

Response to BIS Consultation on Pub Companies and Tenants

From

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Introduction and CV

My name is Howard Day.

I am a Chartered Surveyor who qualified in 1986 and I have specialised in the leisure property sector since the early 1990s.

This response to the BIS Consultation is submitted in a personal capacity and not as part of any particular organisation although I am Director - Leisure at Harper Dennis Hobbs and a member of several professional bodies.

My experience of licensed property is reflected in the fact that I am on the PIRRS Panel of Independent Experts. I am also an arbitrator and mediator. I therefore have experience of valuation and dispute resolution issues in the pub sector.

I am an accredited Expert through the Academy of Experts. In the pub sector, I was the Expert Witness covering valuation issues for the claimant in the high profile case of *Crehan v Inntrepreneur Pub Company and Another* [2003] EWHC 1510 which dealt with the issue of the tie under European Competition Law. The case went onto the Court of Appeal and the House of Lords.

Although, in this high profile case, I was Expert Witness for a tied tenant, as an experienced valuer in the pub sector I have acted for landlords and tenants. For many years I acted for a small plc Pubco as their property adviser and acted for them where they were landlords of tied tenants and also where they were tied tenants of other PubCos.

A lot of my work nowadays is as an appointed third party dispute resolver (arbitrator, independent expert or mediator) and as a dispute resolver I have an eye for seeing opportunities to reduce the costs of disputes.

I hope that some key points contained in this response are taken into account as I am keen that there are no unintended consequences from a Statutory Code.

The subjects I cover are as follows:-

1. Valuation Methodology.
2. The hypothetical landlord at the rental valuation date.
3. Dispute Resolution.

I reference the questions that are relevant to my comments in square brackets and bold [e.g. Q.2]

Where I feel I am able to directly answer questions set in the consultation document, I do so.

At the end, I summarise the possible unintended consequences which flow from these topics.

1. Valuation Methodology

I appreciate the intention of the shadow "profit and loss" calculations on a tied and free of tie basis as shown in the Sample Rent Assessment Statement. (Ref: Annex A). Valuation, however, is a combination of an art and a science and should not be constrained purely by rigid mathematical models. [Q9]

In High Street locations where there are sufficient comparables of similar units, a rent per square foot basis of rental valuation can be applied. In locations where this is not possible and/or premises are on tied leases (and to be valued on a fitted basis), the profits method of valuation is applied as no alternative valuation methodology for trading entities with individual characteristics has been created or widely accepted.

The profits method of valuation can be criticised for its subjectivity and the different number of variables in the calculations can produce diverse end figures which are then presented as opinions of rental value.

The strength of the profits method of valuation is that, where it is applied by experienced valuers in a fair minded way, it can produce a rental figure which applies a rent on an individual trading entity which reflects the position of that pub in the market.

The weakness of the profits method of valuation is that changes made to the many component parts, backed by plausible reasoning or not, can result create either an excessively high or low end result.

Valuers should therefore consider any available significant comparable evidence and "stand back and look" at the market before committing to a valuation figure.

Rigidly keeping ratios between tied and free of tie rents may not allow that to happen.

The market for free or tied pubs and the market for tied pubs can be seen as two sub-markets. The rents achievable depend on supply and demand at any one time in a particular area. That means where a free of tie opportunity is offered in an area where free of tie opportunities are rare and there is high demand, a high rent can be achieved. Conversely, where a particularly good property is offered on a tied basis in a strong trading area with high demand but short supply it is conceivable that the rental bid for the tied lease could be at a lesser differential to the free of tie rents in the area.

Valuation should reflect the market as outlined in the previous paragraph and the rigid adoption of mathematical spreadsheets may mask a more logical outcome.

In the example given at Annex A of the consultation document, the volumes pricing and turnover figures are assumed to stay the same for free of tie and tied models in the same pub. This is unlikely. A guest beer option and different levels of barrelage discounts also makes this more complex.

The one area which must be approached with particular caution is the standard adoption of a 50/50 split of the divisible balance.

It is quite often the case that the tenant's rental bid for a tied lease can be taken at less than 50% and tenant's rental bids for free of tie properties can be in excess of 50% of the divisible balance.

Also when considering the Sample Rent Assessment Statement in Annex A, please note that it is normal for bank charges and depreciation to be incorporated in a line for tenant's capital which annualises the capital cost of fixtures and fittings, holding two weeks stock and also working capital.

The capital cost of any tenant's improvements to be disregarded should also be reflected, if undertaking a "top down" calculation (reflecting the property with the improvements), although a "bottom up" calculation (assuming the property with no tenant's improvements) can ignore this. There should be line in the template thereby raising the question if there are any tenant's improvements to be disregarded and prompting those who may be unaware that authorised tenant's improvements are usually disregarded.

Another observation is that if there are SCORFA items which have an annualised value and they save some operating costs to the tied tenant, I would prefer to see it expressed that way rather than the sample showing that the absence of SCORFA is an additional burden to the free of tie tenant. This is as the operating costs of the free of tie tenant should already cover everything necessary to run the outlet to the FMT level.

Finally on the sample in Annex A, I am not sure why a figure has not been inserted in the machine income row for the free of tie option and I do not understand why a manager's salary item is hanging below the Net Post Rent Balance line.

I now wish to comment on the transition from tied to free of tie which the consultation document suggests is to be assessed in line with the Sample Rent Assessment Statement. If this became the adopted approach and methodology then it would, I assume, also be applied if tenants had a free of tie option.

At the current time, a lot of tied pub leases give the landlord the option to release the tenant from the tie which in turn triggers a free of tie ("release of tie") rent review. If tenants were also able to have the option of triggering a release of the tie then an unscheduled release of tie rent review provision would I presume also have to apply to that tenant's option?

Where the tied rent is relatively high, the tenant may have nothing to fear. In the extreme, in the 1990s I was involved with release of tie rent reviews which went to arbitration leading to nil increases in rent due to those tied rents being at a relatively high level.

However, where the tied rent is reasonable and the pub is in an area where there is strong demand for free of ties leases and/or there is strong comparable evidence, the tenant may need to be wary of what they wish for as the increase in market rent as a result of the release of the tie could be higher than the increase in gross profit levels resulting from the release of tie.

My response to Q.7 ii is:-

The government should be aware that to ensure this overarching principle in practice, it may be necessary to artificially control the ratios between tied and free of tie rental levels which will otherwise fluctuate in the market in a given area depending on demand and supply for tied and free of tie pubs.

Open market comparable evidence may have to be ignored to sustain this position which would go against accepted property valuation principles.

My response to Q9 is:-

The Rental Bid line in the sample in Annex A shows a 50% tenant's bid as a percentage of the divisible balance in both tied and free of tie scenarios but the percentage may differ between tied and free of tie.

There should be specific reference to the rental valuation figures reflecting the market and any available significant comparable evidence.

The sample also does not contain a line for tenant's capital. There is also no prompt to disregard any authorised tenant's improvements.

Any SCORFA items that have an impact on operating costs would I feel be better reflected by deducting from the operating costs of the tied tenant where they save money rather than showing the lack of them as an additional burden on the free of tie tenant.

2. The hypothetical landlord at the rental valuation date

The hypothetical tenant in rent reviews is a readily accepted concept. In the licensed property sector you have the REO as the hypothetical tenant. It is not so readily accepted that there should be a hypothetical landlord but there is such a concept.

If the threshold to comply with the statutory code is more than 500 pubs then is the hypothetical landlord one who owns more than 500 pubs or one with less? A statutory code could create different levels of demand and supply for pubs covered by the statutory code and those not covered. This in itself may have valuation implications. [Q2]

The actual landlord could sell the freehold any day after the rent review date, making assumptions made about the actual landlord invalid. The purchaser of the freehold may have no obligation to continue with the barrellage discounts and SCORFA not enshrined in the lease, so that the tenant may find that the assumptions used to arrive at the rent at review have changed.

To avoid this, barrellage discount levels and any tangible SCORFA would have to be documented in Deeds of Variation to the lease, which then means they would transfer with any change in freehold ownership. This is a complex area which the statutory code does not appear to address?

3. Dispute Resolution

An adjudicator is proposed but the document describes arbitration, not adjudication.

I understand the concept of an adjudicator enforcing the code but not the adjudicator acting as arbitrator on property disputes. Is he/she to be a member of the RICS and/or the Chartered Institute of Arbitrators?

PIRRS was created to give pub tenants the possibility of a rental determination without arbitration proceedings which has enabled tenants to have rental disputes resolved without the fear of arbitration costs being awarded against them.

I understand that the PIRRS has generally been welcomed and it is now being applied to lease renewals in addition to rent reviews, where a new lease has been agreed, save as to rent.

If PIRRS is established to deal with rent issues, why does the adjudicator need to get involved with rental disputes? That would probably increase costs again for tenants facing rental disputes.

Would the Adjudicators arbitration function in the Statutory Code override the Arbitration Act 1996?

I believe that disputes regarding rent and other disputes should be clearly distinguished. The current system of PIRRS could be used and developed to deal with rental disputes. If the Adjudicator was to have a supervisory role overreaching PIRRS there may not be the need for anything more on the issue of rental disputes. [Q6 and Q14 i)

My response to Q14 i is:-

Where there is a rent review, or a lease renewal where the rent only needs to be determined, the adjudicator need not be involved with those individual rental disputes as they could still be dealt with under PIRRS.

Summary of possible unintended consequences

Some of the unintended consequences of a Statutory Code, as currently presented, could be:-

1. The rigid application of a 50/50 split of divisible balance at the Rental Bid level could take the comparison of tied and free of tie away from profits method valuation principles.
2. If a Sample Rent Assessment Statement is not correctly drafted, and there is no "stand back and look" with reference to the market and available significant comparable evidence, then it will take valuers away from established valuation principles.
3. The pub market is currently divided into sub-markets for tied and free of tied pubs. Further sub-division is likely to occur with supply and demand (and therefore values) varying for pubs covered by the statutory code (as owned by Pubco with 500+) and those not – although that can change with freehold ownership.
4. The adjudicator dealing with individual rental disputes as an arbitrator is likely to be more costly than PIRRS.

I hope that these observations are useful and hope that they shall be taken into account when designing the Statutory Code, if one is introduced.

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