Part 1 - Adapting Heads of Terms for the modern retail market - Darren Smith Knights PLC and Peter Leverett from SPACE - Retail Property Consultants.

In this seminar are looking at some key points in the heads of terms against the backdrop of a perceived struggling retail market.

The past 12 months have seen a record number of UK retailers apply for a CVA or to go into administration in response to a testing combination of weaker consumer spending, higher costs and business rates, Brexit, minimum wage increases and the long running impact of a weaker pound.

This slide shows some of the retailers who have entered into CVAs or administration in the last year or are in discussions to do so.

We want to concentrate on some points that will help both tenants and landlords strike a balance and prevent onerous terms from causing tenants to fall into CVAs.

Whilst commercial factors will, to a large extent determine the headline terms (such as the term length and annual rent payable), significant concessions can be won as a result of the Tenant receiving good and timely professional advice from both a letting surveyor and from a solicitor perhaps before the heads of terms are finalised.

Every lease is different and specific to the property in question but the common theme is that the initial draft is generally prepared by the Landlord and will therefore inevitably be weighted in its favour. Some are undoubtedly more biased than others.

Term

<u>Term Lengths</u>

The average length of the term is dropping as more tenants are looking for flexibility with more break clauses and less future commitment.

Flexibility could bring many positive benefits to the high street and centres with more independent, experimental retailers taking space, bring a new vitality. This is not necessarily bad for landlord's either as there are more options to attract a more diverse tenant mix of smaller operators amongst larger established retailers as well as the necessary food, beverage and leisure outlets.

Landlord's with finance are still wedded to the certainty of longer term income from secured leases and crave stability.

Shorter terms may mean additional legal costs in renewing more frequently but contrast that against rent reviewed to market levels and tenants may make some huge savings.

A factor in term length might be the fitting out cost with A3/A4/A5 users perhaps wanting to amortise the cost of its fit out and equipment over a longer period.

Break clauses are an important factor when considering the lease term and we will come back to this in more detail later on.

One thing to consider in respect of term length is SDLT. Shorter leases might attract less SDLT for the tenant at the outset.

Rent Payment / Review

There is increasing appetite for tenants wanting to pay rent monthly which assists in cashflow and Tenants benefit from interest on the money sat in their accounts rather than the landlords.

Review

Open Market rent still appears to be the favoured rent review practice but RPI increases, cap and collared, can play a part. These are often quicker and cheaper to determine.

With respect to open market, there have been Industry led attempts to persuade landlords to move away from upwards only open market reviews in favour of upwards/downwards reviews to properly reflect prevailing rental market conditions on the review date, it is still the case that almost without exception an open market review will be upwards only.

Until we see some changes in the law we are unlikely to see landlord's agreeing to upwards/downwards reviews so for now we must ensure that the drafting of the rent review section in the Lease contains the appropriate assumptions and disregards and other terms for the correct valuation of the hypothetical lease at the review date and ensuring the Landlord does not make a profit on the interest paid on any backdated uplift in the annual rent. These are generally taken for granted but care needs to be taken to protect tenants on review against an artificial position

RICS is consulting on a new code for Leasing Business Premises which is intended to be published as a RICS professional statement. It is hoped this will carry more weight than the current code which no one really pays any attention to.

The new Code recommends a rent review clause to operate on a commercially realistic basis, stating that any definitions of "market rent" should not result in a rent "higher than the true market rent unless expressly agreed by the parties […] in return for financial inducement"

Turnover

Landlord's and retailers need to innovate with new rental models and crucially, to work together, The model adopted by Europe sees more collaboration between landlords and tenants with turnover leases more prevalent. In some instances, base rents have been scrapped entirely with all the rent determined by turnover. Data sharing is actively encouraged and so problems can be spotted and dealt with at an early stage.

In August we saw Mike Ashley ask landlord's to sign deals for inclusive rent equivalent to 5% turnover while some stores rent would not be paid at all just the rates. There are, however, recent reports that some landlords are getting impatient and notices to quit being served on some stores.

Landlords will generally want to retain the right to terminate the lease if a turnover threshold is not met. This will go hand in hand with the keep open clause and compensation rent payable to the landlord for failing to open.

New Builds

New build properties tenants will want to consider agreeing tolerances for the square footage built against the target size as well as rent phasing/stepped rents possibly linked to centre occupation and/or the anchor tenant opening. Perhaps the heads should set out additional rent free or penalties if these are not achieved by a target date.

Alienation

Typically, a Tenant will be permitted to assign or sublet the whole (but not part) of the Lease, in both cases subject to obtaining the Landlord's prior written consent and to share occupation with group companies without having to obtain Landlord consent, provided no landlord/tenant relationship is created.

The assignment provisions in the Lease usually expressly specify both the conditions which must be satisfied for the Landlord to grant consent and the circumstances which would justify the Landlord withholding consent. From the Tenant's point of view the conditions and circumstances should be as few and easy to meet as possible.

Take a couple of examples:

- A typical assignment condition is that the outgoing tenant should enter into an Authorised Guarantee Agreement (AGA) with the Landlord. A Landlord will want this irrespective of the financial strength of the proposed incoming tenant and/or the other security offered by the incoming tenant and most leases are drafted so that the Tenant is required to give an AGA in all circumstances without any requirement for reasonableness taking into account. The outgoing tenant should always try to persuade the Landlord that incoming tenant's financial strength and other security provided is relevant to whether an AGA should be required and that the Landlord's entitlement in the Lease should be qualified and only be insisted upon where it is a reasonable requirement.

- A key negotiation point on underletting is whether the Landlord can insist on the annual rent in the underlease being the higher of the passing rent and the current open market rent. The landlord preferring that there is no risk of adverse rental evidence being created by the underlease if the market rent is assessed to be less than the current passing rent. From the Tenant's perspective, such a provision in the Lease would be detrimental as it would make it far harder to underlet in a recessionary market, at a time when the Lease could be over-rented and therefore at precisely the time when assignment is not viable and underletting is therefore

the most attractive option to the Tenant. An argument that will often help us to persuade a Landlord to permit underletting at the open market rent is that there is case law which supports the view that where the Lease imposes a restriction on underletting allowing it only at the higher of the passing rent in the Lease and the open market rent, it is viewed by the Courts as an onerous term and one which would enable a Tenant to discount the annual rent payable pursuant to any open market rent review in the Lease.

The proposed lease code suggests that AGAs should only be requested where reasonable, and underleases should be granted outside the act and on terms consistent with the headlease. Subleases of part can be granted on different terms where appropriate.

With respect to assignment of shopping centre leases, pre-emption clauses are now popular with landlords and can benefit tenants as well as long as the timings are tight. Where there is a pre-emption clause the landlord should be more flexible on the alienation terms.

Some centres operate lift and shift provisions allowing the landlords to move tenants that are doing well to bigger units and vice versa. The Tenant will want compensation for the fit out costs on the old unit and for the new unit.

Alterations

The main concerns for the tenant are generally what they can/can't do without consent and what needs to be reinstated at the end of the term.

Generally we are seeing that internal non-structural alterations are ok without consent as are signage depending on the brand. Structural alterations may not be appropriate depending on the letting but the tenants will need to consider the need for drilling holes in walls for ventilation and extraction.

We are increasingly seeing clauses trying to prohibiting any alterations that reduce the EPC rating of the property and landlords trying to push the capital cost of improving the energy efficiency of the Property on to the Tenants. It seems overdue to include the liability for energy improvements in the HOTs.

The proposed lease code is largely uncontroversial. It recommends controls that are no more restrictive than necessary and that leases should allow the landlord to require the tenant to reinstate its alterations at the end of the lease where it is reasonable to do so.

The new code includes a new recommendation that tenants should be notified at the outset if the landlord intends to impose any obligations on the Tenant's internal fit-out that might involve material cost or restrict use.

Service Charge

There are 3 key points for service charge. Tenants want to know how much it is, how is it calculated and what's included.

The calculation of the service charge generally follows a standard format but the services will be specific to the centre.

Some key areas to negotiate include:

- Imposing an annual cap on the Tenant's liability. The obvious commercial benefit to the Tenant is that a cap provides budgetary certainty and ensures that it will not be stung for any unanticipated exceptional expenditure which the Landlord may incur. If agreed by the Landlord, it is usually subject to RPI annual review (upwards only) to ensure that the cap increases annually in line with inflation. A tenant has more chance of succeeding with a cap argument when the service charge regime is either new or based on ad-hoc expenditure of the Landlord, as in both cases the Landlord will be unable to provide previous service charge accounts to evidence the likely future liability of the Tenant;

- Excluding certain heads of expenditure from the Tenant's service charge liability. The justification will be specific to the Property. For example, if the Property is a lock-up ground floor commercial unit with no rights to use any services on other floors in the building, then it should not be required to contribute towards maintenance/repair costs of the lifts. We are often spending a great deal of time negotiating exclusions to the service charge clauses and we are usually left with arguing about improvements to the energy efficiency of the buildings;

- Caps on management costs and marketing costs;

- Should there be competitive tendering process for services to ensure the best value is being obtained.

Tenants should welcome the opportunity to join a tenant's association which would allow them to make decisions on allocation of costs for the services.

Landlords are generally reluctant to amending service charge provisions for established centres but this should not prevent the inclusion of reasonable and proper service charge exclusions for capital costs which should not be passed to the tenants.

Break

According to a recent JLL study break clauses are found to have become more frequent in leases of all lengths with just over 40% of all leases now including breaks. We are seeing breaks in a 5 year term at the end of year 3.

However the study goes on to say that the use of the break clauses was found to be relatively infrequent at 32%.Our experience is that the break might be used as a tool to re-gear the lease without exercising.

These breaks are often (but does not have to be) coincide with a rent review date in the Lease, to enable the Tenant to walk away from the Lease if it expects the annual rent to increase on review to a level it cannot afford. Generally the provisions of the lease are drafted so that the break notice will need to be served before the level of the reviewed rent is assessed. The Tenant will have to estimate the new rent before the break is served and factor this into its decision making process.

The key area to negotiate in the HOTs for the Tenant is whether or the extent to which there are any conditions which it must satisfy to enable it to validly exercise the break. The Landlord will typically require conditions that all the rents have been paid, that all tenant obligations in the Lease have been complied with and that the Premises are yielded up and handed back to the Landlord with vacant possession.

On the face of it, these conditions do not sound unreasonable or difficult to discharge. However, the last recession presented numerous examples of landlords exploiting the existence of such conditions to frustrate and prevent tenants from exercising their break, as in a downturn it is still better for a landlord to retain a defaulting tenant who remains liable for business rates rather than take back possession. Case law has shown that the Courts are reluctant to interfere with the commercial arrangements reached by the landlord and the tenant and will construe any conditions in a lease strictly.

When acting for a tenant, there are a number of arguments that can be used persuade the landlord to drop or at least dilute the number and extent of these conditions. They include:

- Advising that the value to the tenant of the break is usually reflected in the tenant having to pay a higher annual rent. As the Landlord has an unqualified right to receive that annual rent, it is only fair that the Tenant should have a unqualified expectation that it can successfully exercise the break;

- even if there are arrears or other tenant breaches at the date of the break, the determination of the Lease following exercise of the break will not extinguish the Landlord's right to pursue its former tenant for those arrears or any losses it has suffered or incurred as a result of the breach; and

- as long ago as 2007, the voluntary Business Lease Code recommended that the conditions are restricted to there being no arrears of the principal annual rent and returning the premises free of any subsisting underleases and occupiers. This is reflected in the new lease code but this goes on to state that unless the landlord has "special reasons for imposing stricter conditions" a tenant's break should be restricted to these conditions.

We are also seeing more frequently landlord breaks appearing in HOTs. These are often linked to redevelopment of the premises. Tenants can be persuaded to relinquish security of tenure for a premium compensation payment. Where leases are outside the act, a Landlord would only be required to serve a break notice on the tenant and not required to accompany this with a hostile section 25 notice.

Social Media / Tech

With social media now instantaneously connecting people in real time perhaps some thought should be given as to what obligations for the landlord and tenant should be included in the lease in terms of policing positive and negative publicity. For example, a landlord of a centre would not want its tenants or tenant's employees being disparaging about the centre.

WIFI is becoming increasing important to tenants, we often find that the Landlord would want to restrict tenants installing their own WIFI wanting them to use the landlords. Tenants are becoming more and more dependent on internet connectivity and would need to provide its customers with access to WIFI to make use of its multichannel approach. Future proofing the store is an important consideration and should be negotiated at HOTs stage.

Exclusivity

We are seeing more and more restrictions in the leases for existing tenants and from landlords in an effort to maintain a healthy tenant mix.

Tenants should consider trying to negotiate reductions in rents if leases to competitors are granted or additional rent free.

Landlords will only generally be able to apply exclusivity clauses to new tenants and not retrospectively across the centre. The tenants should try and negotiate that these restrictions apply to assignees of other tenants as well with a requirement for the landlord to put a restriction of the user clause in the other tenants lease.

Summing Up

To sum up there are, of course, commercial factors that may determine how successful tenants are in negotiation of the terms such as the strength of the location and the covenant strength of the tenant.

Terms will need to be agreed to benefit both parties sharing both risk and reward.

Collaborative not confrontational.

A question of balance - symbiotic relationship.

Constant need for innovation.