Simpson Grierson

Commercial Property

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GROUND LEASES – RENT REVIEWS REVISITED

Recently the High Court heard a case on the valuation of a rent review of a residential leasehold property. The case is an important reminder of how ground lease properties work and the inherent problems in owning a home on such a section. In this FYI we look at ground leases in general and the more detailed points from the case.

Ground Leases in the Media

Leasehold developments have become more common in the property market over the past few years, especially in Auckland where large areas of inner city land have been redeveloped to take advantage of the property boom.

Over the past five years ground leases have had a lot of press, most of which, casts these leases in an unattractive light. Much of the publicity surrounds the rent review process and the potentially large increases in ground rent that often shock the leaseholders.

In 2005/2006, 119 sections owned by the Cornwall Park Trust Board (properties in the One Tree Hill/Greenlane and Royal Oak/Epsom areas) had the ground rents reviewed. 21 years after the last rent review. Owners faced increases of up to 750% and one was shocked to receive a 1817% increase from $1800 to $34,500 per annum.

The Beaumont Quarter development near Victoria Park in central Auckland is the latest and most well publicised occurrence of large ground rent increases. 2008 saw the first rent review at Beaumont Quarter since 2001. Beaumont Partners Limited, the company which owns the freehold land, increased the ground rent by more than 400%. For the some apartment owners that meant their ground rent increased from $5,000 to approximately $20,000 per annum.

Apartment owners were expecting big increases but assumed any increase would be in line with the rest of the housing market in Auckland, which had increased by 85% during that seven year period. A representative of Beaumont Partners defended the increase saying "[w]e've taken a reasonable stance. We're not asking for anything the lease doesn't provide for", and further stated "[t]his is the nature of ground rentals. They sit idle for seven years".

Residents disputed the decision of the Beaumont Partners and the parties ended up taking the review to arbitration. The decision by former High Court Judge Sir Ian Barker was a reduction of the annual ground rent by over $1 million, to $3.1 million.

What has amazed some commentators in the last few years is that people seem surprised when they have a rent review under a ground lease. This indicates many still do not understand the nature of ground leases.

What is a Ground Lease?

A ground lease is a lease of land only. They are often referred to as Glasgow leases. The purpose of the lease is for the site to carry a permanent structure/building. They are usually for a term of 21 years and renewable in perpetuity for successive periods the same as the original term. They have the potential to continue forever, but the tenant can bring the lease to an end by simply not renewing it.

The rent payable under a ground lease is known as ground rent. In the case of perpetually renewable ground leases, the ground rent is reviewed either on the renewal or on more regular dates such as every seven years. The rent reviews are conducted on a current market valuation of the land and valued by an appropriate registered valuer.

The tenant of a ground lease is subject to the same general constraints as any freehold property in respect of issues like tax, rates, town planning and building by-laws. In addition the tenant is subject to the specific obligations and restrictions under the terms of the ground lease. These could include building restrictions on type and size of building, repair and maintenance of the building, redecoration of the building, maintenance of grounds, and insurances to name a few.

Ground rents are often calculated at 5-7% of the unimproved value of the (bare) land at the renewal date. This rent continues until the following rent review date. The rent may seem very cheap towards the end of a lease term simply because the market has moved ahead of the last rent review. But new rents can be valued (especially in times of inflation) much higher than the old rent and tenants can be financially unprepared by such high increases. It is this inherent commercial tension that causes so much anxiety when rents are reviewed.

Mandic V The Cornwall Park Trust Board

These issues were highlighted by a recent case that looked at rent reviews under a ground lease. The tenant is the owner of a ground lease and challenged the valuation of the new rental from the Cornwall Park Trust Board.

The case dealt with the following questions:

1. How should the valuation be calculated? Should the valuation be based on the value of the vacant land i.e 'unimproved value'?
2. When valuing the land should the valuer take in account the restrictions on the use of the land (both external, ie. land zoning, and as a result of the lease)?
3. How are improvements to be valued? How can the value of improvements be based on a market value when no market exists for the sale and purchase of improvements?

How should the valuation be calculated? Should the valuation be based on the value of the vacant land i.e 'unimproved value'?

The tenant argued that the Trust Board valued the ground rent as if the land was vacant and unimproved, which in reality it is not. Because of the terms of the lease the land is likely never to become vacant. The argument is that vacant unimproved land attracts a higher value because a purchaser can develop it freely and unconstrained, which is simply not the case where a ground lease is in place. The tenant put forward the argument that valuers should not have regard to the value of bare land, but instead should adjust the gross value of the land to reflect the constraints upon its use. In essence, the tenant was arguing that the existence of the lease should be taken into account.

Obviously, the Trust Board disagreed. It suggested that purpose of valuing land and improvements, and charging ground rent on only the land value is to recognise the respective interests of the landlord and tenant. The landlord is entitled to have the benefit of any increase in value of the land which has not come about through the tenant's efforts in permanently improving the land. If the

occupied state of the land were to be an element of consideration at rent review then that would undermine the separation of the respective interests of the landlord and tenant.

The Court agreed with the Trust Board's position on this point. This decision is in line with previous cases on ground lease rent reviews.

When valuing the land should the valuer take in account the restrictions on the use of the land (both external, i.e land zoning, and as a result of the lease/s)?

The tenant next suggested that the effect of town planning and current zoning requirements should be considered when assessing the value of the land to the extent that they limit the use of the property. This issue has also been considered before. The Courts have previously recognised that some restrictions can affect the rent review process. For instance, a heritage listing attaches to the building only where a zoning or land use restriction related to the land.

The tenant contended that the lease contains a number of restrictions that should be taken into account on rent review. The restrictions of the lease were listed as a fencing covenant (registered on the title), a restriction on construction without consent and on the use of the property for more than one unit, an obligation to insure and invest proceeds of insurance claims in rebuilding on the land, stipulations as to the maintenance of improvements on the land, restrictions on leasing or sub-leasing and restrictions on any other use other than residential.

The Court concluded that apart from the fencing covenant these restrictions are restrictions on the leasehold interest only. If the lease did not exist or was not renewed the land, without these lease restrictions, would revert back to the landlord. The tenant's argument ignored the nature of the leasehold interest and the purpose of the valuation which is to value the separate interests of the landlord and the tenant.

How are improvements to be valued?

The tenant's final argument was that since there is no market for improvements they cannot be valued on a market basis and should be valued by reference to their cost. The tenant relied on the definition in Urban Valuation in New Zealand which states that the concept of value is "for something to be valued it must also be negotiable in a market, having the purchasing power to be exchanged for money" and that "improvements cannot be assessed in isolation or intrinsically but only to the extent which they increase the selling value of the total property."

The Court did not agree and referred to previous cases that make it clear that improvements were (as well as the land) to be the subject of market value. The value is the capital value into which the value of the improvements is a part. One element or test of their value may well be what a new tenant would give for them if an existing tenant did not renew the lease.

The question of whether improvements in fact have a value, regardless of their cost, is a question for the valuer. The Ratings Valuation Act 1998 excludes any reference to the cost of improvements instead stating that the "[v]alue of improvements means the added value which at the date of valuation the improvements give to the land."

The Court concluded that concept of valuing land and improvements is to decide what proportion of the market value of the property is represented by the improvements. It would be contrary with this purpose to value the land on a market value basis but to treat the parts that contribute to that value on a different basis.

How can the value of improvements be based on a market value when no market exists for the sale and purchase of improvements?

The tenants argued the method being used by the Trust Board for valuations is contrary to the instructions in the lease. They suggest that the lack of market evidence of improvements precludes any method that uses market evidence as a basis for valuation. Their suggestion is that

the value of improvements should be made without reference to the value of the land and therefore the current method used by the Board is incorrect.

The Court decided that the valuer may utilise any appropriate method, including reference to the actual cost of improvements or the estimated cost of constructing similar improvements, provided that the outcome reflects the market value of the improvements.

The Court noted that the absence of sales data to support a market valuation does not preclude such a valuation being undertaken. They confirmed that a valuation inquiry is necessarily hypothetical. The Court also noted that the purpose of valuing improvements is to determine the amount by which they have increased the value of the land and as such it is difficult to see how that can be done without reference to the value of the land which the improvements are said to have improved.

Overall this case is consistent with previous cases on ground rent reviews. It confirms the valuation principles that are to be taken into account when reviewing the rent. While the result may be unwelcome for tenants in this position it is a further reminder that ground leases of this type carry with them the risk that the rent will reflect the prevailing market conditions.

If there is a lesson to be learned from the case and the other ground leases that have been in the media, it is this. You must understand the built in commercial risks of such a property arrangement before you buy. It is difficult and expensive to try to dispute the rent review so understand it before you buy it.

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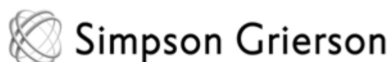

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