Great Portland Estate, Annual Results 2016/17

Interview with Toby Courtauld, CEO, and Nick Sanderson, FD

Q: Toby, how would you characterise these full year results, and the relative performance of the business?

A: I would characterise them in two ways. Firstly, we saw a reduction in valuation by 4.9%, which pushed the NAV down a little bit, and driven by slight rental declines and slight increases in yields. But on the other hand, we produced a very strong operational performance throughout the 12 months, some great leasing, circa £26 million of revenue since last spring, and if you look at the numbers today, we have some good lettings under offer. We've beaten our ERVs, which is always pleasing. We've made some great sales. We've been a net seller now for four years, and we delivered circa £650 million of net sales. And one of the principal consequences of that is that we've put the gearing down at an all-time low at 12.2%, giving us great capacity for future expansion, so those are the two key characterisations.

Now, the one thing I would say about the relative performance, we have underperformed against IPD for the year, and what's happening there is we have been getting out of the portfolio assets with long income, holding onto the assets that we want to develop in the next cycle, and they by necessity have shorter income streams. And shorter income streams have been hit in valuation terms as risk has risen in the broader market and that's why we've slightly underperformed this period. But as a consequence, we own assets that will deliver we think great longer-term growth into the next cycle.

And if you look at the last few cycles for us, it's exactly that sort of asset that's delivered great growth. And if you look at the last cycle of development, £450 million worth of surplus from 17 schemes at an average of 38% profit on cost. So it's worth owning that stock for the long term, even if in the short term you see some valuation decline.

Q: And, Nick, when you look at the financial performance, how resilient then would you say this performance has been?

A: Well, I think picking up on Toby's point about the strong operational performance, I think that has absolutely demonstrated the resilience not just only of the business but of the portfolio, and we've absolutely seen that feed through into the financial results this year.

Clearly, our very strong leasing momentum has seen a significant uptick in our rent roll, up 13% in the year, to a record £110 million at year end. This was one of the contributors to the strong uplift in EPRA EPS per share, up 28% over the course of the year, which has allowed us to increase the rate of dividend growth.

The final dividend is up by more than 14%, taking the full-year dividend up to just under 10%. I think when you then overlay the recycling successes that we've had and our continued capital discipline, shareholder returns have been further enhanced with the special dividend of 32.2p per share, or £110 million in total, which will be paid through to shareholders next week.

And then when you overlay on top of that our recent financing successes, we have the strongest ever financial position with our LTV at a record low 12.2%. We have more than £600 million worth of liquidity and available firepower, and so I say the results show, A, there's lots of resilience to the business, but equally there's plenty of optionality and growth for us to aim for.

Q: Yet, Toby, we have seen rental value declines, as you've said, in some of the areas that you've operated. Is this solely a Brexit effect?

A: No, I don't think it is solely a Brexit effect, although I do think Brexit is relevant. We have seen the economy slowing. It was slowing before Brexit came about. We've also seen significant rental growth over the last - well, since the trough in 2010, we've had compound rental growth well into double digits per annum. So you've seen lots and lots of growth, and I think what's happening is as it always happens, you get towards the back end of the cycle, the economy slows, demand for space slows, you get a bit of a pickup in the supply of space, and that has happened this time, although it's still very low in terms of supply. And that feeds through to rents turning from growing to declining.

As we look into the next few years, I think it's going to be very interesting to see where the market travels from here, because one of the absolutely key characteristics of the Central London office market today, particularly the West End, where three-quarters of our assets sit, is that there is very little supply. There's about 1.6 million feet in total over the next five years of new supply we think, coming on-stream in the West End, and that's roughly 0.6% per annum, which is really nothing on top of vacancy rates that are still in the low single digits at the moment.

So in that context, actually, I think the supply side feels relatively robust, but as I say, we do need demand to continue if rents are going to not fall, and at the moment, there is a degree of uncertainty around there in the markets, not surprisingly, particularly given the uncertainty around Brexit.

Q: So have we seen the peak in the property cycle, and if so, how will the business respond?

A: We've clearly gone through the peak in valuation terms and arguably in rental terms, as well. So I'm afraid we are in for a short-term period of declining valuations, we think. But we've known this for a while. We've prepared for this a number of years ago, and indeed, we turned net seller of assets all the way back in 2014, you'll remember. And this year, as I said earlier, was a record net sales period for us, which is why gearing is as low as it is, and it's why we've also largely completed our development programme for the cycle that's just finished. We still have the back end of three schemes to finish, having delivered 17 in all over this period.

And we begin now instead to turn our attention to the next cycle and the next 14 or so projects that we already have in our pipeline for development, which is an exceptional place to be. 43% of our portfolio is pipeline product for the next cycle. That's as high as it has ever been, so when you ask about preparing, that's how we're preparing.

Disposals and acquisitions

Q: So, Nick, net sellers of assets. Can you run through some of the net sales and what the prospects are from here over the next couple of years?

A: Sure. Toby touched on the fact that we have now, for four consecutive years, been a net seller, and this year was a record year with regard to sales, more than £727 million worth of sales, typically selling off high capital values and very low day-one running yields. The bulk of the sales in the year were made up of two large forward sales of fully pre-let development schemes, raising more than £650 million worth of proceeds, selling at elevated pricing and crucially crystallising very significant development surpluses for shareholders.

The first sale we made of scale was at the back end of last year where we sold 73 to 89 Oxford Street. It was a pre-let retail-led scheme down at the eastern end of Oxford Street. We sold off a very high capital value per square foot, north of £3,000. Sold it off a low prospective running yield of only 3.2% in total, or sub-3% if one looks just at the retail element. And crucially, we monetised a 74% whole-life profit on cost for shareholders, or just under £120 million.

More recently, at the beginning of this year, we sold our largest-ever development scheme, Rathbone Square. Again, the offices, fully pre-let to Facebook. The private residential units, 142, 140 already presold, and the sale to Deka in February monetised a £110 million for shareholders, which we're in the process of returning to them through the special dividend. From here, will there be more sales? Yes, I think there will be, but I think we should expect the rate of sales and the volume of sales to slow from here.

Crucially, we're always looking out for prospective opportunities to add to the existing book of assets. We made £71 million worth of acquisitions this year, both in the West End and one of them adding to the longer-term pipeline of future opportunity.

Q: So Toby you are talking about moving into the acquisition phase. So what should we expect then in the current climate?

A: Well, I think more of what we have delivered over the last two cycles, essentially. We do need pricing for the sorts of assets we want to buy to come off a little bit, to make them attractive enough for us to feel that they are going to be an accretive addition to our existing business, and that's always a key measure. So we're often looking at the opportunity cost of every pound of capital, as to whether it should go into the existing portfolio for development, say, or into the market to acquire new opportunities.

Robin Matthews recently joined the team as our Investment Director. He's in the market a lot right now looking for opportunities where we can find value, and I think we will find value. It's not going to be easy. By the way, it never is easy to buy well in London, but we have definitely turned from being a net seller to being more balanced and possibly a net buyer over the next 12 months.

Focus in Central London. We won't diversify beyond Central London. It's what we know best, and we'll be looking for raw material that we can add to our pipeline with some income growth and some opportunity to redevelop and refurbish, the usual story still very much applying.

Portfolio Management

Q: And, Nick, you secured some pretty good lettings at some pretty good levels. Can you just run through these and the prospects from here?

A: Yeah, it's been a very strong leasing year, on the one hand, securing new tenants into our recently completed development space, but also capturing the significant reversion that sits within the investment portfolio. On the new letting side, at 52 new lettings over the course of the year, pleasingly, the run rate increasing in the second half against the first half, securing more than £20 million worth of rents, on average, just under 1% ahead of ERV.

And within those lettings, we had nine development lettings, securing more than £8 million worth of rent, all of them on 10-year term certains to strong covenants, clearly attractive as we look forward from here.

In terms of capturing reversion within the investment portfolio, we had a record year with regards to rent reviews, 32 settlements in the year, just under £13 million worth of rent, and crucially at a 45% premium to the previous passing rents and also a 2%-plus premium to ERV.

In terms of where next, well, we've had a very strong start to this financial year. We've already secured £5 million of new lettings with a further £6.9 million under offer, together, more than 2% ahead of ERV. And crucially, as we look to the long term, I touched on earlier our record rent roll of £110 million. There is the potential to grow that by a further 54%, if we overlay completion and lease-up of our committed and near-term development programme, and then crucially, the opportunity to capture the 21% reversionary potential that sits within the investment portfolio.

And don't forget, our average office rent today is still only £50 per square foot, and 85% of the portfolio sits within walking distance of a Crossrail station, and as the opening of Crossrail comes nearer every day, the opportunity for further growth we think goes up rather than down.

Q: And, Toby, can you talk to me about how you're meeting clients' needs and the kinds of spaces that you're delivering for them?

A: Well, actually, I think Nick's just nailed it. Crossrail has been such a dominant story in London for at least a decade now, and our experience and the leasing successes we've had, have really been driven by two or three key components. One of them has been location, and I don't mean London versus Birmingham or Manchester. I mean micro-locations within London, so right on top of Crossrail, right next to important interchanges, be they tubes or mainline stations, and if you look at the success of things like Rathbone Square, 50 yards from Crossrail clearly mattered to Facebook. It was clearly important to them to have that node of transport right on their front door, so that's key.

I think the other things that we have really focused on, and we will always focus on, are the efficiency of the space, how it lays out, how it's going to work for businesses. Can they put more people into that net area than they could if it was inefficient and therefore lower their overall costs? What's the micro-location around them like that we create partly and that others are creating for us? And the West End has such an enduring appeal as a location that people want to be in, because it's so vibrant. There's so much going on here, and it has become a real magnet for people from all over the world to come and work in.

And if we can find the right layout of building in the right micro-location near important nodes of transport, you'll always be able to let very well. And our most recent example is in Broadwick Street, where we have just set new records for rent in that street - in fact, in Soho ever, by leasing a building that was once upon a time in the heart of the media industry, and some of the tenants moving in there are financial services occupiers. Why? The building's well laid out. It's well designed, and the micro-location works for their people. Answer is a good one.

Developments and Risks

Q: Can you expand a little more about your development pipeline and what it looks like today.

A: So it's focused unashamedly, as I've just been talking, around nodes of transport. Every single one of the 14 projects we have, 1.6 million square feet thereabouts, is within a five-minute walk of a tube station, Crossrail station, or a mainline station and that's crucial. It's a key part of our strategy, as I say. It's spread around Central London. It's not just West End. It's roughly 50% West End. The balance is on the South Bank, in Midtown, and in the City.

And it's spread from next year, early next year, through to 2023, 2024, and we'll have to see how the cycle unfolds as to which of the schemes we choose to start when. But as I said at the beginning, if you add it all up, it's broadly 43% of our existing business, and it's never been higher as a proportion. I expect us to add to it.

Today, we have £50 million of acquisitions under offer, which would go into our development programme, and I expect to add further as new opportunities are uncovered by us over the next 12, 24 months or so.

Q: What is the corporate risk appetite today?

A: Well, really, there are two key risks that we run within the business, operational risk and financial risk. Our operational risk predominantly focuses on our development activities, and as Toby has touched upon, we've seen a dramatic reduction in the amount of on-site risk that we have today. We have three schemes on-site today. They're all due to complete within the next nine months. They're already 65% presold, and crucially, there's circa £45 million of CapEx still to be invested.

To put that in context, over the last 12 months, we invested £250 million into development programmes. So you can see that our operational risk within the development programme has moved down significantly. The other risk, financial risk, has equally down significantly, and at 12.2% LTV, it's the lowest we've had since 1974. So we've done our derisking.

And I think as we look forward from here, we're very mindful to various PMI indicators that are out there. We look at various CFO surveys. We participate in those CFO surveys, and what we are seeing is that across UK PLC, risk appetite is certainly a long way below where it was two or three years ago, and I think that's exactly the same within GPE, particularly when you overlay on the fact that we are in a very cyclical market, and we're in a market where still pricing is relatively elevated in both the investment market and also the rental market.

So I think you should expect to see us to be reasonably patient until we lift up from here significantly our risk, but we're absolutely not sitting on our hands. We're busy preparing the development pipeline, which Toby touched on. The leasing guys and the portfolio management team are busy capturing the reversion, and equally, we've been busy on the financing side, So as well as giving some money back to shareholders through the special dividend we've been refinancing some of our debt book, locking in low interest rates, and most recently, we raised £175 million of seven-year money in the US private placement market at a fixed-rate coupon of only 2.15%.

As a result of that, our weighted average interest rate across the debt book is down to only 2.7%. We have increased our weighted average debt maturity to 6.4 years, so we've got great firepower, such that when we do want to increase our level of risk within the business, we can move very quickly to do so.

Q: You both mentioned debt at being at historic levels. Will it stay that way?

A: We've been very clear to the market. One of the key messages with GPE is that we will always run with relatively low financial leverage. However, we will flex that leverage depending on where we are in the cycle, and our tolerance range is from 10% to 40%. At the moment, we're at the bottom end of that. That feels absolutely the right place to be, given the market uncertainty, given the position in the cycle and given the elevated pricing that we touched upon, but crucially, it also gives us very significant capacity should new opportunities emerge. I think in the near term, unless we see a major correction in pricing, I don't see leverage moving up very significantly in the near term, because we will need pricing to come down for us to get very aggressively on the front foot with regards to acquisitions.

Equally, you should absolutely remember that one of the core principles of our business is maintaining capital allocation and balance sheet discipline, and if we did find ourselves over the course of the next 12 to 18 months being in a position where we felt that we were over-equitised, we would equally consider giving back further capital to shareholders, as we are doing at the moment. But as we sit here today, the balance sheet position feels just right.

Outlook

Q: So, Toby, how do you view the shape of the business and the overall outlook?

A: I think the shape is very good. As we've been talking about this afternoon, we've got plenty to be getting on with to prepare for the next cycle of opportunity. I think we've played this lead up to the correction in the cycle relatively well. We've been reducing risk appropriately. Our net sales campaign has been very successful.

We have got some growth to capture in the next couple of years, whatever happens, so the 21% reversion that we have, we're getting on and grabbing that as quickly as we possibly can, and there's more to do there. 69% is available by March 19. So we really need to get on and grab that as fast as possible, and our average rents are still low enough, £50 on average across the business in offices, to tell you that we've got good defensive characteristics there. So there's the reversion to capture.

The pipeline preparation, if you were to stand in and amongst the development team today, you'd really sense a lot of energy going into that part of the business, where lots of people are examining options and thinking about the best way of turning raw material into future valuable development prospects. So there's a huge amount of work there.

As I say, we're turning from net sellers to more balanced, possibly net buyers, so there's a lot of work going on looking at where we want to be acquiring and what sort of opportunities we can uncover. So in all facets of the Group, development, investment and asset management, there's a lot going on, but we do all of that from a position of extraordinary, unprecedented financial strength. And I think that gives us confidence.

The last point I would make is we have refreshed the team over the last 12 to 18 months or so. We've got a great gang of young, energetic, enthusiastic, and above all, talented individuals who are all coming together to create this opportunity for the next few years. And that makes it a very exciting place to be. So my outlook, I think our outlook, is a very positive one.

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