Pubs, bars and restaurants

What is the value of a public house as an over-rented investment?

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Abstract

This paper sets out the current position whereby many public houses are being offered as investments, generally by auction. Most of these investments are being especially created by way of sale and leaseback. Some vendors are offering rents which would appear to be substantially in excess of generally accepted market levels. The paper sets out to ascertain what is the true value of an over-rented investment. What advice should be given to lending institutions? What investigations should a potential bidder make? What is likely to occur should existing tenants suffer business failure or assign to a weaker covenant? The paper also considers the yields on prime high-street public house investments and their movement over the past three years. It contrasts these yields with those pertaining to less attractive properties and covenants and those of patently over-rented and poor-risk properties. The paper should be read by lenders, investors and operators in the public house market.

Keywords:

auction sales of pubs, over-rented, over-priced, high risk, bank lenders, property investors

THE CURRENT INVESTMENT MARKET FOR PUBLIC HOUSES

The auction market is red hot at the moment. Some would say it is over-heated. Investors really do not know where to put their money. The Stock Exchange has given most people negative returns over the past five years. The bond market is vulnerable to increased interest rates or company failures. Deposit accounts continue to pay very low returns.

Investors have turned their attention to property, and the smaller investors are particularly interested in lot sizes of under £1m. The

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auction market is a keen supplier of such investments.

Until comparatively recently public houses and hotels were not considered suitable as investment properties. Investors particularly did not like profits-method valuations, because they did not understand them.

The market today is getting an increasing number of public house investments. Chef & Brewer started the trend when it did a sale-and-leaseback deal with Land Securities in 1995. Land Securities has sold many of these investments in the past three or four years, and there are now a wide spread of freehold owners. The lessees in the main are from Spirit Group, which bought the Chef & Brewer chain from Scottish & Newcastle Breweries.

Yates did a joint venture with Quintain in 1997 which was essentially a sale-and-leaseback transaction. Again, Quintain has now sold all of these investments to a variety of purchasers. Yates has assigned some of the leases but remains lessee in the majority of cases.

Both of these transactions were of big, profitable, managed houses (managed houses are the top 20 per cent of public houses in terms of turnover and profitability — most are in town centres and have relatively strong underlying property values in the unlikely event of tenant failure and the investor having to find another tenant or sell the freehold with vacant possession). Some of the Chef & Brewer pubs are not in high streets, but these are generally on large sites in suburban locations and still represent strong property-backed investments irrespective of the covenant of the lessee. Indeed, it can be generally expected that, upon assignment or tenant failure, a tenant of equal stature (or nearly so) could be found in many cases.

BLUE-CHIP YIELDS 2001 TO-DATE

When these sale and leasebacks were created the lessees fully expected to be running businesses from the units for the foreseeable future. The rents may have been full (to maximise the amount of cash raised), but they were not unaffordable, nor were they unreasonable. The first of the Chef & Brewer properties came into auction rooms in July 2002 and fetched returns such as 7 per cent in Orpington, Kent and 7.1 per cent in Farnborough, Hampshire on sale prices of £1.02m and £1.115m, respectively.

Among the first Quintain/Yates investments to be auctioned were the Coventry and Birkenhead outlets, which sold in February 2003 for £1.90m at a yield of 7.7 per cent and £1.02m at 7.8 per cent, respectively. Earlier two Yates outlets, not part of the Quintain estate, sold in July 2001 at yields of 7.4 per cent.

These may be regarded as the 'blue chip' of public house investments. As the auction market has heated up yields have fallen, and the most recent examples are Chef & Brewer investments in Chiswick at 5.1 per cent in February 2005 (although this was low because of an outstanding rent review) and in Reading

at 5.4 per cent in October 2004. Similarly, the last eight Yates investments sold at auction in October 2004 for between 5 per cent and 7.5 per cent, with typical examples being in Oxford at 5.34 per cent and Sheffield at 6.8 per cent. Average yields have reduced from about 7.4 per cent to 5.9 per cent.

In addition, of course, a whole new investment market in licensed properties has developed naturally in the past ten years, with the likes of All Bar One (M&B), Slug & Lettuce (SFI) and Hogshead (Laurel, now R20) taking retail units in town centres which were originally in A1 occupation.

This blue-chip covenant A3 high-street investment sector, where values are significantly above the £1m benchmark, is a relatively well-structured and informed market where rents may be full, but where the majority of investments sold are not sale and leasebacks created by the occupier, but are units originally let at arm's length at market rents pursuant at the time. As has been well documented, there are current issues of saturation in the high street and arguments that the rental tone has fallen in many locations. Nevertheless, a perception of strong location with potential alternative use options continues to transpose into strong realisable prices and yields. Also, rents in this sector are also reviewed on a £psf basis in line with a number of other core property sectors, which makes it easier for the investment purchaser to analyse and consider prospects for future rental growth and, indeed, the serviceability of the passing rent.

SECOND AND THIRD TIER INVESTMENTS—YIELDS 2000 TO-DATE

The interest in sales of public houses by auction has trickled down to smaller pubs usually run under tenancy or lease. To give an indication of the type of pub run by each method it is generally reckoned that a managed house should have a turnover of not less than £10,000 per week (excluding VAT) and the average is probably £13,000–15,000 per week. A leased or tenanted pub will have an average turnover of £4,000–6,000 per week and may be similar to the three pubs most well known to TV viewers — The Rovers Return in *Coronation Street*, The Woolpack in *Emmerdale* and the Queen Victoria in Albert Square.

London and Edinburgh and its various associated companies has raised the most capital by way of the immediate sale of the freehold investment in pubs it has recently acquired. It grants a lease to the trading company, often offering guaranteed uplifts at the fifth- and tenth-year rent reviews. London and Edinburgh in turn grants subleases of its pubs to tied lessees who buy beer on a tied basis. Sometimes the rent collected from the tied lessee will cover the rent paid to the freeholder, but more often London and Edinburgh makes up the shortfall (and its profit) from the wholesale profit it makes as the tied supplier of beer.

Two of the first pubs sold by auction by the London and

Edinburgh Inns Group, in December 2000, were in Bury St Edmunds, which sold for £166,000, showing 7.7 per cent, and in Hastings, which sold for £125,000, a yield of 9.5 per cent. More recent auction sales in March 2005 have seen a property in Midhurst sell for £775,000, a yield of 6.7 per cent, while one in Atherton, Lancashire realised £452,500, giving a yield of 7.5 per cent. Average yields have come down from about 9 per cent to 7.2 per cent.

THE NARROWING YIELD GAP

It can thus be seen that the yield gap between the big managed houses and the tenanted pubs has narrowed from 7.4–9 per cent in 2002–2003 to 5.9–7.2 per cent in 2004–2005. On the face of it this narrowing of the yield gap from around 1.5 per cent to 1.3 per cent or thereabouts is relatively minor, but needs to be considered in the light of the differing characteristics of the two sub-sectors and in particular in the context of the commentary on rents, rental values and capital values which follows. The market needs to be wary of too much yield compression between prime and secondary properties, which is a classic feature of a potentially overheated market. In such conditions the secondary property market becomes relatively more risky, particularly if it becomes exposed to weak occupational factors and unsustainable rents.

INVESTMENT VALUE COMPARED TO VACANT POSSESSION VALUE

So far, so good. But other companies have seen that it is possible to buy pubs with vacant possession at one price and sell them at a much higher price as an investment at auction. This is probably a direct result of market sentiment. There is a general business trend to separate the running of a business from the ownership of property. This has been most noticeable in the hotel industry at present, where there is a trend towards 'sell and manage back'.

The difference in the value of a property to an investor and to an operator is best explained by the risk and effort involved in each case. An investor takes the 'top slice' of profit which he collects as rent, and is unconcerned with the vagaries of running a business. The business operator needs to be actively involved in ensuring that profits are earned and therefore requires a higher return on his invested cash. It will be realised that it is a natural consequence of a sale-and-leaseback transaction that the profits retained by the business operator are at greater risk. They are the 'bottom-slice profits'. A leasehold business is more highly geared than a freehold one.

THE CREATION OF AN OVER-RENTED LEASE

Some of the companies which have recognised that it is possible to turn base metal into gold, by buying a trading business and selling

an investment, have not always been content with the meagre profits that can be obtained by this operation of economic forces. Some are creating investments at rents that are unlikely to be affordable in the medium or even short term. There is nothing illegal about creating an investment at a rent which is up to double the market rate. It is up to the bidder at auction to be aware of the market value of the property he is bidding for. He should make his decision based upon the prospects for rental growth or even the prospect of the existing tenant paying the current rent in the foreseeable future. He should consider what would happen if the current tenant should suffer business failure or seek an assignee. Is there a likelihood that a tenant of equal or better financial standing would wish to run the business, paying at least as much rent as is currently covenanted?

How do valuers treat these?

The author has had recent experience of providing valuations to the lending institutions approached by buyers at auction after they are legally committed to buy. None of these buyers had carried out the research it was suggested should be done. Valuers from the author's firm have had to tell them the rent is approaching double what could be expected on an open market letting; there is therefore no chance of appreciable rental growth in the foreseeable future; they are therefore totally reliant upon the strength and covenant of the current tenant; it is unlikely that the tenant could afford the rent given the slightest downturn in business in that the rent was 90 per cent of anticipated net profit; the firm had no knowledge of whether the tenant had other businesses making sufficient profit to cover any losses at the subject premises; the vendor had been well advised by his solicitor, and the rights for the landlord to refuse consent to assign to a very weak covenant were virtually non-existent; if the lessee failed the rent obtainable for a failed/closed business was probably only 40 per cent of the rent reserved and even then might need a rent rebate to allow the tenant to rebuild a failed business; and the vacant possession value of the property was around 50 per cent of what had been paid for the investment and it could be even less if the business were closed, the trade inventory removed and possibly the building vandalised.

The RICS definition of market value

None of these matters affected the market value of the investment, defined by the RICS as being:

'The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller, in an arm's-length transaction after proper marketing, wherein the parties had each acted knowledgeably, prudently and without compulsion.'

So what is 'market value'?

In the cases reviewed below, the properties had sold for substantially in excess of the auctioneer's guide price. There had been four to six bidders in each case. It is a very arrogant valuer who assumes that all bidders had acted without knowledge or prudence. Possibly without the bids of the eventual buyer the second bidder would have secured the property at two or three bids less, but the price would still have been very high. The author's firm has advised bank managers in these cases that the 'market value' was 90–95 per cent of the price bid by their borrower.

What else should the valuer tell the buyer or the lender?

The firm has felt obliged to supply the lender with the following:

- an opinion of the market rental value so that the lender could be aware of the position should the current tenant fail to perform the covenants of the lease
- an opinion of vacant possession value of the premises should the owner have to retake possession and sell the premises vacant and without either a trade inventory or a set of accounts to prove the goodwill of the business
- a warning that these values would be lower if the business was closed or the building vandalised
- a warning that this was a very high-risk loan and based almost entirely upon the covenant of the existing lessee, and that the firm believed the loan ratio should be based upon either the vacant possession value or an investment value based upon market rental value.

What should the lenders do?

In several of the cases the firm has dealt with, the banks involved have other dealings with the investors concerned and the deals have progressed with the banks taking security on other investments (sometimes involving revaluations of these assets). It is to be expected, however, that there have been and will be other cases where a bidder will not be able to complete a sale because he will be unable to fund the purchase. Big losses will result — not necessarily confined to the 10 per cent deposit. The vendor will be able to sue for the difference between what he was originally bid and what he achieves on a second sale — plus the expenses of the second sale.

SOME CASE STUDIES

Typical examples of the properties involved are given below.

Example 1 — Rural property on main road

Location: Rural (low alternative use value) and virtually totally restricted to A3/A4 use. Very seasonal location which adjoins a

navigable river. In the recent past this business only traded from Easter to October.

Description: A cheaply built 'prefab' on raft foundations.

Use: Bar and restaurant.

Rent: £71,000pa, rising to £80,000/90,000/102,000 after five/ten/15 years.

Alienation: Fairly loose clause.

The business: Open all day in the summer and shorter hours during the winter. The business had only recently been acquired by the vendor with proven turnover of just over £500,000pa. The previous owner was thought to be an above-average trader. The property had been bought only months earlier on a vacant possession basis for circa £560,000 including the inventory.

Price: The guide price was £835,000. The property sold for £945,000 after competitive bidding, giving a net initial yield (taking into account the usual acquisition costs and stamp duty) of 7.1 per cent.

Rental value: £57,500 (ie 81 per cent of the initial rent under the lease).

Example 2 — Rural property in fairly remote village

Location: Bypassed by a trunk road and in a sparsely populated area. If not used as a public house its only likely alternative would be as residential at a much lower value (if indeed planning permission could be obtained).

Description: A Victorian village local.

Use: Bar and restaurant.

Rent: £46,000pa.

Alienation: No provision for an authorised guarantee agreement (AGA), and largely drafted in tenant's favour. The author's firm believed that should the lease be assigned the covenant of the likely tenant would be weaker.

The business: It was estimated that the business had a fair maintainable turnover of £170,000 but was currently trading at much lower levels. The firm also estimated a fair maintainable net profit of £48,000 before rent and depreciation, ie the rent represents 96 per cent of the potential profit. The tenant would have only £2,000pa to live on even after building trade from existing low levels. The business had been acquired only months before with vacant possession, including the trade inventory, for circa £300,000.

Price: The property sold for £565,000, which was £150,000 above the guide price. There was strong competitive bidding. The net initial yield was 7.7 per cent.

Rental value: £25,000 (ie 54 per cent of the rent reserved under the lease).

Vacant possession value: Around £320,000.

Example 3 — Town pub

Location: Market town with an industrial heritage and a reputation as being over-licensed.

Description: A Victorian stone building fronting directly on to the pavement on a steeply sloping site.

Use: Town public house, wet led, with virtually no food. If not used as a public house its only likely alternative use would be as residential at a much lower figure.

Rent: £45,000.

Alienation: Fairly easy assignment, with no requirement for an AGA.

The business: The vendors had only owned the business for six weeks. They had bought it for £240,000 when it was in poor condition with no trade figures represented. The estimate of fair maintainable turnover was £200,000, with a fair maintainable net profit before rent and depreciation of £60,000. It would take some time to build to these levels.

Price: The property sold for £500,000, which was £100,000 above the guide price. The sale price represents a net initial yield of circa 8.6 per cent.

Rental value: £30,000pa (ie 67 per cent of the rent reserved under the lease).

Vacant possession value: Around £300,000.

WHAT ARE THE LESSONS TO BE LEARNED BY INVESTORS?

The examples above demonstrate two stark issues which do not appear to have entered investors' consciousness to any great degree thus far, namely, the sheer degree of the over-rented position in many instances involving the secondary tenanted pub investment market and the significant gap between the respective investment value and vacant possession values in this sub-sector.

This contrasts with the high-street and traditional managed house investment markets where a combination of factors is likely to generate a much closer relationship between investment and vacant possession values, where there is stronger demand from occupiers should a particular business fail (be it from alternate operator or alternative uses) and where in general there is a closer relationship between rents being paid and current open market rental values.

It could be argued given these differences that the yield gap between the big managed houses and the tenanted pubs should have widened, or at best remained static, over recent years rather than closed. Nevertheless, at present there remains strong demand for over-rented investments within the secondary sector. For operators the sale and leaseback provides additional capital which they can use to purchase more properties, increasing their portfolio size which in turn increases buying power. This creates additional company wholesale profit and also helps improve the perception of tenant covenant strength.

Investors are clearly attracted by the yield profile, which remains relatively healthy set against current borrowing costs. Also, it has to be said that to date there have been relatively few company business failures in this sector. For the lending institutions there is a

heavy weight of money available to lend against a relative lack of property stock, while the relatively low single asset values and the ability to take cover from additional properties as security help to balance the potential risks. At present therefore it is still 'so far, so good', but can base metal be turned into gold indefinitely?

CONCLUSION

It is clear that there is an appetite for licensed property as an investment. Many investors are adequately experienced or advised to buy such investments to advantage. The market is currently 'hot' or 'overheated'. There are investors in the market who are willing to buy without adequate advice or knowledge. There are operators who are prepared to create investments at levels of rent which by general standards are likely to prove unsustainable. These are not existing investments but are being created solely to take advantage of current market conditions. If the creators of these investments suffer business failure in the future there will be many investors left with property worth much less than they paid for it. If the creators of these investments find assignees to take over unviable businesses there will be even more stories of heartbreak and bankruptcy. Can the auction houses simply wash their hands of the problem? Is it the fault of greedy investors who do not bother to take advice until it is too late? Or are the banks once again simply too keen to lend? Will it all end in tears?