RENTAL DETERMINATIONS AND ARBITRATION (ADR): A MICRO SOLUTION TO THE MACRO PROBLEM

by Don E Gilbert, Brisbane, Australia.

Australian Asset & Property Consultants and Queensland Lease Consultants
(see www.aaapc.net.au and www.leaseconsultant.com.au)

WAVO 4 Financial Market Security and the Valuation Profession: 23 – 26th November 2009, Guilin Lijiang Waterfall Hotel, Guilin, Guang Xi Province People's Republic of China

Table of Contents

Attachments ____ 2

A. Overview – damage to Intangible Asset Value of leases in Australia due to poor leasing practices and Government protection (rent control) to landlord interests to the detriment of stakeholders ____ 2

B. Factors leading up to the macro problem of the Australian Real Estate Investment Trust sector (the 'A-REIT's') ____ 5

C. Indirect causes (the wider economy) ____ 6

D. A-REIT corrections ____ 7

E. The micro solution: the fall-back; the rent determination/arbitration (ADR process) ____ 9

F. Simple legislation requiring a lease or lease renewal be offered at "market rent", that all dealings with the leases be *"in good faith"*, and a trigger to compulsory mediation and expert determination/arbitration to settle disputes ____ 10

G. Expert's role ____ 11

H. Examples of: Expert determiners who did not fulfil the terms of contract and why ____ 12

I. Facing and overcoming challenges during the determination ____ 13

J. The Role and Responsibility of Professional Institutes ____ 18

K. Benefits and conclusions ____ 19

FOOTNOTES ____ 21

Please Note: all material in this paper and presentation is fully supported by independent research and fact.

Attachments

Table 1: The collapse of A-REITs weighted towards retail as a consequence of gearing

Graph 1: Shows the data from Table 1 and the impact on A-REIT share holder value

Graph 2: Damage to Intangible Asset Value of leases in Regional Shopping Centres (Australia), due to poor leasing practices, lack of tenure, high rent eroding profit causing negative returns

Graph 3: Doncaster Shopping Centre disproportionate occupancy costs as at 26/10/98 vs CCH Business Benchmarks accountancy averages: representative sample of all Regional Shop Shopping Centres (2006/07) and damage to Intangible Asset Value of lease income streams through poor leasing practices

Graphs 4: Damage to investments arising from gearing and consequence of "non-market rents" capitalised to produce "market value" arising poor leasing practices in Australia and damage to Intangible Asset Value of landlord and tenant leases

Graph 5: 360° performance evaluation of valuations. In absence of testing "voracity" of leases and rental income streams i.e. market rent, a valuation could be 100% + out

Table 2: Hypothetical Rent as a Residual can be used in absence of rental "evidence" and or as a "check method"

A. Overview – damage to Intangible Asset Value of leases in Australia due to poor leasing practices and Government protection (rent control) to landlord interests to the detriment of stakeholders

The aim of this presentation is give a brief overview of the factors that have lead up to the collapse of the Australian Real Estate Investment Trusts ('A-REITs') and the wider property industry; to look at the significant affect it has had on investors, financiers, valuers, etc. and to look for more on solutions to the problems. Looking back now, however, I have a far better understanding of the factors that lead up to the collapse and the consequences thereof[i].

For example, Table 1 shows the "boosted up" value of A-REIT shares weighted to retail on the Australian Stock Exchange before and after the market corrected from November 2007 to June 2009. It shows that the sector fell by -65%, while the wider market had fallen by minus -40 to -50%. Excluding two securities, Westfield and CFS Gandel, the rest of the A-REITs weighted towards retail fell by minus -81%. Graph 1 shows the data from Table 1 and the impact on A-REIT share holder value in $A billions.

At previous valuation congresses in Singapore (WAVO 1), Beijing (WAVO 2) and Seoul (the 24th Pan Pacific Congress), my presentations sought to:

- Identify issues in Australia, including those areas in which I believed we are leading shopping centre managers but where "engineered" rents and valuations, caused this sector of the market to collapse. Secondly, that we were due to have a major inquiry into the industry by our regulators, i.e. the Productivity Commission;
- Look for solutions; and
- Follow the collapse of the A-REIT sector which confirmed that my research and simple modelling had been accurate and relevant.

This paper will demonstrate how relevant this research has been, but it will further explore ways to reduce the chances of it happening again, thereby seeking to minimise damage to stakeholders, largely as a consequence of Government inaction in the form of upholding "rent control".

In my previous presentations, I have used uncomplicated tables and graphs to explain some complicated causal factors leading to these events. There are a number of separate areas involved which are further linked, including:

- Economics and economic factors (national and international) including finance;
- Investment and investment factors;
- Business economics;
- Property economics; and
- Valuation factors.

These factors are interrelated and mutually inclusive. One area has a bearing on other areas and vice versa.

One particularly useful concept is to consider the factors that make up a "mature" product within a "product life cycle", and to bear in mind that the A-REITs is a mature industry within an "industry life cycle".

Either the "product" or industry must be reinvented or improved or it falls into decline.

This paper and presentation concentrates on the micro solution, to rebalance the industry, in the form of a "fall-back", entitling the parties to go to independent expert determination, both psychologically and actually, which has been engrossed into State Tenancy Law in Australia[ii], but does <u>not</u> address end of lease issues and unfair bargaining.

In my opinion, the fall-back negotiating parties would have to go to independent expert determination and or arbitration in the event the parties cannot reach agreement about the market rent for new leases or lease renewals, which will have a significant impact on the way in which concerned parties deal with one another and remove protection afforded to landlords by Government in the form of "rent control".

Graph 2 shows damage to Intangible Asset Value of leases in Regional Shopping Centres (Australia), due to poor leasing practices, lack of tenure and excessive rent charging, thus eroding profit and causing negative returns. This further research by me is as a consequence of a presentation, by Ion Anghel PhD, Romania, "Intangible Assets Analysis and Valuation", WAVO Congress, Singapore, Nov 2006.

This will be for the significant benefit of the overall industry, including for asset valuers and asset valuations. For too long, the commission based industry (owners and managers) has been driving share prices, using the equivalence of Mortgage Backed Securities to attract investors into this investment category, and tenant equity to increase rents on individual and collective leases. The effect has been to capitalise short-term, high risk rental income streams into long-term valuations, in breach of International Valuation Standards[iii].

This has resulted in a transfer of cash-flow and capital from one party to the other party by way of disproportionate rent, which is distorting valuations in the process, eg. lending, etc. In effect, the product is "sub-prime" leases.

To illustrate this point, Graph 3, shows disproportionate occupancy costs[iv] for Doncaster Shopping Centre as at 26/10/98 compared to CCH Business Benchmark accountancy averages. This is a representative sample of all Regional Shop Shopping Centres (2006/07).

The lower trend line is the suggested benchmark rent for over thirty retail business categories. The upper trend line is for Doncaster Shopping Centre. The total occupancy cost also coincided with corresponding rents being charged in all Regional Shopping Centres in Australia in 2006/07 i.e. Doncaster specialty shop rents in 1998 were a representative sample of all Regional Shopping Centre rents in 2006/07.

I suggest that the high average rent above the middle trend line represents damage to the Intangible Asset Value of lease income streams through poor leasing practices in Australia; the difference is the amount by which valuers must "mark-down" their valuations or build in appropriate risk factors.

Graph 4 shows the consequential damage to shareholder value, arising from gearing and "non-market rents" capitalised to produce "market value", arising

from poor leasing practices in Australia and damage to Intangible Asset Value of landlord and tenant leases.

At 62% gearing, shareholder value is completely eroded with a realistic 25% reduction in valuations for reasons mentioned above. BDO Kendall's research referred to in Part D below summarises what has occurred. Valuers are belatedly responding[v] (see reasons for inflated valuations in Part B below).

B. Factors leading up to the macro problem of the Australian Real Estate Investment Trust sector (the 'A-REIT's')

In my opinion the following are the direct causes which have lead to inflated valuations, thereby causing share prices to rise disproportionately, and which are summarised below:

- Remuneration linked to commissions, including management fees as a percentage of total income collected, i.e. rent, outgoings, promotion funds, utilities (rather than a fixed annual fee), commissions paid to "leasing executives" to achieve higher rents than the previous business owner closed down/vacated at;
- Moves to a "stapled security model" from the conservative Trust "model" i.e. earning development fees, management fees, rental income;
- Gearing/leverage "financial engineering" for subsequent acquisitions then associated with refinancing difficulties[vi];
- Investment in low grade property in unknown markets at peak of market, while failing to carry out adequate due diligence;
- In Australia, many businesses supply their sales data to landlords who supposedly use the information to verify percentage rental charges. In fact, some of the A-REITs have fraudulently used the tenant's sales data to maximise rents without regard to "market rent" or market rental criteria - see Graph 3;
- With the driving motive being to earn higher management fees/development profit vs hard rental income, "investors" and financial advisors were no longer able to distinguish between different risk profiles of these income streams;
- Asset valuers[vii] valuing on "passing rent" and or being remunerated on "commission based" fees in breach of Australian Property Institute and RICS Codes of Ethics;
- Asset valuers are not trained and do not understand (or distinguish) high risk income streams, i.e. when rent is above the market rent – see Graph 5, being a 360° performance evaluation of valuations. In absence of testing "veracity" of leases and rental income streams, i.e. market rent, a valuation could be 100% + out;
- Specialist Retail Valuers who work for management companies and agencies are sometimes not independent and are "leant on" to not decrease rents,

because management fees are a percentage of income collected. Expert determiners should not accept appointments if they are unable to fulfil the terms of their joint appointment to determine the market rent[viii] as independent experts[ix];

- Valuers are not trained to "test" market rent; have not upgraded skills and are not problem solvers. In effect, they need more inquisitorial skills to test the veracity of evidence and not accept the rent at face value;
- Valuers do not understand or comprehend the "micro" end of the spectrum;
- The culture is still one which expects the landlord/developer expects an "automatic return", irrespective of whether viable or not, or whether it is a good development or a bad one, i.e. price of land (irrespective of whether the price paid is realistic or not), plus development costs, then rent charged (irrespective of whether it is market rent as defined or not), plus automatic increases. This is built into valuations and "value", irrespective of the quality and assessing risk on income streams;
- Access to cheap "capital" created a "property bubble";
- Compression of disposable income, due to central bankers having failed to manage money supply;
- In order to rebalance company balance sheets, those in fiduciary positions have been forced to sell assets in falling markets and raise capital to reduce leverage/gearing.

Leading on from these points, I have formed an opinion that neither financial advisors nor investment bankers understand property modelling, risk profiles, etc. but still raise capital and advise their clients based on flawed assumptions and advice, i.e. to continue to increase rent levels, above those "averages" in Graph 3, thus causing more damage to the quality of rental income streams.

C. Indirect causes (the wider economy)

The events that lead up to the Global Financial Crisis are now widely published. Reserve Banks worldwide did not manage money supply, using low interest rates to stimulate spending, which resulted in high debt levels (personal, government, corporate, national) over a sustained period.

During this time, the community, governments and corporations continued to borrow against their "rising" asset values, which caused debt levels to rise against their equity. At the same time, Eastern Europe sought capital from Western Europe in order to rebuild neglected industries and infrastructure, after the end of Communism.

There has been more lending to other emerging economies (some Asian, South American countries). Mortgage Backed Securities, valued by Ratings Agencies were sold to "investors" all over the world including to government

instrumentalities such as councils, municipalities, superannuation (pension) funds, etc.

Inevitably the REITs became "caught up" as the conservative "culture" and attitude towards investing and investors changed.

When interest rates started to increase from 2004/05 onwards as Governments sought to reign in debt, asset values declined, causing debt levels to become proportionately higher, often in excess of the value of the assets. A crash was inevitable. The "deleveraging" of balance sheets has been the consequence, at all levels, in our economies – see Graph 4.

Consequently, is that many REITs have been forced to sell down assets in declining markets and go back to their investors to seek more capital.

Governments have been forced to "pump prime" economies, by taking on more debt, to ensure sufficient liquidity (money) in the financial system, to avert a long-term recession or even depression.

Arguably, that is the position as I write this paper. Share markets have risen substantially all over the world and there has been some recovery in the A-REIT share prices.

Many respected economists[x] question the replacement of private sector debt with public sector debt, and wonder whether the status quo will be maintained? It is argued that, even with significant corrections in private sector debt, the United States private sector debt is proportionately 70% higher than it was at the start of the Great Depression.

In effect, what has happened is that government money (debt) has been lent to banks, who, in turn, have lent it to the community, business, etc. which multiplies by a factor of eight to ten, in order to build up economic growth. Ultimately, the indebted community ends up with more debt.

The author, Professor Keen, believes economies will lapse back into recession soon after stimulus packages have run their courses or are removed.

D. A-REIT corrections

Share prices have fallen substantially and the reduction in share holder value on the Australian Securities Exchange ('ASX') has been significant – see Table 1, Graph 1 and comment on analysis below.

The corrections essentially revolved around[xi]:

- *"Excessive gearing and associated refinancing difficulties;*
- *Excessive exposure to overseas markets suffering due to economic factors;*
- *Concerns about property valuations; and*
- *Complex nature of operating and financial structures inherent in the Sector."*

It is noted that BDO Kendalls make no mention of the excessive rent levels, nor the dysfunctional operation of the shopping centre industry.

An analysis of Table 1 shows the number of issued shares, converted to Share Holder Value of Australian A-REITs, weighted to retail in November 2007 before the market started correcting. The total value on the Australian Stock Exchange equated to around $97.4 billion, including two of the larger A-REITs, Westfield and CFS Gandel. By June 2009, the sector had fallen to $34.13 billion or by minus -65%. Without the moderating influences of Westfield/Gandel, the A-REIT sector weighted to retail had collapsed by minus -81% as mentioned above. The rest of the share market had fallen by 40 to 50%.

All stakeholders exposed to the A-REIT sector have suffered as a consequence, with around 50% of the Australian population exposed to this sector[xii]. In Australia A-REIT weighted to "retail" is still – 65% or - $63 billion below peaks (excluding significant capital raisings[xiii]), albeit that the sector is showing some signs of recovery.

One of the points I made in my presentation at WAVO 2 in Beijing was that the Productivity Commission in Australia was to undertake an inquiry into the market for retail tenancy leases in Australia. The Investment & Financial Services Association represented retail and wholesale funds management, superannuation and life insurance industries that were responsible for investing $1 trillion on behalf of 9 million Australians made a submission. Their submission is dated 27th July 2007[xiv] (before the major corrections world-wide and to the A-REITs had started). In it they referred to REIT performance levels exceeding Australian equities over the last five years, submitting that in the last 12 months the return was 40.8% versus Australian equities 31.6%, etc and that the sector was less volatile.

At that point, the total A-REIT sector had not corrected and the total market sector was worth $120 billion in May 2007, accounting for 13% of total listed investments. The CEO, Mr Richard Gilbert (no relative), called on the Productivity Commission to recommend no changes be made to impose further regulation, which would result in *"the potential for increased costs, impede competition and thus exert downward pressure on returns to investors."*

It should be noted, and I stress this, that these corrections have only been as a result of gearing, refinancing, concerns about the "stapled" models and valuations. The underlying problems relating to the dysfunctionality of The Market

for Retail Tenancy Leases in Australia remain because the Productivity Commission sought to disregard the hard evidence and fact put forward to it, which would have addressed the imbalances and causal factors with regard to leases, leasing, rents (control) and tenancy disputes. Even at the point when the report was released in March 2008, corrections were significantly underway.

In my opinion, the Presiding Commissioner Dr Neil Byron was under pressure to produce a certain outcome by vested interests; to maintain the status quo. This is surprising as it has been to the detriment of a fully functional market operating for all stakeholders.

In Australia these factors flow into the commercial office and industrial sector as well.

E. The micro solution: the fall-back; the rent determination/arbitration (ADR process)

Part of the macro problem is that the micro market is not working. I set out the reasons why at WAVO 1, WAVO 2, and the 24th Pan Pacific Congress in Seoul.

By failing to do anything to ensure that the micro market can work i.e. the ability to negotiate in an open informed way, both state and federal legislators and regulators are supporting a form of "rent control", that is, engineered rents, which breach IVS Guidelines and the Trade Practices Legislation.

Even the peak body representing share holders the Investment & Financial Services Association, failed to understand what had been occurring in the A-REIT sector. So did the corporate and financial advisors who do not know that the sector has in effect been "gambling" with individual leases, a widespread practice across the sector, in order to provide "shareholder value" or the perception of shareholder value.

In addition, the peak body representing A-REIT interests, namely the Australia Shopping Centre Council, has made every effort possible to subvert independent expert determination and arbitration, to stop a market rent review process, thereby maintaining this form of rent control – see Graphs 2 and 3.

In my opinion, the Australian REITs will remain a "basket case" until there is genuine reform in the area. In marketing terms with regard to product-life-cycles, it would be called a "mature" industry, and having moved into the "dog" category[xv]. It is forced to rely on misinformation to keep income levels up and shopping centres fully leased.

F. Simple legislation requiring a lease or lease renewal be offered at "market rent", that all dealings with the leases be *"in good faith"*, and a trigger to compulsory mediation and expert determination/arbitration to settle disputes

After years of analysis of economics and economies, markets and marketing, businesses and business performance Key Performance Levels ('KPIs"), shops and shopping centre statistics, valuations and valuation technique, tenancy law and commercial law, I have formed an opinion that simplicity is the best solution (although getting the answer might be challenging and difficult), both in triggering lease rental disputes and settling them viz. expert determination.

In 1994/95 I tried to define the market rent, i.e. for individual shops, having valued quite a large corporate portfolio early on in my career, as a consequence of observing industry behaviour in Australia and seeking responsible solutions, with the consequences in mind.

In my submission to the Fair Trading Inquiry (1997), I suggested a basic "trigger" and dispute resolution mechanism which was improved upon by the ACT[xvi], by requiring leases to be offered at market rent, but with compulsory mediation as a further step to settling a dispute before expert determination.

In my opinion, these were substantial improvements, ensuring the negotiating parties would settle the disputes amongst themselves before referring a matter to a valuer for Expert Determination.

The following process, in my opinion, when written into law, will stop rent control and "price fixing"[xvii] dead in its tracks in Australia:

1. Landlord will or will not offer a tenant a new lease (at landlord's discretion);
2. In the event a landlord offers a tenant a new lease or a renewal of a lease, the rent will be at the "market rent" / "current market rent" applicable to the permitted use under the lease i.e. market rent is quantifiable and definable[xviii] - see Table 2 and business models at WAVO 2 & PPC '08;
3. The parties must negotiate "in good faith" in all ways and in all dealings with the lease, including negotiations, representations made and in dealings with regard to the lease. These should become special conditions in leases for parties to have recourse to;
4. In the event that the parties fail to reach agreement, the parties go to compulsory mediation;
5. If the parties fail to reach agreement at mediation, the market rent is to be determined by an expert valuer or is heard by an arbitrator;
6. The valuer should have immunity from suit unless wilfully negligent.

It should be noted that Arbitration is where the parties put a case to an arbitrator who brings down a decision like a "judge", whereas expert determination

requires that expert calls for submissions[xix], does his own further investigation and makes his determination using his/her knowledge/skills, i.e. expertise as an expert.

G. Expert's role

In the first instance, an experts is appointed on the basis of whether he or she has suitable technical qualifications; is a member of appropriate professional bodies; has completed suitable courses; has no conflicts of interest in the dispute in question and is willing to accept an appointment to settle a dispute.

He/she has expertise in a relevant area. An appointment is made either by way of a joint appointment by the parties in dispute or by a nominating body which might be a court, a tribunal or a professional body.

On acceptance of an appointment, the valuer may send out a letter to the parties setting out his terms of engagement in the form of an agreement[xx]. In the letter accepting the appointment, the expert calls for submissions by the parties. In a recent determination I made arising from a joint appointment, I requested a joint meeting with the parties to explain how the process worked, the roles and responsibilities all parties, including myself and what "we" could all do to expedite the process.

This worked extremely well, however there may be instances where disputing parties simply do not want to meet; that is one of the reasons why the role of the expert is extremely important and should not be underestimated.

The expert carries out many things inter alia: his/her investigations; considers relevant legislation; the lease and terms of the lease; factors giving rise to dispute; obtains comparable rental data (if the data is itself a product of fully informed, open transparent negotiations); he/she may carry out a mini "business plan" or rent as residual exercise, particularly for retail businesses, from the Profit and Loss Statements ('P & Ls') which considers business performance levels of an "average hypothetical tenant"; considers gross rent; might carry out linear regression of "tested" evidence; might refer to industry benchmarks (if available); may carry out references and cross-references for consistency and or make adjustments for the specific size, frontage, locational issues using his/her skills and judgement; considers legislative requirements i.e. *"reasonable rent"*; and makes his/her determination.

Retail businesses, per se, each tend to have a different capacity to pay the same or similar levels of rent, even those that appear to be similar businesses in a food court for example.

The determination is made on what two willing informed parties will pay (not actual parties to rent dispute, but to imaginary parties) in an arms-length

transaction. In the retail arena a valuer must consider "permitted use" or a substantially similar use[xxi] that the business operates under in the lease.

With regard to commercial and industrial premises, tenants tend to be renting "space", i.e. premium, A, B, C, etc. and/or location, levels, and so comparisons tend to be made on a dollar per square metre basis ('$/M2'). Adjustments will be made for lease terms, size of tenancy, etc.

In my experience, the bodies who make the appointments should support their appointees (even included in the legislation), but often they do not.

H. Examples of: Expert determiners who did not fulfil the terms of contract and why

The following practices have been observed in some rental valuations and in some cases are compared to asset valuation principles:

- Use of dated evidence, subject to ratchet clauses for 5 – 10 years or more, likened to using dated sales evidence, without making adjustments. It simply demonstrates that the expert does not warrant the "title" of expert or the fees he or she is charging;

- Use of evidence which contributed to business failure within two weeks of the determination being made – suggesting the valuer who accepted the appointment was not au fait with this type of work or the evidence may have been accepted at face value or was not adequately tested or the valuer was incapable of "testing" or understanding the KPIs of the relevant business;

- Widespread use of averages being occupancy cost to sales ratios or rent per square metre $/M2, or the choice of the "averages" and picking a figure to "fit" a pre-determined answer. This is akin to using aged data, data that comes from numerous residential areas for example, from different styles, sizes and ages of comparables and using that figure averaged out – see above;

- Using quite different permitted uses and applying the "evidence". An example of this is using evidence from the industrial warehouse space and applying it to commercial office space – as above;

- Splitting the difference between landlord's "ask" and a tenants suggested "market rental". This could mean a valuer has not fulfilled the terms of his or her contract – as above. He/she has not made a determination in accordance with the contract they entered into with the parties in dispute;

- Where a valuer has all logical avenues closed to him in submissions and has created "additional" floor area by way of space used under license, applied

a rental rate to quite clearly defined "common space" to get to public toilets, to come up with a rental that did not satisfy Spencer v Commonwealth criteria under state retail legislation, definitions, convention and so on;

- Where valuers ignore that outgoings is another form of rent and state laws require that outgoings be included as "rent";

- Where "specialist retail valuers[xxii]" are not au fait with ordinary business terminology or how it impacts on a business or centre and category performance data, or the impact of leases on a business;

- Where valuers not only give the perception of being biased but their demeanour and behaviour shows indifference for natural justice and fairness for the parties whom it is contracted to,[xxiii] for example by giving the one party less than five minutes of their time; and

- A combination of more than one of the above.

I have recently witnessed a valuer, who in my opinion understood all the issues in regard to an expert determination but has clearly been put under pressure by his employers, who are also managing agents.

It is customary practice for management agreements to be on a percentage of rent (and other revenue collected, rather than a fixed fee tendered in the open market on a regular basis). Remarkably, this places "upward pressure" to maintain and continue to increase rent levels; in effect it becomes a form a "rent control". Without considering the consequences, this becomes unhelpful or a form of "price fixing[xxiv] [xxv]" which in Australia is a criminal offence.

And while tested in other areas of the economy, the property industry appears to be immune from cartel-like behaviour, irrespective of the damage caused to stakeholders (share holders, financiers, potential investors, etc.) due to customary practice, by industry participants and inflated valuations.

I. Facing and overcoming challenges during the determination

I have mentioned that this is a challenging and exciting area of work. Despite having written most of the published material on the topic worldwide, understanding and assessing what motivates parties (average hypothetical parties) going into leases is surprising. The most apt commentary can be found in the paper I wrote which is published on the RICS website "Settling Rental Disputes …" about a 1937 Australian case namely Scott LJ in Robinson Brothers (Brewers) Ltd v Houghton and Cheser-Le-Street Assessment Committee [1937] 2 KB 445 at

468 – 471. The judge summarised matters to be considered when arriving at the market rent extremely well.

In my opinion, expert determinations and expert determiners should have wider skills, education and experience than simply having been a valuer throughout one's career. Worldwide there are millions of leases, many, many lease disputes and again in my opinion, there are limited people with skills to settle these disputes. After all, there is no other way to settle rent disputes, and obviously there are many of them. These disputes can extend to other areas of commerce.

Listed below are examples of "experts" who, in my opinion, are a menace not only to themselves, but also to the parties, who appointed them:

The expert who got his answer from "no-where". I have recently been instructed to critique a rental determination carried out by a Victorian based Specialist Retail Valuer. The valuer refers to ample evidence but, in carrying out my critique I contrasted the way he had carried out his determinations, with the way I do mine which is as follows: "*In preparing a rental determination, I thoroughly test the outcome via numerous methods against benchmarks, recently negotiated leases (if the data is available), I make allowances for the lease and lease terms, under or overtrading enterprises, socioeconomic factors, competition, my perception of economic conditions and the like.*

My reports demonstrate sufficient knowledge, skill, expertise and I show a link between the evidence and the outcome" ………… "If the valuer was uncertain, he could have sought the assistance from another expert viz. "testing" the KPIs of the business, which his report should qualify, but he has not done that."

I also stated: "*I had difficulty linking/or there was simply no:*

- *Rental evidence to the outcome; there was no link;*
- *The relevance of the evidence (how old was the evidence, how comparable was the evidence in question, what adjustments were made? How were they made? etc);*
- *In my experience, there might be two, three or four lease renewals that are comparable (which he might need to make adjustments for) but the valuer does not refer to them (direct comparison method referred to in my paper);*
- *Use of benchmark industry percentages to the subject lease. The valuer might also have to make adjustments, which might be made for a multitude of reasons (see Attachment A being FMRC Pty Ltd benchmarks for jewellers);*
- *Whether the KPIs of ABC Jeweller itself falls into benchmark averages; whether it is a growing business; had it grown or was in decline and the reasons why; the operators' knowledge about their competitors' businesses; their product range and pricing; different price points; trends in the industry and so on."*

In this matter, the outcome of the determination was an exact continuation of the minimum ratchet increases in the lease. The expert failed to carry out the terms of his/her appointment in accordance with the agreement entered into with the landlord and the tenant; albeit that the rent would decrease or increase.

In regard to the second matter, I was instructed to critique a determination for a landlord who believed that the expert had obtained his answer from the tenant's expert's submission. This was a South Australian matter and the determination had been carried out by a senior member of the Australian Property Institute. On reviewing the material it was quite clear that the valuer had obtained an answer but it was also clear that he did not know how he got it. From the sketchy information provided, it appeared that he had got the answer either right or substantially right, but not based on his work.

The landlord who engaged my services was demanding blood, a leading barrister was subsequently instructed based on the critique I prepared[xxvi] and in the end it was suggested that the landlord seek further and better particulars on how the valuer had made his determination before seeking to litigate. One could not guarantee that one could overturn the determination or if one could, that the rent might not fall further.

The third example is where the expert who has been appointed, makes his or her determination under the wrong legislation relating to the lease in question.

In some circumstances valuers simply proceed to carry out a determination and fail to consider which legislation applies to a particular lease in question.

One of the common areas where experts fail is to use the correct comparable data eg. they "import" a wide range of data in from a wide geographical area, across widely differing permitted uses such as butchers, pharmacies, jewellery stores, etc. and used for a convenience store determination. The rent might range from $300.00 per square metre to $1000.00 per square metre. A number is "picked" from across the range. In regard to an asset valuation, I have heard of a valuer who imported "evidence" from a small regional town in a lower socio-economic area and used it to value a capital city CBD retail property!

An expert faced with little/no comparable data, as suggested above, can use the businesses own Profit and Loss details as a reference point to establish, in the experts opinion, what a willing informed hypothetical tenant might pay a willing informed hypothetical landlord, based on the businesses viability - see Table 2, considering, of course, amortisation of business set-up costs over the lease term at a realistic risk rate relative to the industry.

In regard to "Testing" the evidence for relevance, a skilled professional expert determiner will not simply accept evidence at face value. He/she might seek to discuss lease renewal terms to ensure it was an arms-length transaction. Maybe he/she will seek to discuss or obtain trading data and ascertain that the rent falls into suggested benchmark levels for the "permitted use" of the business.

In regard to establishing "reasonableness"[xxvii], any rental analysis assessed on a dollar per square metre ($/M2) basis should be multiplied out by the floor area tested against KPIs for it being the reasonable rent under the legislation.

Getting it right – here is an example of commentary I made in my second critique mentioned above, noting some of it is similar to the first critique mentioned before that: *"Clauses 2.02 (c) (vii) (C) and (D) state that the valuer must "take into account the terms and conditions of this lease and any other relevant considerations, and give detailed reasons for the determination and specify matters (including, if relevant, incentives and concessions) taken into account in making the determination". As an experienced consultant/valuer, etc. who has written papers on the topic of market rent and expert determination which has been published locally and internationally, I had difficulty linking:*

- *The rental evidence to the outcome;*
- *The relevance of the evidence (how old was the evidence, how comparable was a motel or motels to the one in question, what adjustments were made for the ABC Motel? etc);*
- *How one can use an "average" from a range of lease rents which, in all probability, commenced at different starting times. Some would comply with having been arms-length transactions (others not), some are comparable to ABC Motel, others not. In my opinion, there might have been two, three or four lease renewals that were comparable (which he might need to make adjustments for) but the valuer does not refer to them (direct comparison method referred to in my paper);*
- *The use of benchmark industry percentages to the subject lease. The valuer states he uses his own experience but he does not demonstrate how he gained the knowledge or expertise in the field or how he uses benchmarks (or that he understands them). The benchmarks used have no independent reference point. Nor has the valuer made adjustments, which might be made for a multitude of reasons (see Attachment A being FMRC Pty Ltd benchmarks for motels);*
- *Whether the KPIs of ABC Motel itself fell into benchmark averages; whether it is a growing business; its annual average occupancy levels; the split in income from different profit centres and what had grown or was in decline and the reasons why; the operators' knowledge about their competitors' businesses; their own tariff rates; average meal income; whether the*

restaurant was leased/sub-leased; marketing effort; experience of operators; trends in the industry and so on.

As I mentioned above, a lot of the evidence (leases) would be in registrable form and is in the public domain. The valuer could readily publish that evidence. [In some states in Australia, leases are not registered on an electronic data base. We are working towards a system whereby all essential lease terms will be provided to ensure more openness and transparency in lease dealings. In addition, ways are being sought to submit tenant sales data to independent third parties for the purpose of managing tenancy mixes and for tenants to establish centre and retail category performance levels, eg. food court sales, sports outlets, women's fashion, electrical retail, fresh food, etc.]

Of all the evidence, other than the table produced by the valuer, there must have been two, three or a few more comparables which he drew on to support his determination. I see none of that in the body of the report.

Additionally, the report is not very well structured. The reader is left wondering where the valuer came from? In fact, I was left wondering whether the valuer has sufficient knowledge, skills expertise to accept the assignment."

I have been challenged three times on rental determinations I have made. In all three instances there was no foundation whatsoever for the challenges; each one was as a consequence of solicitors seeking to overturn an expert determination for their clients. I test my evidence, I test the outcome of what I believe is the market rent for reasonableness in every way.

I demanded an apology from one aggressive firm of lawyers. Until I got it. In another matter, the body who oversees valuers investigated my work and found it was extremely thorough and that I had no case to answer. I subsequently received an apology from the relevant body in writing, for their woeful "investigation" in the same matter.

In another matter, colleagues critiqued my work and confirmed my determination was correct, however it is not pleasant being challenged. It is time consuming and will always damage one's brand.

I have stood up for colleagues in the Tribunal, at a Public Meeting, however there is practice out there which is a further from of rent control (which we seem unable to get away from in Australia), which cannot be condoned for much longer, particularly where senior valuers (or their firms) are not independent of agencies and whose fees are a percentage of rental income collected.

Our professional bodies stand up for the "Old School Tie", not for what is right and what is wrong or what is based on fact.

Some State Governments have legislated to protect their Specialist Retail Valuers, however legislation does not protect one from negligence.

Lastly, in the 1937 Australian case referred to above, Scott LJ in Robinson Brothers (Brewers) Ltd v Houghton and Cheser-Le-Street Assessment Committee[xxviii], recognised that "*This kind of estimating is a skilled business and it is here, especially, that the role of the skilled valuer comes in*" – see full summary in endnotes (referred to in "Settling Rental Disputes ……") at WAVO 2.

In summary the following are a few steps that would assist expert determiners to provide an efficient service to those that appoint them and their clients:

- Legislation protecting the expert determining valuer (noting that wilful negligence offers no protection);
- Wording in the letter setting out the terms of the appointment, which becomes an agreement with the parties in dispute;
- The expert can seek assistance from colleagues in the form of a "peer review" of his or her work;
- The expert may seek to engage fellow professionals in complex determinations or multi-faceted disputes which requires skills outside the field of expertise of the expert who has been engaged (which agreement of his clients);
- Not accepting work he/she has not expertise in or where they have a conflict of interest;
- Agency based valuers not accepting appointments and regulatory bodies should step up to the mark;
- Regularly communicating with the parties who have engaged the expert's services, informing them of progress that has been made, challenges and difficulties, etc. It might even be necessary to call meetings or even stop the process for what ever the reason might be.

J. The Role and Responsibility of Professional Institutes & Governments

I believe that, over the years, that the role and responsibility of Institutes with regard to their professional and non-professional members have become clouded.

Without being disrespectful, Institutes are forgetting that the agenda of the professional or non-professional member is quite different from their own.

The one is to do a "deal" within the simple law of principal and agent (it is an advocate's role), whereas the professional member owes a far higher Duty of Care to the wider community (share holders, banks and financiers, parties to property law disputes, potential investors and the like), and must comply with

federal and state legislation, eg. Corporations Law, Trade Practices Acts and tenancy legislation, etc.

The professional's role is not to "facilitate a deal"; his or her Duty of Care is to "value" the world's assets and charge out their services at an appropriate rate, in line with their responsibility to the community, eg. consider some of the examples I have put forward in this paper.

Institutes must realise that their fee paying members have differing agendas, and that the professional member's interests sometimes requires strong representation to legislators and regulators, and these interests sometimes clash and take precedent over those who facilitate deals.

I know these views are not popular, however, to earn "Professional Fees" versus commission based fees, (or desk-top valuations and or mass produced valuations), the role and responsibilities are quite different. It is impossible for valuers to earn commission based fees, in order to pass the tests of professional valuations by definition.

It might be that the views I have espoused over the years have significant merit in light of the market corrections in Australia and overseas, i.e. sub-prime mortgages and "sub-prime" leases.

To avoid Conflicts of Interest, Governments should be taking advice from independent, objective, professional members of Institutes; not advocate members who have narrower self-promotional agendas. The Role of Governments is to protect the community and act for the Public Benefit.

K. Benefits and conclusions

While this is a complex area, if someone could suggest ways in which to resolve the question of the possibility of asset "bubbles" in an aggressive leasing market, where *in good faith* dealings are severely lacking, I would be pleased to hear their suggestions.

At a micro level, if clear end of lease dispute resolutions were enacted, there would be less potential for: asset "bubbles"; there would be better lease negotiations and more informed outcomes; there would be fewer "stand-over" tactics and gazumping[xxix] at lease end; there would be a better chance for asset valuers to value on market rent (not passing rent); there would be less chance for major property corrections in this investment sector; it would protect shareholder interests; there would be a more efficient allocation of capital to each relevant sector of the economy; it would allow the market to better operate as a "market" per se.

In the end the dysfunctional operation of the A-REIT sector has cost stakeholders a fortune. Many A-REIT security holders were forced sellers who had had very long relationships with the industry class.

A reasonably strong economic recover appears to be on the way in Australia, however the underlying operation of the property industry remains deeply flawed.

There is a "culture" of upholding "rent control" and or price control, even by legislators and regulators which breaches State and Federal Trade Practices Legislation. It defies logic and a Free Enterprise economy.

What the Australian authorities completely and utterly fail to understand and comprehend is the other side of the equation.

1. Had there not been a misallocation of capital, the asset bubble in the A-REIT sector would not have built up so high and crashed so far.
2. There is ongoing wholesale destruction of family and small business capital; in the end the taxpayer is funding the retirement of 10s of 1,000s of failed business owners.
3. The potential of many entrepreneurial ideas are being damaged and destroyed in the process.
4. Both the tangible and intangible asset values of many businesses and property investments are and have been damaged or destroyed as a consequence of the leasing policies.
5. Tax payers have funded elaborate plans to maintain the status quo via "rent control" and in order to keep the consumer spending, and debt has shifted from household to government.
6. The wheels are in motion for further and subsequent declines in this asset class until governments make appropriate decisions.

Here are excellent ideas of a micro solution to a macro problem.

Having had greater exposure to Islamic Business principles, through WAVO Conferences, eg. finance, I believe that there is a serious place in commerce and industry, for many of these ideas for Islamic Business for these principles encapsulated in this paper.

Hopefully enterprising overseas countries will see the light and show Australian regulators and legislators the way. We are a country with brilliant ideas but lack the tenacity and courage to implement them for the benefit of all Australians.

As I write this conclusion, quite fittingly I have just received an emailed letter from the State Premier. My requests seeking solutions to leases, leasing, rent (control) and tenancy disputes has just been passed back to the State Attorney-General

who is my Local Member of Parliament. My Federal Member of Parliament is the Prime Minister of Australia. Hopefully, somehow, sometime, we in Australia can enact model tenancy law, which will add value to the "intangible asset value"[xxx] of both landlords and tenants leases.

DG 5/10/2009

FOOTNOTES

---

[i] Back to basics: an Australian REIT case study of the Shopping Centre Restructuring Professionalism – Preparations for the Future, 24th Pan Pacific Congress, Seoul, Korea, 22nd to 25th September 2008

[ii] ACT – Australian Capital Territory S 51 and S 52 requires that the landlord either will offer a tenant a new lease, or choose not to. In the event a new lease is offered, "must not propose that the rent to be charged initially under the renewed lease exceed the market rent for the premises". It then triggers a rent dispute resolution mechanism if negotiation fails, which then proceeds to mediation, failing which the market rent is determined by a valuer. In some states and territories some valuers called Specialist Retail Valuers are appointed to determine the market rent.

[iii] See – IVS International Valuation White Paper, "The Valuation of Real Estate Serving As Collateral for Securitised, Instruments" – "*The Valuer should investigate …. about prospective contractual rent,…. that the data is indeed accurate. Estimates …. which are unrealisable, are engineered rents; valuations based on engineered rents will not result in Market Value*".

[iv] Occupancy costs are: rent plus outgoings as a percentage of turnover

v See "Dexus takes a razor to portfolio" see The Weekend Australian 4 – 5th July 2009, where JP Morgan said asset valuers are unlikely to bottom until 2010. Values are expected to fall by 25 – 30 percent for office, 10 – 20 percent for shopping centres and 40 percent for industrial property

[vi] BDO Kendalls A-REIT Half Year Survey 2009

[vii] BDO Kendalls A-REIT Half Year Survey 2009; investor concern about valuations

[viii] S 29 RSLA Queensland "…the specialist retail valuer … must determine the rent …on the basis of the rent that would reasonably be expected to be paid ……"

[ix] *"contractual provisions giving rise to the Expert Determination" – The Expert Determination Process by Robert Hunt, Barrister-at-Law, New South Wales*

[x] Professor Steve Keen, Keensian Economics "The great underestimated recession" , Business Spectator, 21st September 2009, and other economists referred to in the article

[xi] BDO Kendalls A-REIT Half Year Survey 2009

[xii] According to Property Council of Australia research, more than nine million Australians invest in commercial property through listed property trusts and superannuation – Sept 2001.

[xiii] The total industry (including commercial), which was worth $120 billion before the market corrected has raised $Aus19 billion since the beginning of the GFC ("Outlook for A-REITs turns positive", 29th September 2009, www.businessspectator.com.au), worth say 40% of the total value of the market, after it had fallen

[xiv] Referred to as submission No 52 in the Commission's report on The Market for Retail Tenancy Leases dated 31s2 March 2008 (after the corrections to the A-REITs had started)

[xv] Derived from the Boston Matrix, a product or industry moves through four phases in its live-cycle. From a "problem child" to a "rising star", to "cash-cow" and ultimately to a "dog". It is up to an industry to continue to "reinvent" a product to extend the life-cycle.

[xvi] Australian Capital Territory, where the nation's capital Canberra is located

[xvii] Trade Practices Act ('TPA')

[xviii] Losses and damages can be calculated and apportioned if parties fail to apply principles that "separate" the landlords interests from the tenants "interests" by way of disproportionate rent allocation

[xix] Refer paper API "Rental Determinations - Determining Valuers Accepting Submissions and the Roles of Experts and Advocates" by Alan Hyam March 2000 who refers to "Handbook of Rent Review" by Bernstein and Reynolds, published by Sweet & Maxwell in London par 9 - 27 with regard to the legal responsibility of an expert valuer that he/she "*Provides his own valuation report as an expert, using his knowledge of the market. Does not need to receive representations but usually invites them for his own protection.*"

[xx] See "Settling rental disputes by expert determination" http://www.rics.org/site/download_feed.aspx?fileID=283&fileExtension=PDF

[xxi] 29 RSLA Queensland (and adopted into other state tenancy law), which calls on a specialist retail valuer to *"determine the rent on the basis of the rent that would be **reasonably expected to be paid for the retail shop**, if it were unoccupied and offered for leasing **for the use to which the shop may be used under the lease or a substantially similar use**"*.

[xxii] A category of valuers in Queensland under the Valuers Registration Act 1992, that are able to do rental determinations in the state

[xxiii] API Information Paper "Rental Determinations" – Alan Hyam LFAPI March 2000 refers to Handbook of Rent Review by Bernstein and Renolds which states *"it is the expert's duty to satisfy himself as to the facts of the relevant evidence"* and with regard to the legal responsibility of the expert valuer *"he is liable in negligence to both parties as he has a professional duty to both"*. McHugh JA in *Legal & General Life of Australia Ltd v A Hudson*

Pty Ltd (1985) I NSWLR 314 states *"By referring the decision to a valuer, the parties agree to accept his honest and impartial decision as to the amount of the valuation. They rely on his skill and judgment and agree to be bound by his decision"*.

xxiv Relevant sections of the TPA of Australia; Criminal offences; s. 44ZZRF—making a contract, arrangement or understanding containing a cartel provision; s. 44ZZRG—giving effect to a contract, arrangement or understanding containing a cartel provision

xxv Price fixing is prohibited in the United States of America under the Sherman and the Federal Trade Commission Act and were totally outlawed in 1975.

xxvi *"I have been provided with a copy of a report made by Mr D E Gilbert of Queensland Lease Consultants ("the Gilbert Report") , who is a recognised expert in the relation of rent review determinations, in particular retail premises."*

xxvii S 29 RSLA Queensland, which calls on a specialist retail valuer to *"determine the rent on the basis of the rent that would be* ***reasonably expected to be paid for the retail shop****, if it were unoccupied and offered for leasing* ***for the use to which the shop may be used under the lease or a substantially similar use****"*.

xxviii *"The matters to be considered in arriving at the rental value of the premises set forth in the classic judgment of Scott LJ in" … "Which may be summarised as follows:*

1. *When the subject premises is let at what is plainly a rack-rent or when similar premises are so let, which are truly comparable, this is admissible evidence of what the hypothetical tenant would pay. This was amended by Lord Denning MR in Garton v Hunter [1969] 2 WLR 86 at 90, who added that 'it is not itself decisive. All other relevant considerations are admissible'.*
2. *Where such direct evidence is not available, resort must be had to indirect evidence from which it is possible to estimate the probable rent that the hypothetical tenant would pay.*
3. *This kind of estimating is a skilled business and it is here, especially, that the role of the skilled valuer comes in.*
4. *In weighing up the evidence bearing upon value, it is the duty of the valuer to take into consideration every intrinsic quality and circumstance that tend to push the rental valuer either up or down.*
5. *A skilled valuer is a professional and must be left to inform her or her mind of all relevant facts.*
6. *The rent to be ascertained is the figure at which the hypothetical landlord and tenant would, in the opinion of the valuer or the tribunal, come to terms after bargaining, in the light of competition or its absence in both demand and supply, as a result of 'the higgling of the market'.*
7. *Every factor, intrinsic or extrinsic, which tends to increase or decrease either demand or supply, is economically relevant and thus admissible evidence for the purposes of the assessment.*
8. *While the landlord and the tenant are hypothetical, the property valued is actual with all its actualities: at 474."*

xxix Gazumping means to "swindle". Unbelievably, it is becoming customary practice for unwitting business owners, to invest in setting up a shop. The tenure granted is not sufficient to amortise the set-up costs, the rent was the rent the previous business owner failed at. Often more similar shops are introduced (loss of derogation of grant), which starts damaging for example the first coffee shop. At lease end, with the business owners capital tied to personal assets and often their bankers, the business owner must then refit the shop and expend more money. On top of it, business owners are required to "tender" against their own assets and "goodwill" against someone with no financial interest in a site i.e. fresh capital. The quality of the income streams of leases has

continued to deteriorate and asset valuers have not made adequate adjustments for in accordance with IVS guidelines. Neither landlord interests, nor financiers seeking mortgage backed security from leases, have worked out how damaging this practice is.

[xxx] Presentation Ion Anghel PhD, Romania, "Intangible Assets Analysis and Valuation", WAVO Congress, Singapore, Nov 2006