

THE PROFITS METHOD EXPOSED: THE BENEFITS AND LIMITATIONS

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ABSTRACT

In his paper, Prof. Millington advocates The Profits Method as an alternative method. It is widely used in the United Kingdom.

This involves a thorough forensic analysis of the Business Metrics and, often, Key Performance Indicators ('KPI's') of the business itself, stripping back often, and the financial reporting of several years' worth of Annual Financial Statements (which are simple business records processed and prepared by an accountant and presented in a Standard Format, i.e. a regurgitation versus any form of serious analysis).

As Specialist Retail Valuers, we then conduct a forensic examination of each line item, e.g. sales; Cost of Goods Sold ('COGS') including opening and closing stock purchases and the metrics; resultant gross profit; major and minor items of income and expenditure, including capital investment depreciation, wages and proprietor wages. The result of this examination leads to a deliberate, informed view on the rent.

Keywords: retail, rent, market rent, profits method, comparison method, valuing rent

SUMMARY

In this paper I will refer quite extensively to Prof. Millington, B.Sc. (Est. Man), FRICS, IRRV., FI Mgt., FVLE., and his benchmark research, *The Shopping Centre Industry – Issues Affecting Property Values* (published in *The Valuer & Land Economist* November 1996 pg. 321 – 328). Professor Alan Millington notes that the Comparison Method is limited for many reasons.

He says that comparisons “may be helpful” but only “if comparable transactions are sufficient in number and sufficiently comparable to be acceptable evidence and to give a reliable indication of either general levels of value or trends in value”.

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It is an intense and forensic analysis of the financial affairs of that particular business via the books of account.

Anyone in any profession, particularly when office bound, who has only ever recorded and processed figures in a “production line” facility to prepare the Annual Financial Statements, has no need to forensically form opinions and views on the origin and accuracy of the figures they are recording, processing and presenting. Theirs is not necessarily an adversarial domain; ours is.

An accountant’s role is protected via disclaimers.

Interrogate an accountant and you can produce three sets of figures: one for the taxman; one that records the actual affairs of the business, and one if you want to sell the business.

Even senior members of the profession admit that some 90% of colleagues do not know, and have no interest, in where these figures come from and how they are made up, i.e. they have no understanding of the metrics.

This implies that most accountants cannot forensically analyse the figures themselves (nor do they have to; it is not part of the job description).

I have canvassed these views, both in Australia and overseas, including at RICS functions, with senior presenters working for middle tier and big firms.

Now this might sound grim in regard to analysis of Annual Financial Statements to form opinions of market rent using the Profits Method, but it is not so for two very important reasons:

1. Using historical data from the actual Annual Financial Statements (the Profit and Loss Statement) to project the figures forwards requires a skill set far outside that of an “average” accountant’s skill set. Why?
 - a. This often involves interrogating business proprietors to query and verify the accuracy of the Annual Financial Statements;
 - b. This includes: finance, forecasting, (core in the field of marketing and economics) catchment analysis, shopping centre metrics analysis benchmarking, financial mathematics (future value, present value, depreciation, amortisation), contract and contract law, sales analysis and sales data metrics and, of course, the actual lease itself. Do accountants do this? I suggest, hardly ever.
2. One requires a serious working knowledge of the alternative: the Comparison Method. Why? This is because “comparisons may be helpful” but only “if comparable transactions are sufficient in number and sufficiently comparable to be acceptable evidence and to give a reliable indication of either general levels of value or trends in value”.

One must have a thorough working knowledge and understanding in regard to the Profits Method (let alone a thorough analysis of each aspect of the data metrics and benchmarking), which easily exceeds the gathering, recording and presenting of a business’s Annual Financial Statements for reporting purposes.

THE PROFITS METHOD AND COMPARISON METHOD UNDRRESSED

First, the market rent can be, and frequently is, an intensely personal, debated opinion held by stakeholders.

Someone believes they bought the property for X but it is worth Y, i.e. whatever the multiple is. Did they do their homework - their due diligence? Did they understand it?

Even major Institutions might firmly believe that their case is the only case. This view has evolved over time.

Take the major retailers, Coles, Woolworths. In the past, rental increases were accepted and passed on and the Australian consumer faced higher prices as a result. The “soft increases” that Landlords achieved were passed on indirectly to the consumer. Well no more; now it is a battle for survival, for relevance or extinction. These huge chains must compete with real competition or die a slow death. Chains such as Aldi and Costco, etc. are gaining ground. Furthermore, it’s all too easy for the consumer to switch to on-line shopping.

The Profits Method

If one considers the Profits Method on its own, this is an intense analysis of the data metrics, of the new business’s projected data metrics (from business plan for Annual Financial Statements that are constructed) for a “Go” “No Go” decision. It uses the businesses historical data to evaluate what the rent ought to be going forward.

Are the site characteristics reflected in the store performance metrics, however? Evaluating this historical data without such reflection could favour the Landlord’s or the Tenant’s case.

How does one know?

If used properly, this method has to be one of the most accurate ways of evaluating the market rent, as long as the business records accurately reflect the performance metrics of a “typical” average hypothetical Tenant trading to “average” standards. Nothing can be closer to the “actual” than the data metrics themselves. There are also derivatives of this method, e.g. industry benchmarks.

Now, let’s turn to the Comparison Method.

The Comparison Method

Referring to Millington again, this is what he said about the Comparison Method: comparisons “*may be helpful*” but only “*if comparable transactions are sufficient in number and sufficiently comparable to be acceptable evidence and to give a reliable indication of either general levels of value or trends in value*”.

This comment immediately suggests subjectivity.

An average valuer appraiser evaluating houses with other houses in a given suburb, industrial property with industrial property, Grade-A offices with Grade-A offices, strata title (units, community title) flats apartments, etc. is largely comparing like with like.

The properties are almost always generic, or close to being generic. There can be slight differences, however: the leases and the structure of the leases, for example; elevation in an Office Tower and some special views, or location site attributes that can add or decrease the “value” of these leases; others might have some in situ benefits, say a mezzanine floor.

Yes there are variances and differences, and adjustments and judgement calls to be made. Even financiers (bankers) think they can flick and tick without a brain, working through the reasoning and logic. Maybe that is why Mackay in Queensland has vacant houses and large tracts of semi-developed township land. It was reported that in Brisbane, Queensland, there are 35,000 units (apartments) in the development pipeline (I am reasonably informed it is higher than that), with

“price” metrics, but no “value” metrics cautioning the borrowers and lenders! Apply a “price” metric to that number and work out the exposure!

What about other capital cities evolving off the back of abnormally low interest rates?

But retail is vastly different. This highly specific segmentation of the market, by the very use that the property is being used for under the lease, slices and dices the whole market by say 1/200th because there are around 200 retail business uses; and scores more if one links some of the sub-markets, not to mention the current propensity to “bolt on” several uses to one store! So each business model changes ...

Who bids for High Street precincts for example; how does the model change over time?

So, Prof. Millington says comparable rents may be helpful, i.e. the data metrics which are mostly a product of gross rent of a highly specific business use, analysed back for comparison purposes to a dollar per square metre rate, but **only** if they are sufficient in number.

Well in my opinion, that is fact. There might be a dearth of evidence, however. That evidence might not be arms-length or may be a product of arms-length negotiations. There are differences between different sites: some shops could be highly efficient, while others could languish with surplus space. There might be basements, and licensed areas and mezzanine floors and so on that distort even the most well intended analysis and use of the evidence. And let’s not forget about incentives and the impact of incentives!

The Comparison Method is highly subjective. Blind use of it causes disputes within disputes. In short, the Profits Method can accurately link store performance metrics to the site and the rent if it is correctly analysed whereas the Comparison method can be highly subjective (and allows valuers appraisers to goose the metrics). For good or bad, our Courts and Tribunals currently prefer the Comparison Method.

THE PROFITS METHOD

Professor Millington suggests that a major determinant of retail rental values is the perceived potential profitability of various retail activities. He states: “...it is the present and future trading potential of a property which determines its present rental value, and in the same way it is the anticipation of future rental returns which determines the present capital value of a property.” He points out the “quasi-monopolistic supply” of retail properties. There is limited bargaining power for the tenant, especially at end of lease, (Millington, A. 1996).

Goodwill and cash flow were thoroughly teased out by landlord representatives to the Committee at the Fair Trading inquiry (Hansard, 1997, pg. 788). On the question of buying or selling a business, Committee Member, Mr Allan Morris, raised the question of goodwill when one bought or sold: “the right to run a two-year lease, but you (Mr Allan Briggs) are saying that that is only a right to a cash-flow”. Briggs responded “On the presumption there is a certain cash flow. I am perhaps getting to the meat of the argument. What are you buying? You certainly are not buying a lovely little shop in a lovely centre. You are buying the cash flow, the business.”

Referring to (Hansard, pg. 786), the concept of goodwill was discussed in the context of security of tenure. The Chairman asked Mr Briggs whether a business in a major shopping centre had “goodwill”, particularly at the end of the lease. His response was, “The value of the goodwill decreases, depending on the term available to the merchant... There is no goodwill attached to a lease, with the exception if a merchant has a five-year lease, let us say, then it has some value. ...

One year into the lease it has four years; two years in it is three years, and so on as it gradually diminishes, but at the end of the lease there is no goodwill.”

Chair – “*At the end of the term?*”

Mr Briggs – “*There is no goodwill.*”

Chair – “*No goodwill.*”

Further on (Hansard, pg. 794) Mr Briggs said, “*The value of any business is driven by the income that you earn and by the bottom line profit that you can make. Our industry is no different from any other. ... If there is a suspicion that the rentals will not be maintained, then the valuer is duty bound to base his valuation on that instinct or knowledge or premise.*”

Clearly there is a circular argument here; but there is a “line in the sand”. Where is it? Where is the Landlord’s and what is the Tenant’s?

Now, when one undresses a business’s (business models) Annual Financial Statements (Profit and Loss Statement) what does one uncover? What is one looking for?

Unlike accountants, who record, compile and present the financial transactions from historical data, we are valuing the lease for the period going forwards.

Typically, this is the work of someone skilled in the areas of marketing (from a single product, to a business model, to an industry) and management accounting, e.g. forecasts and budgets and ongoing working knowledge of same.

We are valuing the period going forwards over a given lease term.

Adjustment Item in Profit and Loss Considerations

| Adjustment | Item in Profit and Loss | Considerations |
|--|--|--|
| Sales/turnover. Given the lease period is the period ahead; a good valuer needs to be able to anticipate likely changes. | Anticipated gross takings (net commission basis newsagency; excluding GST; excluding PBS for pharmacy by legislation ²). | Determined by many things: margins, site, location, frontage/depth, permitted use, product mix, stock availability, advertising and promotion (direct, via third party, e.g. Shopping centre), brand, competition (in centre; wider market), consumer confidence, business model, changing tastes, changing technology, management, new taxes, catchment, demographics, etc. An in-depth analysis of future minimum maintainable sales will force one to carefully consider the data metrics and earnings of the future earnings of the business. |
| Less | Cost of acquiring stock. | Sourcing, margins, exchange rates, labour cost of local manufacture. |

² Pharmaceutical Benefits Scheme income, Australia i.e. extremely low margins, service to the community.

| | | |
|---|---|--|
| Equals | Gross profit from business. | A product of above inputs; the effective gross profit may be reduced via franchise fees (sometimes shown as an expense item in Profit and Loss). This is an extremely useful data metric to understand and there are many things which can cause variances, e.g. pilferage, spoilage, stock dating, variances in opening closing stock, etc. |
| Less | Trading expenses including depreciation but excluding: interest, rent, working proprietor's wage. | Generally, unless acquired via a third party, e.g. Utilities, outgoings (part of rent), all business related expenses are subject to "open market competition". Head Office operating expenses may need apportioning for multiple store operations. |
| Equals | Adjusted net profit as some deductions still have to be made. | Cost of occupation; debt/interest; labour including owners wage/return is excluded but deducted below. |
| This methodology enables a rental valuer to split the "residual" between a working proprietor wage or head office administration management expenses; a genuine risk reward; and the landlord's share. Without these three one does not have a working Free Enterprise System. | | |
| Less | Allowance for say managers wage for working proprietor. | Staff is required: in Australia (and overseas) labour market wages are regulated; a working proprietor requires competitive remuneration (both actually and notionally for purpose of exercise) to justify taking on business risk. |
| Less | Allowance for the risk attached to the business, e.g. appropriate allowance for capital invested at business return is substituted for actual interest that may have been deducted. | Without apportionment of risk/reward appropriate for type of entity, are determined by market forces, Business Capital would not seek leases (Hyam, A. A. 2004, Attachment G being Market referenced profit multiples, with a Return on Investment converter, Copyrighted to BCI Pty Ltd). |
| Equals | Balance available to pay the costs of Property Occupation (rent plus outgoings). | A residual sum is an amount attributed to Property Capital in form of rent and outgoings. High or non-competitive outgoings, management fees, etc. reduces the residual available for rent. |

AUSTRALIAN TENANCY LAWS; PRINCIPLES OF GOODWILL; FIXTURES AND FITTINGS OF THE LESSEE'S BUSINESS AND TERMS OF THE LEASE

Arguably, I believe our State Tenancy Laws (which are largely the same in key areas, e.g. rental determinations) are probably the best in the world. They are, in effect, a derivative of English Case Law about determining current market rent.

Section 29 of the Queensland Act sets out, "*Matters to be considered by specialist retail valuers.*" In making an opinion of the current market rent, the specialist retail Valuer:

(a) *Must determine the rent—*

(i) 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 for which the shop may be used under the lease or a substantially similar use; and

- (ii) *On the basis of gross rent less the Landlord's outgoings, payable by the Tenant under the lease; and*
- (iii) *On an effective rent basis; and*

(b) *Must not have regard to the value of the goodwill of the Tenant's business or the Tenant's fixtures and fittings in the retail shop; and*

(c) *Must have regard to—*

- (i) *the terms and conditions of the lease; and*
- (ii) *submissions from the Landlord and Tenant about the market rent of the shop; and*
- (iii) *The other matters prescribed by regulation."*

Section 33 covers the Effect of determination. It states: ***"The current market rent of the leased shop determined by the specialist retail valuer is the current market rent of the shop and the rent payable under the lease for the rental period under the review."*** My emphasis added.

(b) Several important points come out of this. These are essentially prescriptive signposts for an Expert Determining Valuer to follow:

1. The valuer must not have regard for goodwill or the "Tenant's fixtures and fittings". He does not ignore them; he must quantify their value so that the rent does not adversely impact on the business's goodwill and/or the fixtures and fittings;
2. Section 29 (c) (i) was previously in the Act, removed from the Act and re-inserted. Why? Because valuers failed to realise and needed to be reminded that they are not just valuing or evaluating the rent at a period of time; they are valuing it for the forthcoming term of the lease;
3. The bold portion of Section 33, above, reinforces this.

It follows that the lobby group for Landlords have slowly been whittling down the effectiveness of the State Tenancy Laws. That might be a clever move, but finally it will devalue the leases themselves. And it will come to pass that valuers will take this into account. Why? Because they have to.

Market Rent, as defined by the International Valuation Standards Committee (IVSC), is *"The estimated amount for which a property or space within a property should lease on the date of valuation between a willing Lessor and a willing Lessee on appropriate lease terms in an arm's length transaction, after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion"* - Derived from *Spencer v Commonwealth* 5 C.L.R. 418.

The problem with the definition is that it ignores the highly specific permitted use of a Retail Business Model being evaluated.

Goodwill

Special mention should be made about Goodwill.

1. Considered principles of the Retail Shop Leases Act prescribe what a Specialist Retail Valuer must do and where they overlap in regard to this lease:
 - a. For example, to avoid confusing what belongs to the Landlord and Tenant and to avoid attaching or adding the value of the Tenant's accumulated goodwill to the rent, we assume it is a bare shell;

- b. The permitted use of the shop (or a substantially similar use) is compulsory because a ‘generic’ permitted use in the retail arena is problematic;
 - c. With an “average hypothetical” operator, the lease being evaluated does not comprise the actual parties but is simply an “average” landlord and tenant;
2. To avoid any confusion, Goodwill is:
- a. Site Goodwill = rent, which is what we are seeking to value;
 - b. Business Goodwill = an amount that any hypothetical business investor would or ought to expect to justify when considering taking on business risk. Many valuers do see this as an opportunity to convert business risk reward into rent;
 - c. Personal Goodwill = the owner’s wage;
 - d. True Goodwill = Super Profit. Super Profit cannot be measured into the lease under the Act.

CONCLUSION

The Profits Method, if used by a well-informed valuer, can produce the best estimates of rental values for retail in that it provides “*certainly more reliable estimates than those obtainable from the use of comparable evidence*” (Millington, A. 1996).

The Profits Method can and does link a business’s and the site’s metrics, attributes, flaws, etc. directly to one-another. Provided the operation of the business is to reasonable “average” standards, i.e. the standards of an “average hypothetical operator”, I believe it is a useful method of forming opinions on current market rent.

In order to undertake such a task, a Specialist Retail Valuer must be forthcoming in regard to his interrogation of the businesses data metrics. This can and will sometimes cause a business operator (even some of the largest corporations) to resist. That is because, in the wrong hands, the data can be manipulated.

Forensic evaluation of the Annual Financial Statements (Profit and Loss Statements) for a project period ahead, using historical data recorded and processed by accountants, requires thorough intuition from a practitioner who has developed a working knowledge and experience in this arena. The forensic evaluation of Profit and Loss Statements to evaluate where a business (and the lease impact) will be in a given catchment five or even 10 years ahead requires high numeracy and literacy skills, a lot of patience and quite a lot of time investment.

The Profits Method opens up one’s ability to access leading business benchmarks, that are, themselves, only a tool in the mix for the retail valuer. They are not an absolute. They become another signpost and a signpost only.

Parties to leases often have emotional ties or strongly held beliefs about what rents ought to be in the retail arena. One day the lights are on, and the next there is a “For Lease” sign in the window. This is hardly an informed judgement of evaluating lease risk, but that is about the point we have reached!

Shopping centres have been extended, redeveloped and over-developed; business capital is eroded and wiped out because the metrics do not tie up.

Even the largest retail business models in Australia are having to examine all their metrics, including their leases, and decide upon their future in particular sites. They will be testing the margins.

On the other hand, business models are closing or have closed, e.g. Masters in the Woolworths stable and Dick Smith Electronics, ex Woolworths.

The Comparison Method can be useful and is preferred by our courts and tribunals, but it has its limitations and is far more subjective.

A practicing valuer who uses both methods, and several more derivatives of these two primary methods, by cross-referencing to two or several methods, one can start locking-on to some quite firm figures. Even so, a given catchment or tenancy mix can change. A given type of business can face enormous change, e.g. technical obsolescence, changing tests, etc.

In my next article we will consider the Comparison Method.

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