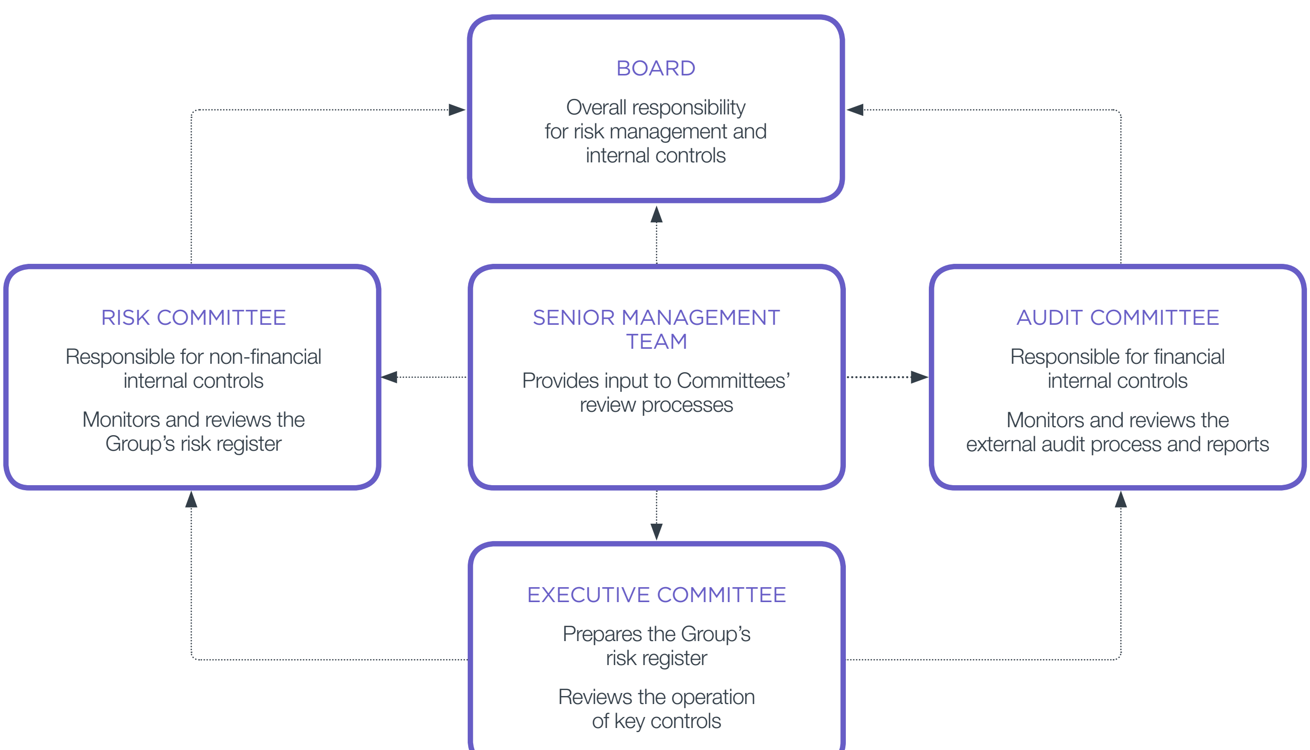
# RISK MANAGEMENT

Derwent London aims to deliver above average long-term returns to shareholders whilst operating within an acceptable risk envelope. The Board recognises that there are inherent risks in running any business and to ensure that the Group's risk appetite is not exceeded, a risk management system is required to ensure these risks are identified, understood and managed.

## RISK ORGANISATIONAL STRUCTURE

Overall responsibility for risk management rests with the Board which has delegated responsibility for assurance concerning the process to the Audit Committee and the Risk Committee. Executive management is responsible for designing, implementing, maintaining and evaluating the necessary systems of internal control. The following diagram illustrates the Group's risk management structure:



The Group operates principally from one central London office with relatively short management reporting lines. Consequently, members of the Executive Committee are closely involved in day-to-day matters and able to identify areas of increasing risk quickly and respond accordingly.

The third party review of the Group's risk management process undertaken at the end of 2013 resulted in a phased programme of improvements. Those that were applicable to the preparation and reporting of the Group's risk register were introduced during the 2013 review of the register and were further refined during the 2014 review which was undertaken during September, October and November 2014.

The review also made further recommendations concerning the documentation of the Group's risk management process and, accordingly, during the year a Group Risk Appetite Statement, a Risk Management Policy document and a Risk Management Process document have been prepared by the Executive Committee, approved by the Risk Committee and adopted by the main Board.

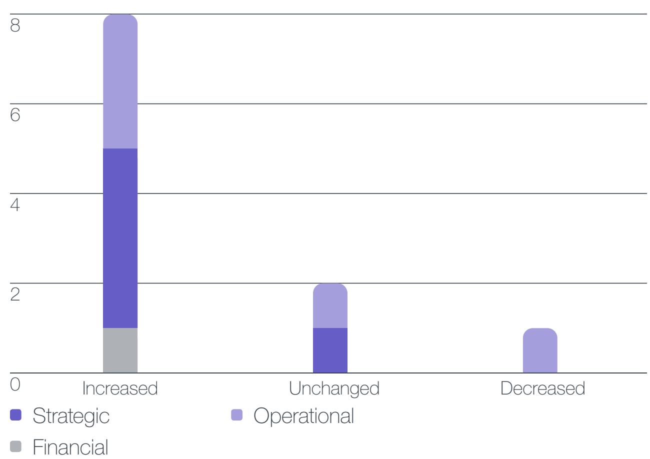
The Group's risk register continues to be the core element of the risk management process. The register is prepared by the Executive Committee which initially identifies the risks facing the Group and then collectively assesses the likelihood of each risk, the impact on the Group over different aspects of the business and the strength of the controls operating over the risk. This approach allows the effect of any mitigating procedures to be reflected in the final assessment. It also recognises that risk cannot be totally eliminated at an acceptable cost and that there are some risks which, with its experience, the Board will, after due consideration, choose to accept. The register, its method of preparation and the operation of the key controls in the Group's system of internal control have been reviewed by the Audit and Risk Committees. In order to gain a more comprehensive understanding of the risk management process and how it applies to particular parts of the Group's business, the Risk Committee periodically receives presentations from senior managers.

In response to the 2014 update to the UK Corporate Governance Code, the Group has revised its procedures to ensure that the necessary monitoring of risks and controls will be carried out throughout 2015.

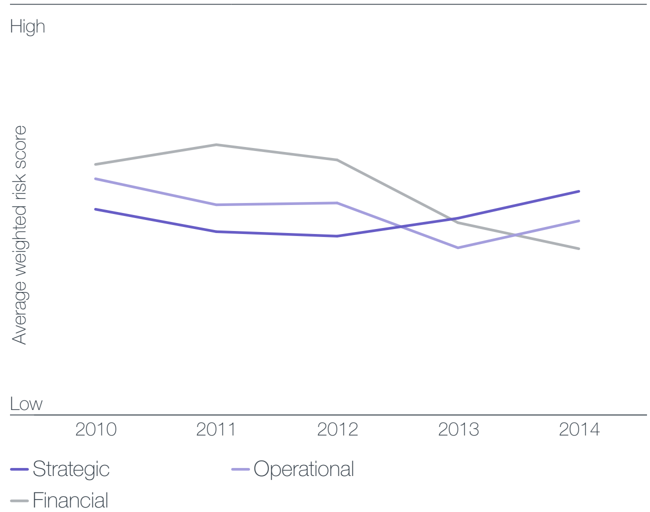
The current risk register includes 46 risks spread between strategic risks, operational risks and financial risks.

The principal risks and uncertainties faced by the Group in 2015, together with the potential effects, controls and mitigating factors, are set out on the following pages.

**2014 major risks**


**Average risk by category**



# RISK MANAGEMENT
## CONTINUED

### Strategic risks

That the Group's strategy does not create the anticipated shareholder value or fails to meet investors' expectations.

| Risk, effect and progression | Controls and mitigation | Action |
|---|---|---|
| **1. Inconsistent strategy**<br>The Group's strategy is inconsistent with the state of the market in which it operates.<br><br>**2. Inconsistent development programme**<br>The Group's development programme is not consistent with the economic cycle.<br><br>The Group continues to benefit from a strong central London market. However, this could be adversely affected by a number of high level economic factors which would reduce the value of the Group's portfolio with a consequent effect on two of its KPIs – total return and total property return.<br><br>The Board sees the level of both these risks as slightly higher than last year. | • The Group carries out a five-year strategic review each year and also prepares an annual budget and three rolling forecasts which cover the next two years. In the course of preparing these documents the Board considers the effect on the Group's KPIs and key ratios of changes to the main underlying assumptions reflecting different economic scenarios.<br>• The Group's plans can then be set so as to best realise its long-term strategic goals given the expected economic and market conditions. This flexibility is largely due to the Group's policy of maintaining income from properties for as long as possible until development starts.<br>• The level of future redevelopment opportunities identified in the Group's portfolio enables the Board to delay marginal projects until market conditions are favourable.<br>• The Board pays particular attention, when setting its plans, to maintaining sufficient headroom in all the Group's key ratios, financial covenants and interest cover. | • The last annual strategic review was carried out by the Board in June 2014. This considered the sensitivity of six key measures to changes in underlying assumptions including interest rates and borrowing margins, timing of projects, level of capital expenditure and the extent of capital recycling.<br>• The three rolling forecasts prepared during the year focus on the same key measures but may consider the effect of varying different assumptions to reflect changing economic and market conditions.<br>• The timing of the Group's development programme and the strategies for individual properties reflect the outcome of these considerations.<br>• Over 50% of the Group's portfolio has been identified for future redevelopment.<br>• During the year the Group's loan-to-value ratio remained below 28%, its net interest cover ratio was above 275% and the REIT ratios were comfortably met. |
| **3. Shortage of future developments**<br>A lack of suitable development opportunities leads to the Group paying a price that results in lower future returns. This would affect the Group's total return and total property return KPIs.<br><br>The level of risk has increased from last year. | • The development opportunities within the Group's portfolio enable the Board to defer acquisitions until more properties become available at an appropriate price level.<br>• The scale of the central London property market means that suitable properties should always be available. | • Over 50% of the Group's portfolio has been identified for future redevelopment.<br>• The Group made principal acquisitions of £90.9m which enhance its holdings in two 'villages'. It has also acquired a major new property through a property 'swap', in 2015. |
| **4. Regulatory non-compliance**<br>The Group's cost base is increased and management time diverted through a breach of any of the legislation that forms the regulatory framework within which the Group operates.<br><br>An increase in costs would directly impact on the Group's total return KPI. A significant diversion of management time could affect a wider range of key metrics.<br><br>This risk has increased marginally due to the increased scale of the Group's development activity and the associated increase in Health and Safety risks. | • The Group's Risk Committee reports to the Board concerning regulatory risk.<br>• The Group employs a Health and Safety Manager who reports to the Board.<br>• The Group employs a Sustainability Manager who reports to the sustainability committee which is chaired by Paul Williams.<br>• The Company's policies including those on the Bribery Act, Health and Safety, Equal Opportunities, Harassment and Whistleblowing are available to all staff on the Company intranet.<br>• Members of staff attend external briefings in order to remain cognizant of regulatory changes. | • A Health and Safety report is presented at all Executive Committee and main Board meetings.<br>• The Executive Committee receives regular reports from the Sustainability Manager.<br>• The Group pays considerable attention to sustainability issues and produces an annual sustainability report.<br>• The Group has reviewed and revised its whistleblowing policy during the year. |

## Strategic risks (continued)

| Risk, effect and progression | Controls and mitigation | Action |
|---|---|---|
| **5. Reputational damage**<br>The Group's reputation is damaged through unauthorised and inaccurate media coverage.<br><br>This risk would most directly impact on the Group's total shareholder return – one of its key metrics. Indirectly it could impact on a number of the formal KPIs.<br><br>The Board considers the risk to be broadly the same as last year. | ■ All new members of staff benefit from an induction programme and are issued with the Group's Staff Handbook.<br>■ Social media channels are monitored by the Group's investor relations department.<br>■ The Group takes advice on technological changes in the use of media and adapts its approach accordingly.<br>■ There is an agreed procedure for approving all external statements. | ■ The Group employs a Head of Investor and Corporate Communications and retains the services of an external PR agency. Both maintain regular contact with external media sources.<br>■ The Company engages with a number of local community bodies in areas where it operates as part of its CSR activity. |

## Financial risks

That the Group becomes unable to meet its financial obligations or finance the business appropriately.

| Risk, effect and progression | Controls and mitigation | Action |
|---|---|---|
| **6. Increase in property yields**<br>Increases in interest rates can lead to higher property yields which would cause property values to fall.<br><br>This would affect the following KPIs:<br>■ Loan-to-value ratio.<br>■ Total return.<br>■ Total property return.<br><br>Interest rates have remained low for an extended period of time and yields have decreased during the year. Interest rates are expected to rise within the next two years. Though there is no direct relationship, this may cause property yields to increase in due course and therefore the Board considers this risk to have increased during the year due to further recent reductions in yields. | ■ The impact of yield changes on the Group's financial covenants and performance are monitored regularly and are subject to sensitivity analysis to ensure that adequate headroom is preserved.<br>■ The management of the Group's financial covenants has been simplified by changes to its financing profile over the last two years.<br>■ The impact of yield changes is considered when potential projects are appraised. | ■ The Group produces three rolling forecasts each year which contain detailed sensitivity analyses.<br>■ Quarterly management accounts report on the Group's performance against covenants.<br>■ Project appraisals are regularly reviewed and updated. |

**Key**

Risk increase

Risk unchanged

Risk decrease

# RISK MANAGEMENT
## CONTINUED

**Operational risks**

The Group suffers either a financial loss or adverse consequences due to processes being inadequate or not operating correctly.

| Risk, effect and progression | Controls and mitigation | Action |
|---|---|---|
| **7. Reduced development returns**<br>The Group's development projects do not produce the anticipated financial return due to one or more of the following factors:<br>• delays in the planning process<br>• delays due to contractors/ sub-contractors defaulting<br>• increased construction costs<br>• adverse letting conditions<br>This would have an effect on the Group's total return and total property return KPIs.<br>The Board considers this risk to have remained broadly the same over the last year. | • Standardised appraisals which include contingencies are prepared for all investments and sensitivity analysis is undertaken to ensure that an adequate return is made in all circumstances considered likely to occur.<br>• The scale of the Group's development programme is managed to reflect anticipated market conditions.<br>• Regular cost reports are produced for the Executive Committee and the Board that monitor progress of actual expenditure against budget and timetable. This allows potential adverse variances to be identified and addressed at an early stage.<br>• The Group uses contractors/sub-contractors that it has previously worked with successfully whenever possible.<br>• Post completion reviews are carried out for all major developments to ensure that improvements to the Group's procedures can be identified and implemented.<br>• Alternative procurement methods are evaluated as a way of minimising the impact of increased construction costs. | • The Group is advised by leading planning consultants and has considerable in-house planning expertise.<br>• Executive Directors represent the Group on a number of local bodies which ensures that it remains aware of local issues.<br>• The procurement process used by the Group includes the use of highly regarded firms of quantity surveyors and is designed to minimise uncertainty regarding costs.<br>• Development costs are benchmarked to ensure that the Group obtains competitive pricing.<br>• The Group's style of accommodation remains in demand as evidenced by the 60 lettings achieved in 2014 which totalled 188,300 sq ft.<br>• The Group has often secured significant pre-lets of the space in its development programme which significantly 'de-risks' those projects.<br>• The Group's cost committee meets on a weekly basis to consider new budget requests or amendments. |
| **8. Inefficient systems**<br>The Group's systems and in particular its IT infrastructure are not developed quickly enough to support the business as it changes and grows or new systems are not implemented effectively.<br>This would lead to increased costs or reduced returns which would affect the Group's total return KPI.<br>Due to the expansion of the Group and increases in the rate of change in IT, this risk is considered to have risen over the year. | • The Group's IT department has been expanded over the last two years to improve the Group's ability to develop its systems.<br>• A steering group has been established from all parts of the business to identify and prioritise requirements.<br>• The proximity of members of the Executive Committee to the day-to-day operations helps identify IT requirements.<br>• System improvements are considered as part of the five-year strategic review. | • The IT department now consists of three people.<br>• The IT steering group met five times during the year.<br>• The IT manager attends meetings with representatives from similar companies in order to share knowledge.<br>• External consultants are used to assist with the implementation of most new systems. |
| **9. Business interruption**<br>The Group suffers either a successful cyber-attack or disaster that results in it being unable to use its IT systems.<br>This would lead to an increase in cost and a diversion of management time. Increased costs would have an impact on the Group's total return KPI whilst a significant diversion of management time would have a wider effect.<br>Due to the Group's increased dependence on IT systems, this risk is seen to have increased over the year. | • The Group's IT systems are protected by anti-virus software and firewalls which are continually updated.<br>• The offsite back-up IT infrastructure has been tested.<br>• A disaster recovery suite has been established. | • Internal and external penetration tests are regularly conducted to assess the effectiveness of the firewalls.<br>• A staff awareness programme has been rolled out to alert staff to the techniques that may be used to gain unauthorised access to the Group's systems.<br>• The Group's Business Continuity Plan is being reviewed and updated by external consultants. |

## Operational risks (continued)

| Risk, effect and progression | Controls and mitigation | Action |
|---|---|---|
| **10. Tenant default**<br>The Group suffers a loss of rental income and increased vacant property costs due to tenants vacating or becoming bankrupt.<br><br>This risk would have an immediate effect on the Group's tenant receipts and void management KPIs and, if significant, on the total property return, total return and interest cover ratio.<br><br>The Board considers this risk to have marginally decreased over the last year | ■ All prospective tenants are considered by the Group's Credit Committee and security is taken where appropriate either in the form of parent company guarantees or rent deposits.<br>■ The Group's property managers maintain regular contact with tenants and work closely with any that are facing financial difficulties.<br>■ The Group's Credit Committee regularly reviews a list of slow payers and considers what actions should be taken.<br>■ The Board regularly considers the merits of tenant default insurance. | ■ The Group has a diversified tenant base.<br>■ The Credit Committee meets each week and considered 113 potential lettings during the year.<br>■ In total the Group holds rental deposits amounting to £10.6m.<br>■ On average in 2014, the Group collected 99% of the rents due within 14 days of the due date. |
| **11. Shortage of key staff**<br>The Group is unable to successfully implement its strategy due to a failure to recruit and retain key staff with appropriate skills.<br><br>This risk could impact on any or all of the Group's KPIs.<br><br>The risk is seen to have marginally increased over the year. | ■ The remuneration packages of all employees are benchmarked regularly.<br>■ Six-monthly appraisals identify training requirements which are fulfilled over the next six months.<br>■ The Nominations Committee consider succession matters as a standing agenda item.<br>■ Requirements for senior management succession are considered as part of the five-year strategic review. | ■ The Group recruited 11 new members of staff during 2014.<br>■ Staff turnover during 2014 was low at 8%. |

### Key

Risk increase

Risk unchanged

Risk decrease

### Viability statement

In accordance with provision C.2.2 of the 2014 revision of the Code, the Directors have assessed the prospect of the Company over a longer period than the 12 months required by the 'Going Concern' provision. The Board conducted this review for a period of five years, which was selected for the following reasons:

i) The Group's strategic review covers a five-year period.

ii) For a major scheme five years is a reasonable approximation of the maximum time taken from obtaining planning permission to letting the property.

iii) Most leases contain a five-year rent review pattern and therefore five years allows for the forecasts to include the reversion arising from those reviews.

The five-year strategic review considers the Group's cash flows, dividend cover, REIT compliance and other key financial ratios over the period. These metrics are subject to sensitivity analysis which involves flexing a number of the main assumptions underlying the forecast both individually and in unison. Where appropriate, this analysis is carried out to evaluate the potential impact of the Group's principal risks actually occurring. The five-year review also makes certain assumptions about the normal level of capital recycling likely to occur and considers whether additional financing facilities will be required.

Based on the results of this analysis, the Directors have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the five-year period of their assessment.