Lambert Smith Hampton

Property Solutions

Empty Property Rates Survey

Lambert Smith Hampton has undertaken research to examine industry views on the impending changes to the system of Empty Property Rates relief in England and Wales.

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The change to Empty Property Rates (EPR) relief, which became effective on the 1 April this year, has provoked the widest reaction to a change in business rates legislation that I have experienced since the introduction of the Uniform Business Rate in 1990. The change essentially removes business rates tax relief for empty property, thereby loading a further burden of taxation upon the landlord who is unfortunate enough to be experiencing rental void periods.

Endless column inches have been devoted to the reactions of property investors, developers, landlords and occupiers, each telling their own story, and most blasting the Government for implementing this most ill-considered policy. However, the problem with mere story-telling is that the content is often emotional and anecdotal, and can be dismissed easily as lacking foundation or analytical rigour.

For this reason, the Rating Division of Lambert Smith Hampton (LSH), has undertaken a programme of research designed to probe and then quantify the reaction of different segments of the marketplace to the changes in EPR legislation. Our researchers contacted an equal number of investors, developers and occupiers, in order to gauge their reaction. The results of the research, detailed in this research paper, are startling. They send a clear and unequivocal message that the most likely longer-term effects of the removal of EPR relief will be to:

- Restrict the commercial property investment and development marketplaces, particularly relating to the industrial property sector;
- Limit the longer-term commercial options open to those businesses which the Government claims will benefit from the changes; and
- Ultimately, make the UK's commercial property marketplace a less attractive option for inward-investment.

A number of key findings are noteworthy

- Asked whether they believed that the changes in EPR legislation would result in more properties being made available in the marketplace, 80% of respondents disagreed. The supporting comments, some of which are referred to in the research document, seriously question the Government's understanding of the dynamics of the commercial property marketplace.
- On the important topic of town regeneration, a mere 7% of respondents believed that the change in EPR legislation would have no lasting effect on the attractiveness of urban regeneration as an investment opportunity. Respondents cited the genuine need for developers to hold vacant property assets for significant periods of time, and suspected that a more prudent and cost-effective solution for the developer may be simply to demolish properties and delay development.
- The survey also considered the effect of EPR legislation on capital values. Seventy percent of respondents expect capital values to drop. Many predict the emergence of a two-tier market in which those properties more likely to experience rental voids are discounted in value to take account of their relatively unattractive investment potential.
- From the occupier's perspective there is some good news in the short term: 53% of respondents believe that rents will fall as landlords soften rental income expectations in order to attract occupiers and avoid EPR taxation. However, there is a strong belief that, as a two-tier market emerges and secondary stock is discounted, again demolition rather than renovation becomes the attractive option, resulting in a longer-term rise in rents.

The findings of our research are both startling and worrying. The impact of EPR relief removal on lease covenants and flexibility is a recurring theme. Landlords have long recognised that it is in their best interests to accommodate the needs of the occupier, with short, flexible lease terms becoming a mainstay of the marketplace.

The changes in EPR legislation now provide the occupier with even greater negotiating strength. Depending on your perspective, this may be no bad thing in the short-term. However, many respondents expect that the longer-term *quid pro quo* may be a greater focus by the landlord on lease length, covenant and the financial strength of the prospective occupier as the availability of quality property stock tightens. Such tightening cannot bode well for occupiers or for the sector as a whole.

The following sections provide the results of our client survey. It makes fascinating reading and, I believe, finally turns anecdote into fact. I encourage you to read it, and I would welcome your comments on any aspect of our conclusions.

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The Survey

We surveyed 100 LSH clients about their opinions on the changes to the system of EPR relief in England and Wales. Our respondents are broken down by sector into: occupiers (37%), investors (34%) and developers (29%). Most of our respondents are in higher management or directorial positions within some of our most valued clients. We asked nine questions regarding their opinions of the changes to the EPR relief system. Their answers support our view of the impact of these changes on the property industry. What is also clear is that this is an emotive issue for all three groups, but particularly developers.

The main opinions from the survey are that the industrial sector will suffer the most with a bigger shock to start with. Speculative development is likely to suffer across all sectors as risk increases and profit margins narrow. Regeneration and accessibility to the market will be the biggest victims. Initially rents will fall as landlords are forced to accept very low rents on empty property while older stock will be demolished at a greater rate and not necessarily replaced. We will end up in a two-tier market where new and modern property lets at market rates on longer leases with less flexibility while older, secondary stock languishes empty until being let at low rents or being demolished.

Impact on speculative development

Speculative development is already a risky proposition and must make a profit for the developer in order to be viable. The increased cost of paying full business rates six months after the building is complete narrows the margin for profit on speculative developments, potentially making many of them unviable.

Most of our respondents (81%) believe that speculative development will suffer as a result of the liability for rates on empty property. Developers will be more likely to seek pre-lets prior to starting construction or leave buildings partially completed until a tenant can be found.

The lack of new speculative development will impact adversely on occupier-choice and, ultimately, demand. This is particularly the case in markets where the supply of good-quality space is very limited but is also the case in markets where speculative development is often the only way to kick-start a stagnant market. More importantly, it will result in pinch points in the supply of new development, particularly when the country is coming out of recession. This legislation will restrict the supply of new industrial and warehouse buildings at a time when demand is picking up, leading to shortages and artificially high rents.

Regeneration of towns

Regeneration projects will, as a result, suffer. Piecing together viable sites in urban areas inevitably requires developers to hold a large bank of property while they assemble the site. The legislation increases the risk in secondary areas where developers may hold vacant property for a substantial amount of time before the location becomes established. When a scheme becomes more marginal, a developer will increase rents to recover the cost of his investment which means that the cost of the property is less affordable for smaller or start-up businesses.

Fewer than 7% of respondents thought that the removal of EPR relief would benefit town regeneration. One respondent said that it would "create urban waste-lands" as property is demolished rather than held vacant during site assembly. This will have the opposite impact from the one the Government is hoping for by making business space less accessible to small and new businesses. One respondent summed up the problem thus: "Speculative development is fundamental to regeneration. Void rates just add to the risk profile and are likely to tip the balance against."

Development of greenfield sites

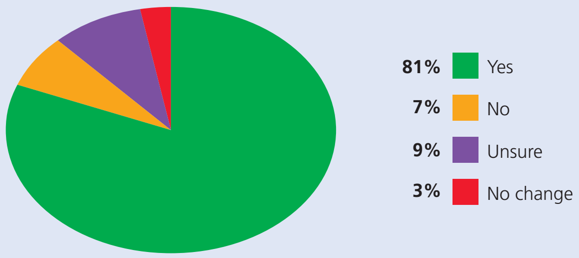
The Government believes that the removal of EPR relief will encourage the use of existing vacant properties and reduce the need to develop greenfield sites. Our survey showed this to be a very emotive issue, with an overwhelming majority of the participants suggesting a lack of understanding in the way the market operates. Many indicated that it is a fallacy to suggest that landlords or developers keep their properties empty out of choice. If a building is vacant long-term it is because demand is low, or the market in that location is over-supplied, or indeed the building specification is not what occupiers want. Rates will not change this. Some suggested that most empty properties are awaiting some form of redevelopment, but many owners can afford neither the time or the cash to do everything at once.

Greenfield sites are likely to get a reprieve from development in the short term, if only because of a drop in speculative development. However, again, the consensus is that the rating system will have little impact on reducing development of greenfield sites. These are generally controlled by planning legislation. Many in our survey believe the legislation to be poorly considered and simply another way of generating revenue for the Government.

> "My own company is now avoiding speculative opportunities due to the higher holding costs of vacant property. Coupled with the credit crisis this additional tax will significantly reduce speculative development."

Chart 1

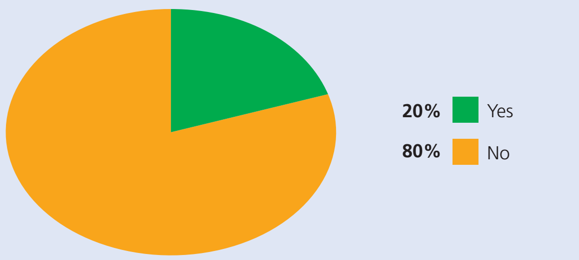
Do you see the removal of empty rates relief as having a detrimental effect on town regeneration? %



Source: LSH Research

Chart 2

Will the legislation bring more vacant properties/sites to the market? %



Source: LSH Research

> "No sane owner would deliberately keep a property empty. The main reason premises remain empty is due to low demand and a slow-moving market."

Impact on capital values

The removal of EPR relief is expected to impact significantly on the investment market. A two-tier market could emerge with properties which are likely to attract voids being discounted in value. Investors are likely to become even more selective about stock, covenant strength and longer lease terms. Demand for second-hand stock is likely to fall as it is more likely to see significant voids.

In the short term at least, as leases near their end, owners will want to avoid the risk of enforced outgoings and therefore values are expected to fall if there is a significant increase in sales. We can therefore expect yields to shift out for properties where the risk of void is near. Pre-let developments on the other hand should increase in value due to lack of new stock.

Our survey supports this view. There is broad consensus among respondents that capital values will decline. Of our respondents, 70% thought that the legislation would lower capital values at least in the short term. The longer-term outcome is less certain. Many of our respondents think that after an initial drop, values will increase as supply becomes an issue due to a lack of new speculative development.

Portfolio reassessment

Of our respondents, 53% said that they would review their portfolio, either by slowing their development programme or demolishing buildings which are unattractive to tenants and buyers.

"We will be selling all properties with short leases unless we know the tenants are going to renew because the closer to the end of the lease, the lower the value, until it will become nearly unsaleable, when vacant, except at a very low price."

Industrial property allocation by investors

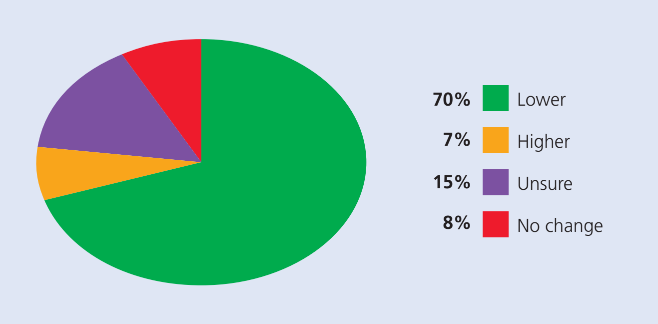
Industrial property has the highest exposure to EPR liability and although most of our respondents said they would be reducing this exposure, many admitted that they would still want to be involved in the industrial sector. As you would expect, a higher proportion of investors (23%) considered reducing their allocation to industrial properties. There was greater uncertainty among occupiers about their approach to industrial properties.

Stock selection will become much more important as investors try to minimise exposure to riskier property. However, as property values fall due to higher holding costs and owners of property accept a hit on price, then allocation to the sector should balance out.

"Investors will be looking to factor empty property rates into their investment appraisals, which will lead to yields shifting out to compensate."

Chart 3

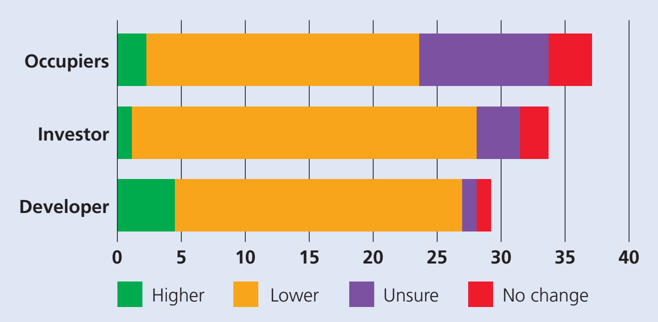
What will be the impact of the new legislation on the capital value of properties? %



Source: LSH Research

Chart 4

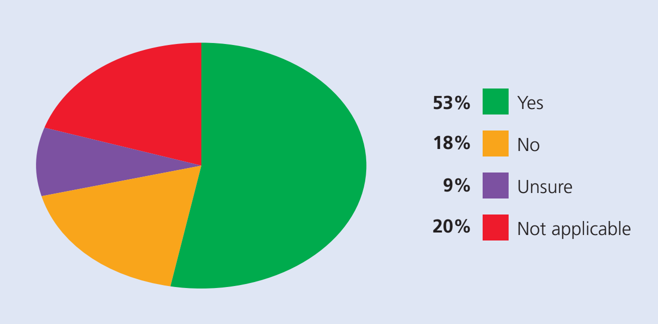
Impact on capital values by category of respondent %



Source: LSH Research

Chart 5

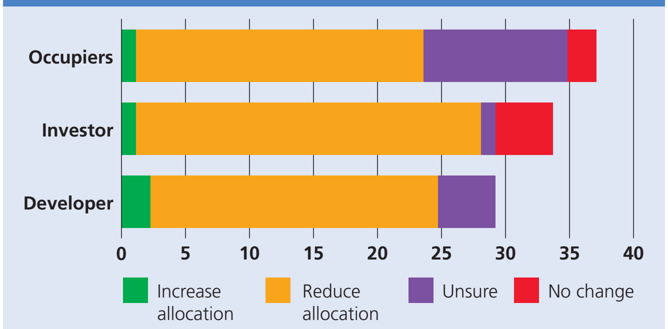
In light of these legislative changes, will you be reviewing your property portfolio? %



Source: LSH Research

Chart 6

What impact, if any, do you think the new legislation will have on allocation to the industrial sector? %



Source: LSH Research

Impact on rental values

Rental values are likely to fall in the short term as landlords try to fill empty properties. Over the long term, rents will climb as supply of space dries up. Companies may not be able to find stock of sufficient quality to expand into and this could, in turn, stifle business growth.

Impact on lease terms and flexibility

At first, rents will fall and landlords will offer greater incentives to let their property. Landlords will focus more on covenant and lease length. Leases are likely to be re-drafted to ensure that tenants stay in rateable occupation until it expires. Emphasis may change in favour of the tenant and incoming tenants may be able to negotiate ever greater incentives such as capped rent reviews or longer review patterns offered in order to secure a longer term.

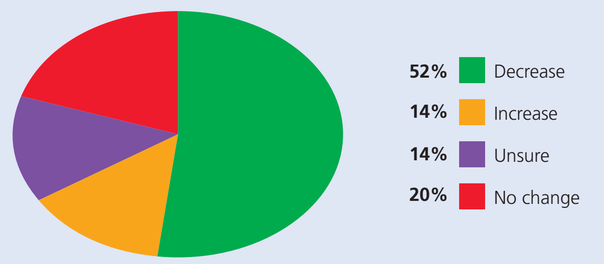
A two-tier market

What a lot of our respondents comments pointed to was the likelihood of a two-tier occupier-market developing. Many believe that good prime stock will not be especially affected while secondary and tertiary stock will drop in value, being worth less at sale and when letting. Landlords left with an unsaleable property may have to resort to demolition as a strategy. This would be a particularly retrograde step for small or start-up businesses which traditionally occupy older, less attractive properties.

> "The pressure is greater to re-let properties and the incoming tenants will be more aggressive with their negotiations."

Chart 7

What will be the impact of the new legislation on rents? %

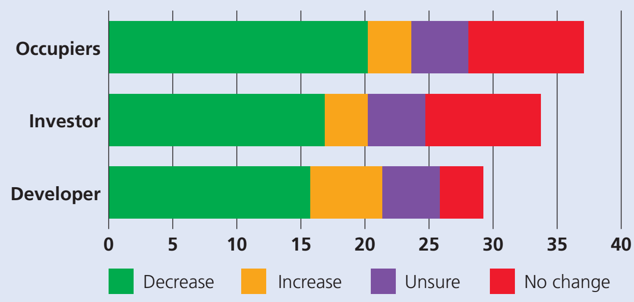


Source: LSH Research

> "I have seen an increased willingness to let at lower rents and grant inducements to get properties occupied."

Chart 8

Impact on rents by category of respondent %



Source: LSH Research

Conclusion

The survey conclusions overwhelmingly confirm anecdotal evidence of market sentiment against the removal of EPR relief and demonstrates the strength of feeling that it has generated.

It is clear that the legislation is likely to have almost precisely the opposite effect from what was intended by restricting development and investment in all markets, particularly within the industrial sector and in secondary locations. It will also limit growth opportunity for small and medium-sized local business and will, eventually, negatively impact on the competitiveness of the UK's commercial property industry in the global market.

We believe that well-advised owners of empty property would be able to mitigate or avoid a substantial proportion of their potential liability for empty property rates. Tenants will find it more difficult as they do not have the same freedom as a landlord or owner-occupier to carry out works to reduce their rating assessment. It is imperative though that the ratepayer consults a rating advisor before the property is completed or becomes empty. Failure to do so will often eliminate many of the opportunities to mitigate the empty rate liability.

Empty Property Rates Survey

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Details of other Lambert Smith Hampton research material can be viewed on our website at http://www.lsh.co.uk
Due to space constraints within the report, it has not been possible to include both imperial and metric measurements.

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