



Awaiting the jury's verdict

Charles Mesquita and Alison Puhar explain why changes could be ahead for property investors

Adapt or you will be forced to" is the tough message issued by the Government to the property industry concerning the need to make the structure of renting property in the UK more flexible, adaptable and understandable.

And how has the property industry answered? With a new voluntary code of practice drawn up by an industry-wide working party in April 2002. If landlords do not adhere to it, then the Government has warned it will step in to legislate change.

The main reason for this turn of events is increasing representation over the last decade to MPs by tenant groups with regard to upward only rent reviews coupled with long leases.

These have limited the mobility of tenants when rents fall and are partly blamed for prolonging the time it took to recover from the 1990s recession. Not only did it hold back the revival of the property market, it is now widely held to be the reason why businesses found it hard to trade out of recession.

The Code of Practice for Commercial Leases in England and Wales makes ten recommendations on negotiating a lease and thirteen on conduct over the duration of the lease. These include:

- Landlords should consider offering tenants choice when it comes to the length of term, including break clauses where appropriate
- Funders should avoid imposing restrictions on the length of lease that may be offered.

Another aspect of the lease system tenants find difficult is "alienation" – the complex assignment and subletting arrangements that leave them with liabilities on properties they have ceased to occupy.

In some cases, such as in the world of distribution where business is contracted out to the cheapest operator, that could mean a firm which signed a

property lease might remain the guarantor for its competitor that now occupies it, and which obtained the contract to provide the distribution service by undercutting the original operator. According to one distributor: "This is rather like having to guarantee mortgage payments for someone who is squatting in your house."

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The code of practice suggests:

- Landlords should only consider requiring authorised guarantee agreements if the assignee is of lesser financial standing than the assignor at the date of an assignment
- Subject to circumstances, the only restriction on assignment of the whole premises should be obtaining the landlord's consent, which is not to be unreasonably withheld.

But what is the likely impact of all this on property investment and occupancy? An anomaly brought up during the 2001 British Council of Offices (BCO) conference in Berlin was that in Germany office lease terms and conditions appear to be more tenant-friendly than in the UK, and yet Germany still had active property investment markets and lower yields.

Similarly, in research for the BCO by Property Market Analysis, it was found flexible leases do not necessarily equate to a rapid turnover of tenants. In European markets, turnover rates are lower than in the City of London. Greater flexibility in the UK therefore may not alter the length of occupation. However, shorter leases may necessitate a closer and more symbiotic relationship between occupiers and investors, as in Europe.

The report added that the varying degree of flexibility of lease terms internationally is not reflected in yields

and values; most countries have similar yields to the UK. So following the code should not unduly affect the investment potential of a property and should benefit the tenant.

But what would happen if the government still felt the need to legislate? Shorter leases are a small negative in the context of a market that

has progressively moved this way over the past decade. In 1992, the average length of a new lease was just over 20 years including breaks. By 2002, it is estimated to be just under 12.

Although long-term rental value growth of the UK property market has failed to beat inflation (-0.9% pa since 1975), performance over the last ten years is better, matching inflation. Any forced indexation would therefore not be bad for the market and could be positive as it would remove a major cyclical element. In turn, indexation of rents could make property better at matching pension fund liabilities than is the perceived case now.

The jury is still out on whether the code of conduct on leases is working. If legislation were to be introduced due to a lack of adoption, any shortening of leases would not have a big impact on the market. In the end, market forces should win out: tenants would benefit in difficult market conditions, landlords when letting markets were strong. Either way, commercial property would remain an attractive investment, complementing other assets with its high yield and positive impact as a portfolio diversifier.

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