

Revaluation 2023

Basic Principles Committee

Practice Note 1 Adjustment of Rents

1.0 Introduction

Non-domestic property has to be valued to Net Annual Value (NAV) 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 the rent were payable in respect of the lease and if the tenant undertook to pay all rates and to bear the cost of the repairs and insurance and the 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" at 1 April 2022 (the "tone" date), which is derived from analysis of all the rents of comparable properties in a particular area.

The majority of properties are valued on the basis of an analysis of local rental evidence. However, for some categories of property, recommendations arising from wider analyses of rents can be found in the individual SAA practice notes.

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

2.0 Leases, associated documents and confidentiality

Valuers should be aware that the lease itself may not provide all of the information required in order to carry out an accurate analysis. For example, details of incentives may be covered in separate documents sometimes referred to as back letters, side letters, etc. and these should therefore be pursued where they exist in an effort to gain a thorough understanding of the rental transaction.

The standard Assessor Information Notice makes it clear to recipients that a requirement to comply with Section 26 of the Non-Domestic Rates (Scotland) Act 2020 cannot be set aside by the existence of a confidentiality clause within the lease or associated documents.

3.0 Rental Analysis

The analysis of rental information is considered within the Steering Committee on Harmonisation “Agreed Joint Paper on the Adjustment of Rental Transactions for Non-Domestic Rating Valuation” and the RICS Guidance Note “Comparable evidence in real estate valuation”, 1st edition, October 2019. Valuers are referred to the terms of both documents for additional guidance.

Of particular relevance is the requirement for valuers to thoroughly examine both the terms of the lease being analysed and the possible motivations of each of the parties to the agreement including, in particular, their motivations in respect of the offer and acceptance of incentives. The following provisions relate to specific aspects of rental analysis which are relevant when adjusting rents to meet the definition of Net Annual Value.

4.0 Rental Information

4.1 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 a five yearly review cycle are acceptable for statutory purposes.

Ref. *Simmons Furniture Store v Assessor for Dumfries (1989)*
Assessor for Strathclyde v British Railways Board & Others (1990)
Debenhams Plc v Assessor for Grampian (1989)

Accordingly, no adjustment should be made to rents set on a review period of up to five years. See paragraphs 4.4.8 and 7.0 for advice on review patterns of longer duration.

4.2 New Rents/Reviewed 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, caution should be exercised with regard to reviewed rents where there has been no uplift on review and the rent review clause is restricted to upward only movement.

In some instances there may be information available from new lettings demonstrating a particular trend in rental levels. Where a sufficient number of new lettings do exist (and the valuer is satisfied that the evidence is from open market transactions concluded at arm's length and substantially on the statutory hypothesis at or near the valuation date) appropriate weight must be given to such evidence.

Ref. *Argos Distributors and others v Assessor for Fife (2010)*
Assessor for Grampian Region v Barclays Menswear Enterprises Ltd. (1990)

4.3 **Reliability of Evidence – Case Law**

Valuers should make themselves familiar with Armour paragraph 19.10. The paragraph makes reference to a number of cases where rental evidence was held to have either no weight or less weight attached to it due to conflicts with the terms of the rating hypothesis:

4.3.1 **Leases not at “arm’s length”**

Leases between connected parties or otherwise not at “arm’s length” should be treated with caution but may be of some assistance. See also paragraph 4.4.6.

Ref. *Assessor for Fife v Dunfermline Cricket Club (1962)*
Elgin City FC v Assessor for Grampian Region (1988)

4.3.2 **Rents agreed in a Restricted Market**

Rents agreed in a less than fully open market will be of little assistance.

Ref. *WH Smith v Glasgow & Renfrewshire Assessors (2004)*
Wincanton Plc v Assessor for Lanarkshire VJB (2012)

4.3.3 Rents resulting from a pre-determined calculation

Reviewed rents calculated on a formulaic basis such as by adjustment on the basis of Retail Price Index should be treated with caution as they may not be equivalent to open market rent. However, in the absence of alternative evidence such rents, suitably adjusted to the tone date, may be the best available guide as to the figure likely to be agreed by the hypothetical parties.

Ref. *Campsie Spring (Scotland) Ltd. v Assessor for Dunbartonshire, Argyll & Bute VJB (2000)*

4.3.4 Rents struck on the basis of Sale and Leaseback

Where such arrangements exist, it is imperative that the valuer ascertains the specific details of the arrangement. If it can be determined that the rents struck with sale and leaseback deals are at open market rental levels, then the information should form part of the evidence when determining value.

Care should be exercised however to ensure that the initial rental does in fact reflect open market value and that it is not based upon a more complex financial arrangement, perhaps reflecting the cost of borrowing.

After the initial setting of the rent there will commonly be provision for a review to open market value. Where this is the case, then the reviewed rents should be given consideration along with other relevant rental information.

Ref. *John Lewis & Co v Goodwin (VO) (1980)*
Assessor for Highland & WI VJB v Marks and Spencer (2009)
Rolls Royce Plc v Assessor for Renfrewshire VJB (2012)

4.3.5 Rents involving complex financial arrangements or part of a larger financial transaction

It may be the case that the structuring of any rental agreement in a particular fashion is to suit the individual tax position of the landlord, the tenant or possibly both. In some circumstances the tax implications may be so significant that they are the principal driver in arriving at the level of rental agreement. Where the tax implications for the landlord or the tenant are atypical such that the arrangement cannot be said to be representative of the hypothetical tenancy on the statutory terms, then it may be necessary to set that rental agreement aside altogether in arriving at the estimated rental value.

Similarly, transactions involving acquisitions and/or disposals of other properties are unlikely to be suitable evidence as to the rent to be agreed on the statutory hypothesis.

Ref. *Occidental Petroleum (Caledonia) Ltd. v Assessor for Grampian Region (1988)*
B&Q Plc v Assessor for Renfrewshire VJB (2004)
Wincanton Plc v Assessor for Lanarkshire VJB (2012)
Glasgow City Assessor v HMV Ltd. (2013)

4.3.6 Evidence of rental values derived from capital values

Normally a notional rental value derived from a capital value is unlikely to provide a reliable guide to the rent to be arrived at under the statutory hypothesis.

Assessor for Glasgow v Schuh Ltd. (2012)

4.3.7 Licences

It should be noted that, in Scotland, a licence for the occupation of lands and heritages is synonymous with a “lease” where the licence confers the rights normally offered under a lease; simply calling a lease a licence does not change the nature of the agreement. However, short term licences to occupy, on terms substantially outwith those of the statutory hypothesis, will carry little weight.

Ref. *David Allen & Sons Billposting Ltd v Assessor for Clydebank (1936)*
Assessor for Renfrewshire v Old Consort Co Ltd. (1960)
Argos Distributors and others v Assessor for Fife (2010)
Assessor for Central Scotland Valuation Joint Board v Bank of Ireland (2011)
Assessors for Tayside & Glasgow v Hutchison 3G (UK) Ltd. & Others (2014)

4.3.8 Turnover Rents

See paragraph 4.4.9 for comment on turnover rents.

Ref. *Morrison E F (GP) Ltd. v Assessor for Central Scotland (2004)*

4.4 Reliability of Evidence - further considerations

4.4.1 Abated rents

There are circumstances, for example in a recessionary climate, where some tenants may have negotiated/re-negotiated their rents between reviews, including the setting aside of “upward only” clauses, and obtained abated rents for varying periods of time through individually discounted rents, group rescue packages or Company Voluntary Arrangements (CVAs). Abated rents resulting from agreements of this nature are neither representative of the open market nor the hypothetical tenancy and should therefore carry little evidential weight. They should be treated with considerable caution and always examined in relation to open market rental

evidence where it exists. A full understanding of the circumstances including any back letters/side agreements is important.

4.4.2 **“Anchor” tenants**

In some cases the rent paid by an “anchor” tenant will be at a lower level than that paid by the hypothetical tenant and extra care will require to be exercised. In particular, valuers should consider the date the transaction was struck relative to others in the development and the rents being paid by similar tenants in comparable units.

4.4.3 **Arbiter and expert witness evidence**

As should be the case with any evidence provided when considering level of value, Arbiter’s awards (particularly reasoned awards) and the opinions of independent experts may provide useful background as may statements on market analysis if provided. Valuers should familiarise themselves with related R.I.C.S. documents, such as the Practice Statement and Guidance Note on Surveyors acting as expert witnesses.

4.4.4 **Cost rents**

Rents related by formula to the cost of construction will be of little assistance.

4.4.5 **Empty property rates**

Valuers should be aware of rents where the primary motivation of the landlord is for the property to be occupied in order to relieve the landlord of the burden of empty property rates, including through artificial or contrived occupation.

4.4.6 **Leases between related parties**

Lease agreements between related parties or companies, e.g. between a company and its pension fund or between a holding company and its subsidiary companies can be based on market rental levels. Where this is the case these may provide useful information.

4.4.7 **Lease variations**

In the absence of other rental evidence, lease variations may represent useful evidence but they will have been agreed by a specific existing tenant and are not therefore on an open market basis. They should be treated with suitable caution and always considered in relation to open market rental evidence where it exists. A full understanding of the circumstances leading to the lease variation including any back letters/side agreements is important. For example, it would be helpful to know if the lease was varied as an alternative to the exercise of a break clause.

4.4.8 **Overage**

Caution should be exercised with regard to leases with a review pattern in excess of the norm. See paragraphs 4.1 and 7.0 for further comment.

4.4.9 **Turnover Rents**

Turnover rents, as applied to retail subjects, are based on applying a percentage figure to the retailer's gross turnover. 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 turnover where a percentage is paid on the turnover which exceeds a threshold figure.

Regular reviews of the percentage, the threshold figure and the base rent usually take place. The rent passing closest to tone date should be taken. However, valuers should exercise caution where that rent represents a peak or trough in the turnover trend.

In normal circumstances 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.

Where the lease provides for a turnover rent with a base rent geared to open market rental value e.g. set at 80% of open market rent, the most reliable route to rateable value will be to gross up the geared rent paid. Base rents at or about the valuation date should be used. Obviously the lower the gearing the less weight should be attached to the grossed up rent. Where possible, grossed up rents should be tested against rents for similar properties which have been let at open market value in the same development to gauge reliability.

5.0 **Deductions from Rent**

Where the rent is inclusive of the costs of items or services unrelated to the occupancy of the lands and heritages, these costs must be deducted. e.g. V.A.T., rates, service charges and other payments for utilities, furnishings etc.

5.1 **Value Added Tax**

The hypothetical tenancy is deemed to be net of Value Added Tax (V.A.T.)

V.A.T. 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 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 2023 Revaluation was 20.0%, that rate having been in place since 4 January 2011.

5.2 **Inclusive Rents**

In certain market sectors, such as the serviced office market, where there is a practice for rents to be paid on inclusive terms, there may be a requirement to make one or more of the following adjustments. The greater the level of adjustment required the more caution that should be exercised. Ideally, such rents should be checked against those passing for comparable properties where the rents have been agreed on or closer to statutory terms.

5.2.1 **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 sought. If the actual costs are not known then an estimate should be made. If the resulting net rent rate is out of line with those for comparable subjects the deduction should be reconsidered.

5.2.2 **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 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.

5.2.3 **Non-rateable plant & machinery, furnishings, fittings or other services etc**

The rent under the hypothetical tenancy excludes non-rateable items

Where the rent is inclusive of the cost of such items an amount or amounts will have to be deducted to arrive at the rental figure for the heritable property. If the actual amounts are not known then an estimate should be made. If the resulting net rental rate is out of line with those for comparable subjects the adjustment should be reconsidered.

6.0 Further adjustments

There may be incentives or capital sums which impinge on the rent. If they do affect the rent the extent to which the rent should be adjusted to allow for this has to be considered.

6.1 Deductions

Under this heading no difference is made between "inducement", "incentive" or "concession". Details of these can often be found, not in the lease, but in separate documents sometimes referred to as back letters, side letters etc.

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 an 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 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.

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 the property being considered has to be taken into account and the application of the allowances modified in accordance with those local 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 or where their presence is key to securing funding to allow the development to proceed.
- 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. See Appendix 1 for examples of the effect of break penalties. Valuers should be aware that as an alternative to analysing to the break period and accounting for the penalty they might analyse to a different time period e.g. if the tenant was granted the first year rent free but has to pay it back with interest upon exercising the break it would be appropriate simply to ignore the existence of the break and analyse over the term of the lease.
- 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. It appears that market practice has been to apply a rule of thumb approach to the problem by analysing incentives over a 10 year period or the length of the lease, whichever is less. However, valuer's judgement should be exercised, paying particular attention to the state of the market for the class of property being considered.

In considering the options above, the adjusted rent, or a range thereof, should where possible be tested against rents which provide more direct and reliable evidence.

(2) RATE - Where sufficient local evidence exists the appropriate yield should be applied on a single rate basis. When considering local rental information an addition may be appropriate depending upon the location and character of the property under consideration.

In the absence of local information, the following yields may be applied:

| | |
|-----------------------------------|-----|
| Retail properties - | 10% |
| Office properties - | 9% |
| Industrial/warehouse properties - | 9% |

6.1.1 Types of incentives and their analysis

6.1.2 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, in the absence of local evidence, 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 by taking as an incentive the rent free period less the usual three months reasonably required for fitting out.

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

Procedure: - Adopting the rule of thumb approach described in c) above, find the capital value over nine years and three months and divide the capital value by the Y.P. for ten years, i.e. the incentive is 1 year less 3 months = 9 months rent free.

| | | |
|-----------------------|----------|---------|
| Rent (agreed) | £53,000 | |
| Y.P. 9.25 yrs at 9% | 6.1 | |
| P.V. 0.75 yrs at 9% | 0.94 | |
| Capital Value | £303,902 | |
| div. Y.P. 10yrs at 9% | 6.42 | |
| Open Market Rent | | £47,336 |

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 ten years.

| | | |
|-----------------------|---------|-----------------|
| Rent (agreed) | £56,000 | |
| Y.P. 2yrs. at 9% | 1.76 | |
| | | £98,560 |
| Rent | £56,000 | |
| Y.P. 6yrs. at 9% | 4.49 | |
| P.V. 4yrs at 9% | 0.71 | |
| | | <u>£178,522</u> |
| Capital Value | | £277,082 |
| div. Y.P. 10yrs.at 9% | 6.42 | |
| Open Market Rent | | £43,159 |

6.1.3 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 - £52,000.

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

| | | |
|-----------------------|---------|-----------------|
| Rent (agreed) | £35,000 | |
| Y.P. 1yr. at 9% | 0.92 | |
| | | £32,200 |
| Rent | £40,000 | |
| Y.P. 1yr. at 9% | 0.92 | |
| P.V. 1yr. at 9% | 0.92 | |
| | | £33,856 |
| Rent | £45,000 | |
| Y.P. 1yr. at 9% | 0.92 | |
| P.V. 2yrs. at 9% | 0.84 | |
| | | £34,776 |
| Rent | £50,000 | |
| Y.P. 1yr. at 9% | 0.92 | |
| P.V. 3yrs. at 9% | 0.77 | |
| | | £35,420 |
| Rent | £52,000 | |
| Y.P. 6yrs. at 9% | 4.49 | |
| P.V. 4yrs. at 9% | 0.71 | |
| | | <u>£165,771</u> |
| Capital Value | | £302,023 |
| div. Y.P. 10yrs at 9% | 6.42 | |
| Open Market Rent | | £47,044 |

6.1.4 **Capital Payments**

These may take the form of what are known as reverse premiums to assist the tenant with cash flow, fitting out costs, or taking over some liability from the tenant. Where it is felt that an adjustment is required, the capital sum should be divided by the Y.P. as appropriate (see para. 6.1). 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.

Rental evidence requiring the analysis of disproportionately large reverse premiums should be treated with caution.

Refer to 6.2.2 for Premiums.

6.1.5 **Assumption of liabilities**

The landlord may assume the liabilities of a tenant in respect of property previously occupied. In this case it will be necessary to estimate the value of the liability transferred. This will normally include such items as rent, rates and service charges for the period until a new tenant is found. It may also include an amount in respect of dilapidations at expiry of the lease. Where it is likely that the hypothetical tenant would have benefitted from an alternative form of incentive an adjustment should be made in line with the recommendations above. However, the more significant the adjustment required, the less reliable the rent becomes.

6.2 **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.

6.2.1 **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. However, the more significant the adjustment required, the less reliable the rent becomes.

Valuers must be careful to consider whether the adjusted rent includes or excludes the improvement primarily to ensure that the correct area etc is used when devaluing the rent.

6.2.1.1 Extensions, Alterations and Improvements

In the absence of rental evidence 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 landlord's break point, as appropriate, and adding this to the rent. Care should, however, be taken to ensure that only expenditure which enhances the rental value of the property is included.

6.2.1.2 Fitting Out New Buildings

Where a property has been let in a "shell" state and the lease provides for a rent review which excludes tenant's improvements, an adjustment to the rent may be required to reflect the value of the fitting out. In the absence of adequate rental evidence for fitted units the cost of the heritable works should be divided by the Y.P. for the whole term of the lease or to the first break point, or as considered appropriate, and the resultant value added to the net rent. Where this adjustment is being applied to a subsequent reviewed rent, it is appropriate to depreciate the costs over the same period.

If the costs relate solely to items of plant and machinery then careful consideration should be given as to whether a rental equivalent approach is appropriate or if they should be disregarded at the rental analysis stage and valued by way of the Contractor's Basis of valuation.

Where the reviewed rent reflects a fitted unit, no adjustment in respect of fitting out is necessary.

6.2.1.3 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 on the basis that there would be no advantage to the hypothetical tenant.

6.2.2 Premiums and Assignations

This is where the tenant pays a capital sum instead of, or in addition to a 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 addition. The amount to be added back should be found by dividing the premium by the Y.P. for the period 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 first term only.

E.g.: A property let on a 9 year lease with 3 yearly reviews to open market rent. The initial rent is £10,000 p.a. and the tenant pays a grassum (premium) of £5,000 at commencement.

| | | | |
|---|---------------|------|----------------|
| Procedure: | | Rent | £10,000 |
| Add the annual equivalent of the grassum: | | | |
| Grassum | <u>£5,000</u> | | |
| Divide by Y.P. 3 years @ 9.0% | 2.53 | = | £1,975 |
| Equivalent rent | | | <u>£11,975</u> |

Rental evidence requiring the analysis of disproportionately large premiums should be treated with caution.

Refer to 6.1.4 for capital payments or reverse premiums.

6.3 Further Adjustments to Statutory Terms

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.

6.3.1 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 | - | 6% |
| Internal repairs only | - | 5% |
| All repairs | - | 11% |

Particular caution should be exercised in the rare case of a property that is not let on an FRI basis being substantially improved by the tenant. In a situation where the landlord is not responsible for repairing the improvements the analysis could be distorted if a standard adjustment for repairs were to be applied.

Example:-

| | |
|--|----------|
| Net rent after incentives: | £100,000 |
| Add for tenant's improvements, say £20,000 | £120,000 |
| Deduct for repairs, -11% | -£13,200 |
| Adjusted rent | £106,800 |

Given that the landlord is not responsible for repairs to the improvements, in the absence of actual repair costs, the calculation should be as follows:

| | |
|--|----------|
| Net rent after incentives: | £100,000 |
| Add for tenant's improvements, say £20,000 | £120,000 |
| Deduct for repairs, say 11% of £100,000 | -£11,000 |
| Adjusted rent | £109,000 |

6.3.2 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. Whilst landlords also have a common law duty to keep the let property in tenable repair, they will generally seek to pass this liability on to the tenant, as anticipated by the definition of NAV.

In an analysis of rents, however, the valuer 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.

6.3.3 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 this is in accordance with the definition of NAV.

In the rare event that the landlord insures without directly recovering the insurance premium, a deduction will need to be made from the rent.

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 4% should be made from the stipulated rent.

7.0 Length of lease and Review Pattern

The review period assumed in this practice note is one to five years.

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.

The adjustment made should take account of the rate of property price inflation together with an appropriate equated yield. As this information may not be available a general adjustment of 1% per annum for every year in excess of a 5 year review pattern has traditionally been used. However, this adjustment is not universally accepted and may not be appropriate in recessionary conditions. In any event it should be used with caution or amended to suit local market conditions.

8.0 Adjusted Rent

After the above adjustments to rent have been made the figure obtained 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 s.6(8) the 1956 Act (see definition at paragraph 1.0).

Rents vary greatly in their reliability and it is essential that all rents are carefully considered before identifying those that will be relied upon in setting the level to be adopted. 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. Even where a property is let close to the tone date on terms similar to the statutory definition of Net Annual Value that rent will not necessarily be conclusive of value and it will still be necessary to have regard to any other open market rental evidence that might be available. This recognises the fact that actual rents are the product of individual negotiations, the outcome of which may be influenced by a variety of factors including the particular motives of the parties to the lease.

Appendix 1

| Rent free period example 1 from para. 6.1.2 | |
|--|---------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Year 1 |
| Tenant or mutual break option after 5 years | |
| Rent yrs 2-5 | £53,000 |
| YP 9.25yrs @ 9% | 6.10 |
| PV 0.75yrs @ 9% | <u>0.94</u> |
| Capital value | £303,902 |
| YP 10yrs @ 9% | <u>6.42</u> |
| Open market rent | £47,336 |
| Adj. for rent free period therefore | £5,664 |

| With break option (no penalty) | |
|---|---------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Year 1 |
| Tenant or mutual break option after 5 years | |
| Rent yrs 2-5 | £53,000 |
| YP 4.25yrs @ 9% | 3.41 |
| PV 0.75yrs @ 9% | <u>0.94</u> |
| Capital value | £169,886 |
| YP 5yrs @ 9% | <u>3.89</u> |
| Open market rent | £43,673 |
| Adj. for rent free period therefore | £9,327 |

| With break option and break penalty (1) | |
|--|--------------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Year 1 |
| Tenant or mutual break option after 5 years | |
| Penalty: | Repay 1 years rent |
| Rent yrs 2-5 | £53,000 |
| YP 4.25yrs @ 9% | 3.41 |
| PV 0.75yrs @ 9% | <u>0.94</u> |
| | £169,886 |
| Payment to landlord if break option exercised: | £53,000 |
| PV 5yrs @ 9% | <u>0.65</u> |
| | <u>£34,450</u> |
| Capital value | £204,336 |
| YP 5yrs @ 9% | <u>3.89</u> |
| Open market rent | £52,529 |
| Adj. for rent free period therefore | £471 |

| With break option and break penalty (2) | |
|--|---------------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Year 1 |
| Tenant or mutual break option after 5 years | |
| Penalty: | Repay 6 months rent |
| Rent yrs 2-5 | £53,000 |
| YP 4.25yrs @ 9% | 3.41 |
| PV 0.75yrs @ 9% | <u>0.94</u> |
| | £169,886 |
| Payment to landlord if break option exercised: | £26,500 |
| PV 5yrs @ 9% | <u>0.65</u> |
| | <u>£17,225</u> |
| Capital value | £187,111 |
| YP 5yrs @ 9% | <u>3.89</u> |
| Open market rent | £48,101 |
| Adj. for rent free period therefore | £4,899 |

| Rent free period example 2 from para. 6.1.2 | |
|--|-----------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Yrs 3&4 |
| Rent yrs 1&2 | £56,000 |
| YP 2yrs @ 9% | <u>1.76</u> |
| | £98,560 |
| Rent yr 5 | £56,000 |
| YP 6yrs @ 9% | 4.49 |
| PV 4yrs @ 9% | <u>0.71</u> |
| | <u>£178,522</u> |
| Capital value | £277,082 |
| YP 10yrs @ 9% | <u>6.42</u> |
| Open market rent | £43,159 |
| Adj. for rent free period therefore | £12,841 |

| With break option (no penalty) | |
|---|----------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Yrs 3&4 |
| Tenant's or mutual break option after 6 years | |
| Rent yrs 1&2 | £56,000 |
| YP 2yrs @ 9% | <u>1.76</u> |
| | £98,560 |
| Rent yr 5 | £56,000 |
| YP 2yrs @ 9% | 1.76 |
| PV 4yrs @ 9% | <u>0.71</u> |
| | <u>£69,978</u> |
| Capital value | £168,538 |
| YP 6yrs @ 9% | <u>4.49</u> |
| Open market rent | £37,536 |
| Adj. for rent free period therefore | £18,464 |

| With break option and break penalty (1) | |
|--|--------------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Yrs 3&4 |
| Tenant's or mutual break option after 6 years | |
| Penalty: | Repay 2 years rent |
| Rent yrs 1&2 | £56,000 |
| YP 2yrs @ 9% | <u>1.76</u> |
| | £98,560 |
| Rent yr 5 | £56,000 |
| YP 2yrs @ 9% | 1.76 |
| PV 4yrs @ 9% | <u>0.71</u> |
| | £69,978 |
| Payment to landlord if break option exercised: | £112,000 |
| PV 6yrs @ 9% | <u>0.60</u> |
| | <u>£67,200</u> |
| | £235,738 |
| YP 6yrs @ 9% | <u>4.49</u> |
| Open market rent | £52,503 |
| Adj. for rent free period therefore | £3,497 |

| With break option and break penalty (2) | |
|--|--------------------|
| Lease length | 15 yrs |
| Reviews | 5 yrly |
| Rent Free Period | Yrs 3&4 |
| Tenant's or mutual break option after 6 years | |
| Penalty: | Repay 1 years rent |
| Rent yrs 1&2 | £56,000 |
| YP 2yrs @ 9% | <u>1.76</u> |
| | £98,560 |
| Rent yr 5 | £56,000 |
| YP 2yrs @ 9% | 1.76 |
| PV 4yrs @ 9% | <u>0.71</u> |
| | £69,978 |
| Payment to landlord if break option exercised: | £56,000 |
| PV 6yrs @ 9% | <u>0.60</u> |
| | <u>£33,600</u> |
| | £202,138 |
| YP 6yrs @ 9% | <u>4.49</u> |
| Open market rent | £45,020 |
| Adj. for rent free period therefore | £10,980 |

Stepped rent example from para. 6.1.3

| | | |
|------------------|-------------|----------------|
| Lease length | 15 yrs | |
| Reviews | 5 yrly | |
| Stepped rents | Yrs 1-5 | |
| Rent yr 1 | £35,000 | |
| YP 1 yr @ 9% | <u>0.92</u> | £32,200 |
| Rent yr 2 | £40,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 1yr @ 9% | <u>0.92</u> | £33,856 |
| Rent yr 3 | £45,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 2yrs @ 9% | <u>0.84</u> | £34,776 |
| Rent yr 4 | £50,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 3yrs @ 9% | <u>0.77</u> | £35,420 |
| Rent yr 5 | £52,000 | |
| YP 6yrs @ 9% | 4.49 | |
| PV 4yrs @ 9% | <u>0.71</u> | £165,771 |
| Capital value | | £302,023 |
| YP 10yrs @ 9% | <u>6.42</u> | |
| Open market rent | | £47,044 |

With break option (no penalty)

| | | |
|---|-------------|----------------|
| Lease length | 15 yrs | |
| Reviews | 5 yrly | |
| Stepped rents | Yrs 1-5 | |
| Tenant's or mutual break option after 5 years | | |
| Rent yr 1 | £35,000 | |
| YP 1 yr @ 9% | <u>0.92</u> | £32,200 |
| Rent yr 2 | £40,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 1yr @ 9% | <u>0.92</u> | £33,856 |
| Rent yr 3 | £45,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 2yrs @ 9% | <u>0.84</u> | £34,776 |
| Rent yr 4 | £50,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 3yrs @ 9% | <u>0.77</u> | £35,420 |
| Rent yr 5 | £52,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 4yrs @ 9% | <u>0.71</u> | £33,966 |
| Capital value | | £170,218 |
| YP 5yrs @ 9% | <u>3.89</u> | |
| Open market rent | | £43,758 |

With break option and break penalty (1)

| | | |
|--|-------------|----------------|
| Lease length | 15 yrs | |
| Reviews | 5 yrly | |
| Stepped rents | Yrs 1-5 | |
| Tenant's or mutual break option after 5 years | | |
| Penalty: | £50,000 | |
| Rent yr 1 | £35,000 | |
| YP 1 yr @ 9% | <u>0.92</u> | £32,200 |
| Rent yr 2 | £40,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 1yr @ 9% | <u>0.92</u> | £33,856 |
| Rent yr 3 | £45,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 2yrs @ 9% | <u>0.84</u> | £34,776 |
| Rent yr 4 | £50,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 3yrs @ 9% | <u>0.77</u> | £35,420 |
| Rent yr 5 | £52,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 4yrs @ 9% | <u>0.71</u> | £33,966 |
| Capital value | | £170,218 |
| Payment to landlord if break option exercised: | £50,000 | |
| PV 5yrs @ 9% | <u>0.65</u> | £32,500 |
| | | £202,718 |
| YP 5yrs @ 9% | <u>3.89</u> | |
| Open market rent | | £52,113 |

With break option and break penalty (2)

| | | |
|--|-------------|----------------|
| Lease length | 15 yrs | |
| Reviews | 5 yrly | |
| Stepped rents | Yrs 1-5 | |
| Tenant's or mutual break option after 5 years | | |
| Penalty: | £25,000 | |
| Rent yr 1 | £35,000 | |
| YP 1 yr @ 9% | <u>0.92</u> | £32,200 |
| Rent yr 2 | £40,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 1yr @ 9% | <u>0.92</u> | £33,856 |
| Rent yr 3 | £45,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 2yrs @ 9% | <u>0.84</u> | £34,776 |
| Rent yr 4 | £50,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 3yrs @ 9% | <u>0.77</u> | £35,420 |
| Rent yr 5 | £52,000 | |
| YP 1yr @ 9% | 0.92 | |
| PV 4yrs @ 9% | <u>0.71</u> | £33,966 |
| Capital value | | £170,218 |
| Payment to landlord if break option exercised: | £25,000 | |
| PV 5yrs @ 9% | <u>0.65</u> | £16,250 |
| | | £186,468 |
| YP 5yrs @ 9% | <u>3.89</u> | |
| Open market rent | | £47,935 |