



MICHAEL LEVER

RENT REVIEW FOR RETAILERS

“Autumn leaves
another year ahead.”

ML GUIDE - RENT REVIEW FOR RETAILERS

INTRODUCTION

I have written this ML Guide for tenants of shops, but the principles apply to all types of business premises, such as offices, factories and warehouses, leisure property, and so on.

Business tenancy rent review law does not, however, apply to agricultural tenancies, residential lettings (where the letting is not separate from the business premises - for example, a shop with a residential flat included in the shop tenancy would be under business tenancy law for the whole of the property, but not in respect of the flat only), fishing and mineral rights, licences, [provided they are not tenancies - simply calling a document a licence doesn't mean it necessarily is one], and tenancies-at-will.

I hope you will enjoy reading and find the information useful. If you have any questions, or need more explanation, then please contact me.

PLEASE NOTE

All the information and comment in this ML Guide is for general information and assistance only and is not intended a substitute for specific advice. Also, all the information is believed accurate in May 2009 and relates to the law in England and Wales only.

MICHAEL LEVER

The Rent Review Specialist
Established 1975

help@michaellever.co.uk

www.michaellever.co.uk

1.0 RENT REVIEW FOR RETAILERS

1.1 With a new letting, when the landlord offers premises to let in the open market, the rent the tenant agrees is likely to be whatever the tenant can afford, based on the tenant's projected figures. As soon as the lease is completed, affordability and business tenancy law part company. The object of a rent review is to enable the landlord to revise the rent payable to the market rent (assuming the lease says the market rent). Although each letting reflects each particular retailer's subjective requirements, business tenancy law assumes the actual tenant can afford the same, pro-rata, as everyone else. Also, because rent is payable regardless of the profitability of the business, it is assumed the tenant is of independent financial means, despite most tenants relying almost entirely on cash-flow (including borrowing) to pay. It is also assumed the tenant is not affected by liquidity problems.

1.2 The market is a community of retailers, but many retailers operate in splendid isolation, different landlords may own the shops, tenancies often last for years, and lettings happen randomly, with shops to let in the locality often in short supply, so rents will vary according to demand for size of premises and/or the trading position. To gauge supply and demand, when considering the state of the market, surveyors make a distinction between shops that are available because landlords are offering them to let, and shop leases on the market because tenants want to assign or sub-let.

1.3 At rent review, because you have the lease, the landlord cannot offer your shop to other tenants, so the lease contains guidelines for calculating the rent as if the premises were available to let. In other words, the valuation approach is objective: the actual tenant's ability to afford the rent is ignored, along with the actual landlord's expectations. (Of course, affordability doesn't mean you couldn't afford it, but that's no reason to agree what the landlord is asking or would accept.)

1.3.1 Instead, and unless the lease states otherwise, the approach calculates the rental value as if the demised premises were to be let in the market by a hypothetical willing landlord to a hypothetical willing tenant, for a term on lease containing conditions that are specified in the review guidelines, and with all matters to be taken into account subject to shop rental valuation and business tenancy law.

1.4 All leases contain guidelines for the review, such as whether notices are required, how they must be worded and when they must be given, how much time is allowed for negotiation, what happens if the parties cannot agree, how the revised rent is to be documented, when the revised rent is due and if interest is payable.

1.5 However, because there is no standard lease in use generally – also, leasing conditions are fashionable, but generally a term lasts for years, (a good idea long ago may not be such a good idea now) - guidelines may be detailed or ambiguous, depending on the lease. Their commercial value depends on what else is in the lease, and part of my job is to consider whether, compared with what would be expected in a lease in the market, there are any disadvantages in your lease that could be used successfully to justify a lower rent.

1.6 A business tenancy is a commercial contract, so all parties are deemed to know what they are doing. There is some legislation, but business tenancy law mostly comprises thousands of Court cases, each decision a precedent. (In my law library, I keep law reports on thousands of judgments, with articles on strategy.)

1.7 Except for compliance with business tenancy law, there is no set formula or logic for what the rent must be. Supply and demand is forever changing, and what with thousands of landlords and tenants, every single lease different, and rental agreements for all manner of reasons, the market is in a constant state of flux. So, as well as all the subjective factors that affect the running of your business, including the sector in which it operates and the intensity of competition, it is of no help to have to accept the rent review will be agreed – or, to resolve a dispute, fixed by someone with no vested interest in the consequences - not based upon what you can afford, but upon the opinions of surveyors. Especially since there is a feeling amongst many retailers that surveyors are inclined to favour the landlord.

1.7.1 Although surveyors are on the side of those for whom they are acting at the time, that many surveyors are themselves landlords and/or also act for landlords more often than tenants, may make some succumb to what is known as “unconscious bias”. (I am not a landlord myself.)

2.0 SHOP MEASUREMENT

2.1 Very large shops, stores and purpose-built supermarkets, may be valued on an overall basis but, with the majority of shops, the total ground floor area is divided into zones, with each zone allocated a capital letter, such as Zone A, Zone B, and so on. Zoning is simply a method of comparing shops of different layouts, configuration, shapes and sizes with one another, in order to arrive at a common denominator.

2.2 Zone A is the most valuable, (because it is at the front of the shop) and each subsequent zone halved-back, but the fraction is a matter of surveyor opinion, so, for example, part of Zone A might be A/2, Zone C could be A/6, or Zone D might be A/10, etc. Basement storage might be valued at A/10, first floor sales A/10 and storage A/12-A/25. For arithmetical ease, the net area of each zone is expressed as a single figure, known as the area in terms of Zone A, or ITZA for short.

2.3 Usually, each zone is 20' (6.1m) deep, but depths vary in some towns and streets – for example, 15' (4.57m), 25' (7.62m), 30' (9.14m). Normally, measurements are taken from the building line to built depth, ignoring shop fittings, wall linings and non-structural partitions, but allowing for piers, columns, and structural walls. (Where the shop window is set back from the building line, the assumption is it could be brought forward, unless obviously not.)

2.4 Normally, ground floor space, unusable for sales, is regarded as ancillary. Basements and upper floors are normally measured overall and valued on actual or potential use, depending upon physical layout and the provisions of the lease.

2.4.1 Residential accommodation is valued on its merits, usually by reference to the number of habitable rooms, rather than the floor area itself.

3.0 RENTAL VALUE

3.1 Rent review is about relating to premises to the comparable evidence: the rent of your premises will be based on what other tenants are paying for their shops at or around about the same time as your review date.

3.2 In the hierarchy of evidence, best evidence is an open market letting, then rent review, then lease renewal. What is known as “reliable evidence” may be hard to come by. Reliable evidence is generally considered to be the product of both landlord and tenant each represented by experienced surveyors, and better still, independent expert determination. Apart from the fact agreements between landlords and tenants are confidential, it is not compulsory to be helpful and many landlords and tenants do not want to get involved. Even so, many transactions are publicised in the media, landlords thrive on confidential information and surveyors and retailers tend to help one another, so evidence is available to professional participants.

3.2.1 Some surveyors consider open market lettings to a tenant that is not represented by a surveyor (where the tenant is not a multiple retailer) as unreliable evidence, but that is only opinion and may carry little or no weight. It is not compulsory for a tenant to involve a surveyor when agreeing a rent. Rents awarded at arbitration are not regarded as evidence of open market, because the award depends upon the evidence presented to the arbitrator at the time.

3.3 Regardless of the evidence, the open market for the actual premises is not being tested, because a new lease from the landlord is not available. To quote from *Wallshire Ltd v Aarons* [1988], a case involving comparable evidence, “second best are rent reviews which are negotiated between valuers, because although their aim is to achieve the same end-result of deciding what the market rent is, their decision is not tested by the market; their decision, their agreement, is based on their conclusions about what the market would decide. Negotiated settlements therefore can be unreliable because of the possibility of error piled on error. They need . . . an occasional window of reality provided by open market decisions”.

3.4 To devalue the comparable evidence, and for ease of arithmetic, actual rents are converted into what is known as the Zone-A rent: for example Zone-A £50. The Zone-A rent is the agreed rent net of any adjustments pertaining to the comparable, divided by ITZA.

3.5 To calculate the rent for your shop, the agreed ITZA for your shop is multiplied by the Zone-A rent. However, although each rent is often agreed on the back of another agreement, every lease is different so each situation can involve a different set of circumstances and different approach to negotiations. An agreed rent may have a hidden story attached, so often it is impossible to get at the facts but, in any event, it may be beneficial to apply another interpretation. The point is valuation is an art, not an exact science, and devaluation is a matter of opinion, so I consider each piece of evidence on its merits.

3.6 With residential accommodation, perhaps behind the shop or more commonly a flat or flats on upper floors above, the standard approach is to estimate the rent as if the flat(s) were let on an assured shorthold tenancy ("AST") and make an allowance for management, etc. Many years ago, the Estates Gazette, which is the leading property magazine, published an article by a surveyor on how flats above shops should be valued at rent review. Although the article was fairly comprehensive, what the surveyor overlooked is that when the review guideline assumption is of a letting of the premises with vacant possession (as is the normal case) the flat would have to be in a much better state overall than the lease would necessarily require. In other words, the overall state would have to be a standard commensurate with a tenant's expectations. On numerous occasions, I have successfully reasoned the point at 'arbitration' and obtained a lower rent as a result.

3.7 Where part of the premises are sub-let on a business tenancy, an allowance may often be obtained for the management costs. In other words, just because you are getting say £5000 a year from the sub-tenant does not mean the full amount would be payable at the rent review.

4.0 PSYCHOLOGY

4.1 Whilst there is no right or wrong way to negotiate a rent review, credibility is important, so regard must be had for shop rental valuation practice and business tenancy law. The main differences between negotiating a rent review and other types of negotiation is that compromise may not be such a good idea, and the landlord may not care about your particular situation and circumstances as much as you might think or want them to.

4.2 The landlord and tenant relationship hinges on a legally binding document and rent review is a tenancy management function. Rent review is not about what you would accept if you were your landlord. You are not, and in business tenancy law "it is not good for a tenant to say what is good for a landlord".

4.3 Landlord attitudes fall into two categories: some after every penny they can get, others more accommodating. Those after every penny are usually indifferent to the wider consequences for your business, so letting off steam will cut no ice. Others may not be as tough or demanding, but that doesn't mean they have to be generous. There is no entitlement to any 'sitting-tenant' discount, so whereas I would use my skills to try to beat the going rate, fact is if the evidence stacks up, then it cannot be argued with.

4.4 Since any increase in rent will affect your business profitability, and if you cannot afford to accept a recommendation, I appreciate it is difficult to emotionally detach from the decision as to rent it is recommended to agree, simply because it is your business that will have to find the money. You may wonder why you should have to fall into line with an open market letting that may, for example, be to a larger company perhaps in competition with you, or a (new) business that, in your opinion, won't last, but many landlords and their surveyors are against letting rents run wild, so whether the landlord wants to be lenient will depend on the particular landlord. As I said above, one cannot argue with the evidence.

4.5 It is important to accept the distinction between the rent another landlord nearby might charge or another tenant might be paying, and the market rent. Different landlords and different tenants think differently. For whatever reason another landlord is not charging as much as it could, or a nearby tenant paying a lot less, that does not mean your landlord has to accept the same Zone-A value. Although such evidence might support a lower rent for your shop, to 'go to arbitration' may be risky, because the overriding factor is not what someone else has agreed for different premises, but what your premises on your lease would let for in the market.

4.6 Whilst you may think the landlord's proposal contains a margin for negotiation, in business tenancy law, a landlord is not obliged to propose a rent that is calculated strictly in accordance with the review guidelines. So the risk of 'going to arbitration' is that market rent would be determined, regardless of the landlord's original proposal, or any lower amount the landlord might have accepted beforehand. In other words, using dispute resolution procedure in the hope of obtaining a lower rent than the landlord would have agreed can backfire.

5.0 'GOING TO ARBITRATION'

5.1 Leases contain procedures for resolving disputes, involving referral to an arbitrator or independent expert. (There are important differences but to explain them is outside the scope of this ML Guide.) In this ML Guide, I use the term 'arbitration' loosely.

5.2 The lease will enable either landlord or tenant, or both, to refer the matter to 'arbitration' and sometimes it can pay the tenant to force the pace. In general, tenants for whom a rent review is a one-in-a-while experience (also a steep learning curve) are less likely to appreciate the advantages of a pro-active approach without guidance, and, even then, reluctant to make the first move because of the extra costs involved.

5.3 The review guidelines normally allow time for the parties to reach agreement, before the right to refer to 'arbitration'. If, for whatever reason, negotiations take longer than the allotted time, then it is nothing personal when the review is referred to 'arbitration', because that does not prevent negotiations continuing in tandem with the application. Often, referral is used as a negotiating ploy. Also, when the 'arbitrator' is appointed, it is often possible to arrange for the 'arbitrator' to not take any action for the time being, so as to allow the parties more time to agree between themselves, if possible.

5.4 Whether you really understood what you were signing, it is not my task to protect you from what you agreed when you took on the lease, although I shall do my best to minimise extra expense. Although you may regard 'arbitration' as a last resort, I suggest it would be better to think of referral as a tactic for obtaining agreement, and not that the landlord does not want to negotiate. Indeed, I may recommend or welcome referral because, although the landlord might envisage putting me, or you, under pressure to make a decision, the 'arbitrator' may take charge of the situation, which would mean the landlord losing control.

5.5 In addition to an application fee, currently £333 inclusive of VAT, payable to the Royal Institution of Chartered Surveyors (RICS) for administering the referral appointment, as soon as application is made, tenant and landlord can become liable for extra costs, even though the matter might be agreed without the 'arbitrator' doing much or anything. So, since a negotiated settlement before 'arbitration' is often a package deal, I may have to recommend you pay all or something towards the extra costs as part of the agreement.

5.6 Avoiding extra costs is not always possible, particularly since there is a limit to how much pressure can be put on the landlord or its surveyor for constructive dialogue. Therefore, in consequence of the market practice, negotiating strategy and 'arbitrator' attitudes towards charging, extra costs may be incurred even if proceedings do not actually go all the way. No tenant wants unnecessary expense, but the view my regular clients adopt is that, since much can be at stake and, as is common in review negotiations better results are often obtained at the 11th hour, any extra costs can be regarded as money well-spent.

5.7 When the tenant is a limited company, a separate legal entity, directors have a duty to minimise risk and not lumber it with a rent the market would not pay. Even if the lease is in your personal name, or with others, and if it is intended to assign the lease after the review, then it would be important to consider the effect of the Authorised Guarantee Agreement, whereby the tenant remains liable for the rent should its first assignee default. Also, with 'upward-only' reviews, (which I explain below) the rent from the review would stay at least the same at each subsequent review throughout the remaining term of lease, which could prejudice marketability of the lease and affect sale of the business as a going concern if in future the premises become over-rented. Therefore, the estimated costs of 'going to arbitration' should be divided not only by the number of years before the next review, but also by the number of years until the expiry of the lease, so as to ascertain the overall benefit.

5.8 Normally, (subject to what the lease says), an increase is backdated to the review date, regardless of when the new rent is agreed or ascertained; and sometimes interest payable at the prescribed rate in the lease, on the difference between old and new rent.

6.0 UPWARD-ONLY RENT REVIEWS

6.1 Many leases contain what are known as 'upward only' rent review clauses. That does not mean the rent must go up at each review, only that the rent payable cannot be below the rent passing before the review date.

6.2 When, on the evidence, the market rent is lower than the passing rent, as does happen, or when the market rent is not high enough to justify the expense of the review, landlords will often take no action to operate the review. For the tenant, an outstanding review can cause problems, because it gives the landlord an opportunity to take advantage if the tenant should want anything involving the lease. Also, an outstanding review leaves the tenant in a state of uncertainty as to the correct rent for the period and that is a business risk.

6.3 Another problem with an outstanding review is that, whereas there may be no evidence at the time to justify an increase, post-review evidence (after the date of review) can be used to demonstrate increase; and if the investment is sold, then it is common for the new landlord to implement outstanding reviews. Post-review evidence is normally adjusted for difference in time, but rents do not increase in a linear way, so it doesn't follow that just because, for example, a year or so later the evidence would support a higher rent, the rent of your premises would necessarily have increased had the evidence been available at the time.

6.3.1 Although post-review comparable evidence is admissible, post-review events are not. The point is that events after the review date could not have influenced the parties at the review date, because at the review date such events had not emerged or occurred.

6.4 To be on the safe side, outstanding reviews should be documented at nil increase and if the landlord will not cooperate and complete a memorandum, then the tenant should either refer the review to 'arbitration' if the lease permits (with a Calderbank offer to protect costs), or serve notice obliging the landlord to implement the review or lose the right to do so.

6.4.1 A Calderbank is a 'without prejudice' offer in writing to settle the rent by a specified time and date, which if not accepted in time could give rise to the other party becoming responsible for all costs and possibly surveyor fees if the outcome of a referral to 'arbitration' is at a rent equal to or less than the offer.

6.5 Strictly, all rent reviews are upward or downward, because a review to market rent is simply that. The 'upward-only' aspect only applies after the market rent has been agreed or set, so another reason a landlord can be reluctant to action a review is to avoid having the market rent 'quantified', in case that could reduce the investment value and possibly breach a loan covenant. By forcing the review, a tenant may be able to strike a deal with the landlord whereby, in exchange for documenting the review at 'nil increase' rather than the market rent, the tenant may be able to obtain a reduction in the actual rent payable.

7.0 CONCLUSION

7.1 Although shop rental valuation and business tenancy law work both ways, the system is often loaded in favour of the landlord. It is the landlord's property; and the tenant has security in not having to relocate frequently, vital when it takes time to establish a profitable business. But, in exchange for rent throughout the lease, the landlord is also spared the cost of re-letting frequently, not to mention empty property rates.

7.2 To an extent, such benefits are implied in a likelihood of settling at less than market rent through amicable agreement. Problems arise when the tenant's business plan loses its way (encountering operational difficulties), and/or when the rent at review is uneconomical. Landlords can be shortsighted, or cannot afford otherwise, so tenant resistance to what the landlord wants is met by referral to 'arbitration', whereby the system kicks in and review guidelines are stuck to, regardless.

7.3 Because the knock-on effect of rental increases elsewhere can drive away from the trading position those retailers whose presence was the main attraction for the tenant wanting to open up there in the first place, an inflexible approach to premises management can mean the tenant becoming caught in a vicious circle of rising rents and a trading position in decline.

7.4 It is not only landlords that can hit hard; a new shopping centre and/or big retailers, including supermarkets, opening in or out of town, can also radically alter the dynamics. In any event, to pay less than the going rate is to enjoy a competitive edge so, as far as possible, I aim to achieve that for you.

8.0 WHEN YOU INSTRUCT MICHAEL LEVER

8.1 In 1975, I pioneered the idea of specialising in negotiating rent reviews. Nowadays, many of my ideas pervade popular thinking. Apart from considerable expertise, you will have access to my experience, which, spanning more than 30 years, handling rent reviews for landlords and retailers, large and small, and dealing with properties from those in 100% prime trading positions in city centres to local shops in back-streets, will serve you extremely well.

8.2 Because I specialise, my fees are generally considered excellent value for money and, unlike most surveyors, I do not charge extra if a review has to go to 'arbitration'.

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