

# A guide for a tied rent assessment and rent proposal

Stonegate Group

PUB PARTNERS

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# The methodology usually employed in pub rental valuations

## 1. Rent reviews

- **Pub Valuation Guidance.** The Lease or Tenancy Agreement will usually incorporate a **rent review section** setting out how the rent review is to be conducted, detailing what should be assumed and what should be disregarded when the rental value is assessed. When valuing pubs any Chartered Surveyor should also have regard to the **guidance note published by the Royal Institution of Chartered Surveyors** entitled 'The capital and rental valuation of public houses, restaurants and nightclubs in England and Wales.' A copy of this may be obtained from the RICS (ref GN67/2010). When valuing any tied pub owned by a company with more than 500 pubs, the valuer (RICS qualified or not) must also refer to the **Pubs Code 2016**. Where text is in italics in the following sections it is a direct quote from the RICS guidance.
- Pubs are generally valued by the **Profits Method**. This valuation methodology aims to replicate the viewpoint of a hypothetical competent new bidder for a lease on its present terms on the assumption that no premium is payable. Such a bidder would assess the pub's trading and profit potential (the Fair Maintainable Operating Profit or FMOP) and then seek to make a rental bid of a level that is just sufficient to secure the new lease against potential competition from other bidders.

*To assess the market rent for a new letting, the rent payable on a rent review or the reasonableness of the actual rent passing (particularly when preparing an investment valuation), an allowance should be made from the FMOP to reflect a return on the tenant's capital invested in the operational entity – for example, the cost of the trade inventory, stock and working capital. The resultant sum is referred to as the divisible balance. This is apportioned between the landlord and tenant having regard to their respective risks and rewards, with the landlord's proportion representing the annual rent.*

- **Optimum Pub Trading Style.** When dealing with a tied lease or tenancy, the valuer should firstly assess the optimum trading style for the pub taking into account its location and facilities as well as the characteristics of its potential catchment market in order to project the turnover and trade mix that a Reasonably Efficient Operator '(REO)' should generate from the premises; being sure to assume what the Lease or Tenancy Agreement specifically details is to be assumed and to disregard what this document says is to be disregarded. This is known as the Fair Maintainable Trade (FMT).
- **Reasonably Efficient Operator.** The RICS Guidance Note defines 'REO' as "A concept where the valuer assumes that the market participants are competent operators, acting in an efficient manner, of a business conducted on the premises. It involves estimating the trading potential rather than adopting the actual level of trade under the existing ownership, and it excludes personal goodwill" (of the actual current pub operator).

*When assessing future trading potential, the valuer should exclude any turnover and costs that are attributable solely to the personal circumstances or skill, expertise, reputation and/or brand name of the existing operator. However the valuer should reflect additional trading potential that might be realised by an REO taking over the property at the date of valuation (s5.12).*

*It is important that the valuer is regularly involved in the relevant market for the class of property, as practical knowledge of the factors affecting the particular market is required. Such knowledge will aid in the analysis and review of historic and current trading performance, as well as forecasts that may show increases or decreases on actual trade. This can assist in forming an opinion of the FMT and FMOP considered achievable by a likely purchaser or REO.*

- **Declared Trading Accounts** In some circumstances the valuer may have access to actual performance data such as profit and loss accounts or management accounts, stocktaking reports and current retail pricing. These may assist the valuer's assessment when it is considered that they reflect the operating style and performance of the typical REO. The valuer should not reflect the actual lessee's own trading performance if it is either less than, or greater than, the level of trade which the valuer believes would be achieved by a reasonably efficient operator. The additional profitability of the pub in the hands of an exceptionally-skilled publican is known as **Personal Goodwill**.

*The accounts of the current occupier may or may not be available. When actual accounts are used to assist in the formulation of an opinion on future trading potential, they will show only how a property is trading under the particular management at the time. Current and past performance is no guarantee as to the future FMT and FMOP (s4.15).*

*The valuer should be satisfied with the accuracy and reliability of trading information and/or projections supplied for the purpose of the valuation. The source and basis of the trading figures (actual and/or projected) and other trading information and assumptions made, should be stated in the report (s4.16).*

*Any accounts disclosure should be treated with caution. It is also lawful to run catering or room letting businesses under a different company or in a different name (often by the other partner when the pub is run by a couple). Finally, complete and accurate accounts are only a guide towards the assessment of FMT in the hands of an REO because the actual operator may be exceptionally good or poor as a publican and business manager.*

- **Sales Mix.** The assessment of Fair Maintainable Trade (FMT) requires an assessment of the appropriate gross profit for the business that takes into account sales mix, appropriate retail pricing and the nature of the contractual supply terms.
- **Operating Costs.** The FMT calculation then requires the levels of expenditure the REO would be likely to incur in achieving such level of turnover and gross profit to be deducted.

The operating costs should include an annual allowance towards the costs of redecoration and repairs and maintenance of the building, to the extent required by the lease or tenancy, also an annual allowance for the cost of repairing and replacing the inventory, then finally an allowance for the costs of statutory compliance and safety checks.

The valuer will not usually, however, take account of any cost to purchase the lease (beyond the cost of trading inventory) or on bank loans and overdrafts, because such factors reflect the personal circumstances of the actual operator rather than the REO.

It is generally assumed that a pub lease will include living accommodation. If there is none, a further adjustment should be made to show the rental cost to secure appropriate residential accommodation nearby.

- **Divisible Balance or NPBR.** Having made such costs deductions the resultant sum is referred to as the Divisible Balance, or Net Profit Before Rent (NPBR). This is apportioned between the landlord and tenant having regard to their respective risks and rewards. The Pub Company's proportion is the annual open market rent which provides for the costs of mortgage finance and equity capital invested by the Pub Company in the property asset, the operational overheads and distributable operating profit/dividends. The tenant's share is their reward for the time spent working in and on the business (drawings) and for the entrepreneurial risk of running their own business (net profit).
- **Manager's salary.** Whether a costs allowance for a manager's salary should be made is a matter for debate case by case. When the trade potential of a pub is high, such that the highest bids are likely to be made by companies which run multiple pubs, it may be appropriate to allow a manager's salary. For very large pub businesses there may be a sub-manager for catering. On the other hand when the trade potential is limited by the pub's size or location the successful bidder is likely to be a hands-on working publican who would not need or expect to employ a manager. In the middle ground between these ends of the trade spectrum the valuer should use his or her knowledge of the parties active in the market at the time of the valuation to assess whether an allowance for manager's salary should be made.
- **Rental Bid to the Divisible Balance.** *How the divisible balance is to be apportioned will be a matter for discussion and negotiation. In simple terms it must provide adequate reward to each party to reflect the risk each take in owning or operating the property (s6.8).*

*The landlord provides the property and the tenant provides time, skill and effort in operating the business. The divisible balance has already taken account of the tenant's capital investment. There is no formulaic approach, but it is market evidence that will give guidance. In most cases the landlord's share will lie within the range of 35 to 65 per cent of the divisible balance. Issues influencing this range are addressed in the following paragraphs (s6.9). It may be that at the lower threshold of a particular sub-market, the available proceeds are insufficient to reward both landlord and tenant properly, resulting in a need for an alternative form of operation – e.g. direct management to lease or franchise, or sale for owner occupation or alternative use (s6.10).*

*As with all valuations, it is the market that provides the best evidence by analysis of transactions of similar properties with similar lease terms. The valuer should always treat 'abnormal' comparables that reflect an overbid, for whatever reason, with caution (s6.11).*

*The level of rent that a tenant will offer will be based on economic supply and demand principles. The greater the demand for a particular property, the higher the percentage of the divisible balance a tenant will be prepared to offer to secure the lease. Where demand is lower, the percentage of the divisible balance will be lower (s6.12).*

# 2. Outline of the procedure to be followed during negotiations

## Tied rent reviews

- If your agreement provides for a cyclical review of the rent to a pre-determined timeframe, usually 3 or 5 years, we will prepare our own assessment of the FMT profit for the tied pub, using our assessment of the performance of the business that might be achieved by a reasonably efficient operator, using our tied price list and any supply discounts that are applicable to your agreement and the actual business rates which apply to your premises (if available). Your Regional Manager or an agent of the Company will visit your pub within 3 months prior to the assessment being made in order to view the entire property and gather supporting material. Thereafter we will set out our opinion of the open market rent applicable to the premises in the format prescribed in Schedule 2 of the Pubs Code, and provide you with our rent proposal in the form of a Rent Assessment Proposal. We will provide tied volume barrelage delivery figures (if known) for at least 3 years prior to the review date. If these details are not available then we will explain why. We will provide all of this to you in writing not less than 6 months prior to the rent review date. These assessments are not intended to be, nor must they be, taken to be projections of your actual profit and loss account.
- Our Rent Assessment Proposals are prepared by a Regional Manager who is fully trained in making such appraisals, assisted and overseen by a Divisional Director. We use widely recognised, industry standard, valuation methods and follow the guidance published by the RICS, including any updates or amendments as may be published from time to time. All rent assessments in respect of new long term lease arrangements will be reviewed by a RICS qualified valuer to ensure compliance with RICS guidance, before they are provided to you.
- In the event that you are achieving a greater level of trade than that which we believe would be achieved by a reasonably efficient operator, we will disregard this level of out performance from our rent assessment (Personal Goodwill). On the other hand if you are not achieving the level of trade which we believe would be achieved by a reasonably efficient operator, then our assessment will also disregard this under-performance.
- If you have, with our written permission through a Licence to Alter, invested in structural improvements to the premises which have had a beneficial impact on the performance of the business, the effect on rental value attributable to such improvements will be disregarded in our rent assessment in accordance with RICS guidance (Lessee Improvements). We would recommend that you take advice from a suitably qualified professional as to how any such disregard will be applied. Any alterations completed without a Licence to Alter will not be disregarded.
- We will provide you with a template proposal in the same form as our Rent Assessment Proposal, to enable you to consider and prepare your own view as to the appropriate trading figures and rent for the premises. After issuing our Rent Assessment Proposal, your Regional Manager will make an appointment to discuss the rent review with you.

- We will ask you to provide us with a copy of your latest accounts, and commit to you that such information will not be used for any purpose other than gaining a clear understanding of your business, in particular your costs, for the purposes of an open and transparent rent review negotiation. If you or your agent makes a reasonable request for further information that is available to us and which is not confidential between us and any other person or company we will provide it. If we are unable to accede to this request we will explain why not. There may be some information such as arbitration awards and other tenant's accounts and business plan projections which cannot be disclosed. The requirements of the General Data Protection Regulations will take precedence over any made in this Code of Practice.
- We will encourage you to seek advice from a suitably qualified trade valuation advisor before the rent is agreed between us.
- We should both aim to complete the tied rent review negotiations within 6 months after the due date. Once we have agreed terms, we will issue the appropriate legal documentation for you to sign and return as soon as possible.
- At our discretion we may offer you a choice of an entirely new agreement, with a range of alternative discount and tie release options. If you elect to pursue this route then we will provide you with a further Rent Assessment Proposal, which will form the basis for us both to negotiate any such new agreement.
- At your discretion you may give an MRO notice in writing, to be received by us within 21 days after you receive our Rent Assessment Proposal.
- If we are unable to agree terms, the dispute resolution process provided in the tied lease or tenancy agreement may be commenced by either party, notwithstanding that the lease may be an old lease which contains only a provision for the tenant to elect to appoint a third party dispute resolver. However, if you serve an MRO Notice before the conclusion of the tied rent review, then, unless you want it to proceed, we will suspend the tied rent review.

# 3. The information to be used to support the tied FMT and open market rent

- **Comparable rental evidence** of new lettings, rent review and lease renewal deals in respect of similar pubs at or shortly before the rent effective date provides evidence of supply and demand at the time. Such evidence should be timely, which can mean that in a stable market evidence over the past two years could be relevant, but in a rising or falling market timely evidence might be limited to the last six months.
- **Comparable trading evidence** when accessible, which can help to assess the trading mix and potential turnover of the subject pub by reference to its competitors. Such evidence is often confidential and Data Protected but is sometimes disclosed in the open market when leases are assigned.
- **Comparable retail prices of drinks and food.** A new bidder, preparing a business plan, should survey the local competition and collect evidence of their retail pricing, customer base and trading hours in order to decide the best positioning for their pub – be that in direct competition for the same trade, or by identifying a different niche or unsatisfied demand.
- **Segmentation and demographic reports** are available from pub companies and third party consumer survey agencies.
- **UK Hospitality and BBPA pub operating costs benchmark surveys.** These surveys both provide average operating cost breakdowns for tied and free of tie pubs and are published annually.
- **Tied supply records and cellar monitoring.** This information is gathered for individual pubs by third parties through delivery records, stocktaking results and draught dispense flow monitoring. Although draught beers and ciders are only a part of the trade potential of most pubs these days, the records of delivered tied drinks volumes may still be commonly used as a starting point for tied rental valuations.
- **Actual trading accounts of the publican.** At the point when the BDM first assesses a rental value ahead of the rent quote to the publican, he or she will often not have access to the actual accounts. These may or may not be disclosed by the publican during negotiations and, if disclosed, may or may not be complete and accurate. Actual trading accounts may provide a useful indication of the costs incurred in running the business.
- **Business Plan projections.** When projections are up to date these can be relevant because they replicate the fundamental valuation assumption of a rent bid made in the open market in competition with other bidders for a new lease on the same terms other than rent.

## Justification for use of such information

*The fundamental basis of all real property valuations, set out in the International Valuation Standards, the RICS “Red Book” and the RICS Guidance Note ‘The capital and rental valuation of public houses, restaurants and nightclubs in England and Wales’, is a comparison with actual open market transactions. Direct evidence of such transactions can often be hard to find (or be confidential even if known to the valuer). A perfect comparable is a rarity because each pub has its own trading opportunities and its own unique features. Valuation is therefore not a science; it is always an opinion. Such opinions will be strengthened by the effort of gathering as much of the above evidence as possible, then by the expertise and experience of the valuer providing that opinion.*

*Comparability between public houses held on different lease terms and with different supply terms is problematic, particularly between tied and non-tied sectors. There is nothing within this guidance that should result in rents in one sector being set at any advantage or disadvantage to another. In arriving at a market rental value, it is preferable for analysis to be made of transactions relating to similar properties with similar lease terms. Indeed, the efficiency of the market relies on transparent market evidence (s7.21).*

*Where the valuer considers that direct comparison is not possible or conclusive, then a broader approach must be made. This will include comparison with both the direct evidence that may reflect different lease/supply terms, and any available benchmarking data. The valuer will use appropriate skill and experience to take account of all available information (s7.22).*

## Lease renewals

For **lease renewals** there usually will be no document, other than the lease itself, to detail rental assumptions and disregards. Once L&T Act notices have been served, the parties will usually need to be legally represented and should seek legal advice.

Section 34 of the Act details that if a Court (or an Arbitrator acting on Court Terms – called PACT) is setting the rent to be payable it will be that at which, having regard to the terms of the tenancy (other than those relating to rent), the premises might reasonably be expected to be let in the open market by a willing landlord, there being disregarded –

- a) any effect on rent of the fact that the tenant has or his predecessors in title have been in occupation of the holding,
- b) any goodwill attached to the holding by reason of the carrying on thereof of the business of the tenant (whether by him or by a predecessor of his in that business),
- c) any effect on rent of an improvement to which this paragraph applies,
- d) in the case of a holding comprising licensed premises, any addition to its value attributable to the licence, if it appears to the court that having regard to the terms of the current tenancy and any other relevant circumstances the benefit of the licence belongs to the tenant.

The terms of the new tenancy will be the same as for the old tenancy apart from “modernisations” that either party proposes and can justify to the Court, the length of the term and the new open market rent.

Then the valuation methodology is the same as for Rent Reviews, as set out above.

# 4. Matters which will be considered to be relevant and irrelevant in such negotiations

## Relevant matters

- When assessing rental values the parties are actually assessing the value of the contract between them, which is the lease or tenancy. Therefore, all the terms of the lease or tenancy are relevant.
- The extent of the actual supply ties and the pub company's current terms for such tied supplies, including for gaming machines.
- Other benefits the pub company provides to its tenants free of charge or at reduced costs, including services, financial support in times of difficulty, product range and promotions etc. collectively known as SCORFA (Special commercial or financial advantages).
- The benefits of the Pubs Code 2016.
- The pub company's records of delivered tied supplies.
- The pub operator's declared actual accounts, stock results and business plan projections.
- Evidence of comparable rental transactions.
- Evidence of declared trading figures for comparable pubs.
- The physical attributes of the pub including size, facilities, location and accessibility. Also considering whether there is surplus building space or land which could either provide scope for trade development, or else become a cause to incur excessive operating costs.
- The actual and potential customer base of the pub.
- The number and location of competing pubs.
- The number and location of complementary property uses such as theatres, restaurants, takeaways and betting shops.
- Availability (supply) of alternative pubs to let or for assignment, and the premiums sought for assignments.
- The range of other pub operators seeking to enter the local pub market and the lease terms they are willing to commit to (for instance whether they seek only free of tie lease terms).
- The general strength of the economy and of the leisure sector of the economy.
- Premises licence terms and other regulatory matters.
- The actual and potential retail selling prices at the pub and its competitors.
- Previously approved tenants' improvements to the property.

The valuers role is to collate relevant comparable information, ascertain its reliability and analyse it to make appropriate adjustments to assist with the subject valuation (s6.16).

## Irrelevant Matters

- The weight to be given to all the available relevant evidence will vary case by case. It is likely that little weight will be given to evidence that is not readily available to a new bidder in the open market, to evidence that cannot be certified to be accurate, to evidence that is out of date and to evidence of lease terms and pub properties that are dissimilar to the subject lease and property.
- It is likely that the only evidence that will not be at all relevant is any expression of opinion of value of the subject pub, or of any comparable pub, that is not the valuer's own opinion. In particular, if a third party valuer is appointed to prepare a case to an Arbitrator or Independent Expert on behalf of either party, they must express their own opinions (not those of their client) and declare all relevant evidence which might be both for and against their client's interests. This is because any RICS-qualified valuer has a duty to "assist the tribunal" to reach the most accurate result it can.

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