UK LEASE EVENTS REVIEW

NOVEMBER 2018

Prepared by MSCI in association with BNP Paribas Real Estate

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SPONSOR'S FOREWORD

In the 20 years since its inception, the Lease Events Review analysis remains as relevant as ever. The storyline may have changed - much of the dramatic shortening of lease terms happened in the period up to 2008 – but the detail of sector change provides a window into the confidence and business planning of the occupational sectors.

The property market as a whole has performed robustly in 2018, with investment volumes sitting at £43.5bn YTD, and leasing markets confounding predictions across both offices and industrial. The retail market, unfortunately, is more troubled with over 2,000 store closures (impacting almost 40,000 employees) already this year.

Given the context, although we have an average unweighted lease length of 7.1 years, what remains most interesting is the way in which differences are played out across the sectors, not just in length of lease, but incentives, propensity to break, vacancy and income.

The macro drivers including demographics, technology, socio-politics and globalisation have resulted in many companies seeking flexibility – in a world where it is ever more difficult to predict, the ability to align property horizons to operational horizons becomes paramount. It is not therefore surprising this year to see the proportion of leases shorter than five years increased to 42.1%, a reversal on 2017.

Meanwhile the leases between five and nine years declined to 36.9%. For larger tenants the ability to have stability is paramount and the longest leases again increased in 2018, highlighting that the leasing market is becoming increasingly polarised.

Industrial, the sector which has seen over 22 million square feet taken up so far in 2018, has sought longer leases in recent years. That now appears to be slowing. In addition, flexibility is being required in the form of break clauses, which are most common within this sector at 47.4%. The UK is, however, the most advanced global online retail market and the impact of e-commerce has driven rental increases. On an unweighted basis 83% of new lettings have seen an uplift in income. However, the upside of e-commerce is not being felt in shops, where only 28% of tenancies witnessed rental growth following new lettings. That said, retail again had the lowest vacancy rate upon expiry, with retailers seeking to maintain their presence in key locations.

As investors, developers and lenders seek to align their strategies to the trends within the occupational markets 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

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INTRODUCTION

While Brexit might not have had the severely negative impact on UK economic growth initially feared, the latest data suggests that exports and business investment are bearing the brunt of the uncertainty. Overall, the UK economy grew by 0.4% quarter-on-quarter in the three months to June 2018. Household consumption rose faster than initially thought while business investment unexpectedly contracted.

Business investment fell again in the second quarter of 2018, suggesting that the uncertainty over Brexit is hitting firms' spending. The Office for National Statistics (ONS) estimated that investment by companies fell by 0.7% in the second quarter of 2018 – the fourth consecutive quarter of weakening.

The Bank of England (BOE) also noted in its quarterly "Agents' Summary of Business Conditions" publication that firms are putting investment on hold, or diverting it abroad, due to fears about new trade frictions with the European Union. This uncertainty, combined with the UK's current sluggish economic growth, may have diluted the trend toward lengthening leases, following several years of increasing occupier confidence. During the first half of 2018, the average unweighted length of leases granted in the UK market was unchanged on the year before. While lease lengths appear to be stabilising around this level, the current average unweighted lease length is still a full year longer than at the bottom of the cycle in 2011.

However, the negative impact on trade and investment was offset by a significant uplift in household consumption expenditure. UK growth has been underpinned this year by a pick-up in consumer spending, as real wages began to rise and the heatwave and football World Cup had a positive impact on retail sales growth.

The Q2 figure would have been a welcome relief after the first quarter saw growth of only 0.1% – the weakest in five years – since the 0.1% contraction recorded in the fourth quarter of 2012. The latest quarterly GDP growth figure brought annual GDP growth to 1.2% for the year to June 2018.

Notwithstanding the sluggish economic growth, the BOE raised its Bank Rate by 25bps to 0.75% in August, as inflation remained above its 2% target. The Bank also cited a recovery in GDP in Q2 and firming wage growth as contributing factors to its decision to hike rates, which resulted in the yield on UK government bonds increasing to its highest level since Q1 2016. The first week of October 2018 saw the yield on UK government bonds increase further and reach its highest level in more than two years, amid growing optimism that a Brexit deal would be reached.

Inflation in the UK – subdued prior to the Brexit vote in June 2016 – has been under pressure ever since as the pound depreciated relative to the major global currencies. UK CPI reached a high of 3.1% in November 2017, the highest inflation rate since May 2012, with rising prices largely the result of a weaker pound.

After easing to 2.4% in June 2018, UK consumer prices rose 2.7% for the year to August, mainly inflated by categories such as transport, which are more exposed to the external cost pressures resulting from sterling's past depreciation and higher global energy prices.

As with the trend in lease lengths, the length of rent free periods also remained relatively stable across all three major property sectors, reflecting the wait-and-see attitude landlords seem to be adopting in the current market. At the All Property level, the rent-weighted rent-free period declined from 9.8 to 8.7 months.

This suggests that larger occupiers are being granted shorter rent-free periods than in 2017 – though this is still significantly higher than the unweighted average.

For 10 years since the global financial crisis, the proportion of leases with a break clause has increased significantly. As at June 2018, 38.5% of leases included a break clause, higher than the levels recorded pre-GFC (22.7% in 2007) and immediately post-GFC (28.2% in 2009).

To evaluate income streams for investors in commercial real estate, risks including lease expiries, break clauses, vacancies and defaults should 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 their analysis is crucial for helping investors, occupiers and landlords to understand the potential of the space they occupy and the income streams they expect.

This MSCI Lease Events Review for 2017 and year to June 2018, in association with BNP Paribas, provides empirical evidence on the likelihood of the different types of lease events. The analysis was based on a sample of over 89,000 extant leases held in the IPD UK Annual and Quarterly Property Universe, and more than 9,300 new leases signed over the last year.

The report examines the influence of three key lease events on the property investment market: lease expiries, break clauses and lease renewals. Each of these events 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 2017

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

The section will first look at the average lease length and how this has changed over time. It will then consider changes in incentives such as break clauses and rent-free periods. It will round off with a view of the property income position that has resulted from lease negotiations so far in 2018.

HOW HAVE LEASES CHANGED THIS YEAR?

During the first half of 2018, the average unweighted length of leases granted in the UK market stood at 7.1 years - unchanged on the year before, but still 20bps longer than the 17-year average of 6.9 years. While lease lengths appear to be stabilising around this level, the current average unweighted lease length is still a full year longer than at the bottom of the cycle in 2011.

The UK's current sluggish economic growth and the uncertainty around Brexit may have diluted the trend toward lengthening leases, following several years of increasing occupier confidence.

While the aggregate unweighted lease length has increased by more than a year since 2011, the share of leases of 20 years and longer has remained stable at 2.6%. This suggests that the more recent lengthening of leases has been driven by a shift from very short leases (0-5yrs) to medium length leases (5-9yrs) rather than an increase in long leases. However, 2018 saw a reversal in this trend.

An analysis of the distribution of leases granted by lease band shows an interesting reversal at the lower end of the lease length spectrum. From 2011 to 2017, the proportion of leases shorter than 5 years declined from 54.2% to 39.4%, but in 2018 this figure increased by 270bps to 42.1%. Conversely, the proportion of leases between 5 and 9 years declined by 210bps to 36.9% in 2018 after increasing from 25.8% to 39.1% during the period 2011 to 2017.

The unweighted 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 for the UK market.

When weighted by passing rent, the average lease length has declined by 6 months since 2015. This stands in contrast to the unweighted lease length, which has increased by 2 months over the same period, suggesting that larger occupiers have on aggregate been negotiating shorter leases.

AVERAGE NEW LEASE LENGTHS TO 2018 (UNWEIGHTED)

FIGURE 1.1

Unweighted lease length distributions

Percent of new lets in each lease length band

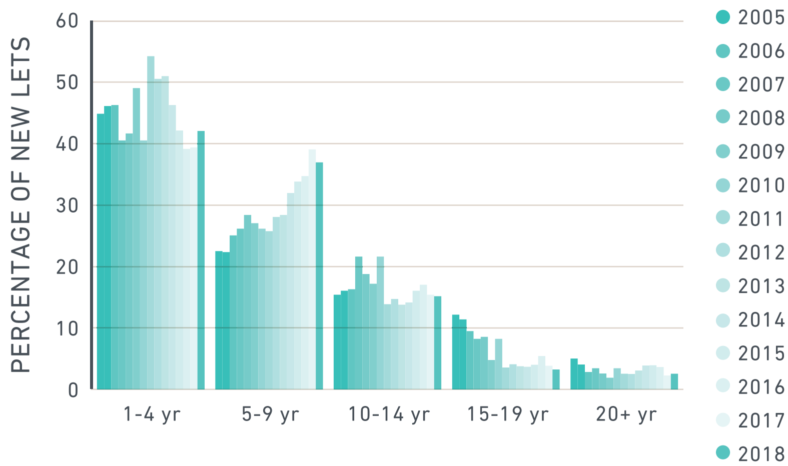


FIGURE 1.2

Unweighted lease length

Unweighted full term; ignoring breaks and including short leases

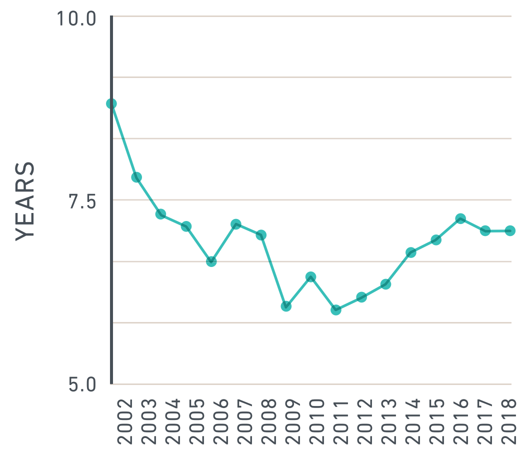


FIGURE 1.3

Change in lease length distribution (2011 to 2018)

Change in percent of new lets in each lease length band

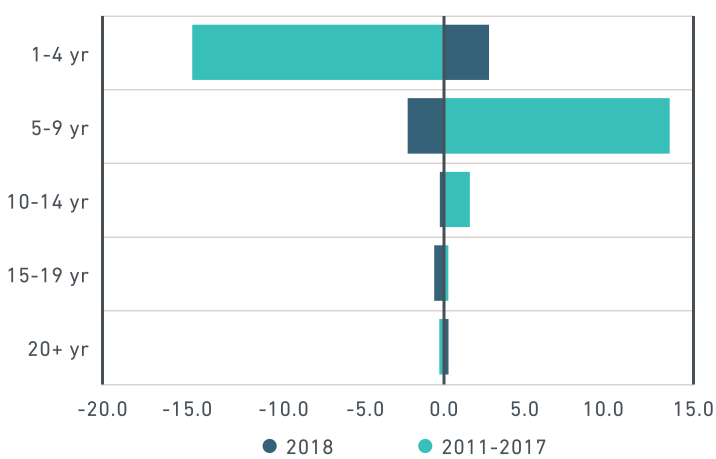
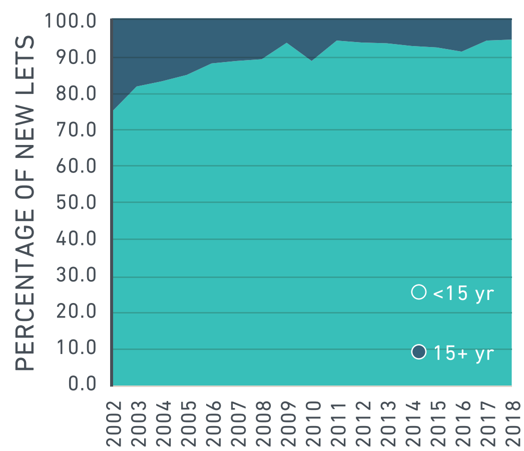


FIGURE 1.4

Unweighted lease length

New lettings



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

Source: MSCI

The 6 months to June 2018 saw pronounced increases in the proportion of very short and very long leases, while the middle brackets all saw decreases. Leases of 20 years and longer saw an increase of 390bps to 17.9% on a rent-weighted basis, while leases of between one and four years increased 530bps to 22.2%. The lease length brackets 5-9 years and 10-19 years saw decreases of 320bps and 700bps respectively.

Since the beginning of the analysis period, there has been a clear downward trend in agreeing new leases of longer than 15 years, particularly among larger occupiers, as evidenced by the stronger trend in the weighted measure. Longer leases appear to have been replaced by those of 5-9 years.

Short leases of up to 5 years became much more prevalent following the financial crisis in 2009.

AVERAGE NEW LEASE LENGTHS TO 2018 (WEIGHTED)

FIGURE 2.1

Weighted lease length distributions

Percent of new lets in each lease length band

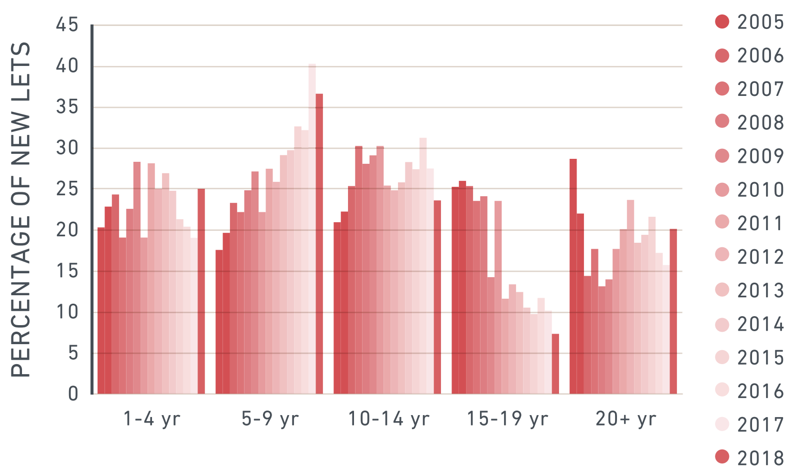
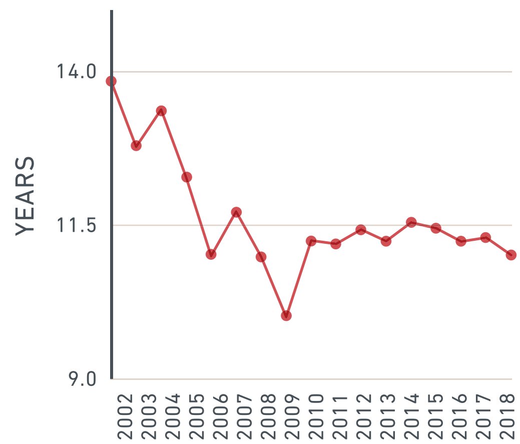


FIGURE 2.2

Weighted lease length

Unweighted full term; ignoring breaks and including short leases



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

Source: MSCI

In a weak economic environment with heightened uncertainty, occupiers sought more flexibility in their use of space. Over the following years, as fundamentals improved and confidence returned, interest in the shortest leases waned in favour of the 5-9 year bracket. However, the declining trend in very short leases has slowed recently and in 2018 there was a step up in leases of 1-4 years, accompanied by a step down in medium-length leases (5-9 years).

For bigger tenants, the propensity to take the longest leases (over 20 years) rose again in 2018. We saw a similar change at the very short end of the scale, with an uptick in the proportion of leases in the 1-4 year bracket. Both these movements reflect a reversal in recent trends, with an increase in leasing activity at each end of the lease length distribution.

For rent-weighted lease lengths by sector, industrial lease lengths notably remained relatively stable into the first half of 2018, while retail and office lease lengths declined by 12 and 15 months respectively over this period.

On an unweighted basis, retail lease lengths ticked up slightly, suggesting that larger retail occupiers are favouring slightly shorter leases in the current climate.

This continues a steadily increasing trend in retail lease lengths since 2013. Office lease lengths have been predominantly flat since the financial crisis, and while industrials saw a significant lengthening from 2001 to 2016, they stabilised in 2017 and 18.

During the mid-2000s lease lengths varied considerably between the sectors. They converged during the latter half of the decade as retail leases shortened and industrial leases lengthened, to meet those of offices in the middle.

After the financial crisis in 2009, industrial lease lengths initially fell back while retail and office leases both lengthened modestly. The increase in industrial lease lengths over recent years has once again led to a convergence in the unweighted measure across the sectors.

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

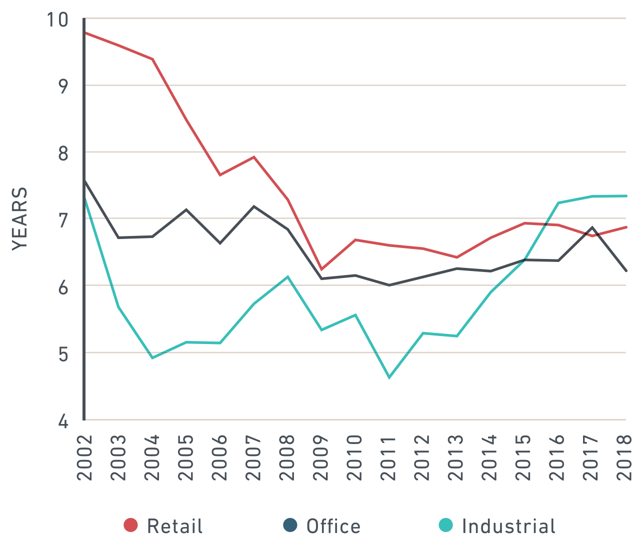
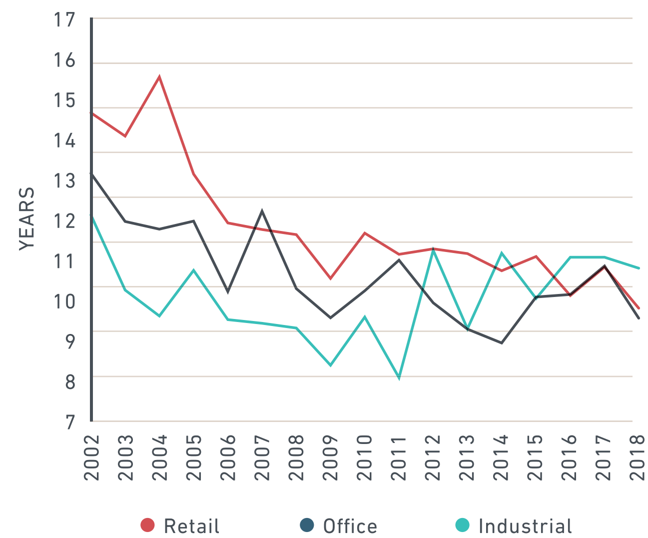


FIGURE 3.2

Average lease length trends by sector

Weighted full term, ignoring any breaks, including short leases



Source: MSCI

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

Office lease lengths saw a steady increase to reach 6.2 years at end Q2 2018, after bottoming out at 6.0 years in 2011. When weighted by passing rent, office lease lengths are considerably higher at 9.5 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 declined from 11.5 years in 2011 to 7.7 in 2018, has been a key driver of the downward trend – notwithstanding a 4 month increase in lease length from 2017 to 2018.

Offices in the South East – outside Central London – have seen a similar trend, with rent-weighted lease lengths declining from 9.6 years in 2011 to 7.9 years in 2018.

While offices in the Rest of the UK saw lease lengths remain flat over this period, with the rent-weighted lease length at 9.9 years in both 2011 and 2018, it had risen in 2015 and 2016 before declining to its current level.

Industrial lease lengths showed no change on an unweighted basis during the 6 months ended June 2018, although they shortened by a little more than 3 months on the rent-weighted measure.

As at June 2018, the average unweighted industrial lease length was 7.3 years, 33 months longer than the 4.6 years recorded in 2011.

Interestingly, the rent-weighted lease length increased by an equal amount over the period, from 8.0 to 10.8 years, suggesting improving sentiment among both small and larger industrial occupiers.

Segmenting by age reveals that industrial property constructed after 1990 has seen rent-weighted lease lengths shorten by around a year since 2011. Industrial property constructed before 1990 has seen lease lengths increase by 3 years over the same period.

In addition to leasing trends by sector and location, this analysis also compares trends for small and medium enterprises (SMEs) versus those for large companies. Large companies have tended to have greater financial stability and thus be able to commit to longer average lease terms. Longer leases also give such companies improved security of tenure, something that may be important to them given that the supply of suitable larger units is generally lower than for smaller units, making it challenging to find large units of appropriate size. This trend is consistent across all the traditional property sectors.

At an All Property level, SMEs had an unweighted lease length of 5.0 years as at H1 2018 – relative to the 5.6 years measured for large companies – a difference of 7 months. On a rent weighted basis, the length of SME and large company leases differ significantly. As at June 2018, SME leases had a weighted length of 7.3 years, compared to the 10.5 years recorded for large companies.

At a sector level, there was little difference in the unweighted lease length of SMEs and large corporations as at June 2018. On an unweighted basis, the average office lease signed by an SME in the first half of 2018 was for a period of 4.6 years, compared to an average of 5.1 years for large companies – a difference of 6 months.

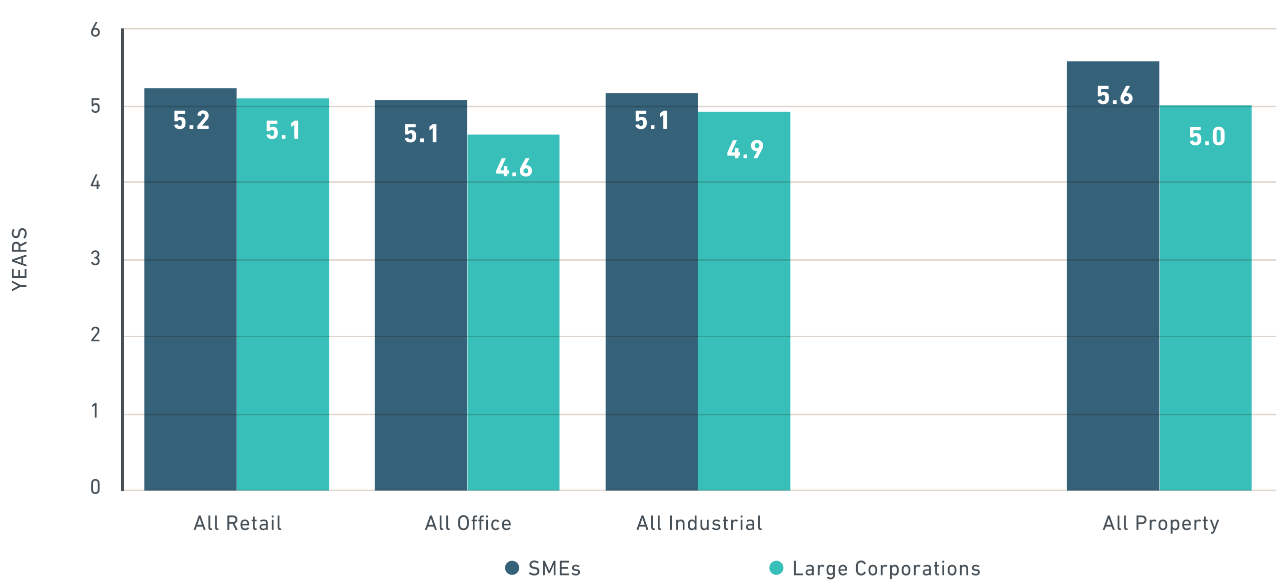
On a weighted basis, the difference between office lease lengths for SMEs and large corporations was significantly greater, as large companies' leases lengthened from 8.7 years to 9.6 years, more than the 0.2 year increase to 6.9 years for SMEs.

Large companies in the retail sector saw rent-weighted lease lengths increase by around 13 months since 2017, while those in the industrial sector committed to leases that were 4 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

While tenant incentives have become the norm in UK leases over the last few decades, there is still a fair amount of variation in the proportion of leases with break clauses and in the length of rent-free periods. Much of the variation in these incentives is due to the economic and business-specific factors affecting the demand for space in the commercial market.

As occupier demand rose in line with the resurgent UK economy from 2013 to 2015, many landlords forecast positive future income growth, leading to the expectation that rent-free periods would shorten and the percentage of leases with break clauses diminish.

However, this analysis shows that as economic growth has tapered off, particularly after the Brexit referendum, despite the length of rent free periods stabilising across all sectors, tenant break clauses have become an increasingly common feature of the UK leasing landscape.

As at June 2018, 38.5% of leases included a break clause, higher than the levels recorded pre-GFC (22.7% in 2007) and immediately post-GFC (28.2% in 2009). For the 10 years since the GFC, the greatest increase has been seen in leases between 11 and 15 years in length, where the proportion with a break clause has risen from 26.6% in 2009 to 52.0% in 2018.

Leases longer than 21 years have also witnessed an increased proportion of break clauses. As at June 2018, 28.1% of leases include a break clause compared to 15.5% of leases immediately post-GFC.

This suggests that while some occupiers remain willing to commit to longer term leases and enjoy the security that brings, they have sought the flexibility now required by their business models through break clauses.

In the year-to-date June 2018, there has been a significant decline in the percentage of leases with a break clause in the 16 to 20-year lease bracket.

Overall, break clauses are now most common in the industrial sector (47.4%) followed by the office sector (40.7%), while the level is lower for retail (30.9%). All three main property sectors have seen the prevalence of break clauses decrease in 2018.

Historically, retailers have seen less need for flexibility in their space portfolios, as evidenced by the low proportion of break clauses and generally longer lease lengths. Occupational space may have been a less scalable factor of production in retailers' business models than for office and industrial tenants.

However, this perception seems to be changing with the rise of internet shopping, as floorspace becomes only one piece of the 'route to market' jigsaw.

Retailers may now want more strategic and tactical flexibility in their use of space, a trend that has fed through to their leasing arrangements over recent years. First, lease lengths fell sharply to 2009 and then stabilised, but since then the proportion of leases with breaks has doubled.

PROPORTION OF LEASES WITH BREAK CLAUSES BY SECTOR

Unweighted; By Lease Length Band; per sector; 2005-2018

FIGURE 4.1

All Property

Leases with break clauses

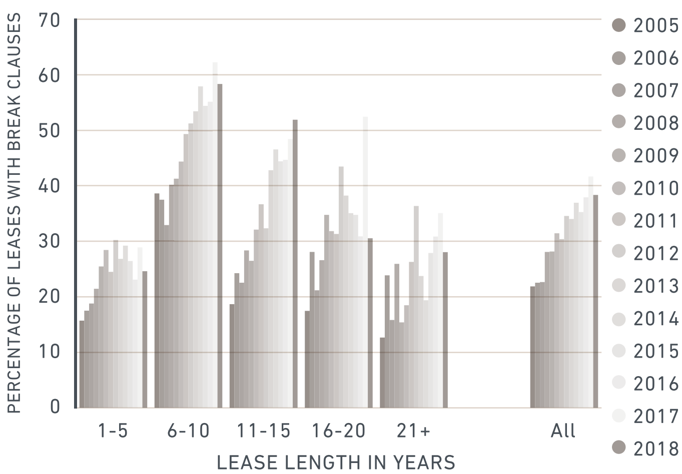


FIGURE 4.2

Retail

Leases with break clauses

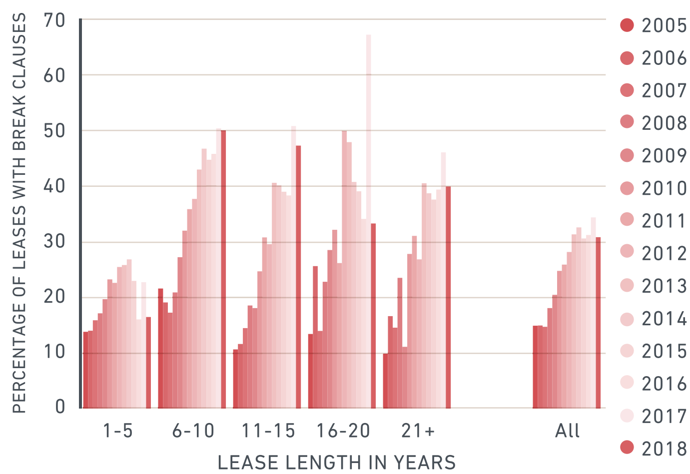


FIGURE 4.3

Office

Leases with break clauses

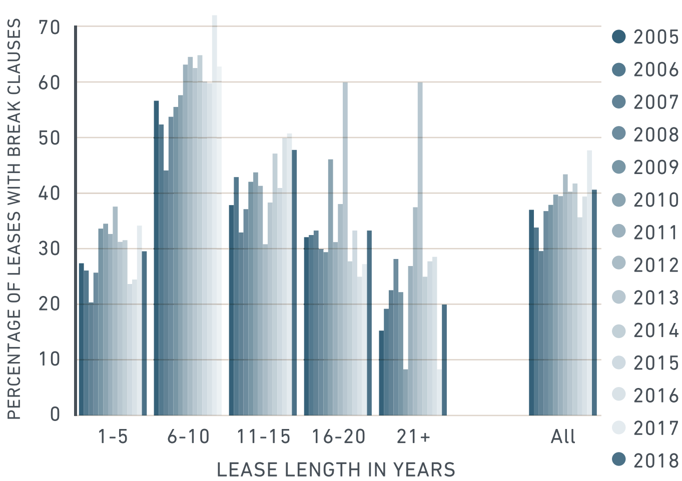
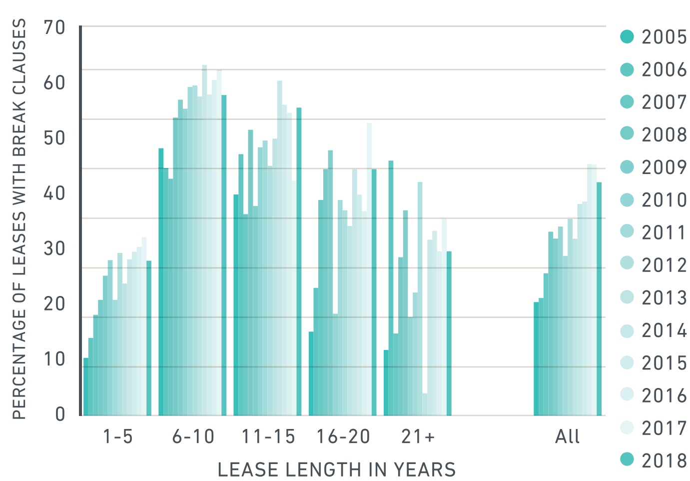


FIGURE 4.4

Industrial

Leases with break clauses



Source: MSCI

Interestingly, the proportion of leases with breaks has increased to a similar degree in the industrial sector, but that is in the context of generally rising lease lengths over the last few years.

The fluctuation in rent-free periods is highly cyclical, with average lengths increasing in weaker economic conditions as many landlords give generous incentives to avoid vacancy. In 2018, the length of rent free periods remained relatively stable across all three major property sectors, after most sectors recorded declines in 2017.

Rent-free periods for offices remained the longest at an unweighted average of 9.1 months. While this was unchanged from a year before, it was 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 ended H1 2018 at 7.1 and 5.3 months, respectively. While retail rent free periods were down by 0.2 months, industrials saw rent free periods increase by 0.4 months during the first 6 months of 2018.

Weighted by passing rent, All Property rent free periods declined from 9.8 to 8.7 months. While larger occupiers may still be incentivised by longer rent-free periods, this measure has declined more than the unweighted figure, driven by a 2.6 month decline in the office sector, where the rent-weighted rent-free period shortened from 12.6 to 10.0 months.

The distribution of rent-free periods shows that, as would be expected, those of less than 12 months dominate each of the three major property sectors.

For the retail sector, 89.1% of rent free periods are less than 12-months long on a weighted basis, and of these 31.0% are shorter than 4 months.

The industrial sector is also heavily weighted toward shorter rent-free periods, with 82.3% being of 12 months or less (36.6% are 4 months or shorter). The industrial sector did however see a noticeable increase in the share of rent free periods of between 17 and 20 months (5.9% to 11.8% of total).

The office sector's pattern of rent-free periods differs from the other two sectors in that the most common period is 9-12 months (28.7% of contracted rent). There are fewer very short periods, with only 62.9% of leases having a rent-free of a year or shorter.

A much greater proportion of office leases have rent free periods of longer than 12 months, with a significant share (8.5%) exceeding two years. This is much less common in the retail and industrial sectors, where rent-free periods longer than 24 months account for 0.8% and 0.9% of rent, respectively.

AVERAGE RENT FREE PERIODS BY SECTOR

FIGURE 5.1

Average rent-free periods by sector

Tenancies equally weighted

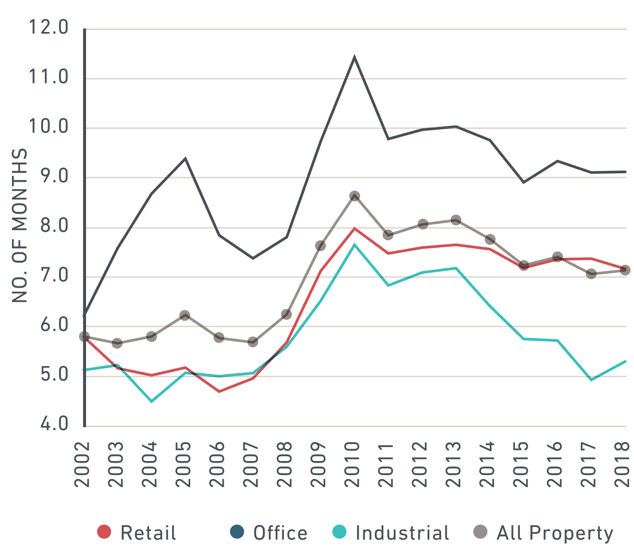
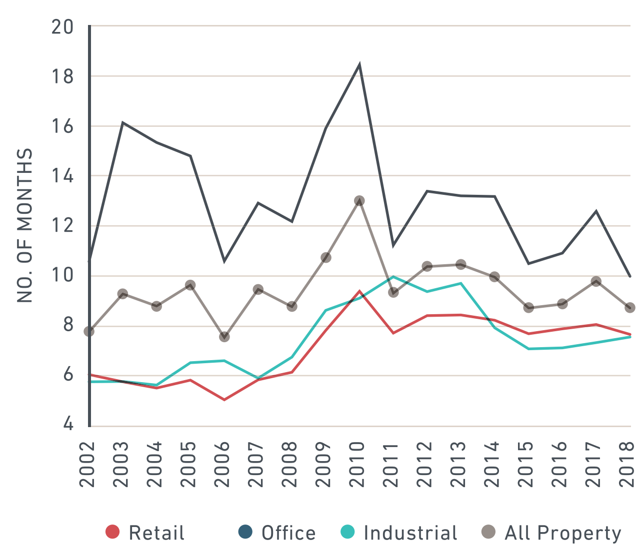


FIGURE 5.2

Average rent-free periods by sector

Tenancies weighted by rent passing



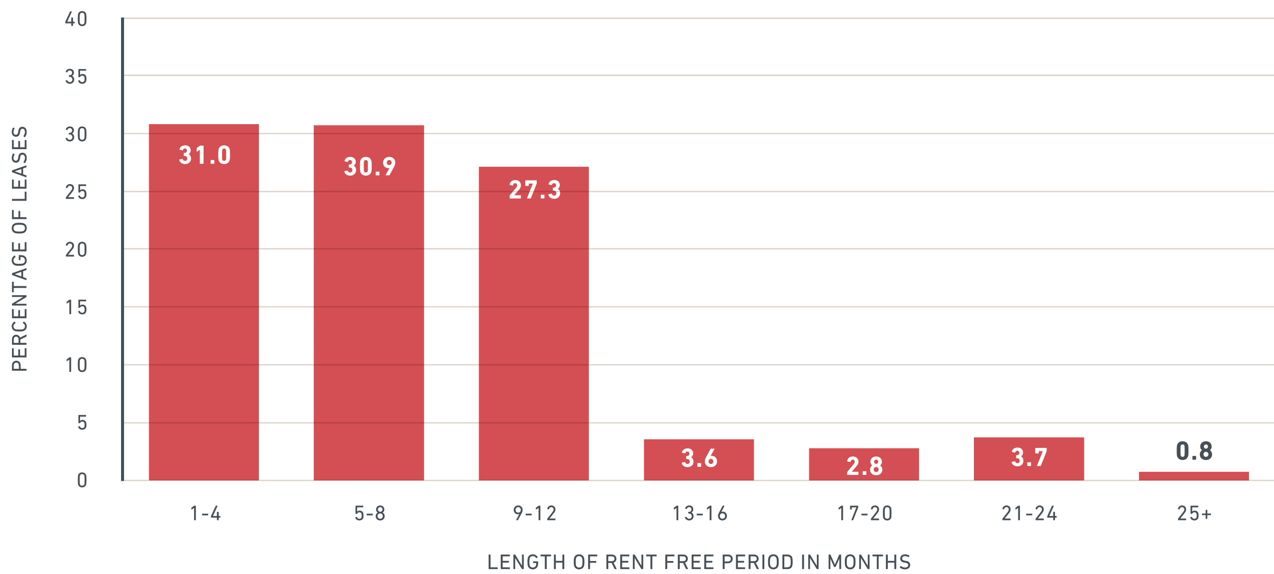
Note: The fluctuation in rent-free periods is highly cyclical, with average lengths increasing in a weaker economic environment as many landlords incentivise generously in an attempt to avoid vacancy.

Source: MSCI

FIGURE 6.1

Distribution of rent free periods for retail

Tenancies weighted by rent passing

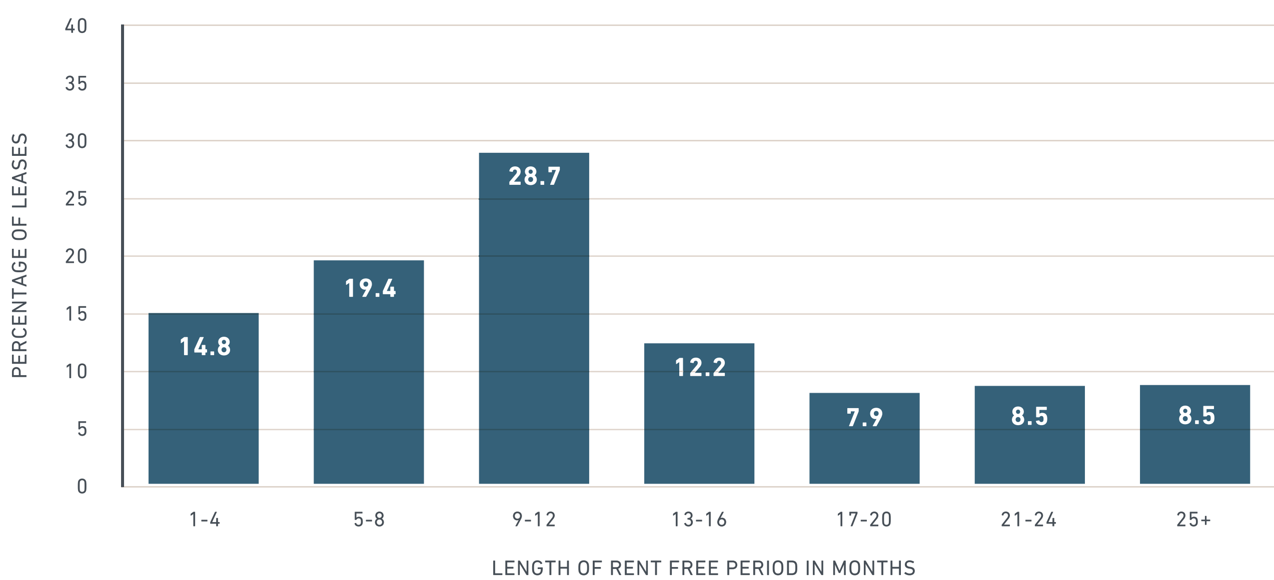


Source: MSCI

FIGURE 6.2

Distribution of rent free periods for office

Tenancies weighted by rent passing

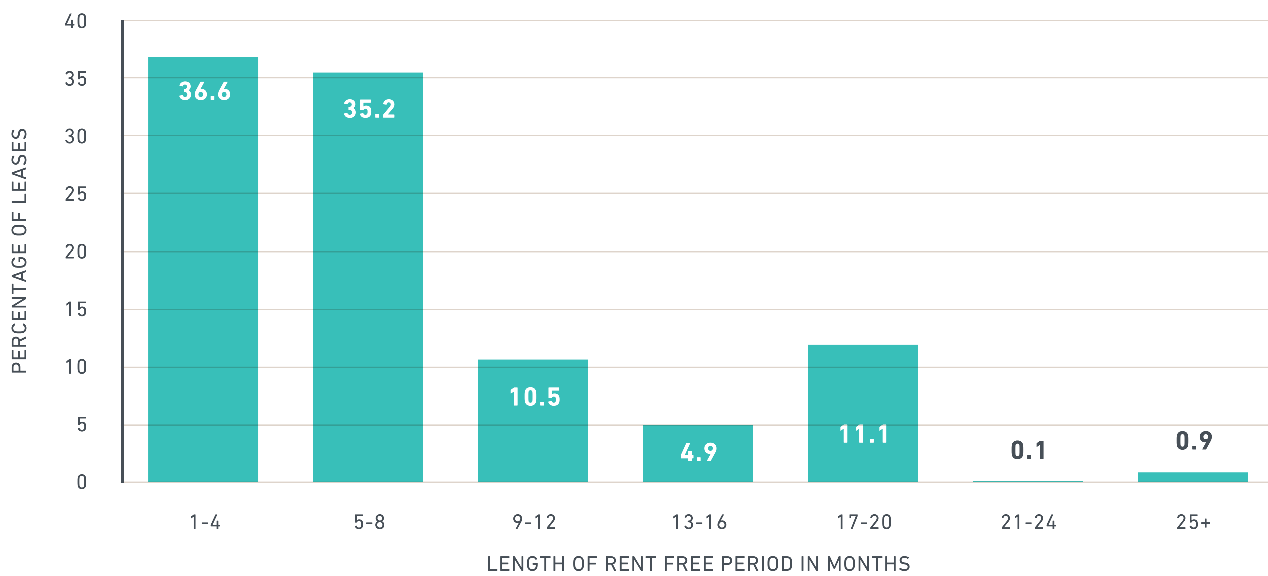


Source: MSCI

FIGURE 6.3

Distribution of rent free periods for industrial

Tenancies weighted by rent passing



Source: MSCI

INCOME SECURITY AND POTENTIAL FOR GROWTH

The graph below summarises the income position for current leases in 2018, drawing 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 income growth available for existing leases due to rental value growth, as at June 2018. Additional factors influencing security of income are developments, vacancies and rent-free periods.

In terms of security of income in the broader UK market, 5.7% of income is at risk due to over renting (top slice). Of the three traditional property sectors, retail is the most over rented at 7.4% of rent passing, compared to 4.3% for offices and 3.1% for industrial.

The retail and industrial sectors both saw a decline in the level of over-renting between June 2017 and June 2018, as market rental values continued to improve.

However, the office sector saw an increase in the proportion of passing rent at risk due to over-renting (4.0% to 4.3%).

At the All Property level, reversionary potential offers the most rental upside at 8.6% of rent passing. A slightly smaller amount (8.1%) is potentially available from letting currently vacant space at market rents. Meanwhile a further 4.7% would be available from newly developed space coming on line – less than the 5.9% of 2017. In addition, a more modest income uplift could be gained from those leases currently in rent free periods. Working through these would lead to an increase in total income equivalent to 3.6% of current passing rent.

The office sector continues to offer the most growth potential, driven by high levels of both reversionary potential (13.2%) and vacant space (17.8%).

Offices also have significant growth potential stemming from space currently under development (10.3%). As seen earlier, offices tend to have longer rent-free periods and currently have double the potential income growth from incentives compared to the All Property average (7.8% vs. 3.6%).

Although the office sector shows the highest potential for income growth of the property sectors, much of this is driven by recent growth in market rents. It remains to be seen whether the potential growth from vacant space can be realised or whether this space is simply not attractive to tenants due to obsolescence.

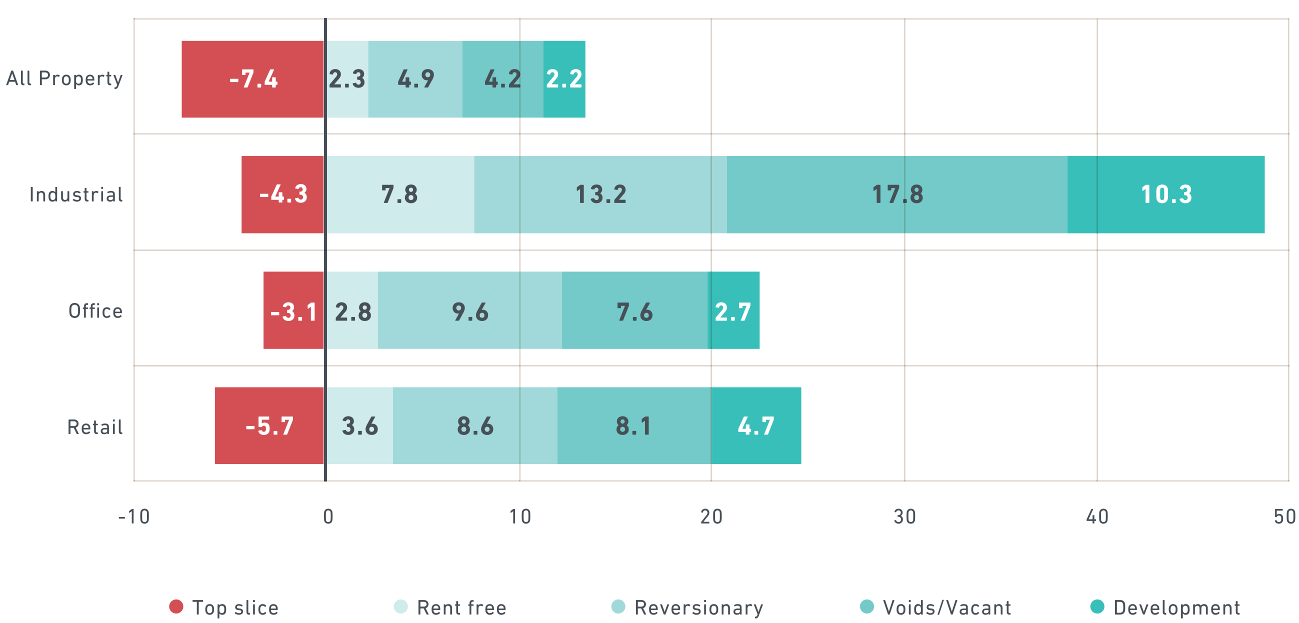
Additionally, this is a static analysis and does not account for the effect on supply of newly developed space reaching the market. With increased supply, market rents may moderate or the space may need significant incentives to be let. The income potential analysis, while informative, should be treated with some caution.

As at mid-2018, the retail sector showed the lowest potential for income growth through rental reversions, letting of vacant space and development completions. This, however, assumes no growth in headline rents. As mentioned earlier, this lower potential and the higher levels of over-renting in the sector reflect its more modest recent market rental growth.

FIGURE 7

Security of income and growth potential by sector

Percentage of total rent passing



Source: MSCI

THE IMPACT OF LEASE EVENTS IN 2017

This section of the report examines the role played by the occurrence of lease events in terms of their impact on investor income. The section will first look at the behaviour of properties as leases edge toward 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 provides analysis at a headline All Property level, then by sector and location.

Finally, this part of the report concludes with a look at the effect of tenant default on an investor's income position. The analysis period for this section is the calendar year 2017, with data sourced from the IPD UK Annual Index.

The analysis is split into "unweighted," based on the number of leases in the 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 after the 2008 market crash saw a consistently worrying trend for investors in terms of the outcome of lease expiries. This was exacerbated by economic and confidence difficulties for occupiers.

In 2017, only about a third of leases were renewed by tenants at expiry. While some landlords managed to find alternative tenants (19% by number of leases, accounting for 18% of contracted income), about half the time (49%) units were left vacant for one quarter or more. These accounted for 53% of passing rent.

As their leases approach expiry, many tenants use the opportunity to push for more competitive rents, especially those who signed at times of elevated 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.

The vacancy rate for leases expiring in 2017 was 49% unweighted (counting all leases equally), rising to 53% when weighted by previous rent passing.

A breakdown of these figures is shown in Table 1.

TABLE 1

Outcome of leases expiring in 2017 for all property

Renewed	32%	29%
New Letting	19%	18%
Vacant	49%	53%

Source: MSCI

FIGURE 8.1

Vacancy rate for leases expiring 1998-2017 by all property

Tenancies weighted by rent passing

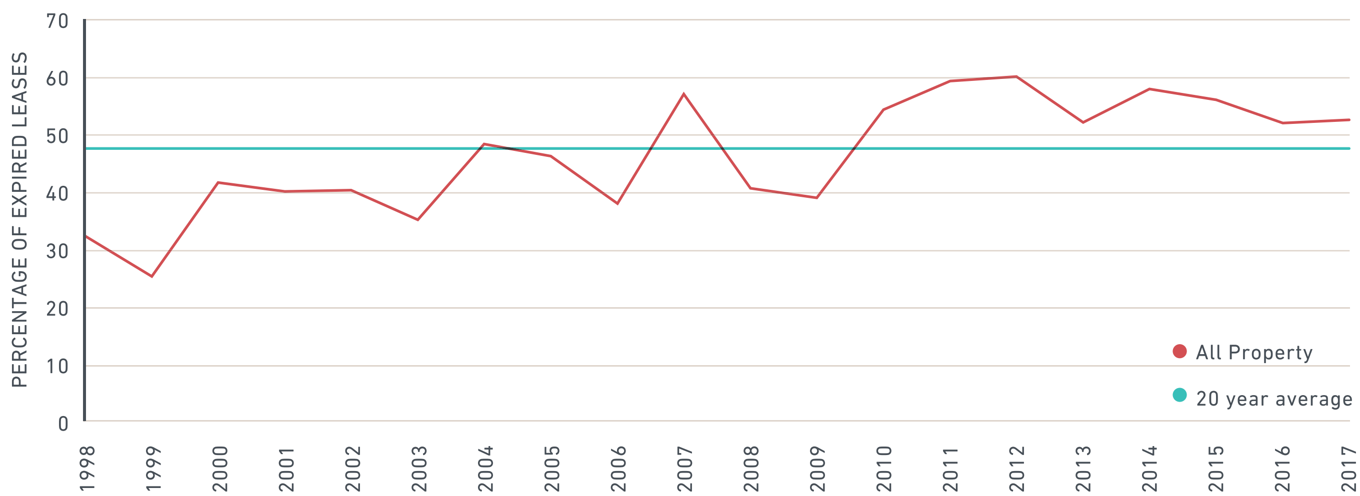


FIGURE 8.2

Vacancy rate for leases expiring 1998-2017 by sector

Tenancies weighted by rent passing

Source: MSCI

This vacancy rate has now been above the 19-year weighted average of 48% since 2009, although it has improved since reaching a high of 60% in 2012.

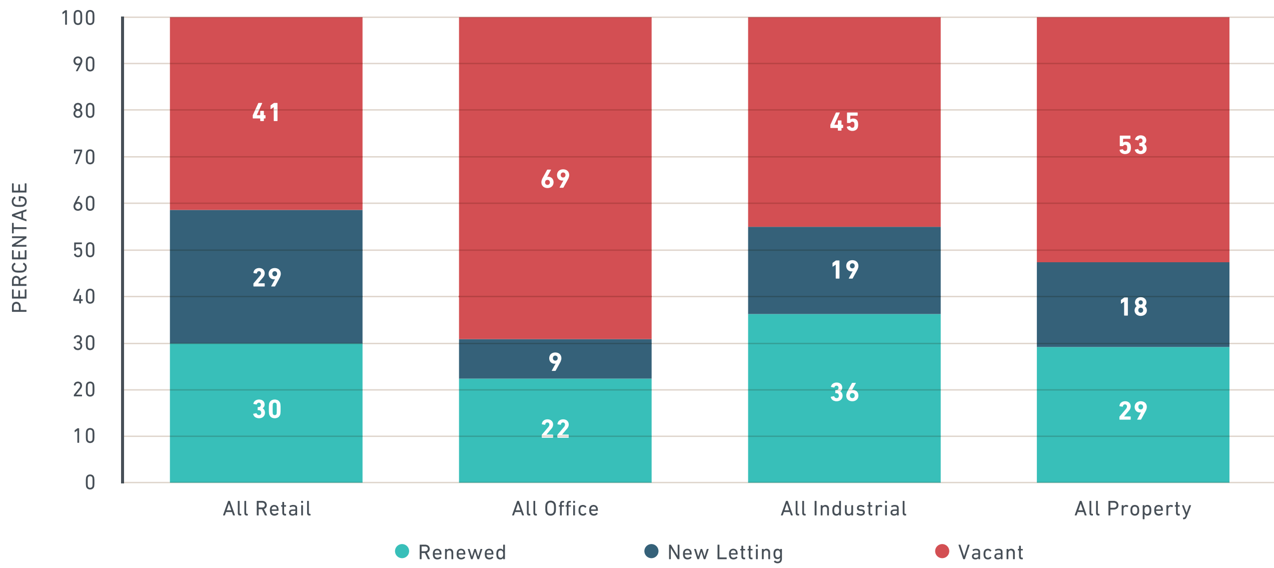
Of leases expiring in 2017, 19% were re-let to new occupiers in the same quarter that the previous lease expired – higher than the 16% recorded for 2016. Weighted expiries produced a similar re-letting figure of 18%, suggesting a similar trend among smaller and larger tenancies.

The increase in new lettings was offset by a reduction in the percentage of leases renewed, from 35% to 32%. When weighted by rental income, 29% of tenants chose to renew their leases in the same quarter as the expiry occurred. This was below the 19-year average of 33%, suggesting that the market is beginning to experience more normal conditions after the crash to recovery phase.

FIGURE 9

What happened when leases expired in 2017?

Tenancies weighted by rent passing



Source: MSCI

By sector, offices had the highest level of immediate vacancy on lease expiry in 2017, both weighted (69% of leases) and unweighted (64%). All Property vacancy rates on expiry, both unweighted and weighted, remained well above their long-term averages. On a weighted basis, vacancy rates were 5% higher than their long-term average (53% versus 48%) and 8% higher when calculated in unweighted terms (49% versus 41%). On a rent-weighted basis, retail had the lowest sector vacancy rate on expiry at 41%, compared to industrial at 45% and offices at 69%.

While vacancy rates for expired leases have remained relatively stable since 2010 for both the office and retail sectors, there has been a significant decline for the industrial sector, from 61% in 2010 to 45% in 2017. This reflects the strength of industrial occupier markets in recent years, as developments in ecommerce have helped support the demand for logistics property.

Despite all the reports of retail sector weakness in the press, on average, it has the lowest vacancy rates on lease expiry among the UK property sectors.

This reflects a structural difference going back more than 20 years. While office tenants demand modern and efficient space with appropriate facilities to reflect their brand image, retailers are more focused on finding a location that helps them capture consumer footfall and hence sales.

Retail tenants essentially rent a box in the right location and supply the correct brand and facilities themselves. As such, they are more likely to seek to maintain a presence in the best locations. If they fail, new tenants will quickly snap up space in good locations.

While the retail vacancy rate on expiry remains lower than for the other sectors, at 41% it is now 9 percentage points higher than its 19-year average of 32%. The recent strength of industrial occupier markets has meanwhile led to the proportion of leases vacant on lease expiry being somewhat lower than the long run average, in contrast to the other sectors. This is consistent with the picture we saw last year.

Detailed trends within the office sector resumed from last year, as the sector saw the highest vacancy rate upon expiry and the lowest renewal and new letting rates.

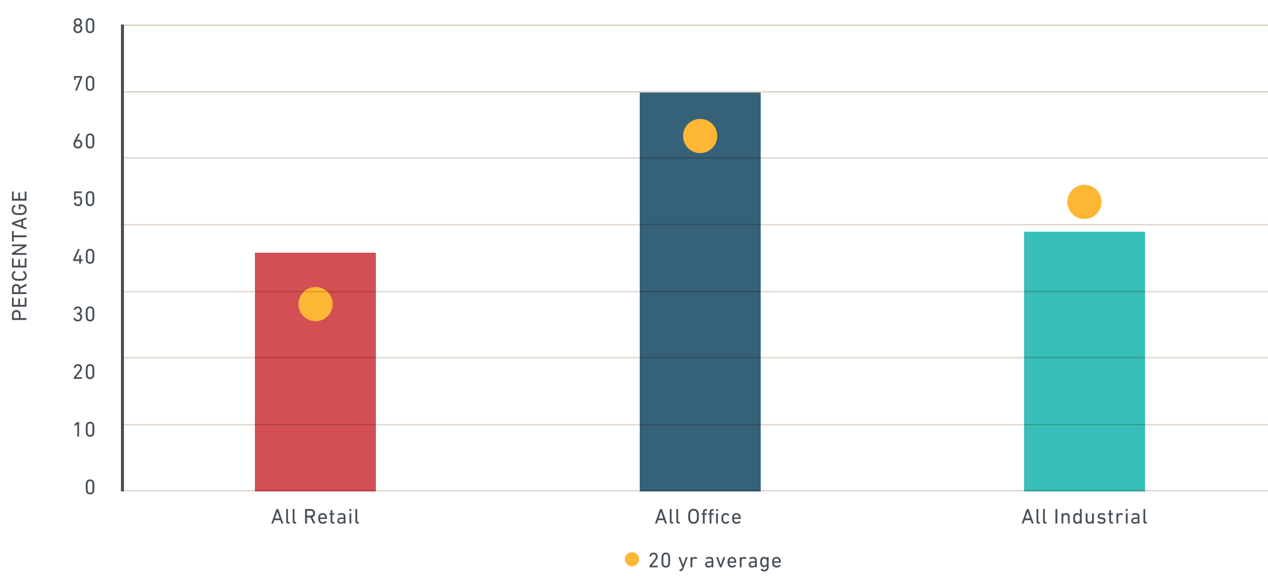
By region, Central London and the Rest of the UK witnessed the highest rates of vacancy upon lease expiry. While the retailer seems to prefer to remain in an established trading location, office tenants tend to be less attached to particular buildings or locations. The high vacancy rate meanwhile indicates the attractive options and deals available to office tenants, particularly those outside Central London and other major UK cities, who may find themselves leaving older, often obsolescent, buildings for modern space. Given that many of these occupiers may have signed leases at rents higher than those current in the market, they can often obtain improved terms and conditions at other locations, and may therefore prefer not to renew.

We saw more change within the retail sector in 2017. In 2016, we saw more regional variation in results and significantly higher levels of vacancy upon lease expiry in the Rest of UK segment. Last year, we hypothesised that structural change driven by ecommerce could be causing weakness in less strategic locations. In 2017, we have less variation between different retail segments but continued high levels of re-letting on vacancy compared to the other sectors. This may reinforce the thesis that, if weaker retailers fail in good locations and formats, there can still be significant demand from other retailers or even other industries to fill the space.

FIGURE 10

Vacancy rate upon expiry

Per sector; 2017 and 20-year average

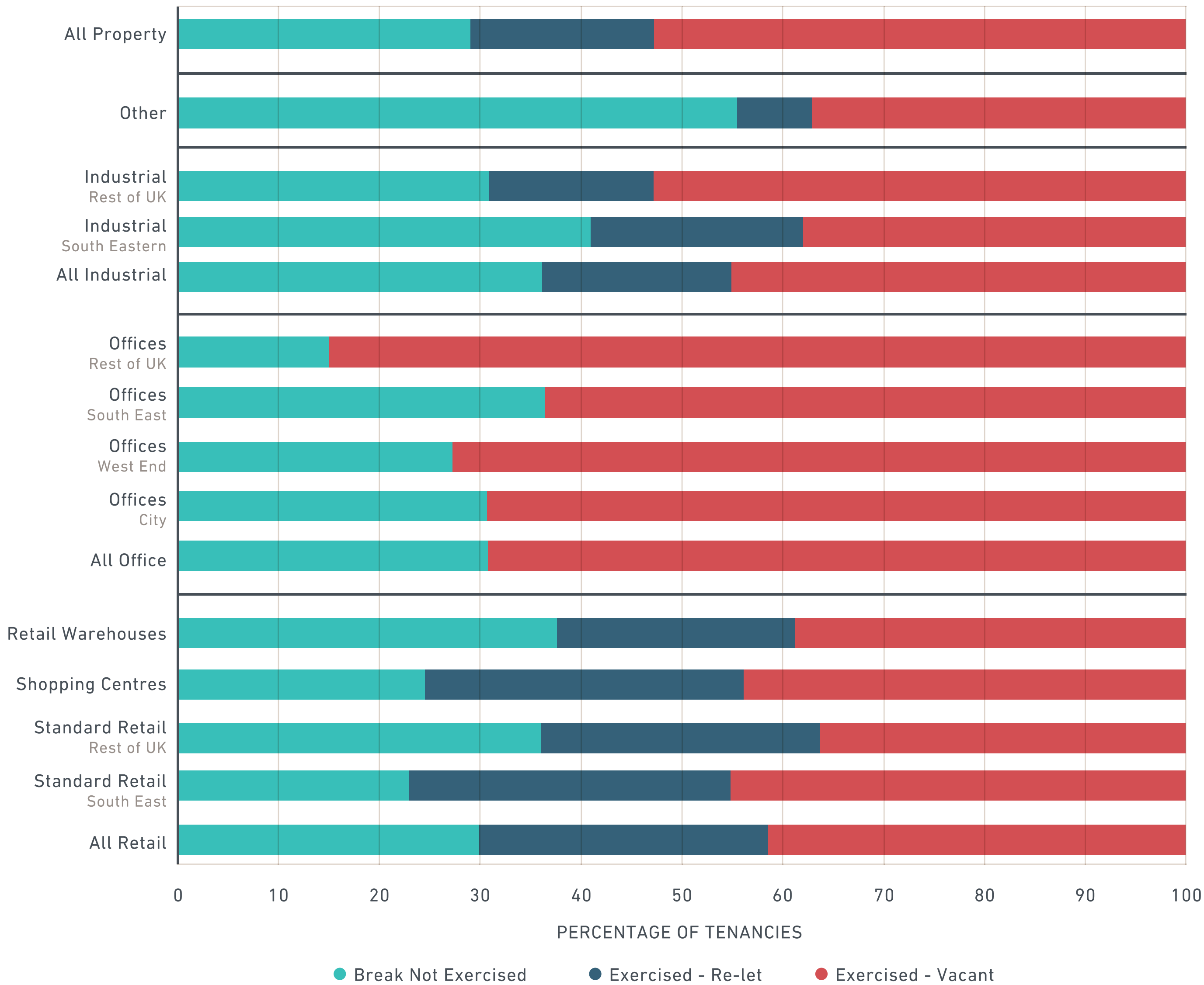


Source: MSCI

FIGURE 11

What happened when leases expired in 2017?

Per segment; rent weighted



Source: MSCI

WHAT WAS THE IMPACT OF BREAK CLAUSES?

Rents for many 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 signed leases then have been eagerly awaiting the opportunity to exercise their break clauses, aiming to work their way out of an over-rented position following the falls in rental levels associated with the GFC. In the period immediately following the GFC, we saw increased rates of breaks and vacancies as a result.

More recently, as rents have recovered in key locations, many tenants may now find it advantageous to remain where they are, given the competition for securing favourable buildings and terms elsewhere.

The percentage of tenants choosing not to exercise their break options declined to 79%, down from 81% a year before.

Table 2 shows the number of tenants across all property sectors who had the right to break in 2017. This is weighted by previous passing rent ("weighted") and by number of leases ("unweighted"). Although, as we saw earlier, it is increasingly common for tenants to seek break options in new leases, it is relatively uncommon for them to be exercised.

While fluctuations in this tendency are highly cyclical, driven by differences between in-place and market rental levels, in 2017 only 18% of leases were broken.

TABLE 2

Outcome of leases with a break occuring in 2017

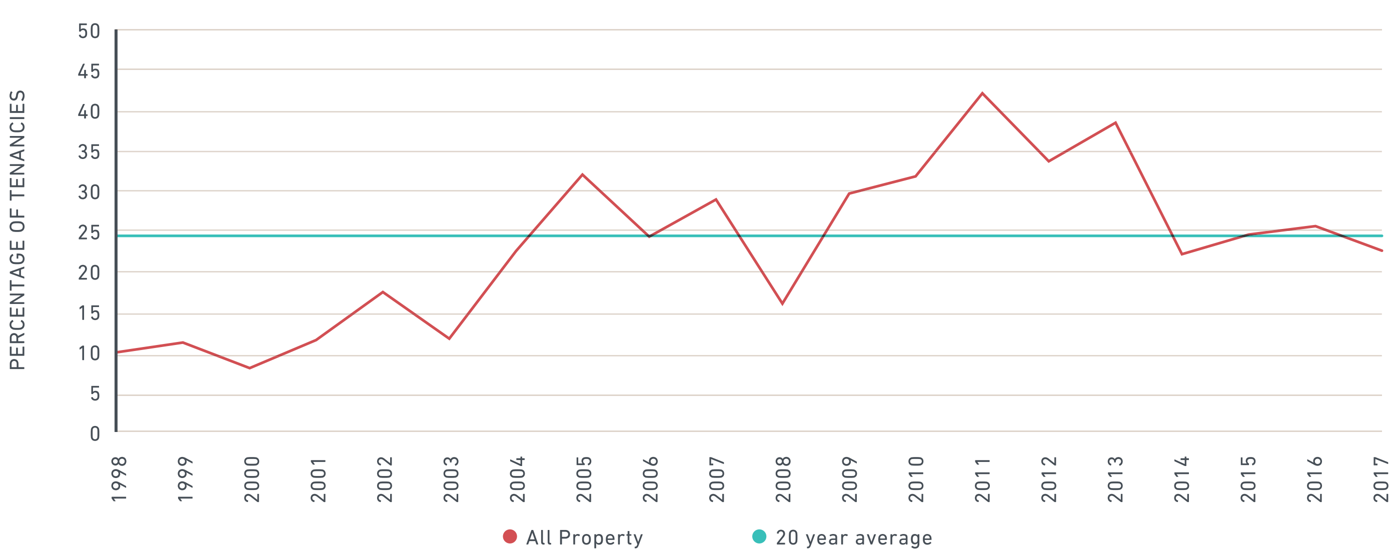
Break Not Exercised	**79%**	**72%**
Exercised - Re-let	**3%**	**6%**
Exercised - Vacant	**18%**	**23%**

Source: MSCI

FIGURE 12

Vacancy rate for exercised break clauses 1998-2017

Tenancies weighted by rent passing



Source: MSCI

Even when accounting for larger leases, only 23% of contracted income was lost due to breaks.

It is important for landlords to understand this interaction. This optionality is an attribute that could help attract tenants, if not secure higher rents, and one that may come at a relatively small cost, given that it is rarely exercised.

The rent-weighted vacancy rate due to exercised break clauses decreased from 26% in 2016 to 23% in 2017. This is now slightly lower than the 20-year average and well below the high of 2011 when 42% of break clauses resulted in vacancy for a quarter or longer.

The unweighted vacancy rate due to exercised break clauses was significantly lower than the weighted at 18%, but this was up from the 15% recorded a year before, although significantly below the 28% recorded in 2013.

The higher percentage of tenants vacating in 2017 on a rent-weighted basis implies that a higher proportion of vacancies were recorded among larger tenants.

The percentage of re-lettings remained low at 6% on a weighted basis, below the long-term average of 9%. Encouragingly, the proportion of break clauses not exercised increased to 72% from 68%.

At a sector level, there were again relatively broad differences in outcomes for break clauses that occurred in 2017. Given the preference for retailers to remain at established trading locations, the break clause action rate here tends to be lower than in other sectors, and this was no different in 2017, when it saw the lowest rate of any sector.

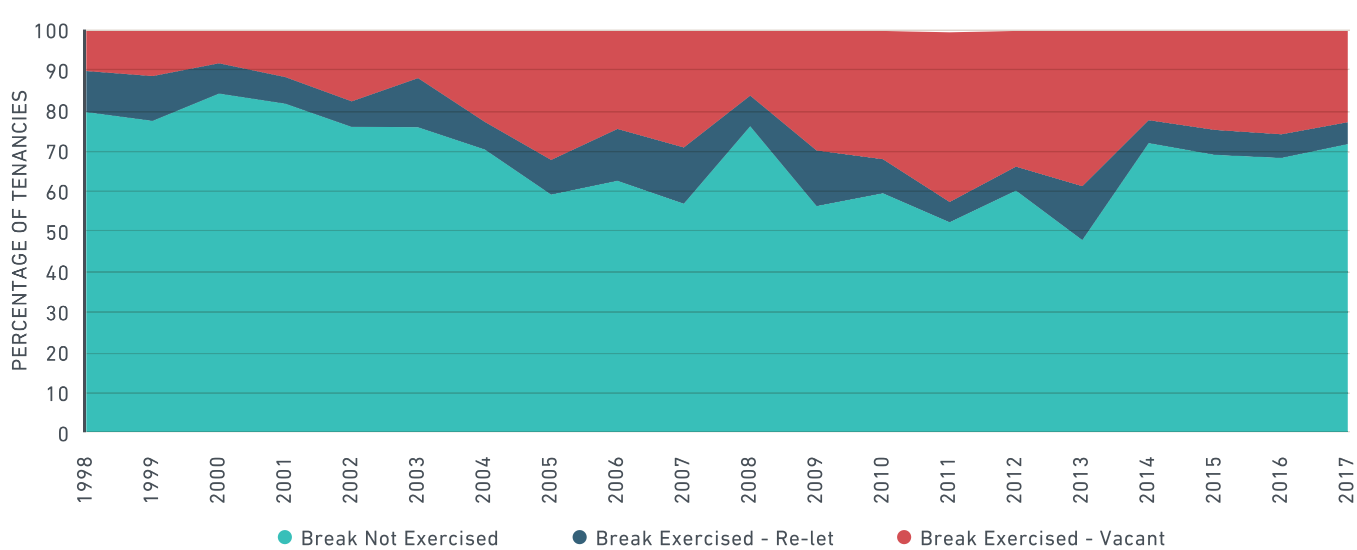
Weighted by previous passing rent, only 16.4% of retail tenants chose to exercise their break options when they arose in 2017. This was the lowest level since 2014 and well below the long-term average of 22%.

On a weighted basis, the industrial sector had the highest percentage of tenants activating their break clauses in 2017 at 42% – up significantly from 36% a year before. The industrial sector saw 30% (un-weighted) of tenants activating their break options in 2017, up from 21% in 2016.

FIGURE 13

Encouraging decline in levels of breaks exercised since 2013

Tenancies weighted by rent passing



Source: MSCI

Of the 30% of leases that had break clauses activated, 7% of these were re-let within the same quarter while the remaining 23% remained vacant for more than one quarter post-break.

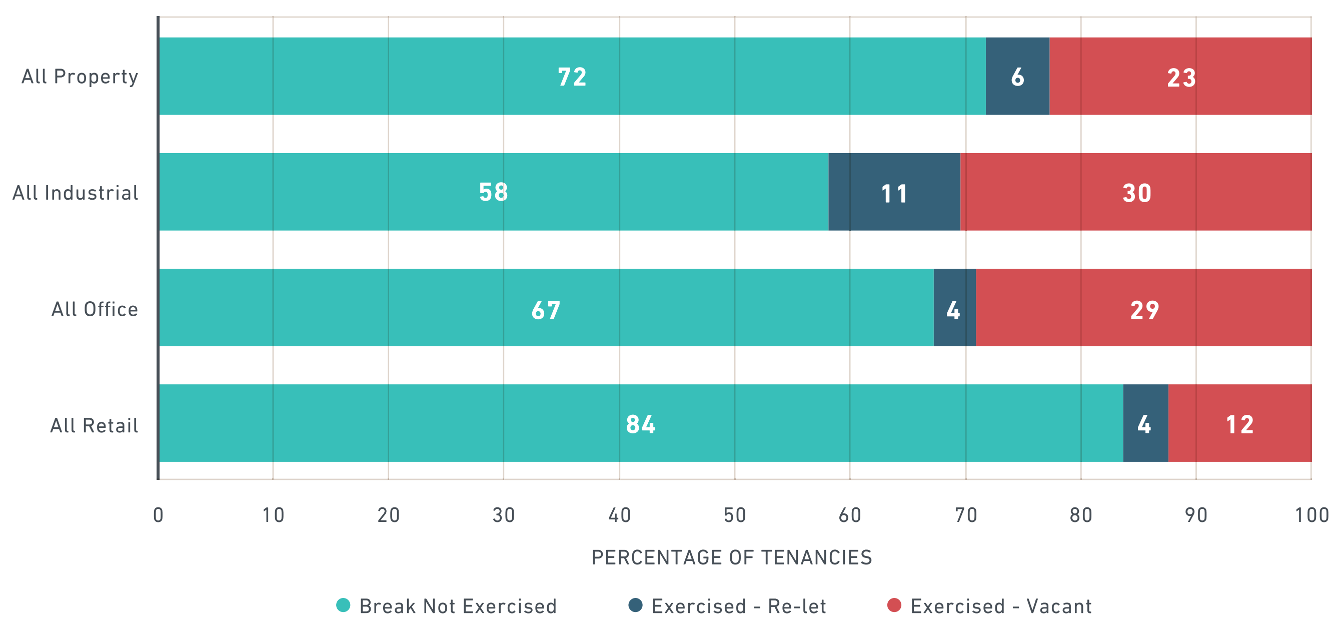
The office sector saw an improvement in the percentage of tenants not exercising break clauses in 2017, from 65% to 67%. The sector saw little change on an unweighted basis, suggesting a larger improvement in the proportion of breaks exercised among larger occupiers. Of these rent-weighted break clause actions in the office sector, 29% were vacant for at least one quarter post-break, while 4% were re-let in the next quarter.

Break clause action rates varied somewhat between different property types and geographies. For offices, the percentage of break clauses exercised increased notably in the City and West End market segments. On an unweighted basis, 47% of City Office occupiers exercised break clauses in 2017 – compared to 23% in 2016 and a 33% long term average.

On an unweighted basis, the prevalence of breaks exercised in the West End office market increased to 39% in 2017 – up from 17% in 2016 and 14% in 2015.

Interestingly, however, the percentage of breaks exercised in the West End decreased significantly on a rent-weighted basis to end 2017 at 15% against 44% in 2016.

FIGURE 14
Break clause actions (weighted)
Tenancies weighted by rent passing

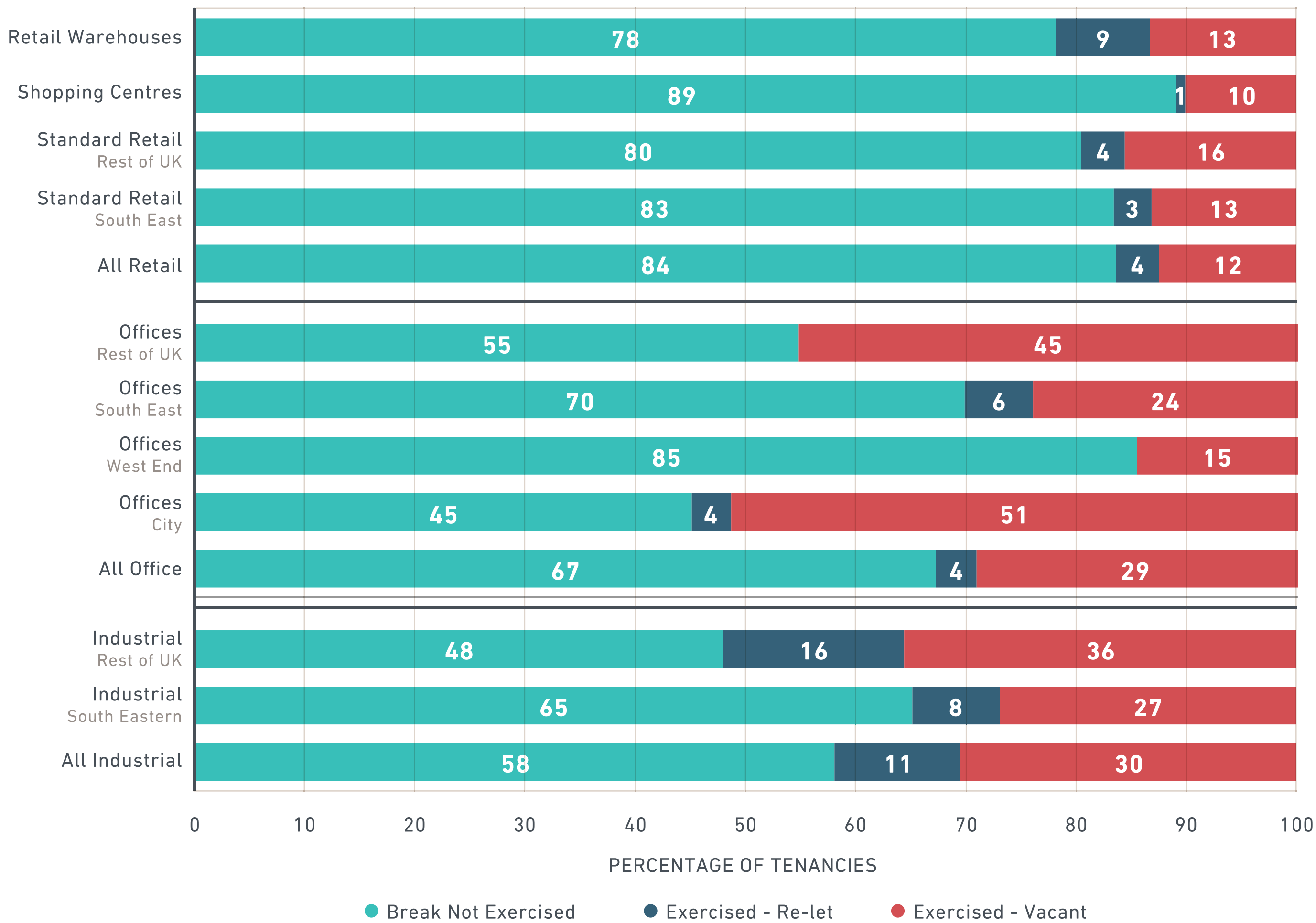


Source: MSCI

FIGURE 15

Regional disparity in lease breaks exercised (weighted)

Tenancies weighted by rent passing



Source: MSCI

This stemmed from the fact that while break clauses were exercised among a significant proportion of tenants (39%), this group only accounted for 15% of total rent passing.

Meanwhile, in the Rest of the South East, 70% of break clauses were not exercised on a weighted basis – a 3% improvement on the year before, when 67% of breaks were not exercised. Meanwhile, 24% of break clauses exercised resulted in a vacancy of at least one quarter, an improvement on the year before when the equivalent figure was 28%.

While retail property had the lowest tendency to exercise break clauses among the major property sectors, there was significant divergence between the segments in 2017. While Shopping Centres, Retail Warehouses and Standard Retail (South East & Rest of UK) all had similar rates of break action, the Standard Retail Rest of UK segment showed substantial improvement in its rent-weighted rate of break action with 80% of break clauses not exercised – up from 58% in 2016.

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 has been one of the key attractions for investors, the restriction on downward reviews meaning that there is often only minimal rental value movement during the life of a lease, particularly in a subdued market.

Therefore, income changes are generally seen at the end of a lease's life, when the tenant has the option to renew or vacate, as the rent will then revert to the open market rental value for the property. This provides for an interesting analysis of an investor's income position for properties when leases approach 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 in 2017.

TABLE 3

Rental change for new lettings in 2017

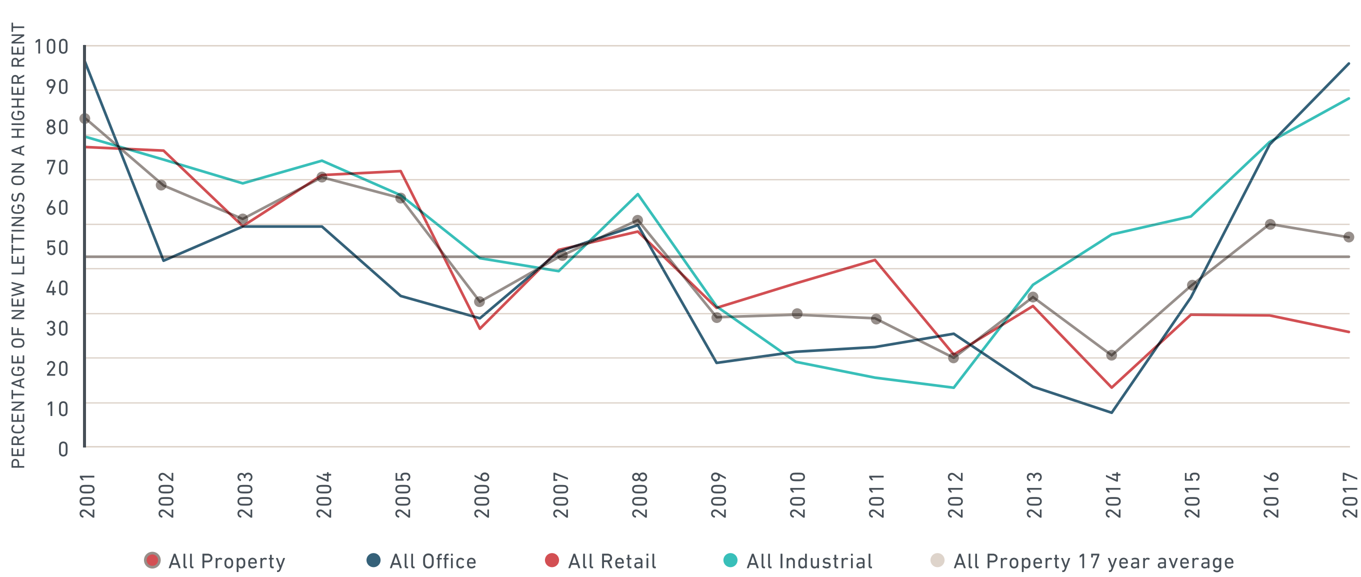
Higher	**52%**	**52%**
Lower	**35%**	**40%**
Same	**13%**	**8%**

Source: MSCI

FIGURE 16

Achievement of higher rent on new lettings 2001-2017

Tenancies weighted by rent passing



Source: MSCI

On an unweighted basis, for the second year running, the rental income achieved on the signing of a new lease or renewal was usually higher than previously. In 2017, 52% of new lettings were at a higher rental than previously achieved while 61% of renewals experienced positive rental reversions.

Between 2009 and 2013, it was more common for renewed or re-let space to achieve lower rents than were previously in place, since the leases had typically been signed during strong market conditions prior to the financial crisis. This trend is now reversing as more and more properties begin to offer reversionary potential.

In 2017, an unweighted 61% of renewals achieved a higher passing rent – up from 52% a year before. Weighted by rent passing, this figure was slightly lower at 54%, implying that positive reversions on renewals were more likely among smaller occupiers in terms of their rent passing.

In 2017, the weighted percentage of new leases reverting higher in the City and West End office markets was significantly up from a year before. As a percentage of City office renewals, 94% of new leases reverted higher on a weighted basis – up from 82% the year before – while the West End office market saw 100% of new leases reverting higher, something last seen in 2013.

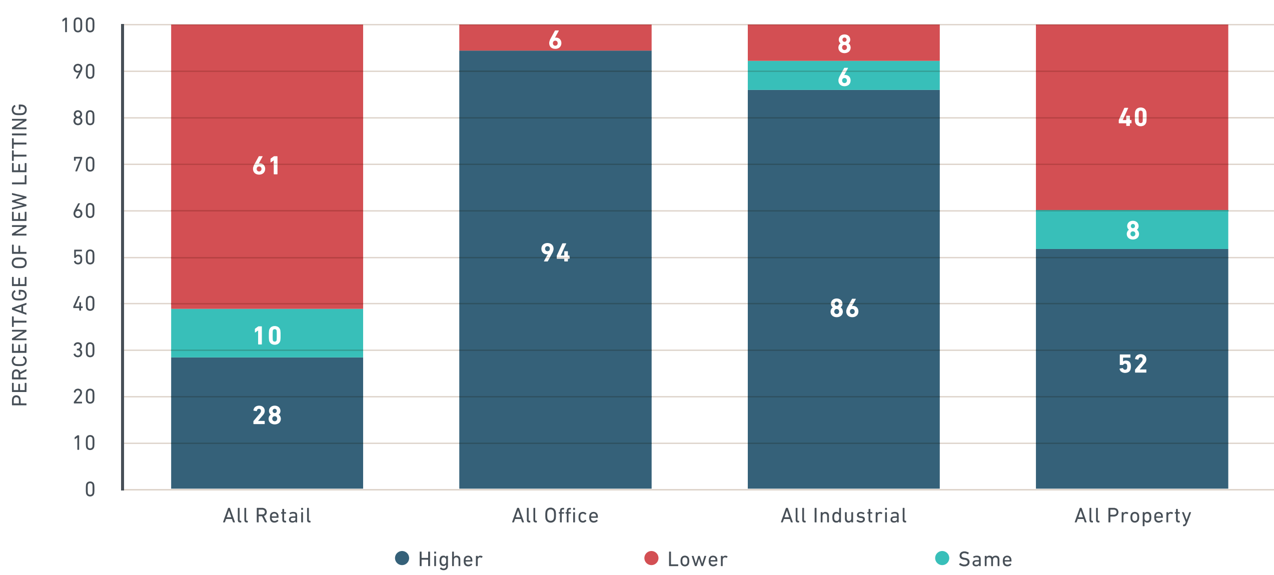
In terms of the percentage of tenancies (unweighted), 35% had lower rental income following a new letting, a slight improvement from the 36% recorded in 2016.

On an unweighted basis, the industrial sector performed best, with 83% of new lettings seeing an uplift in income, while retail properties were the weakest, with only 28% of tenancies witnessing an increase following new lettings. The industrial sector also recorded the largest improvement, given its 68% figure for 2016.

FIGURE 17

Weighted rental change for new lettings in 2017

Tenancies weighted by rent passing



Source: MSCI

INCOME AT RISK

The purpose of the Lease Events Review is to help investors understand in detail the risks they face to their current and future income. Much of the report focuses on the risk from loss of income at pre-scheduled lease events. Although the outcome of these events cannot be known in advance (except where there are early interactions with tenants), they can be planned for. Tenant default adds another layer of uncertainty, since the timing of this event, as well as its outcome, is also unknown. 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 rate of default by UK tenants continued to decline in 2017, falling to 2.3% of all tenancies when weighted by rent passing. This was down 40bps from the 2.7% recorded for 2016 and was the lowest rate of default registered for the UK market since 2007.

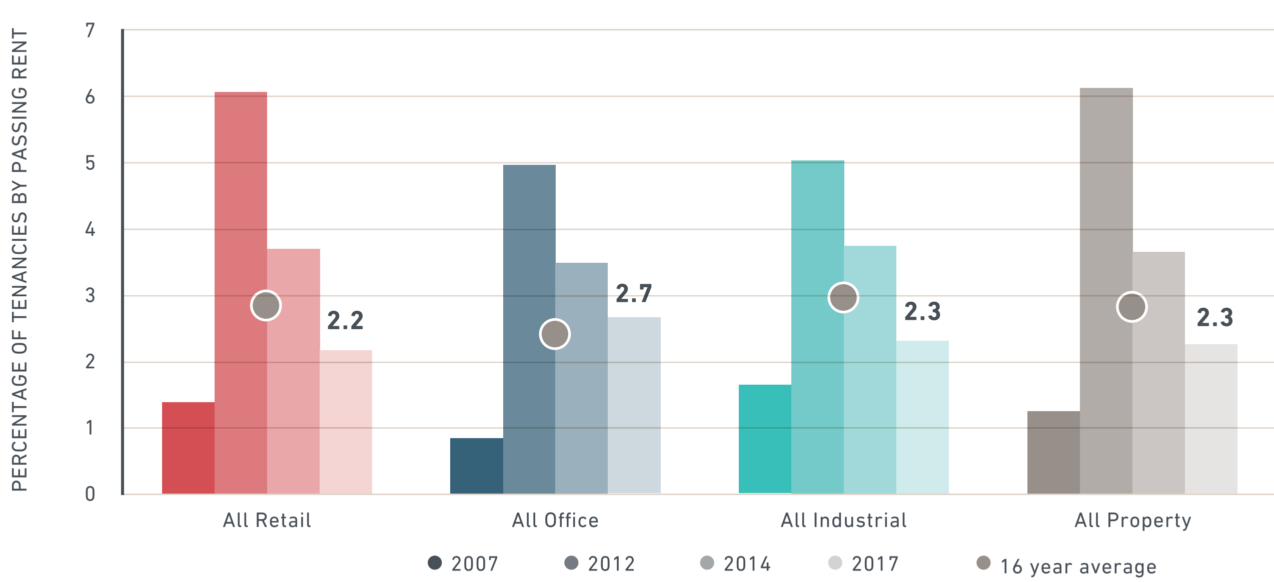
While the 2017 rate of default of 2.3% is well below the long-term average of 3.4%, it remains elevated compared to the pre-GFC period, as it averaged 1.8% between 2002 and 2007. The period 2008 to 2013 saw an average default rate of 5.3%, against which its current level and downward trajectory should be viewed positively.

In contrast to the negative press, the retail sector was the major driver of the declining overall rate of default, with an 80bps improvement in 2017 to 2.2%, as all four retail subsectors saw default rates fall to the most favourable levels since 2007. In the 10 years since the GFC, retail has been the most improved sector with regards to its rate of default. Retail's improvement relative to the office and industrial sectors has been especially pronounced since 2012, as retail was the weakest sector for defaults immediately following the financial crisis, due to fragile consumer confidence and declining sales across the UK.

FIGURE 18

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

Tenancies weighted by rent passing

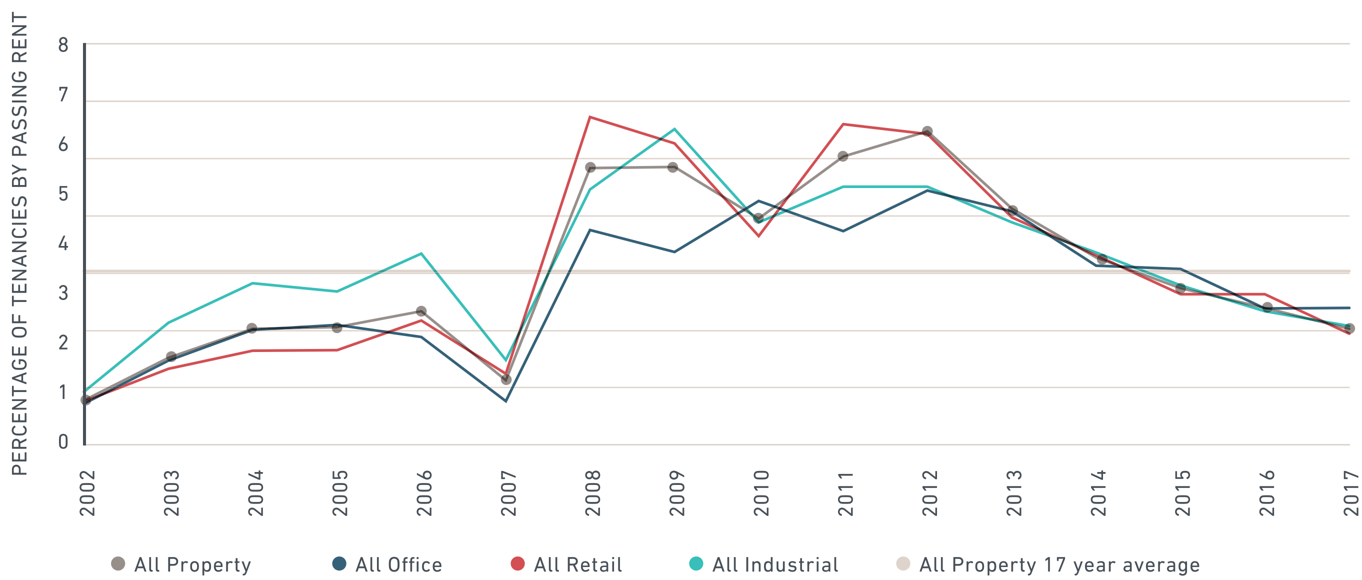


Source: MSCI, D&B

FIGURE 19

Tenants in default by sector, 2002-2017

Tenancies weighted by rent passing



Source: MSCI, D&B

While rates of default have converged at the sector level, they varied more by location and property segment. This was particularly the case for the office and retail sectors, but less so for the industrial sector, where default rates for the South East have closely tracked those for the Rest of the UK.

Offices in the City of London, dominated by financial occupiers, recorded the largest deterioration in default rate in 2017, having been the most improved sector in 2016. The segment's default rate ended 2017 at 4.1%, compared to 2.5% in 2016. Despite this weakening, default rates remain well below the levels of 2012-15, when they averaged 10.0%.

2016 default rates had represented a huge improvement from the extended period of high rates following the financial crisis and through the Eurozone sovereign bond crisis. This period witnessed many defaults by large tenants, and major firms using this window as an opportunity to restructure and rationalise their space requirements and City operations. Although default rates in the City of London are much improved compared with recent history, they are still among the highest in the broader UK market, ranking only behind Shopping Centres.

Conversely, offices in the neighbouring West End market have enjoyed more stable default rates, lying at 2.7% of passing rent in 2017 after peaking at 4.5% in 2012.

Among the retail segments, Shopping Centres had the highest rate of default at 4.1%, although this was a 130bp improvement from the 5.4% rate in 2016, and well down from the high of 9.2% in 2011. This segment, being heavily reliant on consumer confidence, has had a consistently high default rate since the economic downturn began in 2008 – averaging 6.9% for the ten-year period post-GFC. The headwinds associated with ecommerce growth will not be helping either.

It is interesting to contrast Shopping Centres' default rates with their levels of vacancy due to lease expiry or the exercise of breaks. While they have the highest rates of default across all property sectors, they enjoyed relatively high rates of renewal at lease end and the lowest rates of break action. When tenants did leave, the space they left tended to be re-let more frequently.

Although we can show data on rates of tenant default, it is harder to track the outcome of such defaults in terms of re-letting and ongoing vacancy.

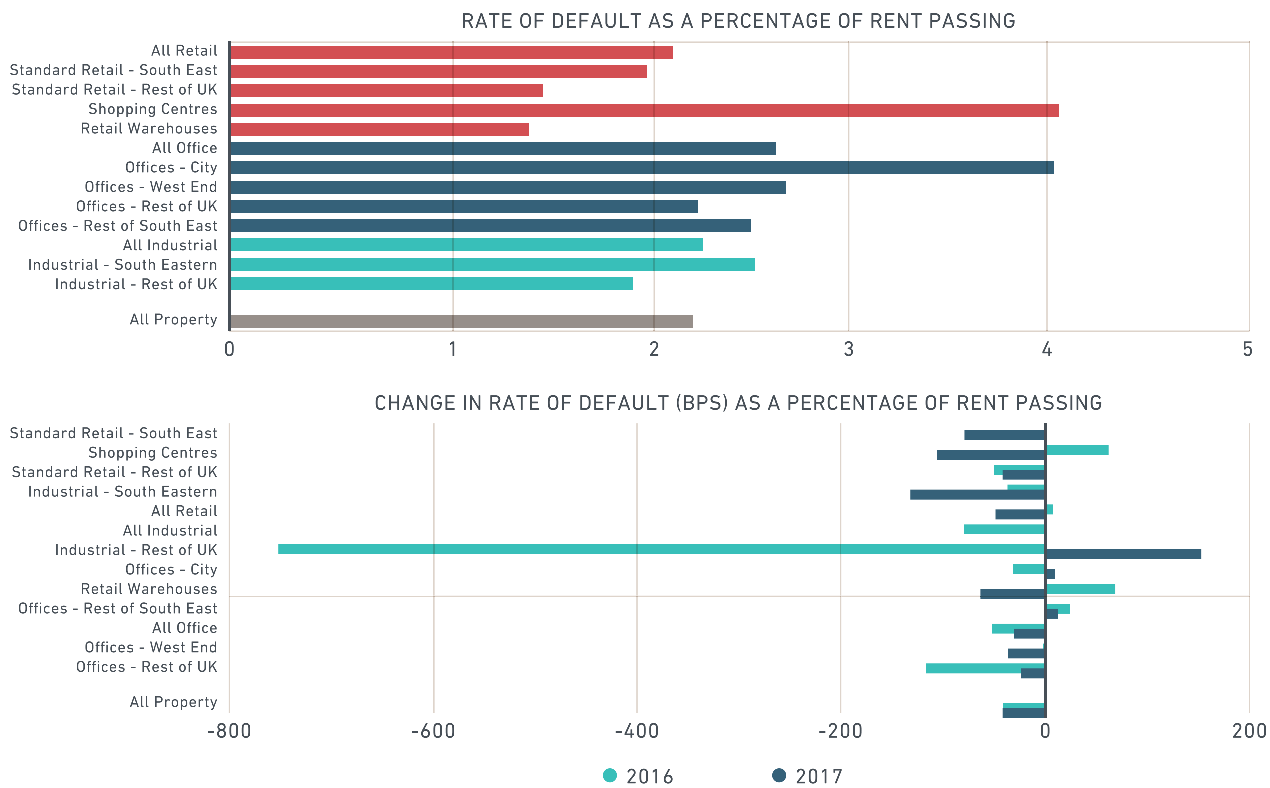
This is easier to do following pre-determined lease events, since the dates are known in advance. Landlords can market space beforehand and line up new tenants to minimise void periods if tenant demand allows.

Tenant defaults are not pre-defined and the space affected may not become vacant immediately after default, complicating the re-letting process. So, while we can track the rate of tenant default, we cannot describe how likely it was that the space they left behind was re-let or remained vacant in the same way that we can for other lease events.

FIGURE 20

Tenants in default by type and location; 2017

Tenancies weighted by rent passing



Source: MSCI, D&B

FIGURE 21.1

Retail defaults down to lowest levels since 2007

2008-2017; All Retail and Retail segments

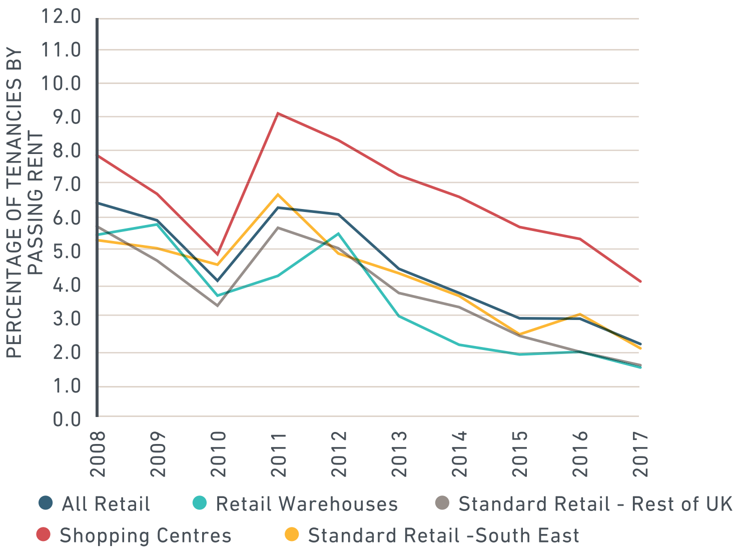


FIGURE 21.2

Office sector defaults: stable overall but up for city offices

2008-2017; All Office and Office segments

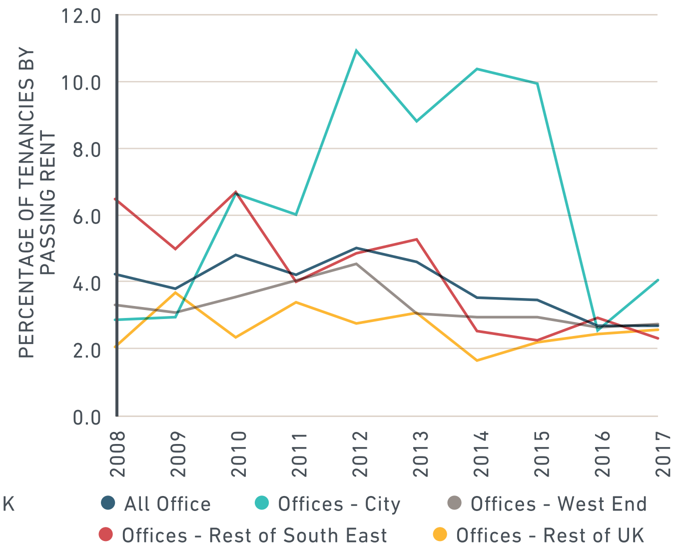
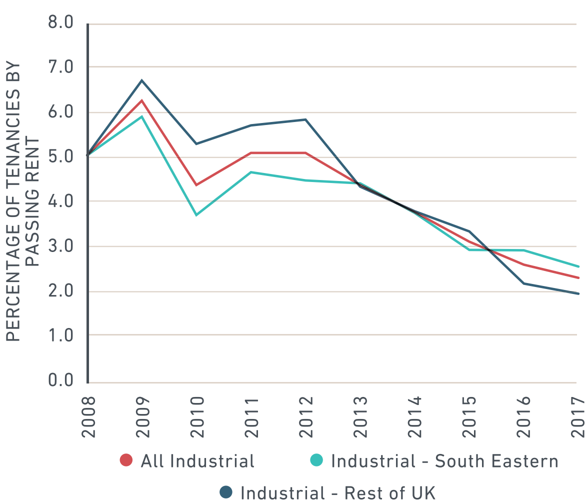


FIGURE 21.3

Industrial tenant defaults continue to improve

2008-2017; All Industrial and industrial segments



DEFINITIONS

Default

The loss of annual income stream from losing four quarters of rent. No allowance has been made for recourse to the original tenant on assignments, for guarantees from parent companies, for rent deposits, or for eventual recoveries from liquidators. In addition, no allowance has been made for the possibility of re-letting a unit within twelve months of the insolvency. The actual level of defaults written-off by landlords in their accounts, in terms of a few quarters of unpaid rent and net of various recoveries is likely to be significantly lower.

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.

Insolvency

There are three main forms of insolvency. Administration is where a receiver, or manager has been appointed with the aim of selling the business as a going concern. Liquidation is where creditors (or sometimes the company's directors) have appointed a liquidator to wind-up the company. Receivership is similar to a liquidation, but is usually where the appointment has been made by a bank.

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. (It also excludes new tenants who are benefiting from a rent-free period).

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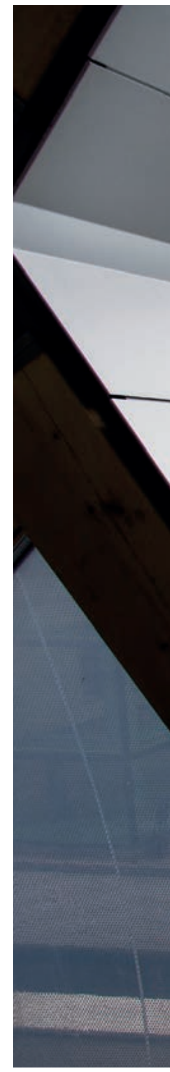

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