



Revaluation 2010 Basic Principles Committee

Practice Note 1 Adjustment of Rents

1.0 Introduction

Non-domestic property has to be valued to Net Annual Value which is defined in Section 6(8) of the Valuation and Rating (Scotland) Act 1956 as follows

“....the net annual value of any lands and heritages shall be the rent at which the lands and heritages might reasonably be expected to let from year to year if no grassum or consideration other than rent were payable in respect of the lease and if the tenant undertook to pay all rates and to bear the cost of repairs and insurance and other expenses, if any, necessary to maintain the lands and heritages in a state to command that rent.”

What is required in rating is to find the rent which the hypothetical tenant might reasonably be expected to pay for the subjects. The actual rent for any property may be of significance, but is not conclusive of value. What has to be established is "a hypothetical level of value" which is derived from analysis of all the rents of comparable properties in a particular area.

This practice note therefore deals with the adjustment of individual rents in order to ascertain the hypothetical level of value as required.

2.0 Rental Analysis

The analysis of rental information is considered within R.I.C.S. information Paper No. 8 “The Analysis of Commercial Lease Transactions” and Valuers are referred to the terms of that document. Of particular relevance is the requirement for Valuers to fully understand both the terms of the lease being analysed and the motivation of each of the parties to the agreement. The following provisions relate to specific aspects of rental analysis which are relevant when adjusting rents to meet the definition of Net Annual Value.

3.0 Rents Returned

3.1 Duration Although the definition of net annual value states that the rent is "from year to year" the Lands Valuation Appeal Court in a number of cases

has indicated that the rents from leases on the normal five yearly review cycle are acceptable for statutory purposes.

Reference: -

Simmons Furniture Store v. Assessor for Dumfries (1989)

Assessor for Strathclyde v. British Railways Board & Others (1990)

Debenhams Plc. v. Assessor for Grampian. (1989)

3.2 New Rents/Review Rents

Much can be said regarding the differences in rent which may arise between the rent achieved at a new letting and a reviewed rent. Some of this comment is made in an attempt to classify one type of rent above the other, implying that it is "a purer reflection of the market".

At the commencement of a lease the tenant does not know the trading potential or the return that will be realised from occupation. The offer of rent is, of necessity, based on expectations of the likely return that will be generated.

At review the review clause normally requires the rent to be agreed as

"....an amount equal to the market rent at the review date of the premises fully serviced as between a willing landlord and willing tenant if offered on lease with vacant possession" ,

or some similar form of wording which requires a "market rent" to be established. The review rent is therefore deemed to be on the same basis as the rent at the commencement of a lease.

In general therefore no distinction should be made between rents at the commencement of a lease and those arising at review. However, particular caution should be exercised with regard to reviewed rents where the rent review clause is restricted to upward only movement.

4.0 **Deductions from Rent**

Where the rent returned is inclusive of items which do not relate to the occupancy of the property but are in respect of other services, including the incidence of taxation, then these costs must be deducted.

4.1 Value Added Tax

The hypothetical tenancy is deemed to be net of V.A.T.

Value Added Tax is imposed on the supply of goods and services and as such is a tax on the final consumer.

The grant of a lease, which establishes a landlord/tenant relationship, will, as a general rule be exempt from V.A.T., subject to certain exceptions. The exception which is of concern is when the landlord opts to be taxed. The option to tax does not require the landlord to

consult with the tenant to whom the supplies are made and on whom the tax burden will fall.

Care should be exercised to confirm whether the rent returned is inclusive or exclusive of VAT. If the rent returned is inclusive of V.A.T. then the tax should be deducted. The rate of V.A.T. at the "tone" date for the 2010 Revaluation was 17.5%. Since 1 December 2008 it has been 15%. It is anticipated that it will return to the higher rate in December 2009.

4.2 Service Charges

The rent under the hypothetical tenancy does not include service charges.

Services provided by the landlord are normally charged for separately from the rent. In these cases no action is required. Where, however, the rent is inclusive of the cost of such services then these costs will have to be deducted to arrive at the rental figure for the property. In these cases the actual costs should be deducted. If the actual costs are not known then an estimate should be made. Every effort should be made to ascertain the actual costs, or as great a part of them as possible, so that any estimate can be as accurate as possible.

4.3 Rates

The rent under the hypothetical tenancy does not include rates.

If the rent returned does include an amount for rates then it should be ascertained if the annual figure paid each year remains the same or whether the amount is varied depending on the amount to be paid in rates. If it is varied then the amount paid in rates for the year to which the rent applies should be deducted from that rent. If, however, the figure remains unaltered throughout the whole lease, or the lease term, then the amount paid in rates (with or without transitional relief) for the year in which the rent was struck should be deducted from the rent. This amount should be obtainable from the Director of Finance.

5.0 Rent Paid for the Property

After the above adjustments have been made (where necessary) the resultant figure is the annual sum, based on the rent returned, which is attributable to the property. In addition, however, there may be incentives or capital sums which impinge on the rent. Whether they do affect the rent or not and, if they do, the extent to which the rent should be adjusted to allow for this has to be considered.

6.0 Deductions

Under this head there is no difference between "inducement", "incentive" or "concession".

There are many reasons why a landlord may seek to offer an inducement as

part of a rental transaction. These may include, among others, the ability to maximise the capital value of his investment, the ability to secure funding at a more favourable rate and the benefit of securing a longer lease than would otherwise be the case. Furthermore an agreed headline rental, when coupled with an upwards only rent review clause, may secure a rental income in excess of the open market rental value of the property for a period exceeding the first or even second rent review.

On the other hand for the tenant a rent free period, reverse premium or contribution towards fitting out made in return for a higher headline rent is effectively a form of unsecured borrowing.

The granting of an inducement may materially affect the taxation, grant or capital allowance position of either of the parties. It should also be borne in mind that the motivation for parties offering or accepting an inducement will differ with each transaction. A tenant accepting an inducement may have different reasons from the landlord offering them. The two parties may often put different interpretations on their agreement.

It is important, therefore, when considering inducements to understand the reasons why they have been agreed and the extent to which (if at all) they drove the transaction. This will help the Valuer to reach a conclusion as to whether any adjustment should be made to reflect the inducement, the means by which any such adjustment should be calculated and the weight and reliability that can be attached to the resultant figure.

Reference: - R.I.C.S. Information Paper No. 8 'Analysis of Commercial Lease Transactions'.

On the assumption that the decision has been made that the incentive does affect the rent and an allowance should be made, consideration has to be given to how any allowance is to be calculated.

Two factors come into play, (1) the length of time over which the allowance should be made, and (2) the rate at which the allowance is made. In both cases the state of the local market for the class of property being considered has to be taken into account and the application of the allowances modified as is appropriate to the market conditions.

(1) TIME PERIOD -Three possibilities arise.

- a) The whole term of the lease is taken. This will normally apply where, on balance, it is considered that the primary motivation behind the inducement is to lock the tenant into a lease or to secure a longer lease than would otherwise be the case. Common examples of this occur where inducements are made to high quality or "anchor" tenants whose presence can be assumed to bring a benefit to the development for the duration of the lease.
- b) The period to the tenant's break clause. In these cases the period during which the tenant has been "locked in" has been reduced and it

may be appropriate to make the allowance over the shorter period. Before this is applied care should be taken to ascertain whether or not there is a realistic possibility that the break clause will be exercised. Frequently the effect of a break clause is significantly weakened by the inability of the tenant to find alternative premises, the need to write off fitting costs over a short period or prohibitive penalty charges.

- c) The period to the review following the point where the market rent overtakes the headline rent. This is often particularly difficult to calculate, as the current market rent, which is what is being sought, is not known. In these circumstances the valuer's judgement must come into play, paying particular attention to the state of the market for the class of property being considered. It appears, however, that where this is considered appropriate, market practice has now settled on a rule of thumb approach to the problem by analysing incentives over a 10 year period.

(2) RATE - Obviously the rate used in making the allowance will vary according to the class of property and the location. Where sufficient local evidence exists the appropriate yield should be applied on a single rate basis.

In the absence of local information the following yields may be applied. These yields are most reflective of the central belt and major towns. When considering rental information from smaller towns an addition may be appropriate depending upon the location and character of the property under consideration.

Retail properties - 5.5%

Office properties - 6%

Industrial/warehouse properties - 8%

6.1 Types of incentives and their analysis

6.1.1 Rent-Free Periods

These arise where the landlord has agreed to a period, not necessarily at the commencement of the lease, when no rent will be paid.

The most common situation is where the landlord allows a period for "fitting out", usually about three months. In these circumstances no allowance should be made and the agreed annual rent, which applies for the first term, without adjustment, should be taken to represent the market rent.

Where the rent-free period is for a longer period then the rent should be adjusted in the following way.

Example: An office property let on a fifteen year lease, with five yearly, upwards only, rent reviews. The first year is rent-free and the agreed rent for the remainder of the first term is £53,000 pa.

Procedure; - find the capital value over fourteen years and divide the capital value by the Y.P. for fifteen years.

| | | |
|-----------------------|----------|-------------|
| Rent (agreed) | £53,000 | |
| Y.P. 14yrs at 6% | 9.30 | |
| P.V. 1yr at 6% | 0.94 | |
| Capital Value | £463,326 | |
| div. Y.P. 15yrs.at 6% | 9.71 | |
| Open Market Rent | | £47,716 say |
| | | £47,700 |

Example: - The same property, as above, but with the rent-free period in years 3 & 4 and the agreed rent for the first term £56,000 pa.

Procedure: - find the capital value for the circumstances as agreed and divide the capital value by the Y.P. for fifteen years.

| | | |
|-----------------------|----------|-------------|
| Rent (agreed) | £56,000 | |
| Y.P. 2yrs. At 6% | 1.83 | |
| | £102,480 | |
| Rent | £56,000 | |
| Y.P. 11yrs. at 6% | 7.89 | |
| P.V. 4yrs at 6% | 0.79 | |
| | £349,054 | |
| Capital Value | £451,534 | |
| div. Y.P. 15yrs.at 6% | 9.71 | |
| Open Market Rent | | £46,502 say |
| | | £46,500 |

6.1.2 Stepped Rents

These arise where, instead of a rent-free period, a reduced rent is agreed for the first year and rises each year for a number of years. This will usually, but not always, occur during the first term of the lease.

Example: - The same property, as above, but with a stepped rent, year 1 - £35,000, year 2 - £40,000, year 3 - £45,000, year 4 - £50,000, year 5 and there after - £52,000.

Procedure: - find the capital value for the circumstances agreed and divide the capital value by the Y.P. for fifteen years.

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|-----------------|---------|--|
| Rent (agreed) | £35,000 | |
| Y.P. 1yr. at 6% | 0.94 | |
| | £32,900 | |
| Rent | £40,000 | |
| Y.P. 1yr. at 6% | 0.94 | |
| P.V. 1yr. at 6% | 0.94 | |
| | £35,344 | |

| | | | |
|-----------------------|----------|----------|-----|
| Rent | £45,000 | | |
| Y.P. 1yr. at 6% | 0.94 | | |
| P.V. 2yrs. at 6% | 0.89 | | |
| | | £37,647 | |
| Rent | £50,000 | | |
| Y.P. 1yr. at 6% | 0.94 | | |
| P.V. 3yrs. at 6% | 0.84 | | |
| | | £39,480 | |
| Rent | £52,000 | | |
| Y.P. 11yrs. at 6% | 7.89 | | |
| P.V. 4yrs. at 6% | 0.79 | | |
| | | £324,121 | |
| Capital Value | £469,492 | | |
| div. Y.P. 15yrs at 6% | 9.71 | | |
| Open Market Rent | | £48,351 | say |
| | | £48,300 | |

6.1.3 Capital Payments

These may take the form of what are known as reverse premiums to assist the tenant with a cash flow problem, fitting out costs, or taking over some liability from the tenant. Where it is felt that an adjustment is required, i.e. that the rent has been increased to compensate the landlord for his capital outlay, then, and only then, the capital sum should be divided by the Y.P. for the term of the lease or to the first break point, as appropriate. If the payment is made at a time other than at the commencement of the lease then the period taken should be the outstanding period of the lease from when the rent has been increased to allow for the payment.

7.0 Additions

These arise when; either capital sums are spent on the property in such a way that the rental value has been increased, or a payment has been made by the tenant, the effect of which is to reduce the rent.

7.1 Tenant's Improvements

Wherever possible the rental value attributable to tenant's improvements should be ascertained by direct comparison with rentals which include that particular feature. Where this is not possible it will be necessary to make adjustments by reference to the cost of providing those improvements as described below.

7.1.1 Extensions, Alterations and Improvements

Works carried out to extend, alter or improve the property will be deemed to affect the rental value of the subjects. In such cases the annual equivalent of the capital expended on the property should be found by dividing the capital sum by the Y.P. for the term of the lease or to the first break point, as appropriate, and adding this to the rent. Care should, however, be taken to ensure that only expenditure which enhances the value of the

property is included.

7.1.2 Fitting Out New Buildings

It is common for new shops and/or offices to be let in a "shell" state with the tenant responsible for "fitting out" the property. This is often carried out to the tenant's own specific corporate requirements. Care should be taken therefore to eliminate from the actual costs incurred any elements of unremunerative expenditure or any amount for non-heritable items.

The initial rent and possibly the review rents will reflect the shell condition and not the fitted unit, and where that is the case the appropriate adjustment will require to be made. This adjustment will be the cost divided by the Y.P. for the whole term of the lease or to the first break point, as appropriate, and the resultant annual equivalent added to the rent. Where this adjustment is being applied to a review rent when the fitting out took place at the commencement of the lease it would be appropriate to depreciate the costs. The rate of depreciation should be taken at 5% per annum from year six to year twenty-five on a straight line basis.

Where the review rent is to the open market rent for a fitted out unit then no adjustment should be made to that rent.

7.1.3 Fitting Out Existing Buildings

Where existing buildings are refitted to an improved standard an adjustment should be made as described above. However, where an existing fitted out property is refitted to the same or a similar standard in order to portray a new "corporate image", no adjustment to the rent should be made for such expenditure on the basis that there would be no advantage to the hypothetical tenant.

7.2 Premiums

This is where the tenant pays a capital sum to the landlord instead of rent. It can be understood as the tenant purchasing a profit rent. Inherent in this is the fact that the rent is reduced because of the payment of the premium; therefore an adjustment to the rent is required. Obviously if the premium, or part thereof, is paid in respect of items other than a reduction in rent, then these should not be included in any add back factor. The amount to be added back should be found by dividing the premium by the Y.P. for the term over which the reduction in rent has been purchased. For example if the reduced rent is only for the first term, i.e. the reviewed rent is to be the full market rent, without reduction; the Y.P. should be for the term only.

8.0 Equivalent Rent Paid for the Property

After these adjustments to the rent the figure that we now have is the equivalent rent for the property. However, further deductions may be required

to equate the rent with net annual value which is, in effect, the rent on a full repairing and insuring basis. This, of course, means that the tenant is required to meet the cost of repairs and insurance, over and above the rent. Where these items are paid for by the landlord, out of the rent, then the cost of these items must be deducted from the rent.

9.0 Deductions

9.1 Repairs

Every effort should be made to get the actual cost of the repairs arising from the lease. Where these are not available the costs should be estimated by reference to the available cost guides. As a last resort the annual repair and maintenance of the property may be estimated on the following basis:

| | |
|-----------------------|------|
| External repairs only | -7% |
| Internal repairs only | -6% |
| All repairs | -13% |

9.1.1 Actual State

The definition of net annual value refers to the tenant being responsible for the repairs and insurance within the context of maintaining "the lands and heritages in a state to command that rent." The implications of this are that the initial rent reflected the state of repair of the property when let and that it has been maintained in such a state. This is in line with the legal position as it is a common law requirement on a landlord to provide the tenant, at the commencement of the lease, with a property reasonably fit for the purpose for which it let. He also has a common law duty to keep the let property in tenantable repair and wind and watertight. In a lease, of course, he generally seeks to pass this liability on to the tenant, as indeed the definition of net annual value envisages.

In our analysis of rents, however, we may not be fully aware of the state of a property when let, other than to assume that it was the same as it is now. No attempt should be made to reflect any differences regarding the state of repair between properties; this is a matter relating to how the analysed rents are grouped when establishing a hypothetical level of value in an area.

9.2 Insurance

Most landlords undertake the insuring of their property and recover the cost, separately from the rent, from their tenant. In these cases no adjustment is required, as the situation is what is envisaged by net annual value.

In the rare event that the landlord insures without directly recovering the premium, a specific deduction will need to be made from the rent. Premiums however vary widely according to the use, construction, age and location of the lands and heritages and no specific advice can be

given which will cover all cases that could occur.

Where an adjustment to rent is deemed appropriate, consideration should firstly be given to any evidence available of insurance premiums. In the absence of information a deduction of 6% should be made from the stipulated rent.

10.0 Miscellaneous

The length of lease assumed in this practice note is the normal five yearly rent review lease. The question of the adjustment required for periods other than five years must be addressed.

Where the lease term, or review term, is less than five years no adjustment should be made and the rent treated as though it were for a five year period.

Where the period of the rent is longer than five years then an adjustment should be made which will allow the rent to be treated along with the rest of the evidence.

When a landlord agrees to a longer period at a fixed rent he requires to be compensated for this by way of an increased rent. This is, of course, due to "losing out" in the opportunity to benefit from any increase in rent due, largely, to inflation. The rate of inflation, or growth, has therefore a part to play in this adjustment, together with the appropriate equated yield. This information is unlikely to be available and a compromise adjustment is suggested. It should be borne in mind that the resultant adjustment applies at lower rates of growth (around 3% per annum) and in exceptional circumstances of higher rates of growth this may be too low.

- | | |
|----------------------------------|--|
| (a) periods up to 5 years | no adjustment |
| (b) periods greater than 5 years | 1% per annum for every year in excess of 5 years |

For example - a 21 year fixed term = $21 - 5 = 16 \times 1\% = 16\%$

11.0 Turn-Over Rents

Turn-over rents, as applied to retail subjects, are based on applying a percentage figure to the retailer's gross turn-over. This figure is obtained in some cases, especially in shopping centres, by the tills in the retail outlets being directly linked to the computer in the office of the landlord's agent. Otherwise provision is made in the lease for regular turn-over statements and turn-over certificates from the tenant's accountant. The figures obtained would be subject to deductions in respect of V.A.T., sales to staff and returned goods. Specific deductions may also be given where a high proportion of sales are by credit cards to take account the charges made by the credit card companies.

The rent under such arrangements is usually, but not always, made up of two distinct parts;

Firstly there is the "base rent" which is generally fixed at a level below the full market value of the property.

Secondly there is the element which is related to the turn-over where a percentage is paid on the turn-over which exceeds a threshold figure.

Regular reviews of the percentage, the threshold figure and the base rent take place. The rent passing closest to tone date should be taken and the modifications detailed above should be applied as appropriate.

The rent passing should be taken as the base rent together with 100% of the turnover rent element. The pattern of rents established in this way should indicate the level of market rent above base rent.

12.0 Adjusted Rent

After the above adjustments to rent have been made the figure that we now have is the adjusted rent for the property. That rent may be considered, together with other rents for similar properties in similar locations, in order to ascertain the hypothetical level of rental value as required under the 1956 Act. The weight to be attached to any particular rent in arriving at the hypothetical level of rental value must ultimately depend upon the valuer's opinion after taking full account of all relevant circumstances.