MSCI Global Intel Report

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After a year of decade-high UK economic growth in 2014, expansion moderated somewhat in 2015. The first two quarters of 2016 have seen growth improve on 2015 levels, driven by consumer spending and investment. The economy advanced by 2.2% year-on-year in the second quarter of 2016 – following a 2% expansion in the previous quarter. Notwithstanding encouraging economic growth – especially when viewed on a quarter-on-quarter basis – the vote to leave the EU has added substantial political and economic uncertainty to the UK outlook.

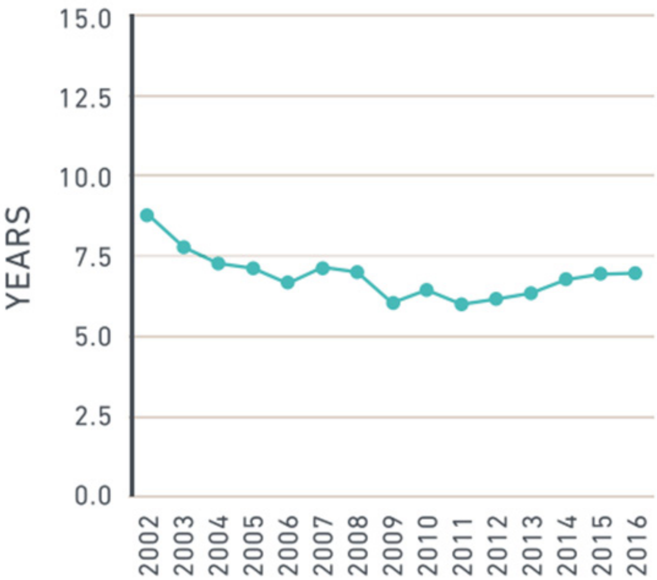
Following the vote many commercial property funds have had to suspend trading in response to capital outflows.

The uncertainty prevalent in the market preceding the Brexit vote saw the rent-weighted UK lease length decline by around half-a-year, meaning that larger occupiers have in aggregate been negotiating for shorter leases.

During the first half of 2016, the average unweighted length of leases granted in the UK market stood at 7.0 years. While only marginally up from 2015, this was a continuation of the upward trend observed since 2011. Average lease lengths have now increased by a full year since the bottom of the cycle in 2011. This follows the broader trend of recent years, in tandem with the economic recovery, with leases lengthening due to supply conditions and growing confidence amongst occupiers competing for space.

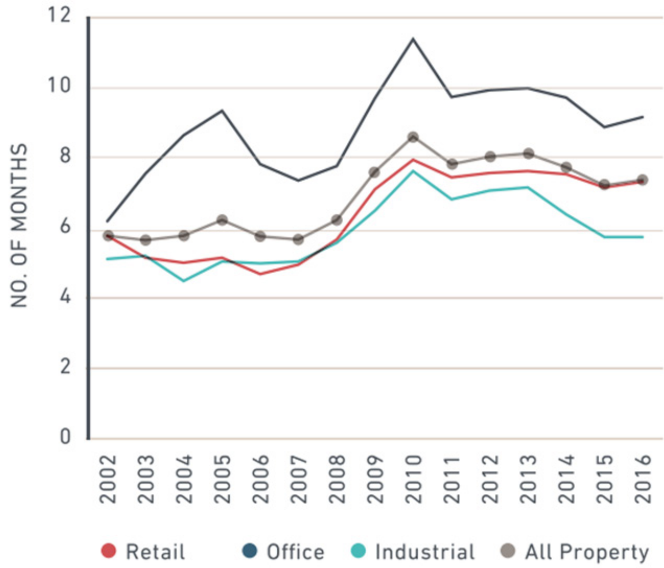
Unweighted lease length

Unweighted full term; ingnoring breaks and inlcuding short leases



Average rent-free periods by sector

Tenancies equally weighted



Source: MSCI

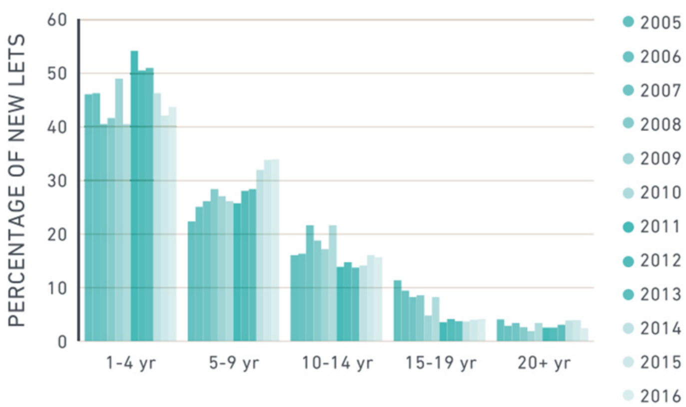
As the fundamentals underlying the UK market have recovered, landlords have been pushing for longer leases in the quest for income security. Since the bottom of the market in 2009, average rent-weighted and unweighted lease lengths have both increased by a year, to 11.0 and 7.0 years respectively. However, there have been significant shifts within the different lease-length brackets.

During the first six months of the year the length of rent free periods increased slightly and the proportion of leases with a break clause also ticked up. To evaluate income streams for investors in commercial real estate, risks such as lease expiries, break clauses, vacancies and defaults have to be assessed.

The main risk to landlords and investors, and one that is quite unpredictable compared to the effect of break clauses or the end of a lease, is tenant default. Tenant default can leave the landlord with significant arrears and a vacant building, with varying levels of recourse depending on the financial position of the defaulting company. Difficult trading conditions for UK retailers over recent years have increased the number of receiverships and liquidations leading to more volatile default rates for all sectors. Through 2015 the rate of default by UK tenants declined, falling to 3.1% of all tenancies weighted by rent passing, a reflection of the improving economic environment. This was the lowest rate of default registered in the UK market since 2007, and compares favorably with the level for 2014, 3.7%. The rate of default had peaked at 6.2% in 2012.

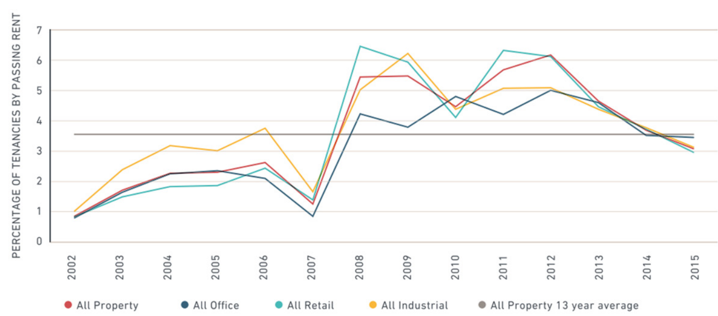
Unweighted lease length distributions

Percent of new lets in each lease length band



Tenants in default by sector, 2002-2015

Tenants weighted by rent passing



Source: MSCI, D&B

To help investors and their fund managers evaluate income streams in commercial real estate, risks such as lease expiries, break clauses, vacancies and defaults have to be assessed. These may be seen as a series of options in the future cash flow from real estate assets. All have a significant impact on the assessment of risk for a cash flow, and as such clear analysis is crucial to help stakeholders understand the potential of the space they manage or own.

The MSCI Lease Events Review for 2015 and year-to-June 2016, in association with Strutt & Parker, provides empirical evidence on the likelihood of the different events. The analysis was based on a sample of over 73,000 extant leases held in the IPD UK Annual and Quarterly Property Universe and more than 9,000 new leases signed over the last year.

Author's Bio

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Max Arkey works in product management at MSCI Real Estate where he heads up indexes and market information products. These analytics are mission critical to the investment process for 19 of the top 20 largest global asset managers, all the way through to specialized domestic investors. For further details contact: max.arkey@msci.com

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