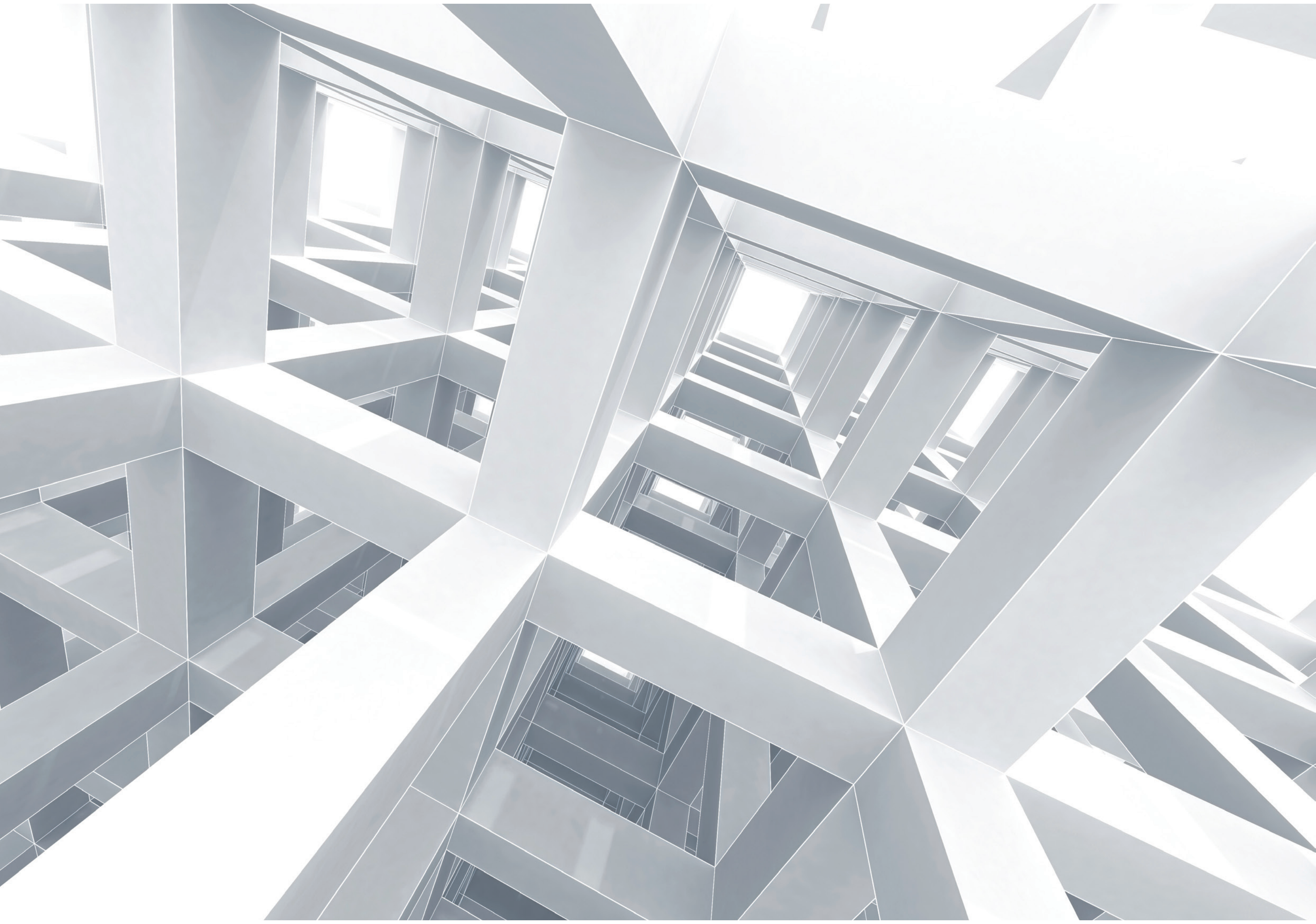
RICS Guidance Note

RICS Guidance, Hong Kong

Analysis of commercial lease transactions



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Paul Dwyer, MRICS – Dwyer & Co Ltd

Simon Lynch, FRICS – Cushman & Wakefield

HK Valuation Professional Group Committee

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Contents

Guidance notes

This is a guidance note. Where recommendations are made for specific professional tasks, these are intended to represent 'best practice', i.e. recommendations which in the opinion of RICS meet a high standard of professional competence.

Although members are not required to follow the recommendations contained in the note, they should take into account the following points.

When an allegation of professional negligence is made against a surveyor, a court or tribunal may take account of the contents of any relevant guidance notes published by RICS in deciding whether or not the member had acted with reasonable competence.

In the opinion of RICS, a member conforming to the practices recommended in this note should have at least a partial defence to an allegation of negligence if they have followed those practices. However, members have the responsibility of deciding when it is inappropriate to follow the guidance.

It is for each surveyor to decide on the appropriate procedure to follow in any professional task. However, where members do not comply with the practice recommended in this note, they should do so only for a good reason. In the event of a legal dispute, a court or tribunal may require them to explain why they decided not to adopt the recommended practice. Also, if members have not followed this guidance, and their actions are questioned in an RICS disciplinary case, they will be asked to explain the actions they did take and this may be taken into account by the Panel.

In addition, guidance notes are relevant to professional competence in that each member should be up to date and should have knowledge of guidance notes within a reasonable time of their coming into effect.

Document status defined

RICS produces a range of standards products. These have been defined in the table below. This document is a guidance note.

Type of document	Definition	Status
Standard		
International Standard	An international high-level principle based standard developed in collaboration with other relevant bodies	Mandatory
Practice Statement		
RICS practice statement	Document that provides members with mandatory requirements under Rule 4 of the Rules of Conduct for members	Mandatory
Guidance		
RICS Code of Practice	Document approved by RICS, and endorsed by another professional body/stakeholder that provides users with recommendations for accepted good practice as followed by conscientious practitioners	Mandatory or recommended good practice (will be confirmed in the document itself)
RICS Guidance Note (GN)	Document that provides users with recommendations for accepted good practice as followed by competent and conscientious practitioners	Recommended good practice
RICS Information Paper (IP)	Practice-based information that provides users with the latest information and/or research	Information

1. Introduction

1.1 The analysis of comparable transactions and the effect of the value of incentives is only one part of the process of considering the value of a specific property. There is no single correct approach to analysis and, as identified in the examples in the appendix (p13), no 'right' answer. Methods may vary depending on the circumstances of individual cases and market practices in different areas and sectors. Changing markets can mean that an approach adopted previously may no longer be appropriate. This is particularly so in Hong Kong, which also has its own distinctive characteristics of deal structure and length of leases, which necessitates unique guidance in the form of these notes.

1.2 It is just as important that valuers use their experience of the market and their understanding of the differi ng practices in different markets when approaching comparable transactions. They should consider the circumstances, understand the transaction being analysed and identify the true incentive, before adopting a mathematical approach. The ultimate aim of the analysis is to replicate how the participants in the market place operate; thereby more accurately reflecting the peculiarities of the market place that are of importance in the concept of a market valuation.

1.3 One essential element of any valuation of commercial property is consideration of its rental value. Although the use of rental value may be different for rent reviews, advising on new lettings, or the starting point of a capital valuation (for financial statements, investment or loan purposes), the underlying principles discussed in this guidance note are the same.

1.4 The valuer may be required to establish the market rent of the subject property. The assessment of that figure will be informed by the results of the analysis of comparable transactions. Market rent is defined in the RICS valuation standards. In the case of a rent review, the rent review clause often contains its own definition, which takes precedence over the market rent definition in these standards. When dealing with rent review valuations it is fundamental to the valuation that the subject rent review clause is correctly interpreted to ensure that the directions and hypothetical leasing scenario contained therein (for example but not limited to the condition of the subject premises on review and the consequential treatment of rent free periods included within comparable evidence) are adopted and correctly applied in the analysis of comparable transactions and the subsequent valuation. If legal advice is required in the interpretation of rent review clauses, this should be taken, to ensure that the valuation is predicated on the correct bases.

1.5 Any property transaction is a result of negotiations between the parties, but in the field of commercial letting in particular there can be a combination of factors that may influence either party. In addition, there are varying degrees by which those factors, individually or collectively, drive the transaction.

1.6 If all lettings in a market were on identical terms, comparing the rents agreed to establish the rent for any property would be straightforward. In practice, letting terms vary considerably, even for similar properties. An essential part of the valuation process is to identify the effect that different terms may have had on the rent that was agreed, and use this when making comparisons between different lettings.

1.7 The purpose of this guidance note is to assist valuers to establish rental value. Evidence of new lettings will generally carry more weight than rents agreed or determined on review or renewal. However, new lettings frequently include rent-free periods or other forms of incentive. This guidance note explores some of the factors that the valuer may need to consider when assessing the impact of such incentives on the rent agreed and its analysis.

1.8 Openness, transparency, and a willingness to share information are of benefit to the market as a whole and are to be encouraged. However, it is recognised that due to commercial sensitivities, lettings of commercial property can be subject to confidentiality clauses and side letters, meaning that the available information may be limited. As assumptions may have to be made, it is very important that the valuer is closely involved with, and aware of, the workings of the particular market. It is also recommended that such assumptions are clearly indicated and the reason for making such are provided.

1.9 This guidance note has been written specifically with regard to practices in Hong Kong, but surveyors operating in other countries may find some of the principles discussed helpful and capable of adaptation to their local circumstances.

2. Motivation of the parties

2.1 The terms on which prospective landlords and tenants will enter into a commercial lease are influenced by the general and local state of the market at the time the terms are negotiated.

2.2 The parties may also be influenced by their respective individual objectives; economic circumstances; accounting practices or tax positions, even though these are not directly related to the value of the property.

2.3 The motivations for parties offering or accepting incentives will differ with each transaction. A tenant accepting an incentive may have different motivations from the landlord offering it. Moreover, the two parties to a transaction may put different interpretations on their agreement.

The following terms are used in this guidance note:

Incentive: this term embraces any form of incentive, inducement or concession made by either party. The most common examples are capital payments and rent-free periods (subject to paragraph 4.1.3 for fitting out periods).

Headline rent: this is the actual contracted periodic rental payment under the lease, which becomes payable after all the initial incentives or concessions in the letting have ended. It is sometimes referred to as the 'face rent'.

Net effective rent: this is the rent that would be agreed between the parties for a letting of the premises on the relevant terms and conditions, but without incentives forming part of the transaction. In some circumstances, such as where a large premium has been paid to secure the property and part of it is considered to be a rental equivalent, the net effective rent could be higher than the headline rent. The net effective rent is sometimes referred to as the 'equivalent rent'.

2.4 Aside from market conditions and the negotiating strength of the parties, the reasons for and influences on the agreement of incentives include among others:

- Investor landlords are generally looking to hold the property for a combination of rental income and capital growth. They will seek to maintain or achieve a given level of rent and/or length of lease, to secure an income stream from a good tenant covenant, for a period that will maximise capital value.
- They may be given to facilitate funding, possibly at a more favourable funding rate. The achievement of higher headline rents may be an important factor.
- If the lessor is a tenant, their motivation may be different from an investor landlord as they will normally be aiming to mitigate or eliminate their continuing liabilities rather than maximising capital value.
- The taxation and land grant positions of the parties may be factors.
- The strength or weakness of the tenant's covenant may be a consideration.
- The actual terms, frequency and nature of rent reviews and the assumptions to be made on future rent reviews may have an impact.
- They may ease cashflow for either party. For the tenant, a rent-free period, coupled with a higher subsequent rent, is effectively an un secured loan from the landlord.
- Depreciation treatment for tenant's fit out.
- Investor landlords moving tenants within their portfolio to free space for other tenants to lease or expand into.

3. Impact of the length of lease and break clauses

3.1 In certain markets the amount of an incentive is directly proportionate to the length of tenant commitment, with larger incentives being payable if the tenant commits to a longer lease. There may also be variations in the preferences of landlords and tenants as to the length of leases.

3.2 Break clauses may have a critical impact on any valuation, depending on whether there is a reasonable possibility that they will be exercised, and the terms on which they are capable of being exercised. Break clauses may have a bearing on any write off period, and it will normally be appropriate to reflect their existence in the yield adopted. The likelihood of the break being exercised (whether by landlord or tenant) should be considered.

3.3 It is not necessarily correct to assume that all tenants might be expected to operate a break clause (especially if there is a penalty for its operation). Exercising the break clause might result in the need to write off fitting-out costs over a shorter period than initially envisaged, which may in turn lead to an adjustment to the tenant's accounts. The effect of the notice period and the tenant's need to secure alternative premises may also be factors. If alternative premises are secured first, there could be an element of double overheads. Landlords' break clauses, on the other hand, are unlikely to be operated if the rent passing still exceeds the net effective rent, unless other pressures dictate.

3.4 The existence and extent of any penalties payable by either party if a break clause is operated (or extra incentives for the tenant if it is not) will need to be considered, because the valuation is likely to be influenced by these factors.

4. Types of incentives

Rent-free periods

4.1 A rent-free period may occur at the beginning of the lease, or at any time during the currency of the term. Occasionally, the tenant is required to pay rent for an initial period as evidence of commitment to the lease, with the free period starting at some future date.

4.2 Rent-free periods may reflect:

- the time required to fit out the property to suit the tenant's needs
- double overheads associated with the time required to reinstate the former premises
- agreement by the tenant to carry out repairs or improve the property, which may benefit the landlord
- commitment from the tenant to pay a higher rent so the landlord maintains rental levels as high as possible
- acceptance of specific liabilities or restrictions under the lease.

4.3 The principle of granting a rent-free period, to reflect the time required for fitting out the property to suit the tenant's reasonable needs, is common practice in Hong Kong and in many other markets, therefore it may not normally be regarded as an incentive. It represents a balance between the need of the landlord to secure an income from as early a date as possible and the tenant's need not to have a rent liability until the property can be occupied. For rent review purposes, it is important to understand the assumptions for the hypothetical tenancy to ascertain how the rent-free period should be treated.

4.4 What is considered a reasonable length of time for the fitting out will vary according to the extent of the works, the size of the property and local market practice. Where specialist fitting out is involved, the time taken may go beyond a normal fitting-out period and not be considered to be part of the reasonable period.

4.5 In some circumstances, usually by the grant of a licence or following an agreement for a lease, the fitting-out period may begin before the formal commencement of the lease.

4.6 Assistance by the landlord with the costs of fitting out (in contrast to the rent-free period to reflect the time taken for the works), may take the form of capital payments to the tenant, or the provision of physical works by the landlord.

4.7 When fitting-out works or improvements are carried out as a condition of the grant of the lease, they are effectively a premium payable by the tenant. It is necessary to establish whether such improvements can be reflected in the rent at review.

Premiums and other capital payments

4.8 The consideration of premiums requires care because they rarely show a consistent pattern. A premium could be made up from several elements and it is necessary to establish them so that only those elements that are appropriate to be reflected in an adjustment are identified. The timing of payments also needs to be considered, particularly where they are close to new lettings, reviews, or renewals.

4.9 A payment by the landlord to the tenant is not necessarily an incentive because it may relate to other issues, such as taking on repairing obligations or an improvement to premises as part of an ongoing or overall refurbishment scheme.

4.10 A payment by the landlord for the cost of works that improve the property in a way that enhances its rental value may not be an incentive, but merely a change in the nature of the property being let. Premiums can also be cash payments to the tenants at the commencement of (or at any time throughout) the lease term, or they can be payments in kind such as subsidies or equipment, or removal/relocation costs.

4.11 A premium paid by the incoming tenant to the landlord, or an existing tenant on a lease replacement, may reflect the fact that the passing rent is below the current net effective rent. The value of improvements; goodwill; a need to be in a particular location or building, or the assignee being a special purchaser may also be considered in this premium. In addition, the premium may account for special modification of the lease terms tailored for that tenant's particular trading circumstances, or even the benefit of restrictive covenants on other tenants in a development.

Conversely, a payment of a premium by an outgoing tenant to an incoming tenant may reflect that the passing rent may be above the net effective rent.

4.12 The assessment of the true capital cost of these benefits to both landlords and tenants can be problematic, and there may be differing interpretations, which include the following:

- The landlord may argue that the whole of the premium represents capitalised profit rent, or it is common in prime locations to find new lettings significantly above reviews or lease renewals.
- The tenant may argue that treating premiums as capitalised profit rent may result in high figures that cannot be justified by other market evidence; its payment of a premium is solely to obtain occupation, which is not related to rental value; or an occupier may be prepared to pay a premium, but would not pay an equivalent amount as rent because of their particular accounting practices.

4.13 The validity of these arguments requires careful consideration to establish what proportion (if any) of the premium should be considered to be paid in lieu of rent.

Stepped rents, rent capping, fixed rent on reviews or on option to renew

4.14 Stepped rents and fixed rents are common in sale and leaseback transactions, and in these circumstances they are not an incentive but a reflection of the capital price raised by the lessee. However, in open market letting, these features can be used as incentives and may influence the headline rent.

4.15 The period over which rents may be stepped is usually, but not always, in the period to the first rent review. Rents may be capped to a maximum or minimum level, or a range, and may also be linked to factors not directly property related. When consideration is given to caps and collars it is necessary to assess their effect from both parties' point of view. For example, a cap and collar at equally beneficial levels can be seen to be of advantage to both the landlord and the tenant. Consequently, this may not be categorised as an incentive. However, asymmetrical cap and collar terms may be categorised as a benefit to the landlord or the tenant. For example, a 10% cap on a rent review when compared to a 50% collar on the same rent review can clearly be seen to be an incentive to the tenant in most markets.

4.16 Rents that were calculated based on a cap or collar would not be analysed, because these reflect a historic agreement and not the present market.

4.17 An agreement that has the benefit of a cap or collar is a form of incentive that affects the rent payable. Analysing such agreements would need to reflect the parties' expectations at the time of the agreement on future rental changes, to determine whether the expected rent would be affected by this provision. Where it is, the capitalised difference would provide an indication of the value of this incentive.

Lease surrenders or take backs

4.18 The landlord may agree to accept the tenant's ongoing liabilities, either partially or in their entirety, in respect of the tenant's previous or other premises.

4.19 The calculation of the benefits to a tenant may consider not only the projected void costs in any existing leases surrendered or assigned, but also the costs of disposal (including legal and agency fees and any necessary incentives), and any accrued dilapidations or other liabilities.

4.20 The landlord may be influenced by their ability or wish to redevelop or refurbish the premises taken back.

4.21 Another example might be marriage (or synergistic) value accruing to the landlord by taking back the premises. This might influence the valuer to make an upwards adjustment of the rent, rather than discount it.

4.22 Care should be taken to understand the motivation for agreement to surrender from the landlord's and tenant's separate perspective. For example, a landlord may wish to repossess the premises to satisfy another tenant's expansion requirement, or a tenant may simply wish to vacate because the premises are surplus to requirements. The motivation may not be related to rent or value but driven by estate management necessity.

Other incentives

4.23 The parties may agree to incentives that may reflect circumstances particular to the letting. These could include concessions in the lease covenants and service charge caps.

4.24 The assessment of these incentives may not be straightforward due to the difficulty in obtaining full details of the amounts involved and assessing the real benefits to the tenant.

5. Analysing the transaction

5.1 The purpose of the analysis is to establish the net effective rent having regard to the package of incentives incorporated into the specific transaction.

5.2 There are two primary methods in common use:

i. Analyse each comparable to a net effective rent and then apply all of them to arrive at one net effective rent for the subject premises, after making appropriate adjustments for differences (for example in lease length) that might cause the appropriate scale of the incentives, and hence the net effective rent to differ; or

ii. 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. Having arrived at the market package applicable to the subject premises, the net effective rent is then calculated broadly in accordance with one of the methods described in this guidance note.

5.3 The treatment of the incentive does not necessarily depend on 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.

5.4 The valuer may need to decide whether the net effective rent is to be calculated including or excluding a rent-free period during which fitting out takes place.

5.5 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.

5.6 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.

5.7 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. The valuation process should also consider whether it is appropriate to calculate the value of the incentive over the period of the lease or the period of the lease less the rent free. For example, assuming a rent was agreed for 36 months with one month's fit-out rent free and one month's incentive rent free, a valuer may choose to value the incentive rent free over 35 months if it is possible to align such a methodology with prevailing market practices.

5.8 Analysis may be calculated on a simple straight line apportionment, or by using discounting through a discounted cashflow (DCF) or all-risks yield approach. In Hong Kong, the clear local market practice for most premises is the straight line approach and this method should be employed unless reasonable to do otherwise.

5.9 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. However, for simplicity the effect of taxation and accounting principles has not been reflected in this guidance note.

5.10 For larger premises it is not uncommon for the value of incentives to be analysed by landlords and tenants reflecting the time value of money.

5.11 Special care must be taken in the choice and analysis of comparable evidence for retail rents. Issues that should be considered include, but are not limited to:

i. Restrictive user clauses that limit the trade that may rightfully be undertaken in the property to be valued and comparable evidence. Different permitted users can afford different rents and consequently this issue could be reflected in the choice of comparable evidence used. While this is an issue with all pieces of comparable evidence for retail valuations, it is particularly evident in shopping centres/malls, in which permitted user clauses are highly prescribed to manage tenant and trade mix and it could have an impact on rents paid. Adjustment for such differences may be appropriate and/or the users may be so different as to render the comparable evidence of little use in the valuation exercise.

ii. Whether or not there are turnover rent provisions in the leases of the comparable evidence to be used to value a straight market rental. In some retail leases, the tenant pays the higher of a base rent or a prescribed percentage of gross turnover as consideration. If the basis of the rent to be valued does not have a turnover rent element, it is preferable to use comparable evidence derived from the same consideration basis. When, due to scarcity of comparable evidence, it is necessary to use comparable transactions that include turnover rent elements, it is important to understand the commercial purpose, dynamics and payment history of that element and reflect these issues in the adjustment process. In Hong Kong, subject to their being no information to the contrary, the base rental element is often considered to be the market rent and in some cases landlords (especially of shopping centres) may include turnover rent provisions in leases, not in expectation of achieving higher windfall rentals but to monitor the performance of retailers in their tenant mix. In these circumstances, the valuer should understand the background and make appropriate judgments in this regard.

iii. Turnover rents on a standalone basis, or on the basis of the higher of a percentage of turnover or a base rent, are more common in shopping centres/malls. The turnover element should be included, but the income streams treated differently. The base rent is fixed and less volatile and provides certainty to the landlord. The turnover rent is riskier due to seasonal variances in income and the nature of the goods being sold. Consideration should also be given to whether the income is solely derived from the particular occupier or is an industry standard.

iv. The analysis of a turnover rent should not reflect the ability of a unique operator to earn those receipts but should reflect the market norm. Consideration of whether different permitted users or trades are able to pay higher percentages of turnover must also be taken into account. If such evidence is to be used, it is important that there is an understanding of the transaction at first hand and particularly whether the 'base rent' forms the main component in the consideration, or whether it is a guaranteed minimum that the landlord expects to receive and the tenant is willing to pay – thereby making it subservient to the turnover rent element.

v. The relevance of comparable evidence derived from shopping centre/malls to value streetfront premises not located in a shopping centre/mall (and vice versa). This is because shopping centre/malls often form individual micro-markets with their own material characteristics. Shopping centre/malls benefit from the conglomeration effect and in some cases high advertising spending and promotional activities. Even apparent close proximity to the subject to be valued may be distorted by location and pedestrian flow differences. The matters outlined in (i) and (ii) may also have a pronounced effect on rent. It is therefore preferable to use comparable evidence derived from streetfront shops to value streetfront shop premises and evidence derived from shopping centre/malls to value shopping centre/mall premises. When, due to scarcity of comparable evidence from street locations (and vice versa), it is necessary to use comparable transactions from shopping centre/malls, it is important to think carefully about the appropriate adjustments necessary to derive guidance from the comparable evidence in the valuation process. Where it is not possible to secure sufficient comparable evidence from the mall in which the subject premises are located, it may be necessary to use evidence from outside the mall. The valuer should exercise special care in adjustments and apply appropriate weighting to ensure primacy of the evidence that most accurately reflects the material characteristics of the subject premises (from the same mall if available).

vi. When adjustments are applied to comparable evidence to reflect the material characteristics of the property to be valued, it is important that the valuer takes into account the cumulative percentage total applied in ascribing weight to the piece of comparable evidence in the valuation process. The greater the percentage adjustment for an individual item of comparable evidence, the less it reflects the material characteristics of the property/lease to be valued and the basis of valuation required. Consequently, less weight should generally be afforded to comparable evidence that has high cumulative percentage adjustment factors.

6. Method of analysis

6.1 There are various approaches to the analysis, which include the three methods outlined in this section. Method 1 is the most common in Hong Kong for straightforward transactions, but other approaches may be used. Where data is to be analysed and aggregated for the purpose of constructing market indices, it is important that a consistent approach is taken.

6.2 The choice of method adopted, and the assumptions behind the analysis undertaken, is a matter for the valuer in the light of the circumstances of the issue to be assessed.

6.3 The appendix includes examples to illustrate the various methods.

Method 1: rent and value apportionment, not assuming time value of cashflows (straight line method)

6.4 This is a commonly used approach, generally adopted in Hong Kong for small premises, which does not take the time value of money into account. However, where the value of the incentive is low in relation to the total rent passing, or where the period over which the inducement is analysed is short, the error caused by ignoring the timing of the rental payments is likely to be considerably less than the range of uncertainty in the assessment of other elements of the transaction.

Method 2: rent and value apportionment assuming time value of cashflows, using a discount rate or all-risks yield

6.5 This method has the advantage of reflecting the time value of money and is common in Hong Kong for larger lettings. However, if an all-risks yield is used, it suffers from the criticism of traditional investment valuation approaches, namely that the use of equivalent yields and current values does not identify the true differences between fixed and variable prospective cashflows from property leases.

6.6 An alternative approach, which is uncommon in Hong Kong, is to analyse the incentive using a discount rate reflecting the borrowing rate (for example, swap rate) plus a margin.

Method 3: comparison by reference to effect on investment value

6.7 This method would only be applicable to investor landlords. It would not apply to occupier landlords subletting surplus premises.

6.8 The capital value-based analysis presents the problem of the arbitrary nature of the adjustments to all-risks yields. Logically, the initial or equivalent yield applied to an investment let at the net effective rent should be significantly lower than that let at a headline rent, which will probably be ex-growth for a significant period, perhaps even for the entire duration of the lease.

6.9 An investment let at headline rent may initially be over-rented. However, there will often be market evidence of yields for similar properties let on similar terms. These yields will already reflect the market's perception of the additional risk attaching to the over-rented element. Therefore, it will not be necessary to adopt a valuation method that treats this separately.

Appendix 1: examples of the analysis of incentives

This appendix illustrates and compares the results of analysing a transaction using the methods outlined in section 6. They do not recommend or endorse any particular approach. To illustrate the principles, the examples are highly simplified and therefore cannot be used as a model approach to the analysis of a specific lease.

Discount rates

In all of the examples, the following discount rates have been assumed:

- Equivalent yield – 6.0 per cent (the investment capitalisation rate).
- Borrowing rate – 7.0 per cent (swap rate for the relevant period plus an appropriate margin).
- Target internal rate of return (IRR) – 8.0 per cent (investors' typical target IRR, or 'equated yield' for an investment in the property).

Note that these rates are for illustration purpose only and valuers should choose rates that are relevant to the date of valuation.

Cashflow in advance

In Method 2, where a discounted cashflow (DCF) concept is adopted, the calculations are presented using a DCF shortcut approach employing years purchase (YP) and present value (PV) factors. The YP factors are on a monthly-in-advance basis on the assumption that that is the reality of the rental cashflows.

Disregard of the fit-out period

Paragraphs 5.5 and 5.6 of this guidance note describe alternative approaches to the disregard of the fit-out period. The examples in this appendix all assume that the fit out took place before the start of the lease term. The alternative would be to assume that under the hypothetical deal, the tenant receives a fit out rent-free period beginning at the start of the lease term. Under this alternative approach, Example 1 (Method 1) would be calculated as $100,000 x 28 months/34 months (=$82,353) where 100,000 x 28 months represents the income received during the first 36 months under the Headline Rent deal, and 34 months represents the income duration where the tenant receives a rent-free period equal to the fit-out period only. All other calculations in the other examples could be similarly adapted.

Example 1

Lease term	36 months
Rent-free period	8 months including 2-month fitting-out period
Headline rent ($)	100,000 per month

Method 1: staight line	
Monthly term rent ($)	100,000
Term	36 months
Total rent-free period	8 months
Fit-out period	2 months
Incentive rent free	6 months
Monthly rent ($)	100,000
Over	30 months
Total rent paid ($)	3,000,000
Total lease term	36 months
Net effective rent ($)	83,000

Method 2: Calculation reflecting time value of cashflow using a money discount rate	
Yield	7%
Headline rent ($)	100,000
YP 30 months	27.61
PV 6 months	0.97
Present value of headline rent ($)	**2,666,171**
Divide by YP 36 months @ 7%	32.58
Net effective rent ($)	**81,846**

Method 3: Comparison by reference to effect on investment rate
This is not likely to apply to a 36-month lease, so the approach will be introduced in example 2

Comparison of results		
Method 1 Straight line	**Method 2** Discounted	**Method 3** Asset value
$83,333	$81,846	–

Example 2

Lease term	72 months with review in year 3
Rent-free period	8 months including 2-month fitting-out period
Headline rent	$100,000 per month

For each of the methods illustrated, the calculations show the effect of reflecting the rent-free period either: (a) to the first review or (b) for the full term of the lease

Method 1: staight line	
(A) To first review only	
Monthly term rent ($)	100,000
Over	30 months
Total rent paid ($)	3,000,000
Total lease term	36 months
Net effective rate ($)	83,333
(B) To end of lease	
Monthly rent ($)	100,000
Over	66 months
Total rent paid ($)	6,600,000
Total lease term	72 months
Net effective rent ($)	91,6667

Method 2: Calculation reflecting time value of cashflow using borrowing rate or target IRR ('equated yield')	
(A) To first review only	
Headline rent ($)	100,000
YP 30 months	27.61
PV 6 months	0.97
Present value of headline rent ($)	**2,666,171**
Divide by YP 36 months @ 7%	32.58
Net effective rent ($)	**81,846**
(B) To end of lease	
Headline rent ($)	**100,000**
YP 66 months	**54.97**
PV six months	**0.97**
Present value of headline rent ($)	**5,308,292**
Divide by YP 72 months @ 7%	**59.00**
Net effective rent ($)	**89,976**

In calculation (B) there is an issue as to appropriate discount rates to be adopted. The existing headline rent is unlikely to grow for some time, so arguably should be discounted at the 7% borrowing rate or possibly the 8% target IRR (equated yield) to reflect property risk.The effective rent will grow and should therefore arguably be discounted at the 6% all-risks yield rate or maybe even at a lower rate if the 6% applies to an investment let at the headline rent

Method 3: Comparison by reference to effect on investment value	
Headline rent ($)	100,000
YP Perp @ 6%	200
PV 6 months	0.9
	19,400,000
To make these values equal: £19,400,000 = 200x	
Therefore: x = 19,400,000/200	
Net effective rent ($)	97,000

This reflects the position purely from the landlord's viewpoint, but it is a very valid approach since it is often the maximisation of capital value that drives the rental package that a landlord will seek to achieve – usually seeking to maximise the headline rent by granting significant incentives.

There are, however, issues in respect of this application. Since the investment let at the headline rent could be said to be over-rented (in comparison with the net effective rent value), it is arguable that a higher capitalisation yield should be applied.

It is almost certain that a lower capitalisation yield would apply to the hypothetical investment let at the net effective rent, which has considerably greater growth potential than the headline rent. It will often be difficult to obtain market evidence to support the selection of that yield. Sales of similar properties that have recently had their rent reviewed (to the current effective rent) would provide useful evidence. However, there may be a shortage of such evidence in market conditions where there are significant incentives.

Incentives other than rent-free

For simplicity of presentation, all of the examples in this appendix have assumed that a rent-free period is the only incentive that has been granted.

The methodology in each case can be very simply adjusted to reflect other incentives. For example, if there was a capital contribution of $50,000 (or other incentives to a value of $50,000), Example 2, Method 2(B) would become:

Headline rent ($)	100,000
YP 66 months	54.97
PV 6 months	0.97
Present value of headline rent ($)	5,308,292
Less capital contribution ($)	-50,000
Present value of the headline and incentive deal ($)	**5,258,292**
Divide by YP 72 months @ 7%	59.00
Net effective rent	**89,129**

A waiver of a reinstatement clause would be treated similarly, but with the timing of the incentive being at the end of the lease it would be analysed as follows

Estimated reinstatement cost ($)	150,000
Lease term	36
Divided by YP 36 months @ 5%	33.50
x PV 36 months @ 5%	0.86
Monthly equivalent	**3,855**

Valuation of a capped rent

When a lease is granted where the rent upon review is to be capped or collared, and the expectation at the time of the lease renewal was that the rent would be capped below the market rent, this is of value to a tenant. The analysis of this incentive could be analysed as follows.

Rent per month ($)	100,000
Lease term	72
Rent review	36
Rental cap on review (%)	120
Estimated rental growth per annum (%)	15
Capped rent ($)	120,000
Estimated market rent at review ($)	152,088
Rental savings ($)	32,087
YP 5% for 36 months	33.50
PV 36 months @ 5%	0.86
PV of capped rental savings	**925,621**

YP 36 momths @ 5%	33,50
Monthly equivalent	**27,627**

Monthly rent ($)	100.000
Less monthly equivalent of rental cap ($)	-27,627
Net effective rent ($)	**72,373**

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RICS HQ

Parliament Square, London SW1P 3AD
United Kingdom

Worldwide media enquiries:

e pressoffice@rics.org

Contact Centre:

e contactrics@rics.org
t +44 (0)24 7686 8555
f +44 (0)20 7334 3811

United Kingdom
Parliament Square
London SW1P 3AD
United Kingdom
t +44 (0)870 333 1600
f +44 (0)207 334 3811
contactrics@rics.org

Europe
(excluding United Kingdom and Ireland)
Rue Ducale 67
1000 Brussels
Belgium
t +32 2 733 10 19
f +32 2 742 97 48
ricseurope@rics.org

Asia
Room 2203
Hopewell Centre
183 Queen's Road East
Wanchai
Hong Kong
t +852 2537 7117
f +852 2537 2756
ricsasia@rics.org

Americas
One Grand Central Place
60 East 42nd Street
Suite 2810
New York 10165 – 2811
USA
t +1 212 847 7400
f +1 212 847 7401
ricsamericas@rics.org

South America
Rua Maranhão,
584 – cj 104
São Paulo – SP
Brasil
t +55 11 3562 9989
f +55 11 3562 9999
ricsbrasil@rics.org

Africa
PO Box 3400
Witkoppen 2068
South Africa
t +27 11 467 2857
f +27 86 514 0655
ricsafrica@rics.org

Ireland
38 Merrion Square
Dublin 2
Ireland
t +353 1 644 5500
f +353 1 661 1797
ricsireland@rics.org

Oceania
Suite 2, Level 16
1 Castlereagh Street
Sydney, NSW 2000
Australia
t +61 2 9216 2333
f +61 2 9232 5591
info@rics.org.au

Middle East
Office G14, Block 3
Knowledge Village
Dubai
United Arab Emirates
t +971 4 375 3074
f +971 4 427 2498
ricsmenea@rics.org

India
48 & 49 Centrum Plaza
Sector Road
Sector 53,
Gurgaon – 122002
India
t +91 124 459 5400
f +91 124 459 5402
ricsindia@rics.org

rics.org