How should rent be valued during the Covid-19 pandemic?

By Aaron Walder and Phil Steadman | 27-04-2020 | 08:00

During the recession of 2008, the courts began seeing more trials of cases that in ordinary times might be expected to settle. Tenants put pressure on their landlords to reduce rent, sometimes substantially, whenever the opportunity arose. One such opportunity was at the statutory renewal of a business tenancy. It was not unusual to see trials where terms of a new tenancy were agreed, but experts were wildly apart on the new rent, because the available evidence led them to different conclusions. Given the unprecedented current climate, it seems likely that such a divergence between experts may well reoccur. Here we set out what we believe the correct approach to be.

The law

The starting point is section 34 of the Landlord and Tenant Act 1954 (the 1954 Act). It states that: "The rent payable under a tenancy granted by order of the court under this Part of this Act shall 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."

While there is no express mention of a "willing lessee" the courts assume one must exist because of the necessity of implying such a concept to allow for consideration of an open-market letting: Dennis & Robinson Ltd v Kiossos Establishment [1982] 2 EGLR 120.

When considering section 34, focus centres on open-market comparables to establish rental figures. It is clear that section 34 is a matter of valuation evidence rather than court discretion: O'May v City of London Real Property Co Ltd (1977) 1 EGLR 76.

The concept of "the willing lessor" needs some explanation. While in reality, given the global pandemic, there may be no willing lessor, or conversely, willing lessee, for valuation purposes they are abstractions, who don't have the real personal characteristics of an actual landlord or tenant.

FR Evans (Leeds) Ltd v English Electric Co Ltd (1978) 1 EGLR 93 explains the nature of the "willing landlord" and the "willing tenant". It noted:

n the landlord is "not afflicted by personal ills such as a cash-flow crisis or importunate mortgagees, nor being someone to whom it was largely a matter of indifference whether he let in October 1976 or waited for the market to improve…".

n similarly, the tenant "was a hypothetical person, not being, nor necessarily having any of the characteristics of, the defendant tenants, actively seeking premises to fulfil needs which the demised premises could fulfil, taking account of similar factors to those taken into account by the willing lessor but similarly unaffected by liquidity problems, governmental or other pressures to boost or maintain employment in the area and so on…".

Given those assumed characteristics, especially the fact that "liquidity problems" and "government pressure" are not to be attributed to the hypothetical willing tenant,

notwithstanding many premises in the hospitality sector are actually not trading or even open at the moment, the rent should be assessed on a hypothetical basis considering the comparable market rents of other premises. Which would, because virtually no transactions would have gone ahead since the lockdown, not be much different to pre-lockdown rent.

So the starting position would be guided by comparable transactions, including pre-lockdown ones. But what if your premises cannot operate as intended? If a lease is subject to a "narrow user" covenant, which limits the practical uses the tenant can use the property for, the rent should be reduced: Northern Electric plc v Addison [1997] 2 EGLR 111.

It is arguable, and grounded in common sense, that the legislation causing licensed premises to close has an effect here. As the law currently stands, a person carrying on a business must, during the emergency period, close any premises in which food or drink are sold for consumption, and cease selling food or drink for consumption on premises.

In valuation terms, the noteworthy point is that the period of enforced closure only lasts "during the emergency period". As set out in paragraph 4 of The Health Protection (Coronavirus, Restrictions) (England) Regulations 2020, that period must be reviewed every 21 days and has already been extended once. Theoretically at least, it can be factored in to the expert's calculations.

A worked example

How would this work practically? Consider the lease of a restaurant in Newcastle up for renewal. It offers no takeaway facilities, so is currently closed, but the hearing to determine the new rent (all other terms having been agreed, including a five-year term) is listed very soon. The premises is 3,000 sq ft, and the current rent is £75,000 (£25 per sq ft). The date for valuation for the purposes of the trial is 1 June 2020.

Arriving at the market rent

Market rent is arrived at by the consideration of comparable transactions, which in normal market conditions is usually relatively straightforward. The well-established hierarchy of evidence results in valuers placing greatest weight on transactions of premises of similar physical and locational characteristics completing around the date of valuation.

Save for lettings which were effectively agreed pre-lockdown, there will be very few lettings which complete during the emergency period. Faced with a valuation date of 1 June 2020, the court will have to determine a market rent where the market has temporarily ceased operating normally. The lack of actual transactions will invariably lead to greater weight being applied to hearsay evidence which should aim to provide examples of where the market may have been operating at, save for the lockdown, in line with the RICS Valuation Practice Alerts, which are updated regularly.

Where, as in the case of this hypothetical, the valuation date falls during the emergency period, the only real option is for the court to deal with this period by way of a notional non-rent period and then determine a headline rent to be paid for the new lease. The exercise will then involve averaging this out over the term.

Added to this uncertainty are practical matters such as the treatment of rental voids for fit out. If tenants cannot instruct contractors to undertake fit-outs, it would seem likely that "usual" fit-out times would have to be lengthened. Against that, of course, a landlord would argue that any recognition of a rent-free period takes that into account.

Hearsay evidence and negotiations currently occurring in the market

There has been a deluge of applications from tenants seeking rent-free periods or deferment of rent during lockdown. Consideration of these applications is more complicated where the parties are in a lease renewal situation. The tenant's financial position could result in them being compelled to agree renewal terms in order to ensure the continuity of their business in the short term, rather than pursuing the matter via court which would take longer and potentially put the business at risk. It is arguable, therefore, that these do not represent "a willing lessee". However, given the abstract nature of the valuation process, the valuer will have to carefully consider if this represents credible evidence that affects the valuation. After all, the press has been reporting landlords standing firm on rent waivers for stronger covenant tenants.

The important point is that there has been a significant increase in communication between landlords and tenants recently. Tenants have sought reductions in rents. Some landlords have accepted these requests, some have accepted subject to the terms of a new lease being agreed and some, of course, have refused. The very fact the tenant may be reluctant to pay any rent at all as they are unable to trade from the premises is a factor to consider.

Adhere to the principles

The pandemic has thrown the valuation of most premises into uncharted waters. Comparable evidence as well as the notional date of valuation will be subject to detailed scrutiny. A different date of valuation by even one month could have a serious impact on the rent to be paid on the new lease.

However, using sound legal and valuation principles, it is possible to assume the following in our worked example.

1. The starting point would be to establish a per sq ft figure from comparable, even pre-lockdown, lettings.

2. Evidence would then need to be gathered (anecdotally if necessary, but supported in writing if possible) as to what rent-free periods were being negotiated in the market.

3. Consideration may also need to be given to a notional period of closure.

4. Finally, these deductions would need to be capitalised for the length of the lease.

In our worked example, assuming the pre-lockdown lettings showed an average rental of £30 per sq ft for similar premises, and assuming the court accepted evidence illustrating a trend towards landlord's agreeing a 50% rent reduction over a period of six months; and also assuming the court accepted the property would not trade for three months, the rent arrived at would be £81,000 pa.

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