Transcript – Conference Call 14.00 (UK time) - 20th September 2019

CONFERENCE CALL FOR THE YEAR ENDED 31 MARCH 2019

Introduction

Good afternoon and welcome to the investor update conference call to discuss the results for the year ended March 2019, as required under the EMTN Programme Notes issued in July 2017.

The call today will be presented by myself, James Hopkins, Annington's CEO and Andrew Chadd Annington's CFO.

The commentary we are going to give is based on Annington Limited's Consolidated Financial Statements for the year ended 31 March 2019, which were posted on our website on 2 September. The format for this call is that we will provide the update and then the moderator will open the floor to questions starting with any questions that have been submitted in advance of the call. The maximum time that this process will take is 60 minutes.

A link to a digital recording of the call will be on our website for approximately 7 days after this call. There will also be a transcript which will be available for the longer term.

Disclaimer

I trust you will all have been able to access the Annual Report and will have had the opportunity to familiarise yourselves with the contents. It is worth reminding ourselves, however, that the report and this telephone call contain forward looking statements which reflect our current views with respect to future events and anticipated financial and operating performance. Any such statements are made in good faith. By their very nature, forward looking statements involve known and unknown risks, uncertainties and other factors and depend on circumstances that may or may not occur in the future. We caution you that forward looking statements are not guarantees of future performance and may differ materially from what actually happens. Although we believe that the expectations reflected in these forward looking statements are reasonable, we can give NO assurance that they will materialise or prove to be correct. You are cautioned not to place any reliance on such forward looking statements which in any event only reflect any sentiment as of the date of this report. Nor do we have any obligation to publicly update or revise any forward looking statements whether as a result of new information, future events or otherwise other than as required by law or regulation.

Annual update

Following the successful refinancing of the Group in FY2017/18, Annington benefited from the greater operational flexibility this afforded and the 2018/19 financial year saw considered investment in PRS opportunities, with close to £86.5m being spent on PRS added to the portfolio this year.

Throughout the year, Annington had also been engaged in discussions with the MoD over the mechanics of conducting the Site Review exercise scheduled to run on 510 sites over a four year period from 2021. This culminated in a binding agreement being reached with the MoD in March this year. In terms of this Arbitration Agreement, the period of negotiation will be reduced from at least four years to two years, through the use of 27 representative sites instead of all 510, to settle the future adjustments to market rent to be applied after the site review.

Furthermore, the MoD has committed to release a minimum of 3,500 properties over the next 7 years at a rate of 500 properties per annum, measured on a two year rolling average basis, with Annington waiving up to £7,000 of dilapidations for each property released, on up to 500 properties per annum for an initial period of seven years.

At 31 March 2019, the Group owned 40,383 completed investment property units. Of these, the MQE Retained Estate comprised 38,726 units leased to the MoD, while 50 units were held in the MQE Surplus Estate and the remaining 1,607 were held in a separate property portfolio of Rental and PRS accommodation. Furthermore, at the reporting date, the Group had a further 256 units under construction and held 5 completed development units for sale.

The Group generated gross property rental income from this investment property portfolio of £196.8 million for the year to 31 March 2019 [Mar 2018: £193.1m] and sold 66 properties [65 investment properties + 1 development unit] during the year ended 31 March 2019, generating £15.1 million in sales income. [Mar 2018: sales of 121 properties for £34.9m – all investment properties].

The carrying value of the Group's investment properties was £7.7 billion, up from £7.1 billion at 31 March 2018. This adjustment reflects revised assumptions regarding the release profile in response to the Arbitration Agreement with the MoD as well as changes in market based financing assumptions.

Market Performance

During the financial year, the UK housing market saw subdued, but still slightly positive, growth in the year, with Nationwide reporting annual House Price Index growth of 0.75% (March 2018: 2.1%), Halifax showing slightly higher annual growth of 2.6% (March 2018: 2.7%), and Rightmove recording an annual fall in asking prices of 0.8% for the year. Overall, this was the weakest rate of growth since 2010, but was broadly in line with market consensus of c.1% for the year. The overall subdued growth during the year demonstrates the same directional trend as the UK equity market, supporting the position that Brexit uncertainty is having an impact on market sentiment.

Regional variation across the UK continued as Northern Ireland, Scotland and Wales all saw some price growth in March 2019. The Nationwide reported that England recorded its first annual price decline since 2012 with prices down 0.7% compared with March 2018. This was driven by price declines in the South East of England, and in particular London, which showed the greatest decline, down 3.9% on the same time last year. Regionally, the most positive picture was seen in the North and Midlands, with the North West and East Midlands showing annual growth of 2.9% and 2.6% respectively.

Rental demand remains strong. The ONS reported that the number of households in the UK private rented sector has grown significantly over the past decade. According to the Ministry of Housing, Communities & Local Government's Housing Survey 2017-2018, one in five households in England are part of the private rental sector, making it the second largest tenure behind home ownership.

There has been a recognition of the need for wider tenure choices in PRS (the Draft London Plan, the new National Planning Policy Framework and Sir Oliver Letwin's Independent review of Build Out Rates). It has become clear that there needs to be more choice in the housing on offer, with the majority of PRS offerings currently being in blocks of flats and more than a quarter of renters in the UK being families with children.

According to Knight Frank, the proportion of households in the private rental sector is expected to rise to 22% by 2023. A corresponding increase in the number of build to rent homes under construction is also being seen with a year on year increase of nearly 40% being reported by the British Property Federation (Q4 2018).

As the year progressed, political and economic uncertainty caused Annington to implement a temporary moratorium on PRS acquisitions in December 2018. Annington will continue to monitor the market and, when the risks evident in the current market have subsided, intends to look for appropriately priced opportunities in the PRS sector.

Operational Environment

Site review:

As mentioned, an agreement has been reached with the MoD to carry out an accelerated process to complete the 2021-2024 Site Review.

Under the original terms of the Agreement, each Site would be reviewed over a four year period commencing in December 2021. The Site Review would be performed in four separate tranches, with approximately 25% of Sites being reviewed in each of the respective review years. The Site Review would subsequently be repeated on the 15th anniversary of the initial Site Review, with the five-yearly Rent Reviews continuing between each Site Review. The Agreement reached is binding on both parties. Any disagreement will be referred to an arbitral panel whose decision will be final.

This accelerated process is designed to produce an equivalent result to the Site Review, but in a shorter period and at a significantly lower cost for both parties. It will also give Annington and the MoD certainty in relation to the future rents payable for the MQE sooner.

MoD Property Releases:

During the year, 243 units were released to Annington by the MoD, compared to only 2 in 2018.

Under the terms of the contractual arrangements with the Group, the MoD has to pay compensation, known as "dilapidations", if it does not return properties to the Group in an appropriate condition, which is defined in the Underlease as "good tenantable repair and decorative order". Poor maintenance of the MQE has resulted in higher dilapidations claims in the past, which according to the MoD, in evidence to the Public Accounts Committee (PAC) on 14 May 2018, is a factor in the slow release of properties to the Group due to budgetary constraints.

Following the signing of the Arbitration Agreement, the MoD has been incentivised to increase release levels, where dilapidations costs of £7,000 per unit will be waived for the first 500 units released each year.

The revised arrangements concerning releases and dilapidations provide considerably improved certainty about the timing and number of released units. This both enables the MoD to address the long standing voids issue that it has faced, and substantially reduces the possibility of Annington having to deal with large or volatile release numbers.

I will now hand over to Andrew to discuss the results for the year.

Financial Performance

Thank you James

Rental income:
As mentioned earlier, gross property rental income for the year to 31 March 2019 amounted to £196.8 million, a 2% increase over 2018 [(2018 193.1 m)]. The majority of this was through APL, where the MQE Portfolio (including Surplus Estate) generated rental income of £180.9 million in the year [(2018: £178.6 m)]. The increase in rental income is driven by the Rent Review concluded in December 2017, which resulted in a rental uplift. In the Non-MQE Portfolio, gross rents for the year to March 2019 have increased to £15.9 million [(2018: £14.3 million)], following the expansion of the Group's PRS portfolio.

Property Disposals:
During the year, the group made a profit of £0.7 million from property disposals. This profit was generated on £15.1 million of gross sales proceeds, which was down from the gross proceeds in the prior year of £34.9 million due to lower volumes of disposals. In the year to March 2019, 65 investment properties were sold by the Group, compared to 121 properties in 2018. Annington Property Limited, the owner of the Married Quarters Estate, generated income of £6.2 million (2018: £27.4 million) through the external sale of 10 units (2018: 111 units). A further 55 properties (2018: 10 properties) in the Non-MQE Portfolio were sold, resulting in income of £8.9 million (2018: £2.3 million).

Site review costs
Included in operating profit are costs relating to the Site Review, which are considered exceptional in nature, due to the size and infrequent occurrence of Site Reviews. Having entered into the Arbitration Agreement and confirming the mechanisms to be applied in determining the rental adjustments, Annington has determined that a significant sum will need to be spent in this round of negotiations, as precedents will need to be developed between the parties as to the way in which a site review will

operate. The Group estimates that the costs associated with this are of such a material nature as to require separate disclosure on the face of the Consolidated Income Statement. The £5.6 million of site review costs incurred in the 2019 financial year have been disclosed separately in the income statement. As required by IAS 1 Presentation of Financial Statements, comparative figures for 2018 have been reclassified, with £1.5 million of cost being re-presented separately as Site Review costs. These were previously classified under Property operating expenses.

Profit for the period

A profit of £457.1 million was reported for the year to 31 March 2019, compared to a loss of £1,059.8 million during the prior year (non-recurrence of costs associated with the refinance in the prior year). This has been largely driven by the unrealised investment property revaluation gains of £481.2 million (2018: £481.9 million loss). The higher valuation is driven by an increase in the value of the MQE following changes to inputs to the cash flow forecast model, which include a revised release profile following the signing of the Arbitration agreement with the MoD.

Balance Sheet Items:

The Group’s total assets amounted to £7.841 Bn. (2018: £7.286 Bn.).

The fair value of all the Group’s investment properties, which are located in England and Wales, is reassessed annually. The Group’s total investment properties were carried at £7.7 billion at 31 March 2019 (2018: £7.1 billion).

The fair market value of the Married Quarters Estate was £7.2 billion, with a further £40.0 million being accounted for in the book value to avoid a double count of the utility provision in the financial statements. The fair value of this portfolio increased £478.3 million, just over 7%, from £6.7 billion.

The Non MQE portfolio’s fair value of £410.3 million (2018: £334.7m) includes 1,607 completed units (2018: 1,365). The increase in valuation is mainly driven by two separate transactions. During the year, Annington completed the purchases of 104 homes from Mill Group’s Oak Portfolio for £23.8 million, and 73 homes from Taylor Wimpey for £23.5 million.

The Group also uses a Special Assumption of Vacant Possession Value (“SAVPV”) to help gauge whether the Group has been achieving reasonable value upon disposal of units released from the MQE Retained Estate and to provide management with a basis upon which to calculate an estimated value for the Retained Estate and potential value to be realised from future sales. At 31 March 2019, the SAVPV of the MQE Retained Estate was £9.1 billion, compared to £9.0 billion at 31 March 2018.

The Group held £175.0 million (2018: £162.9 million) of current assets, excluding investment property held for sale, mainly comprising cash and other short-term investments.

The Group's combined liabilities totalled £4,162.9 million (2018: £4,065.7 million), comprising a mixture of long-term debt and exposure to deferred tax, mostly arising on the revaluation of investment properties. The Group's long-term funding is arranged through AFP in the form of bonds and a term loan.

Aside from debt service costs of £108.3 million (2018: £171.0 million), the major cash outflow during the year related to the Group's expansion into PRS. Payments for acquisitions totalled £86.5m, on top of the £39.4m spent in 2018. Due to the decrease in the number of units sold, net proceeds from property sales decreased to £14.3 million (2018: £37.5 million).

OEIC Conversion

As detailed in the announcement by Annington Funding plc on 2 September, on 5 April 2019, the sole shareholder of Annington Limited ("Annington"), Annington Holdings (Guernsey) Limited ("AH(G)L"), was converted into an Open Ended Investment Company. This conversion will have a number of positive benefits for the Annington Group, including the following:

I. It facilitates the raising of new equity by AH(G)L.

II. It will allow existing investors to redeem their shares at a price calculated with reference to NAV, provided in every case that this does not prejudice the fundamental credit standing of Annington.

Kempen & Co ("Kempen") has been engaged as sole placement agent to support the raising of new equity by way of issuing new shares in AH(G)L.

Dividend policy

As a result of the improved financial profile during the course of 2019, Annington intends to commence paying a dividend and remains committed to maintaining its strong investment grade rating.

Closing

That concludes the annual update.

In response to questions raised before the call with regard to the ownership structure:

"Please can you elaborate on what you mean by not prejudicing the fundamental credit standing of Annington in relation to the raising & redemption of shares under your new holding structure. Can you please explain if there are restrictions on redemptions and any other (new) investment policies introduced under this company structure as it relates to leverage and/or liquidity or any other relevant criteria that could have an affect on the bond issuer. It would be very helpful if the key features of the new company and investment parameters were shared with the bondholders."

Changes to the structure

There are two core changes to the structure :

1. New investors are able to invest in AHGL at a price calculated with reference to NAV (the "Subscription Right").
2. Existing investors are able to exit AHGL at a price calculated with reference to NAV (the "Repurchase Right").

Despite these changes it is important to make clear the fundamental underlying structure of AHGL has not been changed:

- **Current AHGL shareholding, doesn't change**
  - Currently AHGL is held by TFSOFI, TFSOFII, and C-Investors, there is no change to this current shareholding. The Terra Firma controlled funds hold 93%+ of the outstanding share capital.
- **Subscription of New C Shares**
  - New C shares are to be marketed openly
  - Minimum investor commitment is £10m
  - Maximum investor commitment is £250m
  - These are subscribed at NAV plus a 10% fee, although the fee can be waived by the Manager at its discretion
  - C Shares are non-voting in nature, and Terra Firma will continue to control the voting rights through the A shares
- **New Annington Management (Guernsey) Limited**
  - A new vehicle has been inserted beneath AHGL called Annington Management (Guernsey) Limited, there is a minimal fee to cover running costs, and this vehicle is wholly owned by AHGL

<u>Strong liquidity position</u>

- **Repurchase mechanism**
  - This is limited to 5% of outstanding shares per quarter. Where shareholders sell to AHGL, they get NAV less 25%
  - The repurchase date is at the next quarter date plus 12 months, effectively meaning there is up to a 15 month delay before a redemption is effected
  - Terra Firma informs Annington that it has no intention to use this redemption feature to provide liquidity to any part of its investment
- **Gating**
  - The Directors may declare a suspension of the redemption mechanism for a number of reasons, including:
    - There exists a state of affairs which, in the opinion of the Directors and/or Investment Manager, creates an environment in which disposal of the Group or Investments would not be reasonably practicable or might seriously prejudice the interests of the Members as a whole;
    - In the opinion of the Directors and/or the Investment Manager it is desirable for the protection of the Company or in the interests of the Members as a whole
  - Terra Firma has informed Annington that it is of the opinion that maintenance of at least the BBB flat rating is a requirement for the shareholders, and an action that would harm this credit position would undermine the basis of the significant investment made by the shareholders in 2017, and as such may be prejudicial to their interests

“In addition, in relation to the newly released units from the MoD in Bordon & Canterbury, you mention extensive reinstatement works are needed. Can you clarify if these are out of the ordinary compared with previous releases, how much you envisage spending on these units and estimated yield on cost assuming these will be retained for private rental purposes”

Certainly the units released at Bordon and Canterbury have suffered an unusually high degree of dilapidations, with the cost per unit to reinstate considerably exceeding the historical average and recent experience. However, as you know, the MoD is required to hand these properties back in a “good and tenantable condition and decorative order” and, if not, it has to pay compensation in the form of dilapidations. Therefore, with the exception of the first £7,000 of dilapidation cost which, under the Arbitration Agreement, the MoD gets relief from, the majority of the reinstatement cost is being met by the MoD. Any works over and above that are carried out on an added value basis.

As with previous releases, in determining the level of refurbishment spend on these sites Annington seeks to achieve the highest NPV and will adopt the most relevant strategy for the site and local market conditions, which may entail the adoption of a mixed sale and rental strategy to minimise short and medium term void units. All options are evaluated, including Sales, Private and Bulk Rentals as well as combinations thereof.

I will now hand back to the call moderator who will open for questions.