

Revaluation in a Recession

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Outline

- What is a Revaluation and why Revalue
- The size of the Task
- The Importance of Dates
- Situation at AVD and afterwards
- The Property Market at AVD
- Treatment of Incentives
- Impact on Other valuation Methods

What is a Revaluation?

- As per Lord Pearce in Dawkins (VO) v Ash Brothers and Heaton Ltd (1969)

“Rating seeks a standard by which every hereditament in this country can be measured to every other hereditament”

- The object of a revaluation is to ensure this standard is maintained
- Effectively rebasing of property values to keep them as fair and up to date as possible
- 1956 – 1963 – 1973 then big gap
- Modern five yearly cycle started in 1990 so this is the fifth modern revaluation in England and Wales

Why Revalue?

- Rating is a tax based on the annual value of property
- Market rental values can go up as well as down
- Important to keep values relevant to ratepayers
- Restores up to date relativities between:
 - Property types
 - Geographical areas
- Ultimately, to ensure fairness to all ratepayers

2010 – the importance of rates

Non-domestic Rates

- 1.79 million properties in England and Wales
- £51.4 billion rateable value within local and central rating lists
- Yield c. £22 billion a year

The size of the task

Total of 1,793,967 properties to value !

- bulk” classes to be valued include:
 - 510,000 shops (including banks, post offices, etc):
 - 287,000 offices;
 - 195,000 warehouses; 242,000 factories, stores, etc
- other classes with significant numbers:
 - 66,000 licensed properties;
 - 41,000 advertising rights;
 - 47,000 car parks;
 - 38,000 hotels;
 - 33,000 restaurants/cafes;
 - 30,000 schools and colleges;
 - 28,000 hospitals/clinics
- “non bulk” classes include:
 - everything else from A to Z (airports to zoos)

Important Dates for 2010

At a revaluation there are two really important dates:

- Antecedent Valuation Date [AVD]
 - 1 April 2008
- Compilation Date or Material Day
 - 1 April 2010

Antecedent Valuation Date

- Historically, there was no set valuation date but this caused problems in times of inflation
 - Ladies' Hosiery & Underwear v W Middlesex Assessment Committee (1962) – shop valued higher than comps - correctness must not be sacrificed to uniformity
- Another problem is to ensure that all valuations across country are at standard date
 - K Shoe Shops v Hardy (VO) & Westminster City Council (1983) – HL confirmed Valuation date was 1 April 1973
- To overcome problems in K Shoes we now have an Antecedent Valuation Date [AVD]
 - Set two years before coming into force of new rating lists
 - Enables VO to gather and analyse the evidence and then apply to all properties

Compilation Date

- As properties change over time, it is important to establish the exact date when the physical circumstances of the property are taken into account. This is the material day
- Where a VO prepares a new rating list this date is the date the new list comes into force.
- For R2010 this is 1 April 2010 and is known as the Compilation Date

Material Day

- Refer to Local Government Finance Act 1988, schedule 6, para 2(7)
- Lists the factors to be taken at material day – broadly speaking these are all physical
 - state of property
 - state of locality
- All other non physical factors are to be taken at AVD
 - state of economy
 - interest rates
 - fashions
 - level of values

Summary

At a revaluation therefore the following assumptions have to be made:

1. Rental values are as at the antecedent valuation date
2. Physical matters contained in schedule 6, para 2(7) LGFA 1988 are as they are at the compilation day
3. All other matters not mentioned in para 2(7) are taken as at the AVD
4. Therefore, value changes between 1 April 2008 and 1 April 2010 cannot be taken into account but physical changes can

Situation at 1 April 2008

- Economic slowdown – but how much?
- B of E base rate 5.25%
- Stock Market – FTSE 100 @ 5701
- Northern Rock nationalised 18/2/2008
- Prospects for Property
 - Estates Gazette 26 July 2008 *“Incentives up as interest on the wane”*
- Empty Property Rate introduced wef 1 April 2008
- Quote by Bidwells [Data Book no 15] from Dec 2007
 - *“The slowing economy is likely to hit across all regions as tightening credit markets make it more difficult to finance large-scale investment projects. Despite this, occupational markets have remained healthy, with rents growing in most sectors.”*

What has happened since AVD?

- 21 April - B of E and Treasury pledge emergency funding to banks
- 1 May - “worst of credit crisis may be over” (B of E report)
- ‘Melt down’ week:
 - 14/9/08 - collapse of Lehman Brothers
 - 17/9/08 - Lloyds comes to rescue of HBOS
 - 19/9/08 - US officials are working on a plan costing billions of dollars to help rid US banks of their bad debts
- 21 October - the ‘R’ word first used by Mervyn King
- 6 November – B of E cuts base rate by 1.5%
- 23/1/09 – UK officially enters recession as GDP falls by 1.5%
- Currently base rate at all time low of 0.5%

Can these be reflected?

Conclusion

- Standing at AVD on 1 April 2008 looking forward in the light of what has happened up to that point in time, and making reasonable assumptions as to what might happen in the future, what rental deal might a willing landlord and willing tenant have agreed?
- The landlord cannot put off the decision until another day because of uncertainty – and neither can the tenant! Cannot wait for market to settle. The deal is to be done on that day.

Conclusion (cont')

- The events of the past year or so therefore have to be disregarded as they took place after the AVD and indeed were probably unforeseen as at the AVD.
- Interesting case in opposite market conditions:
 - BSC Footwear Ltd v Smith (VO) [1980] – VO used high rents fixed after 1/4/73 to show steep upwards trend – but as not manifested until after 1/4/73 these had to be ignored

Oversupply in 1990 Lists



Oversupply in 1990 Lists

- At AVD, 1 April 1988, economy was booming and office rental values in City of London were at peak.
- By 1992 values had fallen dramatically because of :
 - Low demand
 - Greater supply due to new construction entering market
- Result:
- Assumption in schedule 6 para 2(7) meant any effect on rental values because of recession had to be ignored – not physical
- The change in amount of modern floor space was a physical factor and therefore could be taken into account

Oversupply in 1990 Lists (cont')

- It was agreed that had the extra floor space been in existence at AVD this would have resulted in lower rental values
 - Minimal for modern offices
 - Substantial for older offices
- See VOA Rating Manual Vol 4: section 5. 1995 PN No 2 'Valuation of Space where a Supply/Demand imbalance exists at AVD'
- Question
- Will we have an oversupply situation in any sector of the market at compiled list date of 1 April 2010 compared with the supply at AVD?

Impact of Recession on Property Market

- Greater uncertainty
- Companies retrenching
- Falling demand for property
- Oversupply of property
- Proliferation of incentives on new lettings
- Less transactions
- End result:
 - Less evidence to have regard to
 - Evidence more difficult to analyse and to convert to the statutory terms

Incentives

- Many new rental deals are structured so as to keep the headline (or contractual) rent as high as possible thereby protecting the landlord's reversionary interest. So we have:
 - Capital contributions
 - Stepped rents
 - Rent frees
- Other incentives can include:
 - Shorter leases/flexible lease terms
 - Break clauses
 - Two ways rent reviews
 - Service charge caps
- These all need to be adjusted to the equivalent of a constant rent under the rating hypothesis

Guidance

- RICS Valuation Information Paper No. 8
‘The Analysis of Commercial Lease Transactions’
- VOA Rating Manual Vol 4: section 5: Practice Note 1 – 2010 - Rent Adjustment
- Case Law
 - Morrison E F (GP) Ltd v Central Scotland assessor [2004]
– retail units in factory outlet centre – correct rate/m² – examination of how to analyse rental evidence including rent free periods and inducements.

Incentives in Detail

There are two views:

- Landlord's view - incentives are a one-off payment to secure a letting on a long lease and maintain investment and loan values with the benefit of an enhanced rental flow, and thus should be amortised over the whole length of the lease.
- Tenant's view - rent is subject to review in 5 years time and the rent free benefit should be discounted only to the first review.

Incentives in Detail (cont')

- The RICS/IRRV Red Book – Valuation Information. Paper No. 8 “Analysis of Commercial Lease Transactions” provides some guidance on these issues.
 - See para 5.6 Time over which the incentive should be analysed -
 - *“It will be recognised that the landlord will usually contend for the longest time, such as the full term of the lease, and the tenant the shortest time, such as the first review. The valuer’s decision has to be a judgement between these conflicting claims having regard to the overall effect of the all the incentives, anticipated rental growth and knowledge of the market, motivation of the parties and what, in the real world, the valuer believes might be achieved in an open market letting on the hypothetical terms.”*
- Better guidance given in Previous RICS GN 4

Incentives in Detail (cont')

Example (illustrative only):

- Lease term – 15 yrs with 5 yr rent reviews
- 2 yr rent free inc 3 month fit out
- Headline rent £100,000

A. To first review (straight line method)

Headline rent	£100,000 p.a.
For 5 yrs less 21 month rent free	x 3.25
Value of Headline Rent	£325,000
Spread over 5 yrs	Divide by 5
Net Effective Rent	£65,000 p.a.

Incentives in Detail (cont')

B. To second review (straight line method)

Headline rent	£100,000 p.a.
For 10 yrs less 21 month rent free	x 8.25
Value of Headline Rent	£825,000
Spread over 10 yrs	Divide by 10
New Effective Rent	£82,500 p.a.

Incentives in Detail (cont')

C. To end of lease (straight line method)

Headline rent	£100,000 p.a.
For 15 yrs less 21 month rent free	x 13.25
Value of Headline Rent	£1,325,000
Spread over 15 yrs	Divide by 15
New Effective Rent	£88,333 p.a.

Incentives in Detail (cont')

Results:

A. Amortising to first review	£65,000 p.a.
B. Amortising to second review	£82,500 p.a.
C. Amortising to end of lease	£88,333 p.a.

Conclusion:

- Depending on the assumptions made the end figure can vary enormously!
- As a compromise it is often agreed to amortise incentives over 10 years i.e. to the second review – see Morrison case

Incentives - Conclusion

- But what is the technically correct approach?
- See old RICS GN 4
 - “It is suggested that inducements should usually be evaluated over the period until the term end, or (if earlier) the rent review or break clause, following the time when the open market rental value assessed on the given lease rent review terms, is no longer exceeded by the headline rent”
- It is therefore essential to estimate the projected rental growth. If prospects are poor then the market rental value may well not exceed the headline rent at the first review then the amortisation period would need to be extended.
- So, how does £65,000 compare to £100,000 and will it reach it by first review? Implies 9% year on year growth – seems unlikely but depends on type of property – therefore need to consider 10 yrs.

Incentives - Conclusion

Correct Approach:

- There is no 'correct' approach!
- See VIP No 8, RM: PN No 1 and GN No 4
- The adjusted or Virtual Rent produced from the amortisation is still not necessarily the market rent
- What is sought is what the tenant would have been happy to pay as an annual rent but without the rent free period
- Ultimately, the valuer needs to stand back and look and use professional judgement

Other valuation methods

1. Receipts and Expenditure
 - Valuation based on trading position at AVD
 - Usually based on the 3 years trade prior to AVD looking forward
 - Need to look carefully at figures to see if there is any evidence of trade being affected by the downturn but will it be too early to detect?

Other valuation methods (cont')

2. Contractors

- Valuations based on building costs and land values
- Land values may have been affected – but is there any evidence?
- Building Costs have risen 25 to 30+% since last reval
- All will depend on the decap rate – this has been left unchanged at 5% and 3.33%
- Unlikely to be affected by the downturn in the short term?

And finally ...

- 30 September 2009 – draft lists published
- October 2009 summary valuations issued and available on line
 - 1.3m for 2005, 1.7m for 2010
 - Improved formats where possible
 - On line and in paper
- October 2009 onwards – assistance available from VOA helpdesks
- 1 April 2010 – the compiled lists become live!

The End
Questions?