FINANCE REVIEW

In 2012, EPRA net asset value per share increased by 10.9%, EPRA profit before tax rose slightly despite the increase in development activity and all our planned refinancing was completed.

Damian Wisniewski
Finance Director

Over many years, Derwent London's business model has been to add value through refurbishment, redevelopment and asset management while also maintaining a secure recurring income stream, modest leverage and strong interest cover. The strength of our balance sheet plus the confidence that comes from robust five-year financial projections supports the business and enables us to plan to take account of anticipated market cycles. This allows decision-taking that fuels growth backed by a careful assessment of the risks.

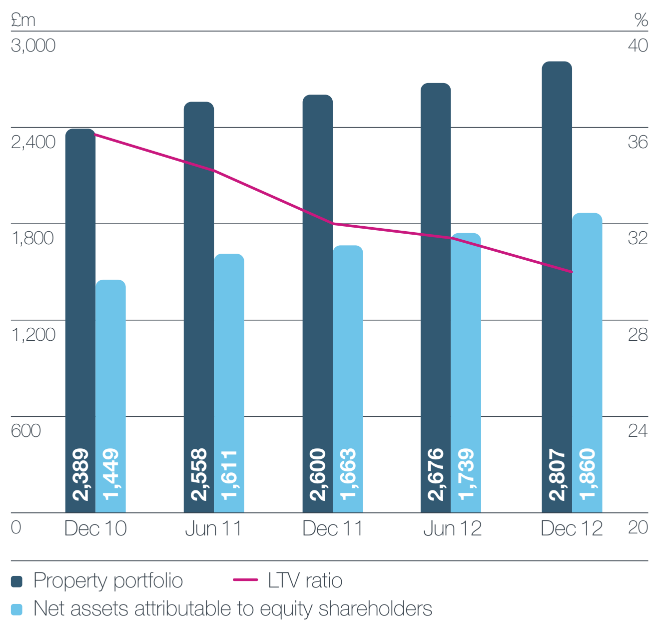
The calendar year 2012 was, in many respects, a significant one for London. Sterling was seen as a relative safe haven while many of the other European economies were under extreme pressure. Notwithstanding the lack of overall economic growth in the UK and the domestic tension caused by a deficit reduction programme, policies exercised by Government and the Bank of England helped to encourage capital flows into London. This strengthened sterling and forced interest rates down to exceptionally low levels though there has been some correction in both measures in the first few weeks of 2013.

Another notable feature of the year for our sector was the continued and substantial disparity between availability and cost of capital for those seen as strong borrowers and the rest. In particular, investors associated with London continued to defy the gloom which was felt in much of the rest of the UK.

All these factors meant that this was a good environment for stronger companies within our sector to refinance. In January 2012, we completed £300m of bank facilities signed in December 2011. In addition, Derwent London secured £83m of inexpensive long-term debt in August 2012, tapping a source which we had not previously utilised.

We also continued our policy of recycling capital through asset sales, improved our overall interest cover and drove rental growth in the portfolio with like-for-like net rental growth up by 8.2% on the year. With low voids and much of the existing development pipeline de-risked through pre-lets, we have been able to push ahead with important new projects such as Turnmill EC1 and 40 Chancery Lane WC2 and to commit to our largest scheme to date at 80 Charlotte Street W1. In addition, we have now agreed to accelerate the development of the White Collar Factory at City Road EC1.

Investment property, net assets and gearing



10.9%
increase in EPRA NAV

Net asset value

EPRA net asset value per share increased to 1,886p per share as at 31 December 2012 from 1,701p a year earlier, an increase of 10.9%. This was largely due to another pronounced rise in value of the property portfolio which showed an increase of 170p per share after allowing for capital expenditure and lease incentives.

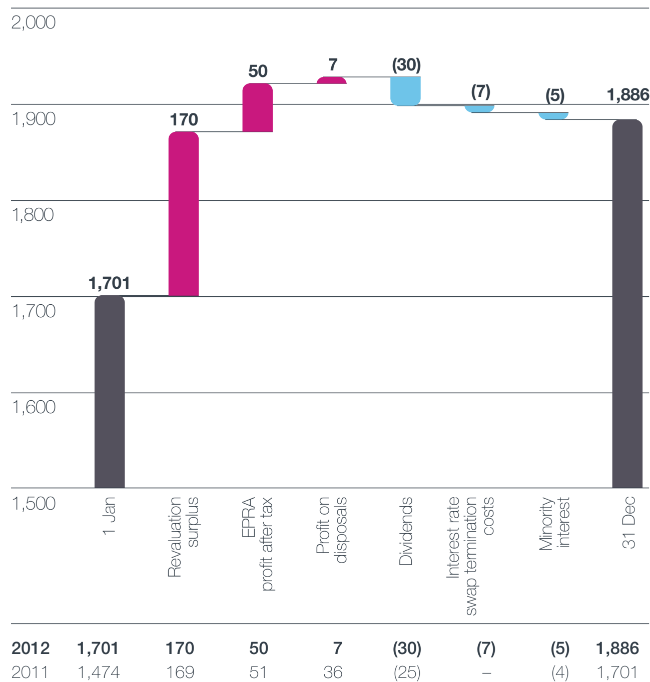
The main components of the rise in NAV per share were as follows:

	2012 p	2011 p
Revaluation surplus	**170**	169
EPRA profit after tax	**50**	51
Dividends paid (net of scrip)	**(30)**	(25)
Profit on disposals	**7**	36
Interest rate swap termination costs	**(7)**	–
Minority interest on revaluation	**(5)**	(4)
	185	227

The Group's net asset value rose to £1.92bn at 31 December 2012 from £1.71bn in 2011 and the value of the property portfolio increased to £2.86bn.

The mark-to-market cost of derivatives rose by 2p per share to 53p, offset by a fall in deferred tax liabilities of 5p as certain historical tax issues were successfully resolved. The fair value of fixed rate liabilities increased by a net 20p per share as medium-term interest rates fell significantly. These combined to bring the Group's EPRA triple net asset value per share to 1,775p at 31 December 2012, an increase of 10.5% over the year.

EPRA net asset value per share p



	1 Jan	Revaluation surplus	EPRA profit after tax	Profit on disposals	Dividends	Interest rate swap termination costs	Minority interest	31 Dec
2012	**1,701**	**170**	**50**	**7**	**(30)**	**(7)**	**(5)**	**1,886**
2011	1,474	169	51	36	(25)	–	(4)	1,701

EPRA net asset value

	2012 £m	per share p	2011 £m	per share p
Net assets	**1,918.0**		1,714.5	
Less minority interest	**(57.6)**		(51.8)	
Net assets attributable to equity shareholders	**1,860.4**	**1,824**	1,662.7	1,636
Adjustment for:				
Deferred tax on revaluation surplus	**4.1**		8.8	
Less share of minority interest	**(0.9)**		(0.6)	
Fair value of derivative financial instruments	**54.3**		51.9	
Less share of minority interest	**(1.8)**		(1.6)	
Fair value adjustment to secured bonds	**17.8**		18.6	
	73.5		77.1	
EPRA adjusted net assets – undiluted	**1,933.9**	**1,896**	1,739.8	1,712
– diluted		**1,886**		1,701

Income statement

Derwent London's development activity increased significantly through 2012. We invested £77.5m in the portfolio and capitalised £4.9m of interest against figures of £41.0m and £2.2m, respectively, in 2011. This rebalancing of activity away from the income-producing part of the portfolio inevitably has an impact upon rental income. However, through strong lettings and asset management together with careful financial planning, we have sought to ensure that earnings are broadly flat year on year.

EPRA recurring profit before tax increased slightly to £52.5m for the year ended 31 December 2012 compared with £52.3m in 2011. The prior year benefited from the write-back of £1.8m of current tax provisions and this is the main reason why EPRA earnings per share fell back a little to 50.4p from 51.6p in 2011.

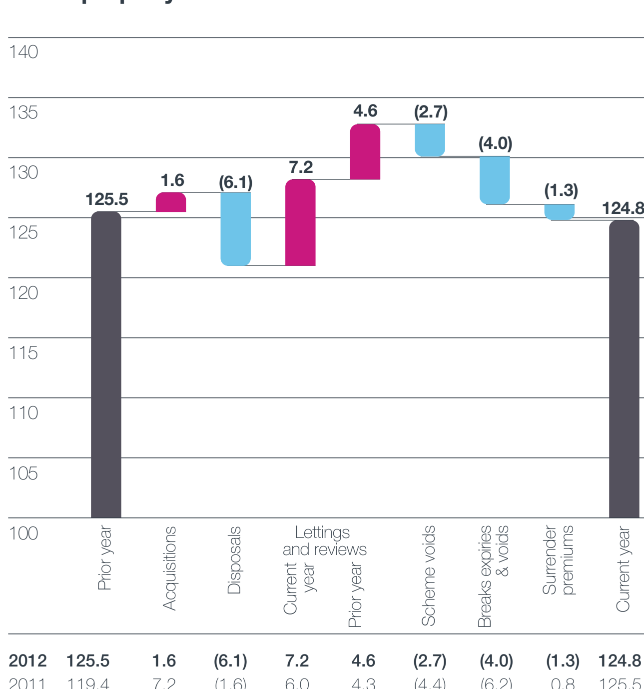
Although we have extended our development programme and recycled capital through property disposals, gross rental income increased slightly during the year by £0.6m to £124.7m. New lettings in 2012 added £3.7m of income in the year while rent reviews, mainly in relation to the settlement of the 2011 review at 8 Fitzroy Street W1, added a further £3.5m. Lettings and reviews from the previous year also contributed £4.6m. Properties acquired in 2012 increased 2012 rent by £1.6m while the loss of income from properties sold was £6.1m. Lease breaks, expiries and voids reduced rent by a further £6.7m. Premiums received from lease surrenders vary from year to year and, on a net basis, were only £0.1m in 2012 against £1.4m in 2011.

Property outgoings overall were £10.3m, a 5.1% increase from the previous year, part of which is due to the higher ground rent paid at 1-5 Grosvenor Place SW1 following the regear. The prior year also benefited from £1.6m of rates credits; in 2012 the recovery of overpaid rates was £0.3m. Surrender premiums paid to tenants fell to £0.2m in 2012 compared to £1.9m in 2011.

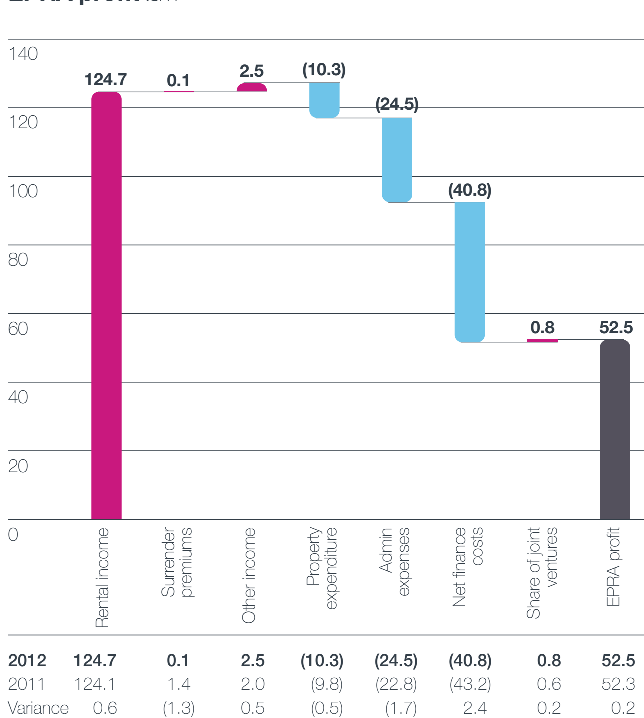
The real progress in rental income levels across the portfolio can be demonstrated by the strong increase in like-for-like property income where the effects of acquisitions, disposals and developments are taken out; EPRA net rental income increased by 8.2% during the year. A full analysis is shown in the table opposite.

Total administrative expenses increased to £25.1m from £22.7m in 2011. Development activity and a greater emphasis on areas such as sustainability have increased headcount again in 2012. If the provision for cash-settled share options is excluded, the underlying increase in administrative expenses was 7.5%, due mainly to increased staff costs. The Group's consistently strong performance over recent years has contributed to an increase in the provision for long-term management incentives of £0.7m compared to 2011.

Net finance costs fell to £40.8m from £43.2m in the prior year due partly to a higher amount capitalised on projects, £4.9m against £2.2m last year. Interest costs have fallen by £2.3m compared to the previous year, offset by an increase of £2.5m in charges for arrangement and non-utilisation fees.



	Prior year	Acquisitions	Disposals	Lettings and reviews: Current year	Lettings and reviews: Prior year	Scheme voids	Breaks expiries & voids	Surrender premiums	Current year
2012	**125.5**	**1.6**	**(6.1)**	**7.2**	**4.6**	**(2.7)**	**(4.0)**	**(1.3)**	**124.8**
2011	119.4	7.2	(1.6)	6.0	4.3	(4.4)	(6.2)	0.8	125.5



	Rental income	Surrender premiums	Other income	Property expenditure	Admin expenses	Net finance costs	Share of joint ventures	EPRA profit
2012	**124.7**	**0.1**	**2.5**	**(10.3)**	**(24.5)**	**(40.8)**	**0.8**	**52.5**
2011	124.1	1.4	2.0	(9.8)	(22.8)	(43.2)	0.6	52.3
Variance	0.6	(1.3)	0.5	(0.5)	(1.7)	2.4	0.2	0.2

EPRA like-for-like net rental income

	Properties owned throughout the year £m	Acquisitions £m	Disposals £m	Development property £m	Total £m
2012					
Rental income	112.3	3.6	1.4	7.4	124.7
Property expenditure	(5.7)	(0.6)	(0.9)	(3.4)	(10.6)
Net rental income	**106.6**	**3.0**	**0.5**	**4.0**	**114.1**
Other[1]	2.6	–	0.1	0.2	2.9
Net property income	**109.2**	**3.0**	**0.6**	**4.2**	**117.0**
2011					
Rental income	105.3	1.7	7.3	9.8	124.1
Property expenditure	(6.8)	(0.4)	(1.6)	(2.1)	(10.9)
Net rental income	**98.5**	**1.3**	**5.7**	**7.7**	**113.2**
Other[1]	1.8	–	0.8	1.9	4.5
Net property income	**100.3**	**1.3**	**6.5**	**9.6**	**117.7**
Increase based on gross rental income	**6.6%**				**0.5%**
Increase based on net rental income	**8.2%**				**0.8%**
Increase based on net property income	**8.9%**				**(0.6)%**

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

The overall profit before taxation for the year was £228.1m, only marginally lower than the equivalent figure of £233.0m in 2011. Overall revaluation gains in 2012 were £175.3m, of which £174.4m passed through the income statement and property disposals, principally of Riverwalk House SW1 and half of 1-5 Grosvenor Place SW1, also yielded a profit of £6.9m. The profit on disposal of investment of £3.9m related to the realisation of exchange gains on the liquidation of our last remaining US subsidiary. The company had been inactive for several years and, as an equal and opposite amount passed through the statement of comprehensive income, this has no impact upon EPRA net asset value or recurring earnings.

In addition to the previously reported £6.3m cost of breaking £130m of interest rate swaps in January 2012, a further £0.6m of breakage costs were incurred in August when the other £65m swap associated with the old £375m loan facility was also closed out. The original loan and swap expiry dates were all in March 2013. The cost of "fair valuing" our other interest rate swaps was £2.4m for the year.

8.2%

increase in EPRA like-for-like net rental income

Taxation

As a REIT, we do not generally pay corporation tax as much of our business activity is tax-exempt. However, part of the business, principally the unelected share in our joint venture with the Portman Estate, is outside the REIT; the 2012 tax charge relating to this non-REIT part of the business was £0.8m, comprising a tax charge of £0.6m and a prior year tax charge of £0.2m. Following successful discussions with HMRC bringing much of our Scottish land holdings within the REIT structure, we have been able to write back £4.4m of the Group's deferred tax liability during the year. In addition, an increase in available tax losses enabled a further £1.3m to be released. The rate of UK corporation tax falls again to 23% on 1 April 2013 reducing our year end deferred tax balance by £0.4m, though this has been offset by the increased deferred tax liability on the year's revaluation gains.

FINANCE REVIEW
CONTINUED

Debt facilities

	£m	December 2012 £m	Maturity
6.5% secured bonds		175	March 2026
3.99% secured loan		83	October 2024
2.75% unsecured convertible bonds		175	July 2016
Overdraft		2.5	On demand
Committed bank facilities			
Term	28		June 2018
Term/revolving credit	90		December 2017
Revolving credit	150		January 2017
Revolving credit	150		January 2017
Revolving credit	125		November 2015
Revolving credit	100		April 2015
Term/revolving credit	125		April 2014
		768	
Total debt facilities		**1,203.5**	

All facilities are secured unless noted otherwise

Financing

By the start of 2012, we had already refinanced the majority of the bank facilities falling due for repayment in 2013. As noted in last year's report, this had been accomplished with the issue of £175m of convertible bonds and £425m of new or enlarged revolving credit facilities signed with relationship lenders. During the year, we have completed the remaining refinancing requirement while also continuing with our strategic aims of diversifying sources of debt, lengthening average debt maturities and managing the cost and risk profile associated with our debt facilities.

In January 2012, the new bank facilities documented in December 2011 were drawn. These consisted of a £150m fully revolving five-year facility provided equally by RBS and Barclays and a new £150m fully revolving five-year facility provided by Lloyds Bank to replace and extend their existing £100m bilateral facility.

In January 2012, we also broke two interest rate swaps with a principal amount of £130m and a weighted average rate of about 5.0% which were due to expire in March 2013. The cost of breaking these swaps was £6.3m, a small discount to the additional interest charge that we would have incurred through the remaining life of the swaps. At the same time, we swapped a total of £70m to April 2019 at just under 2.0%.

Following the repayment in January 2012 of the last loan notes associated with the London Merchant Securities PLC ("LMS") transaction, the £32.5m unsecured "loan note" facility due to expire in June 2012 was also cancelled. In addition, the Group's overdraft facility was reduced to £2.5m from £10.0m in July 2012.

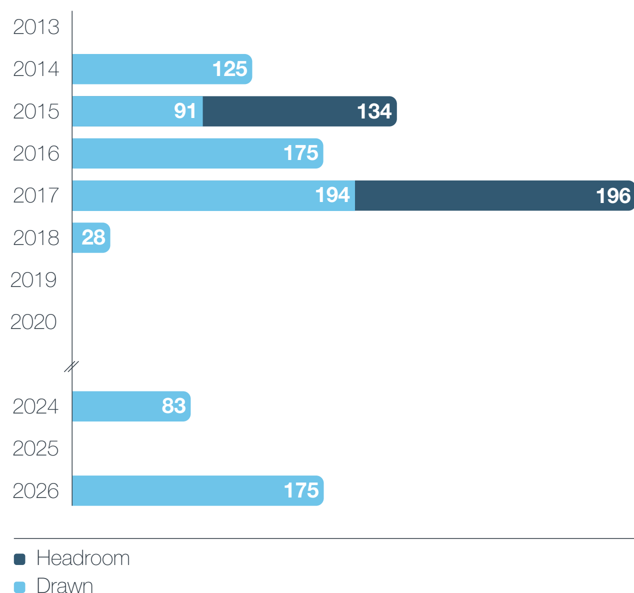
Proportion of non-bank debt

50%

"With low levels of leverage, good interest cover and sufficient headroom under our facilities, the Group is in robust financial shape."

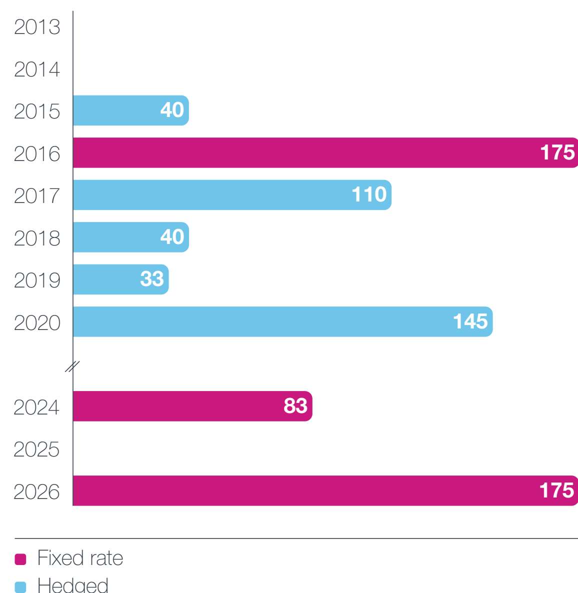
Damian Wisniewski
Finance Director

Maturity profile of loan facilities
As at 31 December 2012[1] £m



[1] Excludes £2.5m overdraft facility

Maturity profile of fixed and hedged debt
As at 31 December 2012 £m



Refinancing of the 2013 debt maturities was completed in August with a new £83m fixed rate loan from Cornerstone, part of the Mass Mutual Financial Group. The new loan was the first transaction entered into by Cornerstone in the UK. It is fixed at 3.99% until October 2024, 210 basis points above the reference gilt, and is secured on two properties in Fitzrovia. The initial loan-to-value (LTV) ratio was 48.3%, the LTV covenant is set at 70% and there is no amortisation to expiry. At the same time, the remaining £95m of drawn debt from the £375m facility arranged by LMS in 2006 was prepaid and the residual £150m facility was cancelled. A termination cost of £0.6m was incurred on a £65m interest rate swap running to March 2013 leaving a forward start swap of £65m at just under 2.0% from March 2013 to April 2019. Overall, these actions reduced the level of swaps at the balance sheet date by £125m compared to a year earlier, while the amount of fixed rate debt increased by £83m. This overall reduction of £42m moved the proportion at fixed rates or swapped to 92% from 98% at the end of 2011 and provided a weighted average cost of debt of 4.88% on an IFRS basis, or 4.63% using the cash cost of the convertible bonds. This is slightly lower than a year earlier when it was 4.91% and 4.65%, respectively. With the high cost of breaking swaps, the proportion at fixed rates continues to be slightly higher than our target range of 60% to 85%.

Available undrawn facilities totalled £333m at 31 December 2012 in addition to which there was £624m of uncharged property. The equivalent figures at 31 December 2011 were £469m and £589m respectively.

Maturity profiles of financing facilities and interest rate hedges as at 31 December 2012 are provided above. The Group's new long-dated loan has increased the weighted average length of unexpired debt to 6.1 years at 31 December 2012 compared to 5.3 years in 2011.

Weighted average length of unexpired debt

6.1 years

FINANCE REVIEW
CONTINUED

Net debt

	2012 £m	2011 £m
Cash	(4.4)	(3.5)
Bank overdraft	–	–
Revolving bank facilities	437.5	477.0
Secured loan	83.0	–
Unsecured loan	–	31.4
Loan notes	–	1.1
Secured bonds 2026	175.0	175.0
Fair value and issue costs	16.4	17.2
Unsecured convertible bonds 2016	175.0	175.0
Issue costs, equity component and unwinding of discount	(10.0)	(12.6)
Leasehold liabilities	8.9	7.4
Bank loan arrangement costs	(6.6)	(3.5)
Net debt	**874.8**	864.5

Net debt and cash flow

Notwithstanding further significant investment in the pipeline and £101.5m of new properties acquired in the year, property disposals ensured that net debt only increased by £10.3m during the year to £874.8m. The principal properties disposed of were Riverwalk House, 232-242 Vauxhall Bridge Road SW1, the Triangle Centre in Scotland and a half share in 1-5 Grosvenor Place SW1, which together provided a cash inflow of £161.0m after costs.

Combined with this small increase in debt, the strong rise in property values meant that the Group's overall LTV ratio fell to 30.0% from 32.0% in 2011. NAV gearing fell correspondingly from 50.4% to 45.6%. We focus more on interest cover than absolute levels of leverage and are pleased to report that gross interest cover rose to 351% for the year compared to 307% in 2011. Net interest cover, after property and administrative expenses and treating interest capitalised as an expense, increased to 223% in 2012 from 214% in the previous year.

Dividend

Our approach is to manage dividend distribution in a way that maintains sufficient dividend cover out of recurring earnings but which also reflects a progressive and sustainable level of growth for our shareholders. The Board has been able to recommend an 8.4% increase in the proposed final dividend to 23.75p per share of which 18.75p will be paid as a PID with the balance of 5.00p as a conventional dividend. This will bring the total dividend for the year to 33.70p per share, an increase of 2.35p or 7.5% over 2011. A scrip dividend alternative will continue to be offered.

Interest cover ratio

351%

Gearing and interest cover ratio

	2012 %	2011 %
NAV gearing	**45.6**	50.4
Loan-to-value ratio	**30.0**	32.0
Interest cover ratio	**351**	307

Debt summary

	2012 £m	2011 £m
Bank loans		
Floating rate	**69.5**	15.4
Swapped	**368.0**	493.0
	437.5	508.4
Non-bank debt		
Floating rate loan notes	**–**	1.1
Fixed rate secured loan	**83.0**	–
Fixed rate secured bonds 2026	**175.0**	175.0
Fixed rate unsecured bonds 2016	**175.0**	175.0
	433.0	351.1
Total	**870.5**	859.5
Hedging profile (%)		
Fixed	**50**	41
Swaps	**42**	57
	92	98
Weighted average cost of debt (%)[1]	**4.63**	4.65
Weighted average cost of debt (%)[2]	**4.88**	4.91
Weighted average maturity of facilities (years)	**5.4**	4.4
Weighted average maturity of borrowings (years)	**6.1**	5.3
Weighted average maturity of swaps (years)	**5.8**	5.0
Available headroom	**333**	469
Uncharged properties	**624**	589

[1] Convertible bonds at 2.75%
[2] Convertible bonds on IFRS basis

"Our approach is to manage dividend distribution in a way that maintains sufficient dividend cover out of recurring earnings but which also reflects a progressive and sustainable level of growth for our shareholders."

Damian Wisniewski
Finance Director