

Quarterly Commentary

matters of importance for landlords of retail property

June 2009, 1

A rare opportunity for landlords

In the light of the credit-crunch, landlords have a rare, possibly unique, opportunity to determine the future of retailing, for good.

At work is a principle which strikes a chord at the heart of investment philosophy: whether landlords should be expected to help retailers that are in difficulties. I think not. For a start, the contention everyone is in the same boat does not hold water. Why is it assumed the recession is like some sort of natural disaster, like an earthquake or tsunami, which has come out of the blue? It is not: a recession is 'man'-made: at a macro level, it is a consequence of how the UK economy has been managed in relation to the whole and, at micro, how each individual business has been managed in relation to the economy.

It's easy to manage without coming unstuck in times of change - all you have to do is listen - so not getting the formula right is tantamount to gross negligence at the highest level. Furthermore, many retailers were struggling before recession arrived. It's also fascinating how many retailers think the world owes them a living. How fond they are of blaming rent, rates, the economy, the government, and so on, for their loss-making. The truth is a failure to address operational difficulties. It is not as though there is no money about. Turnover figures show how much is spent. Indeed, with balance-sheets hung up for all to see, it is interesting how many retailers are heavily indebted. In the aftermath of a booming economy, that few businesses have amassed cash makes one wonder where all the money went.

For an industry that relies on discretionary spending, you'd think prudence would be in abundance. But no. Megalomania and short-term thinking is rife. Generally, retailers don't care where the money comes from. So long as it does. As long as the business plan is approved by the bank and facilities can be renewed, as long as customers can be persuaded to spend more, as long as the lust for more shops can be satisfied, as long as landlords can be dumped or treated like any other supplier, that's all that matters.

A retailing business run on borrowed money can interfere with the law of balance. Opening more shops gives an impression of strong demand, thereby attracting competitors, which in turn puts more pressure on performance and, in effect, creating a vicious circle of rising costs. In 1985, I said "the cost of error is rapidly reaching the point whereby individual foresight will be crushed by the weight of uncontrollable dynamism. In the prime shop market, the corporate income of some retailers is inextricably bound up with the consumer's willingness to keep on spending on credit. It only needs a few months' lull for the structure to crack under the weight of operating costs."

Benefit of the doubt? Why if things are so bad are some retailers doing well then? Such retailers know what they are doing. So, what I suggest landlords should ask is - because the tenant has got into difficulty because of its own attitude - what's the benefit in helping it to survive when you have no control of its operation. A retailer saying it cannot afford to pay doesn't mean it can't. It may mean it doesn't want to have to cut other costs, or change its business style.

In reality, customers dictate terms and, in my opinion, this is no ordinary downturn. It's a shift to an entirely different set of values and way of doing business. Which is why, in my view, landlords should seize the opportunity either to get involved in the tenant's business and sort it out if they have the expertise, or get rid of all the duff retailers by insisting upon lease compliance and re-let the shops, even if that would mean lower rents, to those that understand how to manage a retailer for long-term consistent success.

As I said in 1986, "If landlords and tenants were willing to work together to maximise the profitability of the tenant's business, then that in turn would maintain the growth of the landlord's investment."

I look forward to helping you in some way

Rent review in the prevailing climate

On 21 May 2009, I gave a talk entitled "Rent Review in the prevailing climate" at an event organised by 3CPD, a registered charity for continuing professional development for surveyors, in Berkshire, Buckinghamshire, and Oxfordshire. If you would like a transcript, you can download it from my blog, at <http://michaellever.typepad.com/> but here I shall explore in more detail my approach to rent review, when I am acting for the landlord.

In my opinion, there is no difference for purpose of rent review between the prevailing climate and any other climate. If it is implied the credit-crunch and recession should be taken into account by way of some concession, then the stages at which those factors should be considered are either *before* the review is operated, or *after* the review has been agreed or determined, when it is known for certain how much is actually involved. If those factors are introduced as negotiations progress, then there is the risk of letting rents run wild which, from the point of view of the client may be acceptable, but which from the point of view of the market as a whole may not be a good idea, since it presupposes the existing rent is correct.

Generally, a surveyor's approach to review to market rent has regard to the evidence. In the prevailing climate, where lettings may be few and far between, and when, thanks to accommodating or fearful landlords, many tenants are on concession rents, one question is where is the evidence?

The general rule is that evidence of events taking place after the review date is inadmissible. But, evidence as to rents agreed after the relevant date is admissible. Events after the review date could not have been known at the time of the review.

In practice, evidence is not limited to actual agreements, but also extends to the surveyor's opinion. Even if there were not a lack of evidence, a surveyor's

opinion counts - business tenancy law prefers a surveyor's opinion to that of a tenant or landlord - so when there is a lack, such opinions must be neutral, otherwise any bias could influence the outcome of the review. That is why it is essential for a surveyor, whether or not acting as expert witness, to be unemotional and impartial. The test of (professional) integrity is the test of objectivity: would it be the same opinion whether representing the actual landlord or actual tenant?

Bias enters when, at rent review, before dispute resolution is initiated, negotiations are subjective. As surveyors, we represent the client, including the client's business trading style, even though that style might be outmoded. Therefore, any review agreed, without referral, could be assumed as possibly more or probably *less* than market rent. So, when the evidence comes from negotiated settlements, I think it more likely such evidence is out of kilter with the market rent. ***Which gives rise to thinking that, when tenants get away with paying less rent than they could afford, the saving feeds their business plan and 'living the life of Riley' at the expense of landlords. Which, now the future is no longer as bright or orange, gives rise to thinking why should landlords now be expected to subsidise tenants yet again?***

To ensure neutrality, it is vital to rationally acknowledge and emotionally accept 3 points: first, the market doesn't care about the consequences for any of its participants. The only reason a market exists is for transaction and the only reason people transact is to satisfy their respective needs. Although, basically, everyone has the same needs, timing of satisfaction varies depending on the individual. In other words, who is in the market at any point in time .

The second point, which is fundamental to rent review, is the assumption of a letting of the premises by a hypothetical willing landlord to a hypothetical willing

tenant; and, within the definition, the hypothetical parties are not affected by liquidity problems. In other words, regardless of what the landlord could afford to accept, or the tenant afford to pay, the market rent is paramount.

The third point to accept is that rent is a product of all the terms and conditions upon which the premises are let. Rent cannot exist independently, as in 'this is the rent for the premises' or the 'rent £psf or £psm'. Without knowing or stating or defining how that figure has been arrived at, it should not be assumed the market would accept the same criteria. So, although in the hierarchy, a new letting is considered best evidence, care must be adopted, because 'heads of terms' are in place before the wording of the lease is finalised. On completion of the lease, the test of efficacy is whether if there were a rent review on the same day as commencement of the term the rent would still then be the same.

The money has to come from somewhere so, since negotiations are, for the most part, subjective, one way it is extracted out of landlords is opinion concerning the evidence. In my experience, differences in opinion as to the relevance of evidence depend very much on a propaganda tendency amongst surveyors to reason a difference between evidence involving surveyor-represented parties and the unrepresented. It suggests evidence involving the represented is more reliable. In my opinion, there is no difference. With a new letting, it is not necessary for either landlord or tenant to employ a surveyor. At review, unrepresented landlords and/or tenants may be unfamiliar with the process but, unless caught by a time-of-the-essence notice, the tenant is not going to agree a rent it cannot afford and which in the market it would not pay. An agreement by an inexperienced tenant is as valid as any hard bargain by a large company with expertise. Whether a rent is based on affordability or in accordance with the lease, I do not think one should distinguish as if the market should be controlled by surveyors.

The market is not controlled by surveyors. As surveyors, we interpret what is happening and do what we

To the question whether better to invest in shop property direct, or via a property fund, or buy shares in a property company on the Stock Market, the answer is be very careful.

With shares you are not only buying a share of the property the company owns, but also the ability of the company to manage itself successfully. For example, although I have always admired its choice of property, I think how Land Securities is managed leaves a lot to be desired. Anyone with any experience of the incumbent government would know that Gordon Brown when he was Chancellor of the Exchequer never gave anything away. Also his timing was exquisite: invariably introducing measures when the impact would be least expected. It needed a while for the REIT framework to be worked out, but to time the introduction shortly before values collapsed meant that had LS not been in such a hurry to become a REIT it would not have had to pay anything like £300M in tax.

Then there were share-buy backs: at £17-£18 or so, what was that all about? Why waste cash buying hot air when it was obvious the NAV was based on yield compression?

As for Trillium, yes it was capital intensive, but why accept so much less than floating it separately? Surely everyone knows the William Pears Group are only likely to buy when they expect a jolly good return on capital. As for the 2009 rights issue,

Money Down The Drain

Investment Appraisal



deeply discounted, the amount raised is almost equal to how much LS has 'lost' in recent years. As for British Land, well what do you expect when the old-guard property expertise retires from the board and bankers are in charge!

The definition of a property fund is, in my opinion, the answer to the question where to sell the sort of property for which no one in their right mind would overpay. A product of the financial services industry, and source of revenue, a property fund is a means of using logic to make money out of the naive.

In 1984, (as I say in my forthcoming collection of newsletters: 1984 to 2005), Hugh Jenkins of the National Coal Board Pension Fund said of chartered surveyors "(they) will be continue to be regarded with cynicism, so far as their professional capabilities are concerned, as long as they cling to gut feeling about growth prospects without being able to back them up with fundamental

research." Hang on a minute: whose money is being invested? Okay, research minimises risk in the *hope* that, while short term deals may be lost, the long term *might* bring substantial reward. But limitations imposed by research create problems. It is a feature of professionalism that the combination of knowledge and experience clashes with logic, except in cases of absolute certainty. If you *have* to invest, then you are going to become increasingly frustrated if your adviser's research tells you not to buy, when all about you, others are busy spending and getting all the kudos and excitement, That does not make the advice wrong, since investment is a waiting game (which means it's very boring), but it does nothing for the sale of lucrative financial products, which is why funds overpay. In 1984, when I suggested the modern concept of professionalism removes initiative, several advisers on motivation and corporate strategy agreed with me. Gut-feeling is an essential ingredient in the evaluation of research. You can only draw conclusions from information if you can adopt a broad view. It is not the result of research which provides a span of information, but the questions gut-feeling invite you to ask. Such as why buy when the experienced are selling!

As for buying shop property direct - yes, but only if you know what you are doing! So, to help you make sure, I am compiling the ML Guide to Investment in Shop Property.

can to apply that for the benefit of our clients. If we were to seek to control rents, then there is the likelihood prejudices and inclinations as to what might be regarded fair and reasonable would impose. If that were the case, then we should miss the point the attraction of the market is its indifference. In other words, landlords and tenants come and go, but the property itself remains.

In the prevailing climate, there are innumerable surveyors that, for one reason or another, perhaps affected by the credit-crunch, or with a social agenda, that are into subjectivity in

a big way: and, when appointed as independent expert or arbitrator, imposing the opinion that anything that can be done to help the actual tenant to survive should be done. Even though that is contrary to the market.

Convention can preserves the status quo and protects the actual landlord or the tenant from reality, but esoteric thinking is often at the forefront of change. So, when surveyors complain about lack of evidence, what they are really saying is they are reluctant to give an opinion of rent without reassurance of what other landlords and

tenants have agreed, and even then the agreements must be reliable, based on the surveyor's definition. Essentially, that is a negative approach to valuation. But, valuation is neither logical nor an exact science, it is also an art and were it not for an overwhelming tendency for surveyors to require tangible evidence before expressing an opinion, the art of the positive approach would flourish.

And if that were to happen, not only would rents in the market be allowed to run wild, but also balance and harmony would be restored to the relationship between landlord and tenant.

Landlords losing out at rent review

Having negotiated some 250 rent reviews for Ladbrokes during the past few years, I have a pretty good idea how a large company can get away with paying less than market rent.

And that's not just because I was acting for them! (Incidentally, I do not want to act for them again, so am available to act for its landlords.)

Leasing hundreds or thousands of shops does not necessarily generate more profit - Ladbrokes, for example, runs on wishful thinking: net profit 2008 £243.8M, some £100M less than 2007, total liabilities, before shareholder equity, exceed assets by some £300M, net debt £987M, up by £70M, interest rate blend 6% - but it does increase property costs. And it means hundreds of landlords, so how negotiations are conducted will vary.

Off-pitch and local shops are likely to be owned by private investors, but increasingly in prime positions too. For many, how to get the full rent at review is a steep-learning curve. To an experienced retailer, particularly with an in-house property department, exaggerated proposals cut no ice. Unlike a local shopkeeper, for whom a review may only be once in a while, and for whom an exaggerated proposal can send shivers of fear down the spine, a large retailer will merely reject the proposal and/or require evidence. To an unrepresented and/or inexperienced landlord, any refusal by a multiple retailer to barter presents a dilemma. Because the proposal was only exaggerated so as to reach agreement, the landlord can be at a loss about what to do next, for the best.

For example, a few months ago, a private investor enquired about my services in relation to a property where the multiple retailer tenant's chartered surveyors had responded to his proposal by saying that, in their opinion, there

was no justification for any increase and asking him to sign an enclosed memorandum. Since that is a ploy I have used successfully on numerous occasions, I told him the response was an opening

gambit. The investor was not convinced. He felt that chartered surveyors would not express such opinion if it were not true, so concluded it would best to agree.

Another ploy is to initiate the dispute resolution procedure. When the landlord does not want to incur any extra costs, the review would be agreed at no increase. By not exploring the possibilities, the landlord may have to wait years for another opportunity.

Not appreciating the implications of the review guidelines in the lease is another way to lose out. In one instance, where on the face of it no increase was certain, the landlord's surveyor spotted the 21 year exemption for disregarding the tenant's improvements had expired, which meant my client-tenant would have had to pay the extra rent, had it not been for the landlord's decision to sell the investment at auction with the review outstanding. The property was bought by solicitors for a pension fund. The previous landlord's surveyor was not re-instructed, so I was able to convince the new landlord to agree no increase. Daft: they could've got another £5000 a year.

Another ploy is to query the valuation areas even though the tenant or its surveyor has not measured the premises. By reducing the area by compromise the rent can be reduced as well.

Since the cost of referral can mount up, some tenants, that are emphatic the rent should not increase, will offer to pay an extra £500 a year to get the matter settled. Again, it sounds plausible.

In the prevailing climate, it is all too easy for landlords to be fearful and accommodating but, because there is often scope for rent increase, in my opinion, discretion should be exercised *after* the review has been agreed or determined.

Otherwise, not operating the review is likely to be taken advantage of by large companies and their cunning surveyors.



Next time you are on the Internet, please visit www.michaellever.co.uk

I specialise in negotiating rent reviews and business tenancy advice for landlord and retailers.

I am also a healer and whereas that might be regarded a separate vocation I use it for negotiating psychology, and when 'going to arbitration', and for document advice and investment appraisal, such as spotting problems in the making long before they arise.

My fee for negotiating rent reviews is in keeping with the times. For example, for landlords, I do not charge any extra if the matter has to go to arbitration.

At www.photoshopfront.org you will find a gallery of photographs of types of properties I deal with.

On my blog at www.michaellever.co.uk you will find comment, news and case histories. To keep in touch, please click the RSS feed and add the link to your bookmarks.

My fee revenue for my financial year to 31 May 2009 exceeded my target by about 10%. To complement my services, I have launched some new initiatives.

I am compiling a series of ML Guides on rent review and shop investment, and which can be downloaded free from my web site. I hope you will find the information useful.

To avoid "you are" as the answer to the question: "borrow at 3-5%, buy at 8%+, what's the catch?", I am creating an on-line resource with advice and information for landlords and investors in shop property in England and Wales, at www.shopinvestment.co.uk

In short, the benefit in my services is access to unusual skills, which will contribute far more than most towards maintaining and increasing the value of your property.

Thank you.

Michael Lever