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Department for Business Innovation & Skills (BIS)

Government Consultation

Pub Companies and Tenants

**Response of the
Royal Institution of Chartered Surveyors (RICS)**

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Detailed response to the Consultation

The Royal Institution of Chartered Surveyors (RICS) has noted the publication of the Government Consultation Paper – Pub Companies and Tenants – produced by the Department for Business Innovation and Skills (BIS) in April 2013 and welcomes the opportunity to comment.

This response is made on behalf of RICS Valuation Professional Group who sent the Government Consultation out to a wide selection of RICS members working in the pub and trade-related property sector inviting them to comment. This response has been prepared taking those comments in to account and has been approved by the RICS Trade Related Property Group, the RICS Valuation Standards Board Chairman and the RICS Red Book Editor.

You have requested that responses to the consultation paper are set out as answers to specifically posed questions. You will note that we have not been able to do that as many are not applicable to RICS. We do not directly comment on whether we support the Government's proposals for the key principle to be that *"tied tenants are no worse off than free-of-tie tenants"* as we feel this is for industry and Government to resolve. Instead, given our Royal Charter and remit to act in the public interest, RICS, as the leading professional body representing valuation, has provided advice in relation to the valuation implications on the governments' proposals. We have concentrated our response on the potential valuation implications, practicalities of implementation and also possible unintended consequences that the proposals may have on the property market.

About RICS

RICS is the leading global organisation for professionals working in real estate, land, and construction and on related environmental issues as well as those working in the personal property and business assets sectors.

Over 120,000 RICS members, who are Chartered Surveyors, exist globally and operate out of 146 countries, supported by an extensive network of regional offices located in every continent. RICS Headquarters is based in London and our international work is supported by a network of regional offices and national associations.

RICS members play a vital role throughout the entire asset life cycle – from initial inspection and measurement of real estate, through development and investment to occupation and use of physical structures and other assets, including valuation of financial and business interests. RICS also provides impartial advice to Governments, policymakers and non-Government organisations.

RICS is an independent professional body, which was established in 1868 and has a UK Royal Charter. It is committed to setting and upholding the highest standards of excellence and integrity, providing impartial and authoritative advice on key land and asset issues affecting businesses and society.

RICS is a regulator of both its individual members and firms enabling it to maintain the highest standards and providing the basis for unparalleled client confidence in the sector.



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The general ethical principles for all RICS regulated members and firms are set out in our professional and ethical standards from which the following is an extract:

Act with integrity – Be honest and straightforward in all that you do

Always provide a high standard of service - Always ensure your client, or others to whom you have a professional responsibility, receive the best possible advice, support or performance of the terms of engagement you have agreed.

Act in a way that promotes trust in the profession - Act in a manner, both in your professional life and private life, to promote you, your firm or the organisation you work for in a professional and positive way.

Treat others with respect - Treat everyone with courtesy, politeness and respect and consider cultural sensitivities and business practices.

Take responsibility - Be accountable for all your actions - don't blame others if things go wrong, and if you suspect something isn't right, be prepared to take action.

Members of RICS are Chartered Surveyors who are qualified professionals and generally have five or six years of both study and professional training as a minimum. Thereafter, after qualifying, they gain sector experience in their chosen field. They are required to continue lifetime learning (continued professional development) throughout their career. Many Chartered Surveyors have trained to a higher level in particular specialisms.

As well as learning about legal aspects of property ownership, occupation and management, a Chartered Surveyor is trained to analyse market transactions and, if valuation is the chosen career path, to apply such analysis for valuation purposes. Valuation is not a formulaic process which is one of the common misconceptions held by the layman due to the way that valuations are set out and adjusted to take account of market evidence.

RICS and Valuation Standards

The first RICS Valuation Standards was produced in 1976 and have undergone considerable expansion and refinement through successive editions since then. The current standards and associated guidance are contained in the publication of the "RICS Valuation – Professional Standards", incorporating the International Valuation Standards, which took effect on 30th March 2012. The standards are commonly known as "the Red Book" and contain mandatory rules and best practice guidance for valuations of real estate and other assets. Whilst an obligatory reference work for RICS members and RICS-regulated firms worldwide undertaking valuation work, it is also widely referred to by non-RICS valuers.

The global section of the Red Book provides a broad ethical framework which can be applied to valuations of any asset type in any jurisdiction, in harmony with national legislation and covers the following:

- Compliance, competence, independence and ethical requirements;
- Terms of engagement;
- Valuation bases (global);



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- Valuation applications;
- Investigations, inspections and verification of information; and
- Valuation reports.

The requirements relating to application, competence, independence and objectivity are set out in Valuation Standards VS1.2-1.9.

The global standards and guidance are accompanied by detailed national standards and guidance, of which there is an extensive suite for the UK.

Public houses fall within a category of property known within the valuation profession as trade related property. This is property which has been specially built or substantially adapted for a specific use. In fact most forms of leisure property are trade related properties. They are bought, sold or leased on the basis that it is the trading potential that drives value, both capital and rental.

The valuation of trade related property is normally undertaken using the profits method of valuation, as acknowledged by Guidance Note 2 of The Red Book, which has been in existence for many years. Although a profits method valuation is not a formulaic calculation, it reflects a number of inputs derived directly from property markets analysed and where appropriate adjusted by application of the skills, knowledge and judgement of the valuer. Inter alia it has to take into account the terms of the lease, the physical attributes of the property and the trading potential that the property offers an operator, not necessarily that which is being achieved.

Valuation is by its very nature, subjective. It is an art, not a science. In the UK, the majority of disputes that get referred to a third party – which is very few in both actual number and percentage of reviews undertaken annually – usually have Chartered Surveyors acting on both sides. This clearly demonstrates how even highly qualified, experienced valuers can have differences of opinion. It is not a matter of failure in the landlord and tenant relationship. It is a difference of opinion on one or more of the individual aspects of the rental valuation.

For more information please visit <http://www.ricsvaluation.org/>

RICS Guidance Note GN 67/2010 “The capital and rental valuation of public houses, bars, restaurants and nightclubs in England and Wales”.

This RICS Guidance Note has been mentioned numerous times throughout the consultation paper. It is an update of the previous RICS Valuation Information Paper No 2 and was produced in 2010. It sets out the well established practice of public house valuation derived from the 1970's, when public houses started to be let on commercial leases in addition to traditional tied tenancy. In the remainder of this response, references to the “Guidance Note” mean references to GN 67/2010.



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The procedures in this Guidance Note are recommended for specific professional tasks and are intended to embody "best practice". It recognises six different categories of pub type and four different ways of operating the business. The experienced licensed property valuer will understand the complexities of the individual sectors and how they interact with each other, depending on the circumstances of each property and their ability to be converted. In addition to the above factors, each type of pub and each way of operating it relate to both the tied and free of tie markets.

It is important to note that members are not required to follow the advice and recommendations in the guidance note i.e. **it is not considered mandatory from an RICS perspective**, but they are asked to consider the following:

1. Where an allegation of professional negligence is made, the court is likely to take into account any guidance issued by RICS as to whether the surveyor had acted with reasonable competence
2. Members conforming to the guidance should at least have a partial defence to an allegation of negligence if they have followed the guidance
3. Members have the responsibility of deciding whether the guidance is relevant in each instance. If it is followed in an inappropriate instance then the member will not be exonerated merely because they followed the guidance
4. Where members do depart from the good practice recommended in the guidance note, they should do so for good reason and they may be required to explain why they did so.

The consultation includes the proposal that all valuers should make reference to the guidance RICS has produced. Whilst we do support this position, we refer you to point 3 above which states that there may be specific instances where the valuer feels that it is inappropriate to follow the guidance. RICS makes an allowance for this depending on the circumstances of the case but it appears that the Statutory Code will force him/her to follow it regardless. The government may wish to consider whether there might be exceptions to this proposal, but on the proviso that the Guidance will be followed unless there is a very good reason why it has not been, such reason to be made clear.

Pub Companies with more than 500 pubs

The Government's proposition is that the Statutory Code will apply to those pub companies with more than 500 pubs. The reasoning behind this is because significantly fewer complaints have been made about companies below this level and by setting the threshold at 500 the Code would therefore be able to address almost 90% of the complaints made.



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RICS understands the reasoning behind this distinction to suit the needs of addressing most of the complaints. However, we perceive that this could result in the creation of a two-tier market. This is a concern to many of those valuers working in the pub industry and has been mentioned by a number of our members in their responses to us. Any creation of a two-tier market, within what is already a complex market sector, is likely to cause particular difficulty when trying to assess open market rent primarily because rents are assessed having regard to comparable market transactions. Rents are based on the assumption that there is a “*hypothetical landlord*” (i.e. that the landlord is not necessarily the actual landlord but could be any landlord). However, the Government proposals would essentially introduce two different types of landlord: those with >500 pubs and those with <500 pubs, distorting the market and creating two levels of comparable evidence, thus making it even harder for valuers to ascertain fair market rent.

As an added complication, a pub company with >500 assets could choose to sell the freehold subject to a tied lease the day after rent review. The purchaser of said property (with <500 pubs) will have no obligation to carry on providing the same discounts which are not part of the lease, making the rent payable inappropriate as the assumptions used to arrive at the rent will have changed.

Lease and Tenancy

The consultation does not address the distinction between a lease and a tenancy. Whilst in law the two terms are interchangeable, in common usage within the pub sector they are employed to describe two distinctly different styles of agreement with very different features including length of term, repairing obligations and assignability. The term “lease” is recognised as an agreement that shares many of the features of a typical commercial lease, whereas a tenancy is an agreement used to support a trading/commercial relationship between a vertically integrated supplier/property owner and the operator of the premises. Fundamentally, the risk and obligations of landlord and tenant under the two agreement types are very different.

Right to request open market rent review

Section 5.10 of the report discusses the need to balance risk and reward. In particular it mentions the possibility of providing a right to request an open market rent review where there has been a significant change such as a significant price increase of tied products or where there has been an event outside the tenant's control which affects the ability to trade. In essence this equates to an interim rent review. It should be noted that almost all leases within the industry include periodic rent reviews, usually three or five yearly, for exactly the reason that changing economic or environmental issues may have a bearing on the tenant's ability to pay rent. The changes may be positive – thus resulting in a rental uplift or negative, resulting in a reduced rental. Most commercial property leases include upward only rent review provisions, to the detriment of the tenant. The pub companies have, by their own accord, conceded that regardless of what is in the lease, they will recognise and allow downward rent reviews when appropriate. This is a significant advantage to tenants of pubs.



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RICS understands that the proposal to offer interim rent reviews is put forward with good intentions to ensure that tenants are treated fairly. However, this proposition will have valuation implications which may not have been previously considered. Pub investment, and investment throughout the sector, whether that be ownership investment, loan provision, business development investment or equity investment in the owning and operating companies, relies entirely on a degree of certainty and stability. It is for this reason that pension funds and major property companies do not favour downward rent review provisions. Any further action which creates investor caution or withdrawal from the markets is likely to have significant adverse effects on the industry as a whole.

It is important to appreciate that a landlord cannot just impose a rent increase. This is a commonly misunderstood concept. Market rent reviews are incorporated in the lease terms and are legally binding on both parties to the contract. Reviews are usually agreed by negotiation based on the facts of the subject property and lease terms, with reference to comparable market based evidence. Many things are considered, one of them being how long the timeframe is between each review. For example, the rent agreed on a property with a 7-yearly rent review pattern will most likely be higher than with a 3-yearly pattern. This is because it will not be reviewed again for a further 7 years whereas the latter will come around again allowing for a change much sooner. Any change to this, such as allowing a tenant to demand a review at any time, will distort the market and also invalidate the rent which they had already been paying up until the request. This will cause great difficulty in the pub markets as the rental evidence being used may lose any weight and valuers will find it even more difficult to provide a true market rent.

Another possible consequence is an increase in rental levels across the board as the right to an interim review will be perceived as a significant tenant benefit.

Whilst the consultation process is ongoing and the proposals are debated there is greater uncertainty and instability. Markets generally do not like any form of uncertainty and this could well produce negative market sentiment for all concerned. This may lead to unintended consequences in that investors and operators delay investment in the sector and it may also result in an increase in the number of pubs coming to the market. This is likely to result in depressed capital values, not only to the detriment of the large pub companies but also freehouse owners, both individuals and corporate operators, and investors. In particular this could have implications for those with mortgages. Due to possible decreasing values, pub companies may also seek change of use on vacant buildings to non-pub uses.

Such a period of instability and uncertainty is unavoidable where any intervention is proposed but the sooner that clarity is provided the quicker the markets will adapt to the changes.

Tied Market and Free of Tie Market

The tied and free of tie markets, in the leased sector, although not mutually exclusive, are different in many ways.



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The free of tie market for pubs typically operating under the leased and tenanted model is rare. In fact we understand that only Wellington Pub Company operate this model to any scale or comparability. Other free of tie pubs tend to be both located in urban centres, are large, and are let to managed pub groups, or are ex pubco or brewery freehouse investments owned by private investors. Terms of leases in these instances are varied and many are let on a shell basis where the lessee is required to fit the unit out like a shop. Thus free of tie rental evidence is scarce relative to tied evidence.

On what basis is the pub let free of tie? The obvious conclusion would be that it is let on a long FRI (full repairing and insuring), assignable commercial lease. By contrast, the shorter brewery tenancy has shared obligations such as landlord repairs. This difference is not explicitly shown in the rent example within the consultation paper. Instead the only difference appears to be the wholesale price of drinks, which appears simplistic.

The approach to property ownership is invariably quite different also. The owner of property let on a tied lease has a greater interest in the business being a success and hence who the tenant is. The property investor of a free of tie lease may have very little contact with the tenant and is only concerned about rent being paid. This is often supported by either personal guarantee or rent deposit.

The Rent Assessment Statement

RICS avoids providing standard proforma valuation templates wherever possible. Instead, RICS leaves it up to the expertise and discretion of the valuer to decide how to value an asset and also the level of appropriate detail. We would add that in all cases however RICS promotes the idea of transparency as far as possible.

Some of our members have stated that the rent assessment statement is flawed given that the calculations follow a circular logic which results in rental bids not validated by evidence available from freely negotiated market transactions. If this is the point of providing the model it is incorrect to use the free of tie assessment to produce the tied assessment in this fashion, as valuation should be based on analysis of the market transactions. It is the market which decides what value should be placed on the potential income streams from equivalent tied and free of tie options and also the share of divisible balance, rather than a formulaic approach to balance an artificial calculation.

The rent assessment statement asks the valuer to specifically quantify everything that he/she has considered to obtain a free of tie rent and from this series of balance and measures will then calculate an appropriate rent for its tied equivalent. As mentioned above, this simple formulaic approach takes no account of the real world in which it sits. The open market does not work in this way, and valuation which interprets it, is different to this form of mathematical accounting. The underlying theme of the consultation appears to be that rent assessment is carried out by preparing a profit and loss account calculation without having regard to the use of comparable evidence, which is the fundamental principle to valuation regardless of property type.



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Trying to assess a free of tie profit which is then adjust for the tied model in a formulaic manner, is fraught with difficulty as follows:

- Freely negotiated market evidence in the free of tie sector is scarcer than the tied sector, as mentioned above.
- The calculation of tenant margins under a tied lease are fairly easy to calculate as purchases are known and so is the tenant pricing. However, a free of tie lease rent is more subjective as there is less transparency on purchased volumes and the wholesale price of items is also less certain. The supply market is in itself complex in that some operators will choose to go to a supplier where the price is not just about product but also about brand range, promotional support, technical services/dispense equipment, etc
- The rent assessment statement does not make a distinction between the tenant's attitude to fixed and variable costs. Tenant's profit is more sensitive to change in sales under a free of tie option given the higher fixed rental cost, so a valuer needs to consider the level of retained profit after rent that would be required in order for hypothetical bidders in the open market to accept that risk. This affects the percentage share of rent vs retained profit.
- The rent assessment statement makes no allowance for operators who run multiple sites and are able to gain bigger discounts and other economies of scale. In this instance a large profit is achieved and would not sit comparably with a single stand-alone operator.
- The rent assessment statement assumes a standard adoption of 50/50 split of the divisible balance. It should not be automatically assumed that the divisible balance will be 50/50. We refer you to section 6.9 of the RICS Guidance Note which states: *"In most cases, the landlord's share will lie within the range of 35%-65% of the divisible balance"*.

As mentioned above, the principle of both of these markets should be borne from the use of comparable evidence, as stated within section 7.21 and 7.22 of the RICS Guidance Note. The role of the valuer is to interpret the market, not make the market. As with other real estate sectors, the pub market is not perfect and does not contain perfect information. In order to compare a tied lease with a free of tie lease one would need to collect the full accounts and stock sheets from free of tie tenants to be able to analyse them for comparable purposes. In the real world this would be impossible.

There are certain contradictions between the rent assessment statement and what is stated in the RICS Guidance Note. Both examples of the statement include depreciation and interest charges as an expense where these are excluded under the RICS Guidance Note. There is also no mention for a return on the tenant's capital to be deducted from the Fair Maintainable Operating Profit (FMOP) in order to calculate the divisible balance. This is detrimental to the tenant.



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SCORFA Benefits

We have received a number of responses from our members in respect of an annualised value for all SCORFA benefits received by a tied tenant.

RICS supports the need for transparency in all valuation calculations and it is specifically mentioned within the RICS Valuation – Professional Standards that a valuer should be as clear as they possibly can be when arriving at their opinion of value. This would include laying out the valuation calculation. However, some elements of valuation are often difficult to quantify and it seems that SCORFA benefits, as with many costs, are no exception.

The quantifiable nature of the SCORFA benefits is complicated. Whilst the consultation paper makes this look easy it is not just a case of ascribing a monetary value for all goods and services provided by the pub company. Instead each company provides different SCORFA benefits and tenants place different values on them. The tenant's view on SCORFA may also change as the lease matures. For example, what could be perceived high value on induction, such as training, may have less value as the lessee becomes more experienced in pub management. There has also been no consideration in the list of benefits to take into account the differences in lease terms and the different risk and financial implications of them, such as upward/downward rent reviews and the ability to exit at short notice.

Benchmarking

Data on benchmarking costs has been undertaken over recent years, particularly those published by the Association of Licensed Multiple Retailers and the British Beer & Pub Association. Our members have said in their responses that it has had a positive bearing on rent reviews and the market's understanding of how costs of the operation of a public house have increased as a percentage of turnover. Most public house valuers have access to these benchmarking publications.

The RICS has also recently published the first in its quarterly benchmarking surveys for new tied lease lettings. It is still subjective in that there are many different forms of tied lease and some forms of lease involving a choice of tie provision. Therefore, it is likely as time moves on, to show trend patterns, rather than actual rental levels. An experienced Chartered Surveyor would not adopt benchmarking statistics or general market data for specific valuation purposes but may refer to it as a check system against their own valuation. Such benchmarking information is used more widely by investors seeking information on general market trends.

The Role of the Adjudicator

The consultation discusses the introduction of a Statutory Code and Adjudicator in order to ensure that tenants are treated fairly and it seeks views on whether an Adjudicator should be established to enforce the Code.



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The Government states that the model will be based on the Groceries Code Adjudicator and will have two main functions:

1. An Arbitration function in which they will be able to deliver an open market rent review, in accordance with RICS Guidance and the Statutory Code
2. An investigation function in which they will be able to undertake proactive investigations where they consider that a pub company is breaching the Statutory Code.

These two facets could be referred to as the Ombudsmen role, dealing with general disputes and complaints, and the second, deals with rental disputes. It is important to understand that the resolution of rental disputes is a matter to be determined in accordance with the contractual obligations between the parties, which are set out in the lease or tenancy agreement and which usually referred to the appointment of either an Independent Expert or an Arbitrator.

At a lease expiry, the matter would normally be referred under standard Landlord and Tenant legislation to a County Court, or with the agreement of both parties, to Professional Arbitration on Court Terms (PACT). This is a process recognised by both Solicitors and Chartered Surveyors. It means that on lease renewal an Arbitration process can take the place of a County Court hearing. Both Independent Experts and Arbitrators are usually appointed having relevant experience in the profits method of valuation, and thus will have a better understanding of, and the ability to weigh, the respective merits of the arguments of the parties. An Arbitrator must follow the procedure agreed by the parties or in accordance with the Arbitration Act 1996. These are longstanding and well versed procedures applicable to all forms of commercial property.

If, following consultation, the Government decides to impose an adjudicator under a statutory code, it is important that his/her role is clearly understood because RICS has reservations on how this role might work in practice, particularly in relation to the arbitration function.

RICS provides an established Dispute Resolution Service (DRS). Where the tenant does not agree with the landlord's rental proposal and has not been able to reach agreement by negotiation, it has the right to have the matter referred to a third party. The appointment of either an Independent Expert or Arbitrator (as stated within the provision of the lease) is made by the President of RICS.

We are also aware that there is an existing voluntary arrangement in place involving the use of the PIRRS scheme, which is a low cost expert determination process.

RICS is concerned as to where the Adjudicator function would sit in relation to already successful established processes, embedded in law (i.e. the lease or tenancy agreement). Will the Adjudicator have powers to override a decision made by an appropriately appointed Arbitrator or Independent Expert or PIRRS? We would have extreme reservations concerning this as the decision is usually regarded as final and only subject to appeal in law. The paper states that the Adjudicator would be able to deliver an open market rent but it does not state whether this would be in accordance with the terms of the lease or not.



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We also have concerns in relation to how the Adjudicator process might work on a practical level. Whether or not the Adjudicator is a Chartered Surveyor, he/she will require assistance from other specialist Chartered Surveyors who are actively involved in the relevant local market. It is likely that many such specialists will have a conflict of interest having advised one of the parties on a range of matters, or as an Independent Expert or Arbitrator.

End.



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