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Commercial property valuations and rental values after Covid-19 – challenges and opportunities

Following publication of new RICS Covid-19 valuation assistance to surveyors, Andrew Walker QC considers the current difficulties for commercial property valuations, and landlords' prospects of maintaining rental values for commercial properties in badly hit sectors of the economy

It may strike some as odd to be writing now, in the midst of he Covid-19 pandemic, about rental values. The retail, hospitality and leisure sectors are in financial turmoil, and it is difficult to see any sector of the economy escaping altogether from its economic impact.

But the recent publication by the RICS of a new document to assist chartered surveyors – '**Beyond COVID-19: Valuation approaches and evidence during the COVID-19 health crisis**' ("**the Guidance**") – is a timely reminder that the world will not stand still. Valuations will continue to be needed by investors and funders, owners and occupiers, buyers and new tenants; and also, regrettably, by insolvency practitioners.

In current circumstances, it is unsurprising that many valuers are having to qualify property valuations. There may still be sufficient transactions happening in some markets to provide enough evidence to support a valuation, but there are many markets in which there is currently considerable 'material valuation uncertainty' (a term with a specific meaning under RICS valuation standards), and in some areas that may continue for a while yet. Much will depend on whether economic circumstances lead to enough transactions taking place – either for good (because things are picking up) or for bad (because insolvencies and forced sales become all too common). Nevertheless, there will still be transactions, and these will surely pick up over time.

There are, though, two other issues that we may see come to the fore as a result of the pandemic. Both are mentioned in the Guidance, although only one is dealt with in any detail. Both may lead not only to valuation difficulties but also to valuation disputes.

One concerns the difference between a property's value and what it is worth. The other concerns the potential to change the use of a leasehold property, and whether this might allow landlords to maintain or even increase rental values, even for properties in badly hit sectors.

1) Value v Worth

Under current standards, valuers distinguish between value and worth. In simple terms, value is the market value of a property in the general market; worth is its value to a particular person, who may be a 'special purchaser'.

The Guidance reminds valuers of this distinction, and of its importance in current circumstances, and gives two warnings.

The warnings

The first concerns the possibility of "*unusual pricing*" in the market immediately after re-opening. This is clearly a risk, and I suspect that valuers may need to be alert to this for some time to come.

The second is to be alert to whether a transaction really reflects market value, or whether it reflects "*the needs of an individual buyer and/or seller, who could be seen as a special purchaser*". In the latter case, the transaction may reflect worth rather than market value.

Particular types of property highlighted

As the Guidance indicates, worth may be a key factor in relation to properties which are normally bought and sold on the basis of their "trading potential". As explained in the RICS Red Book Global Standards, VPGA 4, paragraph 1.3, the essential characteristic of such 'trade related' property is that it has been:

> "*designed or adapted for a specific use, and the resulting lack of flexibility usually means that the value of the property interest is intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. It can be contrasted with generic property that can be occupied by a range of different business types, such as standard office, industrial or retail property.*"

This is of particular relevance to sectors which are among those that have been hit the hardest by the pandemic: hospitality and leisure, in particular.

The Guidance goes on to remind valuers of the "*very important*" distinction between the market value of a trade related property and its investment value – or its worth – to a particular operator:

> "*The operator will derive worth from the current and potential net profits from the operational entity operating in the chosen format. While the present operator may be one potential bidder in the market, the valuer will need to understand the requirements and achievable profits of other potential bidders, along with the dynamics of the open market, to come to an opinion of value for that particular property.*"

The valuation difficulties

This highlights two related concerns, certainly in the short term but perhaps also in the medium term.

First, it seems likely that a rather higher than usual proportion of transactions in the market are going to reflect the worth of the property, rather than its value.

Second, valuers may face a challenging evidential mix of few transactions, perhaps limited information about those which have taken place, and reasons at least to question whether they were based on the value of the asset or its worth.

Both of those factors will continue to make valuation more difficult. Valuers will need to take even greater care over their selection and treatment of evidence, and over how they explain the relevant circumstances and facts and their valuation rationale; and valuations will be much more dependent than usual on the skill and expertise of the valuer.

There will clearly be a greater risk of getting it wrong to such an extent as to raise professional negligence concerns.

Although these circumstances may prove particularly challenging in 2020 and beyond, the issues are not new ones. I was involved in a leasehold enfranchisement case in 2017/8 which would have raised before the Upper Tribunal (Lands Chamber) a very similar question: how should valuers (and a valuation tribunal) approach comparable transactions which are said to involve purchasers with specific interests in the flats in question, when trying to value a flat for which there is no such purchaser.

That question arose in the prime central London residential market, but the valuation principles and difficulties are no different. The evidence certainly needs to be weighed carefully (see ***Windward Properties Ltd v Government of St Vincent and The Grenadines*** [1996] 1 WLR 279 at 285–286), but as the case settled before the appeal was heard, further judicial guidance will have to wait.

2) Use changes – a route to higher values?

The second issue concerns changes to higher value uses.

In simple terms, a property's market value is driven by the most valuable use to which it can physically and legally be put, and for which there is market demand.

The Guidance mentions this as a valuation issue, but deals with it relatively briefly and only in connection with trade-related property. (In the final section, it simply cross-refers to VPGA 4 paragraph 1.7, and adds some brief comments.) There is more that might be said.

The permitted use of a property has two main aspects: contractual restrictions and restrictions under the general law (especially planning law).

There is already some flexibility in the planning system in relation to property used in the retail, leisure and hospitality sectors, but in a post-pandemic world, planning restrictions may well be eased further, particularly in relation to retail property. There will be an imperative to help owners, occupiers, investors and developers to find new uses for properties in declining sectors, and to encourage growth in new or stronger sectors. This may well go beyond simply continuing some of the temporary measures for longer.

Permitted uses under leases and restrictive covenants may be more problematical. Restrictive covenants will endure, and will have to be dealt with through existing avenues (such applications to the Upper Tribunal to release or modify them). Restrictions in leases raise rather different issues (although some can be dealt with in the same way as restrictive covenants).

If a lease is brought to an end, then control over use will come back into the immediate landlord's control. This may be affected by restrictions in a superior lease, but where those do not exist, the landlord will be able to seek a new tenant for a higher value use, if (1) that is allowed under the general law, (2) the property is suitable for it, and (3) there are tenants in the market who will want it for that use, given its location and all other relevant factors.

But what if a lease contains a restriction on use and is continuing? Usually, the use and the rent can be changed, but only if both parties want that.

But what if there is a rent review?

Permitted use under a lease – a rent review scenario

Consider the following scenario, which may become more common.

A tenant has taken a lease of a property to use for its business. The initial rent reflected the tenant's intended and actual use of the property. The tenant's business is in a declining sector, or one hit hard by the pandemic. A rent review date arrives during or after the pandemic.

The rent review is to the open market rent on the review date, on the terms of the current lease. The rent being paid is already above the market rental value of the property for the existing tenant's use, so the landlord has no prospect of securing an increase for that use. Any increase in rent would also be unsustainable for the tenant. If the rent review is upwards or downwards, the rent payable seems likely to fall.

However, the location and physical attributes of the property make it suitable for another use. There would be market demand for the property for that alternative use, and the market rent for that different use would be higher than for the current use.

Can the landlord use that potential for a higher value use to maintain or even increase the rent payable on review? Yes it can, in some circumstances.

Permitted use under a lease – the rent review consequences

Most cases will fall into one of four categories, with categories (2) and especially (3) being more common in modern leases:

1) The lease allows the higher value use already (e.g. there may be no restriction on use, or the permitted uses are already wide enough).
2) The permitted use does not include the higher value use, but the tenant may change the use if the landlord gives its consent. If the tenant asks, then the lease says that the landlord cannot withhold its consent unreasonably.
3) The permitted use does not include the higher value use. The tenant may change the use if the landlord gives its consent, but the lease says nothing about the landlord not being able to refuse consent unreasonably.
4) The lease does not allow the higher value use, and there is no provision under which the tenant can ask for consent to a different use.

In each case, most tenants will wish to argue that the rent on review must, even taken at its widest, reflect only the uses already permitted under user covenant – and, ideally, only for the tenant's actual use of the property. If that does not include the higher value use, then that cannot affect the market rent.

In each case, the landlord may look at it differently. It might argue the following:

1) It would be willing to allow the higher value use, or (where relevant) could not reasonably withhold its consent to it.
2) Accordingly, it is a use to which the property could lawfully be put under the lease.
3) As a result, that the rent review must reflect that higher value use.

Who is right?

The text book view?

Alternative use	Who wins?
1) Already allowed – no consent needed	**Landlord**
2) Allowed with consent, not to be unreasonably withheld	**Landlord?**
3) Allowed with consent, but unqualified	**Tenant?**
4) Not allowed – no provision for consent	**Tenant**

The easy cases

(1) Higher value use already allowed – landlord wins

In this situation, if the review is to the open market rent, the landlord should be able to obtain the higher rent.

Because the lease allows it, the potential to put the property to a higher value use must be taken into account on review, unless the rent review clause says something different (or something relevant can be implied). In a nutshell, this is because the market for the hypothetical new lease will include potential tenants for that higher value use, with the result that the market rent must reflect their bids.

Authority for this can be found, for example, in ***Tea Trade Properties Ltd v CIN Properties Ltd*** [1990] 1 EGLR 155 (Hoffmann J). The principles are similar in other circumstances: for example, in relation to the tenant's right to make improvements (***Lewisham Investment Partnership Ltd v Morgan*** [1997] 2 EGLR 150 (Neuberger J)).

(4) Higher value use not allowed; no provision for consent – tenant wins

Here, the courts have held that the possibility of a change of use cannot be taken into account: ***Plinth Property Investments Ltd v Mott, Hay & Anderson*** [1979] 1 EGLR 17. Some have questioned the reasoning, but this is a clear and firm decision of the Court of Appeal, and it is likely to be followed in any but the most exceptional case.

An attempt by the landlord to issue a waiver or consent unilaterally is unlikely to affect this (see, e.g., ***C & A Pension Trustees Ltd v British Vita Investments Ltd*** [1984] 2 EGLR 75).

The more difficult cases

(2) Higher value use allowed with consent, not to be unreasonably withheld – landlord wins?

At first blush, the current case law seems to suggest that the **landlord** will win in this situation, at least if consent could not reasonably be withheld to the higher use in issue.

The main cases are these: the ***Tea Trade*** case (above); ***Aldwych Club Ltd v Copthall Property Co Ltd*** (1962) 185 EG 219; ***Charles Clements (London) Ltd v Rank City Wall Ltd*** [1978] 1 EGLR 47 (where this outcome was common ground); and a much more recent Scottish appeal case, ***East Renfrewshire Council v J H Lygate and Partners*** [2005] Scots CS CSIH 27.

For many years, these cases have been read as saying that, where the user covenant is in this form, the valuation is to be "*on the basis of the most profitable use of the premises for which consent could not be unreasonably withheld*" (see the Handbook of Rent Review, paragraph 5.3.4). For the last few years, though, the authors of the Handbook have suggested that a subtly different analysis would be preferable.

A closer look at this case law may now be timely. Indeed, in the face of the pandemic, it might be a matter of survival for a tenant faced with an attempt by its landlord to apply those cases.

One difficulty is that rent review cases now rarely lead to a court decision. Most leases put the rent review decision in the hands of an expert of arbitrator. This makes it difficult to change the law, if change is needed. Even if asked, the courts may still refuse to give guidance to an expert or arbitrator in advance (as they did on this very issue in both ***Compton Group Ltd v Estates Gazette Ltd*** (1977) 244 EG 799 and ***Forte & Co Ltd v General Accident Life Assurance Ltd*** (1986) 279 EG 1229; although an Australian court was not so reticent in ***Burns Philp Hardware Ltd v Howard Chia Pty Ltd*** (1987) 8 NSWLR 642).

On the other hand, there would at least be a possibility of raising this issue on appeal from an arbitrator's decision; and in most cases, what matters is what the expert or arbitrator decides is right, and she or he might be persuaded to take a different view. I have seen this happen.

(3) Higher value use allowed with consent, but unqualified – tenant wins?

As Woodfall (paragraph 8.037) suggests, a covenant which allows the use to be changed with the landlord's consent does at least contemplate the possibility of a change of use, even if the landlord can act unreasonably in deciding whether to give its consent.

That opens the door to an argument that the possibility of changes of use should be taken into account. If so, then the approach to category (2) might be applicable here too, in which case the landlord could win.

On the other hand, there is no statutory implication that consent is not to be unreasonably withheld to a change of use, and the general view has been that the courts will not usually imply a term to this effect. The landlord might try to argue that such a term should be implied, perhaps based on recent developments in the law regarding contractual powers, but that will not be an easy argument (see my previous article on this).

As a result, the stronger argument is probably that this type of clause has the same effect as an unqualified covenant, i.e. category (4). So the **tenant** will probably win.

Hope for tenants where other uses can be relevant?

If a court (or an arbitrator or expert) were asked to rule on a case in category (2) now, who **should** succeed? There are arguments that might be deployed both ways, but the tenant could well get somewhere on this, particularly for two reasons.

(a) What the cases actually say

The first reason is that, properly understood, the cases may not be as strongly in the landlord's favour as they may look at first blush.

The starting point, as explained in the ***Tea Trade*** case, is this:

"The question on the rent review is not the use to which the actual tenant might wish to put the premises but the purpose for which the hypothetical tenant in the open market might wish to use it. The hypothetical tenant would no doubt have made a request to the landlord for authorisation for whatever use he had in mind."

The judge went on to say that, "*the rent review clause … postulates on the rent review date a hypothetical letting in the open market. The open market, prima facie, means that no potential tenant is excluded from consideration. The valuer should not, therefore, exclude any potential tenant who might wish to take a lease of the building for any purpose for which it could physically and legally be used*."

That is a firm starting point for the landlord, and is the basis for how the case has been understood, but those comments were general ones. Do they really go as far as the landlord needs?

The tenant's argument was that the user covenant meant that the valuer was required to assume that the alternative use was legally impossible. In effect, the tenant argued that it should be treated as a category (4) case. The judge rejected that argument, but in these terms:

"In my view, the landlord would not be entitled unreasonably to refuse the hypothetical tenant's [sic] consent to [the alternative use]. The uncontradicted evidence is that the landlord would have no reasonable grounds for such refusal and this is something which, in my judgment, the valuer would be entitled to take into account. [The user clause] is therefore, in my view, no legal bar to [the alternative use]."

That is also helpful to the landlord's argument, but does it really go as far as to say that category (2) cases are essentially the same as category (1)? Arguably, having decided that other bidders should not be excluded, the judge did not dictate the effect of their inclusion.

The situation was similar in ***East Renfrewshire***. The tenant had put forward no argument or evidence to the arbitrator either (1) that the landlords could refuse consent to the change of use to retail, or (2) that the market would apply a discount to reflect the risk of refusal. As a result, the arbitrator "*was entitled to conclude that the evidence of retail rents was decisive*", and "*was under no obligation to allow for … a contingency in the absence of evidence on the point*". In other words, there was no error of law in the arbitrator's decision, and the result was one he was entitled to reach on the evidence.

The situation was similar again in the ***Aldwych Club*** case, but this concerned the terms of a new tenancy under the Landlord and Tenant Act 1954, and the actual decision appears to have been to insert a user clause in the new lease which permitted the higher value office use from the outset: i.e. it was actually a category (1) case. If so, then this adds little in a rent review situation, although it confirms that in new lease cases, there is "*[no] ground upon which the Court at the instance of the tenant and contrary to the wishes of the landlord could … sterilise the use of the premises to their present use with the consequences that there would be excluded from the hypothetical open market the class of would-be tenants most likely to pay the best rent, namely, those wishing to use the premises as offices*".

In each of these cases, consent could clearly not be withheld to the alternative use. Arguably:

- Even so, the effect on the valuation was a matter for the valuer or arbitrator. The judges opened the door to a higher rent, but did not say that this was the inevitable result.
- In other factual circumstances, the result might well be different.

(b) Who is the hypothetical tenant?

The second reason concerns how a rental valuation should be approached.

When identifying the market rent, valuers assume a notional transaction – one between a hypothetical landlord and tenant. Normally, the notional transaction is the grant of a lease of the property on the terms of the actual lease.

If the lease contains use restrictions, then the hypothetical landlord is to be taken to have sought bids for a lease containing those restrictions.

What about the hypothetical tenant? Even if, as ***Tea Trade*** says, all potential tenants are to be included in the market, including those wanting an alternative use, the cases do not say the valuer should ignore the existence of the restriction. If, on the evidence, that has an effect on those who are interested in bidding for the lease, or on the amount that they are willing to pay, then that should be taken into account.

Similarly, although the cases indicate that the tribunal should take into account evidence from the actual landlord about what it would be willing to allow, they leave the effect of that –

including the weight to be given to it – to the tribunal. Self-serving evidence about a hypothetical situation will no doubt be scrutinised with care.

The right approach?

If the effect of a qualified user covenant on bidders in the market, and the final rent agreed, is a matter of evidence and judgement, then in general terms the true answer in these cases might be something like this:

- If a tenant could not expect to be given consent to change to a particular alternative use, then bidders for that use are unlikely to bid at all. If so, then they will not be part of the market for the lease. Similarly, the possibility of a change to that use is unlikely to affect the successful bid, and the landlord will have no basis for holding out for any sort of uplift. If so, then a possibility of this sort will not affect the market rent.

- On the other hand, if a tenant could be certain that consent could not be refused for a particular alternative (and higher value) use, then bidders for that use will be (or at least may well be) in the market, and might be willing to pay the full rent for that use, or something close to it. If so, then that will be reflected in the successful bid, and may thus flow through to the market rent.

- If a tenant could have some expectation of being given consent to change to that alternative use, but no certainty, then the position may be somewhere in between. There might still be some bidders in the market for the alternative use; but even if not, there might still be an uplift in the rent to reflect the flexibility given by the lease, perhaps because it improves the prospect of finding an assignee in the future, including one wishing to put it to a higher value use (who might thus be willing to pay a premium). As a result, the possibility of a change of use might lead to some uplift in the rent, but not to the level of rent that would be paid for other uses; or it might have no effect at all.

Assessing the market effect of a particular user covenant may not be easy. In most new transactions, the intended use will be permitted from the outset, so there may be few directly comparable open market transactions. Nevertheless, the nature of the task is not altered just because greater expertise, experience and judgement may be needed to do it well.

If all that is right, then the true position with user covenants may be this.

The true position?

Alternative use	Who wins?
1) Already allowed – no consent needed	**Landlord**
2) Allowed with consent, not to be unreasonably withheld	**Fact-dependent**
3) Allowed with consent, but unqualified	**Tenant?**
4) Not allowed – no provision for consent	**Tenant**

User covenants – not the only issue

It should also not be forgotten that other lease clauses, or the physical attributes of the property, may also be a hindrance to a change of use. This was recognised explicitly in the ***Tea Trade*** case. For example, the tenant may need to make alterations or obtain statutory consents (including planning permission).

In principle, the possibility of a different planning permission being sought and granted should be taken into account (see, e.g., ***Rushmoor BC v Goacher*** (1986) 52 P. & C.R. 255 and ***McDonalds Real Estate LLP v Arundel Corpn*** [2008] 2 EGLR 53), and there is no reason in general to take a different approach to anything else that might be necessary before the property could be used for a different purpose.

However, any or all of those requirements may be restricted in some way under the lease (e.g. barring them, or requiring the landlord's consent); and even if they are not, they are likely to bring with them cost, delay and risk, all of which will need to be taken into account.

So even if permitted uses allow a landlord to chase a higher rent, there may still be other hurdles to overcome in order to succeed.

Final thoughts

From a commercial perspective, landlords who are known in the market to be pushing this issue may have to deal with the reputational consequences, including the risk that new tenants are willing only to agree turnover rents with them. The post-pandemic market may already be moving in that direction, but this could give it a further push. They may also find their hopes dashed by a post-Covid-19 oversupply of similar properties, depressing rental values across the board.

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