

Demystifying Long-Term Ground Leases



CBRE are often requested to provide rental advice relating to long-term ground leases. Often this includes a discussion with the lessee as to the processes followed. The following summary has been produced to explain the background to these leases and cover some of the more frequently asked questions on the process.

While the largest proportion of land in New Zealand is held under freehold tenure, there is a range of perpetual leasehold land that covers most use categories (residential, commercial, industrial and rural), extending from high-value coastal and inner city land to high country rural land. In Taranaki, perpetual leasehold land includes leases known as the Waitara Harbour and Borough Endowment, Urenui, Onaero, Tongaporutu, PKW (west coast leases), Regional Council, and Whiteley.

Generally known as “Glasgow” leases, terms are usually for 21-year periods, renewable in perpetuity and with the rental reviewed at the start of each lease term (although some are reviewed more regularly – seven to ten-year terms). The lease document provides the lessee security of occupation as long as the rent is paid and the lease conditions are adhered to. These conditions include signing a new lease when the current one expires.

The lessee owns the improvements (i.e. buildings, site landscaping, section development) and pays an annual ground rent for the use of the land (in a notional unimproved state). The lessor owns the land but gives the right to use and occupy the land to the lessee in return for rent. A lessee is able to transfer (sell) their lessee's interest to a third party provided lease terms are met (including a current signed lease). They may also be able to use their lessee's

interest as security (lenders conditions may vary and lessees should seek and obtain appropriate advice).

When purchasing a leasehold property the buyer obtains the right of occupation of the land as long as the lease is current and the rent is paid. Prior to purchase the buyer should understand all aspects of the lease including the timing and procedures relating to rent reviews and the use the land can be put to.

The value of the lessee's interest will vary during the term of the lease. In most circumstances, it is low at the time of rent review when the rent is at market levels, then grows as time goes by and the lease rental becomes historical and is lower than the market rent. The value of the lessee's interest decreases towards the end of the lease term when there is anticipation of a rent increase.

As rent reviews occur infrequently, the increases can be significant and should be planned for. There have always been tensions in this leasehold land system as each rent review brings about competing perspectives, the lessor desiring the maximum rent after a long period of no rent increases, and the lessee endeavouring to keep the rent to a minimum level.

Rent reviews generally become more contentious following periods of high growth in land values. At such times it becomes apparent that long-term leases disadvantage both parties, particularly

involving leases of residential land. For the lessor it becomes obvious that they are receiving a declining return for the ownership of the land with no rent increase over a prolonged period; while on the other hand when the rent is reviewed, the lessee faces a large increase in rental.

SO HOW ARE GROUND RENTS CALCULATED?

Firstly, the asset leased must be determined. With most ground leases rents are based on the unimproved land, this being the “sale value of freehold land as if no improvements of any description had ever been carried out”. That is, the unimproved land is the asset that is leased. This is the land set within the existing environment or neighbourhood but assumed to be devoid of all improvements and therefore in an unimproved state or condition. Therefore, rent is assessed on what the land was like when it was first leased and excludes:

- Improvements on the land; these are structural improvements including houses, other buildings and fences.
- Any improvements to the land; these are developmental improvements including excavation, access, and retaining walls.

Having established the asset base being leased, consideration then turns to the appropriate rent comparisons or methodologies. The availability of open market comparisons is restricted but there is a body of case law with legal precedents that establish the principles to be followed.

ASSESSMENT METHODS

There are two commonly used methods for assessing the ground rent for land excluding any improvements:

Classic – this involves comparing the subject property with other properties where rents have been fixed by the market so that the ground rent is arrived at after making relevant adjustments for differences in lease

terms, available use, location, size, time and physical attributes.

The direct comparison method is the predominant approach to setting market rentals (i.e. for normal leases or tenancies). However, direct comparison has major limitations when applied to ground rents due to the absence of an active, freely negotiated market and the consequent lack of robust evidence.

Traditional – this involves applying a rental factor rate to the rental value (being in most cases the unimproved value). The rental rate is ideally sourced from other perpetual leased land by direct comparison.

To determine the unimproved value of the land and from that the annual ground rent, the following steps are necessary:

- Assess the value of the land as it is now in its current state, unencumbered by the lease. This can be sourced from current market evidence and is the land value as statutorily defined.
- Assess the value of the land exclusive of lessee improvements (the unimproved value).

The traditional approach has become dominant in the assessment of ground rent due to the lack of suitable comparables, the classic approach being more commonly utilised as a cross-check.

REVIEW OF RENTAL FACTORS

Before applying a rental factor, research is undertaken as to what is occurring in other leasehold portfolios throughout the country. Generally, long-term residential ground leases (21-year terms) demonstrate a reasonably tight or consistent return rate (band of return). While an extended period of low inflation and interest rates has placed some downward pressure on the rental factors applied to leases; the long periods between reviews or renewals (ten to 21 years) means these fluctuations have a lesser impact and

history shows there is a degree of consistency in the rental percentages adopted.

Apart from where percentage rates are prescribed in long term leases, our research indicates that with most leasehold portfolios the rental rate percentage lies within the range of 4% to 6% for standard residential sites; and within 2.0% to 4.0% for coastal locations such as Onaero, Tongaporutu, Urenui, Raglan, Patau (Whangarei) and Kerikeri, where lease terms are more stringent such as the limitations of use and in some cases terminating leases.

While our research involves a diverse range of localities, we note that the rental factors adopted are reasonably similar. This becomes easier to fathom if one accepts that the underlying land values associated with a location often reflect the demographics of that area.

As the percentage factor is applied to the land's value, rentals will be higher where underlying land values (and generally income) are higher and conversely at a lower level in less affluent neighbourhoods where the underlying land values are also usually lower.

Finally, the term “fair annual rent” needs to be understood. A ground rental is determined on an objective test that relates to the land rather than the parties to the lease. That is, the valuer is required to assess a fair rent for the lease area under review, not a fair rent relative to the individual lessee's ability to pay or conversely, the lessor's requirements for a return on the asset. In other words “fair rent” in this context equates to “market rent” for the unimproved land under the terms and conditions of the lease; and covered by the Public Bodies Leases Act 1969.

Opinions expressed in this article are of a general nature and should be used as a guide only. CBRE should be consulted before acting on this information.