Ground Lease Rent Determinations: RDV a New Method

Questions and Answers to Accompanying Research Paper:

1. **Question**: What is RDV?

   Answer: RDV is the Rate of Diminution of Value.

2. **Question**: How is RDV defined?

   Answer: The glossary of the research paper defines RDV as: "Current ground rent, divided by the difference between a notional freehold capital value and a lessees interest sale price."

3. **Question**: How is RDV calculated?

   Answer: Using the above definition, RDV is straightforward to calculate, illustrated in an example. Assume a lessee's interest sale of $1,460,000 where the passing ground rent is $121,000 (at market). The freehold value is estimated at $4,500,000. The mathematical definition of RDV is:

$$\frac{Ground\ Rent}{Notional\ Freehold\ Value - Lessee's\ Interest\ Sale\ Price}$$

Therefore, RDV is calculated as follows:

$$\frac{\$121,000}{\$4,500,000 - \$1,460,000}$$

= 4.00% (rounded)

4. **Question**: Is it implied that by deducting the lessee's interest sale price from the notional freehold value, that the resultant figure is the lessor's interest and together they equal freehold value, when this is not accepted theory nor practice?

   Answer: No, it is not correct to assume that the sum of the lessee's interest and lessor's interest will equal the freehold value. The research paper does not address the market value of lessor's interests.

5. **Question**: What is the basis of RDV?

   Answer: The zero-lease premium condition. This is where a fair annual ground rent should be assessed at the level that creates no lease premium. Section 4.5 of the research paper explains this assumption in greater detail.

6. **Question**: How flexible is RDV?

   Answer: RDV has been applied to commercial property with promising results. Further work is required with respect to varying land types especially those characteristically developed to a significantly lower intensity, such as farmland, industrial land, and service stations.

7. **Question**: Why consider using RDV as a method?

   Answer: New ground leases are seldom available as valid market rental comparisons. RDV is a model which assesses the ground rent percentage based on the analysis of Lessees' interest sales, whether of improved properties or vacant land.

8. **Question**: When would the RDV method be used?

   Answer: If many similar leasehold property's new ground leases are agreed on identical terms, there is no need to debate a market ground rent percentage and no technique other than direct comparison is necessary. The RDV model has been developed for one reason only, to adjust for imperfect comparable evidence, providing a solution to the recurrent problem of ground rent determinations where comparable market ground rents are often not obtainable.

9. **Question**: Is RDV a substitute for the classic or traditional methods of ground rental assessment?

   Answer: No, it is an alternative; these methods may still be used where suitable and comparable evidence is available.

10. **Question**: What is the advantage of RDV?

    Answer: Simplicity. A valuation approach, if it is to be accepted by the profession, must be easily understood and easy to use. RDV has a practical application and is easy to use, where there are lessees interest sales.

11. **Question:** Valuers are challenged when analysing evidence where a ground lease prescribes a 21-year review pattern compared to a shorter 14, 7 or 5 year frequency. Does RDV allow for the margin between ground rent percentages where shorter or longer rent review terms exist, and how does it allow for the difference between a perpetually renewable and terminating lease?

    Answer: The analysis to date has been completed using leases with frequent ground rent reviews (5 or 7 years). It is anticipated that sales of properties with ground rents fixed for 21 years will show a different level of RDV. Short-term terminating leases may

also show a different rental rate. At this stage there is no data to indicate what that rate will be.

12. **Question**: RDV concludes ground rent percentages equating to circa 3% in the current market which is significantly below ground rent percentage benchmarks across NZ; typically, between 5% and up to 6.5%. If RDV is accepted, what impact do the authors expect this will have on lessee's and lessor's interests' values? And if the Lessee's interest varies (i.e. if the Lessee's interest sales vary), what does this do to the RDV?

    Answer: If the RDV method is adopted, lessee's interests will sell for no lease premium, meaning the prices will correlate with the improvements values on fully developed sites. Leasehold assets will become relatively more popular than they presently are. Lessor's interest values will diminish towards land value as they lose some premium associated with over-renting, but may still achieve a premium to vacant land value on their desirable investment merits. If lessee's interest prices are higher, then RDV will increase.

13. **Question**: How does the RDV method reconcile with traditional ground rent legal precedents, for example the Prudent Lessee test? Is the Prudent Lessee test still relevant?

    Answer: RDV is firmly based on the Prudent Lessee test – it relies entirely on analysis of prices that willing lessees have paid to take on leasehold properties. Section 8 of the paper addresses judicial precedents, noting that historic decisions were not informed by the new logic and analysis the RDV method presents, and that the New Zealand courts have in the past been averse to restricting the methods used by valuers so it being up to the profession to develop and test new approaches to ground rent valuations that have been unsatisfactorily left unresolved for many decades. In all likelihood, a legal test case may eventuate however that may be around the finer points of application of the model.

14. **Question**: How should sales of lessee's interests to the ground lessor be viewed?

    Answer: Given these are not arms-length, they will need to be viewed on a case by case basis. Where a lessee's interest sells for a premium to market value, RDV will be overstated.

15. **Question:** In relation to established ground rent legal precedents being founded upon "bare land" or "unimproved land", how does this reconcile with the sales analysis deriving the value of improvements from the lessee's interest sales, within the steps to get to the RDV? And while the improvements at the subject property are ignored, isn't including the value of improvements in the Lessees interest sales when assessing the value as freehold not ignoring them, but having regard to them?

    Answer: Ideally, sales of vacant leasehold development sites would be used to analyse RDV - if any exist. Otherwise, RDV data from a range of market sales sets up the

considerations a prudent lessee might have when evaluating the buildings, it can potentially develop. This is similar to a freehold developer considering the value of what it might build when evaluating a price to pay for vacant land. RDV appears as a market-wide statistic rather than one that is site-specific or affected by the actual improvements on a particular site. The authors do not propose valuing the improvements on any site where a ground rent is to be assessed.

16. **Question**: Would you be able to use RDV to assess a market ground rent for a lease granted under the Public Bodies Leases Act?

    Answer: Yes, this is an ideal application.

17. **Question**: Under the concept of the "zero-lease premium condition", would a sale of a Lessees interest of a vacant site where the ground rent had just been set at market, mean that the Lessees interest sale price would be zero?

    Answer: Yes, in broad terms, as discussed in Section 7 of the paper. The zero-lease premium condition is what was formerly called, the "benefit in the right of renewal". At this stage, it is unknown how the marketplace will receive the model and the assumptions upon which it is based, in particular, this 'zero-lease premium condition'. It is also true that the practical application must be matched by theoretical soundness; and the latter is yet to be tested.

18. **Question**: Would you call the RDV model an equilibrium model, or an indifference model?

    Answer: Both definitions apply. The RDV model places a party in a position of indifference between owning and leasing land, and if applied properly over time, would eliminate lease premiums, meaning lessee's interests would be in equilibrium with respect to improvements values (if any).

19. **Question**: Please explain the basis of the RDV as an "equivalent" yield, referred to in Section 6.4?

    Answer: When analysing a lessee's interest sale with a ground rent that is out of date, valuers anticipate the likely increase at the next ground rent review and account for the difference as 'benefit to run', then base income expectations on the reviewed rent. This is the same calculation as an under (or over-) rented investment property where equivalent yield methodology is widely used by valuers already.

    Using the example in Section 6.4 of the research paper, a lessee's interest sale (LI) at $1,300,000, concerning a property which has an estimated freehold value (FH) of $3,000,000, a current ground rent (GR) of $10,000 pa due for review in 3 years' time, and an expected rent based on nearby settlements of (MR) $60,000 pa.

Applying the RDV formula illustrated in question 2 results in the following RDV:

$$\frac{\$10,000}{\$3,000,000 - \$1,300,000}$$

$$= 0.588\%$$

In this case it would be plainly incorrect to conclude the RDV is 0.588% because the purchaser would have anticipated the increased ground rent in 3 years. We could analyse RDV using the market rent, and after deducting the benefit to run from the lessee's interest price, i.e.:

RDV = market ground rent ÷ [freehold value − (leasehold price − benefit to run)].

The equivalent yield method effectively does the same thing − it just deals with the under- renting in a different order of the calculation. The equivalent yield is best calculated by iteration (i.e. 'Goal Seek' spreadsheet function). In this case, the RDV is 3.2596%, which is the only number that works in the equivalent yield formula, as follows:

$$LI = \$3,000,000 - \left(\frac{\$10,000}{0.032596} + \frac{\$60,000 - \$10,000}{0.032596 \times (1 + 0.032596)^3}\right)$$

$$LI = \$1,300,000$$

In the example, it is reasonable to say the prospect of expected ground rent at $60,000 pa reduced value at an RDV of 3.26%, and the benefit to run (vs $10,000 current rent) has been allowed for in the equivalent yield formula.

This extension of RDV does however introduce one new variable − market rent (based on prevailing settlements). That can have the advantage of materially increasing the number of leasehold sales available for analysis. However, there is a corresponding decrease in accuracy of the data because of the additional variable which may not be as predicted and may not be very certain at all.

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