# VIABILITY STATEMENT

In accordance with the 2016 UK Corporate Governance Code, the Directors and the senior management team have assessed the prospects of the Company over a longer period than the 12 months required by the 'Going Concern' provision.

## Time period

The Directors have determined that the five-year period to 31 December 2023 is an appropriate period over which to assess its viability based on the following:

- for a major scheme, five years is a reasonable approximation of the typical time taken from obtaining planning permission for a development to letting the property; and
- 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 and to assess the potential impact of income lost from breaks exercised.

This time period is challenged annually to ensure it remains appropriate. Although the Board's viability review focused on a five-year period, it did consider a number of longer-term factors when considering the Group's future prospects, including:

- the weighted average lease length of 8.2 years (including rent-frees and pre-lets);
- due to the long-term nature of our business, some of our borrowings extend beyond five years;
- the nature of the property cycle and our expectations of how this impacts us; and
- changes in technology and tenant expectations.

## Assessment of prospects

The Board has assessed the Group's prospects and long-term viability with due consideration to:

- our current position and performance (pages 4 to 43);
- business model flexibility (pages 20 to 21);
- financing arrangements (page 72); and
- principal risks (pages 48 to 57).

The assessment highlighted that the Group has:

- a proven business model which has allowed us to remain flexible and resilient during previous property cycle downturns;
- a high-quality customer base of tenants, with none of our occupiers being responsible for more than 7% of our total rental income;
- income visibility for the life of our leases which on average are 8.2 years (including rent-frees and pre-lets) with upward only or contracted rent reviews;
- good interest in our mid-market space with strong pre-let interest in our schemes;
- good relationships with our bankers and no issues anticipated with respect to the renewal of our revolving credit facilities which are due to expire in 2022; and
- a low loan-to-value ratio of 17.2% and an additional £250m of long-term debt raised via the recent US private placement.

### Principal risks

The Schedule of Principal Risks is 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). It was agreed that none of the changes in risk likelihood or probability during the year (see page 46) had a significant impact on the Group's viability.

The Directors identified that, of the principal risks detailed on pages 48 to 57, the following are the most important to the assessment of the viability:

- Adverse Brexit settlement: As a predominantly London-based Group, we are particularly susceptible to changes which can adversely impact London's future prosperity. Although an adverse Brexit settlement for London would negatively impact our business, it would be unlikely to significantly affect the viability of the Group within the five-year review period.
- Risk arising from our development activities: Our current development pipeline is sizeable and its delivery remains a top priority. Despite developments being inherently risky, our pipeline is expected to be a significant driver of our earnings growth over the next five years. In addition, development uplifts should enhance valuation returns even in a flat or declining market.

The Directors' considered that none of the individual principal risks would in isolation compromise the Group's viability.

p.46 Our principal risks



### Qualifications and assumptions

The key assumptions which underpin our strategic plan are:

- the Group's business model remains broadly unchanged and continues to focus on the central London office market;
- we continue to operate a progressive dividend policy whilst ensuring dividend cover remains in or above the range of 1.25% to 1.5%; and
- our portfolio remains approximately the same size.

We have the ability to flex our business model to react to unforeseen circumstances or changes in the property cycle by either selling a property to generate additional cash flow or commencing or stopping development projects to manage our capital expenditure. We aim to maintain an adequate level of cash and available financial facilities. Regular financial forecasting enables us to identify and plan for additional funding requirements in advance.

## Assessment of viability

To assess the Group's viability, the business model and strategy were stress tested against our principal risks (in isolation and combination), various Brexit scenarios and other sensitivities.

### Sensitivity analysis of our strategy

A detailed five-year strategic review was conducted which considers 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 impact of the principal risks to the Group's ability to deliver its strategic objectives, which are set out on page 31, both individually and in unison.

### Stress testing our risk resilience

The Directors stress tested our strategy against a combination of principal and emerging risks which were likely to have a significant impact on the Group's solvency and liquidity over the five-year review period. A scenario was modelled that assumed a severe decrease in property values combined with significant letting delays at the Group's developments and a fall in rental income.

As at 31 December 2018, the value of the portfolio could fall by 69% without breaching the gearing covenants and our property income could fall by 73% before breaching the interest cover covenant.

### Brexit scenarios

The Board, under the stress testing of our risk resilience, tested the potential impact of various Brexit scenarios, by estimating their financial impact and overlaying this on the detailed financial forecasts included within the strategic plan and five-year forecasts for viability.

A range of Brexit scenarios of 'soft', 'hard' and 'disorderly' were modelled with various levels of impact on our property values and rental income. In all scenarios, our net interest cover remained above 350% and our loan-to-value ratio below 40%, both of which are comfortably within our financial covenants.

p.47 Brexit

## VIABILITY STATEMENT

Based on the Board's assessment, 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 2023.

# OUR PRINCIPAL RISKS

At Derwent London we aim to deliver on our strategic objectives for the benefit of our stakeholders whilst operating within the risk tolerance levels set by our Board.

## The risk profile of the Group

As a predominantly London-based Group, we are particularly sensitive to factors which impact upon central London's growth and demand for office space. Any decline in the demand for London office space or a significant increase in supply could negatively impact upon:

- the value of our property portfolio;
- occupancy rates and, subsequently, our income; and
- availability of properties for acquisition and the ease of disposal and refinancing.

The London office market has proven to be cyclical and can be impacted by a number of external and internal factors. For example, changes in political agendas or economic factors can impact upon:

- the ease of gaining planning permission for new development projects;
- cost of acquisitions, e.g. stamp duty land tax; and
- value of our properties to overseas investors due to exchange rate fluctuations.

## Changes to our principal risks

The principal risks and uncertainties facing the Group in 2019 are set out on pages 48 to 57 together with the potential impact and the mitigating actions and controls in place. Our principal risks are not an exhaustive list of all risks facing the Group but are a snapshot of the Company's main risk profile as at 26 February 2019.

During the year under review, there has been a number of changes to our principal risks:

**New principal risk**

(i) 'Management of succession' has been elevated to a principal risk, due to the importance of retaining our senior management team and maintaining our culture (see page 48).

**Increasing risks**

(i) As at 26 February 2019, arrangements to leave the EU have not been agreed and subsequently the risk that negotiations result in arrangements which are damaging to the London economy has increased.

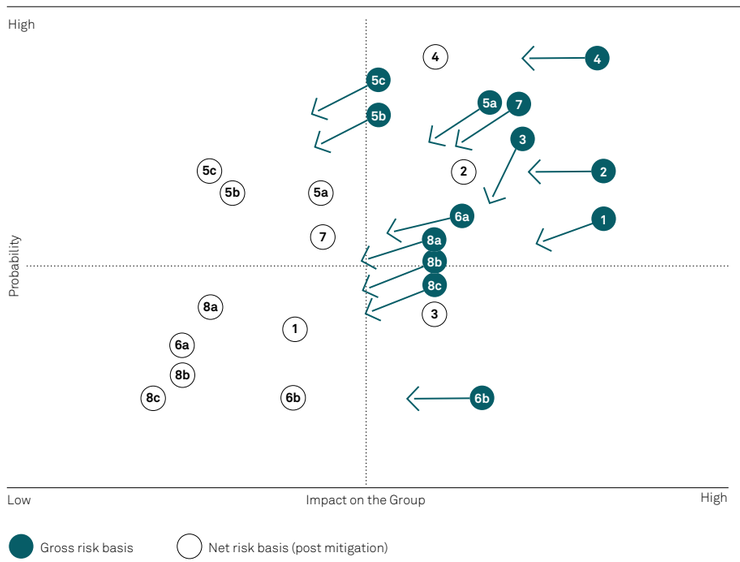
(ii) The possibility that property values will fall has increased due to Brexit uncertainty and as we approach the end of the current property cycle. Recent property cycles last for approximately seven years and the current cycle is over eight years.

(iii) Due to our successful programme to de-risk our developments through pre-lets, there is increased 'on-site' risk of completing 80 Charlotte Street on time. Practical completion of 80 Charlotte Street is expected to be in the first half of 2020, making 2019 an important year. If late, we could face penalties and a loss of rental income.

(iv) Partly driven by Brexit uncertainty and the concerns over contractor business models, the risk of reduced development returns has increased.

**Effect of mitigation actions on our principal risks**

p.48 Risks




1 Failure to implement the Group's strategy
2 Adverse Brexit settlement
3 Management of succession
4 Fall in property values
5a Reduced development returns
5b 'On-site' risk
5c Contractor/subcontractor default
6a Cyber attack
6b Terrorism or other business interruption
7 Reputational damage
8a Non-compliance with health and safety legislation
8b Climate change and non-compliance with environmental and sustainability legislation
8c Other regulatory non-compliance



## Risk management

Risk is inherent in running any business. Our risk management procedures are routinely reviewed and strengthened to ensure that all foreseeable and emerging risks are identified, understood and managed. Our overall low risk tolerance (see page 112), alongside a transparent and collaborative work style, ensures that any potential risk is identified quickly. Our approach to risk management is contained on pages 111 to 112.

The role of our Board, with support from the Risk Committee, is to ensure that our risk management and internal controls are robust so that we remain able to swiftly identify and react to new threats and uncertainties. Balanced with the maintenance of a flexible business model and strong financial structure, this better enables us to weather uncertainties and take advantage of opportunities.

**Derwent London brand**

The Derwent London brand is well-regarded and respected within our industry and is recognised for its innovation and for developing design-led buildings. The protection of our brand and our reputation is important to the future success of the Group (see page 54).

**Development risks**

Our developments are large, high-value projects with life cycles which can be up to five years. The success of our development activities is reliant on taking managed and carefully considered risk, which aims to deliver the office space our occupiers desire when it is needed. In August 2018, the Risk Committee visited the 80 Charlotte Street development to see first-hand how construction and health and safety risks are managed (see page 112).

## BREXIT

Since the referendum decision in June 2016 to leave the EU, we have been operating through a period of heightened economic and political uncertainty.

- If a deal is not agreed between the UK and the EU by 29 March 2019, or no alternative arrangements are agreed, trade to and from the UK will default to WTO (World Trade Organization) rules with the associated tariffs.
- If a deal is reached with a 'transition period' to 31 December 2020 or such other date that is agreed, there will be less impact on our business over the next two years or so. However, uncertainty is likely to continue until new trade and international agreements have been finalised and this may take some time.

As outlined on page 45, we have considered various Brexit scenarios when reviewing our five-year strategy. Although 'no deal' and more adverse Brexit scenarios would likely cause a decrease in earnings and NAV, our financial covenants were not close to being compromised in any of the scenarios, and we continued to be able to carry on with our current business plans.

### How could Brexit impact us?

**Our core income**

Derwent London has no buildings in the City and few occupants from the financial services industry (4% of our portfolio). Our EPRA vacancy rate is low at 1.8% and the majority of recent rent reviews have been above ERV. To date we have not seen, nor are we forecasting in our base case, any significant impact on our operating performance in respect to Brexit.

The current market is supply limited, a situation that may even have been enhanced by the Brexit vote, which has maintained the demand for our buildings and developments leading to substantial pre-letting of the Brunel Building W2 and 80 Charlotte Street W1 developments.

If a deal is reached, we would not expect a significant short-term change in supply within the central London property market and rents would likely remain stable during the transition period. In a 'no deal' situation, if the importance of London as a global centre is diminished, demand for space could decline over time which would likely see an increase in void periods and risk of lower rents when leases come up for renewal. However, our focus on good value, well-designed, middle market rent properties means we are less susceptible to reductions in tenant demand.

**Our developments**

The highest potential impact on Derwent London will be in respect of our developments. In the event of a 'no deal' Brexit, the cost and timeline of our developments could be impacted where we are importing building materials or components from Europe, as they may be subject to tariffs and border delays.

In addition, development costs are likely to increase due to:

- devaluation of the pound leading to price inflation for imported materials on contracts that are not at fixed prices; and
- shortage of skilled construction workers leading to increased labour costs on future development projects.

There will be a heightened risk of contractor or subcontractor default due to the increased costs arising from the risks stated above, which will be carefully monitored as we work closely with our contractors to mitigate this issue.

We have been working with our principal contractors to determine the likely effect of a 'no deal' Brexit on 80 Charlotte Street. As a contingency measure, our contractors have started to pre-order materials and store them in advance of use, where required. Any increase in handling or storage costs of materials will be a contractual cost for our contractors.

The Brunel Building and 80 Charlotte Street developments have not yet been noticeably impacted by Brexit and their building contracts do not contain Brexit clauses. Currently any risks arising on these developments from Brexit are the responsibility of the principal contractor, although delays in completion could potentially result in a reduction in our revenue. In respect to new developments, such as Soho Place and The Featherstone Building, we may be required to accept additional risks in respect to delays and increased costs.

**Value of our buildings**

Since the decision to leave the EU, the valuation of our portfolio has continued to grow, albeit more slowly: 2018: +2.2%, 2017 +3.9%. If a deal is not reached and there is a significant reduction in demand for central London properties, the value of our buildings may decrease. Our external valuers, CBRE, might also add market uncertainty clauses into their valuation (as they did in the 2008 financial crisis).

Although a decrease in value will not have a direct impact on our business model, it will reduce the headroom available for our covenants. Our internal modelling indicated that, as at 31 December 2018, the value of the portfolio could fall by 69% without breaching the gearing covenants.

If there is a fall in property values, there could be opportunities to buy property for future development. Alongside a fall, the devaluation of the pound could increase demand for London properties from overseas buyers, as was seen immediately after the referendum decision. With increased investment in London property, this will provide underlying support for the value of our buildings.