

Straight Talking, Bill Nowlan - In commercial property, tomato rules apply

Landlord-tenant relationships are self-correcting, and do not need government intervention



Slump: the Dublin office market

Rents for commercial properties let on new leases have fallen by 25% to more than 50% over the past two years according to the new IPD report, but are they still too high? Rents are set by the normal market interactive process. Until the recent legislative knee-jerk rent review intervention, the government has had a consistent policy of deregulation in the relationship between landlord and tenant. This has been good for all.

I started my business career as a young teenager bringing tomatoes the family had grown to the Dublin fruit and vegetable market. I learned there that if there were more tomatoes for sale than buyers then prices went down, and if there were too few tomatoes then prices went up. Rent levels are set by exactly the same process but with two important differences.

The first is that the supply chain for new buildings is very long, meaning it takes three to five years to add to supply but this supply cannot be reduced or increased quickly. Secondly, lease terms historically have been for long periods ranging from one year to 15-plus years, leading to inelasticity of actual rents paid.

In Ireland we now have an oversupply of buildings. Users of space are negotiating rents down – just like my tomatoes when there was an oversupply. Demand is low and supply is high. Many tenants entered into long leases during the boom at rents that are now above the going rate. Some tenants are going broke and others are trying to negotiate reductions. Italian restaurant chain Carluccio's very public closing down and reopening of an outlet in Dublin following a significant rent reduction illustrates the point.

I advise both landlords and tenants in such discussions to know both sides of the argument. Some claims are legitimate, others are not.

No landlord wants to reduce rents as it will have a major impact on income and a negative impact on value. The landlord's position is that he signed a contract and tenants may not walk away because times have changed. However, if the choice is between no income or a more than 30% reduction, then a landlord will choose the latter. The tenant regards rent as an overhead hurting his business. In a tough environment he needs to get his overheads down.

In some property types the situation is a lot more stressed than others. In retail, which makes up only about 15% of the property market, the situation can be particularly acute. Usually a retailer would spend about 8% to 10% of turnover on rent and this would represent 30% to 50% of their gross profit in good times.

Many leases were signed on the basis of retail turnover levels in 2005-2007. But with turnover down by 20%-25% and squeezed margins, rent may now be absorbing most of a retailer's gross profit. On the other hand, there are retail tenants whose turnover and margins may not have been significantly squeezed.

In retail the problem is exacerbated by new lettings of nearby shop units at rents significantly below historic levels. This gives rise to the current campaign to adopt new legislation enabling downward rent reviews, which would be a fundamental attack on property rights. Section 132 of the Land and Conveyancing Law Reform Act includes a provision that, in new leases, future rents will be upward or downward at rent review.

It is not retrospective. This legislation is irrelevant, in my view, as the market has already moved to the point that the structure of all leases has changed to align with reality. Short leases, break clauses and turnover rents are now the norm. However, the recent legislation banning new rent reviews is dysfunctional, particularly in the commercial sector, as it is creating serious problems for large financing deals and will have to be revisited.

Two years ago, prime office space in Dublin would lease at €50 per square foot. This has fallen to €30 per square foot. New tenants, or tenants with break clauses, are having a field day in renegotiations. However, the position of non-retail business is fundamentally different to retail.

For a business occupying commercial space, rent as a proportion of overheads is usually well below 10% and may be as low as 3% or 5%. While rent reductions would be welcome, they are not essential. The biggest cost for such organisations is staff, and we all know what is happening on that front.

While retail rents went through the roof, rents for commercial property moved upward only a little faster than inflation over the past seven years, so generally the position is not acute.

As an asset manager, the way I approach any application for rent concession is to look for up-to-date accounts to establish a tenant's true profit position. If survival is at stake, then the landlord may have to make concessions – and many are doing so.

Shopping centre landlords also have to look at the drawing power of the shopping centre overall. They must consider the consequences if key tenants close down. Lessons are being relearned that shopping centres are businesses as opposed to simple high-street investments.

The era of low rents will be temporary if the economy recovers significantly. At prevailing market rental and yield levels, it is generally not viable to carry out new development.

This is the market's self-correcting mechanism, be it for tomatoes or property. Inevitably scarcities will emerge – rents will rise to make development viable again – but it's some way off.

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