Development Securities half-year 2014 results

Interview with Michael Marx, CE0, and Marcus Shepherd, FD

Overview and highlights

Q: what would you pick out as the highlights of the first six months of the year?

A: The highlight to me was the results, the pre-exceptional pretax profit that we recorded of £18 million, more than double the £8 million for the previous comparable period last year was, to me, a more than respectable highlight. Underpinning that, also good performance in all the three main parts of our business, the development part, the trading portfolio and the investment portfolio, all contributing strongly, which is for the first time in the cycle that we've seen that contribution and something that we expect to continue. Secondly, I would say a highlight was definitely the acquisition of the Cathedral Group in May this year, that brought a range of qualities and strengths to our Group that will only redouble our performance going forward. It's brought us a critical mass and ability to run more schemes, five to six million square feet, and possibly more than that in the future, on top of a balance sheet that we have already, provides us with a depth and range of ability to produce further development that we perhaps haven't had previously.

I would say also that our strengthening of our position in Dublin also was a highlight for the period, and noticeably, we are making inroads into development projects and investment projects with local partners, and that's a very encouraging sign, given the strength of the Dublin market.

Q: And Marcus, what else would you say about the financial performance?

A: I suppose the most important thing to me is it really underlies the strategy that we've been taking for the last couple of years. So we've sought to invest in a wide variety of scheme that will deliver trading and development gains on an annualised basis, and that's what we're seeing. So the key underpinning element of the results for the period was the £18.2 million of trading and development gains, alongside, of course, we're starting to see an improvement in the valuation of our investment portfolio.

So when you put those two together, we're actually starting to see the company moving forward in a very positive way.

Q: And you've also reduced your overall finance costs.

A: Yes, that's right. We've taken the opportunity to realign some of our financing to put it more in line with the way the market currently is. We had some long-dated euro-denominated loan notes, which were very inflexible for our business, and the hedging strategy has also proven volatile on our balance sheet and our cash flow. So we took advantage of the situation in the current markets to realign that. We've reduced the terms slightly, but we've also significantly reduced the cost to us.

Q: And you're happy with the shape of the balance sheet now?

A: Yes, we are. We've got a small piece of housekeeping to do in the next couple of years as existing facilities mature, but on the whole, we're very happy with the way the financing worked.

Q: And so overall, Michael, business results were in line with your expectations.

A: It was absolutely in line with the expectations, and I think well down the road to meeting the expectations we have for the balance of this financial year. Underneath the performance which is visible was also the performance which isn't visible, which is the recycling of cash, the engaging of more deals, winning of more deals, which is enabling us to raise the horizons now through our pipeline of guidance that we're giving going forward into future years. So that's the unseen element, which we're trying to guide the market as we can, on top of the actual reporting performance which we've seen at the moment.

Operating highlights

Q: There has been a lot of activity in the period with a large number of disposals and acquisitions, particularly in the investment portfolio, so what's the reasoning behind this?

A: The rationale is quite simple, really. Whenever we buy an investment property, we have an asset management plan for it, and the idea is that we follow through that business plan, and once we see that there's going to be no further growth in that asset, then we need to dispose of it and basically reinvest the proceeds again, so we took the opportunity earlier in this year to dispose a number of assets where we thought we'd extracted the most value we could, and hence we started to reinvest that equity again, so you can see the Chippenham and also in Armagh, so that's just that process ongoing with reinvesting where we see value and hopefully creating higher income streams.

Q: And, Michael, where are you focusing your investment now, and are you still finding good buying opportunities?

A: We are still finding good buying opportunities. In terms of trade for us, the ability to buy and the ability to sell, as good as they were, maybe even strengthening somewhat, is the invest for the exit markets for our product strengthens. The area, the geographic area, very much where it has been for the last two to three years, emphasis on Greater London and the Southeast, avoiding possibly the hot markets in Central London, where we feel less comfortable and where the lot sizes are large. So our diversification into smaller projects, £100m, £150m-type projects, mixed-use schemes, Greater London and the Southeast, which after all is the area which is now seeing considerable economic growth, GDP growth in the UK. Pushing strongly now in those areas, population growth as well, of course. So all in all, that's the area where we are contributing most of our outgoing cash flow into projects.

Dublin, an area, second area for us, which we've identified as an area of opportunity, perhaps where we have what I think I could describe as first-mover advantage. We've been there for several years now. The market is strengthening considerably, and we've been able, together with local partners of considerable reputation and expertise, to secure some very good development and trading projects.

Q: So we can expect you to do a lot more in Dublin.

A: I think we can. I think we will see us recycling in all of the markets, perhaps with something like 20 million Euro of investment already made, equity investments by the Company into Dublin, we might see us now start to turn some of that over and recycle cash before we dramatically increase our exposure above that number.

Q: And so what does the Cathedral portfolio bring to the Group? What can we expect from this?

A: I think more of the same. Cathedral take us into another slightly different area of expertise, public-private partnerships, which is a working relationship with local authorities, whereby we assist local authorities in bringing social and housing benefits such as libraries, theatres, as well as affordable housing, to their towns and to their cities, and giving us the opportunity to make a development gain on private residential student housing and so on. And so Cathedral brings us that expertise to amplify what we are already doing and improving in certain areas the expertise that we have.

A: With the acquisition of Cathedral Group, we've now got a residential skill set that we didn't have before. So because the majority of our schemes have a residential component to them, we've now got greater optionality about how we exploit that. In the past, we've on the whole tended to monetize a position on land as soon as we've got planning permission by selling on to a house builder.

Now, with that additional skill set, we've got a greater range of options. We can either continue as we have in the past in terms of selling on both consented positions, or we can seek to bring in external funding, or alternatively, we can do a certain element of build out ourselves, subject to the impact on our balance sheet, of course. So as I say, we've got greater optionality here about how we can monetize those positions and create greater value for us as a Group.

Q: And turning back to offices Michael, what update can you give us on the development pipeline?

A: It's going well. It's going well. The successful conclusion at the first half of our Hammersmith scheme on the edge of the centre of London, fully let, fully forward funded with Scottish Widows, so much so that Scottish Widows has now forward funded the second building, which is a larger 170,000-square-foot building. It's all together a 300,000-square-foot office development there. Demand good, rents at record levels and yields at close to record lesson, all going very well, because of course the strength of the Central London demand filtering out to the regions as what I describe as rent refugees from Central London moving into fringe Central London areas.

In addition to that, we've acquired a site in Southwark which could see the development of some 200,000 square feet mixed-use scheme, which will include a significant office element to that. That planning for that is underway. Discussion with joint venture partners is underway to secure that, and the entire site that we will need.

We acquired also a building, 150,000-square-foot building on the South Bank, Waterloo, with magnificent views over Houses of Parliament and the West End, and that's a wonderful investment property which we hold at the moment. That has significant redevelopment potential in the medium term. I won't suggest that's a short-term redevelopment potential, but a location like that, giving value like that, with rental income flow, as well, gives the developer all the optionality he needs.

I would say further that the reputation and skill we have to forward fund to work with institutions to shelter risk from a developer, we are carrying now into the Dublin market. So our reputation precedes us, and we're already working on monetary schemes there. Burlington House we've already secured with local partners, so significant developments in Dublin, as well, but operating in the true Development Securities method of forwarding funding with institutional money so that we minimize the impact of risk in the short term.

Outlook

Q: Marcus has already attributed the strong performance to your strategy, so we shouldn't expect any major changes here?

A: No, I don't think so. I think the strategy is vindicating itself. The results that we've seen for the last six months, and indeed, even the year or two before that,

are beginning to show the trends, the last six months definitely strengthening the vindication for the strategy. Diversification, minimizing specific risk into areas of the economy where we're seeing strong GDP growth -- very strong GDP growth, Greater London and the Southeast of England. Acquisition of the Cathedral Group pushing us further into those exact geographic areas with exact same products, emphasizing more residential and student accommodations, those are the aspects of the strategy that reflect themselves in the results and reflect themselves, I believe, in the guidance that we're giving for the years to come.

Q: And, Marcus, talk us through the immediate focus for the remainder of the year.

A: The immediate focus is pretty much more of the same, so it's continuing to deliver on the business plans for all the individual projects that we have. We know we've got a certain number we have to realise over the next six, 12, 18, 24 months, and we just continue working those through. So with those elements where we're seeking planning permission or those where we need to finalise the asset management plans, it's just delivering on those and delivering on value as a result.

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