

# **Do small business tenants need protecting in commercial lease negotiations?**

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***Key words :*** *Landlord and Tenant, UK Commercial and Industrial Property, Small Businesses*

## **Abstract**

This paper sets out the findings relating to small business tenants of a major UK Government funded study into the commercial and industrial property landlord and tenant relationship. The UK Government is concerned that small business tenants do not appreciate many of the implications of signing leases, which in the UK are generally longer than in most other countries of the world.

The objectives of the paper are to identify the characteristics of leases in the UK and any differences between those signed by small, medium and larger companies. It also examines the negotiation process and identifies whether small business tenant negotiations exhibit different characteristics. The findings are that small business tenants occupy on different terms to larger tenants including shorter terms and that the negotiation process is also different. Many small business tenants are unrepresented at the commercial stage of negotiations and take the first terms on offer. They are largely unaware of attempts to make them more informed by voluntary industry Codes of Practice. This can lead to small business tenants being unaware of the implications of certain terms within leases, hence the continuing Government concern over the issue.

## **Introduction**

During 2003 and 2004, the University of Reading was commissioned by the UK Government to provide evidence on the operation of a voluntary code of practice on commercial leases (RICS, 2002) agreed between landlords and tenants of commercial property in the UK. The code was introduced in April 2002. The Reading report was presented to Government in December 2004 and published by them in February 2005 (Crosby, et al, 2005).

The 2002 Code of Practice for Commercial Leases was a voluntary document negotiated by landlord and tenant representative bodies in the UK in response to Government pressure to reform leases. This pressure started in the wake of the 1990 commercial property crash in the UK. Burton (1992) identified three major areas of concern which the UK Government used in its first consultation paper concerning commercial leases (DETR, 1993). These were upwards only rent reviews which led to tenants not being able to reduce rents at the rent review date within the lease even though both trading conditions and market rental levels had fallen significantly, confidentiality clauses, which attempted to hide the details of lease rents and other terms being disclosed to third parties, and the rent determination processes at review and lease renewal. The Government threatened to legislate but the property industry proposed a voluntary solution to these issues with an agreed Code of Practice between landlord and tenant representative bodies. By the time this first Code of Practice for Commercial Leases was agreed and published in late 1995 (RICS, 1995), upwards only rent reviews was still high on the Government's list of issues although the other two had fallen off the agenda due to the results of consultation leading up to the first Code.

Following a monitoring report on the operation of the first Code (DETR, 2000), which concluded that the Code was having no effect on market practices and that upwards only rent reviews still dominated other forms of rent review, the second more comprehensive Code of Practice was agreed in 2002 (RICS, 2002). In addition to the monitoring report (Crosby, et al, 2005), the Government also issued another consultation paper (ODPM, 2004) which invited comment on 6 options to deter the use of upwards only rent reviews.

In the light of the monitoring report and the consultation paper responses, the UK Government decided in the Spring of 2005 not to legislate but they will continue to monitor the market paying particular reference to three issues. The first of these is the upwards only review and the second relates to the ability of tenants to either sell (assign) or sublet to another tenant during the lease term.

The third issue concerns small business tenants. One of the Government's objectives for the 2002 Code of Practice was to increase the awareness of small business tenants. Previous research (DETR, 2000) had suggested that small business tenants did not always take professional advice when taking leases, particularly from agents prior to agreeing the basic heads of terms. Solicitors were more frequently consulted but often after the commercial terms were agreed. However, this research did not include questions of whether this lack of advice to tenants disadvantaged them in lease negotiations and therefore Government added this issue to its agenda when monitoring the operation of the 2002 Code of Practice.

The actual question posed by Government was an assessment of the degree of awareness of property matters among occupiers of commercial property, particularly small business tenants. Lease reform is part of the Government's business flexibility agenda and if the 2002 Code is to result in more efficient economic outcomes, tenants need to be aware of the stipulations of the Code, the alternative contractual terms on offer and, ideally, the business implications of differing terms. DETR (2000) monitored the operation of the first Code of Practice on Commercial Leases in the UK launched in 1995 and found that the Code had no influence on the market at any level as

the vast majority of tenants (86%) were unaware of its existence. For small businesses with less than 10 employees 88% were unaware of its existence. Although small business tenants were not the major focus of this research, differences did emerge from the data analysis concerning not just questions attached to the Code of Practice, but wider issues such as the taking of professional advice before signing the lease. This breaks down into commercial advice on the negotiations as well as legal advice after terms have been provisionally agreed. DETR (2000) found that around 30% of tenants took no advice at all, and another 35% took advice from a solicitor only. This advice may include advice on the commercial implications of certain terms of the lease but may include only legal issues concerning the wording of individual terms.

Based on data collected for the 2002 Code monitoring exercise, this paper aims to identify the position of small business tenants when negotiating leases in the UK. The objectives are to examine both the process by which leases are negotiated and the outcome. It compares the available lease data on small businesses with larger tenants and will identify whether any differences exist in the negotiation process and the outcome of that process. It will also aim to discuss possible policy directions as to whether small business tenants should be treated differently to larger tenants.

### **Small Business Tenants in the UK**

The definition of a small business is based in the EU and the UK on the characteristics of the company and not on the size of the premises they occupy. One research question is whether lease characteristics are based mainly on tenant type or property characteristics.

The definition of a “small business” varies between countries. In the UK the Government usually defines a small or medium sized enterprise (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 firms 50 – 249 employees. While the Companies Act 1985 also refers to turnover and balance sheet figures, this is not usually used for Government statistics. The EU also uses number of employees and refers to turnover and balance sheet figures. It is known that, in the UK, a high proportion of SMEs are in fact micro firms; SMEs comprise over 99% of all businesses, 70% are sole proprietors and a further 20% employ fewer than 5 employees (SBS, 2004).

The ability to respond to changing business circumstances is important for any business. A small business may want to expand and a change of premises may be necessary for this growth. Where premises are leased, the provisions of the old lease will contribute to the ease with which this can be accomplished. However, some researchers have suggested that the large majority of small businesses simply do not want to grow. Hakim (1989) looked at the growth of micro-firms in the UK and found an association between the size of firm and its aspirations for growth. 68% of very small firms (with 2 employees or less) had no intentions to grow despite the prevailing buoyant trading conditions of 1987. However these firms were typically unincorporated home-based firms and the same study found that only 47% of those firms employing between 3 and 9 people had no growth aspirations. The Cambridge Small Business Research Centre (1992) studied small limited companies and found that only 16% of micro and 12% of small firms had no growth aspirations. However, Storey (1994) has suggested that 50% of employment growth in small firms is concentrated in the fastest growing 4%.

Whether the terms of a lease are a barrier to growth has not been investigated. Property is only ever touched upon in respect of the physical premises. For example Morrison *et al* (2003) identified a range of inhibitors to small business growth from previous literature. Unsurprisingly “physical expansion/production limitations” is on the list. However, in a survey of nearly 2000 businesses, the Cambridge Small Business Research Centre (1992) found availability of

appropriate premises or site to be low on list of constraints. Michaelis, *et al*, (2001) conducted a more general survey of small and medium sized business occupiers and found that “suitability of premises” ranks below taxation, cash flow and finance, sales and marketing, regulation, staff, the economic environment and only just above new technology in a list of primary concerns. However none of these surveys investigate how easy it is to leave the current premises.

Storey (1994) says that, amongst small firms, the ‘failures and the trundlers vastly outnumbering the flyers’. He notes that most empirical studies have consistently shown that small firms have higher failure rates than large firms. Defining and measuring failure is not easy as Watson and Everett (1996) found. However, one data set that is frequently used to quantify the number of firms going out of business in the UK is VAT data on deregistration. Not all firms are registered for VAT and not all de-registrations reflect the trader going out of business but nevertheless looking at the survival of VAT registered businesses gives some indication of the proportions that do remain in business.

Table 1 shows survival rates from England to the Rest of the UK. The profile for England is similar to Wales and the rest of the UK although Northern Ireland has the highest level of survivorship apart from one year failures registered in 1999.

**Table 1 : Business Survival Rates in the United Kingdom**

|                         | Registering in 1999 |         |         | Registering in 2000 |         | Registering in 2001 |
|-------------------------|---------------------|---------|---------|---------------------|---------|---------------------|
|                         | 1 year              | 2 years | 3 years | 1 year              | 2 years | 1 year              |
| <b>United Kingdom</b>   | 89.6                | 77.1    | 66.5    | 90.5                | 78.9    | 92.2                |
| <b>England</b>          | 89.7                | 77.1    | 66.4    | 90.5                | 78.8    | 92.1                |
| <b>Wales</b>            | 89.0                | 77.5    | 68.0    | 90.0                | 77.7    | 92.0                |
| <b>Scotland</b>         | 88.1                | 75.7    | 65.3    | 90.2                | 79.1    | 92.5                |
| <b>Northern Ireland</b> | 89.6                | 80.5    | 72.4    | 92.1                | 82.9    | 94.0                |

Source : DTI

Barclays also estimate the number of businesses that survive on an annual basis. Their figures suggest that more businesses fail than are indicated by the estimates of the Department of Trade and Industry. This is not surprising as the latter’s estimates are based on VAT figures while Barclays include the very small businesses below the VAT threshold. According to Barclays (2003), between 1992 and 2003, an average of around 10% of business all closures were of those who had been trading for less than 1 year. Another 14% had been trading between for a year and a further 11% for 2 years. Businesses which had been trading for more than 3 years accounted for less than 10% of closures. Barclays (2002) suggest that between 1992 and 2002, 20% of firms closed within 1 year, more than 50% close within 3 years and 65% within 5 years. The peak period is between 12 and 18 months and after 10 years only around 15% remained open.

There is no breakdown of the type and size of businesses affected and it must be borne in mind that closure does not necessarily mean that a business has failed; for example, it may have been taken over or its owner may have retired. However, it does seem likely that the figures include a high proportion of small businesses. This does suggest that, where new start-up businesses need to rent premises, very short leases and/or early exit mechanisms should be high on their list of priorities. In addition to the risk of failure, success may lead to expansion and change, also precipitating the need to change premises. It should be at least as important as cost of premises so other questions which follow include the length of leases and timing of breaks, ability to assign ad

sublet and whether tenants are prepared to pay additional rents or other payments for flexibility of occupation.

There is therefore some indication that many small businesses will need to change their business premises within fairly short time frames. However, Crosby, *et al*, (2005) indicate that lease lengths in the UK are generally long although there are indications that the longer leases are held by the larger tenants. Whether small businesses have the possible need for change in mind when they sign leases is unknown. Indeed, how small businesses make their leasing decisions is also unclear. There is a body of literature on the wider nature of decision making within small firms, such as the influential work of Storey (1994). Some authors such as Byers and Slack (2001) have explored how strategic decisions are made by small businesses in particular industries, in this case the leisure industry. Within real estate, researchers such as Mazzarol and Choo (2003) have investigated the factors influencing the choice of business location by small firms, but the decision to take a property lease remains unexplored. The use of external business advice has been investigated by several researchers: Bennett and Robson (1999, 2003) considered the extent, source and impact of external business advice by SMEs in Britain while Gooderham *et al* (2004) considered the reasons why firms in Norway varied in their use of accountants as sources of business advice. Brossard (1998) looked at the information sources used by organisations (not specifically small firms) in complex decision making.

### Research Questions and Methods

The above discussion suggests that a number of issues need investigation. First, the actual outcome of lease negotiations concerning lease length and other terms needs to be determined and whether small businesses occupy under similar conditions to larger occupiers or it is property type rather than tenant type which dominates lease characteristics. This is undertaken by reference to the most comprehensive data set of transactions in terms of coverage of the market in the UK; the VOA, and the IPD; less comprehensive in terms of market coverage but much more detailed concerning leases within property owned by the major investing institutions and property companies.

The VOA data represents a structured sample of all lease transactions recorded by them with start dates between 1998 and 2004. The sample is based on locations representing a major metropolitan area, an industrial district and an urban/rural district in each of 11 regions across England and Wales (the 9 Standard Government Regions plus Inner and Outer London, making a total of 33 different sampling points). The number of transactions available for analysis within the VOA is set out in Table 2.

**Table 2 : Number of transactions each year – VOA 1998 to 2004.**

|                  | <b>1998</b>  | <b>1999</b>  | <b>2000</b>  | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>Total</b> |
|------------------|--------------|--------------|--------------|-------------|-------------|-------------|-------------|--------------|
| <b>Factory</b>   | 2188         | 1540         | 1625         | 1552        | 1463        | 1119        | 192         | <b>9679</b>  |
| <b>Office</b>    | 4843         | 3703         | 3912         | 3486        | 3066        | 2384        | 410         | <b>21804</b> |
| <b>Shop</b>      | 5185         | 4128         | 3784         | 3579        | 3565        | 2527        | 406         | <b>23174</b> |
| <b>Warehouse</b> | 1190         | 874          | 977          | 878         | 839         | 660         | 110         | <b>5528</b>  |
| <b>Total</b>     | <b>13406</b> | <b>10245</b> | <b>10298</b> | <b>9495</b> | <b>8933</b> | <b>6690</b> | <b>1118</b> | <b>60185</b> |

The IPD data was based on lease transactions between 1997 and the end of 2003 from records for 10,811 individual properties with a capital value of £105 billion as at December 31<sup>st</sup> 2003 (IPD, 2004). They estimate that it represents 75% of the institutional commercial property stock in the UK.

**Table 3 : 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 |

Note : A property is defined by IPD as the asset which is valued. 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 4 sets out the number of lease transactions occurring within the dataset.

**Table 4 : Number of 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 |

The second set of questions relate 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? In that case it may not address more fundamental questions concerning the suitability of the terms for the nature of the business. For example, a business which runs on fixed term supply contracts should not be signing leases which do not enable the lease to be broken if the contract is 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 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 mainly from the tenants' survey. The tenants' survey was of an approximately 20% sample of all commercial property lease transactions recorded by the VOA in 2003 and the early part of 2004<sup>1</sup>. 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

<sup>1</sup> It consisted of an earlier and therefore smaller download of the data set out in Table 2.

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 5.

**Table 5 : 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 original VOA database from which the destinations were taken allows some analysis of the characteristics of the destinations set against the characteristics of the respondents. The comparison is set out in Table 6. 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.

**Table 6 : 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 7 illustrates.

**Table 7 : 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%                    |

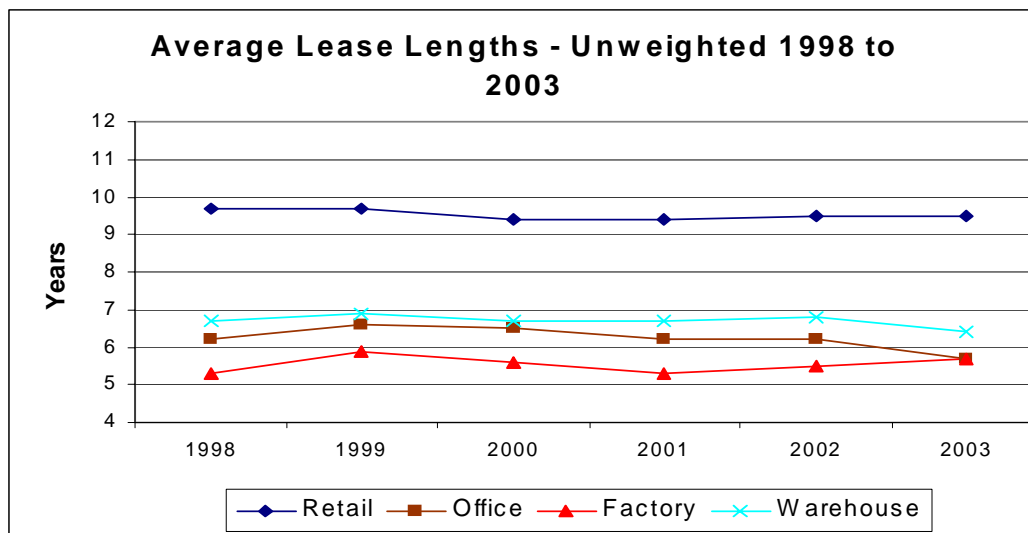
The respondents were spread across the 11 regions with 16% of the respondents' premises based in London, 25% from the rest of the South, 32% from the Midlands including East Anglia and 21% from the North. Wales is represented by 6% of respondents. In addition to the 16% in London, 43% are located in 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 Results

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

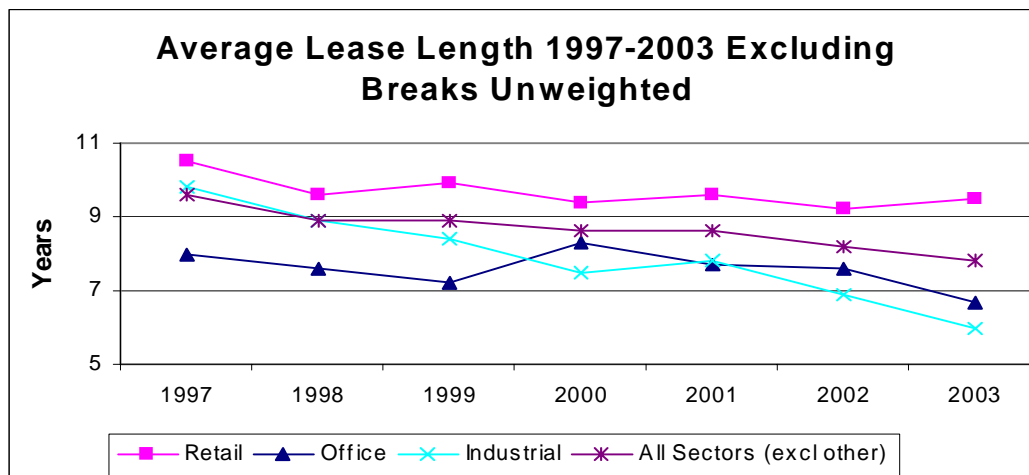
Overall, Crosby, et al, (2005) found that average lease length had fallen in the UK over the period 1998 to the end of 2003, which was also a continuing trend from 1990 onwards where 90% by value of leases within the IPD were for 20 or 25 years (DETR, 2000). In 2003, the average unweighted lease length 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 1). 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 .



**Figure 2 : VOA Unweighted Average Lease Lengths - England and Wales 1998-2003**



As this data includes all properties including both those let to small business tenants as well as larger tenants, VOA data might be expected to show lower lease lengths than in IPD, if the higher quality stock is let to larger occupiers and they occupy on longer leases. However, the difference is marginal with unweighted lease lengths being 9.5 years for retail, 6.7 years for offices and 6 years for industrial (Figure 2). But weighted by rental value, average lease lengths in IPD are actually shorter in retail at 14 years, but longer in offices at 13 years and 10.9 years for industrials.



**Figure 2 : IPD Unweighted Average Lease Lengths - UK 1997 - 2003**

Although the average lease lengths within the different data sets do not show any indication that the property owned by the larger landlords has longer leases, the difference between weighted and unweighted figures does indicate that lower value properties have shorter leases.

A sample of the IPD data can be analysed for differences between different types of tenant; based on the EU/UK definitions for small businesses (IPD use a combination of the employment and turnover criteria previously discussed; the turnover levels relate to those in force up to December 31<sup>st</sup> 2004, not the recent updates). Around 80% by number of the full sample can be identified as 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 8 and Table 9 indicates the further disaggregation of the SME sample.

**Table 8 : 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%                           |

**Table 9 : IPD Leases 2003/2004 – Breakdown of SME Sector by Tenant Type**

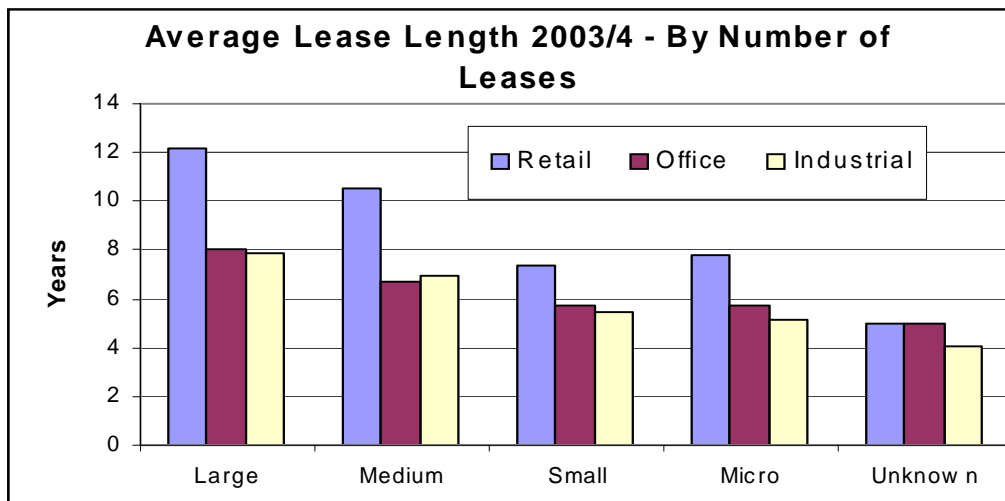
|                         | Medium | Small | Micro | Unknown SME | Total | % Matched out of SME sample |
|-------------------------|--------|-------|-------|-------------|-------|-----------------------------|
| <b>Retail</b>           | 192    | 157   | 410   | 746         | 1,505 | 50%                         |
| <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%                         |

Tables A1 to A11 in Appendix One set out the evidence of lease structure differences within the IPD for the different types of tenants across the three main sectors of retail, office and industrial.

*Lease Length*

Table A1 shows that micro and small tenants occupy commercial leases at average rents around half those of medium sized tenants and less than 25% of those of larger tenants. 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 3. 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 3 : 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 4 illustrate that, where there are reviews, virtually all review periods are 5 years<sup>2</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 tenants occupy on leases with reviews.

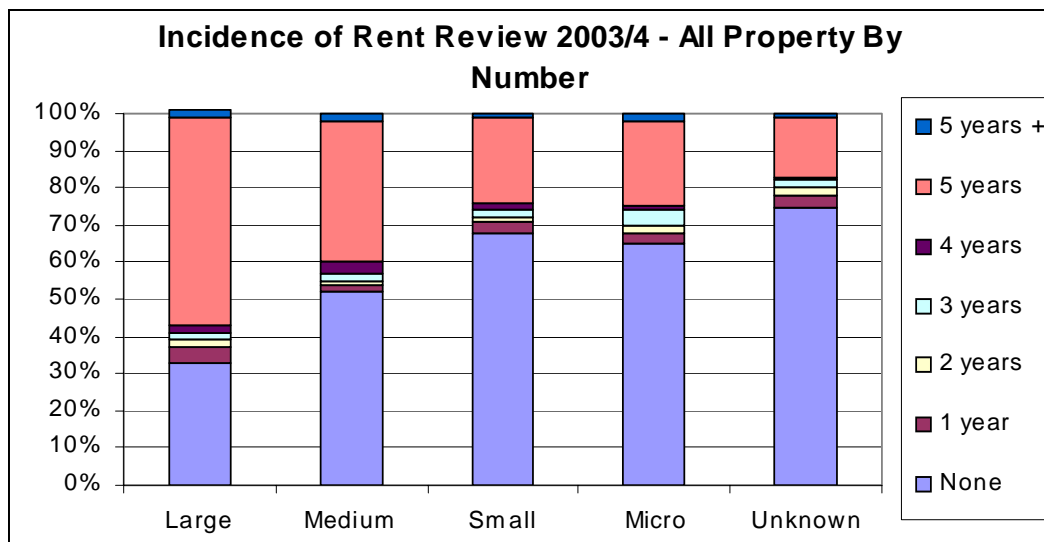


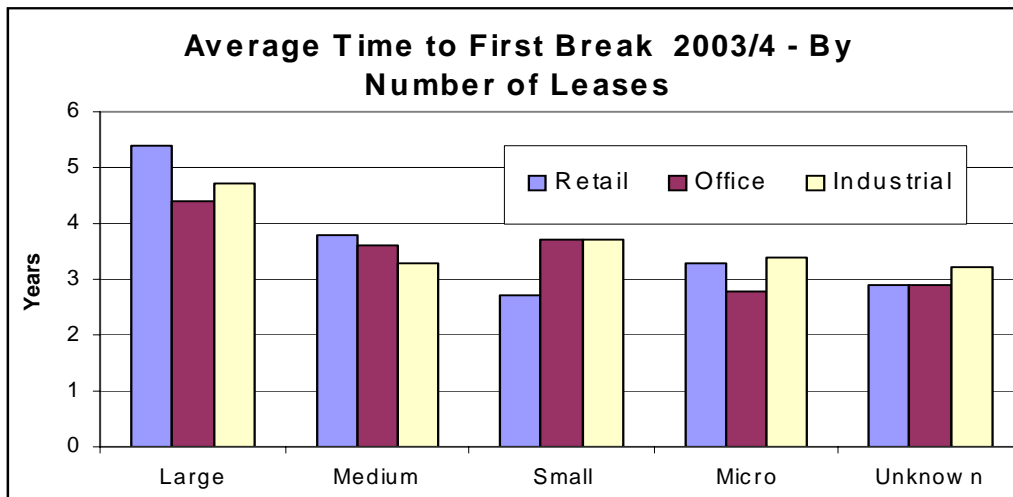
Figure 4 : Incidence of Rent Reviews 2003/2004 – Source IPD

## Breaks

The incidence of 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 8 and illustrated in Figure 6 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, the distinction between medium and smaller enterprises is not apparent as it is with lease length.

<sup>2</sup> Virtually all reviews in the UK are ratcheted upwards only (Crosby, et al, 2005)



**Figure 6 : Average Time to First Break 2003/2004 – Source IPD**

*Summary*

Overall, analysis of the IPD for 2003 and the first 3 months of 2004 indicates that there is a pattern of increasing rent, length of lease, incidence of review and time to first break from micro and small tenants to medium and larger tenants. The combination of shorter leases and fewer reviews also leads to a lower incidence of rent free periods as incentives to let being offered to micro and small tenants (Tables A9 to A11).

The Valuation Office Agency data does not classify by type of tenant therefore cannot be used directly to identify the lease details of SMEs against the larger tenants. However, it does show some similar characteristics to the IPD data in that the higher value premises have longer leases. One interesting issue not picked up by the IPD data is that smaller properties have a higher incidence of shorter, mainly 3-year, rent review periods and these are incorporated into 6 and 9 year lease terms, also more frequently observed in smaller properties. As micro, small and medium sized tenants are more likely to occupy less valuable properties on shorter leases, they are more likely to have 3-year reviews (Crosby, et al, 2005).

There are some findings relating to the terms of leases which are not directly measurable and not directly related to SMEs. Respondents to all the surveys, reported fully in Crosby, et al (2005), indicate that the drafting of break clauses has changed with the effect of making them easier to operate and that schedules of condition are used more frequently with second hand property, potentially reducing the liability for repairs during or at the end of leases. However, problems surrounding assignment and subletting have not eased over time with a significant number of leases having a restriction on subletting at less than the passing rent, and tenants are still automatically asked for an Authorised Guarantee Agreement concerning assigning or selling the lease.

***Leasing process concerning small business tenants***

The second set of 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, knowledge of what was in the lease signed, the extent and nature of any negotiations and knowledge of the Code of Practice.

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 often starting businesses for the first time 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.

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 to the EU/UK definitions concerning employment for 2 reasons. First, the findings of the lease data suggest that the major difference is between micro and small tenants and medium and larger tenants, not between SMEs in general and larger tenants. Second, the tenant's survey only included 9% of respondents over 250 employees and a further 8% with 50 to 249 employees, while 44% had less than 6 employees.

Table 10 sets out the results to a chi-squared analysis of the four business tenant groups and shows that differences in responses concerning the type of premises occupied, the type of landlord, the rent and the lease length are statistically significant. Very small business tenants (micro 1) are most likely to lease retail property, and lease it from private individuals rather than property companies or funds. They will have lower rents and shorter leases. They are also more likely to think they cannot assign or sublet (which may be true).

Their behaviour upon taking a lease is different to larger tenants. They are more likely to have no previous experience of leasing but, despite this, are less likely to take professional advice. Where they do it is more likely to be from a solicitor only<sup>3</sup> (79% of those taking advice) and they are less likely to use an agent<sup>4</sup>. They are less likely to negotiate the terms and are more likely to be unaware of the Code of Practice.

Where tenants take the first lease on offer, the main reason was that they said 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 they got a "take it or leave it" offer from the landlord. It is perhaps only when they want to leave the premises or the rent review comes around that they realise that the lease may not be as suitable as they thought.

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

<sup>4</sup> chi-squared 11.4, *df* = 1, *p* = 0.010

However, compared to DETR (2000), there is evidence of improvement. Overall, awareness of the Code has increased by 50% compared to the first Code. The proportion of micro business tenants who are aware is now 18%; In DETR (2000) it was only 12%. It would appear that a few more tenants negotiate their leases rising from 61% in DETR (2000) to 69% now and therefore the number who take the lease on the first terms offered has fallen marginally from 30% to under 27%. There is also a fall in the 'don't know' responses to questions on lease terms.

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 take their lease with no negotiations also averages 27% but this again rises to 40% for micro (1) tenants and 30% 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. The results are illustrated in figure 7

**Table 10 - Statistical Test Results for Different Firm Size by Number of Employees**

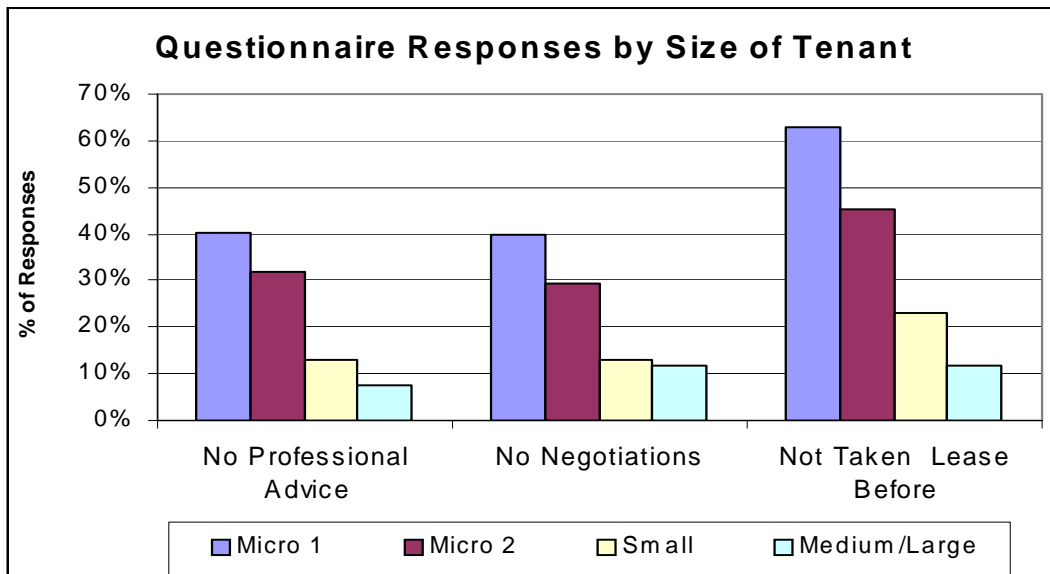
| Test                              | Chi Squared | Degrees of Freedom | P Value | Comment   |
|-----------------------------------|-------------|--------------------|---------|---|
| <b>Type of Premises</b>           | 45.4        | 12                 | .000**  | Micro businesses more likely to be occupying 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                 | .003**  | 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                  | .000**  | Micro (1) businesses less likely to have taken professional advice than small and medium/large businesses.  |
| <b>Lease length</b>               | 17.1        | 6                  | .009**  | 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>Rent</b>                       | 101.6       | 9                  | .000**  | 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>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                  | .021*   | 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  |
| <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 negotiations</b>                        | 32.3 | 6 | <b>.000**</b> | Micro (1) businesses much less likely to 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



**Figure 7 : Questionnaire Responses by Size of Tenant**

## Conclusions

The objective of this paper was to identify the nature of small business tenant leases and the process by which they are negotiated, identify gaps in our information and suggest possible further study and/or policy outcomes.

The results give a clear picture of the different leases taken by small business tenants in the UK compared to their medium and larger sized counterparts and also shows the different processes by which those leases are taken. Small business tenants occupy lower value premises on shorter leases with fewer rent reviews. They also are less likely to take professional advice, particularly at the commercial stage of the negotiations, are more likely to take the first lease offered and are more likely not to have taken a lease of business premises before. They are less likely to have any knowledge of the Lease Code. However, this lack of knowledge and experience does not necessarily mean that they need protecting.

Small business tenants occupy business premises on more flexible terms than larger tenants. Their liabilities under leases are therefore less and they are ultimately not exposed to the longer-term risk of holding long leases. However, some UK leases can still be longer than business needs where businesses are either failing or expanding, or just need to change location for operational reasons. This process of change is under-researched with discrepancies in such basic figures and definitions as the number of business failures. As many small businesses are taking leases for the first time and do not take professional advice, they are vulnerable to abuse given the complexity and length of many lease documents. However, no survey work has been undertaken, as far as we are aware, of businesses which have attempted to leave their premises during the term of the lease for whatever reason. The relationship between business change, business premises and leasing is an area for further research and information.

Although upwards only rent reviews remains one of the major concerns of Government, Crosby, et al, (2005) showed that review type was low down on the list of tenant's concerns and that issues



concerning exit from the premises, lease length, breaks, assignment and subletting, scored higher. 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. More recent changes in the economic climate in the UK, for example with consumer spending starting to slow, may lead to some change in priorities with rent (or more accurately, the inability of falls in rental value to be passed into actual rent payments) becoming a more important issue. However, the UK Government appear to have accepted that assignment and subletting is a more pressing issue with their latest statement on commercial leases (ODPM, 2005).

The Code of Practice was an attempt to apply voluntary controls to lease outcomes and encourage flexibility. Its lack of dissemination to the small businesses, the community it might most benefit, is a major cause for concern and begs questions of whether it should be the focus of trying to get tenants more informed before they negotiate leases or should other routes to this information flow be investigated? The main issue does not appear to be that UK small business tenants are generally being given inappropriate leases; it is their possible lack of knowledge and awareness of the implications of their decisions that could lead to abuse of the minority.

Legislation is still an option for the UK Government. It has shown no interest so far in legislation which affects only small businesses and leaves larger, usually better informed, tenants to negotiate in the free market. Other countries, for example the individual States of Australia, do have such legislation and therefore further study could investigate the objectives of the legislation and its effectiveness. Possible legal targets could be the adoption of a maximum length of lease, countering restrictions on assignment, sub-letting and breaks and outlawing upwards only rent reviews. But there are difficulties in defining small business and/or small business premises. Any legislation may also investigate the issue of cooling off periods; for example, as in some other contracts, parties have the right to revoke the contract within a certain time period.

Whatever the final Government decision on the lease debate issue in the UK, it is obvious that small business tenants are not overly concerned about liabilities under leases when taking on these liabilities for the first time. But the Government is concerned about the awareness of small business tenants and the small business issue may yet be the catalyst for the lease legislation that the UK property industry has fought for the last 12 years to avoid.

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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> |
|-----------------------------|--------------|---------------|--------------|--------------|----------------|
| <b>None</b>                 | 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**

|                         | Large | Medium | Small | Micro | Unknown |
|-------------------------|-------|--------|-------|-------|---------|
| <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     |

**Table A9 : Incidence of Rent Free Periods by Number of Leases**

|                         | Large | Medium | Small | Micro | Unknown |
|-------------------------|-------|--------|-------|-------|---------|
| <b>Retail</b>           | 52%   | 56%    | 34%   | 47%   | 26%     |
| <b>Office</b>           | 39%   | 33%    | 31%   | 34%   | 26%     |
| <b>Industrial</b>       | 22%   | 15%    | 19%   | 16%   | 8%      |
| <b>Other commercial</b> | 62%   | -      | -     | -     | -       |
| <b>All Sectors</b>      | 44%   | 34%    | 25%   | 31%   | 21%     |

**Table A10 : Average Rent Free Period – Unweighted**

|                         | Large | Medium | Small | Micro | Unknown |
|-------------------------|-------|--------|-------|-------|---------|
| <b>Retail</b>           | 5.4   | 5.1    | 4.5   | 4.1   | 3.8     |
| <b>Office</b>           | 7.8   | 8.1    | 6.6   | 5.5   | 8.0     |
| <b>Industrial</b>       | 5.3   | 5.0    | 4.6   | 4.4   | 4.3     |
| <b>Other commercial</b> | 4.8   | -      | -     | -     | -       |
| <b>All Sectors</b>      | 5.8   | 5.9    | 5.1   | 4.5   | 4.9     |

**Table A11 : Average Rent Free Period - ERV Weighted**

|                         | Large | Medium | Small | Micro | Unknown |
|-------------------------|-------|--------|-------|-------|---------|
| <b>Retail</b>           | 5.6   | 5.3    | 4.4   | 4.4   | 4.0     |
| <b>Office</b>           | 18.5  | 9.6    | 7.5   | 5.9   | 9.4     |
| <b>Industrial</b>       | 5.5   | 5.5    | 5.8   | 4.6   | 4.4     |
| <b>Other commercial</b> | 5.3   | -      | -     | -     | -       |
| <b>All Sectors</b>      | 10.4  | 6.8    | 5.9   | 4.8   | 5.6     |