High street A3 rents — The future battleground

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William Graham
is a director of Fleurets, a firm of chartered surveyors which specialises exclusively in the sale and valuation of hotels, restaurants, bars and leisure property. He has been involved in the rent review of A3 properties for over 20 years and is actively involved in the high street.

Abstract
This paper attempts to demonstrate how the high street market has gone from boom to bust to consolidation and why. The reasons for these three scenarios are set out and the importance of issues such as saturation, circuits, rents and retail pricing is highlighted. Alternative bases of rent assessment are considered in a time when there is little evidence of new lettings and ability to pay rent is an increasingly significant issue. Landlords are also not immune from the troubled market and relative covenant strengths are discussed.

Keywords:
ability to pay rent, rental valuation alternatives, saturation, price discounting, covenant issues, development appraisals

A LITTLE HISTORY OF BOOM AND BUST

For once we have a history that all of us can remember, and I am pleased to say that I am not some white-haired old man giving the 'when I was a boy' routine. I would say that, almost without exception, all readers will remember business practice from the early 1990s onwards.

At around that time I can remember having a conversation with Peter Dickson, former chief executive of Yates, who was telling me about how he wanted to create circuits where previously circuits had not existed. His logic was that if you could create a group of similar A3 outlets in a relatively confined area, this would draw trade over and above what the sum total of the individual outlets could achieve, by virtue of their critical mass.

This was a story with which the City fell in love and, certainly, through the mid- and late 1990s we can all remember the press commentary along the lines of 'if you are not in managed pubs, you're nobody', and indeed the reverse that 'tenanted operators were low-life'. Look at the relevant price/earnings (PE) ratios and share prices for 1998/1999 in Table 1, where managed house operators are listed — and, incidentally, I have put in against those

William Graham
Director
Fleurets
18 Bloomsbury Square
London WC1A 2NS, UK
Tel: +44 0207 636 8992
Fax: +44 0207 636 7490
E-mail: bill.graham@fleurets.com

Table 1: Managed house operators

	PE peak 1998–99	Share price peak 1998–99	Today PE	Today share price	Price as % of peak
Eldridge Pope	13	345	6	170	51
JD Wetherspoons	37	465	14	245	45
Luminar	41	982	7	452	53
Regent	42	470	4	30	94
S & N	21	920	15	388	58
SFI	30	300	Suspended	0	0
Springwood	26	250	Suspended	0	0
Yates	29	580	14	144	76
Enterprise	8	400 (1997)	14.7	581	–

Table 2: Rental statistics — London

	1995	1996	1997	1998	1999	2000	2001	2002	2003
No. of new lettings	10	18	48	30	31	13	5	6	4
Average new rent (£)	75	114	123	147	119	150	151	128	147
Mid-quartile (all) (£)	35/90	63/145	76/147	87/167	81/142	71/150	91/171	103/185	102/160
Average rent review (£)	–	–	128	172	123	123	129	153	144
No. of rent reviews	0	0	4	2	8	15	30	46	31

Table 3: Rental statistics — Provincial areas

	1995	1996	1997	1998	1999	2000	2001	2002	2003
No. of new lettings	6	55	63	64	52	28	31	20	4
Average new rent (£)	56	78	86	107	107	106	90	113*	130*
Mid-quartile (all) (£)	45/63	56/97	64/117	68/142	75/126	65/118	64/121	75/131	76/142
Average rent review (£)	–	–	65	–	118	84	94	103	108
No. of rent reviews	0	0	3	0	7	24	69	51	49

* It is believed that the higher rents in 2002/2003 reflected a trend towards larger units.

the price for Enterprise Inns. With statistics at these levels, the impression was clear.

Going beyond this into the early 2000s, we had very few new lettings except for the top quartile of sites, with only a very thin market of potential lessees, yet rising rents continued as the norm based on historic evidence and perceptions of a strong A3 market. Also, I should say that for those sites where deals were crystallising, agreement of rent and terms probably took place several months previously. Should there have been licensing and planning problems, then time may have been stretched out further still.

Tables 2 and 3 give some information from Fleurets regarding rental statistics that show over a nine-year period the number of new lettings each year; the average new rent; the mid-quartile of all rents agreed in each year (new lettings and rent reviews); the average rent review figure; and the number of rent reviews in each year. Table 2 shows the results for London, while Table 3 shows

the merged results for all provincial areas (more detailed figures are available from Fleurets upon request).

Now we find ourselves in the latter part of 2004, and the situation has changed yet again. There are virtually no open market lettings (an arbitrator's preferred evidence) or lease renewals, thus reliance on rent review by agreement or by a third party is the only available evidence. We must consider the effects of 11 September, the post-Iraq situation and the general economic impact. Uncertain times suggest a pessimistic outlook. It is hard to be specific, but the rental effect must be negative.

RIVERS OF BLOOD

Today we have a latter-day 'rivers of blood' situation, although not quite as Enoch Powell imagined it. I am not going to review each and every failure in the A3 sector, but you will all be aware of profit warnings, property sales, receiverships and general disquiet in the high street market. So much so that, without exception, all of the quoted companies in the sector have made negative statements about their futures and several have gone to the wall.

Detailed below are just a selection of headline events which occurred in the A3 market during the period from September 2001 to June 2004.

- 11 September 2001: World Trade Center bombed in New York.
- February 2002: Springwood Leisure, the Midlands-based nightclub operator, placed into administrative receivership.
- February 2002: Vision Capital acquires the majority stake in Avebury Taverns from Credit Suisse First Boston. Press comment indicates that additional capital is to be put into the business for further acquisitions, including group targets.
- 26 June 2002: World 'dot.com' collapse.
- July 2002: Fish Restaurants goes into administration (16 restaurants).
- 2 July 2002: Wall Street Dow Jones Index has largest single-day fall in ten years.
- October 2002: Mustard Entertainment Group (Brannigans Bars) appoints administrative receiver.
- October 2002: Aberdeen Steakhouses and Angus Steak Group appoint administrator.
- 4 October 2002: Old Monk Company plc appoints administrator.
- 21 October 2002: SFI Group issues devastating profits warning including breaching banking covenants.
- 29 November 2002: JD Wetherspoons issues profits warning.
- 11 December 2002: Regent Inns issues profits warning and Eldridge Pope reports a slump in like-for-like sales.
- January 2003: Luminar Leisure and Yates Group issue profits warnings.
- April 2003: Po Na Na shares suspended and a few days later the company goes into receivership.

— June 2003: Pennant Inns goes into liquidation.
— June 2003: Porter Black Holdings goes into receivership prior to acquisition of 17 bars from Regent Inns.
— June 2003: Unchained Growth Pubs plc placed in receivership.
— July 2003: Front Room Ltd put into receivership.
— September 2003: Balaclava Pub Company placed into receivership.
— November 2003: Inventive Leisure, operator of Revolution Bars, issues a profits warning.
— 5 February 2004: Base rate increased from 3.75 per cent to 4 per cent.
— March 2004: Corporate Catering Company (Don Murphy) placed into administrative receivership (seventeen managed houses, mostly leased).
— May 2004: Base rate increased from 4 per cent to 4.25 per cent.
— May 2004: Valleyhill Ltd is put into administration due to substantial debts to HBOS. A 46-strong chain nationwide, including two prime London outlets, run by James Wilson and Barry Polley.
— May 2004: First Leisure plc, Britain's second biggest nightclub operator, is placed into receivership (twenty-eight nightclubs nationwide).
— June 2004: Christie & Co offer a portfolio of 76 public houses on behalf of Enterprise Inns plc. A nationwide portfolio of low-volume tenancies with mixed tenures.

If you refer back to the figures shown above in Table 1, you may believe that PE ratios of around 40 were always going to be unsustainable. You are probably right. In very crude terms, one years purchase (YP) is equivalent to two PE. Freehold pubs are valued at six to eight YP, so pub-owning companies should be valued at 12 to 14 PE if they own freehold assets and less if their assets are mainly leasehold.

Nevertheless, it prompts the question as to why landlords expect the same rent from a company whose trading position in a large leasehold estate has deteriorated to the point where their shares trade at 10 per cent of their former value. The gap between managed and lease/tenanted companies now has nothing to choose between the PE ratios. To prove the point further, Punch's share price has trebled in three months. Not only this, the City is now extolling the virtues of tenanted companies with positive cash flows, etc. The cynics among you might suggest therefore that managed-house companies today represent a speculative buy given the fickle nature of City sentiment. Certainly there is likely to be consolidation among the high street operators.

Most town centres now have too many bars and there are likely to be very few new lettings over the foreseeable future. Future rent reviews must therefore, to a large extent, be decided by comparison with other rent reviews. Analysis of the trend of that evidence is just as important as consideration of those earlier settlements.

Sales less overheads + rent

has to = profit sufficient as a return on capital, risk and endeavour

Figure 1: Ability to pay

SO WHAT IS THE CURRENT POSITION?

Saturation is the key to the current position. It is widely talked about, but what is it? Ask yourself the simple question: 'Will another pub on the circuit (or in the town generally) add to the attractiveness of that circuit and hence draw more custom to that circuit, or will another pub simply spread the available custom more thinly?'. At the point where the market moves from the first to the second position, there you have saturation. No new lettings and various failed units for sale are a good sign of this in a practical sense.

Pretty much all the rest of the problems stem from this. Ultimately, so far as rent is concerned, it comes down to *ability to pay*. As a theme, I will return to this again and again during the course of this paper.

ABILITY TO PAY

Ability to pay is more of a reality check. It is caused by the widespread problem that in the current market there remains a gap between the rent contracted to be paid and the ability of the tenant to afford to pay that rent.

We know the market has turned, probably around 2000 in London and a year later in the provinces (see the number of new lettings in Tables 2 and 3). The difficulty is to prove this to landlords, who despite good evidence to the contrary in retail and office sectors have the belief that A3 rents are on an ever-upward trend. Clearly, they think it is in their interests for this to be the case.

Many of the acquisition surveyors and the boards of directors of the managed-pub companies can shoulder the blame. The market works on evidence — historic transactions in the market, if you prefer. It is no good various tenants saying 'it's not us, it's Company X that makes the silly bids', but to a greater or lesser extent all played the game. In reality, it can be said that those companies still in business were in fact more prudent than Company X, because Company X has gone bust. In my opinion, the level of profit warnings and receiverships in the A3 sector is, in itself, evidence of the lack of ability to pay.

WHY IS RENT PAID/A PROFIT NEEDED?

Ability to pay is the ability of the hypothetical tenant, not necessarily the actual tenant, to afford rent from his profit and still

Landlord	Tenant
— As a return on the investment in the building. — Management of the income.	— As a return on the investment for the fit-out. — Day-to-day work in the pub. — Trading risk.

Figure 2: Reasons for paying rent

leave sufficient for it to be worth his while. That is to say, it means an equitable split of profit between landlord and tenant.

Many landlords and their agents will scream that we are suggesting a return to the old-fashioned profits test. Call it what you will, but none of us should have difficulty with alternative and most appropriate methods of valuation, be that a comparative floor area or a profits test. The only reason why rent is paid is that the occupier wishes to occupy the building to trade at a profit.

The generally held view, with which I agree, is that when you have modern, open-market letting evidence, close by, of similar size and on similar lease terms (a comparable), this should be analysed by way of comparative floor area. Naturally, this itself produces a whole raft of areas to dispute, but nevertheless *that is the rule*. It is a rule reinforced, albeit obliquely, by Red Book.[1] But *is* the rule correct if linkage between rent paid and the ability to pay it is abandoned?

What has caused the sea change shows clearly in two recent cases I have dealt with. We had done what we thought were excellent jobs, getting rents at below the general tone, yet the rents still ate the entire profit. This defies valuation logic, or as a child might say, 'how fair is that!?'.

Equally, and very importantly, I am sure that if we simply advocate a return to a strict profits test we will lose cases of third party. It makes sense to consider a more intelligent and subtle approach but the bottom line is you must revert to ability to pay yet again. This may mean that for the best sites tenants will pay more, and for the below-average sites just the reverse. At least, though, this will ensure ability to pay — which must be in the landlord's, as well as the tenant's, best interests.

SO WHAT IS FLEURETS DOING?

Eighty per cent of our high street rent review work is acting for corporate tenants. In each of the last two years, as a firm, we undertook around 175 rent reviews, with a little over 100 of those on the high street. It does not sound a lot, but it means agreeing a rent review more than every 1.5 working days. It is not a particularly big market and no one does more than us.

There is no one overriding issue that we can use: it is a war of attrition. We have tried to put together a 'bible' — probably without the insight of the original work, but a bible nevertheless.

Minimum wage	=	less profit
National insurance	=	less profit
Disability discrimination	=	less profit
Post 9/11 insurance	=	less profit
European interference	=	less profit

Figure 3: Government interference

This is virtually finished and we have gratefully received input from some of our clients. It is being used by our valuers, who have themselves had considerable input, so that we can offer a considered and consistent approach to both landlords' valuers and third parties. As rent settlements are made, as predicted by our research, so the bible will gather strength as a dynamic piece of work. We are already seeing the initial fruits from these labours.

We are trying to emphasise areas of the market where there is direct, albeit general, evidence. This leads me to three points.

Operational costs for multiple retailers have risen as a result of the minimum wage, National Insurance, property insurance post 9/11, European employment legislation, etc. Tim Martin of Wetherspoons has been widely quoted in the press to the effect that 40p in every £1 taken across the bar now goes to a mix of taxation and government compliance. All of these costs impact on ability to pay. Again, the bottom line is it is not just the tenant's problem. Landlords have to share these problems or risk losing their tenant and reletting at lower levels, potentially to inferior covenants on less attractive terms.

Secondly, there is evidence of quasi profits tests. We now have statistical data of over 200 high street rent reviews from the last two years where customer floor area is analysed against sales and rent. Table 4 sets out in tabular form the results of our analysis.

We can prove whether a unit is 'on or off pitch' by comparison in geographic areas (hypothetical tenant argument excepted). The national average is around £300 sales per customer square foot (outside central London). So if you have sales at, say, £400, this indicates a better pitch than average; at £200 clearly the reverse is true.

These are powerful data, and take a lot of subjectivity out of the argument and prevent, or at least partially prevent, the current pantomime routine where parties take diametrically opposed views of being on or off pitch. Without evidence to the contrary, the arbitrator awards a midpoint. This information is now available to be used on a town-by-town or circuit-by-circuit basis. Floor area analysis can still be used, but discounts or additions at least will have some basis in fact.

Lastly, there is the question of operator requirements. The larger operators publish their acquisition requirements. In most cases,

Table 4: Rent review analysis

	Average customer area (sq. ft)	Average rent psf customer area (£)	Mid-quartile rent psf customer area	Average sales psf customer area (£)	Mid-quartile sales psf customer area	Average rent as a % of T/O	Mid-quartile rent as a % of T/O
West End	2,270	90.73	84.50–101.17	505.00	378.18–668.28	19.7	12.64–21.91
City of London	3,082	52.49	43.41–62.81	405.00	327.42–448.59	12.7	12.98–13.77
Outer London	3,148	33.15	20.75–39.67	288.00	186.18–312.69	13.71	12.59–14.85
South-East	2,571	34.08	24.93–38.92	325.00	190.60–396.42	12.41	8.79–14.25
South-West	2,743	32.90	28.34–34.23	283.00	218.33–307.69	10.99	7.35–12.40
Midlands	3,140	34.31	29.17–40.28	288.00	233.46–322.25	12.65	10.37–14.29
North	3,192	29.55	23.17–33.71	315.00	236.69–332.83	10.89	7.92–12.43

these are now much more specific and more rigorously applied than in earlier years. In essence, operators will be choosy and develop only in small numbers, if at all. Units that are not ideal will not be developed. It is not just a case of shaving a little from the rent of the ideal property that was developed!

These three points of government interference, property pitch and operator requirements raise two further issues.

- Reduced demand for most units.
- Tenants are assumed for rent review purposes to be willing; but how far down does the rent have to go before they become willing? The 'rent review handbook' tells us that willing assumes a rental bargain, but it does not imply enthusiasm.

The result is few new lettings, thus little new evidence, in itself proof of market weakness. These three facts can be empirically proven and have a direct bearing on rent.

Having dealt with direct evidence, there is additional indirect market information which collectively demonstrates *market weakness* and gives a better rounding to the case.

- Disposals. Virtually all the operators have pubs to sell — obviously their worst-performing units which will now have the highest rent (ability to pay again) — Yates, Wetherspoons, Regent, SFI and All Bar One have all sold leasehold units over the past couple of years. Rent is a constant, so as sales fall, rent as a fixed cost becomes a greater percentage of turnover and profit. Not only this, but the average premium being paid is very low. Picture the scene in 1997. There were legal and acquisition costs, planning and licensing fees to pay and then £1,000,000 to fit out. Now look at 2004 and a sale price of £100,000 ... no more than inventory value. The effect of this is a new operator buys a fully fitted unit but only pays a shell rent. That gives him a reasonable chance to make money and play the discounting game simply because he is not amortising a massive capital cost

(ability to pay yet again). Noticeably, buyers of second-hand sites seem reluctant to develop new shell leases! At current rents and sale prices, can you blame them? Ironically, this only increases price discounting and hence increases the competition, enhancing a downward spiral with more units becoming uneconomic.

— Supply and demand. The degree of competition is intense. Few can play Wetherspoons at their own game. Although many have tried, most have failed. High street discounting is simply a euphemism for severe competition for the customer pound. This is saturation. We know of operators in the last two years or so who have pulled away from deals or renegotiated. Landlords have been prepared to renegotiate. This would not have been the case in 1998. Moreover, landlords in 1998 could insist on severe lease terms which tenants were prepared to accept. Weak demand has changed the position very markedly. Leases with severe obligations need to be carefully considered in terms of trying to replicate an open-market transaction at rent review.

— Note bankruptcies, profit warnings and the like. They are not an accident, they occur because the tenant cannot make enough money. Rent, after wages, is their biggest cost.

CONCLUSION

In a relatively short paper it is hard to give anything other than the broad picture. But there is one further point to consider which possibly encompasses all of the factors I have mentioned, and indeed others, and one which I want to emphasise because I think it most ably demonstrates the logic.

Overall, acquisition and development appraisals made by acquiring companies were realistic before saturation. Now they look horribly optimistic. Simply put, the strong market was assumed to continue, probably forever — but then all operators had to be optimistic or they would have been taken over! It has not continued, and landlords have yet to recognise this.

Figure 4 gives a very simplified form of site appraisal from a 1998 development. Where developments of numbers of sites to create critical mass may have been important, return rates were reduced to enable this to take place. Since then, saturation and discounting have bitten hard and the hurdle rates have risen to meet financial and shareholder demands.

To retain my theme of ability to pay, the development appraisal would read very differently today. If you now consider the same appraisal but with modern data the result is obvious. Sales are under pressure, margins even more so. Hurdle rates are up. There is no more rent that can be paid in a great many cases.

This is the most direct line of logic. At Fleurets we are now comparing original appraisals and reconstituting the original appraisal with today's market in mind. This will prove the level of rent that the tenant can afford to pay. It is, after all, the truest test:

Maintainable sales, say		1,000,000
Less cost to operate	600,000	
Less annualised cost to develop	100,000	700,000
Maintainable profit		300,000
Required return	20% on £1m development costs	(200,000)
Available as rent		100,000 (10%)

Figure 4: Appraisal in 1998

this is what actually happens in the open market. It is most specifically not a post-deal analysis by a non-specialist valuer who has an axe to grind for a review that is about to take place around the corner. Nor is it a profits test. It is proof to landlords that rent for A3 units is suffering due to market conditions. Open-market rent is, after all, the usual definition of rent in the lease.

Finally, what is the position for landlords? Historically they have continued to take the highest rent they can get and hope for the best. Inntrepreneur did this in the very early 1990s, and look what problems that caused. Here we assumed there was a different situation because of covenant strength. But in reality, how good are the covenants now of some of the best-known operating companies? Certainly not what they were. In many cases, share prices trade at substantial discounts to book valuations of properties. On the other hand, because of the changes to the accounting standards, few companies have revalued for several years. Properties remain on the books at cost. So perhaps book values actually are closer to share prices than we imagine. Add to this the receiverships and profit warnings, and covenant strength may in fact not be all that a landlord had hoped for.

If landlords proceed to the bitter end, many of their tenants will either have assigned leases to secondary covenants, if possible, or made sub-lettings, where the properties may not receive investment to the same degree and where rent is less secure. Ultimately, landlords may get properties back in poor condition with considerable rent arrears. Worse still, they will then have to relet at lower levels and sustain a period of time with no rental income at all.

The more enlightened landlords have understood the prospect of this doomsday scenario and are taking steps in one form or another to be more modest in their rental demands, and even in some cases consider deferment of rent or actual reductions thereof. I think it is fair to say that this is a pretty small minority! The truth, in my opinion, is that the tenants are being hurt badly at present, as a

consequence of their trading position. Fairly soon landlords will also suffer unless they can take the more enlightened approach.

In acting for tenants, which is the majority of my work, the reality is we must now be presenting cases to arbitrators, whom I think are largely sympathetic to these cases, but the evidence must be produced to allow them to make decisions as to the correct level of rent for the benefit of both landlords and tenants.

Reference

1. Royal Institution of Chartered Surveyors (2003) *Red Book: RICS Appraisal and Valuations Standards*, RICS, London, UK.