BRIXTON - acquisition of Industrious by Brixton

Acquisition & rationale

Q.
What exactly is Industrious?
A.
Well Industrious is a large, privately owned, industrial property owning group that basically owns about 11.6m square feet of space in the UK, about 45 per cent of it in the South. Of that 11.6m square feet, there are 163 estates with over 2,200 separate units.
Q.
And how much are you paying?
A.
Well in net asset terms we calculate at the moment the figure to be about £250m. That will fluctuate a bit, depending on how some of the inter-company debt is actually addressed, and will be set at completion. But it will be around that figure. Plus we're repaying the debt itself, which takes the overall figure we're paying to about £600m. Now that compares with the worth of the gross assets of about £675m. And the difference between the £675m and the £600m is literally the debenture, which we're keeping, and about £15m worth of working capital.
Q.
What is the rationale for the deal?
A.
The rationale really for Brixton is to take the proven business model that we've got, the unique approach to customer management through our estates, and export it into other markets. They are more secondary in terms of the property stock and they're more secondary in terms of their locations, but providing the pricing is right, there's no reason not to do that. We have a precedent set really with what we did in earlier days with the Equiton fund, which is looking at small and more secondary properties in the Southeast, where we are a 30 per cent stakeholder and we run that fund, and we've also more recently done that with the 2.7m square foot acquisition at Trafford Park.
Q.
But doesn't this effectively take you back to where you were a few years ago?
A.
No, not at all. I mean where we were a few years ago was a property company spread amongst six countries that had more than half of its assets in offices. So we went from that to owning about 15 estates in the whole country. They all happen to be in the Southeast and at the end of this we will own something like 240-250 estates spread amongst the country, but still with the major dominance down in the Southeast. It will be something like £1.75bn worth of property in the Southeast.
Q.
You had to win an auction to buy Industrious, but the price does seem a very full one. Have you overpaid?
A.
Well, when anybody buys anything in a competitive situation, one tends to have pay the highest price to win that bidding process. Brixton does have the advantage of certainty of performance. That's really because we finance things on an unsecured basis and we have access to finance for this deal, for example, without recourse to the equity markets, or to third-party funders who are looking at the specific stock. So we can act quickly. So that probably means that we don't necessarily have to be in pounds and pennies the top bidder.
We're quite comfortable with the pricing. Just to give you an example of where it sits, in initial yield terms the portfolio is throwing out about 6.9 per cent. That compares with IPD's figure for the country as a whole on industrial of about 6.95 per cent. So we're right on the average for the country and bearing in mind, as I said earlier, nearly 50 per cent of the stock is in the Southeast, one might expect to pay a higher price for this. If you compare it with Brixton's own

portfolio, that is valued at 100 basis points keener and the Equiton portfolio of secondary properties is valued at 60 basis points keener. So we think there's a margin there to allow for what this portfolio is.
Q.
The industrial market is pretty hot right now. You yourself said at the interims that you were cautious on the outlook. Haven't you bought at the top of the market?
A.
We were very confident about where the occupational market was and is. We've demonstrated continual rental growth. We've demonstrated greater volumes of transactions. Up in Manchester we've demonstrated, on the deals we've concluded since the acquisition in March, a rental uplift of more than 13 per cent on about 15 deals. So the occupational market is fine. Our only level of caution, and just to reiterate this, was over the pricing and the keenness of yield that was being paid. In some instances it was actually driving, in our view, unrealistic rental growth assumptions to support that pricing.
So for this deal to work for Brixton, what we need to see over five years is 1.7 per cent rental growth per annum. That's to hit our pre-tax WACC IRR hurdle. Now we believe that should be achievable. We've also appraised it on a fairly conservative basis, assuming that all the tenants who could leave do leave when they do, any tenants holding over don't renew, any break could happen takes place. So we've allowed a void beyond that. So it's a worse case scenario.
We've also done something that's slightly technical but unconventional, in that we've moved out the exit yield to a degree to really reflect the fact that we do think the investment yields are perhaps at a sort of peak level at the moment.
Even on that basis, we need rental growth which is less than has been experienced on the IP data for the whole of the country over the last five years and is way less than we've achieved in some of our more secondary locations and, indeed, expect to do so from our experiences already up in the Northwest. So we're quite confident about that.

Financing & structure

Q.
So how are you actually financing this acquisition?
A.
Well this is just literally from our own banking resources. We've agreed another facility, in this case with HSBC, for another £250m. It does have an effect on our gearing, which we will talk about, but basically we can stand it on our own book. There's no reason to go to the equity market.
Q.
And so what's the timetable to completion?
A.
Timetable to completion is prescribed. We need to get shareholder approval. That is likely to come through, given the process of the circular and consultation with the UKLA, at some point in December.
Q.
You're buying Industrious through various Jersey entities. Why is that?
A.
That's the way it has really been reconfigured after it was taken private a couple of years ago by Morgan Stanley to make it tax efficient from a stamp duty perspective. It's a very common route. What we're basically buying is a number of Jersey offshore unit trusts and Jersey limited partnerships. So we will continue to run the structure, as many of the institutions and other owners do, through basically a Jersey Board.

The fit

Q.
How does it fit with your existing portfolio? The properties seem very different.
A.
Well, they are different. They're different in a number of respects: geographically, of course; in

terms of size - they tend to be occupied by SME companies typically around 5,000 feet and less; and in terms of quality, they're probably slightly more mixed, slightly older. The reality around the country is in many instances it is not economic to redevelop stocks, so people tend to refurbish. That's the experience we've got vividly up in Manchester of both estates – the Stanley Green one, that we've owned for a long while, and Trafford Park as well.

Q.

But doesn't this deal run counter to your Southeast focus which investors have bought into?

A.

No, I think it is a balance. It's completely a balance. What Brixton is about is the PLC vehicle tends to dominate West London and Heathrow. You'll be aware that we transferred two of the more static, longer let, cleanest properties into the Big Box fund with the Prudential earlier this year. But, basically, buying Brixton, the bulk of our portfolio is still very much that market. There's an exposure to the more secondary, more far flung Southeast industrial market, the smaller lot sizes, through Equiton, where we have a 30 per cent stake.

We will run Industrious as a standalone vehicle. So it will be distinct from Brixton. Basically about half of what we'll end up with will still be in the Southeast and roughly £100m or so will be based around Manchester and £100m around Birmingham. We'll use the existing office in Manchester and a new office which we'll open up in Birmingham as a springboard for more activity in that area.

Q.

Are there any conflicts of interest with the Equiton fund?

A.

We don't think so, for the reasons I've expressed. We're going to run Industrious as a standalone vehicle and therefore it would be sensible to have an element of that portfolio in the Southeast. Our relationship with both our partners in Equiton is very good. They understand the nature of it, both contractually and morally, and we're under no obligation to do anything other than put forward to them the properties that we think are most suitable for Equiton. At this stage, as I say, we're going to keep the Southeast properties within Industrious. There will be some sales out of Industrious and Equiton may want to buy some of those. But I think we will keep the two entities running in parallel.

Q.

How does this acquisition fit into the likely post "REIT" environment?

A.

Well that's another reason for buying the stock really. It's not particularly just to bulk up for bulk up sake, as some people have suggested. There are a number of issues. Certainly this deal is income enhancing from day one. The yield is higher, as I've said, on the portfolio than both the overall Group portfolio, including the joint ventures, and those distinct joint ventures, like Equiton. So it will provide more income and therefore more yield potential. So that's a positive.

We could talk all day as to whether we think REITs are going to come in or not, and there's great speculation as to whether they are, what the restrictions are going to be and what the timing might be. If a suitable mechanism, a flexible mechanism, is promoted, Brixton has always been seen to be one of the more typical REIT candidates because of the way we've structured our business. But we could either deal with Industrious as a separate REIT or, if the legislation isn't favourable, it's of course all domiciled over in Jersey at the moment on a tax transparent basis and we can leave it there.

Gearing & disposals

Q.

This deal is going to drive gearing to over 130 per cent. So are you considering any disposals, in the office portfolio for example, and how are you going to do this?

A.

Yes. Well we thought it was important to try and finance this deal ourselves anyway. So the debt does take the gearing up from 61 per cent, on a sort of pro forma basis, post the June figures, to, as you quite rightly say, 131 per cent. We would not want to run our business at that gearing level. We're on record as saying we're happy in a sort of 80 per cent to 90 per cent level.

But it’s quite common knowledge that we’re planning to exit from our office portfolio, which at the last valuation was valued at £171m in June. We’re in significant discussions with parties on that and that in itself would reduce the gearing level from 131 per cent down to something around 115 per cent. And then, from the sales within Industrious that we plan to do, that will drop the gearing back down to around the 85 per cent to 90 per cent level that we’re looking to get.
Q.
What are you going to sell out of Industrious therefore?
A.
As we all know, the market for industrial stock and property stock generally is very hot at the moment. We know this was keenly contested. The advice we’re getting is simply to offer whatever we want to offer in a single portfolio. We’re probably looking at divesting of something in the order of 50 properties out of the 163. That will roughly leave Brixton with about 7m square feet out of the 11.6 [million square feet] that we’re acquiring. And, as I say, if that happens, it has the effect of reducing the gearing by about another 30 per cent.

Integration & implications

Q.
Will you experience management stretch as a result of this purchase?
A.
Well, there's no two ways about it, it’s a big portfolio. The actual acquisition price for the gross assets is about £675m. So it’s about a third of the value of Brixton’s existing portfolio. Interestingly, we’re getting about two-thirds of the size of Brixton’s portfolio, at 11.6m square feet, compared to around about 17 or 18m square feet of space that we have at the moment. So it is a big chunk of property.
There is an existing management regime in place with six regional offices. We’re intending to run it from three, two of which we already have. So we think we’re more than capable of dealing with it.
There's a lot we can do to build synergies, to drive some cost savings and economies of scale. There's a lot of things we can look at. I mean simple things. When Brixton went through its big growth period of buying all these industrial estates, from ’97 onwards, we ended up with something like 300 separate service contracts on all the estates that we had. Industrious still have 400. We now have 14 or 15. So we get quality service for our tenants. We get cost tension. We get pricing tension and therefore there's a saving. We need to do that with the Industrious portfolio.
The Flexi-Let offering is something that Industrious have built their model around - and we applaud it because it is about offering flexibility but it has become too cumbersome. They have about six different versions of it. It only actually applies to about 8 per cent of their portfolio. We have a very distinct lease pricing model which is more flexible. We can price any length of deal for any covenant strength. That’s the sort of thing that we’re going to start looking at.
We’re very strict on our financial discipline here and that’s another aspect that we can look at in terms of how we drive the forecasting and income projections going forward.
So there's quite a lot to do, but it’s not a particularly daunting task. We've reinvigorated this business pretty thoroughly over the last few years. It’s a bigger business at Brixton and therefore we’re really going to try and do to Industrious what we did to ourselves a few years ago.
Q.
You're talking about B-Serv there. To what extent can B-Serv help you drive future rental growth?
A.
What surprises me is that the average rents, they're low because of the nature of the beast; about £4.40 a foot with an ERV of only £4.50 a foot. Now I think I could suggest that perhaps they’ve been a little less keen on pushing the pricing to keep their vacancies up. Now there is a clear matrix there and one of the things Brixton has found when it has gone into any market - and it doesn’t matter whether it’s prime Park Royal, secondary Heathrow, or certainly secondary up in Manchester, we've been able to immediately drive higher rents and value than expected. And that’s really just by basic effort. That’s before we get B-Serv into play.

First of all consolidation of landlord services, which I've mentioned is just crying out to be done here. But then, secondly, getting into really offering to take some of the burdens of repairs away from the tenants.
Q.
So having completed the transaction where will this leave Brixton?
A.
Where we end up is being by far and away the largest industrial property owner in the country, both in millions of square feet and certainly by asset value as well. Now that's really most important from the point of view of investor perspective and profile, because what has become apparent to us is that the investors do like companies that focus and are specialists. And what we're now demonstrating with this purchase, and we have done with earlier purchases and the move into the Equiton fund and then into Trafford Park, is that we can export the business model.
So we really think it's not being big for big sake, it's being large to get on the radar, particularly of some of the European and American investors, and actually to continue to demonstrate a skill base that perhaps the multi-faceted companies can't share.