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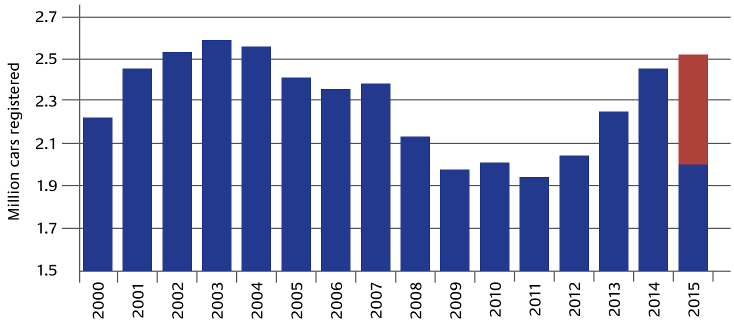
Motor Retail Property Bulletin – Autumn 2015

The UK new car market has grown consistently since early 2012, with September marking the 43rd consecutive month of increases, despite the disturbance over Volkswagen emissions.

The first six months of 2015 represented an all-time high for registrations in the half year but the slowing growth rate apparent in July and August suggests that demand may be levelling out.

Figure 1 shows the pattern of registrations over time overlaid with updated projections that estimate 2015 overall to be another very good year for the industry. Registrations in the year to August are already significantly ahead of the same period in 2014.

FIGURE 1 – NEW CAR REGISTRATIONS



Continued low oil prices are expected to boost new car sales over the next few years through low pump prices.

So far 2015 has seen strong performance from UK Motor Retailers. Research from performance specialist ASE shows twelve month dealer profitability down slightly on the 2014 figure – this despite a 5% increase in overall turnover.

Rent is a key component of dealer overheads. Currently the average rent paid stands just below £12.50 per square foot – significantly lower than the prime rents seen in the market that range from £13 to £15 in Scotland to some £30 in London.

Rental growth over the past five years has been positive but constrained with reviews showing an average uplift of just under 9% on a five year period – around 1.7% per annum.

Notwithstanding the above, the actual level of increase may be dictated by the lease terms. To the extent that lease terms are ever standard, the most common rent review term covers a five yearly review cycle with uplifts based upon the then open market rental value.

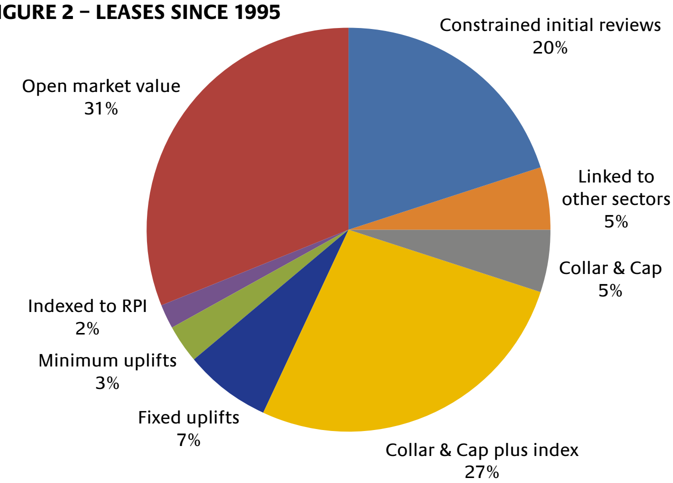
September 2015 Data	
Prime Yield	4.75%
Average Yield	6.5%
Average Rent psf	£12.39
Average Lot Size	£4.5m
Average CV psf	£193
Average Unexpired Lease Term	13.6 years
Average Floor Area	23,190 sq ft

Analysis of automotive lease activity over the past twenty years shows that under a third of new leases offered fitted this pattern and the majority had rent review clauses in which the method of review and/or the level of review was prescribed in detail.

In 29% of cases the rent was reviewed with reference to an index, overwhelmingly RPI, and in the majority of cases with a prescribed minimum and maximum value (collar and cap).

15% of leases have reviews where rental uplifts are fixed or have minimum and/or maximum values. A small proportion (5%) of leases have rents reviewed with reference to other sectors – usually retail warehouses.

FIGURE 2 – LEASES SINCE 1995

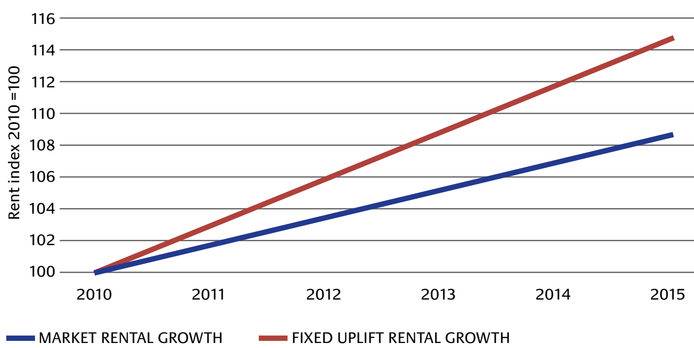


20% of leases analysed have clauses that restrict the first, and occasionally second, reviews to specific uplifts with the remainder of the reviews to open market rental value.

Many of these leases were agreed at a low point in the market and, as the market is improving have served to protect landlord's income (and increase tenant's costs) by, for example, enshrining a 2.75% compounded annual uplift at the first review.

Figure 3 shows the difference between fixed uplifts and market over the five years from 2010. For a lease agreed in 2010, a 2.75% compounded annual uplift would have delivered an increase of just under 15% on review while reliance on open market rents would only have delivered a 9% increase.

FIGURE 3 – IMPACT OF DEFINED LEASE TERMS



However, the market is now thriving with significant demand from occupiers and investors and this has begun to drive up rents.

By way of example the former Saab City on The Highway on Wapping (42,500 square feet) was let, following administration, to Alan Day Volkswagen in May 2012 at just £7.05 per square foot.

By comparison the new, 27,500 square feet Porsche dealership at Beckton that was completed in June 2015 was let at £17.43 per square foot. Even allowing for age, size and location this represents a significant increase in rent.

Over the next few years it is likely that the market will deliver higher income to landlords than predefined review terms.

Research from IPD in 2014 found that un-weighted retail lease lengths had reversed a trend that saw them reach a low of 6.2 years in 2009 to reach 7.7 years in 2014. In weighted terms, this represents a lengthening of two full years, from 10.3 to 12.3 years.

Retail leases are longer mainly because of the effect of supermarkets and retail warehouses, the latter making up a significant proportion of the overall retail sample.

Leases granted on retail warehouses have consistently been three to four years longer than the all property average, while standard shop and shopping centre leases are much closer to the sector average.

Lease lengths for automotive property tend to be more aligned with retail warehousing and are significantly longer than the retail average with a 20-year term very common.

REGEARING LEASES

Lease events place landlord and tenants at opposite ends of the negotiating table. Whether it be debating terms at the start of a lease, rent review discussions within the term of a lease or lease renewal/exit consultations at lease expiry, directly opposing objectives lead to dispute.

Suppose altering lease terms mid-way through a lease could mutually benefit both landlord and tenant? Lease re-gears present an opportunity for both landlord and tenant to secure a result that benefits both parties.

In simple terms re-gearing a lease involves agreement between landlord and tenant to alter the existing lease terms for mutual benefit. This may be:

- An increased lease term
- Removal of break clauses
- Variation of rent review (RPI in addition to Market Value basis)
- Variation of other lease terms: repair, alienation, tenant covenant/additional guarantees

The benefits to both landlord and tenant are often numerous. The primary benefit for landlord is the ability to increase the Capital Value of their asset by altering lease terms that affect value; the increase in value ("marriage value") can then be shared between landlord and tenant as it is the cooperation of both parties that have enabled the increase.

The tenant's proportion of marriage value can be paid as a capital sum, reduced passing rent, by way of an additional rent free period or a combination of all three.

In the current market climate a lease extension has the added benefit that the tenant does not have to enter the highly competitive occupier market in order to relocate. Furthermore, a lease extension can benefit the landlord by removing the need to compete for dwindling income stock. While Net initial yields continue to compress there are compelling arguments for a landlord to manage assets intensively and enhance existing income stock.

Typical triggers for a Lease Re-gear might be:

- Sub 10 year leases (depreciating income stream)
- New Manufacturer Standards for upgrades or expansion
- Receipt of a request for a Licence of Alterations
- Expiry of fixed increase structures relying solely upon Market Value
- Overrented property
- Rent review negotiations (which can be incorporated into re-gear discussions)
- Tenant wanting to protect their trading position
- Accounting regulations (altering lease structures to reduce contingent liabilities)

A lease re-gear is often the best solution for both landlord and tenant to benefit from their mutual interest in the property as partners rather than adversaries. For example we have recently concluded a lease re-gear on behalf of the Landlord at Stockton on Tees Mercedes where the rent was rebased in return for a significantly extended lease term. The re-based rent has enabled the tenant to fund improvement works.

Tenant Benefits	Landlord Benefits
Better dealership security (afforded by an extended lease)	Capital Value increase
Lower operating costs (rent free, capital contribution, re-based rent)	Longer income / removal of tenant breaks
Assistance with capital expenditure items including improvement works to meet Manufacturer Standards	Improved covenant strength
Removal of onerous lease terms (repair, rent review, alienation)	Removal of onerous lease terms which may affect future value increases
Potential for introducing inflation linked rent increases more aligned to operating cost profile	Re-basing of an overrented asset
Provides a longer period over which to write off investment expenditure such as fit out costs	Introduction of RPI linked income
Ability to extend or alter the premises to comply with franchise partner standards	Physical improvement of the asset

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