

# Strutt & Parker / IPD Annual Lease Events Review

7 July 2009  
Lovells LLP, London



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the property world



# The Robustness of Property Income

Malcolm Frodsham – July 2009



Research  
Programme  
2006-2009

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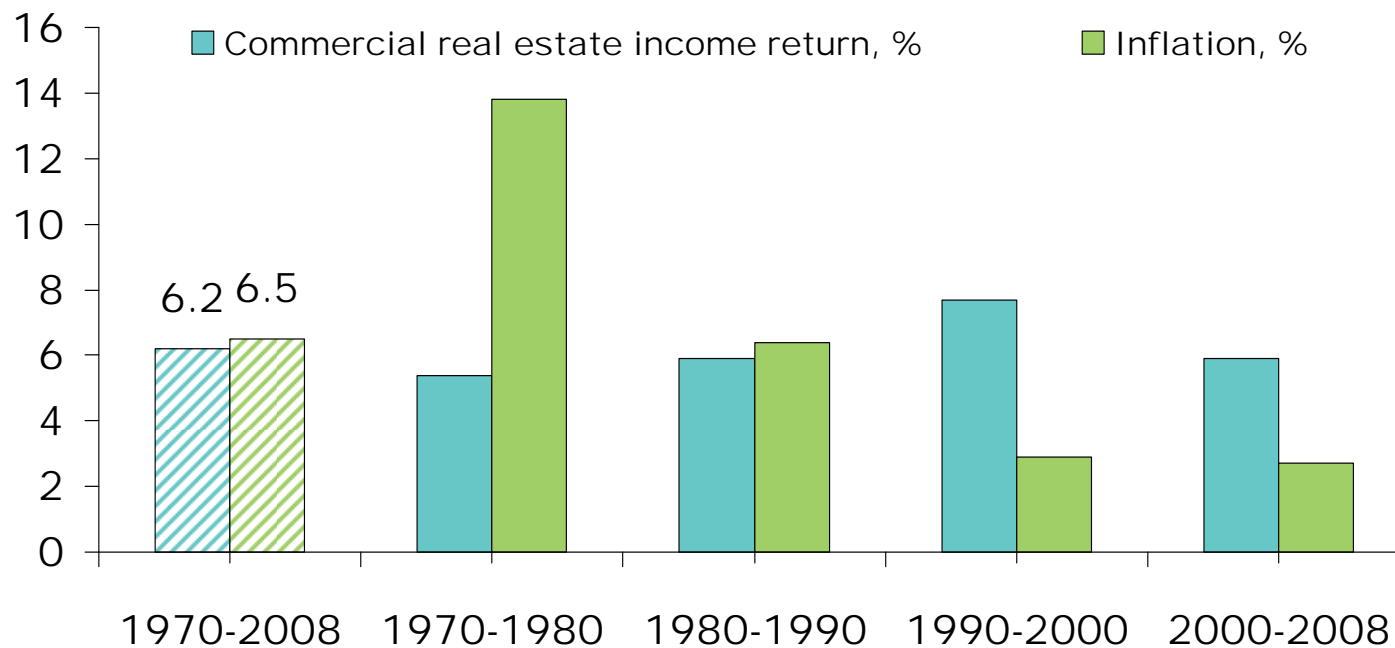


# The 'robustness' of property income

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- The primary investment attribute of long term investment in commercial real estate is a stable income return
- This makes it a very attractive asset to lend against

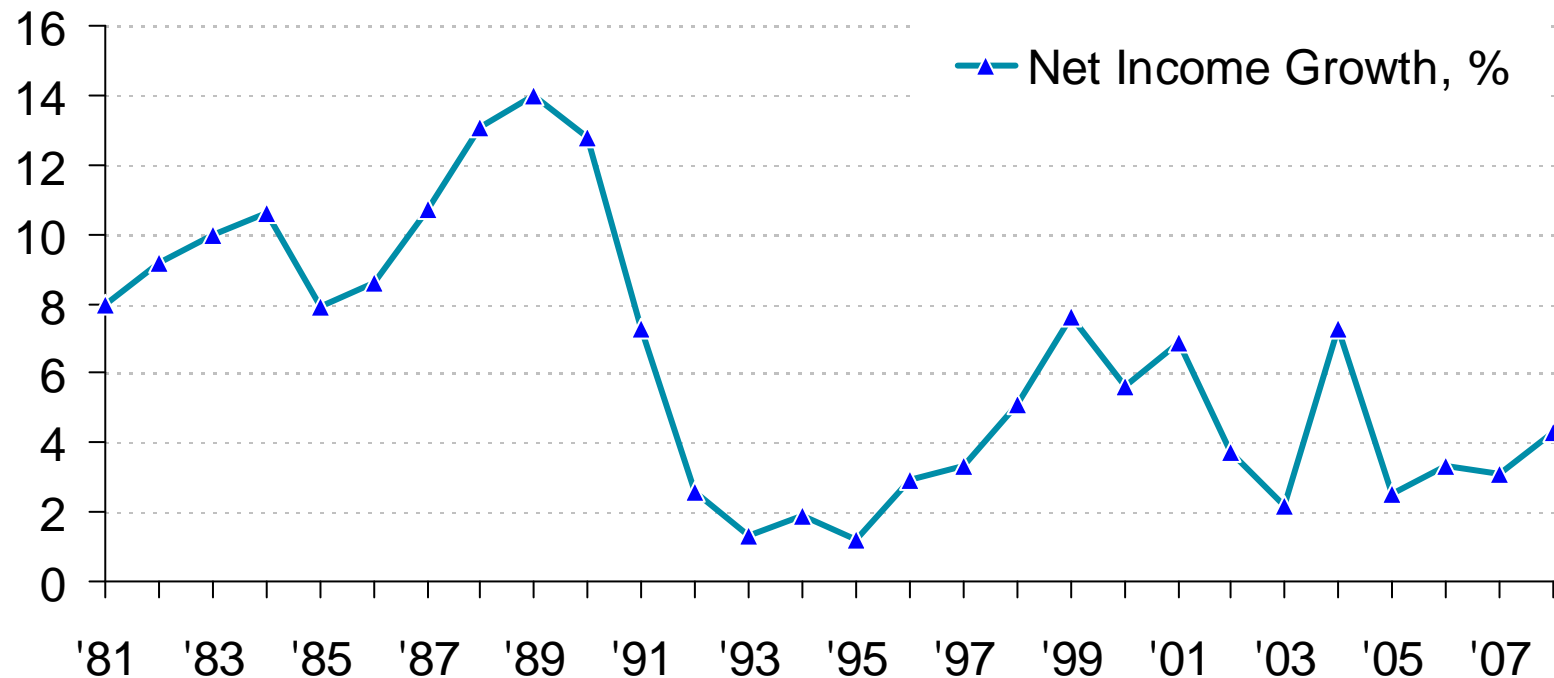


# The 'robustness' of property income

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- The main pillar of the stable income return is the secure income stream



# The 'robustness' of property income?

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- Are cracks appearing in this stability?

Net income growth  
turned negative...

... Reversionary  
potential is  
declining

... Over-renting is  
emerging



The pattern of income delivery is influenced by the fundamentals of demand...

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- The rent that tenants are *willing* to pay is a function of the utility of the space:
  1. the property's use class (retail or office, for example)
  2. asset location (the region, town or even street)
  3. building condition (often described in terms of Grade A to E)

# ...and supply

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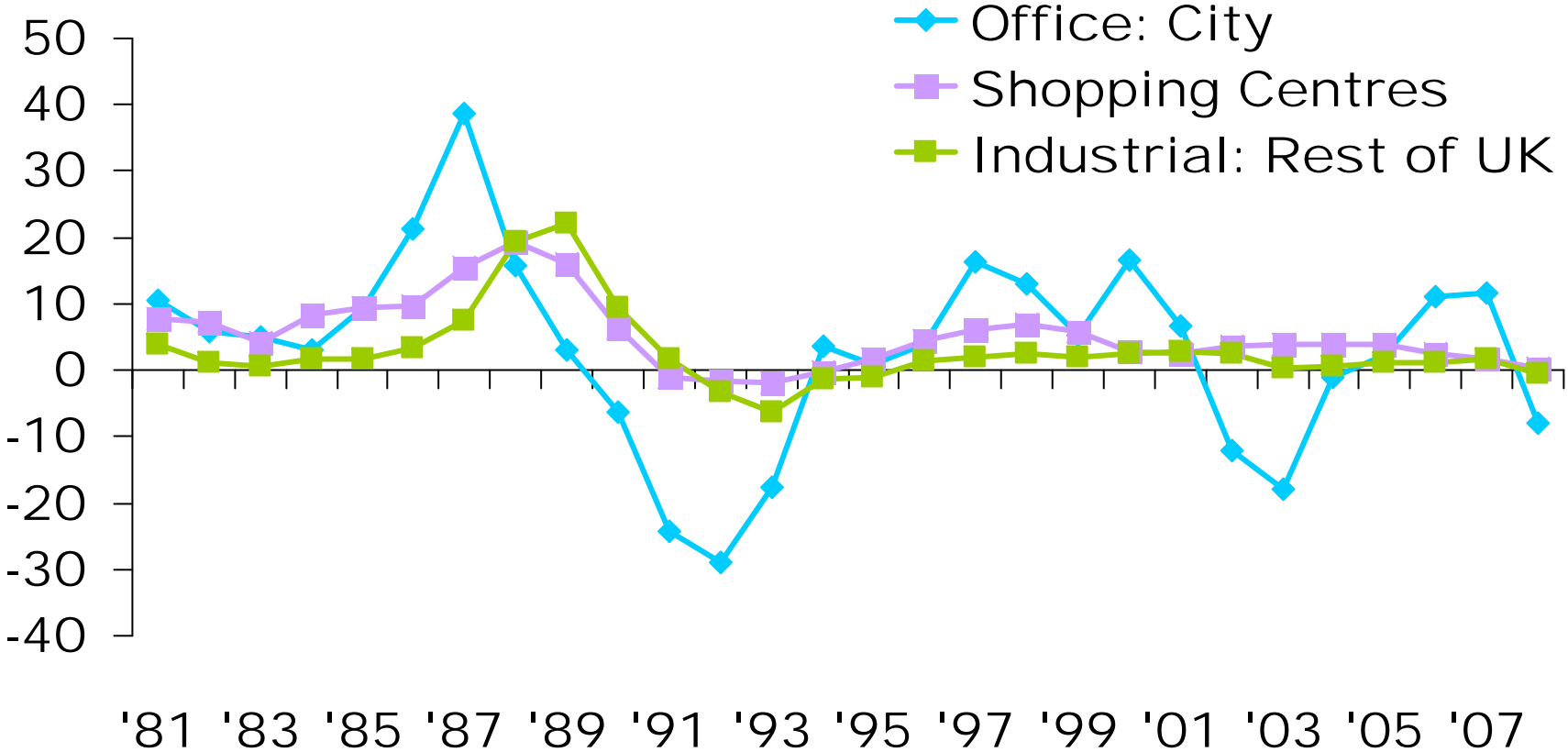
- The rent that assets command in the market is *also* a function of supply.
- Rental cycles are more cyclical where:
  1. demand is more volatile
  2. building cycles are more pronounced

# Creating rental cycles of varying degrees of volatility

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Rental value change by category of asset, % y/y





# Real estate assets are physical investments...

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- Rental value changes for individual parcels of space are also affected by two additional factors;
  1. the location of the space can improve or be marginalised
  2. the physical characteristics of the buildings
    - i. Physical deterioration
    - ii. How the building meets tenants' functional, legal and aesthetic requirements

...producing a wide variation in rental value change *within* categories

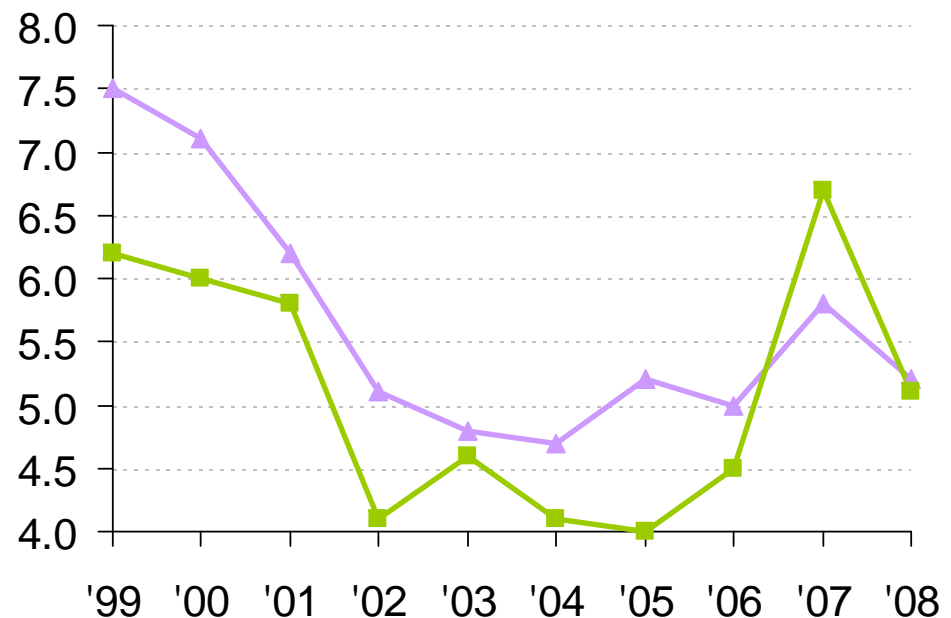
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Rental value growth of *individual* shopping centre assets is more volatile than for *individual* regional industrials...

...even though the average volatility over time of shopping centre rental value growth is below that of regional industrials

Volatility of individual asset rental value change, %



—▲ Shopping Centres      —■ Regional Industrials

Actual income received is filtered through the terms of the lease...

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The terms upon which space is leased to a tenant will determine the income, as opposed to the current estimated market rental value, that the investor actually receives

**This provides security:**

1. The lease provides security to the income stream with the tenant contracted to lease the space for a defined period
2. Rent is typically only adjusted upwards through the course of a lease

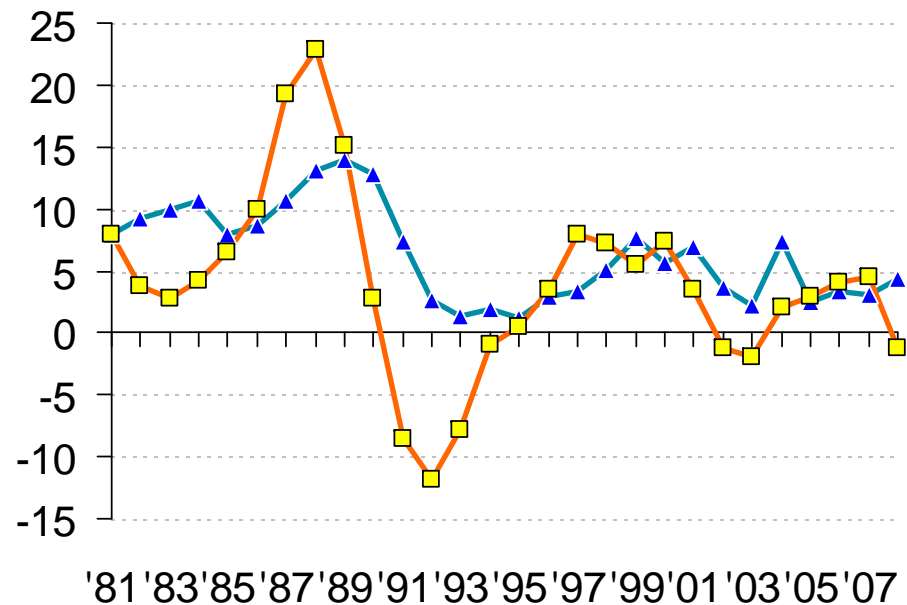
...producing a stable income profile...

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The lease produces a pattern of investor income that is more stable than the underlying pattern of estimated market rental value change

The average change in net income on real estate assets, % y/y



—▲ Net Income Growth    —■ Rental Value Growth

# ...and an asymmetric pattern to income change on individual assets

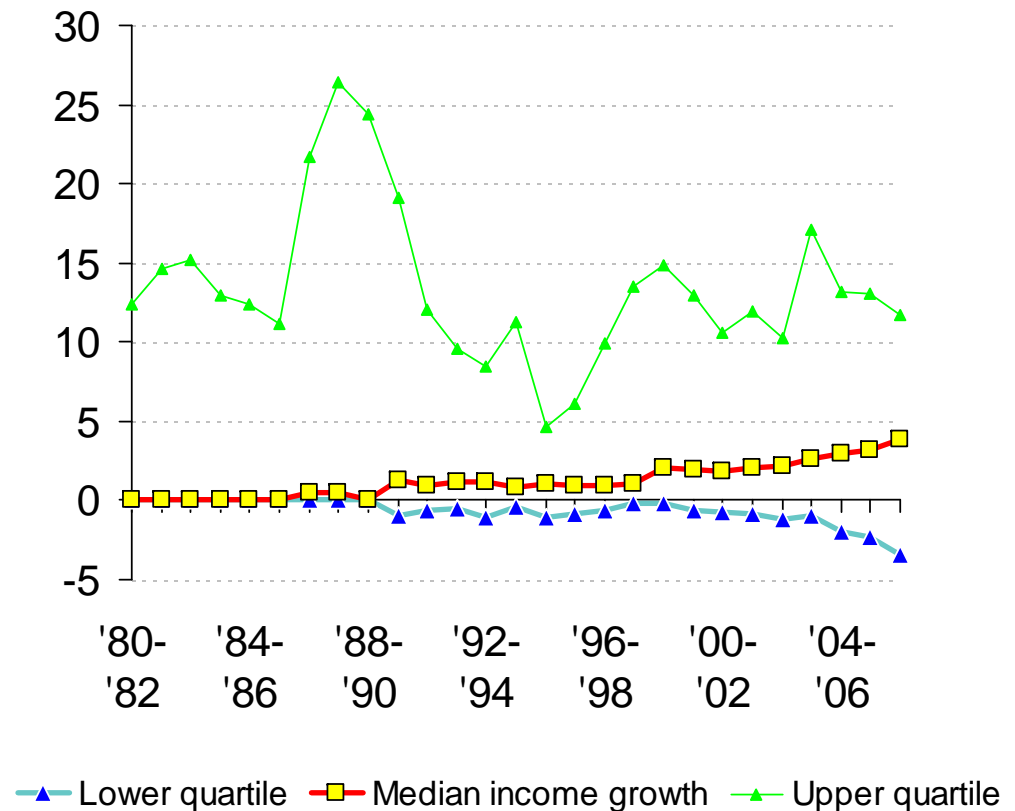
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There are a much larger proportion of assets generating no income change in any individual year compared to those generating rising income and this is much greater still than those experiencing a falling rent roll in the year

1. during the term of the lease the rent is stationary between rent reviews
2. at rent review the rent may rise significantly as the rental value growth over the period since the last review is concentrated into one uplift

The inter-quartile range of net income change across individual assets , % over 2 years



So how robust is the income  
from real estate today?

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# Falling lease terms...

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The proportion of existing leases, %

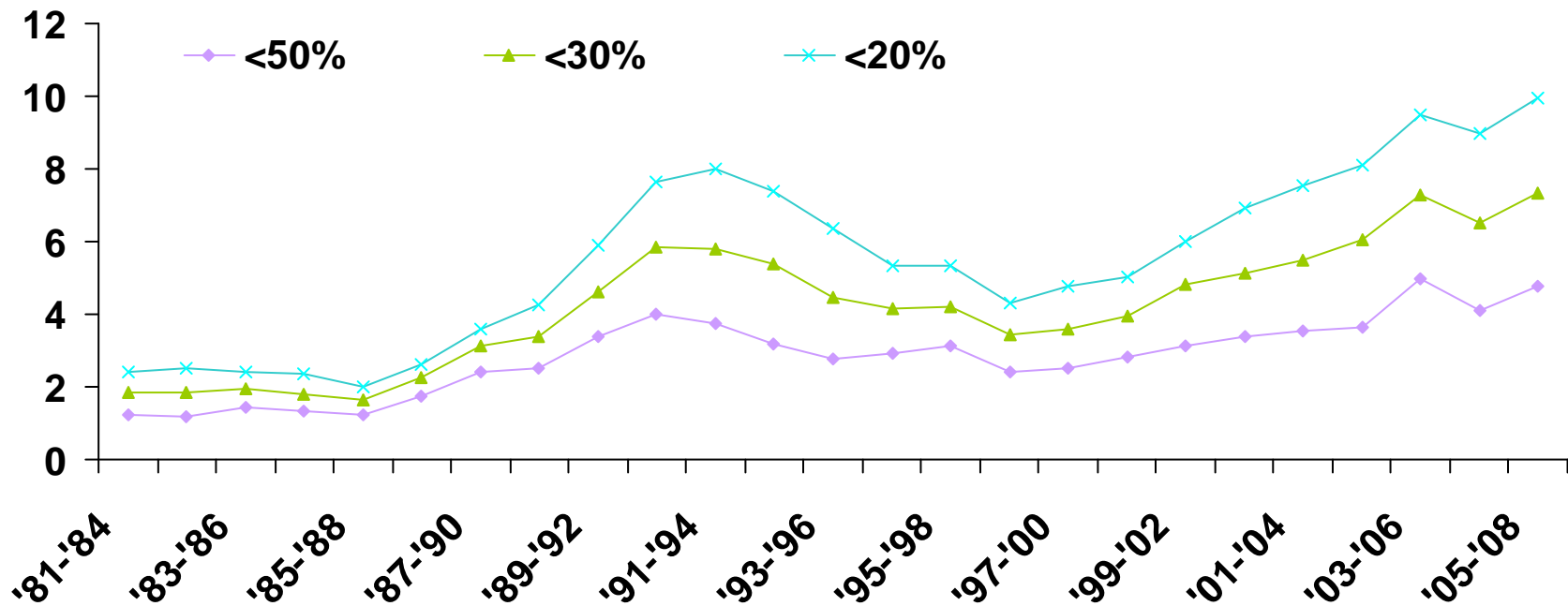
	<i>lease term unexpired, years</i>			
	<i>&lt;5</i>	<i>5-10</i>	<i>10-20</i>	<i>20+</i>
<b>1992</b>	32.6	12.3	33.8	21.4
<b>2008</b>	62.5	21.7	12.4	3.5

...resulting in an increased proportion of assets experiencing income falls...

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The proportion of real estate assets experiencing a fall in rent passing, %





# Investors & lenders need to understand the cash flow risks

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## **The key events:**

1. What happens at lease expiry?
2. What happens to the rent at re-letting?
3. What happens at break?

## **The key risk & return affects:**

1. How volatile are these variables?
2. How are they related to the rental cycle?
3. How do they relate to the age of the building?

## **The implications:**

1. How does this affect the risk premium?
2. How does this affect valuation?
3. What is the implication for lenders' margins?

m4

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## Slide 18

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Please enter details, such as date, location, name of speaker and address at the end of your presentation.

Melody Brooks, 02/02/2006

# Report tracks the major lease events that determine the income stream from real estate

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1. What happens following the expiry of a lease:
  - how frequently does the tenant renew their lease
  - how quickly can the unit be re-let if the tenant vacates the unit?
2. What happens to the rent on a new lease compared to the previous lease
3. Break clauses:
  - how frequently have they been exercised?
  - how quickly have units been re-let if a lease break has been exercised?
4. Tenant default
5. Average length of current vacancies



The research draws on IPD's unique databank:

- Covers an estimated 54% of all professionally managed property investment in the UK
- Analysis from 1998 to 2008
- At least 40,000 leases in each year
- Excludes 'non-standard' leases
- Compare the tenant records in the valuation in those buildings at the end of the preceding year with the valuation tenant records at the end of the year.
- Changes in the tenant records between the two valuation dates have been allocated to a particular event; lease expiry, break clause exercised or default.

# Measuring the *Robustness of Income*

## (1) Lease expiries

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What was the outcome by the end of the year of lease expiries due in 2008?

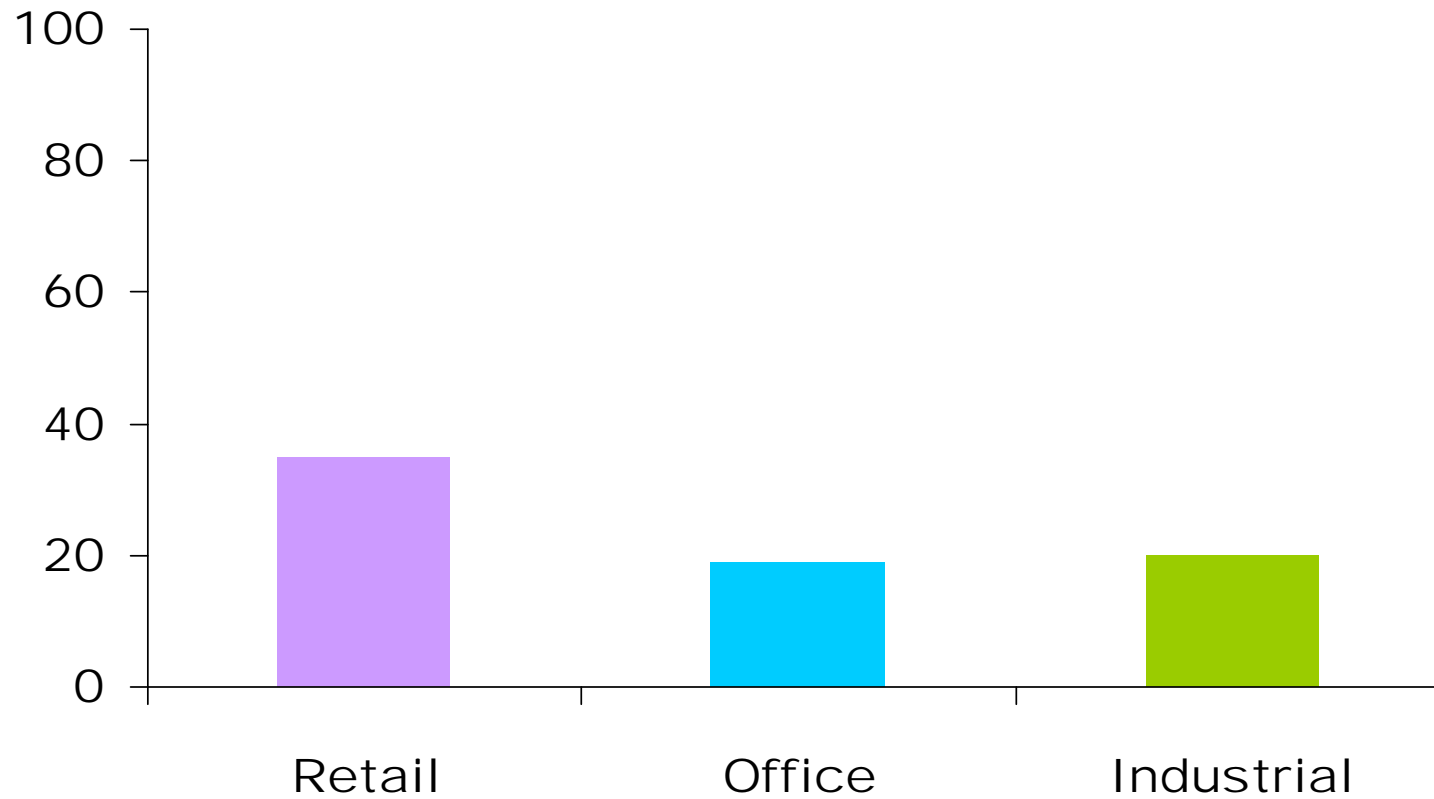
- Identify the occupier of a unit where a lease expiry is due in the next calendar year and compare this to the occupier of that unit at the end of that calendar year
- The number of leases due to expire in each year of the analysis varies
  - In 2008 the sample consisted of 3,633 tenants with an ERV of approximately £219 million

# Caution\*\*

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The proportion of units 'holding over' at the end of the year with a lease expiry in 2007, %, weighted by ERV at end of previous year

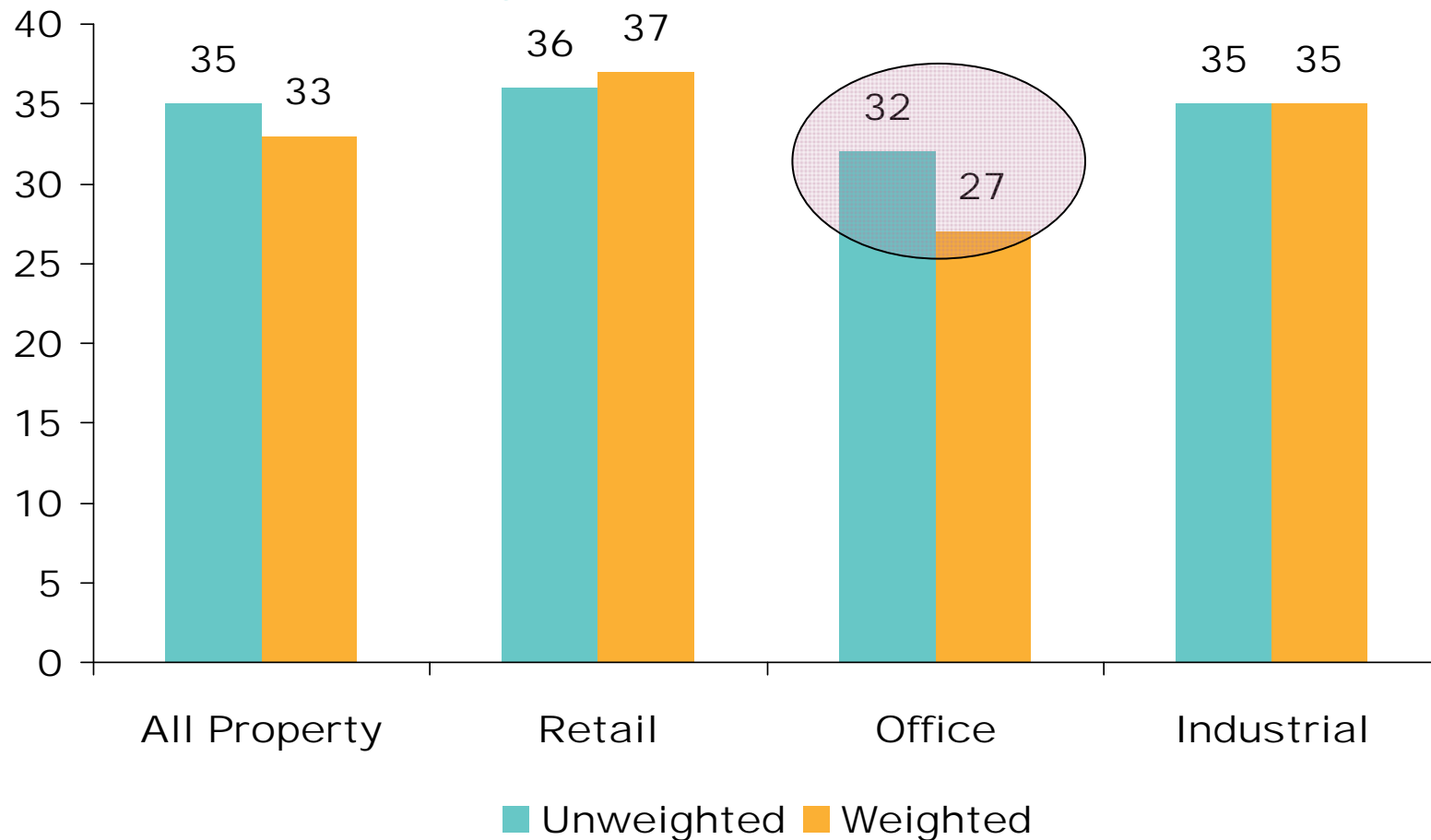


# Similar lease renewal rates across the sectors

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Lease renewal rate, by sector, %



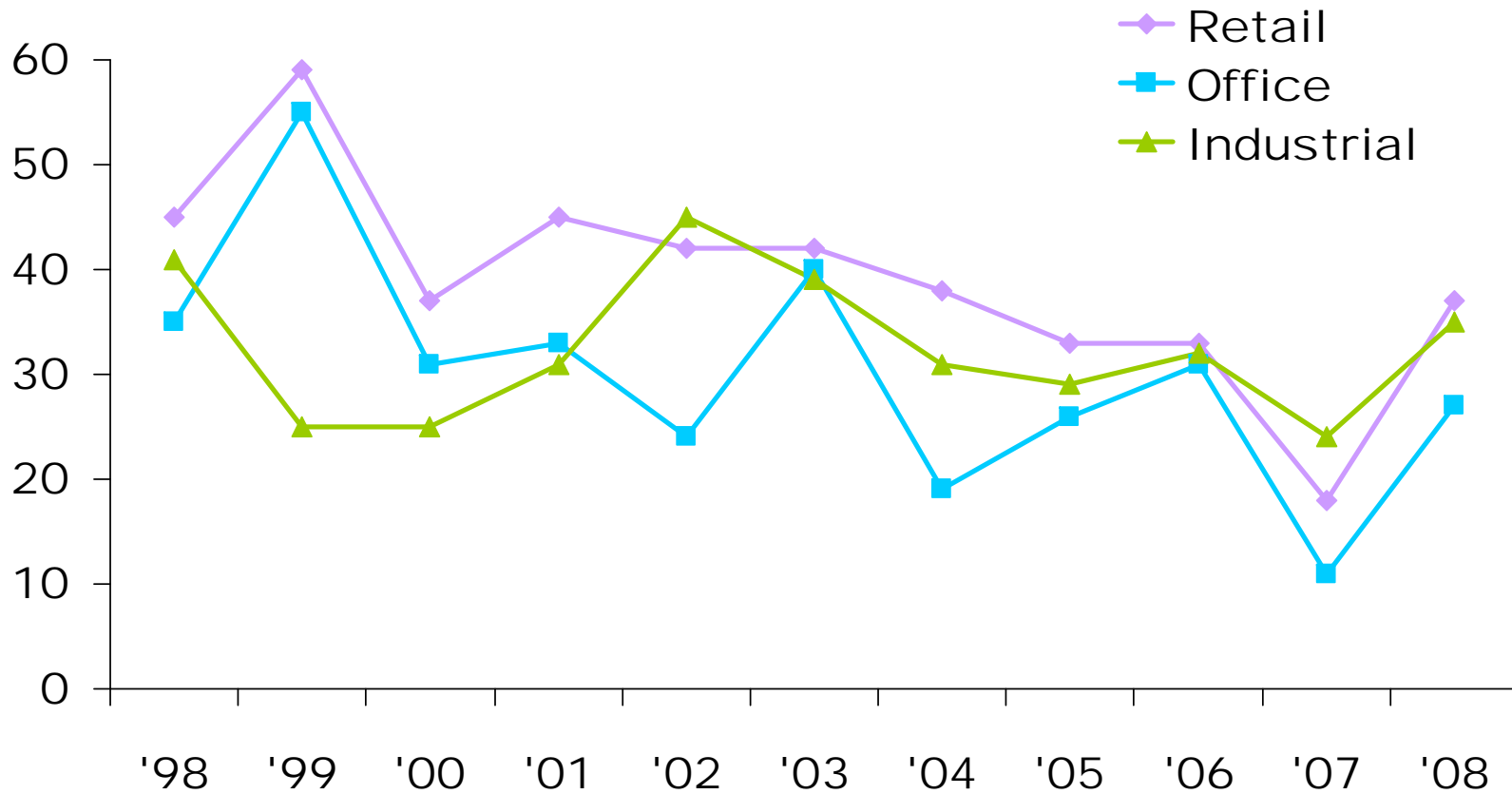


# Tenant retention rates almost back in line with the long run average

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Lease renewal at calendar year end, weighted by ERV, 1998-2008, by sector, %

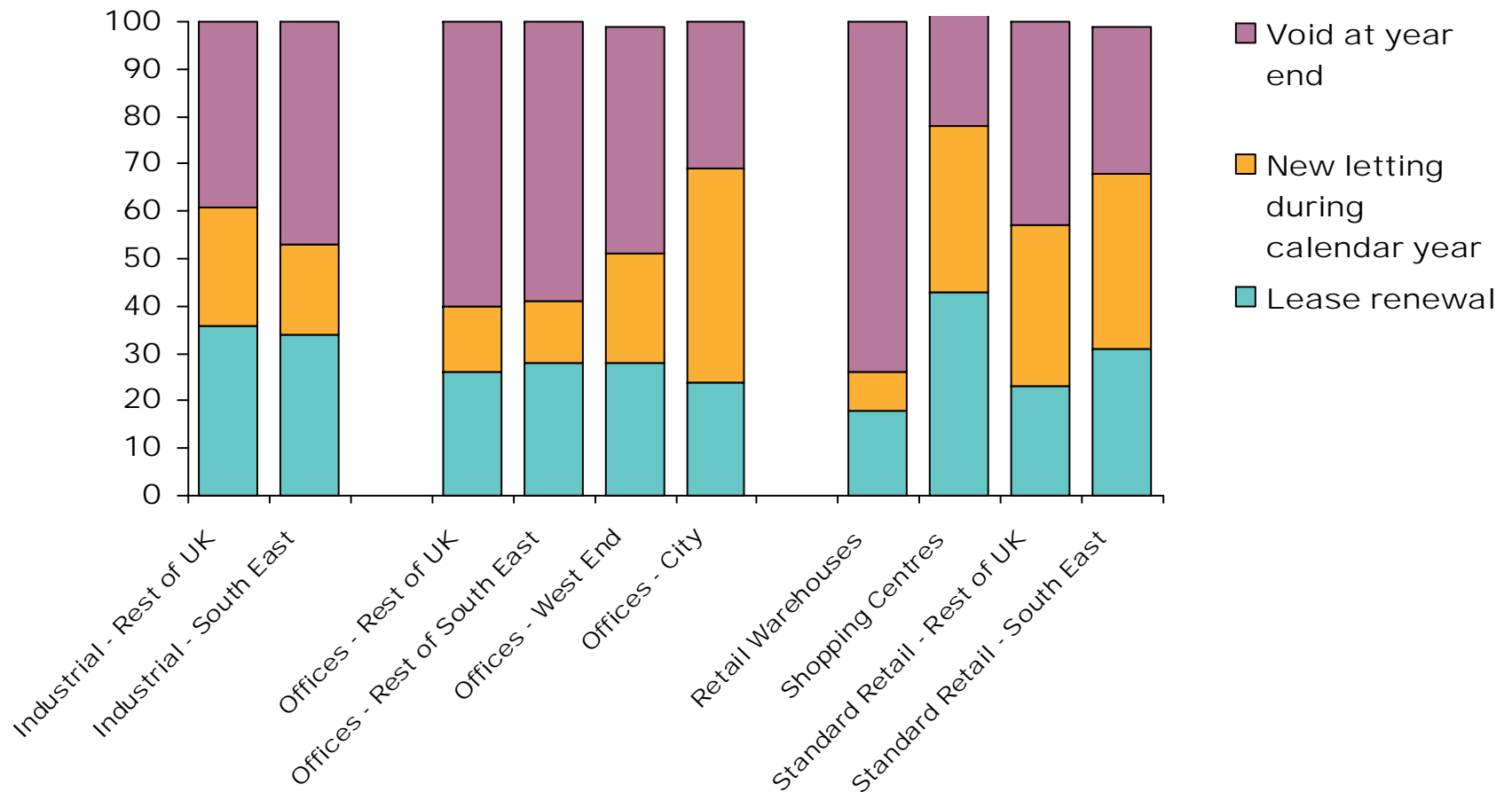


# Retail Warehouses register lowest rate of lease renewal

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Status of lease at end of year following lease expiry in 2008, weighted %

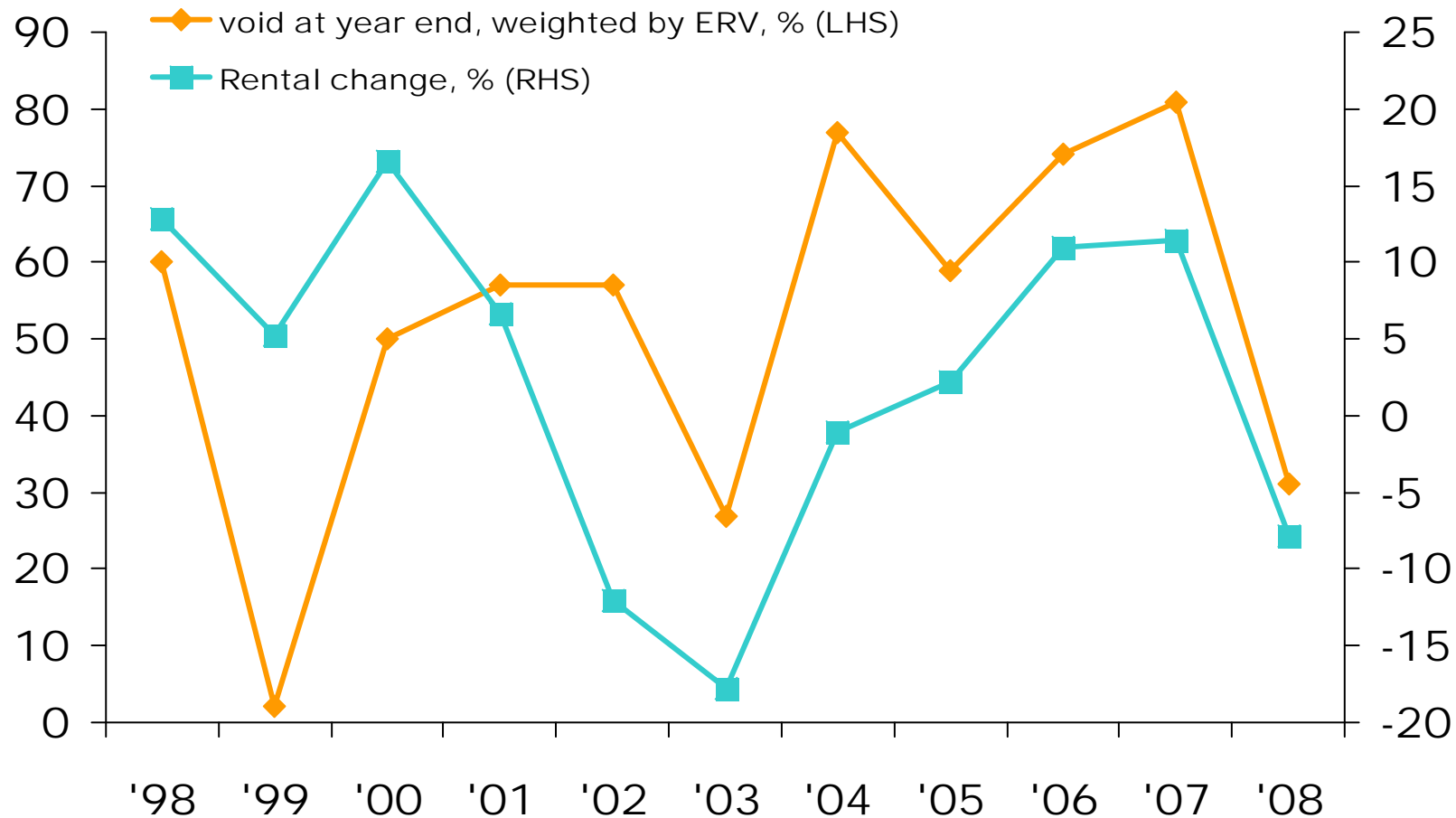


# Relationship to the rental cycle vacancies

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## void at year end versus rental growth, City Offices



# Lease renewal rate versus length of previous lease

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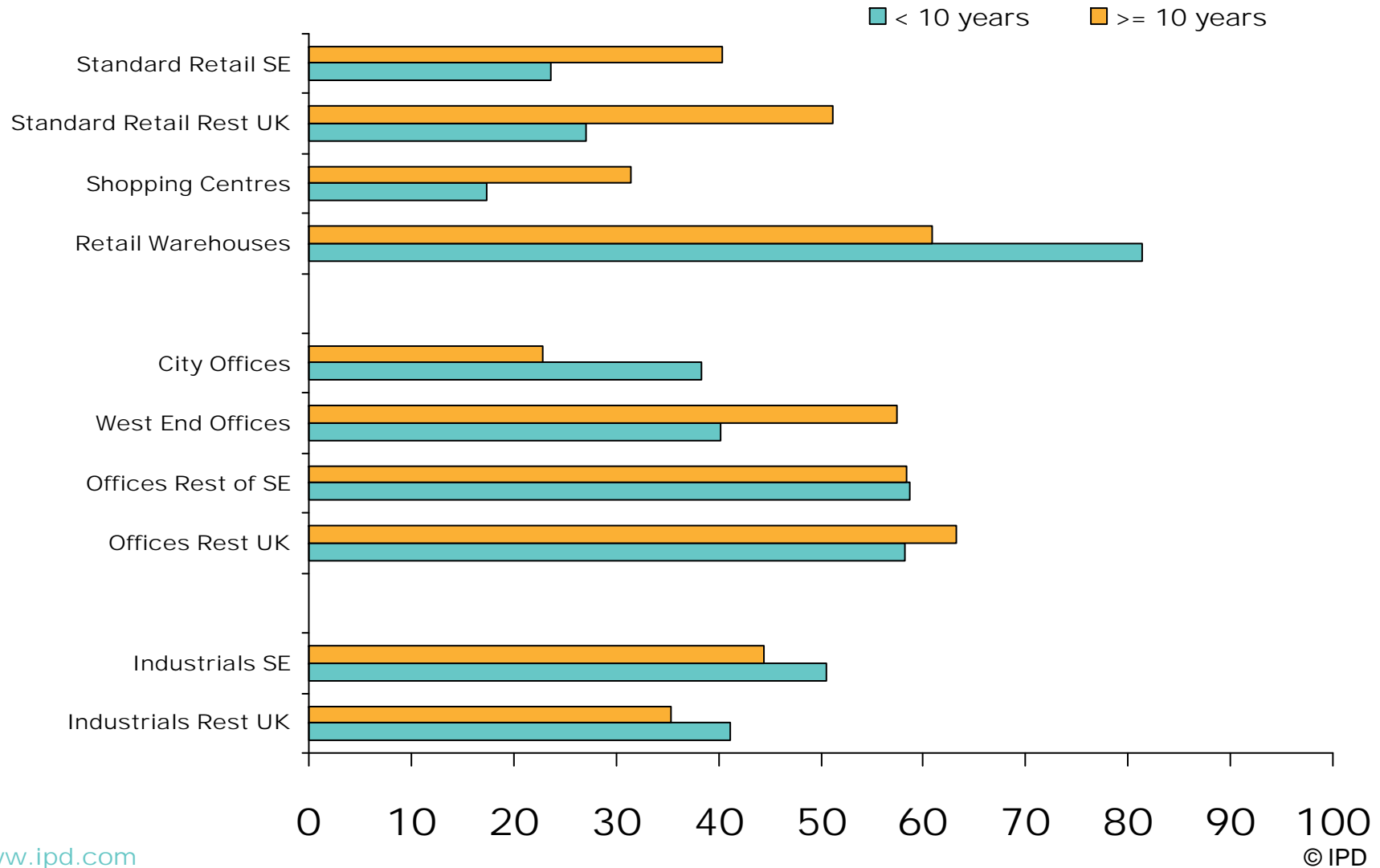
## The length of lease is expected to impact upon the expected Outcome of the lease expiry in several ways

1. Expect to see *higher* renewal rates upon expiry of longer leases:
  - assets commanding longer leases originally are likely to have been better located and therefore are more likely to achieve a lease renewal
2. Expect to see *lower* renewal rates upon expiry of longer leases:
  - tenants that have been in a building on a long lease are more likely to have experienced a ‘corporate event’ that requires new premises
  - assets which have been occupied for a long period of time are more likely to have become obsolete

# Impact of length of previous lease

## Proportion of leases that went void by previous lease length, %

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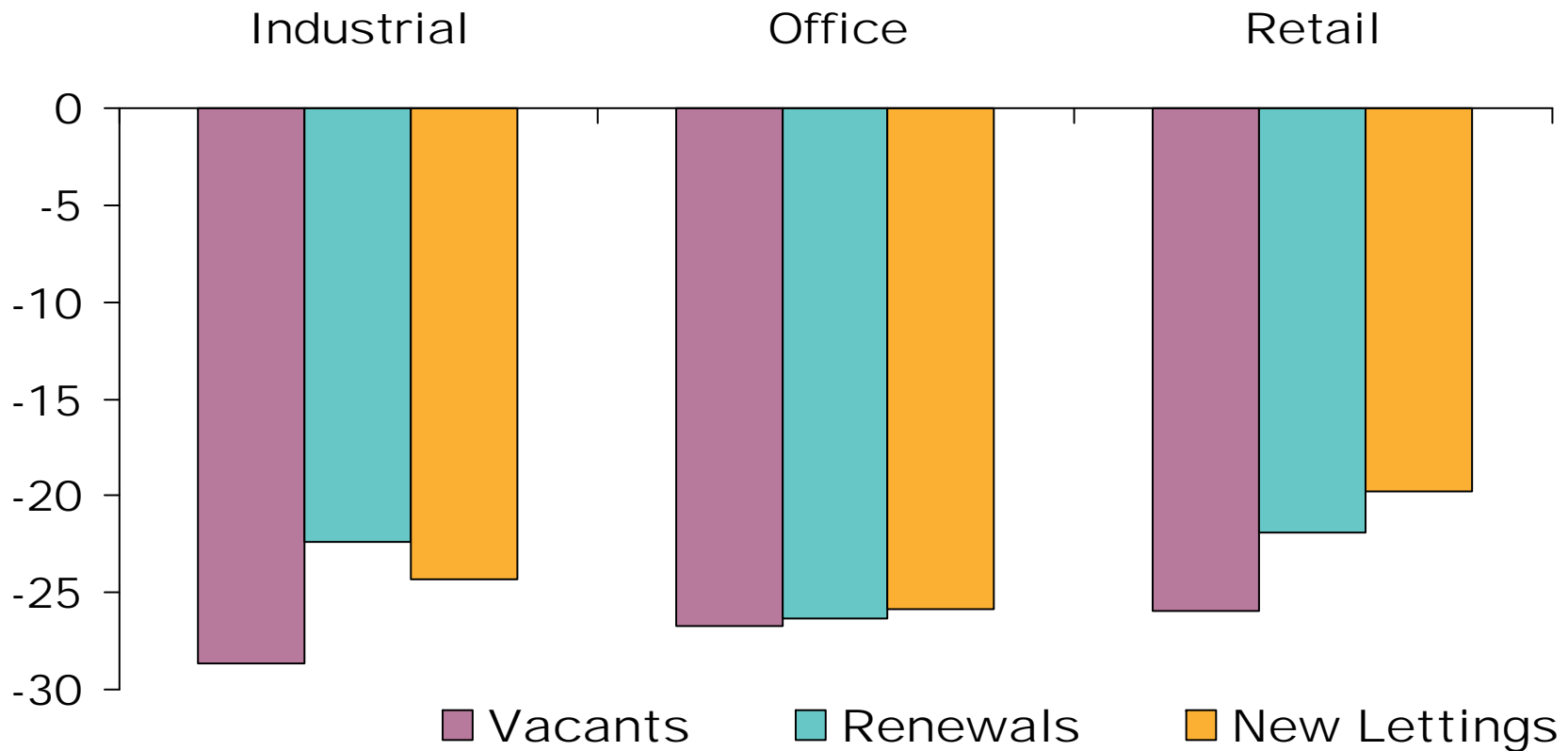


On balance it was a year for secure income funds...

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Mean capital growth rates versus status at year end, 2008, %



# Measuring the Robustness of Income

## (2) Rent at re-letting

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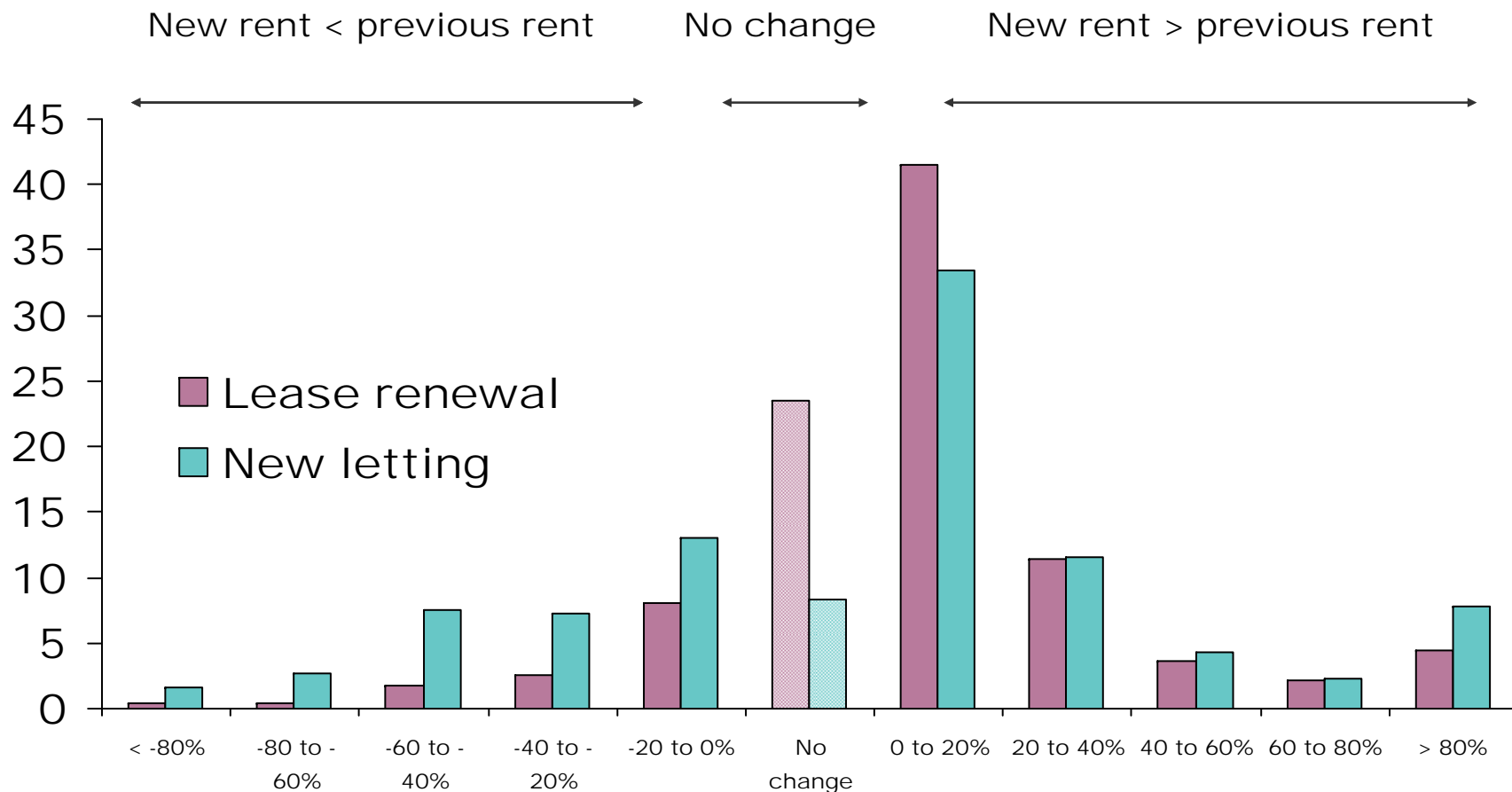
To provide evidence on the spread of rent agreed upon lease renewal versus that on a letting to a new tenant

- Track the rent passing on new leases versus the rent on the preceding lease
  - identify the rent passing on leases starting in the calendar year – substitute ERV if rent free period
  - compare this to the rent of that unit in the preceding year
- The number of new lettings in each year of analysis varies
  - In 2008 the sample consisted of 2,166 tenants with an ERV of approximately £291 million
    - 1,289 lease renewals
    - 877 new lettings

# The risk @ new lettings...

Change in rent following lease expiry in 2008, all property

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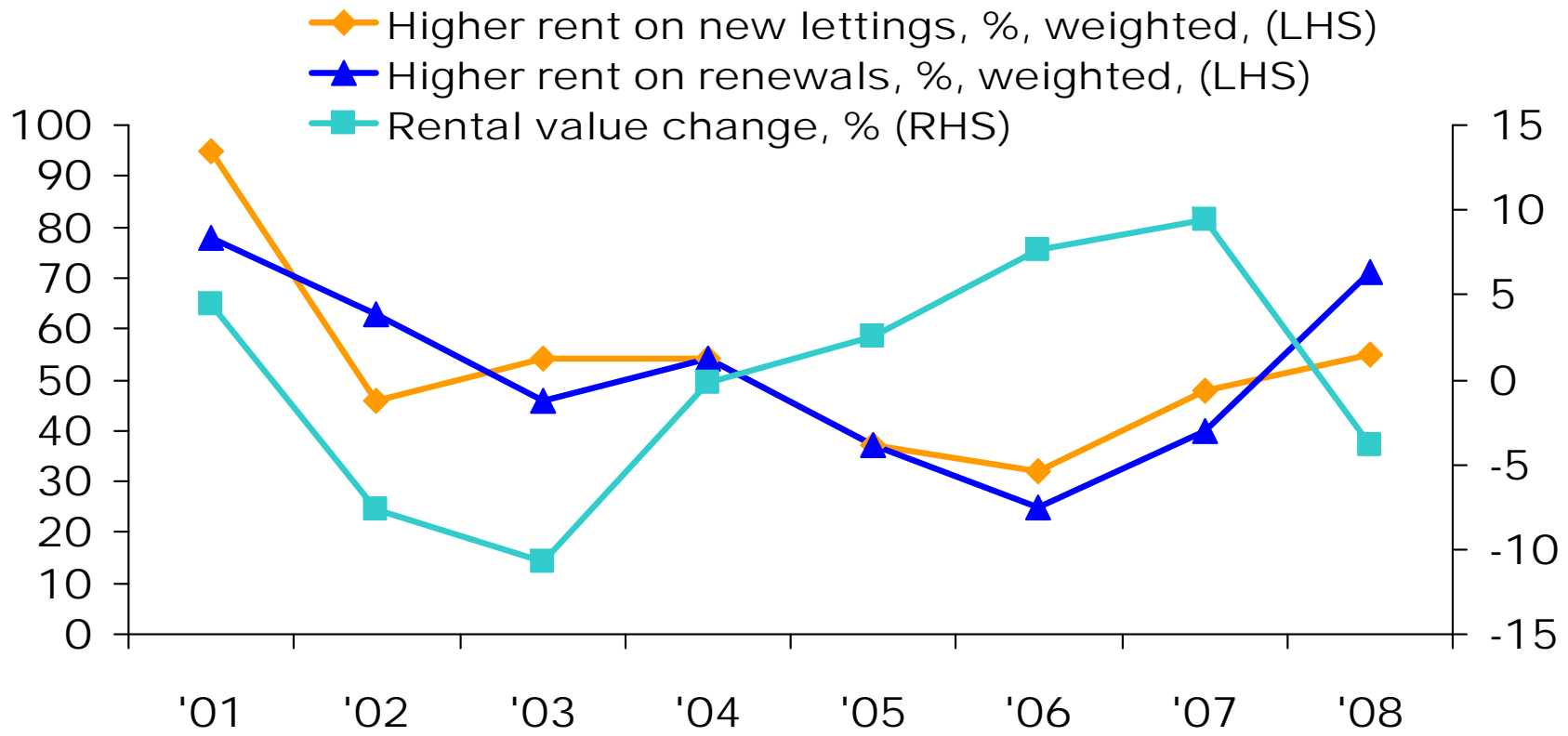


# ...switch to better outcomes upon lease renewal than new letting

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Lettings at a higher rent than the previous lease versus rental growth, %, Offices



# Measuring the Robustness of Income

## (3) Break clauses

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To provide evidence on the probability that a tenant will exercise a break clause in their lease

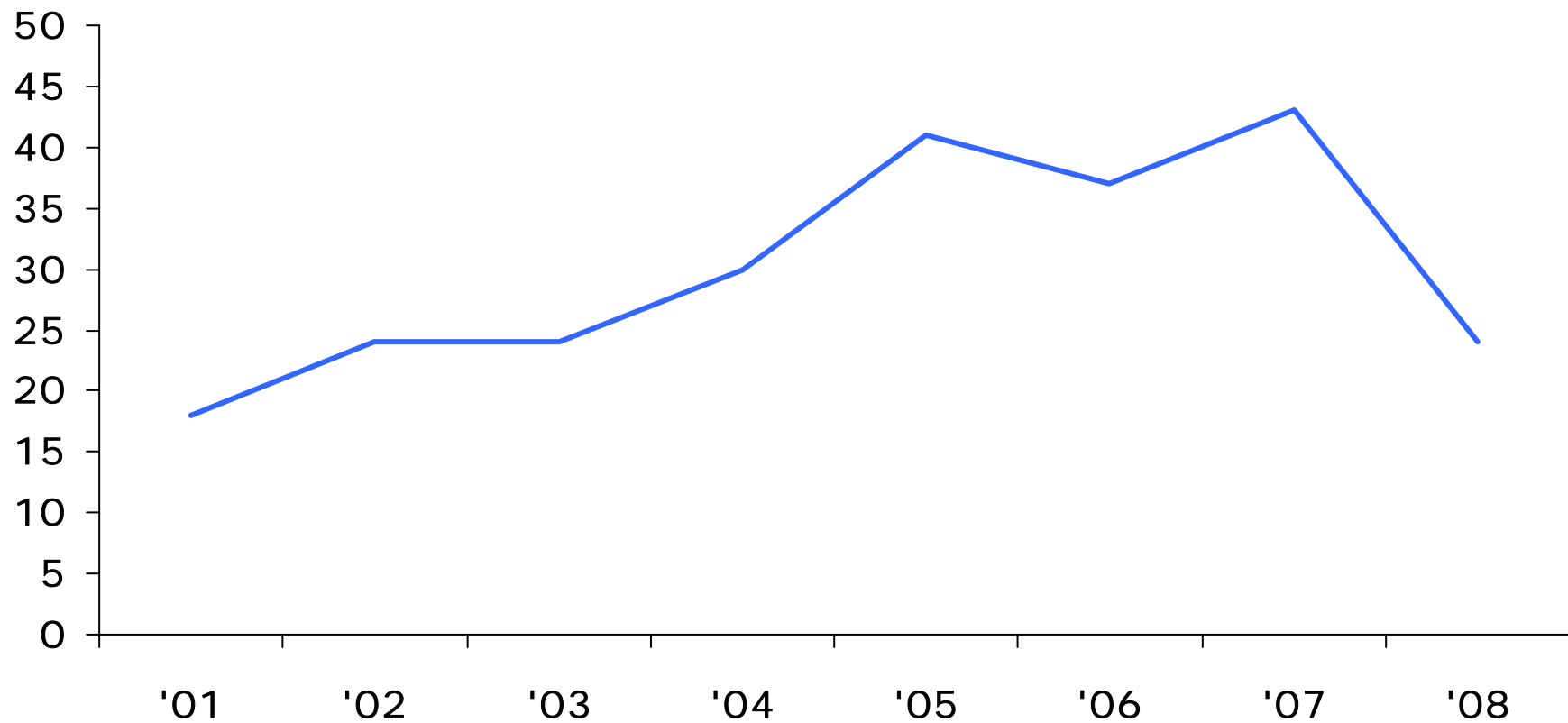
- Track the proportion of tenants exercising a break clause in their lease – the “propensity to break”
  - identify the occupier of a unit where a break is due in the next calendar year
  - compare this to the occupier of that unit at the end of that calendar year
- The number of leases which contain a break clause due in the year of analysis varies
  - In 2008 the sample consisted of approximately 1,900 tenants with an ERV of £168 million

# Significantly reduced incidence of breaks in 2008

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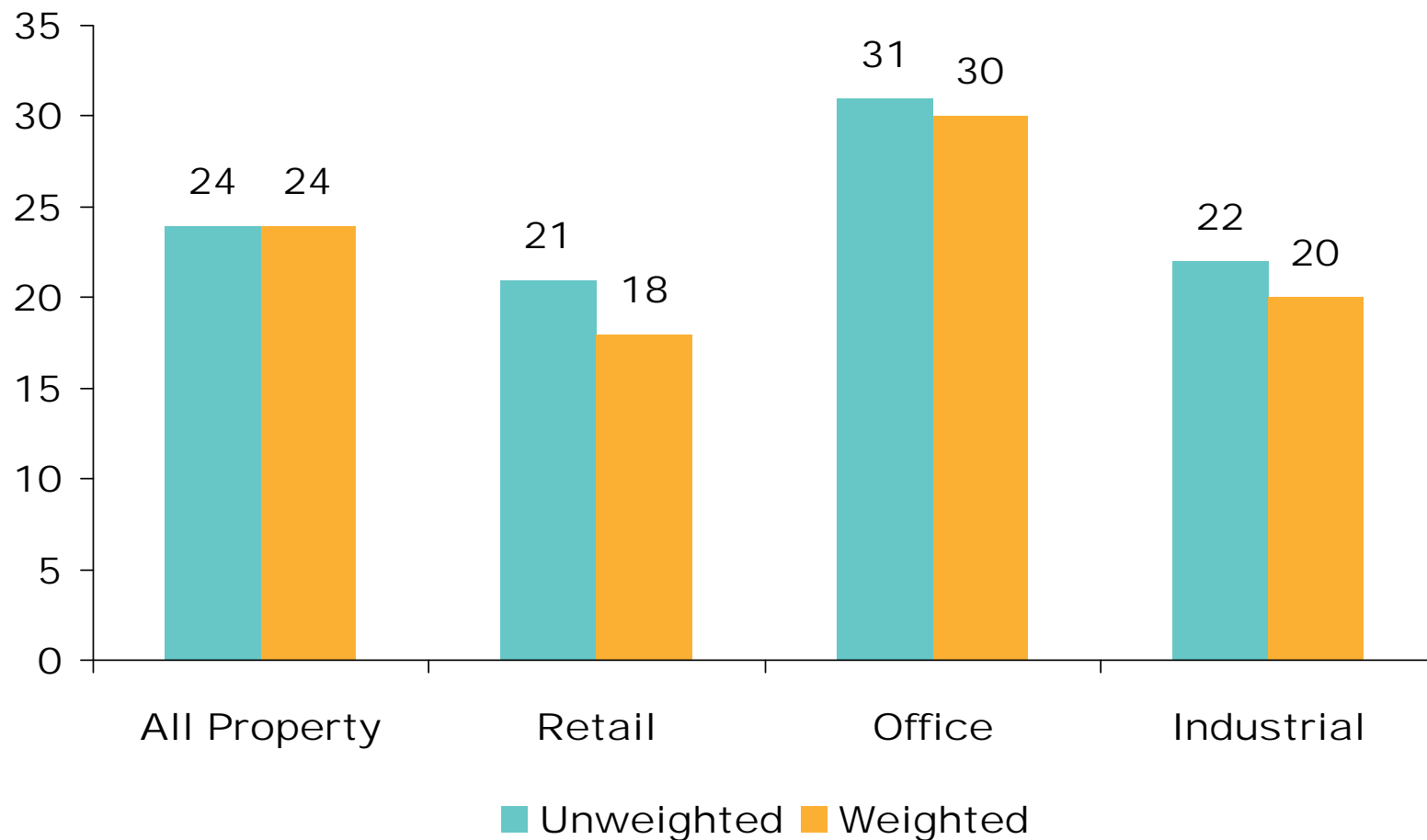
Propensity to break, weighted by ERV, %



# Propensity to break in 2008

Weighted by ERV at end of previous year

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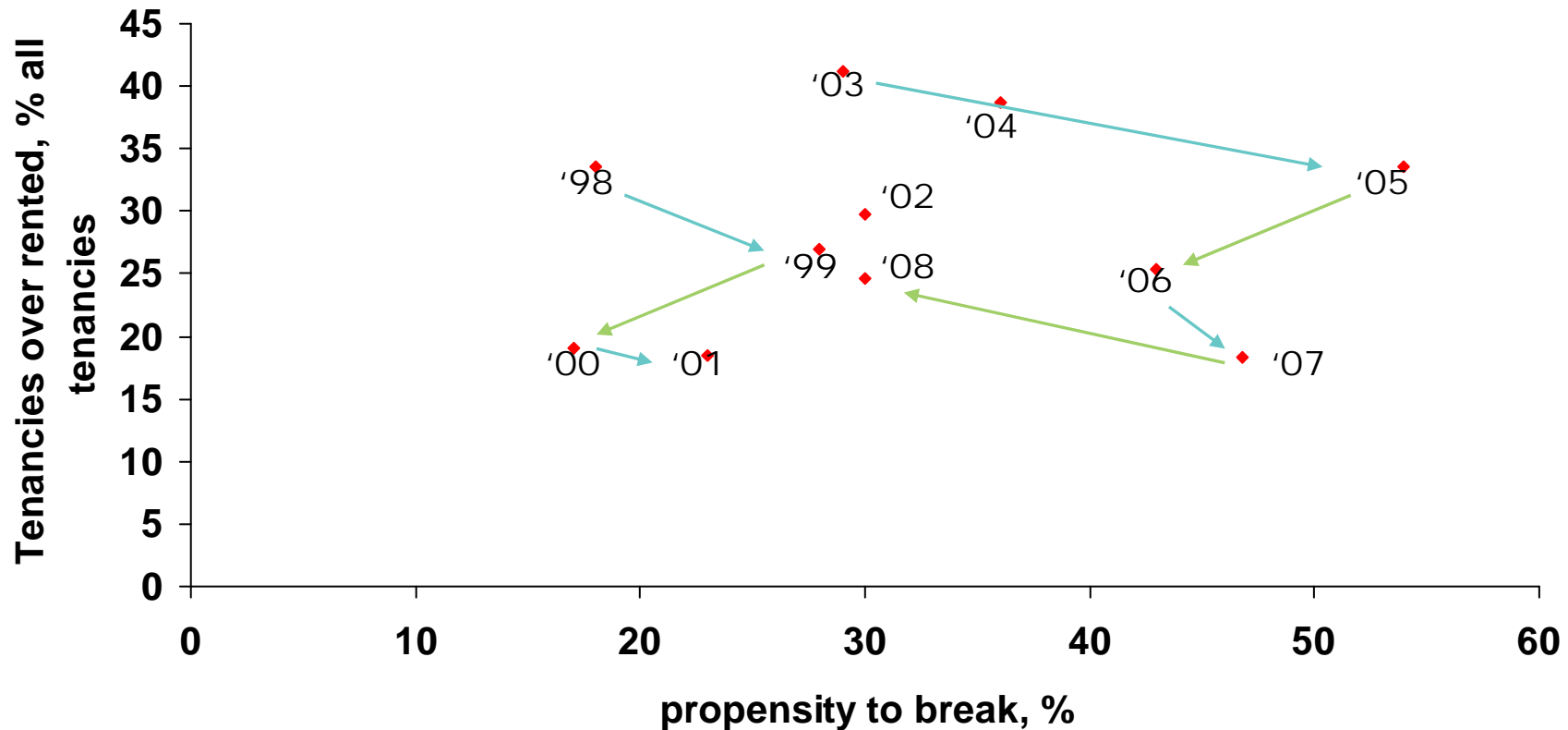


# Propensity to break in 2008 looks 'low'?

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Propensity to break vs degree of over-renting  
in Offices (% of units), 1998-2008



# Measuring the Robustness of Income

## (4) Tenant default

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To provide evidence on the proportion of tenants entering liquidation / receivership in investment portfolios

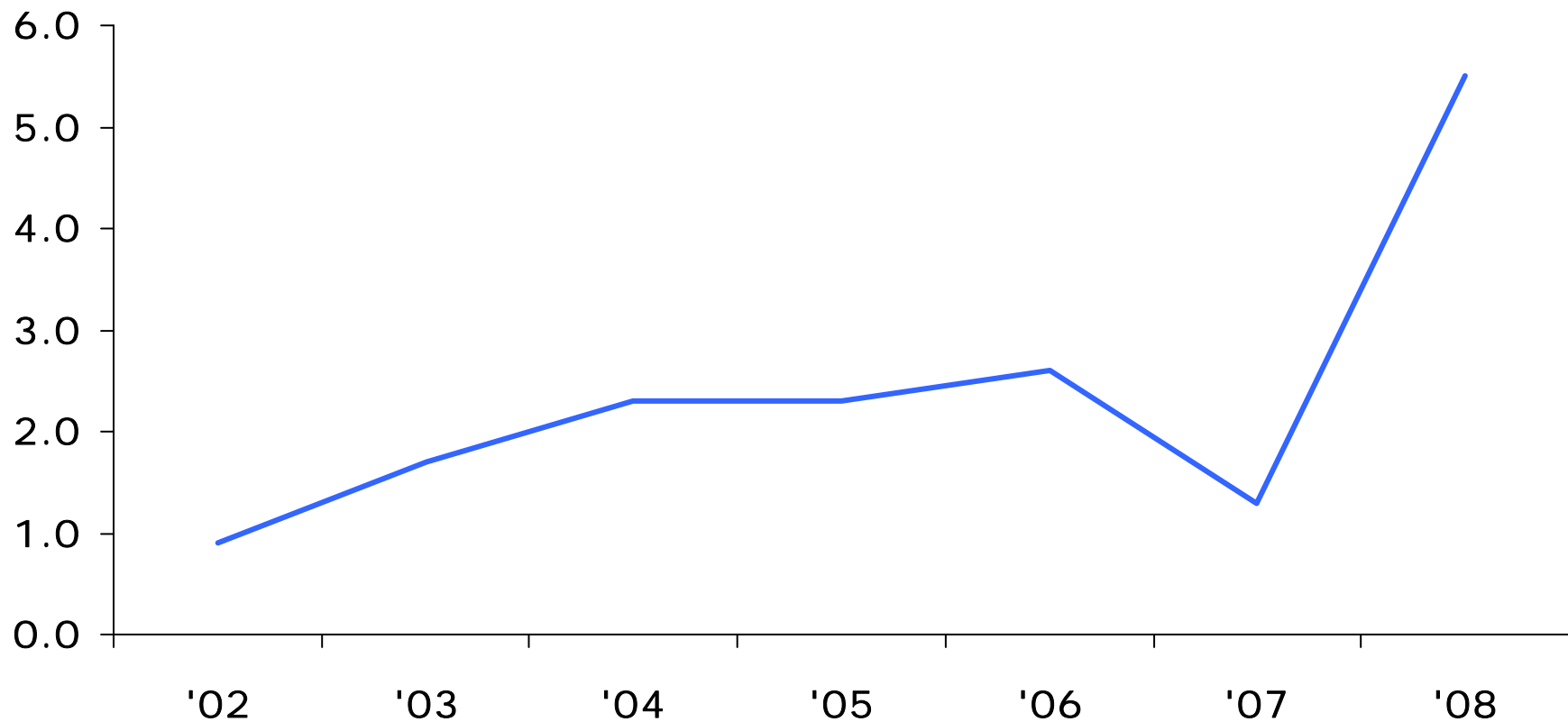
- To determine the incidence of a tenant entering liquidation / receivership on their lease IPD utilise the IRIS risk analysis service which credit rates all tenants within the databank each quarter.
- The rates that tenants enter liquidation / receivership is measured as the hit to the annual income stream from losing four quarters of rent.
  - The figures presented in this section are not attempting to quantify the lost income to the owner from defaults
  - rather the risk to the owner of leases not being honoured by tenants due to business failure which requires a re-letting of the unit.
  - The income loss to the owner from tenant default will depend upon factors such as: the level of rental arrears, recourse to the original tenant on assignments, guarantees from parent companies, rent deposits, eventual recoveries from liquidators, time taken to re-let, costs of re-letting, service charge losses, dilapidations and empty rates.

# Rate of tenants entering liquidation / receivership soars in 2008

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Tenants rated 0 or 1 y Dunn & Bradstreet,  
weighted by ERV, %

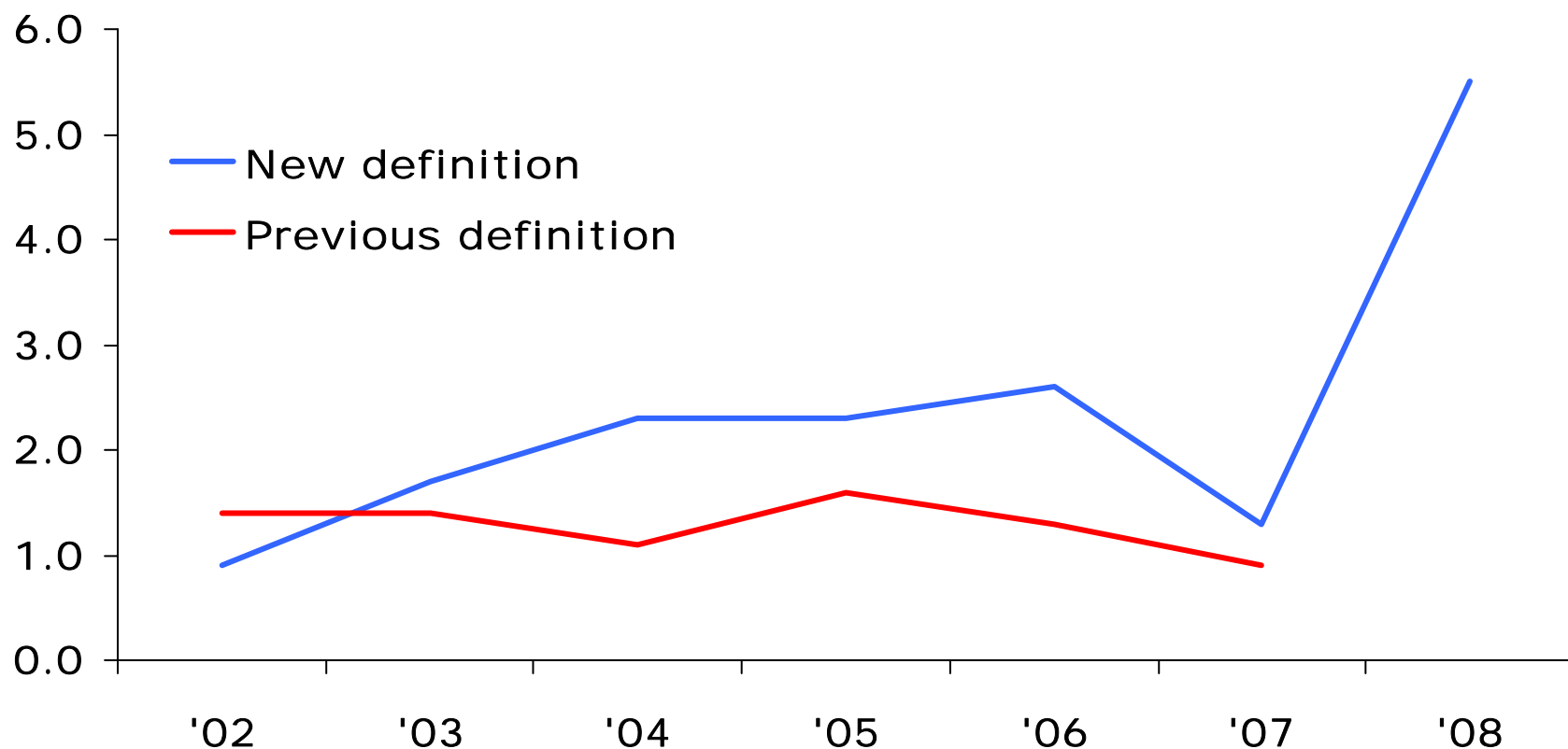


# Rate of tenants entering liquidation / receivership soars in 2008

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Tenants rated 0 or 1 by Dunn & Bradstreet,  
weighted by ERV, %

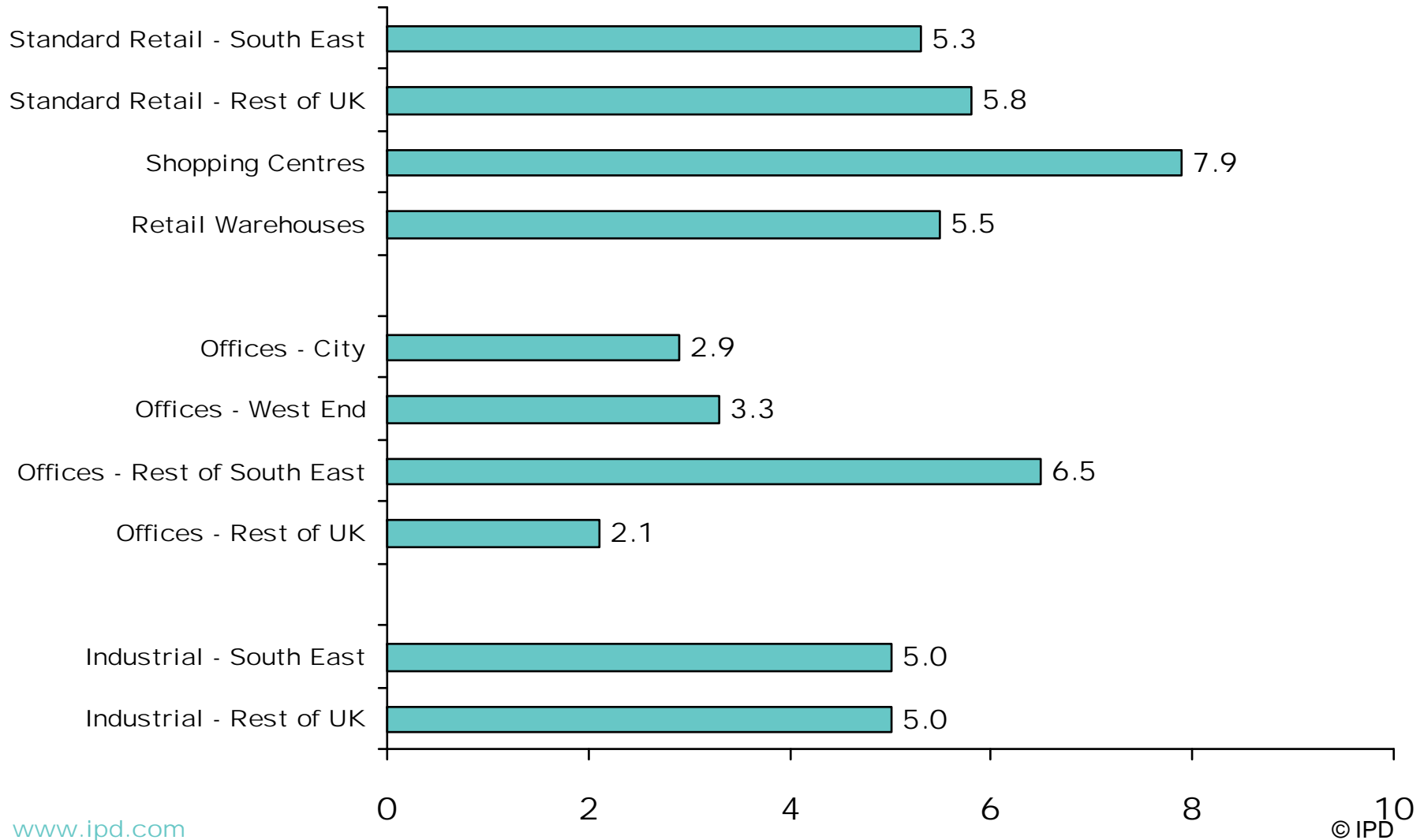




# Shopping Centres top default rates in 2008

Rate of tenants entering liquidation / receivership, 2008, %

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# Measuring the Robustness of Income

## (5) Average vacancy period

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To provide evidence on void rates and the average age of voids

A void unit is defined as one for which the landlord is receiving no income and where there is no tenant occupying the space.

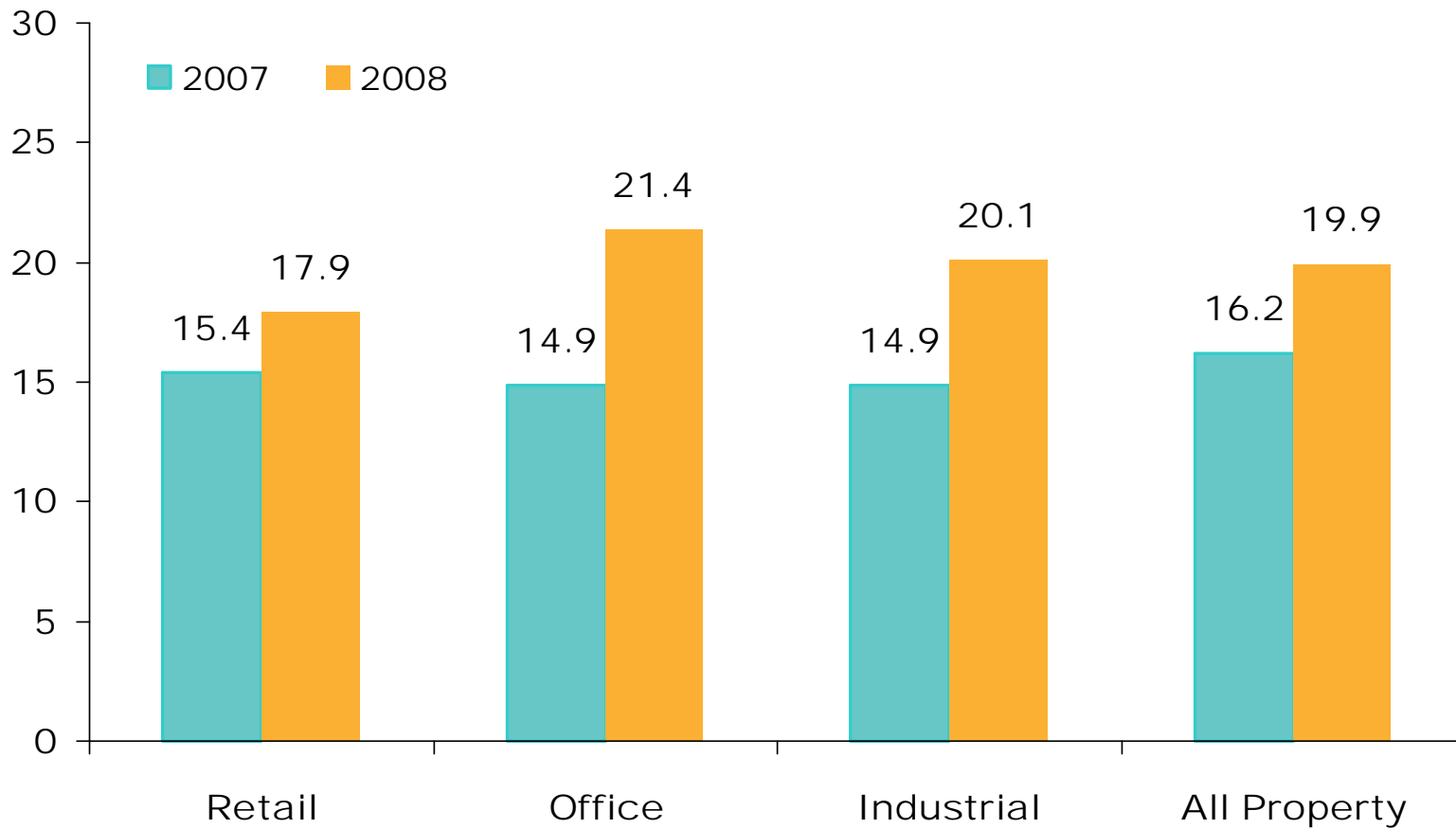
As a result, “void units” exclude empty or vacant units where rental payments are still being honoured under an existing lease, and new tenants who are benefiting from a rent-free period.

# Average age of voids in all sectors rise

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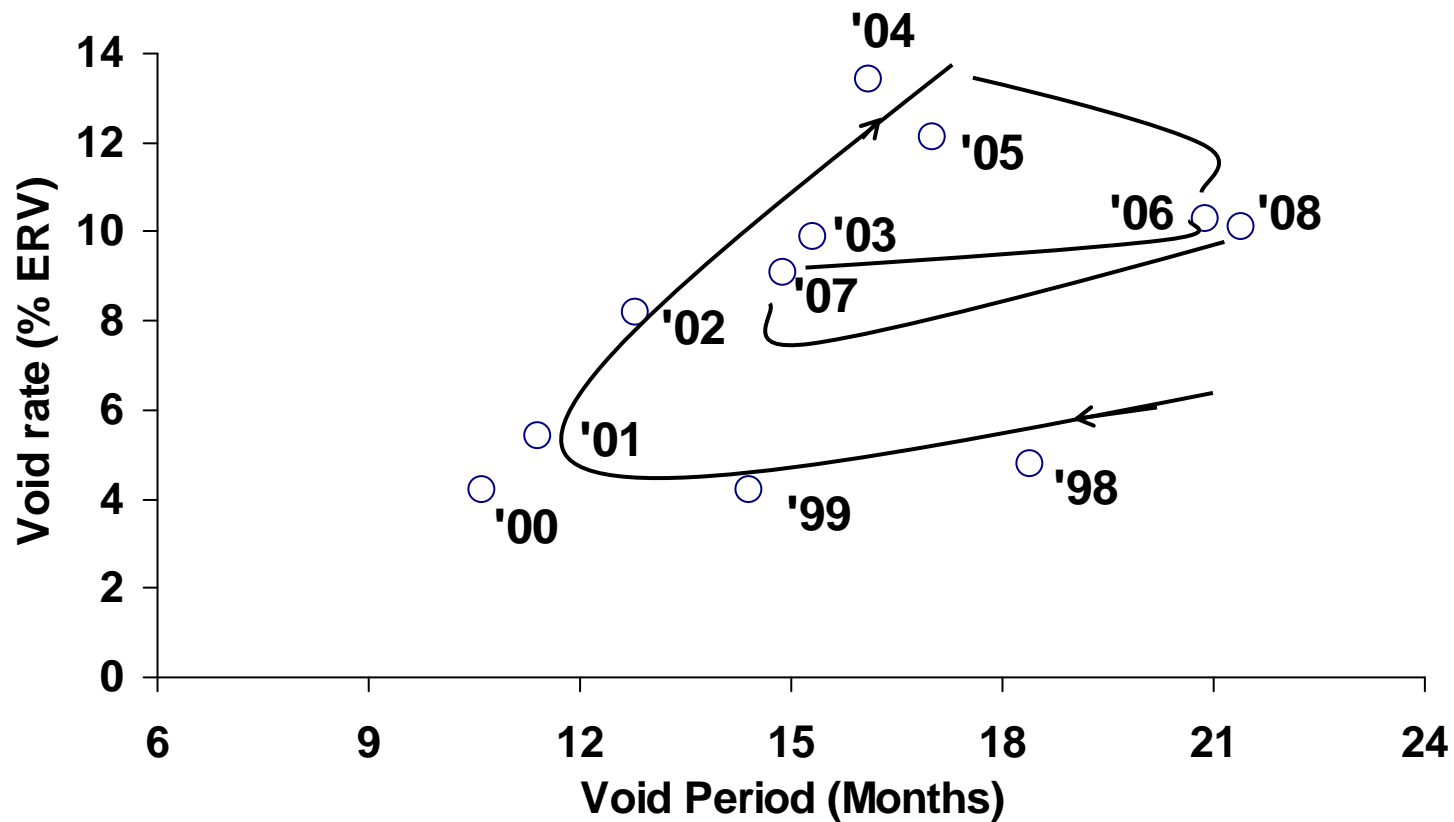
Average age of voids, months, weighted by ERV



# Void Periods Vs Void Rates - Offices

Average void period, months, void rate, %

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Source: Strutt & Parker Lease Events Review

# The Robustness of Income

## Summary

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- Real estate delivers a secure income to investors
- In part, this security reflects the long-term fundamentals of tenant demand which sets long run rental growth around inflation
- But in the short term lease terms play a major role in smoothing market fluctuations in rental values
- This protection is a lot greater than suggested by average market rental movements as changes in rental values on individual assets are much more volatile than the average



## Research Programme 2006-2009

The IPF would like to thank the supporters of its 2006-2009 research programme:

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