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**BRIXTON**

**Tim Wheeler, Chief Executive and Steven Owen, Deputy Chief Executive**

# BRIXTON - interim results

## Results highlights

Q.

**On the face of things these interim results seem good. So, what for you are the highlights?**

A.

Well, I think they are an excellent set of results. Property investment is about many things: it's partly about timing and partly about endeavour and we've been particularly active over the last 18 - 20 months.

It might be worth just setting the scene first on what we have been up to and then go into the numbers themselves. We were looking back at some figures in '97 when the management here changed. Then we owned 9m sq. ft. of industrial space worth £600m. And today we're up to about 25m sq. ft. worth over £2.1bn. Now, even in the last 20 months, from the beginning of 2004, the net addition to the portfolio has been 9.5m sq. ft. There has been a lot of space added.

So, it's even more remarkable in some ways that the results have stood up so well, given the changes that we still continue to go through. Looking at those numbers, we're very pleased with the NAV growth, which is nudging 10 %. That's been driven by capital value surpluses of 4.9 %. It would have actually been even higher had the Stamp Duty Land Tax relief not been taken away in Disadvantaged Areas.

Adjusted earning per share uplift is good, about 6.5 % growth. And profit before tax is roaring ahead still, at over 40 %. But, more importantly, the underlying investment profit is also going up.

I can only really say that this is due to the efforts of those around me here, because we've had a very, very busy few months.

Q.

**Once again sharpening investment yields in the market place have moved your net asset value up, this time by 10 %. But surely this level of increase isn't sustainable.**

A.

Well, there's been much commentary about this. It's perfectly possible that yields will compress a bit further, with interest rates potentially falling more. But the jury is out on that and you'll get different schools of thought.

What we have already said is that 40 % of the increase in value on the capital side this time round has been from rental growth and that remains, and has always been, the important bit in the way that we manage Brixton.

So, let's look at that rental growth. We saw 2.4 % according to our valuers on the portfolio overall, and 6.5 % on Industrious. Now, actually what we achieved was 6 % on the portfolio and 17 % on Industrious. It's worth comparing that with IPD, 0.2 %, and

others have recently reported flat rental growth on their UK industrial portfolios.

What this actually means, and this is again the crux of it, is that when we bought some of the major holdings that we've done recently, whether it's Trafford Park, where we needed 0.7 % rental growth per annum, or Industrious, where we needed 1 % per annum over 5 years to hit our pre tax WACC and create shareholder value: we've actually done it since the acquisitions. So, we've actually cleared that hurdle in 7 or 8 months on Industrious and in a year and a bit on Trafford Park. That's what really generates value. If yields fall further, great. But these are tangible rental improvements.

## Industrious

Q.

**These are the first set of results to reflect the Industrious purchase earlier this year. You were criticised at the time about this purchase. What would you say to your critics now?**

A.

Well, the results have come through very well in terms of Industrious. It's mainly been about income growth but, obviously, we bought at a time since when yields have continued to compress. So, there's been yield driven capital growth there as well. But it's really the income side that we concentrate on.

But perhaps, before looking at that, I'll just turn to some of the criticism, because we have an opportunity now of actually looking back at what was said and, obviously, explaining what has happened since.

Many comments were made particularly from two analysts' houses. I don't think you need to look much further than the title of one of the notes that called our purchase "Industrial waste" and said there was only marginal capacity to increase growth from this portfolio. Others said that really we were a late player in the yield shift cycle. Now, that's obviously been proven to be completely incorrect in our terms of our sub sale of the 40 % of the portfolio, and other activity in the market, whether it's Ashtenne to Warner, or some of the other activity that's gone on with the major players. So, there has been more yield compression.

There was also the thought that we were actually trying to grow the company for its own sake, not at all a message we tried to articulate, but a message that was picked up in some quarters. We were always saying that it is about growing shareholder return. And I think what's significant is that we have got the gearing back down to 75 % and that the market capitalisation of the Company, which for the first time ever is over £1bn, is 25 % higher than it was on the day we announced the Industrious exchange (Nov 2004).

So, I think we can really look back and say that a lot of the fears that were expressed - and we weren't quite sure why they were being expressed at the time - have been allayed by the results that I'll now go on to talk about.

In terms of what we've actually done, we've seen capital value growth in Industrious since we bought it on 31 January this year, call it February, of 10 %.

We've also seen the valuers put the ERV enhancement at 6.5 %, so that's rental growth. But on the lettings that we've done, the 59 lettings that we've done, we actually averaged 17 % growth.

It's even more interesting when we look at something called Flexilet, which was the flexible inclusive product that Industrious were running for shorter term leases. We said it was a good product, but needed to set aside other things. So, we've got a menu, other

pricing models, as well.

At the time of purchase on the retained portfolio only 15 % of the income was covered by this Flexilet model, which we thought was very strange given the promotion that had gone on behind it. Of the lettings that we've done, the one's I've just described, 30 % of them have basically been Flexilet deals in terms of income. And those lettings haven't been at the 17 % enhancement, they've been at a 33 % enhancement.

And these results are really quite interesting when you think what our detractors said that the assets had been heavily sweated by previous management, that there was marginal opportunity for further growth and disputed our contention that actually softer rental deals had been done to fill the portfolio up, to get income, in advance of the sale.

Q.

**So, you're achieving the uplifts that you potentially saw there?**

A.

Yes, I think we're exceeding them to be honest. We've got to put that again into some sort of third party context. We use two firms of valuers who assessed the rental value on this portfolio when we bought it within a whisker of the rental value that were provided for us by the vendors' surveyors, another international firm of chartered surveyors. And, indeed, those numbers were effectively being used by previous management. Previous management were using the December 2003 ERVs, which were only 1 % lower than the ones that basically CBRE, King Sturge and DTZ came to the same answer on when we bought the portfolio in February. We have pushed those rents forward by 17 %.

## New acquisitions management

Q.

**The valuation surplus for the whole portfolio was up 4.9 %. The portfolio also showed good ERV growth, but both Industrious and Trafford Park exceeded this. So, is this a sign of things to come?**

A.

Well, I don't think these things can be seen as an immediate one-off gain. Both holdings at Trafford Park and the Industrious portfolio have obviously been owned and run by professional teams of dedicated real estate people before us. So, it's not as if we're going into a situation that hasn't been worked to a degree. We do things differently at Brixton, though, and one of those things is obviously the customer service, B-Serv, management model. Now, ironically, it takes a while for those things to filter through because it's about consolidation of services, which means cheaper services for the tenants. It's about getting their confidence. It's about getting to know them better. And those things actually tend to flow through over a longer period of time. So, that makes it even more extraordinary that we've seen the sort of growth coming through that we have, whether it's capital value movement of 10 % on Industrious or valuers rental value movement of 6.5 %, and actually achieving 17 %.

Those are big numbers and it's about endeavour. It's about the way we've focused the teams. We've closed down a number of the Industrious offices. They had five offices. We've opened one new base in the Midlands. We've introduced contracts management, to consolidate the supply chain. We've introduced customer management, that's people going to see folk. And we've more concentrated the asset managers on income generation, which is really what they're dedicated skill should be.

So, I think there's probably a bit further to go in terms of what we can achieve. We've introduced more leasing products. There was really only Flexilet or longer leases. We've introduced a fixed price option for fixed term leases, which are short leases or longer leases. It's a bit like going to a restaurant and having a choice of five main courses. That's the way we deal with leasing through a dedicated leasing centre.

## Lettings and voids

Q.

**More than a million square feet has been let in the year to date, despite some recent negative market sentiment. Where is that demand coming from?**

A.

Well, actually it's 1.13m sq. ft. So, it's even more than that, year to date. The number itself is extraordinary. On a pro rata basis compared to month by month last year, which was a record year for us, it's up 120 % and we've let 50 % more this year than we did in the whole of last year. So it is quite a remarkable figure.

Where's it coming from? Well, a couple of things have happened. The level of enquiries in 2004 kicked up in our core market of West London by about 50 % over 2003, again according to King Sturge. That level of enquiries into the first half of '05 has continued at a pace. But, most interestingly, it's in the sub 25,000 square foot category where there's been a real upsurge; a 50 % increase this half compared to the last half of last year in those smaller units.

Now, we've done 180 lettings this year, only eight of these are units bigger than 25,000 sq. ft. and that's exactly our market. This really isn't complicated. Most of the bigger spaces in the recent past have been taken by retailers, or retail orientated companies, as they've consolidated their supply chains. That's never really been Brixton's core market. And therefore, the surveys that you see about falling demand tend to be heading towards that end of the market. That's not us. In fact, only 12 % of our portfolio covers retail tenants in distribution units.

Q.

**But, given that your lettings are so strong, why are voids still an issue. You've passed the pinch point in lease expiries. So, why do voids remain stubbornly high at 10 %?**

A.

Well, I don't think 10 % is particularly high. It depends which portfolio you're looking at. The significant thing is this is the first time that Industrious has been taken on board in the numbers. Now, Industrious is a secondary portfolio, Trafford Park is also a more secondary portfolio. They have historically reasonably high levels of vacancy. So, we're probably going to running not a lot dissimilar to that going forward.

The other important point is that over time leases have got shorter. So, by their very nature, you're going to tend to have higher vacancy rates than traditionally people have expected. But these rates aren't in anyway a concern to us. And, interestingly, despite all that extra work and rental growth that we've seen in Industrious, the vacancy rate there does remain below 10 %. And, indeed, on an income basis, rather than an area basis, the vacancy rate is less at 11.2 % than it was at the '04 year end - 11.7 % - and where we find ourselves today in area terms it's 10.3 %, as against 10.2 % at the year end last year. And it was down a little bit at 9.1 % at the half year stage, which was great.

But just to give you one example of how things can change. Since the half year, the 9.1 % to the 10.3 %, two things have happened. We've finished a new scheme at Park Royal. One unit is let and we've got very good interest but this and a unit coming back to us where a tenant's gone bust at Hemel does change the vacancy rate by 1 %.

So, if we did no development our vacancy rate would be less. But that's not what we're really here to do.

## IFRS and dividends

Q.

**Steve, clearly IFRS has had a big impact on the numbers. So could you talk us through the main areas which have been affected?**

A.

Well, the main areas that have been affected are:

Firstly, the fair value of movement in investment properties is now shown in the profit and loss account and not in the balance sheet.

Secondly, the movement in the fair value of derivatives is also shown in the profit and loss account; previously it was just a note to the accounts.

Thirdly, our share of joint venture profits is now shown just as a single line in the profit and loss account and the balance sheet, and it also includes the movement in the fair value of investment properties and derivatives.

And, fourthly, deferred tax on the revaluation movements in investment properties and derivatives is now charged into the profit and loss account; previously they were disclosed as a note to the accounts.

The effect of all of that is to substantially increase the volatility in the profit and loss account. So, if we look at the pre tax profit for the whole of 2004 published under UK GAAP it was £53m. Under IFRS it's £175m. Looking at the first half profit for 2004, under IFRS it's £93m and the first half profit for 2005 is £132m. So, these are significant movements in the P&L.

Now, what we have done in conjunction with UK property industry practice is that we've analysed in the interim report this pre tax profit to get back to investment profit, or underlying profit, which is a measure that has been used for many, many years by the quoted property sector.

Q.

**You say that IFRS won't affect the cash flow, but it must affect some things. For example, you've increased the dividend, but given the strength of your results, couldn't you have done more?**

A.

Well, this is where we need to look at the different components. In terms of strategy, our strategy is based on the fundamentals of the business of a property investment company and not on accounting presentation or disclosure.

In terms of cash flows IFRS is all about fair value accounting and does not affect the cash flows arising from the business. And in terms of our dividend and our dividend policy, our dividend policy has always been to pay a dividend out of our post tax investment profit or underlying profit. And these are profits that are derived from our recurring rental income activities.

The effect of IFRS has been to put into the profit and loss account unrealised profits, predominantly from the movement in the valuation of our portfolio. So, of the £132m profit made in the first half of 2005 under IFRS, £106m of that was unrealised. And you can't pay a cash dividend out of unrealised profits, which is why our dividend policy, as I said, is based on investment profit.

So, if you look at our adjusted earnings per share at the half year, they were up 6.5 %. We have increased the interim dividend by 2.5 % and what we look for in terms of the dividend policy is a progressive dividend policy each year. If we look at 2004, the total dividend for 2004 was 11.5 pence compared with adjusted earnings per share of 14.5 pence. Now, that's a payout ratio of 79 % and in a REIT environment it's likely that we will have to continue to make a high payout.

## Balance sheet

Q.

**Let's turn to gearing, now that Industrious has been both bought and parts of it sold on, now that you've disposed of offices completely, have you got gearing back to where you want it?**

A.

Well, we've said that we're comfortable in the 80 % to 90 % range and gearing in the last 12 to 18 months has been both higher and lower than that. At the end of the half year it was 75 %. Equally, we're comfortable with that.

I think the key point about gearing is whether you have the flexibility within your balance sheet to use your gearing. Now, in a rising property market where values are rising, it is beneficial to have high gearing. Our gearing at the end of last year was 56 %. So, the increase up to 75 %, predominantly because of the acquisition of Industrious, has helped to augment returns to shareholders.

But the key to all this flexibility is having an unsecured financing strategy, which enables us to move quickly in terms of taking advantage of opportunities.

Q.

**Given what you've just said, are you happy with the shape of your balance sheet?**

A.

Yes, I am, because in the first half of the year we reduced the level of secured debt relative to total debt, by increasing the level of unsecured debts through the acquisition of Industrious.

We also bought back a small amount of the existing Brixton debentures and redeemed the £60m debenture that we acquired on the acquisition of Industrious through a £60m tap on to our 2019 unsecured bond. So, I'm quite happy with the shape of the balance sheet plus the fact that in terms of financial capacity, we've also got £243m of undrawn committed bank facilities available to us for future investment and opportunities.

## Outlook

Q.

**So, how do you see the outlook for 2005 and beyond?**

A.

Well, it's to continue with what we call occupational out-performance. That's two things. It's an out performance on the rental side, which benefits our shareholders, and it's hopefully out performance for the people that occupy our units, through better quality of services and cheaper services to boot. So, that must continue through.

We have a diverse portfolio. It's got larger. It's more diverse and spread, which spreads risk, and that's something that I think we should all be fairly conscious of. The number of tenants has gone up from 1,100 to 1,900. We're still very heavily focused towards areas of economic growth. Our markets do remain good. You've seen the good level of enquiries that I've explained that there are generally.

Overall, there's been a drop in availability over the last 18 months to the half year this year in industrial space throughout the country. The South East has been pretty static, but Greater London has fallen quite significantly in the last six months. And, interestingly, some of those locales that we've picked on seem to have had the biggest fall in availability. The North West is the prime example - it's come down by 25 %; the West Midlands, where we're based, by about 11 %, as well.

There are some worries about the economy and where that is. But, as I say, our markets

remain robust. The portfolio is more diverse than it's been and it's really more of the same thing. It's getting on and working these assets and improving the stock that we've got.

Q.

**So, would it be fair to say that your future is now one of consolidation? Or do you still see room for opportunistic acquisition?**

A.

Well, we always like to be active and opportunistic. If you'd asked me that question 20 months ago I don't think we'd have said we were going to turn over 23m square feet of space, £1.6bn worth of property, and buy what was probably, or allegedly, the third largest industrial company in the country. So, there will always be opportunities.

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