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UPWARD ONLY RENT REVIEWS VERSUS INDEXATION: AN INVESTIGATION INTO THE IMPACT OF DIFFERING MECHANISMS UPON MARKET EFFICIENCY WITHIN THE COMMERCIAL REAL ESTATE SECTOR.

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Caroline Seibel completed her undergraduate degree in 2010 in Real Estate at Nürtingen-Geislingen University in Germany. She then went on to complete a Masters in Real Estate with Distinction at Sheffield Hallam University. She currently works as a Real Estate Consultant for Ernst & Young Munich, Germany. Tony Cheetham is a Principal Lecturer at Sheffield Hallam University. He is a member of the Royal Institution of Chartered Surveyors. His professional practice experience spanned 15 years, prior to joining the university in 2007. This article is based on Caroline's research undertaken for her Masters thesis on Upwards-only Rent Reviews and Rent Indexation supervised by Tony Cheetham.

ABSTRACT

The purpose of this study was to investigate whether the traditional, upward-only rent review clauses in English commercial leases can be replaced by rent indexation. Analysis of the existing literature found widespread criticism of upward-only rent reviews. Most importantly, they represent a disadvantage for tenants and an advantage for landlords. Contrary to this, analysis of the qualitative data, gathered through semi-structured interviews with professionals, showed that property market forces have shifted. This leaves tenants in a stronger negotiation position. A clear trend towards shorter leases and break options as opposed to rent review mechanisms. The evidence within the study suggests that the Codes of Leasing Practice have not had a significant impact on the flexibility of commercial leases. The findings of the study indicate that the Government should not legislate against upward-only rent reviews as this could have major negative impacts on the property market. Indexation was found to be a fair and reasonable option for both landlords and tenants. However, the exclusive use of indexation in commercial leases would lead to a distortion of the property market as the determination of market rents and values would be impossible.

The principal conclusion of this dissertation was that the self-adjustment of the market, which led to a higher flexibility in commercial leases, made a restriction of upward-only rent reviews unnecessary. Moreover, rent indexation is a well-established rent review mechanism in England – a tool whereby both parties can benefit. An exclusive use of indexation in commercial leases though seems most unlikely.

Key Words: Upward-only Rent Reviews, Rent Indexation, Rent Review Mechanisms, Voluntary Codes of Practice

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INTRODUCTION

There has been an ongoing discussion about rent reviews in England ever since they became a standard clause within commercial leases in the late 1960s. In order to maintain a rent which reflects the economic situation, many commercial leases contain a clause stating that the rent will be reviewed in certain periods (commonly every five years) and adjusted to the open market rental value. The “upward-only” part of these clauses has proved to be particularly problematic. In times of economic recession many business tenants have found themselves tied to long leases with upward-only rent review (UORR) clauses. The rents in these leases are, in the majority of cases, higher than the open market rent and therefore often lead to tenants being unable to pay their rent. Consequently, tenants (especially small businesses) claim that the use of these clauses is unreasonable. Landlords, on the other hand, wish to maintain the secure income flows. They advance the view that a ban of UORRs will lead to a decrease in investment and lending activity as (overseas) investors will not regard UK investments as secure and reliable anymore. With UORRs, investors have a secure income stream for at least five years and can calculate with not less than that income for the remainder of the lease term. This is one of the factors that make UK commercial property an interesting and potentially lucrative investment opportunity.

At the time of writing, the Government has not established legislation on the management of commercial leases in the UK. However, several Codes for leasing business premises have been introduced over the previous 20 years in order to give a guideline for commercial leases (for both landlords and tenants) and to get a picture of the industry’s opinion of UORRs. As an alternative to the voluntary Codes, the Government could legislate against UORR clauses in commercial leases. However, this might either lead to higher initial rents (an uplift of between 5% and 16% should be applied according to Ward et al. (1998)) as landlords and investors aim to maintain the value of the property / investment, or even to more leases being contracted out of the 1954 Landlord and Tenant Act to preserve the upward-only clauses at lease renewal.

At the start of 2010, the Irish Government banned UORRs for commercial leases in Ireland. Analysis of newspaper articles shows the multiple effects this prohibition had on the Irish property market and the economy in general. In Ireland, UORRs were banned for leases coming into effect after the 28th of February 2010. This created a two-tier market as leases which came into effect before that date (and contained an upwards only rent review clause) significantly gained value for investors. Therefore, it is not only important to discuss the question of whether upward-only clauses should be abolished, but also how they should be banned and what consequences a legislative intervention could have.

In Germany, many commercial rents are subject to the adjustment to an index (so-called “index-linked rents / rent indexation”). Lease clauses provide for the rents to be adjusted in regular intervals according to a certain index. In most cases, this index is either the RPI (Retail Price Index) or the CPI (Consumer Price Index). However, as commercial leases in Germany are not subject to many statutory provisions, any index can be agreed between landlord and tenant. This leads to the question of whether a property index could be used to adjust commercial rents according to the overall movement of the property market, rather than a measure of inflation. It seems likely that adjusting the rents to a property index leads to a more precise reflection of the market activity. Having been established for more than 30 years, and with a market coverage of 55% the IPD (Investment Property Databank) property index in the UK is far better established and more sophisticated than its German counterpart. This was established 16 years ago and only enjoys a market coverage of 17% (IPD 2011, pp29 and 45).

LITERATURE REVIEW

In their research relating to the changing patterns of commercial leases, Hamilton et al. (2006) outline some of the advantages of upward-only lease clauses. Not only is the income stream between reviews comparable to a conventional bond, that is fixed in nominal terms and therefore prone to inflation (p34), but also are the returns linked to levels of economic activity. Consequently, property assets have equity features without the risk of a fall in nominal income (p34). In their research about the impacts of UORRs on commercial property lending, Maxted and Porter (2003) outline further that the long term positive cash flow (due to average lease lengths of around ten years) leads to high levels of debt provisions from banks as these leases are considered to be very secure (p1).

In 2004, the Office of the Deputy Prime Minister (ODPM) issued a paper which discussed different options for deterring or outlawing the use of upward-only rent review clauses. It was stressed that a decisive advantage of UORRs is that they sustain capital values and hence investment in property (p5). This is due to the fact that UORRs provide a guarantee for the rent not to fall at any time over the term of the lease.

In the summary of responses to the ODPM Consultation Paper on Upward Only Rent Review Clauses in Commercial Leases (2005), it is stated that UORRs are a key feature of property income security as they reduce uncertainty for investors, developers and landlords and are therefore “*underpinning the attractions of property as a long-term investment class*” (p6).

However, tenants seem to be disadvantaged by these clauses. According to the OPDM, tenants are at a competitive cost disadvantage, especially in a falling market, as an UORR clause maintains the rent at the existing levels, whereas new entrants to the market are paying less rent (ODPM 2004, p4). In an extreme case, the “*rigid application of UORRs in a falling market can put the tenant out of business*” (ODPM 2004, p5). Retail tenants in particular face these disadvantages as their turnover is likely to decrease in a recession with the rent maintaining its level. Furthermore, it is outlined in the summary of responses to the OPDM (2005, p4) that UORRs not only produce higher costs in a low inflation environment, and therefore give rise to inflationary pressure, but also inflate property prices and consequently distort investment choice.

Full lease term on all leases
(Ignoring any breaks)

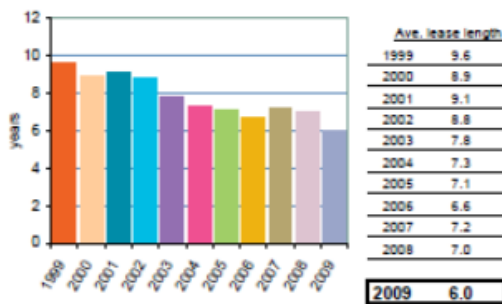


Taking breaks into account
(Period to expiry or first break)

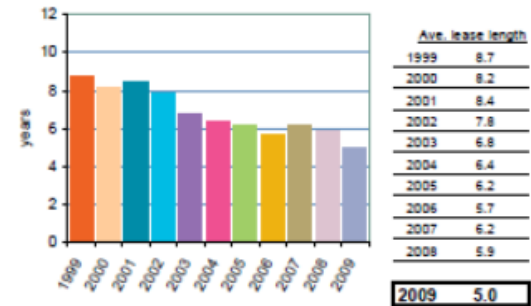


Equally Weighted

Average Lease Length



Average Lease Length



Excluding short leases

(Period to expiry or first break on all leases excluding those under 4 years and licenses)
BPF/IPD Basis

Average Lease Length

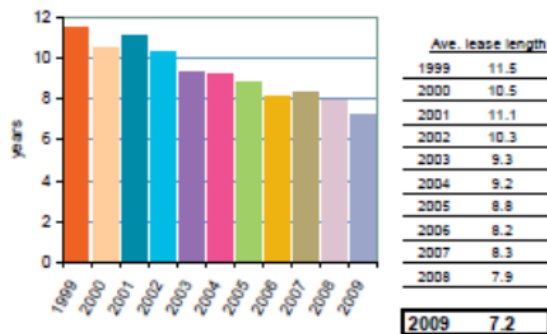


Figure 1: Headline Average Lease Length for All Property (BPF IPD Annual Lease Review 2010, p4)

At this point, it is also worth noting that over the past couple of years, the average lease length in England has decreased considerably.

Figure 1 shows that the average lease length fell from 8.7 years in 1999 to 5.0 in 2009 (taking breaks into account). Consequently, it can be argued that the market will further regulate itself which in turn could make a legislative intervention unnecessary.

In their research, Maxted and Porter (2003) examine the impact of banning UORRs on commercial property lending. It is outlined that by outlawing upward-only clauses, it is likely that a greater risk would be attached to commercial property loans as the investment would lose the long term security of income. As a consequence, more equity would be required by the lending organisations thereby reducing the actual value of loans (p1).

Furthermore, it is outlined that lending is likely to be concentrated on experienced borrowers who will need more time, money and patience, as well as less risk adversity to close a deal (p20).

A report to the British Property Federation (a membership organisation devoted to representing the interests of all those involved in property ownership and investment) conducted by Cass Business School (Key and Almond 2004), which also analysed the impacts of banning UORRs, came to the conclusion that the introduction of up and downwards (two-way) rent reviews would lead to a cut in the allocations to property in institutional portfolios of between 2% and 5% (p1). In this study, the results are derived from an income simulation and several option pricing approaches. It is concluded that a ban on UORRs would lead to *“a general increase in risk and uncertainty attached to rental income streams”* (p15).

Moreover, the BPF responded to the Consultation Paper of the ODPM (BPF 2004), stating the negative consequences of a ban of upward-only clauses. Surely, however, as this organisation represents the interest of property owners and investors, it would not be unreasonable to assume an unfavourable bias towards an abolishment of UORRs? This would reflect the view that development and regeneration would be negatively impacted, attaching more risk and therefore attracting less investment, according to the BPF (p2). The Federation also claims that the ban would not only change the risk – return profile of property as an asset, manifesting itself through less capital being invested in the industry, but it would also lead to poorer terms for lending to the property industry (p2). Higher interest rates, shorter terms, and lower loan-to-value ratios seem likely to be predominant in the market according to the BPF’s study. As a consequence of the raising of finance for commercial property projects being more difficult and expensive and with fewer lenders being prepared to provide finance, the overall regeneration activity could be reduced (p20).

According to the ODPM Consultative Paper – Summary of Responses (ODPM 2005), property owners and investors go as far as claiming that a ban would damage the whole UK economy, affecting not only domestic and foreign investment, but also development and regeneration (p8).

Apart from these arguments, which do not favour a ban of UORRs, the summary of responses to the ODPM Consultation Paper outlines the advantages of a legislative abolishment. Most importantly, a ban would ensure a more equitable sharing of the risk of holding property between landlords and tenants (ODPM 2005, p7). The current use of UORRs obviously puts the tenant in a disadvantage. The landlord profits in a boom as the rents increase according to the increase of the open market rental value and he also profits in a recession as the rents can only go upwards. Consequently, favourable voices to the ban claim that the abolition would help to make *“the property industry more responsive to market factors, helping to eliminate the boom/slump cycle”* (ODPM 2005, p7).

The English Government is aware of the negative impacts of UORR clauses in commercial leases. For that reason, three Codes of leasing business premises have been published since 1995. Research conducted by Cathy Hughes and Neil Crosby of the University of Reading (2010) outlines that many in the industry see *“the whole code concept as ineffective and unlikely to ever achieve changes to certain aspects of landlord behaviour”* (abstract). It is also stressed that the first Code of practice, published in 1995, was poorly disseminated (p3). Neil Crosby and Sandi Murdoch (RICS 2000) monitored the impact of the 1995 Code of Practice. Their report states that not only do small business tenants rarely fully appreciate the implications of an UORR clause (p1), but also that only 14% of tenants are aware of the existence of the Code, of whom the majority were professionally represented and were not small business tenants (p7). Consequently, the 1995 lease Code was a *“complete failure”* (p7).

The second Code of practice, published in 2002, had a better impact than the 1995 Code. However, Crosby and Hughes (2010) put emphasis on the fact that the *“dissemination of the second code was better, but not seen to be directly influencing leasing negotiations or practice”* (p3). Consequently, the Governments’ aim of increasing the awareness of the Codes and therefore of alternatives of UORRs, was not achieved. The BPF assigned the blame on the occupiers as *“the majority of businesses that signed new leases containing UORRs were offered alternatives, but most occupiers turned them down on the basis that they were most expensive”* (Davey 2003). The BPF also claimed that there is a disparity as tenants wish to be offered more flexible leases on the one hand, but on the other hand reject them as they are unwilling to pay the price for it (Davey 2003).

In order to improve the flexibility of commercial leases, increase the awareness of the Codes and to avoid legislative intervention, the Government published a third Code in 2007. Even though the 2007 Code of Leasing Business Premises aims to encourage more flexibility with commercial leases, the research to monitor the dissemination, awareness and use of the 2007 Code (Crosby and Hughes 2009) shows that it has *“failed to reach small businesses and the improvements in the dissemination and awareness of the 2002 code over the 1996 edition has clearly stalled”* (p29).

The analysis puts emphasis on the fact that the Governments’ aim of increasing the flexibility of commercial leases has not been achieved with any of the Codes. Consequently, the impacts of a legislative intervention have become a focal point of interest.

In Ireland, the application of UORR clauses is prohibited for all leases signed after the 28th of February 2010. The legislative intervention was as highly debated in Ireland, as it is in England. Surprisingly, one argument was not discussed before the coming into effect of the law, even though its development seems logical. Due to significant legal difficulties, the law could not be applied retrospectively to existing lease contracts (Hancock 2009). Consequently, the legislation provided *“little financial relief for those businesses in greatest difficulty as a result of their existing tenancy arrangements”* (Rent Reviews 2010). This formed a **two-tier market** which led to less demand for old leases tied to UORR clauses which in turn led to a significant decrease in the value of the lease.

As a result, when it comes to an abolishment of UORR clauses in commercial leases, the main focus of attention should not only be on the impacts on the financial sector, but also on the property sector in general. Furthermore, the example of Ireland shows that a possible legislative intervention has to be thoroughly analysed before eventually implementing it.

Having examined the problems attached to the use of upward-only clauses in English commercial leases, it is now imperative to consider potential alternatives to UORR clauses. As the adjustment of rents to an index is the most common rent review mechanism in Germany and is widely accepted in the German property market, the main focus of this study will be the application of index-linked rents. The most commonly used indices in commercial leases are the CPI and the RPI. As this is a measure of inflation, it might cause rents to change disproportionately as inflation and the property market do not always move in parallel. Consequently, rent indexation linked to a property index could possibly best reflect the open market rent for commercial property leases. However, *“the lack of a single, definitive property market index, and the differences in the indices that do exist, have led to confusion from both within and outside the property industry”* (Morrell 1991, p36). A “Tracker-Index” is needed as a basis for an indexation in commercial leases which is related to the property market. This index should be representative of the overall market and should contain a sufficiently large sample of properties in order to not be influenced by the effects of individual stocks (Morrell 1994, p17). The fact that valuations are usually used for the construction of property performance indices creates fundamental difficulties (Morrell 1991, p35). Not only do potential differences exist between valuations and actual sale prices, but also are reported returns likely to overstate true returns.

English property indices are, especially compared to other countries, very sophisticated. However, research has to be conducted in order to outline their strengths and weaknesses and to establish potential for improvement of English property indices.

ANALYSIS

To analyse the research question further, interviews with professionals of the property sector in Yorkshire (Leeds and Sheffield) and Manchester have been conducted. Figure 2 shows the location and role of the interviewee and the form of the interview. Apart from one interview, all interviews were

conducted face-to-face in order to extract as much information as possible. As anonymity and confidentiality have been granted to the interviewees, no names or company names will appear in this paper. Numbers were allocated to each interviewee to quote them correctly in the following.

Interviewee	Role	Location	Form of the Interview
I1/I2	Investment	Leeds	Face-to-Face Interview
I3	Lease Advisory	Leeds	Face-to-Face Interview
I4	Investment	Leeds	Face-to-Face Interview
I5	Lease Consultancy	Leeds	Face-to-Face Interview
I6	Lease Consultancy	Leeds	Face-to-Face Interview
I7	Investment	Leeds	Face-to-Face Interview
I8	Lease Advisory	Sheffield	Face-to-Face Interview
I9	Lease Consultancy	Manchester	Face-to-Face Interview
I10	Lease Consultancy	Leeds	Interview in Writing

Figure 2: The Interview Sample

With the aim of analysing the data as thoroughly as possible, the interviews were sectioned into three main blocks: 1) upward-only rent reviews, 2) the role of the English Government and 3) Indexation.

Upward-only Rent Reviews

In order to understand how professionals perceive upward-only rent reviews and ascertain their level of experience, the interviewees were asked if they had any experience with UORRs. To begin with, all participants pointed out that almost every rent review they dealt with contained an upward-only clause and that upwards and downwards rent reviews are a very rare entity in English commercial leases. Interviewee I6 pointed out that upwards and downwards rent reviews would completely change the commercial property landscape as tenants would have to be prepared to pay more rent initially - around 10% - due to the fact that a lease without an upward-only clause is more risky for the landlord or investor.

When asked if the interviewees considered UORRs as a positive or negative instrument, that is if either landlords or tenants are disadvantaged by these clauses in commercial leases, the answers were not as straight forward. Depending on their respective representee (landlords, tenants in addition to investors or developers), the answers of the interviewees diverged. Generally, all interviewees were of the opinion that upward-only clauses are negative from a tenant's viewpoint and positive from a landlord's perspective. The participants outlined several reasons why UORRs are beneficial from a landlord's point of view:

- Provide certainty for the landlord
- Commercial property with a secure income stream can be bought and sold like a bond
- Give landlord security that rents will not go down
- Protect the investment value
- Help the investment market flow as it competes with other asset classes.

On the other hand, depending on the state of the market, upward-only clauses are a disadvantage for both landlord and tenants.

"In a rising market, landlords are disadvantaged because they can only ensure that their rental income keeps pace with open market values every three or five years depending upon the frequency of the rent review period. In a falling market, tenants are disadvantaged by having to pay a high rent fixed when economic conditions were stronger that doesn't take account of subsequent rental decline" (I10).

Furthermore, I4 summarised the positives and negatives of UORRs as follows:

“From a tenant’s point of view it is a devilish product – why should they pay more than the property is worth because of the rigid system. But being realistic, even a tenant wants buildings of a certain standard and certain specifications and the landlords’ investment numbers or development numbers stack up against the presumption of UORRs and that’s really what underpins the UK investment and development market. Without it we would be in even greater difficulties than we are now in terms of the development pipeline as the numbers just wouldn’t stack up.”

So even though upward-only clauses seem to be generally negative for tenants and positive for landlords, they are still a basic feature of commercial leases in England. This is likely to be caused by two main reasons. Firstly, landlords are more often represented by professional bodies and are therefore better informed and more aware of the market. Many tenants don’t even know that alternatives exist and are therefore happy to accept what is being offered to them. Secondly, traditionally the landlord has had better negotiating powers; he has been able to dictate the terms of the lease.

However, more recently, this balance of power has shifted. Consequently, with more availability of stock, the tenants gained more negotiation power. Nevertheless, the professionals’ opinion relating to the shift of negotiation power is divided. I7 emphasised that “landlords are still in the driving seat”, whereas I6 pointed out that “the landlord’s got no negotiating position in most cases at the moment” and therefore “has got to take what he can get” (I1/I2).

From this shift in the balance of power – however big it is – two major trends in commercial leases emerged: firstly, the traditional 25-year lease is hardly ever granted anymore; shorter leases with a five year period and a lease renewal after five years are more common, which is effectively an upwards-downwards review (I9). Indeed, instead of alternative rent review mechanisms, tenants tend to push forward break options. Even though this is potentially a disadvantage for landlords, it is also a fairly high-risk strategy for tenants, as using a break option, simply to negotiate a rent reduction, requires more thought and effort from the tenant and possibly the valuation of alternative premises.

Consequently, even though most people are aware of the fact that UORR clauses represent a disadvantage for tenants, a change in people’s perception does not seem likely. Many of the participants in this study stressed the fact that upward-only clauses are simply part of the English commercial lease tradition and therefore people want to sustain them. However, the tenants’ lack of knowledge about alternative rent review mechanisms seems to be a major problem.

Role of the Government

As outlined in the literature review, the Government issued three Codes of Leasing Practice since 1995. When asked about the impact of these Codes on commercial leases, the interviewees’ opinions were divided. Some of the participants were of the opinion that the voluntary Codes did have a positive impact. I6 stressed that they “*caused shorter leases. (...) The Codes did have an impact on the flexibility of leases*”. And I3 added that “*generally, landlords do think about the Codes*”. Moreover, I10 was of the opinion that “*it has made some of the larger, well-known landlords realise that the landlord and tenant relationship is a partnership and the latter need to succeed to ensure the continued profitability of the former*”. Contrary to this however, the interviewees pointed out that as long as the Codes are not compulsory, they will have less of an impact than it was hoped to have.

“I don’t think it [the Codes] was inventing anything that didn’t already exist. I don’t think it particularly achieved or delivered anything that wasn’t already within the industry”. (I4)

I8 hazarded the guess that around 80% of the people who are looking to take a lease have probably not cast their eye across the Codes. According to this section of the participants, this is due to the fact that most of the time agents are acting for landlords and the documents are essentially to help the tenants. Consequently, the general lack of knowledge of the tenants has a negative influence on the impact of the Codes of Practice.

Furthermore, several interviewees pointed out that the increasing flexibility of commercial leases has not been caused by the Codes but by market conditions. Accordingly, the market regulated itself and became more flexible with shorter leases and break clauses. Yet, I5 pointed out that “*if the market gets stronger for landlords again, they will be less willing to grant flexible lease terms*”. Consequently, it needs to be noted that several participants were of the opinion that the voluntary Codes did have an impact on commercial leases. The extent of that impact and the role of market forces and its self-regulation cannot be measured. However, the reduction in lease length over the last 20 years as well as the improved flexibility in leases, with break clauses and rent-free periods, certainly reduces the difficulties of upward-only rent reviews.

There almost was an unanimous agreement from the interviewees that the Government should not ban upward-only rent reviews. There were a number of explanations for this.

“The Government just putting a ban on it would have a catastrophic effect, especially in the current market. It needs to be brought in slowly, not with legislation; this would cause more confusion than anything else” (I8)

Apart from the confusion a possible abolishment could cause, many professionals were of the opinion that the market is capable of regulating itself. The increased flexibility in lease terms made upward-only clauses effectively redundant. Hence, there is no need for legislation against these clauses. Only one participant was in favour of the Government banning upward-only clauses as *“there would be more rent review work - from a surveyor’s point of view – because at the moment rents are not contested. Without UORRs, rents could go upwards and downwards”* (I6). However, this professional also stressed that a ban would cause problems to the investment market.

Even though the professionals mostly agreed on the fact that the Government should not ban upward-only rent reviews, they were still asked about potential impact and effects that this ban could have.

Three major effects were identified by most of the participants:

- Increase in yields
- Decrease in values
- Two-tier market

A ban on upward-only rent reviews is likely to cause higher yields as the investment per se becomes more risky. The security of the income stream is not guaranteed anymore. Depending on the alternative rent review mechanism, rents could go up and down instead of upward-only, or be linked to an index. This additional risk is likely to be reflected in higher yields.

Moreover, a ban would probably have an impact on the general demand for property and therefore the overall attractiveness of property as an investment. Consequently, a ban could lead to a significant fall in property values due to an imbalance of demand and supply in the market place. As outlined in the literature review, the Irish Government considered banning UORRs retrospectively. According to I10, the IPD has predicted a 20% drop in values if upward-only rent reviews are abolished retrospectively. This prediction is likely to be applicable for the English property market, too.

At least in the short term, a ban of UORRs could lead to a two-tier market, with assets with long leases and UORRs being more valuable than assets with an alternative rent review mechanism. However, most of the professionals agreed that the impacts and effects of a potential ban would only be short-term as the market will readjust eventually.

Indexation in English Commercial Leases

When asked about their experience with indexation as a rent review mechanism, all interviewees stated that they have little experience. However, I1 and I2 pointed out that it is growing as *“pension funds are after RPI increases because of the ageing population”*. The continuing increase in older people leads to a draw on the pension pots. Consequently, pension funds use indexation in order to have a constant and secure increase in rents. Some participants commented that even though professionals do not deal with indexation on a daily basis, it does not mean that it does not exist as a rent review mechanism in England. If it is an index-linked review then usually the landlord will simply inform the tenant about the change in rent; a professional is not needed in most cases.

No general consent could be determined about the question of whether indexation constitutes a positive or a negative instrument. I2, I2, I3 and I7 agreed that it provides certainty for both landlords and tenants.

“It gives you security from a tenant’s point of view. Rents will increase but only in steady amounts and you can budget for it. (...) For landlords it’s also positive, they know for a fact that even in a worsening market they get an increase, whether it’s a small or a big one.” (I8)

Moreover, it was added by I7 that indexation is especially positive for small investors or tenants as they do not have to understand the property market. The respective index will deal with it and the investor has a guaranteed growth.

On the other hand, indexation has disadvantages, too. As previously discussed, the most significant disadvantage of UORRs is the fact that rents can only go up or retain their level, even in a downturn of the market. I6 put emphasis on the fact that indexation is even worse as rents will always go up, unless there is a deflation. Moreover, four participants agreed with I10 stating:

“It depends upon the state of the market. It gives both parties a degree of certainty, but would (a) lead to a tenant perhaps paying more than open market value during a recession and similarly (b) could mean that a landlord would be unable to secure the full value in stronger economic conditions when rents are out-pacing general inflation.”

With regards to the sector in which indexation is predominantly used as a rent review mechanism, three sectors were mentioned most frequently. First of all, student housing and the hotel sector (especially budget hotels) commonly use indexation. This is done for two reasons. These developments are usually purpose build and as a consequence, the developers and investors need long leases in order to secure the income. With RPI increases, the asset will perform in line with the RPI and the rent will therefore, as long as there is no deflation – steadily increase. Secondly, there is a lack of evidence of open market transactions for rent reviews with Halls of Residence and Budget Hotels. Thus, indexation is used to avoid the lack of comparable evidence needed for open market rent reviews.

The second sector where indexation clauses are frequently used is the retail sector as the retailers’ *“business plans are more closely aligned to indexation rises”* (I4). Moreover, according to I4, retailers can usually afford to take inflation-based rent review clauses as they do not get obsolescence in retail buildings. I3 stressed an important point, which was agreed upon by five other professionals:

“It’s more about the actual property, not sector linked, more the kind of property and the market around it, if it’s unusual building or a lack of evidence”

Consequently, with more obscure property, where comparables are missing and therefore open market rent reviews are not feasible, indexation is a well-established alternative.

When asked whether the interviewees consider rent indexation as an alternative to upward-only rent reviews, most of them agreed that indexation has been - and will remain to be - an option. Banning UORRs and replacing them exclusively with rent indexation could lead to a lack of understanding of the “correct” level of the market rent. I6 and I7 agreed that as the rents would no longer be linked to the actual market, but to an index (which is currently an inflation-based index in most leases), it would be difficult - if not impossible - to understand and estimate the movements of the market, given the reliance upon retrospective data relating to wider business cycles, rather than the property cycle itself. All interviewees considered indexation as a fair alternative (as long as both parties are well-informed) as *“it is a mechanism which both parties can use to create value”* (I4).

CONCLUSION

The most important finding of this study is that there is no clear ‘YES’ or ‘NO’ answer to the research question. This initial conclusion can be derived through analysing the conclusions relating to the single “blocks” of data analysis.

In the literature review it was emphasised that the replacement of UORRs would lead to a higher risk attached to property as an asset class, as the long term security of income would be lost. This would make property as an investment significantly less attractive. The interviewed professionals, especially those working in investment agencies, agreed to these findings, putting emphasis on the imperative impact that pension funds as investors have on the UK property market. If property lost its security as an asset, pension funds are likely to lose their solid standing within the UK economy. Consequently, the replacement of upward-only rent reviews could not only have a significant impact on the property market, but also on the UK economy on the whole. However, the interviewees were also of the opinion that tenants tend to be disadvantaged by UORRs in commercial leases.

The attitude of the interviewed professionals towards the Codes of Practice also corresponds with the findings in the literature review. The Codes did not have a significant impact on the commercial lease practice and alternatives to upward-only rent reviews are offered according to the state of the market and the respective negotiation positions of the parties. Many professionals (especially landlords and their representatives) are aware of the Codes, but do not consider them a helpful tool for lease negotiations.

With regards to a potential legislative intervention to ban UORRs, this is considered to be negative – both in the literature review and amongst the interviewees. The example of Ireland shows the negative effects a ban could have. Several interviewees stressed that the market is best left to adjust itself as a legislative abolishment could have unforeseeable consequences which could further distort the market. With the creation of two kinds of leases – leases before and after the ‘due date’ – a retrospective ban could create significant legal problems.

When discussing rent indexation in England, the interviewees considered retaining upward-only rent reviews to be the most preferable option, especially for certain sectors and properties. However, it was also agreed that indexation should not replace open market rent reviews as the tracking of an inflation based index does not reflect market rents. Consequently, the exclusive use of indexation as a rent review mechanism could lead to a distortion of not only values and rents, but also of the property market in general.

Two very interesting results of the study can be determined. Firstly, all interviewees agreed that the property market already adjusted itself. The traditional 25-year lease with five yearly rent reviews has been replaced by shorter leases with a term of typically five to seven years. Moreover, due to the state of the economy, the negotiation position of landlords and tenants has changed, leaving the tenants in a stronger position. Also, as outlined in the literature review, tenants generally do not seem to favour an abolishment of UORRs. Even now, being in a very strong negotiation position, they prefer upward-only rent reviews over a ban or rent indexation. This might be due to the fact that landlords usually offer lower initial rents with upward-only clauses which are an incentive for tenants.

In summary, it can be noted that rent indexation is a fair and reasonable alternative to UORRs. The continuing trend towards shorter leases definitely makes a legislative intervention by the Government unnecessary though.

Limitations

There are a number of limitations within this research paper which need to be considered in order to put this study in context.

Firstly, the time and resources available to the researcher were limited. Even though saturation of knowledge was observed by the researcher after ten interviews, the sample is nevertheless small.

Moreover, as the study relies heavily on the opinions expressed by these ten interviewees, the generalisations could be constrained

Furthermore, the findings of this study could be biased as it is possible that the interviewed professionals generally do not favour open market rent reviews to be replaced by indexation. Landlord and tenant surveyors in particular could consider a potential ban of upward-only rent reviews as a threat to their job. Hence, a degree of bias could be expected from the interviewees as they have a vested interest in protecting their own livelihoods. However, all interviewees seemed to give honest answers as they are of the opinion that the market adjusted itself and therefore, a ban of UORRs is not necessary.

Another limiting factor could be that the interviewed professionals represent different clients: landlords, tenants and investors or developers. Accordingly, the expressed opinions could have been dependent on the respective representee. However, as it was the aim of this study to examine the research question as thoroughly as possible, a variety of different opinions due to the respective representee, can only increase the value of the research findings.

Furthermore, the geographical limitation – with interviews only being conducted in Yorkshire (Sheffield and Leeds) and Manchester – means that the research findings cannot simply be extrapolated on the UK property market in general.

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