FINANCE REVIEW

After an outstanding year of net asset growth and the conversion of £175m of bonds into new shares in January 2015, we believe the Group is in a very good financial position to deliver its substantial pipeline of regeneration projects.

DAMIAN WISNIEWSKI
FINANCE DIRECTOR

Derwent London had its strongest year of net asset growth to date in 2014. The increase in net asset value (NAV) was £705.2m for the year, up by 29.7% from the end of 2013, with a total return for the year of 30.1%. This growth was largely driven by a combination of favourable letting conditions, demand being well in excess of available good-quality office space thereby causing market rental values to rise, and particularly strong investment demand.

The extent of yield movement during 2014, influenced as it is by many external factors, exceeded our expectations. This fall looks likely to continue into 2015 but our view is that equivalent yields must now be approaching cyclical lows. Our predictions for London office ERVs in 2014 proved to be more accurate and we continue to anticipate further growth to come. In 2014, the Group's ERV grew by 9.4%, which has further increased our rental reversion. With lettings from our recent developments, we therefore saw rental income grow in 2014 while keeping firm control of our operating costs, with a corresponding positive impact upon recurring profit, EPS and interest cover. As a result, we increased the final dividend by 8.7% giving a total of 39.65p per share for the year. This represents the seventh successive year of dividend growth since 2007, the year of the merger of Derwent Valley and London Merchant Securities, the average annual growth rate since then being 8.4%.

Levels of apparent liquidity chasing the London property sector have seemed the highest for many years with available cash now seeking debt as well as equity returns. We have taken advantage of these market conditions by completing £100m of 15 and 20 year US private placement funding in January 2014 and extending our £550m revolving unsecured bank facility in December 2014 to a January 2020 maturity. The latter included a worthwhile reduction in the margin payable. As explained later, our 2016 convertible bonds also completed their conversion to new ordinary shares in January 2015 which further strengthens the balance sheet and improves interest cover.

	2014	2013	Increase %
EPRA NAV per share	**2,908p**	2,264p	28.4
EPRA NNNAV per share	**2,800p**	2,222p	26.0
Property portfolio at fair value	**£4,168.1m**	£3,353.1m	24.3
Gross property income	**£138.4m**	£131.6m	5.2
EPRA profit before tax	**£62.3m**	£57.8m	7.8
Profit before tax	**£753.7m**	£467.9m	61.1
Dividend per share	**39.65p**	36.50p	8.6
NAV gearing	**32.9%**	40.0%	n/a
Net interest cover ratio	**286%**	279%	n/a

Net asset value growth

The yield shift referred to above, together with development profits from our projects and strong underlying rental value growth across the portfolio, produced a 28.4% increase in EPRA net asset value per share during 2014 to 2,908p per share from 2,264p a year earlier. The revaluation surplus and profits from property sales together accounted for 687p compared to 378p in 2013.

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

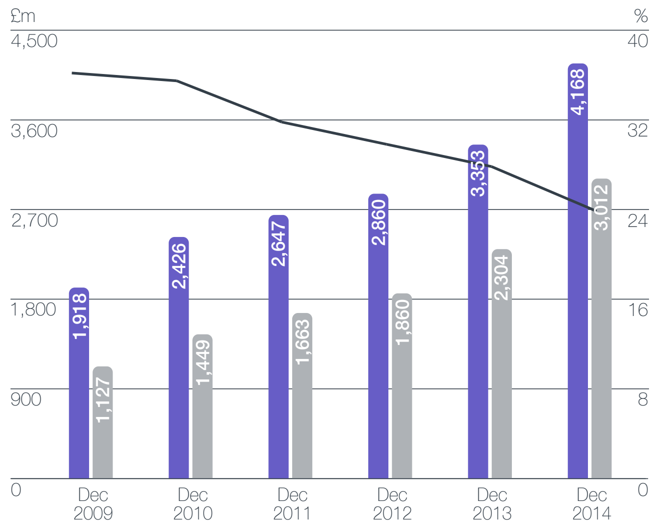
	2014 p	2013 p
Revaluation surplus	**654**	326
Profit on disposals	**33**	52
EPRA profit after tax	**57**	54
Dividends paid (net of scrip)	**(35)**	(30)
Equity portion relating to issue of convertible bonds 2019	**–**	12
Interest rate swap termination costs	**(2)**	(13)
Dilutive effect of convertible bonds 2016	**(46)**	(10)
Non-controlling interest	**(10)**	(7)
Other	**(7)**	(6)
	644	378

A detailed reconciliation of the EPRA NAV to the IFRS NAV is shown in note 38 to the financial statements.

The rapid growth in NAV per share above the 2,222p conversion price for the convertible bonds originally due to mature in 2016 gave rise to a further 46p per share of NAV dilution in 2014 after 10p per share in 2013. As the EPRA NAV per share is a fully diluted measure, there will be no additional impact as a direct result of the conversion of the bonds in 2015, though the unamortised issue costs of £1.4m will effectively be written off at the point of conversion. As they were redeemed in January 2015, the bonds were reclassified as current liabilities at the 2014 year end.

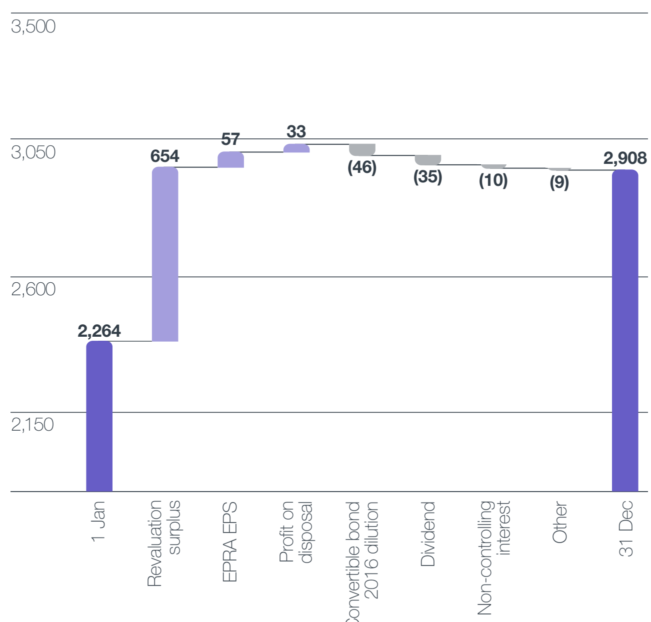
With financial markets across much of the global system chasing yield and the fear of deflation or continued sluggish growth in many European markets, there has been a quite extraordinary movement in the UK 10-year gilt rate over the last year or so. At the end of 2013, the 10-year gilt rate was around 3.0% and expected to rise further but, by the end of 2014, it had fallen to about 1.8%. As noted above, this trend has been very positive for our property valuations but the fair value adjustments to our debt instruments have naturally moved in the opposite direction. Accordingly, we saw a £9.3m or 9p per share increase in the mark-to-market cost of unwinding interest rate swaps taking the balance sheet exposure to £25.2m or 24p per share at the end of 2014 compared to 15p per share a year earlier. As the swap curve has fallen across its entire time range, the impact upon the fair value of our long-term fixed rate debt liabilities was more marked and increased from £15.2m in 2013 to £78.8m or 76p per share in December 2014. These adjustments took the Group's EPRA triple NAV per share to 2,800p at 31 December 2014, which represents an increase of 26.0% over the year.

Property portfolio value, net assets and gearing



■ Property portfolio at fair value — LTV ratio
■ Net assets attributable to equity shareholders

EPRA net asset value per share p



2014	**2,264**	**654**	**57**	**33**	**(46)**	**(35)**	**(10)**	**(9)**	**2,908**
2013	1,886	326	54	52	(10)	(30)	(7)	(7)	2,264

Income statement

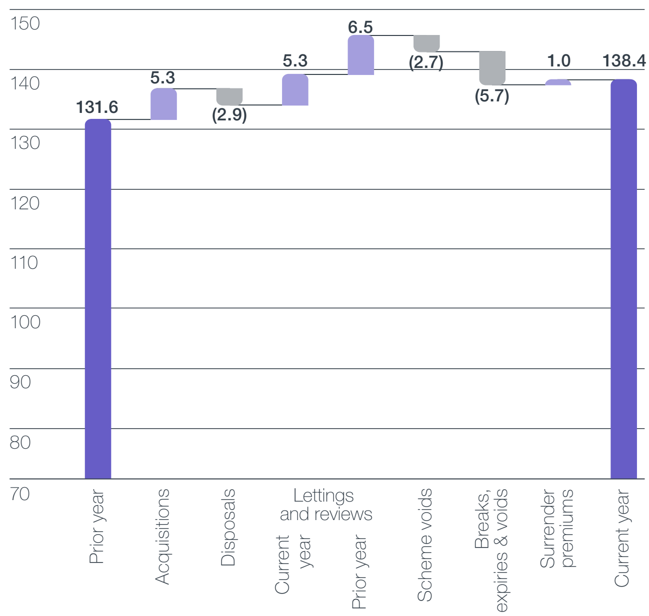
As in 2013, we have continued to see a useful improvement in recurring earnings despite higher levels of regeneration activity across our portfolio. EPRA profit before tax, which excludes £3.9m of trading profits on sales of our residential units at Queens, was up to £62.3m, an increase of 7.8% from the £57.8m comparative figure in 2013. EPRA earnings per share were also increased, rising to 57.08p from 53.87p a year earlier. The overall IFRS profit before tax, which includes fair value movements on property and interest rate swap values plus profits from our disposals, was £753.7m, by far the highest annual figure that the Group has yet seen. The revaluation surplus of £667.1m generated much of this 2014 IFRS profit. A table providing a reconciliation of the IFRS to EPRA profit before tax and earnings per share is included in note 38.

With the sales of apartments at Queens contributing £15.7m, gross property and other income reached £180.5m in 2014, up from £160.5m in 2013. Gross property income for the year, almost all of which is rental income, increased by 5.2% to £138.4m from £131.6m in 2013. Additional income generated from lettings and rent reviews in 2013 and 2014 totalled £11.8m, more than offsetting the £5.7m of rent lost from lease breaks, expiries and voids and £2.7m of void costs on new schemes. An additional £5.3m came from properties acquired with £2.9m lost on properties sold and £1.6m received from ‘rights of light’ settlements. After taking account of irrecoverable property costs, net property and other income rose by 9.5% from £124.3m in 2013 to £136.1m. Of this, £128.7m was net rental income, 5.8% higher than in 2013.

EPRA like-for-like gross rental income, which removes the impact of development activity, acquisitions and disposals, increased by 2.9% during the year with net property income on a similar basis up by 5.6%. The underlying trend is stronger than these figures indicate as the prior year benefited from £1.4m of back-rent arising from a single review. If this is also excluded, the underlying like-for-like growth rises to 4.3% for gross rents and to 7.2% for net property income. A full analysis is shown in the table below.

We have seen a 6.4% increase in the Group administrative charge for the year to £28.1m; this is largely due to increased staff numbers and higher salary, bonus and incentive payments to our staff and senior management team, the levels of which rose by £1.3m in 2014.

Gross property income £m



2014	**131.6**	**5.3**	**(2.9)**	**5.3**	**6.5**	**(2.7)**	**(5.7)**	**1.0**	**138.4**
2013	124.8	4.1	(3.2)	10.1	1.7	(2.5)	(4.0)	0.6	131.6

We have again included the EPRA cost ratios this year, the main ratio having reduced to 24.2% from 25.1% in 2013; excluding direct vacancy costs, it rose slightly to 22.9% in 2014. The ratio of irrecoverable and administrative costs to the property portfolio fair value also fell in 2014, to 0.8% from 1.0% in 2013. As in prior years, our income statement does not take account of any capitalisation of overheads, all of which are expensed in the year.

At £42.4m, finance costs were only marginally higher in 2014 than in 2013 in spite of average borrowings being about £95m higher. The total charge takes account of interest capitalised on projects of £5.3m compared with £4.8m in 2013. The reduction in our overall interest rates is largely due to the refinancing activities that we undertook during 2013.

28.4%
increase in EPRA NAV per share

7.8%
increase in EPRA profit before tax

	2014 %	2013 %
EPRA cost ratio, incl. direct vacancy costs	**24.2**	25.1
EPRA cost ratio, excl. direct vacancy costs	**22.9**	22.6
Portfolio cost ratio, incl. direct vacancy costs	**0.8**	1.0

EPRA like-for-like net rental income

	Properties owned throughout the year £m	Acquisitions £m	Disposals £m	Development property £m	Total £m
2014					
Rental income	103.3	6.2	2.0	25.2	136.7
Property expenditure	(3.9)	–	(0.1)	(4.0)	(8.0)
Net rental income	**99.4**	**6.2**	**1.9**	**21.2**	**128.7**
Profit on sale of trading properties	–	–	3.9	–	3.9
Other[1]	3.5	–	–	–	3.5
Net property income	**102.9**	**6.2**	**5.8**	**21.2**	**136.1**
2013					
Rental income	100.4	1.0	4.8	24.7	130.9
Property expenditure	(5.0)	–	(0.7)	(3.5)	(9.2)
Net rental income	95.4	1.0	4.1	21.2	121.7
Other[1]	2.0	–	–	0.6	2.6
Net property income	97.4	1.0	4.1	21.8	124.3
Increase based on gross rental income	**2.9%**				**4.4%**
Increase based on net rental income	**4.2%**				**5.8%**
Increase based on net property income	**5.6%**				**9.5%**

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

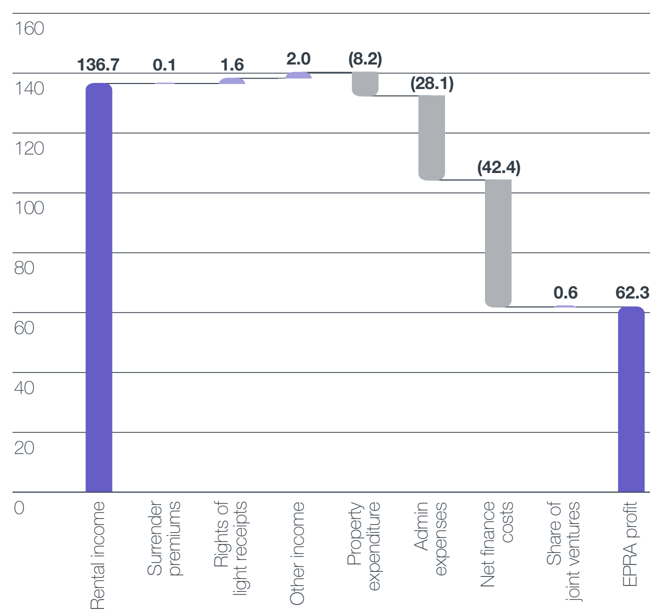
In terms of the non-recurring elements of the income statement, profits on disposal of investment properties totalled £28.2m in 2014 with a further £2.0m from the sale of our 25% interest in the shopping centre in Prague. The strong investment market for these smaller and very liquid lot sizes meant that prices achieved were particularly good. Finally, the adverse movement in derivative fair values referred to earlier was £9.4m in 2014 and there was a £2.0m cost incurred deferring two forward-start interest rate swaps.

Taxation

The tax charge for the year increased to £3.9m in 2014 from £2.4m in the previous year, most of this increase being due to a higher deferred tax charge on the revaluation of the unelected share in our 55% subsidiary held jointly with the Portman Estate which is outside the REIT regime. As in 2013, the main part of the current tax charge of £0.8m was also due to our joint investment with the Portman Estate.

In addition, £4.4m of tax was withheld during the year from shareholders on property income distributions and paid to HMRC.

EPRA profit £m



2014	**136.7**	**0.1**	**1.6**	**2.0**	**(8.2)**	**(28.1)**	**(42.4)**	**0.6**	**62.3**
2013	130.9	0.7	–	2.0	(9.3)	(26.4)	(41.2)	1.1	57.8
Variance	5.8	(0.6)	1.6	–	1.1	(1.7)	(1.2)	(0.5)	4.5

FINANCE REVIEW
CONTINUED

Debt facilities

	£m	£m	Maturity
6.5% secured bonds		175	March 2026
3.99% secured loan		83	October 2024
4.41% unsecured private placement notes		25	January 2029
4.68% unsecured private placement notes		75	January 2034
2.75% unsecured convertible bonds		175[1]	July 2016[1]
1.125% unsecured convertible bonds		150	July 2019
Committed bank facilities			
Term – secured	28		June 2018
Term/revolving credit – secured	90		December 2017
Revolving credit – unsecured	550		January 2020
		668	
At 31 December 2014		**1,351**	
Conversion of 2.75% unsecured convertible bonds		(175)[1]	
At 31 January 2015		**1,176**	

[1] Bonds all redeemed in January 2015

Maintaining strong and flexible financing

After a significant year of refinancing in 2013, we continued to strengthen our platform in 2014 and all our financing ratios improved compared to the prior year as indicated in the table below. The recent conversion of the 2016 convertible bonds into new shares in January 2015 also provides significant additional firepower to finance the pipeline in the next few years and its impact is shown as a proforma column in the table.

In January 2014, £100m of 15 and 20 year US private placement notes provided by New York Life were drawn thereby increasing headroom on our revolving bank facility. Full details were set out in last year's annual report. The Group has a strategy of arranging a sufficient amount of long-term fixed rate debt when we believe that conditions are favourable and this financing enabled us to extend the weighted average maturity of our debt without a significant increase in the average cost of our funds. The financial covenants also matched those of our unsecured bank facility.

Ensuring that the cost of our debt is competitive is another of our financing priorities. It became apparent in the second half of 2014 that conditions in the bank lending market for credits like ours had improved markedly due to increasing competition among lenders. As a result, margins being offered and up-front fees were gradually reducing. Accordingly, we engaged with the four banks providing our £550m facility and agreed an extension from September 2018 to January 2020. The margin was reduced by 35bp, effective from the date of signing on 19 December 2014. In addition, we agreed to reduce the maximum net asset gearing covenant from 160% to 145%. As our gearing had already fallen substantially from the original time that the loan was established in September 2013, there remains very significant headroom under this covenant.

These actions increased the weighted average length of our drawn debt to 6.6 years at the end of 2014, rising further to 7.9 years after conversion of the £175m convertible bonds 2016. They also increased the proportion of debt provided by non-banks to 66% from 60% at 31 December 2013. The long dated US private placement notes increased our cost of debt slightly but, by the end of the year, the spot interest rate was only slightly higher than a year earlier at 3.78% on a cash basis against 3.64% in December 2013. The IFRS rate increased to 4.22% at 31 December 2014 from 4.10% a year earlier. It is worth noting that the proforma cash and IFRS interest rates, after conversion of the 2016 bonds, rise to 3.99% and 4.27%, respectively.

Net debt and cash flow

Net debt increased again during the year to £1,013.3m from £949.2m, the main reason being £113.2m of cash outflows on projects. This includes capitalised interest of £5.3m, up from £4.8m the year before. We have continued to refresh the portfolio with new acquisitions totalling £92.2m in 2014, mainly relating to 19-23 Featherstone Street and Angel Square. We have also raised £99.0m during the year from selling six investment properties, and gross proceeds from the sale of the apartments at Queens W2 generated a further £15.7m. We will receive a further £27.3m before costs on the recently announced property swap.

Our operating cash flow in 2014 showed strong gains. Cash receipts from recent lettings, including the burning off of rent free and half rent periods, combined with low irrecoverable property costs and reduced interest payments to improve our net operating cash inflow by 14.1% to £65.6m in 2014.

The Group's loan-to-value (LTV) ratio fell to 24.0% at the year end from 28.0% in 2013. Net asset value gearing fell correspondingly to 32.9% from 40.0%. After conversion of the 2016 bonds in January 2015, the proforma LTV ratio fell further to 19.9% and the NAV gearing to 26.0%. As a result, the amount of debt within the Group could increase by a further £225m to get back to the level of NAV gearing at 31 December 2014 which indicates how much additional project headroom the latest issue of new ordinary shares has generated. Interest cover has shown similar improvements; in 2014, overall net interest cover increased to 286% from 279% in 2013 and will improve further without the £7m pa of interest (IFRS basis) on the 2016 convertible bonds.

As at 31 December 2014, the undrawn amount of financing facilities and cash totalled £336m, sufficient to cover about two years' capital expenditure and an increase over the £296m comparative figure as at 31 December 2013. With our low gearing level, uncharged properties of £2.7bn, reputation and well-established credit rating, the Group has access to additional debt sources.

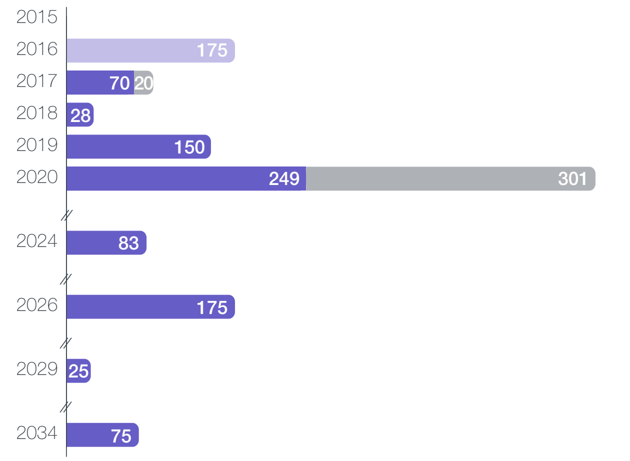
£550m

of bank facilities extended at a lower margin

£175m

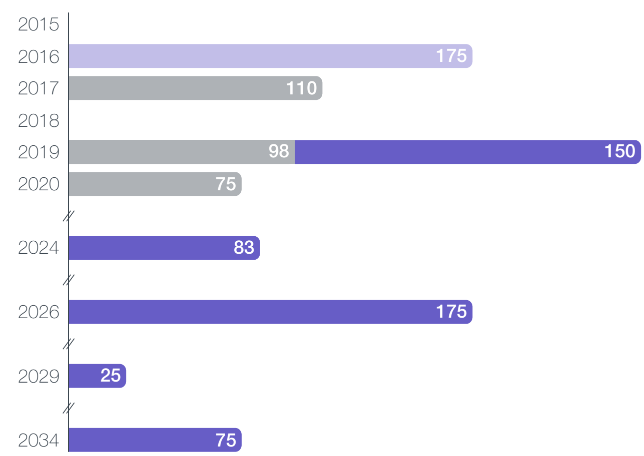
of convertible bonds converted into new shares in January 2015

Maturity profile of loan facilities £m
As at 31 December 2014



■ Headroom
■ Drawn
■ Convertible bonds 2016 converted into new shares in January 2015

Maturity profile of fixed and hedged debt £m
As at 31 December 2014[1]



■ Hedged
■ Fixed rate
■ Convertible bonds 2016 converted into new shares in January 2015

[1] Excludes forward start swaps

FINANCE REVIEW
CONTINUED

Net debt

	2014 £m	2013 £m
Cash	**(14.8)**	(12.5)
Bank facilities	**347.0**	385.0
3.99% secured loan 2024	**83.0**	83.0
6.5% secured bonds 2026	**175.0**	175.0
Acquired fair value of secured bonds less amortisation	**16.0**	16.9
4.41% unsecured private placement notes 2029	**25.0**	–
4.68% unsecured private placement notes 2034	**75.0**	–
2.75% unsecured convertible bonds 2016	**175.0**	175.0
1.125% unsecured convertible bonds 2019	**150.0**	150.0
Equity components and unwinding of discounts on convertible bonds	**(12.9)**	(16.8)
Leasehold liabilities	**8.3**	8.2
Unamortised issue and arrangement costs	**(13.3)**	(14.6)
Net debt	**1,013.3**	949.2

Gearing and interest cover ratio

	Proforma[1] %	2014 %	2013 %
Loan-to-value ratio	**19.9**	**24.0**	28.0
NAV gearing	**26.0**	**32.9**	40.0
Net interest cover ratio	**n/a**	**286**	279

[1] After conversion of unsecured convertible bonds 2016

Debt summary

	Proforma[1] £m	2014 £m	2013 £m
Bank loans			
Floating rate	**64.0**	**64.0**	167.0
Swapped	**283.0**	**283.0**	218.0
	347.0	**347.0**	385.0
Non-bank debt			
3.99% secured loan 2024	**83.0**	**83.0**	83.0
6.5% secured bonds 2026	**175.0**	**175.0**	175.0
2.75% unsecured convertible bonds 2016	**–**	**175.0**	175.0
1.125% unsecured convertible bonds 2019	**150.0**	**150.0**	150.0
4.41% unsecured private placement notes 2029	**25.0**	**25.0**	–
4.68% unsecured private placement notes 2034	**75.0**	**75.0**	–
	508.0	**683.0**	583.0
Total	**855.0**	**1,030.0**	968.0
Hedging profile (%)			
Fixed	**60**	**66**	60
Swaps	**33**	**28**	23
	93	**94**	83
Percentage of debt that is unsecured (%)	**58**	**65**	63
Percentage of non-bank debt (%)	**59**	**66**	60
Weighted average interest rate (%)[2]	**3.99**	**3.78**	3.64
Weighted average interest rate (%)[3]	**4.27**	**4.22**	4.10
Weighted average maturity of facilities (years)	**7.1**	**6.2**	5.9
Weighted average maturity of borrowings (years)	**7.9**	**6.6**	6.3
Undrawn facilities	**321**	**321**	283
Uncharged properties	**2,718**	**2,718**	2,144

[1] After conversion of unsecured convertible bonds 2016 into new shares
[2] Convertible bonds at 2.75% and 1.125%
[3] Convertible bonds on IFRS basis

Dividend

Growing the dividend at a meaningful but sustainable rate remains an important goal for Derwent London. With recurring earnings continuing to grow, the Board has recommended an 8.7% increase in the proposed final dividend to 28.00p per share for payment to shareholders on 12 June 2015. 22.35p will be paid as a PID and the balance of 5.65p as a conventional dividend. The total dividend for the year is 39.65p per share, an increase of 3.15p or 8.6% over 2013. The scrip dividend alternative remains popular and so, as in recent years, it will again be offered.

Our financial outlook

After an outstanding year of net asset value growth and the conversion of £175m of bonds into new shares in January 2015, we believe the Group is in a very good financial position to deliver its substantial pipeline of regeneration projects.

Your Board remains alert to the risks that development activity brings. In addition, our experience of several previous property cycles is a constant factor when assessing the amount of risk we take on and the disciplined way in which we manage the business. The London office market feels to have some way to run with solid tenant demand, robust rental growth and a relatively constrained supply of new space in our principal locations but conditions can change.

Our programme of investment in the portfolio currently anticipates £163m of capital expenditure during 2015 with a further £166m in 2016. Out of this total of £329m, £134m is contracted and £252m is associated with committed schemes. Therefore, there remains some flexibility in the delivery of this pipeline from 2017 onwards but, even allowing for this full amount of expenditure and in the absence of any further property disposals or a significant movement in property values, the Group's LTV gearing is likely to remain below 30%.

Our business model requires us to plan and deliver value-added projects to bolster our returns. In order to achieve this over the longer term, we will continue to refresh the pipeline and recycle capital to ensure a healthy balance of income and value creation. With low gearing and our focus on income generation, we believe we are well placed to fund the delivery of this pipeline while continuing to grow earnings, interest cover and the dividend that we pay our shareholders.

"In order to plan and deliver value-added projects to bolster our returns, we will continue to refresh our pipeline and recycle capital to ensure a healthy balance of income and value creation."

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FINANCE DIRECTOR