Pubs, bars and restaurants

Is the profits-method valuation a thing of the past?

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Abstract

This paper concerns some recent important arbitration decisions. In essence, two of these backed the profits-method valuation for:-

- (a) an out of town purpose-built food pub.
- (b) a fully fitted city centre unit, built as a public house and with a user clause restricted to public house or wine bar.

The third arbitration case concerned a town centre A3 unit, where the Arbitrator favoured an approach based upon an analysis on a gross internal area (GIA) basis but said he could have been persuaded to consider profits if better evidence of fair maintainable trade had been produced.

Keywords:

public houses, rent review, profits method, fair maintainable trade, open A3 user

INTRODUCTION

With the proliferation of high-street A3 over the past ten years a lot more retail surveyors have become involved with the rental valuation of public houses. The vast majority of these are agreed by reference to an analysis of gross internal area (GIA) (usually excluding stairs and sometimes, where bank vaults etc are involved, excluding structural walls). This has led retail surveyors to consider that profits-method valuations are a thing of the past. But this is not always so.

Licensed retailers still make their calculation as to how much they can afford for a site by reference to expected profits and the total cost of creating a business unit compared to its ultimate value to a retailer. It therefore follows that when rent review negotiations are debated the relevant strengths of a unit to be valued, by reference to known comparables, should be ascertained. An understanding of the licensed retailer's decision-making process is paramount.

There have been three recent cases which have gone to

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arbitration, essentially on the basis of valuation. In two of the cases the arbitrators have favoured the profits-method valuation whilst in the third the arbitrator laid down a position whereby he might have been tempted to adopt a profits-method valuation. *It can therefore be categorically stated that the profits-method valuation refuses to lie down and die.* It must, of course, not be overlooked that in something like 30,000–40,000 pubs which are leased by breweries and pubcos to retailers on a tied basis, rent reviews and lease renewals are agreed using the profits method. There are an increasing number of traditional pubs, let in a fully fitted condition rather than as a shell, which are let free of all ties. These have also had their rents agreed on the profits method. Inns and pub-restaurants have also traditionally been rented using the profits method of valuation.

The three recent cases have involved very different types of property and, to preserve confidentiality, the name of the premises, the parties involved and rental figures contended for and ultimately awarded have not been divulged.

CASE 1

West End of London pub. Prime position close to a number of pubs, bars and restaurants, all of which recently had rent reviews agreed by reference to analysis of GIA values.

The landlord is a property company. The tenant is a substantial nationwide operator of public houses. Both parties were represented by experienced A3 valuers, as is the arbitrator. The premises have traded as a public house since construction in the 1950s.

The surveyors attended a preliminary meeting with the arbitrator where they immediately identified a difference of opinion as to the appropriate valuation methodology. The surveyors could not agree whether the valuation approach should be dealt with as a preliminary issue or within their submissions. The arbitrator decided that the valuation methodology should be addressed as part of the submissions rather than as a preliminary issue.

Both parties agreed that the premises were to be valued in their original fully fitted condition. This is an important point. There were subsequent alterations and improvements which were to be disregarded in accordance with various licences for alteration. A summary of the cost of carrying out the work detailed in the licences for alteration was supplied to the arbitrator.

Areas were agreed. Trading figures of the pub in question and also relating to 13 other public houses in the immediate locality were supplied by the tenant's representative.

The landlord sought to value the premises by reference to floor areas. The landlord's surveyor's submission was that there was no reason why the subject premises could not be valued by reference to comparable transactions, analysed on a floor-area basis, where the leases permit open A3 consent. He accepted that A3 use included restaurants, whereas this use was precluded by the lease of the

subject property. The landlord's surveyor felt that pub operators would outbid restaurateurs for this site and gave recent examples of restaurants being converted to public house use. He felt that a 'fully licensed public house' user encompassed not only traditional pubs but also modern bars, café pubs and gastro pubs. He gave examples.

The lease also permitted use as a wine bar, and the landlord contended that such premises were always valued by reference to floor areas.

The landlord's surveyor pointed to six premises very close by which had all recently been subject to rent reviews and which had been agreed by reference to floor areas. All had open A3 users and could be used as restaurants, but he felt that the parties dealing with these reviews had placed most weight on comparables being used as bars and not as restaurants.

He accepted that one local public house had been valued on a profits basis. He also accepted that the subject premises had been valued on a profits basis on all previous rent reviews going back at least to the 1970s. He contended, however, that times change and the traditional basis of valuation should also change. He said that prior to 1990 there was little evidence to analyse on a floor-area basis, but in today's market there was no need to 'fall back' on the traditional basis. Finally he noted that the arbitrator had recently decided two cases on a profits method but differentiated those premises from the subject premises by virtue of location, physical characteristics and trading styles. Also the subject premises could be used as a wine bar as well as a public house. He felt that the top bid would come from a public house operator and it would be nonsense to value the subject premises at a lower value than two of the immediately local comparables because the subject premises could not be operated by restaurateurs.

The tenant also emphasised that each case was to be judged on its own merits and the key factors to be considered were the assumed lease terms, the physical nature and configuration of the property and the nature of the trade.

The tenant's surveyor referred to the RICS valuation information paper 'The Capital and Rental Valuation of Restaurants, Bars, Public Houses and Nightclubs'. This stated that the primary method of valuing licensed premises is by reference to trading potential. He made the point that the premises are not readily adaptable to uses other than that of a public house. The user provision within the lease, its purpose-built nature and its trading style all dictate that the premises should be valued by reference to potential trading performance.

There were also clauses within the lease for the tenant to preserve the character of the premises with the licensing justices and to maintain and extend the business, which also pointed towards a profits valuation.

Counsel's opinion from a previous case was produced which

concluded that the best comparable evidence will come from properties with a similar user clause.

The tenant's surveyor also referred to the two recent arbitration awards given by the arbitrator where he had concluded that it was recognised practice to value fully fitted public houses on a profits method of valuation. In disregarding the improvement works, the arbitrator was to consider a basic three-bar public house, on two floors, with no air conditioning.

The arbitrator agreed that each property has to be judged on its merits. He concluded that he was not bound by previous arbitration awards, the RICS information paper or counsel's opinion (on another property). Each property needs to be considered in the context of the market for the subject property at the date of review, and in particular its location, condition, physical layout and lease terms.

The arbitrator noted that both parties agreed that this was a prime position for a public house but was not persuaded that the rent would be in line with those agreed for properties with other A3 users.

The arbitrator decided that the user must dictate a predominance of wet sales. It precluded some of the possible occupiers suggested by the landlords, but would include modern bar, gastro pub and possibly café bar. The arbitrator considered the premises to be too small for many of the potential tenants suggested by the landlords. He concluded that tenants want the freedom of an open A3 user and the user clause in this current case was most restrictive. The arbitrator agreed with the landlord that tenant demand was likely to come from small emerging companies. They are sensitive to terms which might inhibit the use and possible premium value of the premises. They would worry that various concepts may not come within the permitted use.

The arbitrator found that if he were to value the premises on an overall basis by reference to floor area he would apply a discount from those with an open A3 user. He was uncertain as to how to calculate the appropriate discount, however, so he looked carefully at the profits method of valuation. He decided that it would be wet-led operators who were the most likely tenants. The premises were too small for the major high-street bar operators. Also, as originally configured, the premises were fitted out as a traditional public house. All these factors prompted the arbitrator to determine that the premises should be valued on a profits method of valuation. The bid would reflect the prime position as a public house.

Both parties had put forward short-form profits valuations and the arbitrator gave specific consideration to:

- the assessment of the fair maintainable trade
- the effect on fair maintainable trade of the tenant's alterations and improvements
- the tenant's bid.

The computation of these figures was very dependent upon the premises in question and is not considered in detail here. The important point is that with a strict public house user (and even with a public house and wine bar user) of a fitted-out public house an arbitrator has decided that the profits-method valuation is appropriate. The size may have been of relevance. The premises were to be differentiated from larger shell units let to an open A3 (or A3/A1) user, where valuation by reference to GIA is the norm.

CASE 2

Public house restaurant in north of England. Close to motorway and retail and leisure park, but self-contained and surrounded by large car park. Purpose built for public house restaurant operator.

This is another case where the parties' surveyors were unable to agree whether the premises should be valued by the profits method or by reference to GIA. In this case, despite a strong request from the arbitrator, neither surveyor was willing to put an alternative valuation based upon the other party's contention. This left the arbitrator 'comparing apples with pears'.

The landlords are a property company and were represented by an experienced retail surveyor.

The tenants are a substantial national public house operating company that had recently taken over a regional company which had developed the property five years earlier. They were represented by an experienced licensed property specialist. The arbitrator was also an experienced licensed property specialist. After receipt of submissions and counter-submissions, the arbitrator asked that the parties provide a 'fall-back figure' based upon the other party's valuation method. He also referred the parties to the RICS information paper on the valuation methodology. Notwithstanding this RICS guidance, the landlord's surveyor refused to provide a profits-method valuation. The tenant's surveyor referred to the RICS guidance as supporting his view that it was correct to utilise a profits-method valuation in this case.

The property is a modern purpose-built public house with family dining facilities and an 80-space car park. It had been fitted out by the lessees and a justices' full on licence, public entertainment licence and a permit for four amusement with prizes (AWP) machines are in force.

It is a local community pub and drive-to family food outlet. It is one mile from the nearest small town and three miles from a more substantial market town. It backs on to an A road and is close to a motorway junction. It is also close to, but not part of, out-of-town retail and leisure developments. There are a wide range of restaurants, bars and cafés which form an integral part of these schemes. Further development including a business park, 200 new homes and a hotel were on the drawing board. The landlord contended that these raised the value of the subject premises, whereas the tenant said they created additional competition while

not necessarily bringing new custom to a unit which was not within any of the schemes.

The surveyors agreed GIA areas on the ground floor and first floor. Additionally the tenant's surveyor put forward a figure for 'customer area'.

The tenant's surveyor informed the arbitrator of the business enjoyed at the premises. The arbitrator concluded that the fitting out of the premises as a food-led managed public house was the most suitable use of the shell unit. He said that while this was probably not relevant to a GIA valuation it was an important consideration in assessing fair maintainable trade for a profits-method valuation. He went on to consider whether he felt, for various reasons, the actual turnover necessarily reflected the fair maintainable turnover; also, whether the actual tenant was a close approximation to the hypothetical tenant. He was keen to remember that the lease assumed a shell unit and the goodwill of the tenant was to be disregarded — a point which had been recognised by the tenant's surveyor.

The arbitrator then considered the comparables that had been referred to him. He was disappointed that neither expert had been able to point him to suitable comparables trading as food-led pubs. The landlord's surveyor expressed surprise that the tenant's surveyor could not find such comparables, but the arbitrator confirmed that he had been asked if he could point the parties to relevant comparables from his own experience and had to say that he could not. He therefore believed the tenant's surveyor.

The landlord's surveyor pointed to a fried chicken restaurant, a pizza restaurant and a pasta restaurant on two separate business parks. The arbitrator found them poor comparables because of their location. The landlord also referred to a Mexican restaurant some 20 miles away, but the arbitrator could see few similarities with the subject premises. A nearby Cantonese restaurant was dismissed as dissimilar, and indeed no rental evidence had been offered on this property.

The tenant's surveyor said these restaurants were not good comparables and they would have different hypothetical tenants to that of the subject premises. The arbitrator agreed. Fast-food operators would be unlikely to have a requirement for premises of the size and location of the subject premises.

The arbitrator then considered the method of valuation to be adopted. He concluded the premises were best suited to trade as a family pub restaurant. Using inquisitorial powers the arbitrator had interrogated the most likely potential lessees. They confirmed that while they put their offers to landlord's surveyors in terms of '£s per square foot' they actually computed their offer by way of a profits valuation or an operator's appraisal.

The arbitrator considered the most likely tenant would be an operator of a food-led pub group, similar to the actual tenant. Their rental bid would have been based upon detailed profits

projections having regard to the viability of the individual location, rather than the rates per square foot attained on retail or business parks.

The landlord's surveyor argued that a profits-method valuation did not disregard the tenant's goodwill as required by the lease, but the arbitrator, following RICS guidance and the tenant's argument, did not agree. In fact, the arbitrator found the RICS valuation information paper ('The Capital and Rental Valuation of Restaurants, Bars, Public Houses and Nightclubs') directed him to an analysis of actual trading performance as a help in formulating his assessment of fair maintainable trade. The primary method of preparing a rental valuation of licensed premises is an analysis of comparables by reference to trading potential.

The paper does make some exceptions to this rule, ie bars and restaurants occupying premises readily adaptable for retail or other commercial uses may attract rents on a floor area basis, and the valuer should follow the workings of the market.

The paper quotes examples such as units on retail parks, high streets or secondary retail parades where the unit is readily adaptable for A1 use and not purpose built as a public house. The arbitrator decided that the subject premises were not on a retail park (although very close) and had been purpose built as a public house. He therefore concluded that the premises should be valued by reference to fair maintainable trade.

The exact figures used in the valuation are not relevant here, but the arbitrator was presented with a problem in that the landlord's surveyor had neither made a profits-method valuation of his own nor had he commented upon the tenant's valuation in any detail. The arbitrator was therefore obliged to utilise the tenant's surveyor's valuation, which he amended using his own general knowledge and experience. He pointed out that had he been appointed as an independent expert he might have produced a different figure.

First, he was concerned with estimating fair maintainable trade. He looked at the actual figures (as recommended by the RICS) and took note of the figures adopted by the tenant's surveyor, but made alterations based upon his own judgment. He then looked at gross profit margins, expenditure and hence net profit figures. From that he deducted the amortised costs of fitting out the premises from shell and also deducted interest on tenant's capital in respect of stock, glass and working capital. This gave him a divisible balance. Finally he took a 'tenant's bid' in order to reach his opinion of rental value based upon a profits-method valuation.

Secondly, he considered what is known as 'the operator's appraisal'. This is a computation made by operators which calculates the *maximum* amount they can afford to bid. They will not always bid up to the maximum, but if the rental required by a landlord exceeds this maximum they are unlikely to proceed with a letting. In this case, the operator's appraisal exceeded the profits-

method valuation so the arbitrator adopted the average of the two figures. The figure finally awarded was below the passing rent.

As a comment, this contributor would say that sometimes when a profits-method valuation or an operator's appraisal produces a figure below the passing rent, a landlord will argue that 'such a silly figure must be wrong'. But it can be argued that it is proof that a deal would simply not be done at the date of rent review because the value to the tenant was so much less than the cost to the landlord. A rent review clause merely indicates that one must find a figure at which a willing tenant and willing landlord would compromise. At what level the parties become willing is the debate that has resulted in so many third-party referrals over the past couple of years.

CASE 3

A town-centre 'young persons' venue' bar in the West Country. Good location on a developing circuit, following recent A3 lettings. Former retail unit.

The landlords are retailers, operating from another part of the building in question. They were represented by a specialist licensed property valuer.

The tenant is a large national group of licensed victuallers specialising almost entirely in large town-centre bars. They were represented by a specialist licensed property valuer. The arbitrator is also a specialist licensed property valuer.

The parties were agreed that the unit was to be valued in shell condition. The user clause is open A1/A3, although the parties are agreed that A3 produces the highest rental figure. A new 15-year lease is to be assumed. Tenant's occupation, goodwill and improvements are to be disregarded. Once again there was a difference of approach to the valuation, but in this case it was the landlord's surveyor who wished to pursue a profits-method valuation while the tenant's surveyor valued the property by reference to a rent per unit area, after considering comparables. The arbitrator decided first to determine which method of valuation provided him with the greatest assistance.

The landlord relied upon the RICS valuation information paper, and particularly the words 'properties which are fully equipped and trading as operational entities, may be valued by reference to actual potential trading performance, according to market practice'. He also quoted from the paper, which requires the valuer 'to assess the fair maintainable level of trade and the future maintainable profits that can be achieved by a competent operator'.

The tenant's surveyor made the point that such premises 'may' be valued by reference to profits but this was not a 'fully equipped and trading operational entity', as it was to be valued in shell condition. He believed the RICS paper related more to traditional pubs than shell units, where it was market practice to value them by reference to floor area.

The arbitrator agreed with the tenant's surveyor that the type of premises described in the RICS valuation information paper as being suitable to be valued by the profits method was not what was to be valued in this case. The RICS valuation information paper had referred to some types of bars and restaurants, when readily adaptable for retail or other commercial uses, being more often valued by reference to floor area. This was one such property.

The arbitrator said there was no dispute that potential operators would look to the trading potential of a unit before agreeing a rent. The difference of opinion lay in that the landlord wished to adopt a direct profits approach to the valuation whereas the tenant looked 'at the result of those profits cogitations as witnessed by an analysis of the rents paid on a floor area basis'. The subject premises had in fact formerly been used for retail purposes.

The landlord's estimation of trading potential was based upon his own experience and also reference to two other arbitration awards. The tenant placed much reliance on the analysis and application of rental transactions of other similar licensed premises nearby. Lettings of similar shell units in the town centre had completed close to the review date.

The arbitrator noted that the RICS makes it clear there is much merit in using the profits method in valuing licensed premises, but it also makes reference to comparables, which the arbitrator took to mean detailed knowledge of trade and profit compared to market rental information for similar properties in the area. The arbitrator considered that he may have been more influenced by the landlord's argument had he been able to give more detail of the trading figures of local comparable premises to back up his estimate of fair maintainable trade and net profits.

He concluded by summarising his task of valuing the property in shell condition and found the argument for using floor area analysis far more helpful and therefore decided to consider the valuation on that basis. In this case both surveyors had agreed to put alternative arguments on both a profits-method valuation and an area analysis, so the arbitrator had evidence which could be weighed.

CONCLUSION

So what does one conclude from these three cases? Area analysis was the preferred method in Case 3. Predominantly this was because there was more reliable evidence to help the arbitrator on this basis. He may have been tempted to take more notice of a profits-method valuation if reliable evidence had been presented to him of the trade at local comparable premises. But the key point was that this was a shell unit on a high street which had been converted from A1 use. It is market practice to value such units by way of area analysis.

Case 2 was valued on the profits basis because it had been purpose built as a pub/restaurant. It was effectively a solus operation although it was close to a retail/leisure park. It might

have been valued on an area basis if it was used as a public house but within a standard shell identical to others used as fast-food restaurants and where there were a number of closely similar comparable units.

Case 1 was valued on the profits basis because it was a fully fitted public house. It had been built as a public house and the user clause did not permit general A3.

There will be a lot more arguments over the next few months and years. Each case will be judged on its merits and there are sure to be subtle changes from the facts outlined in these three cases. But the fact remains that three fairly high-profile cases have been argued in depth, and while arbitration awards do not carry the weight of Appeal Court decisions, they certainly set out a few markers which those who are involved in the rental valuation of pubs, bars and restaurants would be foolish to ignore.