

Thought
leadership

The only way is up

Summer 2012



Executive Summary

Current market conditions in the UK, and even more so in Ireland, have exposed many occupiers to the downside of upwards only rent reviews (UORR). Most leases due for a rent review in 2012 on upward only terms are being reviewed with a previous rent agreed during the peak of the market in 2007.

The danger for investors in the current market is that whilst RPI linked leases appear to be a more attractive proposition than UORR, the contrasting directions of open market rental value growth and RPI means that it would be punitive for most occupiers to accept these terms.

Those 2007 leases granted subject to RPI inflation indexation would now be subject to significant growth in rent payments. RPI inflation has increased by 18% since the peak of the market in 2007, compared to rental value falls across the board in commercial property. For longer leases granted since 1987, RPI inflation has grown by 140%, with average rental growth for out of town retail warehouses the only sector to match or exceed that.

Offices

Since 1992, there have only been a few occasions when office rental value growth over a five year period has

consistently been higher than RPI inflation. Constraints on supply due to a more restrictive planning regime have seen West End rents outstrip inflation over the five year periods to 2008 and 2009 respectively but the subsequent economic downturn means that the net increase in rental values by 2015 will be small.

In the current office market, in the City and outside of London in the secondary market in particular, there is very little business sense for an occupier to agree to RPI linked rent reviews given the likely movement of average rental values. If a tenant is on these terms, there is an increased risk of break clauses being taken where available, especially as it makes assignment or subletting even more difficult if the occupier finds itself in difficulty.

Retail

Problems on the high street and retailers going into administration are attributed in part to the leasing agreements in place. With the possible exception of retail warehouses where average rents are set to rise by 9% in the five years to 2017, RPI inflation linked rent reviews are unsuitable for standard retail and shopping centres. By moving to a system of upwards or downwards open market rent reviews or a system based on turnover, the risk of defaults on rent payments decreases, whilst maintaining income for the investor that will increase in line with any upturn.

Industrial

In the past 25 years, average rental values in this sector have risen 60%, compared to 140% for RPI inflation. Even on closer inspection, five year average

growth has consistently been below RPI inflation with a few minor exceptions. Headline rents have remained subdued as a result of over supply in many markets, whilst the increased use of inducements has also kept average rental values down. Many leases signed on an UORR basis in the early 1990s will have seen rental commitments change very little, having been over rented until the late 2000s, a problem now affecting recently signed leases on RPI inflation linked reviews.

Conclusion

At face value, investors always look to create maximum value for their asset and our analysis supports the theory that an investor should insist on RPI inflation linked rent reviews to do this. Yet to do so would be disadvantageous for any occupier. Many investment decisions are being taken on the basis of covenant strength yet a tenant in an over rented property subject to RPI inflation linked rent reviews will encounter greater difficulties than a competitor on an alternative measure.

With the greater prevalence of shorter leases and rental values still below peak highs, it could be argued that a true UORR no longer exists. For many leases granted in the current market, the tenant can effectively incorporate an upwards/downwards rent review by negotiating a lease term of less than five years. The use of short leases, particularly in secondary properties across all sectors, negates the need for a tenant to commit to UORR or RPI inflation linked increases.

Introduction

The traditional UORR has been referred to as the UK property industry's sacred cow; such is the reverence with which it is held.

The clause is a remnant of an era when leases were for 25 years and it provided greater protection to developers, landlords and lenders alike against turbulent rental growth. Similar leases signed towards the late 1980s are soon set to expire and be replaced with a very different type of lease.

Over the course of 2012, many of the leases signed at the height of the market in 2007 will have their first rent review in a noticeably different market than when

the terms were signed.

This bulletin sets out to examine the best possible rent review options for different sectors and the case for sticking with or alternatively even legislating against the upward only clause.

Modern leases now offer a much higher degree of flexibility and lease lengths have been reduced significantly. The latest IPD/BPF lease review shows that the current average length for a commercial lease in 2011 is 4.8 years to the first break clause, down from 8.7 years in 1999. Almost three quarters of all leases in 2011 were for five years or less.

The Law Society's code for leasing business premises was amended in 2008 to include the option of CPI/RPI inflation index linking as a way of reviewing rent in addition to UORR. Index linking

leases is the norm for most European markets where lease lengths have always been much shorter, whilst it is also the preferred option for the majority of sale and leasebacks. For retail in particular, turnover rents are standard across much of the globe.

From a tenant's perspective, will those occupiers with UORR be at a significant disadvantage to those reviewed by alternative measures such as RPI inflation or turnover? Many retailers in particular are seeking to put pressure on landlords about the frequency of rent payments yet little discussion has been had as to what is the best way to set rent at a level that is fair to both parties - in both good times and bad.



The case for and against Upwards Only

The UORR was first introduced during the 1950s to combat the detrimental role inflation paid on leases that were sometimes in excess of 90 years.

Although lease lengths began to shorten in the 1960s towards 25 years, the use and frequency of rent reviews soon became widespread within the commercial property market. During the 1970s and 80s, the volatile and often high level of inflation and rental growth meant that the UORR gave a degree of certainty to both parties, with the rent fixed for five years whilst the landlord would be protected from any major fall in open market rental values during the term of the lease.

“The UORR is a massive attraction providing a **guaranteed income stream over the term of the lease**, especially longer leases, where rental income won't go down. It allows the **opportunity to create an annuity product** which doesn't exist in other established markets.”

Neal Dovey, Senior Director, Investment, GVA

The fairness of UORR clauses comes under particular scrutiny now when there is a marked change in economic and market conditions between the initial rent being agreed and the date of reviews. When leases were commonly 25 years in length, it was believed any discrepancies would iron themselves out over the length of the lease and open market rental values would be higher. Now the average lease length to the break option has shortened to 4.8 years in 2011, with less than 30% of

commercial leases longer than this.

The other reason behind the use of the UORR is to compensate the landlord for rent free periods and obsolescence, both of which are direct costs at the start and end of the letting process. The number of new leases taken out in 2008-2010 dropped by 35% compared to 2005-2007, meaning the average rent free period in 2011 was 12.7 months for all property (based on rent passing) as landlords sought to incentivise in a low demand market.

Current market conditions in the UK, and even more so in Ireland, have exposed many occupiers to the downside of the UORR. Any lease due for a rent review in 2012 on upward only terms is being reviewed with a previous rent agreed during the peak of the market in 2007 (28,884 leases undertaken in 2005-07 according to BPF). Since then, open market rental values have fallen across

the different sectors and many locations which are examined in more depth later in this bulletin.

Yet despite this backdrop, there has been little call for reform of the UORR in the UK in the same way there was in Ireland. The issue of rent itself has certainly been raised by the retail sector in particular, but this is largely due to the timing, frequency and level of payment rather than voicing particular concern at how that rent was set.

One reason for this may be that with shorter leases and falling average rental values, UORR are almost obsolete in the current market. Yet UORR acts as a balance to provide greater fairness than RPI inflation linked leases. Adding the option of a downwards review would make the system even fairer although this could prove to be too damaging for investors.

Table 1 - Alternatives to UORR

Index linked Review	Rent or % of rent linked annually or at review date to changes in an index such as RPI inflation. Commonly used in sale & leasebacks although Southern Cross is an example of the problems it can create. There are examples of GDP being used as an index. Underlying upward trend is based on economics rather than the property market and it is our view that this measure is damaging to landlord's and occupier's interests in the long term.
Turnover related review	Typically used in retail and some leisure schemes. Types range from base rent of 80% OMRV (collar) plus 7-15% of turnover (cap) to 100% turnover. Landlord gets immediate benefit of any upturn in business rather than waiting for a rent review. Active asset management and transparency is required but technology is available to provide this. GVA believe that this method or the downward/upward open market review is the most suitable for the retail sector in particular.
Fixed increases	Pre agreed incremental increases in rent at set dates within lease. If market conditions change, the occupier is legally bound to pay an increase in rent which may not have happened if on an UORR clause. Much like an index linked review, it does not take into account conditions in the market at the date of review and could penalise occupiers, increasing chances of break clauses being taken if available.
Downwards and upwards open market review	Open market rent reviews with the option of downwards included. Replaced UORR in all new leases in Ireland from February 2010. GVA consider this to be the fairest method available to adjust rent at review although it increases the likelihood that an investor will see income fall. However, this method is the least likely to force an occupier to try and break the lease.
Short lease and renewal	Occupier takes a short lease (<5yrs) and hedges that the rent will be unchanged or cheaper at renewal in existing premises or new. By default, this becomes an upward or downward open market review but without the security of a longer lease for the landlord. This method is most commonly used in secondary markets and has a knock on detrimental effect on capital values.

The Irish example

The issue of UORR clauses was put under the spotlight by the Irish government in 2010 when the inclusion of this clause was banned in all new commercial leases (signed since 28th of February 2010).

The government planned to introduce a retrospective ban on the practice on all existing leases with the law expected to be introduced in late 2011, before being dropped in a dramatic u-turn at the end of the year in the 2012 budget.

In the wake of the global financial crisis, the Irish property market is suffering a myriad of problems. Property values in the country have fallen by 60% post crash and as a result many tenants, in particular retail, are committed to leases signed during the boom period with rental obligations which they now cite as a main reason for pushing their businesses towards financial ruin. Retail expenditure has fallen by up to 30% but rents remain unchanged.

The legal obstacles arising from re-writing every existing commercial lease in itself would be significant. Investor's financial agreements with banks would have been agreed on the basis of UORR clauses. In addition, the government concluded that this was unconstitutional and could have left the State open to compensation claims from landlords.

A more pressing concern was voiced by NAMA, Ireland's largest property owner with a portfolio of €74 billion in loans, legislation would see €14 billion wiped off the value of the commercial property sector. The consultation period had already caused the nascent investment market to grind to a halt, total transactions falling by 80% in value between Q1 and Q2 2011. Further capital losses predicted of 20% if the legislation went ahead could have proved catastrophic for the state owned vehicle.

“The decision not to abolish UORRs in existing leases but to prohibit them in new leases has led to a two-tier market with a tenant on an existing lease with a peak rent on UORR trading beside an incoming tenant paying half the rent with the prospect of future downward reviews if warranted. The consequences for tenants are business failures and inability to assign legacy leases, which in turn erode landlord rent rolls and asset values.

Those advocating indexation to consumer prices would do well to remember that this can produce greater increases in rent than market trends. Landlords will gain little by insisting on struggling tenants to continue to pay “boom time” rents particularly in recessionary times. It is my opinion that **“open market rent”** negotiated between a willing lessor and willing lessee remains the fairest measure of lease rent for both parties.”

Jack Devlin, Director, GVA Donal O Buachalla, Dublin



Outlook for Inflation

Inflation is an issue that has an important bearing on the broader economy as well as commercial property values and rent reviews.

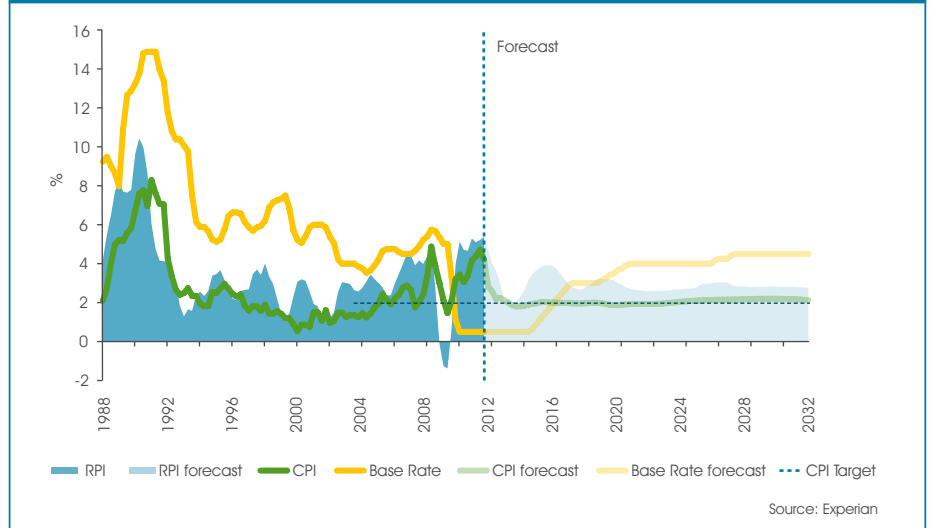
Over the past two years, the government target rate of 2% pa (CPI measure) has been exceeded, caused by the rise in VAT in 2010 to 20%, as well as high imported energy and fuel costs and other commodity prices. The Retail Price Index, which is a more accurate measure of inflation in the economy and more broadly used, stood at 3.6% pa in March 2012, having peaked at 5.6% pa in September 2011.

The strong falls at the end of 2011/early 2012 indicate that inflation is likely to return towards the target rate of 2% later this year. The Bank of England's Monetary Policy Committee in its February 2012 inflation report expects CPI to be below the 2% target by the end of 2012; other forecasters are a little more conservative expecting that it will not be until early 2013 that it will fall below target.

With interest rates at record low levels and little economic growth, some economists have raised the possible issue of deflation, particularly as since the start of the financial crisis, Sterling has fallen by about 30% compared to the Dollar and 17% against the Euro. This is partly due to the £375 billion quantitative easing programme by the Bank of England. The higher cost of imports has also helped to keep inflation up for those goods and services.

If the price of imports and fuel were to fall rapidly as a result of a further global economic crisis, then there would be a risk of deflation in the UK. If protracted, this would have a significant impact on RPI inflation linked leases as it could sanction downward rent reviews – the very thing it was intended to avoid. However this risk remains very low and RPI inflation is forecast to increase by 13% to 2017, at an annualised rate of 2.7%

Figure 1 - Inflation outlook



Sector Performance

In order to examine the correlation between inflation and average rental growth, we have examined monthly rental data for each sector since 1987 and compared rates of rental growth with RPI inflation to establish which parts of the commercial property market might benefit from inflation linked rent reviews or whether the UORR or any other measure provides a better alternative.

Offices

Last 5 years

GVA estimates that for leases signed in 2007 and due for review in 2012, there is 3.7 million square feet of office space in central London with a rental income of £195 million. Over that period, average rental values have overall fallen by 6% in both the City and West End. Outside of London, office rents have fallen nationally by 8% over the same time period, whilst for secondary office space average rental values have fallen 18% since 2008.

Most rent reviews in 2012, based on an UORR, are likely to settle with the passing rent remaining unchanged. One of the main discrepancies with the UORR is that despite its name, rent can remain unchanged at review if open market values have fallen. Some leases signed in the early 90s still pay the same rent now as then. Timing within the cycle has a significant bearing for both landlord and occupier on how much rent changes over the lease.

Figure 2 - Average Office Rental Values

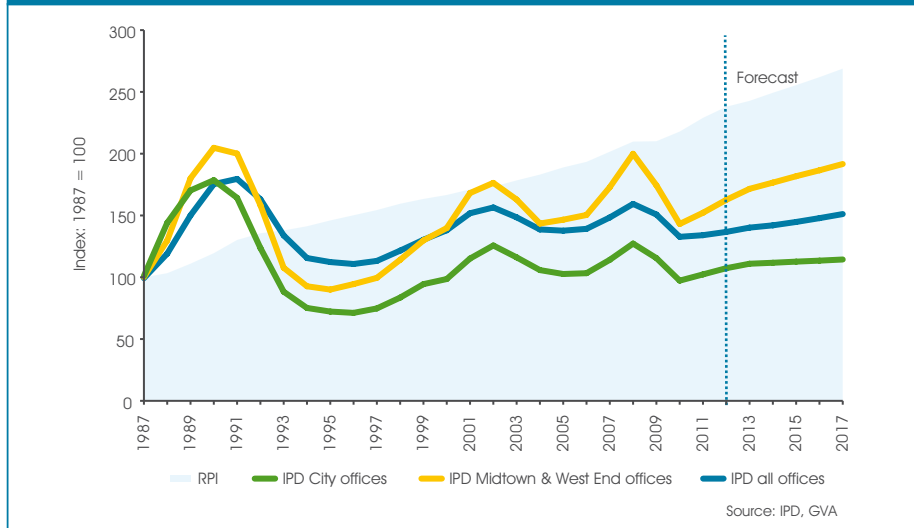
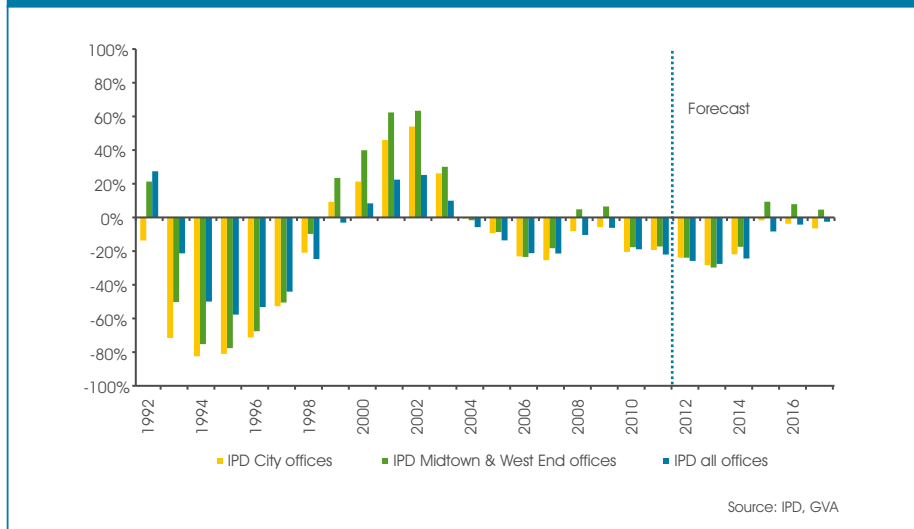


Figure 3 - 5yr Office Average Rental growth minus RPI



Last 25 years

Since 1987, RPI inflation has increased by 140%, whilst over that period, average rental values in the West End have risen 61% and by just 6% in the City. Come 2017, average office rents for the City are forecast to be just 0.6% higher than the 2007 figure, whilst RPI will have increased by 31%. However, in the West End, it is forecast that rental value growth from 2007 - 2017 will be 11.7%.

Since 1992, there have only been a few occasions when office rental value growth over a five year period has consistently been higher than RPI inflation (as Figure 3 illustrates). Constraints on supply due to a more constrictive planning regime have seen West End rents outstrip inflation more often. For the City and national markets, average rents are set to remain below the highs of 2008 for at least a decade.

Short term outlook

The danger for investors in the current market is that whilst RPI linked leases appear to be a more attractive proposition than the UORR, the contrasting directions of open market rental value growth and RPI inflation means that it would be punitive for most occupiers to accept these terms, especially on a lease of more than five years. Office rental values remain below peak levels and this trend is set to continue until at least 2017 in most areas.

In the current office market, (particularly) in the City and the secondary market outside of London, there is very little business sense for an occupier to agree to RPI linked rent reviews given the direction of average rental values. If a tenant is on these terms, there is an increased risk of break clauses being taken where available, especially as it makes assignment or subletting even more difficult than on leases with UORR clauses if the occupier finds itself in difficulty.

Retail

Last 5 years

Since 2007, standard (high street) retail average rental values have fallen by -10.1% nationally, shopping centres -12.8% and retail warehouses -6.3%. In some locations, these falls in rental values have been even greater. It is in the retail sector in particular that UORR or RPI inflation linked reviews discriminate against occupiers during any downturn.

The burden of peak retail rents in Ireland led the government to ban the UORR for all new leases in 2010, whilst in the UK many retailers are applying pressure on landlords to reduce the impact of rental payments by moving to monthly payments instead of quarterly in advance or raising the threat of Company Voluntary Agreements (CVAs) to reduce the bill.

Last 25 years

The retail sector has seen rental value growth rise with and outpace inflation during periods of economic growth over the past 25 years. This is especially so for out of town retail warehouse units with average rental value growth of 170% in the last 25 years (RPI 140%), with demand outstripping supply as a result of national

Figure 4 - Average Retail Rental Values

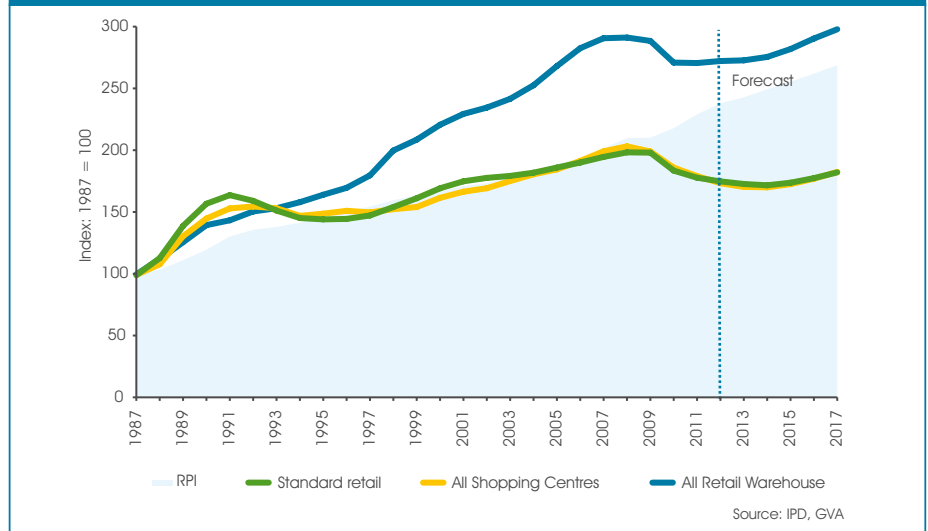
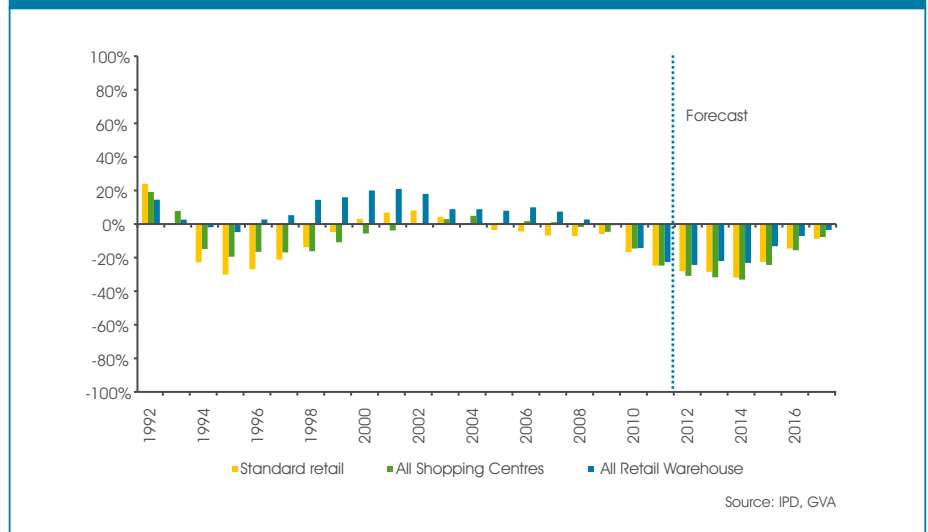


Figure 5 - 5yr Average Retail Rental Growth minus RPI



planning policies restricting development within this particular sector.

While any RPI inflation linked review may provide balance and fairness in the upward parts of the cycle, there is little equitable justification in sticking with it as a landlord if it increases the chance of bankruptcy of the occupier during the downturn.

If turnover was used as a way to calculate rental commitments, then pressure on retail occupiers would ease significantly during any market slowdown yet benefit the investor immediately when conditions improve, rather than waiting for the next

rent review. Instalment of a collar of up to 80% basic rent ensures that the investor receives a sufficient guaranteed income whilst when turnover is higher than this figure, a pre agreed percentage of turnover is also paid, at no extra burden to the occupier.

Five year average rental growth for larger, out of town units regularly exceeded RPI inflation by as much as 20% in the late 90s/early 00s, whilst shopping centres and the high street only saw slight gains above inflation over a five year period during this time.

Short term outlook

Since 2010, the case against linking retail rent reviews to RPI inflation has increased markedly. On an annualised basis, average five year rental growth less inflation for the period 2010 – 2017 is expected to be -20.4% for all retail. The lowest point of this measure will be in 2014 at an expected -29.2%, before softening to -8.9% in 2017.

To put this into context, between 2007 and 2017, RPI inflation is forecast to increase by 31%, whilst average rental growth is forecast to be -6.0% for standard retail, -7.6% for shopping centres and 3.1% for retail warehouses. Admittedly, from 2012, average rental growth for all retail is expected to be 4%, although this should be compared to an expected increase of 13% in RPI inflation.

On the basis of this evidence, with the possible exception of retail warehouses where average rents are forecast to rise by 9.1% in the five years to 2017, RPI inflation linked rent reviews are unsuitable for standard retail and shopping centres. The plight of the retail sector in the current economic environment is a particular cause of concern with a mounting list of casualties.

By moving to a system of upwards or downwards open market rent reviews or a system based on turnover, covenant strength would increase. This reduces risk of default on rent payments, whilst maintaining income for the investor that will increase in line with any upturn.

Industrial

Last 5 years

The industrial sector has seen rental value growth remain much more subdued than the rest of the commercial property sector; with average rent levels lower in 2012 than in 2009, due to an annualised growth rate of -0.4% over that period. Over the same time frame, RPI inflation has increased on average by 2.9% per annum. A large increase in supply means the sector is yet to see average rental values match the boom of the late 80s which saw average rental growth of 72% in the five years to 1992.

Figure 6 - Average Industrial Rental Values

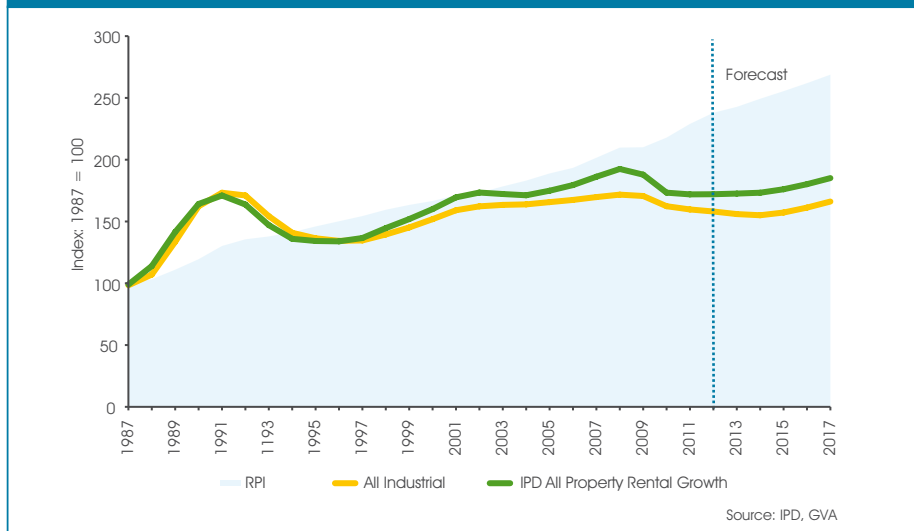
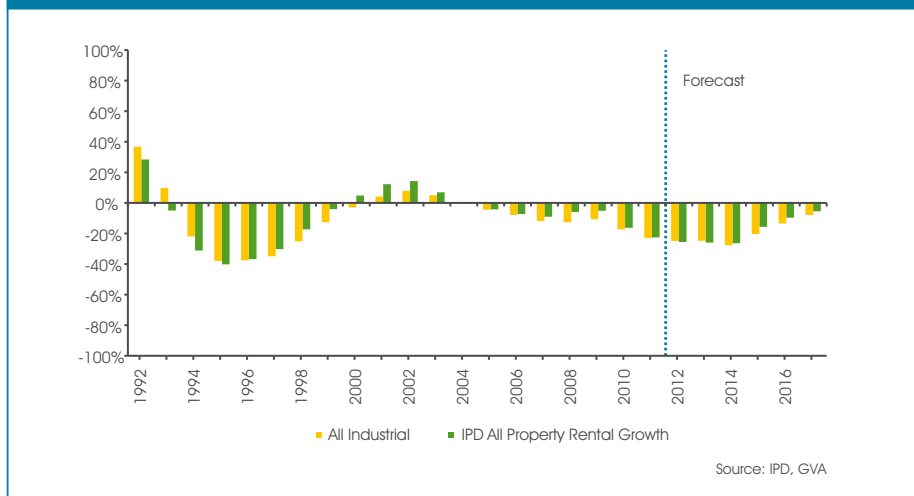


Figure 7 - 5yr Industrial average rental value growth minus RPI



Last 25 years

In the past 25 years, average rental values in this sector have risen 60%, compared to 140% for RPI inflation. Even on closer inspection, five year average growth has consistently been below RPI inflation with a few minor exceptions. Headline rents have remained subdued as a result of over supply in many markets, whilst the increased use of inducements has also kept average rental values down. Many leases signed on an UORR basis in the early 1990s will have seen rental commitments change very little, having been over rented until the late 2000s, a problem now affecting recently signed leases on RPI inflation linked reviews.

Short term outlook

There was a brief stage in the early 2000s when five year average rental values grew at a marginally faster rate than inflation, however since then inflation and industrial rental values have followed different paths. Since 2007, average rental values have fallen by 6.8% and are only expected to grow by 5% in 2012 – 2017, leaving rental values still almost 2% below peak 2007 levels. This is compared to RPI inflation growth of 18% in the five years to 2012 and an expected further increase of 13% to 2017.

Conclusion

Despite the increased popularity of RPI inflation linked rent increases, the use of this measure is generally onerous upon the tenant and to the landlord's advantage, based on five yearly growth cycles for each year since 1992. There have been some periods where open market rental growth has fleetingly exceeded inflation but the longer term view is that inflation has grown consistently in comparison to the up and down nature of commercial property rental values.

At face value, investors always look to create maximum value for their asset and should insist on RPI inflation linked rent reviews to do this. Yet to do so would be disadvantageous for any occupier. Many investment decisions are being taken on the basis of covenant strength yet a tenant in an over rented property subject to RPI inflation will encounter greater difficulties than a competitor on an alternative measure such as the UORR or based on turnover.

We are aware of a number of leases where venture capitalists have tied tenants into long leases subject to RPI inflation indexation for 25 years or more, many of which started between 2000 and 2007. These occupiers are now paying way above market value, with the prospect of having to do so for many years to come. It was this level of rental commitments that caused the downfall of Southern Cross as the initial rental level was too high and kept increasing.

From an investor viewpoint, RPI index linked leases are almost invariably better than UORR for performance on rental growth. They are however entered into at the risk of long term damage to the tenant's business if the lease is of significant length. However, when the lease ends, the rent paid on a new lease will be linked to the prevailing level of market rents so may well lead to a fall in income for the investor.

In contrast, a tenant signing a lease today subject to annual or fifth year RPI index linked rent increases should know that they are likely to be "over-renting" the longer the lease lasts. In order to ensure some fairness, the tenant should seek break clauses on a regular basis during the term to allow an exit or renegotiation of the lease. Alternatively, the inclusion of an upwards/downwards rent review at some point in the lease term would allow a rebalancing of the rent fixed to RPI inflation as would happen at a break.

With the greater prevalence of shorter leases and rental values unlikely to reach the highs of 2007 for at least another five years, it could be argued that the UORR is no longer the contentious issue it once was. For many leases granted in the current market, the tenant can effectively incorporate an upwards/downwards rent review by negotiating a lease term of less than five years. The use of short leases, particularly in secondary properties across all sectors, negates the need for a tenant to commit to UORR or RPI inflation linked increases.

The percentage of leases granted without any mechanism to amend the rent must therefore be increasing. For those that do, we question how many tenants appreciate what they are signing up to in RPI inflation index linked leases and whether landlords appreciate the damage to the tenant's business or ultimately the investment interest if the RPI inflation index linked rent increases significantly above market rent.

On a balanced basis, the UORR still has an important role and should continue if only to maintain an equal level of fairness that recognises the cyclical nature of property compared to RPI inflation. For an investor, it provides a guarantee that the level of income will not fall, whereas for the tenant it provides a much greater degree of protection to over renting than RPI inflation linked leases when rental values are in decline.



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