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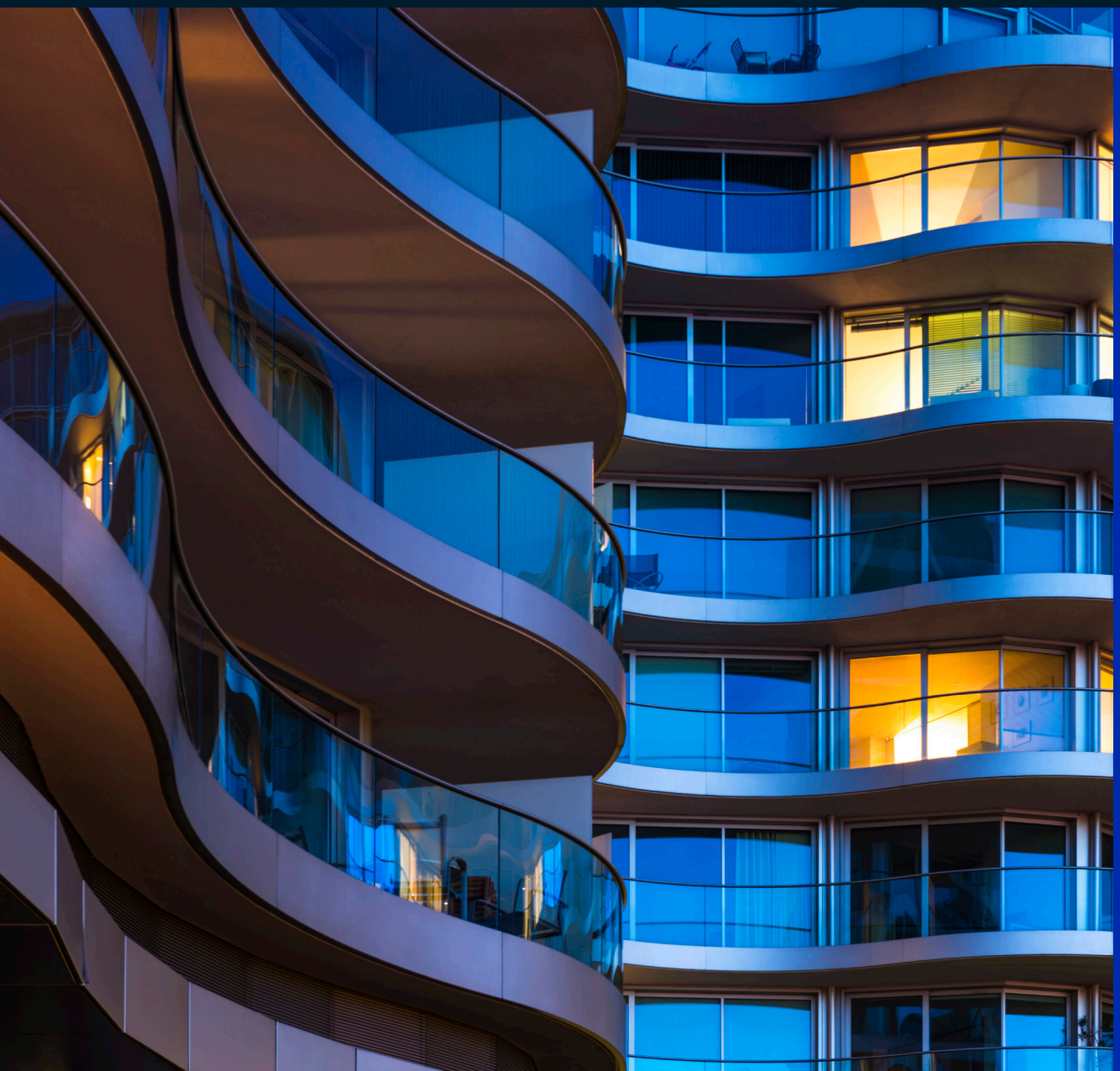
BNP PARIBAS REAL ESTATE

UK Lease Events Review 2019

Prepared by MSCI in association with BNP Paribas Real Estate

November 2019



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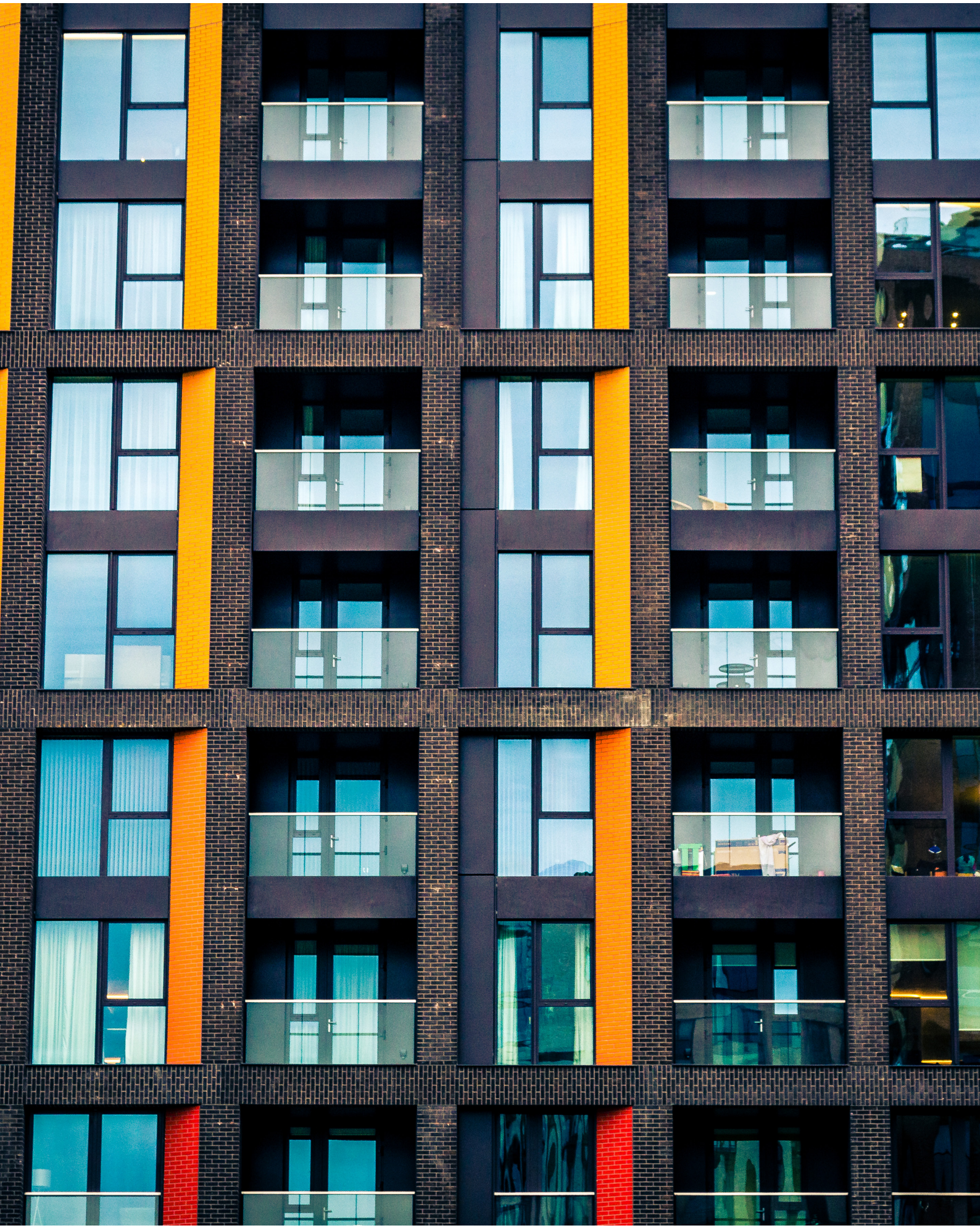

Sponsor's Foreword

Now in its 21st year the UK Lease Events Review remains the go to assessment of the robustness of income flowing from commercial real estate assets. The macro picture across the world and closer to home is volatile although the UK economy to date has held up better than anticipated 3 years ago following the EU referendum. In a future of lower returns, anchored by global bond rates, the need to understand income is ever more important.

In 2019 leasing across core markets has held relatively steady thus providing confidence to investors, nevertheless, UK capital markets have been impacted by the ongoing lack of clarity around politics and moving deadlines for exiting the EU. The £13 billion transacted in Q3 brings the year to date total to £33.4 billion, 26.1% below 2018 and 37.1% off the peak in 2015. As with everything though, the headline figures disguise a more complex underlying picture. Notably, the market has shifted towards the operational assets within the alternative sectors; with the sector accounting for 43.0% of volume so far this year, up from 37.7% last year. Moreover, seven of the top ten transactions year to date have been BTR, Healthcare, or Student Accommodation deals, accounting for £4.6bn alone. Due to the differing nature of these operational leases they are not picked up as part of the MSCI review.

The 2019 analysis builds on themes that have been emerging over recent years. The larger occupational leases represented within the weighted bracket have become marginally longer. In general terms it would appear that larger occupiers have found their leasing sweet spot whereby the balance between flexibility of the lease, fit out costs, and operational stability require a lease of about 10 years. For smaller occupiers, or those in less expensive accommodation, lease terms have slightly shortened again to 6 years and 3 months.

The structural evolution of both short leasing and movement to online retail have been steadily eroding the income security of retail and offices. The former has low levels of renewals, the lowest since 2007, and high vacancy upon expiry. Offices also have low renewal levels, most likely driven by the repurposing of buildings, as take-up levels across UK markets are relatively steady. On a positive note for retail, for those businesses in good locations with robust footfall and trading, there is limited exiting of leases at breaks. Retail has the highest percentage of breaks not exercised at 76%. Not unexpectedly, industrial has demonstrated rental growth throughout the latest time period with 70% of leases renewing at a higher rent.

BNP Paribas Real Estate and formerly Strutt & Parker have supported the MSCI analysis of leasing for over 20 years due to its pivotal role in assessing the changing nature of income. Never has that been more crucial as we move through changing asset types and investor preferences and I would personally like to thank MSCI for continuing to undertake such an important piece of work.

Etienne Prongué
Deputy CEO BNP Paribas Real Estate UK

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Introduction

Economic data emerging during the fourth quarter of 2019 indicates that the UK economy is stalling amid growing anxiety over the prospect of a no-deal Brexit and weakening global economic conditions. The UK economy contracted by 20bps in the second quarter of 2019, the first decline since Q4 2012 and after an initial growth of 0.5% in the first quarter of the year. In annual terms, the UK economy expanded by 1.2% in Q2 2019, the slowest growth in seven years.

At the time of writing, the government's primary focus was to avoid a disorganised exit from the EU, as such an outcome would likely deliver a major negative shock to the UK economy. At the same time, there is a need for swift and tangible action to inject momentum and confidence into the UK economy, including the delivery of key infrastructure projects across the country.

Overall, the latest figures suggest that the unwinding of heightened levels of stockpiling, growing anxiety over the prospect of a no-deal exit and moderating global growth is increasingly weighing on economic activity.

The Q2 contraction was largely driven by a 1.4% fall in output from the industrial and construction sectors. The manufacturing sector, which accounts for around 10% of UK economic output saw production drop by 2.3% in the quarter. The services sector was the only positive contributor to GDP growth in Q2 notwithstanding the growth of only 0.1%, the weakest since Q2 2016.

The latest data also revealed that business investment in the UK fell by 0.5% in Q2 2019. It has now fallen in five out of the last six quarters and is further confirmation that it remains a weak point for the UK economy.

Business investment remains a key leading indicator for the property sector and the recent contraction could stifle growth prospects. In contrast, household spending increased by 0.5% in Q2 2019, boosted by the recent pickup in real wage growth.

In what would normally be a positive development, the UK's trade deficit narrowed by £16 billion to £4.3 billion in Q2 2019. However, the improvement came as a result of a 2% drop in exports and a 13% decline in imports. The improvement in Q2 may well be short-lived with Brexit uncertainty, including the absence of clarity on trade conditions after October 31st, and a slowing global economy likely to increasingly weigh on the UK's net trade position over the medium-term.

Meanwhile, the UK jobs market remains encouragingly strong with employment reaching a record high of £32.8 million during the second quarter. At the same time, earnings growth increased to 3.9%, the highest rate since 2008 and comfortably above inflation which ticked up to 2.1% in July 2019. While consumer prices may drift higher in the coming months, the UK's weakening economic outlook should ensure that any increase in consumer prices is temporary.

The Bank of England recently downgraded its UK GDP growth forecast for 2019 and 2020 citing growing concerns over Brexit and a deteriorating global economy as key drivers behind the forecast downgrades.

The bank did, however, upgrade its forecast for 2021 giving landlords and occupiers further food for thought with regards to upcoming tenancy decisions. The first half of 2019 already saw a shortening in the length of the average new lease indicative of the cautious approach taken by landlords and occupiers alike.

However, lease length is only one of the factors involved in tenancy decisions where incentives, concessions and risks combine to impact on future cashflow. Rent free periods, break clauses, vacancies, rental reversions and defaults can all be considered a series of options in the future cash flow from real estate assets. They all have a significant impact on the assessment of risk, and 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 review of lease events for 2018 and year to June 2019, in association with BNP Paribas Real Estate, provides detailed analysis on the likelihood of the different types of lease events. The analysis was based on a sample of over 95,000 extant leases held in the MSCI UK Annual and Quarterly Property Universe, and more than 8,900 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 2019

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 2019.

How have leases changed this year?

During the first half of 2019, the average new lease on commercial property signed in the United Kingdom shortened by almost 5 months to 6.3 years. This is the shortest lease length since 2012 and only 3 months longer than the 2009 low when the average new lease length was 6.0 years.

The average unweighted lease length has now shortened every year since 2016's Brexit referendum with the UK's current sluggish economic growth and the uncertainty around the Brexit endgame also playing their part in driving the shortening trend. The unweighted analysis counts all leases equally, regardless of the size of the contracted rent, and ignores break clauses making it a representative indicator of market leasing for the UK market.

Notwithstanding the shortening trend at an aggregate level, the share of leases of 20 years and longer remained relatively stable during the first half of 2019. As at the end of June 2019, 3.4% of leases were 20 years and longer as compared to the 3.1% at December 2018. Rather than a shift away from longer leases, it was an increase in the proportion of short leases which drove the overall, unweighted lease length down.

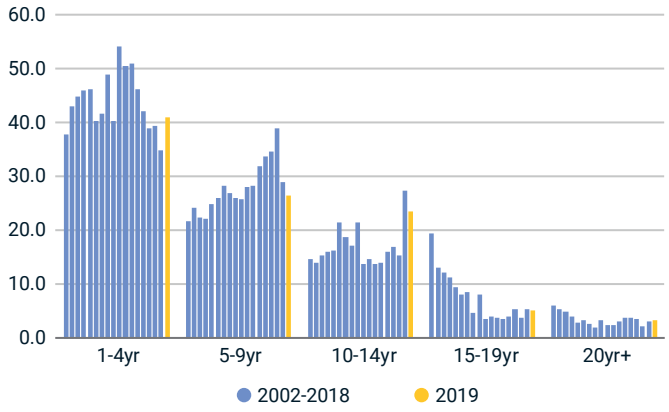
An analysis of the distribution of leases granted by lease band shows an interesting reversal at the lower end of the lease length spectrum. From 2011 to 2018, the proportion of leases shorter than five years declined from 54.2% to 35.0%, but during the first six months of 2019 this figure increased by 610bps to 41.1%.

This shift was virtually mirrored by a decline in the proportion of leases in the 5-9 year and 10-14-year brackets which saw a decline of 630bps to end the six-month period at 50.2% of total leases. This was after an increase from 39.6% to 56.5% during the period 2011 to 2018.

Figure 1

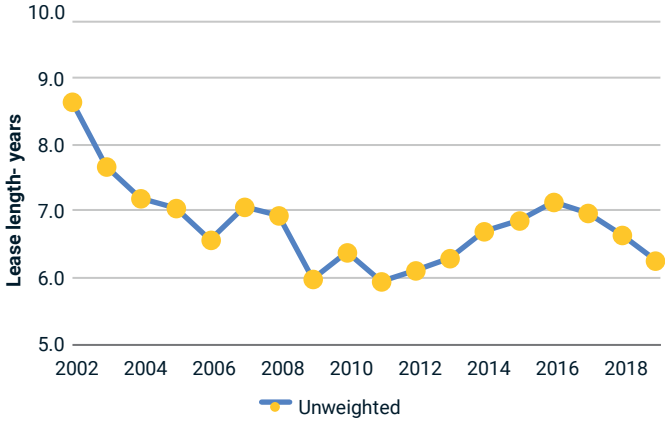
Unweighted lease length distributions

Percent of new lets in each lease length band



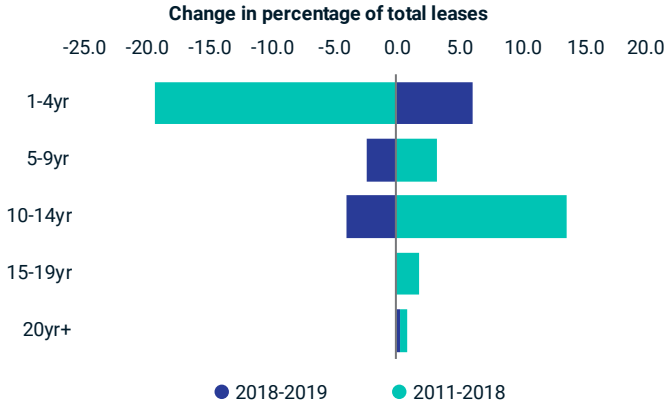
Unweighted lease length

Unweighted full term; Ignoring breaks & including short leases



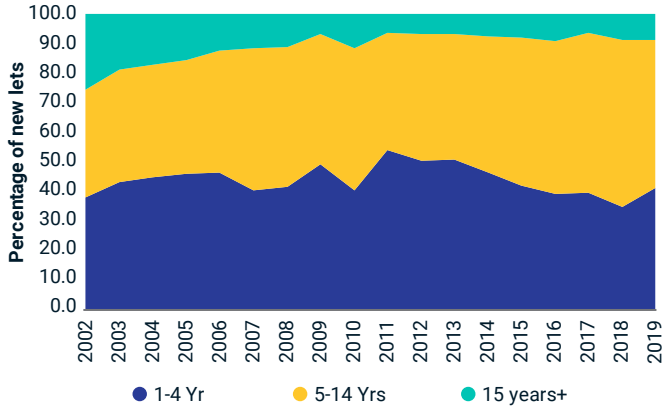
Change in lease length distribution (2011-2018 & 2018-2019)

Change in percent of new lets in each lease length band



Leases longer than 15 years exceedingly rare

94% of leases now shorter than 15 years



Note: Unweighted Full term; Ignoring breaks & including short leases

Source: MSCI

In contrast to the decline in the unweighted lease length, the average rent-weighted lease length increased by 2.3 months to 10.6 years during the first half of 2019, suggesting that larger occupiers have, on aggregate, been negotiating longer leases. Despite the recent lengthening, the rent weighted lease length for the first half of 2019 remained 11.5 months off the highs of 2014 exemplifying the rising uncertainty of the current macroeconomic and geopolitical backdrop.

Like the trend observed in the unweighted dataset, the 6 months to June 2019 saw increases in the proportion of very short and very long leases.

The proportion of the overall rent passing attached to shorter leases than five years increased from 16.8% to 21.0% as at 2019Q2. Leases of 20 years and longer saw an increase of 180bps to 14.2%.

Meanwhile the mid-length brackets all saw decreases on a rent weighted basis during the first six months of 2019

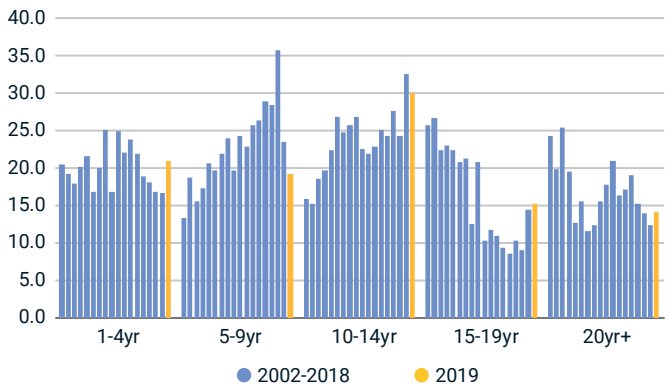
On a rent-weighted basis, the bulk of leases signed in the first half of 2019 were between 10 and 14 years in length. 30.2% of the overall rental passing fell into this bracket – down 250bps since 2018.

During the first half of 2019, 15.3% of rent passing could be attributed to leases of between 15 and 19 years in length - a pronounced increase from the period 2011 to 2017 when an average of 10.1% of rental was associated to this length of lease.

Figure 2

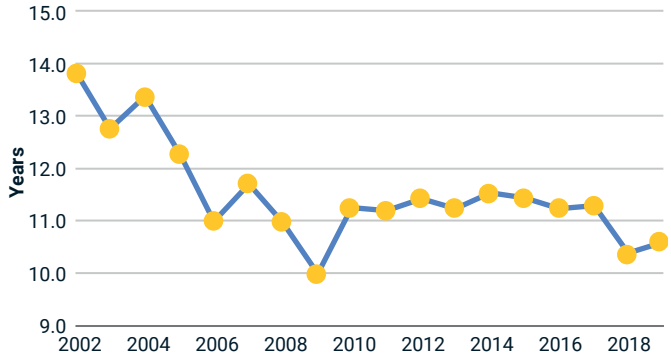
Weighted lease length distributions

Percent of new lets in each lease length band



Weighted lease length

Weighted full term; Ignoring breaks & including short leases



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

Source: MSCI

All three of the main property sectors saw their average, unweighted lease lengths decline during the first half of 2019. This marks a continuation of the shortening trend that started in 2018 following a lengthening of leases across the three sectors that followed for several years in the recovery phase post the global financial crisis.

Since 2016, occupiers in the industrial sector have had the longest average lease length highlighting the strength in the sector's underlying fundamentals. From 2002 to 2015, industrial leases were on average shorter than that of both retail and office.

In June 2019, the average unweighted industrial lease length was 6.7 years, more than 2 years longer than the 4.6 years recorded in 2011. The average office lease has reverted to the same level as 2011 - just over 6 years. Meanwhile, the average retail lease is now more than half a year shorter.

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.

Retail and industrial rent-weighted lease lengths trended down during the first half of 2019 to end the period at rent-weighted lease 9.9 years (down 7.8 months) and 9.4 years (down 6.4 months) respectively.

Despite the recent shortening, industrial lease lengths remain well off its lows of around 8 years. However, retail lease lengths have not been shorter at any time during the series' 18-year history.

The office sector meanwhile saw a 3.6 month increase in its rent weighted, lease length during the first half of 2019 to end at 10.2 years which is just below the long-term average of 10.6 years. When weighted by passing rent, office lease lengths are now 16 months longer than they were in 2014.

Offices in the South East – outside Central London- have been a key driver of the upward trend in the year to June 2019- with the average rent-weighted lease lengthening from 8.7 years to 11.9 years.

Central London's average rent-weighted office lease at 10.0 years is also now 2 years longer than it was in 2014– notwithstanding a shortening to below 8 years during 2017.

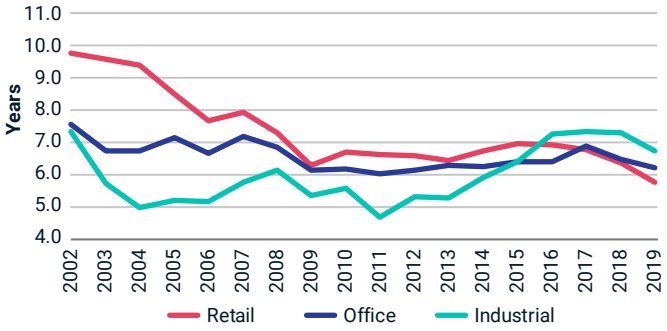
Similarly, offices in the Rest of the UK saw lease length increase over this period, with the rent-weighted lease length increasing from 8.9 years in 2014 to 11.4 years as at June 2019.

Segmenting by age reveals that office property constructed before 1990 has seen rent-weighted lease lengths shorten by 16 months since 2015. Meanwhile, newer office property – constructed after 1990- has seen its rent-weighted lease length increase by a year implying that larger occupiers are currently more likely to commit to longer leases in newer accommodation.

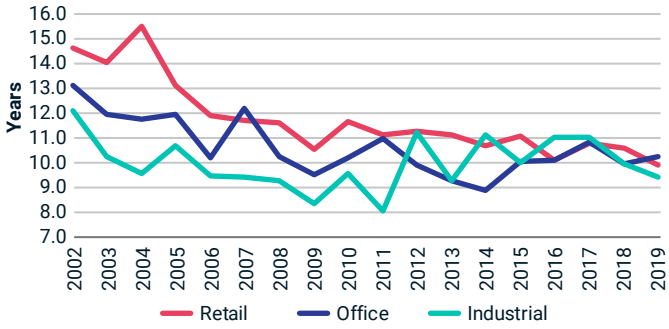
Figure 3

Average lease length trends by sector

(Unweighted full term, ignoring any breaks, including short leases)



(Weighted full term, ignoring any breaks, including short leases)

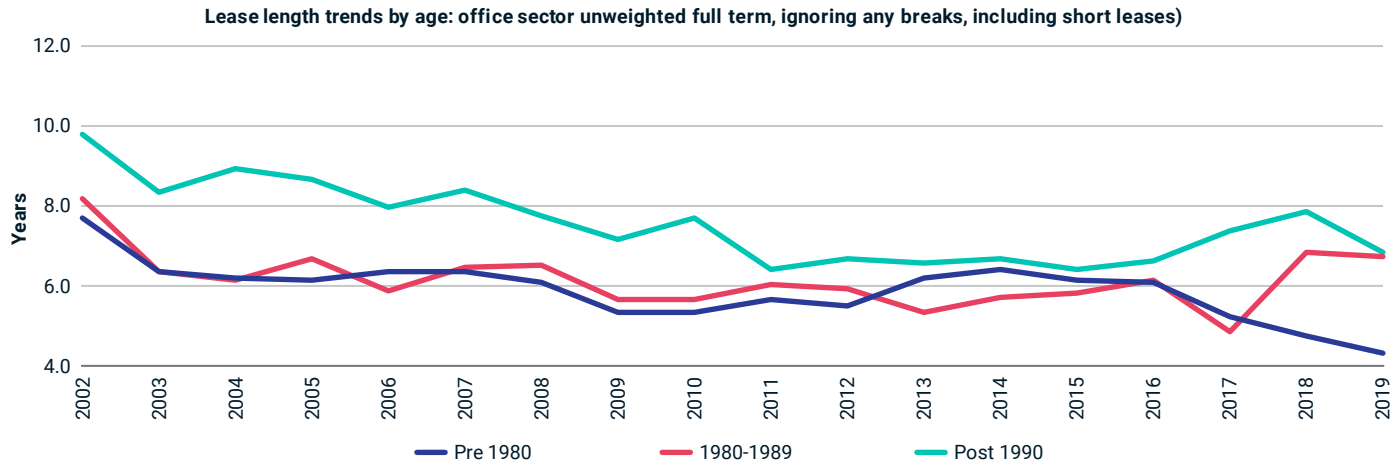


Source: MSCI

Figure 4

Average lease length trends by age: Office sector

(Unweighted full term, ignoring any breaks, including short leases)



Source: MSCI

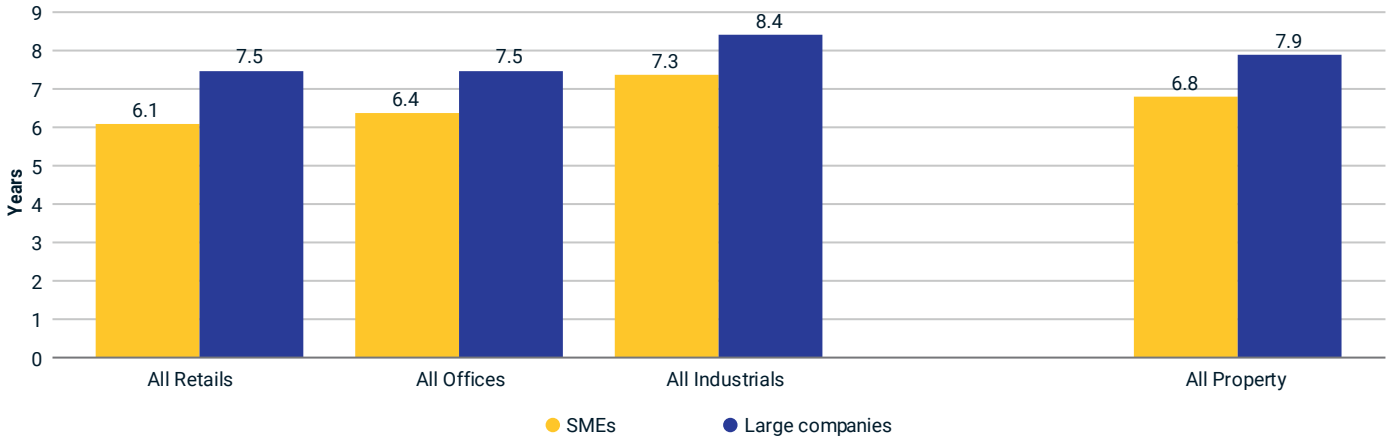
In addition to leasing trends by sector and location, the analysis highlighted in Figure 5, below, also compares small and medium enterprises (SME's) – defined as those employing less than 250 employees and netting less than 50m EUR- to larger companies. Large companies have tended to have greater financial 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.

Figure 5

Average lease length trends by tenant type

(Unweighted full term, ignoring any breaks, including short leases)



Source: MSCI

At an All Property level, SMEs had an unweighted lease length of 6.8 years as at June 2019 – a little over a year shorter than the 7.9 years measured for large companies.

The difference in lease length between SMEs and large companies was reasonably consistent between the three main property sectors. Large companies in the retail sector had an average, unweighted lease length of 7.5 years – 17 months longer than that of SMEs. Comparatively, large company leases in the office and industrial property were 14 and 13 months longer respectively when compared to SMEs.

The rent weighted lease length of SME and large company leases were both longer than on an unweighted basis. This indicates that larger occupiers tend to prefer longer leases irrespective of its number of employees. As at June 2019, SME leases had a weighted length of 10.4 years, compared to the 9.8 years recorded for large companies.

Break Clauses and Rent-Free Periods

As at June 2019, 35.6% of leases included a break clause, down from 40.5% in 2018. The main driver of the decline was leases between 11 and 15 years in length, where the proportion with a break clause reduced from 44.8% in 2018 to 37.8% in 2019.

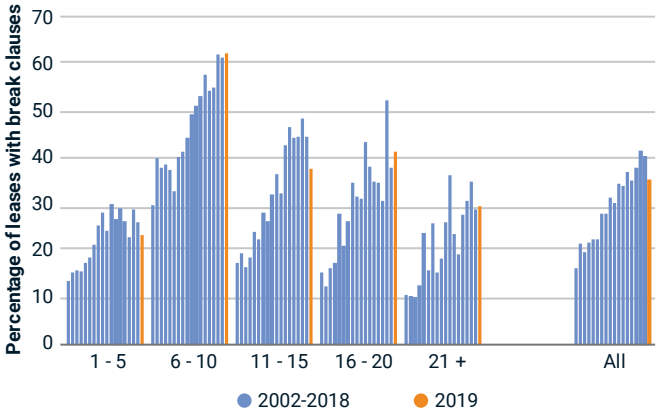
The only bracket to post a meaningful increase in the percentage of leases with a break clause was the 16 to 20-year lease bracket. This suggests that while some occupiers remain willing to commit to longer term leases and enjoy the security that brings, they have sought the flexibility now required by their business models through break clauses. In contrast, landlords have been less inclined recently to agree to break clauses on short leases in the current leasing environment. Leases of between 1 and 5 years saw a 290bp decline in the proportion of leases with break clauses in going from 26.4% to 23.5%.

Overall, break clauses are now most common in the industrial (43.4%) and office sectors (43.8%), and notably lower in the retail sector at 29.2%. 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.

Figure 6

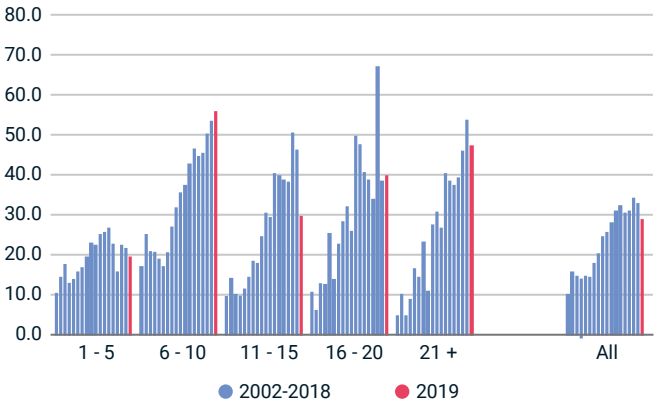
Average lease length trend by sector - All property

Leases with break clauses



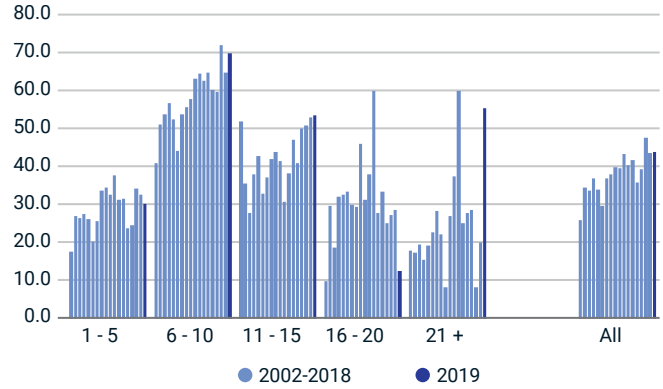
Average lease length trend by sector - Retail

Leases with break clauses



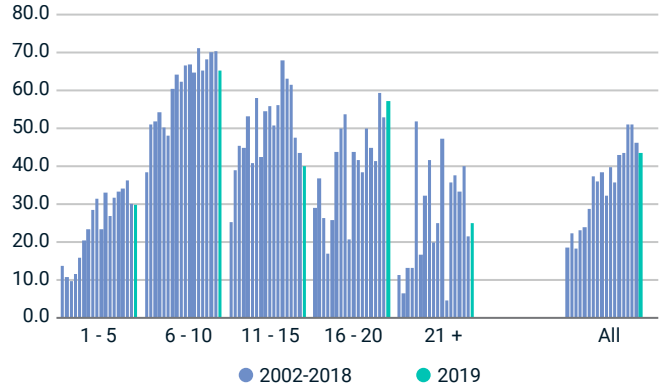
Average lease length trend by sector - Office

Leases with break clauses



Average lease length trend by sector - Industrial

Leases with break clauses



Source: MSCI

The length of rent-free periods has historically been closely tied with the macroeconomic environment – increasing in times of slow growth as landlords' focus on increased in tenant retention.

Rent-free periods for offices remained the longest at an unweighted average of 8.8 months. While this was virtually 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 the first half of 2019 at 7.4 and 5.0 months respectively. Like the office sector, retail and industrial rent-free periods were stable vs the year prior.

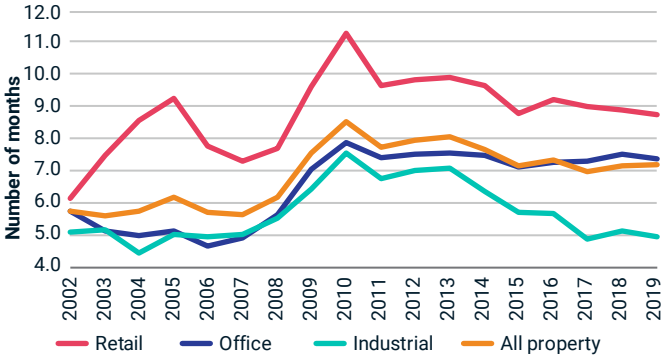
Weighted by passing rent, All Property rent free periods increased from 9.6 months in 2018 to 10.3 months at June 2019.

Larger occupiers are still incentivised by longer rent-free periods. Since 2016, the weighted rent-free period increased more than the unweighted figure. Interestingly, 2018 was the first year where the weighted level of rent-free periods dipped below the unweighted mark implying fewer rent-free periods are being conceded to larger-ticket tenancies.

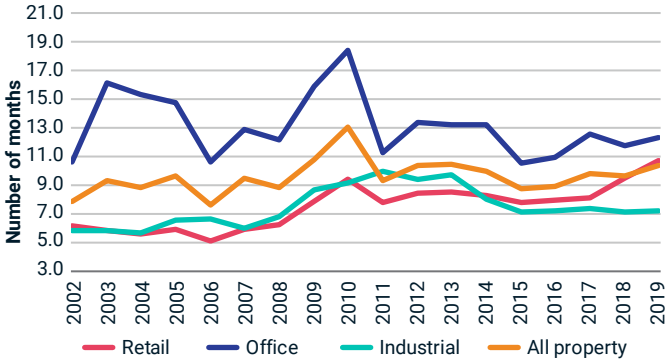
Figure 7

Average rent-free periods by sector

Tenancies equally weighted



Tenancies weighted by rent passing



Source: MSCI

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).

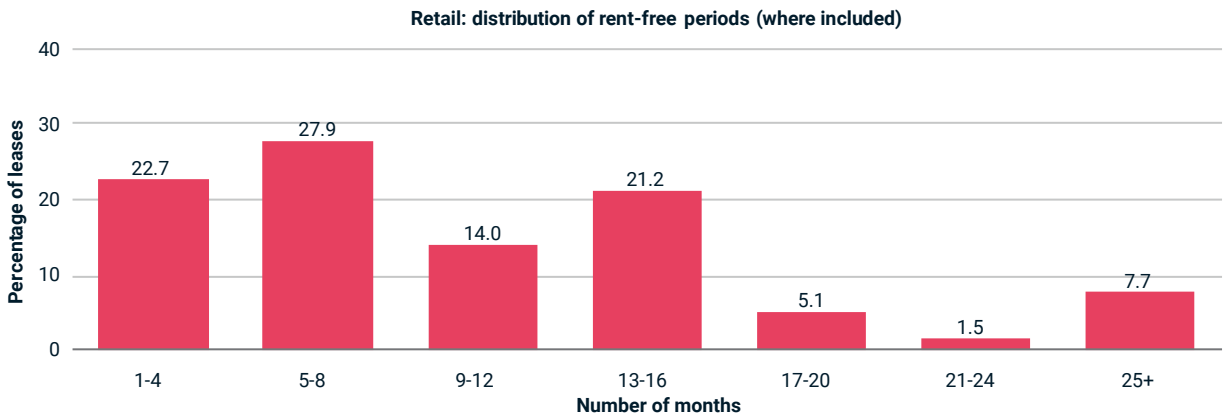
The office sector's pattern of rent-free periods differs from the other two sectors in that the most common period is 9-12 months (28.7% of contracted rent). There are fewer very short periods, with only 14.8% of leases having a rent-free of 1-4 months.

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.

Figure 8

Distribution of rent-free periods for retail

Tenancies weighted by rent passing



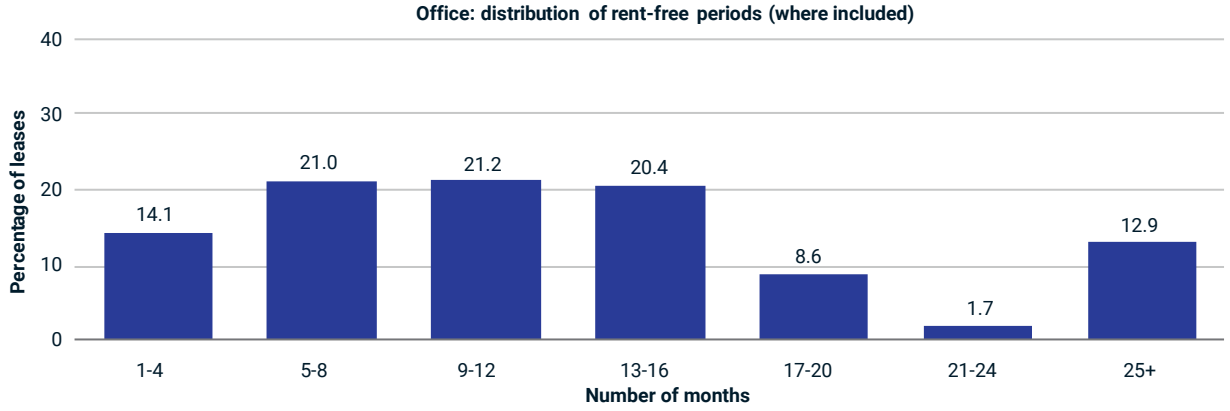
Note: Tenancies weighted by rent passing

Source: MSCI

Figure 9

Distribution of rent-free periods for office

Tenancies weighted by rent passing



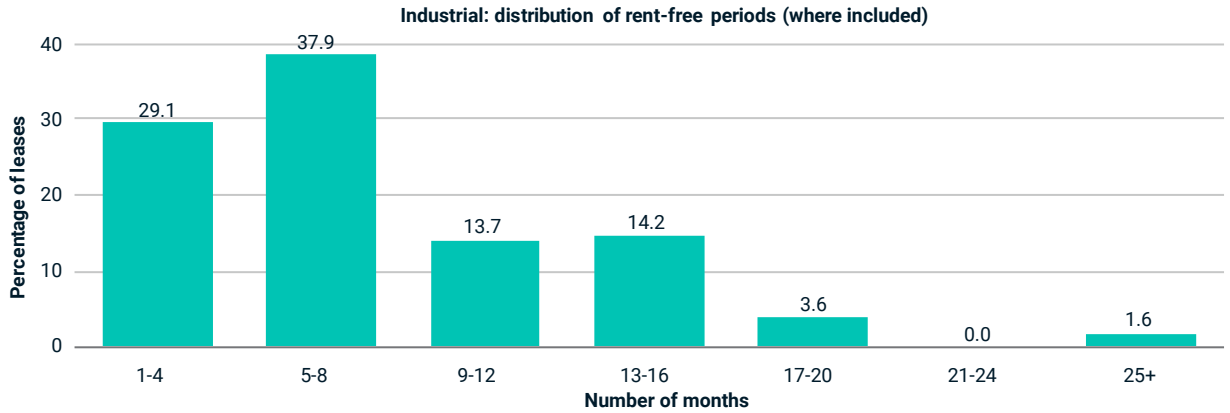
Note: Tenancies weighted by rent passing

Source: MSCI

Figure 10

Distribution of rent-free periods for industrial

Tenancies weighted by rent passing



Note: Tenancies weighted by rent passing

Source: MSCI

Income security and potential for growth

The graph below summarises the income position for current leases in 2019, drawing on the portfolios in the MSCI UK lease database. Top slice represents income that is at risk due to over-renting (where passing rental is greater than the open market rental value), while reversionary potential represents income growth available for existing leases due to rental value growth, as of June 2019. Additional factors influencing security of income are developments, vacancies and rent-free periods.

As at June 2019, we estimate that 6.4% of income was at risk due to over-renting. The retail and industrial sectors both saw a decline in the level of over-renting between June 2018 and June 2019, as market rental values continued to improve.

However, the office sector saw the proportion of its rent passing at risk from over-renting increase 2.6 times, moving from 4.3% to 11.0% making it the most overrented of the three traditional property sectors when compared to 6.6% for retail and 2.5% for industrial.

Driving the office sector's current overrented status, is the 'Rest of South East' office segment with 19.3% of rent passing at risk. Offices in Central London and the Rest of the UK has a lower exposure to reversionary risk at 8.2% and 5.4% respectively.

At the All Property level, reversionary potential offers the most upside at 20.4% of rent passing which is significantly more than the 8.6% of 2018. All three sectors held more potential for positive rental reversion in 2019 than they did in 2018. The office sector led the charge at 25.6% of rent passing.

A further 17.1% is potentially available from letting currently vacant space at market rents. Again, the office sector leads the way by virtue of its higher vacancy rate especially in the South East of England – excluding the London market.

A smaller 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 5.7% of current passing rent. As seen earlier, offices tend to have longer rent-free periods and currently has double the potential income growth from this type of tenant incentive compared to the All Property average (11.8% vs. 5.7%).

The availability of newly developed space has the potential to boost passing rental by 4.9% - not dissimilar to 2018's level of 4.7%. On this measure, the three sectors are relatively evenly matched at around 4%. While the office sector has seen a decline – going from 10.3% in 2018 to 3.8% - the retail and industrial sectors now have more to gain from development completions.

Figure 11

Security of income and growth potential by sector at Q2 2019

Percentage of total rent passing

Source: MSCI

The impact of lease **events in 2018**

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 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 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 2018, with data sourced from the MSCI UK Annual Property 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?

In 2018, the percentage of leases renewed at expiry retreated to the lowest level since 2007 with 29% of leases expiring being renewed – which accounted for 23% of rental passing. The year-on-year decline in the renewal rate was more pronounced on a rent weighted basis, suggesting that a declining proportion of large tenancies counting among those renewed.

As the renewal rate retreated to its lowest level since 2007, the vacancy rate for leases expiring simultaneously hit its highest level on record since the series' inception in 1998. The vacancy rate for leases expiring in 2018 was 56% unweighted (counting all leases equally), rising to 61% when weighted by previous rent passing.

Meanwhile, 16% of leases were let to new tenants, 56% of units were left vacant for one quarter or more, accounting for 61% of passing rent.

Of leases expiring in 2018, 16% were re-let to new occupiers in the same quarter that the previous lease expired – lower than the 19% recorded for 2017. Weighted expiries produced a similar re-letting figure of 16%, suggesting a similar trend among smaller and larger tenancies.

The increase in vacancy resulted in a lower percentage of leases renewed, from 32% to 29%. When weighted by rental income, 23% of leased income was renewed in the same quarter as the expiry occurred. While this was down on the 29% of a year before it was above the 20-year average of 19%

A breakdown of these figures is shown in Table 1.

Table 1

Outcome of leases expiring in 2018 for all property

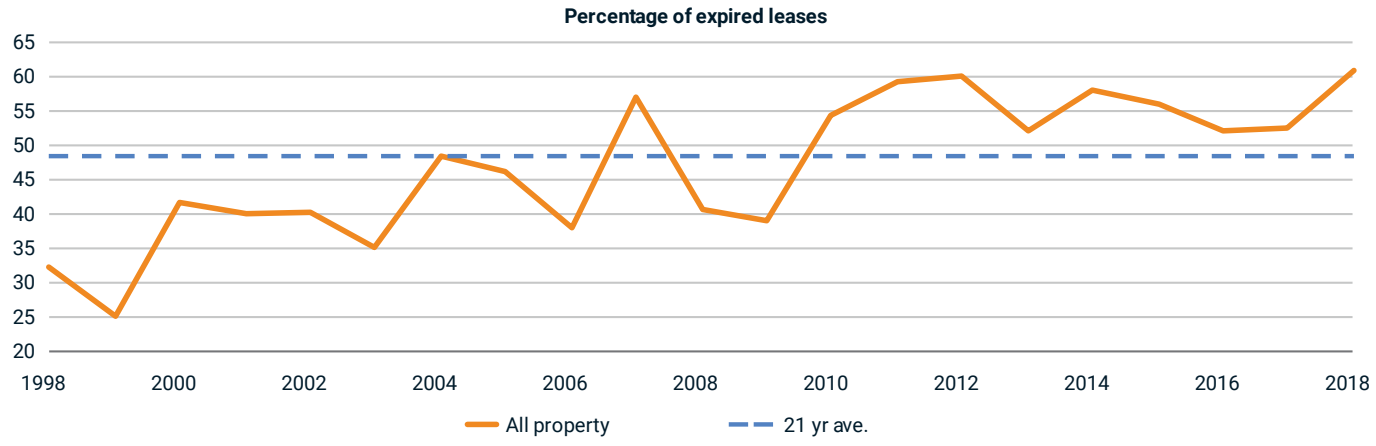
	Unweighted	Weighted
Renewed	29%	23%
New letting	16%	16%
Vacant	56%	61%

Source: MSCI

Figure 12

Vacancy rate for leases expiring 1998-2018 by all property

Tenancies weighted by rent passing

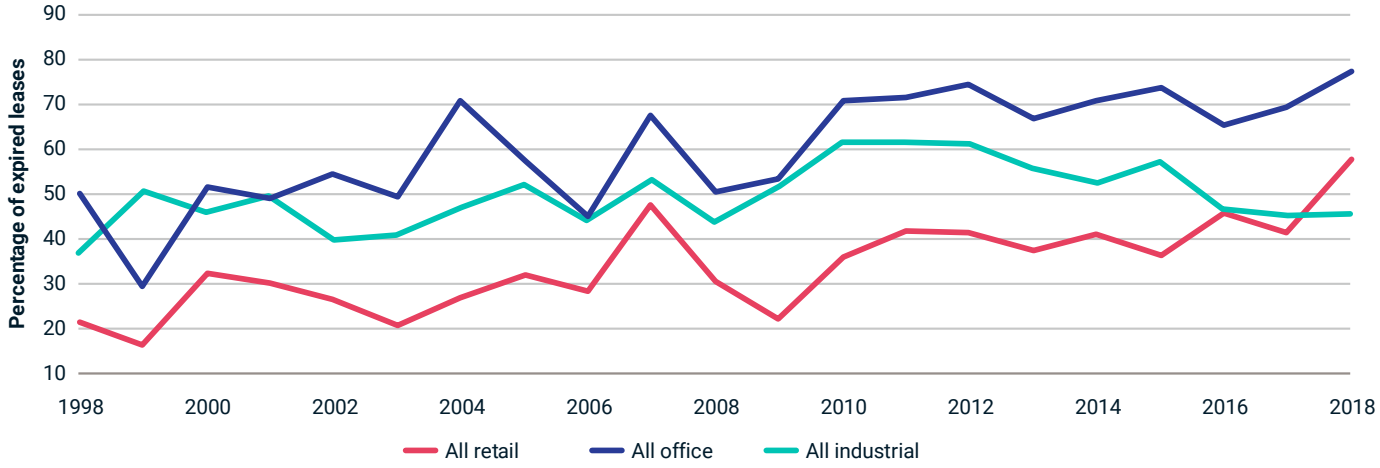


Source: MSCI

Figure 13

Vacancy rate for leases expiring 1998-2018 by sector

Tenancies weighted by rent passing



Source: MSCI

By sector, offices had the highest level of immediate vacancy on lease expiry in 2018, both weighted (77% of leases) and unweighted (73%).

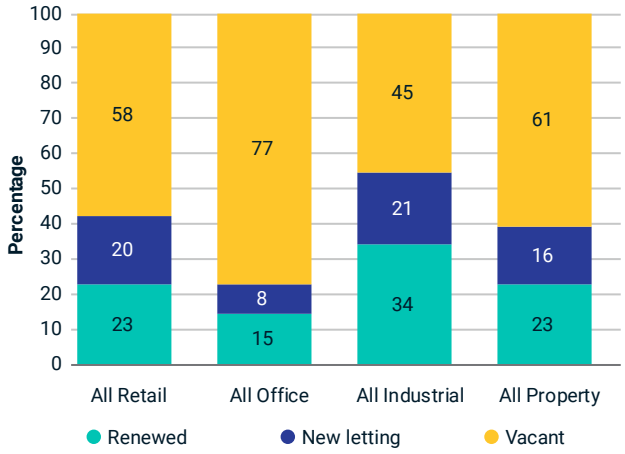
All Property vacancy rates on expiry, both unweighted and weighted, remained well above their long-term averages in 2018. On a weighted basis, vacancy rates were 13% higher than their long-term average (61% versus 48%) and 14% higher when calculated in unweighted terms (56% versus 42%). On a rent-weighted basis, industrial had the lowest sector vacancy rate on expiry at 45%, compared to retail at 58% and offices at 77%.

Since 2013, the vacancy rate for expired leases has declined by 10% for industrial property – going from 55% of passing rent to 45%. At the same time, the retail and office sectors saw vacancies upon expiry increase by 20% and 11% of rental passing respectively. This reflects the relative strength of the industrial occupier market in recent years, as developments in ecommerce have helped support the demand for logistics property.

Figure 14

By sector: What happened when leases expired in 2018?

Tenancies weighted by rent passing



Source: MSCI

The industrial vacancy rate on expiry at 45% is below its long-term average of 50%. Industrial in the South East as well as in the Rest of the UK saw the same with vacancy rate on expiry equal to 48% and 42% of rental passing respectively.

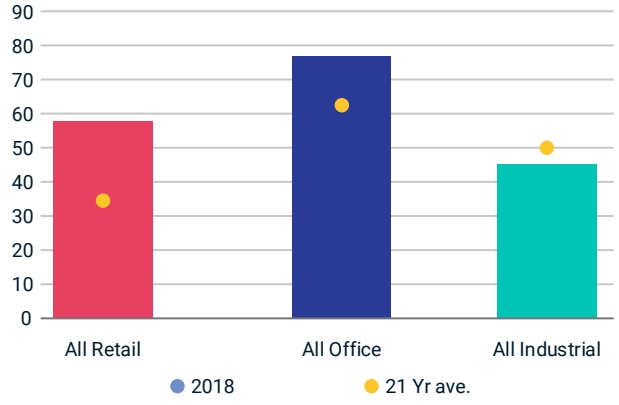
The recent weakness of the retail sector has seen its vacancy rate on expiry move to an all-time high of 58% during 2018. This has seen retail's vacancy rate on expiry move significantly beyond its long-term average of 34% in what could potentially be a sign of a structural e-commerce driven change, rather than a short-term dip.

As in 2017, regional variation in 2018's results saw significantly higher levels of vacancy upon lease expiry in the Retail Warehouse segment (69%) as well as among standard retail units in the South East (68%).

Figure 15

Vacancy rate upon expiry

Per sector; 2018 and 21-year average

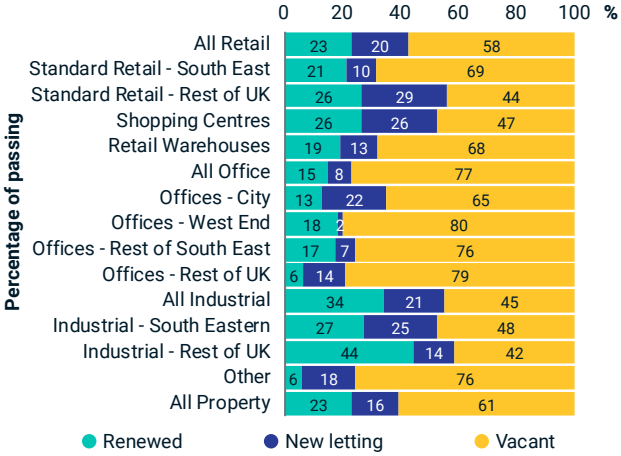


Source: MSCI

Figure 16

What happened when leases expired in 2018?

Per segment; rent weighted



Source: MSCI

Office's vacancy rate on expiry remained the highest on a sector level. By region, the West End and the Rest of the UK witnessed the highest rates of vacancy upon lease expiry at 79% and 80% respectively. Offices in the City saw the lowest vacancy rate on expiry at 65% which was improved from the 69% of 2017.

The Rest of the South East, saw the highest year-on-year increase in its vacancy rate on expiry by increasing from 63% of passing rental to 76% in 2018. The high vacancy rate 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.

What was the impact of break clauses?

The percentage of tenants choosing not to exercise their break options declined to 78.8%, down marginally from 79.1% a year before.

Table 2 shows the number of tenants across all property sectors who had the right to break in 2018. 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 tend to be highly cyclical, driven by differences between in-place and market rental levels, in 2018 only 21% of leases were broken. Even when accounting for larger leases, only 26% of contracted income was lost due to breaks – in line with the long term average.

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 cost determined to be reasonable relative to the fact that it is rarely exercised.

Table 2

Outcome of leases with a break occurring in 2018

	Unweighted	Weighted
Break not exercised	79%	70%
Exercised - re-let	3%	4%
Exercised - vacant	18%	26%

Source: MSCI

Figure 17

Vacancy rate for exercised break clauses - All property; 1998-2018

Tenancies weighted by rent passing

Source: MSCI

The rent-weighted vacancy rate due to exercised break clauses increased from 23% in 2017 to 26% in 2018. While this is now marginally above the 21-year average of 25% it is still comfortably below the high of 2011 when 42% of break clauses resulted in vacancy for a quarter or longer.

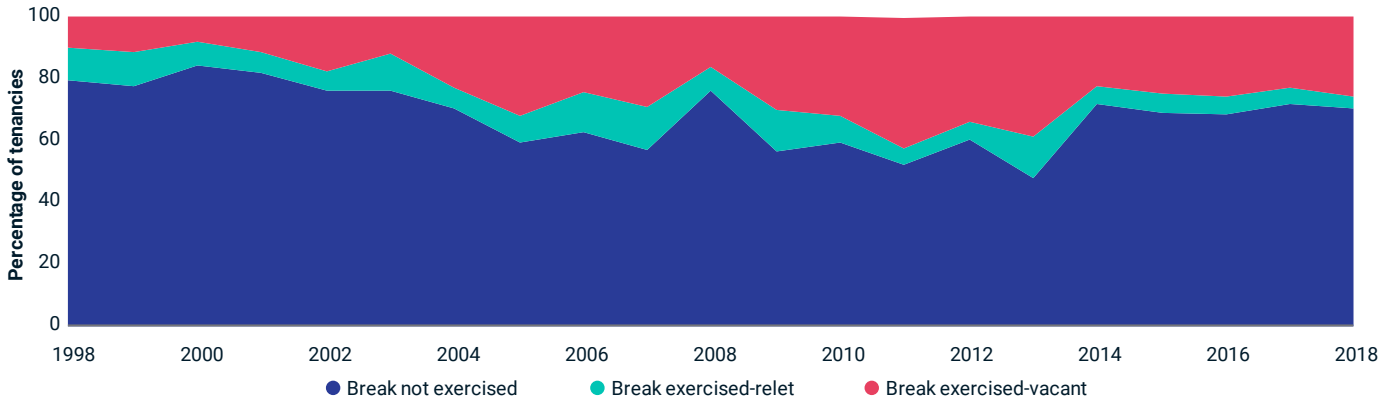
The unweighted vacancy rate due to exercised break clauses at 18% was lower than the rent-weighted figure of 26%. This is unchanged on the year before and remains below the recent high of 28% recorded in 2011 and 2013.

The higher percentage of tenants vacating in 2018 on a rent-weighted basis implies that a higher proportion of vacancies were recorded among larger tenants. The percentage of re-lettings declined to 4% from 6% on a weighted basis, below the long-term average of 9%. Encouragingly, the proportion of break clauses not exercised remained stable at 79% on a rent-weighted basis. On an unweighted basis, the percentage of break clauses not exercised decreased from 72% to 70% suggesting a higher level among smaller tenancies.

Figure 18

Outcome for all property post-break clause

Tenancies weighted by rent passing



Source: MSCI

At a sector level, there were again broad differences in outcomes for break clauses that occurred in 2018.

From 2010 to 2017, the retail sector had a lower percentage of break clauses exercised compared to the office and industrial sectors on a rent-weighted basis, which were underpinned by retailers' desire to remain at established trading locations. That changed in 2018, when the industrial sector boasted the lowest level of breaks exercised at 18.8% of rent passing – its lowest level since 2002. Retail and office meanwhile both saw an increase in the percentage of passing rental exposed to exercised break clauses.

Weighted by previous passing rent, 23.9% of retail tenants chose to exercise their break options when they arose in 2018 – above the long-term average of 22.1%. This was the highest level of retail breaks exercised since 2013 when exercised break clauses accounted for 43% of passing rent.

On an unweighted basis, 19% of retail tenants chose to activate break clauses in their lease agreements during 2018, up from 14% in 2017. Of the leases that had break clauses activated, 15% of these were re-let within the same quarter while the remaining 85% remained vacant for more than one quarter post-break.

On a weighted basis, the office sector had the highest percentage of tenants activating their break clauses in 2018 at 36% of passing rental – up from 33% a year before. 89% of office break clauses activated resulted in vacancy while 11% of cases saw an immediate re-letting.

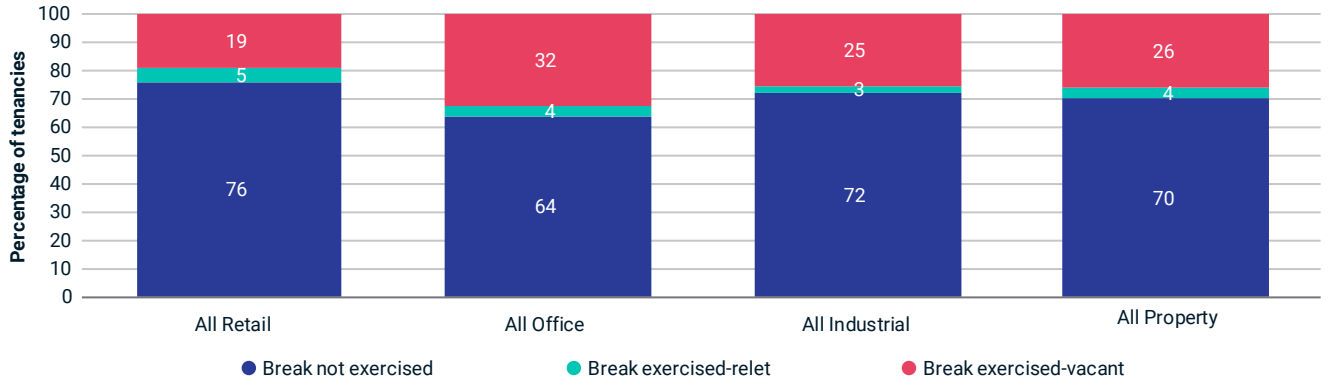
On an unweighted basis, 26% of office tenants chose to activate break clauses in their lease agreements during 2018, up from 23% in 2017. Of the leases that had break clauses activated, 12% of these were re-let within the same quarter while the remaining 88% remained vacant for more than one quarter post-break.

The industrial sector saw 28% of tenancies (weighted by passing rent) activating their break options in 2018, a significant turnaround from the 42% recorded in the year before. On an unweighted basis, 19% of industrial tenants activated break clauses in 2018, down from 30% in 2017. Of the 19% of leases that had break clauses activated, 3% of these were re-let within the same quarter while the remaining 16% remained vacant for more than one quarter post-break (a similar breakdown to the one observed for the retail sector).

Figure 19

Break clause actions by sector

Tenancies weighted by rent passing



Source: MSCI

Break clause action rates varied somewhat between different property types and geographies. For offices, the percentage of break clauses exercised increased notably in the West End while decreasing in the City office segment.

On an unweighted basis, 19% of City Office occupiers exercised break clauses in 2018 – significantly less than the 47% in 2017. In contrast, the prevalence of breaks exercised in the West End office market increased to 47% in 2018 – up from 39% in 2017.

Interestingly, however, the percentage of breaks exercised in the West End showed a larger increase on a rent-weighted basis in growing from 15% in 2017 to 37% in 2018. This suggests that break clause activations had a bias towards smaller tenants in 2017 while the occurrence of breaks were more evenly spread across the spectrum of tenants in 2018.

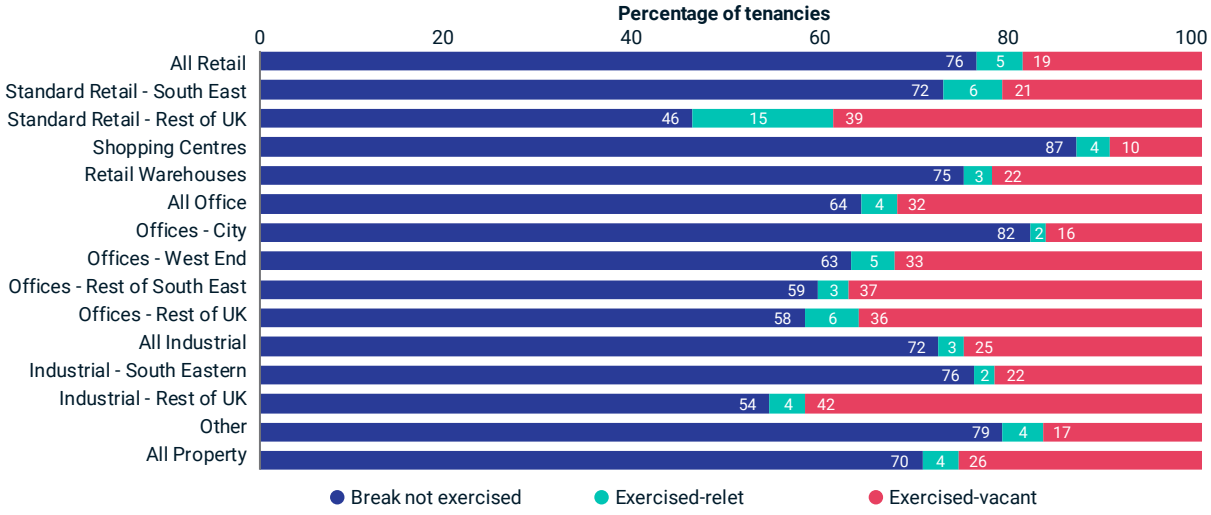
For offices in the Rest of the South East, 59% of break clauses were not exercised on a weighted basis – an 11% decline on the year before, when 70% of breaks were not exercised. The increased rate of break clause activation also resulted in a lower percentage of re-letting as 92.2% of breaks resulted in a vacancy of at least one quarter, a deterioration on the 79.4% of 2017.

Retail had the lowest tendency to exercise break clauses among the three main property sectors but there was some variance in the underlying segments. While Shopping Centres, Retail Warehouses and Standard Retail in the South East all had similarly low rates of break action, the Standard Retail Rest of UK segment saw its rent-weighted rate of break action increase from 20% to 54% in 2018 (16% to 32% on an unweighted basis).

Figure 20

Level of lease breaks exercised vary by property segment

Tenancies weighted by rent passing



Source: MSCI

What is happening on renewal and re-letting?

Upward only rent reviews have long been the norm in the UK commercial property market and a key attraction for investors. However, with the rising threat posed by business rates hikes, online competition and import costs, rising rents may have become unsustainable. Incremental increases in labour costs since the introduction of the National Living Wage may also be affecting the bottom line.

The restriction on downward reviews means that there is often only minimal rental value movement during the life of a lease, particularly in a subdued market, which increases the probability of rent reversions upon expiry. This allows an interesting analysis of an investor's income position for properties when leases approach expiry.

Earlier in this report we observed that a large proportion of expiries currently result in vacancy. To avoid this loss of income (and the associated cost of letting and tenant installation), many landlords will agree to revised terms.

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 2018.

Table 3

Rental change for new leases in 2018

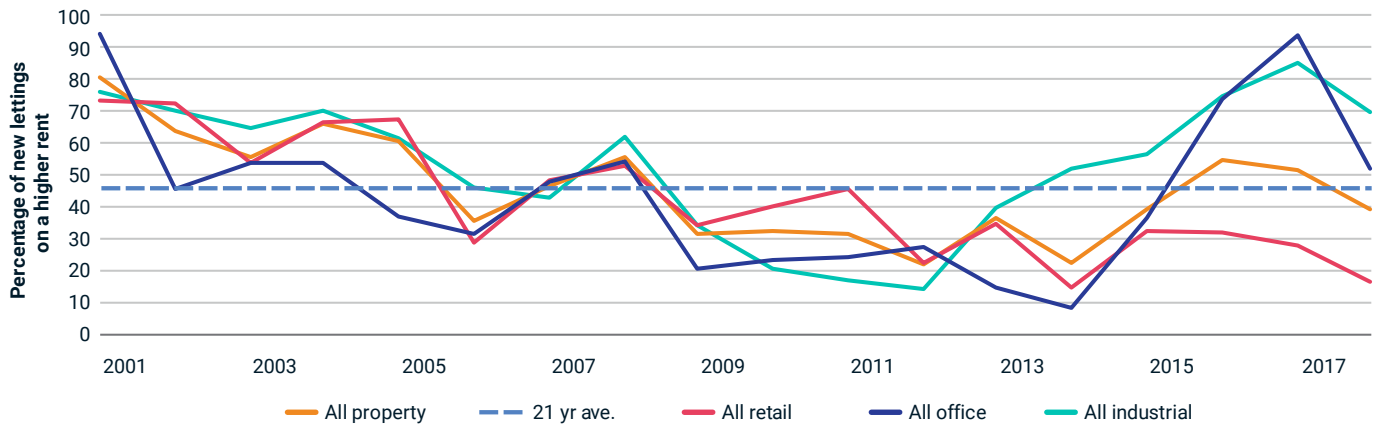
	Unweighted	Weighted
Higher	56%	39%
Lower	33%	51%
Same	12%	10%

Source: MSCI

Figure 21

Achievement of higher rent on new lettings 2001-2018

Tenancies weighted by rent passing



Source: MSCI

On an unweighted basis, the rental income achieved on both the signing of new leases and renewals in 2018 were, on average, higher than what was achieved the year before. In 2018, 56% of new lettings were at a higher rental than previously achieved – the highest level since 2008 and the second successive year where more than half of new deals were penned at a higher rent.

From 2009 to 2015, most deals were done at a lower rental since the leases had typically been signed prior to the financial crisis. This trend is now reversing as more and more properties begin to offer potential for positive rental reversions.

In 2018, an unweighted 61% of renewals achieved a higher passing rent – stable on a year before. Weighted by rent passing, this figure was somewhat lower at 49%, implying that landlords were more likely to achieve positive reversions on renewals among smaller-ticket occupiers.

In 2018, the rent weighted percentage of renewals reverting higher in the City office market was significantly down on the year before. The inverse happened in the West End office market with a rebound in the weighted percentage of renewals reverting higher.

As a percentage of City office renewals, 52% of leases reverted lower on a weighted basis – up from 33% the year before – while the West End office market saw 93% of renewals reverting higher, up from only 16% in 2017.

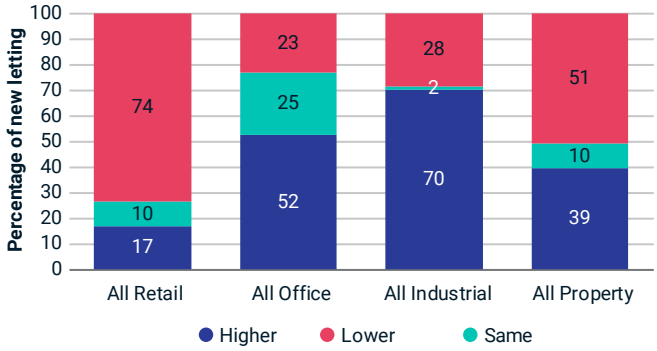
In terms of the percentage of tenancies (unweighted), 33% had lower rental income following a new letting, a slight improvement from the 35% recorded in 2017.

On an unweighted basis, the industrial sector performed best, with 82% of new lettings seeing an uplift in income, while retail properties were the weakest, with only 30% of tenancies witnessing an increase following new lettings.

Figure 22

Rental change for new lettings in 2018 by sector

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 increased to 4.2% of tenancies in 2018, when weighted by passing rent – the highest since 2013's level of 4.7%. This marks a sharp rebound after the 2.3% recorded for 2017, which was the lowest rate of default registered for the UK market since 2007.

The 2018 move was mainly driven by an increase in retail sector defaults which climbed to 6.1% of passing rent. This is just below the 2008 and 2011 levels of 6.5% and 6.3% respectively, highlighting the difficult operating environment faced by retail players especially those with exposure to the Retail Warehouse segment.

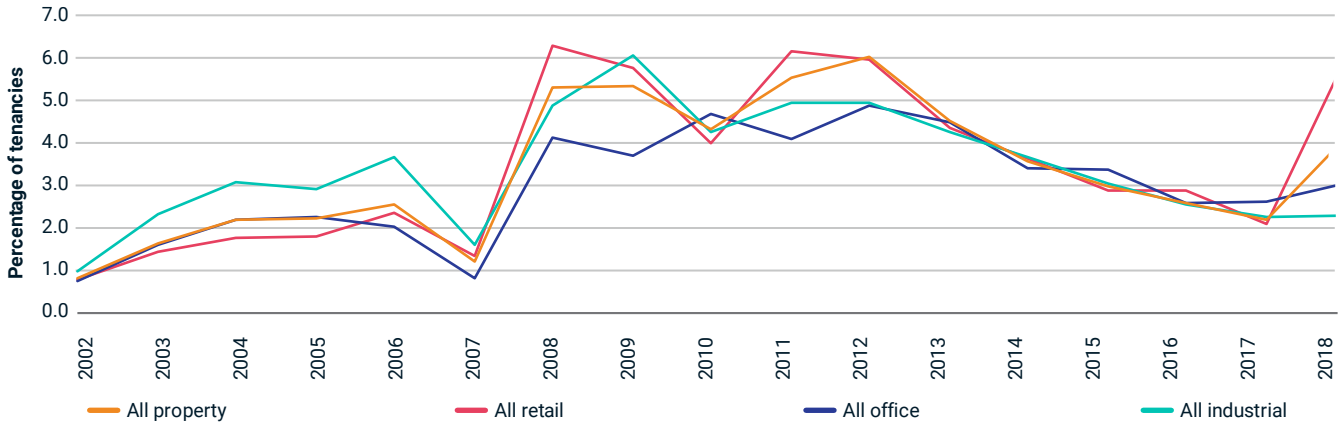
Default rates for Retail Warehouse rose to 9.0% of passing rent, a new high for the segment and historically only matched by Shopping Centres in 2011 & 2012 and City Offices during the period 2012-2015.

Among the other retail segments, Shopping Centres had a default rate equal to 5.8% of passing rental, up from 4.1% in 2017. This segment, being heavily reliant on consumer confidence, has had a consistently high default rate since the economic downturn– averaging 6.6% since 2008.

Figure 23

Tenants in default (in liquidation or receivership)

Tenancies weighted by rent passing



Source: MSCI, D&B

Rates of default have continued to vary by location and property segment during 2018. This was particularly the case for the retail sector, while the spread was tighter amongst the office and industrial segments.

Offices in the City of London, dominated by financial occupiers, was the only office segment to record an improvement in its default rate during 2018. The segment's default rate ended 2018 at 3.6%, compared to 4.1% in 2017.

Although office-sector 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 Retail Warehouses at 9.0% and Shopping Centres at 5.8%. Conversely, in London's West End, the default rate among office tenants have been consistently lower. In 2018, it increased by 60bps to 3.3%, not significantly beyond the 17-year average of 2.7%.

The industrial sector boasted the lowest level of default in 2018. The sector's aggregate rate of default has now for three successive years accounted for less than 3% of total rent passing.

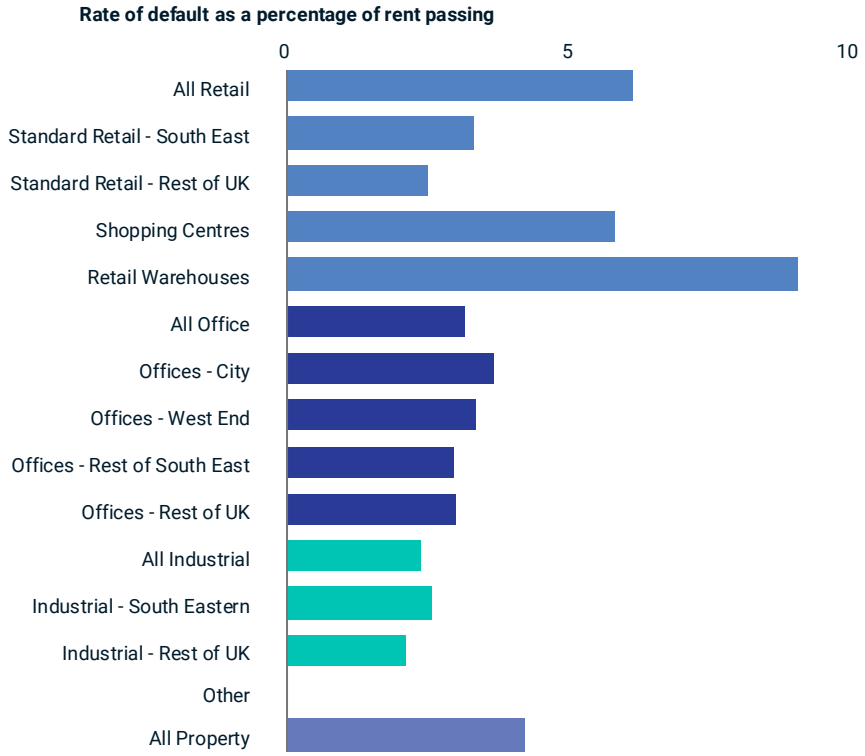
Although we can show data on rates of tenant default, it is harder to track the outcome of such defaults in terms of re-letting and ongoing vacancy. This is easier to do following pre-determined lease events, since the dates are known in advance.

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 24

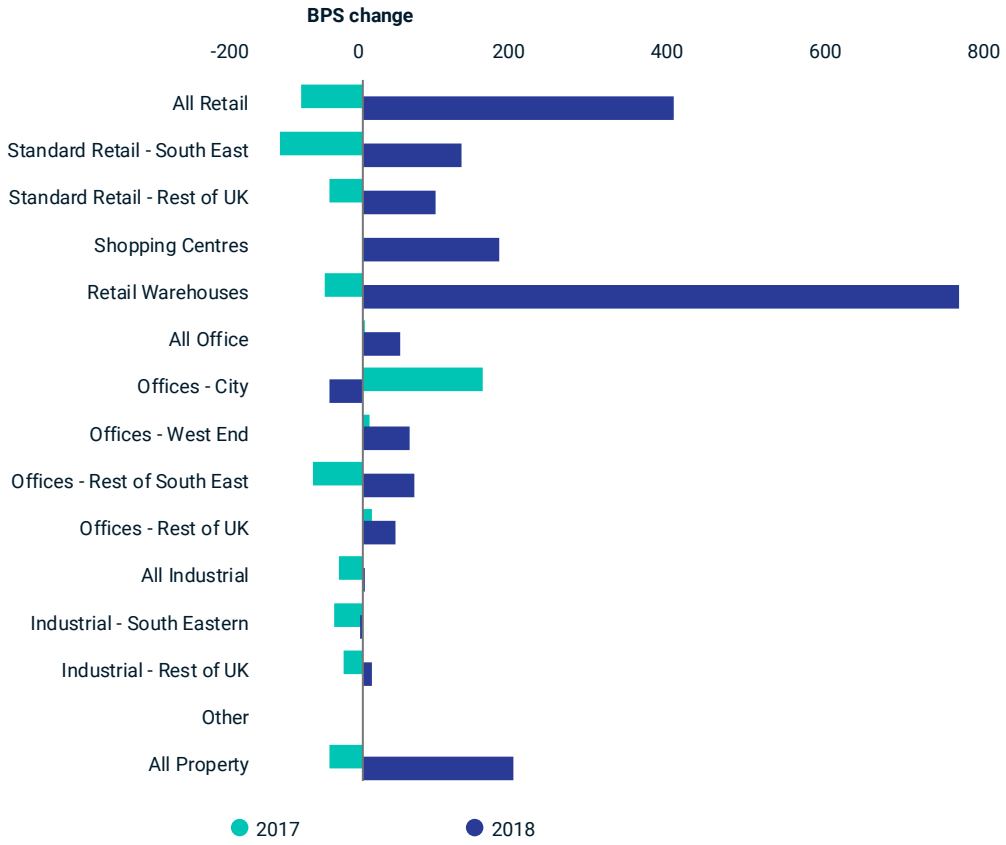
Tenants in default by region and type

Tenancies weighted by rent passing



Rate of default - y/y change 2017 &

Tenancies weighted by rent passing

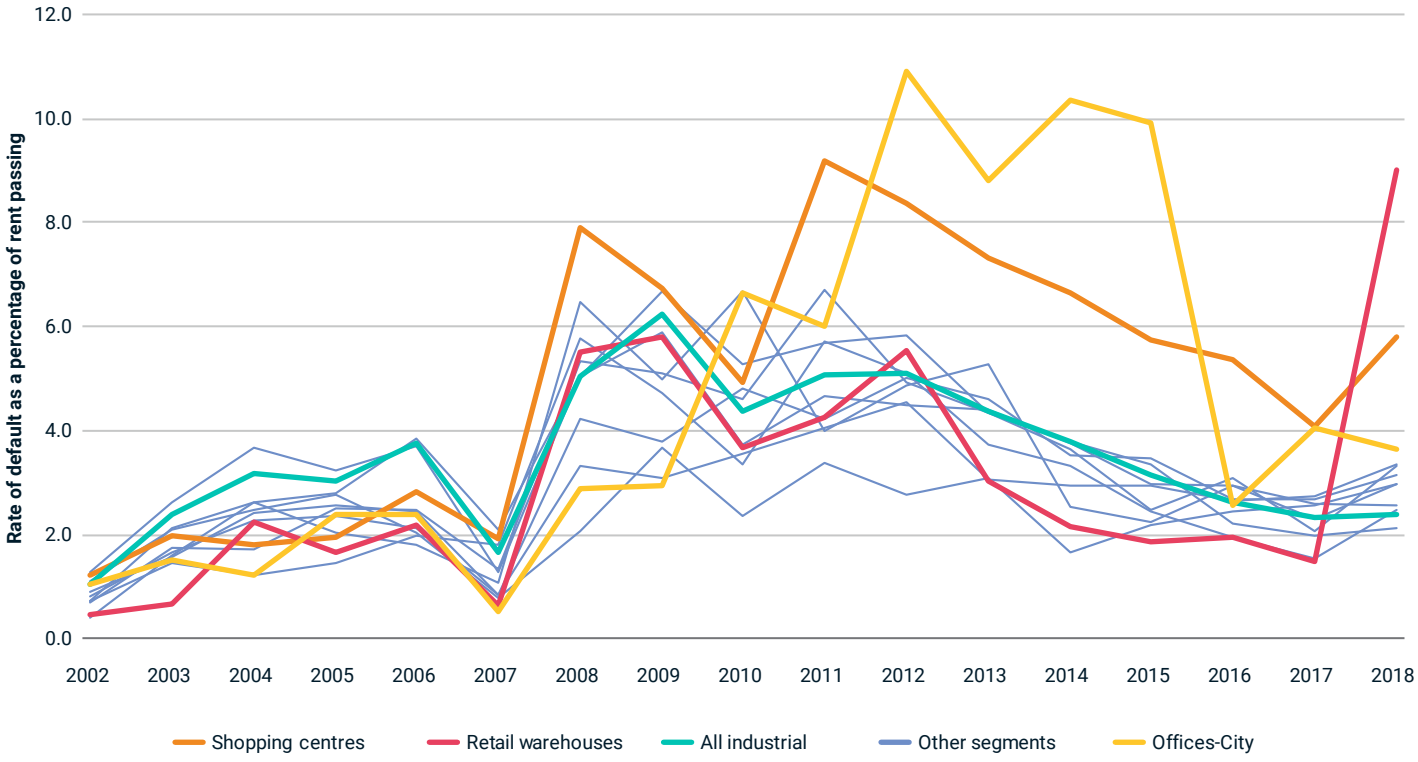


Source: MSCI, D&B

Figure 25

Segment level defaults defaults

2002-2018; All property segments



Source: MSCI, D&B

MSCI Real Estate
Will Robson
Head of Global Real Estate Research Solutions
Ninth Floor, 10 Bishops Square
London E1 6EG

T: +44 20 7336 9269
E: will.robson@msci.com

BNP Paribas Real Estate UK
Etienne Prongué
Deputy CEO BNP Paribas Real Estate UK
BNP Paribas Real Estate UK 5 Aldermanbury Square
London EC2V 7BP

T: +44 20 7629 7282
E: etienne.prongue@realestate.bnpparibas

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