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Break Clauses – Who holds the Risk in your Rental Income?

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Research Team

Micheal Reevey, *Addleshaw Goddard*
Andrew Blower, *Addleshaw Goddard*
Malcolm Frodsham, *IPD*
John Danes, *Aberdeen Asset Management*

1. Introduction

The current economic conditions have led to a substantially weakened occupier market. Traditionally the investor landlord would have income protection during this period of downside risk from the contractual obligations of the lease. However in this downturn this income protection has been substantially weakened by both shorter lease lengths and, in particular, by break clauses. This paper therefore looks in some detail at the topic of break clauses establishing the legal context first, to provide a background to an analysis of data from the Strutt and Parker/IPD Lease Events Review and a discussion of the implications of current trends on the use of break clauses for investors.

2. Short history

Break clauses are not new. Legal records show that landlords and tenants were arguing in the courts about the exercise of break clauses during the 19th century.

As early as 1804, a break notice signed by only 2 of the 3 executors of the original lessor was found by the court not to be valid because it was required to be given by all three. Towards the end of that century, in 1885, a court decided that a notice attempting to terminate a head-lease which was given to an under-tenant rather than the tenant was not effective. A few years later, in 1889, the court again considered an argument regarding the proper recipient of a break notice; the question was, where there are two lessees and a lease doesn't provide otherwise, does the break notice have to be given to each of them? It was held that both lessees must receive the notice.

Many break rights are dependant on compliance with covenants. Throughout time the courts have had to determine what amounts to 'compliance'. In 1909 it was held that the requirement to have 'duly paid the rent' was complied with despite the payments not being punctual. The key element was that the rent had been paid up to date by the break date.

Although not a new concept, break clauses are very current issue for the property industry. The profile of break clauses naturally increases in periods of economic downturn as tenants seek to reduce costs, end commitments to properties they no longer need and become more wary of taking on long-term commitments to new properties. At the same time, landlords experience increasing difficulty in maintaining income in the face of declining demand. The negotiation, exercise and landlords' attempts to contest the validity of break clauses have, therefore, significantly increased in the last two years.

The analysis undertaken by IPD for the Strutt and Parker/IPD Lease Events Review supports this. The average over a twelve year period is for 71% of break clauses not to be exercised (29% being exercised) whilst the relevant figure for 2009 was 56% not exercised (44% exercised). The re-letting figures show a small worsening of the position in 2009 but the proportion of premises not re-let following the exercise of a break remains roughly two-thirds.

In the very weak occupational market of the last two years, landlords have been willing to offer break clauses even on shorter leases, such is the imperative to get a building occupied and income producing. The recent changes to empty rates legislation have put increased pressure on landlords to secure tenants for vacant buildings, to reduce their empty rates liability. In the current market conditions, break clauses are typically being demanded by tenants even when it is unlikely they will actually be used, as extensive fit out costs would make breaking the lease after a relatively short period of time uneconomic in most circumstances. Tenants benefit from increased flexibility as a consequence, in case their circumstances change unexpectedly. They will also be able to use the impending break clause as a negotiating tactic with landlords, who will be desperate to retain tenants if market conditions remain weak, and may offer rent free periods/contributions towards fit outs as an incentive for tenants not to exercise the break.

[1] This is one of thred IPF Research Programme Short Papers focusing on leasing issues and drawing on data within the Strutt and Parker/IPD Lease Events Review 2010. The two other papers focus on rent reviews and prepacks. See the IPF website www.ipf.org.uk for further details.

It would be wrong to assume that break clauses are always capable of being exercised by only the tenant. Mutual break clauses and landlord's break clauses have also been used. Whilst it may seem unattractive to a landlord to break a lease, with the attendant loss of income stream, in the current economic climate, the reasons that landlords seek to include breaks include:

- Occupiers of property who sublet part may be unclear as to whether or not they will, at some point in the future, need to occupy the sub-let part for their own business. A break clause enables the landlord to regain possession of that part.
- An investor may be aware that there is an opportunity to redevelop the property and/or change the use to a more valuable one. The break clause provides a mechanism whereby the landlord can gain the necessary vacant possession in order to achieve this.
- Certain specialist areas may customarily have a landlord's break, one example being leases of units in outlet malls where there is often a break clause exercisable by the landlord if the tenant fails to achieve a specified level of turnover.
- The landlord may take a simple view that, if a tenant is insisting on a break, the landlord loses nothing by making the break mutual. Even if it cannot currently see itself exercising a break, if circumstances were to change, then a landlord's right to terminate may prove to be an advantage.

Landlord's break clauses do need to be read in conjunction with the security of tenure provisions of the Landlord & Tenant Act 1954 (the 1954 Act) and, to be effective, the lease must be contracted out of the 1954 Act or there must be a ground for possession of the premises under the 1954 Act at the time of operation of the break.

Break clauses can be used to overcome a problem with the 1954 Act. That provides that security of tenure can be excluded only for leases of a fixed duration. Landlords and tenants cannot enter into leases which will run from, say, month to month until determined by a month's notice and also exclude that lease from the security of tenure. A lease for a fixed term of, say, five years but incorporating a mutual break on the one month's notice can be an effective solution to this problem.

Tenant's break clauses are often sought either for specific or general market reasons.

A specific reason is something which a tenant can identify at the time that it takes the lease as a possibility which, if it occurs, would mean that the tenant would no longer require the premises. Examples include:

- A central London office occupier may, for example, be taking some additional space but may have a premises strategy of locating all its people in one building. It may, therefore, seek break clauses in the lease of the additional space to give it some options to bring that lease to an end if it finds the new accommodation.
- A retailer may have concerns about the medium term profitability of a new shop and may, therefore, seek a break clause after, say, five and/or ten years which it can exercise if the shop is not sufficiently profitable.
- The practice of agreeing to breaks may have arisen in connection with ceratin properties or types of properties e.g. some multi tenanted industrial estates feature short leases with rolling break clauses.
- A tenant may be aware of a strategic review that is likely in two to three years' time that may mean that it will no longer operate in a certain geographical location and it will, therefore, want the opportunity to end the lease after, say, five years.
- Occasionally, there can be a problem with the property; for example, a property could be subject to a restrictive covenant which, if enforced, would prevent the tenant from using the premises for its intended purpose. In those circumstances, one possible approach is for the tenant to seek the right to break the lease in the event that the covenant is enforced.

General market reasons are that, whilst the tenant cannot point to any one specific factor which makes it need a break, its bargaining position in the market at the time of negotiating the lease is such that it can secure the break at little, or even no, additional cost (in terms of rental level or incentive). In such circumstances a tenant may well take the view that the break offers it an element of flexibility should its plans need to change, for example to take into account a different macro economic environment. The need for the property industry to respond to occupiers' requests for flexibility has been championed by central government and is recognised in aspects of the Lease Code.

In addition, tenants accustomed to operating in a US or European market, both of which have generally operated on the basis of much shorter leases than the UK, have sought break clauses as a way of limiting their exposure to something more in line with what they are accustomed to accepting.

For whatever reason it is used, a tenant's break clause is very much part of the general trend for tenants to be committed to premises for shorter periods and that shorter commitment impacts on value. Those responsible for assessing value need to consider the likelihood of the tenant exercising the break clause, the prospects and costs of achieving a further letting and the impact of void periods (including the possibility of liability for empty rates) in the event that the break clause is exercised.

3. Recent developments

There have been two major developments in the negotiation of break clauses.

The first is that they have become simpler.

Older leases typically provided for conditional breaks, ie. the break would only be effective if various conditions were satisfied. The types of conditions fall into two categories:

- The mechanism of exercising the break, such as the requirement for a notice to be in a specified form, served by a specified date and for time to be of the essence in respect of that date. Such conditions are enforced strictly and, if a tenant fails to comply, it will find that it is not effectively operating its break. As one judge famously remarked "If the clause has said that the notice had to be on blue paper, it would have been no good serving the notice on pink paper, however clear it might have been that the tenant wanted to terminate the lease".
- The performance of covenants. Conditions of this nature have ranged:
  - In scope, from requiring complying compliance with all covenants to requiring simply that the principal rent is paid.
  - In timing where some require covenants to be observed and performed up to date on which the lease is intended to terminate whilst others require compliance only at the time of the service of the break notice.
  - As to materiality in that some require absolute compliance and others require compliance in material respects (so that the tenant is not prejudiced by an immaterial breach of covenant).

    If a break clause provided that, for the break to be effective, the tenant had to comply with all the obligations in the lease in every respect from the date of service of the notice up to the date of intended termination, the break would be virtually impossible to exercise. Most landlords could find some, possibly minor, breach of a repair or reinstatement obligation or something left behind which would mean that vacant possession had technically not been delivered.

Tenants have, therefore, fought back and it is now common market practice that a break clause will either be unconditional or, if it is conditional, will only be conditional on matters which should not really be capable of dispute. The lease code now provides that the only preconditions which should be incorporated are that the principal rent should be up to date and that the tenant should give up occupation and leave behind no continuing sub-leases and many new break clauses follow this lead.

The other area where negotiations have become more sophisticated is in relation to the financial consequences of a break. Examples are:

- Some leases provide that if a tenant break is exercised, the tenant will pay to the landlord an additional sum by way of compensation. Typically, this is between three and nine months' rent.
- If the tenant has succeeded in negotiating a substantial rent-free period, it may be that part of that rent-free period will be after any date of termination as a result of a break clause so that the tenant will get the benefit of it only in the event that the break clause is not exercised. For example, if there is to be a lease for ten years with one year rent-free and a break clause at year five, six months of the rent-free period may be at the start of the lease and there may be a further six months rent-free after the expiration of the fifth year.
- Tenants have sought to make it clear that where a break date does not coincide with a quarter day, then the tenant is obliged to pay rent on the previous quarter day only up to the break date, ie. the landlord is not to be entitled to the windfall of any rent in respect of any period after the break date.
- In outlet malls, there are sometimes quite sophisticated provisions that, if the landlord exercises the break, the tenant will be reimbursed a proportion of its fitting-out costs.

4. Break clauses in renewal leases

Many leases in England and Wales are subject to renewal under the 1954 Act. Where this applies, the normal negotiation between landlord and tenant is influenced by the fact that the tenant has a statutory right to a new lease and that if the parties cannot agree terms, the court will settle them.

With tenant's break clauses being a more common feature of new leases, it was at one time thought likely that tenants would frequently apply for break clauses to be inserted in renewal leases. Whilst this does occur from time to time, it is not commonplace and there are probably two reasons for that

- lawyers, and particularly the judges that decide court cases, are usually persuaded that if the tenant requests something for its benefit, such as a break clause, it should be prepared to pay for that e.g. by a higher rent. This acts as a disincentive for Tenants to request break clauses
- on a renewal many tenants seek short leases (often five years or less with no rent review). It is less likely that the tenant will be faced with substantial fitting out costs as tends to be the case on the taking of a new lease, therefore one of the incentives for taking a longer lease (i.e. the desire to write down costs over a number of years) does not apply. Landlords have taken the view that courts are unlikely to impose, particularly in the current economic situation, leases of a significantly longer length than the tenant has requested, so leases for these short periods, which make break clauses unnecessary, are often granted

There is no evidence of this trend changing.

5. Exercise of break clauses

The coincidence of break dates with rent review has had a significant impact upon the security offered by the combination of long leases and upwards only rent review. This is particularly significant in a period of economic downturn. Tenants have been seeking to secure benefits in return for agreeing not to exercise the break. The things which tenants have been seeking are:

- Rent-free periods.
- Reductions in rent.
- Additional break clauses (eg. a tenant will waive a break clause at year 5 if it is granted a further one at year seven and/or year ten).

The landlord then has to decide whether or not to call the tenant's bluff. The cost of relocation, the lack of availability of suitable alternative premises and the need to write-down fitting-out costs may all be factors which would make it commercially unattractive for a tenant to break.

In difficult financial times, the landlord may equally be faced with considerable difficulty in securing another tenant, or at least another tenant of the same quality of covenant and at the same rental level, should the existing tenant actually exercise the break. In addition to a rental void, re-letting difficulties could create for the landlord substantial service charge and insurance charge shortfalls and a liability for empty rates. An investor may, therefore, take the view that it is worth making a concession to the tenant to avoid the risk of those difficulties.

The steps which an investor can take in order to protect its position are:

- Draft the break clauses in such a way that they are conditional on as many matters as possible which will give the best chance of finding something which the tenant has not done and which can be used to allege that the break clause has not been validly exercised. Tenants are now resisting this.
- Negotiate the break clause so that there is a significant period between the service of the break notice and the actual termination date. This will give the landlord a reasonable period during which to market the premises and to secure another tenant.
- Provide for there to be some sum payable to the landlord by way of compensation in the event that the break clause is exercised. Such compensation could make a valuable contribution to the cost incurred in reletting, providing new incentives/rent-free period and recovering voids.
- Obtain a good understanding of the tenant's business so as to get a view as to whether it really is in the tenant's interest to exercise a break clause and what incentives it may be appropriate to offer to a tenant in exchange for it not exercising the break clause. Even in 2009, the Strutt and Parker/IPD analysis shows that more than half the break clauses which could have been exercised were not exercised.
- Take legal advice in relation to the operation of the break clause. There are a number of matters of which a landlord needs to be aware, eg.:
  - It is not obliged to provide information or assistance to a tenant to help it exercise a break.
  - If it is going to rely on non-payment to challenge the exercise of the break, it is necessary to check either that the missing payment does not require a demand for it to be due or, if it does require a demand, that demand has been made.
  - If a tenant services the break notice, it does lose its right under the 1954 Act and must, therefore, be prepared to vacate.

6. Evidence from the market

The increase in both the prevalence and exercising of break clauses has emphasised the need for clear market data on this issue. If a tenant exercises a break then the landlord suffers a potential loss in income if:

i) the unit experiences a prolonged vacancy period or

ii) the rent of the subsequent letting is below that of the previous lease.

Further, the landlord suffers a potential loss in asset value and income security if the subsequent lease is shorter than the preceding lease. Where these factors become evident in the market careful analysis of the implications for portfolios is required.

Evidence of this happening is clear in the first half of 2010 on both the income and asset value side (see Table 1 below). On average the rent achieved at a re-letting following the exercise of a break was -19% i.e 19% lower than the rent under the preceding lease. Nearly seven out of ten leases re-let at a lower rent passing. The average fall in rent was greatest on industrial assets at over 25%, compared to an average of -20% on retail assets and -10% on office assets. This pattern is both a reflection of the rental value trends over recent years (back to when rents in the preceding leases had last been marked to market) and also the fall in rent on the individual assets due to their particular micro location or other factors.

In addition to reductions in headline rents, almost a third of the new leases granted following the exercising of a break contained a rent free period. The length of that rent free period averaged nearly seven months and the average lease length was only 5 years. As a comparison the average length of the lease that had been broken was over 8 years.

The evidence shows that breaks created a compounded issue for owners of real estate in 2010 by forcing them to re-let assets in a weak market and accept both lower rents and shorter lease terms.

Of course 2010 is a weak occupier market and such results may be more positive for the investor if the occupier market was very strong. However, if the propensity of tenants to break is linked to both falling rental values in the market generally and specifically on the unit, both of which would seem to be perfectly reasonable assumptions, then breaks significantly erode the security of income provided by the lease.

Table 1: Impact of exercised breaks on lease terms

	Retail	Office	Industrial	All Property
Average original lease length (months)	7.9	9.1	8.1	8.2
Average length of re-lettings following a break	4.2	5.3	6.8	5.0
Proportion of leases with rent free period	28.6%	42.9%	16.7%	29.5%
Average rent free period (months)	6.9	8.0	2.9	6.8
Proportion of leases re-let at a lower rent	75.0%	55.6%	70.0%	69.2%
Average rental uplift	-20.0%	-10.0%	-26.2%	-19.0%

Source: Strutt and Parker/IPD Lease Events Review 2010

Not only do break clauses increase the exposure of the owner to market rental movements generally and specifically on the asset but potentially the owner is more exposed to the success of the tenant's business. The evidence for 2010 suggests that there is an increased chance of a break being exercised if the tenant is rated of higher risk than if they are rated as lower or low risk. Table 2 below shows that a much lower proportion of breaks have been exercised by stronger retailers (12.0%) than weaker ones (28.6%). This effect is also present for offices and industrial assets although the differences are less marked. For offices 37.7% of high risk tenants exercised breaks compared to 32.6% of low risk tenants. For industrials the difference was marginal at 31.0% v. 29.6% respectively.

Table 2: Link between tenant risk rating and exercise of break clauses - Retail

	Re-lettings following a break		Unexercised breaks		Vacant following a break	
Risk Rating	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants
High	8	18.6	32	74.4	3	7.0
Maximum	13	12.5	73	70.2	18	17.3
Medium-high	0	0.0	16	100.0	0	0.0
Low-medium	3	6.3	27	56.3	18	37.5
Low	0	0.0	52	86.7	8	13.3
Neglible	3	6.3	43	89.6	2	4.2
Total	27	8.5	243	76.2	49	15.4

Table 3: Link between tenant risk rating and exercise of break clauses - Offices

	Re-lettings following a break		Unexercised breaks		Vacant following a break	
Risk Rating	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants
High	2	6.5	18	58.1	11	5.5
Maximum	1	4.5	15	68.2	6	27.3
Medium-high	1	5.6	10	55.6	7	38.9
Low-medium	1	4.0	15	60.0	9	36.0
Low	4	6.3	47	74.6	12	19.0
Neglible	5	6.2	50	61.7	26	32.1
Total	14	5.0	155	64.6	71	29.6

Table 4: Link between tenant risk rating and exercise of break clauses - Industrial

	Re-lettings following a break		Unexercised breaks		Vacant following a break	
Risk Rating	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants	Number of Tenants	% of Tenants
High	1	2.3	29	67.4	13	30.2
Maximum	6	8.6	49	70.0	15	21.4
Medium-high	1	6.3	14	87.5	1	6.3
Low-medium	0	0.0	28	75.7	9	24.3
Low	2	2.5	59	72.8	20	24.7
Neglible	2	3.3	40	66.7	18	30.0
Total	12	3.9	219	71.3	76	24.8

As a consequence of this increased use, and exercise, of break clauses, investors will now typically demand a greater risk premium for assets with impending break clauses. Target returns/hurdle rates for such assets will therefore be higher. This is one reason behind the greater divergence in pricing between long-let assets and those with impending break clauses. The extent of the adjustment to the hurdle rate will depend upon asset specific factors. In some circumstances, for example for a rack-rented asset on a prime retail pitch in a town with very low vacancy rate, for a retailer with a strong covenant, a minimal risk premium will be added as the retailer will be thought to be unlikely to break. However, if the break clause were on an over-rented asset in a market with a high vacancy rate, where the tenant might be looking to downsize, a sizeable risk premium would be added as the tenant would be viewed as almost certain to exercise the break.

The extent to which break clauses are offered by landlords will vary with the ebb and flow of market conditions. In the future, as market conditions improve, it is likely that landlords will come under less pressure to offer break clauses. There is already a substantial variation in landlords' willingness to offer breaks. For example, for prime central London offices, where the occupational market has improved over the last year, landlords are less inclined to offer breaks. However, for provincial office markets, where demand remains weak, there is a greater reliance on the public sector, and availability rates are at record levels, landlords are much more willing to offer break clauses, even on relatively short leases.

7. Conclusion

Break clauses have a long history and are here to stay. It is unlikely that well advised tenants will accept highly conditional or complex break clauses except in genuinely exceptional circumstances. Rather, it is likely that the market will accept that break clauses are intended to be capable of operation without undue difficulty and that they will either be unconditional or conditional upon only such matters as payment of rent and delivery of occupation (as recommended by the Lease Code). However, their implications for investor landlords continues to evolve.

The increased prevalence, and in particular the increased exercise, of break clauses is leading to a greater level of understanding of their financial implications. It is anticipated that both landlords and tenants will become more sophisticated in negotiating matters such as payments if they are exercised and incentives if they are not, as well as looking more closely at the impact of break clauses in terms of valuation and rental level.

The evidence suggests that a number of factors are combining to fundamentally change the risk profile of the income stream from property assets. Break clauses are just one of these factors but they are a significant one as they are a mechanism by which much of the income risk of a downturn is transferred to the landlord. Typically it appears that the impact is felt most keenly by the landlord within specific sectors and from higher risk tenants. The logical conclusion would be for the pricing of assets in these sectors of the market to adjust downwards to reflect these changes.

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Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk