

DOUG STEVENS SEMINAR

MONDAY 14th MARCH 2016

08.00HRS TO 09.00HRS

VENUE : **CBRE**

`C-BAR`

Henrietta House

Henrietta Place

W1G 0NB

SUBJECT

1. *SERVICE CHARGES*
2. *HEADLINE RENTS*
3. *OPEN QUESTIONS*

SEMINAR BY DOUG STEVENS TO 1st & 2nd YEAR GRADUATES

DELIVERED AS A POWERPOINT PRESENTATION

SERVICE CHARGES

▶ WHAT IS A SERVICE CHARGE?

- ▶ Service charges enable an owner to recover from the occupiers the costs of servicing and operating a property.

▶ WHAT WILL IT COVER?

- ▶ It will include reasonable costs of maintenance, repair and replacement (usually where beyond economic repair) of the fabric, plant, equipment and materials necessary for the property's operation, plus any other works and services the parties agree are to be provided by the owner, but subject to reimbursement by the occupier.

▶ WHAT DON'T THEY INCLUDE?

- ▶ initial costs (including the cost of leasing of equipment) incurred for the design and construction of the fabric, plant or equipment
- ▶ setting up costs, including costs of fitting out and equipping the on-site management offices that are reasonably considered part of the original development cost of the property any improvement costs above the costs of normal maintenance, repair or replacement. future redevelopment costs
- ▶ costs between the owner and an individual occupier, ie, - enforcement of covenants - collection of rents - costs of letting units - consents for assignments - subletting - alterations - rent reviews, etc.
- ▶ costs arising out of the failure or negligence of the manager or owners

ON WHICH PROPERTIES ARE SERVICE CHARGES LEVIED?

- ▶ SHOPS/STORES IN SHOPPING CENTRES. SHOPS IN LARGE BLOCKS
- ▶ UNITS ON RETAIL PARKS & LEISURE PARKS
- ▶ OFFICES IN MULTI-LET BUILDINGS
- ▶ RESIDENTIAL, etc
- ▶ WHY ARE THE MAIN FACTORS WHICH GOVERN SERVICE CHARGE LEVELS?
- ▶ THE SIZE OF THE BUILDING/CENTRE - ECONOMIES OF SCALE
- ▶ THE TYPE OF BUILDING/CONSTRUCTION - MULTI-LET - COVERED/OPEN - GLASS/BRICK
- ▶ THE LEVEL OF SERVICES - AIR CONDITIONING - LIFTS /ESCALATORS
- ▶ WHAT ARE TYPICAL SERVICE CHARGE RATES PER SQ FT?
- ▶ LARGE COVERED REGIONAL SHOPPING CENTRE - 1M sq ft +
- ▶ WESTFIELD £15 - 18 psf
- ▶ OPEN SHOPPING CENTRE £3- £5 psf - security, cleaning - BUT less M & E as it is not an environmentally controlled environment
- ▶ RETAIL PARK £1.50 psf - landscaping

MEDIUM SIZED COVERED SHOPPING CENTRE - RUGBY

- ▶ Clock Towers Centre. Modern covered scheme of 220,000 sq ft 60 units multi-storey car park above
- ▶ On-site Centre Manager and Operations Manager.
- ▶ The service charge is apportioned on a floor area basis.
- ▶ There is a separate service charge for the scheme and for the car park.
- ▶ The service charge year runs until 31st December each year
- ▶ the table below sets out the service charge expenditure in recent years:
- ▶ Y/E December 2013 £1,171,262
- ▶ Y/E December 2014 £1,157,309
- ▶ Y/E December 2015 (budget) £1,206,076
- ▶ The service charge budget for the year ending December 2015 is £1,206,076
- ▶ and this equates to **£5.43 per sq ft** overall.
- ▶ The marketing and promotions budget for year ending December 2015 is £92,000
- ▶ The landlord makes a direct contribution to this budget of 50% (£46,000 - 2015)
- ▶ A full planned preventative maintenance report (PPM) was commissioned and implemented in 2014 to make provision for the scheme for the next five years.
- ▶ These works are incorporated into the latest service charge budget.

WHAT CAN THE PAYER OF SERVICES CHARGES REASONABLY EXPECT ?

- ▶ **Princes House Ltd v Distinctive Clubs Ltd [2006] All ER (D) 117 (sep). [2007] 14 EG 104 (CS)**
- ▶ ‘Tenants who agree to service charge clauses under which they contract to pay against a surveyor’s estimate or an accountant’s certificate rely upon the professional people involved performing their roles with professional scrupulousness, diligence, integrity and independence , not in a partisan spirit supposing their **only task to be to recover as much money as they can for the landlord.**’

Jonathan Gaunt QC sitting as a deputy high court judge

- ▶ OCCUPIERS VIEW SERVICE CHARGE AS A COST OF OCCUPATION EQUIVALENT TO RENT
- ▶ WHERE THEY CAN CHALLENGE THE SERVICE CHARGE LEVEL THEY WILL DO SO
- ▶ SOME USE SERVICE CHARGE CONSULTANTS TO FORENSICALLY EXAMINE THE SERVICE CHARGE
- ▶ SERVICE CHARGES ARE BOTH A MINEFIELD AND A BATTLEFIELD FOR DISPUTES
- ▶ **IS THERE A CODE TO GOVERN HOW SERVICE CHARGES ARE LEVIED/MANAGED ?**
- ▶ **YES - AN RICS CODE**

RICS Code of Practice

Service charges in commercial property (3rd edition – 2014)

- ▶ WHAT DOES IT SEEK TO DO ?
- ▶ The Code is to promote best practice in terms of service charges for commercial properties in new leases or renewed leases
- ▶ It sets out the best practice for every aspect of charging for the management and operation of a building, procuring services, accounting for and certifying costs, etc.
- ▶ BUT unless the Code is being used to help draft the service charge provisions which will go in to the lease for a newly developed building it cannot over-ride the service charge provisions in an existing lease
- ▶ The administration of service charges in an existing lease **MUST** follow the service charge provisions set out in that lease whether or not they constitute RICS best practice
- ▶ **EVERY LEASE MAY HAVE DIFFERENT SERVICE CHARGE PROVISIONS**
- ▶ Many clauses might be standard but variations often negotiated by tenant
- ▶ So each and every lease must be read to establish -;
 - what heads of service charge are recoverable?
 - how each tenants service charge is calculated?

SCOPE FOR ARGUMENT?

- ▶ SHOULD TENANT IN COVERED CENTRE IN AN EXTERNAL FACING UNIT PAY THE SAME AS MALL TENANT ?
- ▶ NO
- ▶ SHOULD AN ANCHOR STORE HAVE A CONCESSIONARY RATE?
- ▶ YES - BUT
- ▶ DOES THE LANDLORD ALWAYS RECOVER THE FULL SERVICE CHARGE COST ?
- ▶ NO
- ▶ WHAT IS A SERVICE CHARGE SHORTFALL?
- ▶ LANDLORD CANNOT RECOVER FULL SERVICE CHARGE COSTS - VOID UNITS - TENANT HAS CONCESSIONARY TERMS (SHORT TERM LEASE) - OR TENANT HAS NEGOTIATED FAVOURABLE VARIATIONS TO STANDARD SERVICE CHARGE PROVISION -IE, INCREASES LIMITED TO RPI (RATHER THAN ACTUAL INCREASES) OR CAPPED SERVICE CHARGE ie, IT CANNOT EXCEED A SET SUM
- ▶ THERE IS AN OPORTUNITY TO RE-NEGOTAITE AT LEASE EXPIRY ON RENEWAL

SERVICE CHARGE - CASE LAW

▶ CHRISTMAS DECORATIONS

▶ [Boots UK Limited v Trafford Centre \[8 December 2008\]](#)

- ▶ This case involved a challenge to commercial service charges and the interpretation of the lease provisions.
- ▶ The tenant objected to having to contribute towards costs the landlord had incurred in relation to entertainment, Christmas decorations, a Santa's Grotto and a Skywall
- ▶ It was agreed that the landlord could charge for these items under the service charge provisions, and the judge was asked to decide whether such items constituted "promotions".
- ▶ The tenant argued that anything that was designed to bring custom to the centre was promotion and that therefore the landlord was liable to contribute 50% of the costs.
- ▶ The judge actually distinguished between (i) items that were definite "promotion" and (ii) those that were merely "of benefit" to the Centre (eg attractions, facilities or amenities at the Centre).
- ▶ The Landlord would be liable for 50% of the former, but would have to make no contribution for the latter.
- ▶ On the facts it was held that the four items were merely of "benefit" to the Centre as opposed to actively promoting it.

CASE LAW ON REPAIR V REPLACEMENT/IMPROVEMENT

- ▶ **OPPING CENTRE ROOF - SHOULD YOU PATCH AN OLD ROOF OR REPLACE IT ?**
- ▶ **Postel Properties Ltd v Boots the Chemist (1996)**
- ▶ The issue was the roof of a Milton Keynes shopping centre. The centre was constructed in 1975 and the roof had a life expectancy of 20 years.
- ▶ When repairs were carried out after 15 years, the landlord took the opportunity to replace the roof covering altogether.
- ▶ It was held that this was acceptable and the cost could be recovered from tenants. The reasoning was that the works were such that a reasonably minded building owner would have undertaken them and they did not amount to giving the landlord something different from what had existed before.
- ▶ **WHAT ABOUT UPGRADING EXISTING AIR CONDITIONING SYSTEM ?**
- ▶ In contrast, the case of **Fluor Daniel Properties Ltd v Shortlands Investments Ltd (2001)** established that a landlord cannot recover improvements when the premises or facilities in question are in proper working order.
- ▶ In this case, the landlord of a commercial block equipped with an air-conditioning system failed to convince the court that its demand for £2m under the service charge to recover expenditure on upgrading this system was justified.

THE SERVICE COSTS

- ▶ Best practice recommends that services are procured on an appropriate value-for-money basis, and that competitive quotations are obtained or the costs benchmarked.
- ▶ Owners should not profit from the provision or supply of services.
Save for a reasonable commercial management fee that reflects the actual costs of managing the services, the amount an owner may recover is limited only to the proper and actual cost incurred in the provision or supply of services.
- ▶ All costs are to be transparent so that all parties, owners, occupiers and managers, are aware of how the costs are made up.
Management fees are to be on a fixed price basis with no hidden mark ups.

COSTS

- ▶ **DETAILED EXPENDITURE REPORT**
- ▶ **Cost category**
- ▶ **Management fees**
- ▶ **Accounting fees S/C audit fees**
- ▶ **Site management resources Staff costs**
- ▶ **Site accommodation (rent/rates)**
- ▶ **telephones/stationery**
- ▶ **Health, safety and environmental Risk assessments and audits**
- ▶ **DETAILED EXPENDITURE REPORT**
- ▶ **Cost category**
- ▶ **Management fees**
- ▶ **Accounting fees S/C audit fees**

COSTS CONT`D

- ▶ **Site management resources Staff costs**
- ▶ **Site accommodation (rent/rates)**
- ▶ **telephones/stationery**
- ▶ **Health, safety and environmental Risk assessments and audits**
- ▶ **UTILITIES Electricity Oil Gas Water**
- ▶ **Procurement consultancy**
- ▶ **SOFT SERVICES**
- ▶ **Security guarding**
- ▶ **Security systems**
- ▶ **Cleaning and environmental Internal cleaning**
- ▶ **External cleaning**
- ▶ **Window cleaning**

COSTS CONTD

- ▶ **Hygiene services/toiletries**
- ▶ **Waste management**
- ▶ **Pest control**
- ▶ **Seasonal decorations**
- ▶ **Internal floral displays**
- ▶ **Estate cleaning**
- ▶ **External landscaping**
- ▶ **Marketing and promotions**

COSTS CONT`D

- ▶ **HARD SERVICES**
- ▶ **Mechanical and electrical services (M&E) M&E maintenance contract M&E repairs**
- ▶ **M&E inspections and consultancy**
- ▶ **Life safety systems maintenance**
- ▶ **Life safety systems repairs**
- ▶ **Lift and escalators Lift maintenance contract**
- ▶ **Lift repairs**
- ▶ **Suspended access equipment Maintenance contract 00**
- ▶ **REPAIRS**
- ▶ **Fabric repairs and maintenance Internal repairs and maintenance**
- ▶ **External repairs and maintenance**
- ▶ **Redecorations Estate repairs and maintenance**
- ▶ **Car park repairs and maintenance**

COSTS CONT`D

- ▶ **INCOME**
- ▶ **Interest**
- ▶ **Income from commercialisation**
- ▶ **INSURANCE**
- ▶ **Engineering insurance**
- ▶ **All risks insurance cover**
- ▶ **Terrorism insurance**
- ▶ **EXCEPTIONAL EXPENDITURE**
- ▶ **Major works**
- ▶ **Plant replacement**
- ▶ **PLANNED PREVENTITIVE MAINTENANCE (PPM)**

ALLOCATION AND APPORTIONMENTS

- ▶ **Costs should be allocated to the relevant expenditure category. Where reasonable and appropriate, costs should be allocated to separate schedules and the costs apportioned to those who benefit from those services.**
- ▶ **The basis and method of apportionment should be demonstrably fair and reasonable to ensure that individual occupiers bear an appropriate proportion of the total service charge expenditure that clearly reflects the availability, benefit and use of services.**
- ▶ **Managers are expected to make available to all occupiers a full apportionment matrix that clearly shows the basis of calculation and the total apportionment per schedule for each unit within the property/complex.**
- ▶ **Costs are to be apportioned to each occupier in accordance with the core principles.**
- ▶ **The basis and method of allocating and apportioning the service charge expenditure is to be transparent and clearly communicated to all.**

ALLOCATION AND APPORTIONMENTS CONT'D

- ▶ **Any inducements or concessions to attract occupiers to a property are to be borne by the owner, and not spread among other occupiers.**
- ▶ **The rationale for the apportionment between occupiers should be set down in writing, and subsequently re-examined periodically to see whether there is a need for a new apportionment matrix or new apportionment method to be applied.**
- ▶ **Where reasonable and appropriate, costs can be allocated to separate schedules and the costs apportioned to those who benefit from those services.**
- ▶ **In many cases, particularly regarding buildings with a variety of users, not all of the occupiers will benefit from the services to the same extent. In such circumstances, it may be necessary to divide the service charges into separate parts (schedules) to reflect the availability, benefit and use of services, with each part being individually apportioned between occupiers according to the core principles.**
- ▶ **The allocation of costs to separate schedules is essential in achieving a fair and proper apportionment of costs between those occupiers that benefit from specific services. Occupiers will therefore often pay different percentage apportionments under different schedules**

APPORTIONMENTS CONT`D

- ▶ **Floor-area apportionment** Apportionment based on floor area is the most common, and often the simplest, method of apportionment. The standard floor-area apportionment is the ratio the premises bear to the total lettable parts of the building. RICS Code of Measuring Practice sets out definitions
- ▶ **Rateable values** are no longer recommended as an appropriate method for calculating service charge apportionments
- ▶ **Weighted-floor area apportionment.** In addition to the usual recommended methods for the apportionment of service charges, many shopping centre developments often feature a 'weighted-floor area' basis of apportionment that seeks to reflect the different costs involved in servicing different-sized units.
- ▶ **A weighted-floor area apportionment** discounts the percentage the occupier will pay over a certain size to reflect the benefit of the services provided. The floor area is divided into bands with a progressive discount, and is a similar concept to the zoning of shops for rental purposes.
- ▶ **Therefore, for example, a 5,000m² unit may not cost five times that of a 1,000m² unit, but a 500m² unit may cost twice that of a 250m² unit. There is no such thing as a standard weighting formula. Where the use of a weighted formula is considered to be appropriate, this is to be formulated to reflect the particular circumstances, size of units, layout and use of the scheme being serviced (see below).**

WEIGHTING OF FLOORSPACE

▶ BY FLOOR

▶ SIMILARLY, THE FLOOR AREA OF ANCILLARY BASEMENT AND UPPER-FLOOR ACCOMMODATION, OR OF REMOTE STORAGE, MIGHT BE DISCOUNTED TO REFLECT THE REDUCED BENEFIT DERIVED FROM CERTAIN SERVICES AS DISTINCT FROM THE GROUND-FLOOR RETAIL SPACE OR MAIN OFFICES.

▶ GROUND FLOOR 5,000 SQ FT @ 100% 5,000

▶ FIRST FLOOR 5,000 SQ FT @ 50% 2,500

▶ STORE OF 10,000 SQ FT (G/F 5,000 F/F 5,000) ON A WEIGHTED BASIS IS 7,500 SQ FT (NOT 10,000 SQ FT)

▶ OR BY SIZE

▶ COMPARE A 1,000 SQ FT UNIT WITH A 10,000 SQ FT UNIT - ALTHOUGH TEN X LARGER IN FLOOR AREA, THE 10,000 SQ FT SHOULD NOT PAY 10 X THE SERVICE CHARGE OF THE SMALLER UNIT.

▶ FIRST 5,000 SQ FT @ 100% (5,000)

▶ THE NEXT 5,000 SQ FT @ 75% (3,750)

▶ EXCESS OVER 10,000 SQ FT @ 50% (5,000)

▶ **20,000 SQ FT** STORE UNWEIGHTED IS 20,000 SQ FT – BUT WEIGHTED IT IS **13.750 SQ FT**

EXISTING LEASES

- ▶ **The basis by which service charges are operated and managed is set down in the contract between the owner and occupier, otherwise known as the lease.**
- ▶ **Many service charge disputes are caused by the failure of managers and/or occupiers to read and properly understand the respective obligations and liabilities under the contractual arrangement made between them.**
- ▶ **Therefore, care and attention is required to understand the contractual basis of the service charge arrangements properly.**
- ▶ **Existing leases may contain service charge provisions that differ from the recommendations in this Code.**
- ▶ **Where this is the case, this Code cannot override the lease, but existing service charge clauses are to be interpreted as far as possible in line with the principles and practices as set out here.**
- ▶ **This applies unless the lease specifically stipulates a different approach, which therefore has legal force. Where doubt or possible ambiguity exists, seek specialist professional advice**

NEW LEASES

- ▶ **As new leases are granted and older leases renewed, it is essential to bring service charge clauses up to modern standards.**
- ▶ **If modernisation of the service charge provision of the lease is required, both to meet best practice and in the interests of compatibility with other occupiers, and this results in an increase or decrease in the amount payable by the occupier, this is to be taken into account in any negotiations, for instance, as reflected in the rent payable.**
- ▶ **While this Code cannot override the lease, it does set out the industry-accepted best practice in the field of service charges. It will help solicitors, their clients (be they owners or occupiers) and the managers of service charges to draft, interpret and operate leases in accordance with best practice.**
- ▶ **It is recommended that owners, occupiers and their solicitors ensure the lease they sign reflects this Code, which will enable more effective, business-focused service charge management during the course of the lease.**
- ▶ **Terms should be relevant and appropriate recognising the length of the lease term, and the scale and type of property concerned.**
- ▶ **At the time of lease renewal, the service charge clauses will certainly require review and probably modernisation/updating.**
- ▶ **It is recommended that new leases be drafted with sufficient flexibility to allow for changes in best practice.**

NEW LEASES CONT`D

- ▶ **The attention of owners, managers and occupiers is also drawn to the Code for Leasing Business Premises, which provides further guidance for negotiations before the grant of a lease or lease renewal in creating a document that is clear, concise and authoritative.**
- ▶ **Further information can be obtained from www.leasingbusinesspremises.co.uk It is unlikely that all leases within a multi-let property will fall for renewal on the same date.**
- ▶ **Modernising the service charges on an ad hoc basis may lead to a ‘dual’ service charge, where in effect two service charge arrangements would operate in tandem, with one based on the older form of leases, and the other based on the modern form.**
- ▶ **Therefore, interim arrangements may be necessary to ensure the practical operation of the services and the recoverability of the service costs during the intervening period until such time as all leases have been modernised.**
- ▶ **For example, renewal leases might reflect the ideal service charge regime going forward, as well as the status quo, so that when the tipping point is reached, the owner can swap from the old lease service charge regime to the new.**

REPLACEMENT / ENHANCEMENT

▶ LIKE-FOR-LIKE REPLACEMENT

- ▶ The service charge should be limited to the costs of replacement and renewal of fabric, plant or equipment only, providing: + the relevant items being replaced or renewed are beyond economic repair, or efficient or economic operation + replacement or renewal of such items is a relatively low cost compared with the much greater cost that could occur due to material postponement of the replacement or renewal or + replacement or renewal of such items is a proper requirement of any public or competent authority or legislation, or of the insurers.

▶ REPLACEMENT WITH ENHANCEMENT

- ▶ Where plant and equipment that has become dilapidated or worn out is replaced, the replacement will usually include an element of enhancement or upgrade of the previous equipment, due to the fact that the replacement will be of an equivalent modern standard. Strictly speaking, replacement of plant and equipment by its modern equivalent would generally fall within the definition of repair and not improvements.
- ▶ However, there may well be a tendency towards exceeding the design specification of the original equipment in order to meet modern requirements, or to introduce new products or practices intended to improve the service levels and/or value for money. If the costs are to be recovered through the service charge, it is important to consider whether the intention is to improve or repair the existing equipment

IMPROVEMENT AND ENHANCEMENT

- ▶ **Service charges would not generally include the cost of improvement above the cost of normal maintenance, repair and replacement as above, but it is likely that circumstances will arise where owners and occupiers would see a direct benefit from the introduction of new innovations or additional improvement or enhancements of the building fabric, plant, or equipment.**
- ▶ **The service charge might include such costs where the expenditure can be justified following analysis of reasonable options and alternatives, and having regard to a cost/benefit analysis over the term of the occupiers' leases.**
- ▶ **Managers should communicate any proposals clearly to occupiers, and provide the facts and figures to support and justify such a proposal (see also section 9 Environmental sustainability).**

REFURBISHMENT

- ▶ **Refurbishment is a different concept to improvement. Within the scope of the refurbishment works proposed there may include elements of catching up on accumulated disrepair as well as elements of improvement.**
- ▶ **The amount occupiers will contribute towards the cost of refurbishment will depend on the extent and nature of the works proposed, in addition to the wording of the lease.**
- ▶ **Owners will seek to protect the value of their investments and to maximise rental levels. Refurbishments are often dictated by market forces, and are generally timed to coincide with rent reviews or lease expiries.**
- ▶ **Occupiers often object to contributing towards the cost of refurbishment because not only will they be paying for the cost of refurbishment through the service charge, but also through increased rents as a result of any improvements.**

SWEEPER CLAUSES

- ▶ It is often difficult to predict precisely what services might be provided through the duration of a long lease, and which are to be covered by the service charge.
- ▶ To avoid the risk of incurring costs that might fall outside of the service charge, most leases contain a 'sweeper' provision entitling the owner to charge, not only for the services specifically listed, but also for other miscellaneous services that might be provided in the future.
- ▶ This is not usually a problem for short leases however, as in these cases it is far easier to accurately predict the services that are to be provided.
- ▶ Unless a lease incorporates very clear wording to the contrary, if the owner had in mind the provision of a service, but has not covered the right to include the cost of providing it in the service charge, he or she will not generally be able to use the sweeper clause as authority to recover the cost.
- ▶ A sweeper clause cannot be used to cover the cost of something that was left out of the lease in error. The intention is to give the owner the ability to provide further services that are not identified or in contemplation at the time the lease was granted, and that, for any reason, are considered necessary or desirable to be provided at a later time

MARKETING & PROMOTIONS

- ▶ The marketing of and promotional activity for a shopping centre scheme is recognised as being of joint benefit to all stakeholders, and are therefore jointly funded.
- ▶ The **service charge budget and accounts** should be **transparent** and should include the gross marketing and promotional expenditure and the contribution from the owner. This will clearly show the net contribution due from the occupiers. It is best practice for marketing plans (including promotions) to be prepared and presented to occupiers in advance of the period to which they relate.
- ▶ Where the service charge bears the cost, all pedestrian flow-data collected is to be issued to occupiers as a matter of course.
- ▶ Any costs incurred in relation to the initial promotional launch and/or rebranding of a scheme are to be borne by the owner, and are not to be considered as recoverable service charge costs.
- ▶ It is recommended that any plan to relaunch a centre be discussed between manager and occupiers so that they can agree to an appropriate split of the expenditure to each party.
- ▶ The marketing of vacant units in the scheme is not a service charge item.

COMMERCIALISATION - MALL INCOME, etc

- ▶ Increasingly, owners are finding additional non-core income streams from their investments. It is clear that they are entitled to receive this income from the investment they have made. However, if the service charge has provided either the initial capital or ongoing services for the income stream, the income is to be used as a credit against the service costs.
- ▶ When the owner provides the capital but uses the services to support the operation, an appropriate contribution to the service charge is to be made by the owner to reflect the benefit and use of the services. Best practice for the owner is to clearly state his or her policy with regard to miscellaneous income within the development. As well as rents being collected on occupational leases, income is also generated from other sources.
- ▶ Many properties receive income from vending-machine takings, selling recyclable waste, etc., while shopping centres and malls also receive income from promotional space (e.g. advertising on displays and drums and in car parks, etc.) and licences granted for other mall activities (e.g. children's rides, photo booths, etc).
- ▶ Occupiers may also have (chargeable) use of photocopiers in the management offices. How such income is treated varies considerably from property to property, and from owner to owner

SUSTAINABILITY

▶ Green leases

- ▶ The sustainability debate has been very much focused on how to develop more sustainable buildings, but it has ignored two key issues: what to do with existing buildings and the role of the occupier in reducing emissions. The recent emergence of green leases in the UK may be one way of addressing these issues. Green leases are standard commercial property leases pertaining to cooperation between landlord and tenants, with the aim of reducing waste production and energy and water consumption.

▶ Carbon Reduction Commitment Energy Efficiency Scheme (CRC)

- ▶ In May 2010 the government committed to increasing the proportion of tax revenue accounted for by environmental taxes. The government classifies environmental taxes as those that meet all of the following three principles:
 - ▶ + the tax is explicitly linked to the government's environmental objectives
 - ▶ + the primary objective of the tax is to encourage environmentally positive behaviour change and
 - ▶ + the tax is structured in relation to environmental objectives (for example, the more polluting the behaviour, the greater the tax levied).

SHOULD WE MAKE A RENTAL ADJUSTMENT FOR EXCESSIVE SERVICE CHARGE ?

▶ EXAMPLE SUPERMARKET PAYING (UNWEIGHTED £5 psf) – OTHER COMPS AT £3 psf

▶ YES - USUAL TO TAKE 50% OF THE EXCESS – SO ADJUST RENT BY £1 psf

▶ SHOULD WE MAKE A RENTAL ADJUSTMENT FOR CONCESSIONARY SERVICE CHARGE ?

▶ EXAMPLE STORE PAYING ONLY £3 psf WHEN TRUE COST IS £5 psf

▶ YES - AGAIN MAKE AN ADJUSTMENT OF 50% OF THE UNDERPAYMENT ie, ADD £1 psf

HEADLINE RENTS & NET EFFECTIVE RENTS

▶ HEADLINE RENT

▶ A headline rent is a rent that is above the market rent. A headline rent review provision may be agreed at the time of grant of a lease to take account of some form of concession that is given to the tenant such as a shorter term, a break option or a rent-free period. The benefit to the landlord is that the headline rent will increase the value of its reversionary interest.

▶ Landlords will sometimes try to achieve the payment of a headline rent on review because it enables them to obtain an increase in rent when the market is flat or falling. To achieve that, the rent review clause would need to provide that any rent-free period or other inducement is to be disregarded or treated as having expired. It would not be sufficient for the provision to say that no reduction or allowance is to be made on account of the rent-free period or concession.

▶ NET EFFECTIVE RENT

▶ The rent payable on a rent review is typically based on the hypothesis that the tenant has enjoyed a rent free period for fitting out (or does not need one), but any rent free period longer than that needed for fitting out, regarded as an inducement, is still to come. Rent review surveyors have to arrive at a rent payable from day one and use their skill and experience to calculate the net effective rent from the open market headline rent and the inducement.

HEADLINE RENT CASE LAW

- ▶ Headline Rent Clauses seek to ignore all inducements normally available in the market at the time of the review. The “Headline Rent” cases of 1994 were four appeals heard simultaneously by the Court of Appeal as to whether four rent review clauses achieved this
- ▶ [\(Co-Operative Society Limited v National Westminster Bank plc\)](#).
- ▶ Three similar clauses sought to do so by directing a disregard of any effect on rent of all such inducements. The Court of Appeal held that this did not result in headline rents because the hypothetical tenant would know that he would not get the benefit of any such inducements and so would offer a commensurately lower rent to take account of that fact.
- ▶ In the fourth case, [Broadgate Square-v-Lehman Brothers](#), the definition of the reviewed rent was “the best rent which would reasonably be expected to become payable after the expiry of a rent-free period of such length as would be negotiated in the market upon a letting of the Premises as a whole”. The Court of Appeal held that this wording left no alternative to a headline rent.
- ▶ In [Broadgate Square Plc v Lehman Brothers Ltd](#) the lease provided for the rent to be reviewed to the best yearly rent reasonably to be expected after expiry of a rent--free period of such length as would be negotiated in the open market on a letting of the whole of the premises, between willing parties, with vacant possession without fine or premium. The court held that reference to the rent--free period being of “such length as would be negotiated in the open market” made it impossible to restrict the words to only rent--free periods for a tenant having to move in/fit out.
- ▶ The courts try to construe headline rent clauses so as to favour the tenant wherever possible.

EXAMPLE OF HEADLINE RENT

- ▶ OFFICE BUILDING 10,000 SQ FT TO LET ON 10 YEAR LEASE (NO BREAKS)
- ▶ CURRENT TONE £50 PER SQ FT
- ▶ RENTAL VALUE £500,000 PER ANNUM EXCLUSIVE (PAX)
- ▶ BUT LANDLORD OFFERS £ 1M TO TENANT IF THEY WILL PAY £60 PER SQ FT (£600,000 PAX)
- ▶ LANDLORD SEES BIG UPLIFT IN CAPITAL VALUE
say extra £100,000 pax @ NIY 5% (20 x) = £2m uplift in value
- ▶ TENANT GETS CAPITAL SUM £1M BUT HAS TO PAY A HIGHER RENT OVER THE TERM
- ▶ THE HEADLINE RENT IN THIS TRANSACTION IS £600,000 pax - £60 per sq ft
- ▶ CAN THE EVIDENCE AT £60 PER SQ FT BE USED ON OTHER RENT REVIEWS ?
- ▶ NO - NOT WITHOUT AN ADJUSTMENT TO A NET EFFECTIVE RENT
- ▶ WHAT IS THE TRUE (NET EFFECTIVE RENT) PAID BY THE TENANT
- ▶ TAKE CAPITAL SUM - SPREAD IT OVER THE LENGTH OF THE LEASE - £1M OVER 10 YRS
- ▶ = £100,000 pax DEDUCT THIS FROM ACTUAL RENT PAYABLE = £500,000 pax = £50 per sq ft

CO--OPERATIVE WHOLESALE SOCIETY LTD V NATIONAL WESTMINSTER BANK PLC

- ▶ **The Court of Appeal held that the wording of the clause meant that it was necessary to assume that any rent--free or concessionary rent period or other inducement had already been given, i.e. before the hypothetical lease was agreed.**
- ▶ **Therefore the valuer would not be comparing like with like if he simply took the headline rent from a comparable property that provided for a rent--free period after commencement of the term.**
- ▶ **The court said that the effect of the provision was that the hypothetical tenant was to be treated as already being in occupation, so he could not argue for the equivalent of a rent--free period for fitting--out.**
- ▶ **Therefore the clause only succeeded in denying the tenant the right to claim discount for the time and cost of fitting—out ; it failed to remove the discount for other inducements.**

ANALYSIS TO ESTABLISH NET EFFECTIVE RENT

- ▶ **RICS Guidance Note 6 to the Red Book (RICS, 2012) set out 4 methods to analyse Net Effective Rent. The purpose of the analysis is to establish the net effective rent having regard to the package of incentives incorporated into the specific transaction.**
- ▶ **Method 1 devalue to a net effective rent and then apply to arrive at net effective rent for the subject premises, adjusting if necessary for any differences (eg, lease length) that might impact on the scale of the incentive**
- ▶ **Method 2 use the comparable evidence to find the market package (the headline rent and incentives) that would be likely to be agreed in the market place for the subject premises, and then adjust that transaction to reflect the assumed lease terms and then calculate the net effective rent.**
- ▶ **Method 3 is based on subjective capitalisation rate adjustments between the rate applied to a headline rental value and the rate applied to an effective rental value.**
- ▶ **Method 4 is an explicit discounted cash flow approach requiring both a target return rate and a rental growth rate as inputs.**
- ▶ **Method 1 (straight line) most commonly used for retail. Method 4 (DCF) often used for offices**

ANALYSIS TO ESTABLISH NET EFFECTIVE RENT CONT'D

- ▶ The treatment of the incentive does not necessarily depend upon its nature. However, the way in which the payment is made and the manner in which the tenant chooses to spend it may have relevance, for example, in terms of accounting or tax implications.
- ▶ The valuer may need to decide if the net effective rent is to be calculated including or excluding a rent-free period during which the fitting out works take place.
- ▶ In the case of rent reviews, the lease wording should be checked carefully. There are two possible approaches. The first is to assume that under the hypothetical 'net effective rent deal', the tenant would receive a rent-free period equal to the fitting-out period only. An alternative approach is to assume that the fit out has taken place before the start of the lease term.

ANALYSIS TO ESTABLISH NET EFFECTIVE RENT CONT'D

- ▶ **As an example, a hypothetical deal has a total rent-free allowance of six months including an assumed fit-out period of two months. In the first approach, the comparison would be between a headline rent deal with six months rent-free and a net effective rent deal with two months rent-free. In the second case, the comparison would be between a headline rent deal with four months rent-free and a net effective rent deal with no rent-free period. It is common for rent review clauses to specify the second approach, which is also the basis adopted in the examples in the appendix to this guidance note. However, the calculations could be easily adapted to reflect the first approach.**
- ▶ **The time over which the incentive should be analysed is a much debated point. The landlord will usually look for the longest time, such as the full term of the lease, and the tenant for the shortest time, such as the first review. The valuer has to decide between these conflicting claims, having regard to the overall effect of all the incentives, anticipated rental growth and knowledge of the market, motivations of the parties and what, in reality, might be achieved in an open market letting on the hypothetical terms. Tenants will commonly seek to minimise the anticipated rental payments, and the occupier landlord will try to mitigate the liability. Investor landlords will commonly seek to maximise capital value.**

ANALYSIS TO ESTABLISH NET EFFECTIVE RENT CONT'D

- ▶ **Devaluation may be calculated on a simple straight-line apportionment, or by using discounting through a discounted cashflow (DCF) or all-risks yield approach. The clear local market practice for relatively small premises is the simple straight-line apportionment approach and hence this method should be employed unless reasonable to do otherwise.**
- ▶ **It is arguable that the tax and accounting implications of the incentives, from both the landlord and tenant's point of view, should be taken into account in the analysis.**

ADJUSTING FOR INCENTIVES

- ▶ 3 MONTHS IS A GENERALLY ACCEPTED PERIOD TO FIT OUT (larger stores 6 months +)
- ▶ ADJUSTMENT FOR RENT FREE MADE TO NEXT RENT REVIEW (OR EARLIER BREAK)
- ▶ FOR A 5 YEAR PERIOD THERE ARE 20 QUARTERS SO 3 MONTHS IS 1/20th ,ie, 5%
- ▶ SO IF TENANT IS GIVEN 12 MONTHS RENT FREE DEDUCT 3 MONTHS (FITTING OUT)
- ▶ AMORTISE (SPREAD COST) OF THE NET 9 MONTHS OVER THE 5 YEAR PERIOD - 15% (3 X QUARTERS)
- ▶ THEREFORE IF HEADLINE RENT IS £100,000 (WITH 12 MONTHS RENT FREE) THE NET RENT PAYABLE IS 15% LESS (£85,000 pax) SO ANALYSE £85,000 pax TO ESTABLISH NET EFFECTIVE RATE

- ▶ SHOULD WE TREAT CAPITAL AND RENT FREE INCENTIVES THE SAME ?
- ▶ NO UNIVERSAL AGREEMENT - SOME TREAT CAPITAL OVER WHOLE LENGTH OF LEASE (NOT TO R/R) BUT TREAT RENT FREE TO THE NEXT RENT REVIEW