

Commercial Property Solutions

Practical And Professional Commercial Property Comment
From The Culshaw Partnership

Issue 23

March 2009

Lease Re-gearing



Contents

Lease
Re-gearing.

Page 1

Lease
Re-gearing (cont).
Leases Lengthen.

Page 2

Yield Gap
Emerging.
How We Can
Help.

Page 3

Market Indicators.
C.P. News.
Contact Details.

Page 4

In today's climate, investors are relying upon asset management in an attempt to improve performance. Tenants are looking for "cost certainty" so that they can properly run their businesses. Landlords and tenants are increasingly turning to a tool that helps both meet their aims: lease re-gearing. Re-gearing arrangements generally involve amending the terms of existing leases by changing the arrangement for rent review - from an open market review to a fixed or index linked increase, or a combination of the two, such as an open market review with maximum and minimum uplifts - and extending the lease term. Changes in the rent review arrangements to fixed or index linked increases and to term length can help landlords to improve the capital values of their properties and offer tenants more certainty as to future rents. Re-gearing negotiations may also offer a tenant an opportunity to revise other provisions that no longer suit its business needs; for example, adding break clauses or changing under-letting restrictions.

How to vary terms

A deed of variation of the lease is required when the parties merely want to revise the rent review provisions. However, should they also want to extend the term, three possibilities are available:

a) In addition to the variation of the existing lease, the landlord and tenant can enter into a future lease (a "reversionary" lease), which will come into effect when the existing lease expires.

b) The existing lease is surrendered and replaced by a new lease, which will include the new rent review provisions and is for the longer term.

c) The parties could use a deed of variation to vary the term and rent review arrangements. However, as a matter of law, a variation to the term amounts to a surrender of the existing lease and the grant of a new lease, and is therefore no different from option (b).

The Reversionary Lease

This is granted for a term that commences on the expiry of the existing lease. Its term must commence within 21 years of the date of its grant. The reversionary lease will normally be based substantially upon the terms of the existing lease, so the tenant/landlord covenants will be similar to those in the existing lease. However, because the tenant will have two separate leasehold interests, provision has to be made to prevent the existing lease or the reversionary lease from being assigned separately, thus ensuring that both leases are held by the same tenant at all times.

It is also necessary to ensure that should the landlord forfeit the existing lease (on default or insolvency of the tenant, for example), the reversionary lease will automatically determine. Where there is a guarantor to the existing lease, that guarantor should also be required to execute the deed of variation, thereby ensuring that its obligations will also apply to the revised rent review arrangements.

Surrender & New Lease

The surrendered lease is determined and both parties will be released from their obligations and liability for any prior breach. The parties need to consider the extent of this release; for example, if a service charge is payable, the landlord will want to ensure that it can recover any balancing payment. There are two alternatives with regard terms of the new lease. The landlord and tenant could agree to base the new lease substantially upon the existing lease, this has the advantage of minimising the need for negotiations although, it may disadvantage one or other of the parties. If the existing lease is an "old" tenancy for the purposes of the Landlord and Tenant (Covenants) Act 1995 (namely granted before 1 January 1996), the landlord should bear in mind that, in

(Continued on page 2)

Lease Re-gearing (cont from Page 1)

(Continued from page 1)

surrendering the lease, it may lose a valuable covenant.

Stamp duty land tax (SDLT) will be payable on the new lease. The tenant should check whether it can offset any SDLT paid on the lease being surrendered against the SDLT to be paid on the new lease.

Other Points

First, what is the intention/expectation with regard to alterations. The landlord will want to ensure that it can require the removal of the alterations. The tenant will want these alterations to be disregarded on rent review.

When changing from open market rent review to fixed/index-linked increases, the parties must consider what provisions are needed to deal with the rent at which under-leases can be granted. The parties need to look at any timing arrangements under the

existing lease and review what should happen in the case of the new or reversionary lease. For example decorating covenants, these will usually provide for the tenant to redecorate every three years in the case of the exterior. Under a 10 year term, the tenant will be decorating in the ninth year. Personal concessions or covenants in the original lease may become redundant.

Lastly, other aspects of the existing lease may need to be updated so as to reflect changes either in the legislative framework or in market practice since the existing lease was granted. Examples include the new rules relating to energy performance certificates and recommendations introduced under the 2007 *Code for Leasing Business Premises* or the RICS 2006 *Code of Practice on Service Charges*.

Added certainty

In today's market, re-gearing should be seen as an opportunity for both parties to achieve their aims. Both parties face risks when agreeing fixed or index-linked rents in the short and long term. Overall, however, the added certainty for the parties is generally attractive. In considering the issues fully at the outset, the landlord and the tenant will be able to achieve their respective objectives more fully and far more quickly.

Estates Gazette 10th January 2009

C. P. Comment :

Re-gearing can certainly make sense for all parties and we are getting approaches from tenants as well as landlords interested in exploring the opportunities that this might throw up.

Leases Lengthen For First Time In Almost 10 Years

The average length of commercial property leases has risen for the first time in almost a decade. In the 15 months to March 2008, lease lengths rose by six months to 6.2 years, according to the Investment Property Databank's and British Property Federation's *Annual lease review*.

The report, which draws on evidence from 75,000 tenancies, found that 63% of new leases were less than five years in length. These accounted for just one-third of total passing rents, meaning that tenants which occupy larger units tend to sign longer leases. A total of 8,668 leases were signed between January 2007 and March 2008, providing a passing rent of £783m.

However, IPD co-founding director Ian Cullen predicted that the trend would reverse when the full effects of the economic downturn had been recorded.

"Both before and for some months after the credit crunch, rents continued to rise," he said. "In the absence of excess capacity, lease

terms finally nudged out in response to this pressure." He added: "Property demand circumstances are likely to be very different by this time next year."

Estates Gazette 13th December 2008

C. P. Comment :

And How!

Unfortunately this cautiously neutral assessment was based on transactions for the 15 months to March 2008 and the gentleman's prediction for the following 12 months has been proved all too correct.



Yield Gap Emerging

THE QUARTER has seen England and Wales entering the most pronounced period of weakness in over 16 years. A raft of economic data has confirmed the ongoing slide of the economy with survey indicators pointing to a recession as severe as that of the early 1990's. A contraction is well underway across the manufacturing sector with output having fallen over the past six months. This has also been reflected in the latest RICS' commercial property survey, which saw tenant demand ease back for the fourth consecutive quarter as businesses put investment decisions on hold. Unlike the slowing UK economy in 2005, limited external support will be gained from a weakening global economy. Amid all the gloom, one positive is the dramatic declines in inflation which should accompany the global slowdown. Real incomes will gain some support as a result, although at an aggregate level, rising unemployment may act as a bigger drag on overall consumer

demand in the economy. Indeed, talk of deflation risks are now mounting which will ensure that aggressive cuts in global interest rates are not reversed any time soon. With UK rates set to fall to 1% in 2009 a positive yield gap is rapidly emerging in the commercial property market. However, with the banking sector set to shrink their balance sheets, credit in the commercial property sphere will remain restrictive for some time. That said, those with access to equity are starting to see some real value in the UK market commercial property prices in dollar terms are now 50% down on the June 2007 peak and with further declines expected, equity investors and sovereign funds may be tempted back into the market. We are only half way through the price correction in the commercial property market with values set to fall through 2009 and 2010 as rental declines gather pace. On a positive note, the rapid re-pricing across the market has

pushed UK yields to among the highest in the developed world with a very wide gap emerging compared to finance costs. For unleveraged investors (like pension funds). High yields provide good long term value especially for prime properties.

Indeed, stimulus plans by central banks worldwide and accelerated fiscal packages, might see a return to higher inflation once the worst of the current slowdown has passed, with property tending to act as a good hedge.

RICS Business January 2009

C. P. Comment :

Interest rates at such unprecedented levels have created a "yield gap" not seen for a very long time.

See 'Market Indicators' overleaf.

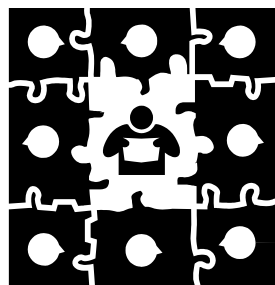
How We Can Help You

Dilapidations

At the risk of repeating myself, and I am, now is the time for all landlords, (those still with tenants) to look closely at their property with an eye to dilapidations. In these straitened times tenants will more than ever be tempted to avoid expense, and you must keep on top of the issue unless you are prepared to risk being left with a badly deteriorated property when your lease does come to an end, however that may occur.

During the lease you are entitled to carry out works and recover the costs from your tenant as a debt whereas if you leave it until the lease ends or is brought to an end

you may only recover damages and your lawyer will tell you how expensive and time consuming that exercise could be.



The Culshaw Partnership
one company for all your
property needs

Services We Offer :

Property Management

Rent Reviews/Lease Renewals

Investments

Dilapidations

Planning

Rating

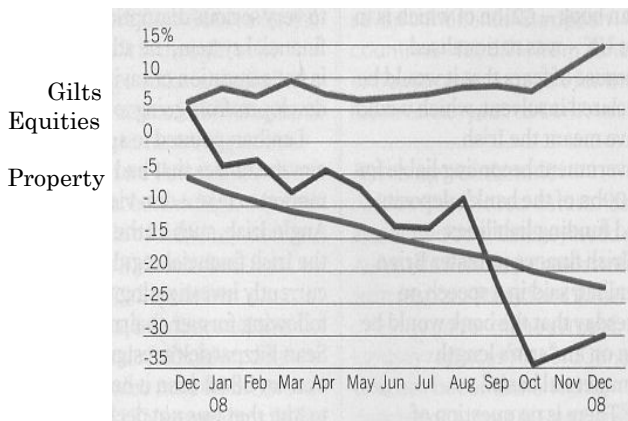
Sales & Lettings

Survey & Valuations

Landlord & Tenant Disputes

Market Indicators

Property, Equities and Gilts; Total Returns



11th February saw the first of the main London Auctions of the year and it would be wrong to place too much emphasis on a few transactions on one day.

However the “yield gap” discussed overleaf clearly attracted a lot of interest and a marked shift in yield as compared to December 2008.

A 90% success on the day and an average retail yield of 6.7% (8.3% December 2008).

C.P. News

I don't know how you all spent the first week in February, but in large part the Culshaw Partnership, in common with the rest of the Country was forced to bow to the power of nature. Rather more than the usual annual heavy frost here in Uppingham (12-14 inches of snow more!) meant a quiet few days with staff unable to get in not that that mattered much as most businesses we deal with were lacking their key people as well. Unlike the nations schools though, the Culshaw Partnership was open for business throughout, principally it has to be said, because the writer and fellow Partner both live in Uppingham and neither of us could think of an excuse not to struggle in.



Commercial Property Specialists

Contact :

Partners: John Tookey or Justin Fowler

**The Culshaw Partnership
29 High Street East
Uppingham
Rutland
LE15 9PY**

**Tel :
01572 822791**

**Fax :
01572 821653**

**e-mail :
info@cpship.co.uk**

**website :
www.commercialpropertyspecialists.co.uk**