Regular Feature

Pubs, bars and restaurants

Profits method valuation succeeds following further challenge

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Abstract

This paper deals with the assessment of the rental value of shell condition pub restaurants where located on either retail or leisure parks. Should rental valuation be by reference to either direct floor area comparison or by the profits method? In the virtual absence of market lettings of such properties how is the limited comparable evidence from rent reviews to be compared and contrasted? Two disputed rent review cases in the northwest resulted in independent expert valuer determinations. What were the respective Landlord's and Tenant's arguments? How did the experts determine these cases and what reasons were given? What conclusions may be drawn from the outcome of these cases?

Keywords:

pub restaurant, out of town retail park, out of town leisure park, fast food restaurant, profits method valuation, comparable floor area valuation, treatment of tenant's, improvements.

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INTRODUCTION

In the March 2005 edition, we considered the rent reviews of three differing types of public house where the use of the profits method of valuation had been challenged at arbitration. These examples included a

fully fitted city centre bar, an out of town purpose built food pub in shell condition and a town centre 'high street' bar, also considered in shell condition. The arbitrators supported use of the profits method for both the fully fitted bar and the out of town food pub, however, preferred the floor area comparable approach for the shell condition 'high street' property.

There had been an anticipation among both landlord's and tenant's advisors that the arbitration result of the out of town food pub would settle disputes over the correct valuation methodology generally applicable to such properties. Indeed a number of disputes were settled in the light of the given arbitrator's award. However, despite this property sharing size, design and rent review assumption characteristics with many others having outstanding rent reviews, it was located just outside a retail and leisure park development and was effectively a solus sited pub restaurant. Therefore, despite the many similarities, as a consequence of the location differences, the arguments over valuation methodology remained unresolved.

Throughout 2005, a battle continued to quietly rage over the appropriate valuation method to be adopted on rent review of such shell condition purpose built pub restaurants situated within retail and leisure park developments. Landlords of these properties have vehemently argued via their external valuers for the use of the comparable floor area valuation approach. Two such landlords had sought significant rental uplifts arguing their cases before third parties, who this time were appointed in the capacity of Independent Expert valuers. Conversely, the tenants in these cases continued to dispute the use of the comparable floor area valuation approach, arguing instead for the profits method. The floor area comparable approach being used only as a check or simply to counter the landlord's arguments. These rent review cases date back to 2003, however, have only recently been resolved by the third-party determinations.

We now have two Independent Expert valuer decisions both relating to out of town pub restaurants in the north west of England, one located on a retail park and the other on a leisure park. The nature of the two properties involved in these disputes and the respective arguments and valuation methodologies adopted in these cases shared much in common.

The issues arising from the arguments presented, the Independent Expert's rent determinations and conclusions which may be drawn, are of interest and relevance to other unresolved and future rent review cases of this category of licensed property. This article therefore examines the property characteristics, key rent review assumptions, valuation approaches adopted and decisions made by the two Independent Expert valuers.

Category of property

The cases recently determined each involved public house restaurants located within the urban catchments of two of north west England's major towns. The key feature of these pub restaurants is their location within purpose designed and developed out of town retail or leisure parks. Such developments are now common close to our larger towns and cities, usually located with main road access in suburban or edge of town

positions. The success of such schemes has largely been driven by increased reliance on car usage, the convenience and ease of access, usually free car parking and for some uses, the synergies to be gained by co-locating with other complimentary uses. Some such developments involve predominantly retail with supporting A3, both licensed and unlicensed (fast food restaurants) the retail parks. Others however comprise solely leisure uses, the leisure parks. Such leisure park developments will often now include representation from a multi-screen cinema, 10 pin bowling centre, fast food restaurant with drive through facility and other branded restaurant operation with a pizza, pasta, texmex, or fusion style of offer. Some have included in addition a family-oriented pub/restaurant. Developments of pub restaurants within such schemes became increasingly popular from the mid to late 1990s and was largely championed by two particular corporate operators prepared at that time to take rack rented leasehold interests. Such pub/restaurant operations have sometimes also featured purpose designed and fitted indoor children's play facilities, the so-called 'play barns'.

These pub restaurants were usually designed and developed with a specific end user in mind. Thus, the eventual tenant may have contributed to planning the detailed building features including overall size, building style and external appearance in order to ensure the properties developed met with their specific design requirements. The greater majority of such premises are detached buildings with a traditional brick finish under pitched roofs having part single and part two stories with private service yard access, paved and landscaped amenity land and either designated or shared customer car parking facilities. In terms of overall gross internal floor area, examples are found to be in the range of 7,000 to circa 12,000 ft² dependent upon the inclusion or not of a childrens play barn facility and/or domestic living accommodation.

Key lease and rent review terms

The shell condition properties constructed by the developer landlords have tended to be let on institutional fully repairing and insuring terms usually for a term duration of 25–35 years with 5 yearly rent reviews. Rent review is normally to open market rent in shell condition assuming lease terms as per the actual lease. The hypothetical lease term will commonly be for the unexpired balance remaining at the rent review date, subject to a specified minimum term, usually 15 years. The usual disregard of tenant's occupation and goodwill will apply as well as the specific disregard of the authorised tenant's fitting out works. The specific user clause included has tended to vary but will commonly provide for pub restaurant within use class A3 of the Town & Country Planning (Use Classes Order) 1987 or such other use within Class A3 as may be consented to by the Landlord. It must be remembered these user clauses were drafted long before the 2005 use class amendments were introduced. Some examples have specifically barred certain primary food offer types, for example pizza, pasta or burger, included as trade protection measures for the benefit of other occupiers within the specific development. Commonly however the actual user clause for the purposes of rent review

will not restrict the use of the premises to only a pub restaurant but will allow all potential A3 uses. Where indoor children's play facilities form part of the premises, specific allowance for this supplementary use is provided and commonly also for the provision of staff domestic living quarters.

The landlord's case

The Landlord's cases were primarily founded on rental valuations adopting comparable floor area methodology. Use of this valuation approach was justified by emphasising the contractual right to use the subject properties for a broad range of trading styles and types within Use Class A3. It was argued that the properties would appeal in the market place, not only to operators of pub restaurants, but also to a range of other restaurant operations. Thus, comparable evidence from a variety of restaurant types was introduced. Specific reference was made to the RICS Valuation Information Paper 2 — The Capital and Rental Valuation of Restaurants, Bars, Public Houses and Nightclubs in England, Wales and Scotland. Section 4 of this paper notes the primary method of rental valuation for licensed properties is the analysis of comparable transactions by reference to trading potential however also details properties where valuation other than by reference to trading potential is considered the market practice.

Section 4.2 was directly quoted

'In the UK examples of such property valued by direct comparison based on the floor areas are fully licensed or restaurant licensed A3 units on retail parks, in high street retail units and in secondary retail parades where the unit is readily adaptable for general A1 retail use not purpose built as a public house'.

The Landlord's advisors also included profits method valuations described as secondary 'check' valuations. It was however claimed that the RICS guidance note was unequivocal in respect of the valuation method to be applied and this was to be by reference to floor area and direct comparables.

Turning to the comparable evidence presented and relied upon by the landlords, there was a limited amount of transaction based evidence closely located to the subject properties. In the absence of such evidence, A3 comparable premises located on leisure and retail parks across the entire country were introduced. It was argued there was remarkable consistency in rental values of A3 premises on the best performing out of town retail parks and also relativity in value between large and smaller A3 properties. Local transactions involving a Pizza Hut and McDonalds were referred to, these properties having smaller floor areas of only 3341 and 3200 ft². The landlords also had access to a body of evidence derived substantially from A3 premises situated on retail or leisure parks throughout England, tenanted by national corporate operators of branded restaurants including for example Pizza Hut, McDonalds and Frankie & Bennys.

It was recognised that such comparables were different in size and in consequence larger examples were drawn from distant locations. Despite

the fact that the two disputes involved properties in Lancashire, comparables were referred to in Cambridge, Basildon and Maidstone involving transactions of premises of 6068, 7161 and 4265 ft². The conclusion reached indicated only a 5% value differential in terms of rent p.s.f. was applicable between the larger and smaller A3 properties. In selecting a rent p.s.f. applicable to the subject properties no rationalised adjustments were detailed to the rents deduced from branded rectangular box restaurant comparables in order to reflect the differences of location, likely end user or size. While not specifically referred to by the landlord's valuers, it was apparent a number of the smaller A3 restaurant comparables presented as evidence provided a user entitlement to include either A1 or A3. Evidence provided by the tenants of pub restaurants similar to the subjects was dismissed on grounds of inferior trading locations. The arbitration award on the earlier case was distinguished by reference to its location not being on a retail or leisure park, also describing it as flawed. No attempt was made to utilise rents p.s.f. derived from analysis of similar pub restaurant properties.

In the 'check' profits method valuations also provided, the adopted Fair Maintainable Trade figures proposed were significantly greater than the actual trade achieved. Argument was submitted that the actual tenants were effectively under performing relative to true potential. In one case a strong attack was made on the family food led style of operation with play facilities claiming this was outdated. It was claimed that trade performance was limited by likely family demand times and would put off other potential custom. The use of retail price discounting was criticised as contributing to poorer profitability. It was argued the hypothetical tenant would establish an offer with a broader mass market appeal and with no price discounting.

A controversial aspect of the profits method approach is the allowance made for the value of the tenant's improvements, that is generally fitting out works. This is usually reflected by deductions made to the fair maintainable operating profit. Such deductions are influenced by the investment sum required to convert the shell condition property into a fitted property capable of achieving the adopted trade. The landlord's approach was to take a straightforward 10% allowance of the assessed total capital sum for works, fees and for provision of all necessary fixtures, fittings and equipment. The total investment sums adopted were based on the advisors personal opinions although no particular expertise or experience of such building costs was evident. A tenant bid at 50% was ultimately applied to the Divisible Balance (i.e. the net profit after allowance for the tenant's fitting out costs and tenant's capital).

The landlord's profits method valuations arrived at rents which supported the figures they had previously assessed by the comparable floor area method.

The tenant's case

The tenant's cases were primarily founded on the profits method of valuation. Use of this valuation methodology was justified by reference to the most likely behaviour of prospective tenants for this category of

property when bidding in the market. Also by reference to the common practice of valuation of public houses and by reference to the Handbook of Rent Reviews — Reynolds and Fetherstonhaugh.

Importantly reference was also made to Valuation Information Paper 2 published by the RICS as previously referred to. Specifically with regard to use of comparable floor area methodology the wording — ‘*where the unit is readily adaptable for general A1 use not purpose built as a public house*’ was emphasised.

The tenant’s advisors made the point the subject properties *were* purpose built as public houses and physically *were not* at all suitable for alternative A1 use.

For comparable evidence the tenant’s advisors drew on a number of transactions involving very similar properties. It was recognised because of the absence of locally located examples such comparables were drawn from a wider geographical area. This is not considered to be unusual as pub restaurants of this nature are unlikely to congregate together to avoid excessive competition. It was emphasised that despite the variance in location, such evidence nevertheless carries weight because of the similar design, size, trading and likely end user aspects. The tenant’s comparables were however largely properties within 50 miles of the subject properties in the north of England.

Evidence derived from retail/leisure park located single-storey rectangular box design restaurants was however distinguished from the subject premises by virtue of size, appeal to end user, breadth of user permitted, scale of the individual leisure park development and overall cost of fitting out to the occupying tenant. The point was made that such evidence is not readily applicable to much larger pub restaurants nor was it easy to make accurate adjustments.

The tenants in assessing Fair Maintainable Trade sought to arrive at an opinion of trade as might be expected to be calculated by the hypothetical operator. While recognising the hypothetical tenant would not have access to the actual trade records, these were declared to the Independent Experts on the grounds of the duty to aid the expert with all material facts and knowledge.

The actual trade was considered to be a reasonable starting point from which to assess trade potential, particularly given the achieved trade was a known fact.

The tenant’s advisors based their estimate of development costs on cost consultants advice sourced from those directly involved in advising on actual projects for this category of property.

On the key profit adjustment to allow for tenant’s required capital investment, a different approach was adopted. The expenditure on initial fitting out works and associated fees was distinguished to that on furnishing and equipping the completed property. It was argued that the investment in initial works cannot be recouped at the end of the lease and must be written off over the assumed period of the hypothetical lease. It was submitted to properly reflect both the cost of the capital used and the writing off of this investment an annual equivalent deduction must be made based on a dual rate taxed Years Purchase figure. Such annual equivalent deduction was calculated using an appropriate interest rate to

reflect the risks and efforts involved in the business endeavour. This approach resulted in much greater adjustment of the fair maintainable profits than did the landlord's straightforward 10% on total capital.

As a secondary valuation method the tenant's valuers adopted an Operators Appraisal method. Such approach mimics the reasoning adopted by a prospective tenant considering an opportunity to develop such pub restaurant available in the market. Such approach had been given credibility by the arbitrator in the case considered in the March 2005 article. A detailed consideration of this approach maybe found in the December 2003 edition.

The same sales, profits and development costs are used as for the profits method, however additionally an allowance is made for anticipated required future expenditure on periodic refurbishment. The rent is assessed by considering the residual sum remaining after allowing the tenant operator an appropriate market return on the investment required for such business endeavour and development.

The independent expert determinations

In the two cases recently concluded the first provided a rental valuation without reasons. The second however was required to provide a fully reasoned valuation.

The first determination was made on the profits method basis. The awarded figure was at circa 85% of the passing rent and equated to circa 11.4% of the Expert's adopted FMT.

The Expert in the second case was obliged to provide a reasoned determination. He was therefore initially faced with determining the appropriate valuation methodology applicable. The Expert turned to the RICS Valuation Information Paper No 2 quoting Sections 4.1 and 4.2 in full. He found that the subject premises were purpose built as a pub restaurant and were not readily adaptable for an alternative A1 use, either by reference to design or location within the immediate situation on the retail park.

The subject pub restaurant premises were distinguished from the rectangular box restaurant comparables submitted by the landlords, on the grounds of ease of adaptability to alternative A1 retail use. The rectangular box restaurants were considered to be far more readily adaptable than were the pub restaurants.

The Expert concluded the subject property should be valued on a profits basis. No mention was made by the Expert in this case of the tenant's operator's appraisal.

In arriving at an FMT for the subject property, the Expert agreed that the best place to start was with the actual trade performance figures. He did however recognise another operator may consider a different style of operation was appropriate. The Expert was not however persuaded by the landlord's arguments that the actual tenant was underperforming; finding the suggestion it was not a competent operator unsustainable. The Expert had previously secured the actual trading figures of a number of the pub restaurant comparables put forward by the tenant. The information

gleaned was used to consider total sales performance by reference to the net customer bar area, thus the adopted FMT was rationalised by reference to other similar pub restaurants.

In consideration of the comparable evidence the Expert did distinguish some by reference to the quite different geographical location and importantly by reference to differing overall size and physical design characteristics.

The Expert found there was potentially a difference in pub restaurant trading potential between predominantly retail park and predominantly leisure park locations. The latter he considered would enjoy a greater prevalence of evening custom by reference to likely synergies with the other leisure uses. The Expert however had insufficient information to develop this line of reasoning.

The Expert considered that the fast food category of restaurants was likely to have special appeal in retail park locations similar to that of the subject, but that such special appeal may not apply to traditional pub restaurants.

The Expert's profits valuation adopted an FMT 12.5% greater than that of the tenant but 19.1% less than that of the landlord. A net profit of 30% was applied similar to that of the tenant, less than that submitted by the landlord at 33%.

On the question of adjustments to account for the disregard of the tenant's fitting out works, the Expert accepted there was an argument in favour of adopting an annual equivalent deduction based on a dual rate Years Purchase, however he opted for a straight forward 10% of capital deduction, considering such original fit out was not exhausted at the end of the term and that the tenant enjoyed the protection of the Landlord and Tenant Act. No detailed explanation or justification for this approach was however provided by the Expert.

The resulting rent determination was for a figure marginally above the passing rent, that is resulting in less than half of 1% increase. The awarded figure was at circa 10.7% of the Expert's adopted FMT prior to an end adjustment specified in the lease.

CONCLUSIONS

The fundamental differences between the parties adopted positions in these cases arose from the primary valuation methodologies used and importantly the weight fairly attached to differing types of comparable evidence presented. Some involved very similar pub restaurants, some far smaller rectangular box design restaurants with different categories of likely occupier.

The outcome of these expert decisions indicates there is recognition of the differences between the rectangular box restaurant premises and the larger subject category of pub restaurants. There is in consequence a weakening of the weight of evidence derived from differing types and sizes of restaurant properties. The contractual right to use for an alternative restaurant type is insufficient on its own and there must be a real prospect of demand from this category of tenant to justify the giving of any weight to this type of comparable evidence. Of more significance

is the primacy given to use of the profits method of valuation applicable to the pub restaurant properties. This primacy of the profits method valuation is notwithstanding the shell condition assumption and location on retail or leisure parks. In each case despite the landlord's advisors fervent argument to the contrary, the experts opted for profits test method valuations.

These two recent expert determinations now add to the growing body of evidence for the shell condition pub restaurant category of property. The profits method has again prevailed and the justification for this has been closely examined and rationalised.

It is apparent from the research undertaken by the parties in these cases that there are virtually no lettings now occurring of pub restaurants on shell condition rack rental terms. Only one such letting was identified and there is an apparent unwillingness of many companies to now consider acquisitions of this nature. One possible conclusion is that the returns now demonstrated by the investments made in the late 1990s have simply failed to meet expectations. The results of rent reviews are thus the primary evidence currently available for other such rent reviews.

The fact that this form of licensed property development has not proved as successful as operators had hoped, coupled with the three third party decisions at 67%, 85% and 100.05% of the passing rents, is now having a follow on effect in rental negotiations for shell condition pub restaurants in general.

Nil increases have been agreed in respect of 2003/2004 reviews in at least seven cases for pub restaurants located as far a field as Kent, West Midlands, Leicestershire, Yorkshire and Lancashire. There is currently therefore no evidence of rent increases being successful negotiated for this category of pub restaurant property during the past two years.

The issue of appropriate adjustments to allow for tenant's fitting out works remains an area where the detailed rationale of approach has not yet been fully examined. There is however a gradual acceptance there is justification to amortise such capital expenditure over the length of the lease. The case of GREA Real Property Investments versus Williams (1979) considered among other things the disregard of tenant's improvements. This judgement found the tenant will consider such improvements a wasting asset and such works will remain for the benefit of the landlord at the end of the lease. It is reasonable to conclude the tenant will require to account for both the cost of the capital employed to carry out the improvement and the writing off of this investment over the contracted term.

This reasoning we maintain supports the use of adjustments calculated by reference to dual rate years purchase tables.

Some consider the possibility of renewal under the Landlord & Tenant Act (1954) security of tenure provisions should be accounted for in the duration adopted for such amortisation, although the '21 year rule' must be remembered. Countering this argument is the tenant's tendency to account for investments made only during the period of the actual lease term enjoyed.

Practitioners in this market sector will no doubt wish to consider carefully the developing body of evidence supporting the profits method

of valuation for use when assessing the rental value of pub restaurants, whether or not located on retail or leisure parks. In the second case outlined the tenants' valuer was successful in securing the Experts' additional determination on his costs resulting in 100% liability falling on the Landlord.

Those offering expert evidence to either Arbitrators or Independent Experts will now need to rationalise these recent expert decisions when making future submissions in rent review cases for this category and style of pub restaurant property.