# Each to their own

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**The demand for owning assets is changing with rapid shifts in commercial cultures. Claire Haynes and Helen Garthwaite ask how landlords can keep up**

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The way in which businesses want to own and use their properties is changing. Traditionally, a business would purchase freehold premises or take a 25-year full repairing and insuring (FRI) lease on a market rent. As a model of ownership and occupation, this has historically offered stability and investment certainty for all the stakeholders. In recent years, however, these property ownership and occupation structures have come under pressure from market disruptors to adapt and better serve the needs of businesses.

## Changing needs

The workforce no longer needs or wants to be in the same space for the entirety of the working day or week, as technology enables them to be agile. This socio-economic transience is transforming work?life culture, the way in which properties are used and the terms on which they are occupied. A rise in the contingent workforce is also increasing the demand for flexible space.

Sole owner-occupancy of properties by businesses has fallen; 55% by value of the UK?s commercial property is now rented rather than owned by occupiers. Many businesses no longer want to invest capital in premises and spend time on property management issues. It is no secret that the average lease term has fallen from 25 years in the 1980s to just 7.2 years today.

Larger tenants with established businesses currently opt for longer lease terms of 10?14 years. High fit-out costs and security of tenure make such leases attractive to them, and landlords remain keen to keep such good tenants, both as a reliable source of income and as positive for the capital values of the properties they occupy.

Investors have also changed; historically, the sector was dominated by direct investment from UK pension schemes and insurance companies, but recent years have seen the growth of collective schemes enabling smaller and overseas entities to enter the market. Overseas investors are now the largest group of new investors in UK property, showcasing its strength over the long term. These investors are likely to have little appetite for change to existing ownership models as they see property only in respect of the returns it offers.

However, there is now some demand for shorter-term flexible space. Much of this is satisfied by serviced office providers and the ever-increasing number of collaborative working hubs. Technology, media and telecoms businesses as well as start-ups have embraced collaborative working and the benefits this offers. Over the past few years, there has also been an increase in corporations taking flexible workspace for distinct projects and to plug workspace shortages.

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## Leases and licences

Occupiers can also enter into short-term management agreements, which take the form of a licence with a right for the landlord to allocate alternative space or workstations if required. As such, there is no grant of exclusive possession of the space, which is a key legal characteristic of a lease. The occupiers have little security of tenure, and while this does not suit every business, the process on termination of the agreement is easy for them, without the costly reinstatement obligations required by leases.

These new models of property ownership are not for everyone. Some businesses simply want their own flexible arrangements with a landlord, or they wish to futureproof existing arrangements. Has the legal system adapted to this situation?

A lease in an institutionally acceptable form will contain wide-ranging restrictions on alienation. There will be a ban on assignment and underletting without landlord consent and a prohibition on the sharing of space or parting with possession of it, so these restrictions limit the use of flexible arrangements by tenants. They mean that the sector is grappling with deeds to vary the terms of existing leases and the granting of management agreements and licences, which are the thin end of the wedge in relation to alienation covenants.

Under the existing rules, a lease cannot be granted for an indefinite period; a fixed term must be set out in the tenancy agreement. Even periodic tenancies are for a measurable period of time, terminable by notice, usually of the same length as the period for which rent is paid.

Most short leases are contracted out of the Landlord and Tenant Act 1954 so the tenant does not gain security of tenure and an entitlement to a new lease at the end of the term of the existing tenancy. So once the end of a contracted-out lease is reached, the parties must enter into a new tenancy in order to regularise the position.

If a tenant is left to continue in occupation of the premises after the end of the existing contracted-out lease?s term without documenting a new tenancy, they can inadvertently gain security of tenure, making it a lengthy and costly exercise for a landlord to terminate the resulting tenancy and obtain vacant possession of the premises.

Around 40% of leases now contain a break option entitling the tenant to terminate before the end of the lease term, reflecting the increasing desire for occupier transience. Break clauses also contain legal traps, however, and a landlord will often do all it can on to keep a tenant on the hook paying rent for the remainder of the term.

So there are flaws with the existing system of ownership and a desire for change from occupiers; but institutional landlords and lenders are still nervous about moving away from traditional landlord and tenant relationships.

From both an investor?s and lender?s point of view, any changes in the ownership model must not increase investment risk either, and without changes to regulatory structures, investment and lending criteria, it is unlikely that any new ownership models will ever become standard in the market. A long-term approach to property management must be maintained to enable any change of practice. How does the property ownership model evolve while still being attractive to key stakeholders? How this tension will be resolved remains to be seen, but innovative thinking will be required.

## Investment in residential

In the UK residential sector, there has been a push towards building to rent as more people have been priced out of ownership. Institutional investors are keen to exploit this new model with specific, measurable income flows. The cycle of occupation is expected to be shorter than a traditional FRI lease, but it will be attractive to investors and occupiers in the same way that student accommodation has proved to be. Occupier demand for build-to-rent properties will be high as institutional investors aim to construct quality accommodation, which is scarce in the residential market.

The government has recently set out its strategy to increase the supply of accessible and affordable housing. As well as the build-to-rent model, schemes such as the Home Building Fund and the Accelerated Construction programme have been set up to improve housing supply and increase the number of developers active in the market. At the consumer end, shared ownership and the government?s Starter Homes scheme are popular as first-time buyers take advantage of the incentives.

On a smaller scale, crowdfunding initiatives and community-led projects have enabled individuals to pool their resources to get on the property ladder. An appreciation and acceptance of such projects by lenders and investors is essential if more are to be pioneered and completed successfully.

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## New uses

What about the physical nature of buildings ? do they lend themselves to different ownership structures? Changing occupier requirements are reflected in the use of our existing buildings. Traditional buildings adapt well to new uses, as the high demand for conversions of old industrial buildings into high-specification residential developments attests. Historically speaking, buildings were made to last.

Could the change in occupier requirements see an end to the category A office specification, which has been a core standard in property investment and occupation for many years? We are at a crossroads ? desire for the bespoke in one direction, readily accessible space with some uniformity in the other.

In some sectors, the trend for keeping costs to a minimum has resulted in purpose-built spaces with a shorter lifespan, which tend not to lend themselves to evolving uses and ownership. Tight planning controls also restrict changes of building use. These influences are pushing against the desire for flexible space that can be adapted over time by generations of occupiers.

Many new developments are mixed use, with office space next to residential accommodation, retail, restaurants and coffee shops. This balance can be a delicate but harmonious one, though when the good times are over and new developments stall it is existing buildings that must adapt to supply quality space for occupiers.

The ownership dream is still alive, but occupiers are prompting changes to the model, so lenders and investors must look to adapt their investment criteria to keep pace. The legal framework must also evolve to protect all parties in their new ownership arrangements.

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## Further information

- Related competencies include Landlord and tenant (including rent reviews and lease renewals) , Leasing/letting
- This feature is taken from the RICS *Property journal* (July/Aug 2017)
- Related categories: UK commercial real estate agency , Leases , Lease renewal