THE CHALLENGES AND MYTHS OF LESSOR AND LESSEE INTEREST VALUATIONS

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ABSTRACT

The valuation of partial interests in leases, particularly long term ground leases, is complex and not suited to simple single period analysis. This study will demonstrate the complexities in lessors’ and lessees’ interests with reference to the New Zealand situation. In New Zealand there has been an active market for the leasehold estates (lessees’ interests) of both rural and urban land which is designated as Maori Reserved Land. While Maori have been the beneficial owners of this land for the past 150 years they have not actively participated in the control or occupation of the land. This has resulted in recent legitimate claims to return this land to Maori and accordingly the registered title to lessees’ rights has become less secure and the risk of major change in the lessees’ rights has increased substantially over the past few years.

The effect of the change of the risk level of lessees’ rights on the market for these tradeable securities is examined in this paper. This exploratory research establishes a lessees’ rights risk index and hypothesises that the sales figures of lessees’ interests, adjusted for other market factors, should be inversely related to the lessees’ rights index. Little evidence is found to support the hypotheses and there is discussion on reasons why the market behaviour does not take account of this additional risk. Comment is made on valuation theory in relation to the leasehold interests and a model to compensate both lessees’ and lessors’ for the intended change is referenced.
1. **INTRODUCTION**

This paper examines market behaviour related to leasehold estates in long term land and ground leases as well as the valuation concepts of these partial interests.

In New Zealand, as in places like the State of Hawaii, there is a long history of ground leases. The majority of these leases resulted from the original settlement and development policies of the Government of that period. Substantial land holders such as the Government (The Crown), Church Trusts, Maori Trusts, state owned enterprises and other local bodies had an interest in establishing land leases in order to retain ownership of the land while achieving its productive development and the generation of income. In many cases leases were established granting the lessee a perpetual right of renewal.

This study focuses on the valuation approach to long term (either terminating or perpetually renewable) leasehold estates and the determinants of the market behaviour where a strong demand and turnover of lessees’ interests exists. Long term land leases comprise a reasonable portion of the total land area of New Zealand and encompass rural, residential, industrial and commercial land. The nature and tenure of lessees’ and lessors’ rights in land leases have been contentious issues in New Zealand over the past 150 years, but despite this fact the market continues to actively trade in these interests.

Of particular interest to the writer is the market reaction to a real risk of substantial change in the property rights of lessees of Maori Reserved Land. The uncertainty relates to the basis of establishing the rental for the leases and the continuation of the perpetual right of renewal. The efficiency of the market in its response to this probable change is tested and this is related to the theory and informed judgement on value of leasehold estates. Finally reference is made to a model that has been developed to compensate the parties for the change in their rights to the land leases.

2. **THEORETICAL APPROACH TO VALUING LEASEHOLD ESTATES**

A lessee’s interest in real estate relates to the use and occupation of that real estate. In the case of long term land leases developed with substantial improvements, the use and occupation relate to the developed property for the specific period of the lease. When valuing the leasehold estate it is essential to take account of the nature of the assets covered by the lease, the level of rent in relation to market rent and the costs and obligations of the lease.

Developing from the classical rent theories of Ricardo and von Thunen, it is generally accepted that rent should relate to the productivity of the real estate. Hence it is logical that the theoretical approach to the valuation of a leasehold estate should be based on the productivity of the estate; I will refer to this as the **Productive Approach**. Accordingly the value of the lessee’s interest should relate to the residual income achievable from the real estate after allowance is made for all costs and obligations of the lessee. This approach considers the productivity in terms of the efficient, highest and best use of the real estate, and takes account of reasonable costs in the production of the income, including rent to be paid in terms of the lease. The value of the lessee’s interest may incorporate not only the lessee’s profit rental but other assets and rights which attach to the lessee. The function of the rent benefit is expressed in the American Institute of Real Estate Appraisers Study Guide (1984), as
the lessees profit advantage (market rent less contract rent), may be capitalised at an appropriate rate for a direct indication of lease value. (p. 65)

A further approach used to value the leasehold estate is to rely on market evidence, I will refer to this as the **market approach**. Where market evidence is available it is indicative of prices being paid in the market place and therefore forms the basis for the market value. However, markets for partial interests are notoriously difficult to analyse due to the complexity of the particular partial interests and the relatively small size of such markets.

Valuers are continually being challenged by differing resultant figures when a productive or a market approach is adopted. This situation is likely to be even more prevalent when dealing with complex issues such as partial interests. A major objective of this study is to examine the efficiency of the market in taking account of external factors impacting upon the productivity of the real estate and, accordingly, the value.

Another approach used to determine leasehold interests is to establish the freehold value and thereafter attempt to partition the value between the lessor and the lessee. The major difficulty with this approach is that the sum of the lessor’s and the lessee’s interest may not equal the value of the freehold interest. There is legal statute in New Zealand that assumes that the sum of the lessor’s interest and the lessee’s interest equals market value (Mahoney v Newman Brothers 1947); however this fact does not influence the market behaviour. I believe that the more usual situation is that the interest of the two parties does not equal the freehold interest and therefore have concern about using this approach. The major valuation texts and current articles refer to the reasons why this partitioning approach is not accurate. The Appraisal of Real Estate (1989) emphasises:- “different discount rates are used in valuing different lease interests because the rates selected reflect the risk involved.” (p. 115)

In a local article Dixon and Carlisle (1984) state:

It is not necessarily the case that the sum of the lessee’s and lessor’s interests equals the unencumbered freehold value. In fact, depending upon the unexpired term of the lease and the circumstance of the transaction, there may be a substantial gap between the total of the lessee’s and lessor’s interests compared with the freehold interest. (p. 192)

The ability of the lessee to receive an adequate return from the leasehold estate should be the basis for establishing the value of this interest and the complexities and uncertainties related to a leasehold estate must be taken into account in the assessment. For instance, when considering the leasing of public lands, such as Government grazing leases in the USA, Sunderman and Spahr (1994) state:

Before a person is willing to invest large sums in capital investment he or she must have long term property rights or privileges. Without long term property rights or privileges, risk of losing the lease may outweigh any possible expected return. (p 181)

Carneghi (1994) highlighted the problems which confront the acquisition and use of land leases and listed these as:-
• The required negotiating and drafting of a ground lease making a transaction more expensive than a purchase.

• Leasehold financing is more difficult to obtain the fee financing, and

• A greater risk is involved. (p. 259)

It is this element of risk which is the focus of this study. Other authors such as Gane (1995) have also examined the risk related to leasehold interest. Gane examines the identification of the additional risks involved in leasehold interest and the impact on the investors’ perception of its market value as well as their targeted returns.

This study examines the particular risk to a specific sector of the land lease market in New Zealand which is the leasehold estates on Maori Reserved Land. It is necessary to provide a detailed historical background to this risk and accordingly the nature and history of disputes over Maori Reserved Land are set out in the following section.

3. LAND LEASES ON MAORI RESERVED LAND

The Treaty of Waitangi signed in New Zealand in 1840 set aside designated lands to be reserved for the indigenous people, Maori. Soon after the signing of the Treaty there were numerous land disputes and confiscation laws came into effect in 1863. Within the first two decades, after the signing of the Treaty, there were strong allegations by Maori of unfulfilled promises and disputes over land, in particular on the West Coast of North Island, New Zealand. In 1880 the Government appointed a commission (West Coast Commission) to investigate the grievances. The initial Commission found that there was a failure to set aside Maori Reserves as promised. A second Commission, commenced later in 1880, was empowered to make grants of land and set aside reserves for Maori. However, the management of the reserves was to be vested with a public trustee and it was deemed prudent to allow new settlers to occupy and develop the reserved lands for the benefit of themselves and Maori. The initial West Coast Settlement Reserve Act (WCSRA 1881) vested the management of the reserves in the Public Trustee and empowered the trustee to lease the reserves for the benefit of “the natives to whom the reserve belonged” on the one hand and for “the promotion of settlement” on the other.

Maori were not party to the decision making in relation to their reserved lands and since the 1880’s have made strong representation regarding the lack of control of these lands since that date. Numerous commissions of inquiry, (1890, 1891, 1906, 1912, 1913, 1927, 1934, 1948, 1965, 1975), are evidence of the severity of the grievances and the inability of the Government to settle the land control issue.

3.1 Perpetually Renewable Leases

Perpetually renewable leases essentially resulted from the West Coast Commission and were placed in the statute by the West Coast Settlement Reserve Act 1892. At that time there was strong representation from the settlers that the development of virgin lands with only a 21 year or a 30 year lease period was not viable and there is substantial evidence that settlers were unwilling to develop land on this basis. As a result the Government considered it necessary to
make the leases perpetually renewable to effectively develop and settle the land. The rental for these leases was based upon an unimproved value for this land. The Act also permitted existing and older style leases to be converted to leases granting substantial tenure through perpetual renewability.

Maori objected to the granting of perpetual renewability but were initially uninformed as to the provisions of the 1892 Act. Furthermore, Maori were not eligible to become lessees of reserved land. During the depression years of the 1930’s the rentals payable on the leases were reduced and the Government supported the rental reductions in the Native Purposes Act 1935. In the years following the enactment of this Act there was a high degree of Maori dissatisfaction with the levels of rental and their dissatisfaction finally resulted in a Royal Commission on rentals under Sir Michael Myers in 1948.

3.2 The Myers Commission 1948

The Commission report stated that the establishment of the perpetually renewable leases in 1892 was “an earnest and honest attempt to settle finally, a difficult and complex problem”; however the report goes on to state that “subsequent developments mainly economic in the general conditions of the country, which were not foreseen and which the legislators of the day could hardly be blamed for not having anticipated” (p. 8), had changed the situation.

The Myers Commission was strongly critical of the 1935 Act (Native Purposes Act), and its effect upon Maori beneficial owners. It stated:

Our investigations leave no doubt in our minds and we think could leave no doubt in the minds of any reasonable person bearing all the circumstances dispassionately, that the Maori beneficial owners of these lands have suffered a grave injustice as a result primarily of the actions of the legislature in 1935 (p. 6) . . . we might add that our criticism is probably much less harsh than was the criticism in 1892 by various prominent legislators themselves regarding previous enactments and regulations affecting the West Coast Settlements Reserve and the administration hereunder (p. 8).

In order to rectify the injustices of the past the Commission stated “in our view the beneficial owners should now be given the fullest measure of justice and future security that is reasonable and possible to give them” (p. 28). The Commission recommended that the lessors receive a return on the unimproved value of the land and suggested that the rent should be fixed at 5% of the unimproved value. It went further to state that the beneficial owners should not suffer from a reduction in the unimproved value of the land in future except in the case of deterioration of specific land parcels. The report also suggested a simple tribunal system to settle the level of rent rather than the existing arbitration procedure.

3.3 Maori Reserved Land Act 1955

As a result of the Myers Commission the Maori Reserved Land Act 1955 was enacted. The Act had two main purposes; to standardise the leases of Maori Reserves on a national basis and to deal with the rapidly fragmenting beneficiaries’ interest. The Act established rent on the basis of a percentage of the unimproved value fixed for a period of 21 years with perpetual rights of renewal and further gave Maori trustees the authority to convert specific term leases
to leases that were perpetually renewable. The Act also empowered the Maori Trustees to grant new leases with rights of renewal in perpetuity. Section 34 of the Act provided for a rental of 4% of the unimproved value of the land for any urban land and 5% in the case of rural land. The Act also permitted the sale of the lessors interest to existing lessees provided the beneficial owners indicated a willingness to do so. Because of the dispersion of Maori owners this approval was often difficult to obtain and dissatisfaction rose amongst Maori regarding the action of the Trustees in the disposal of the lessors’ interest.

During the 1960s there was a strong movement by Maori to regain control of their reserved lands. The West Coast Settlement Reserve Advisory Committee was formed to establish a corporation to take over control from the Maori Trustee. With pressure from this Advisory Committee and other ownership groups the Government established the Commission of Inquiry into Maori Reserved Land (The Sheenan Commission).

3.4 The Sheenan Commission (1973-75)

The Sheenan Commission was appointed in December 1973 to review the Maori Reserved Land Leases and in 1975 it produced a substantial and historic document. At an early stage in the Report it stated “The Commission recognises the desire of the Maori to identify with his land and we acknowledge that the present administration completely precludes this. It is probable that the desire to identify is as much a need to have control as to actually have physical access to the land (p. 33)”.

The Commission drew a distinction between Glasgow-type leases and these leases because the former involved two interested parties whereas Maori Reserved Land leases involved four distinct parties. These were the legislature, the Maori trustee, the lessee and the beneficial owners. In relation to the role of the beneficial owners it stated:

> The beneficial owners are not a contracting party and their role is a completely passive one. They are treated as children or persons under disability. They are not well informed upon the law or the facts concerning the lands in which they have an interest, they are not adequately consulted or indeed capable of being adequately consulted even when major changes in the law or the leases which affect their interests are contemplated. (p. 53)

The position of the lessees was also described in the report as:

> They (lessees) have felt that their’s was a positive contribution to a developing society in that they were building towns, breaking in virgin lands, and in many ways contributing to the continual growth of a new society. (p. 61)

In their conclusions the Commission strongly supported the concept of returning control, and possibly, occupation of the reserved lands to the beneficial owners. On page 62, it stated “the Commission is of the opinion that no arrangements in regard to rural Maori reserved lands should preclude the possibility, however difficult, of realisation of direct use and occupation of these lands by the beneficial owners. This can only be done by purchasing the lessees interests; or selling individual farms and purchasing similar farms in the same area.”
In relation to the perpetually renewable aspect of the leases they stated:

The question might well be asked as to how the lessors of these lands can escape from the restrictions and essential inequities which arise from the right of perpetual renewal provided for in the present lease. (p. 68).

While the Commission did not recommend the cancellation of the perpetually renewable nature of the leases it dealt with the conditions of renewal of the leases, particularly the rental, and also made a recommendation that the beneficial owners should participate in capital gains on these lands which arose from the changes in zoning and land use. The basis assessed for future rental by the Commission was that the rent should be determined at 1% above the rate of Government long term securities where rent reviews are at 21 year intervals. There was a further proposal that should the rents be renewed at lesser periods than 21 years then the government stock used in the assessment should relate to the same time period. This proposal was to ensure that leases with a short term renewal were capitalised at a lesser figure. The proposed figures at the time for rural land were 7% for a 21 year fixed lease, 6% for a 7-10 year lease renewal and 5% for a 5 year renewal. The Commission also recommended five yearly reviews of rental. Another major recommendation of the commission was the establishment of representative organisations of owners, referred to as Maori Incorporations, which would take over the administration of the leases from the Maori Trustees. Specific Maori Incorporations were recommended for various regional interests.

The only recommendation of the Sheenan Commission accepted by the Government was the establishment of Incorporations of Owners to have title and administer the reserved lands. The basis for establishing the rentals was not amended from the Maori Reserved Land Act 1995.

3.5 Waitangi Tribunal Finding

The Treaty of Waitangi Act 1975 established a mechanism to consider concerns about the implementation of the Treaty of Waitangi referred to as the Waitangi Tribunal.

The Waitangi Tribunal’s Ngai Tahu Report 1991 was an historic document, not only in that it had received 900 submissions and had taken four years to complete, but because of its findings and the initiation of a process of settlement by negotiation. The report, inter alia, dealt with perpetually renewable leases on the West Coast of South Island, New Zealand.

After studying the historical records of the perpetually renewable leases the Tribunal stated: “The Tribunal found that the Maori owners never gave their consent to perpetual leases in 1883 or 1887” and further it found that “the Crown has failed to move in respect of recommendations contained in the 1975 Commission report (Sheenan Report), and should have done so.” (p. 139)

In summary the Tribunal found that the implementation of perpetual rights of renewal, the prescribed rent, and the failure to implement the 1975 Commission of Inquiry report, were all breaches of the Treaty of Waitangi. As a result the Tribunal recommended:
1. That the Maori Reserved Land Act 1955 be amended so that the leases prescribed in this Act will:

   a) over two 21 year lease periods convert to term leasehold those lands subject to the leases prescribed in the above Act;

   b) immediately change from a fixed percentage rental basis to one of a freely negotiated rental, subject to the Arbitration Act; and

   c) immediately change from the present rental review period of 21 years to a rental review period of 5 years in respect of commercial and rural land and 7 years in respect of private residential land.

2. That the lessees be reimbursed by the Crown for any provable loss suffered by them as a result of the legislative changes recommended above. (p. 141 & 142)

This finding of the Waitangi Tribunal was a watershed decision and clearly influenced not only the land on the West Coast of the South Island, but all Maori Reserved Land subject to perpetually renewable leases.

3.6 Reactive Government Policy

Being conscious of the ramifications of the Ngai Tahu Report, the Crown reacted promptly and set up a review team in September 1991, with Steve Marshall as Chairman. The review team was instructed to make recommendations on ways to remove the inequities facing the beneficial owners of Maori Reserved land. The review team was specifically requested to consider the recommendations of the 1975 Commission of Inquiry and the Ngai Tahu Report of the Waitangi Tribunal. In its report the Marshall Review:

   . . . reached the conclusion that serious inequities exist in respect to the legislatively granted perpetual right of renewal, the length of the rent review period, the prescribed level of rentals, and the general conditions pertaining to the administration of leases. These inequities are a direct result of lease terms established by Parliament. (p. 7)

The Committee recommended that the Government accept that change to the statutory contract was required to effect the removal of existing inequities and that it accept responsibility for payment of appropriate compensation for all provable losses during the transition process of the change. They also recommended that the Crown acknowledge their responsibility for past losses due to these statutory contracts and that, when the transition period was over, the perpetually renewable leases should be leases without legislative prescription.

In response to the report of the Review Committee (Marshall Report) the government issued a paper in 1993 entitled “A Framework of Negotiations: Toitū te Whenua” and also appointed the Reserved Lands Panel to consult on the proposals of this framework. The framework suggested that existing leases should be converted to a term tenure after a further 42 or 63 year period but that no compensation should be payable to the lessees for their loss of
perpetual right of renewal. As a further step in the development process the Government appointed a panel to consult with affected parties and report back on its proposals.

### 3.7 Reserved Lands Panel 1993 (Trapski Report)

The Reserved Lands Panel under Judge Trapski consulted with numerous parties on the framework and reported back in January 1994. The panel report commences:

> ... in our case the plea for finality was in order to bring certainty to a situation where uncertainty has been wreaking havoc in the lives of so many for so long. ... The facts overwhelmingly call for immediate action to dismantle and abolish the system of perpetually renewable leases of Maori reserved land. (p. 5) ... The legislatively imposed system of perpetually renewable leases of Maori Reserved Land is generally accepted to be inequitable and unjust and should be terminated.

(p. 6)

The report emphasised the active role which the Government should take in facilitating negotiations and alleviating hardship for the parties involved. The specific recommendations of the panel were that the perpetually renewable leases should be terminated after the existing term and two further twenty-one year periods of renewal. The rentals or leases should be renewed to market levels in three years time and thereafter the rentals should be reviewed every three years and fixed by agreement between the parties or failing agreement, by arbitration. In addition the panel recommended that the role of the Maori trustees should be phased out of the administration of this land.

The Trapski report was published in January 1994 and that year could be considered as the period of greatest uncertainty for Maori Reserved Land lessees. The panel confirmed the Government’s proposal to terminate the leases with no compensation to be paid to the lessees; this was the lessees’ worst fear.

The next step was in January 1995 when the Government released a policy document entitled “Toitu te Mana & Toitu te Whenua” - Maori Reserved Lands Government Policy Decisions 1994. This document proposed legislation to amend the Maori Reserved Land Act 1955 so that all perpetually renewable leases would terminate at the end of the current term plus two further periods of twenty-one years. It did however include a payment of compensation to lessees for the loss of perpetual right of renewal. The amount of compensation was to be between 1.85% and 2.9% of the unimproved value of the land. It further proposed that there should be a three year delay before market rentals where phased in and the rent reviewed every seven years. In addition lessors and lessees would be granted the right of first refusal to purchase the other party’s interest.

In order to test the proposals in the Government policy document the Minister appointed a consultative working group in 1995 to discuss the effects of the proposal with appropriate parties. The consultative working group held an inquiry between March and August 1995 and early in 1996 a Crown negotiator was appointed to enter into discussions with representatives of lessor and lessee groups and reach agreement on levels of compensation and the basis of moving to market rents.
The next step of the Government was to propose the Maori Reserved Land Amendment Act 1996 in July 1996. This document was the combination of the earlier Government policy documents, Review committees, consultative working groups and negotiations. The proposals in the Amendment Bill were, to a large extent a compromise on previous positions. The Bill proposed the continuation of the right of perpetual renewal but specified the phasing in of market rents after a three year delay. It provided that rentals would be reviewed every seven years. The Bill provided for compensation to lessees for the move to market rental on a formula basis but restricted the compensation to a period of twenty-one years. In addition compensation was payable to the lessors for the delay in phasing in the market rents. Both parties were granted the right of first refusal to purchase the other party’s interest.

The aim of the Bill was described as:

... restore balance to the relationship between owners and lessees. It will place lessees and owners in a close normal commercial lease relationship. For the lessees the policy reviews and consultations have generated uncertainty. The Bill aims to provide certainty for lessees and give them compensation for the proposed move to market rentals. (Forward to Bill by Minister of Maori Affairs & Lands, p. 2).

After the first hearing of the Bill it was referred to a Select Committee and an Independent Panel was appointed by the Minister to report to the Select Committee on the proposals within the Bill. The writer was a member of the three person Independent Panel which held enquiries between August and December 1996.

The recommendation of the Independent Panel was that the compensation model should be amended to more fully represent fair compensation to both parties, that the proposed change to market rental should come into effect within the next three rather than seven year period, and that the basis for establishing future rents should not be prescribed in the legislation but rather determined by the market players. At the time of writing, November 1997, the Amended Bill is again before Parliament with several amendments including some recommendations by the Independent Panel.

3.8 Future Developments

The writer anticipates that the Maori Reserved Land Amendment Act will come into effect in 1998. This Act should bring certainty after a long period of uncertainty and place the Reserved Land leases on a commercial footing. It has the ability to permit the beneficial owners to regain freehold ownership of their property by exercising the right of first refusal and will permit the existing lessees to receive reasonable compensation for their property rights. Provided the Amendment Act comes into effect in the near future, the injustices related to property rights on Maori Reserved Land will finally, after almost a century of delays, be positively addressed.
4. LESSEES RIGHTS RISK INDEX

The security of tenure of the leasehold estate (the lessees’ rights) on Maori Reserved Land has changed radically over the past few years and it is desirable to record the change in level of risk. There are currently 2,236 leases on Maori Reserved Land and the land encompassed by these leases is 26,000 hectares. Accordingly a change in these leases has a substantial effect on several communities within New Zealand.

The history of perpetually renewable leases on Maori Reserved Land in New Zealand indicates that the lessees’ rights, while they have been supported by legislation, have been at risk because the beneficial owner of the land have never been party to the lease agreement. In 1975 a Commission found that the existing leases were unfair and that the rental structure should be changed as well as the control over the leases. This was the first substantial statement that there was uncertainty about the tenure of these leases and from this date lessees should have inferred that the current title could change because of ongoing representation by the beneficial owners. Despite ongoing representation by Maori it was not until 1991 that the leases were considered to be a legal breach of an agreement. A summary of the major stages in the evolution of the perpetually renewable lease conditions is shown in Exhibit 1 below:
Exhibit 1

Evolution of Perpetually Renewable Leases on Maori Reserved Land

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1892</td>
<td>Prescribing of perpetually renewable leases</td>
</tr>
<tr>
<td>1948</td>
<td>Grave injustices of rent levels highlighted (<em>Myers Commission</em>)</td>
</tr>
<tr>
<td>1955</td>
<td>Entrenchment of perpetually renewable leases and fixing of return rate to lessors (<em>Maori Reserved Land Act</em>)</td>
</tr>
<tr>
<td>1975</td>
<td>Sheehan Commission recommends increased rents and new control structure - but no lease changes actioned</td>
</tr>
<tr>
<td>Nov 1991</td>
<td>Proposal to change perpetually renewable leases to term leases with compensation for provable losses (<em>Marshall Review Panel</em>)</td>
</tr>
<tr>
<td>April 1993</td>
<td>Government proposes remaining term for leases of 42/63 years and no compensation for lessees.</td>
</tr>
<tr>
<td>Jan 1994</td>
<td>Reserved Land Panel confirms recommendation on term leases, market rent and no compensation</td>
</tr>
<tr>
<td>Jan 1995</td>
<td>Government proposes to terminate perpetually renewable leases and offer some compensation to lessee</td>
</tr>
<tr>
<td>July 1996</td>
<td>Maori Reserved Land Amendment Bill published allowing for continuation of perpetual right of renewal and compensation models.</td>
</tr>
<tr>
<td>Nov 1997</td>
<td>Maori Reserved Land Amendment Bill at second reading stage.</td>
</tr>
</tbody>
</table>

Based on the published Commission Reports and statutory proposals, as outlined above, the writer structured a risk index on the security of lessees’ rights in relation to Maori Reserved Land. While this index has been subjectively structured it resulted from consultation with legislators, officials and professionals involved in the administration and transfer of leasehold estates. The index starts in 1975 at a figure of 30 and there is little change over the next thirteen years. However by 1989 the Waitangi Tribunal had heard submissions in relation to the injustices in Maori Reserved Land leases and the statement by the Tribunal that the leases were a breach of the Treaty of Waitangi was the start of a sharp rise in the index. The beginning of 1995 was the first proposal of compensation for lessees and this caused the index to change direction. The index is illustrated on Exhibit 2 below.
5. THE VALUATION OF LESSEES RIGHTS: MARKET BEHAVIOUR

In order to examine market behaviour of leasehold estates a comprehensive study was undertaken of the data available in New Zealand on leasehold sales. The main source of sales data was obtained from Valuation New Zealand who collate all sales records in New Zealand and from the Wellington Lessees’ Association. In addition Valuation New Zealand had analysed dairy sales throughout New Zealand and expressed the sales on the basis of kilograms of milk solid. The base data was further analysed by the writer and the data and the correlation matrix are indicated on Exhibit 3.
### Exhibit 3

**LEASEHOLD & FREEHOLD SALES DATA**

<table>
<thead>
<tr>
<th>Year ended December</th>
<th>Lessees' Rights Risk Index</th>
<th>NZ Dairy Land Price Index</th>
<th>Taranaki Leasehold Dairy Sales Analysis</th>
<th>Leasehold % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Lessees' Interest as % of Freehold Value</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sale Price $ per ha by dairy index</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sale Price as % of Freehold Value unit kg MS</td>
<td></td>
</tr>
<tr>
<td>1975 = 30</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>31</td>
<td>491</td>
<td>2,501</td>
<td>67.10</td>
</tr>
<tr>
<td>1982</td>
<td>31</td>
<td>748</td>
<td>3,698</td>
<td>2427</td>
</tr>
<tr>
<td>1983</td>
<td>32</td>
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<td>3,757</td>
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<td>1984</td>
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<td>882</td>
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<td>1985</td>
<td>32</td>
<td>927</td>
<td>2,447</td>
<td>1312</td>
</tr>
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<td>1986</td>
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<td>841</td>
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<td>1957</td>
</tr>
<tr>
<td>1991</td>
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**Correlation**

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**Source:** Valuation New Zealand, Wellington Lessees Association and Writer

This time series data has been examined to find the relationship between the lessees’ rights risk index and sales of lessees’ rights. As it is anticipated that the change in lessees’ rights risk index should have a direct affect on the sales figures, the following hypotheses are proposed:

**H₁** Sales prices of lessees’ interests have a strong inverse relationship with the lessees’ rights risk level

**H₂** The value of lessees’ interests as a percentage of the freehold value has a strong inverse relationship with the lessees’ rights risk level.
\( H_3 \) The volume of sales of lessees’ interest has a strong inverse relationship with the lessees’ rights risk level.

**H1 Sale Prices of Lessees’ Interest and Risk Level**

An examination of Exhibit 3 indicates that the sale prices of lessees’ interest in dairy land in Taranaki are strongly positively related with the risk index; correlation is 0.9565. This is at odds with hypothesis 1 but an examination of the correlation between the New Zealand Dairy Land Price Index and the Risk Index shows that there was a strong increase in dairy land prices at the same time as the risk index was increasing; the correlation being 0.321. It would therefore appear that the general increase in dairy land prices has had a substantial effect on the prices paid for lessees’ interests in dairy land.

In order to lessen the effect of the general increase in dairy land prices the sale prices of leasehold interests in Taranaki have been deflated by the dairy price index and the resultant figures are included on Exhibit 3. The relationship between the lessees’ rights risk index and the Taranaki leasehold sales adjusted by the dairy index, are shown on Exhibit 4 below.

**Exhibit 4**

Comparison of Lessees’ Rights Risk Index and Adjusted Sales Figures of Lessees’ Interests in Dairy Land (TLDP).

Source: Valuation New Zealand and Writer.

A visual examination of Exhibit 4 will show there is no clear inverse relationship between the risk index and the adjusted leasehold sales. The correlation between these two indices is 0.2169. This is a weak positive correlation and hypothesis 1 is accordingly not supported despite removal of the variable of dairy sales price change.
It will be noted that there was a sharp decline in the sale price in 1993, but the decline was not sustained in 1994 and followed a sharp rise in 1992. There is insufficient evidence to link this fall to the change in risk level.

$H_2$ **Value of Lessees’ Interest as Percentage of Freehold Value and Risk Level**

As demonstrated above the lessees’ interests in dairy land was strongly influenced by the general price increase of dairy land. The impact of this increase can also be partially excluded by relating the sale price of the lessees’ interest as a percentage of freehold sale price. As the risk to the lessees’ rights increases the lessee sales figures should become a lesser percentage of the freehold price.

Exhibit 5 illustrates the relationship between the risk index and the lessee sales as a percentage of the freehold sale price using three sets of data being Taranaki Dairy Land on a unit per m$^2$ basis and as a unit per kg milk solids and Wellington lessees’ rights sales.

**Exhibit 5**

**Comparison of Lessees’ Rights Risk Index and Lessees’ Rights Sales expressed as a percentage of Freehold Sales**

Note: TLFH = Taranaki Lessees’ interests as percentage of freehold as rate per m$^2$
TLMS = Taranaki Lessees’ interests as percentage of freehold as kg milk solids
WLCV = Wellington Lessees’ interests as percentage of freehold as rate per m$^2$

*Source: Valuation New Zealand, Wellington Lessees’ Association and Writer*

Looking at the Taranaki lease sales there is no clear negative correlation with the risk index and the correlation statistic is 0.2867, which demonstrates that there is a weak positive relationship between these figures. It will further be noted that there is reasonable similarity in the graphs between the leasehold price as a percentage of freehold and the index of the
leasehold sales deflated by the dairy index and shown on Exhibit 4. It can be inferred from this that the freehold sales of dairy land in Taranaki have followed closely the dairy land price index for New Zealand. A further attempt to adjust the percentage of leasehold to freehold value was done using the unit basis of kilograms of milk solids and this graph is included in Exhibit 5. However the relationship on a unit basis of kilograms of milk solids showed a positive correlation of 0.6574 and accordingly did not support the anticipated negative correlation. The Taranaki sales figures do show a sharp drop in 1993, 1995 and 1996 and this may be partly due to a delayed response to the increase in risk of lessees’ interests.

Another group of leasehold properties in the Wellington area which included commercial and residential properties was analysed to examine the relationship of the leasehold sale prices to the Government Value of those properties. This series is also indicated in Exhibit 5.

This graph indicates a reduction in the leasehold figures as the risk index increases and the correlation matrix indicates that the relationship is -0.2773. While the correlation statistic is the correct sign the coefficient of 0.28 does not demonstrate a strong relationship.

From the above it must be concluded that the use of a relationship to freehold sale prices does not assist in supporting hypothesis No. 2. In fact it is noted that the leasehold sale price, as a percentage of the freehold sale prices for dairy land in Taranaki, has increased as the lessees rights risk index increased; this is an unexpected finding.

A further examination of Exhibit 5, indicates that since 1993 there appears to have been a reasonable negative correlation between the leasehold sales prices and the risk index. It would appear that the risk level has had some impact on the sale prices from the beginning of 1993 but even since that date a strong negative relationship is not sustained. Further evidence may indicate a lagged effect but the data available is too limited.

H₃ Volume of Lessee Sales and The Risk Index

Hypothesis 3 requires the examination of the volume of leasehold sales as a percentage of the total leasehold population and states that it will decrease as the risk index increases. The number of sales in each year from 1981 to 1995 was analysed as a percentage of the total number of leasehold properties and it was noted that on average 7% of the leasehold interests were traded each year. Exhibit 6. illustrates the relationship between this series and the risk index and while there is greater volatility since 1989 there is very little discernible relationship with the correlation coefficient being -0.1111.
Exhibit 6

Comparison of Lessees’ Rights Risk Index and Volume of Sales of Lessees’ Rights (SLTL)

Source: Valuation New Zealand and Writer

Accordingly there is no evidence from these figures that the percentage of leasehold property sales has not been adversely affected by the increase in the risk index and consequently Hypothesis 3 is not supported by this data.

Conclusions on Market Behaviour

It is clear from the above figures, even without detailed statistical testing, that none of the three hypotheses have been proven. In fact there is little evidence to support the proposal that the market was aware and took cognisance of the substantial increase in the lessees’ rights risk index which took place between 1991 and 1994. The Wellington leasehold sale prices showed some adjustment for the risk index but the relationship was not strong enough to infer that other factors were not involved in the determination of the results. A perceived downturn in sales price was noted from 1992 and it is possible that the increased risk could have been a factor in the price change.

The general conclusion from this analysis is that the market had limited awareness of the substantially increased risk to the security of the lessees’ interest or did not perceive the risk as substantial. There was evidence that the sales of the lessees’ interest followed closely the sales trends of freehold land and that the market continued to purchase leasehold interests at a relatively high proportion of the value of the freehold interest. Since the beginning of 1993 the sale prices of lessees’ interests in Taranaki have fallen sharply (except for 1994) and it is probable that the increased risk is a component of this price adjustment.
6. LESSEES’ PERCEPTIONS OF THEIR RIGHTS

While it is surprising that the sale prices of lessees’ rights did not demonstrate a clear awareness of the substantial change in the security of tenure, there are several reasons why this situation exists. The writer has had the opportunity of receiving numerous, literally hundreds, of submissions from lessees or their representatives on how they view their rights and their expectations of the future.

Three major factors which may explain, to a large extent, why the market failed to react to the increased risk are:

1. a lack of understanding of the nature of leasehold tenure,
2. an unwillingness to accept that the Government would change their legal rights and
3. misguided professional advice.

There is little doubt that a number of lessees do not clearly comprehend the nature of their tenure. In fact, a reasonable number consider that they are purchasing freehold land and improvements with the only difference being the obligation to pay rent. In addition as the rent is fixed for a period of twenty-one years, the need to make allowance for substantial future increases in rent is seldom taken into account in the value of the lessees’ rights. Back in 1968 a Committee investigating levels of rental and freeholding of Crown Lands (Beattie Commission, 1968), made the following comment:

what we can only construe as lack of understanding of leasehold tenures is revealed by purchasers who buy leaseholds at the same level of prices as is inuring in the time for leasehold land. They seem completely blind to the fact that although they are paying a price equivalent to freehold land, they still must pay rent under the lease for the remainder of the term and then conceivably be faced with an increase on renewal. (para 4.3)

Later in 1993 a Ministerial inquiry into perpetually renewable leases (Lusk Report 1993), also commented on the lack of understanding of leasehold interests and said:

In recent years arbitration awards, articles in the Valuers’ Journal, and other reports, have stressed the need to educate lessees before they acquire their interests. Vendors and their Real Estate agents, for obvious reasons, have no interest in pointing out to potential purchasers the very real hazards of leasehold ownership and the restrictive rights and heavy obligations that it entails. That there is a need for these people to have access to such information is obvious. (p. 60)

Despite comments from the distant and recent past there is still evidence today that many lessees do not fully understand the rights that they are purchasing.

It is also probable that a number of lessees did not believe that the Government would “tamper” with their legal rights. The lessees’ rights were inscribed in the title to the land and that title specified the conditions of the lease including the basis for rental. While numerous
submissions were being made for change and commissions and review panels were recommending change, a number of lessees believe that the Government would not amend the leases. To some extent this attitude has been supported by a softening of the attitude of Government. In recent years the Government and commissions have made recommendations that perpetually renewable leases should be cancelled and the term of the lease defined with no compensation to the lessees, but this situation is now unlikely to arise. Without doubt there will still be substantial changes which will seriously affect the level of rent and the security of tenure, but probably not to the extent which was contemplated in 1993 and 1994. With legislation likely to be introduced in 1998, this group will find that their legal rights have changed and that, just as the Government imposed the legislation, it is able to change it.

It is also interesting to note that in Australia many lessees of ground leases choose not to freehold their land despite their right to do so. In these cases the Government is their lessor and they consider that they will receive more favourable treatment from the Government as a lessee than as an owner.

The third point about the market is that, unfortunately, there are still a number of real estate professionals who do not comprehend the nature of lessees’ interests or do not acknowledge the changing nature of these interests on Maori Reserved Land. In submissions to the Independent Panel appointed to advise on the Maori Reserved Land Amendment Bill stated it was often stated by the professional advisers of the lessees that the lessee’s interest in land was:

“... akin to freehold in all aspects except for the requirement to pay rental, based on unimproved value and renewable at twenty-one year intervals.”

It was unrealistic in 1996 to refer to the leasehold interest as akin to freehold and such an attitude tends to misinform potential buyers. There is a serious responsibility on real estate professionals to ensure that they make lessees aware of the lease conditions as well as their rights and, in particular, valuers should not prepare a report on the value of these interests without specifying the nature and the risks related to these partial interests.

7. COMPENSATION MODEL FOR CHANGE IN LESSEES’ INTERESTS

In terms of the proposed legislation for Maori Reserved Land there is, in addition to a change in the basis of rental and lease reviews, an allowance for compensation to the lessees and the lessors. Furthermore, the Government is adamant that compensation should be paid prior to the commencement of the changes in 1998. This has made it necessary to develop a compensation model which can be applied to the 2,236 leases and results in compensation figure which the Government considers fair to both lessees and lessors. Such a model is incorporated within the Maori Reserved Land Amendment Bill.

The details of the compensation model cannot be dealt with in this paper but the Second Schedule of the Bill is attached as Annexure “A” and this schedule includes both the formulation of the model and the quantification of several variables used in the model. The intention of providing this Schedule is to demonstrate transparency in the approach of the Crown. The writer is most willing to discuss this model with any interested persons.
8. CONCLUSIONS

The security of tenure in leasehold estates on Maori Reserved Land offers an interesting case study on change in market price as a result of a change in tenure risk. The assumption was that the substantially increased risk would result in a major adjustment of the sale price of the lessees’ interests. However there proved to be little evidence that the market took much cognisance of these changes and it was not possible to demonstrate statistically that the risk factor caused a change in sale price. A number of issues are mentioned which may contribute to this lack of reaction from the market, but they do not adequately explain the market’s inertia. There is evidence of a difference between valuation theory, which would suggest that this type of risk should be taken into account because of its affect on both the tenure and the profitability of the land covered by these leases, and actual market practice. The concept that the sum of the lessors’ and lessees’ interests should equal market value is a further complication in the legislation in New Zealand.

The two issues of market reaction to a complex partial interest tenure and the construction of a compensation model to recompense for changes in partial interest rights are discussed in this paper. It would be interesting to discover whether similar experiences have been recorded in other parts of the world; there is a lack of documented results on the market behaviour of leasehold estates. The writer intends to take this research further and would welcome input from other interested parties.

Terry P Boyd

November 1997
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