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BRITISH PROPERTY FEDERATION

UK Lease Events Review

November 2014

Prepared by IPD in association with Strutt & Parker and the British Property Federation

Sponsor introduction

It is our pleasure to provide this introduction to our joint Lease Review and Lease Events report. Having brought both reports together last year, we are delighted to provide the industry with this second edition and to continue its more comprehensive insight into what is happening with new and existing leases.

The past year has been marked by a strong commercial property investment market, attracting capital from all parts of the world to the UK - not only to London, but increasingly to the regions as well. This report seeks to understand whether that returning investor confidence is underpinned by strength in the occupier market.

So far as new leases are concerned, for the best part of two decades now the general direction of travel has been towards shorter terms. First this was due to structural factors, and then the recession brought lease lengths down further. Some gentle unwinding has, however, taken place since the depths of the recession, and that trend has continued over the past year, with the average length of a new lease now 6.8 years (or 5.0 years if the period to first break is included), compared with 6.3 years a year ago. Across most measures, in all sub-sectors of property, occupiers seem willing to take on slightly longer-term commitments.

A greater confidence on the part of occupiers is also being seen in their behaviour on break clauses, with fewer being used, particularly on short leases, something that became quite commonplace during worse times. Occupiers are however continuing to benefit from significant rent-free periods, which are at record levels across all sub-sectors, and average 10.1 months overall in 2014.

Much has been made of the importance of small and medium-sized businesses (SMEs) to the current recovery. We include an analysis of new leases to SMEs every alternate year. Only 1.6% of SMEs took out a lease of 16 years or longer in the current analysis, which is consistent with previous reports. There has been a sizeable shift in the SME community, however, away from leases of up to five years, down from 78% to 66% (un-weighted) in 2012, and towards leases of between six and 10 years, up from 19% in 2012 to 29% now.

Various statistics from the Lease Events part of our report capture the true pulse of the occupier community. They illustrate that trends in occupation vary significantly between property sub-sectors, and paint a picture of continued challenges for property owners when lease events occur. Vacancy rates on lease expiry and breaks may be past their peak, but they remain very high in historical terms. From a position a decade ago when two-thirds of new lettings were achieving a higher rent, only about a third did so in 2013. On a brighter note, however, fewer tenants were in default in 2013, with the biggest improvement seen for retails, the sector which has been most affected by occupier insolvency in recent years.

Our thanks to the staff at IPD, who work to enhance the sector's knowledge, and through their statistical outputs help underpin property as a professional investment asset. We hope you take something of interest from this latest report and the trends that it illustrates.

Ian Fletcher

BRITISH PROPERTY FEDERATION

Andy Martin

IPD introduction

The last year has seen dramatic improvements for the UK economy, and crucially such improvements have not been confined to London, as was the case in the initial rebound of 2010. Economic growth has now been consistent for the last six quarters, and positive quarter-on-quarter since Q4 2012. However, confidence has taken rather longer to return to the commercial property market, with investment returns moderating until the third quarter of 2013. Since then, performance has improved across the market, even in the beleaguered regional retail sector. Meanwhile, London has strengthened further, with returns in 2014 close to double those for the equivalent quarters of 2013.

Growing confidence in the UK economy has bolstered occupier demand, helping lease terms to stabilise and even lengthen as the risk associated with letting subsides in many parts of the market. Similarly, landlords, faced with growing demand for space from tenants, have been able to agree longer terms and reduced incentives, as the UK market edges towards conditions not seen since before 2007.

Lease expiries, break clauses, vacancies and defaults are all risks which investors need to assess when evaluating the income streams from commercial real estate. These can be considered as a series of options in the future cash flow from real estate assets. Their analysis is crucial for helping investors, occupiers, and landlords to understand the potential of the space they occupy or the income stream they expect.

This Lease Events Review for the year 2013 and the half-year to June 2014, produced by IPD, provides empirical evidence on the likelihood of different lease events and outcomes. The analysis for the end of 2013 is based on a sample of over 90,500 leases, held in the IPD UK Annual and Quarterly Property Universe.

The lease events section of this report examines the influence of three key types of lease event on the property investment market: lease expiries, break clauses and changes 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 consumption, all of which have a direct impact on leasing conditions.

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The new lease review in 2014

How have leases changed this year?

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

In the UK, the traditional lease with a five-year upward-only rent review remains dominant, albeit with a shorter total term. However, since 2009 more modern types of lease, for example with RPI-linked uplifts or turnover-based final rents, have featured increasingly in segments such as supermarkets and retail warehouses.

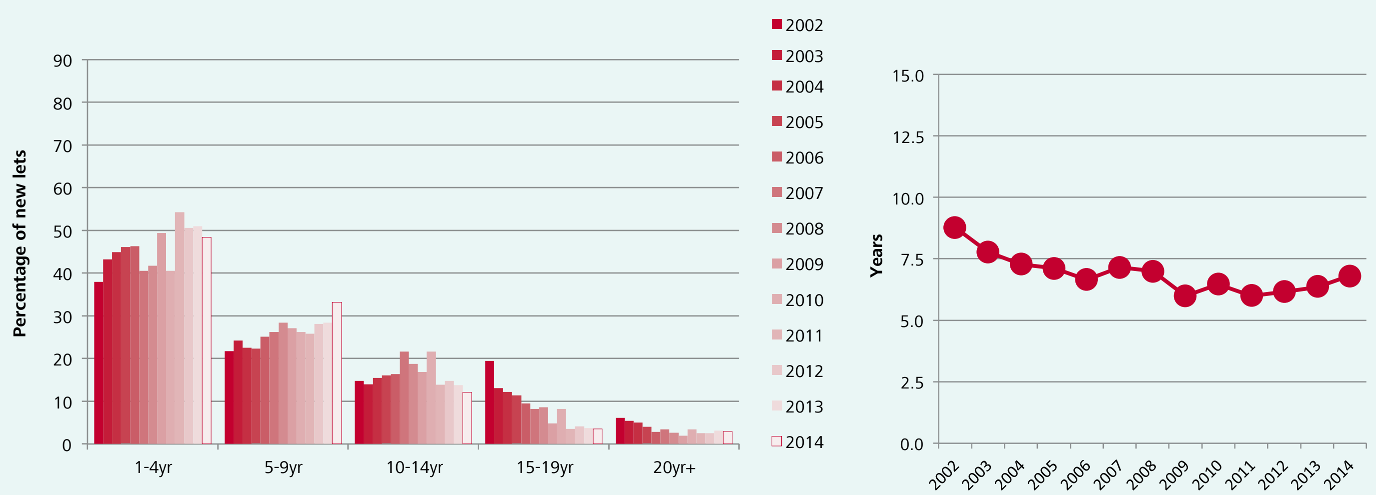
This section will firstly look at the average lease length and how this has changed over time. It will then review incentives such as break clauses and rent-free periods and their recent history. Finally, it will consider changes in the income resulting from lease negotiations that have concluded in 2014.

Based on the number of leases granted, the average lease length has increased. This is a reversal of the recent trend and reflects growing confidence amongst occupiers. However, the majority of leases were still considered to be short, with close to half (48.4%) of new leases granted so far in 2014 having a term of four years or less. This figure is un-weighted, counting all leases equally regardless of the level of contracted rent or the effect of break clauses.

The sheer number of short leases signed means that the average un-weighted lease length remains shorter than in the past, although the average lengthened to 6.8 years in 2014, compared to 6.3 years for the full year 2013. The most relevant comparison is with the medium-term average for the most recent cycle 2002-2014, which stands at 6.9 years.

The distribution of lease lengths shows how rare leases of over 10 years have become in recent years, as the shortening trend has continued for leases of longer than 15 or 20 years. Sub-10 year leases made up 82% of those signed in 2014, leaving just 7% of new leases at over 10 years in length. Overall, while leases on average lengthened in 2014, they are shorter than at the peak of the last cycle in 2007, when leases of longer than 10 years made up more than 12% of those signed.

Figure 1.1 & 1.2: Average New Lease Lengths to 2014 (un-weighted)



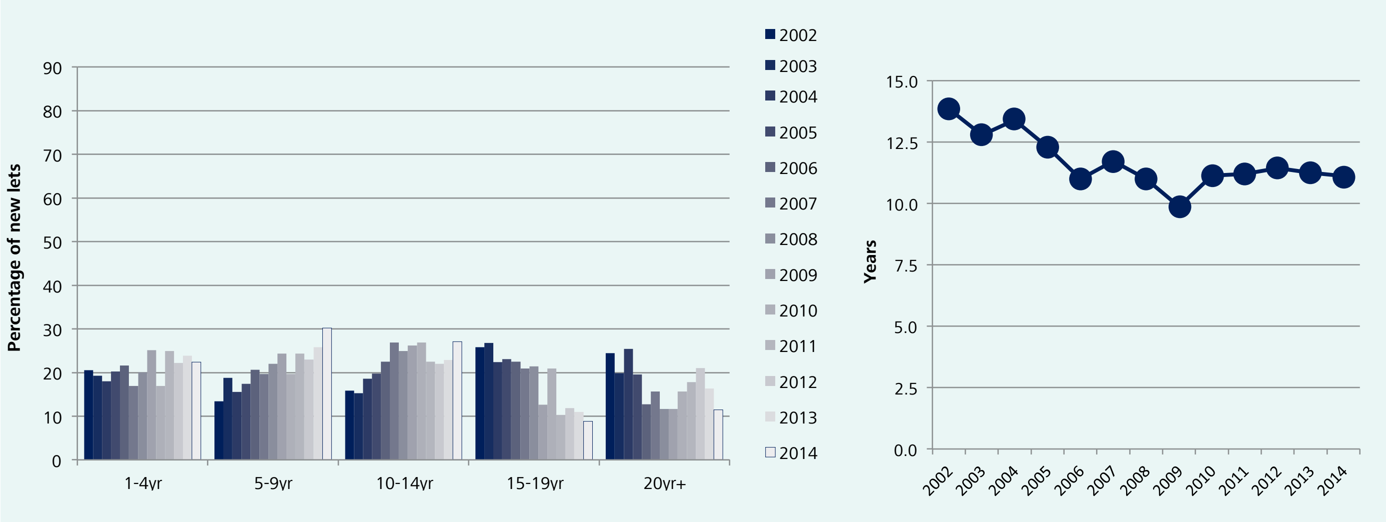
Note: Full lease term on all leases; tenancies equally weighted

Source: IPD

When weighted by passing rent, long-term trends remain similar, but the distribution differs significantly as bigger buildings with higher total rent tend to have longer leases. Nonetheless, when weighted by rent, sub-10 year leases still make up the majority of those signed, at over 52% in 2014. However, in line with the recovering market, lease terms have lengthened since 2009, when they had fallen to a weighted 9.9 years, to reach 11.1 years in 2014.

In the first half of 2014, leases of over 10 years in length still represented approximately half of the lettings market for commercial property when weighted by rent passing, although this percentage has fallen from two thirds of the market (66%) in 2004 to less than half of the market (47%) in 2014. Longer, traditional leases (20+ years) account for only 11.5% of those signed so far in 2014 on a rent-weighted basis. On an un-weighted basis, this falls to only 2.9% of leases, highlighting the dominance of very short leases for small units.

Figure 2.1 & 2.2: Average New Lease Lengths to 2014 (weighted)



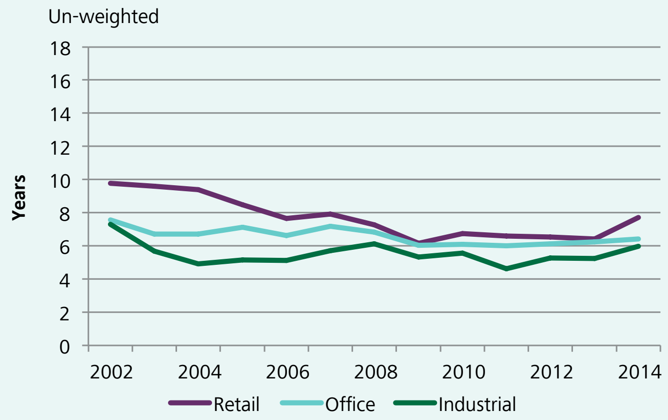
Note: Full lease term on all leases; weighted by rent passing

Source: IPD

When examining leasing trends at a sector level, we see divergence in lease length due to the differing property management requirements for the sectors. For example, office tenants are relatively flexible in terms of location, being able to relocate quickly and efficiently, whereas retail tenants are often tied to a location because of their consumer base or target market. When comparing the three main sectors for the current year 2014 on an un-weighted basis, the analysis shows that retail leases have lengthened further again this year. Office leases have remained stable, while industrial leases have lengthened, even though they remain the shortest on average by sector.

Since 2009, when the market was at its lowest ebb, un-weighted retail lease lengths have come back from a low of 6.2 years to reach 7.7 years in 2014. In weighted terms, this represents a lengthening of two full years, from 10.3 to 12.3 years. Retail leases are longer mainly because of the effect of supermarkets and retail warehouses, the latter making up a significant proportion of the overall retail sample. Leases granted on retail warehouses have consistently been three to four years longer than the all property average, while standard shop and shopping centre leases are much closer to the sector average. Supermarket leases tend to be longer again, often being inflation or turnover-linked.

Figure 3.1 & 3.2: Average New Lease Length Trends by Sector (Full term, ignoring any breaks, including short leases)



Source: IPD

On an un-weighted basis, office lease lengths have risen consistently, albeit at a marginal rate, since a low of 6.0 years in 2010, and have now come back to 6.4 years. When weighted by rent passing, lease lengths are considerably greater, largely due to the desire of larger tenants to minimise the disruption caused by relocation. However, weighted lease lengths here shortened in contrast to the rest of the market, falling to 8.7 years in 2014. This represents the shortest lease term on record for the office sector since IPD began this analysis.

The reduction in lease lengths for the office sector has been largely driven by central London properties, where tenants have demanded more flexible terms in line with trends in the rest of Europe and North America. For the broader office sector, buildings located outside London, and particularly beyond the South East of England, have seen leases lengthen the most. Much of this trend is due to renewed confidence amongst regional occupiers, many of whom are starting to prefer the security of slightly longer leases, whereas in London the preference is for flexibility, while the effect of developer pre-letting has been to reduce total lease lengths.

Industrial leases have also lengthened, although lease terms for this sector had decreased most during the downturn. Average un-weighted lease lengths fell from 6.1 years in 2008 to 4.6 years in 2011, but have since risen to 6.1 years. As in the office sector, the flexibility of industrial tenants means that terms tend to be shorter, although this varies significantly across the sector, with tenants who have high-cost fit outs or have installed plant and machinery tending to favour longer terms.

When weighted by passing rent, average industrial leases have been steady in 2014 at 9.3 years, unchanged from 2013. This is however down from 11.2 years for leases signed in 2012, suggesting the initial recovery in industrial lease terms to have been a blip, with lease lengths in 2013 and 2014 being closer to the long-term (2002-2014) average of 9.7 years. Additionally, in terms of location, industrial leases weighted by passing rent are shorter in Greater London than the rest of the UK.

In addition to examining leasing trends by sector, this year's analysis includes leasing trends for small and medium enterprises (SME's) versus that of large corporations. Perhaps surprisingly, leases for SME's edged close to same lengths as those signed by large corporations in 2014, averaging 5.9 years compared to 6.0 years for large corporations taking office space. While the spread has narrowed, on an all property level, the trend remains consistent with previous years, as the SME preference for shorter leases remained. All property SME's lease lengths, un-weighted, were 6.2 years compared to 7.8 years for large corporations.

Break clauses and rent-free periods

The inclusion of letting incentives in modern UK leases has grown dramatically in the last few decades. Much of the fluctuation in these incentives is due to economic factors affecting the demand for space in the commercial market. The improvement in the UK economy through 2013 and early 2014 has led to increasing demand for space.

This raised expectations that rent-free periods would shorten and the number of leases with break clauses would diminish. However, IPD data as of June 2014 shows that economic improvement has yet to have much effect on overall trends in the length of rent-free periods, mainly because vacancy remains high in many parts of the country.

However, the occurrence of break clauses in shorter (1-5 years) lease agreements has declined drastically in the past two years, even though they remain a prominent feature of longer leases. In fact, break clauses were included in 28% (weighted) of commercial leases with a term of 1-5 years in 2010, when the economy was still in recession, but by 2014 only 2.2% of such leases included a break clause. This is evidence of the growing demand for short-term space from occupiers, meaning that landlords may be under less pressure to be flexible with incentives, given that a short lease term can itself act as an incentive for cautious tenants.

Break clauses are most common in leases of 6-10 years and 11-15 years in length, and feature in 43% of leases between 11 and 15 years. Overall, 27.5% of new leases signed in 2014 had break clauses, close to the average for the last few years. Across the sectors, it is more common for offices (31.6% of leases) and industrials (28.0%) to have break clauses than retails (25.5%).

Figure 4.1, 4.2, 4.3, 4.4: Proportion of Leases with Break Clauses by Sector

Source: IPD

Alongside break clauses, rent-free periods remained a common incentive in 2013 and 2014. Rent-free periods have been included in some 10.1% of new leases signed so far this year, having become much more common in the downturn. This growth in the prevalence of rent-free periods is a feature of all three market sectors, and their length has increased in each.

Having traditionally been a feature most common in office leases, retail and industrial leases have also increasingly included rent-free periods. The increase in rent-free periods is highly cyclical, with average lengths increasing in a weaker economic environment as many landlords provide such incentives in an attempt to prevent vacancy. In 2014, rent-free periods remained longest for offices, at an un-weighted average of 13.1 months. Meanwhile rent-free periods for retail leases reached their highest ever level in IPD's record at an average of 9.8 months, and industrials saw a more marginal increase to a 7.8 month average.

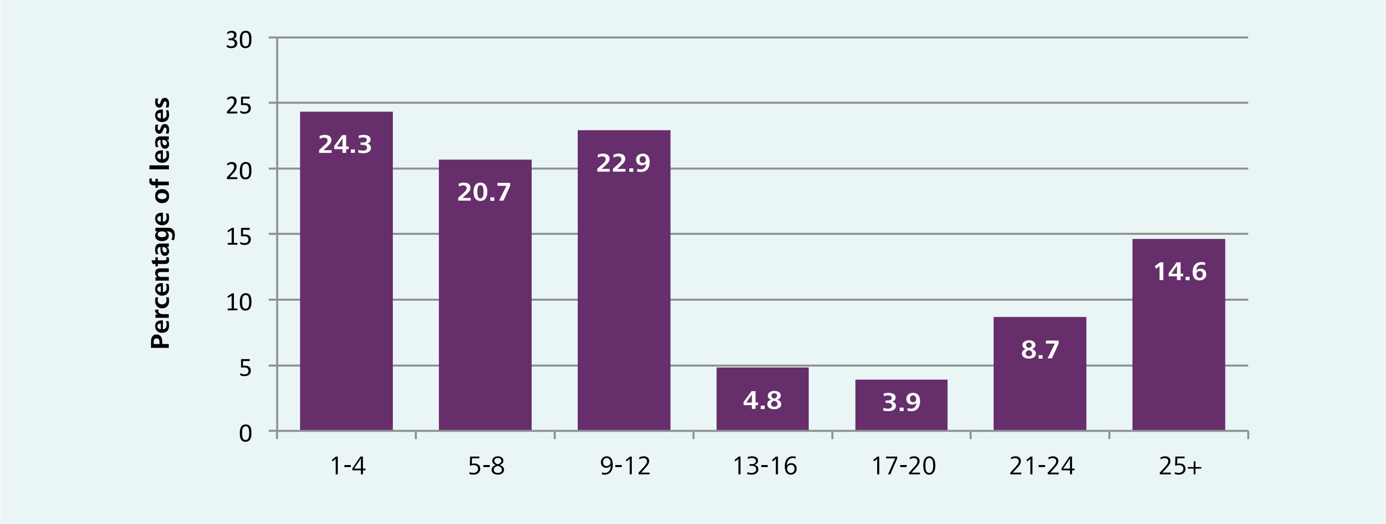
Figure 5.1 & 5.2: Average Rent-Free Periods by Sector

Note: Tenancies equally weighted (lhs); tenancies weighted by rent passing (rhs)

Source: IPD

The distribution of rent-free periods is skewed towards shorter leases at a market level, perhaps reflecting the compensating effect of higher rents for shorter income streams. Offices buck this trend with more rent-frees granted on leases of nine to 12 years in length than for shorter tenancies. The retail and industrial sectors see a more even distribution, with the inclusion of rent-frees in 20- 25% of leases with terms of between one and 12 years.

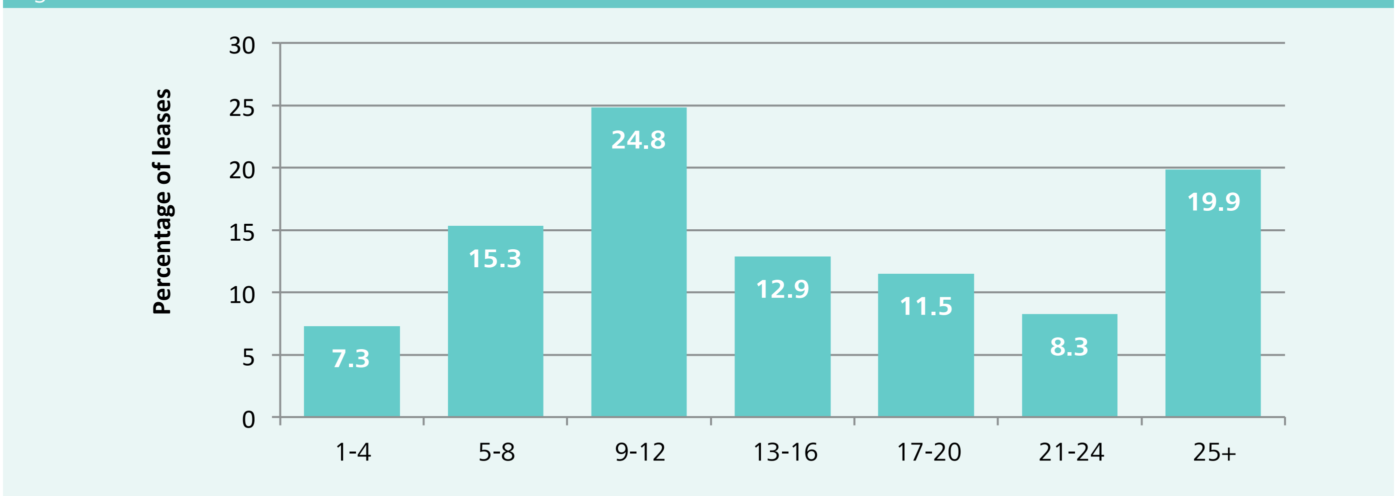
Figure 6.1: Distribution of Rent-Free Periods for Retail



Note: Tenancies weighted by rent passing

Source: IPD

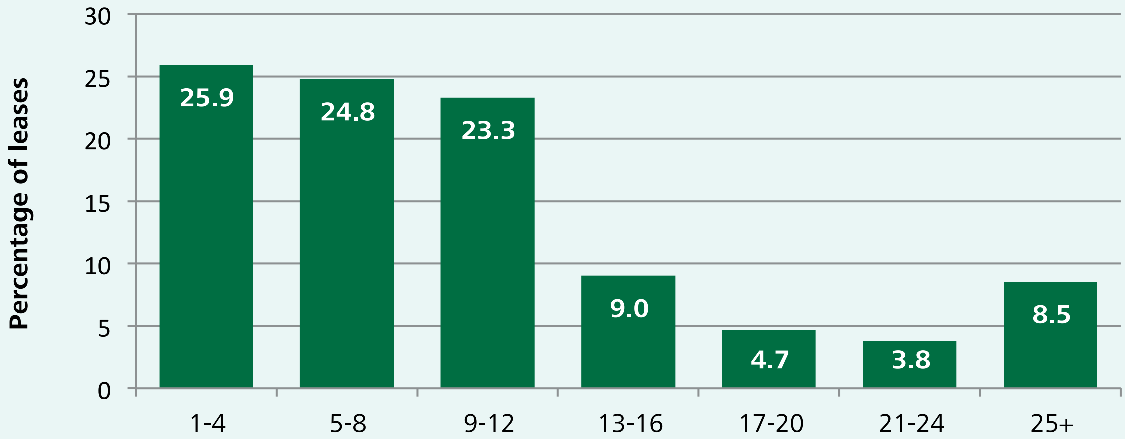
Figure 6.2: Distribution of Rent-Free Periods for Office



Note: Tenancies weighted by rent passing

Source: IPD

Figure 6.3: Distribution of Rent Free Periods for Industrial



Note: Tenancies weighted by rent passing

Source: IPD

Income security and potential for growth

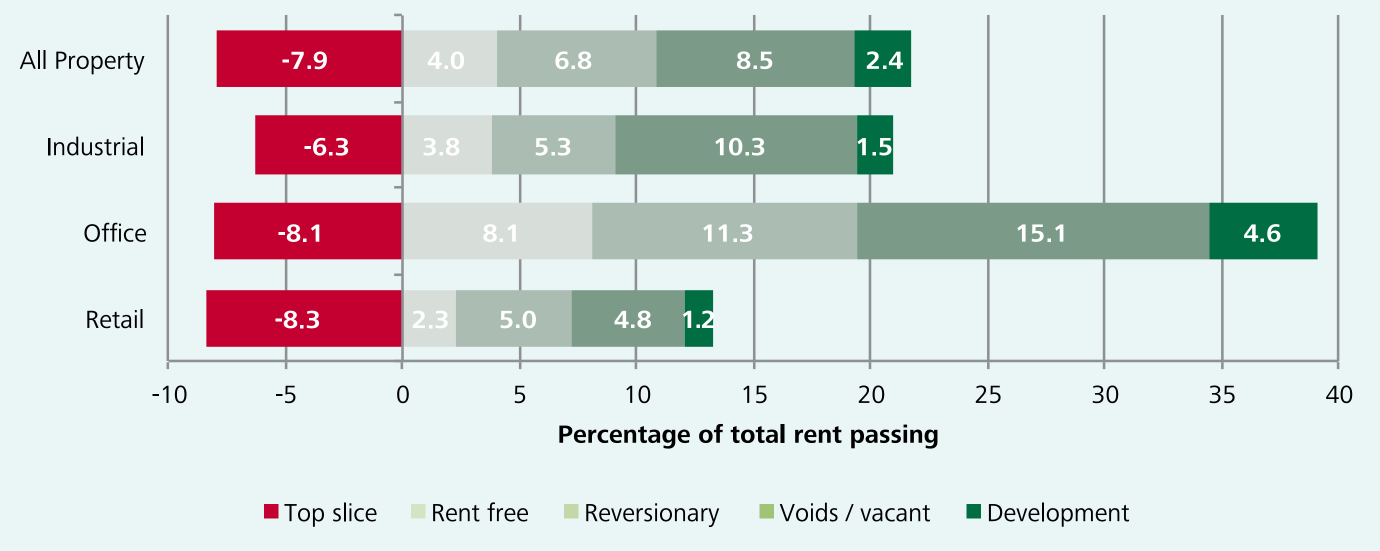
The graph below summarises the income position for current leases in 2014. Top slice represents income that is at risk due to over-renting, while reversionary potential represents potential income increases due to rental value growth in the analysis period of January 2013 to June 2014.

In terms of security of income in the broader UK market, just under 8% of income is at risk due to over renting (top slice). Of the traditional property sectors, retails are the most over-rented at 8.3% of rent passing, compared to 8.1% for offices and 6.3% for industrials. All market sectors saw a decline in the level of over-renting between June 2013 and June 2014 as the growth in market rents narrowed the income gap.

As would be expected, the ending of vacancy or voids is the event which offers the most income growth potential on letting, at over 8.5% at the all-property level. Given the level of vacancy in some office markets, and even in key locations like the City of London, this sector offers the highest potential income uplift upon letting of vacancy/void space at 15.1%. Similarly the income growth potential from development is highest for offices which, despite having the highest vacancy, also have the largest proportion of income tied up in developments at 4.6%.

The retail sector offers the least potential for income growth, with reversionary potential of only 5.0% and income in developments at 1.2%. On the other hand, its vacancy rate of 4.8% is almost half the all property average of 8.5%, arguably placing the investor in a stronger position to Increase rents, as demand picks up in improving consumer and economic conditions.

Figure 7: Security of Income & Growth Potential by Sector



Note: Percent of total rent passing

Source: IPD

The impact of lease events in 2013

This Lease Events section of the report examines the role played by historic lease events and their impact on investor income. The section first looks at the trends associated with leases approaching expiry, particularly the renewal rate of tenants. It then reviews the exercise and impact of inducements and incentives such as break clauses. Each part of the report provides analysis at a headline all property level, and then focuses on sectors and locations. The section concludes with a look at the effect of tenant default on income. The period of this analysis is the calendar year 2013, with data sourced from the IPD UK Annual Index.

This analysis is split into 'un-weighted', based on the number of leases in the sample and 'weighted', where the data reflects the level of rent passing. From an investor perspective, the 'weighted' analysis is more relevant as it highlights the level of income at risk or lost upon expiry.

What is happening on expiry?

The years since the 2008 market crash have seen a consistent, and continuing, weak trend in terms of the outcome of lease expiries for investors, much of which has been further exacerbated by economic and confidence difficulties for occupiers. This has meant that the majority of properties in this analysis fell vacant upon lease expiry, a trend that continued in 2013 with 42% of expiring leases (un-weighted) followed by vacancy. As leases approach expiry, many tenants use the opportunity to push for more competitive rents; especially if their previous lease had been signed in times of record rent levels, meaning that they are now paying on an over-rented basis.

Table 1: Outcome of Leases Expiring in 2013 for All Property

	Un-weighted	Weighted
Renewed	49%	39%
New Letting	9%	9%
Vacant	42%	52%

Source: IPD

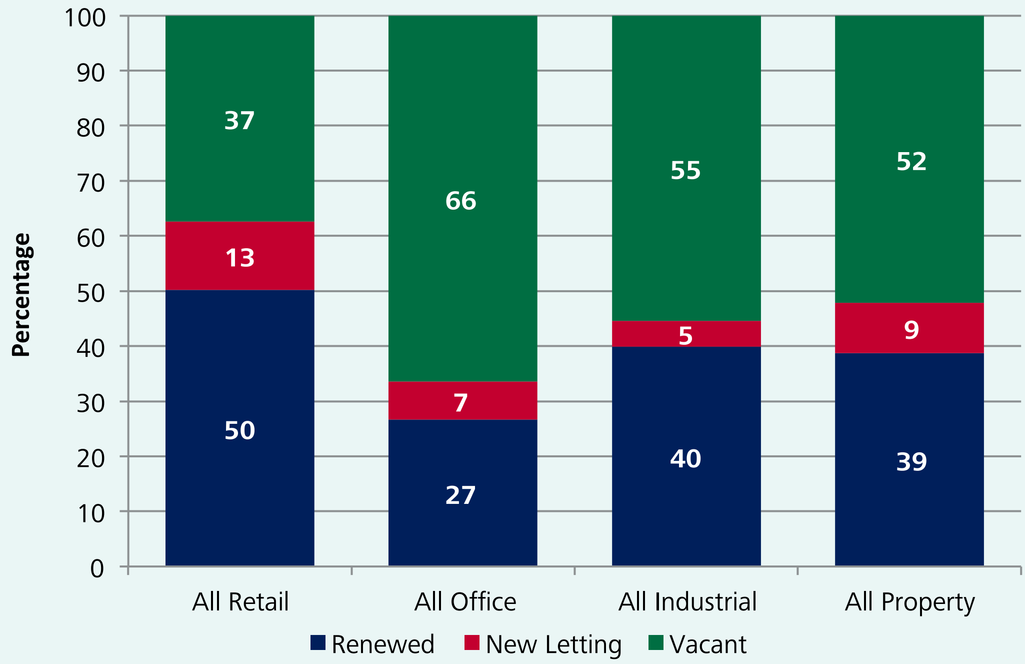
Figure 8: Vacancy Rate for Leases Expiring 1998-2013 (weighted)

Source: IPD

The vacancy rate for leases expiring in 2013 was 42% on an un-weighted basis (counting all leases equally), rising to 52% when weighted by previous rent passing. This weighted vacancy rate has now been above the 16-year average of 46% since 2009, although it has improved from a high of 60% in 2012.

Of the leases which expired in 2013, a small proportion, 9% of the total (un-weighted), was re-let in the quarter when the previous lease expired. When weighted by rent passing, the figure was also 9%. For renewals, the market saw a significant improvement from 2012; weighted by rental income, 39% of tenants chose to renew their leases in the quarter when the expiry occurred. A breakdown of these figures is shown in Table 1.

Figure 9: What Happened When Leases Expired in 2013? (Weighted)



Note: Tenancies weighted by rent passing

Source: IPD

By sector, offices had the highest level of immediate vacancy, both weighted (66% of leases) and un-weighted (58%), when leases expired in 2013. Retails had the lowest vacancy rate, but this in part reflected the fact that retailers often want to remain on the same pitch. The retail sector also had the highest level of new lettings. Nonetheless, at 13% this still represented a small proportion of retail expiries on a weighted basis, with the most common outcome, as for the rest of the market, being vacancy.

The office sector saw the highest vacancy rate on expiry and the lowest renewal rate. While a retailer's preference is often to remain on an established trading pitch, office tenants tend to be less attached to particular buildings or locations. However, high vacancy rates tend to increase the number of options and deals available to office tenants, particularly outside central London where they may have the chance to leave older obsolescent buildings for more modern space. Given that many of these occupiers signed leases at rents higher than current market levels, they can often benefit from improved terms and conditions at other locations, implying a smaller likelihood to renew.

What was the impact of break clauses?

With rents for most sectors, segments and locations in the UK commercial property market reaching record highs between 2007 and 2008, many tenants who signed leases then have been eagerly awaiting the opportunity to exercise break clauses. However, with rents recovering in key locations and certain markets, such as central London, edging close to peak rents in 2014, many tenants are now opting to remain due to the competition for securing favourable buildings and terms.

The percentage of tenants choosing not to exercise their break decreased further in 2013 as rental growth returned nationally. Table 2 shows the total number of tenants who had the right to break in 2013. This is analysed both weighted by previous passing rent and by number of leases (un-weighted).

Table 2: State of Leases With a Break in 2013

	Un-weighted	Weighted
Break Not Exercised	63%	48%
Exercised - Re-let	8%	13%
Exercised - Vacant	28%	39%

Source: IPD

Figure 10: Vacancy Rate for Exercised Break Clauses 1998-2013 (weighted)

Note: Tenancies weighted by rent passing

Source: IPD

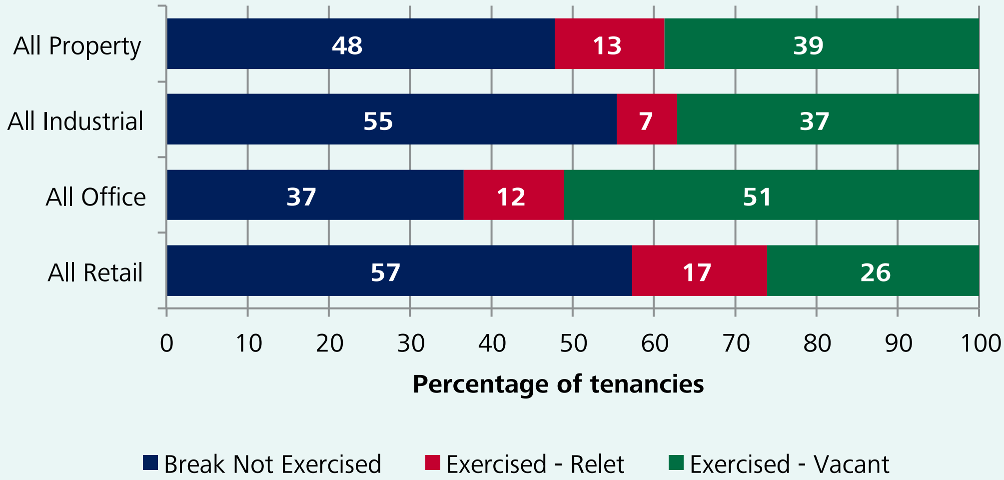
Despite significant economic improvement and a broad pick-up in the commercial property market, the vacancy rate for exercised break clauses rose by five percentage points between 2012 and 2013. This means that for 28% of units where a break was exercised, they remained vacant for a quarter or longer.

Weighted by previous rent passing, the vacancy rate was even higher, rising from 34% to 39% between 2012 and 2013. This increase may come as a surprise to many investors who might have expected a fall through the year as occupier confidence improved, particularly in the retail sector.

However, while the vacancy rate has increased over the last year, the re-letting rate has improved significantly for both weighted and un-weighted analyses. The re-letting time for units is a key indicator of occupier market confidence: 8% of units were re-let immediately after a break in 2013, more than double the 4% rate recorded in 2012.

Despite this recent improvement, the rate at which properties are immediately re-let remains below the long-term (16-year) average of 9% and well below the 13% rate achieved in 2007. Cautious occupier sentiment continues to prevail across most sectors and locations, with the exception of central London, where demand expansion and rental growth is continuing apace.

Figure 11: Break Clause Actions (Weighted)



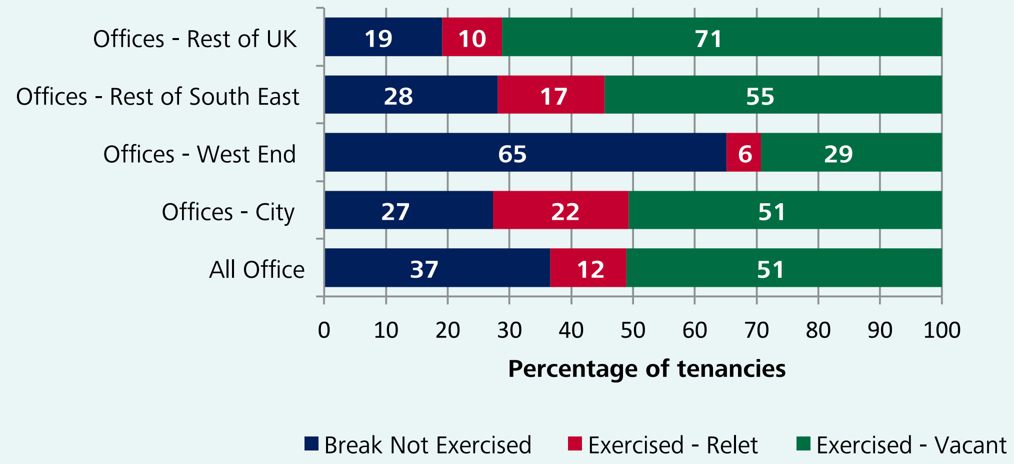
Note: Tenancies weighted by rent passing
Source: IPD

When examined at a sector level, there was a broad divergence in the outcomes of break clauses in 2013. Given the preference of retailers to remain at established trading locations, the break clause action rate here tends to be lower than in other sectors. In line with 2012 when retails saw the lowest rate of any sector, only 30% of retail tenants chose to exercise their break options in 2013, although this was still ahead of the 21% long-term un-weighted average. When weighted 43% of retail tenants exercised their break clause, increasing from 25% in 2012.

In 2013, offices recorded the highest rates of tenants exercising breaks - 51% on an un-weighted and 63% on a weighted basis. Of these break clause actions in the office sector, 39% of the properties affected were vacant for at least one quarter following the break, the highest level for the main property sectors. Meanwhile, 33% (45% when weighted) of industrial tenants decided to take up their break options, and where breaks were exercised only 6% were promptly re-let, with 27% remaining vacant for more than a quarter.

Break clause action rates varied by location, but not by as much as in previous years. Markets with high turnover, like offices in London's West End, where tenants move frequently to secure better deals or better-quality space, saw a significant decrease in the number of tenants exercising breaks; this may be explained by the strong rental values now being achieved in such locations, combined with their limited availability of office space.

Figure 12: Regional Disparity in Lease Breaks Exercised (Weighted)



Note: Tenancies weighted by rent passing

Source: IPD

The strong West End performance when it comes to tenants not choosing to break is clearly illustrated by Figure 12. Popular office locations, like the City of London, with a large variety of tenants and stock, tend to have a higher turnover than secondary locations, which often have longer leases - hence the higher break rate of 73% (weighted by rent passing) in the City. In the West End, where competition and rental values are even higher, tenants that have secured space are often reluctant to break and re-enter the letting market.

Offices outside the South East had the highest level of tenants exercising breaks at a dramatic 81% on a weighted basis. Offices in these regions had a similarly high level of breaks acted upon, with 72% of tenants choosing to exercise their right to break. These high break rates will be of concern to investors, given that many tenants in regional or secondary locations are higher risk and subject to weaker covenants. Moreover their building stock is likely to be older, raising the issue of eventual obsolescence.

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 property market. This almost-unique aspect of UK leases is one of the key attractions for investors, as excluding the possibility of downward reviews means that there are often only small changes to rental levels during the life of a lease, particularly in a subdued market.

Therefore, the end of the lease, when the tenant has the option to renew or vacate, is the point when income changes are likely to be greatest as the rent reverts to open market rental value.

Table 3: Rental Change for New Lettings (Renewal or Re-Letting) in 2013

	Un-weighted	Weighted
Higher	30%	37%
Lower	46%	44%
Same	24%	19%

Source: IPD

Figure 13: Achievement of Higher Rent on New Lettings 2001-2013

Note: Tenancies weighted by rent passing

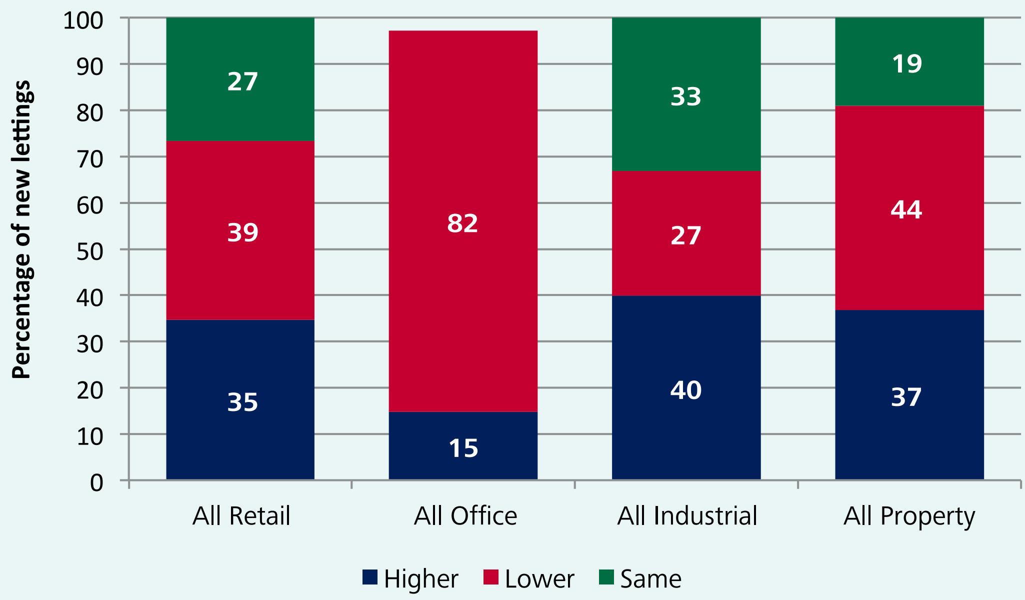
Source: IPD

Table 3 shows, in percentage terms, the proportion of 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.

Rental income continued to fall for a significant proportion of tenancies that were renewed or re-let in 2013, particularly with many leases signed or reviewed at the market peak in 2008 coming to an end. However, the situation improved compared to 2012, with 6% more of the renewals or re-lettings achieving a higher rent than previously.

Across all tenancies in the sample, 46% (un-weighted) had lower rental income following a new letting, falling from 55% in 2012. Compared to last year, 30% of tenancies recorded a rental uplift following a new letting, up from 24% in 2012. On an un-weighted basis, the office sector performed most strongly, with 32% of new lettings seeing an income uplift, while industrials were the weakest with 29% seeing income growth. The industrial sector did however see the biggest improvement compared to 2012, rising from 11%.

Figure 14: Weighted Rental Change for New Lettings in 2013



Note: Tenancies weighted by rent passing
Source: IPD

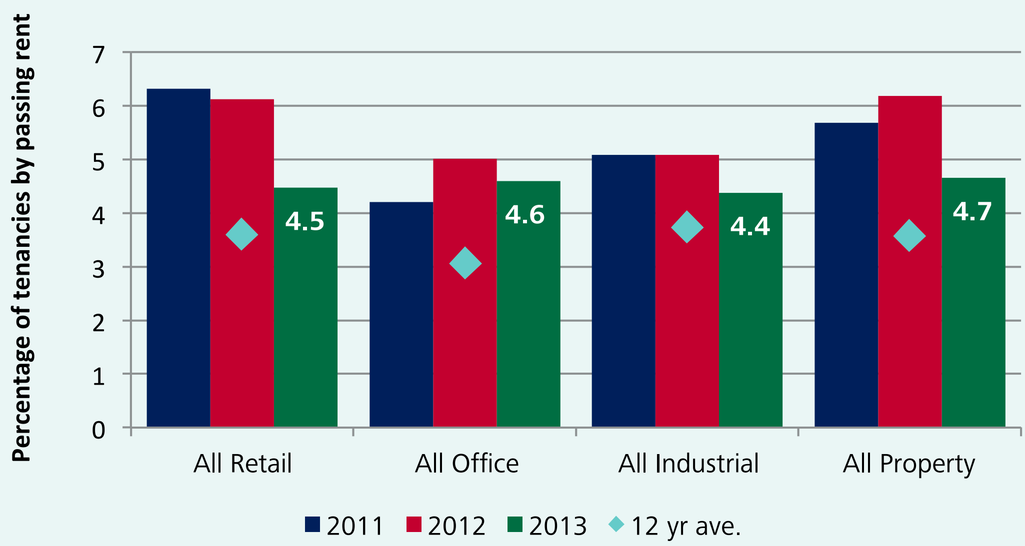
However, when examined on a weighted basis (by rent passing) the picture by sector is significantly different, highlighting the effect of larger tenancies on the results. For example, for offices only 15% of new tenancies achieved a higher rent, with 82% recording a lower figure. Much of this difference between the weighted and un-weighted results is due to the fact that larger tenants have a stronger bargaining position, with many pushing landlords, who are keen not to be left with a large vacant building, to sign at a lower rent.

Income at Risk

A major risk to landlords and investors, and one which is far less predictable in its effect on income streams than lease-breaks or vacancy, is tenant default. Tenant default can leave the landlord with significant rent arrears as well as a vacant building, with varying levels of recourse depending on the financial position of the defaulting company. Difficult trading conditions for UK retailers in recent years have increased the number of receiverships and liquidations in this sector, while default rates across the market as a whole have been volatile.

However, 2013 witnessed a sea change, with the default rate falling to 4.7% of all tenancies weighted by rent passing, as against 6.2% in 2012.

Figure 15: Tenants in Default (in Liquidation or Receivership)

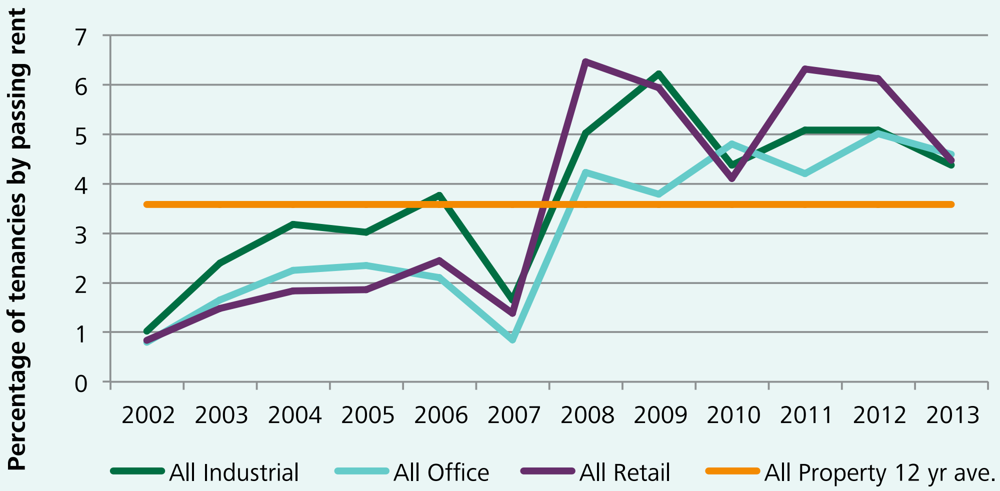


Note: Tenancies weighted by rent passing
Source: IPD, D&B

Retail has been the weakest UK sector in terms of defaults in recent years, hit by fragile consumer confidence and declining sales. However 2013 saw a significant turnaround, with the default rate falling to 4.5% from a high of 6.3% in 2011, and coming closer to the long-term (12 year) average of 3.6%.

Warming occupier sentiment also spread to the office and industrial sectors, with many tenants expanding their space requirements and raising employment levels through investment. The default rate for offices fell back to 4.6% in 2013 from 5.0% in 2012, though this was still above the 4.2% rate seen in 2011. The rate for industrials fell to 4.4% from 5.1% in the two previous years.

Figure 16 Tenants in Default by Sector, 2002-2013



Note: Tenancies weighted by rent passing
Source: IPD, D&B

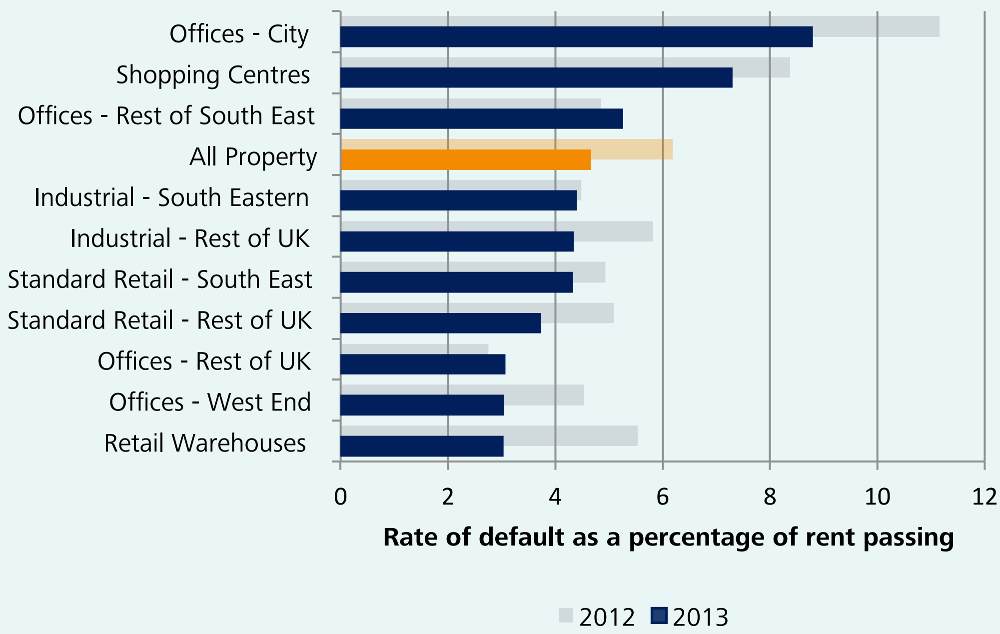
Despite recent signs of improvement, rates of default remained above the long-term averages for retail, office and industrial property, with significant volatility evident since the market crash of 2008. However, the rate of default has varied significantly between location and property type. Offices in the City, dominated by financial occupiers who have aggressively rationalised their businesses over recent years, had the highest rate of default in 2013 at 8.8% of passing rent, although this was an improvement from 10.9% in 2012. As in previous years, this was primarily due to a number of large, strategic defaults by major firms restructuring and rationalising their City operations. Conversely, offices in the neighbouring West End had the lowest rate of default for the office sector at 3.0%.

As in previous years, offices outside London and the South East showed a lower rate of default, at 3.1% of rent passing, although this reflected a modest increase from the 2.8% exhibited in 2012 - making this segment one of only two locations to have recorded an increase (along with offices in the South East). Historically, and despite weaker economic fundamentals, offices outside London have shown consistently lower levels of default. Much of this is due to the fact that regional offices have a disproportionate number of government and semi-state occupiers.

In the retail sector, shopping centres had the second-highest rate of default at 7.3%, encouragingly down from 8.4% in the previous year. This segment, being heavily reliant on consumer confidence, has had a high default rate since the economic downturn began in 2008.

The high rate of default in locations such as the City and among shopping centre tenants may seem surprising, but given the economic sensitivity of occupiers in these markets and associated high turnover levels, their volatility (both for total return and default rate) has also been high historically. In fact, the long-term average default rate (12-years) for all UK property is 3.6% of passing rent, against the City's rate of 3.9%, while shopping centres show a higher figure of 4.7%.

Figure 17: Tenants in Default by Type and Location



Note: Tenancies weighted by rent passing

Source: IPD, D&B

Conclusion

Our combined Lease Review and Lease Events 2014 report again illustrates occupiers' ongoing demand for short leases. Company culture and requirements often change faster than the buildings they occupy, and the inherent need for flexibility is something that our industry continues to adapt to. The 2014 analysis shows that the average un-weighted lease length is 6.8 years. Again, on an un-weighted basis, 78% of new leases granted to date in 2014 were for a term of five years or less. The weighted picture is different: although sub-10 year leases still make up 52% of the market, the fact that 47% are over 10 years in length implies that, both for larger spaces, and perhaps those which benefit from high levels of CapEx for fit-out, occupiers still seek long leases.

The data shows a mixed picture on lease renewals and vacancies at expiry, very much reflecting the broad cross section of geography, sector and quality of stock within the IPD universe sample. On a weighted basis, 52% of leases expiring were left vacant in the following quarter, down from a high of 60% in 2012.

Occupiers have been sitting tight now for some years as they determine their ongoing space and headcount needs in uncertain economic times. Alongside renewed confidence in economic growth during 2014 we have seen a surge in activity as companies move into better quality or more appropriate space on lease expiry. It is perhaps therefore no great surprise to see that offices have one of the highest levels of immediate vacancy following expiry. However, the environment is more complicated as renewals weighted by rent show 39% of occupiers choosing to renew their leases. In areas where rents are rising, there is a strong incentive to renew.

What does this mean for investors? The shortening of leases over the past two decades represents a major structural shift – albeit one that now appears to have found its floor. As the market pays a premium for increasingly rare, bond-like long income, the opportunity remains to take advantage of the most dynamic tenant market of recent years and the shorter leasing it demands. Understanding what occurs at lease outcome is now fundamental to investment appraisal, especially given that future technological shifts all point towards a future of ever more flexible and fleet of foot occupiers. The ability to manage the risk in a portfolio of shorter income tenants puts renewed pressure on asset managers, but has the upside that companies are willing to pay more for the flexibility they require.

Again, we thank IPD for their continuing analysis which brings much needed clarity to the question of income risk for those who invest in UK property.

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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* INREV/ANREV Fund Manager Survey 2012
** MSCI 2013