

Property Topics & Guides

Rent Reviews Guide



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Introduction

Rent Review clauses are a feature of most modern commercial leases which are granted for a term in excess of 3-5 years.

The majority of rent review clauses in the UK are upward only, particularly for office and industrial premises.

The upward only rent review is one of the longstanding features of the UK property market, and much less usual overseas. As a consequence, many tenants, international tenants in particular, find this characteristic of UK property leases surprising.

Many rent review provisions are complex, and expert advice is essential in virtually all cases.

There are a number of issues that need to be considered:-

- The timetable for notices and conducting the review and whether time is of the essence
- The demise- (what' included)
- Floor area as defined by RICS/ISVA Revised Code of Measuring Practice
- Building Specification
- Improvements to be excluded
- The terms of the lease
- The notional terms of the tenancy for the purpose of review
- Market comparables
- Tactics and timing
- Interest provisions on settlement post review
- Dispute resolution and procedures

It is important to understand the method of calculating measured floor area by reference to the appropriate industry guidelines, a detailed

understanding of the provisions of the rent review clauses and the inter-relationship of clauses within the lease.

Timetable and Preparation

It is important to establish whether your lease specifies a strict timetable for conduct of a rent review or whether it allows flexibility to negotiate an agreement without adhering to a strict timetable.

Establishing the timetable for your negotiations would normally be considered in the context of tactical advantages in relation to the market and any interest provisions that may apply to settlement subsequent to the review date and a tenant's own budgeting planning requirements.

There are a proportion of older leases that state that time is the essence for the service of rent review notices and it is essential that leases be checked in good time in advance of the review date (often more than 12 months before) to identify if this wording is present. If it is, it is essential that time limits are strictly adhered to, or the tenant's ability to challenge the quoted rent may be lost.

Whilst the lease may not specifically specify that time is of the essence for the service of rent review notices and the conduct of the rent review itself, the inter-relationship of other clauses within the lease can give rise to the same effect. The usual example is where there is a relationship between the timing of the rent review notice and the serving of a notice to exercise a break option.

In any event, it is important to understand the

procedures whether expressly stated or implicit in the lease and to ensure any necessary steps are diarised well in advance of the review date.

Preparation in good time of the review date is advisable. Tactics are one of the key points to establish early on and typically these are formulated against the backdrop of market conditions and trends. In a rising market, for example, the tenant may be best advised to seek a settlement as early as possible to minimise the risk of comparable rental evidence arising subsequent to the review date that demonstrates a higher rental level than that which had arisen prior. Whilst comparable evidence closest to the review date is considered the most relevant, it is also appropriate to have proper regard to comparable transactions that have been concluded at other times.

Other aspects of the lease may also influence the strategy established. These may include for example consideration of the interest provisions for settlement subsequent to the review date. Typically, most modern leases will specify that where the rental is increased subsequent to the review date, the difference between the old rent and the new rent is accrued as a debt and repaid with any interest upon settlement.

Some leases apply relatively penal rates of interest at 2-3% above base, by way of example, which is essentially an incentive for the tenant to reach a settlement as early as possible.

Other issues such as the third party procedures, including whether it is to be an Expert or Arbitrator appointed, are considerations when establishing a strategy. This particular topic is addressed in greater detail elsewhere.

Strategic alliances

One of the primary goals to establish at the outset when formulating a strategy for the review

is to seek any advantageous alliances with other parties in the geographical area with similar types of premises who may also have rent reviews forthcoming in the near term. Working together with other occupiers and/or their representatives can provide a formidable resource.

Typically, it is appropriate to contact all local companies with similar premises to establish what opportunities may be available.

Market Research & Analysis

This should be considered as the major time consuming task of any rent review and essential to success. It is also important to understand in considerable detail the prevailing comparable evidence when compiling your arguments and presenting your case to the landlord. Rent review surveyors all too often plunge directly into negotiations at an overly high or overly low rent, depending upon which side they are representing, and undertake their research later during the review process. The representative that is the first to provide comprehensive and well researched comparable evidence often has the opportunity to maximise the prospects for a favourable settlement. The opposition often merely review the evidence submitted to them and forgo the spadework themselves.

Understanding the premises

The floor area of the accommodation to be reviewed is one of the key points to be addressed at an early stage. The Royal Institution of Chartered Surveyors (RICS) and ISVA provide a Code of Measuring Practice setting out the basis to adopt for different categories of property.

Many tenants assume that the floor area will be specified in their lease. This is, however, rarely the case. Even if it is, this should still not be

relied upon.

Typically, offices are measured on a net internal area basis calculated by reference to the Revised Code of Measuring Practice issued by the RICS and ISVA.

Shops are also measured on a net internal area basis but with an ITZA (Zone A) adjustment reflecting frontage, depth and different zones of the property.

Industrial and warehouse premises are typically let on a gross external basis but reviewed and valued on a gross internal area basis.

Floor areas are often the source of dispute at review and it is important that these are carefully checked. It is also important not to rely upon floor areas previously measured unless these have been independently professionally referenced but this is rare for the majority.

Repairs & Improvements

Most leases typically provide for tenant improvements to be disregarded but this is not implicit and even if expressly stated, there can be exceptions.

Under the terms of most leases tenants are required to obtain landlord's consent before making improvements and where these are unauthorised there can under certain circumstances be the opportunity for the landlord to incorporate these improvements at review. This is a notorious area of disagreement and it is important to identify works that have been carried out and to establish whether these are an improvement, a repair or otherwise by way of an obligation contained within the lease or under the terms of the original letting.

Another typical term within modern leases is that for any disrepair that is the responsibility of

the tenant is to be disregarded as it is typically assumed that the tenant has complied with all repairing covenants. However, it is unusual for there to be an assumption that the landlord has complied with its repairing obligations and in circumstances where the landlord has a significant repairing responsibility, usually a multi-let office building, a failure to have done so or to provide good quality services can affect the rental value.

Basis of review and rent review assumptions

The lease will specify the notional terms of the tenancy for the purpose of the review.

Most standard form of wording in leases specifies the review to open market rental value assuming that the property is available to be let in the open market. A number of points are typically disregarded, such as the tenant's occupation, goodwill, improvements (see above) and there are usually further assumptions about the terms of the lease on which the property is let such as the length of the term, the existence of any break clauses and any other key points.

Understanding the implications of the notional term of the tenancy is particularly important. Certain aspects of these terms frequently provide the tenant with an opportunity to negotiate a reduced headline rent. These provisions should always be studied and understood carefully against the context of the prevailing market.

One of the more complex topics to address in terms of comparable evidence in the rent review process is considering the impact of a rent free period granted on new lettings when seeking comparables. The majority of new lettings incorporate rent free periods sometimes to assist during the fitting-out period but frequently as an additional inducement. Typically the rent does not become payable until anything

between 3-18 months after the new lease commences depending upon the original lease term granted and prevailing market conditions. In more difficult market conditions, substantially longer rent free periods are often granted as a pure letting incentive for the tenant to take the premises.

This gives rise to much debate in many rent reviews whether one should discount any headline rent achieved by apportioning the rent free period over a specified period of time. It is common in most current day leases for the two types of rent free periods to be dealt with differently. Most leases now specify that the new rent at review is to be that rent which will be payable after the expiry of the fitting-out period. If the rent free period granted on any lettings goes beyond the typical fitting-out period, then the headline rent can be apportioned to reflect the presence of this additional incentive.

Some leases are drafted in a manner in an attempt to ensure the review is undertaken directly against headline figures whereby such additional incentives are not discounted from the headline rent on comparables. However, often such clauses are ineffective in achieving their aims following a number of court cases on this issue.

Upwards Only

The vast majority of current leases specify that the rent shall be reviewed in an upwards only direction typically at 5-yearly intervals (although occasionally 3-yearly). There is no restriction on how often a rent review is implemented, but these are the typical patterns.

An upwards and downwards review is not always beneficial to a tenant, however, as a lease incorporating such provisions is inherently more valuable to a tenant and, as such, may attract a premium rental anywhere between 5-15% above prevailing market evidence for comparable

upward only review structures.

Key Terms that affect the Rent Review

Break Clauses

One of the most valuable characteristics to assume for a lease at review are regular tenant break options.

Break options and drafting of such clauses is a complex area and a detailed analysis would run to many pages.

In simple terms, a regular and effectively operable break clause will enhance rental value providing it is to be included within the virtual lease being reviewed. It is important to thoroughly understand the clauses to establish this.

The structure of the break clause and any conditions attached are also important and need to be considered carefully.

Alienation Provisions

Sub-let their lease. The majority of leases allow tenants to assign their lease subject to landlord's consent, not to be unreasonably withheld. The lease will further specify whether a sub-letting of the whole or parts of the property is also permitted.

Any unusual restrictions on alienation provide opportunities for tenants to negotiate a discount.

Building Service Charges

Where a tenant occupies part of a multi-let property, the landlord is generally responsible for repairs to the structure, exterior and common parts of the building and will cover his portion through a service charge.

For some buildings, older ones in particular, the service charges may be somewhat higher than the normal pattern for comparable properties and

this should be considered at rent review as to whether there is scope to negotiate a discounted rent to reflect this. There might be other variations in the service charge structure where for example the landlord takes responsibility for repairs, but does not fully recover this which will conversely justify a higher rental.

Other Lease Terms

There are a range of other terms that could reduce or enhance rental value and it important that the whole lease is assessed to establish this.

Researching Market Rents & Comparables

This is typically the most time consuming but certainly the most important component of any rent review process.

It is also important to consider comparables in a wider geographical area and access to comprehensive market databases is essential in this regard.

The firms of agents (Chartered Surveyors) listed on the Officespace site have access to all the UK's leading property information databases including Property Intelligence, Focus, Costar Group, Real Estate Information and EGI Databases.

These organisations employ a considerable number of staff and resources in compiling market transactions and rent review evidence, coupled with lease details of buildings across London and the south east. However, whilst these are essential tools, this information is only usually adequate to provide a snapshot. It is important for the rent review surveyor to undertake detailed and thorough research by speaking to the relevant professional representative who handled the original letting or rent review of the subject comparable premises.

Negotiation & Dispute Resolution

Clearly it is in everyone's interest to achieve settlement of the review by negotiation.

Landlords and/or their representatives do not always behave reasonably, however, and sometimes it is necessary to apply greater pressure to reach a settlement or to proceed toward determination by third party.

Leases will typically direct the dispute resolution procedures in the event parties cannot agree and this is usually in the form of the appointment of an Arbitrator or Independent Expert.

Where a tenant can apply for the appointment of an Arbitrator or an Independent Expert this can be worthwhile undertaking early on to minimise delays in the event of a failure between the parties to agree. The cost of an application to the RICS for the appointment of an Arbitrator or an Independent Expert is approximately £300 including VAT. Alternatively, you may wish to try the identity of a suitable appointee with the other side, but this in reality rarely happens.

An additional way of applying pressure to your opponent is through the service of a Calderbank Offer. This offer increases the risk of your opponent having to pay all the costs in the subsequent arbitration. A Calderbank Offer should always be drafted appropriately and in the prescribed form.

Independent Expert Determination is a private process where an Independent Expert with inquisitorial powers provides a binding decision. He can use his own expertise in addition to considering representations made by the various parties.

Arbitration is a judicial, private, binding process

where the appointed third party provides a decision based upon their evaluation of each sides' representations. He is not empowered to

use his own expertise in the decision making.

The Arbitration Act 1996 allows both parties to agree on the appropriate procedures for resolving their dispute. It is usual for the parties involved to hold a preliminary meeting with the Arbitrator to discuss and agree directions.

The standard way to proceed is typically through written submissions and counter-submissions with both parties and the Arbitrator with the right to call an oral hearing at a later stage if there are any matters of evidence which need to be examined in more detail.

Under the 1996 Act, the Arbitrator is able to make his own enquiries on matters of evidence. He will also produce a reasoned Award.

Conclusion

Rent review procedures can be complex and it is important that any party undertaking such negotiations or their representatives has a thorough understanding of the processes as well as prevailing market conditions and comparable evidence.

It is important that time is allowed well in advance of the rent review date to avoid the risk of failure to meet any specified procedural steps - for example, by serving a counter notice or making an application for an Arbitrator within a strict time limit. Any correspondence should be carefully worded in the prescribed form to ensure binding agreement is not reached unwittingly, or that any Calderbank letter is drafted in the prescribed form.

Once a new rent has become binding, the majority of leases contain the provision this should be formally recorded by way of a Memorandum. A Memorandum should be completed.

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It is impractical for a bulletin of this length to be all encompassing and it is important that the contents of this leaflet are not relied upon for any specific circumstance. It is always important to seek specific professional advice. Andrews Denford & Boyd cannot be liable for any loss or damage arising in any way from the contents of this document.

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