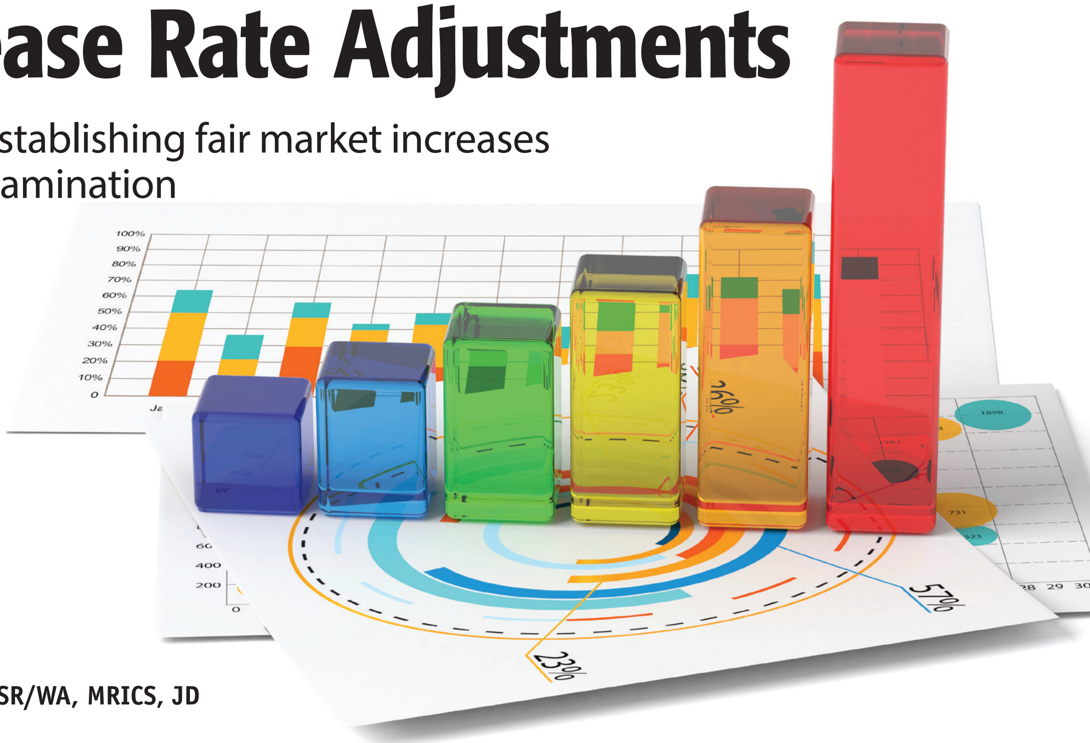
ANALYZING
Market Lease Rate Adjustments

For long-term leases, establishing fair market increases requires a thorough examination



BY TIMOTHY J HOLZHAUER, MAI, SR/WA, MRICS, JD

Many agencies, municipalities and other organizations own land under long-term ground leases which can span 30 to 50 years or even longer. The leases allow for beneficial public use and provide income to the organization. However, given the long-term nature of the leases, determining how often and how much to adjust the rate can be a daunting challenge.

Unlike short-term leases of one to ten years, long-term land leases are usually intended for development. A developer is not likely to build new infrastructure or make expensive building improvements without the opportunity to earn a sufficient return on their investment. Properties like public airports, ports, parks and even excess land are suitable for long-term land leases.

With long-term leases, public agencies need an appropriate way to increase rents over time to reflect market changes, while remaining fair to both the tenant and the public. Given the impact that a rate increase can have on a tenant's income, appraisers are often asked to develop opinions for use in market rate adjustments. The goal is to assist the agency in determining a fair market rate that is beneficial to both the public and the tenants.

Understanding the Methodologies

When drafting a lease and its associated adjustment terms, having a solid understanding of the methodologies is essential. Some leases may have annual or semi-annual rate increases based on Consumer Price Index rates, however given a lengthy term, the index rate does not always keep pace with real estate values. A more common method is to make market rental rate adjustments every three to five years based on an appraisal.

In determining the best way to develop an opinion of market rent, the methodology and requirements are often dictated by regulations or lease terms. In other cases, the appraiser determines which method is appropriate. Regardless of the methodology listed in the regulations and leases, Uniform Standards of Professional Appraisal Practice (USPAP) requires that every appraiser "must not allow assignment conditions to limit the scope of work to such a degree that the assignment results are not credible in the context of the intended use." What this means in practice is that while a lease may specify a certain methodology, if another type is also required to support the opinions, it must be completed as well.

Definitions and Uses

The first step in completing a market rent analysis is determining which definition of market rent is appropriate. The variations in the comparisons can have a slight or significant effect depending on which definition is used. One of the most commonly used definitions is from the Dictionary of Real Estate Appraisal published by the Appraisal Institute (see sidebar on page 37). Others might come from local, state or federal regulations or from the lease itself. Using the incorrect definition may significantly affect the assignment results.

> "...there are also regulations, lease requirements and agency guidelines that can affect the use and utility of the land being analyzed."

Lease terms may also have specific requirements, including some that call for a particular methodology. For example, one of my current assignments explicitly calls for using a sales comparison approach using similar land sales—not a comparison to other leased properties—followed by the selection of a cap rate from the market. Another assignment had a regulatory call for a specific rate of return. Still others have called for a comparison to other rental rates for similar properties locally, regionally or nationally. As stated earlier, the appraiser is required to determine whether the methodology called for is sufficient for credible assignment results, and if not, they must complete any additional work necessary to ensure credibility and clearly state the source of assignment conditions that affect the analyses.

Beyond the methodology, there are also regulations, lease requirements and agency guidelines that can affect the use and utility of the land being analyzed. For instance, properties on airport land might be affected by security or noise restriction requirements. There may be height restrictions that limit building construction, use requirements that allow airport only uses or even specific requirements for allowable ground rent. These variables must be considered for each property type. It some cases, local zoning restrictions might affect use, such as a specific overlay over industrial property adjacent to piers and docks that restrict the industrial use to only marine-related industrial. If the lease specifically calls for use restrictions, those need to be considered.

Considering the Restrictions

The appraiser must examine the impact of the lease restrictions on property rights being appraised, along with easements, restrictions or encumbrances that would affect it for overall market value as well.

USPAP Standard 1(e) requires that "during the appraisal process the appraiser must identify the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including: . . . (ii) the real property interest to be valued . . .. The real property interest being valued will affect the opinions developed in the appraisal."

When developing an opinion of market rent, it is rare to consider the leased fee interest and leasehold interest. However, if a property is being acquired subject to an existing lease and the lease is to remain after the acquisition, an opinion of the leased fee interest might be necessary. If there is an existing lease in place and the lease is being terminated for an acquisition, a valuation of the leasehold interest may be needed. In those cases, the actual contract rent is likely to be used in the analyses. Yet, if fee simple is considered, it is somewhat restricted when a market rent analysis is appropriate.

Fee Simple Absolute is used to describe entirely unencumbered fee simple ownership of property. In the case of publicly-owned land that is encumbered by long-term leases, there may be restrictions within the lease or other potential restrictions or encumbrances, such as access easements, utility easements and use restrictions that place some limitations on the fee simple use. The appraiser must be sure that only the rights that will be leased are valued and that the market rent analyses considers the restrictions.

As defined, market rent requires that the valuation include consideration of lease terms such as "permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements." When a lease being considered uses the market rent definition, then all of those items must be considered, if applicable. For example, on a recent rent analysis assignment, the property was adjacent to a marina. While the zoning allowed for construction up to 85 feet—the height commonly being developed in the marketplace—the lease specified that the site would be used only for a restaurant and only with a one or two story structure. That limitation would need to be considered when making a comparison to land sales that were being developed with taller structures.

Two Methodologies

There are two primary methodologies used in a market lease rate analysis. The first is using comparable land leases and making adjustments for property differences. The second is a sales comparison approach of comparable land sales to determine fee simple market value of the property, followed by using either a defined or market derived rate of return or a capitalization rate. Depending on the market, one methodology may have more reliable and common data, while the other may not be fully developed or is used only as a test for reasonableness.

1 Market Lease Rate Comparison

When sufficient data is available, one of the most reliable methodologies is direct comparison to similar long-term land leases. Preferably, the leases found will have been recently negotiated in the open market and will have reasonably similar uses and terms.

Before conducting a comparison, the appraiser will need to examine the terms and requirements of each lease comparable and determine exactly how the lease rate was established. Some agencies have specified lease rates that are non-negotiable. Those rates may not necessarily reflect the market, particularly when associated with properties that cannot be found from another source. For instance, if the only availability of large hangars for business or commercial jets is at government-owned facilities—and all of the facilities in the area have leases with non-negotiable rates—then the rates are not based on local market negotiations. There is no meeting of the minds, and therefore they may not reflect market rates.

Similarly, if the only recent lease rates are based on renewals of long-term leases, the recent rate increases may not reflect a mutual agreement. Most long-term leases have rate increases every three to five years, and those are often set by appraisals conducted by the agency. If a tenant does not agree with the rental rate, their choice is to accept the rate anyway or pay for their own appraisal and possibly an arbitration or litigation process to change it. Since this can be a very time consuming and costly process with uncertain results, tenants typically accept the rates they are offered. This does not reflect a negotiated rate with both parties in agreement, but rather a business decision to avoid the costly process of challenging the rates. Any adjusted lease rates used in comparison should be used with caution, along with verification that the rate was reflective of a market negotiation.

Adjustments to land lease comparables should also consider the original condition of the leased land. If costs for entitlements, site preparation, contamination clean-up or any other site development costs were made by the tenant as conditions of the lease, the lease comparables should be investigated for the same costs and adjustments made as appropriate. Other adjustments should be made for market conditions as of the time of lease negotiation or commencement, location, use and utility, improvements, and other typical land comparison adjustments.

If the site has use restrictions such as aviation-only or marine-only uses, the first choice for comparable land leases should be similar properties at other ports, airports or similar use-restricted properties. The Federal Aviation Administration suggests that a benchmark of other airports of similar size and with similar infrastructure should be used exclusively for airside aeronautical facilities, while local non-aviation land can be used for commercial non-aeronautical uses. If non-aviation land leases are used, some consideration must be given to the effect of the use restrictions. In some cases, these restrictions might have a negative or positive impact, depending on the supply and demand for that type of property. This consideration also impacts the sales comparison analyses.

Short-term leases might also be beneficial in the comparison, but consideration must be given to the use and utility of those sites. These leases are often driven by different motivations, as tenants of short term leases will not typically develop the site with entitlements and buildings, as the length is not sufficient to justify the cost. These leases are less desirable for comparison but can be used to help in the analyses, particularly in support of adjustments used in comparison of long term leases.

Definition of Terms

Contract Rent: The actual rental income specified in a lease.

Fee Simple Estate: Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

Leased Fee Interest: The ownership interest held by the lessor, which includes the right to receive the contract rent specified in the lease plus the reversionary right when the lease expires.

Leasehold Interest: The right held by the lessee to use and occupy real estate for a stated term and under the conditions specified in the lease.

Market Rent: The most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease agreement, including the rental adjustment and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements.

Source: The Dictionary of Real Estate Appraisal, 6th Edition, Appraisal Institute, 2015

2 Land Sale Comparison and Rates of Return

Another methodology that can be used as the primary market rent analysis, or as a test for reasonableness of the lease rate comparison, is land sale comparison. This can be used to develop an opinion of fee simple land value, followed by applying a market derived or pre-determined rate of return. As with a lease rate comparison, the first choice in comparables for restricted use properties should be similar properties.

The Florida Department of Transportation considered the implications of using non-aviation land uses for aeronautical properties and developed guidelines determining that: "When using the sales comparison approach, airports must clearly distinguish between aeronautical and non-aeronautical property as these two types of airport property require different bases for comparison. It is recommended that, for the purpose of determining market value, aeronautical property is compared to similar aeronautical property at other airports. Market value of non-aeronautical property, on the other hand, should be determined by comparing it to other similar property, serving the same function, and located in the local community around the airport."

The analyses are similar for ports and other restricted use properties, and typically feasible for smaller ports and airport properties that might be privately owned. However, this can prove to be more difficult for larger public properties where there are few comparable sales, as agencies do not often sell sites for development. In markets like this, non-aeronautical land sales can be considered, with some caution in developing adjustments similar to those in the lease analyses.

Once a land sale comparison is completed, a rate of return is applied to the land value to develop an opinion of annual market lease rate. The rate of return can sometimes be the most complicated part of the analyses. If a rate of return is set by the lease terms or regulatory requirements, the appraisal should clearly state the source to ensure the user of the report understands the meaning.

If not set by other requirements, the rate of return should be based on anticipated investor requirements for a return on the land investment, balanced by the tenants' willingness to pay for the long term lease. Use of other long term leases is preferable, and verification of recent leases with confirmation of the rate of return would be ideal, but can be difficult to obtain. Discussing the desired rate of return with the market participants can be helpful. As the case with the lease rate, shorter term leases can be used for comparison with caution for the differing investment criteria. Improved property overall rates should be avoided, as the long term investment has a different reversion rate of return. This is because the improvements are a depreciating asset while the land alone is often projected to appreciate.

As with developing an overall capitalization rate in the analyses of improved properties, other methodologies might be used to develop an opinion of rate of return. Other investment types with similar long term returns might be considered, as well as developing the rates using the band of investment or built-up rates. While these rates are less desirable, they can be used as a test for reasonableness for the lease rate comparisons.

In Summary

Given the impact that a long-term lease rate adjustment can have on tenants, appraisers are often asked to conduct lease rate analyses. Ideally, the lease rate analyses should be based on recently negotiated long term leases on similar properties. There are a variety of other methodologies that can help with the analyses, and comparisons can be made to other reasonably similar properties. Supporting lease rates can also be developed by use of a sales comparison with a market derived or regulation driven rate of return.

The goal of developing a supported lease rate adjustment is to assist the agency in determining a fair market rate that is beneficial to both the public and the tenants. And a reasonable, supportable and well-documented lease rate analysis can go a long way in preserving the relationship between landowners and tenants. ✪

References

2016-2017 Uniform Standards of Professional Appraisal Practice

Federal Aviation Administration Compatible Land Use Planning Initiative (63 FR 2776)

Federal Aviation Administration Advisory Circular 150

Guidebook for Developing and Leasing Airport Property, Transportation Research Board, ACRP Report 47

Guidelines for Determining Market Value & Market Rent of Airport Property, prepared by The Center for Urban Transportation Research and University of South Florida, April 2012

Timothy is a Director in the Dispute Analysis and Litigation Support Practice Group with Cushman & Wakefield of Washington, Inc., Valuation & Advisory. An appraiser since 1986, he was previously a Review Appraiser for the National Park Service and for the U.S. Fish and Wildlife Service within the U.S. Department of Interior, Office of Valuation Services.