UK LEASE EVENTS REVIEW

NOVEMBER 2015

Prepared by MSCI in association with Strutt & Parker

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SPONSOR'S FOREWORD

Now in its 17th year, we are proud to have sponsored the lease events element of this report since its inception. In recent years we have joined forces with the BPF and incorporated information on new leases, allowing us to present the full spectrum of UK tenant behaviour in one report.

In its entirety, the report gives us the ability to consider outcomes when lease events occur (be they expiries, tenant break options, or tenant defaults), and the likely terms of new leases in the aftermath of those lease events. Thus giving investors a strong insight into the future cash flows from their property investments. The ability to drill down to different sectors and geographies allows investors to take this analysis further, looking in detail at the variable lease event outcomes and new lease lengths of the various segments.

Over the long-term the UK property market has transitioned from 20-year plus leases to an average lease length of just over seven years in the first half of 2015. Although we have seen a recovery from the depths of the market in 2009, where the average new lease was for just six years, we continue to consider the shift to shorter leases a 'structural change' and don't expect new lease lengths to trends upwards to any significant degree as occupier demand grows.

Indeed, in the past year we have seen serviced office operators catapulted into the limelight as they take increasing amounts of space, often being the first to prelet major office developments in London. Whilst they themselves are signing leases of up to 20-years, this of course disguises the fact that the underlying demand for their services is from occupiers taking on much shorter commitments – something not picked up in the data. On the retail side, major landlords are increasingly looking to pop-up retail to not just fill empty space, but actually act as a key plank of their footfall strategy – with today's consumer always looking for a new and unique experience.

Looking forward, with yields at historically low levels, particularly in prime segments, and the consensus suggesting a turning in the interest rate cycle sometime next year, investors' ability to maintain and grow property income will be key to driving returns. The rental growth outlook certainly appears strong for the next five years, and not just in central London. It will be those investors that take a realistic view on lease events, and plan appropriately for their outcome and aftermath, with a focus on the underlying drivers of demand, who will succeed as the property cycle moves into its next phase.

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

STRUTT & PARKER

Andy Martin

INTRODUCTION

The UK economy transitioned to a growth phase from a recovery mode through the latter half of 2014. The recovery broadened, finally spreading beyond the borders of the M25, with regional businesses and property markets experiencing significant improvements.

The year to-date in 2015 has provided further economic growth, albeit at a slower pace. The UK economy appears to have moved into a period of relative stabilisation, despite the general election in May and a China-fuelled shock to global stock markets during summer. The level of economic growth may have been modest recently, but improving employment levels and the much-awaited boost to real earnings have reinforced the positive narrative.

Inflation still remains a challenge as price growth continues to be well behind the Bank of England target rate and interest rate hikes are likely to be stymied by concerns for economic growth through 2016 and 2017. Global concerns also weigh heavily on the UK market outlook. Slowing growth in BRIC nations, especially China and Brazil, will affect UK trade expectations and the upcoming European Union referendum remains “the elephant in the room.”

The broadly positive economic news in the UK, in conjunction with a growing appetite by would-be tenants for business space, has fuelled improvement in the commercial property investment market. Investor confidence remains high, pushing yields down to record lows in buoyant markets such as London and strengthening prices for the majority of property markets across the UK.

The growing confidence in the economy has also boosted occupiers’ sentiment, helping lease terms stabilise and strengthen, as risks associated with lettings subside for many parts of the market.

In addition, growing demand from tenants for space, have enabled landlords to demand longer terms and reduce incentives as the UK market edges towards normality not seen since pre-2007.

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

This MSCI Lease Events Review for 2014 and to June 2015 provides empirical evidence of the likelihood of the different lease events and their outcomes. The analysis was based on a sample of more than **82,200** extant leases held in the IPD UK Annual and Quarterly Property Universe and **9,170** new leases signed over the last year.

The report examines the influence of three key lease events on the property investment market; the effect of expiries, the impact of break clauses and the change in rental conditions upon lease renewal. Each of these factors have a direct effect on lease conditions and are intrinsically linked to the broader economic landscape and improvements in business activity, as well as to exports and consumer trends.

REVIEW OF NEW LEASES IN 2015

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 further 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 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 for most commercial property sectors, albeit for a shorter total term as tenants push for greater flexibility.

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

The section will firstly look at the average lease length and how this has changed over time. It will then look at incentives such as break clauses and rent-free periods and how these have changed over time. It will then round up with a look at how income positions have changed in the market follow lease negotiations so far in 2015.

HOW HAVE LEASES CHANGED THIS YEAR?

During the first half of 2015, by the total number of leases granted in the UK market, the average lease term agreed was 7.2 years. This shows a further lengthening, for the fourth consecutive year. Average lease lengths have grown by close to 20% since the bottom of the market when an average of 6.0 years was recorded. This follows the broader trend of recent years, in tandem with the economic recovery, where leases have lengthened due to supply issues and growing confidence amongst occupiers competing for space.

However, despite lengthening lease terms, most leases signed in the UK were still considered to be short. On an un-weighted basis, close to three quarters (73.1%) of new leases granted to date in 2015 were for a term of five years or less. The un-weighted analysis counts all leases equally, regardless of the size of the contracted rent and ignores break clauses.

As such, it is a representative indicator of market leasing in the UK as a whole.

The distribution of lease lengths shows how rare leases over 10 years have become in the UK market with the diminishing trend continuing for leases longer than 15 or 20 years. Sub-10 year leases made up 92.4% of leases signed in the first six months of 2015, with just 3.1% of leases over 20 years in length.

When weighted by passing rent, the long-term trend of lease lengths shortening remains but the distribution differs significantly as larger buildings with larger rents tend to have longer leases. The average contracted lease length agreed in the UK, weighted by passing rent, in the first half of 2015 was 11.5 years. This is unchanged from the 2014 average.

AVERAGE NEW LEASE LENGTHS TO 2015 (UN-WEIGHTED)

FIGURE 1.1

Un-weighted lease length distributions

Percent of new lets in each lease length band

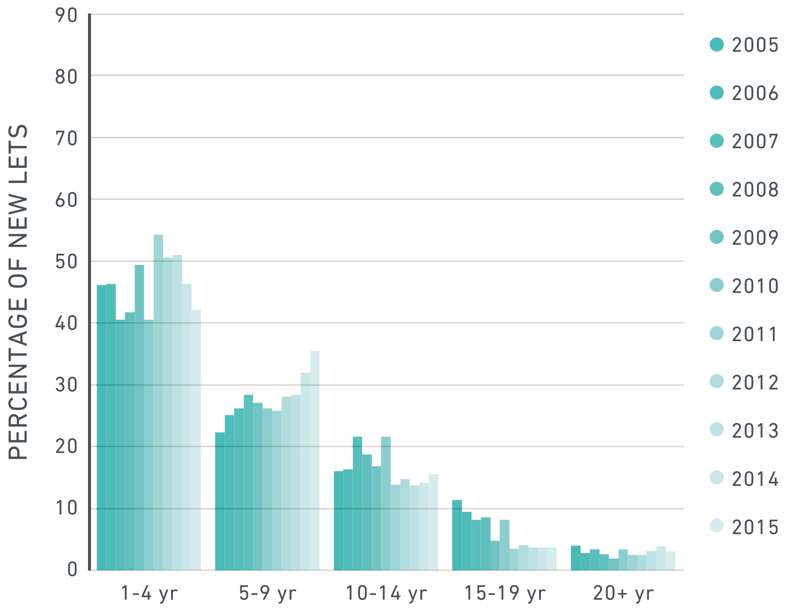
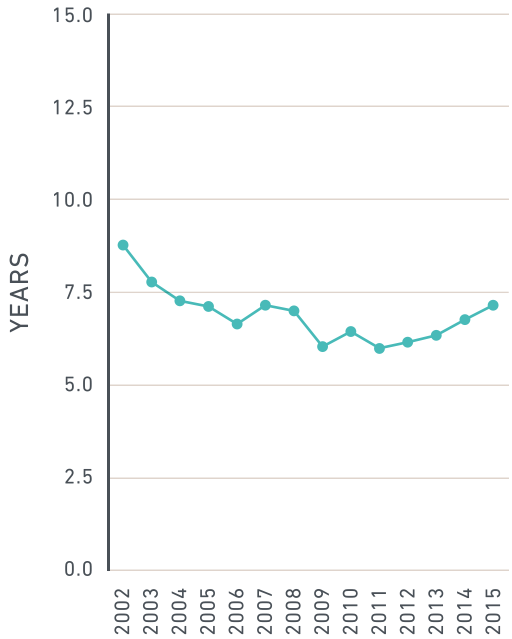


FIGURE 1.2

Un-weighted lease length

New lettings



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

Source: MSCI

Nonetheless, when weighted by rent, short leases (sub-10 years) almost make up half of leases signed. In the first six months of 2015, 48.3% of leases were less than 10 years in length; this is consistent with recent years and broadly unchanged from the 48.4% proportion noted in 2014. As the UK market has recovered, landlords have pushed for longer lease terms from tenants, reversing the shortening trend which was prevalent during the market crash. When the market bottomed out in 2009, average weighted lease lengths fell as low as 10.0 years (6.0 years un-weighted), before subsequently recovering.

In the first half of 2015, leases over 10 years, still represented over half of the lettings market for commercial property when weighted by passing rent. This percentage has fallen to 51.7% in 2015 from two-thirds of the market in 2004 (66.4%). Longer, traditional leases (20+ years) accounted for 20.1% of the market in 2015, up from 17.2% in 2014 on a rent weighted basis. However, with all leases weighted equally (un-weighted) this falls as low as 3.1% of the market. This reinforces the view that larger tenants prefer longer leases, whereas smaller tenants have a strong preference for increased flexibility.

AVERAGE NEW LEASE LENGTHS TO 2015 (WEIGHTED)

FIGURE 2.1

Weighted lease length distributions

Percent of new lets in each lease length band

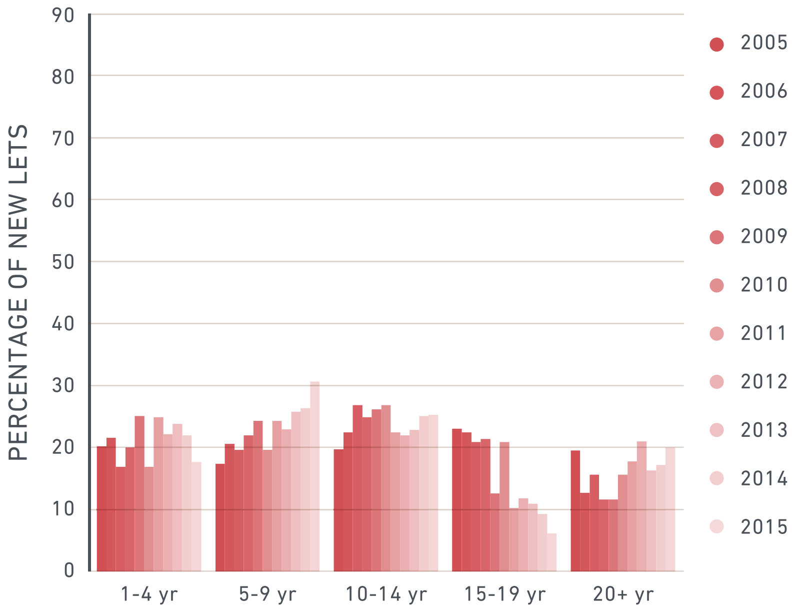
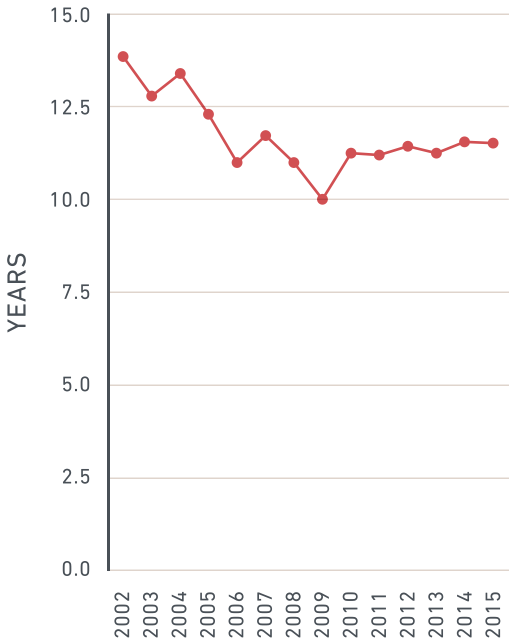


FIGURE 2.2

Weighted lease length

New lettings



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

Source: MSCI

When examining leasing trends on a sector level, we see a consistent divergence in lease terms due to differing property management requirements for the different sectors. For example, office tenants are relatively flexible in terms of location, as they are able to relocate quickly and efficiently, whereas retail tenants are often tied to a location because of their consumer base or target market.

Comparing the three main sectors (retail, office and industrial) for the current year 2015 on an un-weighted basis (all tenancies equally weighted) the analysis shows that leases across all sectors have lengthened. Retail leases remain the longest on average and industrial the shortest. However, industrial leases signed in 2015 to-date are the longest recorded since 2002, further evidence of the sharp recovery in tenant demand for manufacturing and warehousing space.

Since 2009, when the market was at its lowest ebb, retail leases, on an un-weighted basis, have changed from an average length of 6.2 years in 2009 to 7.5 years in length by 2015. In weighted terms (by passing rent) this stretches to 11.6 years. Retail leases are traditionally longer than other sectors for several trade specific reasons. Supermarkets and retail warehouses tenants — the latter making up a significant portion of the overall retail sample — tend to prefer long leases given costs associated with fit-outs as well as the need to build a consumer base at their chosen location.

Leases granted on retail warehouses have consistently been three to 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

Un-weighted full term, ignoring any breaks, including short leases

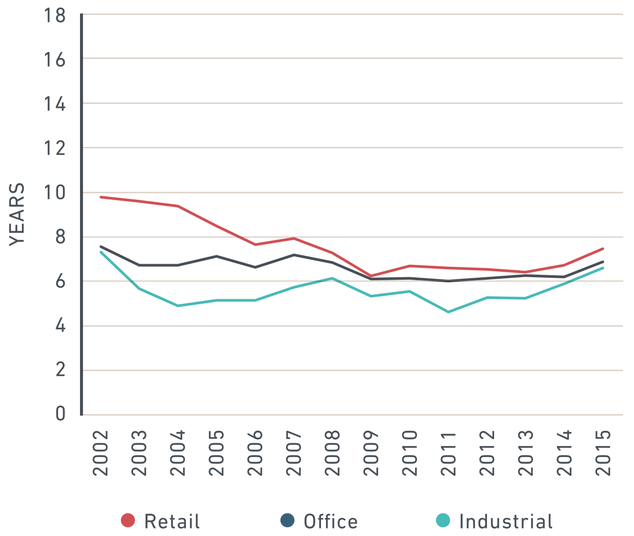
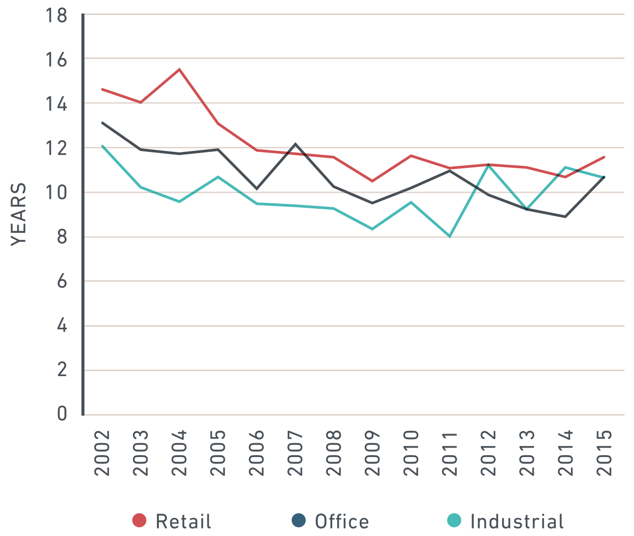


FIGURE 3.2

Average lease length trends by sector

Weighted full term, ignoring any breaks, including short leases



Source: MSCI

Office lease lengths have strengthened consistently, albeit marginally since a low of 6.0 years in 2011, on an un-weighted basis, and have since risen to 6.9 years. When weighted by passing rent, office lease lengths are considerably stronger mostly due to the desire for larger tenants to minimise disruption caused by new lease or relocation. More recently, the office space market has shifted from being a tenant's market to a landlord's market, particularly as demand surges in locations such as central London. This has further pressured larger tenants into accepting less flexible lease terms. However, leases for the office sector remain short compared to long-term trends.

Average lease lengths for the UK office sector have fallen from an average of 20 years in the early 1990s to an average of seven years since the dotcom bubble burst in 2000.

The reduction in lease length in the office sector has been driven by a shortening of leases in central London in particular, as tenants move for more flexible terms more in line with trends in the rest of Europe and North America. However, there has also been a clear stabilisation in lease lengths in the last decade, following the sharp contractions of the 1990's.

On a regional basis, offices located outside of London, and particularly those in the South East of England have seen leases lengthen the most. The South East has performed particularly strongly, both in terms of economic growth and real estate investment performance, as the location reaps the benefit of being on the hinterland of a buoyant London, despite this lease terms remain shorter given the pre-dominance of small and medium enterprises (SME's).

Average un-weighted office lease lengths in the South East rose to 6.1 years in 2015, London remained at an average of 6.3 years, whereas the rest of the UK recorded an average office lease term of 6.2 years.

Industrial leases have lengthened in 2015 on an un-weighted basis, although contracted marginally when weighted by passing rent. This sector had fared the worst during the downturn as average un-weighted lease lengths fell as low 4.6 years in 2011, but have since recovered to an average length of 6.6 years in 2015. Similar to the office sector, the flexibility of industrial tenants means that terms tend to be shorter, however this varies significantly within the sector and particularly for tenants who have high-cost fit outs or installed plant and machinery. When weighted by passing rents average industrial leases fell marginally in the first half of 2015 to 10.7 years from 11.1 years in 2014.

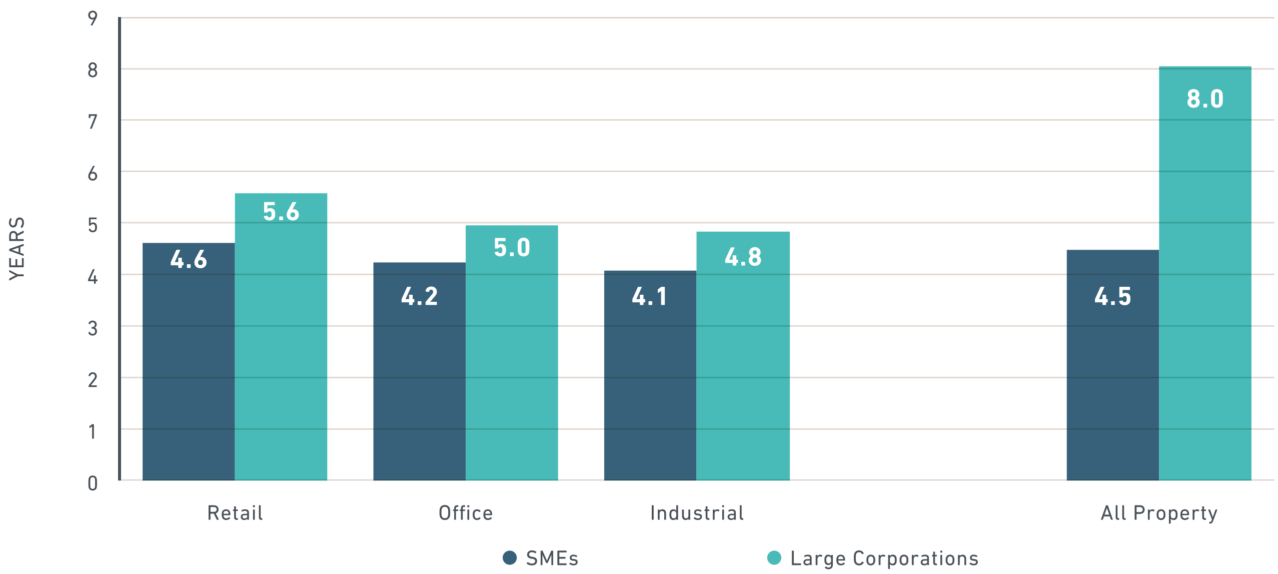
In addition to examining leasing trends by sector and location, this analysis includes leasing trends for small and medium enterprises (SMEs) versus trends of large corporations. Given the respective space requirements, large corporations have tended to have longer average lease terms. This trend is consistent across all of the traditional property sectors.

On an un-weighted basis, the average office lease signed by an SME in the first half of 2015 was for a period of 4.2 years, compared to an average of 5.0 years for large corporations. On a weighted by passing rent basis, lease lengths for SMEs had edged close to those of large corporations in 2014, averaging 5.9 years for offices compared to 6.0 years for large corporations. This gap widened to 1.7 years in 2015 as a limited supply of large floor-plate office space pushed larger companies to take on longer commitments.

FIGURE 3.3

Average lease length trends by tenant type

Un-weighted 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 affecting 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, has meant that demand for commercial space can often outstrip supply at certain locations and sectors. This has been further exacerbated by the dearth of speculative developments outside London since the market crash of 2008.

As occupier demand rises in line with the resurgent UK economy, many landlords are forecasting future income growth with the expectation that rent-free periods would shorten and the percentage of leases with break clauses would diminish. However, as of June 2015, this analysis has shown that while rent-free periods are decreasing across all sectors, tenant break clauses are a firm facet of the UK leasing landscape. Over one-third (37.3%) of all leases signed to-date in 2015 have included a tenant break option, rising marginally from 37.0% in 2014.

The occurrence of break clauses in shorter lease agreements (one to five years) has fallen significantly in the last three years, but they remain a prominent feature within longer lease agreements.

Break clauses were included in 24.7% of commercial leases with a term of one to five years in 2015, down from 30.3% in 2012, when the economy had fallen back into recession and vacancy levels remained high.

This underlines both the growing demand for short-term space from occupiers and the flexibility now expected as standard even by short-term tenants. As a result, landlords have been less generous with other incentives, such as rent frees.

Break clauses are most common in leases 6-10 years in length with 57.8% of such leases including a tenant break option. This is higher for office sector leases where 66.7% of 6-10 year leases include a break clause and lowest for the retail sector where less than half of leases, at 48.5% include such an option. Overall, 37.2% of new leases signed in 2015 included tenant break clauses. Across the sectors, it is more common for office (43.0% of leases) and industrial (41.9% of leases) to have break clauses than retail (31.0%).

Alongside break clauses, rent-free periods remained a popular feature in UK leasing. In new leases signed in the first half of 2015, the average rent-free period included was 7.3 months (un-weighted basis) for All Property, having grown during the market downturn as landlords were keen to avoid vacancy. The average rent-free period in the UK market during 2014 was 7.7 months.

PROPORTION OF LEASES WITH BREAK CLAUSES BY SECTOR

FIGURE 4.1
All Property
Leases with break clauses

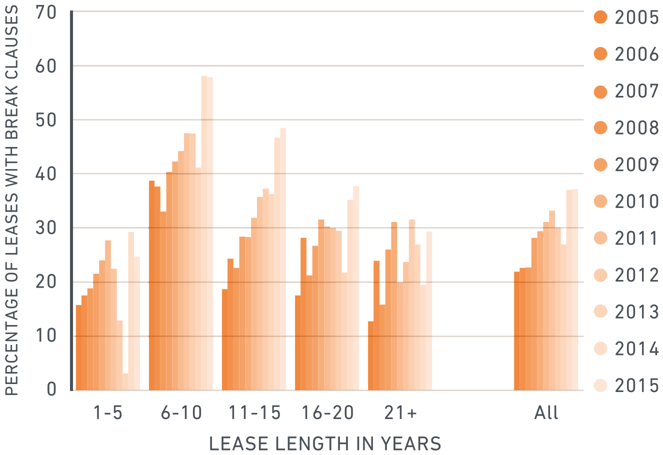


FIGURE 4.2
Retail
Leases with break clauses

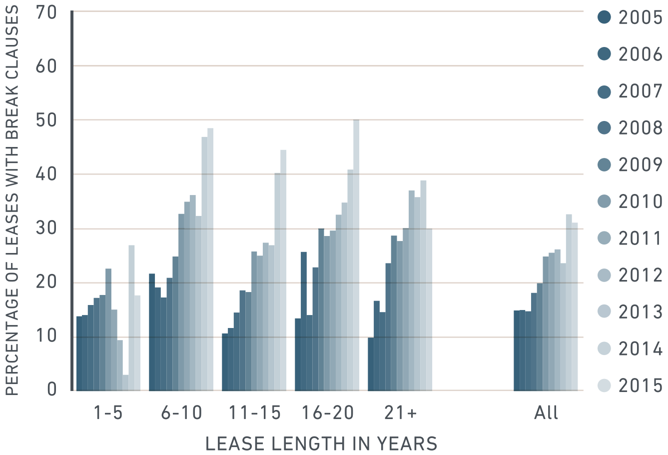


FIGURE 4.3
Office
Leases with break clauses

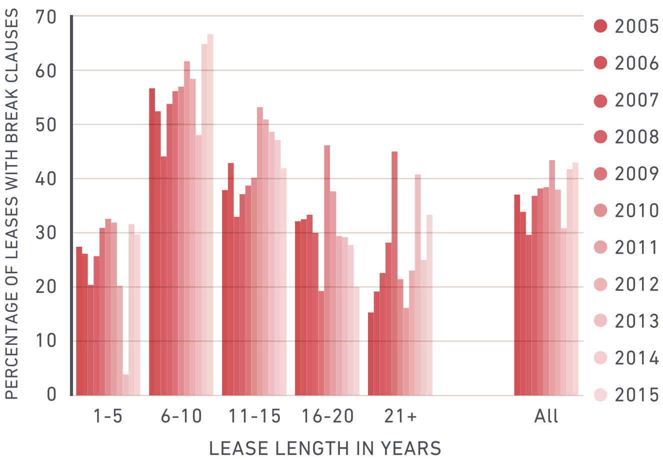
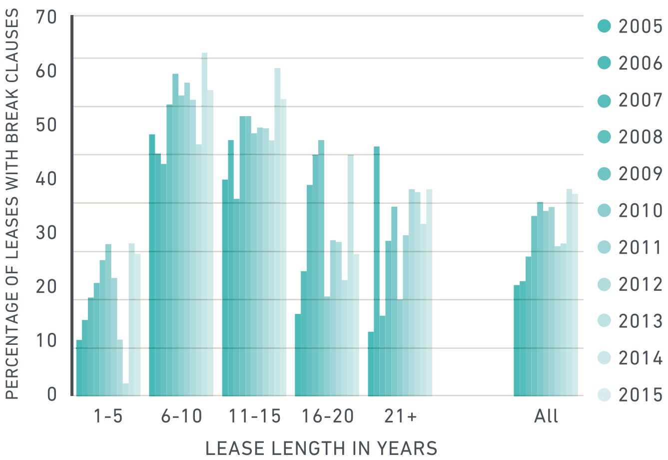


FIGURE 4.4
Industrial
Leases with break clauses



Source: MSCI

Rent-free periods remain a prevalent feature of all three sectors, however with increasing occupier demand; the length of these incentives has fallen in each of these market sectors.

Rent-free periods have traditionally been a feature most common in office leases, but retail and industrial leases have increasingly included such an incentive. The fluctuation in rent-free periods is highly cyclical, with average lengths increasing in a weaker economic environment as many landlords incentivise generously to prevent vacancy.

In 2015, rent-free periods for offices remained the longest at an un-weighted average of 8.6 months, down significantly from 9.7 months in 2014. Rent-free periods for office leases reached the highest ever recorded in 2010 at an average of 11.4 months, highlighting how much letting conditions have improved for landlords since then. Average rent-free periods also fell for the retail sector, to 7.3 months from 7.5 months. The industrial sector saw a similar decline from a 6.4 to a 6.0 month average rent-free period.

AVERAGE RENT FREE PERIODS BY SECTOR

FIGURE 5.1

Average rent-free periods by Sector

Tenancies equally weighted

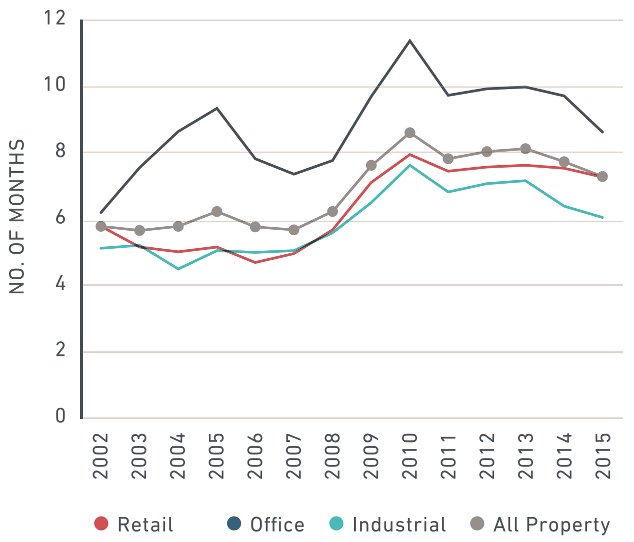
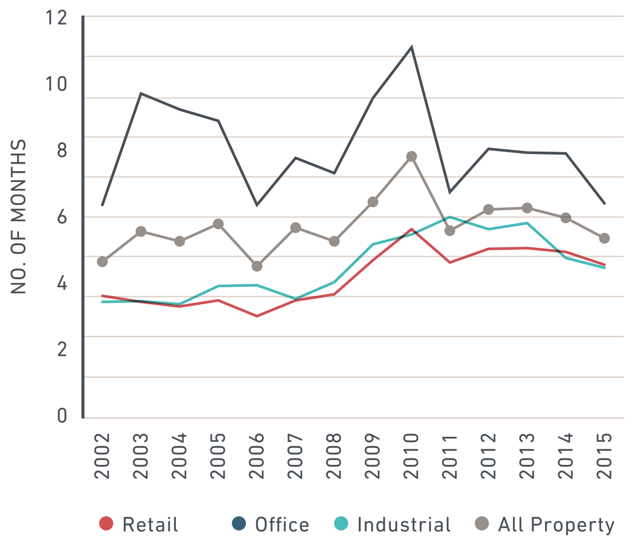


FIGURE 5.2

Average rent-free periods by Sector

Tenancies weighted by rent passing



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

Source: MSCI

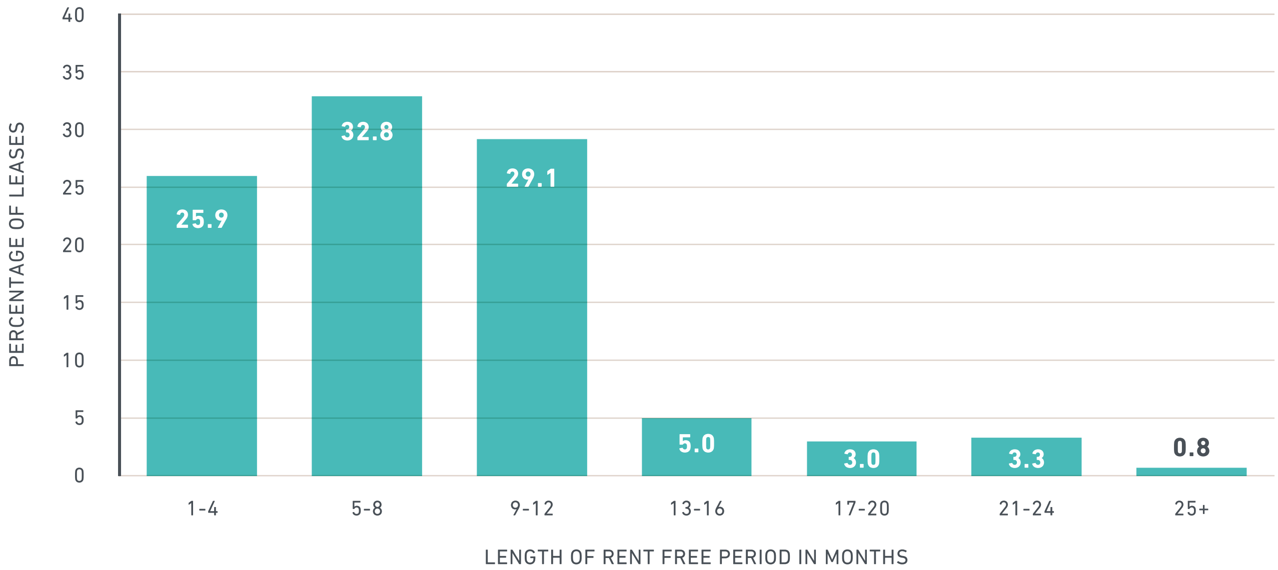
The distribution of rent-free periods shows, that as would be expected, rent- free periods of less than 12-months dominate each of the key sectors. For the retail sector, 90.6% of rent- free periods are less than 12-months long, and of that, 30.7% are less than four months.

The office sector deviates slightly from the retail sector with 81.4% of rent-free periods being less than 12 months, although the office sector has the largest proportion of longer rent-free periods, with 18.6% above 12 months in length. The industrial sector closely replicates the retail sector, with 94.6% of rent-free periods less than a year in length.

FIGURE 6.1

Distribution of rent free periods for retail

Tenancies weighted by rent passing

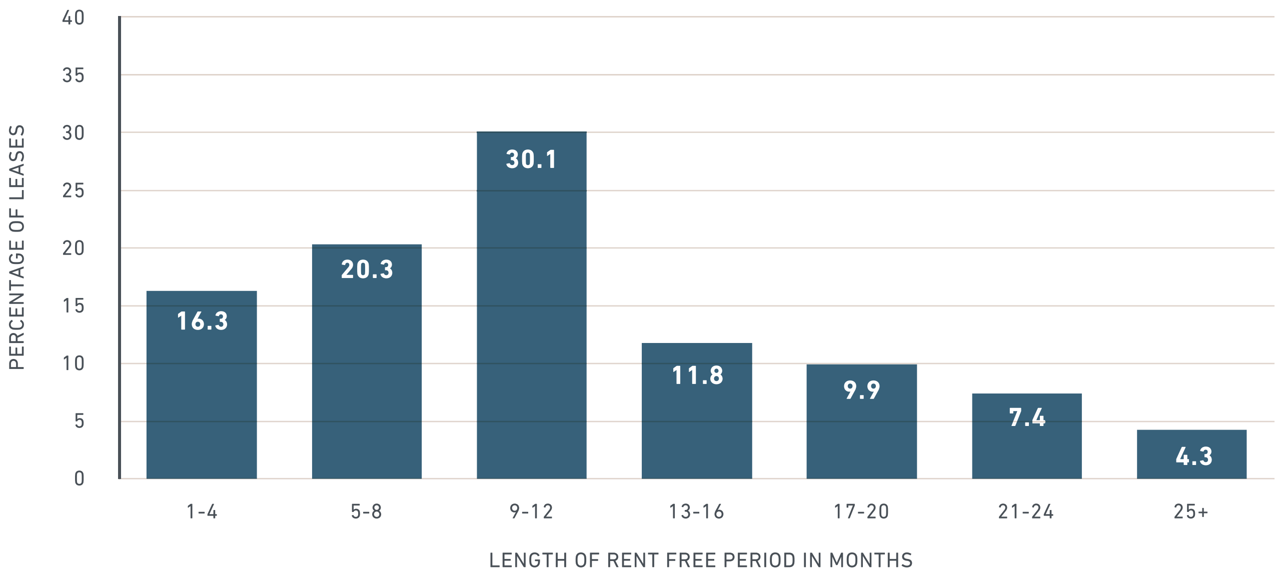


Source: MSCI

FIGURE 6.2

Distribution of rent free periods for office

Tenancies weighted by rent passing

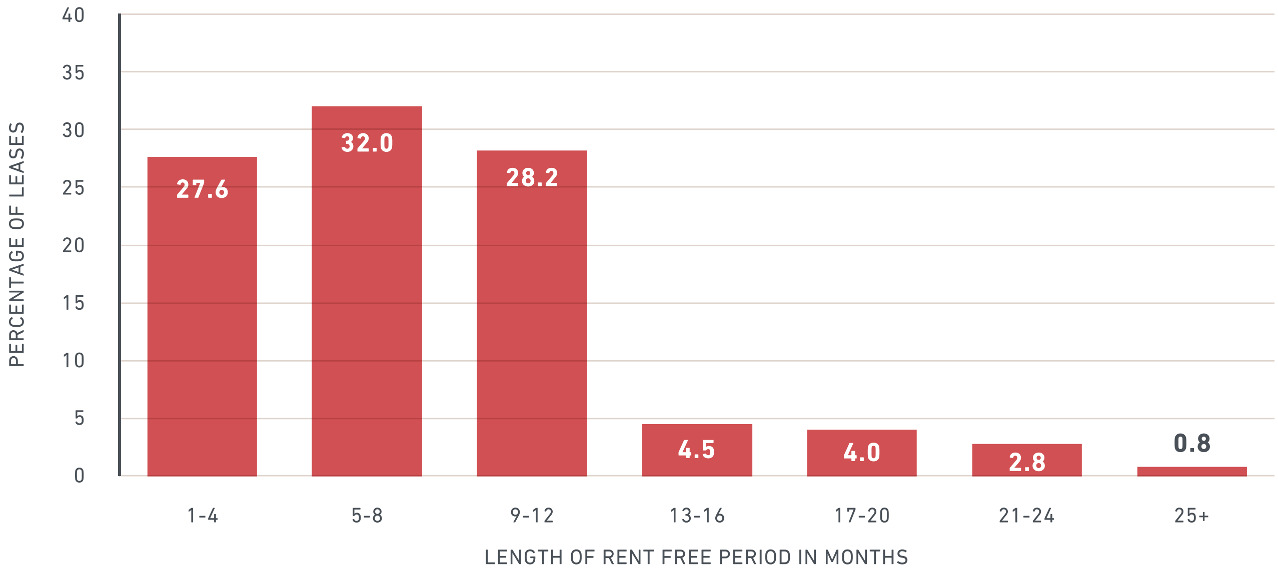


Source: MSCI

FIGURE 6.3

Distribution of rent free periods for industrial

Tenancies weighted by rent passing



Source: MSCI

INCOME SECURITY AND POTENTIAL FOR GROWTH

The graph below summarises the income position for current leases in 2015 given the portfolios in the MSCI UK lease database. Top-slice represents income that is at risk due to over-renting, while reversionary potential represents income available for the portfolios due to rental value growth in the analysis period of January 2014 to June 2015.

In terms of security of income in the broader UK market, 7.2% of income is at risk due to over renting (top slice). Of the traditional property sectors, retail is most over-rented at 8.5% of rent passing, compared to 5.4% for offices and 5.8% for industrial. All of the market sectors saw a decline in the level of over-renting between June 2014 and June 2015 as the growth in market rental values narrowed the income gap.

Vacancy and voids offer the most potential on letting for income growth at over 4.8% at the All Property level. Given the high level of vacancy in certain office locations across the UK, and even in key locations such as the City of London, this sector offers the highest potential income uplift upon letting of vacancy/void space at 14.9%. Likewise, income potential from current developments is driven by offices, which, despite having the highest vacancy, had the largest proportion of income tied up to developments at 6.4%.

The retail sector offers the least potential for income growth with reversionary potential of only 4.8% and income in developments of 1.4%.

However, the vacancy rate of 4.8% for the retail sector is significantly below the all property average of 8.0%, which arguably puts investors in a better position as demand picks up with improving consumer and economic conditions.

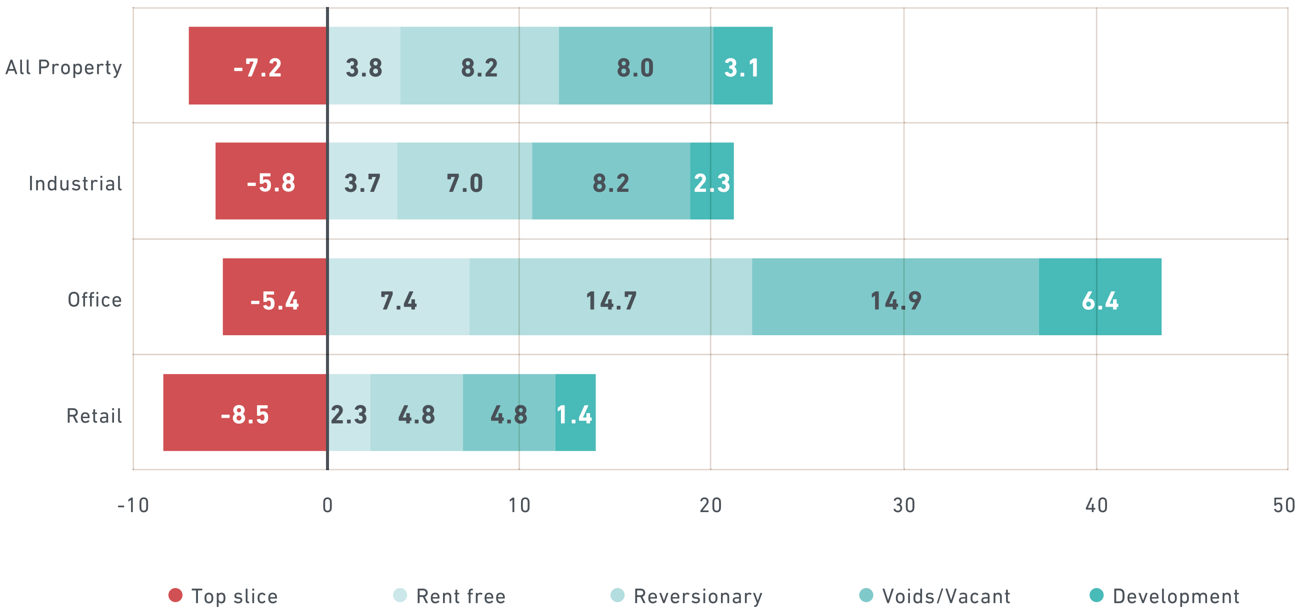
The industrial sector retains a high level of potential income tied to vacancies, at 10.3% and this could be further boosted by income growth due to a reversionary uplift of 5.3% upon review.

The industrial sector also benefits from the lowest level of over-renting, at 6.3% of income, compared to the 8.3% of top-slide income at risk in the retail sector, and 8.1% in the office sector.

FIGURE 7

Security of income & growth potential by sector

Percentage of total rent passing



Source: MSCI

THE IMPACT OF LEASE EVENTS IN 2015

This section examines the role played by occurrence of lease events and their impact on investor income. It will first look at the behaviour of properties as leases edged towards expiry, particularly the renewal rate of tenants. It will then look at 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 at Sector and Location level.

Finally, this section will round up with a look at the effect of tenant default on an investor's income position. The period analysis is the calendar year 2014 with data sourced from the IPD UK Annual Index.

This analysis is split into 'un-weighted' which is simply the number of leases in this analysis 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 level of income under risk or lost upon expiry.

WHAT IS HAPPENING ON EXPIRY

The period post-2008 market crash had seen a consistent worrying trend in terms of the outcome of lease expiries for investors, further cautioned by economic and confidence difficulties for occupiers. The majority of properties in this analysis fell vacant upon lease expiry, and that trend has continued in 2014 with 48% of leases (un-weighted) 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 for those who signed at times of record rent and who are now paying on an over-rented basis. As a large proportion of such expiries result in a vacant property, many landlords will agree to revised terms, including rental abatements.

TABLE 1

Outcome of lease expiring in 2014 for All Property

	Un-weighted	Weighted
Renewed	**43%**	**34%**
New Letting	**9%**	**7%**
Vacant	**48%**	**58%**

Source: MSCI

FIGURE 8

Vacancy Rate for Leases Expiring 1998-2014

Tenancies weighted by rent passing

Source: MSCI

The vacancy rate for leases expiring in 2014 was 48% un-weighted (counting all leases equally) and rose to 58% when weighted by previous rent passing. This vacancy rate has now been above the 16-year weighted average of 47% since 2009, although improved from a high of 60% (weighted) of leases expiring in 2012, but deteriorating from the 52% posted in 2013.

Of leases expired in 2014, a small portion, 9% (un-weighted) of the total, was re-let in the same quarter the previous lease expired. Weighted expiries produced a marginally better figure of 7%. For renewals, the market weakened from 2013, as the renewal rate fell to an un-weighted 43% in 2014 from a 49% the year prior.

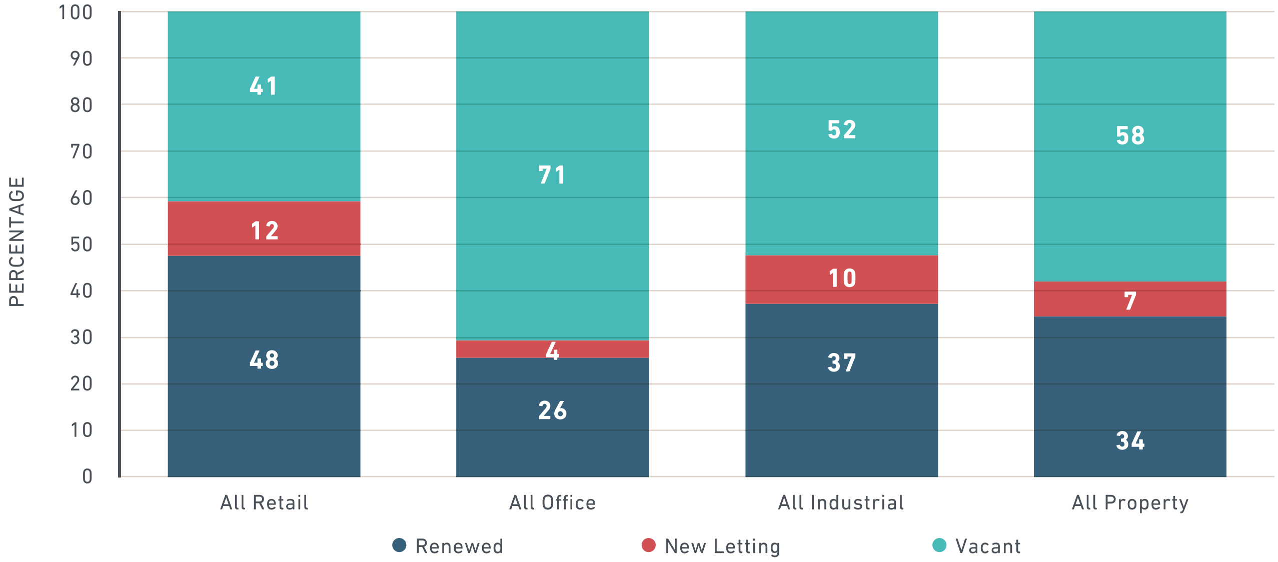
The expected boost in appetite for tenants to renew expired leases due to increased competition for space in a growing economy remained elusive, despite a small improvement in 2013. When weighted by rental income 43% of tenants chose to renew their leases in the same quarter as the expiry occurred. This was above the 17-year average of 38% suggesting that the market is beginning to experience more normalised conditions, but still a long way off buoyant occupier demand. A breakdown of these figures is shown in Table 1.

Sector level analysis shows that the office sector has the highest level of immediate vacancy, both weighted (71% of leases) and un-weighted (59%), when leases expired in 2014.

FIGURE 9

What happened when leases expired in 2014 (Weighted)

Tenancies weighted by rent passing



Source: MSCI

Vacancy rates for both calculations rose between 2013 and 2014, and remain considerably above the long-term average.

Retail had the lowest vacancy rate, but this is a common trend as retailers mostly want to remain on the same pitch. Nonetheless, like the office sector, the rate of vacancy upon expiry rose over the last year. The retail sector also had the strongest new lettings performance. Nonetheless, this still represented a small portion of the market at 12% of weighted leases with the most common outcome, like the rest of the market, being vacancy. Un-weighted (counting all leases equally) the new letting rate fell to 8% for the retail sector, remaining below the 25% long-term average for the fifth consecutive year.

The office sector saw the highest vacancy rate upon expiry and the lowest renewal rate. While the retailer preference is often to remain on an established trading location, the office sector is much more flexible with office tenants tending to be less attached to particular buildings or locations than retailers would be. The high vacancy rate also highlights the attractive options and deals available to office tenants, particularly those outside of central London who are leaving older, often obsolescent, buildings for modern space. Given that many of these occupiers may have signed leases at rental levels higher than current levels, they can often avail of improved terms and conditions at other locations, so tenants often have a 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 clause aiming to work their way out of an over-rented position.

Rents are now recovering in key locations, as the broader UK economy improves. Certain locations, such as central London, 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 in securing favourable buildings and terms elsewhere. As a result, the percentage of tenants choosing not to exercise their break option rose further in 2014.

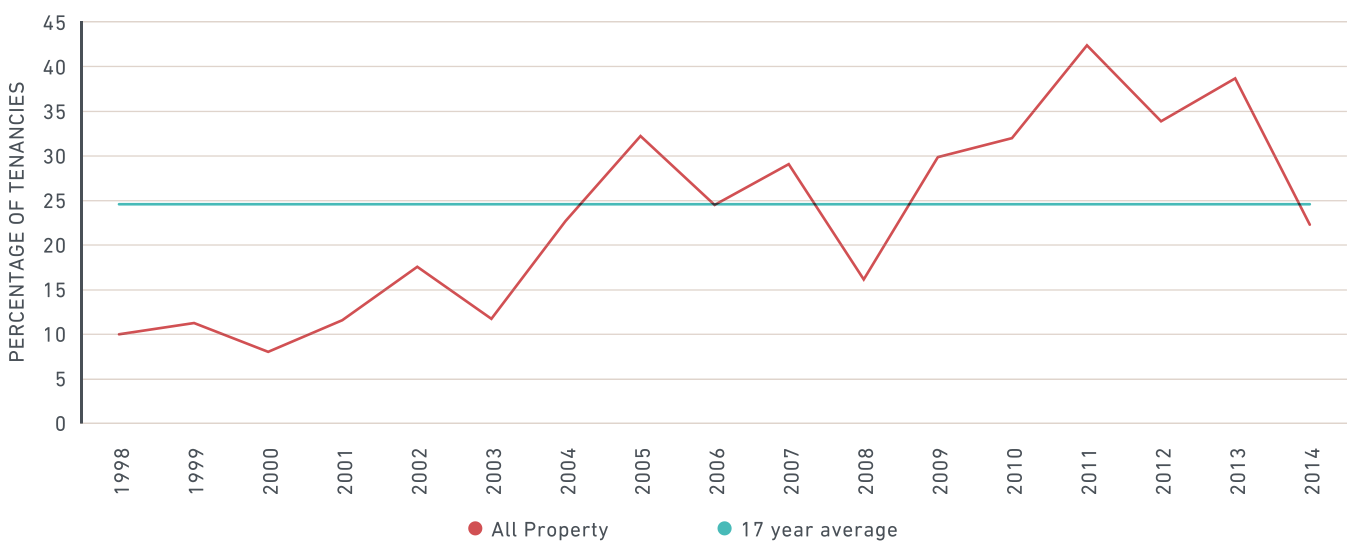
Table 2 reveals the results of the number of tenants for All Property who had the right to break in 2014. This is analysed on a weighted basis by previous passing rent (weighted) and by number of leases (un-weighted).

TABLE 2
Outcome of leases with a break occuring in 2014

	Un-weighted	Weighted
Break Not Exercised	**71%**	**72%**
Exercised - Re-let	**6%**	**6%**
Exercised - Vacant	**24%**	**22%**

Source: MSCI

FIGURE 10
Vacancy Rate for Exercised Break Clauses 1998-2014
Tenancies weighted by rent passing



Source: MSCI

The significant economic improvements and a broad pick-up in rental values for commercial space helped the vacancy rate due to exercised break clauses fall to its lowest level since 2008. This translates as 24% (un-weighted) of units remaining vacant for a quarter or longer a break arose and exercised. In 2013 the vacancy rate was 28% significantly above the long-term average of 18% of leases where a break option was acted upon.

When weighted by previous rent passing, the vacancy rate falls moderately, highlighting the limited supply of larger areas of commercial space, particularly well-located offices in London and other cities. As a consequence, the post-break vacancy rate fell dramatically to 22% in 2014 from 39% in 2013 in tandem with improved market conditions. The decrease on a weighted and un-weighted basis is a welcomed shift in the vacancy trend for post-break outcomes in the UK market. This will provide some comfort to investors who can look forward to further improvements as occupier demand for space grows.

However, while the vacancy rate has improved significantly over the last year, the re-letting rate has fallen for both weighted and un-weighted analyses. The re-letting time for units is a key indicator of occupier market confidence, but also reflects the quality of space coming onto the market once the previous tenant opts to break.

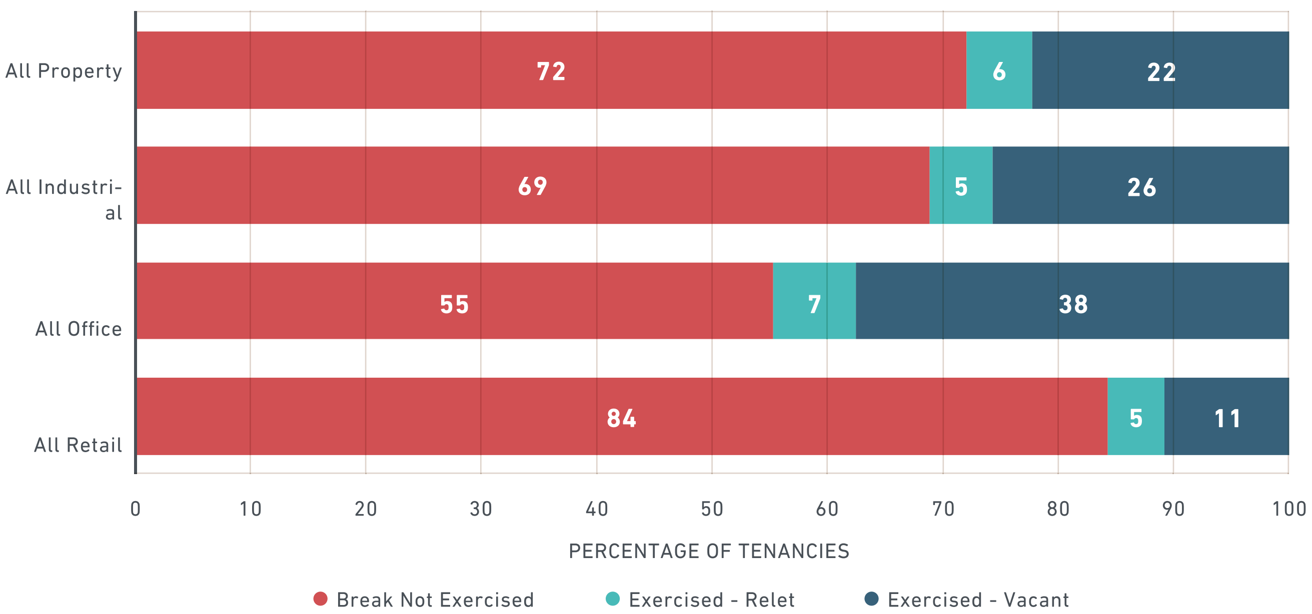
The decline in re-lettings may reflect location or specification obsolescence in commercial space coming to the market and as a result, the vacancy rate may be artificially higher as landlords refurbish or renovate. In 2014, 6% of units re-let immediately after the previous tenant opted to enforce a break option, a fall from the 8% rate recorded in 2013.

When examined on a sector level, there is again a broad divergence in the post-break outcomes for break clauses that occurred in 2014. Given the preference for retail tenants to remain at established trading locations, the break clause action rate tends to be lower than in other sectors, this was no different in 2013 with the lowest rate of any sector.

FIGURE 11

Break Clause Actions (Weighted)

Tenancies weighted by rent passing



Source: MSCI

When weighted by previous passing rent, only 16% of retail tenants chose to exercise their break options when they arose in 2014, which is still below the 22% long-term average.

Offices continued to record the highest rates of tenants exercising breaks at 44% un-weighted and 45% weighted. Of these rent-weighted break clause actions in the office sector, 38% were vacant for at least one quarter following the break being enforced, the highest recorded for the main property sectors in 2014. The long-term average post-break vacancy rate for offices is 32%, with the 2014 figure of 38%, the second highest vacancy rate recorded in the history of this analysis.

The industrial sector saw 31% (un-weighted) of tenants activating their break options in 2014 in their lease over the course of last year. Only 5% of these buildings were promptly re-let and 26% remained vacant for more than one quarter post-break.

Break clause action rates varied by location, but not by as much as in previous years.

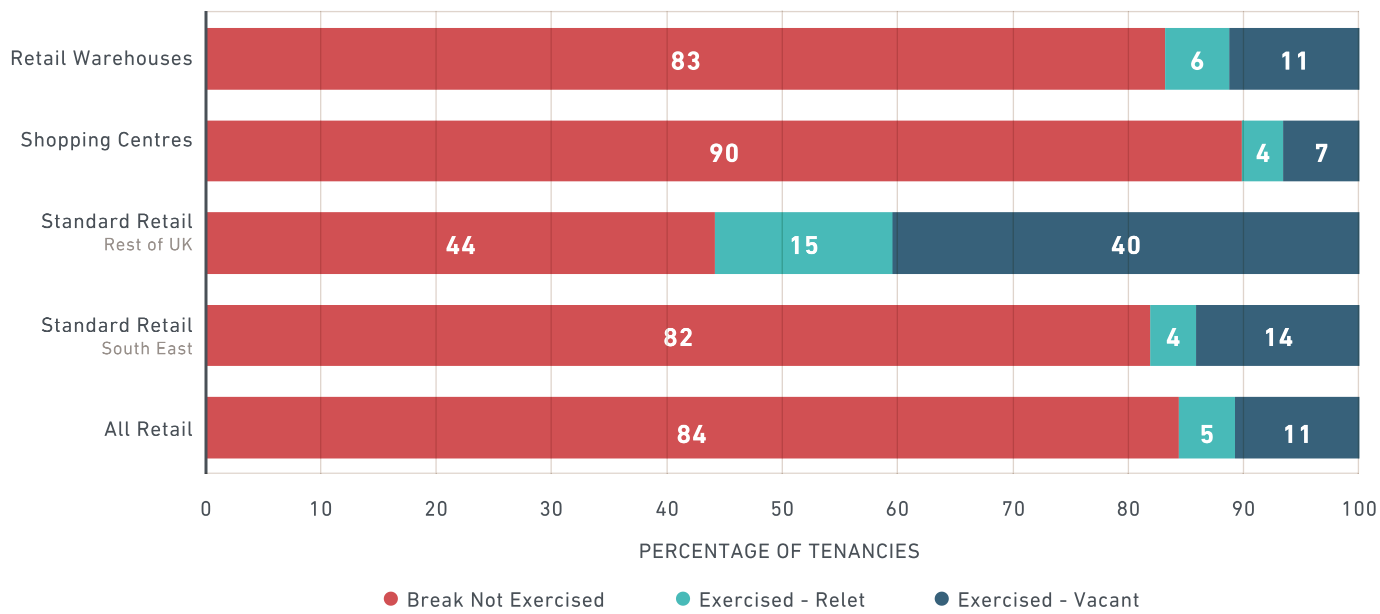
Markets with high turnover, like offices in London's West End, where tenants move frequently to secure better deals or better quality space, saw an increase, to 54% rent-weighted, in the number of tenants opting to exercise their break clause. This trend was reversed in the City of London with only 41% availing of a break option in 2014, down from 55% in 2013.

Outside of London, offices in the rest of the UK (excluding London and the South East) had the highest level of tenants exercising breaks at a dramatic 59% of tenants weighted by previous passing rent. Offices in the rest of the South East (excluding London) had a similarly high level of breaks acted upon, with 51% of tenants choosing to exercise their right to break. The high break rates in markets outside of the capital will be of concern to investors, given that many tenants located in regional or secondary locations would be deemed as higher risk with weaker covenants and building stock is more likely to be older, raising the issue of eventual obsolescence once the current tenant departs.

FIGURE 12

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 almost unique structure of UK commercial property leases is one of the key attractions for investors: such a restriction on downward reviews means there are only minimal rental value movements during the life of a lease, particularly in subdued markets.

Therefore, income movements can 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 interesting analysis of an investor's income position for properties with leases approaching expiry.

Table 3 shows, in percentage terms, the proportion of units which saw a positive change in rental income or All Property upon a new letting, including both renewal by existing tenants or re-lettings to new tenants.

TABLE 3

Rental Change for New Lettings in 2014

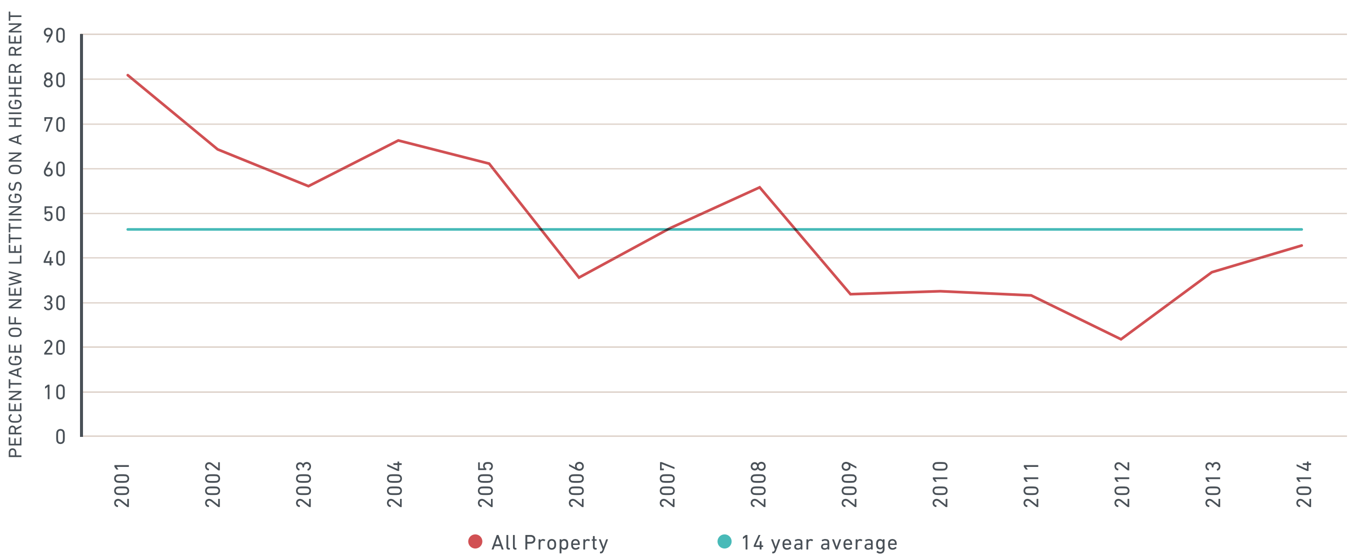
	Un-weighted	Weighted
Higher	**46%**	**43%**
Lower	**29%**	**48%**
Same	**25%**	**10%**

Source: MSCI

FIGURE 13

Achievement of Higher Rent on New Lettings 2001-2014

Tenancies weighted by rent passing



Source: MSCI

On an un-weighted basis, for the first time since 2008, rental income achieved from the signing of a new lease or renewal was proportionally higher in the market than a rental income decline. Rental income had continued to fall between 2009 and 2013 for a significant proportion of tenancies that were renewed or re-let, particularly as peak time 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, 36% of the renewals or re-lettings are achieving a higher rent than previous passing rent.

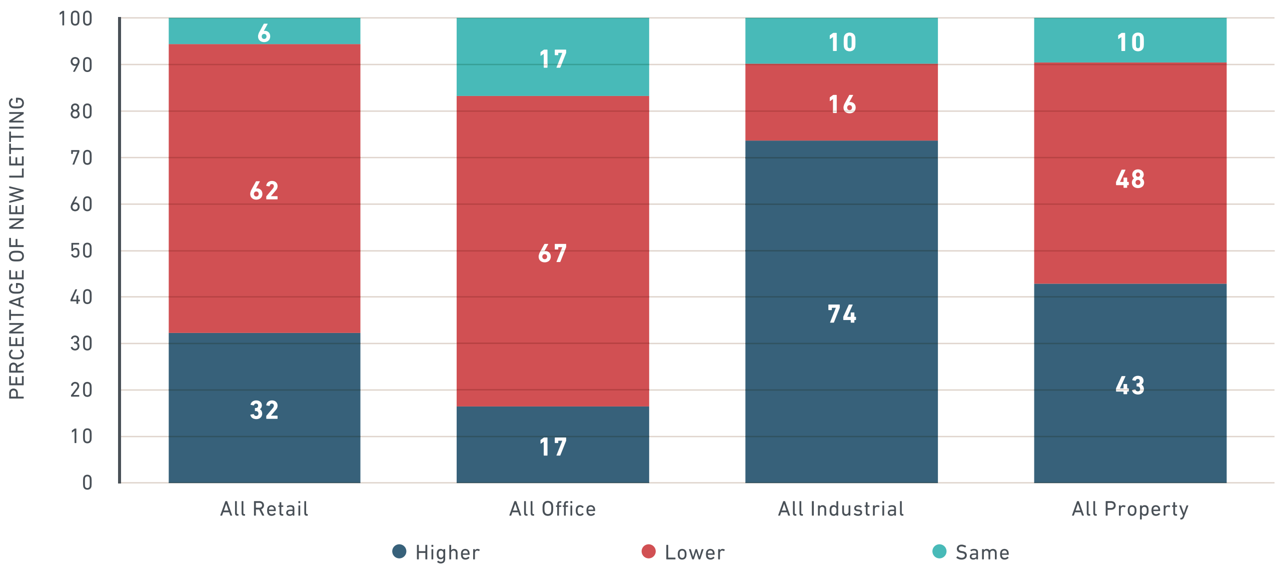
When weighted by rent passing, this figure rose to 39%, as more valuable prime buildings, especially in key markets such as London, have experienced greater rental value growth than the secondary and tertiary markets.

In terms of percentage of overall tenancies in the sample (un-weighted), 27% had lower rental income following a new letting, falling from 32% in 2013. On an un-weighted basis, the office sector performed the strongest with 57% of new lettings seeing income uplift, while retail properties were the weakest with 29% of tenancies witnessing a growth in rental income. The industrial sector, with 31% of properties recording a higher rental income than previously contracted, also saw the most considerable improvement from the 19% figure recorded in 2013.

FIGURE 14

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, which is almost unpredictable compared to planning income streams in the run up to a break or vacancy, 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. The difficult trading conditions for retailers in the UK in recent years has increased the number of receiverships and liquidations meaning default rates for all sectors have been volatile.

Throughout 2014, the rate of default by UK tenants declined, falling to 3.7% of all tenancies when weighted by rent passing, in line with an improving economic environment. This is the lowest rate of default registered in the UK market since 2007 and represents a further decrease in the rate of default since 2013, when the rate was 4.7% for All Property. The rate of default had peaked at 6.2% in 2012.

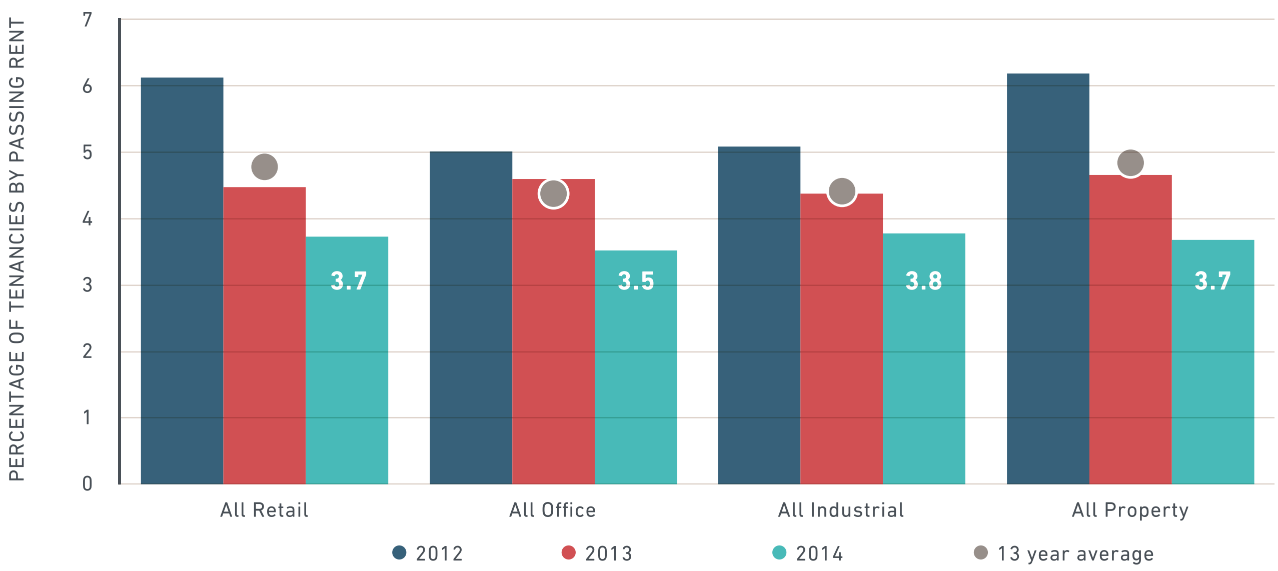
Retail had been the weakest sector with the highest level of default in recent years having been heavily hit by fragile consumer confidence and declining sales across the UK, however 2013 saw a significant turnaround and 2014 continued that positive trend. The default rate fell from a high of 6.3% in 2011 to 4.5% in 2013 and 2014 saw the retail sector edging closer to the long-term (12 year) average of 3.6%, with an average rate of 3.7% by the end of December 2014.

The improving occupier sentiment also spread to the office and industrial sectors with many tenants more willing to expand space requirements and grow employment levels through investment or use of cash reserves. The default rate for offices fell to the lowest level since 2007 at an average rate of 3.5% in 2014. This reflects the improving business environment in the UK services sector. The rate for industrials fell to 3.8%, having stood at 4.4% in 2013.

FIGURE 15

Tenants in Default (in Liquidation or Receivership)

Tenancies weighted by rent passing

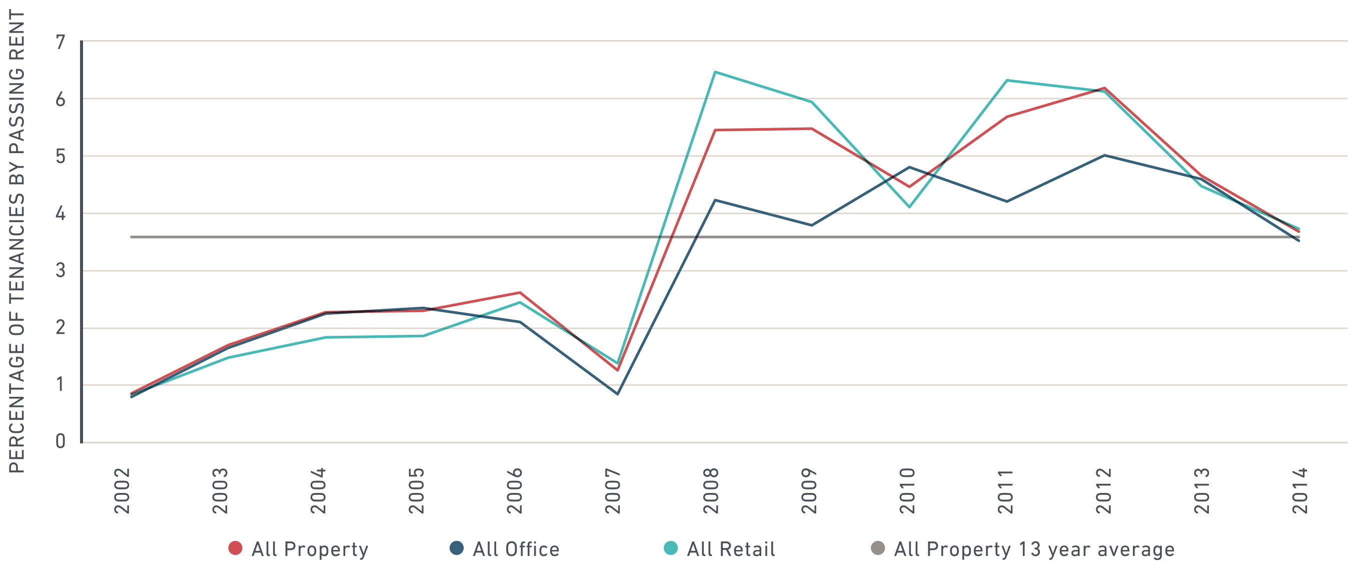


Source: MSCI, D&B

FIGURE 16

Tenants in Default by Sector, 2002-2014

Tenancies weighted by rent passing



Source: MSCI, D&B

The rate of default varied significantly between sector, location and property type. Offices in the City, dominated by financial occupiers which have seen aggressive business rationalisation over recent years, had the highest rate of default again in 2014, at 10.4%. This represented a rise in the default rate compared to the 8.8% figure in 2013, making offices in the City of London the only primary segment to record an expansion in the rate default between 2013 and 2014.

In line with previous years, the high rate of default in the City may be partly explained by the number of large, strategic defaults by tenants as major firms restructure and rationalise this space requirements and City operations. Conversely, offices in the neighbouring West End had the lowest rate of default for the office sector at 2.9%, the lowest level for this market since 2007.

Offices outside central London and the South East recorded the lowest average rate of default in the UK at 1.6% of rent passing, a decrease from 3.1% in 2013.

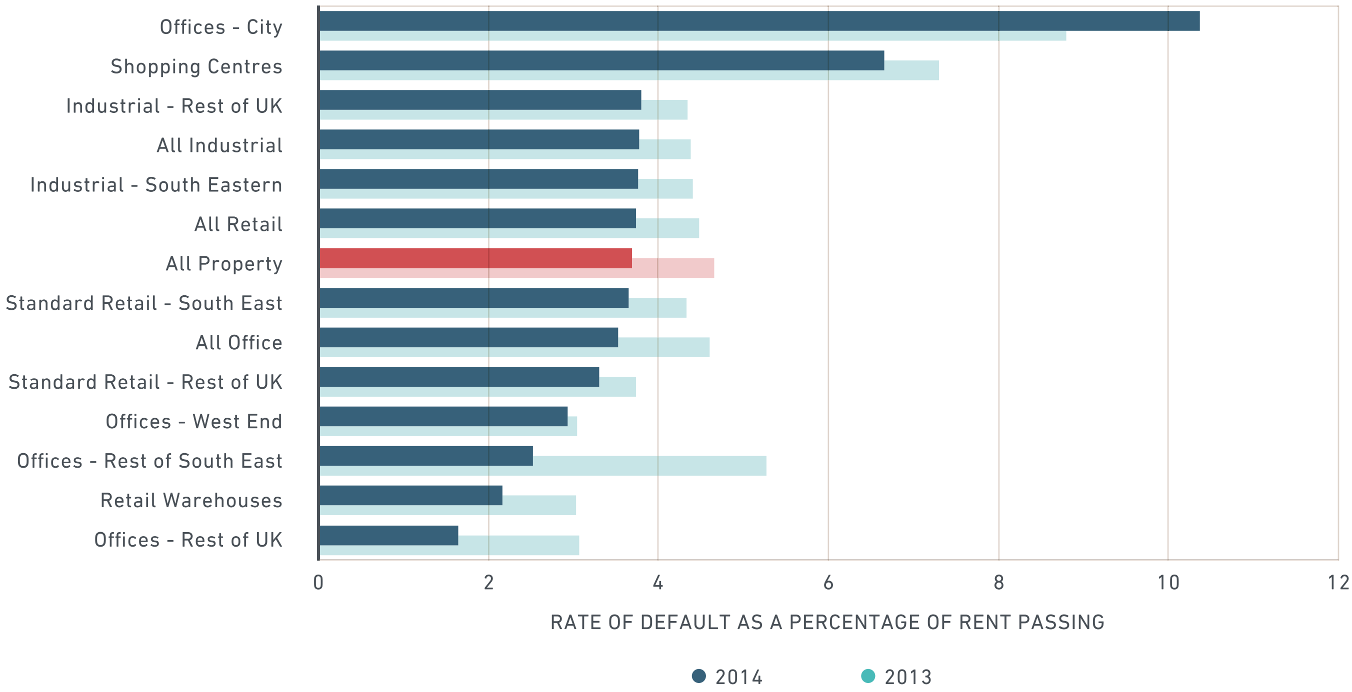
Similarly, offices in the South East of England saw a significant decline in the rate of default, falling to 2.5% of passing rent in 2014, compared to 5.3% in 2013. Historically, and despite weaker economic fundamentals, offices outside London have displayed lower levels of default on a consistent basis. Much of this is due to the fact that regional offices have a disproportionate level of government and semi-state occupiers, hence the relatively low rate of default and low risk.

For retail, Shopping Centres had the highest rate of default at 6.7%, a modest improvement from the 7.3% rate in 2013, and encouragingly down from a high of 9.2% posted in 2011. This segment, being heavily reliant on consumer confidence, has consistently had a high default rate since the economic downturn began in 2008; however the default rate has consistently contracted since 2011.

FIGURE 17

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)

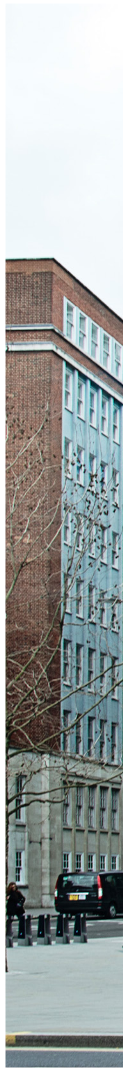
The annual rent the valuer estimates could be charged if the unit were let in the open market on the valuation date.

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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