International Valuation Guidance Note No. 2

Valuation of Lease Interests (Revised 2003)

1.0 Introduction

1.1 International Valuation Standards (IVS) General Valuation Concepts and Principles distinguish between *real estate,* the physical tangible "thing" (see Concepts & Principles, Section 3.0), and *real property,* which pertains to the rights, interests, and benefits related to the ownership of real estate. *Lease interests* are a form of real property, arising from the contractual relationship (the terms of which are conveyed by a *lease*) between a *lessor,* one who owns the property leased to another, and a *lessee,* or tenant, one who typically receives a non-permanent right to use the leased property in return for rental payments or other valuable economic consideration.

1.2 In various States further distinctions are sometimes drawn between very short-term use and occupancy of real estate (as for example admission to a theatre for the duration of a specific performance) and the terms and conditions requisite for the qualification of the contractual agreement as in a lease.

1.3 To avoid misunderstandings or misrepresentations, Valuers and users of valuation services should recognise the important distinction between the physical and the legal issues involved in considering lease interests. For example, because land unencumbered by a lease is legally different from a *leasehold* (the lessee's, or tenant's, legal position) and the *leased fee* (the lessor's legal position) the market valuation of these interests is conducted under different assumptions even though the lease interests encumber the same land. A lease might specify, for instance, that the lessee has no right to sell or transfer the leasehold interest, causing it to be unmarketable during the term of the lease. Its value to the lessee, therefore, lies solely in the rights of use and occupancy. Even though the leasehold cannot be sold for this period, it does have monetary value to the lessor in the form of income.

1.4 This class of ownership is, as for the fee simple, or freehold, interest, common to all types of property assets valued. A property may comprise one or more legal interests, each of which will have a *Market Value*.

1.5 In no circumstances is it considered proper to value lease positions separately and to then aggregate their estimated values as an indication of the *real estate's* defined value. Lease contracts establish unique legal estates that are different from fee simple, or freehold, ownership.

1.6 At present International Accounting Standard 40 (IAS 40), Investment Property, does not permit a lessee to treat an interest in property held under an operating lease as an *investment property,* even if the lessee acquired the interest in exchange for a large, up-front payment or the lease runs a very long term. IAS categorises all leases as either *operating* or *finance leases,* and IAS 17, Leases, deals with the accounting of these assets.

As part of its Improvements Project of 2002, The International Accounting Standards Board (IASB) proposed that the definition of *investment property* be amended to permit a property interest held by a lessee under an operating lease to qualify as *investment property* provided that

a) the rest of the definition of *investment property* is met; and

b) the lessee uses the fair *value model* set out in IAS 40, paragraphs 27-49.

Further, a lessee that classifies a property interest held under an operating lease as *investment property* is required to account for the lease as if it were a finance lease.

Revised IAS 16, Property, Plant and Equipment, will be mandatory for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application (after publication of the revised Standard programmed for the second quarter 2003) is encouraged.

1.7 The relationships between different legal interests in the same property can be complex and can be made more confusing by the different terminology used to describe the various interests. This Guidance Note (GN) seeks to address and clarify these issues.

2.0 Scope

2.1 This GN sets out definitions, principles, and important considerations in the valuation of and related reporting for lease interests.

2.2 This GN is to be applied with particular reference to IVS Concepts and Principles and to IVS 1 and 2.

2.3 This GN applies in States where a lessee holds an interest in land and/or buildings, which is regarded as a separate legal estate. A lease interest is subordinate to a superior interest which itself may be either another lease interest for a longer term or the ultimate fee simple, or freehold, interest.

3.0 Definitions

3.1 Terms basic to the definition and valuation of legal interests include the following:

3.1.1 *Freehold Interest* has the same meaning as *Fee Simple,* representing the perpetual ownership in land.

3.1.2 *Lease*. A contract arrangement in which rights of use and possession are conveyed from a property's title owner (called the landlord, or lessor) in return for a promise by another (called a tenant, or lessee) to pay rents as prescribed by the lease. In practice the rights and the duties of the parties can be complex and are dependent on the specified terms of their contract.

3.1.3 *Lessor Interest*. The interest held by the lessor in either of the circumstances set out in para. 3.1.5, 3.1.6, or 3.1.7 below.

3.1.4 *Lease Interest,* also known as *Lessee Interest, Tenant's Interest,* or *Leasehold Estate*. The ownership interest created by the terms of a lease rather than the underlying rights of real estate ownership. The lease interest is subject to the terms of a specific lease arrangement, expires within a specified time, and may be capable of subdivision, or subleasing to other parties.

3.1.5 *Freehold Investment,* or *Freehold subject to Lease Interest/s,* has the same meaning as Leased Fee Interest, representing the ownership interest of a lessor owning real estate that is subject to (a) lease(s) to others.

3.1.6 *Headlease,* or *Master Lease*. A lease to a single entity that is intended to be the holder of subsequent leases to sublessees that will be the tenants in possession of the leased premises.

3.1.7 *Headleasehold Interest* has the same meaning as *Sandwich Lessor Interest*. A lease that represents the intermediate interest between a superior interest, such as the freehold, and sub- or underleasehold interest(s), such as that of the tenant(s) in possession. The owner of the headleasehold interest is therefore both a lessee, to the superior interest, and a lessor, to the subordinate interest(s).

3.1.8 Lease Types

3.1.8.1 *Ground Lease*. Usually a long-term lease of land with the lessee permitted to improve or build on the land and to enjoy those benefits for the term of the lease.

3.1.8.2 *Turnover Lease,* or *Percentage Lease*. A lease provision in which some or all of the rental amounts to be paid is based upon a percentage of the revenues derived from that leased unit by the lessee. It is common for such arrangements to include a guaranteed minimum, or base rent, which is not dependent upon the lessee's operations for its amount, as well as a percentage, or participation, rent in operating revenues over a stated amount.

3.1.9 Rent Types

3.1.9.1 *Market Rent*. The estimated amount for which a property, or space within a property, should lease on the date of valuation between a willing lessor and a willing lessee on appropriate lease terms in an arm's-length transaction, after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

If the terms of the lease vary from those that the market would deem to be appropriate, i.e., the market norm, then the *market rent* applicable to that lease would also vary as a reflection of those terms.

3.1.9.2 *Contract Rent,* or *Passing Rent*. The rent specified by a given lease arrangement; although a given contract rent may equate to the market rent, in practice they may differ substantially, particularly for older leases with fixed rental terms.

3.1.9.3 *Turnover Rent,* or *Participation Rent*. Any form of lease rental arrangement in which the lessor receives a form of rental that is based on the earnings of the lessee. Percentage rent is an example of a turnover rent.

3.1.10 A rental that is more than market rent constitutes *excess rent*. Such rental, if considered at all, is commonly capitalised at a higher discount rate because of the higher risk and potential uncertainties associated with the consequences of the lessee's disadvantage. From a lessee viewpoint, it is from the payment of excess rent that a negative *Market Value* (see para. 5.18 below) of the lease interest may arise. In some States any value that is ascribed to excess rent is considered personal property because its basis arises from the contract, not the real estate.

3.1.11 Typical Value Components

3.1.11.1 *Freehold,* or *Leased Fee, Value* is generally considered to be the sum of the present value of anticipated net incomes to be received under the lease plus the present value of the anticipated value of the property when use and possession are regained by the lessor. In practice, the type of value (e.g., *Market Value*) must be identified, defined, and appropriate to the situation.

3.1.11.2 *Leasehold Value* is the value of the lease interest. Although property rights conveyed to a lessee include the rights of use and possession, their value to the lessee is generally offset by the obligation to pay a continuing rental amount for those rights. Hence, a leasehold value arises only where a property's market rent is greater than its contract rent. Where a contract rent exceeds the market rent, a negative leasehold value may occur. In practice the type of value (e.g., *Market Value*) and the legal component being valued (e.g., leasehold) must be identified, defined, and appropriate to the situation.

3.1.11.3 *Marriage Value,* or *Merged Interests Value*. The excess value, if any, produced by a merging of two or more lease interests in a property, over-and-above the sum of the values of those individual interests.

3.1.12 *Sale and Leaseback*. A simultaneous sale of real estate and lease of the same property to the seller. The buyer becomes the lessor, or landlord, and the seller becomes the lessee, or tenant. Because there may be unique circumstances or relationships between the parties, sale and leaseback transactions may or may not involve typical market terms.

3.2 Lease definitions set out in the International Accounting Standards are:

3.2.1 *Operating Lease*. A lease where the lessor retains substantially all the risks of ownership of the leased property. (See "Classification of Leases" in IAS 17.)

3.2.2 *Finance Lease*. A lease that transfers substantially all the risks and rewards incidental to an ownership of an asset to the lessee. Title may or may not eventually be transferred (IAS 17, para. 3).

4.0 Relationship to Accounting Standards

4.1 Where a lease interest has a short term before expiry or a review date as to market rent, the *Market Value* of that lease interest may not be material. The Valuer must, therefore, discuss with the directors whether such short lease interests are to be valued. If they are omitted from the valuation of an entire portfolio, the report will need to contain a reference to their omission and to the reasons that their values are not material.

4.2 The accounting treatment of leases, as defined in para. 3.2 above, is as follows:

4.2.1 Leases in the Financial Statements of Lessors

4.2.1.1 *Operating Leases*. Under an operating lease, the risks and rewards incident to ownership of an asset remain with the lessor. Therefore, the asset is treated by the lessor as a depreciable asset. The depreciation, or revaluation, of leased assets should be on a basis consistent with a lessor's normal depreciation or revaluation policy for similar assets.

4.2.1.2 *Finance Leases*. An asset held under a finance lease should be recognised in the balance sheet not as property, plant, and equipment but as a receivable at an amount equal to the net investment in the lease. Under a finance lease, substantially all the risks and rewards incident to ownership are transferred by the lessor. Thus, the lessor treats lease rentals receivable as repayments of principal plus financing income to reimburse the lessor for its investment and services.

4.2.2 Leases in the Financial Statements of Lessees

4.2.2.1 *Operating Leases*. The charge against income under an operating lease should be the rental expense for the accounting period.

4.2.2.2 *Finance Leases*. These should be recognised as both an asset and a liability in the balance sheet of a lessee at amounts equal at the inception of a lease to the *fair value* of the leased property or, if lower, at the present value of the minimum lease payments. Therefore, at the inception of the lease, the asset and the liability for the future rentals are recognised in a balance sheet at the same amounts. Due to the workings of finance leases, the asset and related liability are unlikely to be equal in amount after the inception of the lease.

4.3 Possible changes to IAS on the treatment of leases are currently under consideration. A G4+1 Position Paper entitled "Leases: Implementation of a New Approach" was issued for comment by the staff of the IASB in February 2000. Leasing is a global business, and differences in Accounting Standards can lead to considerable incomparability. The IASB has an active research project seeking to improve the accounting for leases by developing an approach that is more consistent with the conceptual framework of definitions of assets and liabilities. The project may result in an amendment to or replacement of IAS 17.

5.0 Guidance

5.1 **Lease interests are valued on the same general principles as freeholds, but with recognition of the differences created by the lease contract encumbering the freehold interest, which may cause the interest to be unmarketable or restricted.**

5.2 **Lease interests, in particular, are often subject to restrictive covenants or alienation provisions.**

5.3 **Freeholds subject to lease interests are for accounting purposes considered investment properties, and as such are valued on the basis of *Market Value*.** Headleasehold interests are also commonly valued on the basis of *Market Value*.

5.4 In some States **a lessee may have a statutory right to purchase the lessor's interest, usually the freehold, or may have an absolute or conditional right to a renewal of the lease for a term of years. The Valuer should draw attention to the existence of such rights and**

indicate in the Valuation Report or Certificate whether or not regard has been paid to them.

5.5 **The Valuer shall be properly acquainted with the terms and conditions of the lease and the statutory provisions that affect the particular lease interest.** In considering how to appropriately value a lease interest, the Valuer may need to seek advice or clarification as to the correct classification of the lease interest in order to carry out a valuation in the appropriate manner.

5.6 To promote understanding and to avoid potential abuses, **Valuers shall take reasonable steps to ensure that performance of the client's instruction will lead to conclusions that are neither misleading nor inappropriate in the circumstances.**

5.7 **In valuing a lease interest, a Valuer must be aware of, understand, and correctly apply those valuation methods and techniques that are necessary to produce a credible valuation that is not misleading.**

5.8 **Clear, unambiguous, and unequivocal disclosures must be made by the Valuer in communicating valuations of lease interests. These will include disclosures outlined in International Valuation Standards 1, 2, and 3 (IVS 1, 2, and 3), and International Valuation Application 1 (IVA 1). The requirements for valuation reports are addressed in the IVS Code of Conduct, and IVS 3, Valuation Reporting.**

5.9 **Each legal interest in a property shall be valued as a separate entity and not treated as though merged with another interest.** Due to restrictions incorporated within a lease document, the values of the lessor and/or lease interest(s) may be reduced. Similarly, a merger of those interests could create an increase over the sum of the values of the individual interests. This *merged interests value* is often referred to as *marriage value* (see para. 3.1.11.3 above) and should be referred to as supplementary advice only. Calculations on a merged basis (calculation of the value enhancement resulting from a merger of interests) may be undertaken as a valuation based on specific assumptions only and where the Valuer's Report is appropriately qualified.

5.10 **Valuation of lease interests, including those discussed in para. 5.9 above, require mathematical computations. Valuers shall exercise care to distinguish between mathematical results and the weight that will be afforded to those results by the applicable market.**

5.11 **In analysing rental transactions, the Valuer shall take into account any element of lease inducements, concessions, or payment of premiums that could have an effect on the market rent.**

5.12 **Differences between contract rent and market rent will occur** from time to time due to supply and demand changes in the rental market. In a falling rental market, the property may become "over-rented" (i.e., contract rent exceeds market rent) and the lease interest more difficult to dispose of other than through payment of a "reverse premium", implying a negative *Market Value* (see para. 5.18 below). In a rising market, the contract rent may become "reversionary" (a financial benefit over the remaining term of the lease), and the lease interest may attract a positive *Market Value*.

5.13 **Onerous lease covenants may adversely affect the *Market Value* of a lease interest. The Valuer must draw attention in the Valuation Report to the existence of such circumstances.** The most common situation where this adverse effect arises involves restrictions on assignment, or the right to sublet. It is not uncommon to find a lease covenant that prohibits or imposes conditions on assignment of the whole or part of the interest. Sometimes there is a clause that entitles a lessor to determine, or obtain forfeiture, of a lease should the lessee become bankrupt or go into liquidation other than voluntarily for the purposes of financial restructuring.

5.14 **Where a lease covenant affects *Market Value*, its effect must be taken into account by the Valuer. Examples of unusual or onerous covenants that may affect the value of the interest and comment on the effect in the report include:**

5.14.1 **Restrictions on Use**

A covenant may restrict the use of the property to a particular use class or a specific trade or type of business. Such restrictions will be relevant when determining both rental and capital values provided that the restriction is not so severe as to prevent lease or sale. In many instances the effect will be to reduce values, but in some circumstances monopoly values may be created.

5.14.2 **Dilapidations and/or Reinstatement**

Accrued dilapidations, as a consequence of breaches of covenants, may be substantial. The costs of reinstatement of the premises, following alterations by the lessee, may be considerable.

5.14.3 **Rights to Acquire Other Interests**

A lessee may have either a statutory right or an option included in the lease document to purchase the freehold interest.

5.14.4 **Options or Rights to Determine or Renew**

A lease may contain an option exercisable by the lessor or lessee to renew or determine the lease, either as of right or in certain stated circumstances.

5.15 Valuations of lease interests can be complex, rendering it more difficult to find and apply relevant market support to be used in reporting *Market Values*. Valuers and users of valuation services are cautioned to take special care in the selection of qualified Valuers, identification of the purpose and intended use of the valuation, identification and definition of terms, and itemisation and explanation of appropriate discussions and disclosures.

5.16 **Inter-Company Leases**

5.16.1 Where a property is subject to a lease or tenancy agreement between two companies in the same group, it is acceptable to take account of the existence of that agreement when valuing for the purposes of financial accounts provided that this agreement is on arm's-length terms in accordance with normal commercial practice. However, **on consolidation of the results and balance sheets of those companies into the**

group accounts, the existence of the lease must be disregarded and the property valued as owner-occupied. If asked to produce a valuation taking account of an inter-company agreement, the Valuer must disclose in the report the relationship between the parties to the agreement.

5.17 **Leasehold Improvements**

5.17.1 **It is customary for some properties to be taken on lease in a physical state not capable of occupation for the purposes of the lessee's business without further building and fitting-out work to suit a particular user's requirement.** Examples include: new stores or unit shops completed to shell condition with the incoming occupier providing such items as shop fronts, suspended ceilings, floor and wall finishes; generic industrial buildings which the occupier adapts to suit a particular trade or process; and offices where the occupier provides partitioning to suit specific needs.

5.17.2 **In the above circumstances, the directors might decide that the value to the business of such a property should, following improvement, be arrived at in either of the following ways, depending on accounting policies being used:**

a) ***Market Value*** **at the valuation date, as in its state after improvement; or**

b) ***Market Value*** **at the valuation date, as in its state before adaptation and, as a separate amount, the** ***depreciated replacement cost*** **(DRC) of the fitting-out work to the improvement.**

5.17.3 The valuation of leases requires that particular care be exercised in ascertaining what is to be valued; for example **a Valuer must determine the effect, if any, of past alterations to improvements that were carried out by the lessees.** What is seen and noted during a property inspection in respect of buildings may not be what has to be reflected in the valuation (see para. 5.17.2 b above). **If, in the absence of documented licences, the extent of the improvements cannot be confirmed, the Valuer should proceed on the basis of stated assumptions.**

5.18 **Negative *Market Values***

5.18.1 **Where lease interests are liabilities to an undertaking they are said to have a negative *Market Value*.**

5.18.2 **Negative *Market Values* can arise, for example, on lease interests where the contract rent, or passing rent, reserved under the lease exceeds the market rent.** Such values might result from onerous covenants being placed on the lessee, which are likely to result in costs that will exceed the value that might otherwise be placed on the interest, assuming the obligations of these covenants have been met.

5.18.3 **If the positive *Market Value* of an undertaking's assets is shown in a financial statement, then it is proper that the Negative *Market Value* of its liabilities also be shown.** To report the value of a lease interest that is a liability as 'nil' would not indicate the true situation. Any Negative *Market Value* should be reported separately in the Valuation Report or Certificate and should not be set off against a positive *Market Value* on other property.

5.19 ***General***

Due to the relative complexity of lease interest valuations, **it is essential that the client or the client's legal advisor provide the Valuer with either copies of all the leases or, for multitenanted property, typical sample leases together with a summary of lease terms on the other leases.**

6.0 Effective Date

6.1 This International Valuation Guidance Note became effective 1 July 2000.