



## **COMMERCIAL LEASE TRENDS FOR 2014**

### **Notes from a Presentation given by N B Maunder Taylor BSc (Hons) MRICS, Partner of Maunder Taylor**

The following is a written copy of the presentation given by Nicholas Maunder Taylor on 25 February 2014 at the annual Maunder Taylor Property Evening.

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### **INTRODUCTION**

According to the RICS, occupier demand has now been growing for the last five quarters in succession. In addition, since quarter two of last year rental expectations have been consistently up.

According to IPD, actual rental growth in the last quarter has been the strongest year on year growth rate since the 2008 banking crisis.

The economic recovery is widely forecast to gain further momentum this year.

The general outlook this year is far more positive than in previous years, however, what is the outlook for commercial leases?

For the purposes of this presentation I have analysed all commercial lease transaction that have come across my desk since 2008. Tonight, I intend to examine those transactions, concentrating on:-

- Lease lengths
- Break clauses
- Rent free periods
- Security of tenure.

I will then be considering what 2014 may have in store for commercial leases.



## DATA

When presenting analyses and conclusions based upon a certain set of data, it is important to quality that data and have an understanding of its application and limitations.

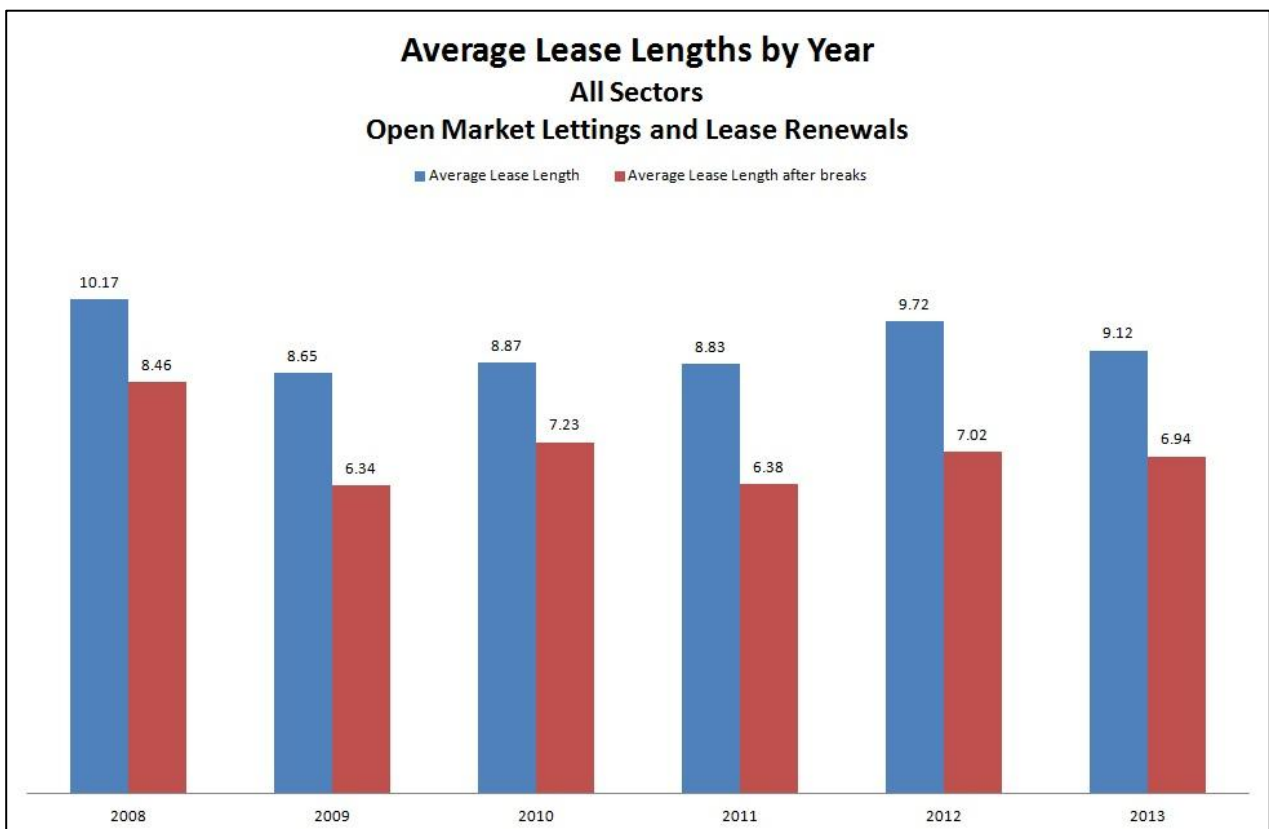
For the purposes of this presentation I have analysed 564 commercial lease transactions. There is a relatively wide geographical spread, from York down to Hastings and from Margate across to Frome, although the majority of the data is primarily from the London and Home Counties.

All three main property sectors are covered. The transactions relate predominantly to the retail sector, accounting for 60%. Industrial transactions account for 25%. The lowest representation of transactions comes from the office sector, accounting for 15%.

The leases are mostly from secondary investment markets.

## AVERAGE LEASE LENGTHS

In the following chart average lease lengths are considered. The blue columns show average total lease length year on year; the red columns show the average length of the same leases, but only up to the first break clause.



What is seen here is a general reduction in lease lengths over the period. This is expected and has been widely reported over the last few years.

In terms of total lease length (shown by the blue columns) the average in 2008 was just over ten years. This reduced to just over nine years in 2013, showing a drop of 10% over the period.

What is perhaps more interesting is the effect of break clauses, shown by the red columns. The average length of leases up to the first break in 2008 was just under 8½ years. This reduced to just under seven years in 2013, showing a drop of 18%.

Thus, the graph shows a general widening of the gap between total lease length and lease length up to the first break clause.

The graph illustrates that over the last two years lease lengths have grown marginally, however, the general trend of a deterioration in lease lengths since 2008 remains, and it is noted that 2013 shows a reduction on 2012.

It is worth noting that in late 2013 the RICS announced that the UK wide average lease length is now less than six years. The London and South East, as this chart shows, is faring a little better than the UK average.

This next chart compares lease lengths between open market lettings and lease renewals. The blue columns show average lease lengths from open market lettings; the red columns show average lease lengths taken at lease renewal.



What is seen here is that leases taken at renewal are generally longer than those taken in the open market. This is to be expected; businesses already in situ are more confident about their ability to trade and so are more willing to commit to longer lease terms. However, an interesting pattern emerges.

During the recession lease lengths were similar, regardless of whether they were taken on the open market or at renewal. This tends to demonstrate that during those years there was a lack of confidence, even with those who were negotiating leases over their existing premises.

However, in the last two years, as the country emerged from recession, leases taken at renewal were again longer than those taken in the open market. This therefore suggests that tenant confidence is returning.

Whilst this is positive news, however, it should be remembered that lease lengths are still shorter compared to 2008, and the effect of break clauses, not shown in this chart, makes them shorter still.

The market may be recovering, and there is more occupier optimism, but tenants are still wedded to flexibility.

### **WHERE ARE THE LONGEST LEASES?**

It is natural to ask where the longest leases exist.

Of the 564 leases I considered, 27 of them had unbroken terms of 20 years or more. These were not clustered in any one year, however, spread throughout the six years which were researched.

It is noteworthy that every one of these leases was in the retail sector, and that catering uses (including A1 catering) accounted for over 50% of them.

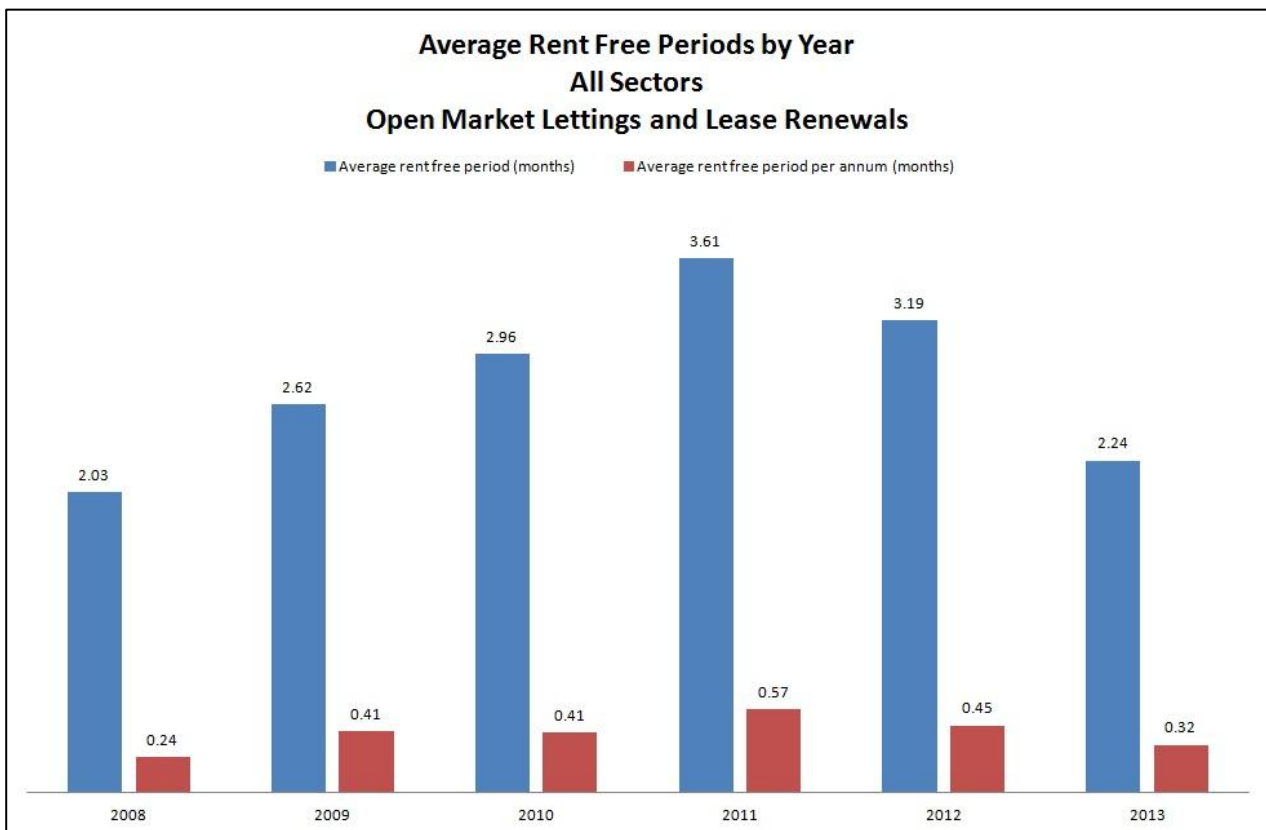
A summary of the leases is as follows:-

USE	NUMBER OF LEASES	PERCENTAGE OF LEASES
A3/A5/A1 (Food)	14	51.8%
A2 (Retail office)	2	7.41%
Convenience stores	2	7.41%
Hairdressers	2	7.41%
Properties requiring major repair/refurbishment, including to residential upper parts	2	7.41%
A1	1	3.70%
Off-licence	1	3.70%
Dry cleaners	1	3.70%
Never took occupation	1	3.70%
Unknown	1	3.70%
<b>TOTAL</b>	<b>27</b>	<b>100%</b>

It is noted that very few of these uses offer “straight retailing”, and that many have a service element to them. Furthermore, it is noted that many of these uses require a significant fit-out or other capital expenditure, therefore meaning the tenant’s require a longer lease term over which to write that capital expenditure down.

## **RENT FREE PERIODS**

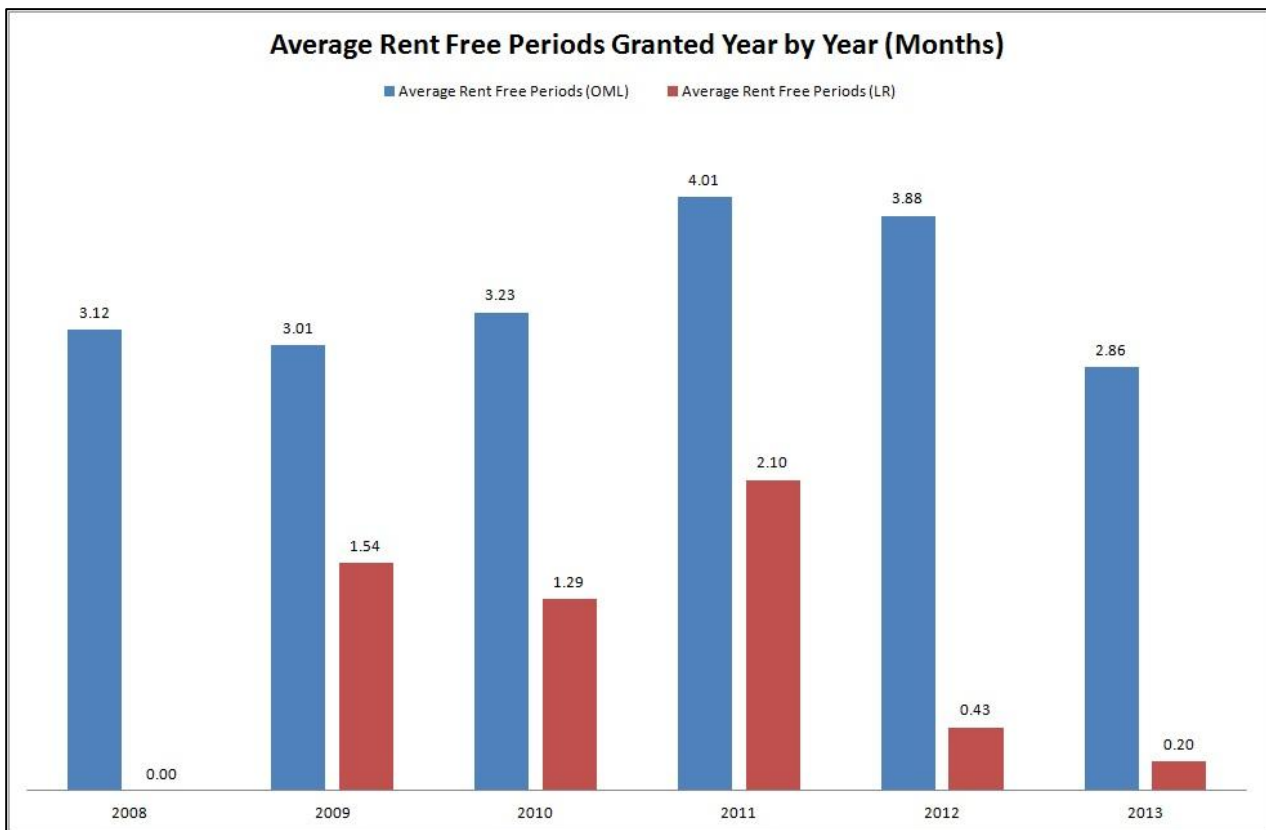
This next chart considers rent free periods. The blue columns show average rent free periods granted year by year; the red columns show average rent free periods granted per annum of the lease.



To illustrate, in 2008 the rent free period granted for an average lease was just over two months (shown by the blue columns). This represented approximately one week of rent free per annum of the average lease (shown by the red columns).

As expected, the length of rent free periods grows during the recession, but with the recovery is falling back again.

This chart has put all rent free periods, from both open market lettings and lease renewals, into one basket. The next chart splits them up:-



This chart is a good illustration of the negotiating strengths and weaknesses of landlords and tenants over the last six years. The blue columns illustrate average rent free periods granted for open market lettings; the red columns show average rent free periods granted at lease renewal.

It is important to understand that under the provisions of the Landlord and Tenant Act 1954 Part II there is no entitlement for tenants to receive rent free periods at renewal. Thus, in 2008, which was pre-recession, rent free periods at lease renewal were non-existent.

Comparatively, in 2009 to 2011, rent free periods at renewal increased significantly. Tenants during those years were in far stronger negotiating positions, requiring rent free periods or threatening to move elsewhere. Landlords were more willing to grant those rent free periods in order to keep their tenants.

Many landlords were also willing to trade rent free periods in order to maintain a headline level of rent and therefore shore up their capital asset values. In other words, a tenant may claim that rents have fallen and argue that their rent should go down at lease renewal; their landlord, however, then proposes that the tenant leave the rent the same in return for a rent free period at the commencement of the new lease. That way, the landlord takes a short-term cashflow hit but after the expiry of the rent free period the estate is still valued on the headline rent. Given the funding crisis of the current recession, it was critical for many landlords to do what they could to maintain asset value.

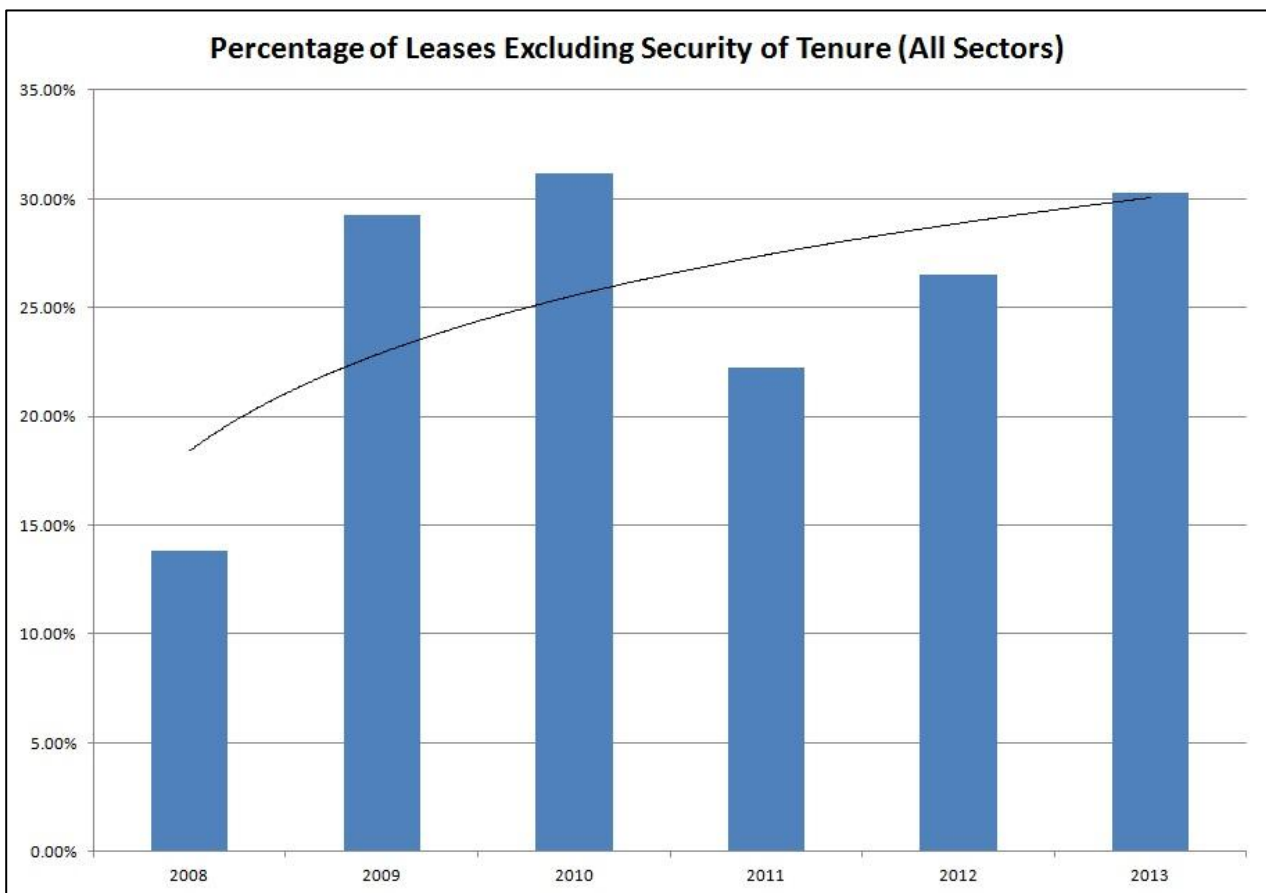
During the last two years, the economy has moved into a recovery and landlords are far less prepared to grant rent free periods at renewal. The graph shows a significant fall back.

However, the market has not returned to the 2008 position where no rent free periods are granted at all. Many tenants continue to want, even expect, rent free periods at renewal.

It is noteworthy, therefore, that both landlords and tenants are negotiating outside the strict parameters of the 1954 Act and that is something this presentation will return later.

### **EXCLUSION OF SECURITY OF TENURE**

This next chart considers security of tenure. Security of tenure is generally conferred by commercial leases unless they are specifically contracted out of the relevant provisions of the 1954 Act. Where tenants enjoy security of tenure they are generally entitled to a new lease when their existing tenancy comes to an end.



With tenants wanting shorter and ever more flexible leases, it would be expected that a high proportion of leases would be granted outside the Act, without security of tenure. This would allow landlords to retain a greater degree of control over their properties, rather than committing to a tenant who wants short term flexibility.

Broadly speaking, this is what is happening. The trend line on the chart shows an increase in leases being granted outside the Act. However, the columns show that the trend is far from smooth.

In 2008 to 2009 there was a significant change in attitude. The number of leases being granted outside the Act doubled. It is likely that this was a knee jerk reaction to the voracity of the recession, and where the attitudes of many landlords and tenants were geared towards short-termism.

In 2011, the number fell back again. Tenants recognised they were in strong negotiating positions and as well as short leases and break clauses, they demanded statutory protection too.

However, by 2013 the instance of leases without security of tenure was back up to 30%. This compares with 15% in 2008.

Thus, clearly tenants remain wedded to flexibility and to short leases, but more and more so landlords have a price for this: exclusion of security of tenure.

What is interesting is that as the market strengthens, tenants seem to want the flexibility of short leases more than they want security of tenure.

It has been demonstrated above that tenants remain wedded to flexibility for the future. The exclusion of security of tenure in leases is, to a certain extent, the landlord's flexibility for the future.

It is worth considering security of tenure on a sector-by-sector basis.

## **SECURITY OF TENURE SECTOR-BY-SECTOR**

From the outset, it is important to remember that the data considered relates mainly to the secondary investment markets.

### **Retail**

The retail sector has experienced the smallest change. The incidence of leases excluding security varies between 6% and 12%. This is likely to be due to the fact that position and pitch are of considerable importance to retailers. They are therefore more likely to need security of trading position when compared to the other sectors.

The retail sector also has the longest leases and the leases which attract the smallest rent free periods.

### **Offices**

Offices have seen a significant fluctuation during the last six years. Exclusion of security of tenure shows anything from 15% to 45% during that period.

What is most interesting, however, is a spike in 2013. During 2013 over 70% of leases considered excluded security of tenure.

It is suggested that this spike is due to the changes in permitted development, where the ability to change use from office to residential is now permitted development and therefore far easier than it



used to be. Landlords are looking to exclude security of tenure in order to keep their future development options open.

## **Industrial**

The industrial sector shows a consistent trend of more and more leases excluding security of tenure. The increase from 2008 on the estates considered has been from 25% to 42%.

It is fair to say that the secondary industrial market is probably the most flexible of any sector at the present time. It is therefore not surprising that this is the sector where lack of security of tenure is most common.

## **SUMMARY OF DATA**

Lease lengths:

- Have grown slightly during the last two years, demonstrating a return of occupier confidence for 2014.
- However, compared to 2008 lease lengths have reduced significantly and 2013 showed a further reduction on 2012.
- Leases are getting shorter, and tenants remain wedded to flexibility.

Rent free periods:

- Rent free periods are scaling back, again suggesting a stronger market for 2014.

Security of tenure:

- The incidence of leases being granted without security of tenure is increasing.
- As much as tenants will generally want 1954 Act protection, this appears to be one of the areas they are willing to compromise on providing they get other things they want.
- With some 30% of all new leases considered excluding security of tenure, is the market telling the legislators that it might be time for a change?

## **THE YEAR AHEAD - RETAIL**

Retail is the sector with the longest lease structures, lowest rent free periods, and where tenants are most likely to enjoy statutory protection. Having said that, however, retailers are still finding trading to be tough and still prefer flexible leases as a result.

Supermarkets have moved into secondary retail positions. This has strengthened many of those positions, but sometimes at the expense of the traditional high street.

The traditional high street continues to suffer. Secondary pitches are pulling retailers away; the internet is pulling trade away. Agents we have spoken to in some locations complain of there being “too many shops”.

With occupier demand increasing, available stock may fall during 2014, however, flexibility is still an issue. The trend for shorter leases looks set to continue.

However, will shorter leases come at a cost? If retailers take, say, five year leases with three year break clauses, then how much they are going to spend on fit-out for such a short period of time? The answer is, arguably, not much. If that is the case, there is a further threat to the traditional high street in the future.

In conclusion, retailing remains tough. In the short term, with the general strengthening of the economy, retail is expected to hold its own this year. The longer term risks to the traditional high street, however remain. These are still going to have to be addressed at some stage and at a fundamental level.

### **THE YEAR AHEAD - INDUSTRIAL**

Industrial leases are short and will stay short. The greatest turnover of leases is in the industrial sector.

For several years industrial landlords would do what they could to keep their tenants, sometimes granting leases by the month instead of the year and giving way large rent free periods. As the market improves, however, landlords are becoming more robust. They are no longer so concerned about the threat of getting a vacant unit back if a tenant decides to go.

This should be interesting. With the high incidence of lease ends, and more robust landlords, there could easily be a higher turnover of units within the industrial sector.

That is something which is anticipated for 2014, however, it is not something which should be feared. It is considered that this year there is sufficient background occupier demand to support the higher turnover of units.

### **THE YEAR AHEAD - OFFICES**

Locally, there has been an oversupply of office stock for many years. Letting vacant offices has been difficult compared to shops and industrial units and rents have remained largely static.

The changes to permitted development last year have a good effect on the local market. Many landlords are now actively looking to convert their vacant offices to residential. Quite often these are in larger office buildings where a mixed use development is proposed, that is where landlords are looking to convert some, but not all, of the office floors. We are then seeing several landlords look to plough their profits from the residential development back into the remaining office floors, refurbishing them and revitalising them.

Thus, in the local market, available stock is falling and the quality of vacant suites is expected to improve. Locally, after many tough years, the office market is expected to harden this year.

### **1954 ACT AND SECURITY OF TENURE**

In the office and industrial sectors more and more landlords are refusing to confer security of tenure in their leases. As this trend becomes more common, tenants in these sectors are less and less afraid about accepting leases with no security of tenure. This trend is expected to continue.

If such a suggestion were put to the market then a knee jerk reaction from tenants would be that this is something they could not condone. Tenants will suggest that ultra-aggressive landlords will wait until the last day of an old lease and then bully their tenant into taking onerous leases at inflated rents.

In reality, this is not happening in current market conditions. In the cases we have dealt with a lack of security of tenure has placed the parties on a relatively level negotiating table. Parties are starting negotiations earlier and negotiations are generally at a more sensible level from the outset.

It will be a slow process, however, I am expecting the 1954 Act to come under more and more pressure as segments of the market move slowly towards rejecting it.

From a personal point of view, I would like to see more discussion about whether the 1954 Act has had its day.

### **CONCLUSIONS**

Thus, for 2014 confidence is up, however, lease lengths continue to fall and flexibility is still king. The market continues to improve, however, a great degree of caution still exists.

There is now more equality to the market, however, and to the negotiating positions of the parties. This will make things interesting, for as well as flexibility the market also now has a lot more activity. If activity is added to flexibility then the one thing 2014 will prove to be is a very busy year, and that should be welcomed.