

UK COMMERCIAL PROPERTY FOCUS

15th Jul. 2009



Editors: Roger Bootle and Ed Stansfield

The effect of voids on landlords' income during a downturn

- **The current commercial property occupier market downturn could run for another 12-18 months, and we think that, depending on the sector, rising voids over that period may take up to 5% off a typical landlord's rental income stream. Clearly, that would be a significant blow. But by far the bigger problem is simply that new lettings are going to have to be done at lower market rents.**
- Company insolvencies rose in 2008, and, given the weak economic backdrop, are likely to continue to increase for some time. It is difficult to anticipate how far corporate failures might climb, not least because of the scope for the Government to step in with rescue packages. **We suspect, however, that over the next few years the office sector will be hardest hit by occupier insolvencies** – and, hence, voids – followed by industrial property, with retail least affected.
- In previous work, *ignoring voids*, our simple cashflow modelling suggested that some landlords might see falls in rental income over the next few years of up to 9% in the retail sector, 20% or so in the industrial sector, and about 24% in the office sector. We have re-run those calculations in this *Focus*, *this time accounting for the influence of voids*, and **this suggests an additional reduction of perhaps 1% in retail incomes, about 3% in the industrial sector and 5% or so in the office sector.**
- **Admittedly, there is plenty of uncertainty around the precise levels of these estimates and they are probably best treated as plausible worst-case scenarios.** But the key point is that the adverse, cyclical influence of rising voids on landlords' income streams over the next few years may well be relatively small compared with the simple fact that new lettings are going to have to be done at much lower levels of market rents.
- **Overall, structural changes to lease terms in the UK commercial property market mean that landlords' rental income streams are already more vulnerable to occupier downturns than they were 20 years ago.** And company insolvencies are likely simply to exacerbate the downward pressure on landlords' income streams over the next few years. Admittedly, not all landlords and portfolios will be affected. **But on average, lower income security over the long-term is consistent with higher commercial property investment risk.**

Kelvin Davidson

Capital Economics Ltd

Europe

150 Buckingham Palace Road
London SW1W 9TR
United Kingdom
Tel: +44 (0)20 7823 5000
www.capitaleconomics.com

North America

2 Bloor Street West, Suite 1740
Toronto, ON, M4W 3E2
Canada
Tel: +1 416 413 0428

Managing Director
Property Economist
Property Economist
Property Economist
Property Economist

Roger Bootle (020 7808 4999, roger.bootle@capitaleconomics.com)
Kelvin Davidson (020 7808 4990, kelvin.davidson@capitaleconomics.com)
James Purvis (020 7811 3917, james.purvis@capitaleconomics.com)
Seema Shah (020 7808 4988, seema.shah@capitaleconomics.com)
Ed Stansfield (020 7808 4992, ed.stansfield@capitaleconomics.com)

The effect of voids on landlords' income during a downturn

The terms and conditions of commercial property leases in the UK are relatively rigid, meaning that landlords have some protection against drops in the actual income that they receive when estimated rental values (ERVs, or open-market rents) are falling. **However, structural changes to commercial property leases in the UK, such as the greater prevalence of break clauses, have meant that landlords' incomes are now more exposed to market forces than they once were.**

Indeed, as outlined in "The effects of structural lease changes on landlords' income" (*UK Commercial Property Focus*, 29th May 2009, available to clients on our website), we estimate that, for a given fall in ERVs, structural lease changes mean that the actual income received by a typical landlord might now decline by twice as much as it would have done in the early 1990s. (Conversely, landlords are now able to capture more fully the benefits of an ERV upswing.)

Of course, the rental incomes actually received by landlords are not only determined by structural lease factors – they are also strongly influenced by cyclical economic conditions, and especially the rate of corporate insolvencies and lease defaults. After all, even an ultra-long lease with no break clauses provides no income in the event of the tenant going bust. This piece builds on our work from the *Focus* referred to above, extending the analysis to cover the potential cyclical influences on landlords' income streams through the occupier market downturn that is now underway.

Lease expiries, breaks and corporate insolvencies

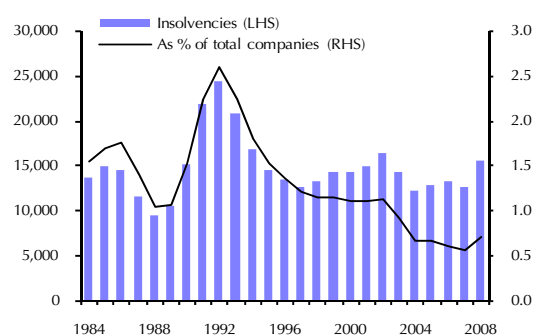
Two of the main ways in which leases come to an end, potentially leading to a void, are that they reach the end of their agreed term or a break clause is exercised. On the basis of research from IPD/BPF and IPD/Strutt & Parker, we estimate that about 5-10% of existing leases could be vulnerable to voids as a result of break clauses being exercised. And perhaps another 10-15% of leases reach their agreed expiry date in any given year.

Accordingly, due to these two structural factors, as many as 25% of existing leases could come up for renewal, and, hence be at risk of a void, in any given year. However, although that presents substantial scope for landlords' incomes to suffer, these so-called lease events are largely known in advance and can be planned for.

A third way in which leases can come to an end – the tenant simply going bankrupt – is much less predictable. **And in the current weak economic environment, it is this cyclical influence of insolvency-driven voids that will become an increasingly large threat to the security of landlords' income streams.**

Chart 1 shows company insolvencies since 1984. After falling over the course of late 1980s, insolvencies rose sharply during the recession of the early 1990s to peak in 1992 at more than 24,000, equal to 2.6% of the total number of firms.

CHART 1: INSOLVENCIES IN ENGLAND AND WALES, 1984-2008



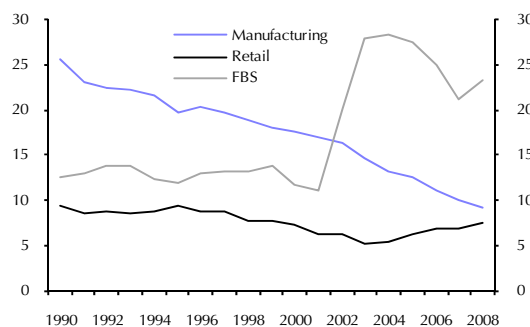
Source - Insolvency Service

After then easing down to around 12,500 by 1997, the number of company insolvencies has since averaged about 14,000 per year, though as the recession hit in 2008 they rose to 15,500. However, despite the rise last year in absolute terms, the proportion of firms going bust was still only 0.7%, lower than any year prior to 2004.

Manufacturing accounted for a larger share of company insolvencies than retailing and financial & business (FBS) services each year from 1990 to

2001. (See Chart 2.) However, reflecting the continued downward trend in the absolute number of manufacturing firms, this sector has since seen its share of insolvencies fall below the FBS sector and is approaching retail.

CHART 2: INSOLVENCIES IN SELECTED SECTORS, % SHARE OF TOTAL, 1990 – 2008



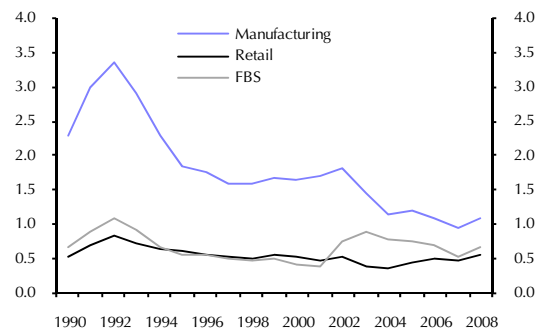
Source - Insolvency Service

Another interesting point from Chart 2 is that the share of insolvencies accounted for by the FBS sector hasn't yet come close to returning to its pre-dot.com bust levels. Admittedly, the FBS sector's contribution to overall company insolvencies did edge down in 2005, 2006 and 2007, but then ticked up again last year. Given the continued (though now less dramatic) problems in global financial markets, the FBS sector's share of insolvencies would seem likely to rise again this year and perhaps even into 2010.

Of course, arguably the more important measure of the adverse influence of insolvencies on property landlords is the share of total firms *within each sector* going bankrupt (as opposed to each sector's share of the total).

On this measure, owners of industrial property are likely to have fared worst over the past 20 years or so. As Chart 3 shows, almost 3.5% of manufacturing firms went bust in 1992 – far higher than 0.8% of retailers and 1.1% of FBS firms – and, of the sectors given here, manufacturing has also had the highest share of insolvencies ever since.

CHART 3: INSOLVENCIES IN SELECTED SECTORS, % SHARE OF FIRMS WITHIN EACH SECTOR, 1990 – 2008



Sources - Insolvency Service, National Statistics

The shares of retail and the shares of FBS firms going bust have been broadly similar to each other over the past 20 years, but there have nevertheless been periods in which FBS firms have fared relatively poorly against retail – namely in the early 1990s recession and in the years following the dot.com bust in the early 2000s.

A projection for insolvencies and voids

Of course, what really matters is not what has already happened but what is likely to happen over the next few years to company insolvencies and commercial property voids.

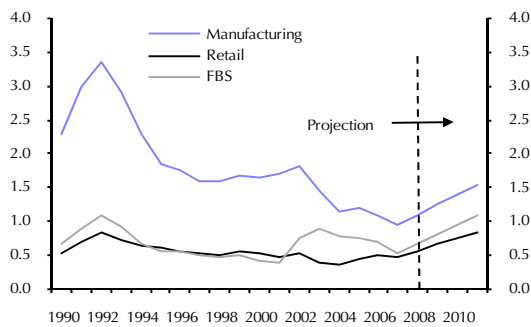
Specific forecasts of how sectoral insolvencies might evolve over the next few years are difficult. **However, what we can be sure of is that in the current recessionary environment the proportion of firms winding up will rise.** For the purposes of this exercise, we assume that insolvencies in the retail sector will rise from their current level of 0.6% of active firms to the same peak, of 0.8%, that they reached in 1992. Similarly, we assume that FBS insolvencies will rise from 0.7% of firms to their 1992 peak of 1.1%.

Manufacturing, however, is a little more difficult. Simple inspection of Chart 3 suggests it is unlikely that, from a much lower base, manufacturing insolvencies will rise back to the 1992 peak of about 3.5% of the number of firms in the sector. This perhaps captures the idea that the long period

of decline in manufacturing's importance to the overall economy means that only the fittest have survived and this will make the sector more resilient than in the past.

Between 1990 and 1992, the proportion of manufacturers becoming insolvent rose from 2.3% to 3.4%, i.e. an increase of almost 50% in percentage terms. In what follows, we assume that the same percentage increase will occur again over the next few years, pushing up manufacturing insolvencies from their current level of about 1.1% of firms to around 1.5%. (See Chart 4.)

CHART 4: INSOLVENCIES IN SELECTED SECTORS, % SHARE OF FIRMS WITHIN EACH SECTOR, 1990 – 2011

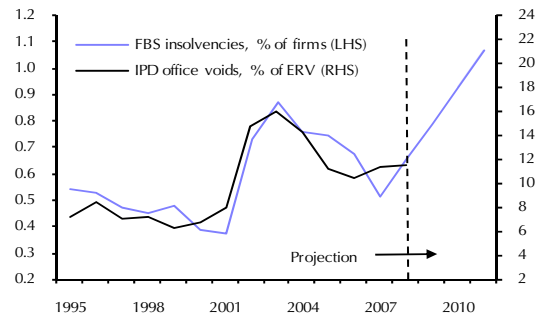


Sources - Insolvency Service, National Statistics, Capital Economics

If anything, given that this recession is arguably worse than that seen in the early 1990s (e.g. we expect the output gap – a guide to how much idle productive capacity there is the economy – to be bigger this time around), the risks to those projections are surely on the upside.

So what might those insolvency rate projections imply for voids on the IPD figures (which, although they only go back to 1995, are the best data we have covering all three main property sectors)? In the office sector, there has been a strong correlation between FBS insolvency rates and IPD voids since 1995. (See Chart 5.) **On this basis, office void rates could climb to more than 20% over the next few years.** That would also be consistent with the figure suggested by our current GDP forecasts.

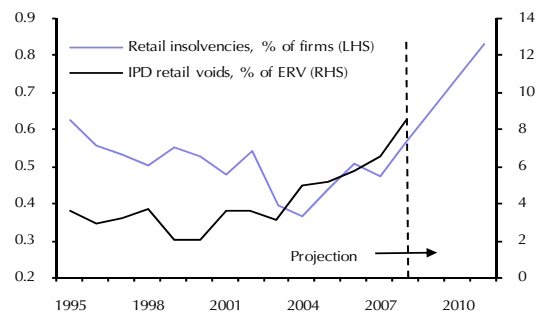
CHART 5: FBS INSOLVENCIES AND OFFICE VOIDS, 1995 – 2011



Sources - Insolvency Service, National Statistics, IPD, Capital Economics

Unfortunately, at best, only a loose correlation exists between insolvency rates and IPD voids in the retail sector, and even that tenuous link has only emerged in the past 3-4 years. (See Chart 6.)

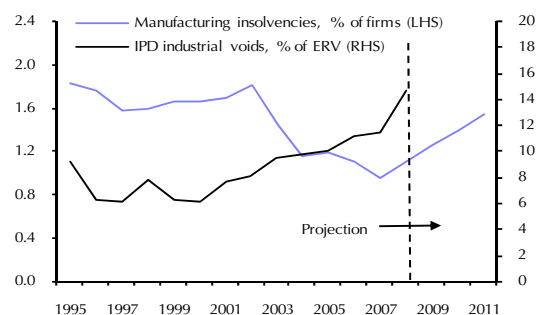
CHART 6: RETAIL INSOLVENCIES AND VOIDS, 1995 – 2011



Sources - Insolvency Service, National Statistics, IPD, Capital Economics

In the industrial sector, the situation is even worse, with manufacturing insolvency rates showing no correlation at all with IPD voids. (See Chart 7.)

CHART 7: MANUFACTURING INSOLVENCIES AND INDUSTRIAL VOIDS, 1995 – 2011



Sources - Insolvency Service, National Statistics, IPD, Capital Economics

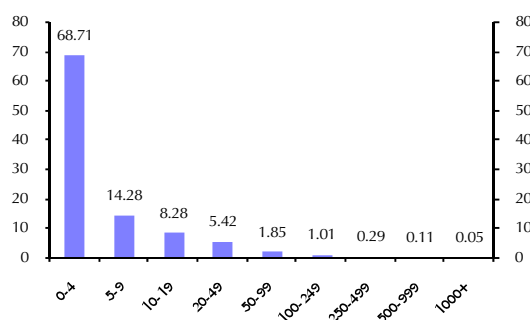
It is not obvious to us why the link between insolvency rates and IPD voids is not stronger in the retail and industrial sectors. One possible explanation is that space in these two sectors *may* be less amenable to re-fit/refurbishment than offices. This would mean that the scale of obsolescence would tend to increase and might help to explain why, regardless of the state of occupier demand, retail and industrial voids have simply edged higher in recent years.

But regardless of the reasons why, the fact remains that the lack of correlation between insolvencies and IPD voids in the retail and industrial sectors makes it difficult to envisage where those void rates might head. Despite this, however, given that retail voids are starting from the lowest base, and given some signs of a correlation in Chart 6, we suspect that voids in this sector might perhaps hit 12% to 13% over the next few years. The picture is even hazier in the industrial sector, but, on balance, a void rate approaching 20% isn't out of the question based on the pace of recent rises.

Given all of this, we suspect that over the next few years tenant defaults and voids will have the biggest adverse effect on landlords' income streams in the office sector, followed by industrial, with retail suffering the least.

Admittedly, that view does not take into account the size of the firm becoming insolvent. As Chart 8 shows, the proportion of very big firms (say employing at least 100 people) in the UK is low.

CHART 8: FIRMS BY EMPLOYEES, % SHARE IN EACH BAND



Source - National Statistics

But, assuming that all firms use space equally efficiently, the bankruptcy of a company employing 100 people would tend to be much worse for property demand and, hence, rental values and income than the bankruptcy of a firm employing two people.

At face value, the office sector might seem most vulnerable in this regard, because the credit crunch has had its biggest direct influence on financial services companies – such as RBS and HBOS – who are among the UK's very biggest firms by employee numbers. Of course, it now seems that the worst has passed for many financial companies and, partly due to government backing, the risk of outright collapse of one of the big banks is now surely far lower than it has recently been.

Indeed, in terms of risk, bigger upside to our projections for property voids arguably exists outside of the office sector. For a start, data from National Statistics show that the retail and manufacturing sectors both have bigger shares of large (defined here as at least 10 employees) companies than the FBS sector. (See Table 1.)

TABLE 1: SIZE OF FIRMS BY SECTOR AND EMPLOYEE NUMBERS, % OF FIRMS IN EMPLOYEE NUMBER RANGE

	1-9 employees	10+ employees
Manufacturing	74	26
Retailing	83	17
FBS	90	10

Source - National Statistics

Indeed, perhaps more concern should focus on the retail sector, where household names such as Woolworths and MFI have already gone bust. Against the backdrop of high indebtedness, further falls in house prices and our expectation of declining consumer spending, there is surely a substantial risk that there will be more casualties among the UK's larger retailers.

The impact on income streams

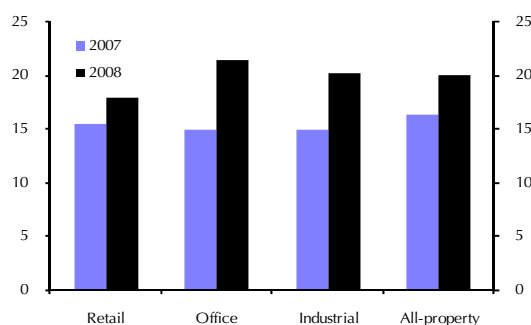
Risks aside, however, our central view is that offices are likely to suffer the most from rising voids over the next few years, followed by

industrial property and then retail. So how might this impact on landlords’ income streams?

Based on our current ERV (or rental value) forecasts, our cashflow modelling in “The effects of structural lease changes on landlords’ income” suggested that an individual retail landlord might see their actual rental income received fall by about 10% over the next few years, versus 20% in the industrial sector and about 25% for offices. That analysis, however, did not account for voids. For the purposes of this piece, we have re-run the initial calculations, assuming that voids now do have an effect.

The way we did this was to make two key assumptions. First, upon the break of a lease by a tenant, we assume that the property stays empty for one year before being re-let. This assumption is broadly consistent with data from IPD/Strutt & Parker, though is arguably a little conservative. (See Chart 9.)

CHART 9: LENGTH OF VACANCY, MONTHS, 2007 AND 2008



Source – Strutt & Parker/IPD

Second, to reflect our earlier view that offices were likely to be hardest hit by voids (with retail least affected), we assumed that the number of leases subject to voids was nine out of 15 in the office sector, six out of 15 for industrial, and just three out of 15 in the retail sector. (For a more detailed discussion of the methodology behind our cashflow modelling, see our previous *Focus* referred to above.)

So what were the results of all this? In the retail sector, for example, Table 2 shows that the influence of voids only takes another 1% off rental income streams relative to the scenario of no voids (i.e. the falls increase from 9% to 10%). The figure was bigger, at 3%, in the industrial sector, and bigger again, at 5%, in the office sector.

TABLE 2: ERV AND MODELLED INCOME, % CHANGE FROM PEAK TO TROUGH, BASED ON CAPITAL ECONOMICS’ ERV FORECASTS

	Retail	Industrial	Office
ERV forecasts	-18%	-25%	-34%
<i>Modelled net income:</i>			
- Excluding voids	-9%	-20%	-24%
- Including voids	-10%	-23%	-29%

Sources - IPD, BPF, Capital Economics

Admittedly, none of this analysis is definitive – merely hypothetical modelling, and there are problems with it. For a start, rising voids and falling market rents are not mutually exclusive. In addition, our modelling assumes that tenants never (always) exercise the right to break when ERVs are above (below) the level of rent set at the previous review. Making this assumption ignores such important considerations as the quality and/or quantity of space the tenant may require.

We are not actually forecasting that industrial incomes, for example, will fall by 20-25% over the next few years. Indeed, the figures in Table 2 are perhaps best treated as plausible worst-case scenarios. **The key point from the Table is that the adverse influence of rising voids on landlords’ income over the next few years may well be relatively small.** Rather than from voids, **by far the biggest knock to incomes is set to arise simply from new lettings having to be done at much lower market rental levels.**

Conclusions

Structural changes to lease terms in the UK commercial property market mean that landlords’ rental income streams are already more vulnerable to occupier market downturns than they were 20 years ago. And corporate insolvencies, tenant

defaults and higher voids are likely to exacerbate the downward pressure on commercial property income streams over the next few years.

Our analysis suggests, however, that it is simply declining market rents that will have the biggest downward influence on incomes. And in our view, it is the rental incomes on offices that stand to suffer the most during the downturn, from both a structural and cyclical point of view.

The relative influences of structural lease changes and cyclical void rates aside, however, the big picture is that lower income security over the long-term – although it won't affect all investors and portfolios is consistent with higher commercial property investment risk. This is one reason to be cautious about the degree to which yields could fall back during the eventual property market recovery.