

## **PRRES 2006 Auckland**

### **Flexible leasing and the small business tenant.**

**Neil Crosby+, Cathy Hughes and Sandi Murdoch**

The University of Reading  
PO Box 219  
Whiteknights  
Reading  
RG6 6AW

+ Corresponding author  
Email [f.n.Crosby@rdg.ac.uk](mailto:f.n.Crosby@rdg.ac.uk)  
TN + 44 (0)118 931 8177  
Fax + 44 (0) 118 931 8172

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### **Abstract**

This paper examines the framework for commercial lease negotiations in Australia and the UK. The paper discusses the different approaches to lease negotiations in the different countries and specifically examines the process by which small business tenants negotiate leases in the UK.

This paper uses a combination of literature review and survey evidence and finds that in some States in Australia legislation was proposed after a voluntary code had not worked and now all States have a legislative framework. In the UK the Government has relied upon voluntary codes of practice but has decided that the awareness of small business tenants concerning the implications of some lease clauses is still poor. This conclusion is based on the findings of this research which concludes that small businesses in the UK have very different negotiation processes than medium sized enterprises and larger corporate occupiers. Despite being less experienced in taking leases, they are less likely to take professional advice, more likely to take the first lease offered and are less likely to know about the existence of the code of practice. However, they do tend to occupy on shorter leases than larger tenants which have a lower incidence of upwards only ratcheted rent reviews.

The voluntary code of practice is having little direct effect on UK practice. However, the literature review gives no indication that any research work has been undertaken on the relative success of the legislative option adopted in Australia and therefore this remains as a major research question

## Introduction

In Australia, small retail business tenants are protected by legislation and the Reid Report (1997) recommended a countrywide consolidation of that legislative framework and the Baird Report (1999) expressed its concern that a Uniform Retail Tenancy Code had not been established. However, in 1999 the Australian Federal Government declined to accept those recommendations and responsibility for legislation or regulation lies with the individual States. However, it did suggest key minimum standards which should cover disclosure, rent reviews, ratchet clauses, relocation expenses, outgoings and assignment.

The current situation is that all States now have some form of small retail business tenancy legislation or regulation (see Table 1.).

**Table 1 : Australian State Legislation**

State	Name of Act	Last Amended
Australian Capital Territory	Leases (Commercial and Retail) Act 2001	4 <sup>th</sup> March 2003
New South Wales	Retail Leases Act 1994	6 <sup>th</sup> December 2002
Northern Territory	Business Tenancies (Fair Dealings) Act 2003	
Queensland	Retail Shop Leases Act 1994	Proposed amendments 2005
South Australia	Retail and Commercial Leases Act 1995	6 <sup>th</sup> December 2001
Tasmania	Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998	
Victoria	Retail Leases Act 2003	22 <sup>nd</sup> November 2005
Western Australia	Commercial Tenancy (Retail Shops) Agreements Act 1985	28th June 2001

*Source: Prepared by authors from main sources Philips Fox (2004), Clayton Utz (2005)*

In the UK, the whole issue of commercial landlord and tenant relations have been the subject of Government scrutiny over the last 15 years. Following the University of Reading report for the UK Government (DETR, 2000) into the operation of a voluntary code of practice (RICS, 1995), small business tenants were raised as a particular issue. As a result of that monitoring exercise, the UK Government orchestrated a re-writing of the voluntary code of practice agreed in 2002 (RICS, 2002) and has just finished a monitoring exercise of that code (Crosby, *et al*, 2005).

Despite criticisms of the landlord and tenant relationship explored in the monitoring exercise, the UK Government again declined to add to the existing legislation in this area and the existing legislation does not include small business tenancy legislation. However, the Government did identify small business tenant awareness as one of three major concerns it still has (ODPM, 2005).

A previous paper at this conference have compared and contrasted the Australian and UK Government approaches to small business tenants (Murdoch, *et al*, 2001). It concluded that intervention has usually been designed to help the less knowledgeable and experienced tenants avoid onerous or biased agreements. It is usually assumed that the less knowledgeable and experienced tenants are the small business tenants. In order to examine whether these tenants are the most vulnerable and are less informed than their corporate colleagues, this paper examines survey evidence of UK tenants.

There have a number of studies of small business decision-making but few address property issues. The small business service of the UK Government illustrate the importance of the small business sector to the UK economy representing 52% of turnover and 99% by number of business of the total (SBS, 2004). But research also shows that despite many of these businesses having growth aspirations, 50% of employment growth is represented in 4% of firms (Hakim, 1989; Storey, 1994; CSBRC, 1992); although much of this research is dated. This raises questions of whether these business require flexible lease contracts. However, the number of new businesses which are still trading after 10 years is only around 15% and more than 50% close within 3 years so the lack of growth does not mean a lack of change in circumstances (Barclays, 2002; 2003). Whether leases impact by inhibiting growth or affecting closure has not been investigated but a survey by Morrison, *et al* (2003) found physical expansion difficulties was on a list of constraints to small business growth. However, both Michaelis, *et al* (2001) and CSBRC (1992) found that suitability of premises low on a list of business concerns. As these surveys are all of existing businesses it is perhaps unsurprising. A more interesting result on the property implications might come from businesses which had moved or closed.

Finally, what constitutes a small business needs to be examined. The definition of small and medium sized enterprises (SME) in the European Union (EU) and the UK is based on the characteristics of the company and not on the size of the premises they occupy. The definition of a "small business" varies between countries. In the UK the Government usually defines an SME as one employing fewer than 250 employees. SMEs are further sub-divided as follows; micro firms 0 – 9 employees, small firms 10 – 49 employees (ie including micro firms) and medium sized firms 50 – 249 employees. Turnover and balance sheet figures are not normally used for UK Government statistics. The EU uses number of employees but also refers to turnover and balance sheet figures. Tenancy legislation in Australia is normally based on the size of the premises as well as definitions of the status of tenants and any introduction of legislation in the UK would have to grapple with the definitional problem of exactly what constituted either small business tenants and/or small business premises. This paper does not address definitional issues but does examine whether there are distinctions between SME tenants and the larger corporates, or whether any distinction is within the different groups of SMEs.

### **Research questions and methods**

The overall aim of this paper is to examine the process by which small business tenants negotiate leases in the UK and to discuss the possible use of legislation in addressing issues raised within that process. Australian legislation appears to be aimed at protecting tenants who may be vulnerable in market negotiations and this research therefore has the objective of examining how leases are negotiated and whether certain tenants obtain different leases. It identifies how tenants protect themselves against any unscrupulous behaviour and whether leases outcomes are appropriate.

In order to achieve the aims and objectives, the paper will examine the negotiation process and the outcome that stems from that process, including any trends, and identify any differences in both process and outcome between small business and other tenants. These findings will form the basis of future research to be undertaken in Australia after this conference. That research aims to examine whether the Australian approach has addressed any issues raised by the UK research and whether the same or similar legislation would be appropriate in the UK.

The first set of research questions relates to the processes small business tenants go through in taking a lease. Do small business tenants take leases without prior advice; if they do get advice, does that advice enable them to enhance the commercial deal or is it only advice of a

legal nature? If either no advice, or purely legal advice is taken, this may indicate that more fundamental questions concerning the suitability of the terms for the nature of the business are not being addressed. For example, a business which runs on fixed term supply contracts should not be signing leases which do not enable them to be ended if the business contracts are not renewed.

These issues are addressed via two types of survey. A preliminary set of 46 interviews was held with landlords' and tenants' agents and solicitors in three different types of location around the UK in March 2003. Manchester represented a major urban conurbation with a mixture of institutional landlords and corporate tenants as well as local landlords and small business tenants. Smaller industrial districts and more rural market towns were represented by a number of towns in North Derbyshire and Berkshire/Wiltshire respectively and a number of interviews were also carried out in 2 towns in Wales. Few institutional landlords owned property in these two non- metropolitan regions but multiple retailers were represented in these towns. This provided an interesting about-face to the usual stereotype of powerful landlord and weaker tenant with large multiple retailers taking premises from small business landlords.

The interviews provided a basis for a set of questionnaire surveys of landlords, tenants, agents and lawyers and this paper draws from the tenants' survey. The tenants' survey was of an approximate 20% sample of all commercial property lease transactions recorded by the Valuation Office Agency in 2003 and the early part of 2004 in 29 districts across England and Wales. One metropolitan centre, one industrial district and one urban/rural district within each of the nine Standard Government Regions of England and Wales plus one Inner London and one Outer London Area were chosen randomly. The Data Protection Act did not allow the names of tenants to be revealed, only their addresses; accordingly the questionnaires had to be addressed to "the Manager" of the premises. It had to be accepted that this in itself might adversely affect the response rate.

In total 1238 questionnaires were sent out, followed by two reminders. The total response was 428 (34.6%) of which 313 (25.3%) were usable. The results are set out in Table 2.

**Table 2 : Tenant Questionnaire– Response Rate**

	<b>Questionnaires sent out</b>	<b>Total response</b>	<b>% Response</b>
<b>Completed questionnaires</b>		313	25.3%
<b>Questionnaires returned uncompleted</b>		35	
<b>Returned by Post Office</b>		75	
<b>Returned completed but too late to include</b>		5	
<b>Total</b>	1238	428	34.6%

The VOA database allows some analysis of the characteristics of the destinations set against the characteristics of the respondents. The comparison is set out in Table 3. The responses are generally a good match. The average rateable values, average lease lengths and proportions of factories, warehouses and other properties in the destinations and responses are very similar. The main difference is that the proportion of retail leases in the destinations is higher than in the responses and the opposite is true for offices. The average rent for the responses is higher, as is the average floorspace per letting.

**Table 3 : Comparison of Characteristics of Tenant Survey Destinations and Responses**

	<b>Destinations</b>	<b>Respondents</b>
<b>Average lease length</b>	7.8 yrs	7.1 yrs
<b>Average effective area</b>	320 Sq.M	407 Sq.M
<b>Average Rateable Value</b>	£30,538	£30,469
<b>Average rent</b>	£47,291	£58,018
<b>Retail</b>	39%	32%
<b>Office</b>	35%	40%
<b>Industrial</b>	12%	10%
<b>Warehouse</b>	11%	13%
<b>Other</b>	3%	5%

The majority of respondents were SMEs. Using the employment criteria, as no details of turnover were available for the respondents, under 10% of responses came from businesses that employed more than 250 employees. Furthermore, most were micro businesses with just under 45% of respondents employing 5 or fewer employees and another 14% employing fewer than 10. Only 32% of respondents also hold leases on other business premises, therefore the majority were tenants of only one commercial property. Table 4 illustrates.

**Table 4 : Tenant Respondents by Type of Business**

<b>Number of Employees/Type of Business</b>	<b>Number of Respondents</b>	<b>% of Respondents</b>
<b>0-5 Micro (1)</b>	138	44%
<b>6-9 Micro (2)</b>	45	14%
<b>10-49 Small.</b>	78	25%
<b>50-249 Medium</b>	24	8%
<b>250 Large</b>	28	9%
<b>Total</b>	313	100%

The respondents were spread across the 11 regions with 16% of the respondents' premises based in London, 25% from the rest of the South, 32% from the Midlands including East Anglia and 21% from the North. Wales is represented by 6% of respondents. In addition to the 16% in London, 43% are located in metropolitan areas, 27% in urban/rural locations and 13% in industrial districts.

More details of the characteristics of all the respondents to the surveys including landlord, agents and solicitors can be found in Crosby, *et al*, (2005) as well as very detailed commentaries on the limitations of the lease data and the transformations which had to be made before the data analysis took place

The second major question concerns the outcome of the negotiations, namely the leases being taken by small business tenants. The survey work gives some basic data on these leases but the main analysis for lease terms is based on the Investment Property Databank. This is a private dataset from which analyses can be requested but the individual property transactions are confidential. IPD data is based on records of 10,811 individual properties with a capital value of £105 billion as at December 31<sup>st</sup> 2003 (IPD, 2004) (see Table 5). IPD estimate that it represents 45% of the total property assets in the UK investment market.

**Table 5: IPD Database 1997 to 2003**

	1997	1998	1999	2000	2001	2002	2003
<b>Number of Properties</b>	15,367	15,384	14,409	14,213	12,372	11,699	10,811
<b>Capital Value (£ million at year-end)</b>	71,700	81,954	91,530	100,524	101,121	104,424	105,072

*Source IPD.*

Note : A property is defined by IPD as the asset which is valued for performance measurement purposes. This may cover several buildings in some instances, e.g. an industrial estate, or part-ownership of a single building, such as in the case of some shopping centres.

These records contain individual occupational lease details as well as value, physical, tenant and location data. This enables analysis of lease structures by reference to un-weighted as well as value and floorspace-weighted criteria and also by property type, location and physical quality. Table 6 sets out the number of lease transactions occurring within the dataset over the last 7 years from 1997 to end of 2003.

**Table 6 : Number of Lease Transactions Each Year – IPD 1997 to 2003**

<b>Principal Commercial Sectors</b>	1997	1998	1999	2000	2001	2002	2003
<b>Retail</b>	2,353	2,673	2,843	2,952	3,017	2,868	3,506
<b>Office</b>	1,322	1,493	1,425	1,827	1,569	1,588	1,529
<b>Industrial</b>	636	739	732	1,494	1,891	1,330	2,222
<b>All Segments (excl other)</b>	4311	4905	5000	6273	6477	5786	7,257

*Source IPD*

This dataset does not cover the whole market as the landlords are normally large-scale investors such as Pension Funds or Property Companies. However it does have significant numbers of secondary property and it also has significant numbers of small business tenants. Using Experian data, IPD is able to identify their status including the number of employees and turnover and so can classify SMEs by both number of employees and financial indicators.

Tenant categories have been identified for the dataset from 2003 onwards. For the year 2003 and the first 3 months of 2004, around 80% by number of the full dataset sample can be identified as either larger tenants or SMEs. Around 60% by number and 80% by value of the SME sector can be further broken down into micro, small and medium. The breakdown of the full sample for the years 2003/4 is set out below in Table 7 and Table 8 indicates the further disaggregation of the SME sample.

**Table 7 : IPD Leases 2003/2004 – Breakdown by Tenant Type**

	Large	SME	Total	% Matched out of whole sample
<b>Retail</b>	1,596	1,505	3,101	82%
<b>Office</b>	512	807	1,319	79%
<b>Industrial</b>	510	1,516	2,026	79%
<b>Other commercial</b>	26	23	49	67%
<b>All Sectors</b>	2,644	3,851	6,495	80%

*Source IPD*

**Table 8 : IPD Leases 2003/2004 – Breakdown of SME Sector by Tenant Type**

	Medium	Small	Micro	Unknown SME	Total	% Matched out of SME sample
<b>Retail</b>	192	157	410	746	1,505	50%
<b>Office</b>	168	115	254	270	807	67%
<b>Industrial</b>	217	345	505	449	1,516	70%
<b>Other commercial</b>	6	4	7	6	23	74%
<b>All Sectors</b>	583	621	1,176	1,471	3,851	62%

Source IPD

A detailed cross sectional breakdown of the differences between the leases of larger and smaller tenants will be taken from this IPD subset for the years 2003/4 to identify small business tenant lease characteristics.

General lease trends across all tenants can be identified over the last 7 years from the IPD. In addition, Crosby, *et al* (2005) had access to a sample of the Valuation Office Agency lease data used for the questionnaire surveys and that also enables general trends to be isolated since 1998. However, this data cannot be disaggregated for different tenant categories so cannot be used for further analysis of small business tenant leases even though it potentially covers a wider spectrum of prime, secondary and tertiary property than the IPD. Both IPD and the VOA data are used to indicate general trends over the last 6/7 years.

## 5. The results

### 5.1 *Leasing process concerning small business tenants*

The first set of research questions relates to the process by which small business tenants take leases. The questionnaire survey asked a number of questions including the amount and nature of professional advice obtained, the extent and nature of any negotiations, knowledge of the Code of Practice and knowledge of what was in the lease signed,

The questions were based upon the findings of the preliminary interview survey of 46 agents and solicitors detailed previously. The findings of the interview survey were that:

- It was rare for small business tenants to be represented in the commercial stage of lease negotiations but they usually employ a solicitor.
- Solicitors were often not involved in the commercial part of the negotiations.
- The professionals thought that small business tenants were not able to negotiate the best deal available to them (because they were unaware of the implications of certain lease terms and were not taking advice at the initial stages of the process).
- Most small business tenants are aware that leases are negotiable but often they simply take what is on offer.
- It is only at the small end of the market, often where the landlord's agent is also the managing agent, that there appears to be a view that it is in the interests of both parties for the tenant to be given a lease appropriate to the business needs of the tenant.
- Although solicitors can often rescue a poor deal, it is also clear that this can be difficult or sometimes impossible where they are not involved until after heads of terms have been negotiated.

- Tenants starting businesses for the first time often want to get in as soon as possible and the advisor fee level and pressure to complete from both sides make detailed lease negotiations difficult to achieve.
- The Code of Practice has no direct impact on lease negotiations and professionals thought that only the larger tenants were aware of its existence.

In order to analyse the questionnaire responses for differences between small business tenants and the rest, the questionnaire responses were split into four groups; micro (1) with up to 5 employees, micro (2) up to 10 employees, small up to 50 employees and medium and larger tenants with over 50 employees. These do not conform strictly to the EU/UK definitions concerning employment, however as the tenant's survey only included 9% of respondents with over 250 employees and a further 8% with 50 to 249 employees, these two groups were combined<sup>1</sup>. In addition, 44% of respondents had fewer than 6 employees so the micro group was split into micro (1) and micro (2), enabling any differences between these two sub-groups to be highlighted.

The different tenant groups within the analysis occupy different property types owned by different categories of landlord. Table 9 sets out the results to a chi-squared analysis of these four groups and shows that differences in responses concerning the type of premises occupied and the type of landlord are statistically significant. Very small business tenants (micro 1) are most likely to lease shops (as opposed to the larger tenants who are more likely to lease offices) and to lease them from private individuals rather than property companies or funds.

**Table 9 - Statistical Test Results for Property Characteristics and Attitudes of Tenants for Different Firm Size by Number of Employees**

Test	Chi Squared	Degrees of Freedom	P Value	Comment
<b>Type of Premises</b>	45.4	12	<b>.000**</b>	Micro businesses more likely to be occupying retail premises, small businesses more likely to be in industrial property and medium/larger business more likely to be in offices.
<b>Landlord type</b>	29.9	12	<b>.003**</b>	Micro (1) businesses more likely to have a private individual as landlord, medium/larger businesses more likely to have a property company landlord and less likely to have a private individual.
<b>Professional advice</b>	30.2	3	<b>.000**</b>	Micro (1) businesses less likely to have taken professional advice than small and medium/large businesses.
<b>Satisfaction with terms of the lease when taken</b>	3.1	3	.376	No significant differences
<b>Previous experience of leasing</b>	55.8	3	<b>.000**</b>	Micro (1) businesses much less likely to have had a lease of commercial premises before, small and medium/large businesses much more likely to have had experience of taking a lease.
<b>Presence of</b>	32.3	6	<b>.000**</b>	Micro (1) businesses much less likely to

<sup>1</sup> The lease data analysis in the next section indicates that the major differences are not between lease terms for medium and large tenants so this suggests that this compromise has not hidden any differences between these two groups.



<b>negotiations</b>				negotiate, small and medium/large businesses much more likely to negotiate the terms.
<b>Awareness of Code of Practice</b>	14.0	3	<b>.003**</b>	Micro (1) businesses less likely to be aware of the Code, medium/large businesses more likely to be aware of its existence.

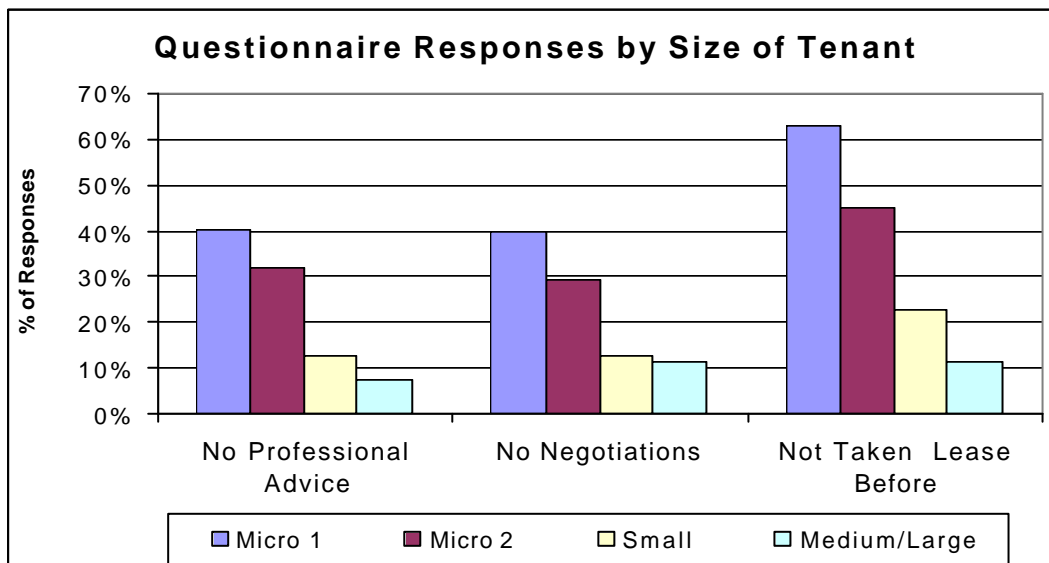
Note :

\*\* Significant at the 1% level

\* Significant at the 5% level

The analysis of responses on lease negotiations shows that micro tenants are more likely than medium or large tenants to have no previous experience of leasing but, despite this, they are less likely to take professional advice. Where they do it is more likely to be from a solicitor only<sup>2</sup> (79% of those taking advice) and they are less likely to use an agent<sup>3</sup>. Overall, 27% of tenants take no professional advice but this rises to 40% for micro (1) tenants and to 32% for micro (2) tenants. The number of tenants who have no experience of taking a lease before is 42% but this rises to 63% for micro (1) tenants and 45% for micro (2) tenants. Micro tenants are also less likely to negotiate the terms and are more likely to be unaware of the Code of Practice.

The number of tenants who take their lease with no negotiations also averages 27% but this again rises to 40% for micro (1) tenants and to 30% for micro (2) tenants. The results are illustrated in Figure 1.



**Figure 1 : Questionnaire Responses by Size of Tenant**

Where tenants took a lease without any negotiations, the main reason given for the lack of negotiations was that the lease suited them (51% of those saying they took the lease on the first terms offered) although a large minority (27%) suggested that it was because the offer from the landlord was made on a “take it or leave it” basis. Where there are negotiations, the

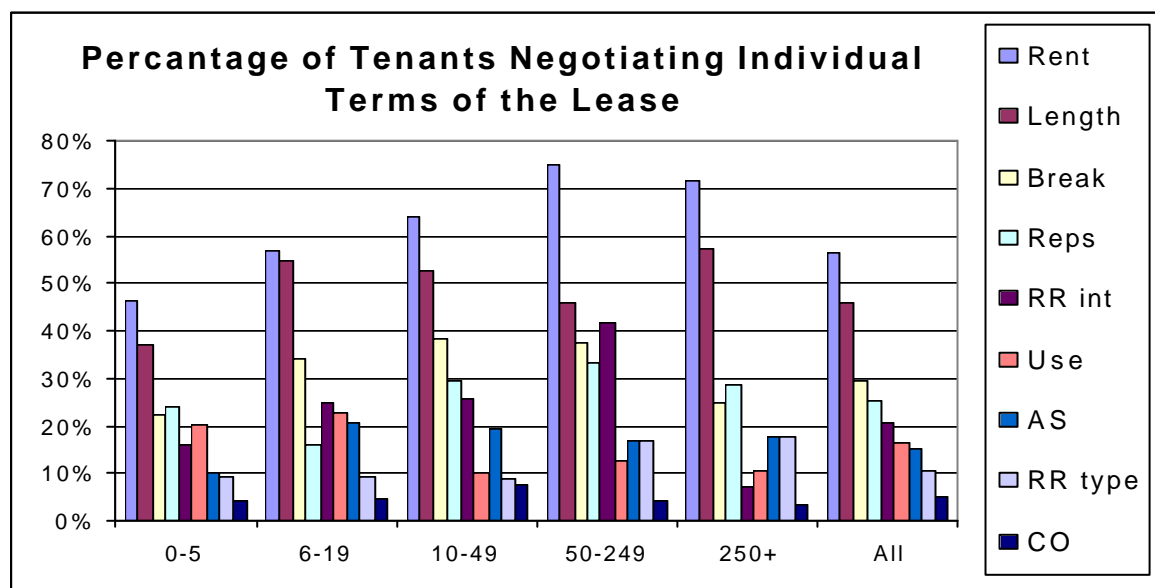
<sup>2</sup> chi-squared 8.4, *df* = 3, *p* = 0.038

<sup>3</sup> chi-squared 11.4, *df* = 1, *p* = 0.010

most frequently negotiated part of the contract is the rent with overall 57% of respondents suggesting that they negotiated on rent. However, only 46% of micro (1) tenants discussed the rent. Length of lease was the next most discussed issue; again only 37% of the micro (1) tenants discussed it compared to 46% of all tenants. As indicated in Table 10 and Figure 2, the same picture emerges for most of the other terms, i.e. tenants' breaks, rent review interval and type and assignment and subletting. However, the user clause is the exception and micro (1) and (2) tenants negotiate more than small, medium and larger tenants on what they can use the premises for. Micro (1) tenants are equally concerned about repairing liabilities.

**Table 10 : Issues Negotiated by Tenants**

	No of Employees					
	0-5	6-9	10-49	50-249	250+	All
<i>Rent</i>	46%	57%	64%	75%	71%	57%
<b>Lease length</b>	37%	55%	53%	46%	57%	46%
<b>Break clauses</b>	22%	34%	38%	38%	25%	29%
<b>Repairing liabilities</b>	24%	16%	29%	33%	29%	25%
<b>Rent review interval</b>	16%	25%	26%	42%	7%	21%
<b>Use</b>	20%	23%	10%	13%	11%	17%
<b>Assignment and subletting</b>	10%	20%	19%	17%	18%	15%
<b>Rent review type</b>	9%	9%	9%	17%	18%	11%
<b>Contracting out</b>	4%	5%	8%	4%	4%	5%



**Figure 2 : Percentage of Tenants Negotiating Individual Terms of Leases**

Compared to DETR (2000), there is evidence of some improvement in awareness of property matters across tenants as a whole. Although DETR (2000) did not specifically address the small business tenant issue, some data is directly comparable with that collected for this study and a few comparisons can be made. The proportion of micro business tenants who are aware of the new Code is now 18%; in DETR (2000) it was only 12%. It would appear that a few more tenants bargain over their lease terms, rising from 61% of all tenants in DETR (2000) to 69% of all tenants now; therefore the number who take the lease on the first terms offered has

fallen marginally from 30% to under 27%. The number of micro tenants with fewer than 10 employees taking professional advice has also increased slightly since DETR (2000) where it was 60% across both micro (1) and micro (2) tenants as opposed to 60% for micro (1) and 68% for micro (2) tenants now.

In addition to the findings on the process, there is some evidence of the changing awareness of tenants within their “don’t know” responses concerning terms of the lease. Compared to DETR (2000), there is a fall in the “don’t know” responses concerning the ability to break and sublet and the existence of rent reviews.

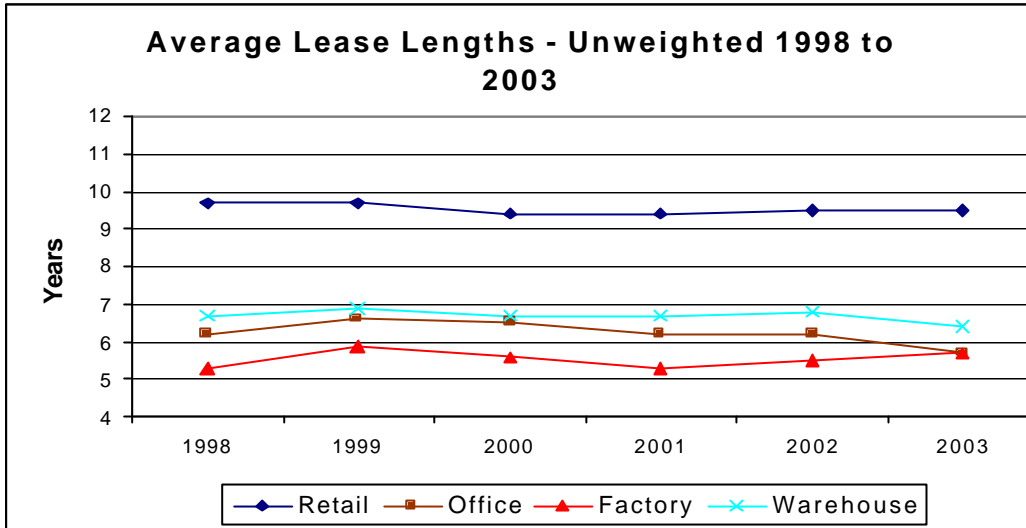
To summarise, the process by which small business tenants take a lease is different from larger tenants and this is particularly marked for micro businesses. Many have no previous experience of taking leases; they are less likely to take professional advice and, where they do, this is far more likely to be from a solicitor, after the commercial deal has been struck, than from a property agent. A large minority are offered a lease on a take it or leave it basis. Although a majority of those who accepted a lease on the first terms offered thought that the terms suited them, this could be due to lack of experience; it may be that it is only later, for example at rent review or when wishing to leave the premises, that the shortcomings in the lease become apparent. Where they do negotiate the terms of their lease, there are indications that micro (1) tenants focus on the state of the premises, the goods they are allowed to sell or the use to which they can put the premises rather than on less urgent concerns. They seem to be concentrating on the immediate issues of running the business and are not necessarily considering future potential problems such as needing to change premises on account of failure or expansion, or a level of rent that cannot be reduced in a market down turn.

Having set out the findings concerning the process of the negotiations and the differences between small and larger business tenants, the next section identifies the actual leases negotiated by the different tenant categories.

## **5.2      *The outcome of lease negotiations: the leases held by small business tenants***

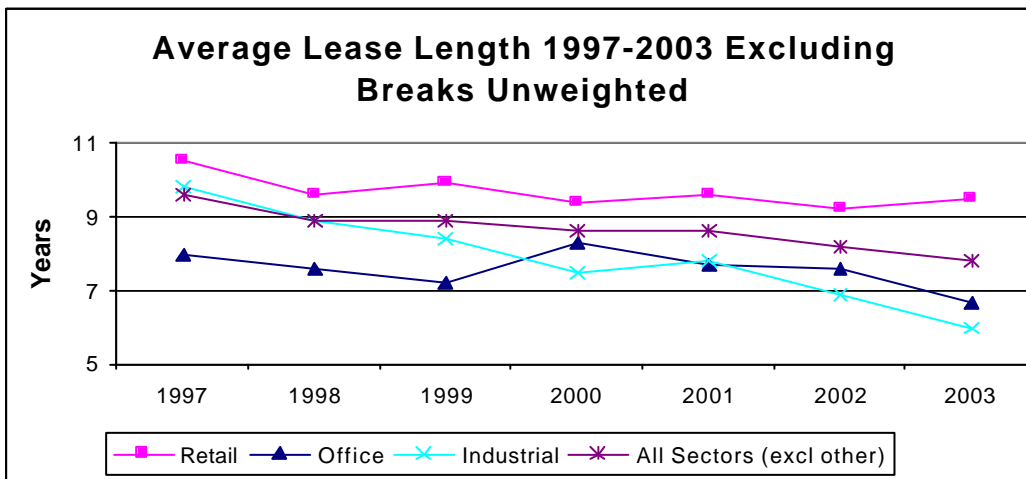
### **5.2.1      *Overall trends in lease length***

Overall, the average lease length has fallen in the UK over the period 1997/1998 to the end of 2003. This is a continuation of a downward trend started in the immediate aftermath of the commercial property market crash of 1989/1990. In 1990, 90% by value of leases within the IPD were for 20 or 25 years (DETR, 2000). In 2003, the average unweighted lease length from the VOA data was 9.5 years for retail leases, 6.4 years for warehouses and 5.7 years for offices and factories (Figure 3). Weighted by rent it was 14.4 years for retail, 10.1 years for warehouses, 10 years for warehouses and 8.9 years for offices. This suggests that larger and/or higher value properties have longer leases.



**Figure 3 : VOA Unweighted Average Lease Lengths - England and Wales 1998-2003**  
 : Source : Crosby, *et al*, (2005)

If it is assumed that the higher quality stock is owned by the major investing financial institutions and property companies and that their property is let to larger occupiers, it might be expected that the VOA data, which includes all properties, would show shorter lease lengths than in IPD, which is data from the larger owners only. However, the difference is marginal with IPD unweighted lease lengths being 9.5 years for retail, 6.7 years for offices and 6 years for industrial (Figure 4). The difference is also marginal when the weighted lease lengths in IPD are compared to the VOA data. Average lease lengths in IPD are actually shorter in retail at 14 years, but considerably longer in offices at 13 years and slightly longer in industrials at 11 years. This lack of major differences apart from offices may suggest that the institutional landlords own a large amount of “secondary” stock and therefore that the IPD SME data is a good proxy for all SME lease data.



**Figure 4 : IPD Unweighted Average Lease Lengths - UK 1997 - 2003**

The difference between weighted and unweighted figures do however indicate that lower value properties have shorter leases.

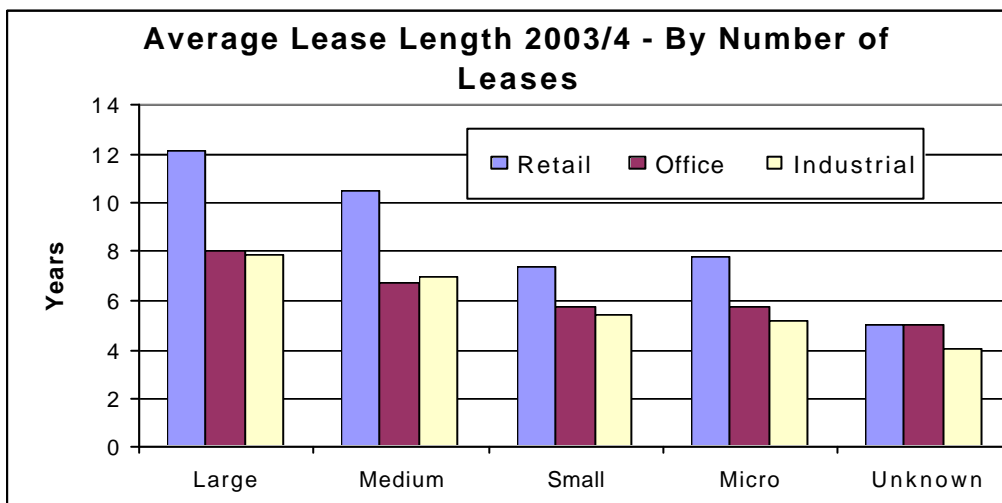
### 5.2.2 Measurable lease terms of small business tenants compared to larger occupiers

Different categories of tenant lease commercial property at different rental levels, with small businesses tenants occupying at average rents that are around half that of medium sized enterprises and 25% of that of larger tenants. They also occupy on different lease terms and some of the details of the basic measurable ones are set out in Tables A1 to A8 in Appendix One and are discussed below.

#### Lease length

Table A1 shows that small and micro tenants occupy on leases with unweighted average lease lengths of around 6 years compared to 8 years for medium sized tenants and 10 years for larger tenants. Retail tenants occupy on longer leases regardless of tenant type but the same pattern of longer leases for larger tenants is evident across all sectors. Weighted average lease lengths set out in Table A2 follow the same patterns but the difference in lease length between different tenant types is accentuated with larger tenants occupying on lease lengths that are virtually double those of small and micro tenants. There are no differences between micro and small tenants.

Average lease lengths to first break are set out in Tables A3 and 4 and illustrated in Figure 5. The same patterns as average lease lengths excluding the impact of break clauses can be observed. Small and micro tenants occupy on shorter leases than medium sized enterprises and they in turn occupy on shorter leases than larger tenants, with retail having the longest leases compared to both office and industrial, which are similar.



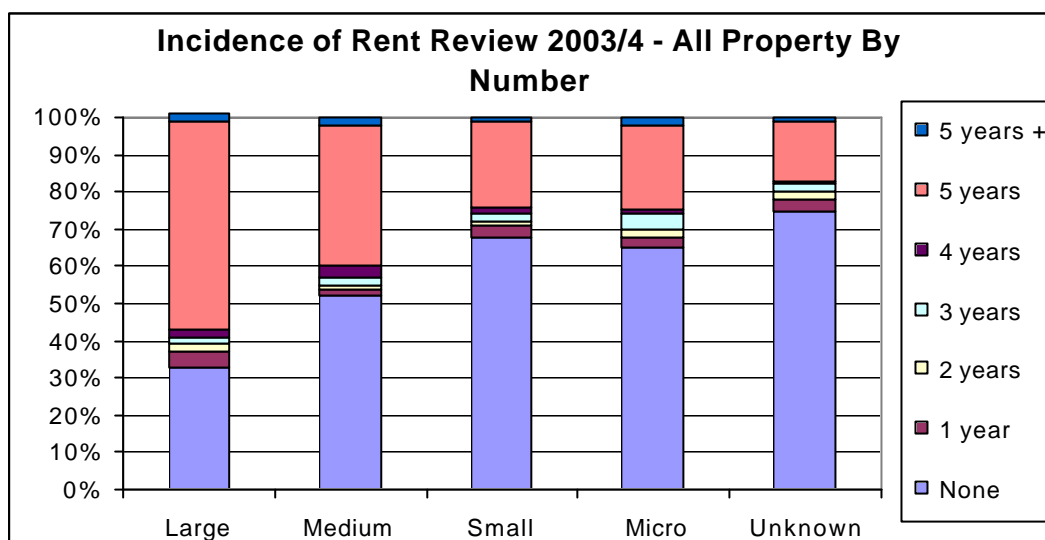
**Figure 5 : Average Lease Length 2003/2004 - Source IPD**

#### Rent reviews

As the small and micro business occupy on shorter leases they would be expected to have either fewer reviews within leases or shorter reviews. Table A5 and Figure 6 illustrate that, where there are reviews, virtually all review periods are 5 years<sup>4</sup> and the incidence of shorter reviews is insignificant. Less than a third of small or micro tenant leases have reviews, this falls to around half of leases to medium sized enterprises and two-thirds of larger company

<sup>4</sup> Virtually all reviews in the UK are ratcheted upwards only (Crosby, *et al*, 2005)

tenants occupy on leases with reviews. The VOA data does indicate one difference to the IPD data concerning rent reviews and that is that lower value properties let on shorter leases do have a number of 3 year rather than 5 year review periods (Crosby, *et al*, 2005).

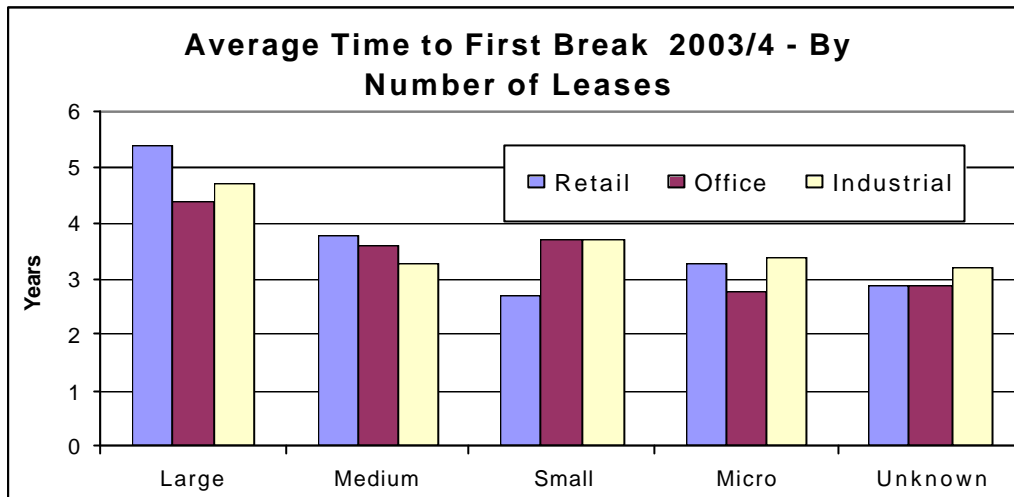


**Figure 6 : Incidence of Rent Reviews 2003/2004 – Source IPD**

### Tenants' breaks

The incidence of tenants' breaks in leases set out in Table A6 shows a less consistent pattern of difference between SMEs and larger tenants than with lease length and rent review. Although in retail, small and micro tenants seem to have more breaks than medium and large tenants, retail has the lowest incidence of breaks in leases, despite having the longest leases. The incidence of breaks in offices is much higher than in the other two sectors but there is no pattern of increasing or decreasing incidence according to tenant type. The incidence of breaks in small and micro industrial company leases is lower than that in leases of medium and large enterprises, in direct contrast to retail.

The average time to first break in leases set out in Tables A7 and A8 and illustrated in Figure 7 does have a pattern according to tenant type with SME tenants having a shorter average time to first break than the larger tenants. Given the length of leases, it would be expected that the shorter leases would also have shorter breaks where there were breaks. This is consistent across all sectors and both weighted and unweighted. However, unlike with lease length, there is no apparent distinction between medium and smaller enterprises regarding time to first break.



**Figure 7 : Average Time to First Break 2003/2004 – Source IPD**

5.2.3 *Questionnaire survey lease data*

The questionnaire survey data does give some indication of the different lease terms given to small business tenants and this has been used to supplement the IPD data. Table 11 sets out an analysis of the responses of different types of tenant to questions concerning clauses within their lease.

**Table 11 - Statistical Test Results on Lease Terms for Different Firm Size by Number of Employees**

Test	Chi Squared	Degrees of Freedom	P Value	Comment
<b>Rent</b>	101.6	9	<b>.000**</b>	Micro (1) businesses much more likely to have a low rent below £10,000, and increasingly less likely to occupy on higher rents, small businesses more likely to have a rent of more than £10,000 and medium/larger businesses more likely to have rents of over £50,000
<b>Lease length</b>	17.1	6	<b>.009**</b>	Micro (1) businesses more likely to have a short lease, micro (2) and small businesses more likely to have a lease of between 6 and 15 years and medium/larger businesses more likely to have longer leases
<b>Existence of rent reviews</b>	4.7	6	.579	No significant differences
<b>Basis of rent review</b>	17.6	12	.130	No significant differences
<b>Can rent go down at review</b>	7.3	8	.505	No significant differences
<b>Existence of breaks</b>	14.9	6	<b>.021*</b>	Micro (1) businesses are more likely to be unaware of whether there is a break in the lease. Small businesses are more likely to know if they have a break and more likely to actually have one in the lease. Medium/large businesses are less likely to have breaks in their leases.
<b>Existence of right to assign</b>	12.6	6	<b>.049*</b>	Micro (1) businesses are more likely not to be able to assign, small and medium/large businesses more likely to be able to assign.
<b>Existence of right to sublet</b>	35.0	6	<b>.000**</b>	Micro (1) businesses are more likely not to be able to sublet, small and medium/large businesses more likely to be able to sublet.
<b>Awareness of whether contracted out</b>	10.4	6	.109	No significant differences

Note :

\*\* Significant at the 1% level

\* Significant at the 5% level

This shows that micro (1) tenants are more likely to be occupying on low rents and short leases and are more likely to be unaware of whether there is a break in the lease than the other respondents. They are also less likely to be able to assign or sublet.

To summarise, both the empirical and the questionnaire data suggest that small business tenants occupy on shorter leases at lower rents with fewer reviews than larger tenants. The incidence of breaks is lower and the incidence of prohibitions on assignment and subletting appear to be greater.



## **6. Conclusions**

### **6.1 *Summary of findings***

The real estate agenda has largely ignored small business tenants and the small business research agenda has largely ignored property issues. This means that there have been large gaps in our knowledge concerning the decision-making processes attached to taking leases and whether current leases are appropriate for small business tenants.

The process by which leases are negotiated in the UK has been investigated and major differences have been found between small business tenants and the medium or large tenants. The most marked contrast is actually between the very small micro (1) tenants and the rest rather than all small business tenants and the medium and larger tenants. The micro (1) business tenants with fewer than 5 employees are less likely to take professional advice, particularly at the commercial stage of the negotiations, and are more likely to take the first lease offered. They are less likely to have taken a lease of business premises before or to have any knowledge of the Lease Code.

There is ample evidence of the characteristics of the leases taken by small business tenants compared to the larger tenants. Overall, lease lengths have fallen consistently since 1990 and continue to fall. The leases obtained by small business tenants are different to larger tenants with the average unweighted lease length across all properties for the micro tenants being around 6 years. The average unweighted lease length for larger tenants across all properties is over 10 years. But even within each tenant category the higher the rent the longer the lease so more valuable properties command longer leases. Other lease terms tend to show similar patterns with all small business tenants having a lower incidence of rent reviews within leases and shorter time to first break.

The findings of this research indicate that there are differences between small business tenants and the larger and medium sized company tenants in the leases that are taken and the process by which those leases are negotiated. The empirical IPD lease data analysis shows that the main differences in the terms of leases are between the medium and larger tenants and the small business tenants. The leases taken by micro tenants within IPD are closer to those of all small business tenants. This is in contrast to the findings of the questionnaire data concerning the bargaining process where the micro (1) tenants exhibited different negotiation behaviour than other small business tenants; for example, taking less advice and accepting the first terms offered more often. It may be that, if micro (1) tenants had taken more advice and were more experienced, they would have had different leases to the other small business tenants. Alternatively, it could be concluded that, since they have the same leases as other small business tenants despite a different negotiation process, those differences have no major effect. The micro tenant could be benefiting from leases that reflect the negotiating stance taken by the “larger” small business tenants.

Although, overall, small business tenants get different leases to larger tenants this does not, in itself, demonstrate that their leases are appropriate to their needs. A lease that suits one small business may not suit another. The data shows that the average lease length is now around six years for small tenants and, although the evidence from the economy concerning the growth, contraction and failure of businesses is far from conclusive, this may not meet the overall needs of many small businesses. However, overall lease length is not the sole measure of an appropriate lease. Tenants may also need the flexibility to exit their leases early by way of assignment, subletting or a break and, because the needs of tenants differ, an appropriate outcome will hinge on the individual tenant’s ability to appreciate their business needs and to negotiate effectively.

This research suggests that very small business tenants are not aware of the implications of leases and, furthermore, take little appropriate advice prior to signing leases. The evidence suggests that their priorities, especially when negotiating their lease, are dictated by immediate operational needs, with little consideration being given to future and longer-term property requirements. Micro (1) tenants concentrated, when they did negotiate, on issues such as rent, user and repairs rather than review type or assignment and subletting and breaks. In order to obtain real flexibility, tenants need to both understand current requirements and anticipate future changes in those requirements. Only then can they hope to get the lease that suits their particular needs. However, especially in the case of new businesses, those operating small business are likely to be both optimistic and have short planning horizons. Thus, even if their optimism turns out to be well-placed, they may not think to negotiate lease provisions that allow them the flexibility easily to move and grow. They are even less likely to contemplate the possibility of their business going wrong or the potential impact of a falling property market and the way in which the terms of their lease could make a bad situation worse.

## 6.2 *Policy implications*

The UK Government Action Plan for small businesses is intended to promote enterprise and productivity. It is in this context that the Government has a legitimate interest in encouraging flexible lease contracts by encouraging the offering of choice to tenants and discouraging the use of provisions such as upward only rent reviews and lease clauses which unduly restrict rights to assign and sublet. Increasing the property awareness of those that need to take leases of premises to operate also manifestly advances the interests of small business. The UK Government has, in the 2005 Budget statement, re-iterated its concern that more progress should be made in these areas.

The fact that tenants themselves do not always share this concern does not in itself indicate that Government is on the wrong track. For example, the Code monitoring exercise (Crosby, *et al*, 2005) showed that review type was low down on the list of tenants' priorities, but this may be partly a function of market conditions at the time of the survey, with tenants surveyed in 2004 not expecting rents to fall in the foreseeable future. It would be interesting to see if opinions from existing tenants gathered in a falling or fallen market would change, with the upward only rent review rising nearer to the top of the list of concerns. Similarly, although small business tenants do not articulate any serious worries about their lease terms, since many – especially the micro tenants - do not negotiate at all, this suggests that they may simply be unaware of potential problems of exit strategy or future rent review issues and that the Government's wish to put them in a better position to protect themselves is well justified.

To date, despite intermittent threats to legislate, the Government has pursued a voluntary route for implementing its policies on commercial leasing, using Codes of Practice as a means of keeping pressure on landlords to give more choice to tenants. Although tenants' groups are continuing to press for a legislative solution, the Government has effectively committed itself to the non-mandatory approach for a further next three years.

The voluntary Codes of Practice have also been the primary mechanism for raising the property awareness of small business tenants in the UK. The lack of dissemination of the Codes to small businesses, the community that they might most benefit, is a major cause for concern. It raises policy questions as to whether Codes are the best way of helping small tenants to negotiate leases. It may be that other methods need to be investigated. The example of Australia may be helpful. Murdoch, *et al*, (2001) report that a 1991 Retail Tenancy Code of Practice was promoted in New South Wales by both the Property Council of Australia and the Retail Traders' Association. However, legislation was finally proposed after the State Government decided that the voluntary code had not worked.

It would appear that all Australian States have come to the same conclusion. However, what is not clear is whether the perceived problems have been solved by the legislation. What were the particular problems of the small retail tenant in Australia. Are they any different to the problems encountered by UK tenants? It is these and a number of other more detailed questions that must be addressed before any similarity between small business tenants in the UK and Australia can be identified and the legislative option investigated for potential success in the UK.

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## Appendix One – IPD Lease Data Tables

**Table A1 : Average Lease Length – IPD Unweighted**

	Large	Medium	Small	Micro	Unknown
<b>Retail</b>	12.2	10.5	7.4	7.8	5.0
<b>Office</b>	8.0	6.7	5.7	5.7	5.0
<b>Industrial</b>	7.9	7.0	5.5	5.1	4.1
<b>Other commercial</b>	20.8	-	-	-	-
<b>All Sectors</b>	10.6	8.1	6.0	6.2	4.7

**Table A2 : Average Lease Length - IPD ERV Weighted**

	Large	Medium	Small	Micro	Unknown
<b>Retail</b>	15.2	12.2	7.8	8.6	6.2
<b>Office</b>	14.7	9.7	7.2	7.7	6.3
<b>Industrial</b>	13.5	9.3	7.4	6.9	5.7
<b>Other commercial</b>	24.8	-	-	-	-
<b>All Sectors</b>	14.9	10.5	7.6	7.9	6.2

**Table A3 : Average Lease Length – IPD Unweighted - to lease expiry or break**

	Large	Medium	Small	Micro	Unknown
<b>Retail</b>	11.3	9.8	6.4	6.5	4.3
<b>Office</b>	6.3	5.0	4.5	4.4	4.2
<b>Industrial</b>	6.1	5.4	4.6	4.3	3.7
<b>Other commercial</b>	19.3	-	-	-	-
<b>All Sectors</b>	9.4	6.8	5.1	5.1	4.1

**Table A4 : Average Lease Length - IPD ERV Weighted - to lease expiry or break**

	Large	Medium	Small	Micro	Unknown
<b>Retail</b>	14.4	11.5	7.0	7.3	5.5
<b>Office</b>	13.3	7.3	5.6	6.3	4.9
<b>Industrial</b>	11.8	7.2	5.7	5.7	4.8
<b>Other commercial</b>	23.8	-	-	-	-
<b>All Sectors</b>	13.8	8.8	6.2	6.6	5.3

**Table A5 : Distribution of Rent Review Periods by Number of Leases**

	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Micro</b>	<b>Unknown</b>
<i>None</i>	33%	52%	68%	65%	75%
<b>1 year</b>	4%	2%	3%	3%	3%
<b>2 years</b>	2%	1%	1%	2%	2%
<b>3 years</b>	2%	2%	2%	4%	2%
<b>4 years</b>	2%	3%	2%	1%	1%
<b>5 years</b>	56%	38%	23%	23%	16%
<b>More than 5 years</b>	2%	2%	1%	2%	1%
<b>All trackable leases</b>	2,423	520	565	1,085	1,367
<b>% of all leases</b>	92%	89%	91%	92%	93%

**Table A6 : Incidence of Breaks by Number of Leases**

	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Micro</b>	<b>Unknown</b>
<b>Retail</b>	16%	17%	22%	26%	18%
<b>Office</b>	36%	43%	34%	43%	22%
<b>Industrial</b>	35%	35%	22%	21%	12%
<b>Other commercial</b>	15%	-	-	-	-
<b>All Sectors</b>	23%	31%	24%	27%	17%

**Table A7 : Average Time to First Break – Unweighted**

	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Micro</b>	<b>Unknown</b>
<b>Retail</b>	5.4	3.8	2.7	3.3	2.9
<b>Office</b>	4.4	3.6	3.7	2.8	2.9
<b>Industrial</b>	4.7	3.3	3.7	3.4	3.2
<b>Other commercial</b>	-	-	-	-	-
<b>All Sectors</b>	5.0	3.5	3.5	3.2	3.0

**Table A8 : Average Time to First Break - ERV weighted**

	<b>Large</b>	<b>Medium</b>	<b>Small</b>	<b>Micro</b>	<b>Unknown</b>
<b>Retail</b>	7.2	3.6	2.6	3.0	3.7
<b>Office</b>	5.7	4.7	4.1	3.4	3.6
<b>Industrial</b>	5.3	4.2	4.5	4.7	4.1
<b>Other commercial</b>	-	-	-	-	-
<b>All Sectors</b>	6.2	4.3	3.9	3.6	3.8