Hicks Baker
Commercial Property Consultants

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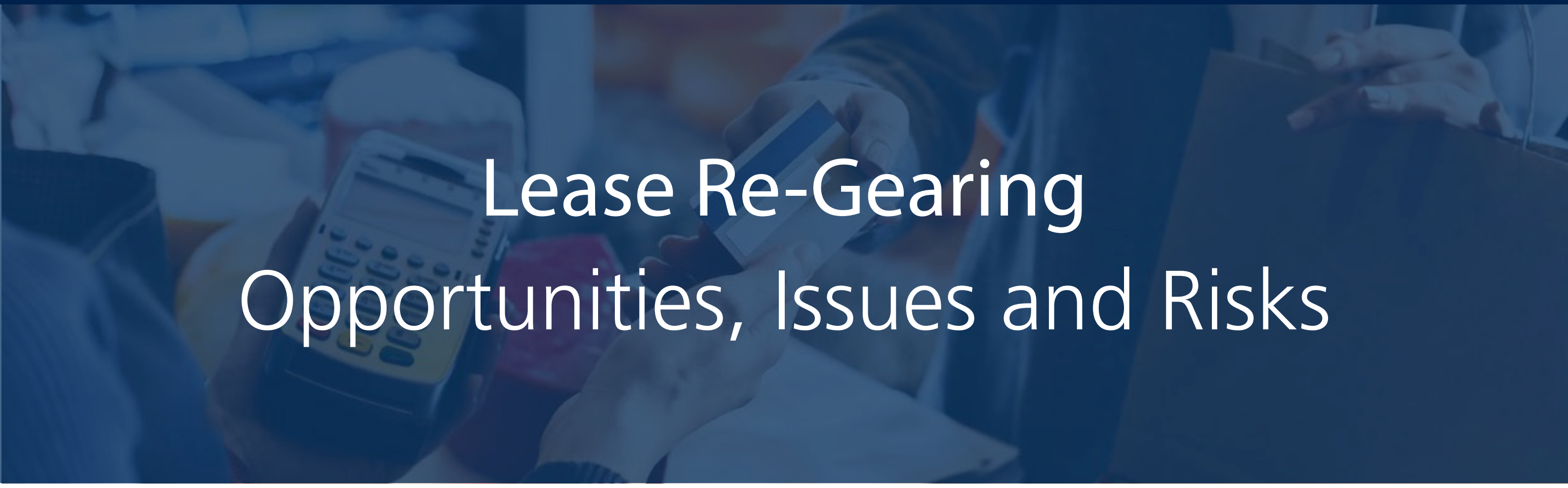


Lease Re-Gearing
Opportunities, Issues and Risks

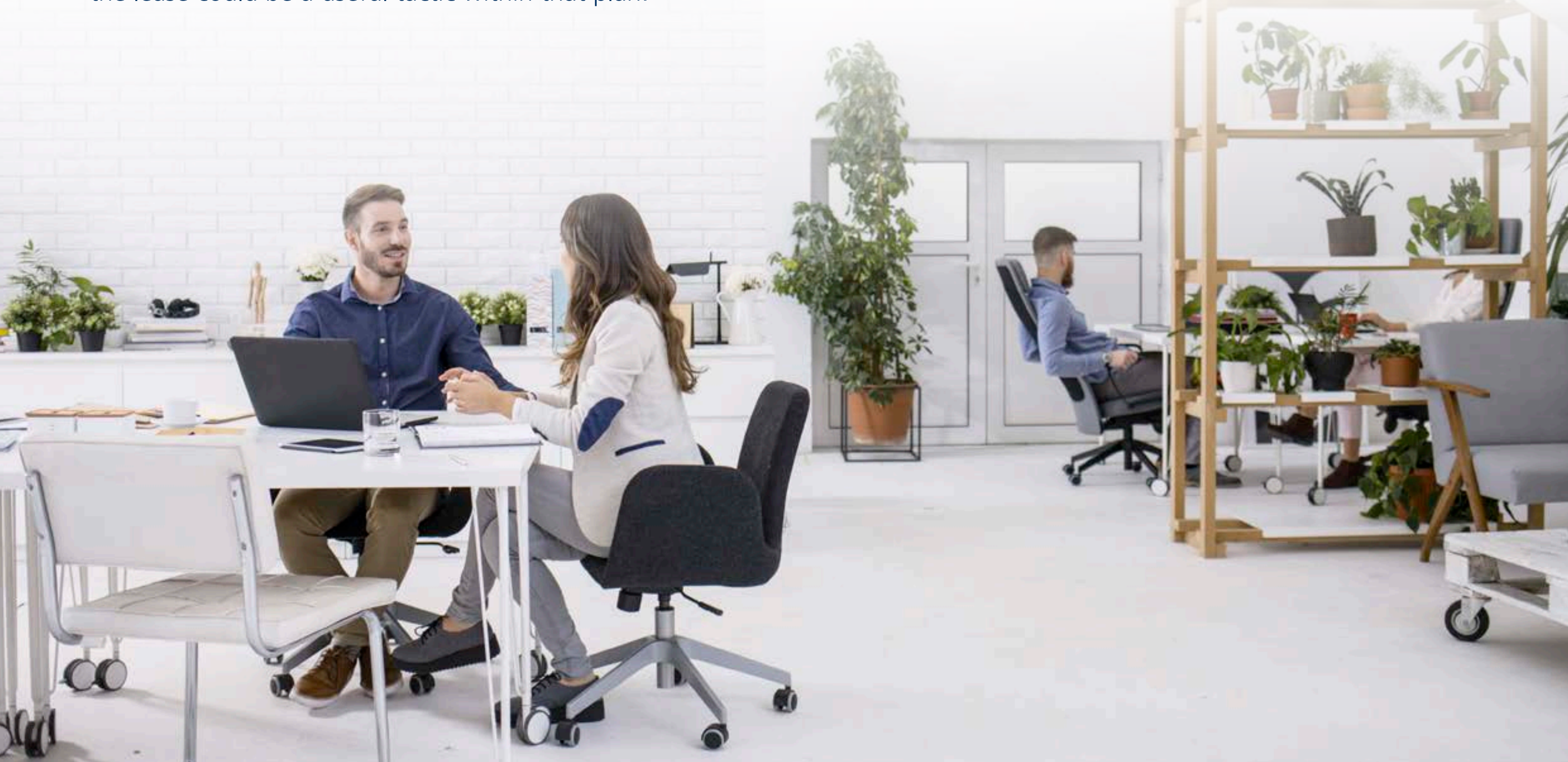
In normal times amending commercial lease terms tends only to happen when there is a break or renewal due. But Covid-19 has resulted in times that are anything but normal and has resulted in a lot of re-gearing activity over the last 12 months.

It's worth noting that there is a lot of uncertainty in the market as we wait to see the full impact of government financial support being phased out and what happens when the moratorium on forfeiture under the Coronavirus Act no longer applies.

The most important thing for commercial landlords - as we explain below - is not to panic, but to take stock and reassess your property and investment strategy. Re-gearing the lease could be a useful tactic within that plan.

The reality for many landlords and their tenants is that the commercial property market is very different from how it was when lease agreements were initially negotiated.

There is strong downward pressure on rents and capital values in the retail sector. There could be significant advantages in the stability that comes from re-gearing lease agreements to be more in line with the market.



Trends

For landlords, securing a viable long-term tenant for retail units is an important mechanism for maintaining the value of their investment. In a fairly extreme example of devaluation, a shopping centre in Coventry that was anchored by a Debenhams store sold at auction for £4.9m, having been valued at £37m eight years before.

Market trends vary for different types of retail, with high streets and town centre shopping centres being more affected than out of town retail. Estimates put the oversupply of UK retail space at 25%, accross the country, which places a premium for landlords on secured occupancy

In the office space market a lot will depend on whether businesses choose to call all staff back into the office, continue work from home policies, or adopt hybrid working. Research conducted by the BBC showed that 43 of the UK's top 50 firms plan to adopt hybrid working models. If this is reflected across the economy there will be many businesses with more space than they need.

The Thames Valley is seeing healthy demand for premium office space in convenient locations with good transport infrastructure and amenities. Even so, there's a 'wait and see' tendency as new work patterns gradually take shape.

Sustainability is becoming an increasingly significant factor in the viability of office accommodation. There's the possibility of a mandatory EPC rating of B coming into force by 2030 as a milestone en route to achieving net zero carbon by 2050. Owners of older and less energy efficient properties face difficult choices over whether to invest in upgrades, particularly in the face of trends towards remote and flexible working.

The industrial property sector has been the most stable over the past few years so tenants in desirable properties will typically have less leverage than in other sectors. Even so, landlords can derive a benefit from adopting an active asset management approach that includes re-gearing and property upgrade options in return for secure longer term occupation by a tenant with good covenant strength.

Regearing Realities

As ever, strength of covenant and business stability will be important factors. A business that was struggling before the pandemic is unlikely to have transformed its prospects even if it has been kept afloat with government support.

Landlords should explore their long-term financial objectives and plans for the property. A sound tactical approach might be to nurse properties through the current period of uncertainty and keep as many options open as possible. Re-gearing could give landlords a bit of breathing space while they reassess their strategy.

If the tenant's business has a viable future (perhaps with a reduced cost base) the landlord will need to weigh up any concessions they offer against the likelihood of an extended void period and refurbishment costs to make the property attractive to a new tenant. There is more interest currently in profit and turnover based rents.

Tenants will need to balance the value of continuing to trade from a profitable location against any financial advantage they could gain from exercising a break and moving to cheaper premises (not forgetting their dilapidations liabilities, which could be significant).

Providing that both parties are willing, re-gearing need not be a long or costly process.

Alternatives

Sometimes re-gearing will not be an option – possibly because the tenant doesn't have a viable future trading from the property or because the landlord is unwilling to offer sufficient concessions.

For landlords who would potentially end up with an empty and hard to let property the options are limited. They can explore change of use under the revised permitted development rights or consider how the property could be altered or redeveloped to make it more attractive. Both of these could be expensive or unaffordable.

Tenants who occupy spaces that are too expensive, too large or just unsuitable can explore assignment or subletting (assuming the lease allows this) if the landlord is unwilling to re-gear the lease.

Whatever your current situation and your plans, it makes sense to consult a specialist who understands the local commercial property market. This will allow you to negotiate from a position of greater strength and knowledge.

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