



Research
Programme
2006-2009

Rent Reviews – Revolution or Evolution?



IPF Research Programme
Short Paper Series
Paper 11

November 2010

This research was commissioned by the
IPF Research Programme 2006–2009



Investment
Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

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The programme is funded by a cross-section of 24 businesses, representing key market participants. The IPF gratefully acknowledges the continuing support of the contributing organisations.

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RENT REVIEWS – REVOLUTION OR EVOLUTION?

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1. Introduction

To combat the erosion of real rental income over time it is common practice in the UK commercial real estate industry to insert a provision in each lease to review the rent receivable periodically to current open market rental levels.

This rent review provision has typically been 'upwards only' which protects the owner from potential falls in income throughout the lease term. Such protection is afforded from falls in rental levels due to both general cyclical market downturns or more localised rental falls for the specific asset. Thus the upward only rent review provision protects the investor from both falls in general market rental levels and more localised adverse events, but exposes the occupier to the same risks.

The gap between such open market reviews has varied over time and between the sectors, from frequencies of around 42 years down to three years. This gap in the timing of the review bestows a benefit to the occupier of keeping the rent fixed for a period even when market rents are rising.

Over time lease lengths have shortened which minimises the benefit to the investor of the upwards only nature of the rent review clause but the practice of only reviewing rents at periodic intervals has remained. These review provisions distinguish the UK market from most other European countries.

The industry has recently been witnessing significant pressure on lease lengths and on the inevitability of upwards only reviews. With the substantial, and well documented, downward trend in the length of lease terms¹, there has also been speculation about the demise of the open market rent review and a move towards other forms of rent review.

Whilst such institutionally acceptable leases took hold as a tradeable, long term income stream, occupiers have been consistent in questioning the fairness of upwards only reviews, albeit such consternation was – until relatively recently – met with a landlords' wall of silence and assertions that the market will find its own level. Indeed, during the 1990's, the upward only nature of rent reviews began to attract the attention of government. In July 1994, Tony Baldry, then Environment Minister, called on the property industry to negotiate a code of practice on business leases following on from a consultation which included the issue of upwards only rent reviews. Preferring self regulation to legislation, the Code for Leasing Business Premises in England and Wales (The Code) was launched in 1995 albeit with the limited mission to increase awareness and understanding of upwards only reviews rather than suggesting alternatives. Subsequent research suggested that The Code had "practically no impact²" and a revised Code called for "lease choices" as part of providing occupiers with flexible, user friendly and affordable property.

In 2003, the British Property Federation (BPF) published research into over a thousand leases which indicated that over 90% still contained upwards only reviews³. A revised Code was published in 2007 in order to promote and encourage flexible alternatives to upwards only reviews⁴. Whilst there has been limited evidence of a greater use of alternative rent review procedures, the downturn in the commercial property market since the Lease Code's introduction may have acted as a catalyst to bring about greater change than had been expected.

¹ See, for example, the BPF/IPD 2010 Annual Lease Review

² DETR Monitoring the Code of Practice for Commercial Leases, April 2000

³ BPF research as reported in PropertyWeek 11 April 2003

⁴ http://www.leasingbusinesspremises.co.uk/downloads/code_comm_lease090805.pdf

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This paper will consider what trend, if any, there is away from upwards only rent reviews, particularly in the context of a continued shortening of lease lengths, together with other factors affecting choice of rent review mechanisms and whether there is a move towards some of the alternative rent reviews available. Despite the longevity of the upwards only review, our research suggests that the market is flexible and has been the subject of change both at a sector specific level and as a reaction to the downturn in the property letting market over the past few years.

This paper is based on the views of approximately 200 transactional real estate lawyers located in the UK. It is therefore anecdotal and constructed from the current experience of practitioners across the regions, active in all sectors of the real estate market. The empirical data is drawn from the IPD UK Annual Databank.

Being largely drawn from DLA Piper's client base, the views expressed are not a fully representative sample of the industry. However, the data gathered provides a useful snap shot of the current views of a significant segment of commercial property occupiers.

2. The trend towards shorter leases

Data analysed for the BPF/IPD Annual Lease Review and the Strutt and Parker/IPD Lease Events review, over the last 10 years, shows there has been a trend towards shorter lease terms and an increase in the prevalence of breaks within leases. 72% of new leases granted in 2009/2010 were for a term of between one and five years; a rise of almost 20% since 1999. Whilst shorter leases are more common in respect of property with lower rental values, on a rent weighted basis, the number of new leases granted for a term of between one and five years was 43% in 2009/2010, compared to 24% in 1999, a rise of 19%. There has also been a significant fall in the number of leases being granted with terms of more than 10 years on both an unweighted basis and a rent weighted basis. However, this is not necessarily spread equally across different sectors. For example, in the leisure industry, some tenants are still taking longer leases than the general market norm, with terms of between 20 and 25 years.

Break clauses are most likely to be present in leases with a term length of six to 10 years, but in 2009/2010, 24% of leases with a term length of only one to five years also contained a break clause. This is an increase of 10% since 2002⁵. Numerous factors have contributed to this, including the willingness of landlords to grant shorter leases to provide cover (however temporary) for business rates liability.

⁵ For further information, see the IPF Research Programme Short Paper 10: Break Clauses.

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3. Alternative types of rent review

3.1 Open market rent review—the traditional model

Unlike the limited but well trodden path of government intervention in influencing residential rent levels, parties to commercial leases are generally free to negotiate and agree whatever initial rent they choose. The traditional method of rent review in the UK is to calculate the rent by reference to comparables in the current market at fixed intervals. Since the early 1980's, rent reviews have usually been carried out at five yearly intervals, although the length of such intervals has historically been subject to variation. For example, seven yearly rent reviews were common in the 1960's and three yearly rent reviews were used in the 1970's. Leases will usually contain rent review provisions which allow for the rent to be increased to the higher of (1) the then current rent at the date of the rent review; and (2) the rent which would be payable in the open market.

Open market rent reviews are considered to be beneficial for the landlord as they provide an upwards only increase in accordance with the market, whilst simultaneously providing a floor below which the rental income will not fall for the duration of the lease. This relative stability of income is attractive to both investors and providers of debt financing. Further, as such rent reviews are widely perceived in the UK property industry as the safe norm, upwards only open market rent reviews are often the most acceptable rent review provisions to funders. In an era of increasing cautiousness in lending, this has increasing significance.

However, open market rent reviews are reliant on the landlord being able to produce evidence which supports an increase in rent and do not provide landlords with any increase in a falling market. The economic downturn has created a dearth of comparable evidence, with fewer new developments reaching completion and rent reviews of existing properties concluding with nil increases.

There has been significant debate about the fact that open market rent reviews are usually upwards only. As mentioned above, there have been several threats from Government to abolish upwards only rent reviews as the Republic of Ireland has done for all new leases entered into after 28 February 2010⁶. The perceived unfairness of upwards only rent reviews resulted in the Lease Code. It recommends that landlords offer alternatives to their proposed rent review provisions priced on a risk-adjusted basis and specifically uses the example of offering an upwards and downwards rent review as an alternative. In practice, many tenants have been prepared to accept an upwards only rent review as an inevitable part of the property market. Some consider its removal to be of insufficient value to justify an increased initial rent. However, landlords are keen to avoid legislation like that in Ireland and therefore there may be more reference to and use of the Lease Code in the future.

From our research, upwards only open market rent reviews appear to have retained their leading position in a number of sectors, particularly the office sector. Many tenants are prepared to accept upwards only rent reviews as the standard market position, in consideration for negotiating other provisions.

The principal finding has been that overall, flexibility in lease negotiations, and as a result in leases, has increased. Perhaps unsurprisingly, there are certain "sweet spots" for some tenants which are of less importance to others. The same principle applies with landlords. Property owners with debt providers may be subject to rigorous and

⁶ section 132 Land & Conveyancing Law Reform Act 2009

wide ranging restrictions on what they can agree with tenants due to the requirements of their lenders, who are keener than ever to focus upon the financial fundamentals. We found that property owning clients with portfolios free of debt were able to sacrifice open market reviews in return for enhanced service charge provisions or other areas of importance to tenants. This discretion gives them the freedom to act creatively without the need to consult with or obtain consent from bankers.

3.2 Index linked rent review—A move to the European model?

Index linked rent reviews are typically linked to increases in the RPI (Retail Prices Index), although other indices such as RPIX (the Retail Prices Index excluding Mortgage Interest Payments), CPI (the Consumer Prices Index) and indices appropriate to the specific properties are also used. They bring greater certainty to both parties and obviate the need for negotiations between the parties and their expert rent review advisers. They are the norm in leases across Europe and so are familiar to international investors.

Findings collated from our professional support lawyers suggest that index linked review clauses have been downloaded from DLA Piper's intranet about three times more often than turnover rent clauses as an alternative to upwards only open market rent reviews. In the office sector, there was a noticeable move to RPI linked rent reviews and/or service charge provisions several years ago. However, this has not been sustained, with more recent office lettings reverting back to open market rent reviews over the last 18 months. Therefore – in our view – this does not represent the market norm. The majority of our landlord clients active in the office sector are now choosing to offer shorter leases – either 10 years, with a break at year-five, or a five year lease. In either case, even where the parties agree an upwards only review, the tenant is able to either vacate or threaten to do so. We have not detected a significant move towards index linked review clauses in other sectors, although they are always a possibility now that both parties are prepared to approach rent review provisions with more flexibility. One exception may be new asset classes or out of the ordinary lettings (such as very large data centres) where the lack of meaningful comparable evidence has resulted in index linked uplifts being used.

3.3 Fixed increase rent review—Certainty for both parties?

In addition to index linked rent reviews, there has also been greater use of fixed increase rent reviews by which the rental increases are agreed at the start of the lease. The agreed increases can apply for the duration of the lease term or be fixed for an initial period of five or 10 years, following which open market rent review provisions will apply. Fixed increases are also used in conjunction with other rent review provisions, such as a rent review to the highest of a fixed increase and the open market rent.

Fixed increase rent reviews give both parties absolute certainty as to the costs for the duration of the lease term. This enables the landlord to accurately value his investment. For the tenant, whilst fixed increase rent reviews represent guaranteed increases in rent regardless of the state of the market, they also provide comfort that there will be no unexpected, substantial rent increases. The difficulty for both parties with fixed increases is establishing the appropriate levels at which they should be set.

As with all of the alternatives to open market rent reviews, there is now more awareness of and willingness to agree fixed increase rent reviews. In particular, they are becoming popular in long retail and leisure property leases where the high initial fit out costs mean tenants are looking for a long term commitment.

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That having been said, some landlords are unwilling to 'second guess' the market and risk being tied into a long term tenancy with a rent that may increasingly fall behind the market. Whilst far from consistent, there is evidence that many fund managers are unwilling to fully sacrifice the potential for future rental increases for certainty. Furthermore, tenants are not pushing for this change either. This has been most evident in City and West End lettings where there is a feeling that the durability of the market will inevitably result in an improvement in market sentiment and hence rental growth over the course of the lease.

3.4 Caps and collars–The best of both worlds?

Caps and collars (whereby maximum and minimum thresholds of increase are set in advance) were consistently the domain of service charge negotiations, but are now increasingly being used in relation to rent reviews. Whilst index linked rent reviews can more obviously be linked to caps and collars, they are also starting to be applied to open market rent reviews. Intended as a compromise or 'soft' open market review, they allow the landlord to seek an uplift to recognise an improvement in the letting market but provide the tenant with some ability to financially model rental costs over the course of the lease.

As with other alternative rent review provisions, caps and collars provide both parties with some certainty and consistency in the rent figures reached following each rent review. However, they do also carry the same difficulty in establishing appropriate figures at the outset of the lease. Whilst there are no fixed reference points for caps and collars, the parties usually accept that caps and collars should be set at levels which allow for a moderate, but not excessive, rental increase. We therefore often see these figures being agreed between 2% and 4%.

Caps and collars are very popular with multiple retailers. They are also now a common requirement of supermarkets and department stores who, we find, tend to take longer leases of between 30 and 35 years on the basis of open market rent reviews with caps and collars at fixed percentages. In addition, some supermarket tenants now seek to include an option to renew on the same terms (specifically including rent review) at the end of the lease term which they can use in conjunction with security of tenure. Therefore, if the existing rent review provisions are the most attractive option at the end of the lease term, the tenant has a contractual right to renew on exactly the same terms. This provides an absolute guarantee to the tenant of the new lease terms, unlike a statutory renewal where the landlord has the right to object to the lease terms. However, if market practice has significantly changed during the lease term and the tenant believes it can procure better terms by reference to the market, it can choose not to exercise the option to renew and can instead rely on its security of tenure.

3.5 Turnover rent–A partnership approach?

Rent calculated as a percentage of the tenant's turnover is already commonly used in some sectors, particularly retail. Turnover rent provisions will usually incorporate a minimum rent to provide the landlord with some guaranteed income which will be increased in proportion to the tenant's turnover and is subject to the usual upwards only review.

The underlying principle of turnover rents is that they will encourage both parties to work in partnership to maximise the potential of the business. For example, the landlord of a shopping centre operating turnover rent leases has more of an incentive to attract and maintain an appropriate mix of tenants as he will benefit from the improved turnover created by increased footfall. They can also be particularly useful in regeneration schemes where

both parties recognise that initial footfall may be low, but the parties are prepared to share the benefits of the longer term success of the scheme.

However, turnover rents are complicated to operate and create issues such as how turnover is monitored and audited, how information is kept confidential and whether assignment is possible. Turnover rents can also represent a difficulty for landlords seeking to ensure that tenants maintain an expected level of performance and are therefore often seen in conjunction with mutual rights to terminate if minimum levels of turnover are not reached.

There is more use of turnover rents, but unsurprisingly we find it is limited to the retail and leisure sectors. We would say that the default position on new shopping centres is for there to be turnover rent provisions for all leases, perhaps with the exception of those to anchor tenants. The same goes for shopping centres which have been redeveloped and for new lettings in established centres. Retail warehousing has not shared the same profile, with open market reviews remaining the standard position. This may well reflect the more intense managerial role performed by shopping centre managers and their teams in assisting the tenant in increasing footfall and demand.

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4. Sectoral variations

Retailers operating from multiple properties, often numbering in the hundreds, are well placed to gauge the effect of any changes away from upwards only review. Such retailers often have a menu of issues that are important to them when leasing space, including alternatives to upwards only reviews. The increasing cost of tenant fit-outs and the need to amortise or write off the costs over a period of years (usually no less than 10 years) has meant that many retailers are less interested in a short lease with a tenant's right to break. Instead, the preference is for turnover rents which are often a key aim. According to our data there has been a marked trend towards pure turnover rent provisions – operating without any base rent or base rent review. This has been a rapid change from what would have previously been acceptable to large property companies.

In the office sector there has been a more limited move away from upwards only reviews although many tenants are questioning whether there will, in any event, be significant rental growth over the next five years. This is particularly so where the initial 'headline rent' (the level of rent after the expiry of any incentives offered to the tenant which is used for purposes of market comparison, for example) is kept high by offering an extended rent free or reduced period at the beginning of the term. As noted above, there was a perceivable move towards RPI linked rent reviews in City offices several years ago, but this has been replaced in the last 18 months with a return to open market rent reviews.

5. The position in other European real estate markets

UK rent review provisions have operated independently of the rent review trends used elsewhere in Europe. Whilst open market rent reviews are the traditional model in the UK, other European countries have favoured index linked rent reviews, usually by reference to consumer prices indices. For example, in France there is an automatic right for either party to request that the rent be revised every three years, even if there is no formal rent review procedure in the lease. If requested, such a rent review is index linked. In Italy, rents can be adjusted annually by reference to the local consumer prices index, ISTAT, with the amount varying depending on whether the lease is residential or non-residential⁷.

Although European countries tend to favour index linked rent reviews, other forms of rent review are also used, but open market rent reviews are still uncommon. For example, in both France and Germany, turnover rents are commonly used in relation to retail leases.

In light of the global impact of the economic downturn, there has been much speculation about the potential for a levelling out of the rent review provisions used across Europe, including a move in the UK market towards index linked rent reviews. Such levelling out would enable investors to more easily compare investment propositions in different jurisdictions.

Our international investor clients often tell us that greater uniformity across global real estate markets would assist benchmarking and efficient asset allocation across sectors and jurisdictions. Indeed, such harmonisation is seen in areas such as environmental performance. However, the reluctance of the UK market to move away from open market rent reviews has so far prevented investors using their experience in other jurisdictions to guide investments in the UK. Ultimately, the unique attractiveness of the UK upwards only rent review (admittedly together with the tax regime on transfer, the transparency, liquidity and maturity of the market and many other factors) has provided a risk/reward profile which may be very different from elsewhere, but which has still encouraged international investors.

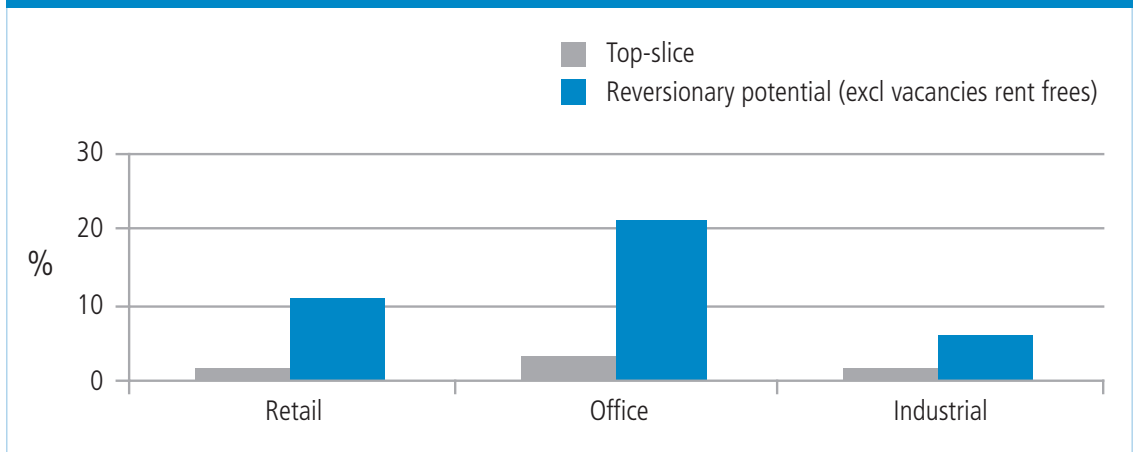
⁷ Examples from www.dlapiperrealworld.com, a free access website created by DLA Piper's real estate group which provides extensive information about sales and purchases, leases, real estate taxes, finance, construction, planning and zoning and corporate structures for investments in Australian, European and US jurisdictions.

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6. Implications for investors and occupiers

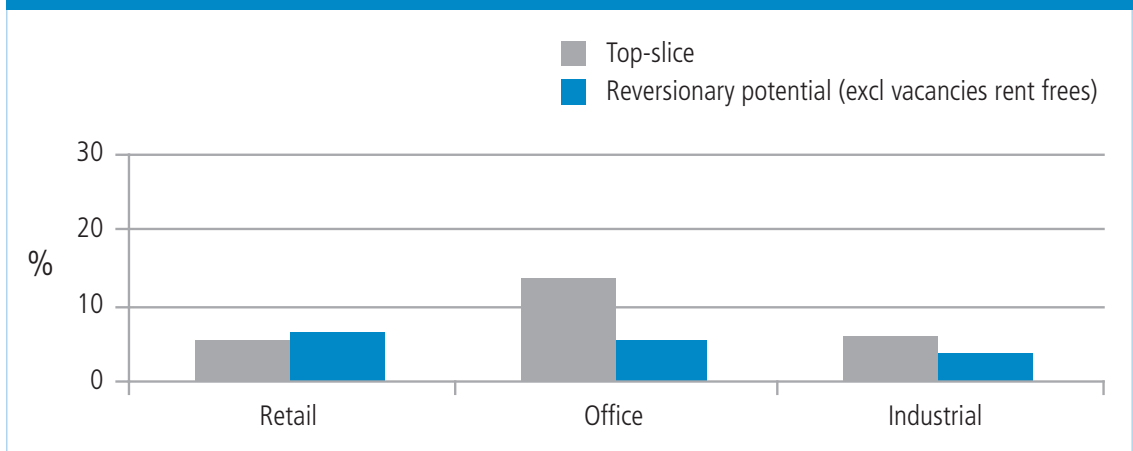
The relative benefit to the owner of the upwards only nature of rent review clauses versus the benefit to the occupier bestowed by the periodicity between rent reviews can be measured each year using the IPD Annual Databank. The total benefit to the occupier is the gap on each asset between the current rent payable and that which would be charged if the asset was let today (the 'open market rental value' as estimated by the valuer) when the rent payable is lower. This is the "reversionary potential". The total benefit to the owner is the same gap when the rent payable is higher than the current open market rental value; the "over-renting" or "top-slice".

Figure 1: 2008, % total income



Source: IPD Annual Digest 2008

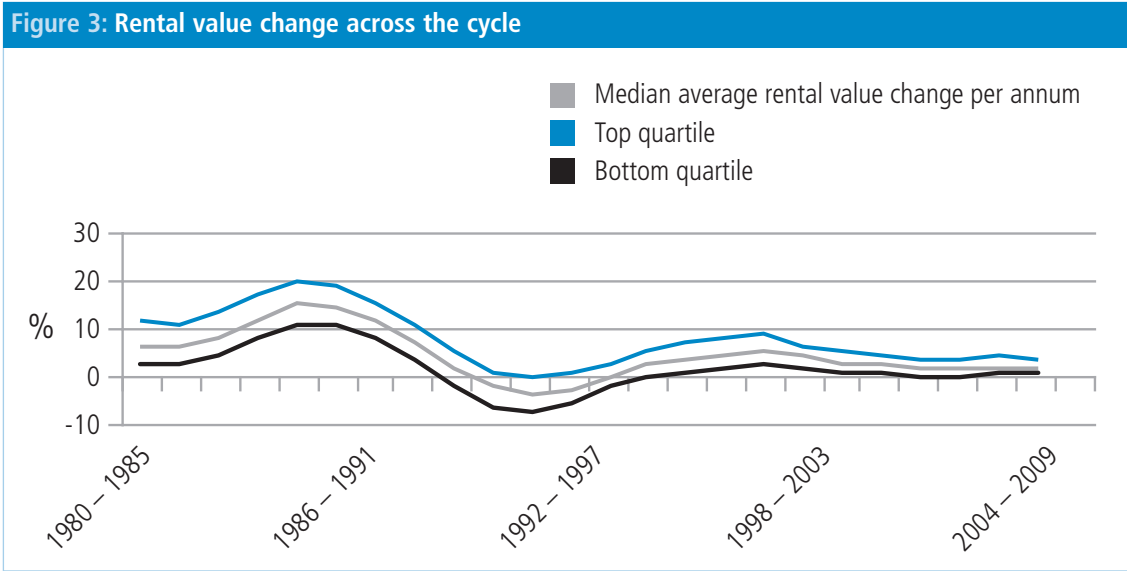
Figure 2: 2009, % total income



Source: IPD Annual Digest 2009

As market conditions switch from rising rental values to falling rental values the relative benefits of the UK rent review provision swing from occupier to owner: the occupiers benefitting in aggregate during strong market conditions and the owners in weak conditions. The timing of rent reviews and lease expiries during the cycle will therefore determine the scale of this relative benefit through the cycle: a Central London occupier with a lease expiring in 2010 and with a review in 2005 is likely to more enamoured of UK leasing conventions than one with a review in 2008 and expiry in 2018!

It could be argued that the almost randomly distributed benefits bestowed by the rent review clause add to the 'adversarial' reputation of the UK commercial property leasing market. The dispersion of benefits though is perhaps less significant for owners and occupiers of commercial real estate that have a portfolio of assets and leases which have a spread of rent review dates and lease expiry dates and more of an issue for owners and occupiers of single assets. The issue becomes more acute not only because there is no diversification benefit from a spread of the key dates within the lease, but also because of the large 'specific risk' attached to an individual asset. In statistical terms the dispersion in rental trends across individual assets is greater than the deviation in rental levels through the cycle – see the inter-quartile spread in individual asset rental growth in Figure 3 below.



The impact of this risk to the occupier can be significant, for example a sole retailer trading close to a new shopping centre opening may end up paying a rent well above current market levels. The protection to the owner – especially if the owner has mortgaged the asset – is equally significant in a downturn. In political terms sympathy is more likely to lie with the occupier but the economic externalities are also beneficial in terms of the stability of the financial sector. The upward only rent review is therefore more economically beneficial for the largest assets, occupiers and leases and potentially most problematic for smaller occupiers and assets.

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7. Related lease issues

A combination of factors including weaker market conditions and the introduction of the Lease Code are encouraging greater flexibility in negotiated lease terms. According to the 2010 Occupier Satisfaction Survey (Property Industry Alliance, 2010) of all the factors investigated, "rent review terms and conditions achieved through lease negotiation" scored most highly in terms of improvement in tenant satisfaction in the last 12 months, followed in second place by 'the leasing process'. This greater flexibility is manifesting itself in a number of forms.

7.1 More flexible rents

Landlords are showing greater flexibility about rent levels within the first five years of the lease term. In addition to traditional rent free incentives, there is increased use of stepped rents within the initial period of the lease term. For example, a three month rent free period followed by six months of half rent. This provides the landlord with some initial income, but gives the tenant phased stages before the full rent is payable.

There are also more all-inclusive rents being offered to compete with serviced office space. These are typically used for shorter and more flexible leases, for example, leases with rolling breaks after the first six months. However, in longer leases, they can be combined with annual RPI uplifts to protect the landlord. This appears to be a minor market arising specifically in response to the growth in serviced office space, rather than a widespread trend across the market.

7.2 Other incentives

Over the last few years, landlords have been increasingly prepared to offer substantial incentives for new leases, including rent free periods and contributions to fit out costs. This is closely linked to rent review provisions as securing generous incentives is often a higher priority for tenants when negotiating heads of terms than agreeing a specific type of rent review.

The use and importance of incentives varies across sectors. For example, in recent years, lengthy rent free periods have been offered for leases of new city centre offices. Additional rent free periods have also been agreed from the fifth anniversary of the term commencement date if the tenant's break option is not exercised. However, in the retail sector, contributions to initial fit out costs can be of greater importance to tenants.

7.3 Break clauses

When negotiating heads of terms, break clauses are often a more significant issue for tenants than the method of rent review. The exercise of break options is also becoming a particularly contentious issue as many tenants seek to use the threat of impending break options to negotiate reduced rents. There are also more break clauses linked to rent review provisions enabling tenants to wait until the rent review is agreed before deciding whether or not to terminate the lease. (See *IPF Research Programme Short Paper 10: Break Clauses* for further analysis of this subject).

7.4 Lease renewals

As most older leases in the UK contain open market rent review provisions, statutory lease renewals under the Landlord and Tenant Act 1954 are likely to lead to new leases with open market rent reviews. This is because the tenant is entitled to a lease in substantially the same form and with substantially the same terms as the existing lease and is under no obligation to accept any terms that are more onerous than the existing lease. In a statutory renewal, if either party wants to change the terms of the lease, they must justify the change and generally this will only be allowed if it is considered reasonable. For example, if a practical issue has arisen on a previous rent review due to some confusing wording in the rent review provisions, it may be reasonable to amend this to avoid confusion and additional cost on future rent reviews. However, it is much more difficult to argue for a completely different kind of rent review provision unless there is a very good reason for it, such as a significant change in the proposed term length.

In respect of informal rent reviews whereby the parties do not comply with the statutory procedure under the Landlord and Tenant Act 1954 and negotiate completely new heads of terms, the terms of the rent review in the existing lease may have little impact on what the parties negotiate for the new lease and will not dictate that an open market rent review apply to the new lease.

7.5 Lease renewals

There are SDLT implications of the different types of rent review. A straight RPI linked rent review which does not contain any other provisions and by which rent is simply increased in accordance with increases in RPI is ignored for SDLT purposes and therefore can represent the most beneficial SDLT position for the tenant. In respect of other types of rent review, rent increases after the fifth anniversary of the term commencement date are disregarded. However, a tenant is obliged to make further SDLT returns and payments on any abnormal rent increase after the fifth anniversary. In the case of fixed increases, it is possible to calculate at the outset of the lease whether an increase will be abnormal or not and therefore the tenant can prepare to make the appropriate additional payments. In the case of open market rent reviews where the future rent is not known until some years later, the tenant must remember to monitor the rent following each rent review and calculate whether there has been an abnormal increase. There are various calculations involving RPI and other factors to determine if there has been an abnormal increase⁸, but as a rule of thumb, an increase of more than 20 per cent over five years is likely to be considered abnormal.

7.6 Service charge

As with caps and collars in rent review provisions, tenants are increasingly keen to fix service charge costs and analyse in more detail service charges being raised. Service charge caps are now very popular, although they are often increased in line with increases in RPI.

⁸ See paragraphs 14 and 15 of schedule 17A to the Finance Act 2003.

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8. Conclusion

We have found a perceptible increase in the use of alternative rent review provisions, but despite some initial movement towards index linked rent reviews, there has not been a mass move away from open market rent reviews. However, as lease lengths shorten, rent review provisions are becoming less widespread and as break clauses become more common they become less relevant.

Despite the fact that upwards only reviews have been considered *de rigueur*, the market and its main players have shown flexibility in their readiness to look at – where considered appropriate – alternative rent review structures and patterns. This is born out by the Occupier Satisfaction Survey results.

Tenants do not appear to be unduly concerned about accepting open market rent review provisions and are prepared to accept them in order to negotiate other, higher priority, terms. This may be because in practice, tenants expect to exercise break clauses on the fifth anniversary so that the rent review provisions are irrelevant in any event.

Whilst there may still be some movement towards alternative rent reviews, the evidence here suggests a substantial shift is unlikely in the short term given that at least the next five years will be governed by the leases being granted now. There is no evidence of widespread harmonisation with the position adopted on rent reviews across much of the rest of Europe. It appears that whilst leasing practice within the UK property market is changing, that change is more evolution than revolution and in line with the process of lease modernisation seen more generally in the UK in recent years.



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