit on disposals	**39**	33
EPRA profit after tax	**71**	57
Dividends paid (net of scrip)	**(30)**	(35)
Interest rate swap termination costs	**(6)**	(2)
Dilutive effect of convertible bonds	**(17)**	(46)
Non-controlling interest	**(8)**	(10)
Other	**(3)**	(7)
	627	644

A detailed reconciliation showing adjustments from the IFRS NAV to the EPRA NAV is shown in note 37 to the financial statements.

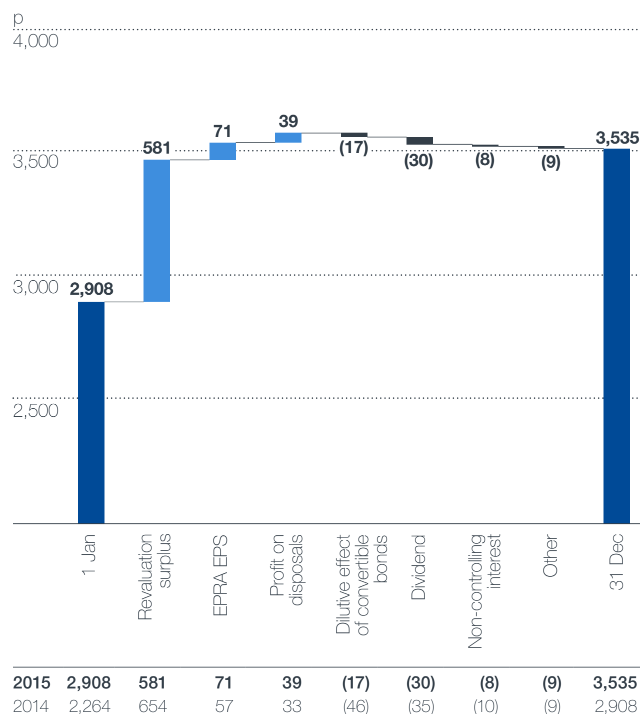
The contribution to NAV growth per share from property revaluations has fallen slightly from 2014, due partly to the larger number of shares in issue, but, at 581p per share (584p including our share of joint ventures) remained at a very high level. Of this increase, 55% came from an increase in estimated rental values adopted by our valuers, 24% from development profits and a relatively lower 21% from yield shift. We also made substantial property disposals during the year achieving 39p per share over book values and demonstrating that our valuations are underpinned by market demand. One of the properties, 9 and 16 Prescot Street, was sold into a joint venture in which the Group has a residual 50% interest. This is the main reason why the carrying value of our investments increased from £7.4m to £30.7m during the year.

As the £175m convertible bonds due in 2016 were redeemed early and converted into new shares in January 2015, there was no further dilution relating to those bonds in 2015. However, with the Group's NAV per share now over £33.35, which is the conversion price of the 2019 convertible bonds, the fully diluted EPRA NAV per share has taken into account 17p per share of dilution in 2015 in relation to the 2019 bonds. Note that the earliest date that the 2019 bonds can be converted into new shares is July 2016.

Property portfolio value, net assets and gearing



EPRA net asset value per share



	1 Jan	Revaluation surplus	EPRA EPS	Profit on disposals	Dilutive effect of convertible bonds	Dividend	Non-controlling interest	Other	31 Dec
2015	**2,908**	**581**	**71**	**39**	**(17)**	**(30)**	**(8)**	**(9)**	**3,535**
2014	2,264	654	57	33	(46)	(35)	(10)	(9)	2,908

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Medium and long-term interest rates continued to move up and down with market sentiment through 2015 and into 2016. The 20 year swap, for example, varied between 1.7% and 2.5% through the course of 2015 and, since the year end, has fallen back to well under 2.0%. These are substantial relative movements but interest rates generally remain at very low levels by historical standards, helping to underpin property yields. We have continued to monitor these rates and to buy down swaps from time to time thereby managing our interest rate exposure. The mark-to-market cost of all our interest rate swaps fell from £25.2m to £17.6m through 2015, the latter figure representing less than 2% of year end net debt. Fair value exposures for our fixed rate debt and bonds also closed substantially through the year helping the EPRA triple net asset value to increase by 23.7% during the year to 3,463p per share.

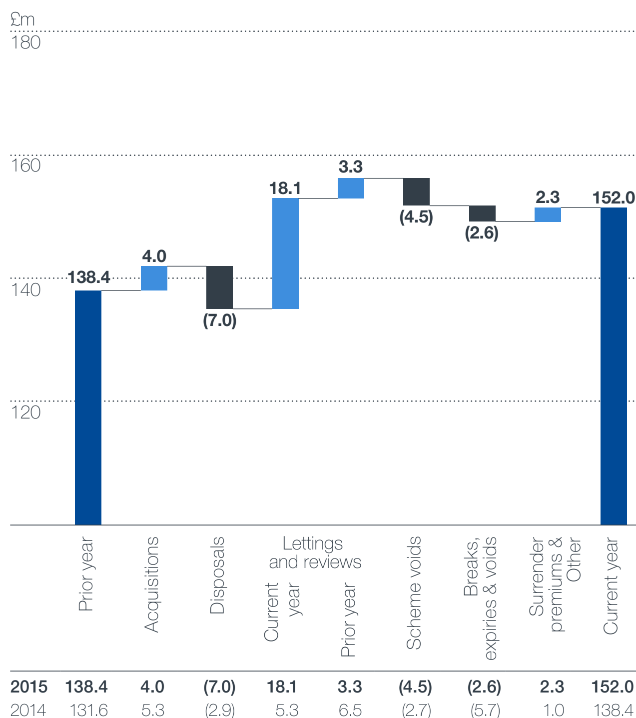
Income statement

As we progress through the current long London office property cycle, there is naturally a greater focus on income generation. Lettings from recent developments and asset management initiatives have had a tangible impact upon the Group's property income, a trend expected to continue over the next few years. Gross rental income was up by 8.5% to £148.3m and net rental income by 7.8% to £138.7m. Allowing for the profits from sales of residential apartments and other property income, net property and other income increased by £12.5m or 9.2% to £148.6m for the year.

In 2015, the increase in gross rental income came mainly from lettings and rent reviews which added £21.5m of income including £18.3m from lettings commencing in the year. Property acquisitions added another £4.0m of rental income while the disposals brought it down by £7.0m. Rent lost from lease breaks, expiries and voids was £2.6m and from schemes starting was £4.5m. An additional £2.3m came from various small premiums received and 'rights of light' settlements. The other property income of £3.7m related to compensation received from contractors for schemes at 40 Chancery Lane, Turnmill and 1-2 Stephen Street which were delivered late. The contracts were at fixed prices and the sums recognised partly offset the rent lost in 2015 due to the late completion of the projects.

Administrative expenses increased by 7.0% to just under £30.0m in 2015, due mainly to higher staff salaries and bonuses. However, finance costs were reduced considerably, by 17.0% to £35.2m, as the total amount of debt fell following the conversion of the 2016 bonds and the average interest rate on that debt was also reduced during the year. This came mainly from lower margins on our bank facilities but was also achieved by breaking or re-setting swap rates during the year at a cost of £4.0m. The positive impact of this will be felt for several years. In addition the start date on a £70m forward start swap was deferred at a cost of £2.4m. The interest capitalised in 2015 was £5.0m, a small reduction on the £5.3m in 2014 and, as before, no overheads or property costs were capitalised. Our EPRA cost ratios were almost identical to the previous year.

Gross property income



2015	**138.4**	**4.0**	**(7.0)**	**18.1**	**3.3**	**(4.5)**	**(2.6)**	**2.3**	**152.0**
2014	131.6	5.3	(2.9)	5.3	6.5	(2.7)	(5.7)	1.0	138.4

The combination of rental growth and lower finance costs drove the recurring EPRA profit before tax to £81.6m, up by 31.0% over the year. After taking account of property valuation uplifts, profits on disposals of properties and fair value movements, the overall IFRS profit for the year increased from £749.8m in 2014 to £777.2m for the year ended 31 December 2015.

Cost ratios

	2015 %	2014 %
EPRA cost ratio, incl. direct vacancy costs	24.3	24.2
EPRA cost ratio, excl. direct vacancy costs	22.3	22.9
Portfolio cost ratio, incl. direct vacancy costs	0.7	0.8

EPRA like-for-like rental income

	Properties owned throughout the year £m	Acquisitions £m	Disposals £m	Development property £m	Total £m
2015					
Gross rental income	114.9	6.4	3.5	23.5	148.3
Property expenditure	(4.5)	(0.5)	(0.8)	(3.8)	(9.6)
Net rental income	**110.4**	**5.9**	**2.7**	**19.7**	**138.7**
Profit on disposal of trading properties	–	–	3.2	–	3.2
Other[1]	2.7	–	0.6	3.4	6.7
Net property and other income	**113.1**	**5.9**	**6.5**	**23.1**	**148.6**
2014					
Gross rental income	109.4	0.4	9.7	17.2	136.7
Property expenditure	(4.5)	–	(0.7)	(2.8)	(8.0)
Net rental income	104.9	0.4	9.0	14.4	128.7
Profit on disposal of trading properties	–	–	3.9	–	3.9
Other[1]	3.4	–	–	0.1	3.5
Net property and other income	108.3	0.4	12.9	14.5	136.1
Increase based on gross rental income	**5.0%**				**8.5%**
Increase based on net rental income	**5.2%**				**7.8%**
Increase based on net property income	**4.4%**				**9.2%**

[1] Includes surrender premiums paid or received, dilapidation receipts, compensation for lost rent and other income.

A table providing a reconciliation of the IFRS to EPRA profit before tax and earnings per share is included in note 37.

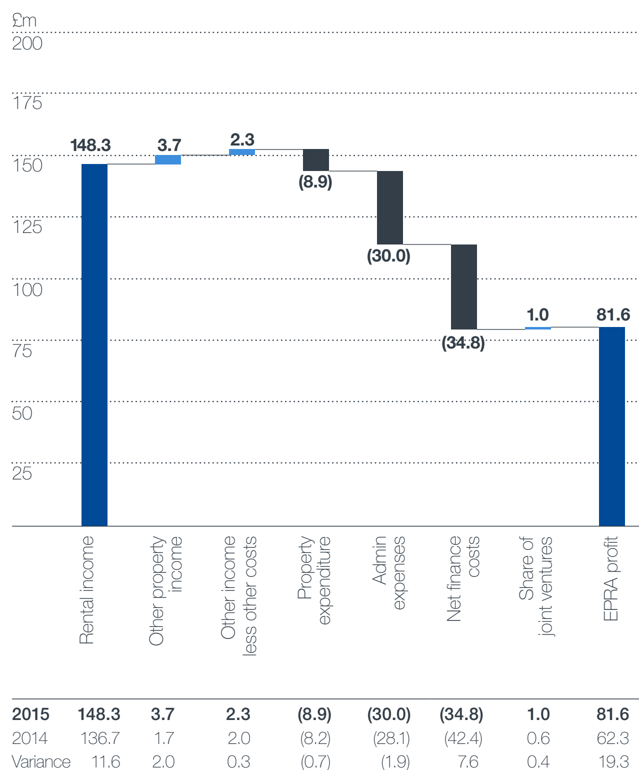
EPRA like-for-like gross rental income, which removes the impact of development activity, acquisitions and disposals, increased by 5.0% during the year with net rental income on a similar basis up by 5.2%. These figures demonstrate the gradual capture of our rental reversion as we move through the current property cycle. A full analysis is shown in the table below.

Taxation

The corporation tax charge for the year increased to £1.9m in 2015 from £0.8m in the previous year, most of this increase being due to the profits arising on the sales of residential apartments which were held as trading stock and therefore outside the REIT tax environment. The deferred tax charge for the year was lower than in 2014 at £0.4m as this took account of certain historic tax losses which were previously not recognised.

In addition, and in accordance with our status as a REIT, £4.8m of tax was withheld from shareholders on property income distributions and paid to HMRC during the year.

EPRA profit



	Rental income	Other property income	Other income less other costs	Property expenditure	Admin expenses	Net finance costs	Share of joint ventures	EPRA profit
2015	**148.3**	**3.7**	**2.3**	**(8.9)**	**(30.0)**	**(34.8)**	**1.0**	**81.6**
2014	136.7	1.7	2.0	(8.2)	(28.1)	(42.4)	0.6	62.3
Variance	11.6	2.0	0.3	(0.7)	(1.9)	7.6	0.4	19.3

Debt facilities

	£m	£m	Maturity
6.5% secured bonds		175	March 2026
3.99% secured loan		83	October 2024
1.125% unsecured convertible bonds		150	July 2019
4.41% unsecured private placement notes		25	January 2029
4.68% unsecured private placement notes		75	January 2034
Committed bank facilities			
Term – secured	28		June 2018
Bilateral revolving credit – unsecured	75		July 2020
Club revolving credit – unsecured	550		January 2021
		653	
At 31 December 2015		**1,161**	

Refinancing to fund the pipeline

Derwent London has had another significant year of financing activity.

As noted above, the first element was the early conversion of the 2016 convertible bonds into new equity and the resultant issue of 7.88m new ordinary shares. This brought down our net debt by £170.5m and significantly reduced financial gearing while also boosting interest cover. Together with the general improvement in our financial risk profile over recent years, it also enabled Standard and Poor's to upgrade our corporate credit rating, which now stands at BBB+ with a stable outlook.

With effect from March 2015, we extended the maturity of a £40m interest rate swap from June 2017 to June 2022 thereby reducing the rate payable from 3.0% to 2.35%. This had no associated cost and extended the weighted average maturity of our swaps while also saving interest charges of £260k per annum until June 2017. In July 2015, we paid £2m to reduce the coupon on a £75m interest rate swap from 2.975% to 2.49% through to April 2020.

Then, in July 2015 we completed a new unsecured and fully revolving £75m facility with Wells Fargo. The facility has a five year term but can be extended by up to two years upon request and can also be increased in amount by up to £25m during its term. The previous £90m secured facility from the same lender, of which £70m was drawn, was repaid and cancelled at the same time. The margin under the new facility is substantially lower than previously and, at a cost of £2m, we also reduced the amount hedged under this facility from £70m to £40m and extended the swap period out to July 2022 at a new lower rate of 2.446% (previously 3.18%). This refinancing extended the weighted average maturity of our debt, lowered our annual finance costs and provided greater flexibility: the new facility is fully revolving (i.e. we can draw and repay between zero and £75m) whereas the previous facility only had a £20m revolving element and it also increased our unencumbered property assets by £390m. The financial covenants for the new facility are identical to those of our existing £550m unsecured bank facility.

The final step in 2015 was to extend the maturity of the £550m unsecured revolving bank facility from January 2020 to January 2021. There is an additional one year extension option available, subject to the usual consents.

All of these actions have helped us extend the weighted average maturity of our debt from 6.6 years at December 2014 to 7.3 years at December 2015. The average interest rate on our debt has also been reduced from 4.22% at December 2014 to 3.93% at December 2015 on an IFRS basis and from 3.78% to 3.68% on a cash basis. In addition, unencumbered property assets have increased by 36% during the year to £3.7bn.

The proportion of our debt that is fixed or swapped into fixed rates was 85% as at 31 December 2015. This excludes a £70m forward start swap which would become effective in March 2016 unless we pay to defer it.

With long-term interest rates remaining at very low levels, our most recent refinancing activity has been to increase the Group's long-term fixed rate unsecured debt by accessing the US private placement market for the second time. In February 2016, we agreed to issue £30m of new 3.46% senior notes expiring in May 2028 and £75m of new 3.57% senior notes expiring in May 2031. The £105m funds will be drawn in May 2016 from three new institutional relationships and have identical financial covenants to both our existing unsecured bank facilities and the private placement notes issued in January 2014. Together with the planned property disposals in 2016, this will increase our financial firepower further from the £269.0m of undrawn facilities and cash at 31 December 2015 and will also further extend the weighted average maturity of our debt.

Net debt and cash flow

Net debt was reduced significantly during the year to £911.7m from £1,013.3m, taking the loan-to-value ratio down to 17.8% and NAV gearing to 22.8%. These are now at the lower end of our target range but are only expected to grow modestly through the next few years. Net proceeds from the sale of properties during the year totalled £277.2m; this sum exceeded properties acquired by £31.0m so we have been net sellers of property for the fifth year in a row before taking account of capital expenditure. Cash flows invested in our projects during the year increased to £116.4m but were more than covered by the deleveraging impact of the early redemption of the 2016 convertible bonds.

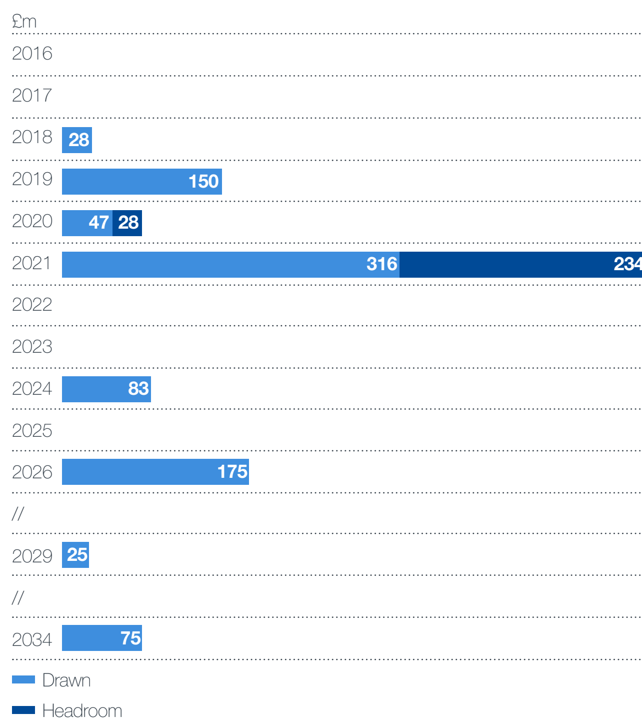
As planned, the net cash from operations has increased significantly again, to £76.0m for the year from £65.6m in 2014. Most of this increase comes directly from higher property income receipts. This has helped us to grow interest cover again, a particularly important metric that the Group uses in its business planning. From 286% in 2014, this rose to 362% for the year ended 31 December 2015, calculated on the net basis as set out in note 39.

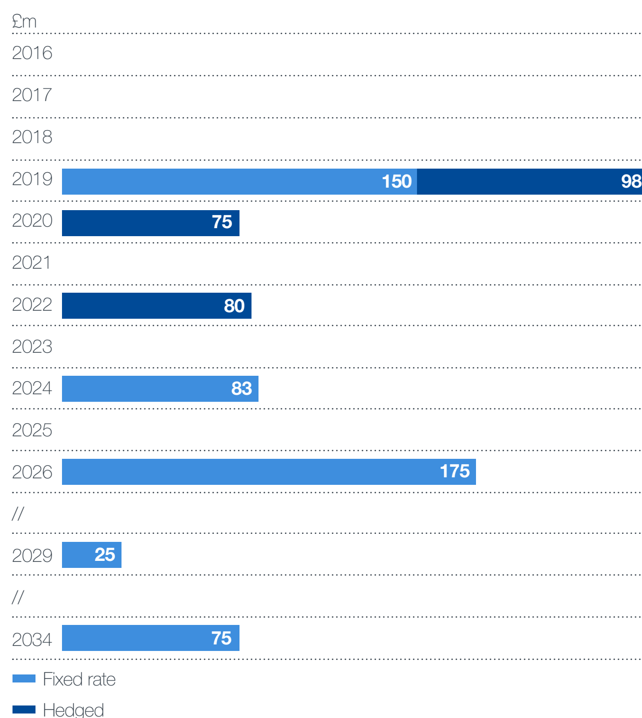
£75m

new revolving unsecured bank facility added in 2015

£105m

new unsecured 12 and 15 year private placement funding arranged in February 2016





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Net debt

	2015 £m	2014 £m
Cash	**(6.5)**	(14.8)
Bank facilities	**390.5**	347.0
3.99% secured loan 2024	**83.0**	83.0
6.5% secured bonds 2026	**175.0**	175.0
Acquired fair value of secured bonds less amortisation	**15.0**	16.0
4.41% unsecured private placement notes 2029	**25.0**	25.0
4.68% unsecured private placement notes 2034	**75.0**	75.0
2.75% unsecured convertible bonds 2016	**–**	175.0
1.125% unsecured convertible bonds 2019	**150.0**	150.0
Equity components and unwinding of discounts on convertible bonds	**(7.7)**	(12.9)
Leasehold liabilities	**23.2**	8.3
Unamortised issue and arrangement costs	**(10.8)**	(13.3)
Net debt	**911.7**	1,013.3

Gearing and interest cover ratio

	2015 %	2014 %
Loan-to-value ratio	**17.8**	24.0
NAV gearing	**22.8**	32.9
Net interest cover ratio	**362**	286

Dividend

With the step up in recurring earnings in 2015, the Board has recommended a 10.0% increase in the proposed final dividend to 30.80p per share for payment to shareholders in June 2016. All 30.80p will be paid as a PID. The total dividend for the year will be 43.40p per share, an increase of 3.75p or 9.5% over last year. As before, we will be offering a scrip dividend alternative though this will be reviewed later in the year depending upon equity market conditions.

Our financial outlook

With low financial gearing, enhanced interest cover, substantial recent pre-lets to de-risk the pipeline and additional financial headroom, we are well placed to build out our current committed programme of projects and thereby crystallise anticipated development profits over the next few years. Recurring earnings growth has also accelerated in 2015 and, with substantial rental reversion in a portfolio with low average rents, should continue to increase as we move through this property cycle.

Our consistent and focused business model is based on the fundamental balancing of the portfolio between income and value growth while retaining a conservative level of financial risk. The portfolio remains full of opportunities for many years to come but, with low passing rents, also offers many defensive qualities should the current global economic uncertainty bring a more challenging occupational environment for London's office landlords. At the moment, conditions remain favourable for us and, with limited new space being built in our markets and low interest rates supporting tight property yields, we aim to continue delivering and de-risking our committed projects over the next year while also continuing to capture rental reversion and grow earnings.

Debt summary

	2015 £m	2014 £m
Bank loans		
Floating rate	**137.5**	64.0
Swapped	**253.0**	283.0
	390.5	347.0
Non-bank debt		
3.99% secured loan 2024	**83.0**	83.0
6.5% secured bonds 2026	**175.0**	175.0
2.75% unsecured convertible bonds 2016	**–**	175.0
1.125% unsecured convertible bonds 2019	**150.0**	150.0
4.41% unsecured private placement notes 2029	**25.0**	25.0
4.68% unsecured private placement notes 2034	**75.0**	75.0
	508.0	683.0
Total	**898.5**	1,030.0
Hedging profile (%)		
Fixed	**57**	66
Swaps	**28**	28
	85	94
Percentage of debt that is unsecured (%)	**68**	65
Percentage of non-bank debt (%)	**57**	66
Weighted average interest rate – cash basis (%)	**3.68**	3.78
Weighted average interest rate – IFRS basis (%)	**3.93**	4.22
Weighted average maturity of facilities (years)	**6.8**	6.2
Weighted average maturity of borrowings (years)	**7.3**	6.6
Undrawn facilities	**262**	321
Uncharged properties	**3,709**	2,718

"We continue to balance our portfolio thereby providing strong total returns from a combination of recurring income and value creation."

DAMIAN WISNIEWSKI
FINANCE DIRECTOR