Development Securities 10/04/2014 **FAT-UK-532**

DSC GBP £2.38 Special **MED.** **B**

Developers back in vogue

The recent strength of Songbird Estates has reinforced our view that property developers are coming into favour. This is as the UK economic recovery is picking up and boosting rents and valuations. As such we are increasing our exposure and rate Development Securities as a buy.

Real estate is a reasonable way to gain exposure to the strength of an economy but high gearing also makes it vulnerable to a downturn. With the UK economy's momentum firming up the sector looks set to continue to outperform.

Existing UK portfolio real estate holdings

Our existing holdings illustrate this with Grainger seeing a 24% increase in tangible net asset value per share in the year to September 2013. Songbird Estates meanwhile saw a 61.6% increase in the year to December 2013.

In the case of Songbird the significant jump was due to a high level of gearing combined in an upward property revaluation. Debt clearly works both ways with it having a leveraged effect on performance in periods of economic strength.

The relatively low risk property group Daejan Holdings saw its net asset value per share rise by 13.6% in the year to September 2013 to £64.49. Given a sizeable residential element and a focus on the South of the UK we expect further gains.

As such the current share price of £48.50 remains attractive with it being a discount of a quarter to the last estimated NAV per share. However, as a family controlled company a discount is likely to remain in place.

Given the sector momentum we added Quintain Estates to the portfolio in mid-March. The group had a NAV per share of 112p at September 2013 and is set to update the market in May for the NAV at the end of March 2014.

We are confident that the UK economic recovery will see momentum continue to favour real estate. Accordingly, we view it worthwhile adding a further UK real estate stock to the portfolio.

In our mid-March (FAT UK 528) look at two UK property developers we chose to add Quintain Estates (QED) to the portfolio. We now view it as appropriate to add fellow UK property developer Development Securities (DSC).

Turning to the charts we see that DSC have been in a rising trend since 2011, and hit three-year highs of 269p in January. However, with a double top now in place we may see additional weakness if support at 220p fails to hold when tested. Prices therefore need to move away from the lower boundary. Over the long term, we favour the shares continuing their upward trajectory, underpinned by the fundamental investment case.

The financial year for Development Securities is to the end of February and as such results are set to be reported in late April or early May. We view it as worthwhile adding the stock ahead of these results.

This is as the next valuation may see scope for investor sentiment to improve. Even if this doesn't occur we view UK real estate as having good medium term prospects as the UK economy gathers momentum.

The group reported a basic net asset value per share at 255p as at 31st August 2013 which was only a modest 2.4 % on the year before. However, Development Securities has a strong pipeline of projects which look set to boost its value.

Development securities in focus: five core principals

Development Securities is, as the name suggests, a property developer with all the risk that this entails. It does have some investment properties which provide income to support the group's operating expenses and the dividend.

The dividend has recently been 4.8p a year which generates a yield of around 2% on the current share price. The group has **five core principals** which include to predominantly invest in the UK (an initial Irish investment was made in 2013).

A second principal is to primarily focus on commercial property although the group has shifted its stance since 2009. The development scope now includes mixed-use developments with residential, hotel and student accommodation.

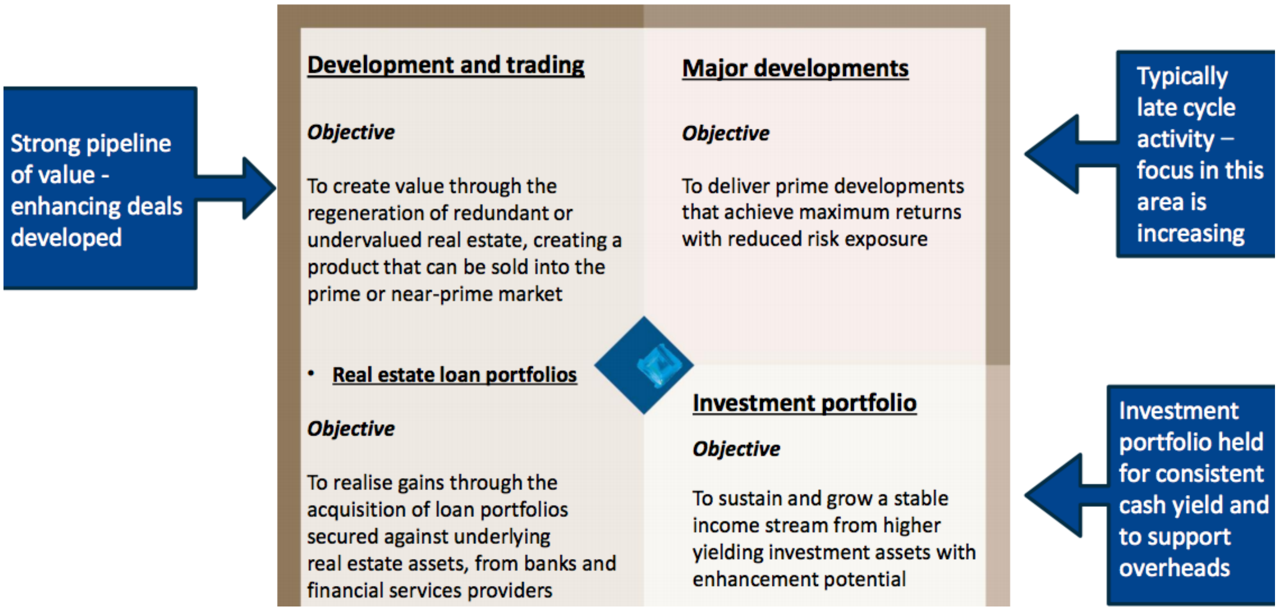
The third principal is to maintain a property investment portfolio so that rents support operating expenses. This includes commercial and retail assets and helps offset the uneven cashflow from development projects.

Moving to the financial front and the fourth principal is to avoid major developments using the balance sheet. As such these are funded through forward sales, pre-lets and joint ventures with investment partners.

Lastly, the group aims to have "modest" levels of financial gearing at around 50%-60%. On the 31st August 2013 the group reported effective gearing (including the share of joint ventures) at 56.5%.

Development Securities' three-pronged strategy

The group's three-pronged strategy is given in the graphic below and shows a balance between development and the investment portfolio. Major developments are undertaken late into the property cycle.



Source: Development Securities presentation

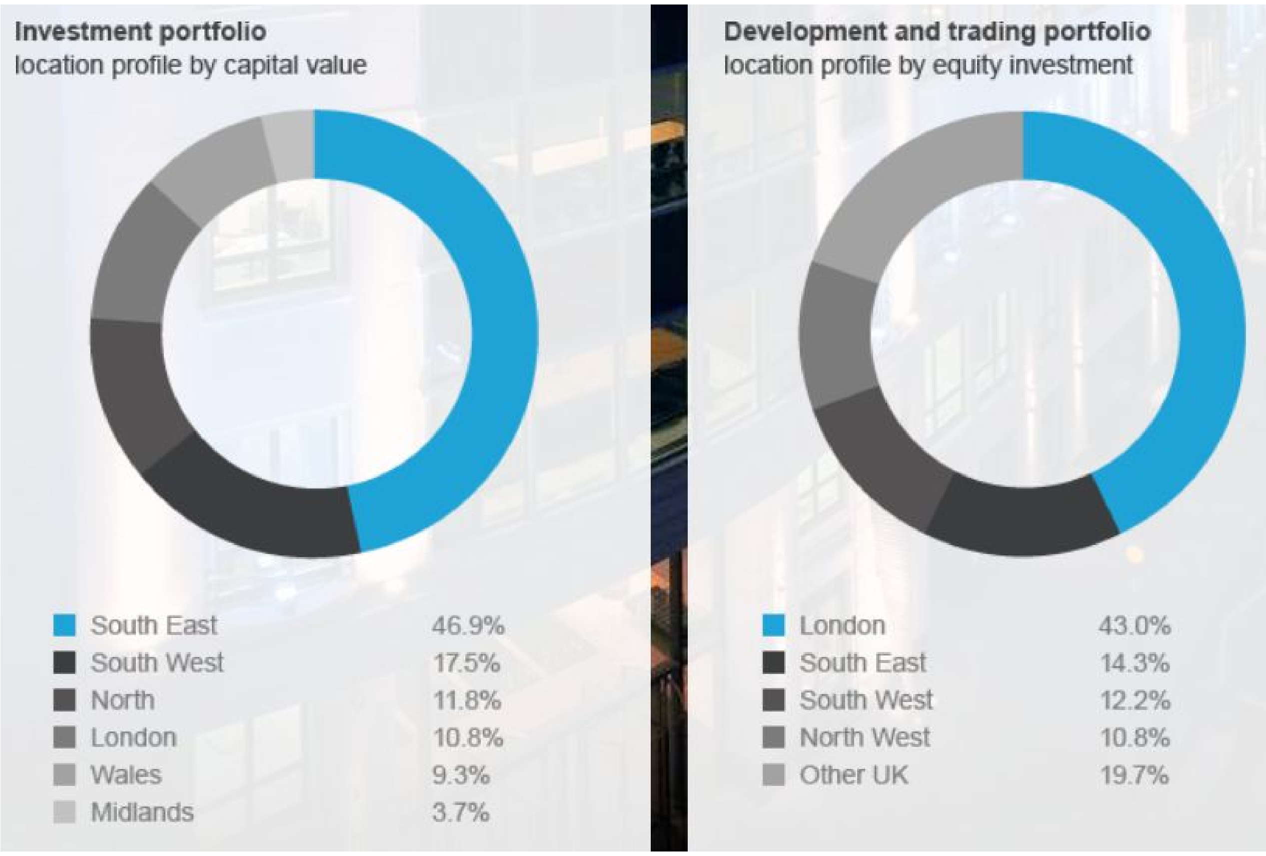
In terms of development and trading and the focus is to turn undervalued real estate assets into prime or near-prime products that can be sold. This is done through regeneration which may involve gaining planning permissions.

The group also invests in the real estate loan portfolios which financial institutions are looking to exit. These loans are secured against the underlying real estate assets providing a measure of security.

The investment case

The investment case for Development Securities is that the group is set to benefit as property value gains in central London move out across the country. The group has limited central London exposure but is developing in greater London.

Asset exposure: The development & trading portfolio is biased to London



Source: Development Securities website

A number of the group's London development properties are set to benefit from the Crossrail which is set to open in 2018. Projects affected include The Old Vinyl Factory at Hayes, Cross Quarter at Abbey Wood, and Paddington Central.

Crossrail booster at six London development sites

Source: Development Securities website

The company is also moving increasingly into residential property development which should provide significant potential given housing demand. This is through mixed-use schemes which include residential, commercial and retail.

The group states that around 7,000 residential units are in development with a 2.4m euros scheme recently acquired in Dublin. In London the residential programme of the group has a gross development value of around £1bn.

London residential programme

- Over 2,500 residential units within London schemes valued at c.£1 billion
- Planning consent for change of use adds significant value to residential land/phase within mixed-use schemes
- Focus on £300 - £500 psf sales value for domestic market

	Scheme Name	Number of Units	Estimated end value
Constructed / Completed	Wick Lane Wharf, London (JV)	112	
	Westminster Palace Gardens*	23	
	Neo Bankside*	5	
Under Construction	The MVMNT, Greenwich* (JV)	181	
Planning Permission Granted	Cross Quarter, Abbey Wood	216	
	Rembrandt House ,Watford	107	
	Shepherds Bush Market (JV)	212	
	The Old Vinyl Factory ,Hayes (JV)	685	
	399 Edgware Road	183	
Design Phase	Valentines House, Ilford	110	
	Morden Wharf, Greenwich (JV)	700	
	TOTAL	**2534**	**c.£1 billion**

*Sales already achieved

Source: Development Securities presentation

The share price is also below the estimated net asset value per share which contrasts to the rest of the sector which is mostly at a premium. For example, Helical Bar's NAV was 282p on 30th September 2013 while the shares are 362p.

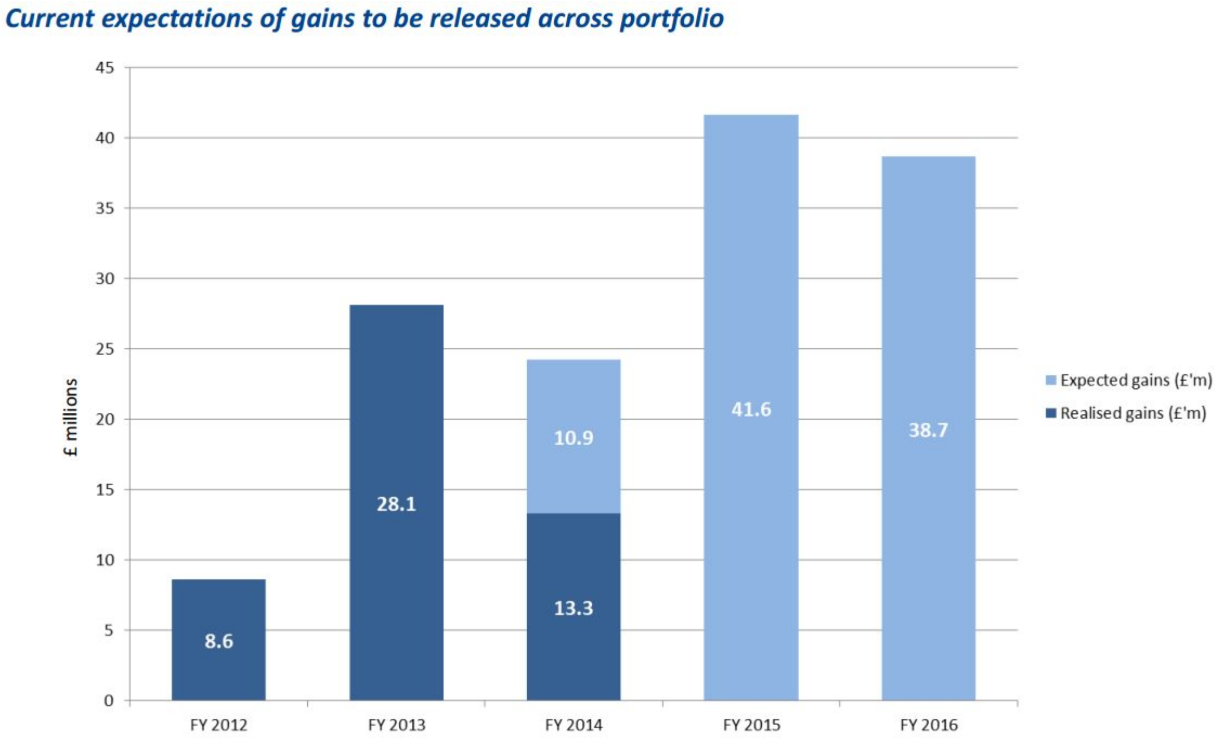
By contrast the share price of Development Securities is around 240p which is below the 31st August NAV at 255p. The group has also seen NAV gains with the figure 249p the year before.

On the risk side of the equation the company has seen gearing fall in its most recent results with a figure of 45.7% as at 31st August 2013. This compares to 47.9% the year before.

Factoring in the gearing in joint ventures and the fall is from 67.7% to 56.5% over the same period. Rising valuations should see gearing fall further and a strong market for sales also lowers the development risk.

Development gains set to increase

Development Securities is also set to see a number of developments come to maturity in the near-term. The current financial year (to end February 2015) will see a significant uplift in realizations to an expected £41.6m.



Source: Development Securities presentation

This will clearly help bolster the balance sheet and cashflow and therefore helps lower the immediate risk profile. Property developers typically get caught out when there is a cashflow gap or loan covenants are in danger of being hit.

Recent financial results

Looking at the interim financial results (six months to the end of August) and the turnaround in fortunes is clear. The group returned to a profit having made a loss in the same period the year before.

This was as property revaluation gains were positive at £0.5m versus a loss of £4.4m in the prior period. In our view, this bodes well for the turnaround in fortunes which we expect to have continued in the second half.

Results for the six months ended 31st August 2013

	Six months ended 31st Aug 2013 £m	Six months ended 31st Aug 2012 £m	Year ended 28th Feb 2013 £m
Profit before revaluations, interest & taxation	12.7	9.5	23.8
Net finance costs	(5.8)	(4.9)	(9.3)
Profit before revaluations and taxation	6.9	4.6	14.5
Swap mark-to-market valuations	0.7	(0.9)	(0.8)
Property revaluation gains/(loss) (including joint ventures)	0.5	(4.4)	(12.9)
Profit/(Loss) before tax	8.1	(0.7)	0.8
Profit/(Loss) per share	5.9p	(1.4)p	2.0p
Dividend per share	2.4p	2.4p	4.8p

Source: Development Securities presentation

The improvement is also evident in the valuation gains in the six month period to the end of August 2013. Using the Non-EPRA figures the group saw a 4p uplift which contrasts to a 2p uplift in the six months to the end of February 2013.

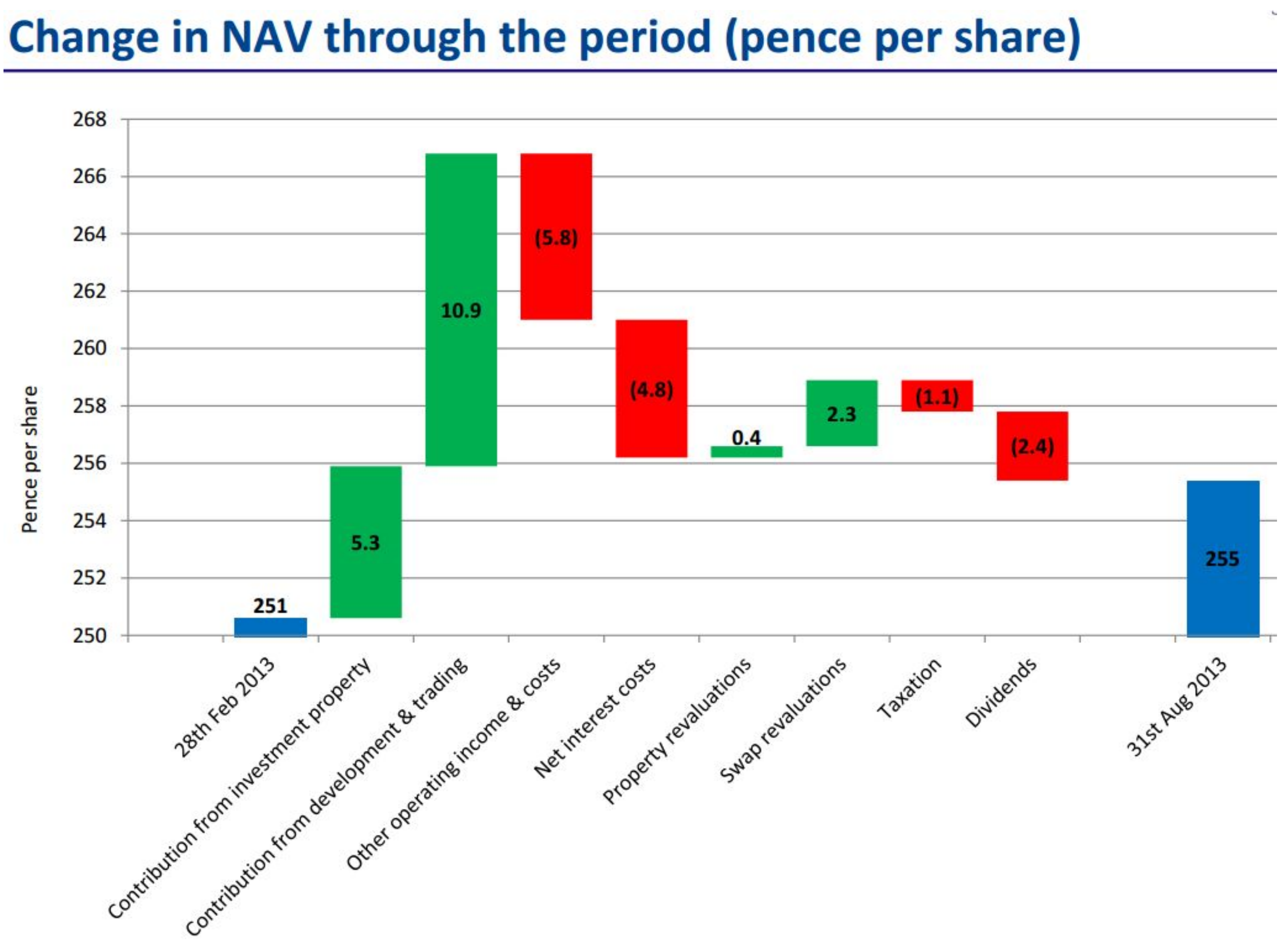
Valuation

	EPRA			NON-EPRA		
	Six months ended 31st Aug 2013	Year ended 28th Feb 2013	Six months ended 31st Aug 2012	Six months ended 31st Aug 2013	Year ended 28th Feb 2013	Six months ended 31st Aug 2012
Net Asset Value (£'m)	320.5	317.5	317.4	312.6	306.6	304.4
Net Asset Value per share (pence)	262	260	259	255	251	249
Earnings/(loss) per share (pence)	5.1	10.5	0.6	5.9	2.0	(1.4)
Development and trading profits (£'m)	13.3	28.1	11.9	13.3	28.1	11.9

Source: Development Securities presentation

The contributors to the net asset value per share gain in the first half are given below. Clearly development and trading was a key driver of the uplift while the investment properties were also supportive.

Net asset progression in the first half of the financial year



Source: Development Securities presentation

Recent trading

Since the interim results were announced on 22nd October the group has been relatively active. The group's interim management statement in mid-January 2014 also appears to show increasing optimism.

The CEO of Development Securities, Michael Marx, stated that:

"With the economy showing continued signs of recovery, and confidence and activity levels rising outside of the Central London property markets, we also see further opportunities to invest in assets where we can create value through regeneration."

On the balance sheet front the group recently restructured Euros 47m of medium term notes which is set to save £0.8m a year. As other debt instruments mature the group should also be able to refinance them at lower rates.

Summary and valuation

Development Securities has shown evidence of a turnaround in fortunes in its interim results (six months to end August 2013). We expect this to continue as property price increases in central London ripple out across the UK.

The group is also set to see significant realizations in the next two years which is at a time of strong market conditions. It also has an increasing residential exposure and benefits from the development of Crossrail.

Given that we anticipate a strong market for UK real estate as the economic recovery continues we believe the stock offers good value. This is as it remains at a small discount to NAV while most other real estate stocks are at a premium.

The market value is relatively low at £290m and as such liquidity is likely to be an issue when buying the shares. Nevertheless, the company is in a strong position as it takes its developments toward completion in a buoyant market.

Full year results are set to be announced at the end of April or the beginning of May. In our view these should show improving momentum in the company's net asset value per share.

Accordingly, we recommend Development Securities (DSC) as a buy for all members. Given that the stock is relatively illiquid we recommend buying over time.

Snapshot DSC

Development Securities

Latest Closing Price: £2.38

U and I has a three-pronged strategy which includes an investment portfolio to provide income. Major development projects are undertaken with partners towards the end of the property cycle. Over the whole of the cycle the group is involved in regenerating undervalued or redundant real estate.

Market Capitalisation:£290m

	FY1	FY2
Price to Earnings		59
Dividend Yield (%)	2%	
Price to Book		0.9