Great Portland Estates

Preliminary results 2016

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

Full Year Results 2016

Q: Toby, how did the year play out for you?

TC: It played out very well. We have a set of very strong numbers. Across the board, we've delivered some great returns for shareholders, at the portfolio valuation level we're up 14.7 per cent. An exceptional performance by our development book, up 26-and-a-bit per cent. Which feeds all the way down to NAV growth of north of 19 per cent. Which is, for five or six years now, it's been an exceptionally strong period. I think really pleasingly, we've made progress across all of the main areas of our activity. Leasing we've had another record year, we did £31-and-a-bit million worth of leasing. Crucially, we were bang on with our estimate for ERV growth for the year. We estimated 10 per cent, we delivered 9.9 per cent. So the numbers are very strong.

Financial shape for the group, as good as ever. Gearing is the lowest it's ever been. So we've got plenty of capacity for expansion over the next few years, if conditions allow. I think the last thing I would say about the year is we have structured the team by bringing in some new talent, which is very exciting. We've strengthened the Exec Com as part of that process. So we've had a very busy and successful year.

Q: Nick, strong numbers, can you just run through the financial performance?

NS: Sure, I agree, completely strong numbers. Continued growth in all of our key financial metrics meaning that we more than met market expectations. Our key financial metric, NAV per share, was up by 19.5 per cent. Earnings up by just over six per cent. Importantly, we continued to grow the dividend. As we look forward from here, touching on Toby's comment earlier, our financial position has never been stronger. LTV is a record low 17.4 per cent and we have plentiful liquidity north of £470 million. Meaning that we can more than deliver on our existing business plans and any other opportunities that may emerge.

Q: Toby, what should we conclude about the half-year performance? Are you seeing a slowdown in demand in office and retail in the areas in which you operate?

TC: Interestingly, we have seen a slowdown in some of the figures. So if you look at the difference between the first half and the second-half performance at an asset level, valuations were clearly slower in the second half than they were the first. But if you look at the leasing market today, the under-offer space in the market overall is pretty similar to where it was this time last year. So I think we will see a slowdown, I think it stands to reason with some of the uncertainties in the market at the moment, that we do see an element of slowdown.

But overall at the moment, we're not feeling it. Our leasing traction is as strong as it has been all year and I expect us to do more pre-lettings over the next few months.

If you were to say 12 months hence, what will have happened to our rental growth across the group then I think we are forecasting a lower rate for this coming year than for the last. Where it was 10 per cent last year, we're forecasting around five for the year to come. But I think that's as a result of general macro uncertainties as much as anything.

Q: Nick, what about yields? Are you likely to see yield expansion from here on in?

NS: Well yields across the West End and the City are now at record lows. Our view is that they have probably bottomed. But for the short term, barring Brexit, we see them trending flat. Reason being the weight of capital looking to invest in Central London remains at very elevated levels, there's circa £34 billion of equity ready to invest within the Central London market. There's clearly a global search for yield and with UK interest rates remaining on the floor, the real yield gap remains above the long-run average.

As Toby's touched upon, we think there's more rental growth to come. However, probably a year from now, we think there may have been some modest yield expansion at the prime level, as that rental growth is consumed. With likely a larger risk around more secondary properties where pricing has run ahead of the growth prospects on offer.

Brexit

Q: Toby, when you look at the possible outcomes of the UK's EU referendum in June, what outcome unnerves you the most?

TC: Well I'm not going to give a view as to which I would personally prefer or frankly what the group might prefer. I think that the outcome we would least like is the uncertainty of lack of clarity. I think we as business people like certainty, we like to know where we sit and we like, crucially, our businesses, the customers that we work with, to have a sense of where they're going. The uncertainty is an issue because it might put investment programmes on hold, it might mean that businesses that were previously thinking about hiring people and expanding, stop doing so. It's them that we need to be growing to allow us in turn to grow.

When we look at the GDP forecast at the moment, London continues to deliver some fairly handsome growth. Certainly ahead of the UK overall. I think if we leave the European Union, I think we would agree with most forecasts that that will have an impact on forward-GDP growth. So that would be unhelpful. But I think the fundamental worry we have is a period of uncertainty is simply unhelpful.

Q: Nick, any contingencies should the UK vote to leave the EU?

NS: We try to run our business in a way such that (1) we always have resilience but (2) optionality and opportunity in the event of adverse exogenous events such as a decision to leave the EU. Within that regard, if you look at our portfolio today, it's almost fully let. Bearing in mind that more than three quarters of it is in the West End, the vast majority is within walking distance of Crossrail stations. Our average office rent is still £45 per square foot and the portfolio is let to a diverse range of tenants with actually quite a low exposure to the banking sector, which I think is viewed as being the sector that is most at risk if the UK population decides that we should leave the EU.

We're clearly busy on the development front but I think a combination of our pragmatic leasing approach and the high-quality product that we're delivering means that we've taken a lot of risk out of that part of the business with more than two thirds of the committed development programme already pre-let or pre-sold. As we touched on earlier, having been a net seller for the last three years, our financial position has never been stronger. So if there is any dislocation, we'll be able to get on the front foot and capitalise and take advantage of that.

Developments

Q: Toby, what's your reading of the development cycle and how do you view the development pipeline? Given that prime property is holding up quite well?

TC: Well as a development business, we've had an extraordinarily successful run as we've seen in the last five or six years, since we began developing in 2009, during this cycle. On average, our schemes have delivered circa of 50 per cent return. So they've been incredible successful. Today, we have eight schemes on site, it's about a million feet. We've got a bunch of that under offer. Were those deals to close, we would be circa 70 per cent pre-leased. So a lot of the schemes that we have on site at the moment are frankly largely de-risked. It was 29.5 per cent this time last year.

So we've seen a really good run on the leasing side of the equation. Costs are fully fixed, so we have limited risk there. I think the interesting question will be what happens in the next few years. For the next few years, we have two schemes that we call near-term projects, both next to Crossrail stations, right in the middle of the West End. We could start both of them. Then beyond that, we have another 14 schemes that we are working on in what we call our pipeline, and that's never been longer. It's as strong as it's ever been.

If you add it all up, if you add up the entirety of our development business today, it's about 59 per cent of the existing group's assets. So it's a sizeable proportion of the forward returns that we offer for shareholders. Whether we push all of those buttons will depend upon how conditions play out over the next few years. But as it stands at the moment, we feel in a really good place, as I say, with 70-odd per cent were these deals done, de-risked.

The great thing about the positioning we have is that the market overall is relatively undersupplied still. Some people are concerned about the supply side, we're much less to, actually. We think the bigger issue for the development market looking forward is what happens to demand and what tenants choose to do. We don't actually think there is a huge amount of supply on the market, or indeed coming to the market. Actually, if you look at the West End overall, it's a couple of million feet over a few years. Which proportionately is about 0.9 per cent per annum coming on of new stock. So the supply side feels robust.

So the decision for us about pushing buttons will be whether or not the demand is there. If it is, we will.

Q: Nick then, can you run through the levels of Capex that you envisage over the short-to-medium term in the light of that pipeline?

NS: Yeah, so we've now completed 11 schemes this cycle. We've currently got eight on site, as Toby touched upon. There's about £270 million of further Capex to be invested in those schemes. Which, as again, Toby's touched upon, are significantly de-risked. Both on the cost side but also on the leasing side. The two near-term schemes have circa £160 million of Capex to be invested in them, were we to commit to them over the course of the next 12 to 24 months. So collectively there's around £430 million of Capex to be invested in the next few years. Half of which will be invested within the next 12 months. So it's relatively short-dated and it's also relatively highly de-risked already through our activities.

Asset Management

Q: So you've said a record leasing year. So what kind of growth should we expect from here?

TC: Well as I was saying earlier, 10 per cent last year in our rental values growing. For the year to come, we've forecast about five per cent. Broadly equally split between offices and retail across the group. I think could we do better than that? I think if we stay in Europe and if tenant demand continues as it today seems to feel it will, we might beat that. We might beat that. But could it be lower? Yet it could. But overall, I'm not sure that's going to be the most important thing for us. What'll matter more is finding tenants and filling our buildings with them. If you look around the existing investment portfolio today, we've been incredibly successful at keeping tenants in them where we want to keep them and finding new ones where they move out.

So during the year just gone, we had circa 350,000-odd feet of space that tenants could move out of. At the end of the year, of that 350,000-odd, only three per cent was left unleased, which is a great result.

Q: Nick, can you expand on the sectors that have seen the strongest demand for new space?

NS: Yeah, we're seeing demand being relatively broad based but in particular strong demand from the knowledge economy. So in particular, creatives and professional services. I don't think that really should surprise us. If you look at the expectation for the next five years, analysts' estimates are there's 165,000 new jobs going to be created in London. The vast majority of them are in those two sectors. We're seeing it ourselves, from our own letting and pre-letting activities this year. Our largest ever letting and in fact one of the largest ever office lettings in the West End was to Facebook, clearly a tech business. We've been busy letting to the likes of Lionsgate and UBM over the recent years, again other businesses in the creative media arena.

On the professional services side, our second-largest letting this cycle was to lawyers, Bird & Bird, also letting to actuarial firms. I think one of the really interesting things that we're hearing very regularly from existing tenants and prospective tenants is the importance of real estate as a tool not just to retain talent within business but also to recruit new talent. The things that we hear that businesses want are high-quality buildings obviously, but also buildings that are in good locations with great local amenity but also proximate to good public transport infrastructure, and in particular Crossrail. Remember, 86 per cent of our portfolio is within walking distance of a Crossrail station.

That makes a big difference to people when they're looking to recruit new people. Because we know one of the challenges of working in London is getting around it, and being near public transport really helps in that regard.

Disposals and Acquisitions

Q: As you say, you're net sellers of assets. Have you turned acquisitive and have we reached an inflection point?

TC: I suspect this year we will be net sellers again, actually. Yes, we did buy last year, we bought circa £214 million during the financial year. We've just done another deal since then, announced this morning. If you look at the deals that we have bought, they have all been where we already own part of those buildings or where we've used existing, mature assets that we have built to drag in raw material from somewhere else for the next cycle. So most recently, we swapped out of 33 Margaret Street, a building that we bought in 2009, developed through the recession, leased to Savills, we got a great price from an institutional buyer, who in turn swapped with us a building with four years of income off a much lower cost per square foot, off a much lower rent in an interesting part of time, next to Crossrail, where we can develop in the next cycle.

So where we find those sorts of opportunities, we will buy them. Because there's an obvious trade that works very well. But I think overall, market pricing being as it is at the moment, we're more likely to be a seller, crystallising some of the hard work of the last few years, at record prices. If we find things to buy, terrific. But I suspect we'll find more sales than we will acquisitions.

Q: Can you run through the surpluses that you've been able to capture as a result of recycling your capital?

NS: Over the course of the last financial year, our sales were just under £470 million off low yields, on average 3.5 per cent net initial yield, and at high capital values, so just below £2000 per square foot. On average, those sales were made at a 10 per cent premium to the March book value. But crucially, those book values embedded significant development surpluses. So the sales have monetized those development surpluses. The two largest sales in the year were one, 95 Wigmore Street. We sold that this time last year for £222 million. It was a development scheme that we finished in the summer of '13. We let it in its entirety within six weeks of completion and we sold it, as I said, this time last year. Low yield, 3.4 per cent, and we crystallised 105 per cent capital return.

The most recent large sale that we made, one that Toby touched on a moment ago, was earlier this calendar year at 33 Margaret Street. We sold it for £216 million. Low initial yield of 3.3 per cent. We bought in the teeth of the recession, we started the development, pre-let it in its entirety to Savills and at the point of completion delivered a very attractive profit on cost of 57 per cent. But by holding it, benefiting from further rental growth and also continued yield compression, the sale monetised a capital return of north of 130 per cent, and annualised ungeared IRR of north of 23 per cent. Again, as Toby touched upon earlier, unlocking new raw material for us as the sale was through a combination of receiving cash and also 50 Finsbury Square over in the City.

Balance sheet

Q: Plenty of financial firepower on the balance sheet, so are we about to launch into an investment phase?

TC: Let's see. As Nick described earlier, we've got a significant development programme that is still in fairly robust swing and we need to finish that and we'll need some capital to do that. Whether or not we then launch into an acquisition phase, as I was saying earlier, I suspect is a little way off yet. However, as we touched on earlier, if we have market dislocation during this summer's political dramas then we have the capacity to invest as we did in 2009. That's very important. As Nick touched on, gearing at circa 17 per cent gives us significant ability to invest.

I think having that optionality at the moment feels like a very strong place to be. But even if we don't invest, one of the great things about his business is that we have 30-odd per cent, 33 per cent of reversionary potential to capture. So we've got income growth around the corner, whatever happens. We have a development business which is 70-ish per cent pre-let already and yet we've only taken mid-50s per cent of that surplus through the balance sheet, or rather the values have only ascribed so much. So we have, just through the effluxion of time, value coming to shareholders, even if we don't invest at all in the next few periods.

As I say, we will invest if we find value. If we don't, we'll wait and see what happens.

Q: Those LTVs at historic lows, are they going to stay that way?

NS: We're always going to maintain a very strong balance sheet. So the headline is LTV at 17.4 per cent, but to just give you a little bit more colour, interest cover is at 12.5 times. The debt that we have is low cost, on average 3.7 per cent with a marginal rate of 1.6. We have significant protection should interest rates move up, with 100 per cent of our debt either being at fixed or hedge rates. In terms of where LTV goes next, well I ran through the CapEx to come, if you were to overlay that onto today's 17 per cent LTV, that would rise to 27 per cent LTV. But bear in mind, that is before factoring in development surpluses to come. But nor does that factor in potential sales, including sales that we've already made.

So one of the great successes we've had this cycle is down at Rathbone Square where just under half the value is in the residential and we have already sold 98 per cent of the units there. So if we overlay the balance of the proceeds still to come from those sales, LTV would fall back to 23 per cent. As Toby touched on earlier, we're likely a net seller over the course of the next 12 months. So this time next year, could LTV be lower than it is today? It could be, but really that will depend on both the volume and the velocity of the sales activity. But either way, we're going to be sitting here a year from now with a strong balance sheet.

Q: What can you say about the efficiency of that balance sheet?

NS: One of the core parts of our business is to ensure that we run the balance sheet with discipline. Within that, there are four givens. One of them, low-financial leverage, ensuring that we use it as a tool to enhance, not drive returns. Within that, we'll always make sure we have plentiful liquidity. Secondly, we want to deliver sustainable ordinary dividends and ideally continue to grow the dividend in line with our progressive policy. Thirdly, the same discipline with regards to capital allocation that we apply at the asset and the portfolio level, we want to apply at the corporate level as well. Fourthly, we want to maintain an efficient balance sheet.

So within that, historically we have, and we may again do going forward, in the appropriate circumstances and at the appropriate time, consider either raising further equity from shareholders if we feel that we can deploy it accretively or equally returning capital to shareholders if we feel as though we have an excess. As at today, the balance sheet position feels just right.

Q: So Toby, plenty of headroom and options to execute on your strategy. So what about the scope for special dividends or share buybacks or increased returns to shareholders?

TC: Well I think as Nick has just described, we have a series of tests that we will take our own balance sheet through to consider whether it's the appropriate thing to do. If, in going through those tests, we conclude we have more capital than we need then yes, we would give some back. But as Nick has also said, at the moment we don't conclude we have more than we need. I think it would be a foolish conclusion to reach in any event with all of the uncertainty around. Because we may well find that we can use it very accretively in the next 18 or 24 months if conditions allow.

If, on the other hand, we make a significant series of further sales and markets do not offer deep value then it is possible that - and if we perceive that the market over the ensuing few years was relatively benign then it's equally possible we might consider returning some. I think the ability that we have, the optionality of we go left if market conditions suggest so, we go right if market conditions suggest so, puts us in a very strong position. It's rather as we were in 2009 and we have the ability to take advantage of market conditions as they play out.

Management

Q: You talked earlier about strengthening the senior management team. Is it where you want it to be or might you strengthen it still further?

TC: It is where we want it to be. We're delighted with the people we've brought in and the promotions we've been able to make during the year. This is a much bigger business than it was five, six years ago, it's more complicated in the quantity of things that are going on today. We need to make sure we carry on with the same degree of precision and skill that we've always had executing all those various business plans, and we've needed more people to do that. So we've brought them in, we've got some great new talent coming in and coming up through the organisation. That's a terrific place to be at the moment. So no, we're very pleased.

Outlook

Q: Nick, how do you view the financial outlook?

NS: I think we have a positive financial outlook. Barring Brexit, I think we can look forward to further NAV growth, particularly as we capture surpluses within the development programme. Although I do think we should expect to see the rate of NAV growth moderating from here, given what we've delivered over the course of the last five or six years. Also bearing in mind, we are in a very low inflationary environment. We've given a stable outlook for earnings, we will look to continue to grow the ordinary dividend and crucially, as I said earlier, we will absolutely maintain balance sheet discipline and balance sheet strength such that we always have optionality to take advantage of opportunities, should they emerge, whether it's within the existing portfolio or buying in the markets.

Q: Toby, what's the outlook and how well positioned is Great Portland Estates for cyclical change?

TC Well I think - I hope through this discussion, it's become clear that we are very well positioned. We have the ability, as I say, to go left or right. But as it stands today, I think it's a fascinating time. I think we've got a balance sheet that's terrifically strong, we've got a portfolio which has a significant quantity of growth for us to capture in the near term, as we finish the developments that we're building, the eight schemes we've talked about, as we finish the leasing there. We've got reversionary potential of some 30-odd per cent that is there for us to grab. Most of which is in the next 18 to 24 months. So it isn't long-dated, it's relatively near term.

If this great city of ours throws us some opportunities to buy then nobody's better placed than us to do so, as we've shown time and again. So I think our outlook remains positive about the positioning of the group. With the obvious caveats around the uncertainties in the macro environment and the uncertainties around the political environment short term. But those caveats aside, we feel in an extremely strong positon to take advantage as situations unfold.

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