Telford Homes

FY19 results

Executing the Build to Rent strategy

Construction & materials

FY19 results were in line with February guidance and the year ended with lower net debt than we had anticipated. The migration to a dominant Build to Rent (BTR)-led pipeline is well underway. The first developments of this type were handed over in the year and, together with the announced strategic partnerships, other live projects indicate good momentum in this sub-sector. As before, FY20 will reflect other project and open-market effects before earnings start to rebuild from FY21, consistent with our estimates. Telford's valuation looks conservative if the company is able to sustain or exceed our projected FY22 EBIT over the long term.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/18	316.2	46.0	49.4	17.0	6.0	5.7
03/19	354.3	40.1	44.5	17.0	6.7	5.7
03/20e	377.4	25.0	26.3	17.0	11.3	5.7
03/21e	453.7	30.4	30.6	17.0	9.7	5.7
03/22e	511.7	39.8	41.8	19.5	7.1	6.1

Note: Telford's share of JVs is included.*PBT and EPS are normalised.

Busy year although earnings below FY18

FY19 results included record revenue generation and reported PBT met management's February guidance. Although this was below expectations earlier in the year, the company made broad progress across a number of project and tenure types. At the margin, subdued London residential market conditions constrained open-market sales. This, the previously referred to later completion of City North, N4, and the transition to an increasing proportion of BTR developments create a dip in expected earnings in FY20 before they should start to rebuild in FY21e. This profile is in line with our previously published estimates.

Tangible progress in the BTR sub sector

In total, 31% of FY19 revenues were generated from BTR developments, an increase in value of 60% y-o-y to £109m, Moreover, BTR-led projects account for c 70% of the current pipeline's £1.59bn gross development value. The direction of travel is clear; beyond known existing projects, the announced strategic partnerships with M&G and Invesco indicate that further BTR sector developments are firmly on the agenda.

Valuation: Attractive yield ahead of earnings uplift

The company's share price has recently regained the level seen when we initiated coverage at the end of February and has underperformed the FTSE All Share Index by c 3% over this period. On our FY21 estimates, Telford's P/E is 9.7x with a prospective 5.7% dividend yield on offer (as well as 2.9% with the FY19 final). On our updated DCF analysis, the current share price is equivalent to EBIT generation around expected FY21 levels into perpetuity. Raising this to our projected FY22 EBIT generates a 418p per-share valuation for the company.

4 June 2019

Price	**297.5p**
Market cap	**£226m**

Net debt (£m) at end March 2019 Including group share of JV debt	95.7
Shares in issue	75.7m
Free float	96%
Code	TEF
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	7.5	4.9	(35.2)
Rel (local)	10.7	4.4	(30.2)
52-week high/low		465p	267p

Business description

Listed on AIM in 2001, Telford Homes is a London-focused residential property developer. Its portfolio of developments includes open market sales (in multi-occupancy, including mixed-use, developments), the build-to-rent subsector (alongside investment partners) and affordable homes delivered to housing associations.

Next events

FY19 final DPS 8.5p ex dividend	6 June
AGM	11 July

Analyst

Toby Thorrington +44 (0)20 3077 5721

industrials@edisongroup.com

Edison profile page

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FY19 results overview

FY19 PBT met management's revised guidance in February and although this was below the prior year, demonstrable progress was made in transitioning Telford Homes to a BTR-centric developer. As part of this process, net debt declined and the company ended FY19 with a pipeline with a gross development value of £1.59bn. Declared dividends were also as flagged in February (maintained at FY18 levels) and FY20 guidance is unchanged.

Exhibit 1: Telford Homes summary P&L and interim splits

	H1	H2	2018	H1	H2	2019
Group revenue	86.7	208.1	**294.8**	118.8	217.4	**336.1**
Share of JV revenue	12.7	8.8	**21.5**	10.9	7.3	**18.2**
Total revenue	**99.3**	**216.9**	**316.2**	**129.6**	**224.7**	**354.3**
Cost of sales	-75.7	-161.1	**-236.8**	-101.2	-173.8	**-275.0**
Gross profit	23.7	55.8	**79.5**	28.5	50.9	**79.3**
Opex	-13.5	-17.2	**-30.7**	-17.3	-20.1	**-37.4**
Group operating profit	**10.2**	**38.6**	**48.8**	**11.1**	**30.8**	**41.9**
Finance costs	-1.5	-1.3	**-2.7**	-1.0	-0.8	**-1.8**
Pre tax profit - norm	**8.7**	**37.3**	**46.0**	**10.1**	**30.0**	**40.1**
Gross margin % - reported*	23.8%	26.8%	**25.1%**	21.9%	23.4%	**22.4%**
Op Margin % - reported*	11.7%	18.5%	**16.5%**	9.4%	14.2%	**12.5%**

Source: Company, Edison Investment Research. *see Financial performance section for adjusted margins. Our estimates show gross interest, results are reported net; these effects wash out at the reported PBT level.

Portfolio highlights – the rise and rise of BTR: during FY19, Telford handed over four complete developments (shown at the top of Exhibit 2), added two new sites (being Oldfield Lane North, UB6 and International Way, E20 subject to planning consent) and in total worked on 23 live schemes across a full spectrum of project phases.

BTR: the year included the completion of the company's first projects of this type: the Pavilions, N1 (for L&Q), and the BTR portion of New Garden Quarter, E15 (for Folio, part of Notting Hill Genesis, which is Telford's JV partner on this project). Two further ones (Carmen St, E14, and The Forge, E6; both for M&G) are well underway for delivery in FY20. Both of these developments also have affordable homes being built on the same site that have been separately contracted with the housing associations Poplar HARCA and L&Q. The large Parkside, SW11 project is approaching full-build contract stage with Greystar. A £105.5m BTR deal was also signed for Equipment Works, E17, just prior to the end of FY19.

Open market: all units at Stratosphere and Stratford Central (both E15) and Bermondsey Works, SE16, are understood to have been completed and sold now totalling over 500 units (some of which were in prior years). The smaller Calder's Wharf, E14, development has also completed its build phase and is approaching one third sold. The larger Manhattan Plaza and Liberty Building schemes (both E14) are also complete and substantially sold whereas the open-market buildings are due to complete in the coming months and the units are c 85% sold there also. As flagged in the February trading update, the build programme at City North, N4 is c six months behind plan due to third-party actions that mean completion is now expected during FY21. At the end of FY19, Telford had 39 finished units on hand for sale, around half of which have subsequently sold. Management reiterated comments that the London market remains subdued, especially at higher price points but Help to Buy remains helpful at the margin for homes priced under £600,000, which has historically been Telford's main focus in this sub-segment.

Apart from the projects listed below, Telford continues to work on other opportunities in the background, not least with new strategic BTR partners M&G and Invesco.

Exhibit 2: Telford Homes projects active in FY19

	Value £m	Units Total	Units OM	Units BTR	Units AH	Other c 5%+	Brief description
Stratford Central, E15		**181**	157	-	24		LB Newham, Stratford. 31 storey residential tower with apartment mix including one, two and three bedrooms, suites and apartments. Excellent transport links.
The Pavilions, N1		**156**	-	156	-		LB Islington, Caledonian Road. Challenging site built with one-, two- and three-bed units and green conservation space. First BTR completion (for L&Q).
Stratosphere, E15		**341**	307	-	34		LB Newham, Stratford High St. Two residential towers (36 and 12 storeys) with one-, two- and three-bedroom apartments/penthouses. Concierge, gym, roof terrace.
Bermondsey Works, SE16		**158**	148	-	10		LB Southwark, S. Bermondsey. 18-storey tower, connected lower height villas one-, two- and three-bed and duplex apartments. Concierge, gym, roof gardens, school.
Calders Wharf, E14		**25**	21	-	4	Y	LB Tower Hamlets, Island Gardens, adjacent to the Greenwich Foot Tunnel. Four-storey building with one, two and three bedrooms on a riverfront site.
Liberty Building, E14		**155**	105	-	50		LB Tower Hamlets. Limeharbour, Canary Wharf. 26-storey tower, one-, two- and three-bed apartments and a penthouse. Concierge, gym and private gardens.
Manhattan Plaza, E14		**170**	125	-	50		LB Tower Hamlets, Poplar. Up to 21 storeys at its highest point comprising of a mixture of apartments and townhouses. Concierge, gym, roof gardens.
The Forge, E6		**192**	-	125	67		LB Newham, Upton Park. Buildings from three to 14 storeys. BTR homes sold to M&G Real Estate, 67 affordable homes sold to East Thames (L&Q).
Bow Garden Square, E3		**109**	83	-	26		LB Tower Hamlets, Bow. Mixed use scheme in partnership with Polar HARCA with one, two and three bed apartments and suites and villas. Community school and mosque.
Chrisp Street, E14		**643**	443	-	200	Y	LB Tower Hamlets, Poplar. Chrisp St market regeneration in partnership with Poplar HARCA in a GLA new housing Zone. Part of United House acquisition.
Carmen Street, E14		**206**	-	150	56		LB Tower Hamlets, Poplar. 22-storey tower with 150 BTR homes sold to M&G Real Estate and 56 affordable homes sold to Poplar HARCA.
LEB, E2		**189**	124	-	65	Y	LB Tower Hamlets, Bethnal Green. Proposed mixed use scheme with buildings from five to 15 storeys. Now in a planning appeal phase.
Gloucester & Durham, NW6		**235**	133	-	102		LB Brent, South Kilburn. Partnership with borough, site secured via London Development Panel with affordable homes sold to Notting Hill Genesis. Part of a multi-phase master plan.
Stone Studios, E9		**120**	110	-	10	Y	LB Hackney, Hackney Wick. Residential-led, mixed use development with over 50,000sq ft of commercial space.
Parkside, SW11		**890**	-	890	-		LB Wandsworth, Nine Elms, Battersea. Two buildings, community facilities and public space. Partnership with Greystar. Approaching full build contract stage.
Equipment Works, E17		**337**	-	257	80	Y	LB Waltham Forest, Walthamstow. Mixed tenure residential development with c 19,000sq ft of flexible commercial space. BTR deal announced 19 February.
Oldfield Lane North, UB6		**278**	194	-	84	-	LB Ealing, Greenford. Part of Greystar's 20-acre large mixed-use scheme (and c 1,965 homes in total). Acquired in November 2018.
International Way, E20		**376**	204	-	172		Announced 11 Feb 2019. Conditional site purchase (subject to satisfactory planning consent). Next to Stratford International station & Westfield Stratford.
New Garden Quarter*, E15		**471**	183	112	176		LB Newham. Three- to nine-storey mansion block design around a new two-acre public park. JV with Notting Hill Genesis. BTR homes sold to Folio London.
Gallions Phase 1*, E16		**292**	205	-	87		LB Newham, Gallions Reach. Part of a wider multi-phase Notting Hill Genesis redevelopment. Residential-led, part of United House acquisition.
City North*, N4		**355**	308	-	47	Y	LB Islington. Business Design Centre JV (part of United House acquisition). Major mixed use development with new access to Finsbury Park tube station.
Balfron Tower*, E14		**137**	137	-	-		LB Tower Hamlets, Poplar. Refurb of 26-storey, grade II listed residential building. JV: Londonewcastle and Poplar HARCA, part of United House deal.
Gallions Phase 2b*, E16		**267**	132	-	135		LB Newham, Gallions Reach. Part of a wider multi-phase Notting Hill Genesis redevelopment. Mixed tenure, part of United House acquisition.

Source: Company, Edison Investment Research. Note: Key a) unit types: OM = Open market, BTR = build-to-rent, AH = affordable housing, Other = non-residential (accounting for c 5%+ of development value). b) Development value: < £50m, > 50m/<£100m, > £100m /<£150m, >£150m /<£200m, > £200m. *JV. The four shaded developments were all fully handed over in FY19. Some existing open market developments could change to BTR.

Telford's portfolio activity is summarised as follows:

- Gross development value of £1.59bn / 4,900 homes
- 70% of this pipeline by units is BTR-led
- Over 3,000 homes are in the construction phase
- Around 950 units are in the planning phase (including LEB, International Way and Gallions, phase 2).

Financial performance[1] **– changing mix influences revenues and margins:** against our expectations, Telford's FY19 PBT was in line with our expectations at £40.1m, whereas EPS came in ahead due to a lower tax charge (at 16% after the effects of tax credits vs our modelled 22%). Net debt was c £29m lower than we had anticipated at £95.7m.

FY19 results included a record revenue performance, up 12% y-o-y to c £354m, but there were lower reported margins at the gross level (down 270bp to 22.4%) and operating (down 400bp to 12.5%) levels. The equivalent adjusted margins, which reverse out expensed interest costs, were 23.7% gross (-280bp) and 13.1% operating (-360bp).

An increase in the proportion of BTR sales from 21% to 31% contributed meaningfully to these year on year features with revenue in this sub-sector implicitly rising from £68m to £109m. Investors should be aware that there is lower financial risk associated with BTR projects due their forward-funded nature and known purchaser at the outset. Consequently they generate lower contribution margins, although the difference is narrower at the net level after factoring in project interest and selling costs. Individual sale/open-market revenue was 5% below the FY18 level, partly reflecting the market conditions referred to earlier. The sale of freeholds and other land together with other sundry fees and rental income generated revenue of £13.9m in FY19. Putting all of these items together, the blended margins across all projects were as described above.

Net debt declining, BTR activity rising

The statutory, equity-accounted balance sheet showed end FY19 net debt of c £75m, which indicates the Telford's share of debt in JV projects was just over £20m, compared to c £3m a year earlier. The latter movement is consistent with construction progress with open-market units at the New Garden Quarter, Balfron Tower and City North developments in particular, with debt drawn down to fund WIP, following the absorption of the partners' initial equity injections.

The cash flow statement is reported on a group, equity-accounted basis. At the free cash flow level, the primary difference between this and our presentation shown in the financial summary (on an illustrative, including share of JV, basis) is working capital; consistent with the previous paragraph we estimate the c £44m reported inflow here was effectively absorbed on JV projects, which typically have separate borrowing facilities. That said, the company manages projects – wholly owned or otherwise – on a collective basis. At group level, the positive net debt variance against our expectation was most likely due to the timing of receipts relating to the sale of Equipment Works' BTR scheme and or freeholds and other surplus land.

Cash flow outlook: forward-funded BTR projects are inherently less capital intensive from Telford's perspective. There will always be a mix of tenure types in the development portfolio at any one time but an increasing proportion of BTR work will lower the group's borrowing requirement compared to open-market projects. We have modelled a reduction in net debt in each of our estimate years; in reality, debt reduction creates more funding capacity for other projects and, reflecting this, our illustrated profile is unlikely to prevail unless new opportunities cannot be found.

No material changes to estimates

We have made minor changes to our existing estimates and added FY22 for the first time. It is important to note that we expect the P&L composition to change with a much bigger JV scheme contribution in FY20 and FY21 compared to FY19. The proportion of BTR development revenue should also rise, although not necessarily in a linear fashion. For the record, our FY20 estimates are effectively generated from existing, known projects and those for FY21 and FY22 assume new project revenue contributions of c 25% and c 40% from new projects respectively.

[1] All commentary here refers to company numbers presented on an including proportional share of JV basis.

Valuation upside beyond £34m sustainable EBIT

We have updated the DCF matrix analysis employed in our March initiation note as shown in the table below.

Exhibit 3: Telford Homes DCF illustration

Value per TEF share (£)		EBIT (£m)				
		30	35	40	45	50
WACC %	6%	3.97	4.68	5.39	6.10	6.81
	7%	3.24	3.83	4.42	5.01	5.60
	8%	2.69	3.19	3.69	4.20	4.70
	9%	2.27	2.70	3.13	3.56	4.00

Source: Edison Investment Research

Our revised WACC of 7.8% (previously 7%) reflects lower debt on hand and Exhibit 3 suggests the current 297p share price is effectively factoring in EBIT generation of c £34m into perpetuity beyond our initial three-year estimate period. After a short-term earnings dip in FY20, our model generates c £35m EBIT in FY21 followed by c £43m in FY22. Sustaining the latter EBIT level generates an inferred valuation approaching 400p per share for Telford Homes. The amount of debt carried obviously influences the future WACC – with a rising proportion of BTR work putting downward pressure on net debt and raising WACC other things being equal – an investors can use the table to convert their view of sustainable EBIT into a per share value.

Exhibit 4: Financial summary

£'ms	2015	2016	2017	2018	2019	2020e	2021e	2022e
March								
PROFIT & LOSS								
Revenue	173.5	245.6	291.9	316.2	354.3	377.4	453.7	511.7
Cost of Sales	(116.7)	(180.5)	(226.8)	(232.7)	(275.0)	(307.6)	(377.7)	(426.4)
Gross Profit	56.8	65.0	65.1	83.6	79.3	69.7	76.0	85.3
EBITDA	31.5	37.0	39.8	53.8	43.1	32.5	36.9	45.2
Operating Profit (before GW and except.)	30.9	36.4	39.2	52.9	41.9	31.1	35.3	43.4
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit	30.9	36.4	39.2	52.9	41.9	31.1	35.3	43.4
Net Interest	(5.8)	(4.2)	(5.1)	(6.8)	(1.8)	(6.1)	(4.8)	(3.6)
Profit Before Tax (norm)	25.1	32.2	34.1	46.0	40.1	25.0	30.4	39.8
Profit Before Tax	25.1	32.2	34.1	46.0	40.1	25.0	30.4	39.8
Tax	(5.5)	(6.5)	(6.6)	(8.6)	(6.5)	(5.0)	(7.1)	(7.9)
Profit After Tax (norm)	19.7	25.7	27.5	37.4	33.6	20.0	23.3	31.9
Profit After Tax	19.7	25.7	27.5	37.4	33.6	20.0	23.3	31.9
Average Number of Shares Outstanding (m)	59.2	65.5	74.7	75.1	75.4	76.0	76.0	76.0
EPS - normalised FD (p)	32.6	38.9	36.6	49.4	44.5	26.3	30.6	41.8
EPS (p)	33.2	39.3	36.8	49.8	44.6	26.3	30.7	41.9
Dividend per share (p)	11.1	14.2	15.7	17.0	17.0	17.0	17.0	19.5
Gross Margin (%)	32.7	26.5	22.3	26.4	22.4	18.5	16.8	16.7
EBITDA Margin (%)	18.2	15.1	13.6	17.0	12.2	8.6	8.1	8.8
Operating Margin (before GW and except.) (%)	17.8	14.8	13.4	16.7	11.8	8.2	7.8	8.5
BALANCE SHEET								
Fixed Assets	1.9	2.1	2.2	3.4	3.5	3.4	3.1	2.6
Intangible Assets	0.0	0.4	0.8	0.8	0.8	0.8	0.8	0.8
Tangible Assets	1.0	1.5	1.3	2.5	2.7	2.6	2.3	1.8
Investments	0.9	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Current Assets	328.3	337.8	422.1	443.4	457.0	448.0	431.3	389.2
Stocks	277.2	285.6	339.4	373.9	320.6	311.4	294.5	252.1
Debtors	5.9	24.9	37.5	50.8	99.5	99.5	99.6	99.6
Cash	39.7	20.8	39.8	13.8	33.4	33.4	33.4	33.4
Current Liabilities	(208.8)	(150.9)	(217.2)	(214.0)	(204.2)	(188.0)	(160.5)	(99.7)
Creditors	(116.2)	(112.8)	(163.1)	(97.1)	(77.1)	(81.4)	(89.7)	(94.8)
Short term borrowings	(92.6)	(38.2)	(54.1)	(116.9)	(127.0)	(106.6)	(70.8)	(4.8)
Long Term Liabilities	(1.1)	(2.0)	(2.8)	(1.7)	(3.5)	(3.5)	(3.5)	(3.5)
Long term borrowings	(0.4)	(0.7)	(1.1)	(0.4)	(2.0)	(2.0)	(2.0)	(2.0)
Other long term liabilities	(0.7)	(1.4)	(1.7)	(1.3)	(1.5)	(1.5)	(1.5)	(1.5)
Net Assets	120.4	187.0	204.3	231.1	252.9	259.9	270.4	288.6
CASH FLOW								
Operating Cash Flow			27.2	(61.2)	35.5	43.2	59.7	90.8
Net Interest			(3.8)	(5.6)	(6.9)	(4.5)	(3.6)	(3.0)
Tax			(6.5)	(7.6)	(5.5)	(4.0)	(6.1)	(6.9)
Capex			(0.4)	(2.1)	(1.3)	(1.3)	(1.3)	(1.3)
Acquisitions/disposals			(3.6)	0.0	0.0	0.0	0.0	0.0
Financing			0.9	0.8	0.9	0.0	0.0	0.0
Dividends			(11.1)	(12.4)	(13.2)	(12.9)	(12.9)	(13.7)
Net Cash Flow			2.7	(88.1)	9.6	20.4	35.8	65.9
Opening net debt/(cash)			18.0	15.3	103.4	95.7	75.2	39.4
HP finance leases initiated			0.0	0.0	0.0	0.0	0.0	0.0
Other			0.0	0.0	(1.8)	0.0	0.0	0.0
Closing net debt/(cash)			15.3	103.4	95.7	75.2	39.4	(26.5)
Gearing (net debt:net assets)			8%	45%	38%	29%	15%	-9%

Source: Telford Homes accounts, Edison Investment Research. Note: Financials presented including Telford Homes share of JV activities; the company does not currently report a cash flow statement on this basis, so the above represents our interpretation only. Our P&L projections show interest costs gross, before capitalisation effects (and with a higher adjusted gross margin), which net out at the PBT level. Historic P&L numbers have been presented on the same basis.

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Australia

New Zealand

United Kingdom

United States

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia