

Property Law Update

May 2015

Relief for valuers:

Supreme Court overturns
VCAT decision and confirms
standing practice for hotel rent
determinations under the Retail
Leases Act

On 28 April 2015, Justice Croft of the Victorian Supreme Court handed down the decision of *Epping Hotels Pty Ltd v Serene Hotels Pty Ltd* [2015] VSC 104 which reversed an earlier VCAT decision¹.

The decision confirms that the use of the 'profits method' to determine current market rent for hotel premises complies with the Retail Leases Act 2003 (the Act).

1. Background & issues on appeal

At issue was section 37 of the Act, particularly sub-section (2), which governs the process for rent reviews based on current market rent.

Contrary to common practice within the hotel industry, the VCAT member found that the "profits method" of determining market rent, which involves the valuer taking account of the profits of the sitting tenant, was in contravention of section 37(2) of the Act.

Following VCAT's ruling, leave to appeal to the Supreme Court was granted.

One of the main questions considered on appeal was:

Whether the Tribunal erred in finding that the Act does not allow the methodology employed by the Valuer

¹*Serene Hotels Pty Ltd v Epping Hotels Pty Ltd (Retail Tenancies)* [2014] VCAT 97

2. Legislation

Section 37 is as follows:

“37. Rent reviews based on current market rent

(1) A retail premises lease that provides for a rent review to be made on the basis of the current market rent of the premises is taken to provide as set out in subsections (2) to (6).

(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 willing tenant in an 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.”

3. The profits method

Justice Croft referred to a commentary’s (Hill and Redman’s) description of the nature and rationale of the “profits method”, which they described as involving a three step process:

“(a) An estimate is made of the income from the business. In the case of a hotel this will mean that an estimate is made of the likely income from such sources as the letting of rooms, the restaurant and bars and ancillary functions such as holding conferences or running a health club. In the case of a

casino an estimate will be made of the amount which members of the club will gamble and how much will be retained by the operators.

(b) An estimate is then made of the various expenses and outgoings involved in the operation of the premises. To take again a hotel as an example there will be staff expenses, purchases of items such as food and drink, and outgoings such as fuel, rates, insurance and advertising.

*(c) The difference between the income and the running costs is the net profit. This amount is available for the payment of rent. **The final step is therefore to decide what proportion of the net profit should be taken as that which the willing lessee would be willing to pay as rent.**”*

4. Fixtures and fittings

VCAT identified a major issue in the valuer’s methodology and reasoning stating the valuer had taken into account the value of the tenant’s fixtures and fittings contrary to the requirements of s 37(2). To this Justice Croft noted that the value of fixtures and fittings may be included in the calculations within the profits method if this was done in such a way that their value would effectively be ‘cancelled out’.

The following are key points about the treatment of fixtures and fittings accepted by the Court:

- » Section 37(2) requires the specialist retail valuer to assume that there is a willing tenant bidding on the retail premises;
- » In assessing the market that would bid on the lease, the specialist retail valuer concluded that the hypothetical bidder for the lease would be the operator of an hotel and gaming venue;
- » The valuer had assumed that the hypothetical tenant will derive its income from fittings and fixtures that it owns, not from the sitting tenant’s fittings and fixtures. This is precisely what s 37(2) requires the specialist retail valuer to do, i.e. to disregard the sitting tenant’s fittings and fixtures and assume that the hypothetical tenant will lease a bare shell.

5. Status of the “profits method” of rent valuation

The decision provides much needed reassurance of the appropriateness for valuers to adopt the “profits method” of rent valuation for hotel premises. Justice Croft stated that:

“the authorities and commentaries which have been discussed provide more than an adequate basis for the view that the Valuer has, in the present circumstances, in conducting a rental valuation of hotel premises, approached his task with a methodology and reasoning process which has a firm foundation in the general law as being appropriate.”

Ultimately, the Court found that the Tribunal erred in finding that the Act does not allow the methodology employed by the valuer and therefore the “profits method” remains an acceptable means of determining a rent review for hotels and gaming premises.

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