RENT REVIEW GUIDE

UNDERSTANDING RENT PROPOSALS

INTRODUCTION

The Pubs Advisory Service has collaborated with Morgan & Clarke Chartered Surveyors, a tenant-friendly team of expert pub valuers, to create a free series of informative guides aimed at assisting pub tenants across the country at rent review.

The guides will cover topics including:

- **Understanding Rent Reviews** – What rent reviews are, how often they occur, the specific timings and more.

- **Understanding Rent Valuation** – Learn about the relevance of RICS guidance, how pub rents are calculated, and how landlords can interpret the guidance to their advantage.

- **Understanding Rent Proposals** – Learn how to analyse landlord rent proposal calculations, learn the strategies and tactics landlords use, and how to present a counter-proposal effectively.

- **Gathering Evidence** – Learn about the hierarchy of evidence and its relevance during the rent review. We will explain how landlords leverage information to secure rent settlements, and how tenants can evidence their counter-proposal effectively.

- **Negotiating Tactics** – Receive guidance on negotiating tactics and settlement trends that can help you achieve a fair rent price that works for both you and your landlord, as well as advanced strategies for navigating complex rent review negotiations, including the disregard of tenant goodwill and improvements.

UNDERSTANDING RENT PROPOSALS

During a rent review, pub company landlords typically provide their tenants with a written proposal that explains the reasons behind the suggested rent. This proposal often includes a shadow profit and loss account, which shows the calculations supporting the landlord's decision for the proposed rent.

The rent proposal should include a shadow profit and loss account that clearly specifies the landlord's assumptions regarding the Fair Maintainable Turnover (FMT), gross profit, operating costs, and the anticipated future profitability achievable by an Reasonably Efficient Operator (REO). This calculation often includes a detailed breakdown of the income stream from different sources like drinks, food, accommodation, and other sales, along with the corresponding gross profit for each category.

The main goal of the landlord is to secure the highest possible rent, and they may employ tactics to achieve this by inflating the potential profit before rent. There are several methods through which landlords can manipulate the figures in their rent assessment and calculation, resulting in an inflated rent.

1. **Inflate FMT**
2. **Underestimate Tenants Goodwill**
3. **Failure to disregard Tenant Improvements**
4. **Inflate Sales Mix**
5. **Underestimate Expenditure**

INFLATE FMT

Fair Maintainable Turnover (FMT) is an estimation of the trade that a Reasonably Efficient Operator (REO) would be reasonably expected to achieve. However, in many instances, the landlord's assessment of FMT exceeds the current trade achieved by the existing tenant. This matter is widely recognised and often sparks debates regarding what should be considered reasonable, fair, or maintainable.

Through their assessment of FMT and calculation of rent, landlords may indirectly suggest that the REO could capably achieve a higher turnover or profitability compared to the existing tenant.

Unfortunately, it is quite common for landlords to take this approach of proposing a higher level of turnover or profitability for the hypothetical REO tenant. Given the annual decline in on-trade beer volume as indicated by the British Beer and Pub Association (BBPA) beer barometer for almost a decade, coupled with a significant number of pub closures and reduced profitability associated with operating a pub business, landlords face challenges in justifying why the hypothetical REO tenant would expect an increase in the current level of achieved turnover.

Other than inflationary influences, there is unlikely to be any meaningful evidence to support an increase in sales. In fact, the wake of the global pandemic is more likely to have a negative impact on sales, potentially cancelling out any potential inflationary growth and resulting in stagnant sales levels at best, or even modest declines.

If the landlord or BDM (Business Development Manager) has not previously expressed concerns about the tenant's alleged underperformance, the tenant should request evidence to substantiate the landlord's claim. Otherwise, it may be viewed as a convenient tactic by the landlord to adopt this stance at the rent review without previously raising their concerns. Selectively applying the REO status to serve their own agenda could harm the landlord's credibility.

UNDERESTIMATE GOODWILL

The rent review provisions within a lease often involve disregarding the tenant's goodwill. The rental calculation typically assumes vacant possession, disregarding the current tenant and their business. Therefore, any exceptional performance attributed to the tenant should not be considered for the purpose of rent valuation. However, assessing the extent of goodwill that is to be disregarded can be difficult and is often overlooked by many Pub Co landlords.

Goodwill can be classified as either intrinsic or transient, as recognised by the Valuation Office Agency (VOA) when assessing fair maintainable trade for business rates. The crucial aspect is being transient goodwill, which is the trade deemed to be not affixed to the premises, as with intrinsic goodwill, and which could be removed from the property if the trading operator imbued with that goodwill left the premises. Transient goodwill is the extra trade achieved over and above that which would normally be expected to be retained in the property following the guidelines of intrinsic goodwill.

The Royal Institution of Chartered Surveyors (RICS) guidance note for public houses is GN67/2010 'The capital and rental valuation of public houses, restaurants, and nightclubs in England and Wales' defines goodwill as:

"*Personal goodwill (of the current operator)*

The value of profit generated over and above market expectations that would be extinguished upon sale of the trade related property, together with financial factors related specifically to the current operator of the business, such as taxation, depreciation policy, borrowing costs and the capital invested in the business."

Continued...

At rent review, landlords typically fail to disregard the goodwill attributed to the tenant by appropriately reflecting this feature in the FMT of the REO. If the current tenant actual sales surpass turnover expectations, the landlord may attempt to take advantage of the situation by suggesting that the tenant's performance reflects that of the REO, implying that any other tenant of REO status could achieve similar turnover.

This assertion, despite being false, allows the landlord to negotiate from a position that overlooks the goodwill attributable to the existing tenant. Where a landlord has failed to disregard obvious tenant's goodwill, the tenant may end up being compared to their own overperformance, which can lead to an incorrect assessment of FMT and excessive rental value that is deemed unreasonable and unfair.

FAILURE TO DISREGARD TENANT IMPROVEMENTS

When a tenant makes structural improvements to the premises that improve the business's trade and profit potential, the resulting increase in rental value should be disregarded at rent review.

This is typically confirmed in most lease or tenancy agreements with wording along the following lines:

"The effect of such works of a structural nature undertaken by the tenant at the tenant's expense and with the landlord's approval shall be disregarded for the purposes of rent review."

However, landlords typically require a License to Alter before disregarding tenant improvements. If the tenant is undertaking the work at their own expense, the lease often requires the tenant to obtain landlord's written permission or consent.

Continued...

When a tenant makes structural improvements to the premises that improve the business's trade and profit potential, the resulting increase in rental value should be disregarded at rent review.

This is typically confirmed in most lease or tenancy agreements with wording along the following lines:

"The effect of such works of a structural nature undertaken by the tenant at the tenant's expense and with the landlord's approval shall be disregarded for the purposes of rent review."

However, landlords typically require a License to Alter before disregarding tenant improvements. If the tenant is undertaking the work at their own expense, the lease often requires the tenant to obtain landlord's written permission or consent.

Although business development or area managers may verbally approve the work, a written License to Alter is necessary to ensure the works are appropriately disregarded at rent review.

A tenant will have served the necessary planning notices, assuming they needed consent, and all appears to be on track. It is a low trick for the landlord to allow the often-expensive work to complete, and then include positive effect of the improvements in the next rent review in an attempt to secure an increase in rent.

To compound the issue, landlords often fail to inform tenants that it is perfectly legal and possible to seek a Retrospective License to Alter, even if it is many years after the works have been completed, sometimes by a predecessor in title, i.e not the current tenant.

INFLATE SALES MIX

Landlords frequently give priority to the wine, spirits, and minerals (WSM) category when determining the volume of drink sales in their shadow profit and loss calculations. If a substantial portion of the overall drink sales is diverted from ale and lager towards the WSM category, it can have a significant impact on rent calculations and lead to inflated profits. This is because wine, spirits, and minerals generally yield higher gross profit margins compared to ale and lager.

If a tenant accepts a rent proposal from the landlord that is built upon a distorted sales mix and unrealistic projected profits, they may find themselves paying rent based on a drink sales profile that does not accurately represent the pub's offerings or the preferences of their customers.

In cases where the tenant is unable to sell the projected volume of wine, spirits, and minerals (WSM) that the landlord incorrectly assessed as necessary to attain the highly ambitious gross profit level derived from total drink sales, a deficit in net profit before rent will arise. This shortfall will ultimately be deducted from the tenant's share of profits.

For example, the product mix presented within a Pub Co rent proposal is as follows...

Wet Sales	Turnover ex VAT	% of Wet Sales	GP Margin %	Gross Profit
Bitter	£58,104.00	15.2%	52.3%	£30,385.73
Lager	£147,552.00	38.5%	52.1%	£76,923.50
Stout	£18,576.00	4.8%	46.7%	£8,674.99
Bottled Ale & Cider	£19,367.00	5.1%	65.0%	£12,579.24
Draught Cider	£13,105.00	3.4%	60.2%	£7,889.21
WSM	£126,436.00	33.0%	70.2%	£88,735.10
Total	£383,140.00	100%	57.8%	£225,187.77

If the true wet sales mix evidenced by the historic records is applied - based on the same turnover and gross profit margin (%)

Wet Sales	Turnover ex VAT	% of Wet Sales	GP Margin %	Gross Profit
Bitter	£76,628.00	20.0%	52.3%	£40,072.93
Lager	£176,244.40	46.0%	52.1%	£91,881.76
Stout	£15,325.60	4.0%	46.7%	£7,157.06
Bottled Ale & Cider	£22,988.40	6.0%	65.0%	£14,931.40
Draught Cider	£15,325.60	4.0%	60.2%	£9,226.01
WSM	£76,628.00	20.0%	70.2%	£53,778.93
Total	£383,140.00	100.0%	56.6%	£217,048.09

The disparity between the landlord's optimistic assessment and the actual figures leads to an £8,000 difference in gross profit.

After completing the remaining stages of the rent valuation calculation and deducting the operational costs it becomes apparent that the rent is greatly misaligned. Over a period of three to five years, until the next review, this discrepancy results in an inaccurate assessment and an overpayment in rent ranging in the four or five-figure range. Unfortunately, this diminishes the tenant's share of profits.

UNDERESTIMATE EXPENDITURE

Typically, landlords base their shadow profit and loss calculations on annual cost benchmarking guides like the British Beer and Pub Association (BBPA) or UK Hospitality. These guides provide data on the operational costs of running different types of pubs, considering factors such as turnover and business models focused on food or drinks.

The most recent benchmarking report from the BBPA, published in May 2022, includes data from BBPA member companies on the costs of operating tied pubs in the tenanted and leased sector in 2021. It offers insights into the average and range of expenses for different types of pubs.

However, it is important to note that industry cost benchmarking only reflects past costs and does not provide a forward-looking perspective on the actual expenses tenants may incur leading up to the next rent review. By the time the data is published, it is already out of date by 12 to 18 months.

Significant adjustments are therefore needed when applying the benchmarking data, and the BBPA acknowledges this aspect.

As the costs in this report relate primarily to 2021, they will not reflect the full extent of the 2022 energy crisis where pubs are frequently seeing price increases of over 100% on their energy bills. Such large increases, on what is usually the second biggest cost line, will have a significant impact on a pub's overall cost and operating margins. High inflation generally in 2022 will also impact other elements of the model and, therefore, particular caution is required when reviewing the data this year."

For illustrative purposes, the following example provides a sensitivity analysis on cost figures. Even a small underestimation of costs, such as 4%, can have a notable impact on the overall financial outcome.

Pub Co Proposal		Reality	
Fair Maintainable Trade	£360,000.00	Turnover	£360,000.00
Total Gross Profit at 55%	£198,000.00	Total Gross Profit at 55%	£198,000.00
Estimated Operational Costs at 35% of FMT	£126,000.00	Actual Operational Costs at 39% of Turnover	£140,400.00
Divisible Balance	£72,000.00	Divisible Balance	£57,600.00
Rent (Bid at 50%)	£36,000.00	Rent Set as seen to the left	£36,000.00
Tenants Forecasted Profit	£36,000.00	Tenants Actual Profit	£21,600.00
		Tenants Loss	-(£14,400.00)

MORE INFORMATION

For more information please visit our websites:

www.pubs.expert

www.morganandclarke.co.uk

If you require assistance with rent review, lease renewal, Market Rent Only (MRO), or any related matters, please contact us at.

support@pubs.expert

info@morganandclarke.co.uk