# Alternative figures add up to zero

The recent compromise allowing alternatives to upward-only rent reviews will weaken property's stature as a stable, safe investment, writes Anthony Ratcliffe

**1. Financial appraisal for pre-1995 development**

An "old-style" lease can still be cost-effective with upward-only reviews

| | | | | |
|---|---|---|---|---|
| **Valuation** | 20,000 sq ft to be let @ £5 per sq ft (pax) = | | | **£100,000** |
| | 25 years privity FRI lease five-yearly *u/o* r.rvs | | | |
| | Capitalise to show 6.25% YP in perp | | | 16.000 |
| | | | | £1,600,000 |
| | Less investment purchaser's costs | | | |
| | (Stamp duty@4% for parity) @ 5.75% | | | £87.000 |
| | Net investment value | | | £1,513,000 |
| **Site Costs** | | | | |
| Land | 400,000 | | | |
| Purchase costs @ 6% | 24,000 | | | |
| | | 424,000 | | |
| Interest @ 8% for 1 year c/q | | 35,000 | | |
| | | | 459,000 | |
| **Building Costs** | | | | |
| QS Estimate | 500,000 | | | |
| Fees/planning @ 20% | 100,000 | | | |
| | | 600,000 | | |
| Interest @ 8% for 9 mnths year c/q/2 | | 18,500 | | |
| | | | 618,500 | |
| **Letting Costs** | | | | |
| Agents, solicitors | 15,000 | | | |
| Void/promotion | 30,000 | | | |
| | | | 45,500 | |
| **Sale Costs** | | | | |
| Agents, solicitors | | | 30,250 | |
| **Total estimated development costs** | | | | £1,152,750 |
| **Estimated development profit** | | | | 360,250 |
| **Or** | | | | **31.25%** |

So, the war is over - no, not that one, alas. But peace has broken out between the British Property Federation and the Property Market Reform Group. In a compromise, the two bodies agreed to a code of practice requiring landlords to offer priced alternatives to upward-only rent reviews. Occupiers have agreed that any downward review will be no lower than the initial rent. But the result seems unsatisfactory (3 November, P37).

Landlords are still too fragmented, politically naive and "wee timid beasties", when faced by the tenants' big battalions to whom marketing, political lobbying and grouping to protect their interests are second nature. Landlords are isolated and outflanked because not enough major landowners and institutions stand publically alongside the BPF

Take the lease reforms of the Landlord and Tenant Act 1995. What was wrong with the lease structure prior to the reforms? Only the need for measures to protect a former tenant who had long since assigned a lease which had bounced back to him as a consequence of the 1990-92 recession.

Appropriate protection for Mr and Mrs Smith, long-retired tenants, from having to meet a rent liability perhaps four times the level at which they had assigned their lease to a defaulting tenant's predecessors 20 years earlier, was an easy enough reform to achieve.

All that was needed was to reverse the default procedure so that it commenced with the previous tenant and not the original one; to limit the previous tenant's liability to the rent which was being paid at the date of his assignment; and to give the landlord the option to take back the lease upon default, if his preference was to take his chances in reletting in the open market, rather than receive the lower level of rent the former tenant would be liable to pay.

### The too-simple solution

What was wrong with that solution? Simple: it was too simple, and would not have yielded enough pickings for lawyers, a profession much over-represented in the Houses of Parliament. And so we got the over-elaborate and largely unnecessary reforms of the Landlord and Tenant Act 1995 and the landlords lost that battle.

Now six years on, vociferous tenant lobbying groups are again on the attack. Yet what is so unfair about the non-downward review? I hesitate to take issue with John Gummer MP, whose columns in this magazine bristle with common sense, on his point that "outside the industry, the idea that one would be forced to tie oneself to an agreement that allowed only an increase in the cost of one's raw materials and no reduction, whatever the market conditions, would be denounced as positively barmy."

But surely outside the industry, the idea that one would be bound by an agreement that allowed an increase in the cost of one's raw materials only once every five years, whatever the market conditions, would be denounced as being even more barmy!

One of the most active members of the Property Market Reform Group is Arcadia, which holds a significant number of its shopping centre units at rents agreed in the boom conditions of the late 1980s - in many cases still well above current rental values. At that time, Arcadia's property development subsidiary, Burton Group Property Trust, was promoting its own town-centre shopping schemes, reserving most of the prime fashion pitch units for its various retail formats including Burtons, Dorothy Perkins, Evans, Richards and Top Shop.

I wonder how many of those over-let units form part of Arcadia's portfolio today.

Furthermore, major tenants seem to have no problem signing up to 25-year leases, with upward-only rent review provisions, where they themselves are the vendors of the freeholds - note Woolworths, with its recent £650m portfolio leaseback deal, and Marks & Spencer, with a similar £350m transaction. There is a great deal of hypocrisy in the PMRG's stance on the issue of shorter leases and upward/downward rent reviews.

### 2. Financial appraisal for post-1996 development

A newer-style lease still yields the same profits as the previous example

| | | | | |
|---|---|---|---|---|
| **Valuation** | 20,000 sq ft to be let @ £5.63 per sq ft (pax) = | | | **£112,000** |
| | 15 years "new" FRI lease five-yearly u/o r.rvs | | | |
| | Capitalise to show 7% YP in perp | | | 16.000 |
| | | | | £1,600,000 |
| | Less investment purchaser's costs | | | |
| | (Stamp duty @ 4% for parity) @ 5.75% | | | £87.382 |
| | Net investment value | | | £1,520,000 |
| **Site Costs** | | | | |
| Land | 400,000 | | | |
| Purchase costs @ 6% | 24,000 | | | |
| | | 424,000 | | |
| Interest @ 8% for 1 year c/q | | 35,000 | | |
| | | | 459,000 | |
| **Building Costs** | | | | |
| QS Estimate | 500,000 | | | |
| Fees/planning @ 20% | 100,000 | | | |
| | | 600,000 | | |
| Interest @ 8% for 9 mnths year c/q/2 | | 18,500 | | |
| | | | 618,500 | |
| **Letting Costs** | | | | |
| Agents, solicitors | 16,875 | | | |
| Void/promotion | 33,125 | | | |
| | | | 50,000 | |
| **Sale Costs** | | | | |
| Agents, solicitors | | | 30,500 | |
| **Total estimated development costs** | | | | £1,158,000 |
| **Estimated development profit** | | | | 362,000 |
| **Or** | | | | **31.25%** |

### 3. Financial appraisal for post-2001 development

An upwards/downwards lease requires a higher rent to make a profit

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|---|---|---|---|---|
| **Valuation** | 20,000 sq ft to be let @ £6.06 per sq ft (pax) = | | | **£121,250** |
| | 15 years "new" FRI lease five-yearly u/o r.rvs | | | |
| | Capitalise to show 7.5% YP in perp | | | 13.33 |
| | | | | £1,616,626 |
| | Less investment purchaser's costs | | | |
| | (Stamp duty@4% for parity) @ 5.75% | | | £87.875 |
| | Net investment value | | | £1,528,750 |
| **Site Costs** | | | | |
| Land | 400,000 | | | |
| Purchase costs @ 6% | 24,000 | | | |
| | | 424,000 | | |
| Interest @ 8% for 1 year c/q | | 35,000 | | |
| | | | 459,000 | |
| **Building Costs** | | | | |
| QS Estimate | 500,000 | | | |
| Fees/planning @ 20% | 100,000 | | | |
| | | 600,000 | | |
| Interest @ 8% for 9 mnths year c/q/2 | | 18,500 | | |
| | | | 618,500 | |
| **Letting Costs** | | | | |
| Agents, solicitors | 18,200 | | | |
| Void/promotion | 35,300 | | | |
| | | | 53,500 | |
| **Sale Costs** | | | | |
| Agents, solicitors | | | 30,550 | |
| **Total estimated development costs** | | | | £1,161,000 |
| **Estimated development profit** | | | | 367,250 |
| **Or** | | | | **31.62%** |

Mr Gummer makes the point that "countries that have no tradition of the upward-only rent review still manage to get the capital to build homes, offices and factories and appear perfectly able to find investors prepared to fund the proposed buildings". Perhaps so, but in order to achieve this the rents may be higher, the rent reviews more frequent, the owner-occupiers more active, and the commercial tenants do not have automatic rights of renewal. Also, those markets are less sophisticated than our own and attract a fraction of the external investment the UK receives.

### Inflationary effect

Analysis of the inflationary effect an upward/downward rent review lease structure would have on rents is illuminating. Let us assume that the development land price is set and the developer's margin must be preserved for the capital to be risked - a realistic scenario because land owners have a fixed idea of their site's value and developers who prefer to survive have a determined view of the return they require to offset their risk.

In Example I above, we assume an "old" pre-1995 lease for a 25-year full repairing and insuring term with full privity of contract provisions and five-yearly upward-only rent reviews, a fixed land price of £400,000 and a development margin of at least 30%. We see that the developed building must let at £5 per sq ft, assuming that an investor will require a 6.25% yield.

In Example 2, we assume a "new" Post-1995 lease for a 15-year full repairing and insuring term with limited privity of contract provisions and five-yearly upward-only rent reviews. With the same land price and development margin we see that the building must be let at £5.63 per sq ft, a 12.6% rise, assuming a 7% yield.

In Example 3, we assume the "newest" post-2001 lease for a 15-year full repairing and insuring term with limited privity of contract provisions and five-yearly upward or downward rent reviews. Again, with the same land price and development margin, we see that the building must be let at £6.06 per sq ft, a swingeing 21.2 % uplift on the "old" lease rent, assuming an investor will accept an 7.5% yield. Note that, if an 8% yield was required in compensation for the possibility of a downward rent review, the initial rent would need to rise to £6.47 per sq ft, a 29.4% uplift on the "old" lease rent.

Of course, the alternative to the increased rent is a reduced land price, but, with one owner-vendor and several potential tenants, it is more likely that rents will be driven upwards rather than land prices downwards for the development to have the viability to proceed. This would be an unhealthy trend, for both developers and their lenders prefer the bedrock of a strong investment market, with firm yields ensuring the viability of a scheme, rather than the risk of having to reach for higher and unproven levels of rent.

### Balance needed

If the government continues to be seduced by the reformers' arguments, it must, in balance, permit landlords the right to possession in preference to accepting a lower rent, and in any event at the end of the lease term. In recent years, some major tenants have exploited the 1954 Landlord & Tenant Act by insisting on five-year renewals on expired 25-year leases, confident that in a court they would succeed. This leads to a large reduction in capital investment values and is an area where I agree with John Gummer that lease reform is needed and free market conditions should apply.

Long-term leases and non-downward rent reviews bring stability to the economy, capital to the property industry and prosperity to the nation, and are a counterinflationary influence. Both government and reformers should recall that through our various savings schemes, we are all landlords.

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