GOING CONCERN & VIABILITY

INTRODUCTION

In accordance with the 2018 UK Corporate Governance Code (the Code), the Directors and senior management team assessed the prospects of the Company and potential threats to our resilience:

- in the short-term (over the next 12 months as required by the 'Going concern' provision); and
- in the medium-term (a five-year period to 31 December 2027) as required by the 'Viability statement' provision.

This statement also contains references to the longer term threats to the Company's resilience (beyond the five-year period).

SHORT-TERM

Under provision 30 of the Code, the Board is required to report whether it considers it appropriate to adopt the going concern basis of accounting in the preparation of our financial statements. The assessment focused primarily on the short-term and at least the next 12 months to March 2024. The Directors' assessment included consideration of:

- the Group's current financial position;
- the higher levels of inflation seen in 2022;
- the latest rolling forecast for the next two years;
- the timing of repayment of existing financing facilities;
- potential sources of replacement financing; and
- any material uncertainties or assumptions.

The Group is in a strong financial position. At 31 December 2022, the Group has:

- £577m of undrawn facilities and cash (2021: £608m);
- a low EPRA loan-to-value ratio of 23.9% (inc. share of joint ventures);
- a low overall cost of debt with a weighted average interest rate of 3.14% as at 31 December 2022;
- 100% of our borrowings either fixed or hedged;
- significant headroom on our financial covenants (see page 110); and
- strong interest cover of 423% (inc. share of joint ventures).

The Group has sufficient access to finance in the short-term and medium-term. At 31 December 2022, our average maturity of borrowings is 6.2 years and average maturity of facilities is 5.5 years. In addition, the Group has no immediate refinancing requirements, with the next loan maturity being the £83m secured loan with Mass Mutual, which matures in October 2024 (see page 104).

DEBT AND FINANCING / See pages 104 and 105

Material uncertainties or assumptions

The Directors did not identify any material uncertainties to the Company's ability to continue to operate as a going concern over the period of its assessment. The key sources of estimation uncertainty in the next 12 months are considered to be:

- **Fall in property values:** The impact of yield changes on the Group's financial covenants and performance are monitored regularly and are subject to sensitivity analysis and testing against severe yet plausible 'downside' scenarios to ensure that adequate headroom is preserved. The Group's low loan-to-value ratio reduces the likelihood that falls in property values have a significant operational impact on our business, requiring a fall of 60% in property values before our funding covenants would be breached.
- **Impairment review:** Sentiment amongst our occupiers improved through 2022, with rent collection levels across the office portfolio close to pre-Covid levels. However, due to the economic situation, rising interest rates and inflation, there remains a heightened risk of financial difficulty among some of our tenants. The methodology and assumptions used to review our receivable balances are subject to review by the external Auditors and Audit Committee (see page 159).

Key accounting issues or judgements are monitored and discussed with the Audit Committee throughout the year. The table on page 159 provides information on the key issues discussed in 2022 and the judgements adopted.

Group's risk register

The Schedule of Principal Risks contains the risks which are currently impacting on the Group or could impact the Group over the next 12 months. These risks are routinely subject to a comprehensive review by the Executive Committee, Risk Committee and the Board. Consideration is given to the risk likelihood, impact and velocity (speed at which the risk could impact on the Group).

The Board agreed that, given the level of headroom, none of the changes in risk likelihood or probability during the year (see page 113) had a significant impact on the Group's short-term viability.

GOING CONCERN STATEMENT

After making appropriate enquiries, the Directors have a reasonable expectation that the Group and Company have adequate resources to continue in operational existence until at least March 2024. Therefore, the Board continues to adopt the going concern basis in preparing the financial statements.

MEDIUM-TERM

The Directors challenge the time period over which to assess the Company's medium-term viability on an annual basis. The Directors determined that the five-year period to 31 December 2027 remains an appropriate period based on the following:

- for a major scheme, five years is a reasonable approximation of the time taken from obtaining planning permission for a typical development to letting the property;
- most leases contain a five-year rent review pattern or break options. Therefore, five years allows for the forecasts to include the reversion arising from those reviews while also assessing the potential impact of income lost from breaks exercised; and
- our average maturity of borrowings is 6.2 years as at 31 December 2022.

As part of its assessment, the Board considered the Group's emerging risks (pages 124 to 125), including how these were being addressed. Emerging risks involve a high degree of uncertainty and are therefore factored into the Board's medium-term viability assessment and the long-term sustainability of the Group. The methodology used to review and identify emerging risks is on pages 174 to 175.

The Directors concluded that none of the individual emerging risks would in isolation or collectively compromise the Group's viability over the five-year period to 31 December 2027.

The Board's medium-term assessment focused on our strategy, finance and operations.

Viability of our strategy

The Board formally reviews its strategy on an annual basis to ensure it remains capable of sustainable value creation and is responding appropriately to changing macroeconomic conditions, work practices and stakeholder expectations (see page 138).

When assessing the viability of the Group's strategy, the Board's key qualifications and assumptions were:

- a continued focus on the central London office market;
- a strategy of recycling capital by selling buildings when we have maximised their potential, or they no longer meet our investment criteria, and purchasing buildings where there is an opportunity to replenish our development pipeline or add value via asset management or refurbishment;
- a property portfolio which remains approximately the same size, at 5.46m sq ft (2021: 5.57m sq ft); and
- a progressive dividend policy, whilst targeting dividend cover in or above the range of 125% to 150%.

The Board agreed that we have a proven business model which has allowed us to remain flexible and resilient during previous property cycles and periods of significant uncertainty. Additionally, we have the ability to flex our business plan to react to unforeseen circumstances by either selling a property to generate additional cash flow or commencing, stopping or scaling back projects to manage our capital expenditure.

Given the political and economic uncertainties, there has been a slowdown in both the investment and letting markets. However, the Directors noted that occupier demand remains good for the right product.

In the short-term, the Board agreed that no material change was required to its strategy, which continued to generate sustainable returns. Our strong financial position and proactive stakeholder-focused approach will help us to weather the economic and political uncertainty.

Sensitivity and scenario testing

A detailed five-year strategic review was conducted which considered the Group's cash flows, dividend cover, REIT compliance and other key financial ratios over the period. These metrics were subjected to sensitivity analysis to assess the Group's ability to deliver its strategic objectives.

The Directors stress tested our strategy against various scenarios to determine whether they were likely to have a significant impact on the Group's solvency and liquidity in the short- and medium-term.

The scenarios are amended each year as required, to reflect the key areas of concern identified by the Board. The six scenarios assessed were:

- a 'base case' scenario which was management's best estimate of market and business changes;
- three scenarios of varying negative movements in property values based on higher yield and lower rental growth assumptions, or a combination thereof;
- a 'downside' scenario which showed the impact of a 38% fall in our portfolio property values; and
- an 'upside' scenario which showed the impact of a more positive outlook on property values, rental growth and letting assumptions.

In all scenarios, our net interest cover remained above 3.95 times and our EPRA loan-to-value ratio below 40%, both of which are comfortably within our financial covenants.

The modelling indicated that under all scenarios the Group would still be able to execute its strategic plan over the next five years without breaching any covenants or experiencing any liquidity concerns (see page 110).

GOING CONCERN & VIABILITY continued

Nature of office occupation

The Directors considered changing work practices and tenant demand for amenity-rich sustainable space which has been identified as an emerging strategic risk for the Group.

The Board was satisfied that the business was:

- responding appropriately to the changing needs of our occupiers via bespoke solutions which recognise the differing demands of our diverse customer base. For larger occupiers, typically on longer leases, this might mean a combination of core and flex space with some optionality. For smaller occupiers looking for greater flexibility, our 'Furnished + Flexible' product provides an attractive solution (see page 20);
- delivering well-designed, adaptable and amenity-rich workspace. Our customer-focused approach led us to initiatives such as DL/78 in Fitzrovia. Due to its success, an equivalent shared amenity hub has been approved at The Featherstone Building EC1 (see page 24); and
- being proactive to ensure the achievement of our net zero carbon ambitions, operating a continuous upgrade/refurbishment programme to improve the sustainability credentials of our older buildings, and investing in Intelligent Building infrastructure to create sustainable spaces for our occupiers (see page 181).

Viability of our finances

Derwent London would become unviable if we were unable to meet our financial covenants. If this occurred, we would need to repay our debt borrowings, and this would likely require the sale of assets to meet these liabilities. As at 31 December 2022, we have significant headroom over our covenants, as shown below:

	Covenant	31/12/2022
Loan to value (specific assets)	≤ 60%[1]	39%
	≤ 70%[2]	31%
Ratio of unencumbered assets to unsecured net debt	≤ 1.6 times	4.6 times
Group NAV gearing	≤ 145%	30.8%
Consolidated interest cover[3]	> 145%	423%

1 6.5% secured bonds.
2 3.99% secured loan.
3 Includes joint ventures.

Our covenant headroom was subject to sensitivity analysis and scenario testing as part of the Group's strategy review. Even in the most extreme 'downside' scenario we modelled, the covenant ratios are covered and there is sufficient cash and unutilised facilities available.

For the Group to breach the NAV gearing limit, the value of our portfolio would have to fall in excess of £3.2bn (or by 60%). This is significantly higher than we have seen in recent market down cycles, the worst of which was following the Global Financial Crisis where the value of our underlying portfolio fell 34% but still outperformed the MSCI Central London Office Index which fell 43%. Moreover, we have the ability to move properties between the facilities to optimise headroom under covenants.

To assess the Group's liquidity and financial resilience, the Directors also reviewed:

- a detailed five-year strategic review which included assessment of the Group's cash flows, dividend cover, REIT compliance and other key financial ratios. These metrics were subjected to sensitivity analysis to assess the Group's ability to deliver its strategic objectives under varying market conditions;
- the risks which could impact on the Group's liquidity and solvency over the next 12 months, five years and the longer term; and
- the Group's emerging risks.

The Board's assessment highlighted that, despite the macroeconomic environment deteriorating during 2022, the Group benefits from:

- reasonable income visibility for the life of our leases which on average are 7.2 years (including rent-frees and pre-lets) with upward-only or contracted rent reviews. In addition to a known level of tenant lease expiries and breaks which is actively managed by our Asset Management team; and
- a high quality customer base of tenants, with none of our occupiers being responsible for more than 7% of total rental income and relatively low exposure to the retail and restaurant sectors.

Inflation

Inflation is classified as an emerging financial risk for the Group. The Directors considered the current and forecasted rate of inflation.

The Directors' assessment highlighted that inflation is likely to have an impact on the Group's overheads and on our ability to secure fixed price construction contracts in the medium-term (see page 113). Our occupiers will also be impacted by rising prices, including in respect of utility and service charges. The Directors considered that inflation was unlikely to compromise the Group's viability over the five-year period to 31 December 2027.

Viability of our operations

The Board received an update from the Chairs of the Audit and Risk Committees on the work performed during 2022 in respect to risk monitoring and reviewing the effectiveness of internal controls (see pages 161 and 171). It was noted that the Finance team were not aware of any significant financial loss arising from a breakdown of internal controls in the past three years and that during 2023, an independent assessment will be conducted to determine areas of focus for further strengthening of our controls.

Despite the political uncertainty arising from the conflict in Ukraine, and the subsequent impact on supply chains globally, our supply chain has been relatively unaffected due to our approach of early pre-ordering and storage. Early supply chain engagement in project designs helps with the identification of potential risks and alternative solutions.

We have a robust approach to cyber security which is routinely subject to independent testing (see pages 180 and 181). Our Intelligent Building Programme is a medium- to long-term initiative which will assist with meeting our net zero carbon ambitions, the strengthening of our portfolio's cyber security and cost savings for our occupiers.

Of the Group's emerging operational risks, the Board considered planning permission risks and EPC compliance to have the greatest potential impact on the Group in the medium-term. The actions being taken by the Group, in a market where the demand for high quality amenity-rich buildings is increasing, are detailed on pages 23 to 24.

Based on the Board's assessments, none of the operational principal or emerging risks currently facing the Group were likely to have a material impact on the Group's operations or cause it to become unviable in the short- to medium-term.

Related information is on the following pages:

BUSINESS CONTINUITY AND DISASTER RECOVERY / See page 178

ATTRACTING AND OPTIMISING TALENT / See page 59

MANDATORY COMPLIANCE TRAINING / See page 171

VIABILITY STATEMENT

Based on the Board's assessments, 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 to 31 December 2027.

LONG-TERM

The Board considered a number of longer term factors (which could impact on the Company and its business model in the next five to 10 years) and how these were being addressed. These factors included the impact of climate change and technology advancement.

Related information is on the following pages:

OUR STRATEGY / See page 38

OUR DEVELOPMENT PIPELINE / See page 12

VALUE CREATION AND PRESERVATION / See page 138

Climate change

Derwent London is committed to be net zero carbon by 2030. The Group has conducted risk assessments against varying temperature scenarios (1.5°C, 2°C to 3°C, >4°C) to identify and assess our key transition and physical risks. The time frames used for these assessments have focused on our medium- and long-term resilience (see page 74).

Of the risks identified, none were likely to have a substantial impact on the viability of our business, although our cost profile could increase.

The Board receives updates on our progress to net zero carbon by 2030. The factors which could impact in our ability to become net zero carbon by 2030 have been identified as:

- **Newly acquired properties:** one of the ways we add value through our business model is by acquiring poorer quality buildings to regenerate. As a result, there is likely to always be an element of our portfolio which is progressing towards becoming net zero carbon.
- **Unmanaged portfolio:** within our portfolio we have a number of single-let buildings, with long leases, where the occupier is responsible for maintaining the property and ensuring its energy efficiency (currently 19% of our portfolio). As we are not responsible for the management of the building, this could be an area of challenge to achieving net zero carbon by 2030. We are actively engaging with these occupiers to promote the benefits of net zero carbon.
- **Emerging regulation and science:** our strategy to becoming net zero carbon will need to adapt in line with emerging regulation, planning policies and science.

At the Board's strategy awayday in June 2022, the Directors had a tour of the Scottish assets and the location of our future c.100-acre, 18.4MW solar park which is expected to generate in excess of 40% of the electricity needs of our managed London portfolio (see pages 7 and 55).

NET ZERO CARBON / See page 27

Intelligent buildings

Adoption of technology is an emerging risk for the Group. Technology in our sector is advancing at a rapid pace.

The Executive Committee has monitored the phased roll-out of Intelligent Building infrastructure during the year. The Derwent London Intelligent Buildings Programme seeks to enable our buildings (where appropriate) to be digitally monitored and operated more efficiently, driving down equipment faults (and consequential maintenance) and delivering energy and operational carbon savings.

INTELLIGENT BUILDINGS / See page 181