

## RETAIL LEASES: AN EARNINGS BASED RENT VALUATION

In [Serene Hotels Pty Ltd v Epping Hotels Pty Ltd \[2015\] VSCA 228](#) the Court of Appeal of the Victorian Supreme Court decided that an earnings methodology to a rental valuation was available under the [Retail Leases Act 2003](#) (“the Act”).

Serene Hotels Pty Ltd was the Tenant and Epping Hotels Pty Ltd was the Landlord of the Epping Hotel. The leased premises known as the Epping Hotel included a hotel, bottle shop and carpark together with bistro, TAB and 40 electronic gaming machines.

The Lease dated 1 February 2007 was for an initial term of 14 years with a commencement rent of \$475,000 per annum plus GST, fixed for the first 2 years. Thereafter the rent was to be adjusted annually to the greater of the Consumer Price Index for Melbourne (all groups) or 2.5% with the exception for a market rent review to be undertaken on the 5<sup>th</sup>, 10<sup>th</sup>, 15<sup>th</sup>, 20<sup>th</sup>, 25<sup>th</sup> and 30<sup>th</sup> anniversary of the commencement date.

The Lease provided that if the Landlord and Tenant could not agree on the current market rent then the current market rent would be determined by an independent specialist valuer (“the Valuer”) whose decision would be final and binding.

The Landlord and Tenant could not agree on the current market rent on the 5<sup>th</sup> anniversary in 2012 and thereafter the Valuer was appointed.

The Valuer had regard to section 37 (2) of the Act which provides:-

*“Rent Reviews based on current market rent*

*...(2) The current market rent is taken to be the rent obtainable at the time of the review in a free and open market between a willing landlord and a willing tenant in a willing arm’s length transaction having regard to these matters-*

- (a) the provisions of the Lease;*
- (b) the rent that would reasonably be expected to be paid for the premises if they were unoccupied and offered for lease for the same, or a substantially similar, use to which the premises may be put under the Lease;*

- (c) *the landlord's outgoings to the extent to which the tenant is liable to contribute to those outgoings;*
- (d) *rent concessions and other benefits offered to prospective tenants of unoccupied retail premises –*

*But the current market rent is not to take into account the value of goodwill created by the tenant's occupation or the value of the tenant's fixtures and fittings.”*

The Valuer noted that it was appropriate for him to consider the new gaming structure that came into effect in Victoria on 16 August 2012 as it was common knowledge and that the Tenant had committed to the purchase of 40 gaming entitlements at auction in May 2010. Therefore, the Valuer calculated revenue on the basis of the old gaming structure from 1 February 2012 to 16 August 2012 and the new gaming structure thereafter to 1 February 2017.

The Valuer then explained the “long established valuation practice within the hotel industry” of the use of an earnings based methodology EBIDTAR (Earnings Before Interest, Depreciation, Taxation, Amortization and Rent) as his basis for the valuation of current market rent for the Epping Hotel.

The Valuer also considered the following assumptions in his EBIDTAR methodology (1) the possible impact of pre-commitment policy, and (2) a good average standard of management ultimately stating:-

*“Hotel premises are, largely by the nature of their design, specialised improvements. It is my observation over many years that the industry measures value and rental on the basis of trading propensity and operational profitability, assuming good average standard of management. In my view given this market norm, the current market rent for the Epping Hotel should be assessed on the same basis.*

*Therefore, a significant component of this rental determination is the assessment of a reasonable trading level for the Epping Hotel.”*

The Court held at paragraph 29:-

*“....., for example, if a valuer used the Gross Turnover rental approach then based on transactional evidence, 7% to 9% of the gross turnover from bar sales would go towards rent, in accordance with broad industry parameters, as would 16% to 18% of the gross turnover from gaming commissions. On the alternative EBIDTAR rental approach the equivalent broad industry parameters would indicate that 38% to 40% of the EBIDTAR would go towards rent.”*

At paragraph 35:-

*“The valuer decided to apply a 38% rental ratio to the EBITAR for the Epping Hotel for the period up to 15 August 2012 and a decreased rental ratio of 34% to the EBIDAR for the period from 16 August 2012 onwards”*

The Court then went on to state at paragraph 36:-

*“The valuer concluded that the current market rental for the Epping Hotel as at 1<sup>st</sup> February 2012 was \$631,914 per annum plus GST and the current market rental inclusive of GST was \$695,106 (collectively, the market rental determination).”*

This was a substantial increase in rent to the Tenant.

The Tenant originally challenged the market rental determination before the Victorian Civil and Administration Tribunal (“the Tribunal”) on the basis that the Valuer had failed to apply the criteria as set out in section 37 (2) of the Act and was successful at the Tribunal. See [Serene Hotels Pty Ltd v Epping Hotels Pty Ltd \(Retail Tenancies\) \[2014\] VCAT 97](#) .

The Landlord then appealed to the Victorian Supreme Court in [Serene Hotels Pty Ltd v Epping Hotels Pty Ltd \[2015\] VSCA 228](#) with the Landlord being successful. This decision of the Court of Appeal was on the basis of an appeal by the Tenant of the Victorian Supreme Court decision.

The Court of Appeal held:-

*“...The methodology adopted by the valuer is not inconsistent with the Act.”*

The Court further noted at paragraph 35:-

*“...section 37(2) does not demand that a sitting tenant’s fixtures and fittings are simply to be ignored. Rather, it is consistent with section 37(2) to adopt a profits method and recognise that the earnings generated by a tenant will be attributable in part to a tenant’s fixtures and fittings, so long as the value of the tenant’s fixtures and fittings is not reflected in the rent. This can be done by ensuring that the extent to which the tenant’s fixtures and fittings generate the earnings is “cancelled out” when making the final calculation of rent.”*

The series of decisions in this matter has caused considerable discussion and, at times, controversy. It will be intriguing to see whether the approved methodology and interpretation of section 37(2) will be followed and whether it will be followed as a more general principle rather than just the special category of Hotels. The changed gaming environment under this analysis would appear to advantage Landlords. It may be that rental determinations may become more contentious notwithstanding the common lease provision that a Valuers rental determination “will be final and binding on the parties”.

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