TelferYoung
NEWS

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DEMISTIFYING LONG TERM GROUND LEASES

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

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

Generally known as "Glasgow" leases, terms are usually for 21 year periods, renewable in perpetuity and with the rental reviewed at the start of each lease term (although some are reviewed more regularly – 7-10 year terms). The lease document provides the lessee security of occupation as long as the rent is paid and the lease conditions adhered to. These conditions include signing a new lease when the current one expires.

The lessee owns the improvements (ie buildings, site landscaping, section development) and pays an annual ground rent for the use of the land (in a notional unimproved state). The lessor owns the land but gives the right to use and occupy the land to the lessee in return for rent. A lessee is able to transfer (sell) their lessees interest to a third party provided lease terms are met (including a current signed lease). They may also be able to use their lessees interest as security (lenders conditions may vary and lessees should seek and obtain appropriate advice).

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

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

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

Rent reviews generally become more contentious following periods of high growth in land values. At such times it becomes apparent that long term leases disadvantage both parties, particularly involving leases of residential land. For the lessor it becomes obvious that they are receiving a declining return for the ownership of the land with no rent increase over a prolonged period; while on the other hand when the rent is reviewed, the lessee faces a large increase in rental.

So how are ground rents calculated?

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

+ improvements <u>on</u> the land; these are structural improvements including houses, other buildings and fences.
+ any improvements <u>to</u> the land; these are developmental improvements including excavation, access, and retaining walls.

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