FINANCIAL REVIEW

TELFORD HOMES HAS EXPERIENCED ANOTHER RECORD BREAKING YEAR FUELLED BY HIGHER THAN EXPECTED MARGINS IN A ROBUST MARKET ENVIRONMENT

Katie Rogers
Group Financial Director

For the first time, total revenue achieved exceeded £300 million and total profit before tax is up by almost 35 per cent to a record high of £46.0 million (2017: £34.1 million). The Group has been successful in achieving significant profit growth over the last few years and remains focused on continuing its traditional business of selling homes to individuals on the open market but also driving future growth by increasing its activity in the London build to rent sector. To facilitate this growth, the Group has continued to invest in land and work in progress and recently signed a new five year £210 million corporate loan facility providing additional development capital to support further investment.

Presentation of results and alternative performance measures

In the year to 31 March 2015 the Group adopted IFRS 11 'Joint Arrangements', which states that joint ventures should be accounted for as equity investments rather than by proportional consolidation. The Group's joint ventures are an integral part of the business and all developments are treated consistently within the business whether wholly owned or partially owned in a joint venture structure. As such the Board believes that the financial results are most appropriately presented using proportional consolidation, which means including the relevant share of the results of joint ventures in each line of the income statement and balance sheet. This therefore remains the method of presentation within the Group's internal management accounts.

The Board has prepared an income statement and a balance sheet using proportional consolidation along with Generally Accepted Accounting Principles (GAAP) compliant versions presenting joint ventures as equity investments. The key performance indicators and other figures within this report include the Group's share of joint venture results. For further details, definitions and reconciliations of alternative performance measures see notes 2 and 22.

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STRATOSPHERE

A mixed use development in the heart of Stratford incorporating 341 new homes, office and retail space. It received an International Property Award 2017 for Best Residential High-Rise Development in the UK.

E14

The redevelopment of Poplar Business Park has delivered 195 homes and reprovided commercial space for Workspace Group Plc, close to Blackwall Reach DLR station and Canary Wharf.

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Operating results

Total revenue has increased to £316.2 million from £291.9 million last year (GAAP 2018: £294.8 million, 2017: £266.0 million) with the increase mainly due to a greater number of open market residential completions in the year.

Open market residential revenue increased to £225.1 million (2017: £153.5 million) from 476 completions (2017: 289) with an average price of £473,000 (2017: £531,000). The lower average price is due to the mix of developments completing in each period in terms of product and location and to some degree reflects when individual contracts were exchanged with a significant proportion of the homes forward sold a number of years ago.

The Group also recognises contract revenue on construction contracts, in relation to both affordable housing and build to rent homes under development, on a percentage of completion basis throughout the build programme. This includes new contracts in the year but also ongoing profit recognition on contracts exchanged in previous years as the typical build programme spans a number of years.

Contract revenue in the year, including the Group's share of joint venture results, was £86.8 million (2017: £126.6 million) with the reduction purely down to the timing of entering into new contracts as revenue recognition is often weighted somewhat towards the start of the contract as both land and build costs are included in the percentage of completion calculation. In the current year, the Group exchanged contracts to deliver 279 affordable homes whereas in the prior year, the Group exchanged contracts to deliver 400 affordable homes and entered into three new build to rent contracts to deliver 387 build to rent homes.

The Group's strategy to increase the number of homes developed for build to rent investors will, over time, result in a greater proportion of the Group's revenue and profit being recognised on a percentage of completion basis over the life of each development as opposed to individual open market sales where revenue and profit is recognised at the point of legal completion. Build to rent sales will therefore result in the Group recognising revenue and profit earlier than if the homes had been sold to individual purchasers.

Total gross profit has increased to £79.5 million from £63.2 million (GAAP 2018: £74.8 million, 2017: £57.0 million). Total gross profit is stated after expensing loan interest that has been capitalised within inventories of £4.2 million (2017: £1.9 million) and therefore before charging this interest the adjusted gross margin was 26.5 per cent compared to 22.3 per cent last year. The significant increase in adjusted gross margin was due to strong margins achieved on both individual open market sale developments and build to rent developments.

The margin achieved on open market sale completions of 28.2 per cent was higher than that achieved last year (2017: 25.4 per cent) and also ahead of the Group's target when appraising new sites of 24 per cent. The majority of the open market completions in the current year were forward sold a number of years ago where the sales achieved had benefitted from some price inflation prior to launch. This, together with an easing of build cost inflation in the last year, has resulted in strong margins overall. The margin recognised on open market homes is expected to trend down towards the target margin over time as older developments which benefitted from more significant sales price inflation and minimal build cost inflation are replaced with sites appraised more recently.

On build to rent contracts, the Group is prepared to accept a lower gross margin due to the advantages of forward funding and savings in selling expenses and interest costs. Forward funding broadly means an initial payment reimbursing the cost of the land followed by monthly construction payments and finally a payment on completion. As such very little equity is used during construction and no debt is required. The Group expects build to rent transactions to achieve a net margin of approximately 12 to 13 per cent. The Group's normal target gross margin is 24 per cent, which after allowing for selling and finance cost savings of circa eight per cent means a net margin reduction for build to rent of three to four per cent. In the Board's view this reduction is more than offset by a substantially improved return on capital.

The actual margin achieved on the build to rent revenue recognised in the year to 31 March 2018 was well ahead of target at 17.8 per cent (2017: 16.0 per cent). This is due to some of the land being purchased at more advantageous rates prior to becoming part of the build to rent portfolio but also due to build cost savings recognised in the period. When appraising future build to rent developments, the Group's target margins are still expected to be around 12 to 13 per cent to remain competitive in the land market but also to remain attractive to build to rent investors and their yield requirements.

Administrative expenses have increased to £24.2 million (2017: £20.8 million), including the Group's share of joint ventures and £24.1 million excluding joint ventures (2017: £20.7 million). This increase is mainly due to higher employee costs as the Group embeds a new structure established during the year to increase operational capacity and enable further growth in the future. As a percentage of revenue, administrative expenses have remained relatively similar year on year at between seven and eight per cent.

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Selling expenses have increased to £6.5 million (2017: £5.1 million) including the Group's share of joint ventures and £5.7 million excluding the Group's share of joint ventures (2017: £4.1 million). This increase is mainly due to the higher number of open market completions in the year and the sales commission payable as a result, together with the cost of opening and running two new development specific sales centres in the year. There was one significant launch in the year, New Garden Quarter, incurring selling costs of £0.7 million, similar to the £0.9 million of costs associated with the one major launch in the prior year at City North.

The Group's adjusted operating margin has increased by over three percentage points to 16.7 per cent (2017: 13.4 per cent) flowing through from the strong gross margin achieved across a number of developments.

Total profit before tax has increased by almost 35 per cent to a record high of £46.0 million from £34.1 million last year (GAAP 2018: £46.3 million, 2017: £34.6 million). This was ahead of original market expectations mainly due to cost efficiencies achieved in the latter part of the year.

The Board expects the year to 31 March 2019 to show continued growth in revenue and profits with the development pipeline already secured to deliver this growth and a strong forward sold position. Margins are likely to trend towards the targets used during initial site appraisal although this could be improved upon if there is any further easing in build cost pressures. In addition the Group expects to move more towards build to rent transactions as a percentage of its business in the coming years which will reduce reported combined margins.

Finance costs

Finance costs incurred by the Group mainly consist of interest on development financing, non-utilisation fees and amortised arrangement fees. Interest on development financing is capitalised into work in progress as required by IAS 23 and all other fees are charged directly to the income statement.

Total finance costs incurred, including our share of joint venture costs, increased to £8.8 million (2017: £5.5 million). The increase in total finance costs was mainly attributable to an increase in average total borrowings in the year of £111.7 million (2017: £55.1 million) resulting in an increase in interest capitalised within work in progress at £5.2 million (2017: £2.2 million). The increase in borrowings during the year was anticipated as the business continues to grow, funding this expansion through a combination of debt and equity. The increase would have been greater without the build to rent transactions undertaken to date as these have reduced the Group's required debt drawdowns.

Dividend

The Board's policy is to pay one third of earnings as dividends. Following the equity placing concluded in 2015 the Board committed to paying a higher dividend for the subsequent two years to remove the dilutive effect of the new shares, resulting in dividend payments in excess of 40 per cent of earnings.

In the year to March 2018, the dividend is transitioning back to one third. As a result, a final dividend of 9.0 pence has been proposed which, together with the interim dividend of 8.0 pence paid on 12 January 2018, makes a total dividend for the year of 17.0 pence (2017: 15.7 pence). Earnings per share increased to 49.8 pence (2017: 36.8 pence) and therefore the dividend equates to just over 34 per cent of earnings.

The final dividend is expected to be paid on 20 July 2018 to those shareholders on the register at the close of business on 8 June 2018. The ex-dividend date is 7 June 2018.

Balance sheet

Net assets at 31 March 2018 were £231.1 million, an increase from £204.3 million last year mainly due to retained profits. This equates to net assets per share of 306 pence (31 March 2017: 271 pence). As the Group continues to grow, there is ongoing investment in land and work in progress with inventories, including the Group's share of joint ventures, increasing from £339.4 million to £373.9 million. Excluding joint ventures inventories increased from £287.7 million to £300.0 million, with the balance being recorded within investments in joint ventures.

The inventories balance is largely made up of land being progressed through the planning system and land and development costs on sites in design and under construction. The Group has invested over £100 million in new land opportunities since 1 April 2017 and has a development pipeline of just over 4,000 homes, approximately three quarters of which have a planning consent and are under construction. Land creditors, including the Group's share of joint ventures are minimal at £1.5 million (2017: £28.4 million) and £0.2 million (2017: £26.9 million) excluding joint ventures. The significant land creditor in the prior year of £26.9 million was in relation to a development site on Cambridge Heath Road, E2 which unwound following completion of the land transaction in October 2017.

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STRATFORD

CENTRAL

A residential development of 181 homes located in the heart of Stratford overlooking the Queen Elizabeth Olympic Park and Westfield Stratford City.

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Forward sales

The Group continues to seek to secure forward sales to individuals, affordable housing providers and build to rent investors. The Group had secured forward sales of £344 million at 1 April 2018 to be recognised in future years. This is comprised of £243 million in relation to open market contracts, £49 million of affordable housing revenue and £52 million of build to rent revenue.

In all cases, the forward sales not only de-risk developments, they also enhance cash flows and return on capital due to non-refundable deposits received in advance from individual open market buyers and more significantly, the forward funding of affordable housing and build to rent transactions.

Borrowings

The Group funds its development costs through a combination of debt and equity unless subject to a forward funding arrangement. As the business continues to grow, net debt has increased to £103.1 million (2017: £14.3 million) and gearing is higher at 44.6% (2017: 7.0%).

Gearing was always anticipated to rise given the capital intensive nature of the business. Furthermore net debt and gearing have been unusually low over the past few years due to significant cash inflows from the £50 million share placing in 2015 followed by upfront payments received on build to rent contracts entered into during 2016 and 2017.

The Group is still anticipating using debt to fund developments for open market individual sales and the Board is comfortable to do so given that many of the Group's developments have been substantially de-risked by the level of forward sales secured. However as build to rent becomes a more significant part of the business, it will assist in keeping debt and gearing levels at a more modest level. The actual level will depend on the timing of future land purchases and how much the business moves towards build to rent as a proportion of its output.

Telford Homes secured a new five year £210 million revolving credit facility in December 2017, ensuring there is sufficient headroom and longevity to fund the growth of the business over the next few years. The facility, provided by Natwest, HSBC, Santander and AIB, was negotiated with lower interest rates than the previous facility and is governed by standard corporate covenants together with site covenants on a portfolio basis. As at 31 March 2018, the Group had drawn £115 million of this facility, leaving headroom of £95 million to fund future site acquisitions and construction costs. The Group has excellent long term relationships and is well supported by the banks that fund the revolving credit facility as evidenced during the recent negotiations.

Joint venture developments are funded outside of the revolving credit facility with site specific loans secured as and when required. In July 2016, the Group secured a £110 million facility with LaSalle Residential Finance Fund to fund its 50 per cent owned joint venture at City North and, in February 2017, it signed a £33 million facility with RBS to fund Balfron Tower, in which the Group has a 25 per cent stake.

Telford Homes is in a strong financial position with significant headroom within existing debt facilities and equity available to deliver the growth targeted over the next few years. This will be complemented by expanding the Group's build to rent output which requires limited equity and no debt and therefore will enable swifter growth with lower gearing requirements.

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