

# UK LEASE EVENTS REVIEW

NOVEMBER 2017

Prepared by MSCI in association with BNP Paribas Real Estate



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# SPONSOR'S FOREWORD

With the Lease Events Review reaching its 19th year, it is interesting to note that the analysis seems to take on more and more relevance as time goes by.

In an era of short lease lengths, exponential change in technology and high political uncertainty, hard evidence regarding tenant behaviour at lease end would appear more vital than ever in allowing investors to accurately assess property risk and develop future business plans.

The period following the vote to leave the EU in June last year has been one of very mixed messages for investors. The economy comfortably outperformed expectations of growth in the aftermath of the vote; albeit 2017 has seen the expansion of the economy fall back behind that being seen in the Eurozone. Whilst capital values, which declined marginally immediately following the Referendum, have actually rebounded in 2017, with many international investors' appetite for UK real estate assets seemingly undimmed by the uncertainty surrounding the likely future settlement between the UK and the EU.

It is notable that UK domestic investors appear far more reticent to expand their holdings, however. This dichotomy in the market is holding values firm for the time being. In terms of assets transacted, Q1 through Q3 saw £38bn of completed transactions; a number likely to get close to £50bn by year-end. For investors looking forward, the picture is muddled considerably by the outlook for interest rates. Specifically, the uncertainty surrounding what conditions would actually prompt central banks, including the Bank of England, to actually raise interest rates in the future, given the lack of wage-push inflation across developed economies. At the time of writing, UK interest rates have been increased to 0.5%, albeit this is only an increase back to the rate seen prior to the Bank of England's rate cut in August 2016.

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

Although average UK lease lengths have shortened considerably since the 1980s and 1990s, recent years have provided some relief to investors with lease lengths remaining relatively stable. The same is true of 2017. Does this mean that we have reached the end of this structural change in the market? Possibly not. In the office sector, for example, serviced offices, or coworking providers, are becoming a significant part of the market, taking long leases from landlords and picking up the rental premium for leasing out and managing short-term space. We should also be cognisant of the fact that in recent years we have seen economic growth and declining vacancy rates in many markets. A weakening of occupier markets could easily herald the resumption of declining lease lengths for non-core product.

As we move through the final quarter of 2017, our thoughts turn to the future. Clearly, Brexit remains both the hottest topic of discussion and as clear as mud, with the clock ticking down to the UK's exit in March 2019. Tenants are increasingly conscious of this, and we expect them to seek greater flexibility in the next 12 months, as they seek to steel themselves for whatever comes next. Much of the investment market will likely continue to focus its efforts on income security, and long-let logistics assets look set to remain the in vogue investment. For those investors willing to expose themselves to tenants' desire for flexibility, however, there may be strong income returns to be had.

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



Andy Martin



**BNP PARIBAS  
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# INTRODUCTION

Almost a year after the UK voted to leave the European Union, its economic performance has showed mixed results. The risks of an immediate Brexit-induced recession did not materialise despite the substantial political and economic uncertainty it added to the UK outlook. On the contrary, up until the end of 2016 the UK saw a continuation of strong consumer spending and strong output in consumer-focused activities.

However, the UK economy has been showing signs of slowing down in the first half of 2017, with weak growth in the services sector and business investments. In addition, strong consumption growth started to cool down as individuals' purchasing power declined due to a weaker exchange rate.

Following the Brexit vote, the pound depreciated sharply against the major currencies and the domestically-focused FTSE 250 index declined. Government bond yields meanwhile weakened to record lows, on expectations that monetary policy would be loosened in response to the Brexit vote.

The UK economy grew 1.5% year-on-year in the second quarter of 2017, following a downwardly revised 1.8% expansion in the previous period. It was the lowest annual growth rate since the first quarter of 2013, as household spending and fixed investment growth slowed.

On a quarterly basis, the UK economy expanded by 0.3% for the three months to June of 2017, the slowest growth in the G7 for a second successive quarter. Overall, the latest GDP figures suggest that the UK economy is on a low growth trajectory after initially holding up better than expected in the months after last June's Brexit vote, when consumer spending remained strong.

The UK's GDP growth of 0.3% in Q2 2017 was also the joint weakest in the EU (alongside Portugal). In contrast, the Czech Republic (2.5%) recorded the strongest growth amongst EU countries in Q2. The EU as a whole recorded GDP growth of 0.7% in Q2, up from the growth of 0.5% recorded in Q1. In annual terms, EU GDP growth rose to 2.4% in Q2 2017, up from 2.1% in the previous quarter.

For the year ended June 2017, fixed investment was the main driver of UK economic growth, while household expenditure growth eased to 1.6% year-on-year from 2.3% in Q1. Government spending growth remained marginally positive at 0.5% after increasing by 0.3% in Q1.

On the output side, the services industries were the only positive contributor to GDP growth. Industrial production growth meanwhile slowed to 0.2% as at June 2017, as manufacturing, construction and utilities-related activity all slowed through 2017, with business confidence remaining suppressed.

Inflation remains a challenge, as consumer price inflation has trended above the Bank of England's (BoE) target rate of 2% since February 2017. British consumer prices rose 3.0% for the year to September 2017, following 2.9% growth in August; this was also above market expectations of a 2.8% gain. It was the highest inflation rate since November 2014, with rising prices largely the result of a weaker pound. The Bank of England increased the Base Rate to 0.5 percent in November, in an attempt to relieve the squeeze on living standards from surging prices and sluggish wage growth.

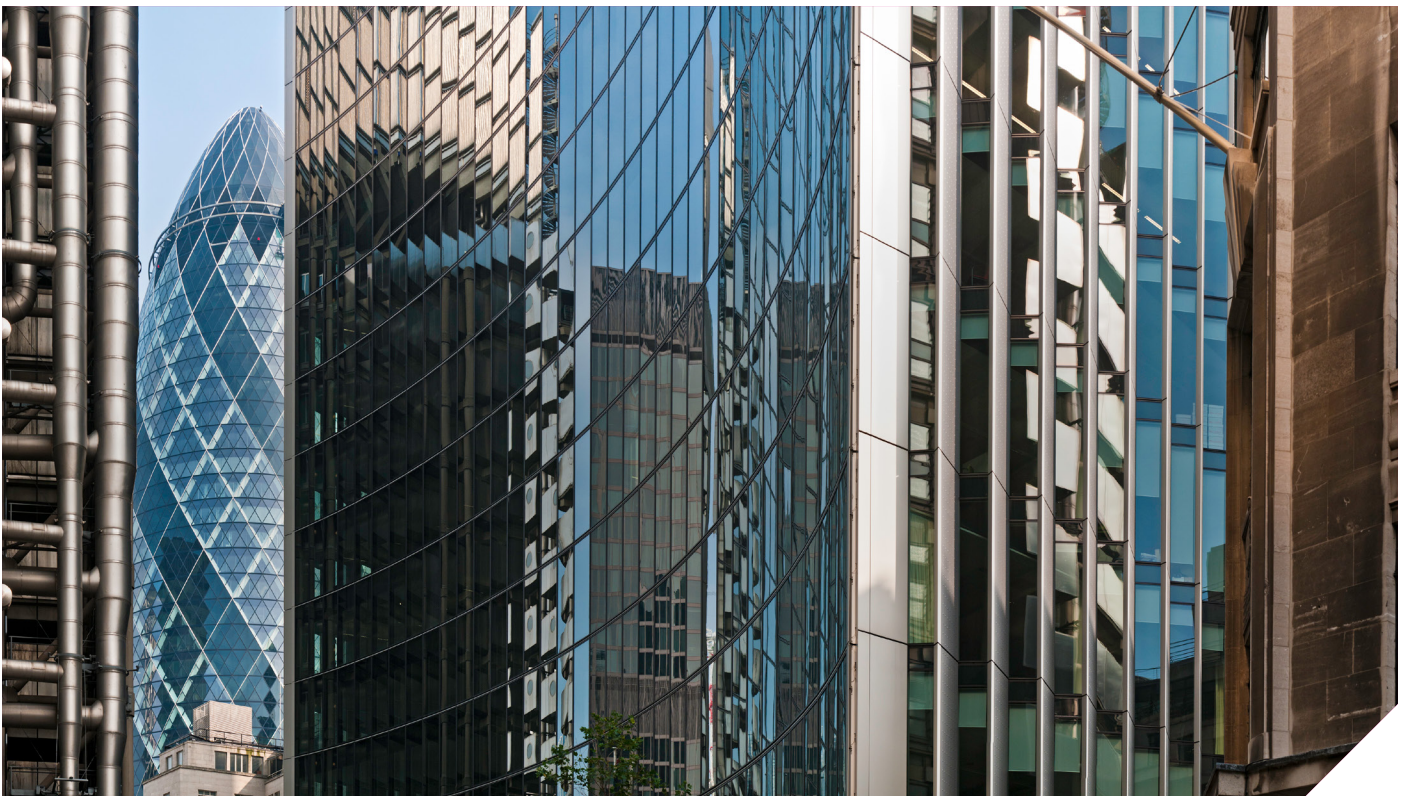
The fallout from the Brexit vote saw the rent-weighted lease length decline by half a year during the first 6 months of 2017 – the largest decline since 2009 – suggesting that larger occupiers have in aggregate been negotiating shorter leases.

During the first 6 months of 2017, the length of rent free periods increased by half a month to 9.5 months, while the proportion of leases with a break clause continued to rise, reaching its highest level in the series' sixteen year history at 40.3%.

To evaluate income streams for investors in commercial real estate, 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 their analysis is crucial for helping potential 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 2016 and year to June 2017, in association with BNP Paribas Real Estate, provides empirical evidence on the likelihood of the different types of lease events. The analysis was based on a sample of over 75,000 extant leases held in the IPD UK Annual and Quarterly Property Universe, and more than 8,200 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 renewal. Each of these events is intrinsically linked to the broader economic landscape and improvements in business activity, exports and consumer trends, all of which have a direct effect on lease conditions.



# REVIEW OF NEW LEASES IN 2016

The New Lease Review section of this research report provides an analysis of the changing patterns of lease agreements in the UK commercial property market. 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 2017.

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## HOW HAVE LEASES CHANGED THIS YEAR?

During the first half of 2017, the average unweighted length of leases granted in the UK market stood at 7.1 years. While only marginally down from 2016, this was the first year that lease length shortened since 2010. Following a number of years of increasing occupier confidence, the uncertainty generated by the Brexit referendum and this year's general election result may have diluted the trend toward lengthening leases. Despite the recent fall, average lease lengths are now a full year longer than they were at the bottom of the cycle in 2011.

Further evidence of lengthening leases can be seen from the distribution of leases granted by lease length band. Since 2011, the proportion of leases shorter than 5 years has dropped from above 54% to 39.3% of the total sample. Over the same period, the percentage of leases of 5-9 years in length has increased by 15% to 40.9% of leases granted on an unweighted basis.

While the aggregate lease length has increased by more than a year since 2011, the share of leases of 15 years and longer has declined from 6.2% to 5.1% of the total on an unweighted basis. This is a continuation of a trend that started in the early 2000s, when new leases of 15 years and longer accounted for more than a quarter of the total. This reveals 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. 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 in the UK as a whole.

When weighted by passing rent, the average lease length has declined by 10 months since 2014. This stands in contrast to the unweighted lease length, which increased by 3 months over the same period. It suggests that larger occupiers have on aggregate been negotiating shorter leases.



## AVERAGE NEW LEASE LENGTHS TO 2017 (UNWEIGHTED)

FIGURE 1.1

### Unweighted lease length distributions

Percent of new lets in each lease length band

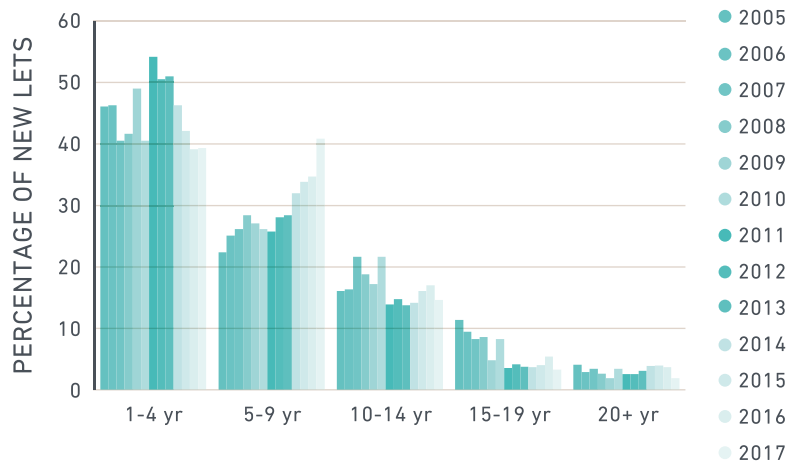


FIGURE 1.2

### Unweighted lease length

Unweighted full term; ignoring breaks and including short leases

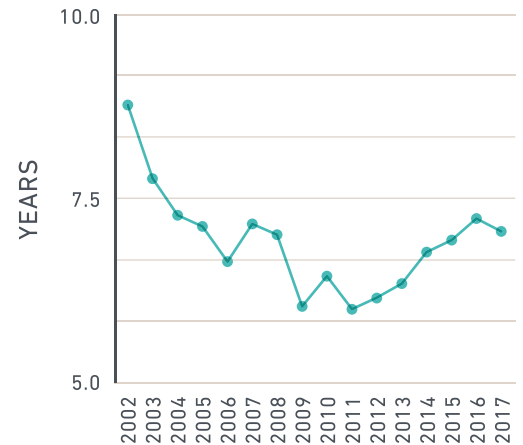


FIGURE 1.3

### Change in lease length distribution (2009 to 2017)

Change in percent of new lets in each lease length band

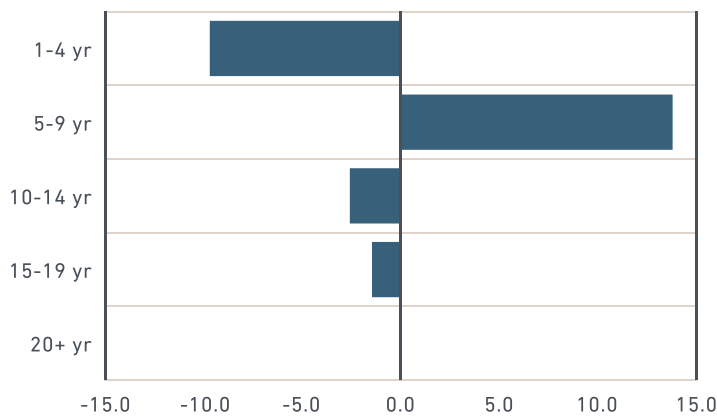
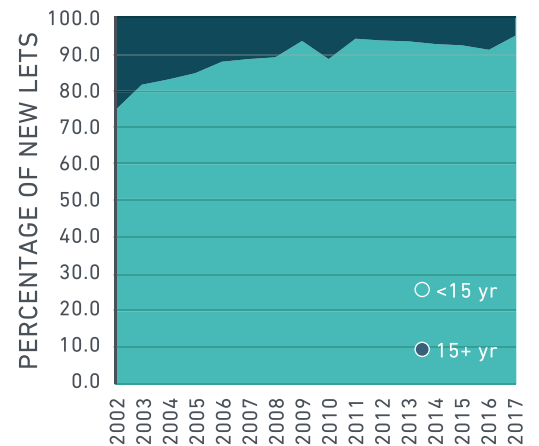


FIGURE 1.4

### Unweighted lease length

New lettings



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

Source: MSCI

The first half of 2017 saw a further decline in the proportion of leases of 20 years and longer, which dropped from 19.2% in 2015 to 12.2% as at June 2017. This decline was mirrored by a 7.4% increase in the proportion of leases of 1-5 years, and suggests an increasing desire for flexibility among larger occupiers.

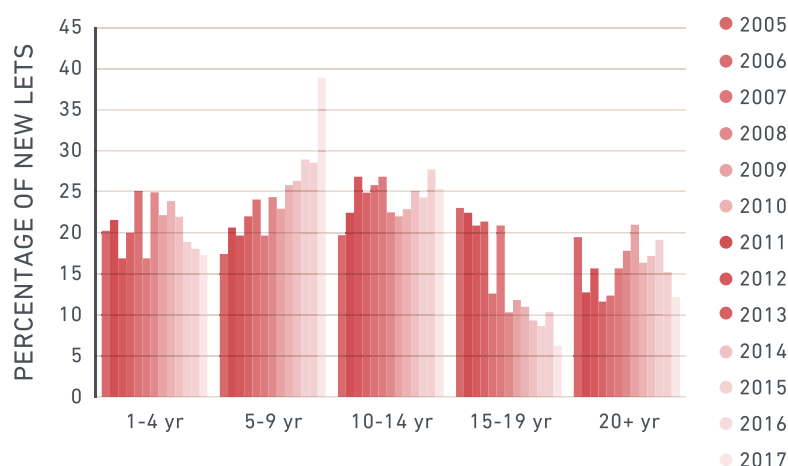
Taking these trends together suggests an interaction between long term movements and cyclical fluctuations resulting from short term market dynamics. Since the beginning of the analysis period, there has been a clear downward trend in new leases longer than 15 years, particularly among larger occupiers, as evidenced by the stronger trend in the weighted measure.

## AVERAGE NEW LEASE LENGTHS TO 2017 (WEIGHTED)

FIGURE 2.1

### Weighted lease length distributions

Percent of new lets in each lease length band



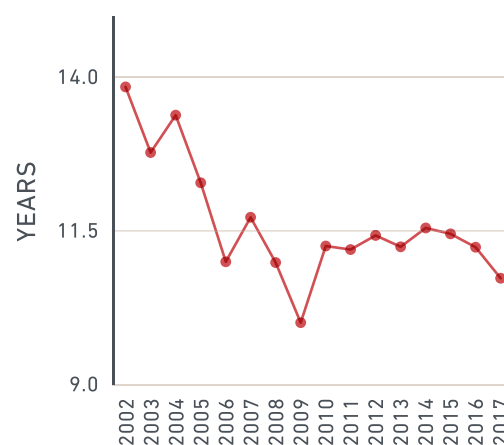
Note: Full lease term on all leases; weighted by rent passing.

Source: MSCI

FIGURE 2.2

### Weighted lease length

Unweighted full term; ignoring breaks and including short leases



Longer leases appear to have been replaced by those of 5-9 years. Occupiers have become much more sophisticated in managing their real estate costs as a factor of production, and the flexibility of shorter leases has a vital part to play in these efforts. Layered on top of this have been more cyclical fluctuations. Short leases of up to 5 years became much more prevalent following the financial crisis in 2009. 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, while not reversed, the declining trend in very short leases has slowed recently, while for bigger tenants the propensity to take the longest leases has also turned down again. At the margins, it seems that recent uncertainty has compounded the longer term trend for shorter leases.

For the first 6 months of 2017, leases of 10 years and shorter accounted for 79.9% of new lettings on a rent weighted basis – up from 70.7% in 2015.

An analysis of lease lengths by sector reveals that all three sectors have seen lease lengths remain relatively stable since last year, although for retail unweighted lease lengths increased by a modest 2 months for the first half of 2017. This continues a steadily increasing trend 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.

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 convergence of 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

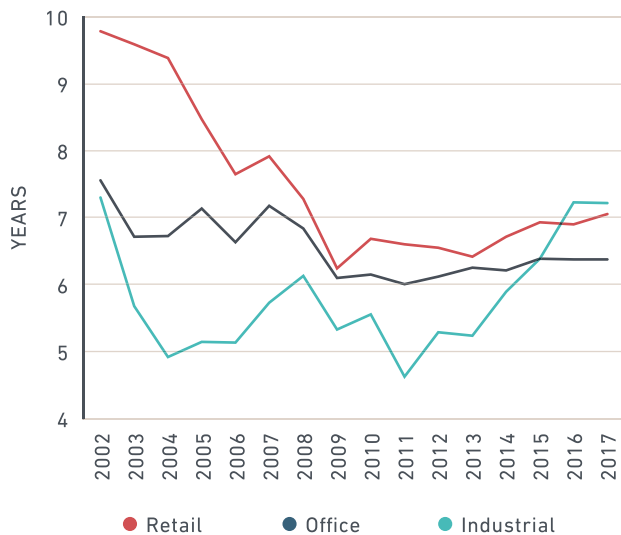
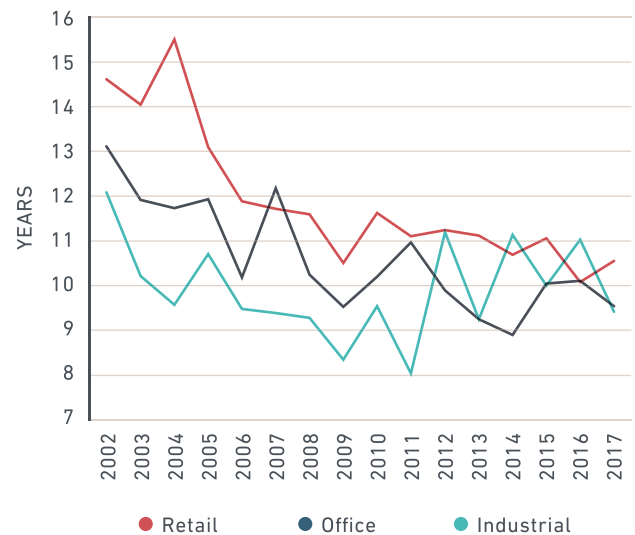


FIGURE 3.2

### Average lease length trends by sector

Weighted full term, ignoring any breaks, including short leases



Source: MSCI

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

While the longer term trend since the financial crisis has been for unweighted lease lengths to remain stable or increase, weighted leases have generally trended downward, though with greater volatility. This may reflect a tendency for tenants taking larger amounts of space to favour flexibility over security of tenure. The greater volatility of the weighted measure reflects the potential for small numbers of large leases to influence overall trends – particularly in the industrial market. The most recent data for 2017 shows office and industrial continuing the longer term trend of declining lease lengths, while retail showed a slight increase on a weighted basis, bucking the longer term trend.

Office lease lengths saw a steady increase to reach 6.4 years at end Q2 2017, 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 in 2011 to 7.5 in 2017, has been a key driver of this trend. Conversely, offices outside Central London and the South East saw rent-weighted lease lengths increase from 9.9 years in 2011 to 10.9 years in 2016, signalling a vote of confidence by large occupiers.

Industrial lease lengths showed little change on an unweighted basis during the 6 months ended June 2017, although they shortened significantly on the rent-weighted measure.

As at June 2017, the average unweighted industrial lease length was 7.2 years, well up from 4.6 in 2011. The increase in industrial lease lengths since 2011 has primarily been driven by longer leases in Greater London. Overall, unweighted lease lengths here are now around 11 months longer than they were in 2011, while the rent-weighted lease length also ticked up by 11 months, suggesting improving sentiment among both small and larger industrial occupiers.

In addition to leasing trends by sector and location, this analysis also compares trends for small and medium enterprises (SME's) 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 and so finding large units of appropriate space can be challenging. This trend is consistent across all of the traditional property sectors.

On an unweighted basis, the average office lease signed by an SME in the first half of 2017 was for a period of 4.6 years, compared to an average of 5.0 years for large companies.

On a weighted basis, the difference between office lease lengths for SMEs and large corporations widened significantly during the first 6 months of 2017, as large companies' leases lengthened more than SMEs'.

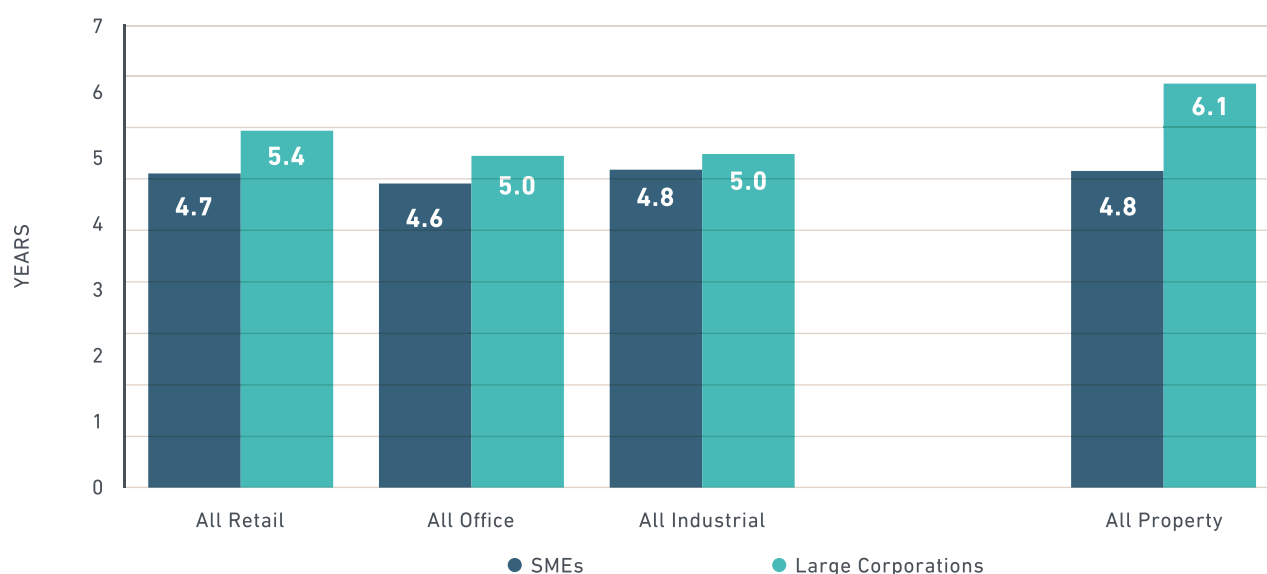
Large companies in the retail sector saw weighted lease lengths decline by around 4 months since 2016, while those in the industrial sector committed to leases that were 13 months shorter than a year before.

The larger the unit of space, the more strategic and long-term the lease is likely to be, for both the occupier with respect of its business operations and for the landlord in the context for the overall asset business plan. Smaller units of space are more likely to be tactical in nature for both tenant and landlord.

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 future income growth, leading to the expectation that rent free periods would shorten and the percentage of leases with break clauses diminish.

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

As at June 2017, 40.3% of leases included a break clause, a rise from 28.2% in 2008. The increase has primarily been driven by leases between 6 and 10 years in length, where the proportion with a break clause has risen from 40.3% in 2008 to 60.9 in 2017.

In contrast, the occurrence of break clauses in leases of 5 years and shorter has fallen significantly, from 30.3% in 2012 to 26.2% in 2017.

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.

Since 2009, the increase in break clauses for leases 21 years and longer has been even greater, rising from 15.5% to 32.5%. Overall, break clauses are most common in the industrial sector (49.4%) followed by the office sector (41.0%), while the level is lower for retail (34.5%). Despite this low level, it has risen far more in percentage terms over the whole analysis period. 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 seen as a less scalable factor of production in retailers' business models than by office and industrial tenants. However, this perception seems to be changing with the rise of internet shopping, as floorspace may no longer be the optimal route to market. Retailers may therefore want more strategic and tactical flexibility in their use of space, a trend that has fed through to their leasing arrangements over recent years.



PROPORTION OF LEASES WITH BREAK CLAUSES BY SECTOR

Unweighted; By Lease Length Band; per sector; 2005-2017

FIGURE 4.1  
All Property  
Leases with break clauses

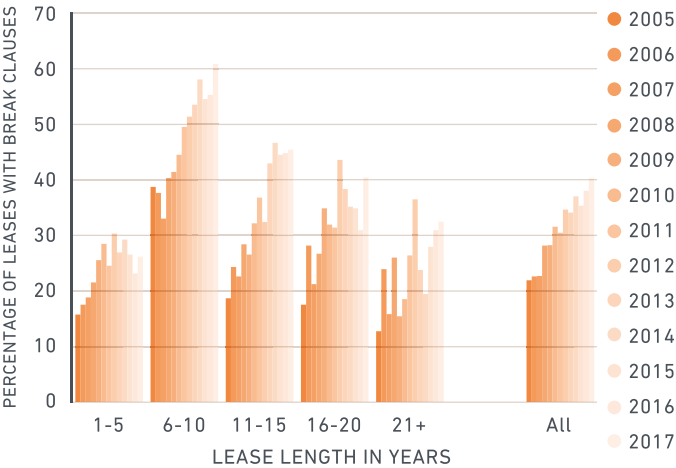


FIGURE 4.2  
Retail  
Leases with break clauses

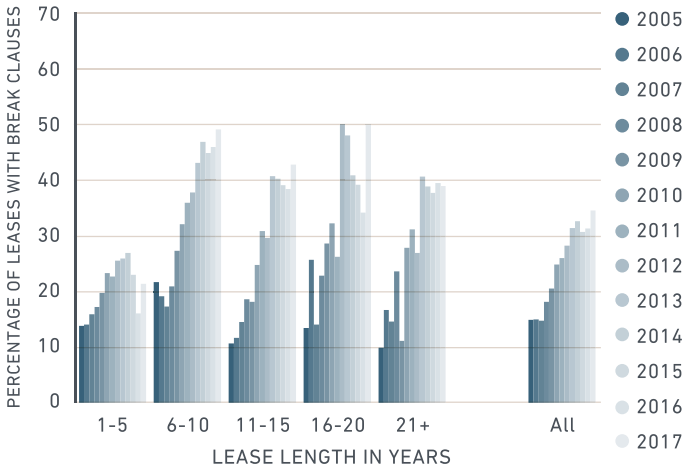


FIGURE 4.3  
Office  
Leases with break clauses

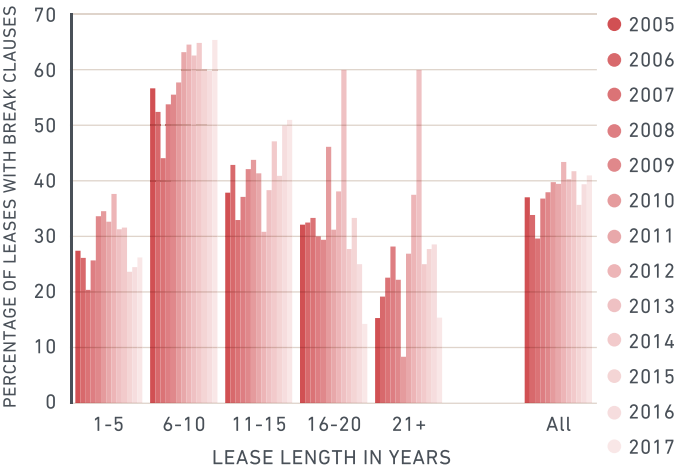
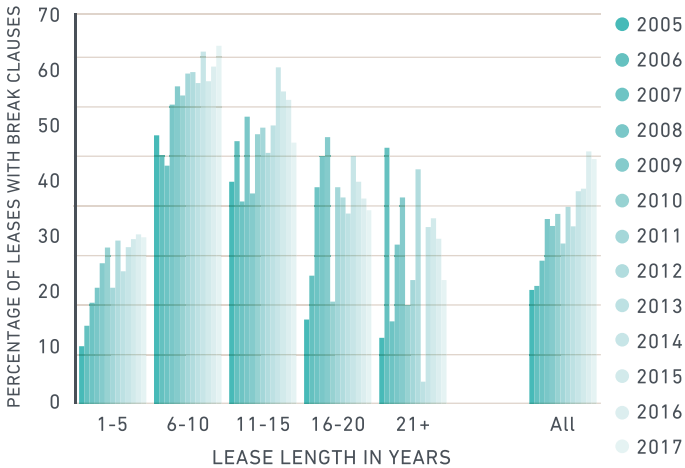


FIGURE 4.4  
Industrial  
Leases with break clauses



Source: MSCI



In 2017, the length of rent-free periods declined across all three major property sectors, after increasing in 2016. Rent-free periods for offices remained the longest at an unweighted average of 9.1 months. While this was up from 8.9 months in 2015, 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 were down from 2016 and ended Q1 2017 at 6.9 and 5.4 months, respectively.

On an unweighted basis, average rent-free periods have continued to fall across the sectors, reflecting a long running trend of improving tenant demand since the financial crisis. However, on a weighted basis, rent-free periods have shown an uptick since 2015/16. This perhaps reflects a marginal shift in the balance of power between landlords and those tenants willing to take larger units of space. With increasing economic and political uncertainty over the last year or so, such tenants are looking for greater incentives for taking more space from landlords, who are increasingly happy to oblige.

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, 87.0% of rent free periods are less than 12 months long on a weighted basis, and of these 30.6% are less than 4 months.

The industrial sector is also heavily weighted towards shorter rent-free periods, with 86.6% being of 12 months or less (34.1% are 4 months or shorter).

The shape of the office sector distribution differs somewhat. The most common rent free period band is 9-12 months. There are fewer very short incentive periods, with only 65.3% of leases having a rent-free period of a year and shorter. A much greater proportion of offices leases have rent free periods of longer than 12 months, with a significant share (6.8%) having rent-frees of more than two years.

## AVERAGE RENT FREE PERIODS BY SECTOR

FIGURE 5.1

### Average rent-free periods by sector

Tenancies equally weighted

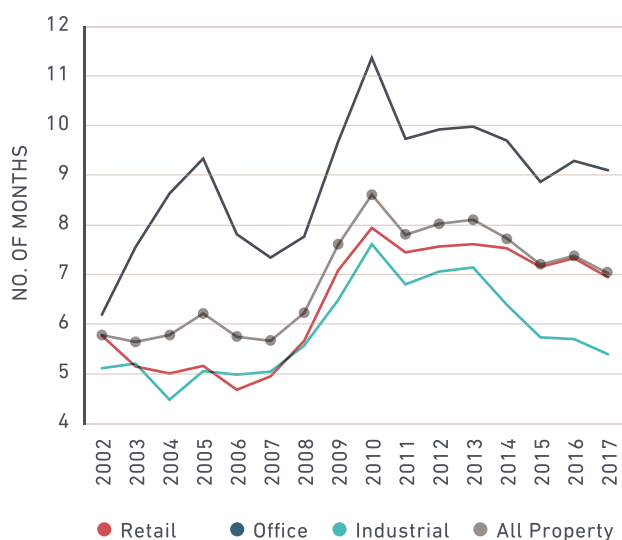
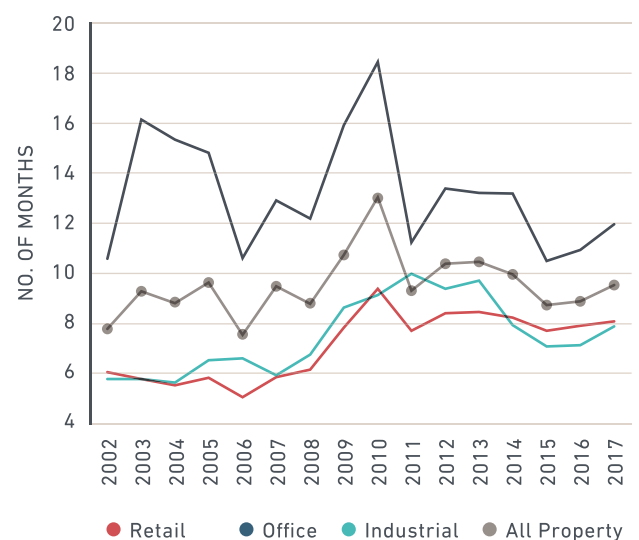


FIGURE 5.2

### Average rent-free periods by sector

Tenancies weighted by rent passing



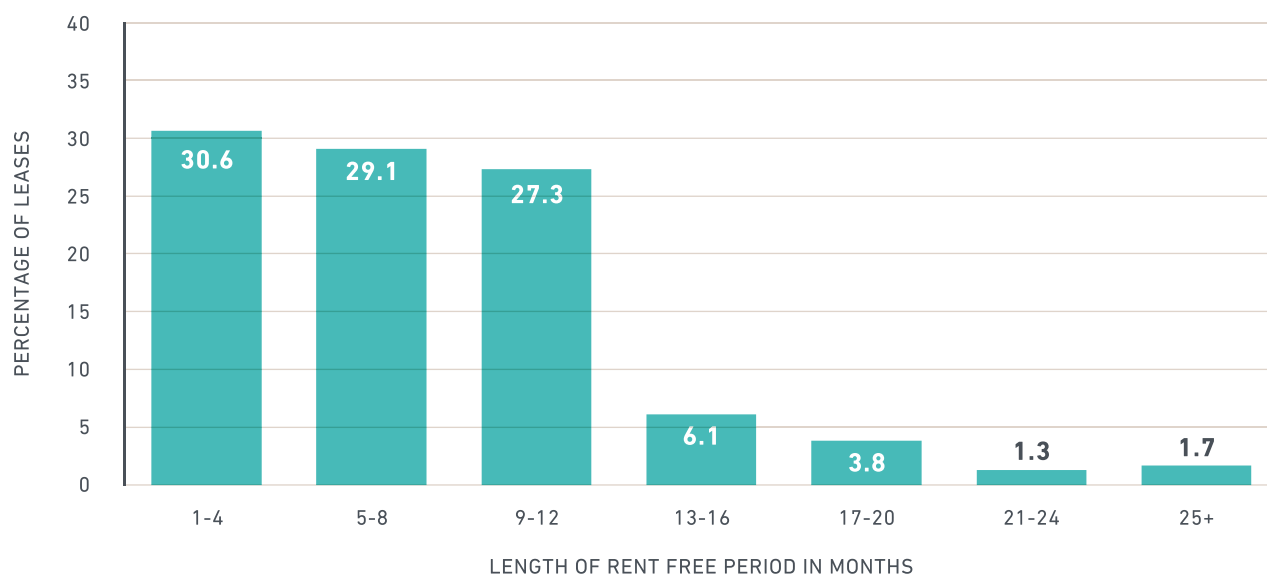
**Note:** The fluctuation in rent-free periods is highly cyclical, with average lengths increasing in a weaker economic environment as many landlords incentivise generously in an attempt to avoid vacancy.

Source: MSCI

FIGURE 6.1

## Distribution of rent free periods for retail

Tenancies weighted by rent passing

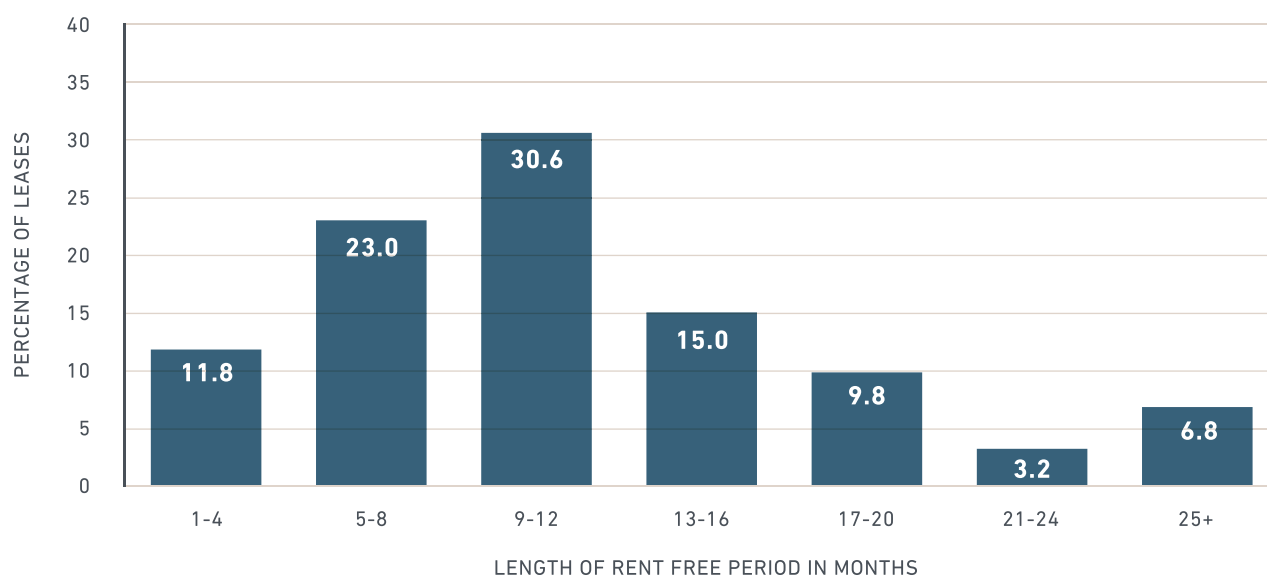


Source: MSCI

FIGURE 6.2

## Distribution of rent free periods for office

Tenancies weighted by rent passing



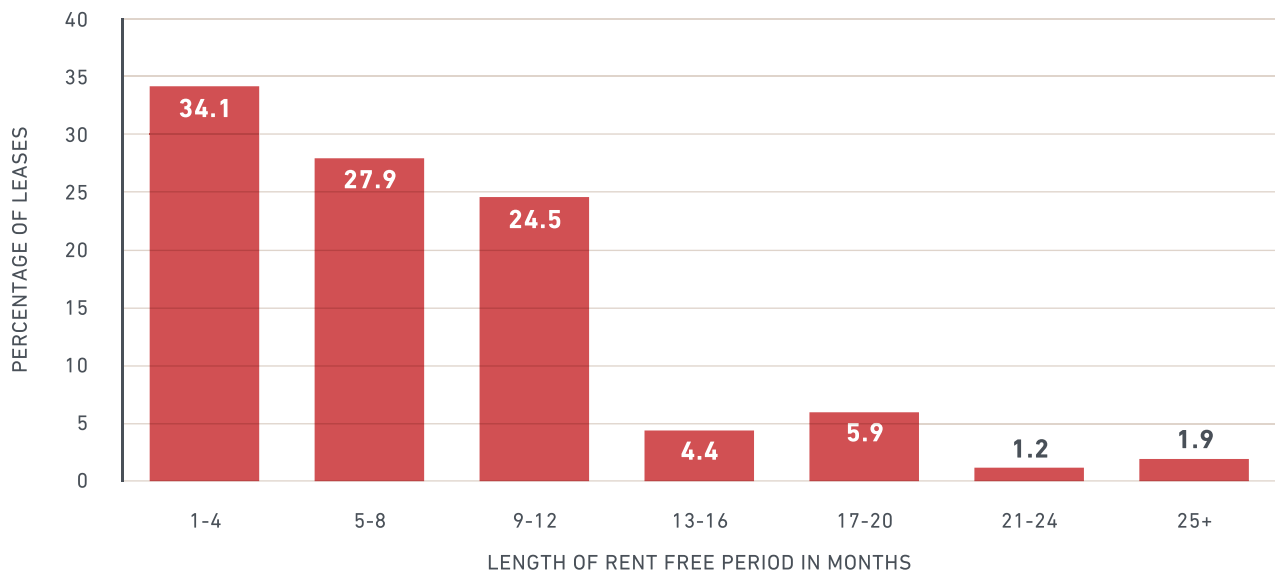
Source: MSCI



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 2017, 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 2017.

In terms of security of income in the broader UK market, 6.0% of income is at risk due to over renting (top slice). Of the three traditional property sectors, retail is the most over rented at 7.8% of rent passing, compared to 4.0% for offices and 3.9% for industrial. All market sectors saw a decline in the level of over-renting between June 2016 and June 2017, as a continued improvement in market rental values narrowed the income gap.

At the All Property level, reversionary potential offers the most rental upside at 8.4% of rent passing. A slightly smaller amount (8%) is potentially available from letting currently vacant space at market rents. Meanwhile a further 5.9% would be available from newly developed space coming on line. A more modest income uplift could be gained from those leases currently in rent free periods. A burning off of these would lead to an increase in total income equivalent to 3% of current passing rent.

The office sector continues to offer the most growth potential, driven by high levels of both reversionary potential (13.8%) and vacant space (16.4%). Offices also have significant potential from space under development (12.9%).

As seen earlier, offices tend to have longer rent-free periods and so currently have double the potential growth from incentives than the All Property average (6% vs.3%). Although the office sector shows the highest potential for growth compared to the other property sectors, much of this is driven by recent growth in market rents. It remains to be seen whether the potential 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 supply effect of newly developed space hitting the market.

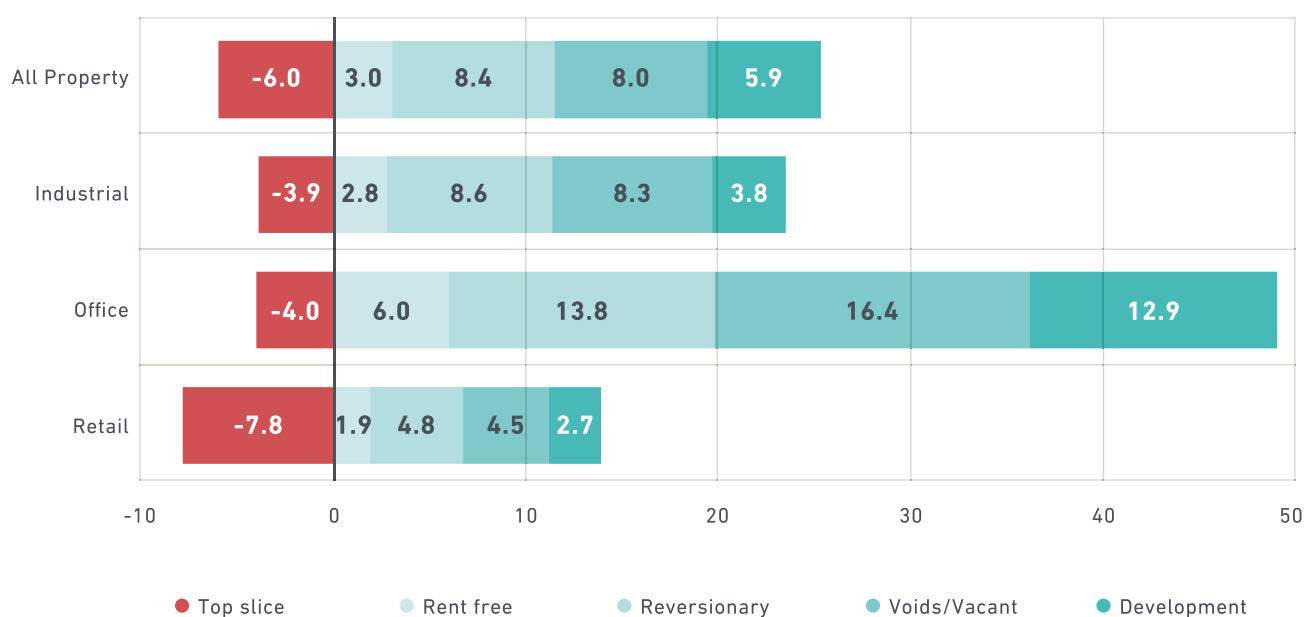
With increased supply, market rents may moderate or the space may need significant incentives to be let. The income potential analysis, while informative, should be treated with some caution.

The retail sector shows the lowest potential for income growth. 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 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 2016

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

Finally, this part of the report will round up 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 2016, with data sourced from the IPD UK Annual Index.

The analysis is split into "un-weighted", 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 in terms of the outcome of lease expiries for investors. This was exacerbated by economic and confidence difficulties for occupiers. As at 2016, only about a third of leases were renewed by tenants at expiry. While some landlords manage to find alternative tenants (16% of the time, accounting for 17% of contracted income), about half the time (49%) units are left vacant for one quarter or more. These account for 52% 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.

TABLE 1

### Outcome of leases expiring in 2016 for all property

|             | Unweighted | Weighted   |
|-------------|------------|------------|
| Renewed     | <b>35%</b> | <b>31%</b> |
| New Letting | <b>16%</b> | <b>17%</b> |
| Vacant      | <b>49%</b> | <b>52%</b> |

Source: MSCI



FIGURE 8.1

**Vacancy rate for leases expiring 1998-2016 by all property**

Tenancies weighted by rent passing

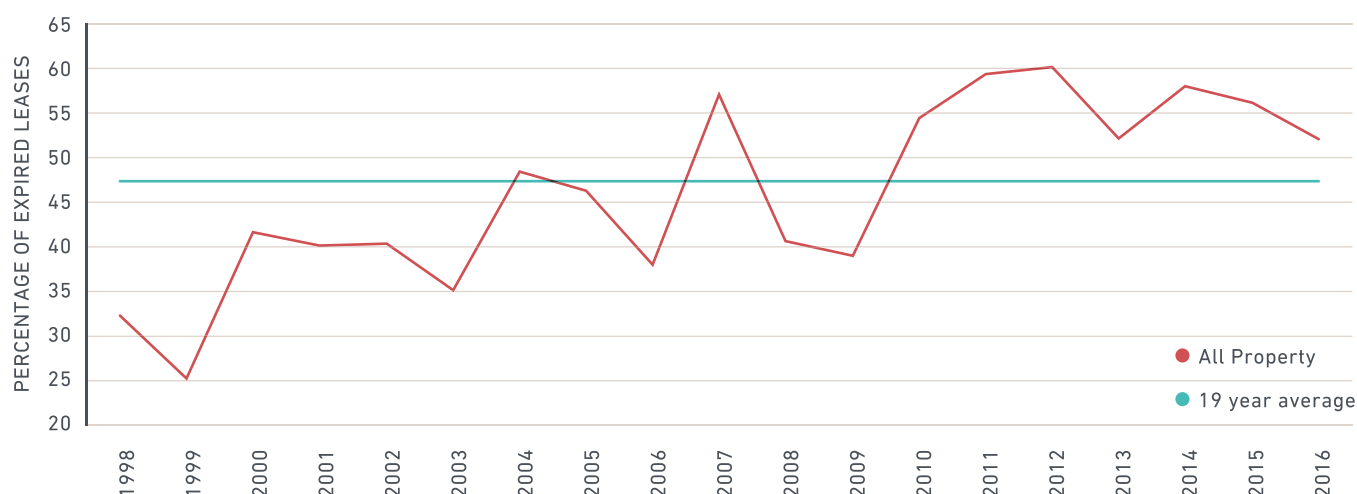


FIGURE 8.2

**Vacancy rate for leases expiring 1998-2016 by sector**

Tenancies weighted by rent passing



Source: MSCI

The vacancy rate for leases expiring in 2016 was 49% un-weighted (counting all leases equally), rising to 52% when weighted by previous rent passing. This vacancy rate has now been above the 19-year weighted average of 47% since 2009, although it has improved since reaching a high of 60% (weighted) in 2012.

Of leases expiring in 2016, 16% were re-let in the same quarter the previous lease expired – a similar level to the 17% recorded for 2015.

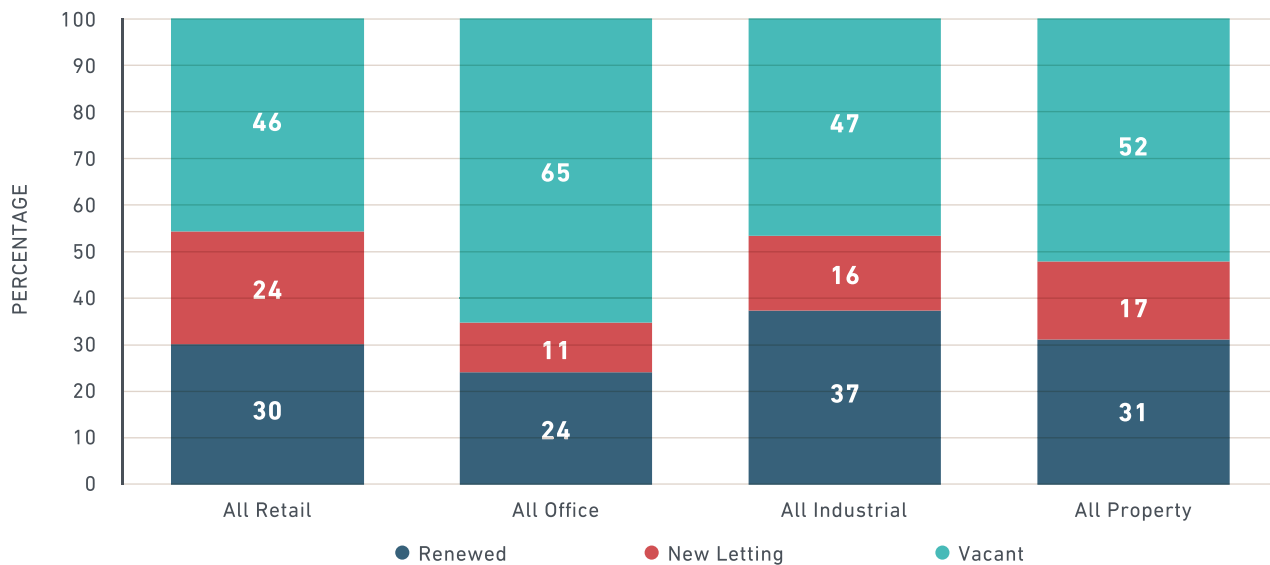
Weighted expiries produced a similar re-letting figure of 17%, suggesting a similar trend among small and larger tenancies. For renewals, the market strengthened from 2015, as the renewal rate ticked up to an un-weighted 35% in 2016, up from 33% the year before.

When weighted by rental income, 31% of tenants chose to renew their leases in the same quarter as the expiry occurred.

FIGURE 9

## What happened when leases expired in 2016? (Weighted)

Tenancies weighted by rent passing



Source: MSCI

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

Sector analysis shows that offices had the highest level of immediate vacancy, both weighted (65% of leases) and un-weighted (69%), on lease expiry in 2016.

All Property vacancy rates upon expiry, both unweighted and weighted, remain well above their long term averages. On a weighted basis, vacancy rates were 5% higher than their long term average (52% versus 47%) and 8% higher when calculated in unweighted terms (49% versus 41%).

At 46%, retail had the lowest sector vacancy rate upon expiry, compared to industrial at 47% and offices at 65%. This reflects a structural difference going back more than 20 years. While office tenants demand modern and efficient space with appropriate facilities reflecting 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 exposure to the best locations. When they do fail, new tenants will snap up space in good locations quickly. Having said this, while the vacancy rate on expiry for retail is much lower than for the other sectors, it has risen significantly over the years and is now, at 46%, 14 percentage points higher than the 19-year average of 32%. The other sectors are much closer to their long term averages.

This could be explained by the structural change occurring in the retail sector caused by the penetration of internet shopping. While it is still true that retailers will seek to hang on to the best locations in affluent catchment areas, with internet shopping they no longer need presence across the whole UK market to access their customers, and so weaker locations will suffer from higher vacancies as leases expire. Given location is the primary driver of attractiveness, we see a polarisation in performance of retail assets by location rather than by asset age or physical quality, as may be more common in the office sector.

These trends are reflected in newspaper headlines describing the death of the local high street and are also apparent from the more granular analysis below, which shows a much higher rate of vacancy on expiry for retail in the Rest of the UK.

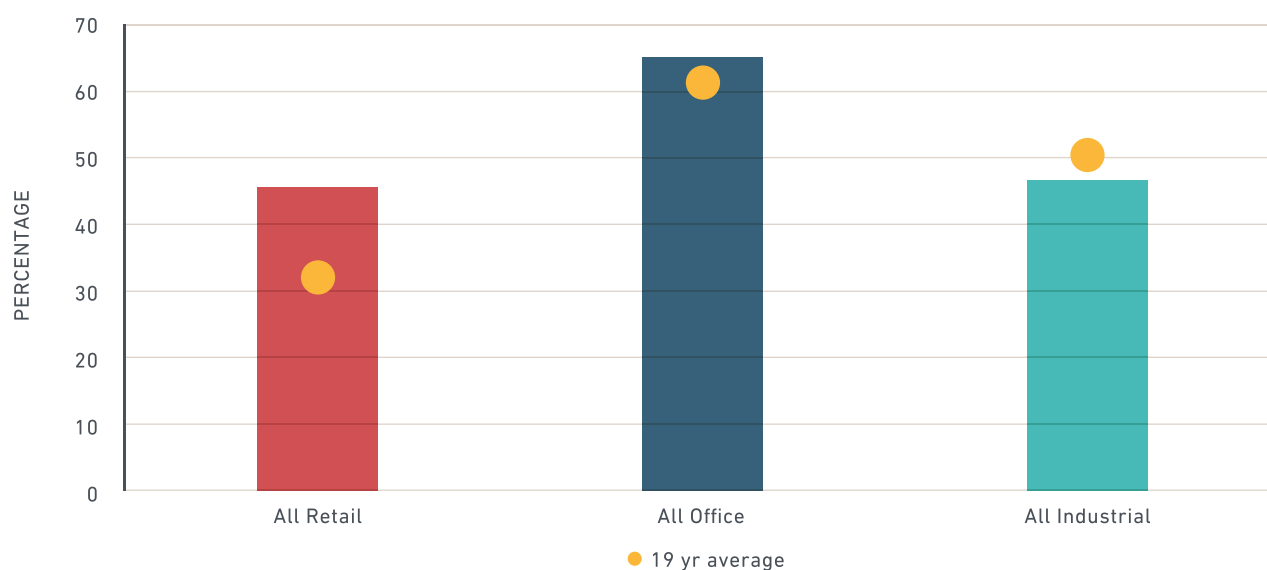
The office sector saw the highest vacancy rate upon expiry and the lowest renewal and new letting rates. While the retailer seems to prefer to remain in an established trading location, the office sector is much more flexible, with tenants tending to be less attached to particular buildings or locations.

The high vacancy rate also highlights the attractive options and deals available to office tenants, particularly those outside Central London who find themselves leaving older, often obsolescent, buildings for modern space. Given that many of these occupiers may have signed leases at rental levels 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.

FIGURE 10

## Vacancy Rate upon Expiry

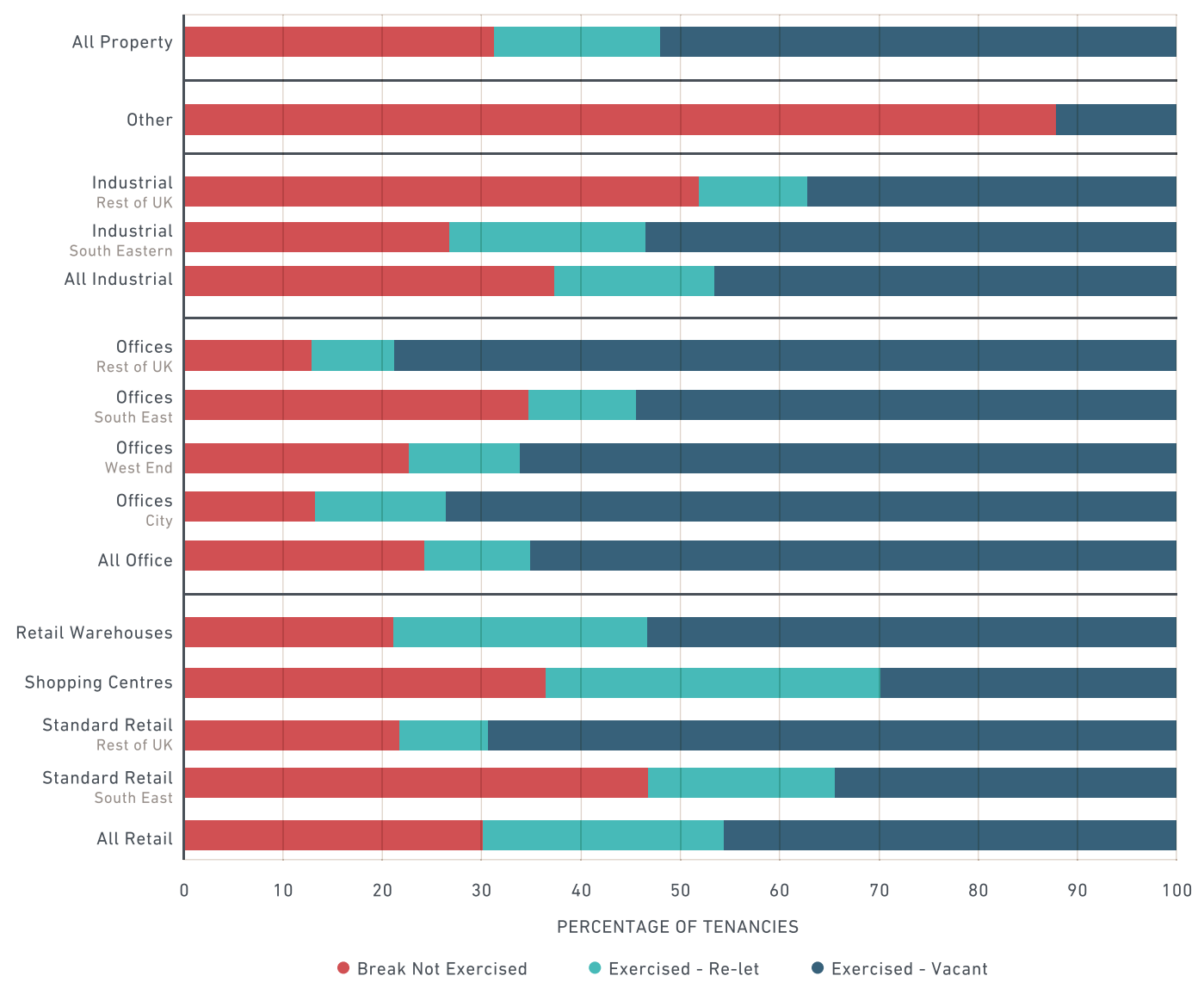
Per sector; 2016 and 19-year average



Source: MSCI



FIGURE 11  
What happened when Leases Expired in 2016?  
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 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 options rose significantly in 2016 to end on 81% - up from 71% a year before.

Table 2 refers to tenants across all property sectors who had the right to break in 2016. This is weighted by previous passing rent ("weighted") and by number of leases ("un-weighted"). 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 the difference between in-place and market rental levels, in 2016 only 19% of leases were broken.

TABLE 2

### Outcome of leases with a break occurring in 2016

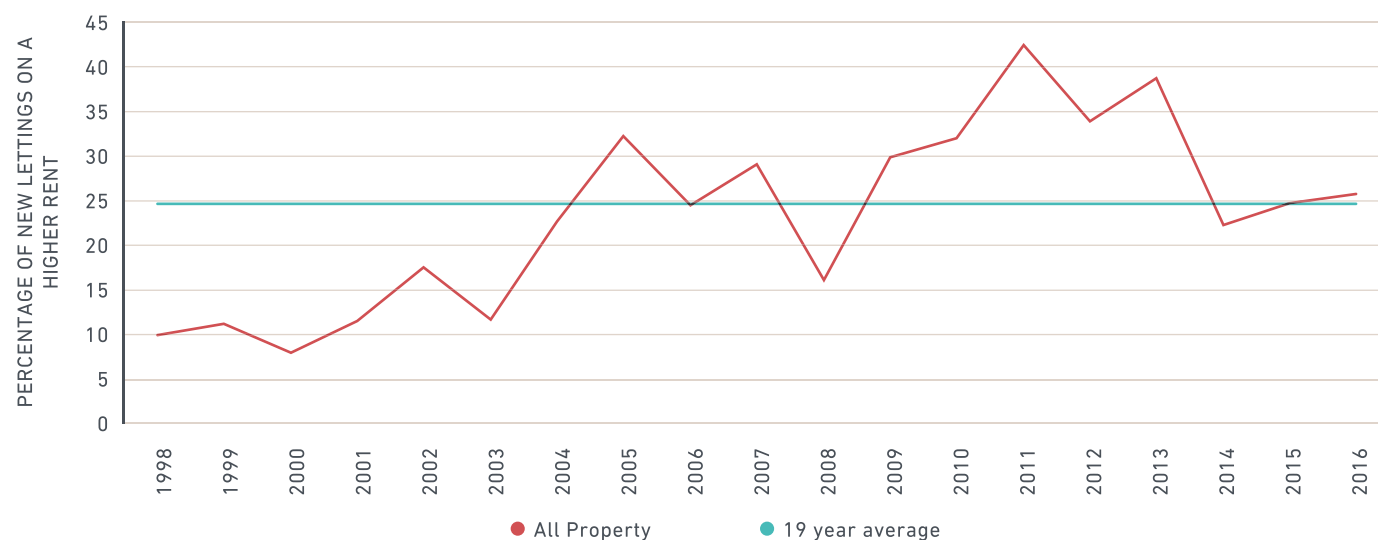
|                     | Unweighted | Weighted |
|---------------------|------------|----------|
| Break Not Exercised | 81%        | 68%      |
| Exercised - Re-let  | 4%         | 6%       |
| Exercised - Vacant  | 15%        | 26%      |

Source: MSCI

FIGURE 12

### Vacancy rate for exercised break clauses 1998-2016

Tenancies weighted by rent passing



Source: MSCI

Even when accounting for larger leases, only 26% of contracted income was lost due to breaks. For a landlord it is important to understand this interaction. It seems that 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 weighted vacancy rate due to exercised break clauses increased by 1% to 26% in 2016. While slightly higher on a yearly basis, this is well off the high of 2011 when 42% of break clauses resulted in vacancy for a quarter or longer. The current number is in line with the long term average of 25%.

The unweighted vacancy rate due to exercised break clauses was significantly lower at 15%, unchanged from a year before, but down significantly from 24% in 2014. The higher percentage of tenants vacating in 2016 on the weighted measure means that most of them were at the higher end of the scale in terms of rent passing.

The percentage of re-lettings remained low at 6% on a weighted basis, below the long term average of 9%.

At the same time the proportion of break clauses not exercised decreased from 69% to 68%.

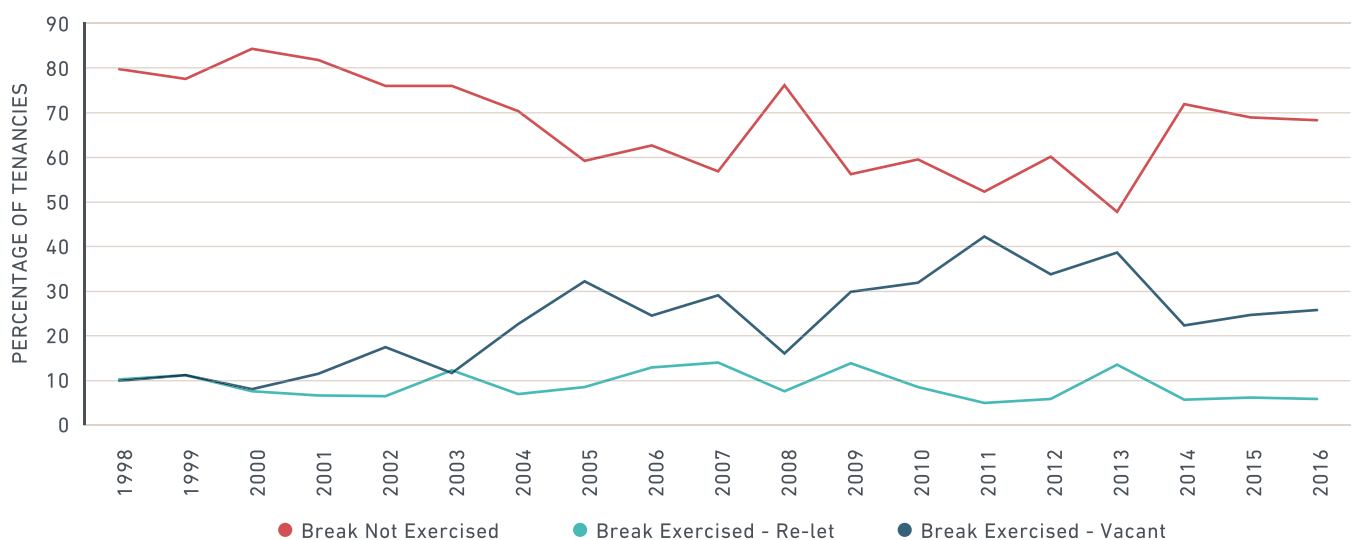
At a sector level, there were again relatively broad differences in outcomes for break clauses that occurred in 2016. Given the preference for retailers to remain at established trading locations, the break clause action rate here tends to be lower than in other sectors, and this was no different in 2016, when it saw the lowest rate of any sector. Weighted by previous passing rent, only 22% of retail tenants chose to exercise their break options when they arose in 2016. Even though this was up from the 16% of 2014, it was still in line with the 22% long term average.

On a weighted basis, the industrial sector had the highest percentage of tenants activating their break clauses in 2016 at 36%. The industrial sector saw 23% (un-weighted) of tenants activating their break options in 2016. Of the 23% of leases that had break clauses activated, 4% of these were re-let within the same quarter while the remaining 19% remained vacant for more than one quarter post-break.

FIGURE 13

## Encouraging decline in levels of breaks exercised since 2013

Tenancies weighted by rent passing



Source: MSCI



The office sector saw an improvement in the percentage of tenants not exercising break clauses in 2016, from 57% to 65%. The sector saw little change on an unweighted basis, suggesting an 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 7% were re-let in the next quarter.

Break clause action rates varied somewhat between different property types and geographies.

Across the office segments, the percentage of break clauses exercised remained low on an unweighted basis.

The prevalence of breaks exercised in the West End and City office markets remained particularly low during 2016 at 17% and 23%, respectively.

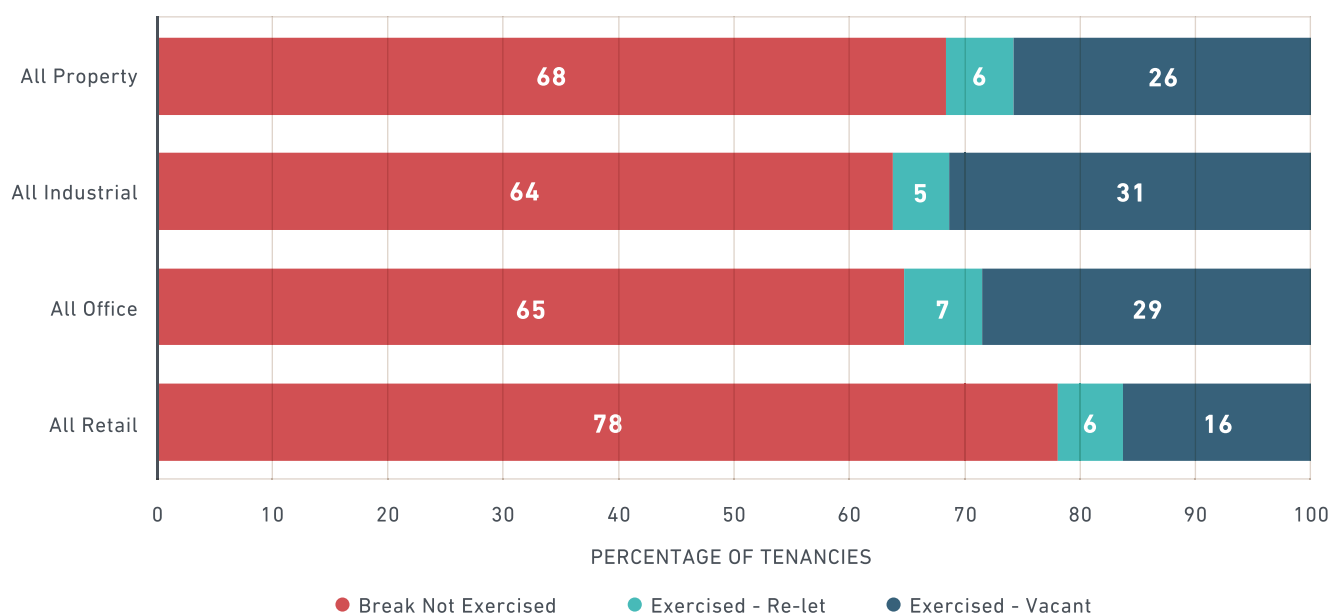
Interestingly, however, the percentage of breaks not exercised in the West End declined significantly on a rent-weighted basis to 56% in 2016 from 78% in 2015. This suggests that break clauses were exercised among some major occupiers.

In the City of London, the percentage of break clauses not exercised in 2016 increased to 77% (unweighted) from 68% a year before. On a rent-weighted basis, the percentage of breaks not exercised increased from 65% to 73%, suggesting similar behaviour among smaller and larger occupiers.

FIGURE 14

## Break clause actions (weighted)

Tenancies weighted by rent passing

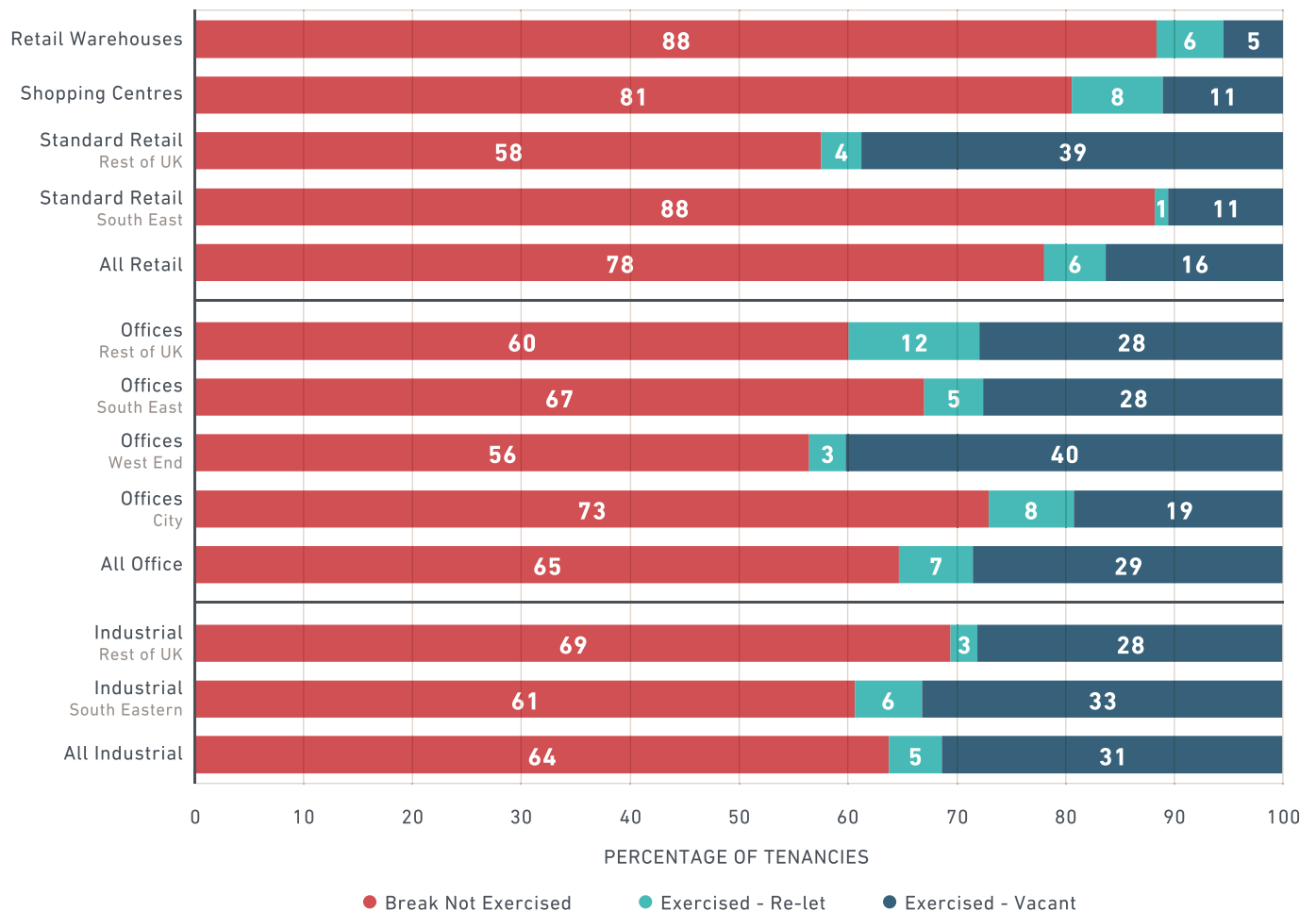


Source: MSCI

FIGURE 15

**Regional disparity in lease breaks exercised (weighted)**

Tenancies weighted by rent passing



Source: MSCI

Meanwhile, in the Rest of the South East, 67% of break clauses were not exercised on a weighted basis – a significant improvement on the year before when only 44% of breaks were not exercised. Meanwhile, 28% of break clauses exercised resulted in a vacancy of at least one quarter, a vast improvement on the year before when the equivalent figure was 51%.

We previously noted that retail property had the lowest tendency to exercise break clauses among the major property sectors. Within the retail sector, however, there is significant divergence between the segments.

Shopping Centres, Retail Warehouses and Standard Retail South East all have similar rates of break action. Meanwhile, the Standard Retail Rest of UK segment stands out, with easily the highest tendency to exercise break clauses at 43%. This may support our earlier theory on the willingness of retailers to retain space in prime locations in the more affluent markets of the South East, while preferring to surrender space in more challenging locations across the rest of the country. This regional dimension is not apparent in the other property sectors.

## 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, 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 movements 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 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 2016, including both renewal by existing tenants and re-lettings to new tenants.

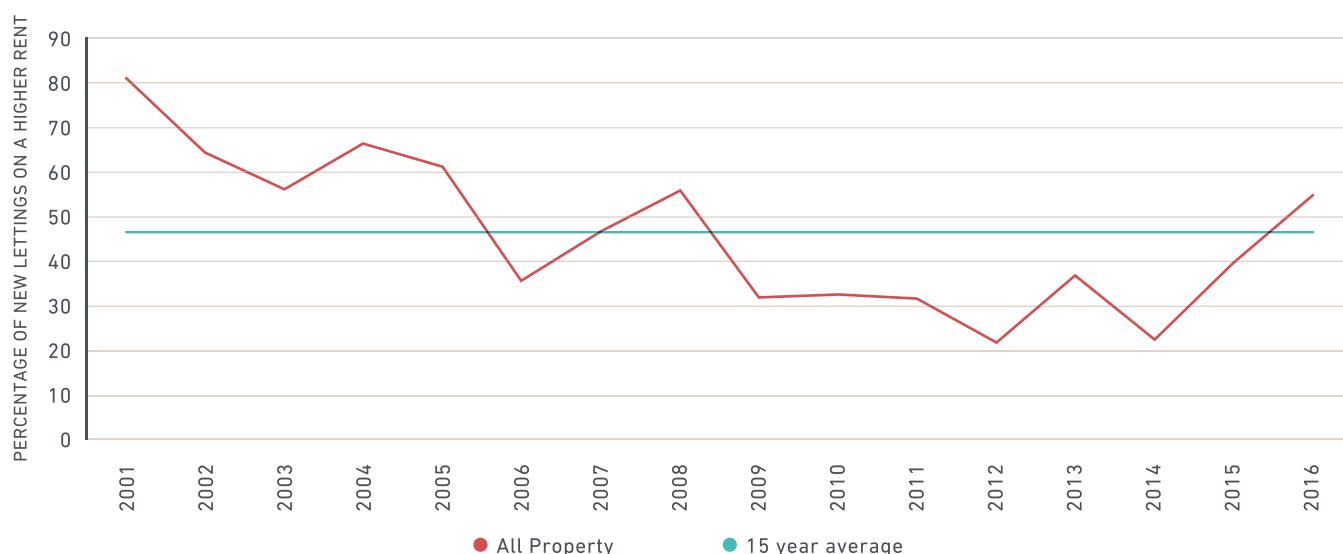
TABLE 3  
**Rental change for new lettings in 2016**

|        | Unweighted | Weighted |
|--------|------------|----------|
| Higher | 54%        | 55%      |
| Lower  | 36%        | 37%      |
| Same   | 10%        | 8%       |

Source: MSCI

FIGURE 16  
**Achievement of higher rent on new lettings 2001-2016**

Tenancies weighted by rent passing



Source: MSCI



On an un-weighted basis, for the second straight year, the rental income achieved from the signing of a new lease or renewal was more often than not higher than the previous income. 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 2016, an unweighted 52% of renewals achieved a higher passing rent. Weighted by rent passing, the figure was lower at 41%, indicating that positive rental reversions were less prevalent among larger occupiers.

In 2016, 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, 82% of new leases reverted higher on a weighted basis – up from 54% the year before – while the West End office market saw 91% of new leases reverting higher (the highest level since 2001). This is perhaps not surprising given the popularity of these segments, which has resulted in strong market rental growth over recent years.

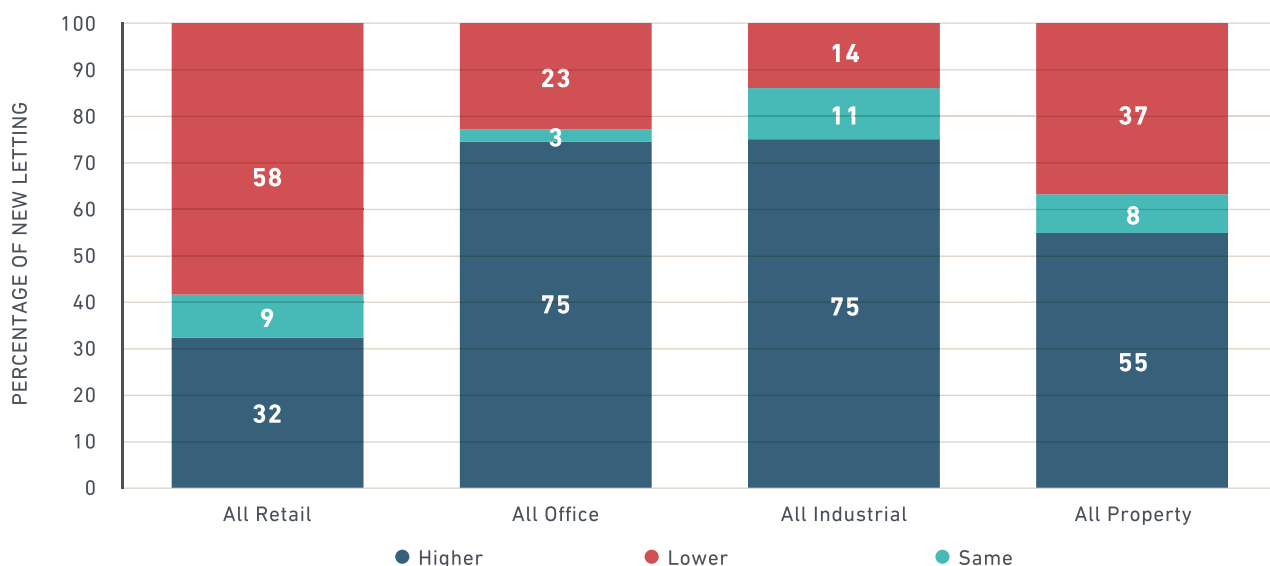
In terms of the percentage of tenancies in the sample (unweighted), 36% had lower rental income following a new letting, an improvement from the 38% recorded in 2015.

On an un-weighted basis, the office sector performed best, with 70% of new lettings seeing an uplift in income, while retail properties were the weakest, with 32% of tenancies witnessing growth. The industrial sector, where 60% of properties saw a rise, also recorded the largest improvement, given the 47% figure for 2015.

FIGURE 17

## Weighted rental change for new lettings in 2016

Tenancies weighted by rent passing



Source: MSCI

## INCOME AT RISK

The underlying purpose of this study is to help investors understand in more 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 declined in 2016, falling to 2.7% of all tenancies when weighted by rent passing, in line with the improving economic environment. This was the lowest rate of default registered in the UK market since 2007 and compared favourably with the rate of default in the elevated period between 2008 and 2012, when it averaged 5.5% for All Property.

Default rates have been declining steadily since then, but remain somewhat elevated when compared to the pre-GFC period, as they averaged 1.8% between 2002 and 2007.

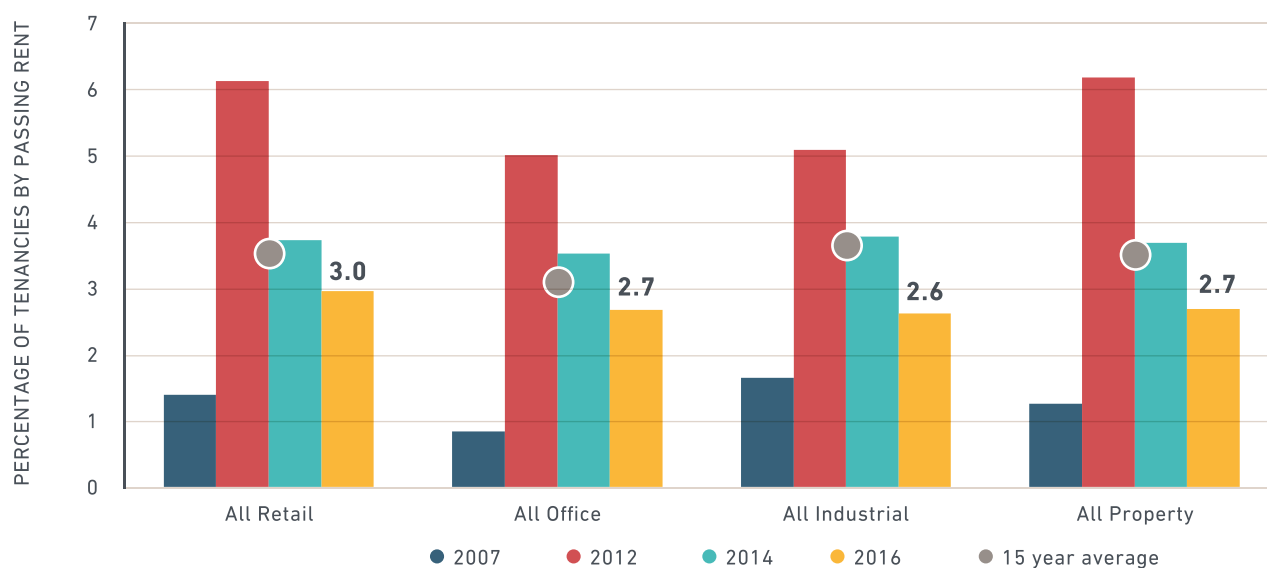
Retail was the weakest sector with the highest level of default in the years immediately following the financial crisis, having been hit by fragile consumer confidence and declining sales across the UK. However 2013 saw a significant turnaround and that trend continued into 2016. The default rate fell from a high of 6.3% in 2011 to 4.5% in 2013, while 2016 saw the retail sector edging below the long-term average of 3.6%, to reach 3.0% by the end of December.

By 2013, default rates had converged across the sectors and have since moved in tandem. The default rate for offices averaged 2.7% in 2016, reaching its lowest level since 2007. The rate for industrials fell to 2.6%, having stood at 5.1% in 2012 – a significant improvement over the period.

FIGURE 18

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

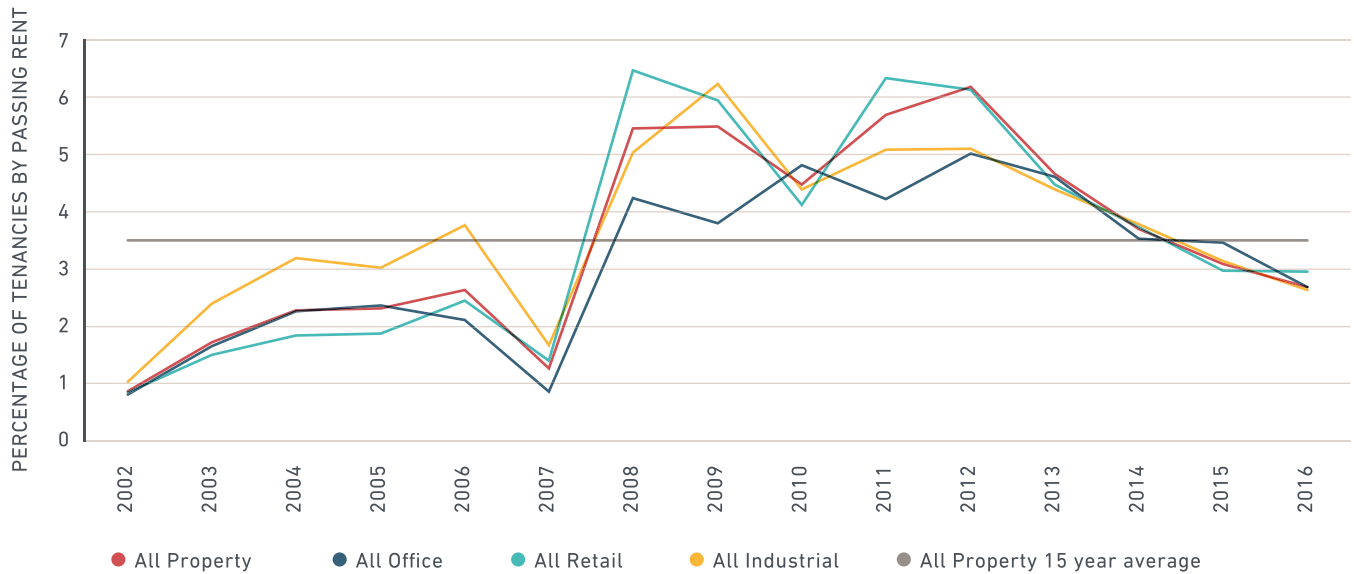
Tenancies weighted by rent passing



Source: MSCI, D&B

FIGURE 19  
**Tenants in default by sector, 2002-2016**

Tenancies weighted by rent passing



Source: MSCI, D&B

While the rate of default has converged at the sector level, it varied significantly at the more granular levels of location and property type. This was the case in the office and retail sectors, but not in the industrial sector.

Offices in the City of London, dominated by financial occupiers, recorded the largest improvement in default rate, from 9.9% in 2015 to 2.5% in 2016. The 2016 default rates represent a huge improvement from an extended period of high rates following the financial crisis and through the Eurozone sovereign bond crisis. This period witnessed a number of large defaults by tenants, and major firms used this window as an opportunity to restructure and rationalise their space requirements and City operations. Conversely, offices in the neighbouring West End market enjoyed much lower rates of default through this period, but these are now marginally higher than in the City at 2.6%.

For retail, Shopping Centres had the highest rate of default at 5.4%, a 0.3% improvement from the 5.7% rate in 2015, and well down from the high of 9.2% posted in 2011.

This segment, being heavily reliant on consumer confidence, has had a consistently high default rate since the economic downturn began in 2008, although the level has declined consistently since 2011.

It is interesting to contrast the relative position of retail segments in terms of their default rates and their levels of vacancy as a result of lease expiry or the exercise of breaks. The chart below shows that Standard Retail in the Rest of the UK had the lowest tenant default rate across the entire retail sector. Shopping centres had the highest by some considerable margin. However, Rest of UK Standard Retail had the highest rates of tenants choosing to surrender space at break dates or lease expiry. This suggests that retailers in provincial locations, rather than failing more frequently, are strategically managing their occupational real estate portfolios to limit costs and optimise their distribution channels in the face of the threat from internet retailing. Not only are retail tenants more likely to leave units in these areas, the space they surrender is also less likely to be re-let. The opposite is true of Shopping Centres.

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.

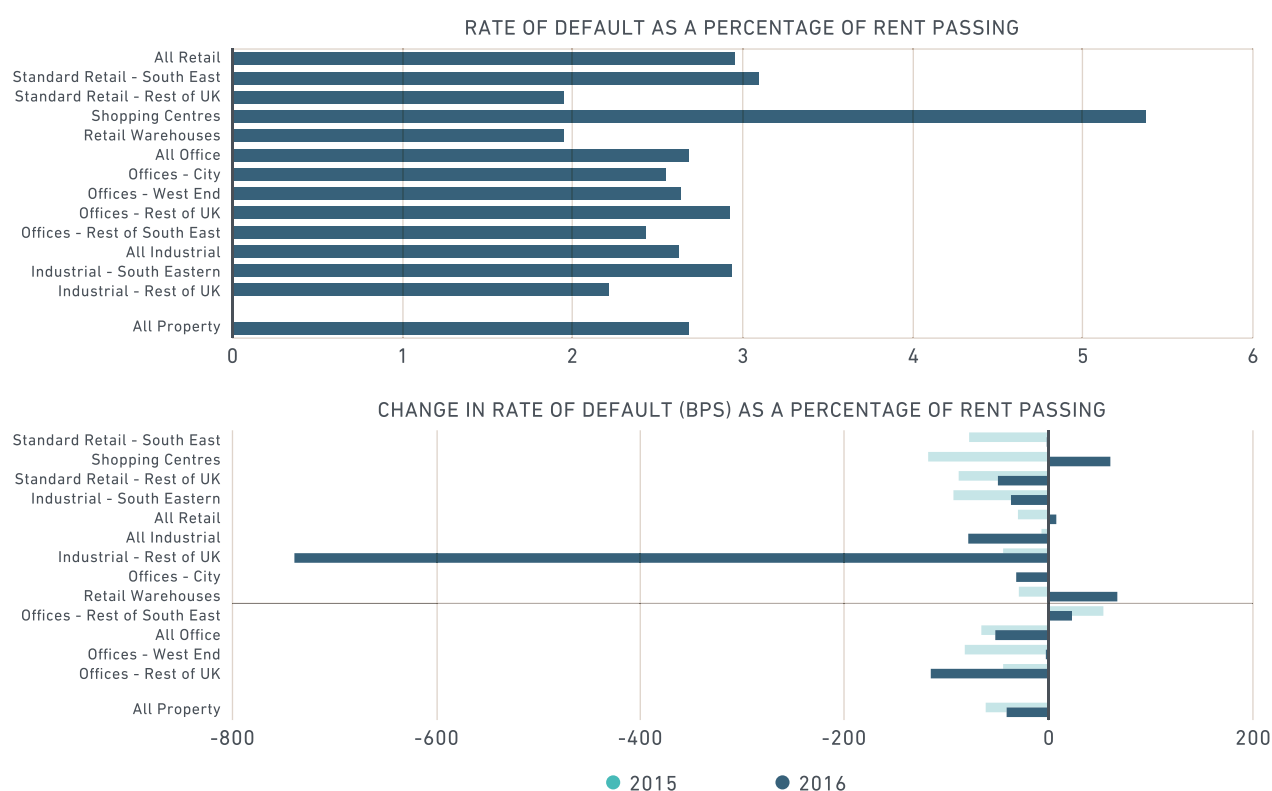
Although the data below illustrates the rates of tenant default, it is harder to track the outcome of such defaults in terms of re-letting and ongoing vacancy. This is easier to do following pre-determined lease events, since the dates are known in advance.

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 concerned may not be vacated immediately following 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 the other lease events.

FIGURE 20

## Tenants in default by type and location

Tenancies weighted by rent passing



Source: MSCI, D&B

FIGURE 21A

**Tenant Defaults: Retail**

2008-2016; All Retail and Retail segments



FIGURE 21B

**Decline in City Office Defaults Drives Office Sector Defaults to Ten-year Low**

2008-2016; All Office and Office segments

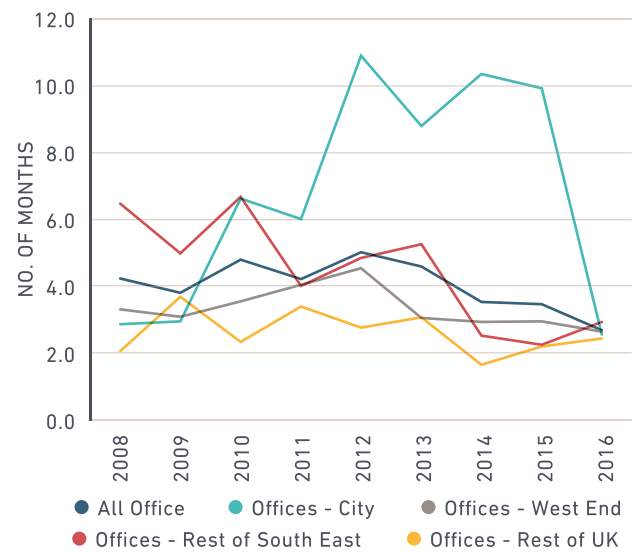
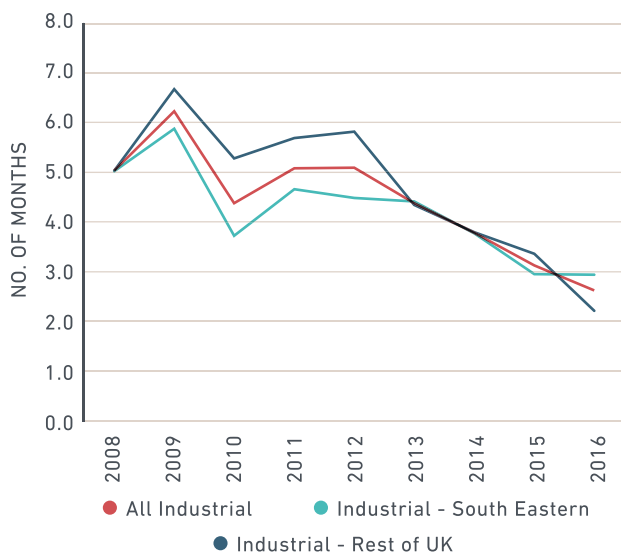


FIGURE 21C

**Industrial tenant defaults continue improving trend**

2008-2016; 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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