FINANCE REVIEW

Derwent London benefitted from a particularly strong performance across all aspects of its financial focus during 2013.

DAMIAN WISNIEWSKI
FINANCE DIRECTOR

With the support of a buoyant occupational market and fierce competition from investors for London's highly-prized stock of real estate, the Group experienced rapid growth in net asset value and one of our highest property valuation increases in recent years. We were also able to grow earnings significantly, further improve our interest cover and maintain modest gearing while investing substantially more in the portfolio than in the prior year. In addition, we entered into three refinancing transactions totalling £800m which combined to move us decisively to a predominantly unsecured debt structure. This enabled the release of fixed charges over much of our property portfolio which will improve operational and financial flexibility. The refinancing also extended the average duration of our debt to 7.7 years and significantly reduced the average cost.

Much has been written about the UK's renewed confidence and the economic growth that emerged in 2013 but London's recovery started far earlier. That has certainly been reflected in our own results over the last year but the recent strength of London's commercial property market is also very evident from the transformation of our financial position over the last five years.

	2013	2012	Increase %	2008	Five-year increase %
EPRA NAV per share	**2,264p**	1,886p	20.0	1,222p	85.3
EPRA NNNAV per share	**2,222p**	1,764p	26.0	1,206p	84.2
Property portfolio at fair value	**£3,353.1m**	£2,859.6m	17.3	£2,108.0m	59.1
Gross property income	**£131.6m**	£124.8m	5.4	£119.0m	10.6
EPRA profit before tax	**£57.8m**	£52.5m	10.1	£22.2m	160.4
Profit/(loss) before tax	**£467.9m**	£228.1m	105.1	(£606.5m)	n/a
Dividend per share	**36.50p**	33.70p	8.3	24.50p	49.0
NAV gearing	**40.0%**	45.6%	n/a	71.2%	n/a
Gross interest cover ratio	**363%**	351%	n/a	247%	n/a

Net asset value and total return

The final quarter of 2013 saw yields on our central London commercial properties driven down significantly, due in part to exceptional investor demand and expectations of continued rental growth. Together with development profits from our projects and strong underlying rental value growth across the portfolio, this helped to provide a £452.5m increase in NAV for the Group over the 12 months to 31 December 2013. This is more than double the NAV increase in 2012 which was, itself, a strong year.

EPRA net asset value per share increased by 20.0% during 2013 to 2,264p per share from 1,886p a year earlier. The revaluation surplus and profits from the sale of investment properties together account for 378p with other items approximately netting out to nil.

The overall improvement in EPRA NAV per share can be summarised as follows:

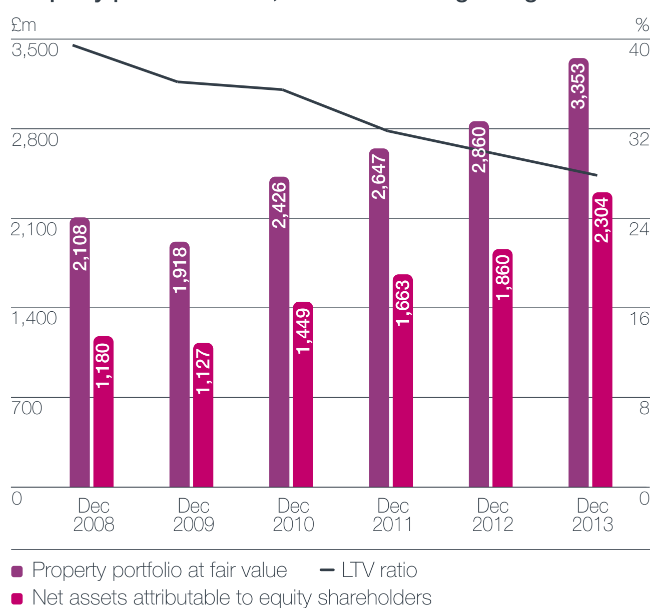
	2013 p	2012 p
Revaluation surplus	**326**	170
Profit on disposals	**52**	7
EPRA profit after tax	**54**	50
Dividends paid (net of scrip)	**(30)**	(30)
Equity portion relating to issue of convertible bonds 2019	**12**	–
Interest rate swap termination costs	**(13)**	(7)
Dilutive effect of convertible bonds 2016	**(10)**	–
Minority interest	**(7)**	(5)
Other	**(6)**	–
	378	185

The EPRA NAV and NAV per share are 'diluted' measures and therefore take account of the exercise of share options and long-term share incentives as well as the conversion of convertible bonds where these reduce the NAV per share. As the NAV per share is now higher than the conversion price of the convertible bonds maturing in 2016 of 2,222p, the dilutive impact of this, equating to 10p per share in 2013, has been included in the calculation of EPRA NAV per share for the first time. Of this, 4p is due to the conversion into shares at a price below the NAV per share and 6p is due to the early write-off of the unamortised part of the bond's equity component; the latter amount will normally amortise up to the maturity date of the bonds in July 2016 unless the bonds are converted into equity at an earlier date.

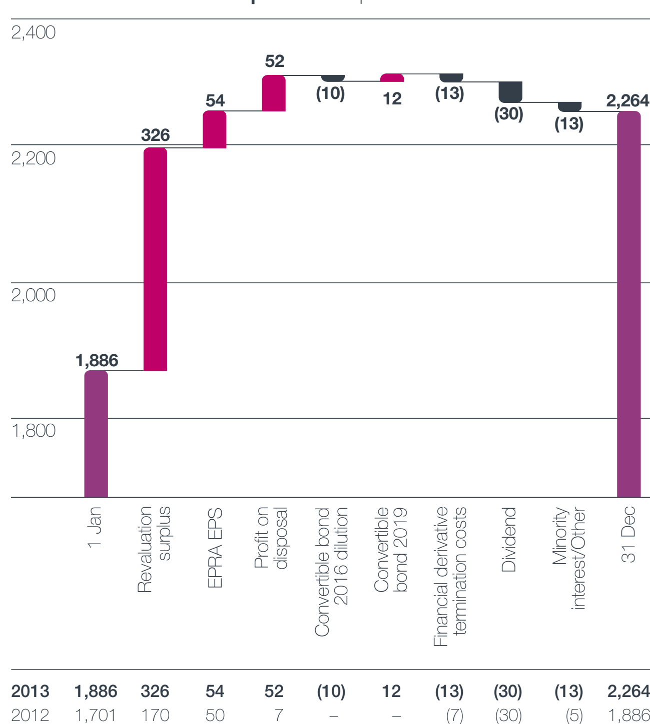
A detailed reconciliation of the Group net asset value to the EPRA NAV is shown in note 17 to the financial statements.

The improved prospects for the UK economy have brought forward the prospect of UK interest rate rises. Although there has been some retrenchment so far this year, this had a beneficial impact on the mark-to-market cost of our interest rate derivatives which fell to 16p per share from 53p in 2012. This reduction was also helped by the unwinding or re-couponing of £190m of interest rate swaps at a cost of 13p per share following the issue of our second convertible bond in July 2013. The equity component of these 2019 convertible bonds recognised at issue was 12p per share, roughly equivalent to the cost of the swaps terminated. The fair value of fixed rate bond liabilities also fell to £15.2m from £58.0m in 2012 and these combined to bring the Group's EPRA triple NAV per share to 2,222p at 31 December 2013, an increase of 26.0% over the year. Note that the EPRA triple NAV now also deducts unamortised loan arrangement costs and fees.

Property portfolio value, net assets and gearing



EPRA net asset value per share p



2013	**1,886**	**326**	**54**	**52**	**(10)**	**12**	**(13)**	**(30)**	**(13)**	**2,264**
2012	1,701	170	50	7	–	–	(7)	(30)	(5)	1,886

Income statement

As well as adding value to our portfolio in 2013, we have also seen a solid improvement in recurring earnings, evidencing the letting and asset management progress made in recent years. EPRA profit before tax was £57.8m, up by over 10% from the £52.5m comparative figure in 2012. EPRA earnings per share were also up to 53.9p from 50.4p a year earlier. In addition, including the fair value uplift in property and derivative values and the profits on disposal of our properties, the overall Group IFRS profit before tax was £467.9m, more than double that of 2012.

Gross property income increased by 5.4% to £131.6m for the year ended 31 December 2013 from £124.8m in 2012. Income from new lettings and rent reviews totalled £11.8m through 2012 and 2013 with a further £4.1m from properties acquired. These more than compensated for the £3.2m of income lost on disposals and £6.5m on voids, expiries and lease breaks. Net property and other income rose 6.2% to £124.3m from £117.0m last year. Of this, £121.7m was net rental income, 6.7% higher than in 2012.

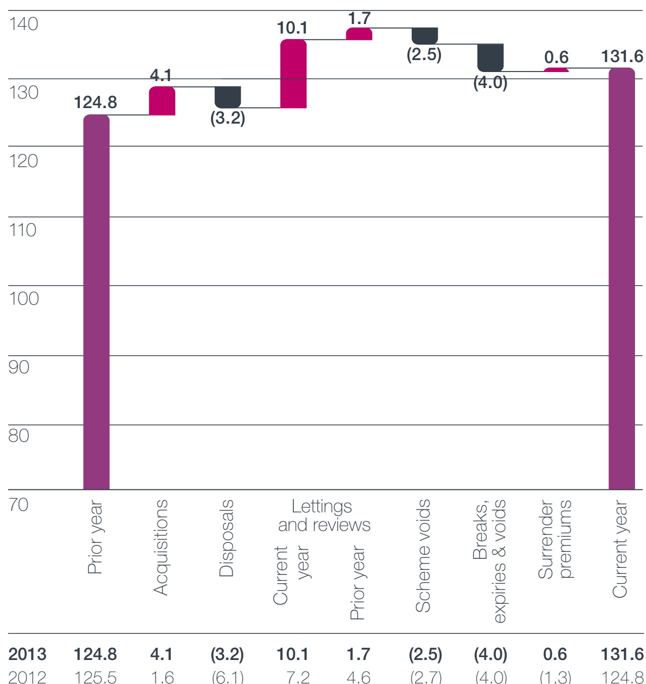
The real progress in underlying rental income levels across the portfolio can be demonstrated by the increase in like-for-like property income where the effects of acquisitions, disposals and developments are taken out. EPRA gross rental income increased by 3.6% during the year on a like-for-like basis. A full analysis is shown in the table opposite.

The cost of running our team has increased in line with activity levels. The Group administration charge for the year rose by 6.4% to £26.7m; this increase is largely due to higher salary, bonus and incentive payments to our staff and management team, the levels of which rose by £1.5m over the year.

20.0%
increase in EPRA NAV per share

10.1%
increase in EPRA profit before tax

Gross property income £m



2013	**124.8**	**4.1**	**(3.2)**	**10.1**	**1.7**	**(2.5)**	**(4.0)**	**0.6**	**131.6**
2012	125.5	1.6	(6.1)	7.2	4.6	(2.7)	(4.0)	(1.3)	124.8

We have included the new EPRA cost ratio figures this year for the first time. The total ratio of overheads and irrecoverable property costs to rental income was 25.1% in 2013 and 25.2% in 2012. Our high degree of development and refurbishment activity adds considerably to the Group's overhead; from our own estimates, this activity represents approximately one third of our total staff costs, so it is arguably unrepresentative to measure running costs against rental income alone. We are therefore also showing the ratio of overheads and irrecoverable property costs to the property portfolio fair value which results in a ratio of 1.0% in 2013 and 1.1% in 2012. Note also that it is our policy not to capitalise development overheads, all of which are expensed in the year.

	2013 %	2012 %
EPRA cost ratio, incl. direct vacancy costs	**25.1**	25.2
EPRA cost ratio, excl. direct vacancy costs	**22.6**	21.1
Portfolio cost ratio, incl. direct vacancy costs	**1.0**	1.1

EPRA like-for-like net rental income

	Properties owned throughout the year £m	Acquisitions £m	Disposals £m	Development property £m	Total £m
2013					
Rental income	105.1	5.2	1.6	19.0	130.9
Property expenditure	(4.8)	(0.1)	(0.4)	(3.9)	(9.2)
Net rental income	**100.3**	**5.1**	**1.2**	**15.1**	**121.7**
Other[1]	1.9	–	–	0.7	2.6
Net property income	**102.2**	**5.1**	**1.2**	**15.8**	**124.3**
2012					
Rental income	101.4	1.1	4.9	17.3	124.7
Property expenditure	(4.4)	–	(1.5)	(4.7)	(10.6)
Net rental income	97.0	1.1	3.4	12.6	114.1
Other[1]	2.3	–	0.1	0.5	2.9
Net property income	99.3	1.1	3.5	13.1	117.0
Increase based on gross rental income	**3.6%**				**5.0%**
Increase based on net rental income	**3.4%**				**6.7%**
Increase based on net property income	**2.9%**				**6.2%**

[1] Includes surrender premiums paid or received, dilapidation receipts and other income

The exceptional uplifts from revaluation gains during the year and profits from the sale of investment properties contributed £393.1m compared with £182.2m in 2012. In total they have provided much of our IFRS profit and net asset growth in 2013.

As part of the refinancing in 2013, £3.2m of unamortised issue costs were written off when the old loans were repaid but this is not taken into account in deriving the EPRA profit before tax. Excluding this amount, net finance costs were almost unchanged compared to the previous year. Borrowings were higher and average borrowing costs were lower in 2013 and the impact of our refinancing on the cost of debt is explained in more detail below.

The total cost of breaking or re-couponing swaps in the year was £13.7m, most of which was judged to coincide with the equity uplift arising on our second convertible bond issue. The increase in interest rate expectations referred to above led to a significant unwinding of the cost associated with 'fair valuing' our other interest rate swaps. This gave a fair value uplift of £38.5m in 2013 compared to a £2.4m deficit in 2012.

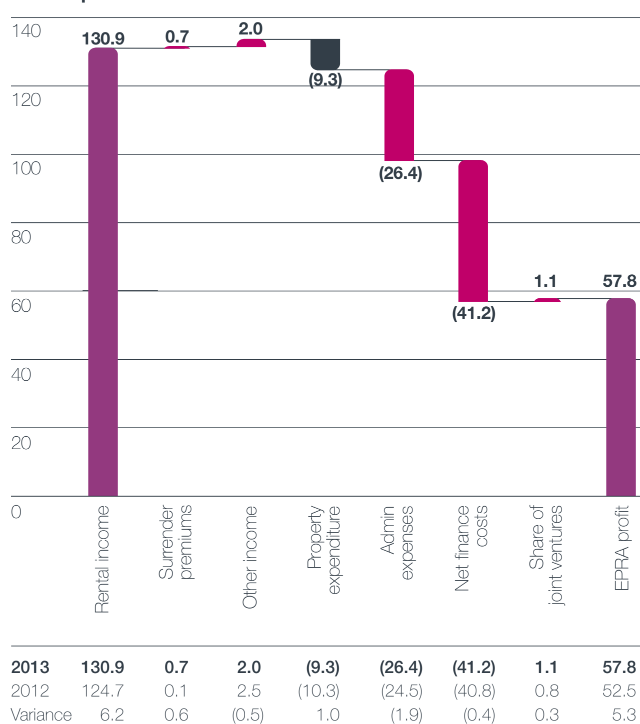
Taxation

Our REIT status significantly reduces the taxation costs of the Group but brings with it a responsibility to our stakeholders and to HMRC to operate within certain rules. We do not generally pay tax on our property business income and gains provided we distribute nearly all of the taxable profits every year and withhold tax on those distributions. In 2013, £4.2m of tax was withheld from shareholders on such distributions and paid to HMRC.

The Group does pay corporation tax on certain income and gains such as those from non REIT-elected companies, trading income, interest and fees. The 2013 tax charge relating to this part of the business was £1.0m, comprising a current year tax charge of £0.8m and a prior year tax charge of £0.2m. The tax charge was primarily due to the unelected share in our joint venture with the Portman Estate which is outside the REIT regime. In addition, during the year there was an increase in the Group's deferred tax liability in relation to revaluation gains outside the REIT amounting to £1.4m.

Following resolution of a long-standing matter in relation to the REIT conversion charge that we paid in 2007, we have been able to utilise £0.6m of a prior year provision of £1.0m and release the balance to the income statement with no additional tax charge.

EPRA profit £m



	Rental income	Surrender premiums	Other income	Property expenditure	Admin expenses	Net finance costs	Share of joint ventures	EPRA profit
2013	**130.9**	**0.7**	**2.0**	**(9.3)**	**(26.4)**	**(41.2)**	**1.1**	**57.8**
2012	124.7	0.1	2.5	(10.3)	(24.5)	(40.8)	0.8	52.5
Variance	6.2	0.6	(0.5)	1.0	(1.9)	(0.4)	0.3	5.3

Debt facilities

	£m	£m	Maturity
6.5% secured bonds		175	March 2026
3.99% secured loan		83	October 2024
2.75% unsecured convertible bonds		175	July 2016
1.125% unsecured convertible bonds		150	July 2019
Committed bank facilities			
Term – secured	28		June 2018
Term/revolving credit – unsecured	90		December 2017
Revolving credit – unsecured	550		September 2018
		668	
At 31 December 2013		**1,251**	
4.41% unsecured loan		25	January 2029
4.68% unsecured loan		75	January 2034
At 31 January 2014		**1,351**	

Maintaining robust financing

During the course of 2013, we arranged £800m of new facilities, all of which are unsecured. By removing the fixed charges that were required under our previous secured funding arrangements, we have improved our financial and operational flexibility and reduced future transaction costs. We also set ourselves the task of obtaining some more medium and long-term fixed rate debt as our judgement was that interest rates were likely to rise further. In addition, we wanted to reduce the overall cost of our debt. The planning for this substantial programme of change commenced in late 2012 and execution was all carried out in the second half of 2013 to take advantage of favourable conditions in the financial markets.

The first step was taken in July when the Group issued £150m of convertible bonds. We believe this form of financing can be particularly attractive to companies with shares trading at a substantial premium to net asset value, which was the case for Derwent London. There was considerable demand for new issuance in mid-year and we sought to take advantage of this with our second convertible bond. These bonds have a six-year maturity and therefore fall due in 2019, three years after our first issue of convertible bonds, which mature in 2016. This second issue is not eligible for conversion into equity within the first three years which avoids the possibility of both bonds converting at the same time. The conversion price was set at £33.35, a 62% premium to the EPRA net asset value at the end of June 2013 and 35% above the share price at launch. The cash coupon settled at 1.125%, a reflection of the very strong level of demand. The IFRS coupon, which flows through the income statement, is 2.67%. The bonds are share settled and are therefore accounted for by splitting their equity and debt components, giving rise to an equity uplift of £12m, net of costs, during the year. Taking advantage of this, we subsequently paid £13m to break, defer and re-coupon £190m of existing interest rate swaps, which has further reduced the weighted average cost of our debt. Note that there remain two additional swaps with deferred start dates which will become active during 2014 unless we opt to delay them further. The first is at just under 2.00% on a principal amount of £65m and the other is at 3.99% on £70m.

The second step was the rearrangement of a large part of our bank facilities. In September, we completed and started to draw down a new £550m unsecured five-year revolving credit facility, replacing £650m of secured bank facilities that were due to expire between April 2014 and January 2017. The new facility was provided by our principal relationship lending banks with HSBC as agent. The margin payable under the new facility is 160 basis points over LIBOR for net asset gearing levels of up to 50%, increasing at higher levels of NAV gearing with a maximum permitted level of 160%. The release of security on the facilities repaid increased the Group's pool of unencumbered assets and, at the end of the year, the value of uncharged properties totalled £2,144m or 64% of the portfolio valuation. As noted above, unamortised arrangement costs of £3.2m were written off in the second half of the year in relation to the secured facilities repaid.

The last piece of refinancing was designed to tap the liquid US private placement market to provide some attractively priced long-term debt for the Group. Terms were signed in November 2013 with New York Life for an unsecured loan of £100m: £25m for 15 years at a fixed rate of 4.41% and £75m for 20 years at a fixed rate of 4.68%. The financial covenants are identical to the new bank facility; the net asset gearing covenant of 160% provides substantial headroom when measured against the Group's NAV gearing level of 40.0% as at 31 December 2013. We agreed a deferral of initial drawing at no cost and the funds were drawn in January 2014 and used to repay revolving bank facilities, thereby increasing the level of available facilities to almost £400m. Of our total £1,351m of facilities, 72% is now on an unsecured basis compared with only 15% in December 2012.

The refinancing carried out in 2013 means that the proportion of non-bank facilities increased to 47% at 31 December 2013 from 36% a year earlier. Taking account of the £100m of fixed rate debt drawn in January 2014 increases this to 51%. We have also seen a substantial reduction in our weighted average interest rate. At the end of 2013, the spot rate fell to 3.64% on a cash basis from 4.63% a year earlier and to 4.10% on an IFRS basis from 4.88% in December 2012. Most of the reduction was seen in the last quarter of the year with an average cash rate of 4.44% for the first nine months of the year and 3.65% in the last quarter of the year. The average unexpired duration of our debt has also been increased; this was 6.3 years at the end of December 2013 increasing to 7.7 years on a proforma basis taking account of the funding drawn in the first week of January. The equivalent figure in December 2012 was 6.1 years.

Net debt and cash flow

Net debt increased during the year to £949.2m from £874.8m as we continue to build out our pipeline of projects. Total capital expenditure for the year was 31% higher than in 2012 at £107.8m including £4.8m of capitalised interest. We have been able to sell well in these markets and raised £149.8m after costs from the disposal of properties, mainly at Commercial Road and the 50% holding at Grosvenor Place. The latter was sold in July 2013 for £132.5m before costs, a 70% premium to the December 2012 book value. We have bought selectively through the year, identifying properties with reasonable yields off modest capital values and future potential to add value. The cash outflow on new properties acquired including 19 Charterhouse Street, Mark Square House and 22 Kingsway was £130.1m or 87% of the proceeds derived from asset sales.

2013 REFINANCING

OUR AIMS FOR 2013 WERE:

- To move towards predominantly unsecured debt:
  - Improves operational flexibility
  - Greater access to capital markets
  - Reduces future transaction costs
- To refinance, taking advantage of market conditions

OUR ACHIEVEMENTS IN 2013:

- £800m of refinancing:
  - All unsecured
  - Reduces average cost of debt
  - Extends average maturity of debt
- Replaced £650m of secured bank facilities

JULY 2013 CONVERTIBLE BONDS

£150m convertible bonds

£33.35 conversion price, 62% above June NAV

6 years longer than average maturity

1.125% coupon rate

SEPTEMBER 2013 BANK FACILITY

£550m unsecured revolving bank facility

1.6% funds drawn at 1.6% margin

5-year term with no amortisation

NOVEMBER 2013 PRIVATE PLACEMENT

£100m unsecured

20 years £75m at 4.68%

15 years £25m at 4.41%

Net debt

	2013 £m	2012 £m
Cash	(12.5)	(4.4)
Bank facilities	385.0	437.5
Secured loan 2024	83.0	83.0
Secured bonds 2026	175.0	175.0
Fair value and issue costs	15.6	16.4
Unsecured convertible bonds 2016	175.0	175.0
Unsecured convertible bonds 2019	150.0	–
Issue costs, equity components and unwinding of discounts	(22.3)	(10.0)
Leasehold liabilities	8.2	8.9
Bank loan arrangement costs	(7.8)	(6.6)
Net debt	949.2	874.8

Gearing and interest cover ratio

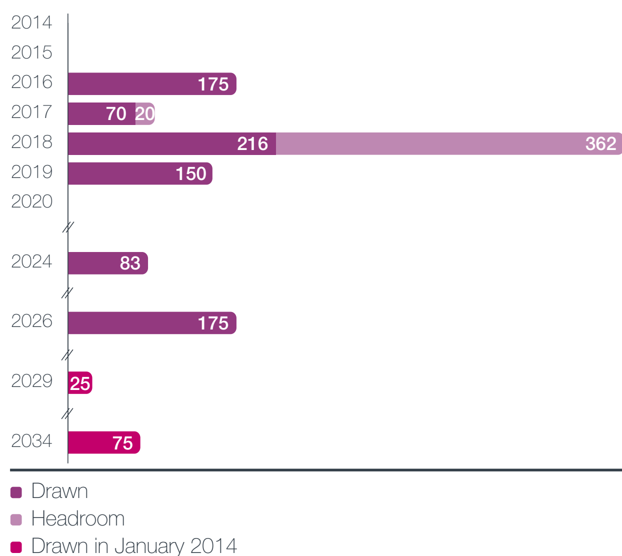
	2013 %	2012 %
Loan-to-value ratio	28.0	30.0
NAV gearing	40.0	45.6
Interest cover ratio (gross)	363	351
Interest cover ratio (net)	279	263

Debt summary

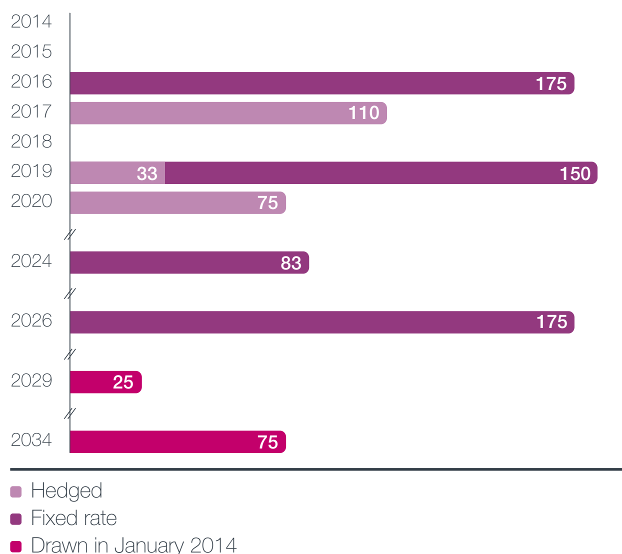
	Proforma[1] £m	2013 £m	2012 £m
Bank loans			
Floating rate	68.0	167.0	69.5
Swapped	218.0	218.0	368.0
	286.0	385.0	437.5
Non-bank debt			
Fixed rate secured loan 2024	83.0	83.0	83.0
Fixed rate secured bonds 2026	175.0	175.0	175.0
Fixed rate unsecured bonds 2016	175.0	175.0	175.0
Fixed rate unsecured bonds 2019	150.0	150.0	–
Fixed rate unsecured loan 2029	25.0	–	–
Fixed rate unsecured loan 2034	75.0	–	–
	683.0	583.0	433.0
Total	969.0	968.0	870.5
Hedging profile (%)			
Fixed	70	60	50
Swaps	23	23	42
	93	83	92
Percentage of debt that is unsecured	63%	63%	20%
Percentage of non-bank debt	70%	60%	50%
Weighted average interest rate (%)[2]	3.88	3.64	4.63
Weighted average interest rate (%)[3]	4.34	4.10	4.88
Weighted average maturity of facilities (years)	6.9	5.9	5.4
Weighted average maturity of borrowings (years)	7.7	6.3	6.1
Undrawn facilities	382	283	333
Uncharged properties	2,144	2,144	624

[1] Includes £100m fixed rate loan drawn down in January 2014
[2] Convertible bonds at 2.75% and 1.125%
[3] Convertible bonds on IFRS basis

Maturity profile of loan facilities £m
Proforma as at 31 January 2014[1]



Maturity profile of fixed and hedged debt £m
Proforma as at 31 January 2014[1,2]



[1] Includes £100m fixed rate loan drawn in January 2014. Drawdown reduces drawn amounts in the revolving bank facility by £99m after costs
[2] Excludes forward start swaps

The overall property value increases referred to above meant that the Group's loan-to-value (LTV) ratio fell to 28.0% at the year end from 30.0% in 2012. Net asset value gearing fell correspondingly to 40.0% from 45.6%. We are comfortable with these levels which give us considerable resilience in relation to our financial covenants. As our property values have now risen by about 81% from their low point in mid-2009, we would naturally expect the LTV ratio to be lower today than in some recent years. Our focus on sustaining interest cover through the cycle has also helped us to grow gross cover to 363% from 351% in 2012. From now on, and in accordance with the covenant definitions within our new unsecured funding arrangements, we will be reporting net interest cover. This is calculated after irrecoverable costs and adding back capitalised interest; it increased to 279% in 2013 from 263% in 2012.

Dividend

Our distribution policy remains unchanged: to maintain good dividend cover out of recurring earnings while also providing a progressive and sustainable level of growth for our shareholders. The Board has therefore recommended an 8.4% increase in the proposed final dividend to 25.75p per share of which 23.50p will be paid as a PID with the balance of 2.25p as a conventional dividend. The total dividend for the year is 36.50p per share, an increase of 2.80p or 8.3% over 2012. The scrip dividend alternative remains popular and so, as in recent years, it will again be offered.

Financial prospects

We started 2014 in a robust financial position and have seen continued strong demand for our properties from tenants and investors alike. We expect to invest about £140m in our projects in 2014 with a similar level of expenditure in 2015. With almost £400m of undrawn facilities and low gearing, we are well-placed to fund this programme. We will be considering further capital recycling from selective property sales while maintaining a healthy balance of interest and dividend cover – disciplines that Derwent London has long believed in.

Our substantially hedged financing position will help to shelter us from the impact of interest rate rises over the next few years and our low gearing should enable us to absorb any cyclical value adjustments without a significant impact upon our business planning. Our flexible business model and income-producing pipeline are major advantages in this respect. Whilst financial risks remain, particularly in relation to construction cost inflation and future upward yield shift, rental growth is strong in our markets and yields are expected to remain firm for some time.

To summarise, pursuing our strategy with an intelligent approach to risk management should enable us to deliver long-term outperformance for our shareholders whilst helping to upgrade London's built environment for other stakeholders.

On behalf of the Board.

JOHN D. BURNS
CHIEF EXECUTIVE OFFICER

DAMIAN M.A. WISNIEWSKI
FINANCE DIRECTOR

27 FEBRUARY 2014