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Financial Review

Workspace-as-a-Service and the increasing deployment of analytical data are leading the changes in real estate trends. Collaboration, flexibility in terms of space – as well as duration and technological advancement – are tenants' key requirements for the way they use space.

These changes are forcing real estate players to adopt new business models, or at least new business lines involving higher complexity. They also present new challenges for financial strategies. We're working hard to adopt a business model that addresses all these challenges in a proactive way and adjusting our financial strategy to support it.

At HB Reavis, we are constantly monitoring, anticipating and analysing market trends as well as adjusting the way we do business and reviewing our financial strategy to suit them. Our aim is to ensure our financial strategy is fit for purpose and allows us to maintain a healthy capital structure while ensuring the availability of both new debt and new equity to support the Group's ambitions.

Occupancy trends are changing. Increasingly, tenants are looking for greater flexibility, driven primarily by the ever-shifting dynamics of today's business models and new economy sectors. In competitive labour markets, tenants need attractive recruitment and retention packages and it is no longer only about remuneration and monetary benefits. The actual working environment now plays an increasingly strong role in recruiting top talent.

Given this new reality, the notion of a tenant committing to a long-term and inflexible lease contract (the most attractive to traditional finance providers and investors) is being challenged. As a major player in leasing markets, we're seeing a clear trend towards more occupational flexibility. This, together with the advent of another recent phenomenon in how tenants use space – the co-working platform – means there's a growing need for more agile debt and equity funding.

Through a combination of divestments and external financing operations we accumulated cash at year end 2018 amounting to €173.8m. This will help us continue our robust development program and support our growth both in an organic manner and potentially through acquisitions, should the opportunity come our way.

In 2018, dividends paid to our shareholders reached 3% of NAV, in line with our financial policy. Our financial policy, refined during the course of 2017 by the measures outlined below in italics, formalises the key financial measures:

- Target gross debt to total assets at 40% (maximum 45%) and net debt to total assets at 35% (maximum 40%) with an appropriate mix of non-recourse project debt and Group-level debt
- Initial maturity of project loan financing and issued bonds to commensurate with the length of our product development cycle
- Cash reserve target at least 5% of total Group debt, with a special reserve build-up profile to cover future bullet repayments for debt well in advance
- Dividend payout in line with historical levels, up to 3% of NAV
- Careful risk management aimed primarily at mitigating foreign exchange fluctuations for all known and estimated non-Euro exposure 12-months forward and interest-rate risks covering 50 – 100% of total medium to long-term debt exposure, both associated with macroeconomic or property cycles

Note: Figures in the Financial Review section are based on audited consolidated financial statements, external valuations and internal management reports. All valuations in the Business Review are based on external valuations and internal management reports before IFRS adjustments and exclude non-core properties. For segment information related to the non-core segment, see Note 6 in the Consolidated Financial Statements. For figures presented in the Segmental Analysis in the Consolidated Financial Statements, see Note 6 of the Consolidated Financial Statements.

How we performed

In terms of overall performance, in 2018 we delivered better financial results than in 2017. Obviously, the main driver was a revaluation gain of €194.8m over the year, up from €95.2m in 2017. At €38.0m, net operating income, in line with our expectations, was down slightly (2017: €38.7m).

Disposal of subsidiaries decreased somewhat to €21.8m (2017: €25.8m). Bottom line: we achieved a total comprehensive income of €102.1m (2017: €96.5m). To support our growthwe also grew in personnel. Primarily, we welcomed people to the business in Germany, but we're also adding some product design related head-office positions so we're ready for further growth.

In terms of the operating profit, the group achieved €197.9m.

€120.1m

Net profit

€102.1bn

Total comprehensive income

€184.8m

EBIT

€38.0m

Net rental income

€194.8m

Revaluation gain

€1,344.1m

NAV (adjusted)

8.5%

Shareholders' return

30.5%

Net Debt Leverage Ratio

The Group balance sheet increased to almost €2.35bn. Adjusted net asset value increased by a modest 5.5% year-on-year and reached €1.34bn. In terms of the 8.5% return on shareholders' equity, we were not able to deliver the 15% long-term target level.

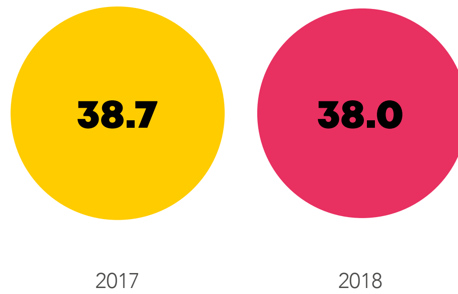
In contrast to the previous year, our net debt leverage ratio return was much closer to the targeted level of 35%. It was 30.5%, up from 26.8% in 2017.

€m	2014	2015	2016	2017	2018
Assets	1,806.1	2,089.3	2,112.3	2,294.8	2,349.9
Cash	155.3	115.4	316.4	279.1	173.8
Borrowings	634.4	736.3	683.0	893.0	891.5
Net Debt Leverage Ratio	**26.5%**	**29.7%**	**17.4%**	**26.8%**	**30.5%**

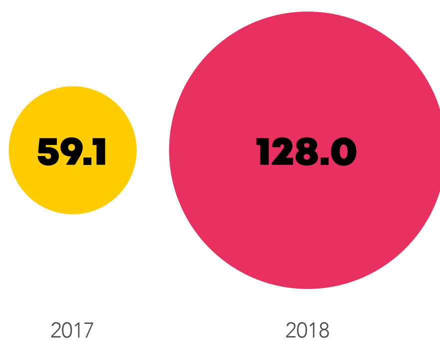
*Including borrowings presented in the consolidated balance sheet as liabilities directly associated with non-current assets classified as held for sale. Excluding borrowings in JV.

How we created value in 2018

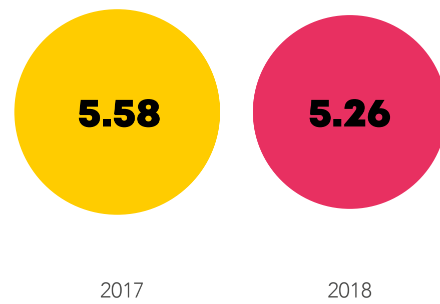
Net Operating Income from Investment Properties (€m)



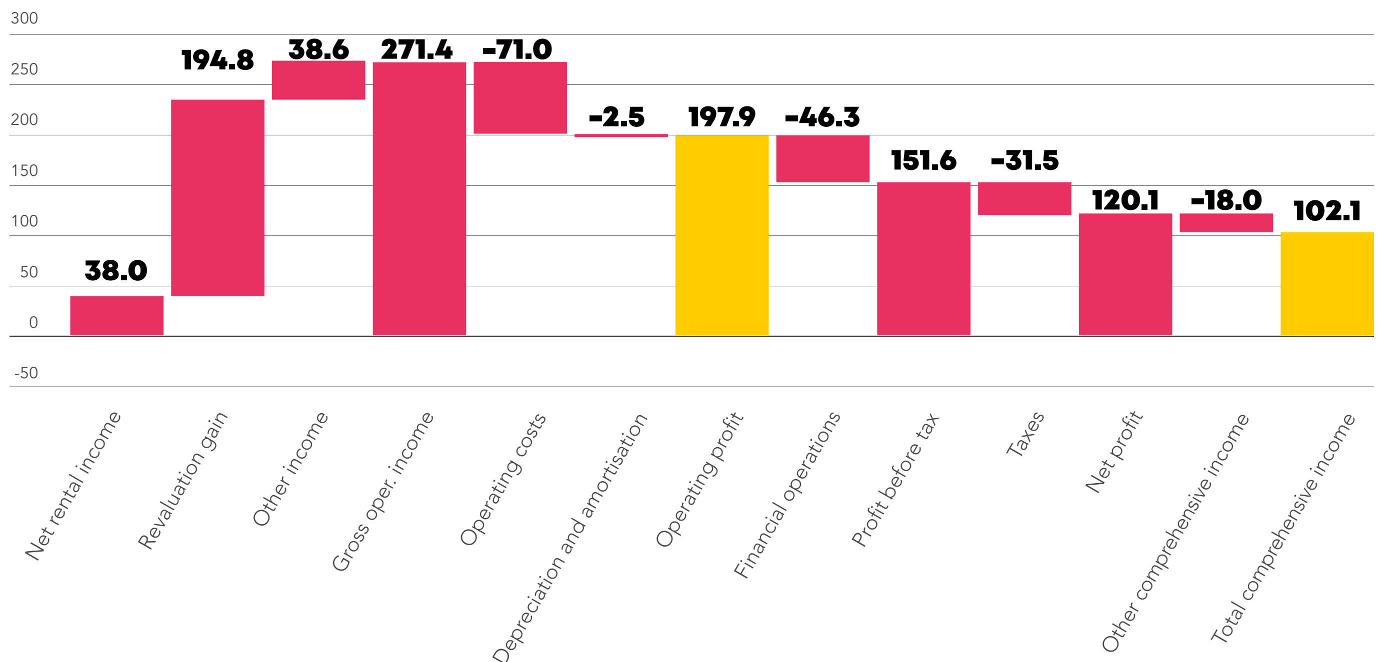
Revaluation Gains



Investment Portfolio Yield (%)



Group Profit Decomposition (€m)



Revaluation gain

A revaluation gain on investment property resulted in €194.8m (2017: €95.2m) in our pipeline. This represents a significant year-on-year increase of around 105%, driven mostly by the construction progress of our projects in Poland, the UK and Slovakia.

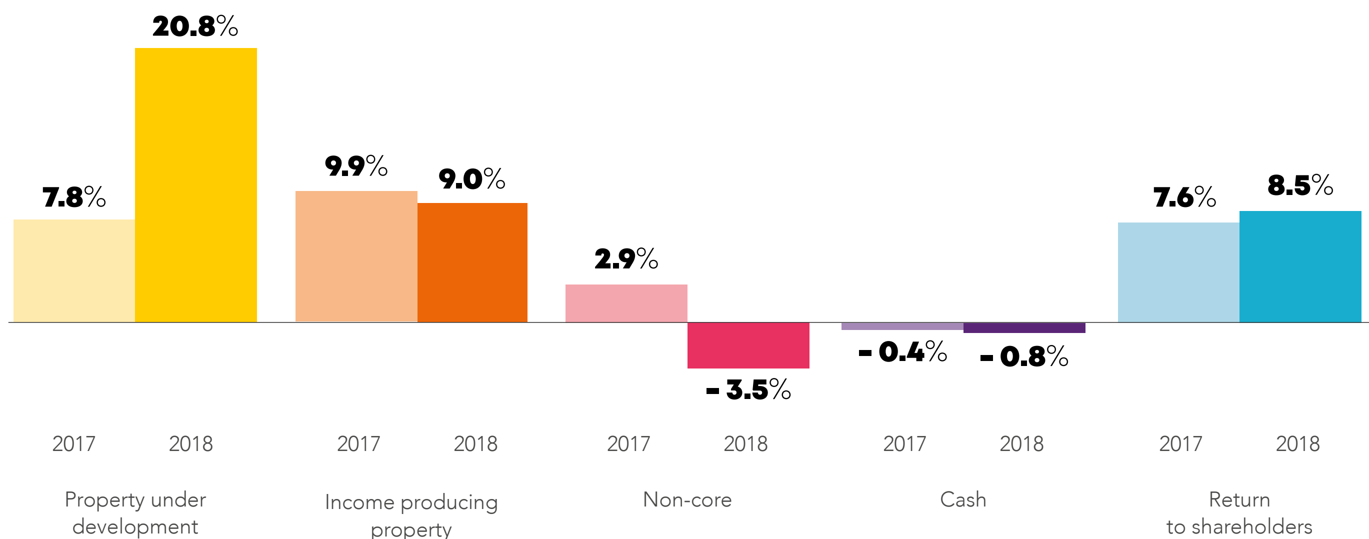
When adjusted for yield shift, the Group achieved a €128.0m (2017: €59.1m) net revaluation gain while the positive yield shift contributed €66.8 million to profits (2017: €36.1 million).

The average investment property portfolio yield decreased by 30 basis points to 5.26% as we continued investments in lower-yield projects in the UK and Poland and enlarged our investments in Germany. Income producing assets, primarily driven by higher yielding Slovak assets, were valued at 5.74% at the end of 2018. The average valuation yield of our development properties, now more heavily weighted to UK and Polish assets, was also down by 25 basis points to 4.79%.

As our strategy in the mid-term is to keep and manage our assets longer after they become mature, the growth potential for our net operating income could be higher in the coming years.

How business lines contributed

In terms of contributions made by our business lines to the overall return on shareholders' equity, the main drivers were both the development portfolio with a high ROE of 20.8% (2017: 7.8%) and income producing property with an ROE of 9.0% (2017: 9.9%). The ROE of our non-core portfolio lagged behind with -3.5% as did cash at -0.8% at the end of 2018.



Note 1: Projects completed in 2018 included in 'Property Under Development.'
Note 2: Segment results based on profit before tax (excluding the translation of foreign operations to the presentation currency).
Note 3: Return to shareholders includes dividends paid out.
Note 4: Investment property value reflected in the calculation above represents HB Reavis's share on properties' fair market value.

How we manage cash flow

In 2018, there was no significant change in the behaviour and appetite of financial institutions that finance real estate projects.

The financing market offered reasonable conditions on loan-to-cost ratio and pricing and the ability to deploy debt funding at earlier stages of the development phase was favourable. These conditions were the same across all our markets except for London, where Brexit prompted financial institutions to reconsider financing speculative office development.

We tried to take advantage of this positive trend to support our growing development operations. As always, we continued to manage cash flow responsibly, prudently and according to proven guidelines:

- Managing financing and investment decisions so that the overall position of our cash reserves plus undrawn committed credit lines remain at a minimum of 5% of the total consolidated balance sheet.
- Preparing regular monthly and quarterly reviews of the consolidated cash flow forecast with a three to five year forecast, including quarterly stress tests for different markets and macro-economic scenarios.

Cash Flows 2014 – 2018

Cash flows	**2014**	**2015**	**2016**	**2017**	**2018**
Cash beginning of period (BOP)	**49.9**	**155.3**	**115.4**	**316.4**	**279.1**
Operating cash flow	**20.6**	**24.3**	**30.6**	**-67.4**	**-6.6**
Land/property acquisitions	-56.7	-40.0	-76.0	-300.4	-157.8
Construction investments	-122.6	-215.5	-244.9	-201.5	-245.7
Land/property exits	88.0	13.5	162.6	23.4	169.7
Other investments	-10.8	-8.1	-1.4	-2.8	-3.3
Investment cash flow	**-102.1**	**-250.1**	**-159.7**	**-481.3**	**-237.1**
Borrowings change	200.7	244.9	379.1	541.2	185.3
Dividends/equity contributions	-13.8	-59.0	-49.0	-29.8	-46.9
Financing cash flow	**186.9**	**185.9**	**330.1**	**511.4**	**138.4**
Cash end of period (EOP)	**155.3**	**115.4**	**316.4**	**279.1**	**173.8**
Share of cash on total assets	**8.6%**	**5.5%**	**15.0%**	**12.2%**	**7.4%**

Note: Figures based on audited consolidated financial statements and internal management reports. For the complete cash flow see the Consolidated Statement of Cash Flows in the Consolidated Financial Statements. Land/property exits are presented net of related investment loans repaid in relation to exit.

In line with our growth strategy, our annual investment in the construction and acquisition of new plots exceeded €400m in 2018.

Our investment in acquisitions during the reporting year decreased to €157.8m. As far as investment in construction is concerned, the amount increased to €245.7m. For the coming years, we plan to keep the amount of investment at around €400m – €500m.

How we finance

The reporting year was another of strong financing activity for HB Reavis, mainly in project financing. In 2018, the Group financing activities focused mostly on securing development financing for major schemes under construction that were successfully accomplished. For example, loans for Nivy Sation and Nivy Tower were signed and both Varso Place and Agora Budapest project loans were approved by lenders and are in the stage of documentation negotiations. Despite having no new issuances on debt capital markets, HB Reavis continued monitoring the market for opportunities and established a new bond issuance programme in Slovakia allowing for new issuances in 2019.

The cost of external debt remained almost flat at around 2.9% while the weighted average tenor declined to 3.2 years at year end 2018 (2017: 3.8 years). This shortening of the tenor was caused by divestments of projects with longer tenor debt (Gdanski Business Center II and Metronom) and no new issuances on the capital markets accompanied by a natural shortening of outstanding bond duration.

Almost €330m (of which €70.4 million were joint-ventures) of external debt was newly raised or refinanced through bank loans.

The Group repaid or offloaded external debt amounting to over €291m. At the end of 2018, external debt (other than from related parties) stood at €846.2m* compared to €878.8m* at the end of 2017. Out of the external debt, 62% stemmed from bank loans while the remaining 38% was from issued bonds.

Despite strong debt raising activities aimed at optimising the Group's capital structure, our overall net debt leverage ratio stood at 30.5% (2017: 26.8%), still significantly below the 35% set in the Group's financial policy.

As of the end of 2018, we maintained well diversified credit relationships with 17 (2017: 14) banking and financial institutions for projects in the UK, Germany, Slovakia, Czechia, Poland and Hungary.

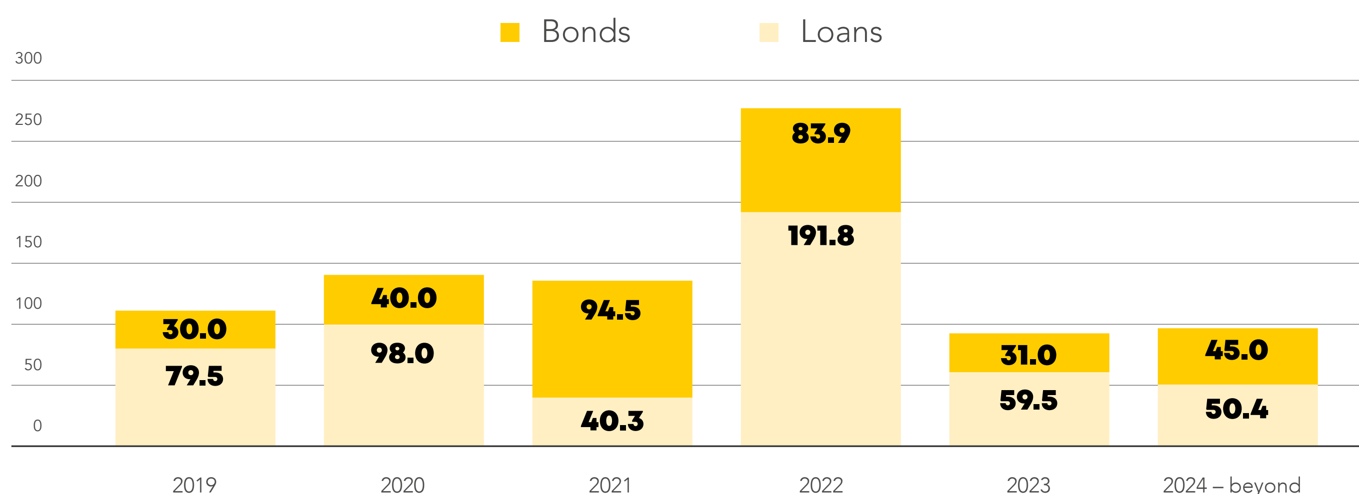
Our traditional source of external debt funding – project linked loan financing – has long been provided by diverse banking partners. This type of loan financing is typically secured against a designated real estate project with limited or no recourse to the Group.

Special project companies (SPVs) contract for bank loan facilities that are subject to lending covenants that typically include maximum loan-to-value ratios and minimum debt service coverage ratios.

A large part of bank debt carries floating interest rates with a variety of hedging arrangements, agreed upon either in the conditions of our loan agreements or on a distinct basis reflecting the Group's needs to mitigate its interest rate exposure. The Group closely monitors interest rates and takes actions whenever necessary. On top of this, leveraging the current low interest rate environment, the Group has started proactively hedging development loans for its projects in earlier stages of construction that are still in discussion with banks. As of year end, the Group had already concluded €100m of interest rate caps with a 7year maturity out of an initial €500m target.

Our loan documentation always incorporates several key elements: achievable covenants and undertakings, operational flexibility and the protection of shareholders' equity. Over the course of 2018 no default events were called or reported in the Group's loan portfolio.

HB Reavis Group Maturity Profile as of 31 Dec 2018 (€m)



* Excluding debt related to JV's and related parties.

How we divest

The real estate industry has been slow to adopt new trends and technologies, while many other fields have experienced significant transformations in the new age of technological disruptors and business innovations. The main reason for the lagged innovation is the unwillingness of large real estate market players to make dramatic changes to the way they are doing business (i.e. development, leasing, asset management), which has proved to be largely successful in the past. However, the disruptive effects of new tech solutions, along with the changing demands of key stakeholders, are already starting to impact the real estate business, favoring those who have the means and motivation to innovate.

With our ambition to be a leading workspace provider, HB Reavis has over the past years significantly invested, both money and time, into efforts to be at the forefront of the industry change. The business model transformed accordingly and with our progressive Workspace as a Service (WaaS) solutions putting well-being and user productivity in the spotlight. Our product offering intends to transform the perception of office space from being merely a cost item, into becoming a valuable tool for businesses to thrive. The aim is to build strong, long-term relationships with tenants, providing them unique solutions and valuable data insights about workspace utilization, employee interactions and well-being.

We see these aspects as increasingly important to companies, who struggle to attract talent and appreciate the opportunities our space offers through innovative solutions. As a result, the effective implementation of our WaaS strategy could be a significant driver of increased valuation of the properties under our management.

To maximize the shareholders' value and to reflect on the Group strategy, we have also shifted our divestment preferences. Apart from the standard sale process, we seek long term partnerships and joint ventures with investors looking to buy our properties. Maintaining control over the assets we divest – through asset management contracts and minority stakes, plays an essential part in recognizing the additional value created by our WaaS solutions and long-term interactions with the tenants. Over the past years we have undoubtedly demonstrated having a close relationship with investors, who clearly valued our real estate solutions through repeating investments. Gaining and maintaining trust is therefore a critical part to implementing our divestment strategy. We strongly believe that investors value having us as a partner in their investments, benefiting from our WaaS solutions, as wells as our strong market presence.

Twin City Tower

Risk management

The Group is exposed to the risks that are part of the general commercial environment, as well as various business-specific risks. An inherent part of the Group's business management is the emphasis on their identification and monitoring.

Where possible, we deploy proactive mitigation tools to manage any risks that could have a material impact on our business. As a SWOT analysis of our business shows, the majority of weaknesses and threats are the focus of our comprehensive risk management.

External risks

Uncertainty in macro and microeconomic environments in Group's markets increases the risk related to property values, development returns, accessibility to external funding and saleability of assets, as well as stability of rental income.

Default of contractual partners and adverse changes in the legal environment can lead to financial losses for the Group.

Description and potential impact of risk	Mitigation
The Group's business is dependent on macroeconomic and property market conditions in each individual country and city in which we operate. Deterioration in commercial property markets leads to a decline in the value of the property portfolio, tenant default and a reduction of income from relevant properties.	• International and segment diversification provides a reasonable balance in mitigating market cycles and fluctuations, as well as concentration risks • Focus on high-quality properties in superb locations with sustainable prospects • Thorough acquisition process involving assessment of legal, tax, economic, technical and social parameters, as well as the timing of the acquisition
Events on financial markets might limit the availability of funding and influence terms of raising capital, while a lack of liquidity might reduce the saleability of assets. Movements on financial markets might influence the development of interest rates as well as currency exchange rates.	• The Group cooperates with a variety of banking partners in different markets • Diversification of funding sources split into bank financing and debt capital markets • Constant reviews of our cash-flows aimed at matching funding sources with committed capital expenditures • The risks associated with rising interest rates are limited through derivative financial instruments, especially CAPS and SWAPS • Foreign exchange rates are monitored daily and, in line with financial policy, we deploy hedging tools, including derivatives to hedge part of this risk
Underlying income could be adversely affected by a weakening of tenant demand resulting from slow economic performance in the EU and corresponding uncertainties in consumer confidence, business activity and investments.	• Focus on developing prime portfolios in sectors deemed to have resilient attributes, on strong tenant covenants • Strong relationships with tenants lead to early identification of issues • Sector and regional diversification of the property portfolio with balanced and diversified tenant mix with limited exposure towards single tenants
When a contractual partner is unable to meet obligations, financial or other, such breaches might lead to direct or indirect financial losses for HB Reavis	• Continuous monitoring and evaluation of the credit standing of contractual partners, such as tenants, suppliers or banks • Deploying protective measures, such as security deposits, bank guarantees or performance bonds
As an international company, we are exposed to a variety of legal risks. These risks vary and relate to the purchase or sale of property, to legal disputes with tenants or joint ventures and development partners or to development and construction processes	• Careful analysis of legal matters in respective environments, including the use of high-quality professional advisers • Continuous monitoring of all aspects of the planning process (including environmental areas) by experienced in-house and external experts

Internal risks

A failure in decision-making on capital commitments, assessment of new acquisitions/opportunities, management of construction and development processes and impacts of changes in organisational structure can all expose the Group to risks leading to adverse financial implications.

Description and potential impact of risk	Mitigation
Weak market analysis (i.e. failure to anticipate adverse market changes) leads to selection of unsuitable and burdensome schemes Heavy capital commitments result in insufficient Group capacity to meet them	• Sophisticated and diligent approach to acquisitions and selecting schemes resilient to market changes • Acquisitions are reviewed and financially appraised by multidisciplinary teams and approved by clearly defined authorisations • Constant budgeting and forecasting of all capital commitments, matching them with available funding sources • Flexible construction pipeline enabling the Group to deploy capital at suitable times
Failure to assess and manage risks during the development process adversely impact future income, capital performance and endanger leasing exposure, timetable and costs, and adverse planning judgements. Poor construction delivery and failures in procurement (of sub-contractors) results in quality issues and cost overruns causing customer dissatisfaction and/or financial damage	• Detailed analyses and appraisal of all developments, including risks, sensitivity and scenarios assessment is commissioned prior to any development commitment • Progress against budget and schedule is monitored throughout the development lifecycle • Before awarding supplier contracts, key contractors are assessed, including financial covenant review • Strong and sustainable relationships are maintained with key suppliers
Organisational structure needs to be adapted to international expansion, which exposes the Group to risks of inappropriate staffing in key positions. Departure or failure to attract competent experts leads to significant loss of intellectual property or inability to properly cover certain sections of the development cycle.	• Selection of high-quality professionals with competitive, performance-driven remuneration packages • Regular performance review of key positions • Succession planning designed to avoid disruption of key business areas