ANZRPGN 3 LEASING INCENTIVES

1.0 Introduction

1.1 Purpose

The purpose of this Guidance Note is to provide information, guidance and advice on leasing incentives to Members undertaking tasks involving the assessment or analysis of rental and capital values.

1.2 Status of Guidance Notes

Guidance notes are intended to embody recognised 'good practice' and therefore may (although this should not be assumed) provide some professional support if properly applied. While they are not mandatory, it is likely that they will serve as a comparative measure of the level of performance of a Member. They are an integral part of the Valuation and Property Standards Manual.

1.3 Scope of this Guidance Note

This Guidance Note applies to Members assessing the impact of leasing incentives on rental and capital values particularly in relation to commercial property.

1.4 International Valuation Standards

This Guidance Note recognises the International Valuation Standards 1 and 2, and the International Valuation Application 2, effective from 2007 by the International Valuation Standards Committee and it is intended to be consistent with the concepts and definitions contained in those standards, however, there may be departures from IVSC Standards to reflect Australian & New Zealand law and practice.

1.5 Cyclical Market

Since the 1960's the commercial property market has experienced increased volatility. This is primarily because demand lead time is far shorter than the time needed to create more supply. This cyclical pattern is unlikely to change in the foreseeable future so that valuation methodology and techniques and the practitioners themselves must be able to cope with the varying market conditions – no matter how extreme.

1.6 Over Supply Leading to Incentives .... analysis of evidence essential

Oversupply of office space in most of the major cities has led to incentives being offered to prospective and existing tenants. Whilst these incentives are of prime importance to the parties directly concerned, they are also important to the market place as a whole to the extent that they may affect market rental values. The analysis of rental evidence for comparative purposes is an essential part of the valuation process and is of particular relevance where rent reviews and asset valuations are under consideration.

1.7 Range of Opinions

The range of opinions amongst valuers and their clients as to how leasing incentives should be interpreted has resulted in a broad ranging public debate.

1.8 Intention of Clarifying Principles

In response to specific requests, this Guidance Note has been prepared with the intention of clarifying the principles involved.

1.9 No Uniformity of Market Conditions

A review of the situation in the various cities clearly shows that there is little uniformity in market conditions. This tends to be the normal situation and makes it impractical to enunciate Practice Standards on how matters must be evaluated.

1.10 Skill of the Valuer is to Investigate

The traditional skill of the valuer is to investigate, report and evaluate the specific situation being considered, taking into account the differing factors which affect rental levels and capital values in the particular location or market.

1.11 Many Factors to Consider

These factors include the wording of the pertinent lease clause (of which there are countless variations), the state of the building, the general market, the size and duration of the lease, case law, and many other factors of which incentives granted on new leases are but one.

2.0 Leasing Incentives

2.1 Rent Freely Negotiated Between Two Parties

The consideration paid for the right to occupy premises owned by another usually takes the form of a periodic rent which, in the case of new lettings, is negotiated freely between the two parties. Rental value is assessed by various methods. In the case of office space, the method most frequently used in rental review determinations is to analyse rents paid for comparable space, thereby deriving a rental rate to be applied to the subject accommodation. Rental values normally refer to accommodation that has been completed up to the stage of the tenant's fit out.

2.2 Supply and Demand ....excess of supply

The fundamental laws of economics apply and in the case of the office market, it is difficult, given the lead time involved in supplying new space to the market, for supply to respond quickly to rise or fall in demand. Surplus space can be withdrawn from the market place but owners are understandably reluctant to take this course. Accordingly, once a significant excess of supply over demand is demonstrated, rental values may fall.

2.3 Incentives for Leasing New Building

In periods of oversupply of accommodation, incentives are often granted during the leasing up of a new building and these amounts are regarded by the owner/developer as part of the capital costs.

2.4 Incentive to Move

The cost of fitting out and relocating can be high and without an incentive from the landlord which meets all or at least a substantial part of these capital costs tenants would, in many instances, not move to new premises.

2.5 Sustaining Rental Levels in Times of Over Supply

If rentals are to be sustained in times of oversupply, some form of compensatory consideration may be required to achieve new lettings. That consideration, where it occurs, is also part of the incentive in whatever form it may take.

2.6 Incentive Benefit Offset Against Commitment

The consideration of incentive, may take the form of a capital payment or relief from a revenue obligation. In either case the tenant receives a benefit which will be offset against the totality of the tenant's rental commitment and fit out cost.

2.7 Incentives Even in Balanced Market

It is relevant to note that lessors have often given incentives to in-going tenants, even when the leasing market has been balanced in terms of supply and demand.

2.8 Extent Incentive is a Reduction of Rent

What has to be assessed is the extent to which a particular incentive package includes an amount, which might be regarded as a reduction from the stated rent. It is noted that leasing incentives have sometimes increased in anticipation of increasing vacancy factors and may be perceived to create a false rental base, which may cause difficulty in the analysis and assessment of rentals and capital values.

2.9 Valuer to Decide Appropriate Technique

There are several techniques for arriving at a value, which are well known to practising valuers some of which are appropriate to different situations. It is up to the judgment of the Valuer in each case to decide which of the techniques to use. In many cases the Valuer may utilise more than one technique in the process of producing a valuation.

3.0 Effective Rental Value

3.1 Converting Incentive Into Periodic Equivalent

Where it is determined that an incentive has been paid, the valuer is called to utilise judgment in the light of the current conditions in the location concerned as to whether any element of the incentive should be regarded as a de facto rent reduction. This element should be converted into a periodic equivalent over the term of the lease. This periodic equivalent should be deducted from the nominated or passing rent in order to arrive at the effective rent. Any effective rental should represent the most valid interpretation of the transaction concerned for comparative purposes, which may not necessarily represent market rent.

3.2 Interpretation of an Incentive in Terms of Cash Flow

Care should be taken to ensure the correct interpretation of an incentive in terms of cash flow. For example, a lump sum payment equal to three years rental, paid at the start of the lease, will not equate to an actual rent-free period of three years.

4.0 Rent Reviews

4.1 Points to Consider in Rent Reviews

In reaching a view as to the rent that should be adopted on review the valuer may take many points into consideration including:

- The specific wording of the subject lease clause.
- Relevant case law.
- The rents being agreed between landlord and tenants on review for similar tenancies in the area.
- The size of the tenancy concerned relative to the size of space of available comparable rentals.
- The fact that a review to market rent may not necessarily be influenced by the level of rent previously passing unless required under the lease conditions.
- Rents on review may fall as well as rise according to prevailing market conditions unless there is provision in the lease to prevent the rental falling.
- Guidance should be sought from a wide range of rentals including rentals freely negotiated at review dates and rentals for new lettings both of which may or may not truly reflect the rent which would be paid in the market. The circumstances of the rentals must be fully investigated and appropriate adjustments may be required up or down in the valuation process.
- The possibility of incentives having an effect on the stated rent as outlined in points 3.1 and 3.2 where new lettings are considered in reaching a view on the current market rent.
- The valuer should have regard to this practice and decide as to whether the amount of the inducement is greater than a reasonable inducement to move and assess as to whether, in all the circumstances, all or part of the incentive granted would be regarded as a rental rebate.

4.2 Deciding the Weighting to Apply to Evidence

From time to time a valuer will be faced with rent reviews occurring, some of which have had regard to the level of effective rent created by incentive payment while others in the same building (or similar buildings) demonstrate a disregard for such consideration. Obviously the Valuer should examine the particular premises, the remainder of the term available and the particular conditions of the lease before deciding the weighting he needs to apply to such evidence in the process of assessing market rent. In fact the lease conditions may require an assessment of a rent level that is not market rent.

5.0 Secrecy Clauses

5.1 Encouragement for Full Disclosure

Secrecy clauses and side agreements in leasing arrangements are a negative development and every encouragement should be given to lessors and lessees to provide full disclosure of all lease arrangements.

5.2 Secrecy Undesirable

Secrecy arrangements are clearly against the operation of an informed market and are thus undesirable.

5.3 Serious Repercussions Can Flow

The Institute recognises that two parties have the right to confidentiality of their commercial arrangements. However, the Institute believes that serious repercussions can flow from the use of non-disclosure or secrecy clauses particularly when their use may distort valuations based on inadequate information.

5.4 Ascertaining Existence

Before accepting instructions valuers should where possible:

- Enquire in writing as to the existence of any secrecy clauses or side agreements.
- Obtain a written response.

5.5 Refuse to Act

The valuer has a right to refuse to act in instances where it is considered that the lack of information prejudices the valuer's ability to discharge the responsibility of making the assessment.

5.6 Professional Responsibility

In discharging this responsibility the valuer should be aware of the liability for potential claims for professional negligence or fraudulent conduct.

6.0 Capital Values

6.1 Adjustments

The capital value of an income producing property should be arrived at by capitalising the market rent making adjustments for any continuing rent free periods, vacancies, leasing up costs, reversions, outstanding repairs/renovations, the strength of lessees' covenants, lease terms and so forth. In a stable market, the assessment of market rental value and the appropriate capitalisation rate can be undertaken without undue difficulty, notwithstanding the degree of research required. The introduction of incentives coupled with a relatively inactive market makes the valuation process more complicated and, possibly more subjective.

6.2 Matters for Consideration

It is recommended that careful consideration should be given to the following matters in addition to the matters referred to above:

- The relativity between the passing rent and market rental value indicated by the long-term rental trend line in the relevant market.
- The need to distinguish between passing rents, market rents and effective rents and their relative growth patterns and the relationship with real net cash flow.
- The proper assessment of the sustainable level of net income.
- Due allowance for the reversionary value of lower than market level rents.
- The capitalisation rate to be applied in the light of market rental levels and the position of the property market in its cyclical movement.
- The danger of applying a capitalisation rate to a passing rent which, for whatever reason, does not represent market rent.
- The precise interpretation of the rent review clause(s).
- Where appropriate, a comparison between the Internal Rate of Return derived from the cash flow as analysed in the above process and the Internal Rate of Return required by buyers in the market place at the date of valuation.
- Adequate allowance for letting up and leasing incentives for vacant areas.
- Adequate allowances for any building works or refurbishments needed.
- Any possible tax implications.

7.0 The Market

7.1 Valuers Interpret

Valuers do not set the market, they interpret it.

7.2 Interpreting Varying Conditions

The market and market practices are subject to continuous change. Consequently, the valuer should interpret these varying market conditions in the application of established methodology.

7.3 Market Dictates Value

The Courts have often noted that it is the market that dictates value (Broken Hill Pty Co Ltd v Australian Mutual Provident Society, reference The Valuer, Vol. 29 at 340).