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Going green: the challenge of refurbishing an existing commercial tower

Is NZ farm land worth what it will produce?

Compensation for Indigenous cultural heritage

Valuing NZ rent reviews: the Real Options approach

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Contents

Going green: the challenge of refurbishing an existing commercial tower *Sarah Bidinost*	357
Is New Zealand farm land worth what it will produce? *Bob Hargreaves and Iona McCarthy*	365
New 'Old' Property: Compensation for Indigenous Cultural Heritage *John Sheehan*	375
Book review: Rural Valuation *Richard Reed*	382
REAL TIME: Reassessing WALT *Mark McNamara*	383
REAL TIME: Valuing rent reviews in NZ: the Real Options approach *Reid Quinlan*	390

Front cover picture: 385 Bourke Street, Melbourne is undertaking a lifecycle transformation and is planned to be a leader in green refurbishment of an existing skyscraper.

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API NATIONAL PRESIDENT'S REPORT

Nick McDonald Crowley
API National President

At the start of what will be a busy year for the Institute it is my pleasure to present my first report to Members.

Over the past 6 months I have witnessed the staff of the API around the country implementing the use of the centralised Contact Management System (CMS). This has been the single most significant change undertaken by the Institute in recent years, and has not been without its problems, particularly in its financial application. There is however a steely desire of National Council, on behalf of the membership, to implement and support Institute staff in their quest to ultimately have a smooth running national based platform from which the Membership will benefit.

On behalf of the Membership, I thank the API staff and those volunteers on the CMS Implementation Task Force for their extraordinary efforts.

The additional work on CMS at a Divisional level has not significantly hindered the wide range of CPD and state based functions that are continuing to be presented. I look forward to attending a wide range of those functions around the country during the course of the next 12 months, and taking the time to meet with, and take feedback from the membership.

My most significant aim, to pick up on Immediate Past President's report earlier this year, is to execute the Nine Point Plan that came from the Strategic Planning Review in February 2010. David Moore circulated a note highlighting the key points agreed by the National Council and State Divisional Presidents and these were also addressed in my acceptance speech as National President circulated in the recent API eNews. It is worth reminding the Membership that these represent National Council's current goals. They are:

1. The development of a National Education program
2. Nationalising the Property Directions Survey
3. Standardisation of membership fees
4. Move towards corporate membership
5. Consistency of Property Excellence Awards to have a national relevance allowing the potential for state awards to move through to a national awards system.
6. Establish a national news subscription service.
7. Develop a national marketing strategy which is sensitive to regional considerations.
8. Review of accounting efficiencies.
9. Review administrative efficiencies that support Member Services at a divisional level.

In addition to the above, it is pleasing to note that there has been further progress on the Capped Liability Scheme. After a recent meeting between the Institute and the Professional Standards Council there is now strong corporate and regulatory support a Scheme that further protects members of the Institute. We are indebted to NSW State President, Robert Hecek in this regard.

The Institute will also monitor ongoing developments in the residential mortgage sector and, through Grant Warner, submissions have been presented to the Australian Competition and Consumer Commission (ACCC) on behalf of the membership.

Obviously there are a range of other issues including, but not limited to, the advancement of the Future Property Professionals Program, updating professional Practise Standards inline with proposed changes from the International Valuations Standards Council (IVSC), and new changes with regard to Mandatory Disclosure to Green Energy Ratings on commercial buildings.

There is a lot of work at hand and I look forward to working with Grant Warner in the National Office and the rest of the API staff around the country over the next 12 months to cement the Institute's role in "leading the property professions".

Nick McDonald Crowley
President
Australian Property Institute

PINZ PRESIDENT'S REPORT

Ian Campbell
PINZ President

We are now half way through the year with seasonal changes upon us. What has made this year more challenging so far in the property sector, has been the proposed changes announced during this year's government budget, the impact upon the economy and property investment particularly. A number of these changes had already been suggested by the Tax Working Group prior to the budget announcement but now the government has been quite clear on the future tax treatment of property.

From 1 October 2010, a reduction in both personal and company tax rates will occur. The reductions aimed at boosting New Zealand's economic recovery, will be funded through a number of ways including an increase in GST from 12.5% to 15.0% and removal of depreciation benefits for property. With GST increasing by 2.5%, the increase in prices will create an inflationary spike at this time. The spike will also affect the Consumers Price Index (CPI) which will impact upon any rents that are determined through the CPI mechanism.

From 1 April 2011, tax depreciation claims for all rental housing and commercial property with a useful life of 50 years or more will be removed. A building with less than 50 years useful life remains unaffected. The removal of the depreciation benefit will mean that owners, including property professionals alike will be closely scrutinized when determining the useful life of a building.

The government is yet to clarify the depreciable components that make up a building, its fabric and how internal fit out can be depreciated or not. It is likely that the industry will be asked to consult on these matters before the new depreciation rules commence.

When considering the useful life of a building, it is likely that our industry will need to issue guidelines which help professionals determine the useful life of a building. This may need to include instances where a major refurbishment of a building has extended its useful life.

With the increase in GST from 1 October 2010 and removal of depreciation benefits occurring from 1 April 2011, landlords will now look at ways to recover cost increases and recoup tax benefit losses. As a result, market commentators suggest that residential rental rates are likely to increase. Other commentators suggest that some landlords may elect to sell their residential investments and flood the market with residential investment stock. Others are indifferent.

Clearly any mix of these scenarios could happen, however over the next 6 to 9 months both buyers and sellers in the market will signal if these tax changes, amongst other global forces will impact upon their appetite to retain their investment. This may mean more reliance is placed upon the knowledge of our members.

Globally we should be mindful while seeing a high New Zealand dollar compared with weaker european currencies and concerns over european sovereign debt, that international markets and economic global conditions still remain fragile, as is so our own property market. A flag of caution perhaps, but worthwhile noting given that we are still expecting the Reserve Bank to increase the OCR above 2.5%, which will increase mortgage lending rates.

Members should note that our joint international property conference in Perth in April 2010 was extremely successful and enjoyable for those who attended. We wish to thank the Western Australian Division of the API and the organising committee in the delivery of an outstanding programme and for hosting our members in Perth. I was pleased to see that some of our members decided to explore the region while visiting Perth. I can add that after driving 10 hours north in a hired campervan after the conference, that the outer regions of Western Australia including Shark Bay and Monkey Mia were truly magnificent, internationally acclaimed and well worth visiting. Notwithstanding this, the next international joint conference will be held in our own scenic town of Queenstown in 2013.

Finally, it is a pleasure for our Institute to host the Valuers Super Summit in Auckland on 17 June 2010 followed by a VRB risk management seminar on 18 June 2010. This is also the venue for this year's AGM. During the summit members will be able to interact with best practice presentations on apartments, compulsory acquisitions, insurance valuations, leaky buildings, taxation and standards as well as celebrating over 100 years of Valuation in New Zealand. We look forward to your attendance in Auckland.

Ian Campbell
President
Property Institute
of New Zealanda

Going green: the challenge of refurbishing an existing commercial tower

A CASE STUDY: 385 BOURKE STREET STAGE 1

When 385 Bourke Street, Melbourne, was first developed in 1983, the brief was to design a modern building utilising the most advanced technology available at the time. More than a quarter of a century later the tower is undertaking a new lifecycle transformation and again is planned to be a leader, this time in the green refurbishment of an existing skyscraper. The primary goal of the transformation is to strategically future-proof the building through a comprehensive sustainability upgrade of the Tower.

Sarah Bidinost

Sarah Bidinost is the general manager of the 385 Bourke Street Melbourne tower valued at $276 million. She has expertise in financial modelling, strategic planning, asset management, leasing, project management; tenant liaison and board member experience. She is a qualified commercial property valuer, an associate director who has been with Jones Lang LaSalle for 10 years, and is an Associate of the Australian Property Institute. Further qualifications include a Bachelor in Business (Property) and practical MBA. Sarah was awarded the 2006 Victorian Excellence in Property Young Achiever of the Year award.

385 Bourke Street is situated on the prominent corner of Bourke, Elizabeth and Little Collins streets in the heart of Melbourne's Central Business District. The original building construction consists of 41 office levels, a banking chamber, a basement level car park and the Galleria multi-level retail centre. The building is owned by the Commonwealth Property Office Fund (CPA). CPA is a sector-specific A-REIT with a mandate to invest in prime quality office buildings throughout Australia. Since purchasing the asset in 1999, CPA has invested more than $65 million in enhancing and upgrading major infrastructure and building services. In addition, throughout this period all mid, high and sky rise levels have been fully refurbished to quality A-grade standards with the last floor due for completion in 2011. The low-rise levels have been updated and represent a further opportunity in the lifecycle development of the building.

The journey: strategic planning

CPA's goal was to undertake strategic future-proofing through a comprehensive sustainability upgrade of the tower. The upgrade was proposed to be undertaken in stages to allow for analysis and prudent review. The first stage of the process was to understand the building and undertake a purposeful building tune-up of maintenance and operational systems through the reduction of energy use, heating and cooling loads, and water savings.

In October 2006, during the initial strategic planning of the sustainability project, the building owners and the property managers worked closely with the appointed Environmentally Sustainable Design (ESD) consultant Umow Lai and Donald Cant Watt Corke to produce a detailed scope and process for improving the sustainability of 385 Bourke Street. The detailed scope and process of the investigation into improving the sustainability of the building was developed by CPA through Colonial First State Global Assessment Management Portfolio Mangers, onsite building management Jones Lang LaSalle, Umow Lai and Donald Cant Watt Corke. The project team identified a number of works that would deliver improved efficiency. The basis of stage 1 was to focus on energy efficiency; building and controls tuning; and minor plant and equipment upgrades.

Changing landscape

Stage 1 of the project was influenced by the changing landscape of available Australian green industry tools, rating, industry knowledge and Victorian leasing market requirements. Developments in these areas affected the goals, timeframes and eventual progressive development of the project's roadmap.

The standardised energy system for commercial office buildings changed during the project.[1] Just prior to the formal start of the project in 2005, the national tender to develop, manage and operate the National Australian Built Environment Rating System (NABERS) was awarded. A key turning point was in 2006 when the Victorian Government, a major commercial market occupier, committed to introducing a minimum 4-star standard for its new commercial tenancies above 5,000sqm. By 2007 Section J was introduced to the Building Code of Australia requiring that commercial and public buildings achieve minimum levels of energy efficiency.[2]

The concept of risk mitigation and sustainable future-proofing further gained momentum in 2007 and included the Rudd Labor Government's commitment of $90 million for the Green Building Fund as part of the Clean Business Australia initiative. The Green Building Fund, managed through AusIndustry (the Australian Government's principal business program delivery division in the Department of Innovation, Industry, Science and Research), was designed to offer assistance funding for energy-efficient retrofitting of existing buildings and support for training to improve the skills of building operators. In 2008 ABGR (Australian Building Greenhouse Rating) was renamed and launched as NABERS Energy with additional tools covering waste, indoor environment and water. In 2010 the utilisation of NABERS Energy is to be further extended and incorporated into the mandatory disclosure of energy consumed by base buildings through the Building Energy Efficiency Certificate scheme (BEEC).

Monitoring

One of the challenges encountered that was considered likely to translate to other existing building upgrades was the accuracy of dated as-built plans. Practical investigation was required. During the 12-month monitoring period for the NABERS rating the importance of the fault-rectification register and permit to conduct work scheme was underlined. The identification and remedying of faults is considered to be key in the ongoing operational maintenance and improvement of the NABERS energy rating. In addition, the various completion dates of the works which comprised stage 1 of the project led to efficiency improvements growing over time as the data required a full 12 months of actual energy consumption to be recorded post completion before the impact of the upgrade measures could be realised under the NABERS energy rating scheme.

Industry participation

In August 2007 Sustainability Victoria (SV), the Victorian Government Agency charged with helping Victorians to act on climate change, launched its Resource Smart building Program. A part of the project's inclusion of industry participation included a partnership agreement between CPA and SV agreed in October 2008. The partnership focus was on the upgrade and green sustainability capital improvements at 385 Bourke St.

CPA and SV shared a common objective of integrating sustainability into commercial property. Building a strategic alliance was seen as a further step forward to facilitate sustainability outcomes through the implementation of innovative property-related projects in areas such as sustainable design, technology and management practices.[3] 385 Bourke Street was identified as having significant potential to deliver carbon reductions and other environmental benefits through a working partnership which including successful implementation of energy efficiency projects. The partnership is anticipated to provide the opportunity for further knowledge sharing and peer review of later stages. In addition, later stages of the overall sustainability upgrade are anticipated to benefit from Government's Green Building Fund.

The project team openly contributed to the industry through knowledge sharing and demonstrating that sustainability and commercial success can be achieved in the same project. The project team was able to utilise its respective financial, property management and technical skills to define a roadmap which could be utilised as a benchmark for the future redevelopment of other existing towers.

In addition, in February 2010 the building was in the initial stages of joining the Melbourne City Council's 1200 Buildings Program.

Financial sustainability: maximising the green dollar investment

A review of the existing environmental performance of the building was followed by a feasibility study. The proposed upgraded management plan included analysis, risk appraisal and costing of the proposed upgrade. A thorough financial sustainable analysis was set up as a fundamental measure of the success.

ANZ

This is where the new era of "financially sustainable" analysis become key to the projects' success. John Dillon, senior portfolio manager at Colonial First State Global Asset Management, noted that keeping buildings up-to-date was essential for maintaining their relevance in the market place. *"It's not only about the environment any more, though it is a very powerful motivator and that's incredibly important, but it's actually about managing your bottom line now. It's about being financially prudent in planning."*[4]

Initial works were undertaken with an occupancy rate of between 73% and 100% of Net Lettable Area (NLA) over three years. The project was viable due to the minimal impact on tenants, enabling the financial returns to be maintained. Without sound financial management of the green focused capital expenditure projects and the cost analysis of each option available, the viability of the project would be at risk, as would be the environmental benefits and risk minimisation for the tenants and landlord from rising energy costs and potential capital value impact over the longer term.

A focus on existing buildings is the key to driving significant emission reductions. New development which achieves high Green Star and NABERS ratings benefits the industry by providing the vital push to be more green competitive. Without the drive to improve energy efficiency, the greatest impact on tenants and landlords would be rising energy costs. A high percentage of a commercial property's operating expenditure is electricity with an analysis of actual costs of a basket of prime buildings within the Melbourne CBD indicating the portion being an average of 21% of building's outgoings.[5] While sustainability was previously in the "nice to have" category, it is now well and truly at the forefront of business considerations not only for the obvious environmental impacts and social responsibility but also for financial business risk mitigation.

The Energy Efficiency Council agrees: *"Energy efficiency policies must focus on retrofitting existing buildings. Standards for new buildings are important, but the energy used in existing buildings over the next 20 years will dwarf the energy from buildings constructed after 2009. Long-term historical trends suggest that existing buildings will account for around 65 per cent of the building stock in 2030, and over the period 2010-2030 will produce well over 10 times the emissions from new buildings."*[6] Similar opinion by Drummond (2007) noted that *"the real challenge will be the greening of Australia's ageing office buildings, which represent 98% of building stock"* however there was a current *"lack of value attached to the long term benefits of green buildings and a too great focus on short term."*[7]

The further impact on a commercial property if action is not taken is the potential risk to capital value over the longer term through a combination of impact on marketability, outgoing rates, rental growth, downtime, risk premiums and depreciation. In a forecast of the world in 2030, Romain (2008) noted the most significant trend which would impact the property world in the next 10 years was *"… people buying property, whether it's old or whether it's new, will actually be asking about its energy and sustainability and its [environmental] friendliness as the number one issue."*[8]

A key area which become more relevant in light of the recent Global Financial Crisis (GFC) was the economic analysis and financial maximisation of upgrading existing buildings. In a local context,

Australia appears to have had a stronger 2009 financial year than was feared would result from the fallout of the GFC. The property industry, however, rationalised its capital spending as a reaction to tightening credit and falling capital values. The sustainability focus remained as a result of the recognition of the need for future proofing of buildings and other initiatives, including the Green Building Fund and 1200 building initiative in Melbourne. Similarly, according to a US study 75 per cent of commercial real estate executives – including developers, rental building owners, brokers, architects, engineers and others – maintained that despite the credit crunch it did not discourage the building green movement.[9] Rick Fedrizzi (2009), president, chief executive and founding chair of the US Green Building Council noted that *"The key to a prosperous future is sustainability, and the triple bottom line – environmental responsibility, economic prosperity and social equity."*

Sustainable redesign

Key to the success of a sustainability improvement program is the identification of the right sustainability improvements measures from the outset. In order to do this it is necessary to ensure that the existing building systems are accurately surveyed and are operationally reviewed to ensure that they are optimised to provide the best performance possible for the building owner. This includes a number of variables from management practices through to plant and controls operation. Traditionally buildings have been managed to maintain occupant comfort but with minimal attention given to achieving the best possible comfort in tandem with optimum energy efficiency. The realisation that one does not necessarily follow the other is key to the successful outcome of an effective upgrade strategy.

The efficiency improvements undertaken in stage 1 of the project focused on the realisation of existing systems and rationalisation of previous upgrade measures, prior to the embarkation of major plant upgrades. The resultant firm operational foundation will be used as the basis of all future building upgrades. The improvements contribute to carbon emission reduction as well as other benefits such as reduced maintenance costs, extended life expectancy and enhanced management of the property through improved system feedback mechanisms.[10]

> ***While sustainability was previously in the "nice to have" category, it is now well and truly at the forefront of business considerations***

Building controls and air-conditioning

Some of the major initiatives of stage 1 of the refurbishment included the upgrade of the Building Automation System, a rationalisation of building control strategies, energy metering of chilled water system, replacement of existing fan motors with high-efficiency motors, implementation of active air quality measurements, review of after hours operation and greater after hours zone control.

One of the most major causes of energy wastage in large buildings is through the lack of optimised control of air-conditioning and ventilation. A common misconception within the industry is that energy plant used to cool and heat the building is the major contributor to energy consumption inefficiency. While inefficient energy plant control is undesirable, the largest energy consumer is generally found within the reticulation plant, especially the fan plant in buildings that utilise air to reticulate cooling and heating energy.

Major progress and improvements at 385 Bourke St include the following:

- Reduction in fan power in air-handling system through attendance to duct leakage and recomissioning of system. In addition, new fan motors complement the variable speed inverter to improved demand matching of fan energy.
- The after-hours air conditioning system is now able to operate on a floor-by-floor basis, compared to the pre-upgraded system which required a large proportion of the plant to run to cool a single floor. In addition, web-based after hours control of air conditioning enables tenants to conveniently select service times.
- Air conditioning systems were reprogrammed to provide much improved use of free cooling – outside cool air – when available, instead of utilising chiller plant.
- Installation of additional energy metering allowing for simplified pinpointing of HVAC system efficiency control problems.
- Recalibration and relocation of key sensors that control major system components, improving operation reliability and efficiency.
- Valve replacements were undertaken when older equipment was upgraded, delivering greater control.
- One of the major initiatives undertaken to improve the water rating of the building was the replacement of calorifier domestic hot water plant with energy-efficient units. This provided the dual benefit of lower

emissions with a new reliable system which allowed the main heating hot water loop to be entirely shut down over summer.

- In addition to the regular air quality monitoring, the air handling systems now actively measure and respond to prevent CO_2 levels rising too high. Monitoring CO_2 concentration is a useful way of determining whether adequate outside air is being delivered to the office areas.
- Energy consumption has reached its lowest peak despite the extreme weather this year.

In February 2009, Melbourne experienced a heat wave which recorded three successive days over 43 degrees which was closely followed by Melbourne's hottest day on record when the temperature reached 46.4 degrees in the CBD.[11] During this time the tenants of 385 Bourke Street were very impressed with how the building coped in the heat and welcomed a reduction in the after hours air conditioning charge rate which was possible due to the plant and controls modifications undertaken during the project.

Eben Simmons, from the ESD consultancy Umow Lai, confirmed in a recent sustainability performance progress report that: *"In February 2009 some of the most extreme summer temperature conditions were experienced in Melbourne … 385 Bourke Street's systems, due to recent upgrades, were able to maintain comfort inside the building at the lowest energy consumption recorded since energy monitoring began."*[12]

The continuing review and fine tuning of the HVAC systems continues to provide improvements to the energy rating.

Other initiatives

Other features of the building that reduce energy consumption and improve indoor environment quality include the use of energy-efficient lighting and the selection of low volatile organic compound (VOC) carpets, paints and other materials.

Active air quality control is also expected to assist in raising comfort and productivity levels in the building. Replacement of air curtains on entrances with automatic doors has saved a large quantity of fan, heating and cooling energy.

The management and project team continue to ask the following question in projects and daily operation of the property: "What existing and new technology can be adopted to improve sustainability?" As an example, this will be undertaken as part of a review of other services including a review of lift operation strategy.

Water

In addition to reducing energy and waste, the project team continues to investigate further avenues to improve the recently achieved NABERS water rating of 2.5 stars as part of stage 2 works under way. These works will include a new water efficiency plan and audit.

The upgrade of wash room facilities in the building has focused on flow-reduced fixtures and fittings and new automated controls, compatible with the existing plumbing systems. This is responsible for a reduction at source of water consumption in the buildings.

Other water savings included the reduction in frequency of fire system testing from weekly to monthly, under the new AS1851-2005 standards. While this operational change will have nil impact on the building's NABERS water rating, it does provide a large water saving for the

network and is recognised as important for social responsibility.

Waste management

The 385 Bourke Street co-mingled recycling program was implemented in October 2005, 12 months before commencement of the stage 1 project. Ricci noted that in the first month the tower recycled close to 34% of its total waste.[13] Steady improvement over the past four years has led to the monthly recycling ratio averaging 64% in the year ending December 2009. The building now recycles around 597 tonnes of paper and cardboard and 48 tonnes of glass, metal and plastics annually.

During stage 1 all construction waste from floor refurbishments or tenancy moves, plant and equipment expired parts and other materials were recycled, which led to a monthly high recycling ratio of 78% in November 2008 being achieved.

Building management continues to work in partnership with tenants including regular tenant communication and education incorporating sustainability meetings, advisement of recycling ratios and in their ongoing contamination reduction program.

Lighting in common areas

To optimise the foyer/atrium lighting system for energy efficiency, a minor controls upgrade and a new control strategy program was implemented for the lighting in the main foyer of the office tower and the high-bay lighting within the Galleria Retail Centre.

The aim was to maximise the use of natural sunlight and to provide only the minimum amount of electrical lighting support when required. This was achieved in part through the installation of a sensor (Lux Meter) which measures the ambient lighting level supplied naturally. Typically these meters are installed in a simplistic 'On' or 'Off' capacity; however by taking an analogue reading from the meter we can determine the light level in Lux. This information, together with further testing and commissioning, enabled building management to determine which lighting circuits and zones needed to be energised at various ranges of ambient light in order to meet the lighting needs of the space. A combination of ongoing energy savings generated as well as the lengthening of individual lamp life, produced a payback period for this item of less than one year.

Key benefits of the improved system included:

- An immediate decrease in electricity usage.
- Reduced re-lamping costs due to the decrease in lamp run hours.
- Reducing re-lamping costs further by extending duration between re-lamping activities, due to smart programming which rotates circuits on a schedule (duty cycle management).
- Lower labor and equipment hire fees due to reduced frequency of re-lamping.

The results

CPA's goal was to undertake strategic future-proofing through a comprehensive sustainability upgrade of 385 Bourke Street. Stage 1 of the refurbishment achieved a movement from a zero NABERS (National Australian Built Environment Rating System) rating to 2.5 NABERS energy star rating in a period of three years. The initial stage of the project was undertaken with high building occupancy and minimal tenant disruption.

The outcome has demonstrated some of the initiatives that can be implemented to make an existing building sustainable. The overall staged sustainability project has been motivated by CPA's focus to ensure 385 Bourke St remains a leading commercial tower with stable financial returns. Additionally, the project team openly contributed to the industry through knowledge sharing and demonstrating that sustainability and commercial success can be achieved in unison.

As at February 2010, further sustainability capital projects were at various stages of development from detailed feasibility, design and investigation stages to the commencement of programmed works including further building tuning, upgrades and innovative onsite energy generation projects. A further case study is planned to be presented in the future to track this important building sustainable redevelopment. ■

NABERS Stage 1 Project Case Study

NABERS Ratings – Effective until January 2011	
385 Bourke Street NABERS Energy	2.5 star
385 Bourke Street NABERS Water	2.5 star

Energy and carbon emission savings	
385 Bourke Street energy use – October 2006	912 MJ/m^2/annum
385 Bourke Street energy use – October 2009	541 MJ/m^2/annum
Percentage energy saving	41%
385 Bourke Street total lettable area	62,000m^2 of which 55,000 is commercial offices
Energy saved	371 MJ/annum/m^2
Greenhouse pollution saved	4680 tonnes CO_2/annum Equivalent to around: • 1017 cars taken off the road • Offsetting annual emissions of 251 homes • Planting of 1265 new trees
Water Consumption	1194 kL/m^2/annum

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Is New Zealand farm land worth what it will produce?

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Introduction

The recent world financial crisis originated in United States as a result of permissive lending practices by bankers and other mortgage originators. The availability of low-cost credit without too much consideration of the borrower's ability to repay loans initially led to a boom in real estate prices. House prices led the boom and were followed by escalating prices for commercial and rural real estate. A similar boom was seen in the real estate markets in New Zealand. Farm land prices increased both as result of cheap credit and as a result of increased world demand for agricultural commodities. The main commodity price drivers in agriculture were the United States' bio-fuel policy based on turning corn (maize) into ethanol and increased demand in developing economies in South-East Asia for milk protein products. There was also an element of speculation with traders and hedge funds using complex financial derivatives to purchase agricultural commodity futures. Speculation had the initial effect of driving commodity prices up, but the credit crisis resulted in reduced liquidity and increased volatility. Consequently many speculators were forced to exit in a falling market. Speculation was reduced when the world recession deepened and credit was restricted.

While the rural financiers in New Zealand did factor debt servicing ability into lending decisions there was an expectation of continued capital growth and sometimes risky lending took place. Part of the problem was that rural lending institutions were all competing for market share and their staff bonus systems were structured to reward staff who increased their lending volumes. Independent banking expert Tripe (2009) used strong words to criticise bank lending practices: "Where it's been really criminal is in the farming sector … They've had some unrealistic views of the riskiness of some of the business they've engaged in."

Research by Eves and Painter (2008) compared farm land returns from Australia, Canada, United States and New Zealand. They noted that since 1990 the price of New Zealand farmland averaged 40 times earnings and expressed doubts about the sustainability of such a high price-earnings ratio when compared to ratios of between 15 and 26 for the three other countries. Locke (2009) pointed out that based on the then early season projected milk payout, a $6 million dairy farm with a $2 million mortgage at 9 per cent interest would make a seasonal loss of $130,000. The Reserve Bank (2009) questioned the sustainability of agricultural debt levels, particularly for dairy farms which appeared to be at the most risk. The Reserve Bank noted total rural debt increased 30 per cent in 2007 and 2008 with dairy farm debt increasing 61.5 per cent.

Returns from farming

Economics teaches us the present value of a farm is equal to its discounted future earnings. It is necessary to define earnings from farming. Farmers typically see earnings from two sides of the business. Firstly, net cash flow from the business of farming and secondly cash flow

from property investment, that is land ownership.

An ongoing problem with farming in New Zealand is the business of owning land has been far more profitable than the business of farming. For example, the capital gains from owning dairy farm land prior to 2008 exceeded 10% per annum compounded. During the same period the returns from the business of dairy farming have typically returned 2%-3% per annum. This is not to say farming is inherently unprofitable but simply the high price of farmland makes it difficult for owner-operators to achieve cash flows beyond 2%-3% per annum. The benchmark summaries for the 2006/2007 season from the Dairy New Zealand Dairy Base (2009) website shows the average owner operator made a 2.8% return on dairy assets while for the same period the average sharemilker made an 8.3% return on dairy assets.

According to Meat and Wool New Zealand (2009) the situation for hill country sheep and beef farmers in New Zealand was worse than their dairy farming counterparts. The average rate of return on total farm capital employed in hill country farms over the period 1999-2008 ranged from -0.03% to 4.6%, with an average of 2%.

In times of low commodity prices the problem with highly leveraged farmers being asset rich and cash poor is accentuated since farm disposable incomes may be significantly below debt servicing requirements. During these periods it is common for farmers to say "land should be worth what it will produce" and "land is overpriced".

In the current situation of low commodity returns it is inevitable that farm land prices have come under downward pressure. Federated Farmers spokesperson Bruce Wills (2009) predicted some New Zealand farms could lose 30 per cent of their value. The most reliable indicator of movements in farm land values is the Quotable Value (2009) farm price index. Due to delays in recording sales data and low rural sales volumes the farm price index lags the market by up to six months, but declines in the index started to show up early in 2009. For example, the average price per hectare of dairy farms decreased by 10.6% in the half year ending June 2009.

An ongoing problem with farming in New Zealand is the business of owning land has been far more profitable than the business of farming.

At the time of writing dairy farms sales volume has decreased significantly with the Real Estate Institute (2009) reporting nil dairy farm sales in New Zealand during the month of August, down from 20 in the same period in 2008 and 19 in 2007. Decreased sales volume is an important leading indicator in real estate cycles, signalling downward pressure on prices due to the mismatch between higher vender expectations and lower bids by purchasers.

Historical perspective

So what happens when it all gets out of hand? Can farming for capital gains continue indefinitely? Perhaps history can provide some guidance? Should the government intervene as it has in the past?

Under 1935 State Advances Act the government-owned State Advances Corporation was instructed to value farm land on the basis of its productivity. Similarly under the 1936 Mortgagors and Lessee's Rehabilitation Act the income approach to valuation was used to assess the debt servicing capacity of farmers. In some cases mortgagees had to write down the principal owing under the mortgage to meet the farmer's debt-servicing ability. Of course this legislation was very unpopular with lenders and was soon repealed. The 1943 Servicemen Settlement and Land Sales Act fixed the price of farm land at 1942 values until 1951. The rationale for the legislation was so the soldiers going away to World War 2 would not be disadvantaged by increases in land prices. Farm land transactions during this period had to be approved by the Land Sales Court on the basis of productive valuations using a capitalisation rate of 4.5% and an agreed system of costs and pricing.

One of the problems with intervening in the market and controlling the price of land was that eventually the legislation had to be repealed and the market allowed to operate. Vendors were well aware that the price of land was likely to go up once the land sales era finished and so there were a number of circumstances where "dodgy transactions" were alleged to have occurred. Thus there was the official price, as specified by the Land Sales Court, but sometimes an additional illegal payment was made to actually secure the vendor's signature.

The most dramatic reduction in rural land prices over the last 50 years occurred during the so-called 'Rogernomics' restructuring during the 1980s. At this time almost all farming subsidies were removed and price of remote hill country farms fell by up to 60% in nominal terms during the downturn. Dairy farms were less affected because they were not subsidised to the same degree as sheep

Factor	Stage 1 Trough	Stage 2 Upturn	Stage 3 Boom	Stage 4 Peak	Stage 5 Downturn	Stage 6 Recession
Farm Profitability	Weak, some losses	Improved overseas product prices	Continual improvement	Decline	Continued decline	Losses are common
Sale Volume	Static, slow turnover	Increasing	Peaks	Decline	Continued decline	Volume low
Listing Time	Long listing time	Time to sell decreases	Listing time short	Longer listing time	Farms hard to sell	Long listing time
Farm Prices	Static	Increase	Rapid increase	Vendors offer attractive financing to keep prices up	Decreasing	Continue to decrease
Lending Criteria	Finance hard to obtain	Relaxed slightly but relatively expensive	Easy credit at favourable prices	Credit tightens, interest rates increase	Credit continues to tighten	Credit difficult to obtain and expensive
Buyer's Attitudes	Farms not seen as a good investment	Existing farmers can afford to expand	Rapid capital gains encourage more buyers into the market	High prices for farms and poor outlook reduce returns and buyer interest	Why purchase in a falling market?	Some bargains available for existing farmers
Sellers' Attitudes	Most sellers still under financial pressure	Backlog of unsold farms decreases. New sellers have higher expectations	An excellent time to sell	Still a good time to sell	Strong vendors withdraw from the market	Financial pressure to sell on many vendors

Figure 1: Farm Real Estate Cycles

and beef farms. However, when inflation is taken into account the drop in the dairy farm index from 1984-1987 was 45% in real terms.

Formulating price expectations

Johnson (1969) identified the difficulty farm buyers have when trying to estimate future agricultural commodity price trends and the effect of these on farm land prices. His research found periods of reduced volatility in farm incomes led to increased farmer confidence and lower capitalisation rates increased land prices. The research period of 1954-1969 was characterised by various industry and government schemes aimed at smoothing payouts to farmers. Johnson found when formulating their bid prices farm buyers appeared to place most emphasis on income in the year just past. Currently some dairy farmers are facing major difficulties because they purchased farms when the milk payout was $7.90 per 1kg of milk solids in 2007/2008 and a year later the forecast payout was $5.20. The forecast payout recovered somewhat to $6.05 for the 2009/2010 season but debt servicing difficulties remain. Leathers & Gough (1984) also investigated the pricing of farm land in New Zealand. They rejected the hypothesis farm land was overpriced. However, they noted the emphasis on deferred earnings (capital gain) created a distortionary effect leading to the same sort of liquidity and debt servicing problems evident in 2009.

Although markets usually get prices right in the end, in the short and medium term markets sometimes get things very wrong. An extreme example was reported by Hutchison et al (1997). In Japan in 1988 at peak values the Emperor's Palace in central Tokyo was worth more than all of the land and developed property in California. The land and gardens comprising the Emperor's palace consists of around 2.37 square kilometres (237ha.), the State of California in the United States is 423,790 square kilometres (42.37 million ha) and in 1988 had a population of 25 million. At the same time the total market capitalisation of Japanese shares exceeded the value of all Wall Street by ratio of 5 to 3 at a time when Japanese economic output was only one-third of that of the US. With the benefit of hindsight it is obvious the market got it badly wrong.

More recently behavioural school economists led by academics such as Akerlof and Shiller (2009) challenged the

efficient market hypothesis. They argued markets can sometimes appear to act quite irrationally, due to psychological factors (animal instincts) resulting in large swings in consumer confidence. Shiller (2005) showed very high price-earnings ratios in relationship to long term averages led to market corrections. He accurately forecast "irrational exuberance" leading to both the dot-com share market bust and the 2007 correction to the US housing bubble. Akerlof and Shiller went on to argue a case for "the steady hand of government" being used to provide an improved framework for markets to operate under.

Farmer incomes are determined by both the price of agricultural commodities and the volume of commodities produced. The traditional income approach to valuation assumes the net operating income is capitalised in a "typical year" but does not account for increasing productivity over time, the economies of scale a farmer adding more land may be hoping to achieve, "excess demand" from city-based investors seeking a tax shelter and changes in the highest and best use of the land to a more urban usage.

The reality is that in New Zealand pastoral farms have continued to get larger and more productive on a per hectare basis. Hall and Scobie (2006) estimated farming productivity increases of about 3 per cent per annum compared with productivity increases in the rest of the economy of less than 1 per cent per annum. Some of these productivity gains have resulted from improvements in plant and animal genetics and better management systems. Other improvements have relied on intensification by increased use of nitrogen fertiliser and supplementary feed.

Farm real estate cycles

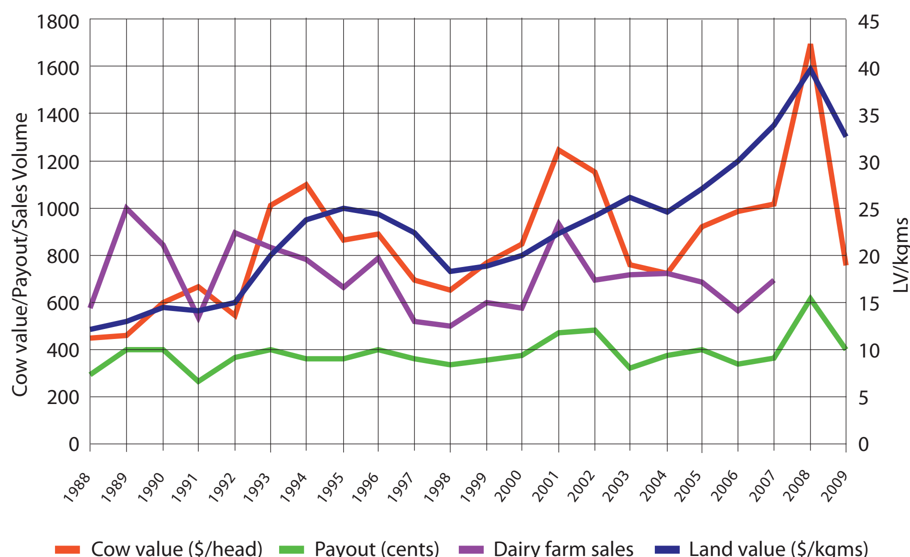
Figure 1 shows a stylised matrix developed by Hargreaves and McCarthy (1995) describing the six-stage rural real estate market and the various drivers of this market.

Farm profitability and sales volume consistently provide leading indications of changes in the real estate market. For dairy farms the most obvious indication that farm values are going to change are forecast changes in the payout. An expectation of an increase or decrease in payout is reflected in dairy farm sale prices and also reflected in the price paid for capital dairy stock. The volume of farm sales also provides an indication of changes in the price of dairy farms. Volumes typically lead prices by about a year.

The length and magnitude of dairy farm real estate cycles is hard to predict but Figure 2 shows that the average length has been more than 10 years over the period from 1988 to 2009. Figure 2 shows the relationship between the real Quotable Value Dairy Farm Index, sale prices, payout, cow sale prices and annual dairy farm sales volumes. The key points that can be ascertained from Figure 2 are that payout, cow prices and farm turnover lead real estate prices both on the upside and downside of the real estate cycle. Farms are getting bigger and thus over time the number of dairy units and volume of dairy farm sales is declining but within this there are still cyclical turnover patterns. For example, the Department of Environment (2007) reported dairy farm numbers decreased from 16,843 in 1994 to 12,810 in 2005 while Statistics New Zealand (2010) noted the national dairy herd was at 5.8 million cows in 2009, double the 1979 tally. Increases in the dairy farm payout quickly get capitalised on to the price of land but decreases in payout take much longer to affect the land prices.

Government intervention in the form of light-handed regulation from the Reserve Bank could result in more sensible loan to value ratios and greater emphasis on debt servicing ability, thereby helping to avoid future farm price bubbles. However, the rural market will continue to demonstrate cyclical effects just so long as New Zealand farmers are subjected

Figure 2



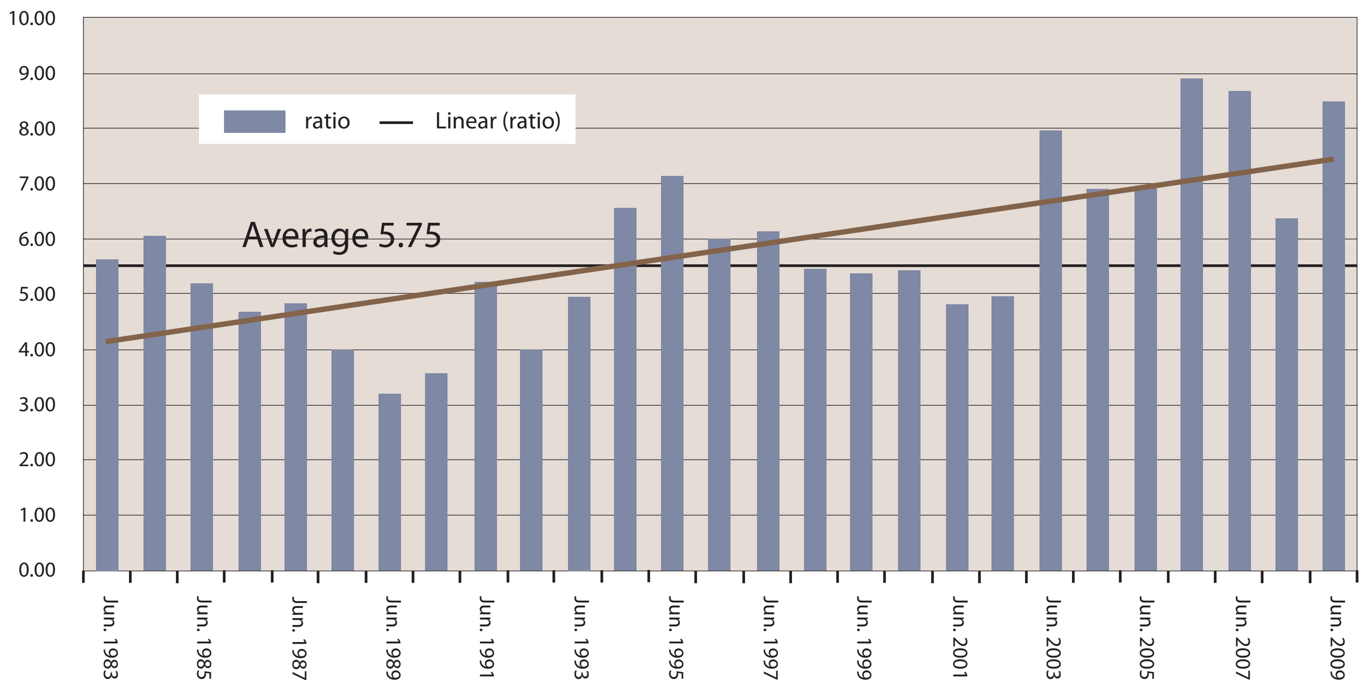


Figure 3 : Ratio of Price Paid per kg ms to Payout

to the ebbs and flows of international commodity prices, currency fluctuations and some farmers continuing to use last year's price as a proxy for future prices.

The bar graph in Figure 3 shows the annual ratio of the price farmers pay per kg of milk solids to purchase dairy farms and the milk solids payout per kg. Over the period June 1983 to June 2009 the ratio averaged 5.75. Periods when the ratio was lower than 5.75 represented good buying. The upwards sloping trend line shows the annual income from the business of farming steadily decreasing in relation to the price paid for dairy farms. The economies of scale made possible by operating larger farms may account for some of the upward movement over time in the price paid per kg of milk solids.

Valuation methodology

Inevitably, valuation methodology in New Zealand has come under scrutiny and questions have been raised about the most appropriate basis for the valuation of farm land. Currently there are three standard approaches to the valuation of farm land; (Murray 1969, Frizzell 1979, American Society of Farm Managers and Rural Appraisers and The Appraisal Institute 2000). These are the comparable sales approach, the replacement cost less depreciation approach and the income approach. Normally valuers use at least two of the three approaches when compiling a rural valuation. The comparable sales approach is where like is compared with like and operates across many markets including farms, housing, the sharemarket, animal sales and plant and equipment sales. This approach works particularly well when there is plenty of recent sales information. The main difficulty with applying comparable sales to the valuation of farm land comes down to the heterogeneous nature of farms. No two farms are exactly alike and the rural market often has relatively few recent transactions. The skill of the rural valuer is in being able to make adjustments for the differences between sale properties and relate this back to the property being valued. Although valuation is an inexact science, rural valuers do have the experience and judgement to make these adjustments.

The second approach is the replacement cost less depreciation method. This method involves calculating the added value of the improvements and adding this to the land value. The added value is estimated by calculating the replacement cost of each improvement and then the deducting an amount for depreciation. There are strong market elements contained in the replacement cost less depreciation method because the historical cost of land is usually irrelevant and the current value has to be estimated from comparable sales of land exclusive of improvements. Similarly there are no textbooks available to assist a valuer with estimating how much depreciation to deduct as the rate of depreciation is driven by the market and keeps changing.

The third approach is the income or productive approach. This approach requires the valuer to do a productive budget. The surplus brought from the

budget is capitalised to arrive at the productive valuation. The linkage between the income from an asset and its value is the capitalisation rate, or yield. After capitalising the income stream the valuer needs to adjust the valuation for the quality of both the locality and improvements. Farms closer to town typically sell for more than farms that are further away. Furthermore, improvements which may not add to the productivity of the farm can have an impact on the value. For example two farms may be identical in all respects except that one has a million-dollar house and the other one a house worth $100,000. The income approach also has some strong market elements. Unless the capitalisation rate used in the income approach is market related then the valuation may not relate to what is actually happening in the market place.

The current reality is that the valuers employed by lending institutions tend to rely on the comparable sales approach, use the cost less depreciation method as a backup method and for the most part ignore the traditional income approach to valuation. However, it is true that various gross income estimates are widely used by buyers and sellers as well as valuers. For sheep and beef farms the price paid per stock unit is the typical gross income metric. The equivalent metric for dairy farms is the price paid per kilogram of milk solids. Like many rules of thumb, gross income estimates present some real dangers when too much reliance is placed on this approach. For example, consider two dairy farms with identical per hectare production but the first dairy farm may achieve this without the use of supplementary feeds and wintering off and make minimal use of nitrogen fertiliser. Clearly, if the second farm makes use of wintering off and supplementary feed then the first farm would be expected to sell for more on a per hectare basis.

Part of the reason the traditional income approach to valuation has not been used very much over the last 20 years relates to the fact it is time-consuming. However, the advent of modern computers and computer spreadsheets now makes it possible to speed up the computational aspects. Online farm databases for the main farming types and regions also provide essential industry cost and price information.

Although markets usually get prices right in the end, in the short and medium term markets sometimes get things very wrong.

It is worthwhile reviewing the theoretical concepts underlying the income approach. The income approach budget for valuation purposes puts the farm in a static or status quo budget position. This means the fertility of the farm remains constant as do the numbers and genetic merit of the animals, improvements are maintained in their present state of repair, and the costs and prices used in the budget will not necessarily be current market prices if it appears that these are out of line with long run prices. This budget also uses the concept of the average efficient farmer. The average efficient farmer is not easy to define, but usually thought of as the average of the top 50% of farmers. The reason for this is that the less successful operators are more likely to be exiting the industry. Conversely, if the valuer is valuing a farm where the current operator is achieving production of 10% beyond what anyone else could achieve then clearly this level of management could not be used in the budget because once this very efficient manager sells the extra production would be lost. The productive budget is not a cash forecast budget because it provides for depreciation in order to maintain improvements and plant and machinery in a steady state. According to Heady (1952) the theoretical concept behind this approach is based on the Euler theorem of production economics whereby all of factors of production are rewarded according to their marginal value product, or market value. In the case of the reward for management this will not be the nominal amount that might be used by lending institutions to calculate a farmer's drawings but would be the amount it would cost to hire an outside manager. If the management factor was under awarded and the surplus inflated by this amount, this would be capitalised into the value of the land and the result is over valuation. Similarly the contribution of the stock and plant is assessed by valuing these items and then charging interest, at a rate that reflects the higher risk, on this value against the budget.

A derivative of the traditional productive approach is the bid price method as described by Klemme and Schoney (1984) and Leathers and Gough (1984). The bid price considers the valuation from the point of view of a potential purchaser. The bid price equals the productive value plus investment value. One of the strengths of this method is that it is forward looking and forces potential buyers to consider the value of a farm on the basis of productivity. When

entering a period when there is little capital gain (and possible capital losses) ahead this seems like a prudent approach.

Thus the first part of the bid price method is to ascertain the productive valuation using the budgetary concepts discussed above. In this case the capitalisation rate used is the real after-tax of cost of capital weighted for the influence of equity and borrowing. For example, with a 50% debt/equity, current debt funding at 7% and an after-tax return to equity of 3% then the capitalisation rate is 5%. The investment value is calculated by discounting the likely selling price at the end of the holding period back to present values. In this case the discount rate will be the same as the capitalisation rate. In the current market care would have to be taken on assessing the likely selling price, historically there has been a 10% annual growth but values have decreased in the past in real terms when farm returns dropped.

A significant difficulty with the capitalisation approach occurs with valuing land uses with fluctuating income streams as might be found in horticulture and viticulture. In these enterprises there are usually negative income streams for several years during the development and establishment phases. As the trees or vines mature, yield increases and cash flow becomes positive and then gradually decreases as the trees/vines age and newer varieties are preferred in the market. In this type of situation the discounted cash flow method is the most theoretically correct valuation technique to use.

The future outlook for farm land values

Based on price earnings ratios, farm land in New Zealand currently appears to be overpriced. A market correction is under way but this may not be as severe as some commentators are suggesting because of the inescapable population pressures that Malthus identified and the demand for bio-fuel crops accentuating the shortage of arable land used for food production. For example, during the period 1960-2000 on a world wide basis, the amount of arable land per person reduced by 44% to 2500m2. Couple this with looming water shortages in countries where agriculture is affected by changing weather patterns and reduced snow melt caused by global warming. In addition, the increased demand for water by industry and cities means farmers are consistently outbid for water rights.

The net result provides competitive advantage to high rainfall countries such as New Zealand where agriculture is largely based on pastoral methods. Also, the world demand for the protein products (milk, meat and fish) New Zealand is good at producing is increasing due to rising middle-class wealth, particularly in India and China. Furthermore concerns about pollution to the environment resulting from factory farming operations favour less intensive pastoral farming systems.

Of course scientists may use genetic engineering to come up with another "green revolution" by producing high-yielding "miracle" crops. However history shows that increased crop yields from improved crop varieties come at the cost of higher inputs of artificial fertilisers.

Future improvements in productivity are likely to become more difficult due to concerns about the environmental damage to the rivers and streams resulting from the waste water discharges produced by intensive farming systems. There is also the question of who pays for mitigating global warming and the contribution to greenhouse gases from farm animals.

Logically the need to mitigate emissions from agriculture is likely to have negative influence on future farm land prices. Currently just under 50 per cent of New Zealand's total greenhouse gas emissions are derived from agriculture. When agriculture is phased into the proposed emissions trading scheme in 2015 farmers will have to start paying for greenhouse gas emissions and this will reduce their cash flows. Certainly scientific developments in on-farm carbon

sequestration and the use of nitrogen inhibitors will reduce the present level of emissions but there will still be a cost to be borne by farmers.

Conclusions

As a result of tighter credit for farmers bank managers are likely to pay much more attention to cash flow. The old sayings that "cash flow is king" and "near cash flow is worth more than future cash flow" will become particularly relevant. Budgets where bankers stretch the rules and factor in interest-only loans and capital gain are likely to be a thing of the past. However, it is not all doom and gloom for investors, history shows that the rural property market is surprisingly resilient in periods of downturn. Smart farmers can influence supply by delaying retirement and minimising the number of farms on the market during tough times. Such actions help to underpin the price of land. In addition, there is only a certain amount of land and strong operators continue to enlarge their operations and compete among themselves for land.

The rural market is also influenced by the urban market. The ongoing demand for lifestyle blocks within commuting distance of towns and cities gives farmers the option of either selling their farm to another farmer, or subdividing and selling lifestyle blocks. There is also a ripple effect when the farmer close to town sells and buys another farm outside the commuting zone thus injecting more capital into this market. Then there is the question of highest and best use to other farm and horticultural endeavours. While dairy farming is currently the highest and best use of much of the better land in New Zealand this will not always be the case. With water shortages looming in the drier parts of the country it seems likely the most efficient use of this resource will be for sustainable horticultural and arable activities.

The reduction in farm prices during 2009 supports the contention that farm land has been over-priced in relationship to its earning capacity. Continuation of the normal ups and downs of rural property cycles seems inevitable given New Zealand farmers' exposure to the volatility of world markets. However, lending institutions do have the power to avoid fuelling property bubbles if they adopt more prudent lending criteria. History shows most banks are unlikely to act prudently in times of easy credit because they are all competing for market share. Fortunately moves are under way in New Zealand by the Reserve Bank to require trading banks to increase their reserve asset ratios to better reflect risk, thereby reducing the amount of available credit.

While the market approach to the valuation of farmland has stood the test of time and is upheld in the New Zealand Courts, it is essentially a backward-looking approach. Valuers are sometimes accused of driving forward while looking in the rear vision mirror. In volatile property markets it is also important to look ahead at future cash flows and likely changes in property values. The income approach to valuation, the bid price method, and discounted cash flows are forward-looking approaches. The authors recommend these approaches be incorporated into buyer calculations and valuation reports.

Readers should note that the conclusions in this paper are specific to the New Zealand situation and may have limited application in other agricultural exporting countries. ■

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New 'Old' Property: Compensation for Indigenous Cultural Heritage

John Sheehan

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Introduction

Indigenous cultural heritage together with native title and statutory land rights comprise a trilogy of legal rights and interests which focus specifically upon Indigenous peoples[2] in Australia. Native title was first recognised in *Mabo & Ors v State of Queensland (1992)* 175 CLR 1 (*Mabo No. 2*) and was partially codified by the *Native Title Act 1993* (Cth). Statutory land rights predate the recognition of native title, and were initially created by the Commonwealth Government in the *Aboriginal Land Rights (Northern Territory) Act 1976* (Cth).

However, the *Aboriginal Land Trusts Act 1966* (SA) predated the 1976 Commonwealth land rights legislation, and arguably was the first true statutory scheme creating Indigenous land rights in Australia, albeit limited to the State of South Australia.

Apart from native title and statutory land rights, it has been recognised by both Commonwealth and State Governments that Indigenous sites and specific items are of Indigenous cultural heritage significance. The *Aboriginal and Torres Strait Islander Heritage Protection Act 1984* (Cth) was the first national statutory protection for Indigenous sites and items and is now only applicable to Commonwealth lands, the States all having complementary legislation. However, Indigenous cultural sites and items present an intriguing issue from a property theory standpoint.

Commonwealth and State legislation all ensure items which may include human remains and sacred (revealed and unrevealed) objects are held by the relevant Government as custodian, but are in fact controlled and safeguarded by the relevant Indigenous peoples. Such a situation which often includes guarantees of access to the sites and items raises the issue of whether Indigenous cultural heritage is property, and hence, capable of attracting compensation for diminution or destruction.

It is this topic which is canvassed in the following paper.

Indigenous cultural heritage as property

It is considered Indigenous cultural heritage sites and items demonstrate a potential for the generation of compensation arising from diminution or destruction. It is recognised there is no specific reference to compensation in States' legislation or in the *Aboriginal and Torres Strait Islander Heritage Protection Act 1984* (Cth), although arguably the rights held by Indigenous people under such legislation could be reasonably construed as property rights.

Interestingly, approvals of cultural heritage management plans under *Part 7* of the *Aboriginal Cultural Heritage Act 2003* (Qld.) or the issuing of Consents under *s.21U (4)* of the Commonwealth legislation arguably contemplate compensation in the manner of a condition of such approval or consent. Similar arguments can be put forward for other States' regimes.

Broadly, the relevant Indigenous people have property in the in situ artefactual material and the reasonable curtilage of land for the repose of such material, and certainly under *s.20* of the Queensland legislation that land could be regarded by analogy as an "Aboriginal place or Aboriginal object" pursuant to the *Declaration of Preservation* envisaged at s.21E of the Commonwealth legislation. Indeed, the absence of such a *Declaration* does not in the view of the author ameliorate the "importance of maintaining the relationship between Aboriginals and that place or object".[3]

There is no other class of persons except the relevant Indigenous group who can assert property in the in situ artefactual material or the reasonable curtilage, and it is arguable that the rights in question have a quality of exclusivity, which could approach freehold title.

In addition, it is conceivable the relevant Indigenous group also has property in the form of access rights to the artefactual material lying in situ, irrespective of whether the land in question is owned by the Commonwealth, State or is held privately as freehold. These access rights are analogous to an easement or right of way, and indeed in the Commonwealth legislation at *s.21U(2)* such rights are referred to as:

> *... entering on or interfering with an Aboriginal place or Aboriginal object in accordance with Aboriginal tradition ...*

In addition, the construing as property of these access rights to enter land are different again to those rights in the Commonwealth legislation that the Minister may or may not confer under *s.21R* to inspect artefactual material.

Support for the notion of property in Indigenous cultural heritage sites and items is also evident in work by Godwin[4] in the Queensland legislative context, which whilst different to Commonwealth legislation, reveals that the fundamental issue of property in the artefactual material, the curtilage and the access rights are markedly similar. Godwin[5] noted statutory rights created to protect Indigenous cultural heritage supposedly vested in the State of Queensland, were nevertheless qualified by the (now repealed) *s.32 Cultural Record (Landscapes Queensland and Queensland Estate) Act, 1987* (Qld) which stated:

Indigenous cultural heritage sites and items demonstrate a potential for the generation of compensation arising from diminution or destruction.

> *... No provision of this Act shall be construed to prejudice –*
>
> *(a) rights of ownership had by a traditional group of indigenous people or by a member of such a group in a part of the Queensland Estate that is used or held for traditional purposes; or*
>
> *(b) free access to and enjoyment and use of a part of the Queensland Estate, where such access, enjoyment or use is sanctioned by traditional custom relating to that part, by a person who usually lives subject to the traditional custom of a group of indigenous people.*

Whilst the 1987 State legislation has been now overtaken by the *Aboriginal Cultural Heritage Act*, 2003 (Qld.), however the discussion by Godwin remains of considerable value. Importantly, he distinguishes rights of ownership under *s.32* of the 1987 legislation from native title, drawing upon *Yanner v Eaton* (1999) 201 CLR 351 which demonstrated that the Crown did not have the equivalent of private property in some natural resources such as fauna. The Court also determined that a native title right to hunt fauna existed, as anticipated by s.223 *Native Title Act 1993* (Cth.)

This incident of native title to access natural resources such as fauna is a usufructory right, however because native title as recognised in *Mabo* must also be founded in a basic right to land, the right to such resources amongst other rights must also be part of the traditional bundle of legal rights to land asserted by native title holders. Arguably, Indigenous cultural heritage as an incident of any surviving native title is by definition also a class of such property.

Adding further complexity to the property scenario, *Wik Peoples v Queensland* (1996) 134 ALR 637; (1996) 141 ALR 129 demonstrated that property such as pastoral leases which are unknown to the common law can be created by statute, and the prospect of other statutory estates is clearly possible.

Arguably, the twofold property rights accruing to indigenous people under the *Aboriginal and Torres Strait Islander Heritage Protection Act 1984* (Cth) are statutory estates created outside the common law, and potentially compensable. These property rights within the 1984 Commonwealth legislation relate not only to Commonwealth lands, but until recently also applied to Victoria which did not until 2006 have its own Indigenous cultural heritage legislation. Nevertheless, with the enactment of the *Aboriginal Cultural Heritage Act 2006* (Vic.) any property rights that could be construed in the earlier Commonwealth legislation in the Victorian context arguably would appear preserved.

Is there a need to clarify property rights?

The foregoing discussion reveals that current Commonwealth and States' legislation is unclear and arguably defective in the area of the property rights of Indigenous peoples in Australia in cultural heritage sites and items. Whether legislation should be amended to clarify the question of property rights in Indigenous cultural heritage sites and items raises an issue of how such rights currently interact with existing Commonwealth and State landholdings, and in particular private freehold rights.

It is commonly held that the Commonwealth and the States "own" in situ Indigenous cultural heritage items and the curtilage, although not the underlying tenure in every case. Further, it is commonly held that Indigenous traditional owners only own artefactual material when it has been collected and removed off site.

However, any "refusal to propertise" such as occurs in the abovementioned Commonwealth and States' legislation, is according to Gray[6] an "absolutely critical" issue in ascertaining whether the matters in hand are indeed property. Yet, there remains in the legislation a continuing sense of place controlled by the relevant Indigenous group, contrary to standard assertions there is no property in Indigenous cultural heritage sites and items.

The "primordial principle"[7] is that once a resource is "excludable",[8] hence controlling access to benefits flowing from the resource, a case exists for property, and Gray points out:

> *[n]o one can claim "property" in a resource in relation to which it is physically unrealistic to control, consistently over prolonged periods, the access of strangers.*[9]

If it is accepted in the earlier discussion regarding the *Aboriginal and Torres Strait Islander Protection Act 1984* (Cth) and in the States' legislation, that control and access to sites and items lies ultimately with the relevant Indigenous peoples, surely the threshold of "excludable" is passed, constituting the crucial test of property. Support for this view, can be found in the manner in which the transition from open access to property rights for natural resources has been treated by the Courts over time, notably when dealing with less familiar forms of property.

A useful example of these judicial considerations is found in *Minister for Primary Industry and Energy and Australian Fisheries Management Authority v Davey and Fitti* (1993) 119 ALR 108, where the view of the Court was sought *inter alia* whether the fishing capacity permitted for the Northern Prawn Fishery expressed in *units of fishing capacity* was in fact "property" within the meaning of *para.51(xxxi)* of the Australian *Constitution* which states that:

> *The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to: –*
>
> *… The acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws:*

In ascertaining the *units of fishing capacity* were property, it was noted by the Court that the limits of operation of *para.51(xxxi)* have not been determined precisely. Importantly, the Court drew upon an early definition of property in *The Minister of State for the Army v Dalziel* (1944) 68 CLR at 290:

> *… [property] extends to every species of valuable right and interest including real and personal property, incorporeal hereditaments such as rents and services, rights of way, rights of profit or use in land of another, and chooses in action.*

The Court decided that the *units of fishing capacity* were property rights which were generated by statute, and were "property" for the purposes of *para.51(xxxi)*.

the Commonwealth also proposes that a new nation-wide definition be adopted for a traditional area

Further, the "excludable" principle was crucial in the *Wik* decision being the determinant of whether particular pastoral leases extinguished native title, the author observing subsequent to the High Court decision that:

> *[t]he duration of the statutory estate, the conditions of its granting, and the degree of exclusivity of occupation are major factors identified in the Wik decision which will determine the capacity of the leasehold interest to extinguish indigenous property interests, whatever that bundle of rights may be. The difficulty compounds when one recognises that leasehold interests, as indeterminate as they may be (especially in terms of degree of exclusivity), may have to accommodate an equally indeterminate native title.*
>
> *…The degree of exclusivity granted to a leaseholder also has a complementary effect on the ability of the leasehold interest to withstand a competing native title interest.*[10]

In a much overdue response, recent attempts have been made by the Commonwealth and some States to clarify the rights of private land owners and Indigenous custodians when Indigenous cultural heritage sites and items are present. Such moves are canvassed in the following section of this paper.

Remedying defective Commonwealth and State legislation

The Commonwealth Department of the Environment, Water, Heritage and the Arts (DEWHA) released a discussion paper in August 2009[11] which proposes nation-wide harmonisation of existing States' Indigenous cultural heritage legislation supplemented by the Commonwealth through matching reforms to the existing *Aboriginal and Torres Strait Islander Protection Act 1984* (Cth) and the *Environment Protection and Biodiversity Conservation Act 1999* (Cth).

However, the Commonwealth discussion paper proposes that "the primary responsibility for the legal protection of traditional areas and objects"[12] should remain with the States, a recognition that the Australian *Constitution* firmly leaves crucial land management powers with the former six pre-Federation colonies, now States. Nevertheless, the Commonwealth proposes that the intent of the *Aboriginal and Torres Strait Islander Protection Act 1984* (Cth) should be redefined to:

> *... [a]knowledge that Indigenous Australians are the primary source of knowledge of their traditional laws and customs and have responsibilities to protect their traditional areas and objects.*[13]

Importantly, the Commonwealth also proposes that a new nation-wide definition be adopted for a traditional area, namely:

Traditional area means an area that meets both of the following criteria:

- *The area has a use or function under traditional laws and customs, or is a subject of a narrative that is part of traditional laws and customs.*
- *The area is protected or regulated under traditional laws and customs.*[14]

The new broader definition[15] would include sites such as ceremonial grounds, burials, keeping places and dreaming places, as well as items of a ceremonial or sacred purpose, and including presumably the land where such items are undisturbed in situ.[16] Where activities are proposed on traditional areas, it is intended that nation-wide standards be adopted including an ability to impose conditions which:

> *.. .avoid or minimise an adverse impact on a traditional area or object when granting approval.*[17]

Importantly, in assessing a proponent's application for approval of a particular activity, consideration must be given as to whether the activity:

> *... would reduce or impede the ability of Indigenous people to:*

i) use or enjoy the area or object under their traditional laws and customs or

ii) maintain their traditional laws and customs about the area or object.[18]

Also where an Indigenous sites or item is threatened, a protection application can currently be made under the *Aboriginal and Torres Strait Islander Protection Act 1984* (Cth), and it is proposed that amendments to this legislation are needed to clearly identify "anyone whose legal rights and interests may be affected" including:

> *... the owners and occupiers and any other person with a legal right to carry out an activity in the area, including persons entitled to explore for mineral in the area.*[19]

Importantly, the Commonwealth proposes amendments to the *Environment Protection and Biodiversity Conservation Act 1999* (Cth) which would remedy the current absence of powers to remedy damage to Indigenous cultural heritage sites and items, or to:

> *... compensate ... [I]ndigenous Australians, who may feel it is unfair that they do not get any benefit when a government fines someone who has destroyed their heritage.*[20]

This proposal for compensation starkly raises the vexed question of whether property in Indigenous cultural heritage exists, and hence whether compensation for diminution or destruction accruing to the traditional "owners" ought to be similar to more familiar classes of property. Unsurprisingly, the proposal has attracted the attention of property development lobbyists such Urban Taskforce Australia who consider that an obligation for compensation for "Indigenous groups" would create "a property right".

Similarly, but on a much more modest scale the Queensland Department of Environment and Management is attempting to resolve the issue of access to private land for the purpose of an Indigenous cultural heritage study, enforced possibly by a statutory notice ensuring access for traditional custodians. Arguably, this form of access is analogous to an easement or right of way and reveals starkly the continuing difficult interaction between Indigenous rights and private freehold rights in particular.

There is also increasing interest is such issues internationally, a further catalyst for legislative change in Australia. Importantly,

the UNFAO[21] has recently published a guide to good practice for compensation when land is compulsorily acquired by governments, and usefully includes a discussion on dispossession of "important religious or cultural sites"[22] sometimes part of customary rights triggering compensation for loss.[23] Instructively, the UNFAO provides the example of recent changes to Ugandan law which as a result:

> *... (t)he legal recognition of customary rights elevated customary tenure to the same level as other forms of tenure, and opened the door for people with customary rights to receive compensation for land that is compulsorily acquired.*[24]

Similarly in Australia, the customary lands held by Indigenous peoples have been recognised by national law, first in 1992 by the *Mabo* decision and secondly by the subsequent *Native Title Act 1993* (Cth). Indigenous cultural heritage sites and items are often an integral incident of surviving native title, and an important diagnostic marker for other incidents.

It is however where native title has been extinguished that Indigenous cultural heritage sites and items has elevated importance for traditional custodians. Indigenous property rights in such sites and in situ items appears so obvious as to be legally uncontroversial, yet until very recent times this has not been so. The profound silence of the six Australian States on this subject strongly suggests an unwillingness or even intransigence to contemplate property rights in Indigenous cultural heritage sites and items. The prospect of a State obligation for the payment of compensation arising from the diminution or destruction of sites or items is a more likely reason for this silence. The recent Commonwealth proposal for compensation discussed earlier in this paper is clearly contrary to the States' position.

Closing comments

The foregoing discussion on the prospect for property in Indigenous cultural heritage sites and items arguably raises at the very least the spectre of a new statutory estate in Australian property law for this purpose. The creation of pastoral leases[25] in the early nineteenth century in the absence of such property rights in the common law revealed from a property theory standpoint how innovative developments in property law can occur in surprisingly swift response to societal needs.

However, Indigenous property rights in cultural heritage sites and items may not be so innovative as might be first thought. The inchoate Indigenous rights currently existing in State and Commonwealth legislation analysed using the lens of Gray's "primordial principle"[26] reveals that once a resource is "excludable",[27] a case exists for property. It seems imminently reasonable to conclude the current ability of traditional custodians to control "the access of strangers"[28] demonstrates that the threshold of "excludable" is passed, constituting as stated earlier the crucial test of property.

Arguably, it is likely that the current proposals of the Commonwealth for nation-wide harmonisation of legislation will see the crystallisation of the inchoate Indigenous rights to cultural heritage sites and items as a "new" class of property. More importantly, the tantalising prospect arises for the development of case law on the assessment of compensation for the compulsory acquisition of these property rights. As often occurs in such matters, the resultant case law may also shed new light on settled land valuation principles which may require recasting or at least, reinterpretation for this new task. ■

Statutes

Aboriginal Cultural Heritage Act, 2003 (Qld.)

Aboriginal Cultural Heritage Act 2006 (Vic.)

Aboriginal and Torres Strait Islander Heritage Protection Act 1984 (Cth.)

Aboriginal Land Rights (Northern Territory) Act 1976 (Cth.)

Aboriginal Land Trusts Act 1966 (SA)

Cultural Record (Landscapes Queensland and Queensland Estate) Act, 1987 (Qld)

Environment Protection and Biodiversity Conservation Act, 1999 (Cth.)

Native Title Act 1993 (Cth.)

Cases

Mabo & Ors v State of Queensland (1992) 175 CLR 1

Minister for Primary Industry and Energy and Australian Fisheries Management Authority v Davey and Fitti (1993) 119 ALR 108

The Minister of State for the Army v Dalziel (1944) 68 CLR at 290

Wik Peoples v Queensland (1996) 134 ALR 637; (1996) 141 ALR 129

Yanner v Eaton (1999) 201 CLR 351

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Sheehan, John (1998) "Native Title and Statutory Estates" *Australian Land Economics Review 4(1), 29 – 35.*

The Australian (2010) "Indigenous sites plan 'only adds red tape' 13 January, 7.

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Urban Taskforce Australia Ltd. (2010) "Push to centralise Indigenous heritage powers jeopardises property rights" Media Release (Sydney: 13 January)

Notes

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[2] Indigenous peoples are also commonly referred in Australian legislation as Aboriginal and Torres Strait Islander peoples.

[3] *s.21E Aboriginal and Torres Strait Islander Heritage Protection Act 1984* (Cth.)

[4] Godwin, Luke (2001), "The Bureaucracy, the Law and Blacks Palace: A History of Management of One Site in the Central Queensland Highlands" *NGULAIG* 18.

[5] Godwin, 19-20.

[6] Gray, Kevin, (1991) "Property in Thin Air", *Cambridge Law Journal* 50(2), 256.

[7] Gray, 268.

[8] Gray, 268.

[9] Gray, 270.

[10] Sheehan, John (1998) "Native Title and Statutory Estates" *Australian Land Economics Review 4(1), 33.*

[11] Department of the Environment, Water, Heritage and the Arts (DEWHA) (2009) *Indigenous Heritage Law Reform: Possible reforms to the legislative arrangements for protecting traditional area and objects* (Canberra: Australian Government, August)

[12] DEWHA, 3.

[13] DEWHA, 11.

[14] DEWHA, 14.

[15] The widening of the definition beyond sites or items of "special significance" has been viewed by the National Native Title Tribunal as possibly covering all of an Indigenous community's traditional country, see *The Australian* (2010) "Indigenous sites plan 'only adds red tape." 13 January, p7.

[16] DEWHA 14.

[17] DEWHA 18.

[18] DEWHA 20.

[19] DEWHA 33.

[20] DEWHA 46.

[21] UNFAO (Food and Agriculture Organisation of the United Nations) (2009) *Compulsory Acquisition of Land and Compensation* Land Tenure Studies 10 (Rome: Land Tenure and Management Unit, Land and Water Division).

[22] UNFAO 2.

[23] UNFAO 36.

[24] UNFAO 34.

[25] See earlier discussion in this paper on *Wik Peoples v Queensland* (1996) 134 ALR 637; (1996) 141 ALR 129.

[26] Gray, 268.

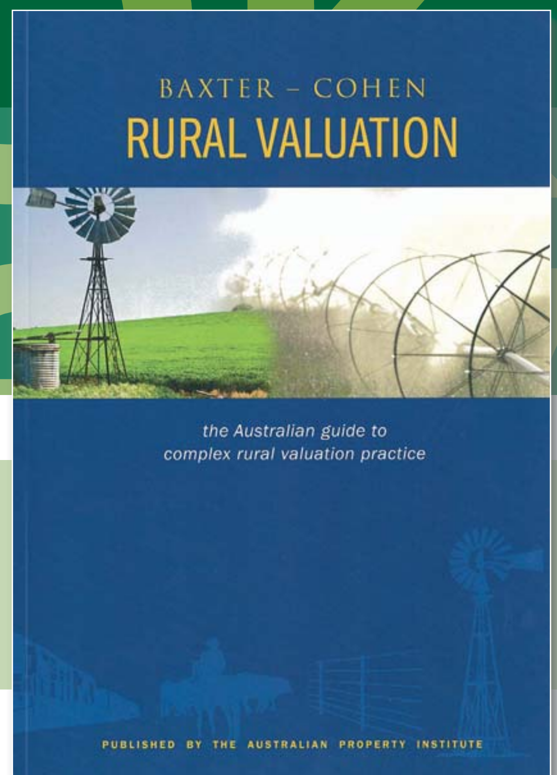
[27] Gray, 268.

[28] Gray, 270.

Book review

Rural Valuation

Edited by Matthew Townsend



Title: Rural Valuation (2009)
Authors: J.S. Baxter and R.K. Cohen
Publisher: Australian Property Institute (Canberra)
Reviewer: Professor Richard Reed (Deakin University)

This book has filled a long-standing void in the critical area of rural valuation in Australia. The authors are Associate Professor James Baxter and Mr Ralph Cohen who are held in high regard in their respective academic and industry fields. The objectives of the text are to enable the reader to gain an understanding about all facets of rural property including supply and demand (sellers and buyers), the value of rural property and factors which affect rural property and production on the land. It is an excellent reference for all stakeholders interested in rural valuation. It can be read in consultation with other specialised text such as the *Valuation of Real Estate* (2007) also published by the API. In *Rural Valuation* there are seven chapters set out in a logical order which starts with basic fundamentals about rural property and then progress sequentially through to complex rural property:

Chapter 1 *(Introduction)* introduces valuation basics and also discusses the background to farm land, implication of native title, markets and other forms of value as well as introducing the concept of most probable use.

Chapter 2 *(Geographic and Spatial Location)* identifies factors affecting the land. This includes weather/climate, rainfall, evaporation, wind patterns, temperature, growing seasons, topography, soil, leaching, water movements in soil, chemical reaction, fertilisers, farm size and shape, land degradation, other issues and further reading.

Chapter 3 *(The Needs of Enterprise)* focus on the farm as a means of production and covers grazing enterprises, livestock basics, cropping enterprises, fruit and vegetable production, rural development, farm improvements, improvements on the land, economic location and summary.

Chapter 4 *(The Impact of Management)* examines how the farm is managed with sections including land management, developing a business plan, management strategies to cope with drought, machinery use, risk, financing the farm, investment and return, sustainability plus further reading.

Chapter 5 *(Externalities)* includes rural industries and valuation practice, agriculture economies and world politics, measuring economic indicators at farm level, trade agreements, Kyoto protocol and impacts, infrastructure development, directions plus further reading.

Chapter 6 *(Basic Valuation Methodology)* covers market analysis, sales analysis, information available to the valuer, property identification in practice, application of valuation principles to rural land, interview techniques, inspection and field notes, valuation approach sales analysis, the choice of unit in rural valuation work, farm improvements and their valuation, valuation of different land categories, differing soil and land classes, valuation of grazing and cropping country, analysis using statistical techniques, summary and further reading.

Chapter 7 *(Valuation of More Complex Properties)* includes impact of planning in rural areas, valuation of irrigated land, valuation of specialised rural properties, valuation consideration for special properties, valuation for statutory purposes in rural districts, compensation for compulsory acquisition, rural rating, hobby farms and rural retreats, report writing for rural valuation, IVSC, API standards and guidelines plus further reading.

A detailed index is also included.

Throughout the book there is the strategic use of diagrams and figures to highlight relevant aspects. *Rural Valuation* provides the reader with a sound knowledge base for valuing rural property in Australia. It is recommended as a sound addition to the valuation-related library of a property professional or any person/s interested in rural property. ■

Reassessing WALT

By Mark McNamara

Mark McNamara is managing director and owner of Property Sphere Consultancy; a commercial valuation and property consultancy practice. He has had 18 years' experience valuing a wide range of property including residential, commercial and development projects and has worked in the Christchurch, Wellington, Hamilton and Auckland property markets of New Zealand. Mark has been involved in asset valuations for both listed and unlisted property vehicles. He holds a Masters in Property Studies and Post Graduate Certificate in Applied Finance and Investment.

This the first of two articles in this edition's Real Time section that aim to generate debate within the property professions. The views expressed are those of the author. Additional contributions to the debate (articles, Letters to the Editor etc) are welcome.

Introduction

Weighted Average Lease Term (WALT) is a risk measure for commercial property that has become increasingly popular. Financiers, analysts and portfolio managers of LPTs in particular focus on the WALT as a measure of risk. Risk in this sense is where WALT is attempting to measure vacancy risk. WALT describes the average time to expiry of leases and is a useful statistic that can be compared to the refinancing risk that became evident through the credit crunch. Those entities which adopted a longer average financing term were considered less risky. Similarly, with property generally, the higher the WALT, the less risk and vice-versa. Hence valuers are requested to calculate and state the WALT in valuation reports.

The conventional methods adopted to assess WALT are numerous but fall mainly into two camps:

1. WALT as a measure of the average time to expiry weighted by net operating income (NOI); and
2. WALT as a measure of the average time to expiry weighted by net lettable area (NLA).

This paper examines the bases and rationale of these methods. Thereafter an additional approach is suggested and explained with the proposition this technique gives an accurate and rational basis for the calculation of duration as opposed to WALT. Using both statistics will assist in forming an accurate view of the expiry risk profile.

Conventional WALT Methods

An example of a typical commercial scenario can be used to illustrate the application of the conventional WALT approaches. A multi-tenanted property with the following tenancy schedule is considered:

The date of valuation is 26 May 2009. The WALT calculation by NOI and NLA is calculated as follows:

There are numerous observations that can be taken from the above example:

- Both methods take no account of the vacant car parks.
- WALT calculated by NOI ignores vacancies.
- Both methods ignore the time value of money.

The WALT could easily be adjusted by including the estimated market NOI and area for the vacant space and car parks in the calculation with a lease term of 0, which would adjust the WALT down to reflect their existence. Time value of money and lease amounts that change over times are things that WALT can't easily handle, and on this basis, the concept of duration is worthwhile examining.

Concept of duration

The last bullet point is the focus of this paper. In doing so, one must examine the concept of duration which can be found in the financial markets which define duration as a measure of the average time at which payments are made. While duration is commonly applied to bonds in the capital markets, the concept is applicable to any cash flow. For example, suppose $100 was to be received in one

Table 1 Tenancy Schedule – WALT Tower

Unit	Tenant	Lettable Area	Term	Expiry	Review Freq.	"Review Type"	Next Review	Net Operating Inc. p.a.	Net Operating Inc. $/m^2	Net Market Inc. $/m^2	Net Market Inc. p.a.
Unit 1	Tenant 1	120.00m^2	3.0	1-Feb-11	3.0	Mkt	1-Feb-11	$72,200	$601.67m^2	$615.00m^2	$73,800
Unit 2	Tenant 2	85.12m^2	6.0	14-Jul-11	3.0	Mkt	14-Jul-11	$28,600	$336.00m^2	$340.00m^2	$28,941
Unit 3	Tenant 3	120.00m^2	3.0	30-Sep-11	3.0	Mkt	1-Oct-10	$50,480	$420.67m^2	$350.00m^2	$42,000
Unit 4	Tenant 4	60.00m^2	3.0	30-Sep-11	3.0	Mkt	1-Oct-10	$25,240	$420.67m^2	$350.00m^2	$21,000
Unit 1	Tenant 1	5 cps	3.0	1-Feb-11	3.0	Mkt	1-Feb-11	$9,100	$35/wk	$35/wk	$9,100
Unit 2	Tenant 2	4 cps	6.0	14-Jul-11	3.0	Mkt	14-Jul-11	$7,280	$35/wk	$35/wk	$7,280
Unit 3	Tenant 3	2 cps	3.0	30-Sep-11	3.0	Mkt	1-Oct-10	$3,640	$35/wk	$35/wk	$3,640
Unit 4	Tenant 4	2 cps	3.0	30-Sep-11	3.0	Mkt	1-Oct-10	$3,640	$35/wk	$35/wk	$3,640
Unit 5	Vacant	2 cps	0.0	26-May-09	3.0	Mkt	26-May-09	$0	$0/wk	$35/wk	$3,640
Totals		385.12m^2 15 cps						$200,180			$193,041

Table 2

1	2	3	4	5	6	7	8
Tenant	NOI	NLA	Years to Expiry	%NOI	&NLA	(4x5) Weighted NOI	(4x6) Weighted NLA
Tenant 1	$81,300	120.00m^2	1.68	40.61%	31.16%	0.68	0.52
Tenant 2	$35,880	85.12m^2	2.13	17.92%	22.10%	0.38	0.47
Tenant 3	$54,120	120.00m^2	2.34	27.04%	31.16%	0.63	0.73
Tenant 4	$28,880	60.00m^2	2.34	14.43%	15.58%	0.34	0.37
Totals	$200,180	385.12m^2				2.04yrs	2.09yrs

month and $100 in three months' time. It could be said that on average one would receive $200 in two months. The duration of this cash flow would be about two months, being the average time of payment.

In the wider finance community, duration is measured not as a simple average of the time of payments but as the weighted average. The timing of payments are weighted by the present value of those payments. That is, in general:

$$D = \frac{(\sum_{i=1}^{n} t_i * PV_i)}{(\sum_{i-1}^{n} PV_i)}$$

Where:

D is Macaulay's duration (named after the concept's originator), [1,2]

t_i is the time of the ith payment, and

PV_i is the present value of the ith payment made at t_i

Application of Macaulay's Duration to commercial property – contemporary approach

The definition of duration in the context of commercial property is average term of rent payments calculated by using the discounted weighted average term of all cash flows up to the initial expiry of the lease(s); i.e., the weights used are the present values (PVs) of these cash flows. This is distinctly

different to the conventional approaches which are weighted by NOI or NLA.

$$\sum \frac{MV_{lease(s)} * D_{lease(s)}}{MV_{lease(s)} + MV_{vac(s)}}$$

Where:

D_{prop} = duration of property

$D_{lease(s)}$ = duration of individual leases

$MV_{lease(s)}$ = market value of lease(s)

$MV_{vac(s)}$ = market value of vacancies

The variable $D_{lease(s)}$ (duration of individual leases) measures the average term of the payment of all cash-flows, both the reversion and rental payments up to the initial expiry. It takes into account the reversion deferred just after the expiry of the initial term of the lease and when rental payments are paid. Duration is calculated by using the discounted weighted average term of all cash flows of the lease. That is, the weights used are the present values (PVs) of these cash flows.

The first step in calculating the properties duration is to calculate the market value of the leases and vacancies $MV_{lease(s)}$ and MV_{vac}. The Modified DCF Approach is ideal for this purpose.[3] A discount rate of 10.00% is assumed with an All Risks Yield of 8.00%. Market and contract rents set out in the Tenancy Schedule are extracted for the calculations:

Table 3: Tenant 1

Net Contract Income	$81,300	
PV $81,300, 1.69 years @ 10%		$120,951
Reversion income:	$82,900	
FV of $82,900, 1.69 years @ 2.16%:	$85,948	
Capitalised in perpetuity @ 8%:	$1,074,353	
deferred 1.69 years @ 10%		$914,520
Capitalised Value (before costs)		$1,035,471
	Say	**$1,040,000**

Table 4: Tenant 2

Net Contract Income	$35,880	
PV $35,880, 2.13 years @ 10%		$65,923
Reversion income:	$36,221	
FV of $36,221, 2.13 years @ 2.16%:	$37,907	
Capitalised in perpetuity @ 8%:	$473,842	
deferred 2.13 years @ 10%		$386,783
Capitalised Value (before costs)		$452,706
	Say	**$450,000**

Table 5: Tenant 2

Net Contract Income	$54,120	
PV $54,120, 1.35 years @ 10%		$65,342
Reversion income:	$45,640	
FV of $45,640, 1.35 years @ 2.16%:	$46,976	
Capitalised in perpetuity @ 8%:	$587,196	
deferred 1.35 years @ 10%		$516,301
Capitalised Value (before costs)		$581,643
	Say	**$580,000**

Table 6: Tenant 2

Net Contract Income	$28,880	
PV $28,880, 1.35 years @ 10%		$34,868
Reversion income:	$24,640	
FV of $24,640, 1.35 years @ 2.16%:	$25,361	
Capitalised in perpetuity @ 8%:	$317,014	
deferred 1.35 years @ 10%		$278,739
Capitalised Value (before costs)		$313,607
	Say	**$310,000**

Table 7: Vacant

Net Contract Income	$0	
PV $0, 0.00 years @ 10%		$0
Reversion income:	$3,640	
FV of $3,640, 0 years @ 2.16%:	$3,640	
Capitalised in perpetuity @ 8%:	$45,500	
deferred 0 years @ 10%		$45,500
Capitalised Value (before costs)		$45,500
	Say	**$50,000**

Step two involves the calculation of $\sum_{i=1}^{n} PV_i$ and $\sum_{i=1}^{n} t_i * PV_i$ for each lease:

Table 9: Tenant 1

1	2	3	4	5
t_i Time	Cashflow	10% p.a. mthly Discount	PV_i 2 X 3	t_i x PV 1 X 2 X 3
0	6,775	1.00000	6,775	6,775
1	6,775	0.99174	6,719	6,719
2	6,775	0.98354	6,663	13,327
3	6,775	0.97541	6,608	19,825
4	6,775	0.96735	6,554	26,215
5	6,775	0.95936	6,500	32,498
6	6,775	0.95143	6,446	38,675
7	6,775	0.94356	6,393	44,748
8	6,775	0.93577	6,340	50,718
9	6,775	0.92803	6,287	56,587
10	6,775	0.92036	6,235	62,355
11	6,775	0.91276	6,184	68,023
12	6,775	0.90521	6,133	73,594
13	6,775	0.89773	6,082	79,068
14	6,775	0.89031	6,032	84,446
15	6,775	0.88295	5,982	89,730
16	6,775	0.87566	5,933	94,921
17	6,775	0.86842	5,884	100,020
18	6,775	0.86124	5,835	105,029
19	6,775	0.85413	5,787	109,947
20	6,775	0.84707	5,739	114,778
20	1,074,353	0.85123	914,520	18,290,406
$\sum_{i=1}^{n} PV_i$	&	$\sum_{i=1}^{n} t_i * PV_i$	1,045,630	19,568,406

Duration of a commercial property measures the risk characteristics of the property by analysis of the individual leases. It is the sum of the weighed durations of the leases divided by the sum of the market value of the leases and market value of any vacant space. The final step in the process is set out in tabular form, as in Table 14.

The computation of duration while perhaps a little lengthy is straightforward in concept. In a practical context computers make the duration calculations with ease.

Conclusions

The resultant duration calculation of 1.80 years is less than WALT calculations (2.04 and 2.09 for NOI and NLA respectively). That duration in this case is less than the WALT

Table 10: Tenant 2

1	2	3	4	5
t_i Time	Cashflow	10% p.a. mthly Discount	PV_i 2 X 3	t_i x PV 1 X 2 X 3
0	2,990	1.00000	2,990	2,990
1	2,990	0.99174	2,965	2,965
2	2,990	0.98354	2,941	5,882
3	2,990	0.97541	2,917	8,750
4	2,990	0.96735	2,892	11,570
5	2,990	0.95936	2,868	14,342
6	2,990	0.95143	2,845	17,069
7	2,990	0.94356	2,821	19,749
8	2,990	0.93577	2,798	22,384
9	2,990	0.92803	2,775	24,974
10	2,990	0.92036	2,752	27,519
11	2,990	0.91276	2,729	30,021
12	2,990	0.90521	2,707	32,479
13	2,990	0.89773	2,684	34,895
14	2,990	0.89031	2,662	37,269
15	2,990	0.88295	2,640	39,601
16	2,990	0.87566	2,618	41,892
17	2,990	0.86842	2,597	44,142
18	2,990	0.86124	2,575	46,353
19	2,990	0.85413	2,554	48,523
20	2,990	0.84707	2,533	50,655
21	2,990	0.84007	2,512	52,748
22	2,990	0.83312	2,491	54,803
23	2,990	0.82624	2,470	56,821
24	2,990	0.81941	2,450	58,801
25	2,990	0.81264	2,430	60,745
25	473,842	0.81627	386,783	9,669,569
$\sum_{i=1}^{n} PV_i$	&	$\sum_{i=1}^{n} t_i * PV_i$	456,999	10,517,510

Table 11: Tenant 3

1	2	3	4	5
t_i Time	Cashflow	10% p.a. mthly Discount	PV_i 2 X 3	t_i × PV 1 X 2 X 3
0	4,510	1.00000	4,510	4,510
1	4,510	0.99174	4,473	4,473
2	4,510	0.98354	4,436	8,872
3	4,510	0.97541	4,399	13,197
4	4,510	0.96735	4,363	17,451
5	4,510	0.95936	4,327	21,633
6	4,510	0.95143	4,291	25,746
7	4,510	0.94356	4,255	29,788
8	4,510	0.93577	4,220	33,762
9	4,510	0.92803	4,185	37,669
10	4,510	0.92036	4,151	41,508
11	4,510	0.91276	4,117	45,282
12	4,510	0.90521	4,083	48,990
13	4,510	0.89773	4,049	52,634
14	4,510	0.89031	4,015	56,214
15	4,510	0.88295	3,982	59,732
16	4,510	0.87566	3,949	63,187
17	4,510	0.86842	3,917	66,582
18	4,510	0.86124	3,884	69,916
19	4,510	0.85413	3,852	73,190
20	4,510	0.84707	3,820	76,405
21	4,510	0.84007	3,789	79,563
22	4,510	0.83312	3,757	82,662
23	4,510	0.82624	3,726	85,706
24	4,510	0.81941	3,696	88,693
25	4,510	0.81264	3,665	91,625
26	4,510	0.80592	3,635	94,502
27	4,510	0.79926	3,605	97,326
28	4,510	0.79266	3,575	100,097
28	587,196	0.87927	516,301	14,456,427
$\sum_{i=1}^{n} PV_i$	&	$\sum_{i=1}^{n} t_i * PV_i$	633,026	16,027,342

Table 12: Vacant

1	2	3	4	5
t_i Time	Cashflow	10% p.a. mthly Discount	PV_i 2 X 3	t_i × PV 1 X 2 X 3
0	50,000	1.00000	50,000	50,000
$\sum_{i=1}^{n} PV_i$	&	$\sum_{i=1}^{n} t_i * PV_i$	50,000	50,000

Table 13: Tenant 4

1	2	3	4	5
t_i Time	Cashflow	10% p.a. mthly Discount	PV_i 2 X 3	t_i × PV 1 X 2 X 3
0	2,407	1.00000	2,407	2,407
1	2,407	0.99174	2,387	2,387
2	2,407	0.98354	2,367	4,734
3	2,407	0.97541	2,347	7,042
4	2,407	0.96735	2,328	9,312
5	2,407	0.95936	2,309	11,544
6	2,407	0.95143	2,290	13,739
7	2,407	0.94356	2,271	15,896
8	2,407	0.93577	2,252	18,017
9	2,407	0.92803	2,233	20,101
10	2,407	0.92036	2,215	22,150
11	2,407	0.91276	2,197	24,164
12	2,407	0.90521	2,179	26,143
13	2,407	0.89773	2,161	28,087
14	2,407	0.89031	2,143	29,998
15	2,407	0.88295	2,125	31,875
16	2,407	0.87566	2,107	33,719
17	2,407	0.86842	2,090	35,530
18	2,407	0.86124	2,073	37,309
19	2,407	0.85413	2,056	39,056
20	2,407	0.84707	2,039	40,772
21	2,407	0.84007	2,022	42,457
22	2,407	0.83312	2,005	44,111
23	2,407	0.82624	1,988	45,735
24	2,407	0.81941	1,972	47,329
25	2,407	0.81264	1,956	48,894
26	2,407	0.80592	1,940	50,429
27	2,407	0.79926	1,924	51,936
28	2,407	0.79266	1,908	53,414
28	317,014	0.87927	278,739	7,804,697
$\sum_{i=1}^{n} PV_i$	&	$\sum_{i=1}^{n} t_i * PV_i$	341,027	8,642,983

is a consequence of the timing of the rental payments and the present value of the reversion. It is worth noting the only property with a duration equal to its WALT is a hypothetical scenario where the only rental payment occurs at the expiry date of the lease. This is significant and suggests duration is a measure of the expiry of a property's rental payments; i.e. it measures the expiry of the rental payments as well as the vacancies. The measure is a time-weighted average of the expiries of the lease's rental payments.

Table 14:

1	2	3	4	5	6	7
Tenant	$\sum_{i=1}^{n} t_i * PV_i$	$\sum_{i=1}^{n} PV_i'$	$D_{Lease}(s)$ yrs (2÷3)	$D_{Lease}(s)$ (4 x 0.5)	$MV_{lease(s)} + MV_{vac(s)}$	$MV_{lease(s)} * D_{lease(s)}$ (5 x 6)
Tenant 1	19568406	1045630	18.71446	1.55954	1040000	1621920
Tenant 2	10517510	456999	23.01429	1.91786	450000	863036
Tenant 3	16027342	633026	25.31863	2.10989	580000	1223734
Tenant 4	8642983	341027	25.34399	2.11200	310000	654720
Vacant	50000	50000	1.0000	0.0833	50000	4167
$\sum \frac{MV_{lease(s)} * D_{lease(s)}}{MV_{lease(s)} + MV_{vac(s)}}$					2430000	4367576

$$D_{prop} = \frac{4367576}{2430000} = 1.80 \text{ years}$$

Conventional WALT techniques focus on the weighted average concept, but ignore the theory of duration. The problem with WALT as a measure of a property's duration is that it reflects only the timing of the initial expiry date. For example, a property with an NOI of $100,000 p.a., fully ratcheted, and an initial expiry 10 years hence has the same WALT as a property with an identical purchase price but with an NOI of $150,000 p.a., fully ratcheted, with the same initial expiry date. But to imply that their identical expiry dates means that they have identical WALT's ignores the fact that the property with an NOI of $150,000 will pay back its purchase price more rapidly than the property with an NOI of $100,000.

It is the writer's view WALT should be not be considered in isolation, but in tandem with duration. This will increase the rigour around the WALT, giving insight into the property's unique characteristics. The extent of vacancies, under or over-renting and income derived from all sources (car parks, telecommunication aerials) are factored into duration. By comparing the WALT with duration, meaningful insight is gained, giving decision-makers a solid foundation in forming their view of the property's expiry risks profile. ■

References

[1] Ben Hunt & Chris Terry, (1994), *Financial Instruments and Markets*, Thomas Nelson Australia, page 274

[2] Macaulay, F. (1938), *The Movements of Interest Rates. Bond Yields and Stock Prices in the United States since 1856*, New York: National Bureau of Economic Research.

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Valuing rent reviews in NZ: the Real Options approach

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This the second of two articles in this edition's Real Time section that aim to generate debate within the property professions. The views expressed are those of the author. Additional contributions to the debate (articles, Letters to the Editor etc) are welcome.

Introduction

Real Options, the application of financial option valuation formulae to real life investment decisions, is an established area of finance. This paper introduces the basic mathematics of valuing rent review options in real estate leases as Real Options. The intention is to show a model suitable for practical use, so standard spreadsheet terminology for Microsoft Excel has been used, as opposed to the "mathematical Swahili" typically used in articles on the topic.

Lessors' interests in land subject to long-term ground leases have been used as an example for application of the formulae, because they have comparatively few variables. The same formulae can be used to value leases over improved properties with different inputs. Three simple ground lease examples have been chosen: one lease with no ratchet clause; one with a ratchet to the commencement rent; and one with a full ratchet clause. Expected future cash flows are valued in these leases using (1) a discounted cash flow approach, (2) the Black-Scholes option pricing formula (with dividends), and (3) a Monte Carlo simulation. Valuation differences are demonstrated that cannot be calculated using traditional DCF or income capitalisation models.

Ground lease basics

Leasehold tenure is common throughout New Zealand in all property sectors. Most ground leases are referred to as "Glasgow Leases" and are perpetually renewable in terms of 20 or 21 years. In practice these leases are virtually always renewed once buildings have been completed on the land.

Current valuation techniques for lessors' interests in land tend to be focused on capitalisation techniques and the Discounted Cash Flow (DCF) approach. These give fairly consistent results but they have their limitations. Capitalisation techniques struggle to differentiate logically between long-term and short-term reviews, ratchet clauses, and terminating versus long-term leases. DCF valuations are a useful tool, but they fail to take into account ratchet clauses and some of the subtleties arising from the plethora of new rent review mechanisms in modern ground leases.

Leases with no ratchet clause

When valuing the traditional "Glasgow lease" the current contract income is known, and can be discounted to the present at the discount rate. The rent at

the next review date rent has no ratchet clause; it is only an agreement to pay the market rate. The expected rent for the next review period is simply the market rent inflated by an assumed long-term market rental growth rate, converted to an annuity for the standard review term, and deferred until that review date at the discount rate.

Because there is no "optionality", just a contract to pay rent at the market rate in the future, volatility has no effect on the value of the lessor's interest. Models incorporating future rental volatility collapse into a Discounted Cash Flow model. In essence, by discounting the median expected point value, the value of all positive and negative market movements is fairly weighted and the value is mathematically correct and risk-adjusted.

An example is a new perpetually renewable ground lease, starting at a market rent (mr) of $100,000 pa, rent reviews every 7 years (rp), and a 7-year term until the next rent review (tr). A discount rate (dr) of 8% is selected and a long-term rental growth rate of 2% pa (gr).

Table 1

Term to Review (tr)	Option PV	Option as a 7-yr Annuity
7 yrs	$14,538	$77,920
14 yrs	$14,634	$78,437
21 yrs	$12,264	$65,735
28 yrs	$9,505	$50,947
35 yrs	$7,051	$37,792
to	to	to
231 yrs	$0	$1
238 yrs	$0	$0
Total		**$399,587**

By treating future review periods as a perpetually inflating annuity, the value at the start of the lease can be calculated using a continuous DCF model[1] as follows:

=mr*((1-EXP(-dr*rp))/dr*(1+1/(EXP(rp*(dr-gr))-1)))

=$1,562,863

The DCF approach calculates the same value for the standard lease with no ratchet clause, the lease with a commencement ratchet, and a lease with a full ratchet clause.

Leases with a ratchet to the commencement rent

A number of modern ground leases include a long-term lease with a ratchet clause tied to the commencement rent. In these leases the initial contract rent can be considered effectively to be a low-risk perpetual payment. The value of the known ratcheted income is given by

Term to Review: (tr)	0 years	7 years	14 years	21 years
Simulation 1	$100,000	$110,936	$180,782	$158,944
Simulation 2	$100,000	$142,344	$261,922	$310,405
Simulation 3	$100,000	$53,393	$34,461	$28,630
Simulation 4	$100,000	$108,784	$72,207	$58,684
Simulation 5	$100,000	$89,762	$49,514	$65,844

Table 2

Term to Review: (tr)	0 years	7 years	14 years	21 years
Simulation 1	$100,000	$110,936	$180,782	$180,782
Simulation 2	$100,000	$142,344	$261,922	$310,405
Simulation 3	$100,000	$100,000	$100,000	$100,000
Simulation 4	$100,000	$108,784	$108,784	$108,784
Simulation 5	$100,000	$100,000	$100,000	$100,000

Table 3

Term to Review: (tr)	7 years	14 years	21 years
Average Contract Rent	$124,850	$150,268	$178,725
Average Increased Rent	$24,850	$25,418	$28,457
Present Value of Increase	$14,194	$8,293	$5,304
Annual Increase Capitalised as a Perpetuity	$177,431	$103,668	$66,295

Table 4

simply capitalising the ratcheted rent into perpetuity (mr/dr **=$1,250,000**).

That leaves the chance of future rental increases over and above the ratchet level to be valued. Now think about share options for a moment. "Call options" give the option holder the right to buy shares at a fixed "strike" price before a certain exercise date. As long as the share price is above the strike price at the exercise date the investor will exercise the option and make a profit.

From the landowner's perspective, a rent review (a call option) gives the owner the right to review the rent on a future exercise date, potentially giving an increase above the contract rent (strike price). As long as the market rent is above the ratcheted contract rent the investor will review the rent and increase the income. That income will be secured as an annuity until the next review date (i.e. make a profit from the review option).

Call options on shares can be valued with the Black-Scholes option pricing formula (as extended by Merton[2] for a dividend-paying stock). This has been simplified for this example where the rent review options commence "at the money", and written in Excel terminology as follows:

```
=mr*(EXP(-(drgr)*tr)*NORMSDIST
((gr+vol^2/2)*tr/(vol*tr^0.5))EXP(d
r*tr)*NORMSDIST(((grvol^2/2)*tr)/
(vol*tr^0.5)))
```

The formula requires just one new input over the DCF approach: the rental "volatility" (vol). this is the standard deviation of market price changes over time (on a logarithmic scale). Volatility can be approximated from historic data and is an area where further research is required. In this example the assumed ground rent volatility is 15%.

The result of the formula is the Present Value (PV) of the risk-adjusted increase in rent (over the commencement ratchet level) expected at each review date.

This needs to be converted to an annuity as it is receivable for a complete review term of 5, 7, or 21 years. This is done by multiplying by (1-EXP(-dr*rp))/dr.

Results are shown in an abbreviated Table 1.

The lease with a ratchet to the commencement rent can therefore be valued as follows:

Ratcheted rental commitment	$1,250,000
Future options to review the rent	$399,587
Indicated Value of Lessor's Interest	**$1,649,587**

These calculations suggest a value 5% higher than the standard DCF approach for the lease with a ratchet to the commencement rent and assuming these inputs of volatility, long-term growth, and discount rate.

The model can be reconciled to the DCF approach by inputting a volatility estimate approaching zero and adopting a nil ratchet level.

This formula is not able to value the options in a fully ratcheted lease because after the first review date, all reviews are "compound options", the result of which depends on the previous option. Future lease terms may also have ratcheted rents on renewal, meaning that the ratchet level is likely to increase every 21 years; another compound option. Compound options are best valued by simulation.

Leases with a full ratchet clause

Some modern ground leases, and many commercial premises leases, include full ratchet clauses which do not allow the rent to reduce below the previous level at any stage. These compound ratchet options can only be modelled using simulations or with heavy duty calculus. The writer hopes that simulations will suffice.

Firstly, future market rents are forecast using the following Geometric Brownian Motion formula, which simulates a random walk with a set drift (growth rate) and volatility, and where each value depends on the value before it:

Xn = Xn-1*EXP((gr-vol^2/2)*rp+vol*NORMSINV(RAND())*rp^.5)

Large but simple spreadsheets can be set up or automated with macros to provide thousands of simulation trials, each of which sets out a possible timeline of future market rents. The average of these simulated timelines increases with the drift rate. The scale of the movements between review periods is a function of the assumed volatility.

Capitalisation techniques struggle to differentiate logically between long-term and short-term reviews, ratchet clauses, and terminating versus long-term leases.

Potential **market** rents at each review date can be arranged in a table such as Table 2 (these numbers will vary every time the spreadsheet is calculated).

Each simulation run is equally likely. The high level of variability shown in this example is a function of the high volatility adopted (15%), coupled with a conservative growth rate of 2%.

At each review date, the **contract rent** will be reviewed to the highest of the previous rent or the market rent, such as in Table 3.

The **average increase** in contract rents at each review date is the "payoff" of the option. This needs to be deferred until the review date by multiplying by exp(-dr*tr), and capitalised into perpetuity (divide by dr). After 10,000 simulations, the average results look similar to Table 4.

When this table is extended to 200 years or more, the option values can be summed as follows:

Ratcheted rental commitment ($100,000/8%) $1,250,000

Future Lessor's Options to review the rent $466,612

Indicated Value of Interest $1,716,612

This approach values the fully ratcheted lease at 10% more than a lease with no ratchet, and 4% more than a lease with a ratchet to the commencement rent.

This simulation approach can also be used to value the un-ratcheted and commencement ratcheted leases by adjusting the simple option payoff formulae. The lease with no ratchet is valued by simulation based on these particular 10,000 trials at $1,559,496 (instead of $1,562,863 by DCF) and the lease with a commencement ratchet is valued at $1,647,012 by simulation whereas the value by formula is

Table 5

Ratchet Type	DCF Approach	Option Formula	Simulation Approach	Best Approach
No ratchet	**$1,562,863**	$1,562,862	$1,559,496	DCF Approach
Ratchet to Commencement Rent	$1,562,863	**$1,649,587**	$1,647,012	Option Formula
Full ratchet Clause	$1,562,863	N/A	**$1,716,612**	Simulation Approach

$1,649,575. The very small difference between the calculated results and the simulated results is due to simulation error and is not mathematically significant.

Results of valuation models

The DCF approach would have valued all three leases at the same price because it ignores volatility.

Using a variant of the Black-Scholes option pricing formula, the value of a commencement ratchet is recognised as adding value over a non-ratcheted example. The fully ratcheted lease is however not easily priced by formula because it requires more advanced mathematics than most valuers would have (including the writer).

The simulation approach can be used to accurately approximate the DCF approach and also the options formula approach. It is most powerful in evaluating the compound options arising from a full ratchet clause, but is not quite as accurate or convenient to use as the DCF or formula approaches.

All three approaches have their advantages in different situations. The values calculated using the three methods are summarised in Table 5.

It is intuitively logical that options to lock in rental increases should add value to investment assets because the risk-adjusted cash flows from ratcheted leases must be worth more than a lease without a ratchet clause. These calculations are consistent with that expectation.

This paper has illustrated just one area where Real Options can be used to value leased assets. There is an obvious potential to use this technique for pricing ratchet clauses in lease negotiations, for net effective rent analysis, and for valuing other leased assets.

The relativity between the values of the different leases will vary depending on the long term growth rates, discount rates and volatility estimates adopted. These are three areas requiring robust historical research and thought. There are many other options inherent in real estate ownership which can be easily valued using Real Options theory and like-minded practitioners are encouraged to make contact with the writer with a view to developing the topic further. ■

References

1. This is a simplified version using continuous discounting of the writer's earlier model *"A DCF Model for Valuing Lessor's Interests", NZ Valuers' Journal* November 1998. A simple conversion factor can be applied to the valuation figures to account for varying periodic payments.

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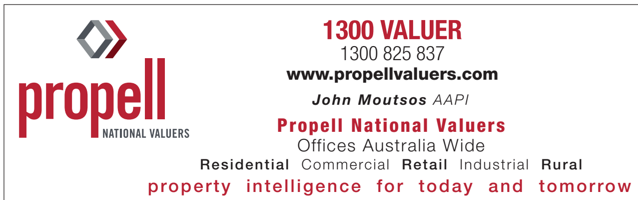
AUSTRALIAN CAPITAL TERRITORY



NEW SOUTH WALES

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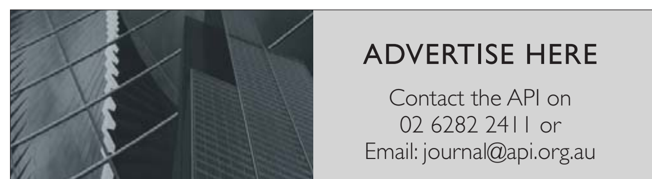

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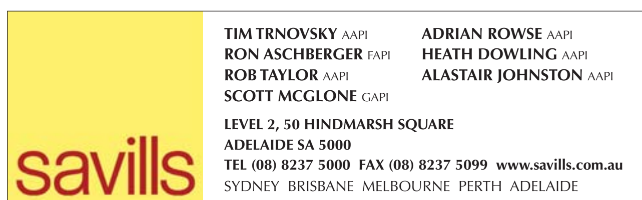

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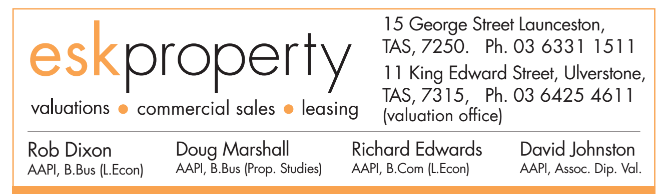

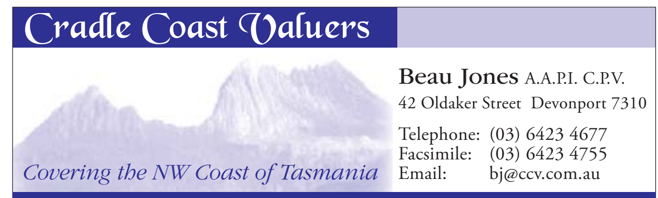

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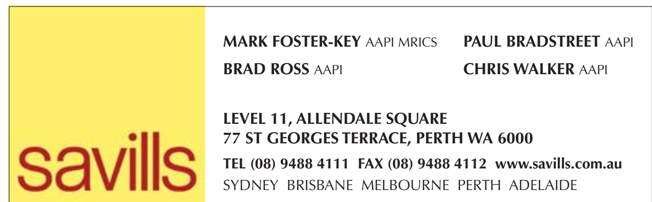

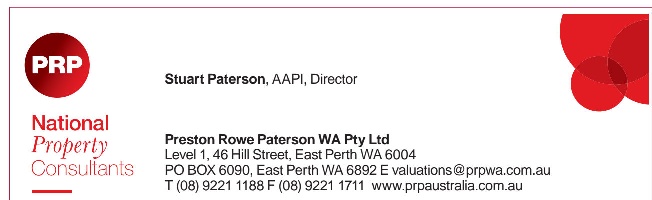

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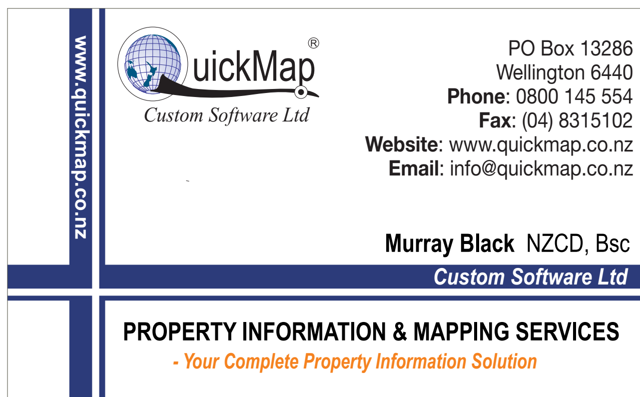

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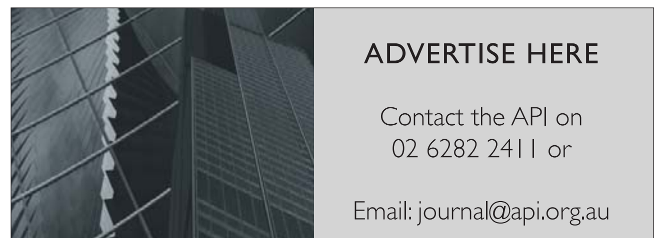

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