

UK LEASE EVENTS REVIEW

NOVEMBER 2016

Prepared by MSCI in association with Strutt & Parker



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SPONSOR'S FOREWORD

It seems incredible that we first started discussing the dramatic shifts in leasing activity almost two decades ago. Now in its 18th year, the analysis remains as important as ever.

Following a stellar year in 2015, the UK commercial capital markets slowed in the first half of 2016. A combination of peaking capital values and EU Referendum uncertainty applied the brakes. Following 23rd June, with the ballot papers counted and the UK voting to leave the EU, we entered a phase of volatility. The immediate aftermath, with closed redemptions and high drama speculation, has however quietened, and a semblance of normalisation has returned.

Trading has been impacted, and as at Q3 £35bn of capital had been deployed into the UK markets, 34% lower than the same period in 2015. At the current time, this puts 2016 on track to match the levels of 2013.

With the capital growth phase of the cycle coming to a close across almost all segments at the end of 2015, the fundamentals of property – certainty of income and rental growth – have again come to the forefront of investors' minds. The deceleration of the markets in Q1 confirmed that notion and the decision that emerged on 24th June cemented it.

This report provides the industry-leading view on how income is changing and as such is a must-read for those involved in real estate across all UK sectors and geographies. It establishes the influence of lease expiries, break clauses and the evolution of rents and incentives upon lease renewal.

Investors may take comfort from leases again lengthening this year, having now increased to seven years, a full year longer than they were at the bottom of the cycle. Incentives also moved out, however, and are now 9.2 months on average, up 3% from 2015. It is also likely, given the current volatility, that landlords will be keen to attract and retain tenants through further incentivisation and flexibility on lease length.

As we move through the final quarter of 2016, our thoughts turn to the future. Every element of UK commercial property leasing is linked to the economic and political landscape, and we are likely to have many months and perhaps years of opacity until the terms of Brexit and subsequent trade agreements are clear. The likelihood is that in the short term the market will be two-tiered, with significant capital seeking safety through prime stock and locations, and speculative buyers assessing the potential for price softening in non-core markets. Occupationally, tenants are likely to continue to seek further lease flexibility to allow for short term planning.

I would like to thank MSCI for continuing to produce the excellent analysis on both new and existing lease activity, which is fundamental in underpinning property as a mainstream asset class.



Andy Martin



INTRODUCTION

After a year of decade-high UK economic growth in 2014, expansion moderated somewhat in 2015. The first two quarters of 2016 have seen growth improve on 2015 levels, driven by consumer spending and investment. The economy advanced by 2.2% year-on-year in the second quarter of 2016 – following a 2% expansion in the previous quarter.

Notwithstanding encouraging economic growth – especially when viewed on a quarter-on-quarter basis – the vote to leave the EU has added substantial political and economic uncertainty to the UK outlook. Following the vote, the pound depreciated sharply against the major currencies and the domestically-focused FTSE 250 index declined. Many commercial property funds have had to suspend trading in response to capital outflows. Government bond yields meanwhile weakened to record lows on expectations that monetary policy would be loosened in response to the Brexit vote.

Growth in leading developed economies remained muted in 2015, and this seems set to continue in 2016/17, with the United States as the fastest growing G7 economy, despite relatively modest forecast growth of around 2% per annum over the next two years. The UK, which has vied with the US for top place in the G7 league table in recent years, is set to fall back due to the impact of Brexit. The global outlook remains mixed, with a gradual pick-up in the US and the Eurozone likely to be offset by a Chinese slowdown and continued recessions in Russia and Brazil.

Inflation remains a challenge, as price growth continues to lag the Bank of England (BoE) target rate. UK consumer prices rose 1.0% in the year to September 2016, above market expectations of a 0.9% gain, following 0.6% growth in August. This was the highest inflation rate since November 2014, as prices rose as a result of the weaker pound.

In the short term, the BoE has indicated that UK inflation could surpass its 2% target, in part because of the interventions it announced in August to offset the impact of the Brexit vote.

Interest rates meanwhile are unlikely to be raised any further, given the downside risks to economic growth through 2016 and 2017. The Bank is expected to loosen monetary policy in the short-to-medium term, to support the economy through this period of uncertainty, while public borrowing is allowed to rise to take the strain of slower growth.

The uncertainty prevalent in the market preceding the Brexit vote saw the rent-weighted UK lease length decline by around half-a-year, meaning that larger occupiers have in aggregate been negotiating for shorter leases. During the first six months of the year the length of rent free periods increased slightly and the proportion of leases with a break clause also ticked up.

To evaluate income streams for investors in commercial real estate, risks such as lease expiries, break clauses, vacancies and defaults have to be assessed. These may be seen as a series of options in the future cash flow from real estate assets. All have a significant impact on the assessment of risk for a cash flow, and as such clear analysis is crucial to help investors, occupiers and landlords understand the potential of the space they occupy or the income streams they expect.

This MSCI Lease Events Review for 2015 and year-to-June 2016, in association with Strutt & Parker, provides empirical evidence on the likelihood of the different events. The analysis was based on a sample of over 73,000 extant leases held in the IPD UK Annual and Quarterly Property Universe and more than 9,000 new leases signed over the last year.

The report examines the influence of three key types of lease event on the property investment market: lease expiries, break clauses and the change in rental conditions upon lease renewal. Each of these factors is intrinsically linked to the broader economic landscape and changes in business activity, exports and consumer trends, all of which have a direct effect on lease conditions.

REVIEW OF NEW LEASES IN 2016

The New Lease Review section of this research report provides an analysis of the changing patterns of lease agreements in the UK commercial property market. This identifies changing and emerging trends in lease lengths, review cycles and other key features of the landlord and tenant market. The section also encompasses a full analysis of lease lengths, break clauses, rent-free periods and income profiles. In the UK commercial property market, lease profiles are continually changing – changes that are closely linked to the broader economy.

In the UK, the traditional lease with a five year upward-only rent review remains dominant for most commercial property sectors, albeit for a shorter average term as tenants push for greater flexibility.

However, following the market crash of 2008/9, it has become increasingly common for modern-style leases, such as RPI-linked uplifts and turnover-based final rents, to feature in certain segments, especially supermarkets, shopping centres and retail warehouses.

This section will first look at the average lease length and how it has changed over time. It then considers incentives such as break clauses and rent-free periods, and concludes with an assessment of the income position that has resulted from lease negotiations so far in 2016.

HOW HAVE LEASES CHANGED THIS YEAR?

During the first half of 2016, the average unweighted length of leases granted in the UK market stood at 7.0 years. While only marginally up from 2015, this was a continuation of the upward trend observed since 2011. Average lease lengths have now increased by a full year since the bottom of the cycle in 2011. This follows the broader trend of recent years, in tandem with the economic recovery, with leases lengthening due to supply conditions and growing confidence amongst occupiers competing for space.

Further evidence of lengthening leases appears when analysing the distribution of new leases by lease-length band. Since 2011, the proportion of leases shorter than five years has dropped from above 53% to 43.8% of the total sample. Over the same period, the percentage of leases between five and nine years in length increased by 8.2% and accounted for 34.0% of leases granted on an unweighted basis.

This unweighted analysis counts all leases equally, regardless of the level of contracted rent, and ignores break clauses. As such, it is a representative indicator of market leasing in the UK as a whole.

While lease lengths have increased on average since 2011, the share of leases of 15 years and longer has remained fairly consistent at 6-7% of the total on an unweighted basis. However, since the early 2000s, the proportion of leases of 15 years and longer has dropped from 25.6% to 6.5%.

When weighted by passing rent, the average lease length has been declining for the last three years. This stands in contrast to the unweighted lease length, which has been increasing, meaning that larger occupiers have on aggregate been negotiating shorter leases. As at H1 2016, the average rent-weighted lease length was 11.0 years, down half-a-year from 2015.

AVERAGE NEW LEASE LENGTHS TO 2016 (UNWEIGHTED)

FIGURE 1.1

Unweighted lease length distributions

Percent of new lets in each lease length band

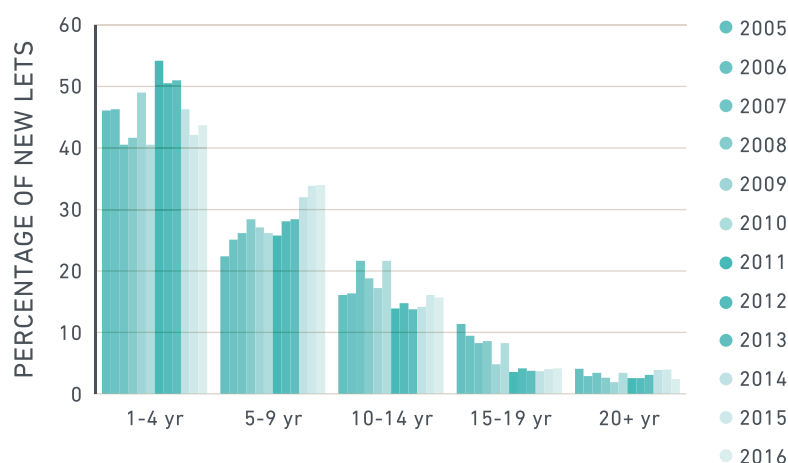


FIGURE 1.2

Unweighted lease length

Unweighted full term; ignoring breaks and including short leases

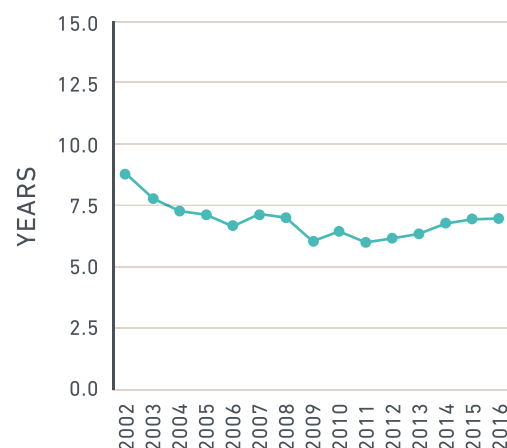


FIGURE 1.3

Change in lease length distribution (2011 to 2016)

Change in percent of new lets in each lease length band

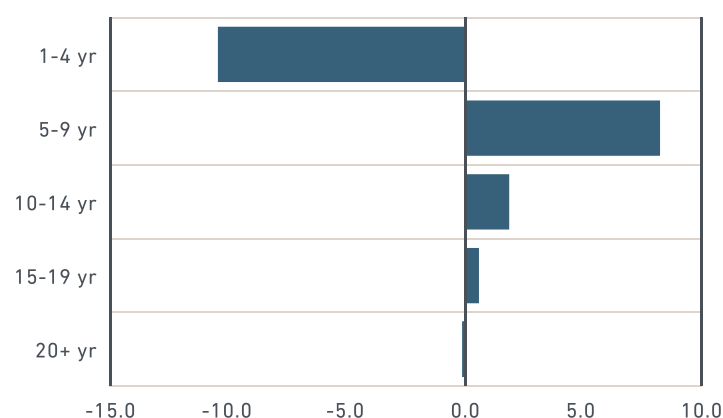
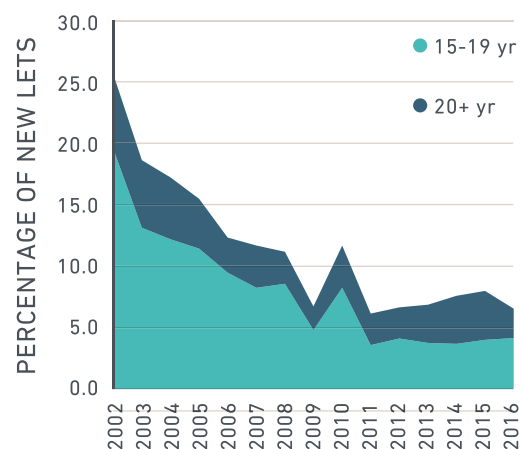


FIGURE 1.4

Unweighted lease length

New lettings



Note: Full lease term on all leases; tenancies weighted by passing rent

Source: MSCI

The first half of 2016 saw a sharp fall in the proportion of leases of 20 years and longer, from 19.2% to 11.6% of the total. Mirroring this decline was an almost equal increase in leases of 6-15 years, suggesting an increased demand for flexibility among large occupiers.

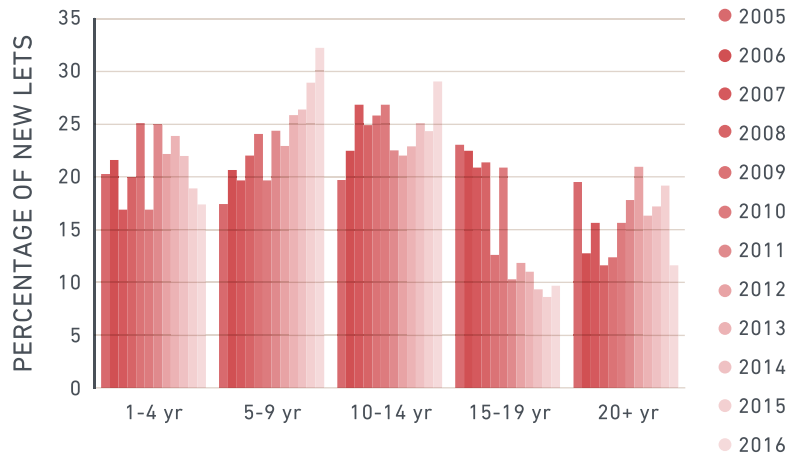
As the fundamentals underlying the UK market have recovered, landlords have been pushing for longer leases in the quest for income security. Since the bottom of the market in 2009, average rent-weighted and unweighted lease lengths have both increased by a year, to 11.0 and 7.0 years respectively. However, there have been significant shifts within the different lease-length brackets.

AVERAGE NEW LEASE LENGTHS TO 2016 (WEIGHTED)

FIGURE 2.1

Weighted lease length distributions

Percent of new lets in each lease length band



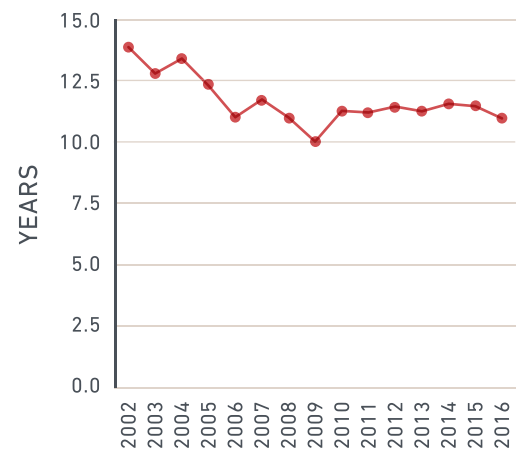
Note: Full lease term on all leases; weighted by rent passing.

Source: MSCI

FIGURE 2.2

Weighted lease length

Unweighted full term; ignoring breaks and including short leases



For the first six months of 2016, leases of 10 years and shorter accounted for 76.5% of new lets on a rent-weighted basis – up from 70.7% in 2015. Notwithstanding, the share of leases of three years and shorter has declined significantly since 2010, perhaps suggesting that smaller tenants have become more comfortable about committing to longer leases. This sentiment may however change post-Brexit, when the next edition of this dataset will be released.

Analysing lease lengths by sector reveals that retail and offices saw unweighted lease lengths increase by one and five months respectively in the first half of 2016. The industrial sector meanwhile witnessed a 2.3 month decline to 6.2 years. Since 2011, there has been a continuing convergence in lease lengths across the three main commercial property sectors, with industrials in particular catching up with the retail and office sectors.

Since 2009, all three main sectors have seen average unweighted lease lengths increase by between eight and 10 months. For the year-to-date June 2016, retail leases averaged 7.0 years in length, offices 6.8 years and industrials 6.2 years.

On a rent-weighted basis, sector-level lease lengths were significantly higher than unweighted. This is partly a function of the longer leases associated with larger tenants and the need to capitalise tenant installation costs.

Retail leases, traditionally longer than office and industrial on a rent-weighted basis, have converged with the other sectors in 2016. Compared to 2009, retail is the only sector where rent-weighted lease lengths are now shorter – the result of retailers in aggregate seeking greater flexibility with the impact of online retail and declining consumer confidence, which have effected consumer spending negatively, particularly in the smaller retail formats.

Leases granted on retail warehouses have consistently been three or four years longer than the all property average, while standard unit shop and shopping centre leases are much closer to the average. Supermarket leases tend to be longer again, often being inflation or turnover-linked.

AVERAGE NEW LEASE LENGTHS TRENDS BY SECTOR

FIGURE 3.1

Average lease length trends by sector

Unweighted full term, ignoring any breaks, including short leases

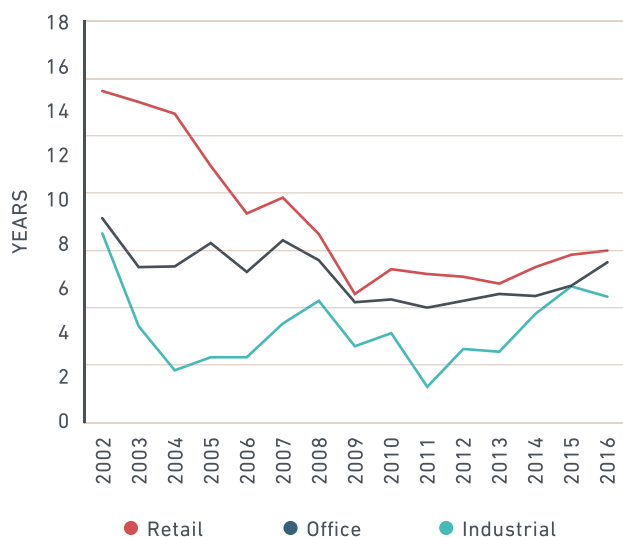
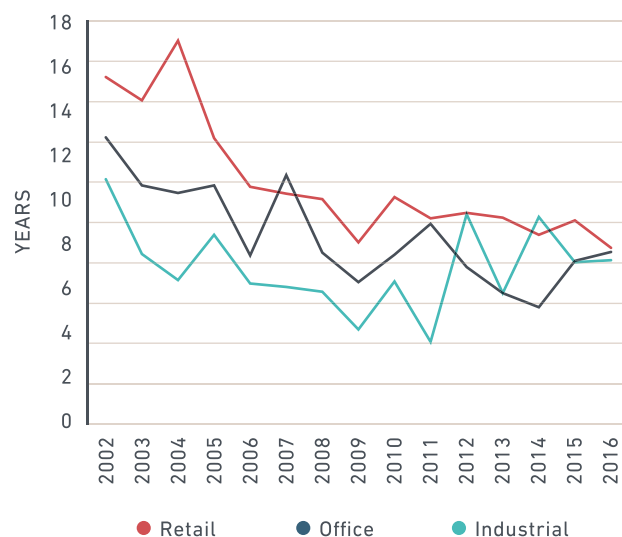


FIGURE 3.2

Average lease length trends by sector

Weighted full term, ignoring any breaks, including short leases



Source: MSCI

Office lease lengths have risen consistently to end Q2 2016 at 6.8 years, since bottoming out at 6.0 years in 2011. Weighted by passing rent, office lease lengths are considerably higher at 10.3 years (down from 11.0 years in 2011), reflecting the desire of larger office tenants to minimise the disruption and costs associated with relocation. The Central London office market, where the average rent-weighted lease length has declined from 11.5 years in 2011 to 7.3 in 2016, has been a key driver of this decline. Reasons for this shortening trend in the capital may include a lack of long public sector leases and private small and medium enterprises (SMEs) paying premium rentals for shorter leases in order to gain greater flexibility.

Conversely, offices outside Central London and the South East have seen rent-weighted lease lengths increase from 9.9 years in 2011 to 12.3 years in 2016, signalling a vote of confidence by large occupiers.

Rental levels may also have played a role in this trend, as rental growth for Office Parks in London and the South East has outstripped the Rest of the UK by an average of 1.9% per annum for the five years to December 2015.

Industrial lease lengths declined slightly on an unweighted basis during the six months ended June 2016, while lengthening marginally on a rent-weighted basis. As at June 2016, the average unweighted lease length was 6.2 years, up from 4.6 in 2011. The increasing industrial lease length has been driven by improved levels of industrial production, capacity utilisation and new orders – a key leading indicator of domestic GDP growth – which in turn has driven up demand for manufacturing and warehouse space.

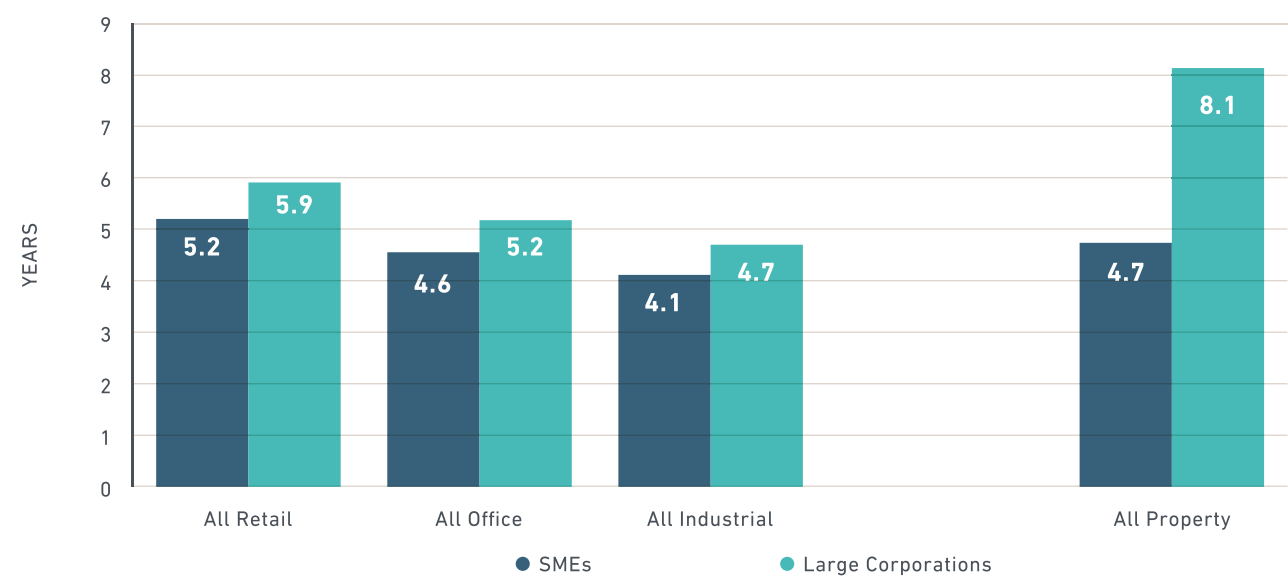
The increase in industrial lease lengths since 2011 has primarily been driven by longer leases for newer industrial space (post 1990) in Greater London. Overall, unweighted lease lengths in Greater London are now 9.6 months higher than in 2011. On a rent-weighted basis, the average industrial lease length in Greater London is 8.0 years. This underlines the demand from large occupiers in the context of intense pressure from alternative uses such as residential, as population growth places ever greater demands on land, particularly close to the City.

In addition to examining leasing trends by sector and location, this analysis also compares trends for SMEs and large corporations. Given their greater space requirements, large corporations have tended to have longer average lease terms; this trend is consistent across all the traditional property sectors.

On an unweighted basis, the average office lease signed by an SME in the first half of 2016 was for a period of 4.6 years, compared to an average of 5.3 years for large corporations. Weighted by passing rent, office lease lengths for SMEs have edged closer to those of large corporations in 2016, averaging 6.3 years compared to 7.6 years for large corporations. This was because large corporations' lease lengths declined, rather than because SME lease lengths increased.

Large corporations in the retail sector saw weighted lease lengths decline by around 11 months since 2015, while large companies in the industrial sector committed to leases that were 17 months shorter than a year before.

FIGURE 3.3
Average lease length trends by tenant type
Unweighted full term, ignoring any breaks, including short leases



Source: MSCI

BREAK CLAUSES AND RENT-FREE PERIODS

The inclusion of tenant incentives and inducements in modern UK leases has grown dramatically in the last few decades. Much of the fluctuation in these incentives is due to economic and business-specific factors that affect the demand for space in the commercial market. The broad improvements in the UK economy since 2013, especially in London and the South East of England, have meant that demand for commercial property can often outstrip supply in certain locations and sectors. This has been further exacerbated by the dearth of speculative development outside London since the market crash of 2008.

As occupier demand has risen in line with the resurgent UK economy, many landlords' forecasts of future income growth were based on the expectation that rent-free periods would shorten and the percentage of leases with break clauses would diminish. However, as of June 2016, this analysis has shown that while the length of rent-free periods is stabilising across all sectors, tenant break clauses remain a consistent facet of the UK leasing landscape.

Close to 38% of leases signed so far in 2016 have included a tenant break option, rising from 35.4% in 2015 and 37.0% in 2014. Since 2012, the occurrence of break clauses in shorter lease agreements has fallen significantly – from 30.3% to 25.4%.

Over the same period, the occurrence of break clauses in leases of 6-15 years has increased. For such leases, the proportion with break clauses increased by 7.2% to 58.6%, while leases of 11-15 years saw an increase of 15.2% to 47.6%. Since 2009, the increase in break clauses for longer lease agreements has been even greater, highlighting the contrast between the need of landlords to secure longer leases and the incentives required to do so.

Break clauses are most common in leases of 6-10 years, with 58.6% of such leases including a break – up from 54.5% in 2015. This is higher for industrial and office sector tenants, with 67.0% and 65.4% of 6-10 year leases including a break clause respectively. Overall, break clauses are most common in the industrial sector (45.0%) followed by the office sector (40.5%). Break clauses were least common in the retail sector (31.6%), where rent-free periods are more common.

Rent-free periods remain a prevalent feature in the UK commercial property market. So far in 2016, the length of rent-free periods has increased slightly across all three major property sectors, after declining in 2015. Rent-free periods have traditionally been a feature most common in office leases, but retail and industrial leases have also increasingly included such incentives.



PROPORTION OF LEASES WITH BREAK CLAUSES BY SECTOR

FIGURE 4.1
All Property
Leases with break clauses

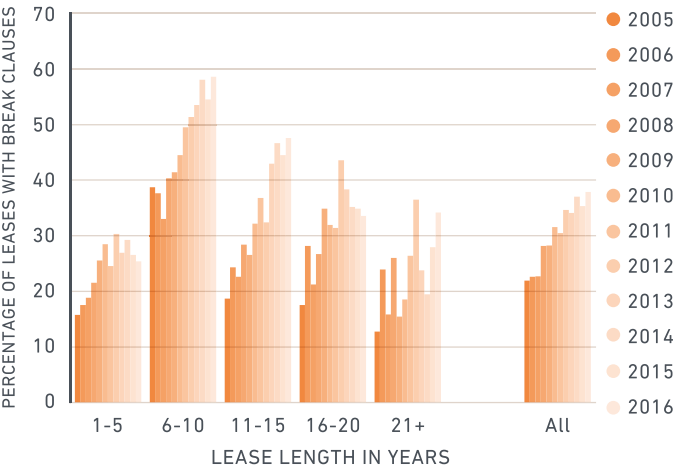


FIGURE 4.2
Retail
Leases with break clauses

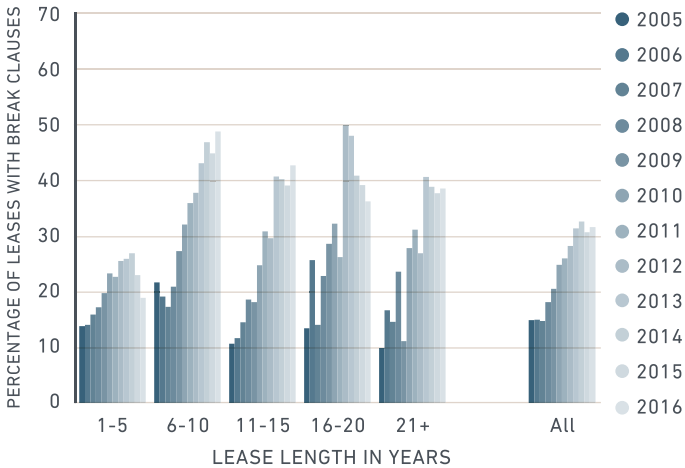


FIGURE 4.3
Office
Leases with break clauses

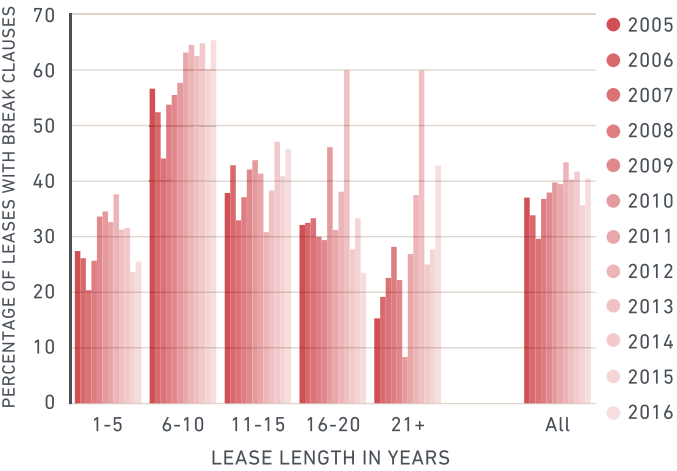
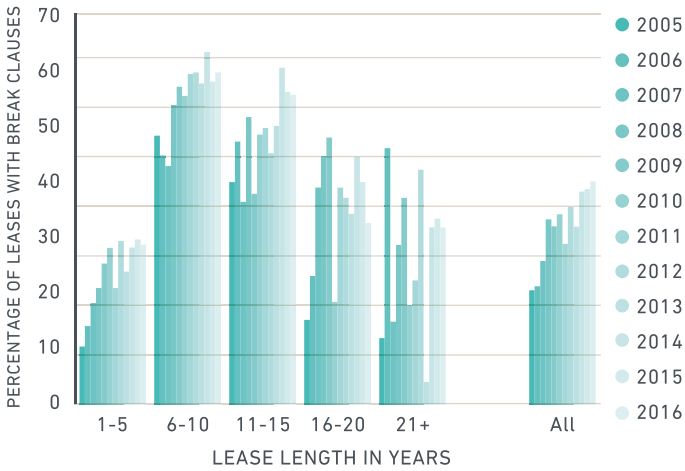


FIGURE 4.4
Industrial
Leases with break clauses



Source: MSCI

The fluctuation in rent-free periods is highly cyclical, with average lengths increasing in weaker economic environments as many landlords incentivise generously in an attempt to prevent vacancy.

In 2016, rent-free periods for offices remained the longest at an unweighted average of 9.2 months. While this is up from 8.9 months in 2015, it is below the 11.4 months recorded in 2010, highlighting the improvement in letting conditions from a landlord's perspective.

Average rent-free periods in the retail and industrial sectors were virtually unchanged from 2015 and ended H1 2016 at 7.3 and 5.7 months respectively.

The distribution of rent-free periods shows, as would be expected, that those of less than 12 months dominate in each of the main sectors. For the retail sector, 88.8% of rent-free periods are less than 12-months long, and of these 31.5% are shorter than four months. While the industrial sector mirrors retail with 10.9% of rent-free periods being 12 months or more, the office sector distribution differs somewhat with 31.4% of rent-frees longer than a year.

AVERAGE RENT FREE PERIODS BY SECTOR

FIGURE 5.1

Average rent-free periods by sector

Tenancies equally weighted

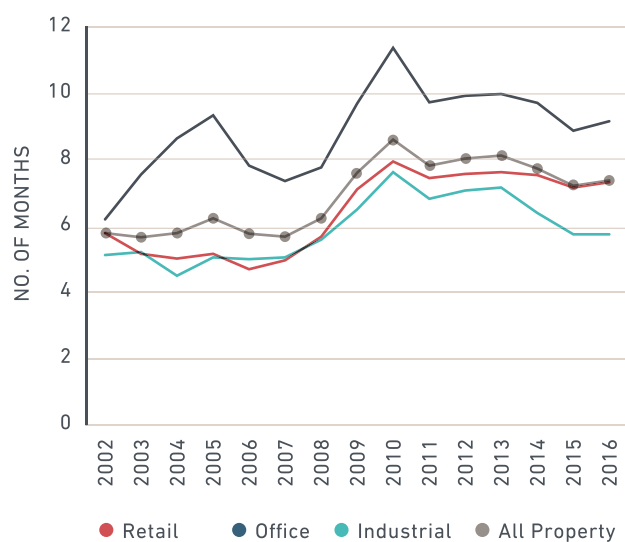
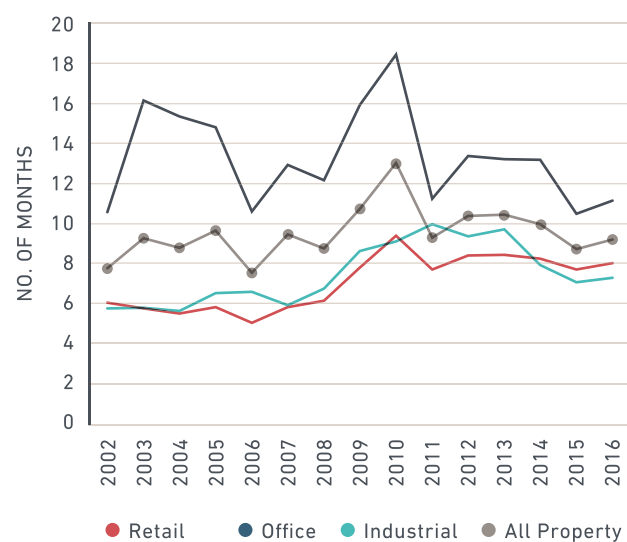


FIGURE 5.2

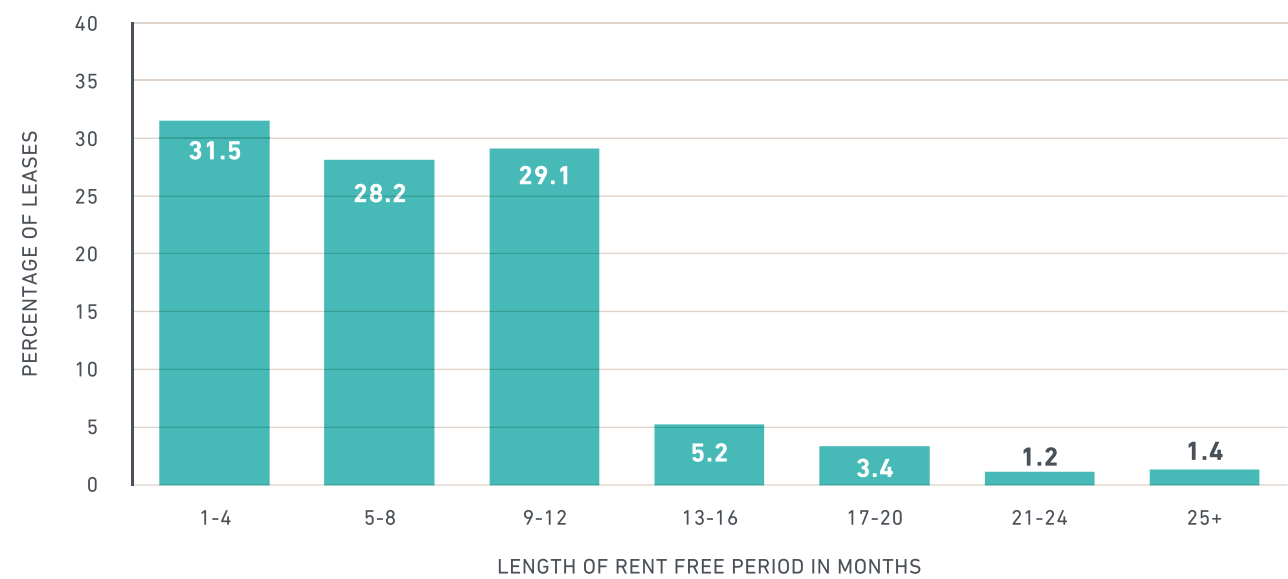
Average rent-free periods by sector

Tenancies weighted by rent passing



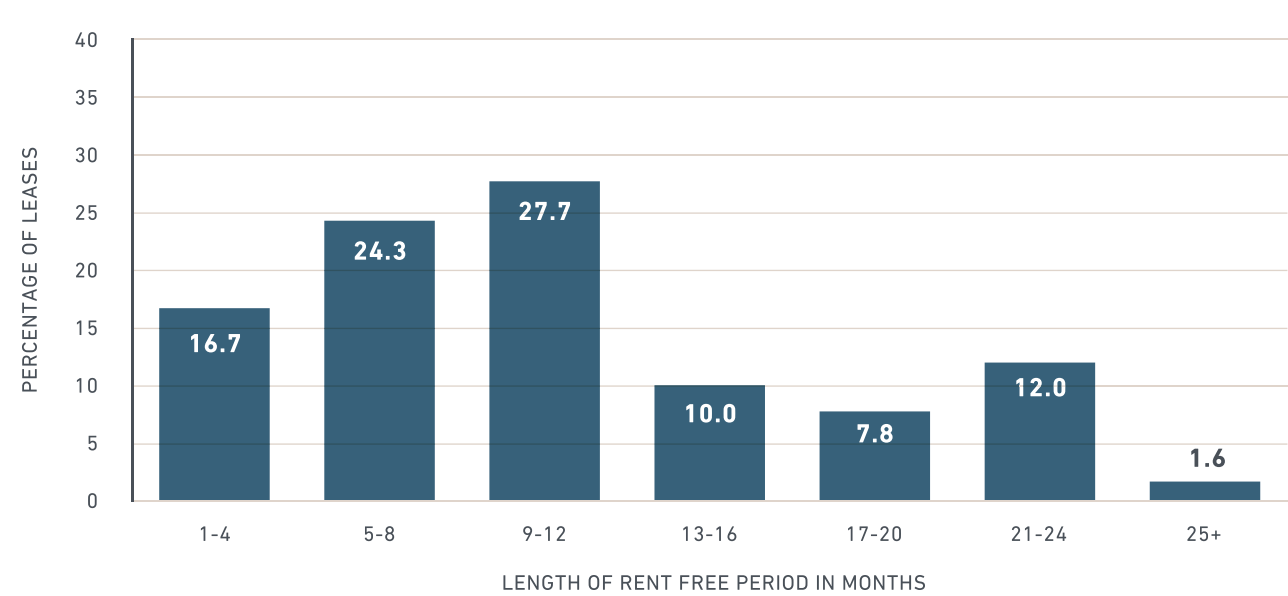
Source: MSCI

FIGURE 6.1
Distribution of rent free periods for retail
Tenancies weighted by rent passing



Source: MSCI

FIGURE 6.2
Distribution of rent free periods for office
Tenancies weighted by rent passing

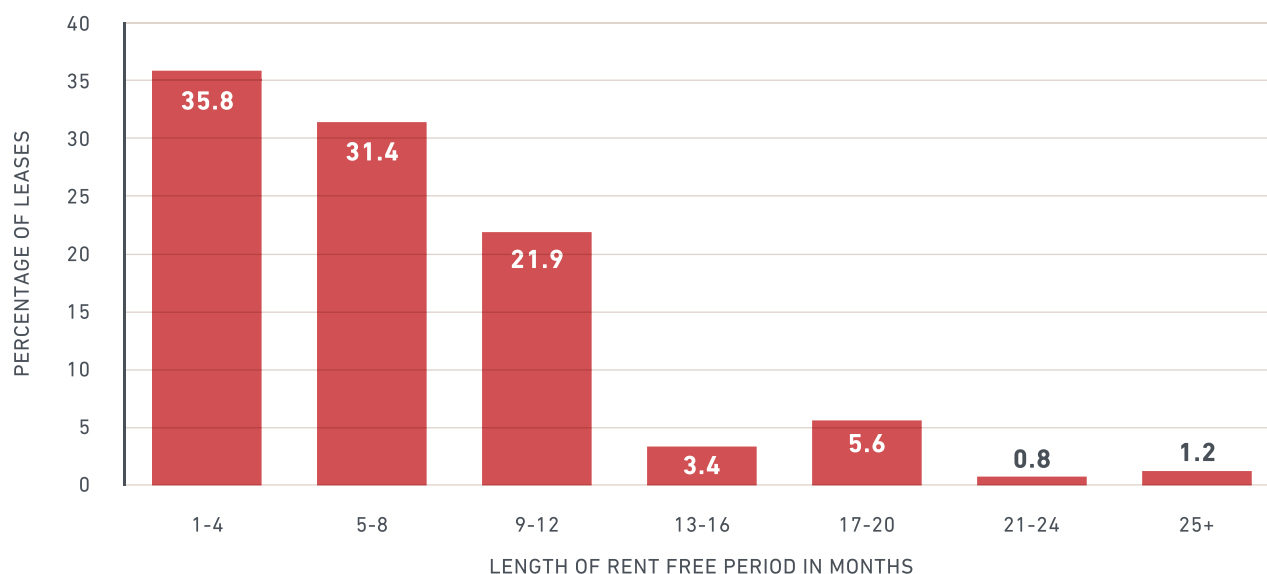


Source: MSCI

FIGURE 6.3

Distribution of rent free periods for industrial

Tenancies weighted by rent passing



Source: MSCI

INCOME SECURITY AND POTENTIAL FOR GROWTH

The next graph below summarises the income position for current leases in 2016, based on the portfolios in the MSCI UK lease database. Top slice represents income that is at risk due to over-renting, while reversionary potential represents additional income available to portfolios due to rental value growth in the analysis period of January 2015 to June 2016.

In terms of security of income in the broader UK market, 6.7% of income is at risk due to over-renting (top slice). Of the three traditional property sectors, retail is the most over-rented at 8.4% of rent passing, compared to 4.2% for offices and 4.7% for industrial.

All market sectors saw a decline in the level of over-renting between June 2015 and June 2016 as a continued improvement in market rental values narrowed the income gap.

At the all property level, reversionary potential offers the most rental upside at 8.9% of rent passing. The office sector continues to show the highest reversionary potential at 16.6% of rent passing, compared to 4.7% for retail and 8.0% for industrial property.

Vacancy and voids offer the most potential on letting for office sector income growth at 17.3%.

This is significantly higher than the 8.1% for industrial and 4.1% for retail – a product of the office sector's relatively high vacancy rates. Likewise, income potential from current developments is driven by offices, with a 9.1% rental upside.

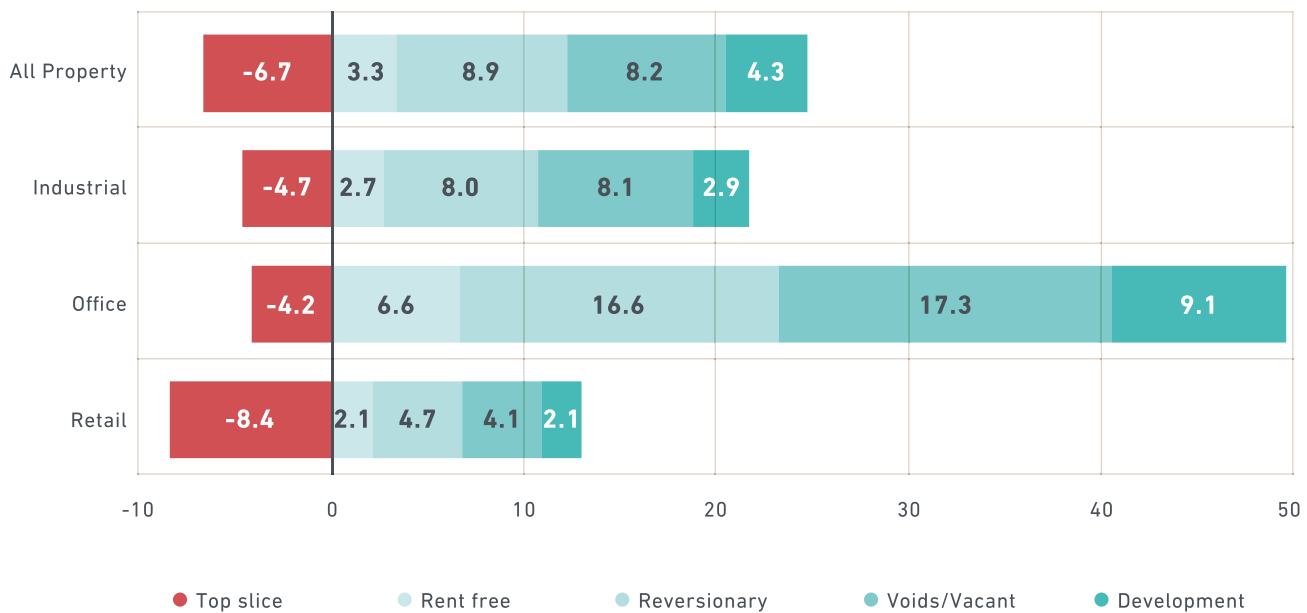
However, the vacancy rate of 4.1% for the retail sector is significantly below the all property average of 8.2%, which arguably puts the an investor in a better position as demand picks up with improving consumer and economic conditions.

The industrial sector retains a high level of potential income tied-up in vacancies, 8.1%, with a further potential boost to income growth from a reversionary uplift of 8.0% upon review.

FIGURE 7

Security of income and growth potential by sector

Percentage of total rent passing



Source: MSCI

THE IMPACT OF LEASE EVENTS IN 2015

This Lease Events section of the report examines the role played by lease events and their impact on investor income. The section will first look at the behaviour of properties as leases edged towards expiry, particularly the renewal rate of tenants. It will then consider inducements and incentives such as break clauses, and how these are exercised. Each element of the report will provide analysis at a headline all property level, then by sector and location.

Finally, this part of the report will assess the effect of tenant default on an investor's income position. The period of analysis is the calendar year 2015, with data sourced from the IPD UK Annual Index.

This analysis is split into 'unweighted', based on the number of leases and 'weighted', where the data is weighted by previous rent passing. From an investor perspective, the 'weighted' analysis is more relevant as it highlights the proportion of income at risk or lost upon expiry.

WHAT IS HAPPENING ON EXPIRY

The period after the 2008 market crash saw a consistently negative trend in terms of the outcome of lease expiries for investors. This was exacerbated by economic and confidence difficulties for occupiers. The majority of properties in this analysis have fallen vacant upon lease expiry, and this trend has continued in 2015 with 49% of leases (unweighted) in the UK market vacant for more than one quarter post-expiry.

As their leases approach expiry, many tenants use the opportunity to push for more competitive rents, especially those who signed at times of record high rents and are now paying on an over-rented basis. Given that a large proportion of such expiries result in vacancy, many landlords will agree to revised terms, including rental abatements.

TABLE 1

Outcome of leases expiring in 2015 for all property

	Unweighted	Weighted
Renewed	33%	26%
New Letting	17%	18%
Vacant	49%	56%

Source: MSCI

FIGURE 8.1

Vacancy rate for leases expiring 1998-2015 by all property

Tenancies weighted by rent passing

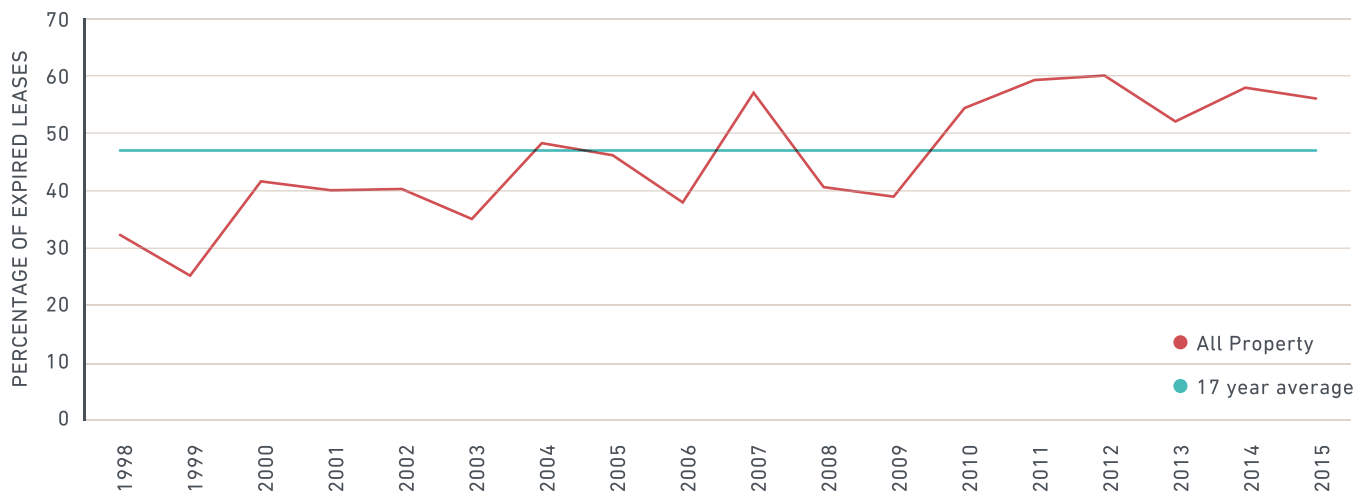
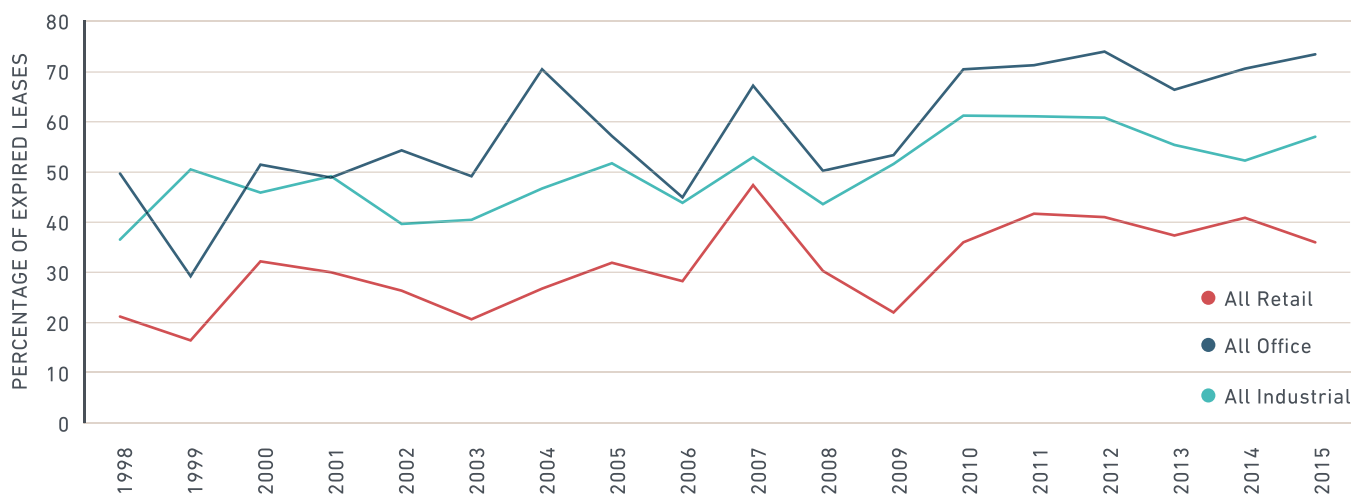


FIGURE 8.2

Vacancy rate for leases expiring 1998-2015 by sector

Tenancies weighted by rent passing



Source: MSCI

The vacancy rate for leases expiring in 2015 was 49% unweighted (counting all leases equally), rising to 56% when weighted by previous rent passing. This vacancy rate has now been above the 17-year weighted average of 47% since 2009, although it has improved from a high of 60% (weighted) of leases expiring in 2012, while deteriorating from the 52% posted in 2013.

Of those leases expiring in 2015, 17% (unweighted) of the total were re-let in the same quarter – up from 9% in 2014.

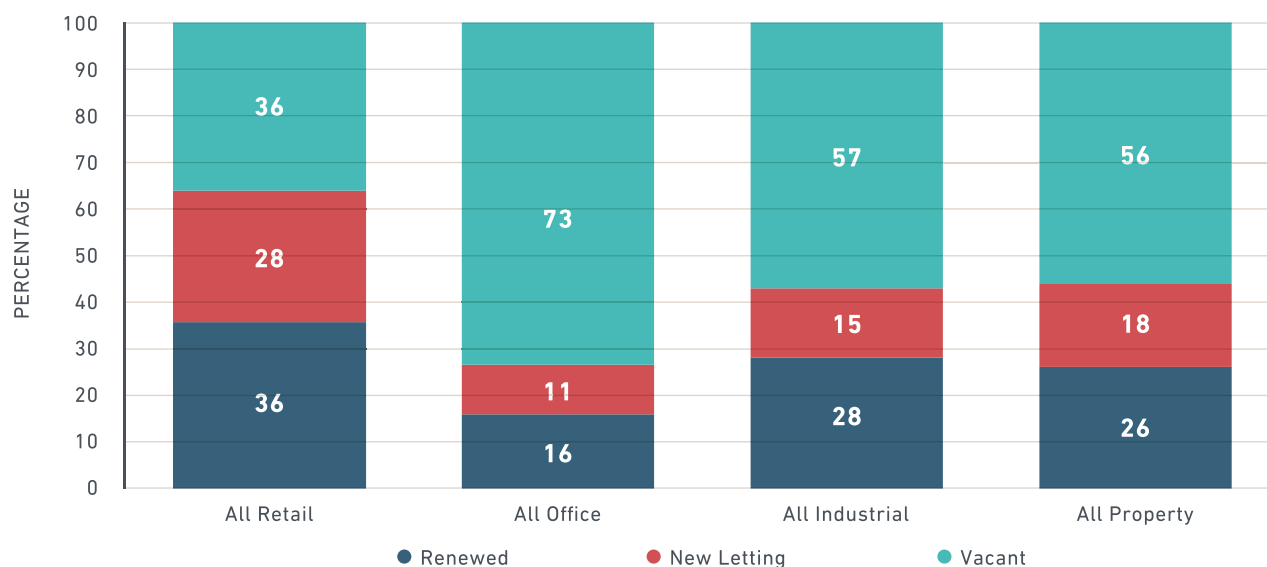
Weighted expiries produced a marginally better figure of 18%. For renewals, the market weakened from 2014, falling to an unweighted 33% in 2015 from 43% the year before.

The expected boost in the appetite of tenants to renew leases on expiry – due to increased competition for space in a growing economy – remained elusive, despite improvements during 2013. When weighted by rental income, 26% of tenants chose to renew their leases in the same quarter as the expiry occurred.

FIGURE 9

What happened when leases expired in 2015 (weighted)

Tenancies weighted by rent passing



Source: MSCI

This was below the 17-year average of 33%, suggesting that the market is beginning to experience more normalised conditions after recovering from the crash. A breakdown of these figures is shown in Table 1.

Sector level analysis shows offices with the highest level of immediate vacancy after lease expiries in 2015, both weighted (73% of leases) and un-weighted (66%).

All property vacancy rates upon expiry, both unweighted and rent-weighted, remain well above their long term averages. On a rent-weighted basis, vacancy rates were 9% higher than their long term average (56% versus 47%) and 8% higher in unweighted terms (49% versus 41%).

At 36%, retail had the lowest vacancy rate upon expiry of the three main sectors. This is a structural trend going back more than 20 years, reflecting retailers' desire to grow market share of consumer spend within their catchment area.

The office sector saw the highest vacancy rate upon expiry and the lowest renewal and new letting rates. While retailers may prefer to remain in established trading locations, the office sector sees much more flexibility with tenants tending to be less attached to particular buildings or locations. The high vacancy rate also highlights the attractive options and deals available to office tenants, particularly those outside Central London who choose to leave older, often obsolescent, buildings for modern space. Given that many of these occupiers may have signed leases at rents higher than current market levels, they can often benefit from better terms and conditions elsewhere, bolstering the preference not to renew.

WHAT WAS THE IMPACT OF BREAK CLAUSES

Rents for most sectors, segments and locations in the UK commercial property market reached record highs between 2007 and 2008 when the last cycle peaked. Many tenants who had signed leases then have been eagerly awaiting the opportunity to exercise their break clauses, aiming to work their way out of over-rented positions.

Rents recovered first in key locations (though they are now starting to decline in some places) as the UK economy improved. Certain locations – including all London's major office submarkets – now see market rents exceeding the peaks achieved at the top of the last cycle.

Many tenants may now find it advantageous to remain in their existing location due to the competition for securing favourable buildings and terms elsewhere. As a result, the percentage of tenants choosing not to exercise their break option rose significantly in 2015, ending on 81% – up from 71% a year before.

Table 2 relates to those tenants – across all property – who had the right to break in 2015, analysed on a weighted (by previous passing rent) and unweighted basis.

TABLE 2

Outcome of leases with a break occurring in 2015

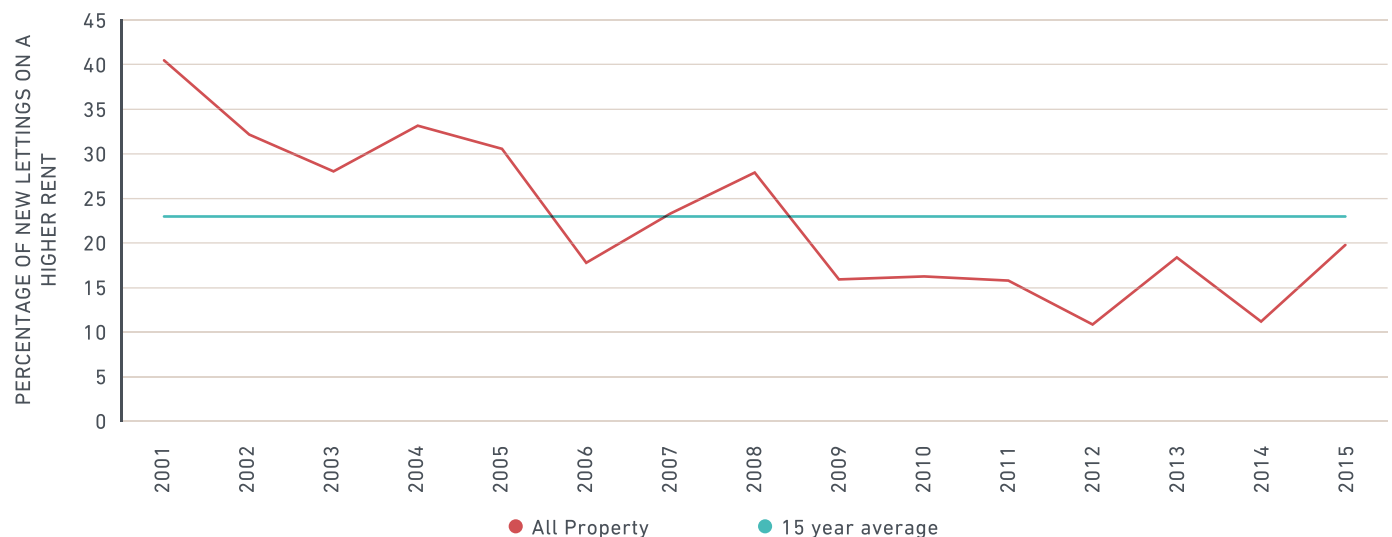
	Unweighted	Weighted
Break Not Exercised	81%	69%
Exercised - Re-let	4%	6%
Exercised - Vacant	15%	25%

Source: MSCI

FIGURE 10

Vacancy rate for exercised break clauses 1998-2015

Tenancies weighted by rent passing



Source: MSCI

The rent-weighted vacancy rate due to the exercise of break clauses increased by 3% to 25% in 2015. While slightly higher than the previous year, this is well below the high of 2011 when 42% of break clauses resulted in vacancy for a quarter or longer. The current level is in line with the long term average.

The unweighted vacancy rate due to the exercise of break clauses is significantly lower at 15%, well down from 24% in 2014. The convergence between the weighted and unweighted results means that tenants vacating due to break clauses exercised in 2015 included some with relatively high levels of rent passing.

While the rent-weighted vacancy rate due to exercised break clauses ticked up, the percentage of re-lettings stayed flat at a relatively low 6%, while the proportion of break clauses not exercised decreased from 72% to 69%.

At a sector level, there is again a broad divergence of outcomes for break clauses that occurred in 2015.

Given the preference of retailers to remain at established trading locations, the break clause action rate tends to be lower here than in other sectors; this was no different in 2015, with retail showing the lowest rate of any sector. Weighted by previous passing rent, only 21% of retail tenants chose to exercise their break options when they arose in 2015. Even though higher than the figure of 16% for 2014, this is still below the long-term average of 22%.

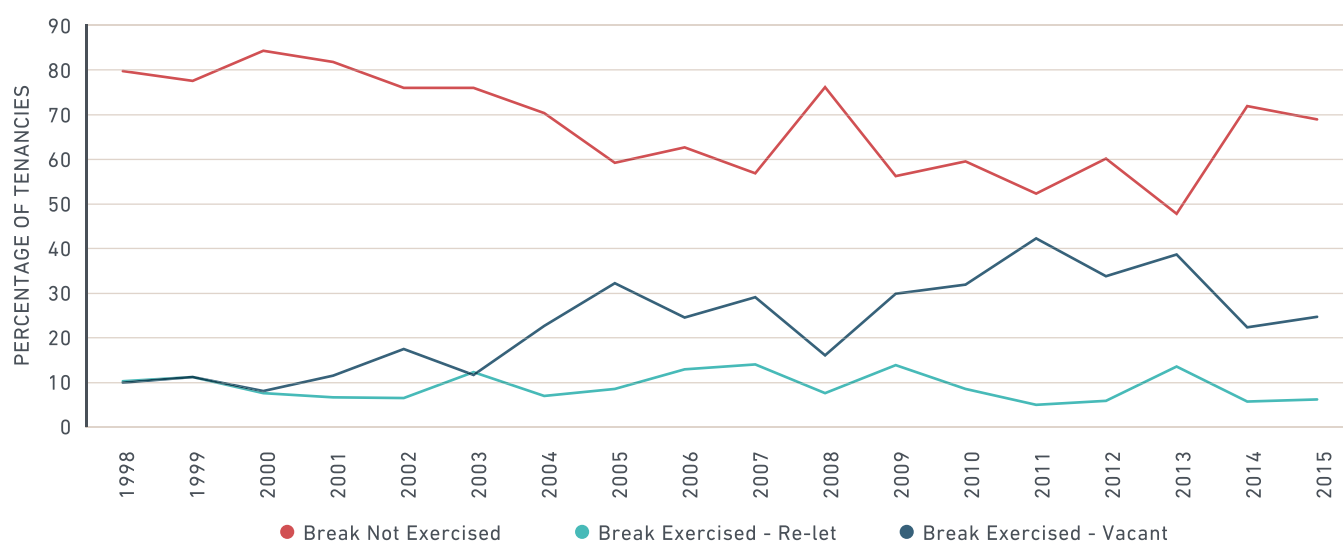
Offices continued to record the highest rates of tenants exercising breaks, at 34% unweighted and 43% weighted. Following these rent-weighted break clause actions, 39% were vacant for at least one quarter, the highest level by sector in 2015, and above the long-term average of 32%.

The industrial sector saw 21% of tenants (unweighted) activating their break options in 2015 over the course of last year. Of these 21% of leases where break clauses were activated, 4% were re-let within the same quarter while the remaining 17% remained vacant for more than one quarter.

FIGURE 11

Encouraging decline in levels of breaks exercised since 2013

Tenancies weighted by rent passing



Source: MSCI

Break clause action rates varied somewhat between different property types and geographies. The percentage of break clauses not exercised increased significantly for offices in London's West End. In 2015 West End office tenants chose not to exercise 78% of break options, up from 66% in 2014.

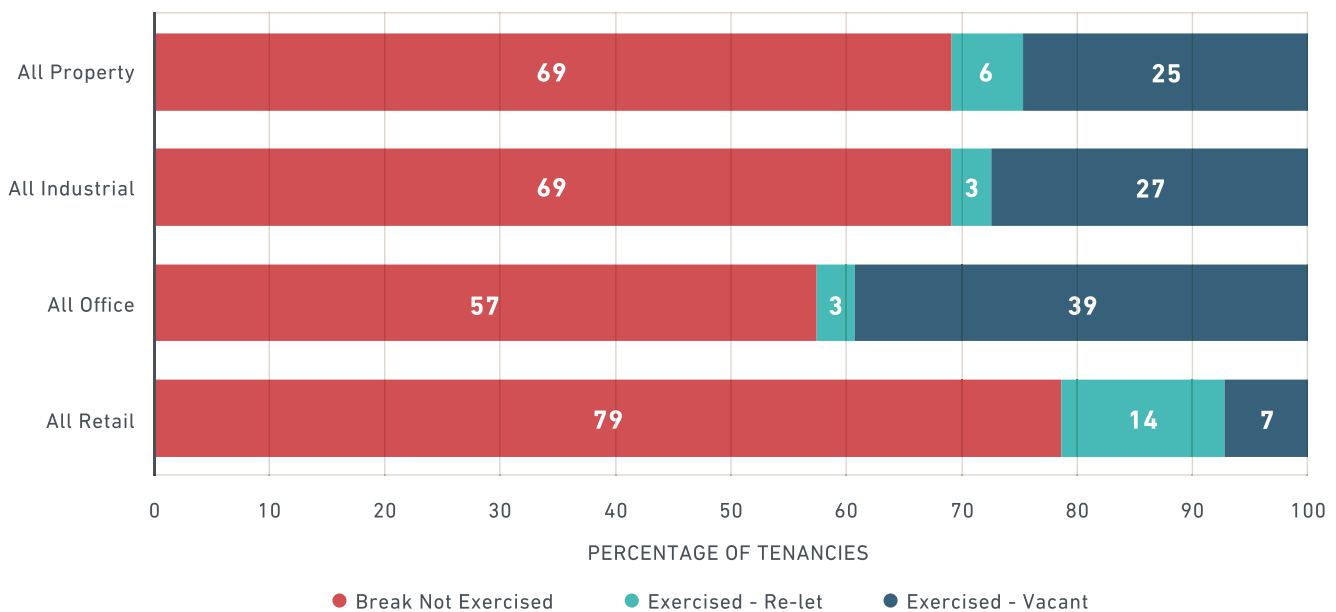
In the City of London, the percentage of break clauses not exercised in 2015 stayed relatively consistent, increasing only slightly from 64% in 2014. Meanwhile, in the Rest of the South East only 44% of break clauses were not exercised, while 51% of those break clauses exercised resulted in a vacancy of at least one quarter.

Shopping centres had the lowest break clause action rate among the retail segments at 15% in 2015, underlining the competition that exists for prime trading space in the context of retail sales growth, which saw its strongest 12-month period since 2004.

The high break rates in markets outside London will concern investors, given that many tenants in regional or secondary locations would be deemed as higher risk with weaker covenants, while building stock is likely to be older, raising the issue of eventual obsolescence once the current tenant departs.

FIGURE 12
Break clause actions (weighted)

Tenancies weighted by rent passing

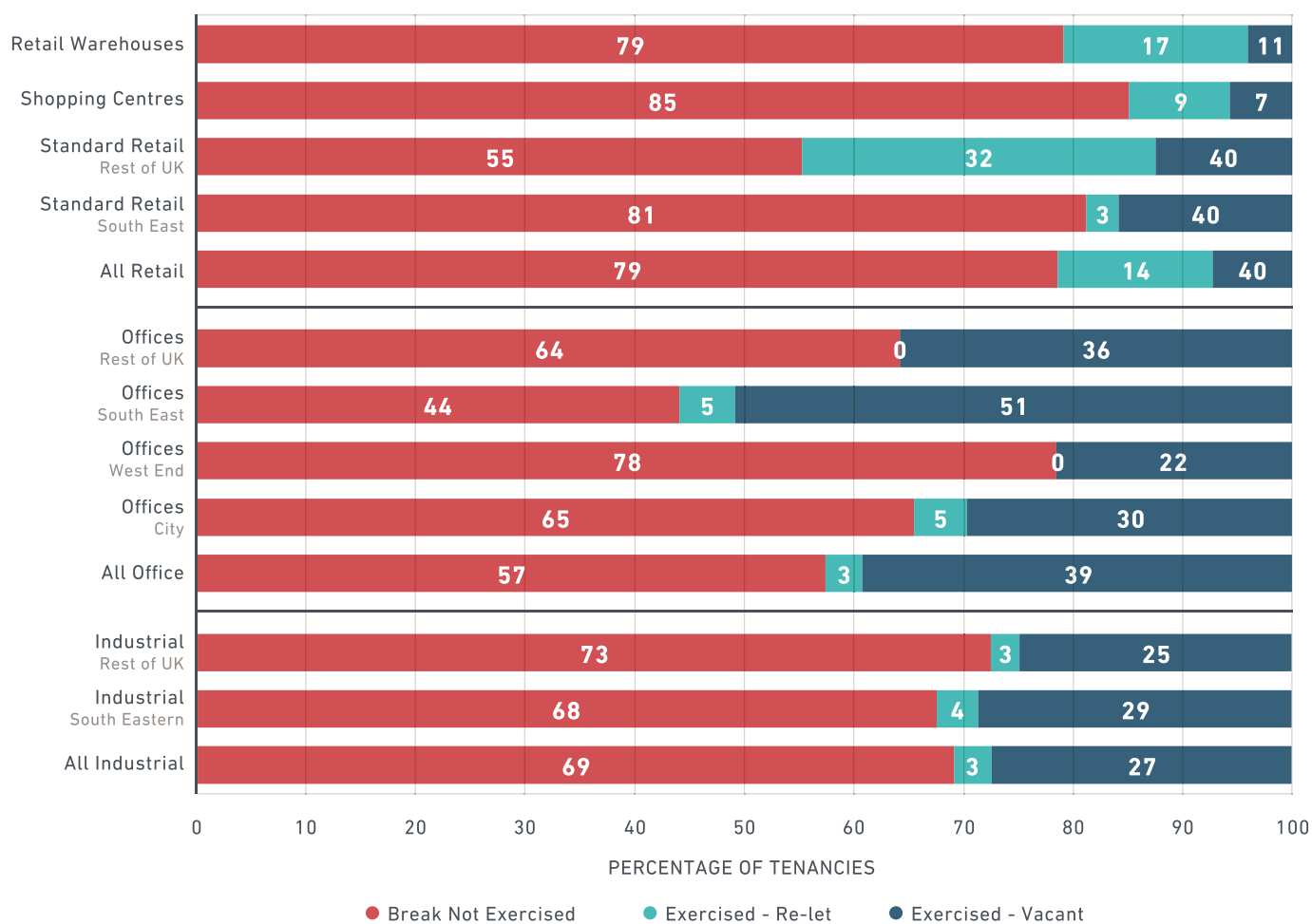


Source: MSCI

FIGURE 13

Regional disparity in lease breaks exercised (weighted)

Tenancies weighted by rent passing



Source: MSCI

WHAT IS HAPPENING ON RENEWAL AND RE-LETTING?

Despite the emergence of new 'modern' lease structures that incorporate turnover rents or inflation-linked rent reviews, traditional upward-only rent reviews remain dominant in the UK commercial market. This unique feature of UK commercial property leases is a key attraction for investors, with the absence of downward reviews meaning there are often only minimal rental changes during the life of a lease, particularly in a subdued market.

Therefore, income movements can mainly be seen at the end of a lease's life, when the tenant has the option to renew or vacate, as the rent will revert to the open market rental value for the property. This provides for an interesting analysis of the investor's income position for properties with leases approaching expiry.

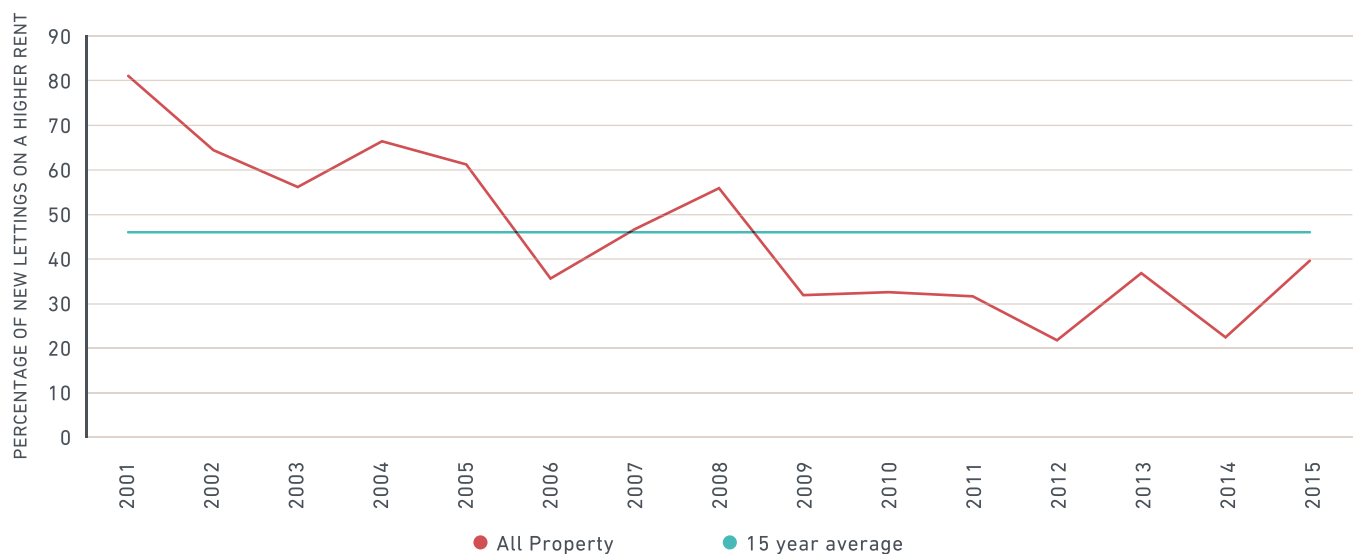
Table 3 shows, in percentage terms, the proportion of all property units which saw a positive change in rental income upon a new letting, including both renewals by existing tenants and re-lettings to new tenants.

TABLE 3
Rental change for new lettings in 2015

	Unweighted	Weighted
Higher	40%	40%
Lower	38%	49%
Same	21%	12%

Source: MSCI

FIGURE 14
Achievement of higher rent on new lettings 2001-2015
Tenancies weighted by rent passing



Source: MSCI

On an unweighted basis, for the second year in succession more units with a new lease or lease renewal saw rental income rise than decline. Rental income had continued to fall between 2009 and 2013 for those tenancies that were renewed or re-let, as peak market leases, signed or reviewed before 2008, came to an end. This trend is now reversing as more and more properties begin to offer reversionary potential.

As a proportion of the market in 2015, an unweighted 42% of renewals or re-lettings achieved a higher passing rent. When weighted by rent passing, the figure was similar at 40%, indicating that positive rent reversions were widespread and not limited to larger occupiers, as was the case a year earlier. In 2015, the rent-weighted percentage of leases reverting lower in the City and West End office markets was significantly up from a year before.

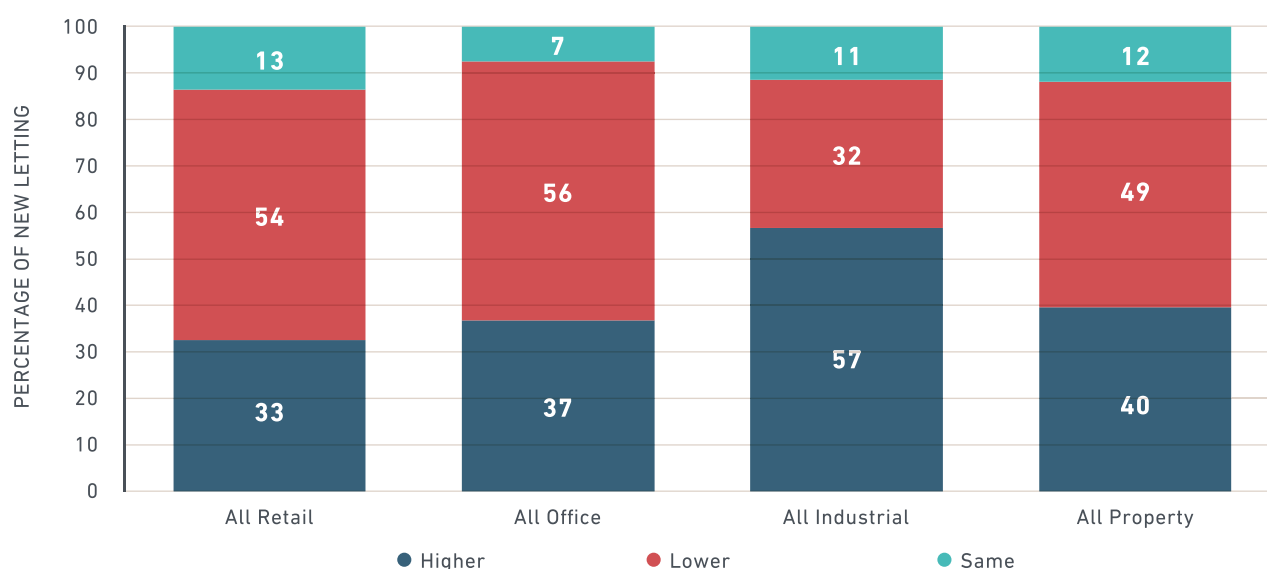
This is perhaps not surprising given the strong market rental growth in these nodes over the last few years. However, on balance a higher percentage of new lettings and renewals still achieved higher rents.

For all tenancies in the sample (unweighted), 38% had lower rental income following a new letting, an improvement from the 42% recorded in 2014. The industrial sector performed strongest with 56% of new lettings seeing income uplift, while retails were weakest with 25% of tenancies witnessing a growth in rental income. The office sector, with 48% of properties recording a higher rental income than previously, saw the stongest improvement, given the 39% figure recorded for 2014.

FIGURE 15

Weighted rental change for new lettings in 2014

Tenancies weighted by rent passing



Source: MSCI

INCOME AT RISK

The main risk to landlords and investors, and one that is quite unpredictable compared to the effect of break clauses or the end of a lease, is tenant default. Tenant default can leave the landlord with significant arrears and a vacant building, with varying levels of recourse depending on the financial position of the defaulting company. Difficult trading conditions for UK retailers over recent years have increased the number of receiverships and liquidations leading to more volatile default rates for all sectors.

Through 2015 the rate of default by UK tenants declined, falling to 3.1% of all tenancies weighted by rent passing, a reflection of the improving economic environment. This was the lowest rate of default registered in the UK market since 2007, and compares favourably with the level for 2014, 3.7%. The rate of default had peaked at 6.2% in 2012.

Retail has seen highest level of default by sector in recent years, due to fragile consumer confidence and declining sales across the UK.

However, 2013 saw a significant turnaround, starting a trend that has continued to 2015. The default rate fell from a high of 6.3% in 2011 to 4.5% in 2013, and by December 2015 had fallen still further to 3.0%, below the long-term average of 3.6%.

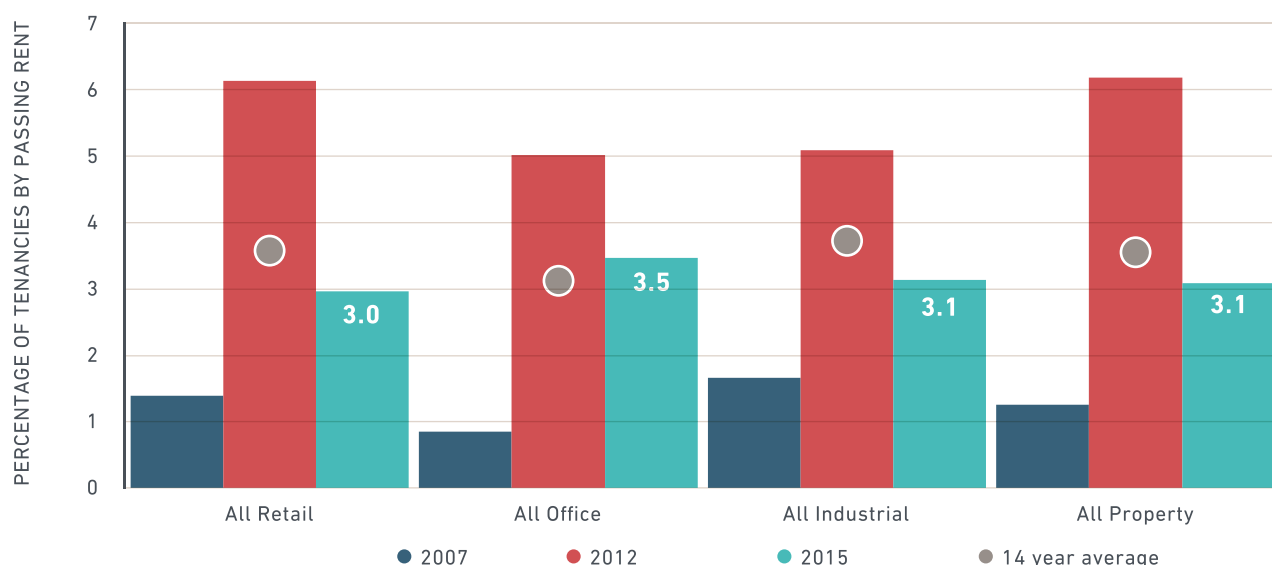
Improving occupier sentiment also spread to the office and industrial sectors, with many tenants more willing to expand space requirements and raise employment levels through investment or use of cash reserves. In 2015 the default rate for offices fell to its lowest level since 2007 at 3.5%, reflecting the improving fundamentals underpinning the UK services sector. The rate for industrials meanwhile fell to 3.1%, having stood at 5.8% in 2012 – a significant improvement over the three year period.

The rate of default varied significantly in 2015 by sector, location and property type. Offices in the City, dominated by financial occupiers that have seen aggressive business rationalisation over recent years, again had the highest rate of default, this year standing at 9.9%.

FIGURE 16

Tenants in default - current level relative to recent peak and trough

Tenancies weighted by rent passing

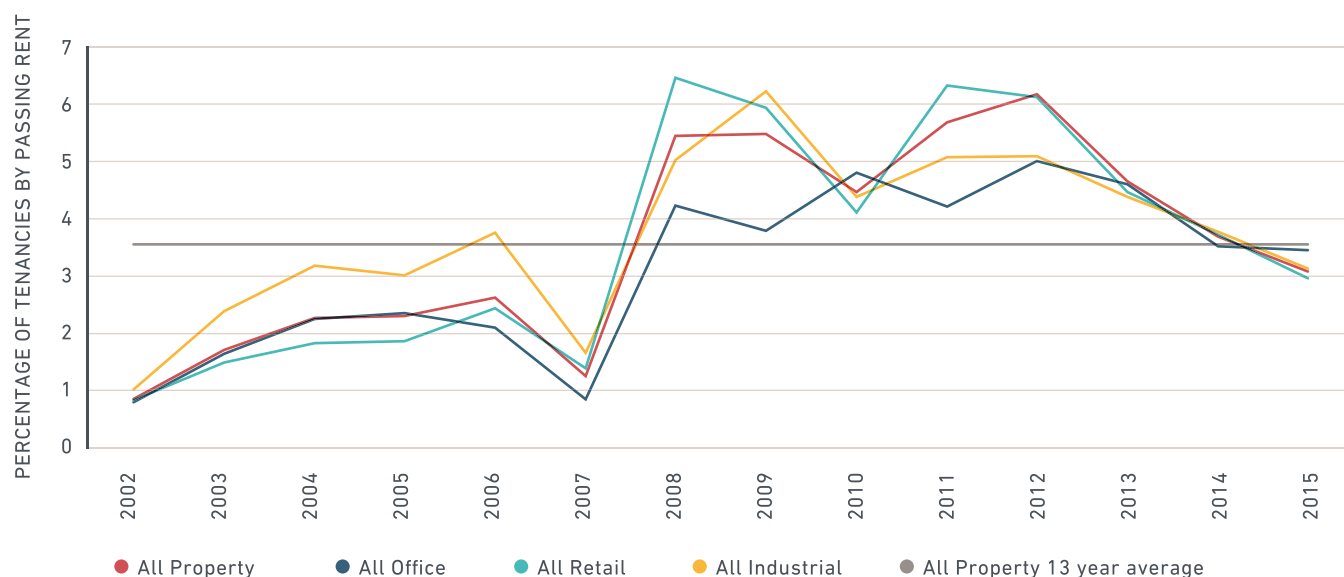


Source: MSCI, D&B

FIGURE 17

Tenants in default by sector, 2002-2015

Tenancies weighted by rent passing



Source: MSCI, D&B

This represented a significant rise from 2.9% in 2009 and 6.0% in 2011, making City offices the only primary market segment to see a rise in the rate of default between 2011 and 2015.

In line with previous years, the high rate of default in the City may be partly explained by a number of large, strategic defaults by tenants as major firms restructured and rationalised their City operations and space requirements. Conversely, offices in the neighbouring West End had a much lower rate of default at 2.9%, virtually unchanged from 2014 and well off their recent high of 4.5% in 2012.

Offices in the South East recorded the lowest average rate of default in the UK at 2.2% of rent passing, a decrease from the 5.3% exhibited in 2013. Conversely, offices in the Rest of the UK (outside London and the South East) saw an increase in the rate of default, rising to 2.2% of passing rent in 2015, compared to 1.6% in 2014.

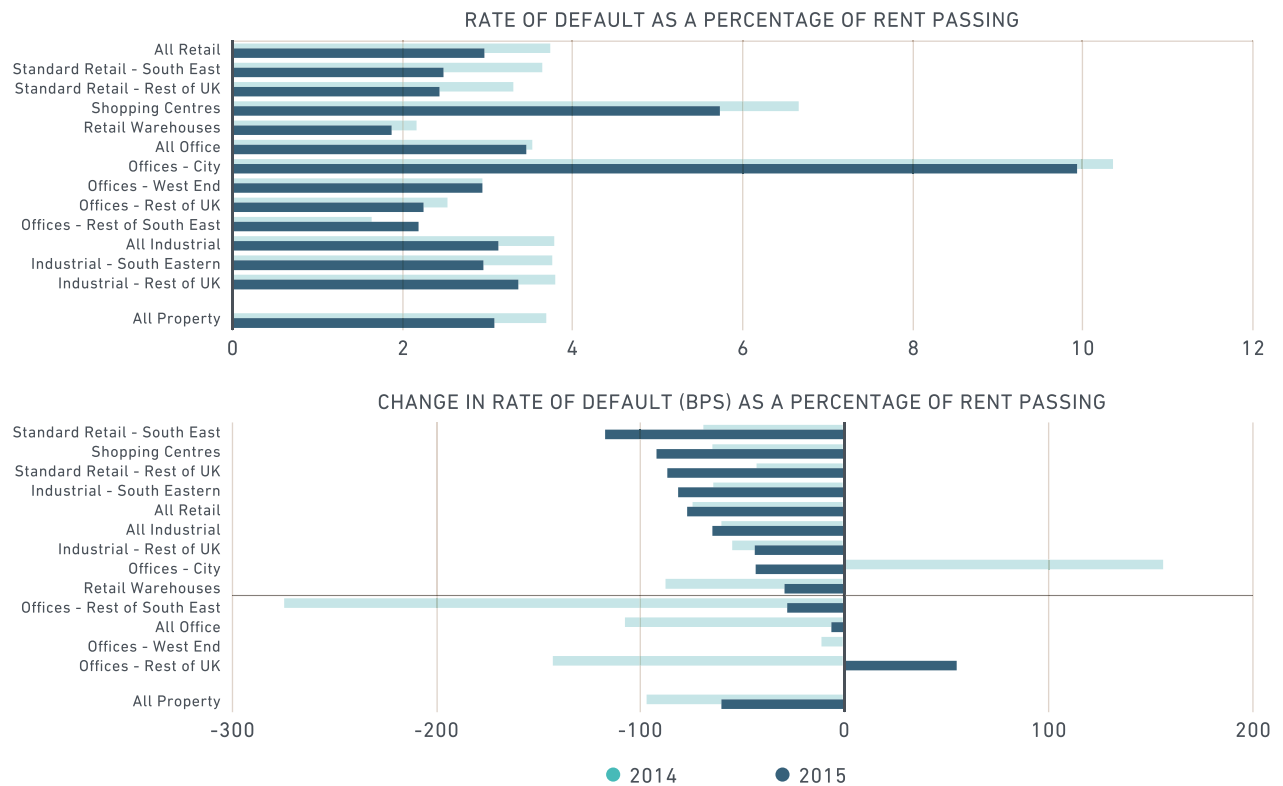
Historically, and despite weaker economic fundamentals, offices outside London have displayed lower levels of default on a consistent basis. Much of this is due to the fact that regional offices have a large number of government and quasi-state occupiers.

For retail, shopping centres were the segment with the highest rate of default in 2015 at 5.7%, a 1% improvement on the 6.7% rate in 2014, and well below the high of 9.2% posted in 2011. Shopping centres, being heavily reliant on consumer confidence, have consistently shown a high default rate since the economic downturn began in 2008. Nevertheless, the rate of default has now fallen year-on-year since 2011.

FIGURE 18

Tenants in default by type and location

Tenancies weighted by rent passing



Source: MSCI, D&B

DEFINITIONS

Rate of Default

Based on tenants with a D&B UK Failure Score of 0 or 1. The D&B UK Failure Score is designed to predict the likelihood that a company will cease operations without paying all creditors over the next 12 months. This includes the onset of failure such as meeting of creditors, administrator appointed, and bankruptcy.

ERV (Estimated Rental Value)

The annual rent the valuer estimates could be charged if the unit were let in the open market on the valuation date.

Rent Passing

The gross annual rent receivable on an accruals basis, before deducting property specific management costs, ground rents and other irrecoverable expenditure.

Vacant

A unit where the landlord is receiving no income and where there is no tenant in occupation. Vacant units therefore exclude empty, or vacant units where rental payments are still being honoured under an existing lease. Vacant units also exclude leases where a rent-free agreement is in place.



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For more information, visit us at www.msci.com.

MSCI

T: +44 20 7336 9200
E: realestate@msci.com

MSCI

Ninth Floor, Ten Bishops Square
Spitalfields, London E1 6EG

STRUTT & PARKER

Andy Martin
Senior Partner
T: +44 20 7629 7282
E: andy.martin@struttandparker.com

Strutt & Parker
13 Hill Street
London W1J 5LQ

msci.com

struttandparker.co.uk

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