

Practice and law

Open letter to John Prescott Upward-only rent reviews have much to commend them - banning them will cause only harm, says Anthony Ratcliffe

You're wrong, John

To the Rt Hon John Prescott Mp, Deputy Prime Minister:

Thank you for your office's letter of 11 June and the enclosed consultation paper, *Commercial property leases: options for deterring or outlawing the use of upward only rent review clauses*. I have studied this and respond with quotations from your paper and my comments, as follows:

"Upward only" a misnomer

The description "upward-only rent review" is a misnomer. This lease clause would be more accurately described as a non-downward rent review, for, in practical use, it means that the rent cannot fall - not that it must rise.

The government is basing this proposal on the mistaken premise that "upward-only rent reviews are a source of grievance to many in the business community".

To the contrary, the upward-only rent review clause is a source of stability and counter-inflation in the commercial property market. It has operated successfully therein for nigh on 50 years, failing only in the recession of 1974 and the deeper recession of 1990. To legislate for amendment on a rent review clause which has worked well for 48 out of 50 years is unnecessary.

The assumption that government interference in a hitherto free-market aspect of lease structure "will promote greater flexibility in the commercial property market" is, in the highest probability, the reverse of what will occur.

We need only recall what happened under the last Labour administration following the imposition of office development permits. A crazed development market, about to collapse under its own weight of newly finished and unwanted office buildings, was given a revived

bull run by George Brown's ill-considered ban on all speculative office developments over 10,000 sq ft in the South East.

The law of unintended consequences had struck again, and banning upward-only rent reviews will lead this government and the property market up a similar cul-de-sac.

Your paper states: "The government's concern stems from evidence from the University of Reading's appraisal... that upward only rent review clauses continue to be the predominant pattern of rent review among longer leases." But the government should not be concerned that upward-only rent review clauses continue to be predominant.

The reason they continue to predominate is

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because tenants will always prefer a lower initial rental over the first period of the lease and will take their chance in mitigating the rent review uplift by negotiation, rather than pay a premium rent for the first period, which may or may not decrease at the rent review.

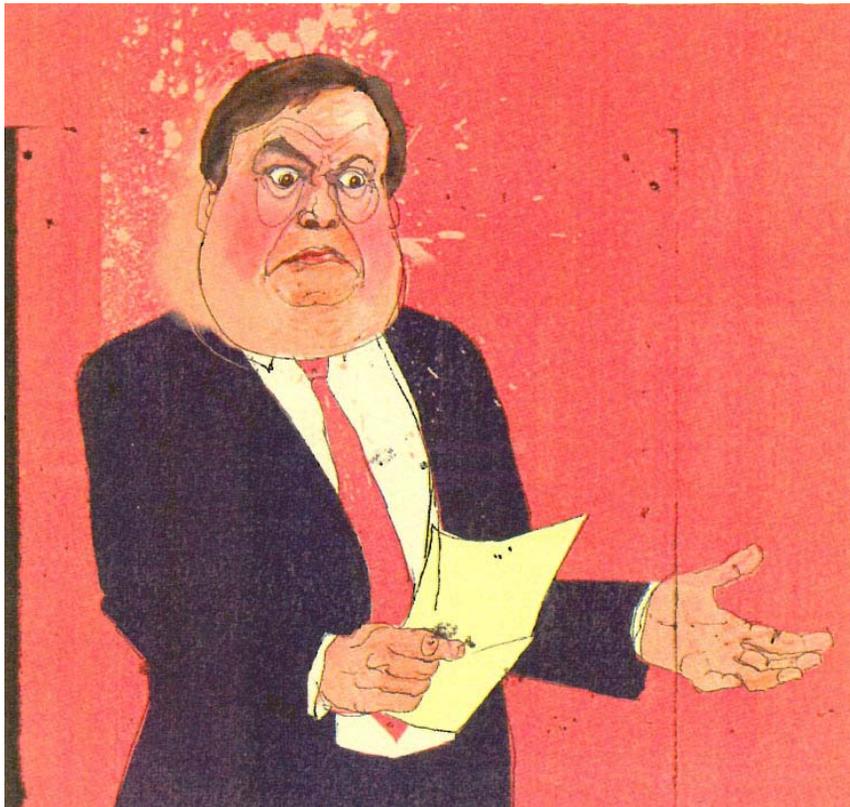
It is untrue that businesses have little choice over the terms they are offered. The law of supply and demand works as well in the commercial property market as elsewhere. Presently the office market is substantially oversupplied, so rents are static, leases are short, and tenants can secure frequent break clauses. Conversely, the retail market is strong, with prime shops in

short supply; therefore, leases are longer, rents are rising, and break clauses less frequent. A downturn in domestic consumer spending will in due course correct this market when it overheats.

The government need not be, as you say, "concerned that upward-only rent reviews... can leave businesses exposed during downturns in the market", for in practice this is a very rare occurrence. In the writer's direct experience of some 40 years negotiating the terms of commercial property leases for both landlords and tenants, tenants have been disadvantaged only twice, in 1974 and 1990. Over the rest of the period, the rent review mechanism has favoured the tenant, for rent reviews are settled on the basis of evidence arising from contracted transactions, which therefore are historical. Inflation works to the benefit of the tenant in the rent review process.

The properly industry was wrong to introduce the voluntary code in April 2002. Its efforts should instead have been directed at showing government that the banning of upward-only rent reviews would wreak havoc on property supply and values and drive rents upwards if implemented. The University of Reading itself considers that the government's commission to study the impact of the voluntary code was the wrong instruction. It should have been asked to investigate whether the upward-only rent review clause truly was "a source of grievance to many in the business community".

We already know that the upward-only rent review is certainly not a source of grievance to Marks & Spencer, Woolworth, WH Smith and Sainsbury, all of whom have in recent years carried out large sale-and-leaseback programmes, with leasebacks for 25 years with



quinquennial upward-only rent reviews. Why did these major retailers commit to such “onerous” lease terms? Because they wished to raise the maximum amount of cash in the sale of their properties, and do not see upward only rent reviews as a problem. Would the purchasing investors have paid so keenly for properties let on leases with the uncertainty of open rent reviews?

The government has said that following its assessment of Reading’s final report, due at the end of 2004, it would consider whether or not to intervene. Government should amend its remit to Reading, asking whether it should involve itself in this issue at all.

It is true, as you state, that “in his 2003 Budget report, the Chancellor of the Exchequer acknowledged the importance of commercial property as a factor of production, contributing directly to economic growth and regeneration in towns and cities”.

Government should reflect on how this happens. Commercial property is a capital

intensive product, consuming large sums of money in the process.

Ultimately, this money comes from the pocket of the investor, who buys the completed and let building. The developer will rake the risk in the creation of the product if he is confident that he can let the building and then sell the investment. He is best helped in this process if he can keep his rent low and sell on a keen investment yield, an essential element of which is the lease structure. An investor will pay more for a longer certain lease term and an upward-only rent review pattern. If the lease is shorter and weaker, the investor will pay less. To ensure his return, the developer would then have to secure a higher rental in compensation, and if he was not confident of that, then the project would be aborted or delayed until he was.

Ergo, open rent reviews will be inflationary and upward-only rent reviews do contribute to the stability of the property market and are counter-inflationary.

You state: “In a falling market, an upward only rent review clause would maintain the rent at existing levels... In a falling market, a lease with an upward-only rent review would have a negative value.”

Since this has only happened twice in the post-war period, in 1974 and 1990, does this matter? The market has its mechanisms – reverse premiums and subsidised sublettings - which can deal with this on the rare occasions when it does happen. One small amendment may have some validity here prohibiting a lease restriction on subletting at a rent below the passing rent.

The consequences of upward-only reviews

Also, you say that “rigid application of upward-only rent reviews in a falling market can put the tenant out of business”.

In most commercial businesses, the combined cost of both rent and rates is rarely more than 10% of the business’s total overhead. Wages, National Insurance contributions, compliance with the numerous regulations which sprout from Brussels or Westminster, and production costs, are all vastly more important elements in the make up of overheads. The proposition that excessive rental in isolation can bankrupt a business is improbable.

Your letter goes on to say that “the tenant accepts the risk of downward market volatility, while gaining limited corresponding benefit during an upturn.

“Upward-only rent reviews introduce rigidity into the property market during a downturn... This could exacerbate wider economic instability.”

Since we already know that post-war rental values have collapsed only twice and for the rest of the period have risen to a greater or lesser degree, these statements are of little weight.

“Upward-only rent reviews adversely affect landlord and tenant relationships during market downturns, when they become a source of friction,” you say. The landlord and tenant relationship is naturally adversarial and all the healthier for it. In a rising market, the review will provide an increase. In a static market, the rent will remain the same. In the current property cycle, rent-reviews are quinquennial. The landlord has the opportunity to raise the price of his product but once every five years,

while the tenant can raise his prices every week, if his market will bear it.

“However, where both landlord and tenant are content that they should apply, upward-only rent reviews can have advantages for both parties.” This is true, and these advantages remain even if the tenant would prefer an open rent review structure.

“Upward-only rent reviews sustain capital values and hence investment in property.” Indubitably, and government should do nothing to imperil this.

Tenants overlook implications of slump

“Tenants may tend to overlook the implications of a downturn because historically rents have fallen relatively rarely.” True - just twice over the past 40 years, in my experience.

“Upward-only rent reviews provide a guarantee that the rent will not fall at any time over the period of the lease, and this helps to underpin the capital value of the property.” True, and of value to everyone, for, through the medium of our pension and other saving schemes, we are all landlords.

“The government is concerned that the widespread use of upward-only rent reviews in longer leases has restricted the degree of flexibility in the market... has inhibited... alternative forms of rent review... indexation or fixed interest rents.” The government is seriously in error here. The UK has the most sophisticated commercial real estate market in the world, with the highest standards of professional examination through the Royal Institution of Chartered Surveyors.

Domestic rent reviews are adversarially contested by expert surveyors representing both landlord and tenant and determined by independent surveyors where agreement cannot be reached. Simplistic and inaccurate alternatives such as indexation or ratcheting, which lead to massive distortions from open market rental value, should be left to those property markets where British property expertise is not yet commonplace.

“The government recognises that regulation of the terms of commercial leases could have unpredictable side effects. Legislative action is always an action of last resort of government.” I am pleased to see the government acknowledging our old friend the law of unintended consequences, although I do not recognise this government as one that legislates as a last resort - since 1997 we have been buried in the stuff!

“The ODPM will be looking to the second phase of the Reading research to shed greater light...” Reading should be asked to answer this fundamental question: does the UK economy need a commercial lease structure that outlaws

What are Prescott's options?

Option 1: do nothing. “The government would continue to persuade the property industry to adhere to the voluntary code of practice.” Why? The wretched thing should be abandoned altogether and the commercial property market left to get on with its business.

“The do-nothing option... the market would remain imperfect.” All markets are imperfect - that is how money is made - but they become much more imperfect when government interferes.

Option 2: ban upward-only rent review clauses. The proposal is too ludicrous to be given credence, but if government is misguided enough to proceed with it, an inadequate gesture of balance should be an amendment to the Landlord and Tenant Act permitting a landlord to regain possession of his property at the end of the lease, without compensation to the outgoing tenant, as applies under Scottish landlord and tenant law.

Option 3: ban upward only-rent reviews subject to a floor of the initial rent. This is a fudge, likely to lead to false initial rents, and a complexity in operation that would negate

its use from the outset.

Option 4: give tenants a right to break if the upward-only rent review produced a rent above open market levels. This would have merit only if this situation occurred more frequently than it actually did in 1974 and 1990.

Errors of commercial judgement have to be paid for, whether they are made by the landlord or the tenant. If the government was to intervene to help the tenant in an over-rented situation, it should also step in to help the landlord where his property has seriously under-rented. Both propositions are foolish.

Option 5: limit lease length. This is impractical. Many tenants, such as in the leisure and retail sectors, require a long lease to write down the cost of a major fitout, or to ensure longevity to build a substantial customer base.

Option 6: require landlords to give prospective tenants priced options. This has proved impractical. My firm offers loads of options. In our experience, the tenant's choice in virtually every case has been the first option, a 25-year lease with tenant's option to determine after 15 years.

upward-only rent reviews, or is the present market-driven structure best left alone to get on with its business and without government interference?

“Consultees are invited to comment on why upward-only rent review clauses have continued to be prevalent in the present low-inflation business environment, which is very different from the high inflation environment in which they were first developed.” This premise is false. The writer can recall that at the time of his entry to the surveying profession, market practice in a period of low inflation was to grant a 21-year lease, with a single upward only-rent review at the end of the 14th year. By the mid 1960s, market practice was to grant 21-year leases with septennial upward-only rent reviews as a response to quickening inflation. By the 1970s, the 25-year lease with quinquennial upward-only rent reviews had arrived. For a short period when inflation was rampant, triennial rent reviews were sought by landlords, until the property crash of 1974 put an end to this. The 25-year lease has lasted for about 25 years, being replaced in the mid 1990s by the 15-year

term, again with quinquennial upward-only rent reviews.

Therefore, upward-only rent review clauses have always been with us through low, higher, rampant, and then again low, inflation. Only the frequency of the rent reviews has changed.

Summary

Government should ensure that Reading are asked to respond to the right questions:

- Do tenants really care? Will they pay a higher rent for the open rent review structure?
- Is there a real demand in the real world for the outlawing of upward-only rent reviews?
- Will the abolition of upward-only rent reviews do more harm than good by weakening property investment values, discouraging overseas investment interest, driving rents higher, and creating greater inflationary pressures?

I hope you will find my views, based on some 40 years' experience in the commercial property leasing market, of interest.

Anthony Ratcliffe is principal of property and surveying firm Ratcliffes