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EVALUATING THE REASONABLE RENT FOR ONE RETAIL LEASE

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ABSTRACT

Purpose: To present a new and improved method and invention for evaluating the rent for retail property. It is important to establish this rent properly because of the implications for tenant's businesses' which potentially flows into the entire property sector.

Approach: The approach uses The Authors' twenty-two years in valuing retail leases for tenants and property owners. In that practice an entirely new step-by-step method has been invented and a computer software program has been developed to assist in this process. Using that software, the paper outlines key steps in evaluating the "reasonable rent" for one retail lease.

Findings: A logical step-by-step process is documented in the paper. Each step links the lease or shop being evaluated to a specific data series, which enables the software or advisor consultant to make an informed opinion regarding the aspect of the specific data series being stress-tested and evaluated. As the parties to a lease or any other stakeholder in the mix, who is reliant upon a lease(s) as a negotiable instrument eg. for mortgage purposes is "walked" through the process, one can make an informed decision about what the "reasonable" rent might be for the lease period ahead.

Originality/value: The Author believes that there is a significant shortfall in the way retail property is evaluated based on setting rentals. This has multiple ramifications for tenants' business, owners of retail properties and potentially the entire retail property industry. The method detailed here, draws in knowledge and experience from several disciplines and provides a way of addressing that shortfall. The product is undergoing advanced beta testing and is a significant improvement of how one retail lease is evaluated. It has already been earmarked to become an "industry" standard.

The methodology here links into the requirements under IFRS 16, which is a requirement by January 2019 to have leases evaluated for Balance Sheet purposes.

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Keywords: retail, market rent, profits method, comparison method, market value.

GLOSSARY OF TERMS

Australian Bureau of Statistics	ABS
Australian Property Institute, 6 Campion St, Deakin ACT 2600	API
Asian Real Estate Society	ASRES
Australian Taxation Office – small business benchmarks	ATO
International Valuation White Paper entitled, *The Valuation of Real Estate Serving As Collateral for Securitised, Instruments*, issued in July 2006 which reads in part: *"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".*	Engineering/engineered value
Financial Accounting Standards Board, 401 Merritt 7 P.O. Box 5116. Norwalk, Connecticut 06856-5116, USA	FASB
When a given asset may have debt (acquired at a lower cost or price than one pays for equivalent capital), which underpins shareholder (aka the beneficial owners) equity to bolster returns. This can and does occur until the cost of debt increases and returns possibly go in the opposite direction. If a property asset is overpriced or overvalued, and underpinned by debt, a flight by shareholders can and will exaggerate a compression in share prices, aka GFC	Gearing/leverage
Global Financial Crisis (2007 – 2009)	GFC
Headline price people are paying for an asset, eg. average price of apartments or houses in a given area, average rent per square foot/square metre, where no "in-depth" analysis has been done or understood. Set of given factors could be "engineering" or masking the real value of asset, or understanding of real value. Headline analysis implies that persons speaking with supposed authority on the "price" of a given asset may have limited knowledge regarding real asset value.	Headline price/headline analysis
International Accounting Standards	IAS
International Accounting Standards Board	IASB

Intellectual Property	IP
International Valuation Standards (Council), 1 King Street, London, EC2V 8AU, United Kingdom	IVS(C)
Key Performance Indicator	KPI
IVS 40.1. *'Market rent is the estimated amount for which an interest in real property should be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'*	Market rent (Gilbert, D. 1995, 2003)
IVS 30.1 *'Market Value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'*	Market value
Left Hand Side	LHS
A measure for something; a means of deriving a quantitative measurement	Metric, performance metric (noun)
Net Tangible Asset value	NTA
Gross rent divided by a business's turnover and expressed as a percentage	Occupancy costs
Amount an uninformed person is will pay for an asset. Underlying value has not been properly evaluated.	Price
Pacific Rim Real Estate Society	PRRES
Real Estate Investment Trust	REIT; (A-REIT), etc.
Right Hand Side	RHS
Royal Institution of Chartered Surveyors, 12 Great George Street (Parliament Square), London SW1P 3AD, United Kingdom.	RICS
Finance industry, academics, valuers / appraisers, real estate practitioners, investment advisors, lessors, lessees, franchise industry	Stakeholders
Australian analytics company who collects processes and presents key data about all classes of Australian retail shopping centres	URBIS/Urbis JHD
The opposite of 'Price'; a person or persons are fully informed about	Value/market value

the value or market value of an asset	
World Association of Valuation Organisations, WAVO Secretariat, 110 Middle Road, Singapore 188968	WAVO

INTRODUCTION

The International Accounting Standards Board ('IASB') through International Accounting Standards ('IAS') 16 and 17, covers the lack of transparency, and was expressed as a concern by the US Securities and Exchange Commission in regard to lease obligations that a company might have. The Financial Accounting Standards Board ('FASB') initiated a project to improve accounting for leases in 2005, which will be implemented from January 2019.

Currently a lease appears as a "straight-line" expense on an Income Statement, and IASB and FASB agreed that a lease is both an asset and liability at the start of its term *IFRS 16 Leases |January 2016 – Project Summary and Feedback Statement*.

The Author believes that top-down analysis and evaluation of risk by valuers/appraisers without the proper evaluation and quantification of risk in regard to leases, contributes to and has contributed to a distortion in the allocation of resources, both physical and financial. In the Author's view, risk metrics play out at a much lower level, in other words at an individual tenant level.

Already, during the Global Financial Crisis ('GFC'), the Australian Real Estate Investment Trust ('A-REIT') Sector faulted and almost collapsed when shareholders' funds ended up on top of debt funding, where cheaper borrowed funds had been used to "engineer" higher returns. Returns are bolstered on declining interest rates; however, the reverse occurs when interest rates increase.

At the other end of the spectrum, traditional "Brick and Mortar" is considered a safe investment category by stakeholders. During the GFC investors had unwittingly acquired A-REIT stocks, not realising that gearing / leverage levels were up to 60.0% of purported Net Tangible Asset ('NTA') levels[2], eg. the Centro Property Group. It was reported that Centro's due diligence regarding the acquisition of US shopping centre investments might have been questionable, as their motive was to buy the "Management Rights", and having less regard to asset value where-in gearing levels were high and not rigorously backed by real value per se.

In effect, with stretched valuations off "untested" store performance metrics, off optimistic consumer spending on the one hand, and "engineered" valuations/appraisals on the other, a sharp correction without any room for compression had to be problematic. And it was.

So, what if the NTAs were not backed by rigorous opinions of market value? Quite basically, the shareholder's part of the investment would not be backed with real asset value; the debt would take precedent and "value" compression would accelerate if shareholders exit the investment.

And that is what happened during the GFC. And this is what Timothy F. Geithner, Treasury

[2] https://www.intelligentinvestor.com.au/nta-do-hard-assets-represent-real-value

Secretary to Republican Fed chairman Ben Bernanke and Republican Treasury secretary Henry Paulson, Jr. describes what they faced in January 2009, following the collapse of Lehman Brothers in September of 2008. In effect, the US economy went into meltdown; firstly, the crippled financial system froze, 750,000 jobs a month were being shed, banks that had overextended themselves were hoarding cash, business was being deprived of financial oxygen and Wall Street and Main Street collapsed and consumer confidence evaporated.

Over the last twenty or thirty years, Australian centres have got bigger, trading hours longer, high rise residential towers have been clustered around centres and public transport corridors. These facts must limit consumer choice, reducing access to "markets" because there are fewer and bigger shopping centres. From the local corner store and the high street shop to the local neighbourhood centre, the concentration of choice is reducing employment opportunities, entrepreneurial opportunity and, of course, local risk-reward (surpluses for new ventures), as well as local multipliers for local discretionary spend as opportunity is corralled into fewer channels. These facts are borne out by falling sales in smaller neighbourhood centres, and often with more vacancies.

Combined with on-line shopping, the tacit and actual subsidies which go to this sector, some of it, allegedly, to "create" and/or prop up "value" and valuations, must be detrimental to local communities and economies. It is both The Authors experience as well as public knowledge in Australia that consumers limited by choice, have been forced to pay higher prices for ordinary goods and services.

Fewer, larger centres obviously mean greater use of the motor car, ironically by an aging population, hence longer trips to get to distribution opportunities. Most obviously, this market distortion has created an excellent opportunity for new market entrants such as Costco and Amazon.

The intense management of leases, manipulation of and misrepresentation of data metrics (facts), and corralling of store, aka business owners via the franchised system of business, is concentrating more and more "risk" into this Industry Sector. Ultimately this will concentrate parts of the economy into fewer, larger centres and fewer larger offers say from Costco and Amazon. This creates obvious draw-backs for regional and rural economies, which are not unrelated to this paper. This introduces another layer of discussion debate, but for another audience and another paper.

A most enlightening statistic[3]is the relationship between retail floor space in the USA of 24.0 square foot per capita, the spend of $14,614 (USD) per capita, then Canada, 16.0 square foot: $10.953 spend; Australia 11.0 square foot: $9,239 spend, then say France and Germany each at 4.0 and 3.0 square feet, with $8,437 and $6,323 per capita spend respectively.

The extent of this over-supply of floor space in the US, is illustrated by Credit Suisse who predict: *"a staggering 20-25% of the 1,100 US shopping malls - between 220 and 275 shopping centers - will shut down within the next five years,"* Are there tools available to make these divestiture

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3 http://investor.ggp.com/sites/ggp.investorhq.businesswire.com/files/doc_library/file/Investor_Presentation_March_2017.pdf

decisions?[4]

New International Accounting Standards under IFRS 16, Australian Unfair Contracts Terms and State Tenancy Laws in The Author's opinion, will test the evaluation of leases, and more importantly the actual rents being paid charged, as both the property industry and business become compliant with the standards and legislation. At this point in time, there are no means of evaluating for example whether a lease is an asset or a liability under a businesses' balance sheet, and, this opens an excellent opportunity for this retail specific software.

Besides the ongoing watering down of State Tenancy Laws (which needs to be reversed), The Author believes that properly accounting for leased assets and Unfair Contracts are invaluable tools in the mix, to keep this unhealthy trend in check and even reverse these trends.

The Author first wrote about this in an exploratory paper in 1995 and, as he learned more about evaluating risk and developed more skills in regard to presenting these issues, he developed software to evaluate the "reasonable rent" that one ought to receive and what should be paid for one retail lease, and to evaluate risk up to and including a whole retail industry. The latter will be covered in a follow up paper.

Most authors of research papers listed in the reference section cover and discuss causation and present the symptoms of a significantly distorted market; however, there is limited / no research to quantify, explain and offer solutions to: a. high overall rent levels; b. low yields with high multipliers; and c. that highly specific and conflicting impact on market value. Yes, there are legal solutions, but legal outcomes in Australia remain tepid.

The Author believes that he has developed a body of knowledge, modelling, and software which covers almost every aspect of valuing retail property to higher confidence indexes verses the basic evaluation of "headline numbers" and applying a multiplier to them.

Many commentators look at "headline value", but what about teasing out the opportunities? If Top Ryde City in Sydney Australia was bought at a 'fire-sale' price of $341 million by the Blackstone Group in around 2013, but it was valued at $840.0 million in 2009, this suggests just a 40.0% confidence index in one valuation alone. Who "tested" or evaluated that that figure represented value per se to the banks to mitigate loss? Are valuers appraiser skills fine-tuned to being able to establish these things? Do they have the tools to stress test the metrics? Perhaps, if justified, Blackstone could have paid more. This paper will present how it could be possible to mitigate losses up and down and why.

OVERVIEW

Understanding risk on an income stream when valuing a property, adopting the capitalisation of net income approach, involves the product of a double multiplier: the net income itself plus the adopted multiplier or "inverse to yield"; whereas if one had properly evaluated and "tested" the rental risks, a more appropriate multiplier might be adopted to ensure more accurate valuations/appraisals. This important link, because it is counter-productive having the rent risk increasing unilaterally, which in turn causes valuation risk to increase exponentially at the same time. Obviously, business capital sits somewhere in the

[4] http://www.zerohedge.com/news/2017-05-31/one-banks-stunning-forecast-quarter-all-malls-will-close-over-next-five-years

“engineering” of the data metrics!

Are landlords doing this knowingly or inadvertently because it does not make sense?

This relationship was extrapolated in, *Comparison method of valuing a retail shop lease, aka from A to B via Z*, (Gilbert, D. 2016), implying that seeking to provide an opinion using this method can cause an error to be multiplied out twice, hence perhaps far higher levels of scrutiny are warranted.

Modelling was developed to explain this risk in an exploratory article written by The Author presented and published in 2011. The Target Market for these articles and papers include the finance industry, shareholders, potential investors, academics, valuers / appraisers, real estate practitioners, investment advisors, landlords, and more relevant to tenants, and the franchise industry.

A failure to properly evaluate and quantify the risk on an income stream would equate to “engineering” the market value, which the International Standards Council (‘IVSC’) in their white paper *‘The Valuation of Real Estate Serving As Collateral for Securitised, Instruments’* state *“…. engineered rents will not result in Market Value”* (2006). This is strongly discouraged by the IVSC and, more recently, is being actively monitored by valuation appraisal associations and institutes such as the Royal Intuition of Chartered Surveyors (‘RICS’) and the Australian equivalent, the Australian Property Institute (‘API’) have been advocating in efforts to improve valuation standards.

Indeed, here is a Member Alert sent out by the API to its members:

> *“Dear Valuer Members and their Clients,*
> *As part of the tender process that precedes formal appointment to value a property, it has come to the attention of the API that some Valuer Members have been approached by clients such as Property Trusts, to supply them with a written response on the critical valuation drivers for specific properties such as the Valuer’s indicative capitalisation rate, market rents, growth rates etc.*
> *In response to ‘opinion shopping’ for valuation metrics the Australian Valuation Standards Committee (AVSC) regards requests of these types as inappropriate and recommends that Members do not comply with provision of the requested information. The AVSC reminds Members that the respective IVSC and API Codes of Ethics and Codes of Professional Conduct protect the interests of the public and the industry by the mandatory compliance with Valuer independence and conflict of interest provisions within the codes. Valuers must be independent and free from any undue influence that may lock them into a predetermined outcome. ‘Opinion shopping’ is not considered an appropriate method to use in order to select a Valuer.”*

The “Front End Loading” of leases by developers and fund managers with lease incentives to bolster purported value may also bolster lease risk, but also increases business risk as rent expenses can also be increased exponentially towards the latter part of a lease. Of interest to tenants and the franchise industry, is the obvious squeeze on a businesses’ cash-flow as the lease term progresses. In response, this paper (and the one following) presents logical modelling, developed by The Author to help assess risk from an individual lease to the industry. It begs the question, is this a form of transference of "value" from the one party's asset to the other? And what is the delineation between the two?

From a practical point of view, The Author has found that understanding, quantifying, and explaining market rent for retail property on individual leases is far more challenging than for the industry, as there is virtually no written material on this topic.

What the IVSC and professional bodies are trying to do is provide practitioners with clues about what they ought to do, but there are few practical tools available, other than practitioners' opinions that can vary widely.

Without being able to quantify and "test" opinions, these provide significant loopholes for some practitioners to "engineer" outcomes or, worse, to blindly provide poor opinions, or to stumble across an "answer" which falls within acceptable tolerance levels (Crosby, Murdoch, and Webb, 2007; Duncan, and Christensen, 1999; Boydell, 1998 and 2001). Who is checking them and to what standards and tolerance levels?

In a 1992 decision Sir Frank Kitto of the Australian High Court provided valuers appraisers with some guidance regarding linking opinions of market value to narrative, which brings a reader along with a valuer appraisers' line of thinking. And this is what he stated about *"detailed reasons"*:

> He said that such a task involves more than: *"... [recitation of] the facts in a degree of pedestrian detail that scorns to [indicate] those that really bear on the problem... and then, without carefully worked out steps of reasons but with a 'blinding flash of light' ... produces the answer with all the assurance of a divine revelation."* (1992) 66 ALJ 787 at 797

The Authors "how to" papers, seek to tease out practical steps to evaluate risk, from a single lease to a whole industry. This has been some twenty-four years in the making, and have been thoroughly documented and copyrighted along the way.

There are most certainly several PhD opportunities for at least five steps of this process, noting that the Intellectual Property is copyrighted to The Author and all software rights are owned by him.

SHOPPING CENTRE AND RETAIL PRECINCT LIFE-CYCLES

From the start, a new property could be a "dog", then a "problem child" and go through various stages of an "industry" or product life-cycle to be a "rising star", a "star", a "cash-cow" and go back to being a "dog". A successful development could easily fall into a rising star, star or cash cow category[5].

So, at what stage in its life-cycle is a property and why is this relevant? A dog implies that it may not have been a successful development. What if the catchment was saturated? What if there simply was no catchment? Well, then the development or the businesses within would be unsuccessful. And there are many examples of this: a shopping centre replacing a High

[5] https://en.wikipedia.org/wiki/Growth%E2%80%93share_matrix

Street in a small country town, for example.

Going through the other stages, and using innovative ways to extend those stages, would enable the stakeholders to benefit from growth in the asset. Businesses would be able to meet their rental obligations, investors would benefit from growth and returns, and finance risk would fall.

Alternatively, once obsolescence is reached, or possibly another property is added into a catchment, it may impact on the original property that was there; perhaps a planning problem?

Obviously when a property reverts to being a "dog" again, it is preferable to re-invest in the asset to extend its life-cycle to hopefully rebuild it and return it to being a rising star or star.

The importance of introducing this terminology is because it is as a shopping precinct kicks into life that all stakeholders benefit from asset growth. The opposite is also true however.

The Author believes that too little attention is given to these stages when assessing and linking rent and/or growth for evaluating market value. Too much emphasis is placed on development building construction and too little regarding the other 95.0% of a property's life aka managing the asset, leases, businesses within, tenancy mixes or understanding the metrics.

And this effectively is about property economics (and not about bricks and mortar), and why this software is potentially so valuable.

EARLY EXPERIENCES IN AUSTRALIA; TO UNDERSTAND HOW AND WHY SOFTWARE TOOLS EVOLVED

One of The Author's earliest experiences in Australia was the evolution and development of the Myer Centre in South Australia. He witnessed the demolition of heritage listed buildings, and the construction and development of a six-level high rise CBD retail property in 1989 - 1991, at a time in the business (and property) cycle which did not add up.

At that time the banks were lending money with gay abandon[6], which has also occurred in the UK (Crosby, N. 2006). Adding to Prof. Crosby's findings, further research undertaken by Maxted and Porter, supporting the fact of exponential credit growth is that the *"aggregated value of outstanding debt secured by UK commercial property only, rose from £225.5bn (2008) to £228.3bn (2009 year-end)"*. This the Author suggests is quite substantial.

Having worked as a junior valuer for a highly respected trust company overseas, whose

[6] Refer to lending cycles in UK, where outstanding bank loans for commercial property in 1972 were £1.0 billion, increased to £3.0 billion in 1975 and fell back to £2.0 billion by 1979. *"History repeated itself ….."* and in 1984 outstanding commercial property loans were £7.0 billion, by 1991 they rose steeply to just under £40.0 billion and fell back to £30.0 billion by 1995.

lending standards were extremely conservative, he found the South Australian behaviour somewhat cavalier.

As it transpired, The Author's suspicions about the Myer Centre were well founded. Rent levels were optimistic, foot traffic on upper levels problematic, the anchor or draw-card on the top level (an electric train for children six stories above the ground floor) seemed risky and tenancy mixes not well matched or managed. And consumer confidence collapsed with the onset of the recession.

The property was sold at "market value" for $151.0 million, after development and interest charges of over $1.0 billion[7] were incurred.

The result of this ill-conceived or not properly evaluated development, caused a chain of events, which are still flowing though the South Australian economy today! The debts that were incurred through over-zealous lending practices were monetised by selling state assets, such as power generation and delivery of electricity to Hong Kong interests. As it has transpired, the consumer in that state now has the highest power bills in the world[8].

The Author's other observation was that this behaviour seems to flow through to both corporate real estate (tenant) concerns and investment real estate concerns. (Crosby, Murdoch, and Webb, 2007; Duncan, and Christensen, 1999; Boydell, 1998 and 2001). He noted that even major specialty retailers were prepared to pay well above market rent rather than give up a site. Of course, the flow-on effect of shops opening and closing, manifests itself into corporate and real estate concerns.

On reading up different requirements set out in leases drawn up by different solicitors on what a valuer/appraiser could or could not include in providing an opinion of current market rent, he realised that data had to become more and more corrupted and combined with a culture to exploit tenant's capital, and that the risk profile of many properties had to increase (Gilbert, D. 1993, 1995 and 2003).

This was subsequently substantiated by the fact that 1989 Australian Bureau of Statistics ('ABS') research indicated that small retailer occupancy costs were 10.0% of turnover in 1989, but by 1996 they had risen to 15.0% of turnover. Comprehensive research undertaken by Jebb Holland Dimasi, which is now known as Urbis Retail Averages, and which is published annually, reports that the percentage of rent to turnover had increased to circa 18.0% by 2004, introducing "on average" negative returns for the "average" retail business model (Macrae, M. 1996).

So far, this paper has covered the symptoms of the problem; what about addressing

[7] Paper in response to cavalier industry behaviour XYX, D 'Economics: a most useful tool for the valuer', *The Valuer and Land Economist*, 1993
[8] 'Australians pay highest power prices in world', *Australian Financial Review*, 5 – 6 August 2017

causation?

EVALUATION OF METHODS TO EVALUATE THE REASONABLE RENT OF A SINGLE RETAIL LEASE[9]

The most surprising observation of The Author has been that:

1. Many / most Landlords do not know what they should receive for one retail lease;
2. Many / most Tenants do not know what they should pay for one retail lease; or
3. If they do, they do not know how to present their respective cases concisely and precisely to the other party.

The reason for this is that it is extremely challenging and the methodology adopted by practitioners is very rudimentary: the rent is evaluated back to a dollar, pound, Euro, RMB, etc. per square foot or square metre and valuer, landlord, a tenant seeks to justify how, what or why it is relevant for different lease conditions for a completely different site for a completely different business model (Millington, A. 1996) and (Gilbert, D. 1995 and 2016).

For example, in the UK the learning institutions have not yet distinguished a differentiation in the way that retail leases are evaluated and compared to one another. Over several hundred permitted uses, retail leases are evaluated as if all retail shops are generic. If McDonald's cannot evaluate what its rents ought to be in Germany, as reported from a Belgian source written Flemish, *Sjoemelt McDonald's met zijn hamburgerprijzen?* [10], reference supplied by someone whose lease was "mispriced" in Holland in a franchised convenience supermarket store, then the evaluation of reasonable rents in arguably the more sophisticated markets of the UK and Europe, explains the extent of the problem, leaving the USA and Asia aside. The Author's research suggests that it a global problem.

To properly evaluate a reasonable rent for a single lease to reasonable standards, the methodology which is being improved on as work-in-progress and invented by The Author comprises:

1. Several data inputs for the shop premises being leased or whose lease is being renewed or disputed;
2. Several methods each to evaluate the "reasonableness" of the performance of a reasonable hypothetical Landlord and Tenant (each with several algorithms), some dovetail into further steps, which links the data metrics together for comparison and evaluation purposes;
3. Methods of evaluating performance levels of the store being evaluated for one permitted use eg. To match supermarkets against supermarkets, pharmacies against pharmacy data metrics, jewellery stores, etc.;
4. Methods of evaluating current rents or proposed rents being charged;

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[9] GEM Method™ ('Gilbert Evaluation Method™ Evaluation Method')

[10] Tanghe, N 5/4/2017 http://www.standaard.be/cnt/dmf20170405_02818377?_section=63757721

5. Methods of comparing rents being charged and measuring same to common standards; and
6. Methods of linking and comparing shop being evaluated, to external benchmarks and linking same to comparable rents at expected store trading levels.

The software invention has:

1. Twelve separate algorithms;
2. Six outputs, of which several can be presented with multiple options of which all 'interact' with one-another including individual components of each output;
3. The shop whose rent is being evaluated can be inputted to accommodate irregular shop configurations;
4. Each step is logical and sequential; it is a walk-through, step-by-step 'argument' which is colour coded for evaluation differentiation identification purposes;
5. Depending on inputs, eg. the number of comparables, store benchmark data available, etc. each highly specific use being evaluated produces several million probabilities which point one to the "reasonable rent" that one ought to pay / receive;
6. Each output is arranged and re-arranged and presented in such a way that one can follow the logic accompanied by say a six-page report.

What appears to be a series of bar graphs, in the outputs is not the case. There are a complex set of algorithms which operate within the software, which directly links the business whose lease is being evaluated to hard evidence.

The methodology is extremely "case sensitive": stores with large footprints and small rent differentials measured on a per square metre or square foot basis such as department stores with more than 5,000 square metres, can be evaluated to high degrees of what the reasonable rent ought to be. Obviously, it is important that the quality of data inputs will cause outputs to be better and more reliable. Some data metrics do not need to be 100.0% accurate, because one might be "arguing" or presenting a "reasonableness" argument. And statistically and mathematically a data series will even out and balance out less critical metrics as the data range is sufficient in number refer Millington's concerns (1996).

It is submitted by The Author that *at this stage*, if each lease were to be evaluated at a point in time to say an 80.0% confidence index, then the multipliers of market value ought to be far more accurate, than when valuers / appraisers apply a multiplier to untested evidence purporting to be "market rent.

It has already been submitted that evaluating the reasonable rent (IVS, 2006) of one lease to justify and prove,) is far more difficult to ascertain than market value, provided rental data metrics and income streams have been thoroughly stress tested. Each lease can have far more intricate variables, eg. location, permitted use, imperfect evidence, how evidence can be used, is it "tested' as being arms-length, how it is relevant, what adjustments ought to be made verses the evaluation of market value, of "tested" evidence and various lease terms, tenure, etc.

HOW TO EVALUATE THE REASONABLE RENT OF A SINGLE RETAIL LEASE

Attachment A refers one to set of interlinked graphs, each representing a different data series, each which refers one to a different “argument” and a different set of probabilities and key decision-making points. As one progresses, it teases out a logic argument of what the reasonable rent ought to be for the retail shop’s rent which is being evaluated.

This quite complicated process is broken down into some of the elements set out in a 1937 Australian Supreme Court case known *Scott LJ in Robinson Brothers (Brewers) Ltd v Houghton and Chester-Le-Street Assessment Committee [1937] 2 KB 445 at 468 – 471***.**

The Author has tailor-made the methodology based on the broad principles embedded in this insightful 1937 decision, which pictorially enables one to “tell a story”. Here is a summary of Scott LJ’s decision:

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 his 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."*

The following are brief examples from several case studies, of several steps of the step-by-step argument to evaluate what one should pay receive for one lease. Whilst headings are sequential in the software presented as figures 1 – 6, only the steps that are for the purposes of presenting the evaluation process are in this paper; hence they do not follow a sequential order.

See Attachment A: Figure 1 Presented by Step 2, Graph 1, Option 1

Figure 1 shows the stress test to the operation of retail shops to establish a “before” and “after” case synopsis to ensure several businesses (related to the lease being evaluated) is being operated to “reasonable standards”.

So far five primary methods have been developed to “stress-test” that the business is being operated to reasonable standards. Whilst the numbering and sequencing of the steps are being changed so that each step is as logical as possible for the end user, the core methods and thinking has remained largely the same since it was invented in 2010.

The data metrics of the step-by-step process and decision-making simply considers the performance levels of several shops presented, when each one was acquired, compared to now on a “before” and “after” basis as Shops A, B, etc. trading at say $10,000, then $12,000 per square metre per annum, which can be disclosed if necessary. In effect, this simple method represents that the business whose rent is being evaluated is a reasonable hypothetical operator or retail chain. In fact, it presents as a growing business model.

There are four other methods in Step 2 to choose from.

Once Graph 1 has been evaluated, one moves to Graph 2 for further evaluation, until by Step 7, Graph 6, one ought to have a comprehensive idea what the reasonable rent for the retail premises ought to be and why. Each step as stated, measures and evaluates a different series of data, to evaluate and quantify a different aspect of what the reasonable rent is for one retail lease.

Obviously if this process is logical and stands up to scrutiny it must be far more sophisticated than comparing and supplanting a rental rate per square metre from A to B irrespective of different locational advantages disadvantages, frontage depth benefits disadvantages, differing businesses models being compared and evaluated against one another, etc.

Steps 4, 5, 6 and 7 now incorporates the outcome of the Profits Method, which links the data metrics into any evidence sourced by any landlord or a tenant presented by green and yellow bar charts respectively. It is a new incorporation into this body of Intellectual Property and only appears in some examples represented by a mustard coloured bar graph.

The Profits Method is an external check linking the Comparison Method to the Profits Method, and hence the actual performance metrics of the business, or a substantially similar hypothetical business as if operated from the same site.

It is submitted that the merging of these two methods, becomes a persuasive tool for fulfilling the evaluation of leases and rents for IFRS 16 reporting, including “tested” market evidence.

Refer Attachment A: Figure 2 Presented by Step 3, Graph 2, Option 2

Like Figure 1, the data metrics consider the operation of the Landlord. This Figure 2 shows the stress tests applied to a reasonably competent Landlord (or shopping centre/mall). Here the Key Anchor must be a key barometer regarding centre traffic and trading potential of the centre. In relative terms, the pharmacy shop (whose lease was being evaluated) trades at higher levels than the Landlord’s centre, by deduction. One is then able to form opinions of the landlord as a reasonable hypothetical owner manager, and in this instance the store whose rent is being evaluated was performing better than the centre in relative terms.

Refer Attachment A: Figure 3 Presented by Step 4, Graph 3

This step (Figure 3) establishes if the store whose rent is being evaluated is trading to reasonable levels and / or are there external factors impeding its operation?

This data series presents the annual performance metrics of comparable supermarket shops on a dollar per square metre basis per annum. The case study suggests that the shop whose lease is being evaluated has trading levels represented by the red bar graphs/charts on LHS are well below those of like comparable supermarkets, eg. $3,600 versus $10,500 per square metre.

It follows that if the retail chain whose lease is evaluated has a history of trading at far higher levels and can and did also grow its business models, (proved Graph 1) then why is the same business whose lease is being evaluated, trading at lower levels and not at least in the middle of that data series?

Perhaps the shop too large or the catchment is saturated compared to other shops, or compared to a national standard. In this instance the catchment was saturated with retail centres.

Once one has stress-tested the operation of the Landlord, the Tenant and the business whose lease is being evaluated reasonably objectively, one can start forming opinions about the reasonableness of the rent.

See Attachment A: Figure 4 Presented by Step 5, Graph 4

Figure 4 compares the occupancy costs against other similar pharmacy shops.

The data series shows that the pharmacy shop whose rent is 14.4% of turnover on the RHS in Figure 4 is well above what other recently negotiated pharmacy shops are paying.

Industry benchmarks are circa 2.5% to 3.3% presented by silver bar graphs/charts, actual tenant and landlord evidence gathered and presented by the yellow graphs/charts and green bar graphs/charts respectively in this "argument". The majority of the pharmacy shops' gross rent to turnover ranges from 4.0 to 6.6%.

A retail shop's rent to turnover ratio (occupancy cost) is a key performance metric, which links the gross rent being paid to the actual performance levels of the stores and often those of a centre or mall whose tenancy mixes are being well managed.

One could ask whether the shop whose lease is being evaluated is under-trading, could it be too large, are there other fundamental reasons. It might be that the gross occupancy costs are too high and warrant “resetting”. There might be an over-representation of businesses in a given category.

The argument of under or over-trading was proven in Figure 2’s step, the centre is under-performing, has high vacancy levels and the pharmacy shop was too large for given trading levels, notwithstanding the store itself had higher performance metrics than the other retail shops on “average”. One is starting to reach informed opinions about what the reasonable rent should be, which are infinitely more sophisticated compared with current methodology. Transferring a rental rate from A to B, which may or may have no bearing on what the “reasonable rent” should be. This suggests to those occupiers and tenants that are negotiating lease costs have a stronger method on which to do so.

See Attachment A: Figure 5 and Figure 6 presented by Graphs 5 & 6.

Figures 5 and 6 present actual data from a rental determination carried out by the Author. Some three to four weeks work has been condensed into the software, which in effect is a form of “beta testing” after the event to see how the software performs.

The evidence is presented as follows: landlord green bar graphs/charts, tenant and or evidence gathered in yellow; actual rent paid and as determined red; new large pharmacy lease, for a better premises 600 metres down the road blue; the outcome of Profits Method in mustard colour; and industry benchmarks silver.

Figure 5 compares the annual rent assuming the rents are all in the same sized premises as the shop whose rent is being evaluated, and the other metric in the second data series is the equivalent rent on a dollar per square metre basis.

Figure 6 replicates Figure 5, but it presents the data on an occupancy cost to sales basis and on an equivalent rate per square foot/metre basis. The occupancy cost directly converts each rate per square foot/metre to the annualized rent for the same sized shop which is being evaluated, which presents the equivalent gross rent as a percentage of the businesses’ estimated future minimum maintainable sales. One is obviously evaluating business performance metrics for the period ahead (Gilbert, D. 1993).

We are now getting to the nub of the “reasonable rent” argument/evaluation in Figures 5 and 6. The rent is presented as: a. an annualized sum, (assuming same sized shop as the shop being evaluated), b. which is thoroughly interrogated with a second data series on a $ / € / ¥ / € etc. rate per square metre / foot basis; and c. a third data series thoroughly interrogates the first and second data series, applying those metrics to the expected minimum maintainable sales of shop. All three data series, are linked for relevance and comparison and evaluation purposes.

The annual rent that was being paid by the tenant was $375,000 per annum, equivalent to $796.18 per square metre represented by the red bar graph in figure 5. The other data series, which mirrors the same data in figure 6 including rental evidence, equivalent pharmacy benchmarks, the profits method etc, shows the same rental rate as $796.18 per square metre, and the equivalent occupancy cost of 14.4%.

That 14.4% is also the same metric on the far right had side of figure 4.

The relevance of all the now "tested" evidence in figures 5 and 6, are presented as if all the shops floor areas were of equivalence to the shop whose rent is being evaluated in 471 square metres. The second way the software is programmed to standardize the evidence to significantly reduce subjectivity, is to evaluate each rent as if equivalent annual rent, was a function of what the shop whose lease is being evaluated's minimum maintainable sales are forecast to be.

These data series accurately show what the rent being paid is (red bar chart LHS) compared to all the other shops in a systematic orderly way. It also shows the rent as determined by The Author, and has been subjected to testing by the courts, presented by the red bar graph/chart on the RHS ($171,000, equivalent to $363.06 a square metre in 471 square metres, and 6.6% of forecast minimum maintainable sales in figures 5 and 6).

The matter was not tested for the veracity of the determination but legal argument for other reasons:

Devery's Pharmacy Services Pty Ltd t/a Westcourt Plaza Pharmacy (Applicant) v Direct Factory Outlets Cairns Pty Ltd RSL 011 – 14 Queensland (Respondent), provides the reader with some useful signposts of what rental determining valuer might be up against. The reader is encouraged to form some opinions on the metrics and the waste that occurs when each lease and each rent is not properly evaluated as being the "reasonable rent".

> In paragraphs 9 and 10 of the decision, the Tribunal stated: *"The valuation of the Current Market Rent was made in a valuation report prepared by Mr Donald E Gilbert, dated 13 November 2013. Mr Gilbert discussed the history of the shopping centre, and summarised his task as:*
>
> *In sum: what is the current market rent for a pharmacy shop in a 471 square metre equivalent store without outside access, located in a DFO-format centre which appears not to have been fully accepted by the Cairns market, post GFC, facing stiff competition in its immediate catchment (including discount pharmacies), all when quite enormous changes are taking place both within the centre and the pharmacy industry, and the current Tenant business has been on rent relief but has just recently completed a refit? This is a complex task.*
>
> *[10] The current annual gross rent at the time of the valuation was $375,636.00*

plus GST. The Lessor proposed a new rent of $383,125.00. The tenant proposed a new rent of $225,000.00. Mr Gilbert determined that the current market rent for the lease year commenced 8 September 2013 calculated on a gross rental basis was $171,000.00 excluding GST for the commencement of the five year option" and in paragraph 31 *"There is no dispute between the parties as to the determination made by Mr Gilbert"*

The benefit of these stages is that it "stress tests" all evidence from the landlord and the tenant, links it to industry benchmarks and links the comparison method to the profits method, and the metrics of the business itself.

Given that it is colour coded, it instantly allows one to evaluate many elements of an "argument" simultaneously, which allows the reader to form their own opinions.

This method points the user to what the "reasonable rent" ought to be because all leases are evaluated on a gross effective rental basis (they include landlord operating expenses, and are adjusted for incentives for like comparison). In effect the methodology "checkmates" an answer, subject to the veracity of data inputs, assumptions, etc. at a point in time.

The methodology "standardizes" most of the road humps identified by the Author in his 2016 papers about the Comparison Method and the Profits Methods of valuing leases.

Referring to Figures 5 and 6, a tenant might note that the determining valuer, after careful evaluation, reduced the annual rent from circa $375,000 to $171,000 per annum. That is because he had tested every metric in the mix. The red bar charts present the argument quite clearly and logically.

The profits method in mustard colour supported a gross rent of $143,000 per annum gross, but by way of a stroke of luck another similar pharmacy shops' lease was renewed at market rent which was conducted by negotiation between a willing informed landlord and a tenant. That lease, the shop, location, size, performance levels, which also had an adjoining doctors surgery, was negotiated at $160,000, shown as $164,850, as it is "standardized" to a shop which is 471.0 square metres; the same size of the shop whose rent was determined.

The methodology leaves the parties in little doubt where the reasonable rent ought to be given stated assumptions.

At this point the Author is not prepared to be drawn in as to whether it will have adopted as a rental valuation methodology. He believes that it is work-in-progress and a useful negotiation tool and a tool to evaluate what the reasonable rent ought to be and would satisfy IFRS 16 requirements.

It overcomes Millington's concerns (1996), because it covers almost every aspect of the evaluation and testing of the metrics; in which he said of comparisons:

"…. may be helpful… if transactions are sufficient in number and sufficiently comparable ... to give a reliable indication of either general levels of value or trends in value",

The Author believes Millington's concerns were valid in 1996, before The Author had overcome the subjectivity issues that Millington identified. The software invention standardizes previous inconsistencies, by stress testing each element of the evaluation process, before one moves to the next stage, which makes the evaluation of the reasonable rent of one retail lease more objective.

CONCLUSION

In the Author's opinion, there are simply too many conclusions that can be drawn from this research paper.

The Author believes:

- Landlords and tenants have not had a medium or methodology to communicate what the reasonable rent is for one retail lease;
- The current methodology of satisfying quite complex "arguments" by adopting a single number aka a dollar per square foot/metre is primitive;
- A "hit" or statistically a "miss" is a more likely an outcome about evaluating what the reasonable rent ought to be using current methodology;
- Once one or several leases are properly evaluated, then whole precincts or malls will follow;
- By following the same methods for a sample of key leases, the risk on rental income streams can be assessed and quantified for those leases, and decisions made on the yields and multipliers that one might adopt to establish an opinion of market value, arguably to more accurate levels than what is currently being achieved on "average";
- The balance of the lease rental income streams can then be evaluated to a higher degree of accuracy than simply evaluating headline numbers aka untested for its veracity off a tenancy schedule and using a supposed multiplier which might or might not be relevant for the particular property;
- The owners of business capital aka tenants in the mix, who enter leases, or renew leases on terms and conditions, which include the rent that is reasonable, will satisfy the criteria and outcomes envisaged under IFRS 16;

- Once the methodology is followed and reasonably tested for each lease being evaluated it might be adopted as a methodology and or "standard";

- A report must then bring the reader from *"... the basis of the valuation, the relevant facts and the reasoning derived from those facts which leads to the final value estimate. He or she should be able to follow and audit each step in the valuer's thought process."* (Hyam, A. 2000, referring to Whipple, R. T. M., 1984).

- In the Author's opinion, the evaluation of the reasonable rent for one retail lease is a risk mitigation and prevention model which, if embraced by stakeholders, will prove to be extremely valuable and introduce long-term stability into the mix.

A follow-up paper will cover the Evaluation of Risk of Multiple Leases in One Precinct; the Evaluation of the Risk of the Overall Rent of an Investment Property, Linked Back to Yields (Multipliers); and Linking Gearing/Leverage to the mix.

It is submitted that several PhD opportunities lie in the arena of: Shopping Centres / malls and product life cycles; the topic of evaluating the rents of retail shop leases by property academics; another perhaps from an accounting source, background; and one from a finance banking source. The follow up paper will identify several other PhD opportunities.

Attachment A: Selection of Case Studies regarding operation of GEM Method™

Attachment B: Current colour coding of bar graphs/charts

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