FINANCIAL REVIEW

TELFORD HOMES IS PLEASED TO REPORT AN INCREASE IN TOTAL REVENUE TO A RECORD HIGH OF £354.3 MILLION DESPITE A MORE CHALLENGING ECONOMIC AND POLITICAL ENVIRONMENT

"Despite build to rent generating lower profit margins, the limited equity requirement will enable swifter growth and therefore higher absolute profits in the medium-term with lower overall gearing requirements."

Katie Rogers
Chief Financial Officer

However, total profit before tax reduced to £40.1 million due to an increase in the proportion of revenue derived from build to rent developments. Build to rent transactions generate lower margins but reduce exposure to market risk and require no debt and limited equity investment. As a result, gearing reduced to 37.0 per cent at 31 March 2019 from 52.2 per cent at 30 September 2018.

Presentation of results and Alternative Performance Measures

The Group continues to comply with 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.

Operating results

Total revenue increased to £354.3 million from £316.2 million last year (GAAP 2019: £336.1 million, 2018: £294.8 million) with the increase mainly generated from build to rent contracts. The Group recognises revenue on build to rent developments, including subsidised affordable housing contracts on these schemes, as contract revenue on a percentage of completion basis throughout the build programme. Build to rent developments contributed revenue, including the Group's share of joint venture results, of £108.7 million (2018: £67.7 million). This includes new contracts in the year but also ongoing profit recognition on contracts exchanged in previous years as the build programme spans a number of years.

Revenue from individual open market sale developments decreased to £231.7 million (2018: £244.2 million). This includes 390 open market completions (2018: 476) with an average price of £552,000 (2018: £473,000) together with subsidised affordable housing revenue on these schemes recognised on a percentage of completion basis. The increase in the average price of the open market completions reflects the mix of homes and developments completing in each period in terms of product and location. Other revenue in the year of £13.9 million (2018: £4.3 million) relates mainly to two small land sales of legacy assets together with freehold sales in the year.

THE FORGE E6

A residential development of 192 homes. All the homes have been sold to M&G Real Estate for build to rent and East Thames for affordable housing.

M&G REAL ESTATE

NUMBER OF HOMES

192

THE LIBERTY BUILDING E14

A completed residential development of 155 open market and affordable homes located in historic Limeharbour, The Liberty Building sits opposite Crossharbour DLR station, which is just three stops from Canary Wharf.

THE LIBERTY BUILDING
LONDON E14

NUMBER OF HOMES
155

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The Group's strategy to increase the number of homes developed for build to rent investors will, over time, result in an even 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 is in line with the prior year at £79.3 million (2018: £79.5 million) and on a GAAP basis £75.0 million (GAAP 2018: £74.8 million). Total gross profit is stated after expensing loan interest that has been capitalised within inventories of £4.5 million (2018: £4.2 million) and therefore before charging this interest the adjusted gross margin was 23.7 per cent compared to 26.5 per cent last year. Total gross profit is similar to the prior year despite an increase in revenue due to the increasing proportion of the revenue arising from lower margin build to rent developments.

On build to rent developments, 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 2019 was in line with the target margin at 13.2 per cent albeit lower than the 18.1 per cent achieved in the year to 31 March 2018 when build cost savings achieved in that year improved the profit margin.

The margin achieved on open market sale developments of 28.3 per cent was largely consistent with that achieved last year (2018: 28.4 per cent) and remains ahead of the Group's target when appraising new sites of 24 per cent. A significant proportion of the open market completions in the current year were from two sites, Stratford Central and The Liberty Building, both of which were substantially forward sold a number of years ago where the sales achieved had benefitted from some price inflation prior to launch. The margin recognised on open market developments is expected to trend down towards the target margin over time as older developments which benefitted from sales price inflation are replaced by sites acquired more recently.

Administrative expenses have increased to £27.6 million (2018: £24.2 million), including the Group's share of joint ventures, and £27.4 million excluding joint ventures (2018: £24.1 million). This rise is mainly due to higher employee costs which have enabled the Group to deliver an increase in revenue in this year and investment in knowledge and experience and an operational structure which enables further growth in the future. As a percentage of revenue, administrative expenses have remained relatively similar year on year at circa 7.8 per cent.

Selling expenses have increased to £9.8 million (2018: £6.5 million) including the Group's share of joint ventures and £9.0 million excluding the Group's share of joint ventures (2018: £5.7 million). The Group adopted IFRS 15 'Revenue from contracts with customers' from 1 April 2018 and the prior year figures have not been restated and are therefore not prepared on a like-for-like basis, see page 80 for further details. As a result of adopting IFRS 15, selling expenses in the year to March 2019 are £0.9 million higher than they would have been under the previous accounting standard and therefore on a comparable basis, selling expenses have increased by £2.4 million.

The increase in selling expenses is largely due to the nature of the individual sale market at present with more intensive marketing required to secure sales including advertising and on-site development specific sales centres and show apartments. There was also more agents commission payable in relation to build to rent developments this year due to the exchange of a forward fund contract for Equipment Works.

The Group's adjusted operating margin has decreased by over three percentage points to 13.1 per cent (2018: 16.7 per cent) flowing through from the lower gross margin achieved as a result of more build to rent activity together with an increase in sales costs as a proportion of revenue due to the more challenging market environment.

Total profit before tax has decreased from the record high achieved last year of £46.0 million to £40.1 million (GAAP 2019: £40.3 million, 2018: £46.3 million). This was below our original market expectations of £50 million due to a subdued London sales market resulting in a slower sales rate and a delay on two build contracts that were expected to exchange in FY 2019 and are now anticipated in FY 2020.

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 marginally to £8.9 million (2018: £8.8 million) and includes £2 million of non-utilisation fees, £0.9 million of amortised arrangement fees and £5.4 million of interest capitalised on developments. Finance costs have not increased despite a rise in average borrowings in the year at £156.0 million (2018: £111.7 million) due to the full year benefit of the new lower rate revolving credit facility signed in December 2017.

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Dividend

The current policy is to pay one third of earnings as dividends however the Board has committed to paying more than this over the next few years where earnings are expected to be lower than those reported for the year to March 2018. During this time, the Board expects the annual dividend to be at least 17 pence per share. In the future, the Board anticipates enhancing the Group's dividend policy to take account of the reduced capital requirements of build to rent transactions.

The Board is recommending a final dividend for the year of 8.5 pence which, together with the interim dividend of 8.5 pence paid on 11 January 2019, makes a total dividend for the year of 17.0 pence (2018: 17.0 pence). Earnings per share equate to 44.6 pence (2018: 49.8 pence) and therefore the dividend payment is 38 per cent of earnings. The final dividend is expected to be paid on 19 July 2019 to those shareholders on the register at the close of business on 7 June 2019. The ex-dividend date is 6 June 2019.

Balance sheet

Net assets at 31 March 2019 were £252.9 million, an increase from £231.1 million last year mainly due to retained profits. This equates to net assets per share of 333 pence (31 March 2018: 306 pence).

Inventories, including the Group's share of joint ventures, are the most significant proportion of net assets at £320.6 million (2018: £373.9 million). Excluding joint ventures, inventories decreased from £300.0 million to £197.4 million. 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 value of unsold finished properties within inventories was £15.7 million at 31 March 2019 (2018: £34.8 million).

In the future a greater proportion of the Group's revenue is expected to be derived from construction contracts, in particular build to rent, and this will ultimately reduce the level of work in progress held on the balance sheet. This is because work in progress is charged out to cost of sales throughout the course of development on a percentage of completion basis as profit is recognised. This differs to open market individual sale homes whereby the work in progress balance builds up throughout the development until handover of each unit when revenue and profit is recognised in full.

Development pipeline

The Group has a development pipeline of 4,900 homes (31 March 2018: 4,000 homes) with a value of £1.59 billion (31 March 2018: £1.31 billion). Over 80 per cent of the units in the development pipeline have a planning consent and are in design or under construction.

The Group seeks to de-risk the development pipeline by securing forward sales whenever possible. In the past a substantial proportion of these forward sales have been to individual investors but going forward they are more likely to be achieved predominantly through build to rent transactions and subsidised affordable housing. Currently 60 per cent of the homes in our pipeline that are under construction are forward sold.

Borrowings

The Group funds its development costs through a combination of debt and equity unless subject to a forward funding arrangement. Due to the strategic shift towards build to rent and therefore more forward funded developments, the business has continued to grow but with a reduction in net debt to £93.6 million (2018: £103.1 million) and lower gearing at 37.0 per cent (2018: 44.6 per cent).

We still anticipate a relatively modest level of debt within the Group to fund open market individual sale developments in a capital efficient way using the relatively cheap debt funding available. However, the Board has stated that gearing is expected to remain under 50 per cent going forward as open market individual sale homes become a reducing proportion of the pipeline.

Telford Homes has sufficient headroom within its five year £210 million revolving credit facility signed in December 2017 with NatWest, HSBC, Santander and AIB. As at 31 March 2019, the Group had drawn £106.7 million of this facility, leaving headroom of £103.3 million to fund future site acquisitions and construction costs. The Group remains well within the development and corporate covenants stipulated within the facility and maintains excellent long-term relationships with its banking partners.

Joint venture developments are funded outside of the revolving credit facility with site specific loans secured as and when required. The Group has a £110 million facility with Lasalle Residential Finance Fund to fund its 50 per cent owned joint venture at City North and a £35 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 sufficient headroom within existing debt facilities and less need for debt going forward with the strategic shift into build to rent. Forward funded build to rent developments will enable Telford Homes to grow with a lower risk and less capital intensive strategy. Despite build to rent generating lower profit margins, the limited equity requirement will enable swifter growth and therefore higher absolute profits in the medium-term with lower overall gearing requirements.

Katie Rogers
Chief Financial Officer

29 May 2019