THE CONTRIBUTION OF UPWARD-ONLY RENT REVIEWS TO THE VALUE OF UK PROPERTY

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March 1995

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Key words: upward-only rent reviews; value of UK commercial property; valuation; risk; institutional investment

THE CONTRIBUTION OF UPWARD-ONLY RENT REVIEWS TO THE CAPITAL VALUE OF COMMERCIAL PROPERTY IN THE UK

1. Introduction

1.1 Aims and objectives

The UK recession of 1990-1993 created a lobby among occupiers of property, especially retail
tenants, which argued strongly during the later part of that period that the standard institutional lease had become unfairly advantageous to landlords. A report by the Adam Smith Institute (Burton, 1992) supported this view, and political support for change emerged.

In Summer 1993, the government, through a consultation paper issued by the Department of the Environment, asked for responses to proposed changes to the legal framework affecting the leasing of commercial property. The first proposal was to make upward-only rent review provisions illegal.

This in turn led to a strong response from institutional property owners, including bodies such as the Association of British Insurers. Commercial property is a very valuable national asset, which serves as the security for much of the nation's pensions and savings. Abolition of the upward-only rent review clause would, it was argued, create significant damage to the value of this asset base.

The overall aim of this paper is to provide a response to the hypothesis that the removal of upward-only rent reviews (sometimes known as ratchet clauses) will reduce property asset values. The paper also seeks to estimate the amount of the reduction. It argues that the fall in the capital value of commercial UK investment property will be a function of changes in risk/return characteristics which, when set within the framework of the current leasing structure and the expected cash flow determined thereby, manifests itself in changes in investment yields. Because the property market generates fewer transactions than some other capital markets, and because valuations are used as a surrogate for transactions when compiling property market data and indices, the way in which valuers approach investment property valuations in practice will also influence the perceived value loss caused by any change in legislation.

The paper identifies the likely level of change in investment yields for the major UK commercial and industrial property types, examines the current leasing structure of those properties and investigates the current application of valuation techniques to these structures. This facilitates the construction of a valuation model of the commercial and industrial property investment market.

1.2 Background

1.2.1 Market

Commercial property in the UK has a value which has been estimated at £250bn (Currie and Scott, 1991). With an equity market worth approaching £500bn and a gilt market worth nearly £200bn, this places the value of the commercial property at between 25 and 30 per cent of the value of the mainstream investable assets of the UK. Recent work (McWilliam, 1992; Baum and Schofield, 1991) has served to reinforce the importance of commercial property to the economy as well as to institutional investors and, through this medium, to the general public.

Over the last 30 years there have been two major recessions in the commercial property investment market in the UK. The first occurred in the early to middle 1970s when commercial and industrial property capital values measured by Hillier Parker fell by 22 per cent between May 1973 and May 1974. They had recovered their 1973 level by 1977. The all property rent index continued to rise throughout the same period. Because of the high inflation rate, real losses in value during this period were substantially higher, with the real capital value index falling by 33 per cent and 19 per cent in the year to May 1974 and May 1975 respectively and the real rent index falling by 18 per cent, 12 per cent and 11 per cent each year between May 1974 and 1977 (Hillier Parker, 1993). Figure 1 shows the level of the Hillier Parker rent index from 1972 to 1994; figures 2 and 3 show yields and capital values respectively.

Figure 1: UK commercial property rent index, 1972 - 1994

Source: Hillier Parker

The second major property recession since the early-mid 1970s dated from late 1989/early 1990 and produced longer lasting but lower real annual falls in value. (Real capital values fell by 13 per cent, 20 per cent, 15 per cent and 12 per cent each year between May 1989 and May 1993, an average of over 15 per cent each year.) However, it created more substantial nominal falls in value than in the 1970s due to the significantly lower inflation rate (an average fall of nearly 11 per cent each year over the same four years).

These falls have been the product of reductions in rental values coupled with rises in capitalisation rates. The all property rent index fell from a peak of 517 in May 1990 to 379 in May 1993, a reduction of almost 10 per cent each year over the three years. The average yield of the all property index rose from a low of 7.2 per cent in May 1989 to a high of 9.2 per cent in May 1993.

Figure 2: UK commercial property average yields, 1972 - 1994

Source: Hillier Parker

Figure 3: UK commercial property capital value index, 1972 - 1994

Source: Hillier Parker

By 1995, the rent index had not yet regained its 1990 level and, given the outlook for lower inflation, was not expected to do so in the short term (Baum and Crosby, 1995a).

1.2.2 Lease structures

Although rental and capital values have fallen, the actual rents produced by many properties let on existing leases during the 1980s and the early part of the 1990s have not fallen. This is due to the nature of the institutional lease which dominates the landlord and tenant relationship in the UK and in particular the standard upward-only rent review.

The institutional lease describes the standard form of agreement entered into between institutional property owners and tenants in the UK (albeit through market practice, rather than regulation). It is unusual in several respects; perhaps the two most notable qualities are the typical length of lease, 15-25 years, and the rent review provisions, which almost always suggest that rent will be reviewed to market levels very five years but that *the new rent cannot be less than the previous rent*. This 'upward-only rent review' clause is unusual and in combination with the long lease produces a unique form of asset class. Its importance has been well illustrated in the very recent past.

By the end of 1992, 60 per cent by capital value of the property assets which make up the main Investment Property Databank universe were let on leases which had over 15 years to expiry and a significant number of these properties were let at rents which exceeded the current open market value. At this time 29 per cent of retail property, 51 per cent of offices and 36 per cent of industrial property were 'over-rented', that is the passing or contract rent exceeded the estimated rental value. In the City of London office market, the number of properties which were over-rented rose to 84 per cent, with the average level of over-renting now as high as 82 per cent (IPD, 1993).

This created a two-tier market. The expected income stream from substantially over-rented buildings let to good covenant tenants had become a fixed cash flow, underpinned by the upwards-only review, until rental values were expected to overtake the contract rents. The rest of the market, where properties were let at rack rents or less (or were vacant), were examples of the traditional UK view of property investment as an equity asset whose value was largely dependent upon future, uncertain growth.

For the first time tenants, who had easily accepted upwards-only rent reviews in a rising market, reaped the disadvantages of being tied into a long lease at an excessive rent. While new tenants were able to demand lower rents and substantial incentives including rent free periods, shorter leases, break clauses and capital payments, existing tenants were locked in with little prospect of being able to persuade the landlord to release them from their obligations and no prospect of a rent reduction at the next review.

Against this background, pressure mounted on the UK government to legislate on aspects of the commercial lease with the outlawing of upwards-only rent reviews as a primary target. Burton (1992) appeared to influence the subsequent consultation paper which was issued by the Department of the Environment on May 27th 1993. The consultation paper discussed upwards-only reviews and asked (inter alia) for evidence of value change if upwards-only reviews were outlawed. This paper sets out to provide evidence of the CONTRIBUTION

OF UPWARD-ONLY RENT REVIEWS TO THE CAPITAL VALUE OF UK COMMERCIAL PROPERTY.

1.3 Methodology

The paper utilises the results of three pieces of work.

First, a questionnaire survey carried out by Corporate Intelligence Group (CIG, 1993) was aimed at investors and advisors represented by the membership of the Investment Property Forum. It was sent to 555 institutional investors, property companies and specialist property investment advisers in July 1993. A response rate of over 27 per cent (151 replies), claimed to represent ownership of at least £39bn of property value, was achieved.

Second, interviews were carried out with professionals who determine the quantitative methods adopted to appraise property investments (actuaries and valuers). In total, representatives from seven firms of actuaries, five actuaries working in insurance companies and eight firms of surveyors and property consultants were interviewed. Valuers were interviewed because they will have a direct impact on the value of commercial property following the changes; actuaries were interviewed because they directly influence the institutional investor and, indirectly, the value of property.

Third, the Investment Property Databank (IPD) was commissioned to provide a set of data relating to the lease expiry dates and ratio of rental value to rent passing on properties within its database, broken down by sector (offices, shops and industrials).

This data and the CIG survey were used to provide a framework for an analysis of the likely change in values of commercial and industrial property resulting from the outlawing of upward-only rent review clauses. The analysis also utilises the opinions of the valuers and actuaries interviewed. The conclusions drawn were founded upon the valuation model of the investment property market constructed by the authors for the purposes of this research and described in Section 2.

2. The upward-only rent review: rental and capital valuation issues

2.1 Introduction

Valuation is the technique of assigning a value to a property. This process is especially important in a market where very little transaction-based evidence actually exists to establish value and where the valuation itself arguably has an effect on the transaction price (Crosby, French and Ward, 1993). How valuers value investment property and how they perceive that values will change is therefore an important indicator of what will actually happen in the commercial and industrial property market if there is a shock to the market.

In order to assess the likely impact on the capital values of investment property, the authors have constructed a model which reflects valuation methods used in practice based on research carried out over the last five years (see, for example, Baum and Crosby, 1995b: Crosby, 1991; Crosby and Goodchild, 1992) and a series of eight interviews with leading valuers in September 1993. The interviewees represent a number of the leading surveying and valuation practices in the UK, and interviewees were at a very senior level within those firms.

The results of the CIG survey have also been built into the model to provide a detailed analysis of value impact resulting from likely yield changes for a variety of existing lease structures. The sample of lease structures is chosen to act as a representative sample of the UK market proxied by the universe held by the Investment Property Databank (IPD).

2.2 Valuation theory and practice

In UK valuation practice, simple investment property is traditionally and typically valued by discounting the current rental value in perpetuity at a single capitalisation rate (the equivalent yield or the all risks yield). Full details are provided in Baum and Crosby (1995b).

The practice of valuation of investment property in the UK was the subject of a comprehensive survey in 1988/89 (Crosby, 1991). This survey revealed that valuers experienced in the property investment market (and therefore carrying out the most valuations of the most valuable property) typically used a horizontally sliced layer technique. This model is based upon the assumption that the rent passing under a lease is a known quantity and, if the lease has a number of years to go before expiry, it can be assumed that the rent will continue into infinity (perpetuity). In a rising market, the assumption that the rent will never fall below the rent passing was perceived to be a very safe assumption.

Given the prospect of lower inflation and the lessons learned by valuing in over-rented markets, it is suggested that layer methods should begin to be replaced by vertically-sliced 'term and reversion' approaches. The outlawing of upward-only rent reviews would re-inforce that change, as the concept of the minimum protected rent layer would no longer be appropriate. In addition, the use of a vertically-sliced technique permits
a more explicit treatment of the likely effect on discount rates of any future change in leasing practice. (For an explanation of these valuation methods, see Baum and Crosby, 1995b.) For reversionary property, the conventional market approach is the use one yield (the equivalent yield is a term originally derived for exactly this purpose) to discount the passing rent until it is reviewed, and the

estimated rental value thereafter. Figure 1 shows a property let with 3 years to run to the next rent review where the estimated rental value exceeds the current rent passing. Note that no growth in estimated rental value is projected.

Figure 4 : Term and reversion - rising market

Where estimated rental value it is higher than the rent passing, the investment is described as over-rented. Where property is over-rented, one vertically-sliced approach would discount the passing income at a bond-related yield, with the reversion to estimated rental value in perpetuity discounted at the all risks yield. At the time of creating the model, however, bond yields and all-risk property yields for prime over-rented buildings were similar, justifying a simple capitalisation of both slices of income at the all-risks or equivalent yield, which is used from this point onwards in illustration of potential value effects. (This creates some uncertainty in measurement of the value effect of the upward-only rent review: see note 5 on page 15.)

Figure 2 shows a property let with 8 years to run to the lease end where the estimated rental value exceeds the current rent passing. Again, note that no growth in estimated rental value is projected.

Figure 2: Term and reversion - falling market

2.3 Establishing a valuation model for existing investments

2.3.1 Introduction

In a model for examining the effects of an outlawing of upward-only rent reviews, the three main factors which need to be addressed are: the length of the unexpired term; the relationship of rent passing to rental value; and the change in the level of yields caused by the outlawing of upward-only reviews.

2.3.2 Changes in yields

Yield is defined for the purposes of this paper as the single capitalisation rate applied to the expected income flow. Following normal UK practice, this takes full account of changes in income which result from the lease contract but ignores projected changes in rental value. Hence a review to market rent will be assumed to be a review to the current estimate of market rent.

The single capitalisation rate used to discount income in this way is known in

UK terminology as the all risks yield or equivalent yield. It takes account of all qualities of the income, including the protection offered by the lease terms including he upward-only review, and the expected growth in income.

The discount rate used to capitalise the initial over-rented income for an over-rented property will not necessarily be the all-risks yield. It should reflect the different qualities of the income. Abolition of upward-only rent reviews (assuming this will not affect existing contracts) will not affect the value of this component of the income stream. However, the value of the reversion, which rests on the assumed re-letting of the property under a new lease, will change, because the quality of this income stream will be lower without the protection of the upward-only review.

The value effect of the upward-only review will therefore be reflected in this component of the valuation. The questionnaire survey addressed this issue, and suggested the expected change in average (equivalent) yield (measured in percentage points) for full-let property caused by removal of the upward-only rent review for a new letting predicted by respondents to be as shown in table 1.

TABLE 1 : AVERAGE YIELD MOVEMENTS IF UPWARD-ONLY RENT REVIEWS WERE TO BE OUTLAWED

`Average yield change	Offices (9.1%)	Shops (7.3%)	Industrial (10.3%)
More than - 2%	1.00	1.00	1.00
- 1.1% to - 2%	3.00	1.00	2.00
- 0.1% to - 1%	1.00	2.00	1.00
No change	3.00	9.00	4.00
+ 0.1% to + 1%	24.00	30.00	25.00
+ 1.1% to + 2%	30.00	36.00	31.00
Over + 2%	36.00	19.00	34.00
Weighted average (to nearest 0.05%)	+ 1.4%	+ 1.15%	+ 1.4%

Source: Corporate Intelligence Group (1993)

Note : The weighted average has been calculated by adopting the 0.5 point within each range (+ 1.1 per cent to 2 per cent = 1.5 per cent) and + or - 2.5 per cent for the outer ranges.

Very few of those questioned felt that yields would fall as a result of the change. The modal response was that yields would rise by over 2 percentage points for offices and industrials and between 1 and 2 percentage points for retail property.

The interview survey of valuers broadly confirmed the findings of the CIG survey. All valuers interviewed felt that the effect on all risks yields would be a rise in the region of 1 per cent to 2 per cent, with a lesser effect on retail property which was suggested to be explained by the higher obsolescence factor in the office and industrial markets, which increases the importance of the upward-only rent review clause over the duration of a long lease.

2.3.3 Effect on valuation

The initial value fall will be a function of the number of years unexpired on existing leases coupled with the level of rent passing as a proportion of rental value. If existing leases have a substantial number of years to run and the rent passing is very high, the effect on value will be minimal. If the period to the lease end is short and/or the property is not over-rented the effect will be great. Examples 1 to 3 illustrate. For simplicity, and because market practice is likely to tend towards such an approach, these all assume the use of a traditional valuation approach and not a rational approach to the valuation of a fixed income; the possible effect of such a simplification is referred to later (see note 5, page 15).

Example 1 Heavily over-rented office let at £300,000 p.a. with 23 years unexpired, with upward- only rent reviews in 3 years and every 5 years thereafter. Estimated rental value (ERV) is £100,000 p.a.

Assuming upward-only rent reviews are not outlawed:

Term rent	£300,000	
YP 23 yrs @ 9.1 per cent[1]	9.5065	
		£2,851,959
Reversion to ERV	£100,000	
YP perp @ 9.1 per cent	10.989	
PV 23 yrs @ 9.1 per cent	0.1349	
		£148,248

Valuation (excluding costs)
£3,000,207

Note: 1. The average Hillier Parker office yield at September 1993. If fixed income yields exceed the all risk yield, the term yield on an over-rented property would be increased. This would increase the fall in value noted below.

Assuming upward-only rent reviews are outlawed for all new lettings:

Term rent	£300,000	
YP 23 yrs @ 9.1 per cent	9.5065	
		£2,851,959
Reversion to ERV	£100,000	
YP perp @ 10.5 per cent[2]	9.5238	
PV 23 yrs @ 10.5 per cent	0.1006	
		£95,825

Valuation (excluding costs)
£2,947,784

Note: 2. The expected yield adjustment of 1.4 per cent to compensate for the lack of upward- only rent reviews is incorporated in the valuation of the reversion.

The valuations are different by £52,423; the outlawing of upward- only rent reviews has only reduced the value by 1.7 per cent. In reality, there would be little or no difference. For a heavily over-rented office an initial yield approach which explicitly ignores the reversion would be used, because in this case the reversion is so far off as to be of no perceived consequence. In addition, both of the above valuations would be rounded to £3 million.

Example 2 Over-rented shop let at £150,000 p.a. with 8 years unexpired on upward- only rent reviews. The next review is due in 3 years' time. Estimated rental value (ERV) is £100,000 p.a.

Assuming upward-only rent reviews are not outlawed:

Term rent	£150,000	
YP 8 yrs @ 7.3 per cent[1]	5.9025	
		£885,375
Reversion to ERV	£100,000	
YP perp @ 7.3 per cent	13.699	
PV 8 yrs @ 7.3 per cent	0.5691	
		£779,613

Valuation (excluding costs)
£1,664,988

Note: 1. The average Hillier Parker retail yield at September 1993. As in Example 1, the term yield would be based upon fixed income yields if over-rented and the fall in value noted below would be higher.

Assuming upward-only rent reviews are outlawed for all new lettings:

Term rent	£150,000	
YP 8 yrs @ 7.3 per cent	5.9025	
		£885,375
Reversion to ERV	£100,000	
YP perp @ 8.45 per cent[2]	11.834	
PV 8 yrs @ 8.45 per cent	0.5226	
		£618,453

Valuation (excluding costs)
£1,503,828

Note: 2. The expected yield adjustment of 1.15 per cent to compensate for the lack of upward- only rent reviews is incorporated in the valuation of the reversion.

The valuations are different by £161,160; the outlawing of upward- only rent reviews has reduced the value by 9.7 per cent.

Example 3 Under-rented industrial property let at £50,000 p.a. with 2 years unexpired. Estimated rental value (ERV) is £100,000 p.a.

Assuming upward-only rent reviews are not outlawed:

Term rent	£50,000	
YP 2 yrs @ 10.3 per cent[1]	1.7286	
		£86,430
Reversion to ERV	£100,000	
YP perp @ 10.3 per cent	9.7087	
PV 2 yrs @ 10.3 per cent	0.8220	
		£798,016

Valuation (excluding costs)
£884,446

Note: 1. The average Hillier Parker industrial yield at September 1993.

Assuming upward-only rent reviews are outlawed for all new lettings:

Term rent	£50,000	
YP 2 yrs @ 10.3 per cent	1.7286	
		£86,430
Reversion to ERV	£100,000	
YP perp @ 11.7 per cent[2]	8.5470	
PV 2 yrs @ 11.7 per cent	0.8015	
		£685,027

Valuation (excluding costs)
£771,457

Note: 2. The expected yield adjustment of 1.4 per cent to compensate for the lack of upward- only rent reviews is incorporated in the valuation of the reversion.

The valuations are different by £112,989; the outlawing of upward- only rent reviews has reduced the value by 12.8 per cent.

2.3.4 The impact range

These examples illustrate three possible cases where the removal of the upward-only rent review would impact the value of property. Of course, there are many more.

In order to describe the effect on the market more fully, the valuation effects of a range of assumptions regarding (i) lease expiry dates and (ii) levels of rent passing to ERV were calculated, assuming a change in yield takes place as suggested by responses to the CIG questionnaire. Market average yields were used to estimate these effects.

Reductions in value were found to range from a maximum fall of just over 18 per cent (office property with around 10 years unexpired and shop property, with 12 to 14 years of the current lease unexpired, both very reversionary, with rent passing only 25 per cent of the estimated rental value) to a minimum of just over 1per cent (industrial property, 25 years of a lease unexpired and heavily over-rented, with rent passing three times the estimated rental value).

3 Quantifying the effect on capital values

3.1 The structure of the UK commercial property market

The UK property market can be described in detail if an assumption is made that the market is proxied by the universe held by the Investment Property Databank (IPD). This is usually accepted as being reasonable, although some sampling error is clearly introduced into any analysis based on the IPD data.

The IPD universe, covering around £40bn of commercial investment property in the UK, is believed to capture around 75 per cent of institutional ownership and therefore around 25 per cent of commercial investable property (IPD, 1994; Currie and Scott, 1991). The degree of detailed analytical power offered is usually accepted as being very high; there is no alternative source of similar analysis of property outside the IPD universe.

As stated above, the initial fall in the value of UK property resulting from abolition of the upward-only rent review will be a function of the number of years unexpired on existing leases coupled with the level of rent passing as a proportion of rental value. IPD data has therefore been used to describe the universe by these factors.

This data has been incorporated into the model set out in the section 2.3.4 to assess the effect of upward-only rent reviews on the capital values of standing investments.

3.2 Results

As reported above, reductions range from 1 per cent to 18.0 per cent, the former for over-rented industrials, the latter for under-rented shops and offices let with around 10 to 14 years unexpired. This now needs to be set against the structure of the market.

Tables 2, 3 and 4 set out the anticipated fall in value from each of the three main sectors of the property market.

The tables show that the structure of the UK property market (as proxied by the IPD universe at December 1992) is roughly 43.4 per cent offices, 42 per cent retail property, and 14.5 per cent industrials.

The retail sector was broadly reversionary, by around 10 per cent. The office sector was over-rented by around 20 per cent. The industrial sector was roughly fully let, with rents passing roughly in equation with rental values. (Note that in a normal market with rental values rising at a reasonable rate - say average inflation and positive real growth - markets with five yearly reviews should always be reversionary, by around ten per cent. A fully-let market, like the industrial market at this time, is not therefore normal).

TABLE 2: REDUCTIONS IN CAPITAL VALUE: OFFICES

` Years unexpired	Rent (£)	ERV (£)	Rent/ERV	Existing CV (£)	Reduction factor	New CV (£)
1	424215	374220	1.1336	4158133.0000	0.8692	3614171.0000
2.0000	311322.0000	311136.0000	1.0006	3419404.0000	0.8697	2973722.0000
3.0000	397677.0000	313537.0000	1.2684	3658066.0000	0.8797	3218006.0000
4.0000	290326.0000	256854.0000	1.1303	2930774.0000	0.8801	2579285.0000
5.0000	347087.0000	265702.0000	1.3063	3235542.0000	0.8909	2882562.0000
6.0000	302670.0000	248362.0000	1.2187	2972149.0000	0.8926	2653053.0000
7.0000	396644.0000	297425.0000	1.3336	3766100.0000	0.9022	3397770.0000
8.0000	575404.0000	430293.0000	1.3372	5528681.0000	0.9074	5016597.0000
9.0000	372234.0000	309857.0000	1.2013	3777472.0000	0.9064	3424057.0000
10.0000	468673.0000	374204.0000	1.2525	4715742.0000	0.9135	4307685.0000
12.5000	2282741.0000	1844885.0000	1.2373	23465195.0000	0.9241	21683672.0000
Total				61627257.0000		55750578.0000

Notes: 1. CV is capital value
2. ERV is estimated rental value

TABLE 3: REDUCTIONS IN CAPITAL VALUE: RETAIL

Years unexpired	Rent (£)	ERV (£)	Rent/ERV	Existing CV (£)	Reduction factor	New CV (£)
1	260843.00	328639	0.7937	4438721.0000	0.8628	3829283.0000
2.0000	227312.0000	272402.0000	0.8345	3650348.0000	0.8630	3150190.0000
3.0000	241830.0000	252147.0000	0.9591	3427141.0000	0.8668	2970597.0000
4.0000	294104.0000	316261.0000	0.9299	4257798.0000	0.8678	3695127.0000
5.0000	233225.0000	236345.0000	0.9868	3224912.0000	0.8723	2813048.0000
6.0000	158731.0000	189072.0000	0.8395	2446736.0000	0.8757*	2142607.0000
7.0000	211481.0000	209447.0000	1.0097	2879985.0000	0.8794	2532695.0000
8.0000	276633.0000	281351.0000	0.9832	3826275.0000	0.8823*	3375922.0000
9.0000	295808.0000	298107.0000	0.9923	4068868.0000	0.8858*	3604203.0000
10.0000	232240.0000	249771.0000	0.9298	3300080.0000	0.8895*	2935421.0000
12.5000	1699272.0000	1798220.0000	0.9451	23839506.0000	0.8989*	21429332.0000
Total				59360370.0000		52478425.0000

Note: * Reduction factor adjusted for to ERV/rent = 1 for reversionary property with over five years to review

TABLE 4: REDUCTIONS IN CAPITAL VALUES: INDUSTRIAL

Years unexpired	Rent (£)	ERV (£)	Rent/ERV	Existing CV (£)	Reduction factor	New CV (£)
1	94478	109488	0.8629	1049382.0000	0.8801	923431.0000
2.0000	83650.0000	87579.0000	0.9551	843490.0000	0.8827	744535.0000
3.0000	70213.0000	69381.0000	1.0121	675660.0000	0.8868	599187.0000
4.0000	66886.0000	61899.0000	1.0806	616667.0000	0.8927	550498.0000
5.0000	80018.0000	80312.0000	0.9963	778622.0000	0.8936	695777.0000
6.0000	74497.0000	79106.0000	0.9417	748121.0000	0.8979*	671738.0000
7.0000	82174.0000	82949.0000	0.9907	801594.0000	0.9027*	723599.0000
8.0000	100042.0000	95669.0000	1.0457	951902.0000	0.9091	865349.0000
9.0000	122907.0000	124727.0000	0.9854	1200584.0000	0.9113*	1094092.0000
10.0000	137699.0000	136986.0000	1.0052	1334286.0000	0.9162	1222526.0000
12.5000	1182143.0000	1166912.0000	1.0131	11433696.0000	0.9278	1060472.0000
Total				20434005.0000		18699194.0000

Note: * Reduction factor adjusted for to ERV/rent = 1 for reversionary property with over five years to review

What effect does this have on the likely impact of abolition of the upward-only rent review clause? The results are summarised in Table 5.

TABLE 5 : SUMMARY OF CAPITAL VALUE REDUCTIONS

	Office (£ Million)	Retail (£ Million)	Industrial (£ Million)
Capital value in IPD (over 15 yrs unexpired)	8142.3000	9510.8000	2611.5000
Reduction in value (%)	0.0000	0.0000	0.0000
Capital value in IPD (up to 15 yrs unexpired)	5769.3000	4423.4000	2220.6000
Reduction in value (%)	9.5400	11.5900	8.4900
Voids and other properties not currently let	1222.9000	438.0000	207.1000
Reduction in value (%)	13.3300	13.6100	11.9700
Existing capital value of all standing investments	15134.5000	14372.2000	5039.2000
New capital value of all standing investments	14421.1000	13799.9000	4825.9000
Fall in value of standing	4.7100	3.9800	4.2300

investments (%)

The model predicts the total fall in the capital value of all existing commercial and industrial investment property will be around 4.5 per cent initially, which would reduce the value of these type of properties held within the Investment Property Databank by £1.5 billion. Over time the total value fall of around 13 per cent for offices, 14 per cent for shops and 12 per cent for industrials will take place, but this will only finally occur when all existing leases have expired.

3.3 Qualifications

However, these results need to be qualified.

1. The majority of valuers interviewed felt that unexpired terms of over 15 years were unlikely to be affected by any legislation on upward-only rent reviews. While an unconstrained model would indicate falls in value at this level, all properties let with over 15 years unexpired were deemed to be unaffected by upward-only rent reviews and the valuation model therefore assumed no immediate fall in value for these leases.

2. Properties coming to the end of a lease for 20 or 25 years are often ripe for re-development or refurbishment. In these cases the reversionary value is the residual land value. A rise in the all risks yield coupled with fixed redevelopment costs will generate a geared fall in residual site values. The model tends therefore to understate the potential falls in value of all properties where the reversionary value is a significant factor in the value and the property is ripe for refurbishment or redevelopment. This understatement will be potentially more significant in the office and industrial markets than in retail, which is less affected by obsolescence (Baum, 1991).

3. The effect of the outlawing of upward- only rent reviews on rents and rental values has not been included in the model. In the short term, the effect would be to reduce headline rents and incentives which would cause a further fall in value. This issue is discussed in a separate paper (Baum, Crosby and Murdoch, 1995), but no adjustment to the valuation model has been made for these factors.

4. The effect on capital values of the introduction of break clauses into many leases has not been taken into account in the model. This would tend to decrease the reduction in value. No adjustment has been made to the valuation model.

5. A 'rational valuation approach' (see, for example, Baum and Crosby, 1995) for the initial term of a property where the rent is expected to be fixed at the current passing rent for a long period should, and in some areas of practice would, base the discount rate on a risk free rate of return plus an illiquidity premium and a tenant default risk premium. Where a reverse yield gap exists, this would reduce the relative value of the term,
increase the proportion of value in the reversion and therefore increase the fall in value. This factor suggests that the value fall assessed in this paper is a minimum estimate.

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4. Conclusions

The removal of upward-only rent reviews will change the nature of the typical UK commercial property investment. Properties let under long leases with upward-only rent reviews are equivalent to a bond investment, but with the prospect of an increased return if current rental values increase above passing rents (including headline rents) in the future. The removal of upward-only reviews will transform the investment into more of a pure equity investment.

There are significant value implications if upward-only rent reviews were to be outlawed. Even if any proposals related only to new lettings, the capital value of both new and existing leases would be affected and the capital value of new lettings will be reduced. As the expected cash flow is expected to be more volatile a higher risk premium will be built into the appraisal of the worth of the expected cash flow, which will lead to a fall in the initial purchase price. The survey found that respondents expected a weighted average increase of 1.4 per cent in the risk premium.

An additional risk premium to account for the possible added volatility of the future cash flow will lead to a fall in capital values. The respondents to the survey indicated a property capitalisation rate increase of 1.4 per cent for offices and industrials and 1.15 per cent for shops. This would lead to an immediate fall in the value of new leases by 13 per cent for offices, 14 per cent for shops and 12 per cent for industrials, given the September 1993 level of the Hillier Parker statistics for average property yields.

However, these value effects will not be felt in practice, because the structure of the UK property market is different from an equity-type market where properties are let on new leases at the estimated rental value. The effect of the dominance of existing contracts will be to dilute the value effect of the removal of upward-only rent reviews from all new leases.

However, even assuming the proposals will not apply to existing leases, the capital value of standing investments will be affected. When the existing lease expires, the property will be re-let on a new lease without upward-only reviews. As the anticipated rise in capitalisation rate will reduce the reversionary value, the effect on the value of standing investments will be a function of the lease expiry date. Where the reversion is over 15 years away, there would appear to be little initial effect on property values. As the reversion gets closer, a reduction in value occurs. The higher the rent on the existing lease relative to estimated rental value, the greater the value of the existing lease and the lower the effect on total capital value.

The fall in value of existing investments is therefore a function of the level of rent passing, the estimated rental value, the level of capitalisation rate and the date of lease expiry. The fall in value of the property investment market as a whole is a function of the way these variables describe the sum of property investments let on existing leases and vacant and to let properties.

Given this, it is estimated that the effect on the value of UK property of the upward-only rent review clause being removed from future leases would be a reduction of 5 per cent for offices, 4 per cent for shops and 4 per cent for industrials, a weighted average (using IPD weights) of 4.3 per cent across all three sectors.

This is likely to be a minimum estimate, understated both through the additional effect of three factors. These are:

(i) the removal of privity of contract, which will accentuate the damage to values caused by the removal of the upward-only rent review (see Baum, Crosby and Murdoch, 1993);

(ii) the valuation simplifications adopted in the research, which ignored the rational but not consistently-applied practice of discounting fixed incomes at bond-related yields (Baum and Crosby, 1995a); and

(iii) the effect of the upward-only rent review clause on agreed rents in new leases and valuation approaches, dealt with in Baum, Crosby and Murdoch (1995).

In conclusion, the study establishes a strong case which should persuade owners to resist proposed changes to this valuable aspect of the UK commercial lease.

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Abstract

The aim of this paper is to provide a response to suggestions that the removal of upward-only rent reviews (sometimes known as ratchet clauses) would reduce commercial property asset values in the UK. The paper also seeks to estimate the amount of the reduction. It argues that the fall in the capital value of commercial UK investment property will be a function of changes in risk/return characteristics which, when set within the framework of the current leasing structure and the expected cash flow determined thereby, manifests itself in changes in investment yields. Because the property market generates fewer transactions than some other capital markets, and because valuations are used as a surrogate for transactions when compiling property market data and indices, the way in which valuers approach investment property valuations in practice will also influence the perceived value loss caused by any change in legislation.

The paper identifies the likely level of change in investment yields for the major UK commercial and industrial property types, examines the current leasing structure of those properties and investigates the current application of valuation techniques to these structures.

This facilitates the construction of a valuation model of the commercial and industrial property investment market, form which it is estimated that the effect on the value of UK property of the upward-only rent review clause being removed from future leases would be a reduction of 5 per cent for offices, 4 per cent for shops and 4 per cent for industrials, a weighted average (using IPD weights) of 4.3 per cent across all three sectors.