PROPERTY LESSONS FROM THE LAST TEN YEARS

How can charities position themselves for the future?

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Celebrating 10 Years TSP

2019 2021

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What Ten Years of Charity Property Has Taught Me

It is more than a decade since the last recession and, naturally, some of the lessons learnt during that time may have been forgotten as economic difficulties subsided. Now that Covid-19 has created a new era of economic disruption, it is a reminder that tough markets can bring both hardship and opportunity. So how can your charity benefit?

Third Sector Property was founded shortly after the worst recession in living memory and I joined the business more than nine years ago, while the economy was still trying to recover. Our company mission was to help charities save money on their property costs. Since then my colleagues and I have saved millions of pounds for our charity clients. These are some of the lessons that I learnt at the time, and which I feel are most relevant in the current market.

The Return to a Buyer's Market?

One of the main ways that charities can benefit from current circumstances is through a lack of competition. There will simply not be the same number of people interested in a building or opportunity. This means that property owners will eventually adjust how they perceive the market, but this psychological shift takes time to occur. Given that economic crises happen quickly, there is often a delay between the crisis event and new, more tenant-friendly, market terms being established. During the last recession this took about three years, from the collapse of Lehman Brothers in 2008 to what is generally considered the trough of the UK commercial property sector in 2011-12, which also coincided with my start at Third Sector Property.

The main way that this crisis is different from the last is the precipitous rate of economic decline. We do not yet know whether the recovery will be equally as sharp (a v-shaped recession). However, there is some hope amongst landlords that this preferred scenario will materialise. Until it does not, market terms are unlikely to change substantially.

Adjusting to the New Normal

I do not think that the best deals will result from the immediate economic crisis, but rather the longer-term, structural change that is likely to result. From my own experience of working with clients throughout the current period, floorspace requirements are being seriously reconsidered. We have all had our remote systems stress-tested, and processes seem to have emerged relatively unscathed. The need to reduce overheads combined with effective remote working practices is likely to reduce the demand for office space. This is a conversation that is no doubt occurring at Board meetings throughout the country.

This will manifest itself in increased volumes of tenant space being marketed during the second half of 2020 and beyond. These opportunities offer much value to new tenants. Typically they have been fully furnished by the previous occupant, meaning that costs of occupation are low. Additionally, the lessor is seeking to mitigate costs, rather than increase value, and will be far more likely to offer generous incentives. Anyone in the market for new space should be actively seeking out these opportunities as they arise.

The conventional leasing model was being disrupted prior to this crisis. In the office sector there was a clear shift to shorter, more flexible leases on fitted space. It was becoming clear that the winners in the sector would be landlords who embraced the concept of tenants being treated as customers rather than serfs. This will only continue as the office becomes smaller and needs to work harder to justify its cost. It also means that there will be opportunities for charities on conventional space. Landlords without the means or ability to offer modern space will have no choice but to discount, in some cases considerably.

Charity retailers have also enjoyed success with boutique style units, which have rejuvenated the sector's image and allowed access to some high-profile schemes. One example is Shelter's boutique store in King Cross' Coal Drops Yard. More of these opportunities will inevitably be available to charities.

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Existing Leases and Portfolios

The key to benefitting as a tenant is a proactive mindset. All lease events should be considered as opportunities to derive material benefit, but break options and lease expiries offer the best prospects.

With a portfolio, start with the properties with the highest occupancy costs and work down from there. Using your tenancy schedule, sort the properties by annual rent from high to low. Work on the top three to five leases as a starting point. These will have the greatest impact and maximise returns on your efforts.

A London head office has an annual rent many times higher than a regional retail unit and is your best opportunity to make savings.

For those higher-value properties, look for lease events in the short to medium term. Anything within three years is a real opportunity. Don't wait for these events to approach. Be proactive and make the first move.

I recently worked with a charity which had a break option approaching on a London headquarters building. Once the break option passed, the lease would have continued for another five years. Working with this client, a new, flexible break option was agreed following an initial two-year period. The landlord also agreed to a 10% rental reduction for the first year of this new arrangement. This represented a great outcome for both parties. The landlord maintained its income in a difficult market and the tenant achieved both a saving and introduced significant flexibility.

Would your landlord consider something similar?

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Negotiating Successfully

Once lease opportunities have been identified, you need to convince the landlord to agree to concessionary terms.

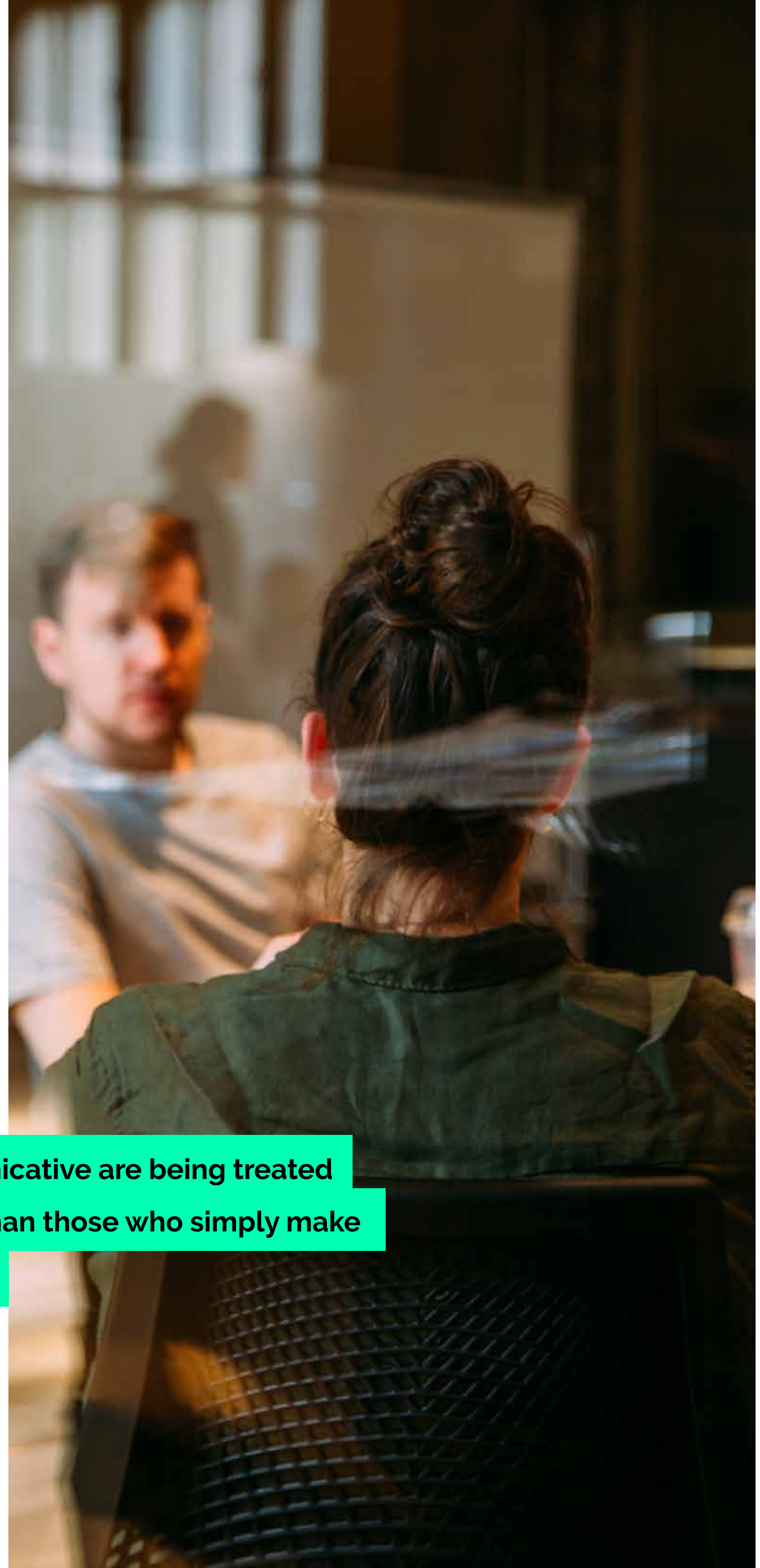
The foundation of a successful negotiation is twofold. Firstly, identify what the current market terms are for your space. This knowledge will allow you to negotiate with authority. Secondly, find a viable alternative option and be genuinely willing to pursue it if negotiations fail. Communicate this fact to the landlord with conviction.

Armed with solid market knowledge and an alternative option, you should strike a conciliatory tone with the landlord. Being adversarial will not yield the best long-term results. Landlords are more likely to agree to new terms with those who make them feel less like they have lost.

Right now, my Property Management colleagues are experiencing this first-hand. Tenants that are open and communicative are being treated far more reasonably by landlords than those who simply make demands, or fail to pay rent in full.

Finally, try and engineer a win-win scenario for both parties. If you want a rental reduction or rent-free period, could you offer a longer lease term in return? Perhaps you could agree to a rent that increases gradually over the lease term. Even smaller gestures like offering to cover the landlord's legal fees can increase your chances of success.

Once you reach agreement, make sure that everything is documented in writing. Legal arrangements like new leases, break arrangements and lease re-gears should be agreed between Solicitors. Short-term rent reductions and payment plans can be agreed by way of a side letter that accompanies the lease and does not necessarily have to incur legal costs. But if you are in any doubt, it is always sensible to seek legal advice.



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New Leases: Pandemic Clauses and Rental Increases

When negotiating new leases during the next year or two, it is sensible to create as much flexibility as possible. Aside from break options, an emerging trend is 'pandemic clauses' in leases, which would define both the landlord and tenant response to new outbreaks and resultant lockdowns. Such clauses would be especially relevant to retail and involve potential rent holidays, reductions or contributions if the property cannot be used.

The second point on new leases is a cautionary note which applies to longer leases with rent reviews. If you have negotiated a fantastic new deal, with a low annual rent and perhaps even a long rent-free period, consider that the rent can be reviewed upwards at a future date.

Many clients that I worked with in London and other major cities in the last market trough found that five years later when their lease was up for renewal or review, rents had increased considerably. The lag between supply and demand meant that there was an undersupply of office space which put upward pressure on rent. In some cases, the market rent more than doubled.
A hedge against a rapidly rising market is to introduce some form of index-linked rental increase into the lease. This is a gamble on future market conditions, but you may find that gradual and more predictable increases are better in the long term. Similarly, a 'cap and collar' rent review clause commits you to a guaranteed increase, but there is also an upper limit. Landlords are receptive to both in my experience.

Another emerging area in retail is rents that are linked to turnover and visitor metrics. Currently these are rare and tend to be confined to managed spaces such as shopping centres, but a recent survey revealed that 41% of landlords are willing to consider this type of rental arrangement. Perhaps your landlord is amongst them?

Time to Buy?

Finally, and on a more optimistic note, market troughs represent outstanding buying opportunities for those with the means to do so. During the last recovery, I was able to successfully acquire a new head office for a client. It was being sold for a price that likely represented less than the build costs. It was in the middle of the Nine Elms regeneration area in London, with excellent fundamentals; it was an outstanding opportunity. Since then it has appreciated considerably. It was a brave decision for the client at the time, but a decision that has been comprehensively vindicated.

We entered this crisis following a period of low interest rates and loose monetary policy. I expect that as a result, the potential for capital appreciation is less than after the last recession. However, it does mean that when market sentiment improves, property values will be underpinned by the availability of finance, meaning that confidence has a greater role to play. Earlier this month, BlackRock, the world's largest investment company, raised £1.3bn for a European property investment fund, saying that it believed Covid-19 would represent "one of the largest market dislocations of our lifetime". You should join them if you can.

Reflecting on the last ten years has reiterated to me that the best opportunities exist at times of crisis. If you can keep a cool head and focus on the long-term view, you will emerge from this period with your property holdings in better shape than ever before.

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