

# Know-How

## Rent Negotiation

and

## Open Market Rent Review

### **Structure of Guide**

This note is a practical guide as to the multiple factors that determine how an appropriate rental value is reached for a lease in various circumstances. It follows the structure on the attached Graphic.

### **Part I Fundamental Concepts**

Paragraph 1 introduces rent valuation; the definitions used in this note; and the distinction between a Rent Negotiation, a Rent Review and a Rent Determination.

Paragraph 2 summarises what is to be valued, that is, a leasehold interest of premises held on certain contractual terms, and what this means in the context of an Expansion Lease, supplemental agreement and personal rights.

Paragraph 3 sets out the core principles of comparable valuation methodology and how they relate to a Rent Negotiation, a Rent Review and a Rent Determination.

### **Part II Rent Negotiation**

Paragraph 4 discusses the fundamental elements of the lease to be valued, that is, the parties' profiles; the physical characteristics of the leased premises; and the impact of the length of the term.

Paragraph 5 discusses the detailed terms of the lease to be valued and how they may impact the rental valuation.

### **Part III Rent Review**

Paragraph 6 sets out the fundamental principles that relate to a Rent Review, that is, the Valuation Hypothesis; contractual 'interpretation'; the presumption of reality; and the meaning of 'Market Rent'.

Paragraph 7 follows the content of paragraph 4 and discusses how the fundamental elements of the Lease may be deemed to change in the Valuation Hypothesis.

Paragraph 8 follows the content of paragraph 5 and discusses how the detailed terms of the Lease may be deemed to change in the Valuation Hypothesis.

### **Annexures**

Annexure 1 contains a summary of the differences between a Rent Review or Rent Determination process conducted by an expert or an arbitrator.

Annexure 2 contains a summary of the differences in the Valuation Hypothesis between a Rent Review and a Rent Determination.

## Part 1

### Fundamental Concepts

#### 1. [Introduction](#)

##### 1.1 **Definitions**

In this note, we use certain defined terms:

**Category 1 Lease:** A lease of premises of 25,000+sf for a term of more than 3 years.

**Category 2 Lease:**

- (a) A lease of premises of 25,000+sf for a term of less than 3 years; or
- (b) A lease of premises of 5,000 – 24,999 sf irrespective of the term length.

**Category 3 Lease:** A lease of premises of less than 5,000 sf irrespective of the term length.

**Comparable:** A lease, usually but not necessarily, with a third party which will be compared with the Lease or Hypothetical Lease, as applicable.

**Expansion Lease:** A lease to be entered into following the exercise of an expansion option, right of refusal or by separate agreement between the landlord and tenant.

**Hypothetical Lease:** In the case of a Rent Review or Rent Determination only, the hypothetical lease deemed to be created by the Valuation Hypothesis.

**Lease:** the lease that is the subject of a Rent Negotiation, or in the case of a Rent Review or Rent Determination, that contains the Valuation Hypothesis.

**Rent Negotiation:** a commercial rent negotiation for a new or renewed Lease.

**Rent Determination:** An open market rent determination by a third-party expert or arbitrator following the exercise of a right of refusal or the exercise of an expansion option to take additional space.

**Rent Review:** An open market rent determination by a third-party expert or arbitrator on a mid-term rent review or following the exercise of an option to renew.

**Valuation Hypothesis:** the theoretical hypothesis upon which a Rent Review or Rent Determination takes place as set out in the Lease. This takes account of some actual facts, disregards other actual facts and assumes "alternative facts".

**Valuation Date:** the date at which the open market rent is to be set.

#### 1.2 **Aims in a Rent Negotiation**

- (a) **Agreed Rent reflects the Grant.** We must ensure that the rent payable by a tenant reflects all relevant valuation factors appropriately (although this has to be balanced with managing vacancy);
- (b) **Terms of Hypothetical Lease.** Where there may be a future Rent Review or Rent Determination under the Lease, we must ensure that the Valuation Hypothesis will work appropriately and give no opportunity for the tenant to bargain for a rent below the expected market value.

- (c) **Adverse Comparables.** We must avoid creating an adverse comparable within the portfolio. In principle, this is not relevant if the terms of the agreed lease are not disclosed or disclosable. This can therefore be avoided if we:
- (i) do not agree to the registration of the Lease or Expansion Lease (or, if necessary, only agree to register a memorandum of the lease or to keep sensitive provisions in a supplemental agreement);
  - (ii) obtain a confidentiality obligation from the tenant and all agents involved before entering into negotiations and a further confidentiality obligation in the offer letter and the Lease or Expansion Lease; and
  - (iii) provide in the Lease or Expansion Lease that the Rent Review or Rent Determination (respectively) is undertaken by a third-party expert rather than an arbitrator as an expert has no right to order the disclosure of Comparable evidence (in contrast an arbitrator who has such power).

If there is a reason why a rent has been agreed that does not align with the expected market levels, the circumstances surrounding this agreement must be recorded.

### 1.3 Distinction between Rent Negotiation and Rent Review

- (a) **Rent Negotiation.** In a Rent Negotiation, the rent will simply derive from the factual situation based upon the relevant valuation factors. There is no predefined contractual basis setting a valuation hypothesis and there is usually no formal valuation. Nevertheless, an analysis of Comparables against the applicable valuation factors should be undertaken to arrive at the correct rent.
- (b) **Rent Review.**
  - (i) In a Rent Review, the situation is more complicated as it is based upon a contractually agreed Valuation Hypothesis. This is set out in the Lease and thus is a question of contractual interpretation governed by the law. In practice, such rents will usually be settled by negotiation rather than by a formal valuation process. However, the Valuation Hypothesis serves as a backdrop to the negotiation and will inform the parties' respective negotiation positions.
  - (ii) If during the rent negotiations a dispute emerges, the valuation process becomes formal, methodical and contentious. Typically, either party may refer the assessment to an independent third party, and he will determine the relevant rent upon the Valuation Hypothesis. Most Rent Review are carried out by an expert who is an experienced surveyor. Occasionally the Lease provides for an arbitrator to be appointed, in which case the arbitrator may be a surveyor assisted by a lawyer or a lawyer assisted by a surveyor. The differences between an expert determination and an arbitration are set out in Annexure 1.
  - (iii) There are two particular points to bear in mind in relation to a Rent Review process:
    - (A) the determination rests upon the interpretation of the Valuation Hypothesis; and

- (B) the tenant may seek to use the Valuation Hypothesis to leverage a rent that is lower than the anticipated market level; and

A Rent Review is therefore an inherently uncertain process and is always disputatious. Generally, this should only be seen as a fall-back solution if the rent cannot be agreed. That said, a Rent Review involves a two-way risk and the prospect of an adverse decision can help to close a gap between the parties' expectations, particularly if the Valuation Hypothesis gives one party obscure negotiation leverage. Hence our aim is not to give the tenant that leverage.

- (c) **Rent Determination.** The principles that apply to a Rent Review also apply to a Rent Determination although the Valuation Hypothesis will differ. The differences are summarised in Annexure 2 and are not addressed in the main body of this note from simplicity.

## 2. [Valuation of the Lease](#)

### 2.1 **Valuing a Lease not the Premises**

- (a) **Lease.** An open market rent is payable for a *lease* of premises, not purely for the physical premises themselves. A lease is a contractual relationship which creates an interest in land. It is the *interest* in the premises granted by the Lease that has a value. A lease has three *essential* elements: the parties; the premises; and the term.
- (b) **Lease Terms.** In addition to the essential elements, a lease generally sets out the detailed terms of the contractual relationship and these can have a considerable impact on the rent payable.
- (c) **Matrix of Factors.** The terms of the lease do not stand in isolation: they need to be looked at in the context of market expectations for the particular use at the Valuation Date. At the highest level, this will depend largely upon the importance of the lease to the landlord and tenant, which, in turn, is closely related to the size of the premises. In this sense, there is not one market for the use in question. For this reason, we group leases into three broad categories and the terms of the lease are looked at in the context of the market for the applicable category. For example, onerous lease terms will likely have a greater impact if they are included in a Category 1 Lease; they may have a lesser impact if they are included in a Category 2 Lease, and no impact at all if they are included in a Category 3 Lease. It depends upon market norms for the particular lease category.

### 2.2 **Multiple Documents – What exactly is to be valued?**

- (a) **Rent Negotiation.** There may be a number of documents that relate to the same landlord and tenant relationship, such as an Expansion Lease or a supplemental agreement. In a Rent Negotiation for a new Lease, the parties will settle the rent on the basis of whole set of documents. In relation to a Rent Negotiation for an Expansion Lease, the overall position will be considered in the context of the current transaction.
- (b) **Rent Review.**
- (i) **Usual Provisions.** On a Rent Review, the same does not necessarily apply. A Rent Review and the Lease interpretation provisions will usually respectively state:

*"The Premises are available to let in the open market .... on equivalent terms to this Lease".*

*"reference to this **Lease** ..... includes any lease, licence or other document collateral, ancillary or supplemental to this Lease or otherwise entered into by the Parties whether or not under or pursuant to this Lease (**Ancillary Document**)...."*

(ii) *Presumption of Reality.*

(A) Even without this express language, the presumption of reality presumes the Hypothetical Lease will be on the terms of the Lease (see paragraph 6.3). The Lease as originally completed may have been varied or supplemented including by a deed of variation, a supplemental agreement or a deed of surrender. In this case, the varied or supplemental lease will be "this Lease". In addition, certain other documents may be completed pursuant to the Lease, such as a Consent to Alterations or Deed of Direct Covenant, which may not vary the Lease but sit alongside it.

(B) If the further lease is not expressed implied to be ancillary to the earlier lease or if the said interpretation provision is not included, there may still be an implication that the lease and the additional lease are deemed to form one demise if their terms cross-refer in a substantial way, for example, if there is a sub-letting right that applies in aggregate across several leases such as a right to sub-let 20% of the aggregate space leased. This could apply even if the multiple leases do not have the same Rent Review date, the rent could be assessed on the basis that it forms part of larger space even if there is no rent to be ascertained for the second space on the relevant review date.

(iii) <sup>1</sup> *Collateral Agreement.* A collateral agreement is an agreement for which the consideration is the signing of another agreement. For example, a plant room licence is collateral to a lease if the consideration for the licence is the signing of the lease. The collateral agreement may not be mentioned in the main agreement (in our example, the lease) but it will be a binding agreement if the promisor intended it to be legally binding and if the promisee entered into the main contract in reliance on this<sup>2</sup>. For example, the landlord intended to be bound to grant the tenant use of a plant room and the tenant only signed the lease in reliance on this. The usual elements for the formation of a contract are required (See Legal Note – Contract Formation). A collateral agreement must be consistent with (and not vary or contradict) the terms of the main agreement.

(iv) *Ancillary Agreement or Supplemental Agreement.*

(A) These are interchangeable terms. An ancillary or supplemental agreement is entered into in addition to a pre-existing agreement and must include terms relating to the original agreement. It will be

---

<sup>1</sup> **Action:** Check law.

<sup>2</sup> **Action:** Check if a statement is needed for this.

subordinate to the original agreement and will terminate if the original agreement terminates. It must be supported by consideration. The ancillary or supplemental agreement either clarifies, supplements or varies the original agreement, for example, by granting special lease terms relating to dedicated areas and facilities, alienation, rent free periods or capital allowances.

- (B) Express language will usually be contained in the ancillary or supplemental agreement that it will be supplemental to the main lease. However, even without express language, this may be implied if the separate agreement cross-references to the main lease, for example, the grant in a separate agreement of dedicated rights to use risers to serve the leased premises.
- (C) If a lease of additional premises is to be granted, this will be by way of Expansion Lease as an amendment of the lease may attract repeat stamp duty (it may be considered to amount to a surrender and regrant) and the practice is that an Expansion Lease is stamped as a stand-alone lease.

(v) *Effect on Valuation.*

- (A) If a collateral, ancillary or supplemental agreement is expressed or implied to be part of the Hypothetical Lease, any special rights which it grants would be considered in the valuation. Most such rights will favour the tenant and this will tend to have an upwards effect on the rent. However, the converse is also true. The inclusion in such an agreement of rights adverse to the tenant, for example, a landlord's termination right or a right to relocate a retail tenant, may have a downwards effect on the rent.
- (B) If a lease of additional premises is expressed or implied to be ancillary to the main lease, the premises to be valued will be the area demised by the Lease and the additional premises.

## 2.3 'Personal rights'

- (a) **Rent Negotiation.** If a right is expressed to be 'personal' to the tenant in question, then it is likely it benefits the initial tenant only rather than its successors in title or assigns. In this case, however, if the tenant has rights to sub-let or assign and the rights are fundamental to the use of the premises, such as rights to use dedicated service media or rights to use a specific service lift for a warehouse, then the practicality of the sub-let or assignment right may be effected which, in turn, may affect the value of the sub-letting or assignment right.
- (b) **Rent Review.** On a Rent Review, the position is unclear. It may be that the valuer considers that the personal right does not benefit the hypothetical tenant and is instead limited to the initial tenant. This may depend upon the exact nature of the right in question including whether its absence from the Hypothetical Lease would substantially prevent or limit the use of premises. An alternative interpretation may be the hypothetical tenant could benefit from these rights but not pass them onto a sub-tenant or assignee although this would likely only to be arguable if there is a sub-letting or

assignment right. In either case, there would be uncertainty as to the correct interpretation which could result in leverage for the tenant.

### 3. Core Principles of Comparable Valuations

#### 3.1 Methodology

- (a) **General Approach.** A comparable valuation methodology is usually adopted to arrive at the rent although in cases where there is no Comparable at all, other valuation methods may be used. This applies, in theory, to a Rent Negotiation, a Rent Review and a Rent Determination although the process is usually more informal on a Rent Negotiation. Comparable valuation methodology involves trying to ascertain a rent by comparing the terms of agreed leases with the terms of the Lease or Hypothetical Lease (as applicable). The aim is to compare like with like and to adjust unlike Comparables so they match as far as reasonably possible the Lease or Hypothetical Lease.
- (b) **Core Elements.** The analysis forms five core elements that apply to analysis of the rent payable for the Lease or the Hypothetical Lease:
  - (i) The economic context in which the transaction is, or is deemed to be, negotiated, that is the overall market conditions including current and anticipated market trends at the Valuation Date;
  - (ii) the nature and characteristics of the parties (see paragraph 4.1);
  - (iii) the physical characteristics of the premises (see paragraph 4.2);
  - (iv) the term of the lease (see paragraph 4.3); and
  - (v) the detailed terms of the lease (see paragraph 5).
- (c) **Adjustment.** One or more Comparables are then compared against the Lease or the Hypothetical Lease. An adjustment may then made to the rental value of certain elements of the Comparable against the same elements of the Lease or the Hypothetical Lease in the form of a percentage deduction or valuation. If the Comparable grants more favourable rights in a particular respect, an amount is deducted from the Comparable and vice versa. In this way, the Comparables are brought into line with the Lease or the Hypothetical Lease and a range of rents for similar transactions is established. Sometimes further analysis is undertaken to work out the amount of the percentage adjustment for a particular element to be valued, for example comparing leases with a certain ceiling height against others with a lower ceiling height.
- (d) **Analyse.** The Comparables are plotted onto a graph and any obvious outliers removed from the analysis. A judgement call is then made as to the rent for the Lease based on the evidence. The normal tolerance for accuracy is 10% either way.

- 3.2 **Economic Context.** A lease transaction will take place against a market backdrop. A matrix of inter-linked factors will affect market confidence and the approach of both the landlord and tenant and these include:

- (a) excess or limited supply and demand of premises for lease – this will be looked at in the context of the size and use of the subject premises;
- (b) macro-economic circumstances, for example, geo-political impacts, interest rates, and alternative markets; and
- (c) specific Government policies, for example, to widen permitted uses for industrial buildings, or covid restrictions.

### 3.3 **Valuation Date**

- (a) **Relevance.** The valuation will take place at a particular date whether on a Rent Negotiation, a Rent Review or Rent Determination. Usually, rental markets will follow a trend upwards or downwards but occasionally there can be a major event that swings the market dramatically on a particular day. In this case, the Valuation Date can be very relevant. All valuations will however, involve an element of trying to foresee future rental trends in the changing economic context over the period for which the rent is being set. Sometimes the rent can be agreed many months before the term start date especially for a Category 1 Lease. This is relevant in analysing Comparables for if the Comparable rent was agreed a considerable period before the term start date of the Comparable, it will have inevitably involved a degree of estimating the future rent at the term start date and therefore becomes suspect evidence.
- (b) **Depends on Transaction Type.**
  - (i) **Rent Negotiation.** In a Rent Negotiation, the Valuation Date is the date when a binding commitment is reached between the parties. This is the date that a binding commitment for the final rent is reached. This may be:
    - (A) the date of a binding offer letter or agreement for lease, or if the rent is renegotiated following an earlier binding agreement, the date a binding commitment for the final rent was first agreed.
    - (B) If there is no binding offer or agreement for lease, the date the tenant is allowed into possession or the date of the lease itself, whichever is earlier.
  - (ii) **Rent Review.** The Valuation Date in respect of a Rent Review is a particular date set in the Lease. This will usually be the last day of an applicable rental period.
  - (iii) **Rent Determination.** The Valuation Date in respect of a Rent Determination is a date to be determined in accordance with the procedure for the expansion option or right of refusal in the Lease. This will usually be the first day of the relevant term of the Expansion Lease.

### 3.4 **Comparable Lease Evidence**

- (a) **Weighting.** Not all Comparables will have the same evidential weight. The following transaction types are weighted in descending order of relevance:
  - (i) a new lease in the open market;
  - (ii) a negotiated renewal Lease or negotiated Expansion Lease whether or not pursuant to an option to renew or a right of first offer or refusal. In the case of a renewal lease, "tenant inertia" may come into play and the tenant may agree a

higher rent to avoid reinstatement and fitting out costs and the upheaval and cost of moving. In the case of an Expansion Lease, the tenant may have particular needs to expand within the building and there may therefore be an element of it making a "special bid"; and

- (iii) a mid-term reviewed rent<sup>3</sup> - the rent may have been a fixed incremental pre-set rent agreed several years earlier or, if it is an open market review, will either have been determined on the basis of or influenced by the applicable Valuation Hypothesis, and could have been subject to a cap or collar.
- (b) **Most Comparable Valuation Date.** Ideally the valuation date for the Comparable will be identical to the Valuation Date.
- (c) **Most Comparable Premises.** Ideally the premises leased by the Comparable will be identical to the subject premises, that is in the same building; of the same size; and with the same physical features.
- (d) **Most Comparable Lease Terms.** Ideally the lease terms of the Comparable will be identical to the Lease or the Hypothetical Lease including financial terms, special terms and restrictions.
- (e) **Adjustments.** It is unlikely that there will be a complete match in all the relevant factors and the valuation will usually therefore include an adjustment to reflect the value of the applicable differences – either upwards or downwards.

---

<sup>3</sup> On a ROFO – the rent may just be negotiated.

## Part 2

### Rent Negotiation

#### 4. Fundamental Elements of the Lease

##### 4.1 Parties.

- (a) **General.** A Rent Negotiation is, of course, conducted between actual parties who will have specific characteristics. For example, the landlord may have a vacancy rate that exceeds the overall market vacancy rate at the Valuation Date and consequent shareholder pressure. The tenant, on the other hand, may not be able to find other space of the size and amenity that it requires and is under pressure to enter into a lease due to its particular business needs. These pressures will factor into the rent to be agreed.
- (b) **Landlord Profile.**
- (i) *Landlord's Vacancy.* The landlord will have the vacancy that exists in its portfolio at the Valuation Date and will consider the vacancy forecast during the lease term. This will be considered not just in respect of the building but also the jurisdiction (and ultimately whole portfolio). The landlord will also be aware of the need to create applicable Comparables for upcoming valuations.
  - (ii) *Risk.* The landlord may be conscious of the risk profile of a particular industry at the Valuation Date. If the landlord considers that a particular type of tenant is a higher risk in a particular market, for example hedge funds or new retailers, then this will influence the rent and other deal terms eg a larger security deposit may be required.
- (c) **Tenant Profile.** The tenant may have a special interest in the space, for example, it may have nearby premises and wish to consolidate or expand certain operations which means the premises have a value for that tenant that exceeds the rent otherwise obtainable in the market. This is particularly important where premises are occupied as one unit but held under two or more leases. The rent payable by the tenant may then exceed market levels. This should be recorded so that any explanation of the outlier rent is included in the Comparable reports.

##### 4.2 Premises

- (a) **Development and Building Physical Characteristics.** The location of the building and its design and manner of construction will impact the rent valuation, particularly in the context of the permitted use for the premises. The relevant physical characteristics include:
- (i) the overall character of the district in which the building is located;
  - (ii) the age, grade and use of the building and development;
  - (iii) MEP provision (especially redundancy) and other amenities of the building and development;
  - (iv) on-site monthly licensed parking or public parking;
  - (v) off-site public parking;
  - (vi) access to MTR/rail/other public transport and whether any access is covered;

- (vii) walking time to MTR/rail/other public transport;
  - (viii) loading and unloading facilities and delivery waiting times (especially for industrial and godown use);
  - (ix) lift service - number of lifts, speed and capacity (especially for industrial and godown use).
- (b) **Development and Building Non-Physical Characteristics.** Other non-tangible factors may also impact the rental valuation although this factor will only be relevant in comparing the Lease to Comparables in other buildings. These include:
- (i) whether the building is in single or multi-ownership - buildings in multi-ownership tend to have less efficient management given the need to involve the owners in decisions; there is usually less scope to accommodate the tenant's expansion needs; and the likelihood of a sale of the reversionary interest, in whole or in part, is greater (a part reversionary sale is particularly problematic for a large tenant as it would be left dealing with multiple landlords);
  - (ii) the standard of management services;
  - (iii) security standard, which will be a significant issue for larger tenants (particularly in the finance industry); and
  - (iv) the lawfully permitted use of the building and development (see paragraph [REDACTED]).
- (c) **Physical Features of Premises.** The physical nature of the leased premises will impact the rental valuation. These relevant factors include:
- (i) floor height;
  - (ii) view;
  - (iii) access of light;
  - (iv) floor plate, layout and efficiency;
  - (v) floor loading (especially industrial and go-down use); and
  - (vi) ceiling height (including restrictions on height in certain parts).
- (d) **Size of Premises.**
- (i) *Quantum Discount.* The size of the premises to be valued raises the question as to whether a quantum discount should be given. Usually there is some discount for large space but the extent of the discount depends upon several factors:
    - (A) the economic context at the time the rent is to be determined (see paragraph 3.2(a)). Whilst the phrase 'quantum' refers to size, it is in effect a discount in consideration of the security of future income that the landlord will receive. In a stronger market, rental insecurity is a lesser concern.
    - (B) How much impact the lease will have on the vacancy rate within the landlord's portfolio and whether it is willing to discount the rent to bring this down (see paragraph 4.1(b)(i)).

- (C) The negotiation position of the parties and whether a discount is necessary to 'induce' the tenant to lease the premises.
- (D) The terms of the Lease and, in particular, if the tenant has extensive surrender rights, a quantum discount may be reduced as there is less rental security for the landlord.
- (ii) *Ancillary Space.* In addition to the premises granted by the Lease, there may be ancillary leases and licences of space granted at or around the same time as the Lease to the tenant. These should be considered as a whole in the context of a Rent Negotiation (see paragraph 2.2(a)).
- (e) **Detailed Condition of Premises.** The leased premises will be valued in the condition set out in the Lease as at the term start date.

#### 4.3 Term

- (a) **General.** The length of the term is one of the yardsticks against which the other provisions of the Lease are assessed. There is a cluster of factors to be considered alongside the length of the term, including:
  - (i) the size of the premises;
  - (ii) the tenant's flexibility rights (surrender, expansion, rights of refusal, sub-letting and assignment);
  - (iii) the scope of the tenant's additional rights (eg signage);
  - (iv) the scope of the landlord's rights (eg termination on sale or redevelopment); and
  - (v) other restrictions in the Lease.
- (b) **Landlord's Termination Rights - Sale and Redevelopment.**
  - (i) *Effect on Rent Valuation.* If the Lease contains a right for the landlord to terminate in the event of a sale or redevelopment, this may affect the rent due to the fact that the tenant actually only has security of tenure for a period of 6 months which would affect the amortisation of its fit-out costs. Where the sale and redevelopment right cannot be exercised for a set period at the beginning of the term, any adverse effect on rent would be lessened depending upon the length of the no exercise period. Likewise, if compensation for lost fit-out costs were to be payable, this would likely lessen the adverse effect.
  - (ii) *Likelihood of Exercise.* If it can be successfully argued that the landlord's sale and redevelopment right is unlikely to be exercised, the adverse effect will likely be lessened. This itself depends upon the economic context at the Valuation Date. For example, including the vacancy rate, interest rates and market rental levels in relation to the rent payable under the Lease.

### 5. Detailed Lease Terms

#### 5.1 Use

- (a) **Use clauses.** The use clauses in the Standard Lease for office, industrial and warehouse space are broadly drawn. In the context of mall retail space, the permitted uses will be more restrictive to enable us to control the tenant mix. In this case, the use could impact

the base rent payable as not all retail uses are equally profitable but lower value uses may be acceptable for overall destination attraction.

- (b) **Possibility of landlord's consent.** In considering restrictive clauses or the absence of flexibility expected in the market, the possibility of obtaining the landlord's consent is to be ignored unless that consent cannot be unreasonably withheld. For example, an absolute covenant not to sub-let (ie a covenant which does not provide for the landlord's consent not to be unreasonably withheld) would legally restrict all sub-letting. In the context of a long lease of a large premises, this may have a negative rental effect. [There may be a similar but less marked impact on a Rent Negotiation.]
- (c) **Goodwill.** The valuer must disregard any goodwill attributable to the Premises by the Tenant's business. Goodwill is only relevant to retail premises. Goodwill is the expectation that existing customers of a business will continue. So the tenant wants goodwill to be disregarded. If not, it could lead to an increase in rent. Consider what goodwill is disregarded – sometimes it is only accrued goodwill from after the start of the lease which may limit the discount.

## 5.2 Financial Terms

- (a) **Tenant's Payments.**
- (i) The rent will take into account the total occupancy cost, that is the total costs in respect of rent, management charges, rates and Government rent.
  - (ii) Note that if the building is in multi-ownership there may be two levels of management charge – those charged by the building management and those charged by the landlord in respect of its owned property.
  - (iii) In relation to Government rent, note that this is not a charge payable for all buildings (essentially those held under a pre-1898 land grant will only be liable to pay nominal Government rent).
- (b) **Incentives.**
- (i) *Types of Incentives.* There are broadly two types of incentives:
    - (A) an allowance to the tenant for a period where it is fitting out the premises and cannot move into them, so that it does not pay rent when it is not operating its business from the premises;
    - (B) a financial inducement to take the premises, that is, in effect to disguise the true market rent. A financial inducement can take several forms: a period of early occupation under a licence; a rent free period; a capital allowance; and a payment for certain capital works by the landlord. This has the effect of disguising the true (lower) rent by keeping the headline (or face) rent high but allowing for a lower effective rent. In certain market conditions and for certain lease types, a rent-free period can go well beyond the time needed for fitting-out.
  - (ii) *Analysing Inducements on Rent Negotiation.*
    - (A) *Consideration of Inducements in Comparable Transactions.* On a Rent Negotiation, in considering Comparable Transactions, any rent free

periods or other incentives included in a Comparable must be analysed and adjusted to reflect the circumstances of the Lease.

- (I) In terms of rent free fitting out periods, you need to try to assess how long it would have taken to fit out the comparable premises and whether this period is properly reflected in the rent free period. Any rent-free period in excess of the time needed to fit out, is in the nature of an inducement.
- (II) If there is an unexpired mid-term rent free period, this would generally be in the nature of an inducement, unless for some reason the initial rent-free period was shorter than the time needed to fit-out which would be unusual.
- (iii) *Assessment of the Effective Rent.* The effective rent is usually a simple calculation whereby the total rent payable over the entire term is divided by the number of months in the term. However, various other factors also play into the calculation of the true effective rent:
  - (A) mid-term rent free periods being calculated in a rental period following an open market rent review;
  - (B) where there are fixed rental increments, the adjustment of the inducement over the period of the initial rent period or the entire term, and ensuring that a like for like comparison is made;
  - (C) any rent-free period has been 'clawed back' due to the tenant's breach of any conditions to which it is subject;
  - (D) management charges not being payable, being discounted, or not subject to increase during the term;
  - (E) out of hours air-conditioning charges not being payable;
  - (F) rates not being payable (if they are payable by the tenant as the default position under the lease);
  - (G) Government rent not being payable (if it is payable as the default position under the lease).

The effect of extended, capped or discounted air-conditioning hours is not usually taken into account in working out the effective rent as the impact is usually limited. However, this may be 'bundled' into an overall adjustment for favourable lease terms.

### 5.3 Flexibility

- (a) **General.** The flexibility rights that a tenant may expect will relate to the size of the premises and the length of the lease term. The tenant will consider both its potential expansion and contraction needs over the duration of the term.
- (b) **Surrender.**
  - (i) Not all surrender rights are equal. The more flexibility granted to the tenant, the greater the valuation impact may be, especially if the configuration of the

surrender premises impacts our ability to relet that space readily. If the landlord has absolute control over the surrender premises, this could lessen or negate the incremental valuation impact depending on the extent of the control retained.

- (ii) There are four main groups of issues to be considered:
  - (A) *How much space can be surrendered and when?* The surrender space may be the whole of the Premises only; part of the Premises only; or the whole or part of the Premises. The right will always be exercisable after a specified date but in addition, there may be limits to the space that can be surrendered within particular periods of the term.
  - (B) *If the tenant can surrender part of the premises; what part is that?* This question arises whether the right is for a surrender of part only or the whole or part. First, there will always be a minimum area and a maximum area that can be surrendered. Secondly, you need to look at the surrender premises both vertically and horizontally and consider the order in which areas may be surrendered. whether the right can be exercised once or on multiple occasions. the configuration of the retained premises. Is it subject to the landlord's consent in terms of configuration and can that consent be withheld?
  - (C) *Is lease varied on a surrender and how?* This could include reduced special rights.
  - (D) *Is any compensation payable by the Tenant?* If compensation is payable by the Tenant, this reduces the benefit to the Tenant and this will be assessed in relation to the earliest possible surrender date and the amount of space that can be surrendered at that time.
- (iii) The rental value involves looking at these factors as a cluster. For example, a surrender of 50% of the premises, even if exercisable only once on a specified date, could have a higher value than a 20% surrender right exercisable at any time, depending upon the size of the premises and configuration of the area that will be retained.

### Part 3

#### Rent Review

##### 6. Fundamental Principles of Rent Review

###### 6.1 Valuation Hypothesis

- (a) **Mix of Facts and 'Alternative Facts'.** A Rent Review takes place upon a Valuation Hypothesis. This is a mix of actual facts and hypothetical circumstances. For example, the Valuation Hypothesis will:
- (i) value the actual premises but assume they are in a *hypothetical condition* (for example, unfitted);
  - (ii) assume the premises are granted on the terms of a *hypothetical lease* which will include most of the terms of the Lease but not all of them (for example, the rent free period granted under the Lease).
- (b) **Reasons.** The reason for this is that the actual condition of the premises and the actual terms of the Lease would skew the rent that should fairly be payable on a mid-term rent adjustment or the exercise of an option to renew, an expansion option or a right of refusal. The reasons for and effect of the various assumptions and disregards found in the Valuation Hypothesis are referred to below.

###### 6.2 Contractual Interpretation

- (a) **Hong Kong Law.** The usual rules of contractual interpretation will apply. These rules are based in the common law. In terms of precedent, the cases determined by the Hong Kong courts are binding on the lower courts. Cases determined in the UK, Australia and other common law jurisdictions are not binding in Hong Kong but are of persuasive authority.
- (b) **General Interpretive Rules.** In Hong Kong, the following general principles of contractual interpretation apply:
- (i) The aim is to find the meaning of the document based upon how a reasonable person would interpret it and to give effect to the commercial intent of the parties as expressed in the document.
  - (ii) The background in which the document was negotiated can be taken into account but evidence of the negotiations and the subjective intent of the individual parties is inadmissible.
  - (iii) The courts will not rewrite the contract; if no other interpretation is possible than one which seems commercially unreasonable, then they uphold that interpretation.
  - (iv) On a dispute as to the interpretation of the Valuation Hypothesis, the courts will seek to avoid an interpretation that would give a windfall benefit to one party that it would not receive on an open market rent negotiation.
- (c) **Little chance to appeal.** However, a lease is unlikely to come before the courts for interpretation. Although it is theoretically possible to seek a declaration as to the interpretation of a lease, this is not normal practice. Usually, the lease will be interpreted

by the independent expert (who is not a lawyer but may potentially appoint one to assist him) and it would only be capable of appeal if the expert went “outside his remit” – which means the expert has answered the wrong question (not that he has got the answer wrong). As mentioned, interpretation issues tend to be matters of leverage in the rent negotiations and, given the difficulty in appealing an expert determination, that leverage can be significant and for this reason, we must avoid giving a tenant such an opportunity to leverage a lower than market rent.

#### 6.3 Presumption of Reality

- (a) **Lease Applies Absent Contrary Intention.** As well as the usual rules of contract interpretation, under the Common Law, the Rent Review provisions will be construed on the basis of what is known as ‘the presumption of reality’. This means that the Hypothetical Lease will be assumed to be on same terms as the Lease, other than the amount of the rent, unless the Lease clearly states otherwise. This reflects the commercial intent which is the tenant is to pay rent at current levels for the lease it actually has.
- (b) **Effect of Presumption.** The presumption of reality could have an upwards or downwards effect on rent on a Rent Review. When negotiating a New Lease, we need to consider whether its terms are properly adapted in the Valuation Hypothesis to produce an appropriate open market rent. We must be alert to whether the standard Rent Review provision needs adjustment.

#### 6.4 Market Rent

- (a) **Meaning.** The Standard Lease requires a determination of the *open market rent*. Reference to an “open”, “fair”, “full”, “market”, “open market” and “highest” rent all mean a rent payable in the open market. The *highest* rent obtainable on the open market is the open market rent. This includes an exceptionally high offer from a tenant with a special interest, for example a tenant with adjoining or neighbouring space for whom the premises have particular value.
- (b) **Reasonable Rent.** However, a ‘reasonable’ rent may not take account of an exceptionally high rent in a Comparable<sup>4</sup>. This is not acceptable wording under our Policies.

### 7. Fundamental Elements of the Hypothetical Lease

#### 7.1 Parties

- (a) **General.** The parties to the Hypothetical Lease are *not* the actual landlord and tenant. They are hypothetical people or companies – an abstraction. In order to find the market rent, the common law<sup>5</sup> assumes a landlord willing to grant the lease and a tenant willing to take premises on terms of the Hypothetical Lease. Even if in reality no landlord or tenant would enter into a lease on the hypothetical terms, it must be assumed that there are two willing parties and that the Hypothetical Lease will be agreed.

---

<sup>4</sup> Ponsford v HMS Aerosols Ltd. (1979)

<sup>5</sup> FR Evans (Leeds) Ltd v English Electric Co Ltd (1978) 36 P&CR 185

- (b) **Hypothetical Landlord's Profile.** The common law describes the characteristics of the hypothetical parties. The hypothetical landlord is willing to enter into the transaction but is not desperate to do so. A willing hypothetical landlord is not forced to let the premises but it is also not prepared to wait until the market improves. It wants to do the deal and it is not impecunious – in other words this is not a forced lease and the hypothetical landlord would not need any inducement from the tenant to lease the premises<sup>6</sup>. As a result, the valuer does not have to consider if the actual landlord has an overall large vacancy as it is simply willing to enter into the lease. However, see the comments in relation to the bargaining position below.
- (c) **Hypothetical Tenant's Profile.** Likewise, the willing hypothetical tenant is actively seeking premises but not under any pressure to sign a lease. It will not pay more than is necessary. Note that there is nothing under the common law that prevents the actual tenant from bidding for the space. The actual tenant will be deemed to have vacated the premises and therefore may be in the market for similar premises (unless the evidence shows that this would not be the case, for example, if it is outsourcing certain functions or moving them to a lower cost jurisdiction).
- (d) **Bargaining Position.** The hypothetical parties are, however, operating in the real market. Whilst there is assumed to be at least one willing tenant in market, it will only pay what the market requires it to. It will be aware of state of market and its bargaining position. Likewise, the hypothetical landlord will consider the vacancy that will arise if the letting does not go ahead. It becomes a judgment call then as to how far the two parties are prepared to negotiate – they both want to do the deal at the right rent.

## 7.2 Premises

- (a) **Development, Building and Premises Physical and Non-Physical Characteristics.** The factors referred to in paragraphs 4.2(a) – (c) apply equally to a Rent Negotiation.
- (b) **Size of Premises.**
  - (i) *Assumption of Leasing in Whole or Part.* The factors referred to in paragraph 4.2(d)(i) in relation to a quantum discount may be adapted in the Valuation Hypothesis which will usually assume that: “*the Premises are available to let in the open market .... as a whole or in parts*”. The Hypothetical Lease may therefore diverge from reality. In the case of a Category 1 Lease or a Category 2 Lease, if the Valuation Hypothesis contains this assumption, the hypothetical landlord could theoretically divide the space and let it to a number of smaller tenants. In relation to a Category 3 Lease, division of the space would not usually be feasible and so in this case, the assumption would be of limited or no effect.
  - (ii) *Effect on Valuation.* This assumption may have the effect of avoiding a quantum discount or avoiding any deemed pressure due to the hypothetical landlord's potential vacancy. This, however, needs to be considered in the context of the length of the hypothetical term (see paragraph 7.3). In the case of a smaller unit, if the hypothetical term is longer than would be usual, the beneficial effect of the assumption could be countered as the hypothetical tenant's longer commitment

---

<sup>6</sup> Northern Electric plc v Addison [1997] 2 EGLR 111; Marklands Limited v Virgin retail [204] 2 EGLR 43

would be a consequent risk and opportunity cost to the tenant. This itself needs to be considered in light of other provisions in the Hypothetical Lease which could be considerably more favourable than a tenant of smaller premises would generally expect with a consequent incremental effect on the rent.

- (iii) *Effect of a Surrender.* If the tenant has surrendered part of the premises, the 'Premises' will be redefined to mean the reduced space (and even if this were not the case, the presumption of reality would generally assume this).

(c) **Condition of Premises.**

- (i) *Summary of Assumptions and Disregards relating to the Condition of the Premises.* On a Rent Review, the deemed condition of the premises diverges considerably from reality. The Lease will usually include certain assumptions and disregards that relate to the condition of the premises, all of which need to be considered together to establish the rent. The overall intent is that there is no windfall for either party and the tenant will not pay rent on its own works. The applicable assumptions and disregards are:

- (A) an assumption that the premises are vacant;
- (B) a disregard of the tenant's occupation;
- (C) a disregard of the tenant's works;
- (D) an assumption that the premises are fitted;
- (E) an assumption that the parties have complied with their repair obligations; and
- (F) an assumption that any damage has been reinstated.

These are discussed in the following paragraphs.

(ii) *Assumption of Vacant Possession.*

- (A) The Valuation Hypothesis will usually include an assumption that: "*the Premises are available to let ... with vacant possession (the Tenant having removed all Installations it has installed)*"
- (B) 'Installations' will usually include "*any item, apparatus, plant, machinery, equipment or appliance attached to or serving the Premises, the Building or the Development from time to time including [a broad list of included items] .....whether installed by the Landlord, the Tenant or any third party at any time including before the Term Start Date and whether or not for the permanent improvement of the Premises or Building but excluding the Existing Furniture and the Tenant's Chattels.*" This definition is essentially referring to fixtures but it avoids the ambiguity as to exactly what comprises a fixture at law.
- (C) 'Vacant Possession' is a legal concept that refers to:
  - (I) the removal of tenant's fixtures from the premises; and
  - (II) no person having physical possession of the premises or any rights of possession in the premises.

- (D) It is necessary to assume that there is no tenant of the premises as otherwise this would impact the rent that an incoming hypothetical tenant would pay (for occupied premises). However, the common law goes further in assuming, contrary to reality, that the tenant has removed any items that the tenant is *entitled* to remove under the delivery back clause.<sup>7</sup>
- (E) The tenant will usually be required to leave the premises complete with all Installations but it must remove "*if the Landlord so requires all or any Installations, Works and Signs at the Premises or Building carried out by the Tenant, any sub-tenant or occupier of or under the Tenant at any time*". Sometimes there may be express exceptions to this. The tenant is therefore usually entitled to remove its own chattels and unfitted items. The remainder forms part of the premises and would be taken into account in the determination of rent under the vacant possession assumption.<sup>8</sup>
- (F) As the Hypothetical Lease specifies the handover condition of the premises, the rent will be set on the implied assumption that the premises will be in that condition at the term start date. However, sometimes the premises may have been handed over in a fitted condition in which case the fit-out will be valued as there is deemed to be a tenant that wants the premises in that condition and it will not have to bear the costs of fitting out the premises. Any unfitted furniture will not be valued as it is not part of the Premises.
- (iii) *Disregard of the Tenant's Occupation.* As mentioned above, due to tenant inertia, a tenant in occupation may pay more to avoid the expense and disruption of moving (which may lead to a higher rent) and the disregard avoids this effect. The same result may be achieved by the vacant possession assumption but the slight distinction is that the vacant possession assumption refers to the condition of the premises and the disregard of the tenant's occupation also refers to the tenant's approach to a new lease of the same premises. It is standard practice to include a disregard of the tenant's occupation. It does not mean that the actual tenant is not a bidder in the open market (unless any bid by the actual tenant is expressly disregarded (which would be unusual)).
- (iv) *Disregard of Tenant's Works.*

<sup>7</sup> 99 Bishopsgate Ltd -v- Prudential Assurance Co Ltd IEGLR 72CA

<sup>8</sup> If this provision is changed so that the tenant is entitled to remove its fixtures and fittings, then the interpretation of the assumption this will depend upon what amounts to a fixture at common law – see *Know How Fixtures and Fittings*. A fixture is an item *affixed* to property which cannot be removed without causing irreparable damage to item itself or to the property (eg an air-conditioning system or marble cladding). If an item is not a fixture it has either become part of the building itself (eg windows or stairs) or is chattel (eg telephone system, desk). There are two categories of fixture:

- *Tenants' fixtures:* a fixture installed by *the tenant* for the purposes of *its trade or business* eg demountable partitions and fixed filing cabinets.
- *Landlords' fixtures:* a fixture that is *not a tenant's fixture*. Note that *landlord's fixtures* can be installed either by the landlord or tenant.

- (A) The Valuation Hypothesis will usually include a disregard of: "*any effect on rent attributable to any Works<sup>9</sup> to the Premises carried out by the Tenant at the Tenant's own expense during the Term with any Required Consents (other than pursuant to an obligation to the Landlord or its predecessors in title);*"
- (B) This disregard therefore negates, to some extent, the effect of the vacant assumption in relation to the effect on rent of the tenant's works with the intent that the tenant should not pay rent for works which it has undertaken at its own cost. Note that:
  - (I) "any effect on rent" relates to either a beneficial or detrimental effect;
  - (II) the 'Tenant' is usually defined to include "*the original Tenant and its successors and assignees*" and the disregard would therefore include works undertaken by an assignor of the lease to the current tenant;
  - (III) the disregard would also include works undertaken by the tenant itself or its predecessors in title under a previous lease ie a tenant who had assigned the previous lease to the Tenant<sup>10</sup>.
- (C) However, the disregard is limited and would exclude the following works.
  - (I) works carried out under an earlier lease, an agreement for lease or an early occupation licence period;
  - (II) works carried out by the landlord at the tenant's expense (usually base building upgrade works which the landlord will carry out and the tenant will pay for);
  - (III) works carried out by a previous tenant under a previous lease which was not vested in the tenant (these are owned by the landlord);
  - (IV) works carried out under an obligation to the landlord. This therefore covers fit-out works (unless the Lease contains an exception "*other than a fitting-out obligation*"), reinstatement of works from a previous tenant and other works that a tenant is obliged to do; and
  - (V) works paid for by the landlord – the landlord may in some cases give a capital allowance for certain works as an incentive but then these works would be taken into account in the determination of rent.

---

<sup>9</sup> Note the language used is "Works" not "Improvements". Generally, an improvement is any alteration or addition to the *fabric or structure* of a building that from the tenant's point of view that improves the premises. They may or may not be part of the tenant's fit-out.

<sup>10</sup> New Zealand Government Property Corporation v HM & S.

- (v) *Assumption that the Premises are Fitted*
- (A) The Valuation Hypothesis will usually include an assumption that: "*the Premises ... are in a physical condition and layout and fully fitted out and equipped for use and occupation so as to enable them to be lawfully used and occupied as required for the willing tenant's business and by any party entitled to use and occupy them for the time being.....*"
- (B) The assumption that the premises are vacant and the disregard of the tenant's fit-out would theoretically mean then that the incoming tenant would have to replace any removed items before it can trade and, as such, it would require the usual rent-free period. This led to a fitting out assumption commonly being included. A fitting out assumption has two effects:
- (I) the incoming hypothetical tenant does not need to do works which the tenant has done or require different works – he wants the premises as they are; and
  - (II) the hypothetical tenant is not entitled to an allowance because the premises are not immediately ready to trade from<sup>11</sup> and no discount will be given to the open market rent to reflect the fact that there is no rent-free period fitting out period under the hypothetical lease.
- (vi) *Assumption of compliance with repair obligations.*
- (A) The Valuation Hypothesis will usually include an assumption that: "the Landlord and the Tenant have fully complied with their respective obligations in this Lease....".
- (B) The state of repair of premises is relevant to value. The valuer must value premises in their condition at Valuation Date. If the premises are in disrepair, the valuer must decide if this is because of a breach of tenant's covenants. Even if there is no assumption that the tenant's repair covenants have been complied with, the tenant cannot rely upon own default to argue that the premises are in disrepair and so to reduce rent payable.
- (C) However, if there is no assumption that the landlord's covenants have been complied with, the valuer would have to assess the effect on the rent obtainable for the premises in their state of disrepair.
- (vii) *Assumption damage has been reinstated.*
- (A) The Valuation Hypothesis will usually include an assumption that: "*any damage or destruction of the Premises, access to the Premises, or any Service Media serving the Premises or the Building has been made good in all respects*".

---

<sup>11</sup> Ocean Accident

- (B) If the premises have been damaged or destroyed through no fault of the tenant, the tenant will usually receive an abatement of rent until the damage is reinstated. The assumption therefore means that the valuer must value the premises on the basis that they have been reinstated. Under the abatement provision, when the damage is repaired, the revised rent will become payable.

### 7.3 Hypothetical Term

- (a) **General.** The factors referred to in Paragraph 4.3 apply equally to the hypothetical term on a Rent Review.
- (b) **Length.** The Lease must be clear as to the length of the hypothetical term and when it starts (which is usually the relevant Rent Review date). The term will either be the residue of the lease or a fixed period. The term and term start date must not be simply omitted. Following the presumption of reality, the hypothetical term would likely be assumed to be unexpired residue at Valuation Date but if the term is simply omitted it would open a question of interpretation which could give the tenant leverage.<sup>12</sup> The length of term must reflect all the circumstances including:
  - (i) the size of the premises;
  - (ii) the condition of the premises; and
  - (iii) the flexibility given to the tenant.

Take, for example, a 100,000 sf grade A office, in bare shell condition. The rent would likely be lower for a term of 2 years than for a term of 10 years, as the tenant could not amortise its fit-out costs over a 2 year period. On the other hand, a hypothetical lease of 10 years would likely attract a discount to the rent for a longer commitment, and that in turn will depend to an extent upon the flexibility rights granted.

## 8. Detailed Use Terms

### 8.1 Use

- (a) The Standard Lease directs the valuer to ignore any restrictions as to use of the Premises in the lease. This may not have much effect if the use restrictions are similar to use restrictions under the Government lease, OZP or DMC or indeed the natural use of property.

<sup>12</sup> **Chancebutton-v- Compass Services (2004):** The hypothetical term was “equal to the term originally granted under the lease”. Held: The hypothetical letting was presumed to be on the same terms as the Lease and that included the original term start date (ie the hypothetical tenant would pay a higher rent because of the shorter commitment). If the intention had been for a review on the basis of a hypothetical lease of 25 years from each review date, the parties would have said so.

Cf **Canary Wharf -v- Telegraph Group (2003)**: A hypothetical term was “25 years”. Held: This meant 25 years from the review date (ie the hypothetical tenant would pay a lower rent because of the longer commitment). The Court did not apply the presumption of reality to reflect the fact that in reality there was a residue of only 15 years. It considered the lease was clear in its natural meaning that the term ran from the time of the hypothetical lease not 10 years earlier.

- (b) This may in some circumstances increase the rent if the permitted use under the lease is less valuable eg use for a supermarket will likely be less than for the use for the sale of watches and jewellery.
- (c) There may be an assumption that all consents for a particular use have been obtained. This may cover special licences that may be required eg for the sale of alcohol or operation of a school. The licence covering the actual tenant's use may be in a personal name and not transferable. It can take a long time for a representative of the tenant to be granted a new licence. This assumption would therefore prevent the actual tenant from arguing that the hypothetical tenant would seek a rent-free period to cover this period.

## 8.2 Financial Terms

- (a) **Tenant's Payments.** The same principles as set out in paragraph 5.2(b) apply. The core principle is that you must try to compare like with like.
- (b) **Incentives.**
  - (i) *Assumption that the tenant has already received a rent-free period or other concession or inducement generally available in the market.* As mentioned above, the vacant possession assumption hypothesizes that the tenant has vacated the premises and removed all items to which is entitled. For this reason, the Lease will usually contain an assumption that the hypothetical premises are fully fitted to avoid a consequence that a rent-free period for fitting out would be needed by the ingoing tenant. On a Rent Review, this is translated into a discount to rent payable.
  - (ii) *Legal interpretation of the "inducement received" assumption.*
    - (A) This assumption, in various forms, has been interpreted by the courts. The question has been are all inducements available in the market intended to be disregarded, which would produce a headline rent on review, or are only inducements in the nature of fitting out incentives to be disregarded, which would produce a true market rent on review.
    - (B) The Courts have opposed clauses that produce a headline rent on principle. They have construed clauses so as not to produce a headline rent wherever possible, sometimes with quite tortuous logic. In 1994, the Supreme Court in the UK interpreted four Rent Review provisions and only one of them produced a headline rent on review, the particular clause being:
 

*"...[the rent] which would reasonably be expected to become payable in respect of the premises after the expiry of a rent-free period of such length as would be negotiated in the open market..."*
    - (C) The basic principles set out by the courts are that the Rent Review provisions should give effect to the basic commercial purpose of Rent Review unless it clearly provides otherwise. The provisions should not confer on a landlord a windfall benefit which it could not get from a new tenant in the open market. The correct approach is to support provisions

which eliminate rent-free periods for fitting-out; and only enforce provisions which disregard all inducements if they are totally unambiguous.

- (iii) *Treatment of Inducements on a Rent Review.* There are two aspects relating to this:

- (A) *The provision of rent-free periods or other inducements in the Lease.*
- (I) If the Lease permits this interpretation (which our Standard Lease does), expired rent-free periods reserved in the Lease are to be disregarded. The tenant has already had the benefit of this and so they are deemed to be removed from the Hypothetical Lease as they would result in a lower effective rent payable from day 1 of the review period.
- (II) If there is an unexpired mid-term rent free period, unless the lease provides otherwise, under the presumption of reality such periods would be deemed to be included in the Valuation Hypothesis, so this would have the effect of lowering the market rent from day 1 of the review period.
- (B) *The adjustment of such payments or allowance that were agreed in Comparables.*
- (I) It would be unfair for a tenant to pay an artificially high rent based upon Comparables which grant a long rent-free period or other inducement designed to disguise a drop in the market. The "inducement received" assumption will therefore be interpreted to limit the Valuation Hypothesis to receipt of inducements in the nature of rent free fitting out periods, if possible. Our Standard Lease expressly provides for this.
- (II) If there is a mid-term rent free period under the Comparable but not in the Hypothetical Lease, this would translate, on a Rent Review, to a rental discount to compensate the hypothetical tenant for the absence of such a rent-free period. This then involves trying to assess the effective rent over the entire term of the Comparable (see paragraph 5.2(c)).

- (c) **Rent Review Cycle.** The Lease may provide for future Rent Review cycles and, absent any other wording, these will be deemed to be included in the hypothetical lease. The length of the review cycle will be relevant in the context of the predicted market pressures, particularly supply and demand. If there is a short cycle, say 2 years, and there is a downwards market, the effect may be beneficial.