

Rental Valuations during Lockdown

How does one value in a world without comparable transactions?

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Introduction

The RICS guidance note “Comparable evidence in real estate valuation” (1st edition, October 2019) opens with this:

“Comparable evidence is at the heart of virtually all real estate valuations. The process of identifying, analysing and applying comparable evidence to the real estate to be valued is, therefore, fundamental to producing a sound valuation that can stand scrutiny from the client, the market and, where necessary, the courts.”

Paragraph 4.1 of the guidance note qualifies the type of comparable evidence that is likely to be helpful:

“Information derived from comparable market transactions will normally provide the best evidence of value. Such evidence should be recent, relevant and comprehensive. ... Transactions in the open market close to the date of valuation will almost invariably provide the best and most reliable source of evidence.”

Section 7 of the guidance note grapples with the problem where there is a shortage of evidence, which can arise for a variety of reasons, including where: “the market may be inactive, with few transactions occurring to provide evidence”. The Note advises, correctly:

“It is important to emphasise that a lack of evidence should not prevent a valuation being undertaken but the skills, expertise and judgement of the valuer become more important in difficult market conditions. The valuer

has to look further afield and across a wider range of indicators when transactional evidence of directly comparable real estate is lacking. In such circumstances, it may be necessary to consider more indirect evidence: for example, local or national economic data that can indicate trends to give guidance towards, rather than direct evidence of, value.”

At present, the market is inactive because we are in the middle of a pandemic which has interrupted the real estate market, temporarily halting transactions. So how should valuers go about using their skills, expertise and judgment to form a view on rental values when there is no comparable evidence? That is the problem we address in this paper. Although this problem also arises in relation to the valuation of freehold property, our focus is on rental valuations in the context of rent reviews and lease renewals.

The problem

During the course of the COVID-19 pandemic, it has notoriously been the case that the leasehold property market has been badly disrupted. Very few new lettings have occurred for weeks, and those that have proceeded usually owe their origins to the days preceding the pandemic.

Although there may not be any new transactions for a good while yet, some lease renewal applications are proceeding in the Courts, while the rent review field remains active (particularly in cases of leases containing upwards and downwards rent review clauses). In each case, the Court or third party determining the dispute will have to grapple with the valuation of a rent at a time of Corona, when (a) the evidence is likely to be that there would have been nobody in the market willing to take a new lease of vacant premises; and (b) the only comparable pieces of evidence are likely to reflect either the market before the pandemic struck, or the market when it is recovering. What is a Court, arbitrator or expert (to which, to avoid repetition, we shall refer simply as “the Tribunal”) likely to do in such circumstances – and what should the parties’ valuers themselves do?

There is one significant difference between lease renewals and rent reviews. With a rent review, there is a fixed valuation date. With a lease renewal, it has been held that the Court must determine the market rent by reference to the state of the market at the date of the hearing, but taking into account changes which might be reasonably expected to take place between the date of the hearing and the date when the term of the new tenancy commences. The court must, therefore, not only have regard to the state of the market at the date of the hearing, but also have regard:

“...to such evidence as there may be that indicates that any changes may have to be taken into account, being changes that the evidence shows are likely to occur between the date of the hearing and the date when, assuming that the court's order stands as it is made by the court, the new tenancy will commence”

per HHJ Finlay QC in Lovely & Orchard Services Ltd v Daejan Investments (Grove Hall) Ltd [1978] 1 EGLR 44.

Thus in the case of a lease renewal, the valuers and the Court must try and predict how things might change between the hearing date and the date when the new tenancy commences. This is not an issue that arises in the case of a rent review.

So, there are really four questions to answer:

- (1) What is the proper approach to take where the evidence is that there would have been no demand for the property on the relevant valuation date?
- (2) What is the proper approach to adopt in relation to comparable evidence pre-dating the impact of the pandemic?
- (3) What about post-valuation date evidence which may reflect different market conditions?
- (4) What can the parties do as an alternative to letting the tribunal decide?

(1) What if there is no demand in the market?

Let us take an obvious, if stark, example: an unopposed application for the grant of a new tenancy of a restaurant in central London. Section 34(1) of the Landlord and Tenant Act 1954 requires the rent payable under a tenancy granted by order of the court to be:

“such as may be agreed between the landlord and the tenant or as, in default of such agreement, may be determined by the court to be that at which, having regard to the terms of the tenancy (other than those relating to rent), the holding might reasonably be expected to be let in the open market by a willing lessor”,

disregarding certain matters.

Suppose that the configuration of the restaurant does not allow for a takeaway service, with the result that it has been unlawful to operate the restaurant since 26 March 2020, as a result of the closure of businesses selling food or drink for consumption on the premises required by the Health Protection (Coronavirus,

Restrictions) (England) Regulations 2020 and the Health Protection (Coronavirus Restrictions) (Wales) Regulations 2020.

Let us also suppose that the lease renewal is heard by the Tribunal now, when those Regulations are still in force.

Of course, the fact that the premises could not lawfully be used by their new supposed new tenant does not mean that there would be no transaction. There might conceivably be a party out there who would take a punt on acquiring a lease of restaurant premises, with a view either to using them for some other permitted activity, or as a restaurant in the longer term once the lockdown has ended. But in practical terms, it is probably right to disregard such outliers, and assume that there would *in fact* have been *no demand at all* at the valuation date.

The section 34 valuation does not embrace that possibility, and neither does the traditional rent review formula, both of which are premised upon the existence of parties willing to transact, even if in the real world there would have been no bidder for the landlord's premises. The authority to which we all turn for that proposition is the judgment of Donaldson J (subsequently upheld by the Court of Appeal in an unreported decision) in FR Evans (Leeds) Ltd v English Electric Co Ltd [1978] 1 EGLR 93.

The case concerned the Walton Works, a huge factory in Liverpool - nearly 1 million square feet of floorspace on a 60 acre site. The arbitrator determined that, at the rent review date in October 1976, apart from the actual tenant, the English Electric Co, "it is very unlikely on the available evidence and on the state of the market that there would have been a potential tenant in the market for the subject premises on the terms of the lease offered". He also determined that, at the valuation date "... if the present tenants had not been in occupation of the subject premises, they would not have made any bid for the lease being offered". So the effect of his findings was there would have been no demand for the premises at the review date if offered to the market on the terms of the hypothetical lease.

Donaldson J held that:

"... the willing lessee is an abstraction—a hypothetical person actively seeking premises to fulfill needs which these premises could fulfill. He will take account of similar factors but he too will be unaffected by liquidity problems, governmental or other pressures to boost or maintain employment in the area and so on. Whilst the hypothetical tenant is a willing tenant, he is not an importunate one. He wishes to take a lease of the premises, but he is operating in a commercial field and in deciding what to

offer in the way of rent will take account, covertly or overtly, of the alternative of taking a lease of two or more other premises. But this is not to say that he would prefer that solution. That will depend on the level of rent which is under consideration. He is a willing lessee, and is quite content to take the (subject premises) at the right price. It is just that he is not considering the proposition or negotiating, in a vacuum.”

It is unclear quite what weight should be given to the phrase “actively seeking premises to fulfill needs which these premises could fulfill” means. On the face of it, the statement means that the right to occupy the premises is to be treated as being of real commercial value to the willing tenant. If so then, although there is no competitor for the willing tenant, he could not get away with offering just £1 to secure its tenancy. If the tenant is actively seeking premises of the kind under consideration, so that the premises are of real value to it, the willing landlord would not entertain such a derisory offer. As Lord Romer said in Raja v Vizagapatam [1939] AC 302:

“The fact is that the only possible purchaser of a potentiality is usually quite willing to pay for it”.

On that basis, we must assume that there would be a transaction, but it will be one taking place in an uncompetitive marketplace, in which the tenant is likely to have the upper hand in the negotiations, but will not get away with a nominal rent.

But there is some support in other authorities for the view that the fact that the hypothetical tenant is willing to take a lease does not mean that the premises are to be treated as being of value to it. In the case of a willing buyer in an a valuation of the open market value of property assumed to have been sold, Hoffmann LJ said that the willing buyer: “... reflects reality in that he embodies whatever was actually the demand for that property at the relevant time”: see IRC v Gray [1994] STC 360, 372. So if there is no demand for an asset, the open market value is nominal – see RCC v Bower [2009] STC 510 for an example.

In Dennis & Robinson v Kiossos Establishment (1987) 54 P & CR 282, Fox LJ recognised the possibility of a nominal market rent:

“... the willing lessee is not going to pay more than the market requires him to pay. It is essentially a matter for the valuer to inquire into and determine the strength of the market. He is, for example entitled, if such is his expert opinion on the facts, to say that, having regard to the state of the market and the condition of the property, a tenant, though a willing tenant, could not be

expected to take the stipulated lease save at a low or nominal rent, and that the full yearly market rent must be determined accordingly.”

In EE v Islington LBC [2019] UKUT 53 (LC) at [93], a case on the new Electronic Communications Code, the Upper Tribunal concluded that “... if the characteristics of the premises mean that, in reality, nobody would pay anything for them, the correct conclusion may be that their market value is nominal” although on the facts of that case, the Tribunal held that the rent should not be nominal.

However, in none of those cases was there any consideration of Donaldson J’s statement that the willing tenant is “actively seeking premises to fulfill needs which these premises could fulfill.”

Woodfall para 8.029 says of Donaldson J’s formulation:

“However, it would be wrong to lay stress on the word “actively,” for the fact that the tenant is willing does not mean that he is eager.”

We expect that this issue will be hotly debated in the coming months.

(2) How to use out of date evidence

If in fact there is no market for the premises at the valuation date, then it will also follow that any comparable evidence that does exist will be much less helpful than would ordinarily be the case. It will be evidence of values in a pre-COVID world, reflecting a quite different balance of supply and demand.

We have faced this kind of problem before. Perhaps the most recent example is the financial crisis triggered by the insolvency of Lehman Brothers in September 2008, when rental values declined drastically, making pre-crash comparable evidence of doubtful utility. Even then, however, the market still functioned to an extent, and there was some evidence available to guide valuers. It is quite unlikely that this crisis will afford the same opportunities.

Valuers will therefore have to be creative. Given the global reach of the RICS, it may well be that the experience of markets in, say, Hong Kong and Germany will provide some useable material showing the extent to which pre-crisis evidence was at all helpful in analysing values. There may be a resort to other methods of valuation altogether, based upon profits or discounted cash flow. We shall all wish to scrutinise the early decisions dealing with this problem. We and some of our colleagues are currently engaged in lease renewals coming up for hearing and there will no doubt be lessons to be learned from those.

(3) Post valuation date evidence

As we have explained, in a 1954 Act lease renewal, the valuation date is in practice taken to be the date of the hearing, but having regard to likely changes in the future.

The position is usually different in rent review, because the determination normally occurs some time after the valuation date (which is almost always the review date itself). It will therefore often be possible to adduce evidence of post-review date comparable evidence. The arguments as to the admissibility of that evidence are well-rehearsed, and discussed in a number of authorities, including Staughton J in Segama NV v Penny le Roy Ltd [1984] 1 EGLR 109 and Knox J in Re: EFC Publishing Ltd [1990] BCC 335. In essence, if a comparable transaction after the review date can reasonably be said to be probative of the state of the market at the review date, then it should be admitted in evidence. If, by contrast, the market at the transaction date has been affected by an unrelated factor that was not present or foreseeable at the valuation date, then it should be left out of account.

To apply this to the supposed facts, assume that the valuation date occurs during lockdown, at which point the swirl of rumour and counter-rumour makes it virtually impossible to forecast when the trading restrictions might be lifted. By the time the Tribunal comes to determine the rent, however, the lockdown has ended, and the market is returning to normal, with plenty of transactions occurring. To what extent are those transactions admissible?

There is a powerful argument that post-valuation date events are completely inadmissible, which has logical force and is supported by a number of judicial statements see e.g. HHJ Finlay QC in Gaze v Holden [1983] 1 EGLR 147:

“The valuer has, as best he can, to form his own judgment as to how these possibilities and various prospects that are inherent in the then existing situation affect the value of the property as at that date; but he is not entitled to take into account events which happen subsequently and which resolve how these various possibilities and prospects in fact turn out”.

However, some judges have expressed the view that evidence after the valuation date can give support for how things would have appeared at the valuation date: see e.g. Smiley v Townshend [1950] 2 KB 311, where Denning LJ said that events after the end of a lease were probative of how matters appeared at the end of the lease. In discussing the valuation of an agency at the date of its termination, Lord Hoffmann said in Lonsdale v Howard & Hallam Ltd [2007] 1 WLR 2055 at [39]:

“What matters, of course, is what would have appeared likely at the date of termination and not what actually happened afterwards. But I do not think that the court is required to shut its eyes to what actually happened. It may provide evidence of what the parties were likely to have expected to happen”.

This is another topic we anticipate will generate considerable debate.

(4) Creative solutions for the parties

The analysis above demonstrates that if a valuation has to occur while we are still in lockdown, or in the immediate aftermath with no deals to speak of, then the valuers’ task (let alone that of the Tribunal) will be difficult, to say the least – and will not necessarily be any easier in the case of a post-lockdown valuation in rent review.

In those circumstances, one or other party, or perhaps both, may want to consider creative solutions. A number of possibilities occur to us:

- Agreeing a new tenancy at a low rent, but with a term that the rent is reviewed after a set period – 6 months or a year.
- Agreeing a rent free period followed by a rent based on pre-pandemic comparables.
- Agreeing a stepped rent.
- Agreeing a turnover rent.
- Agreeing a tenancy with a mutual break clause after a year.
- Simply adjourning the lease renewal/rent review until after the lockdown, which may be necessary anyway if the county court cannot process remote hearings (although sensible parties will wish in any event to consider PACT or determination using an available dispute resolution mechanism such as Falcon Chambers Arbitration as an alternative to court).

It is wrong to see such solutions as favouring one party or the other. True, in retrospect the movements in the market may favour one party or the other. But surely that is preferable to the lottery that ensues when nobody – landlord, tenant or third party – really has any idea what is happening at the valuation date.

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