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Valuers Property Advisors

Topic: Demystifying Ground Leases

Presenter: Trevor Walker

Local Knowledge, National Coverage

1. Leasehold Land Structures

2. Ground Rental Reviews

3. Impact of Ground Leases for Property Managers

4. Leasehold Valuations

5. Who Gets The Value Growth?

6. Modern Thinking

1. Leasehold Land Structures

- Building Leases relate to the contracted occupation of buildings – most familiar lease.

- Ground Leases relate to the contracted occupation of land – least understood lease.

- The two lease types are the same, same… but different!

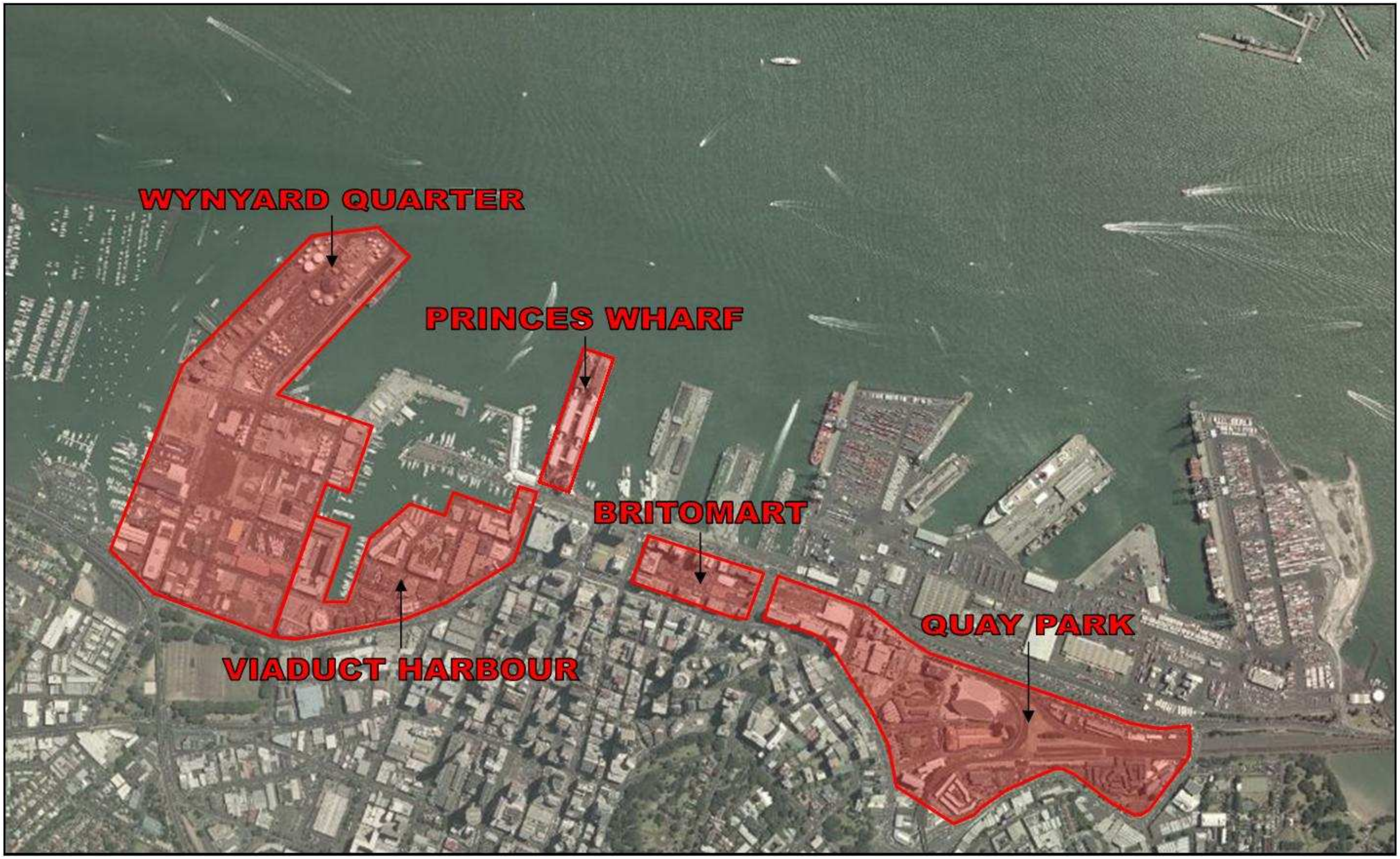
Same, same

- Pays a market rent for use rights .
- The rent is reviewed at regular intervals.
- The lessor retains ownership of the land.
- The lessee has a contracted interest in the land.

…but different

- Usually long term (60-150 years or perpetually renewable)
- Right to develop the land and obtain a return on the investment over the life of the development.
- Rent reviews are usually less frequent (5-21 year rent reviews)
- Rent reviews are based on the land component of the property only.

Auckland CBD Leasehold



2. Ground Rent Reviews

Two valuation approaches:

- Classic Approach –rental comparison. Often limited directly comparable market evidence.

- Traditional Approach – Freehold Land Value x rental factor(%) = ground rental

  $500,000 LV x 6.5% factor = $32,500 p.a. rental

Ground Rental Factors

- A valuer's way of adjusting for different lease terms.

5 year reviews	6.5% perpetual 6.25% terminating
10 year reviews	6.75% perpetual 6.5% terminating
21 year reviews	7.5% perpetual 7.25% terminating

Valuer must:

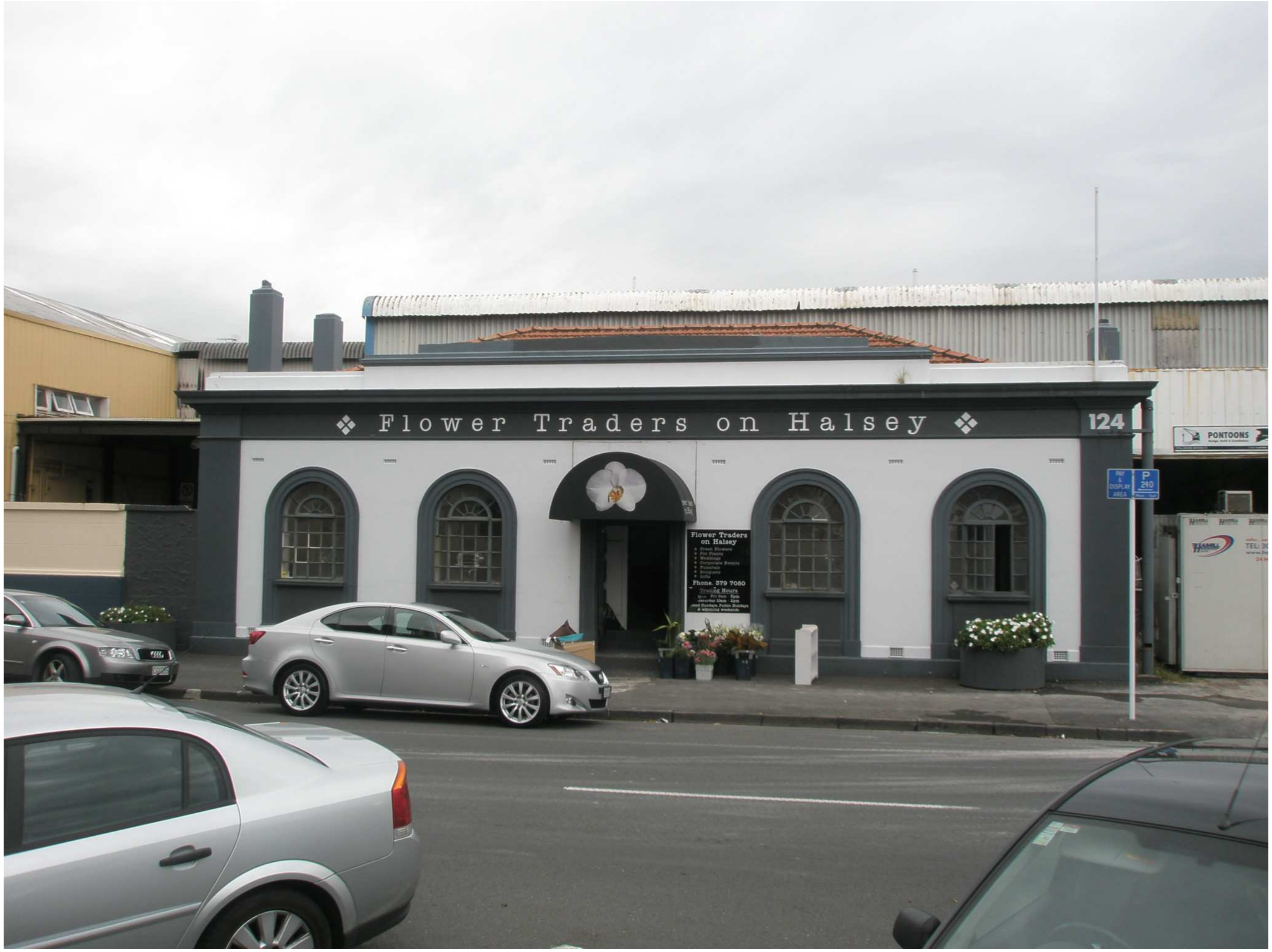
- Have regard to:
  - lease terms
  - highest and best use of the land
  - original state of the land

- Disregard:
  - lessee improvements
  - lessee's resource consent
  - heritage listed buildings

Implications:

- Limited market evidence of vacant land in developed areas.

Heritage Buildings on Leasehold Land



Heritage Buildings on Leasehold Land

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- The highest and best use of the land - does not reflect the restricted use imposed by the heritage building.

- Ground rental can become unaffordable for the heritage building end user.

Planning Changes Impact on Ground Leases – from this…

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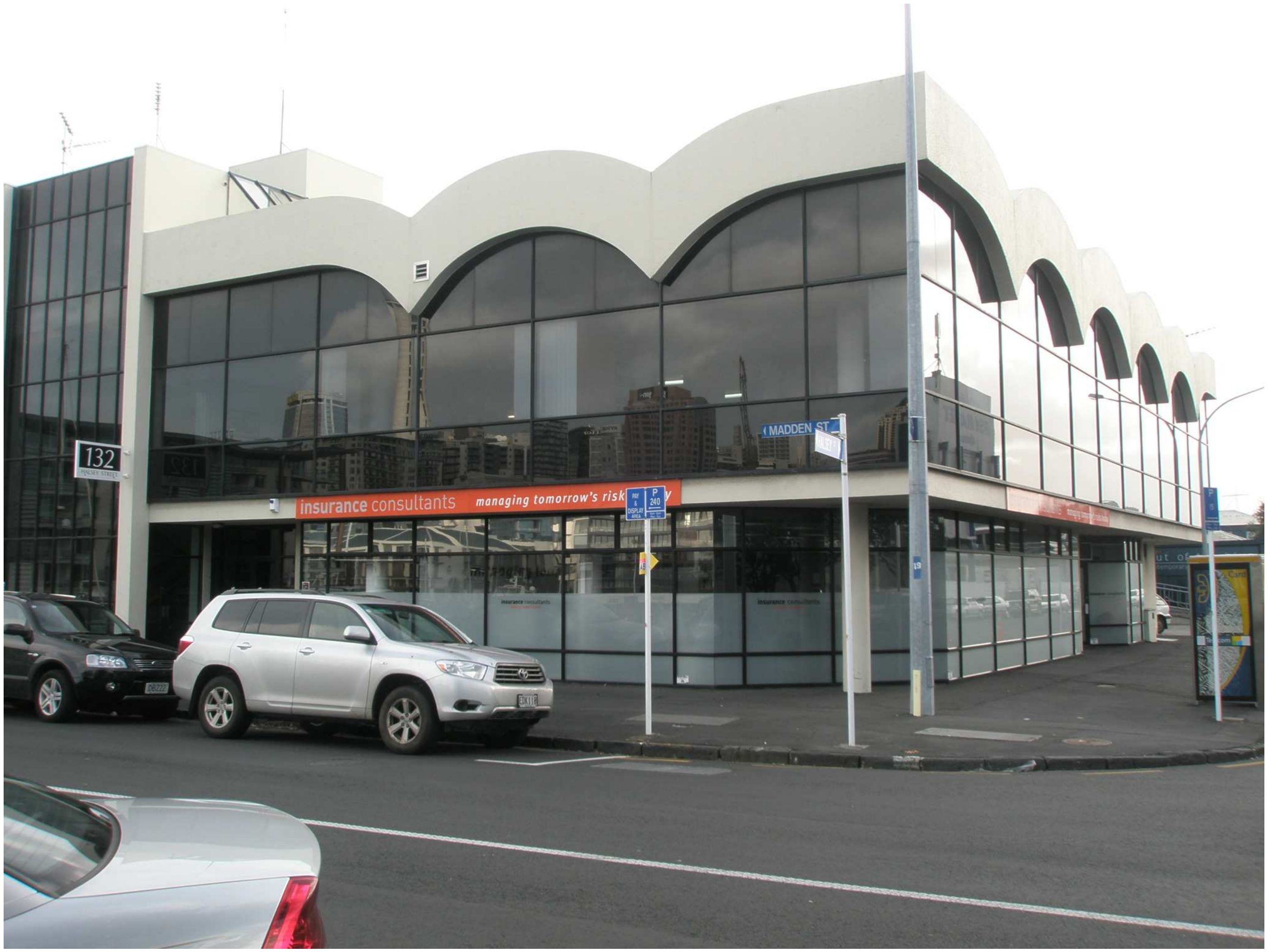

... to this

Planning Changes Impact on Ground Leases

Example:

Planning allows for a 2 storey building

Ground rental = 2 x $500/FAR x 2,000 m2 = $2.0m LV

$2.0m LV x 6% = $120,000 p.a.

Plan Change allows for 6 storey building

Ground rental = 6 x $500/FAR x 2,000 m2 = $6.0m LV

$6.0m LV x 6% = $360,000 p.a.

Loss in Value to Ground Lessee:

- $120,000 p.a. /4,000m2 building = $30/m2 ground rental

- $360,000 p.a. /4,000m2 building = $90/m2 ground rental

- Additional ground rental = $60/m2
- $240,000 p.a additional ground rental
- This additional ground rental reduces the net building rental.
- Capitalised at 8.5% = $2.8m loss in value

3. Impact of Ground Rents for Property Managers

Where Council is the ground lessor:

- Ground rent reviews require a consistent approach to valuations and any settlement agreements.
- High probability of arbitration.
- Current trend

  - shorter review periods (5 years rather than 21 years) to avoid high increases in ground rentals which can cause problems for lessees.

  - annual CPI indexed rentals between market reviews.

Example: Fanshawe St Carpark

- A recent example of what can happen under a 21 year review. The ground rental changed from $51,775 p.a. to $440,544 p.a. between 1986 and 2007, an increase of **750%.**
- High ground rental increases have implications for ground lessee’s and sublessee’s where they are liable for the ground rental.
- It is important that the land continues to be developed to it’s highest and best use.

Where Council is the Ground Lessee:

- Requires an understanding of the ground lease terms
- Restrictions on use
- Requirements for the ground lessors prior approval to:
    - sublease,
    - plans of development,
    - subdivide
- Property Law Act 2007 – now requires that the lessor cannot unreasonably withhold consent unless there is an absolute prohibition.

Subleases:

- Example of Total Occupancy Cost (TOC) subleases of leasehold property:

Premises rental	$250/m2	$300/m2
Opex	$50/m2	$50/m2
Ground Rental	$50/m2	N/A
TOC	**$350/m2**	**$350/m2**

Note: the lessee pays the same market TOC irrespective of the obligations relating to ground rental.

Subleases:

- Tenant will only pay $350/m2 TOC irrespective of what the ground rental is.

- If ground rental goes up, then the net rental will reduce by the same amount so that the TOC is maintained at the market level of $350/m2.

- It is common for subleases to exclude the requirement for the tenant to pay ground rental for simplicity in the leasing and rent review process.

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- If the lessee pays ground rental, then must consider rental obligations where the review dates don't coincide (potential for shortfall or overpayment of rent)
- An example would be a review of a 7 year ground rental resulting in a 100% ground rental increase that is passed on to a tenant.

Premises rental	$250/m2		$250/m2	fixed
Opex	$50/m2		$50/m2	variable
Ground Rental	$50/m2	->	$100/m2	variable
TOC	**$350/m2**		**$400/m2**	
	market		*above market*	

4. Leasehold Valuations

Requires a consideration of the respective cashflows.

1. Lessee's interests are based on the present value of rental benefit from the leasing arrangement, plus a premium for the rights of ownership of the lease.
2. Lessor's interest is based on the present value of the future expected cashflows using DCF modeling.

Requires market evidence of:

- Freehold land sales
- Ground rentals (new and reviews)
- Premises rentals
- Lessee's interests/ Lessor's interests

Note: Often difficult to get current market evidence. Makes leasehold valuations difficult.

Leasehold Premiums

- Leasehold premiums arise as a result of a lessee being able to sell the lessee's interest.
- Range from nil – 80% of freehold land value
- Premiums are a very volatile property interest
- Premiums reflect the high demand that can exist for unique locations under buoyant market conditions.
- Premiums can also reflect rent free periods at lease start up dates.

5. Who Gets The Value Growth?

- When land is separated into lessor and lessee interests, who benefits the most?
- The desire to create new leasehold tenures from freehold land has occurred in prime locations. Examples include Viaduct Harbour, Britomart, Wynyard Quarter, Princess Wharf, Beaumont Quarter and Albany.
- The winner is usually the ground lessor because they receive a fixed return (equivalent to a low risk bond rate) for the market value of the land (subject to reviews and usually a ratchet clause) and land has long term value growth characteristics.

The ground lessee owns:

- a depreciating asset
- the potential for a below market ground rental for a limited period
- a premium (goodwill) component for the right to own the lease (while there is market demand for the lessee's interest)
- Leasehold land is regarded as an inferior property investment to freehold and this is understandable given the fluctuating nature of property values.

Leasehold v Freehold

- The advantages of a leasehold structure over freehold is the ability to better direct land use, urban design and social infrastructure development.
- This makes leasehold particularly attractive to Council's where they wish to have a greater level of control than purely planning controls.
- Particularly useful for joint venture type developments involving extensive public infrastructure development.
- Retains long term control of land.

- A lessee's interest provides for a lower entry cost. The lessee is not required to purchase the total freehold land value and this means there is more funding for more land and buildings or there is a lower cost for the acquisition.
- Overall management of a precinct by the ground lessor, rather than building by building management, will ensure good urban design.

6. Modern Thinking:

Example: Britomart, Downtown Auckland

Ground Lessor – Auckland City Council

Ground Lessee – Britomart Group Company

Developer – Cooper and Company

- Land comprises a 5.8 ha downtown block of commercial land with 18 heritage buildings and 8 proposed new buildings, a bus terminal, and public carpark.

Britomart

- Council acquired the land to facilitate the development of the Britomart Underground Train Station and then sold the lessee’s interest in the balance of the land. The main lease terms are:

- Price: achieved freehold value
- Term:150 year terminating lease from 16 June 2004
- Rental: $1 p.a. (no review)
- Lessee’s Outgoings: rates, insurance, building maintenance and building redecoration every 5 years.

Britomart

- Council has an encumbrance on the land to require the ground lessee to undertake certain development work.
- Ensures developed in accordance with a design plan.
- Requires refurbishment of the heritage buildings.
- Provides for development of public areas.
- These are considerable obligation on the lessee.
- At the expiry of the 150 year term the land reverts back to council
- No compensation payable.

Britomart

- This variation of lease has enabled a significant part of downtown Auckland to be rejuvenated.
- Council have been able to cater for transport (underground train station, bus station and public carparking), public open space and roading.
- Cooper and Company has obtained a significant development site in a prime central city location.

Conclusion

Leasehold is not a dirty word.

However, there are certain criteria that are required for it to be successful. It requires:

- Buoyant market conditions
- A unique landholding that will create strong demand, i.e central city waterfront land.
- Good management and design
- Development to highest and best use
- Predictive planning to ensure continued financial viability for lessee.