A Critical Analysis of Land Tenure and Property Value: Case of a Leisure Property

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Introduction

This report refers to a valuation carried out in 2008 of a hotel in suburb of Colombo for a selling purpose. The client was the owner operator of the hotel. The hotel is subject to two legal interests i.e. Leasehold and Freehold. This multiplicity of interests having an adverse effect on the sustainability of the value arose the necessity to advise the client to take remedial measures. Thus, in addition to the assessment of market value, there was the necessity to assess the rent for the part of property affected by the lease terms. The objective of the critical analysis is to analyze the effect of existing land tenure of the subject property and to advise the client with regard to action that has to be taken to sustain the value of the entity.

Critical Analysis

Approach: The valuation exercise entailed in the ascertainment of the Market Value[4] and to advise on the effect on the value imposed by the land tenure and to mitigate diminition in value. The latter part was opted for the Critical Analysis as it is encompassed not only the aspects of valuation but also resolution of legal issues on market valuation, a tool for compromise. In this instance, Market Rent[5] was based in relation to equity held by lessor and the lessee, which could be justified being a business-like approach.

Property inspection: The measurement was carried out in compliance with the RICS Code of Measuring Practice (6th Edition) and the local practice. Subsequently, plans were drawn to scale using Auto CAD. In addition, following aspects were notable,

a) Collation of operational data from the financial statements, management accounts, and other sources of country specific tourism data,
b) Analysis of sales to arrive at the capitalization rate applicable to the type of property,
c) Application of statutory enactments governing state land and alienation of the same,
d) Preparation of valuation report to the client,
e) Evaluation of the effects of the leasehold land on sustainable trade of the hotel,
f) Analyzing impact of the goodwill on value of the hotel,
g) Analysis of market expectations of lessor in terms of rent and other terms and conditions,
h) Inspection of plant & equipment to estimate remaining useful life,
i) Inspection on evidence of contamination and hazardous materials if any, and disposal of the garbage to conform to environmental statutes

Profile of the Property

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[4] RICS Valuation Standards – PS 3.2
[5] RICS Valuation Standards – PS 3.3

Location: The subject hotel & resort is located in a suburb of Colombo in a popular resort area, which is in transition from residential to hospitality trade, and which has been declared as a resort area.

Access: The hotel can be accessed by proceeding from Colombo along Galle road about 10km to Mount Lavinia junction and on Hotel Road.

Description: It is a city hotel with 224 fully air conditioned rooms predominantly attracting business travelers and short stay holiday makers using as a transit hotel. The hotel was built about 200 years ago in the Roman Style of architecture. Initially, it was a residential property and with extensions and additions to the structure, subsequently converted into a hotel in early 1900's. Though the structure had been developed over a period of time, its configuration and architectures had maintained its functionality as a city hotel with unique resort characteristics.

Floor area
Freehold - 248,946 sq.ft.
Leasehold - 38,000 sq.ft.

Land extent
Freehold - 4 acres
Leasehold - 0.75 acres

Comparison of the Performance of the Hotel with the Industry

Performance of the Industry
Table 1: Tourist arrivals of Sri Lanka

Tourist Arrivals	**2007** – 494,008	**2008** – 438,475	**Change** – 55,533	**Growth** – - 11.24

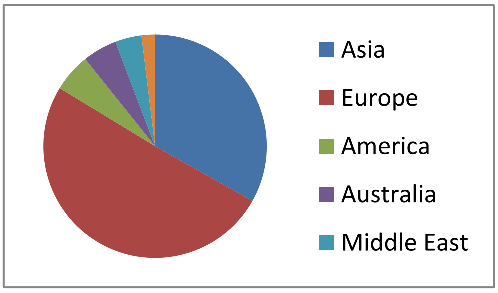
Source: Annual report of Sri Lanka Tourist Board – 2008

Table 2: Arrivals by Region - 2008

Asia	145,354	33.15%
Europe	221,658	50.55%
America	24,311	5.55%
Australia	21,839	4.98%
Middle-East	16,776	3.84%
Other	8537	1.95
Total	**438,475**	**100%**

Source: Annual report of Sri Lanka Tourist Board – 2008

Figure 1: Arrivals by Region–2008



Performance of the Hotel
Table 3: Key Indicators of Hotel Performance – 2007

Item	Hotel	Colombo region	Country average
Occupancy rates	67.58%	63.9%	46.17%
Group travelers	20%	24%	32%
Free Independent Travelers	80%	76%	68%

Average stay	3 Nights	3 Nights	10 Nights

Source: Annual report of Sri Lanka Tourist Board – 2008

Author compiled the table using the data from financial report of the hotel & the annual report of Sri Lanka Tourist Board

Figure 2: Key Indicators of Hotel Performance – 2007

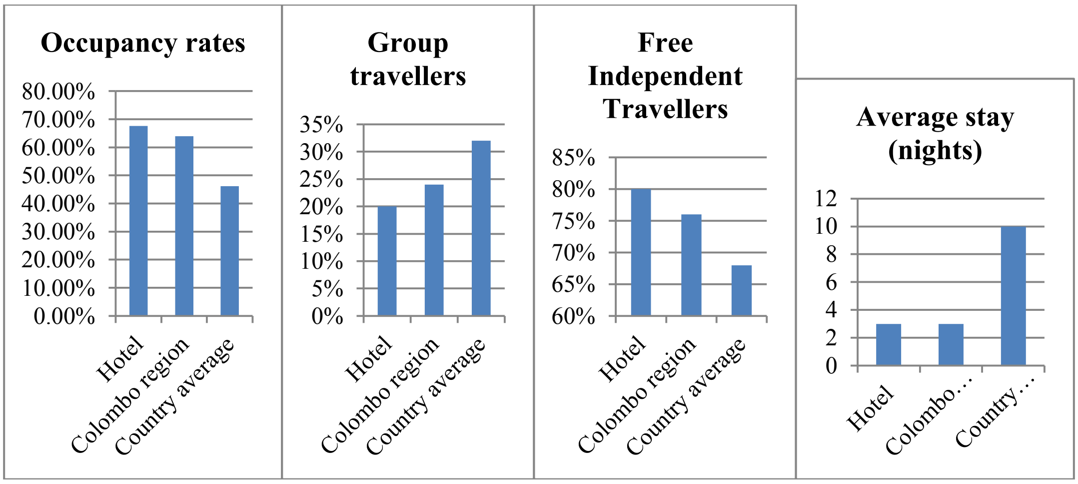
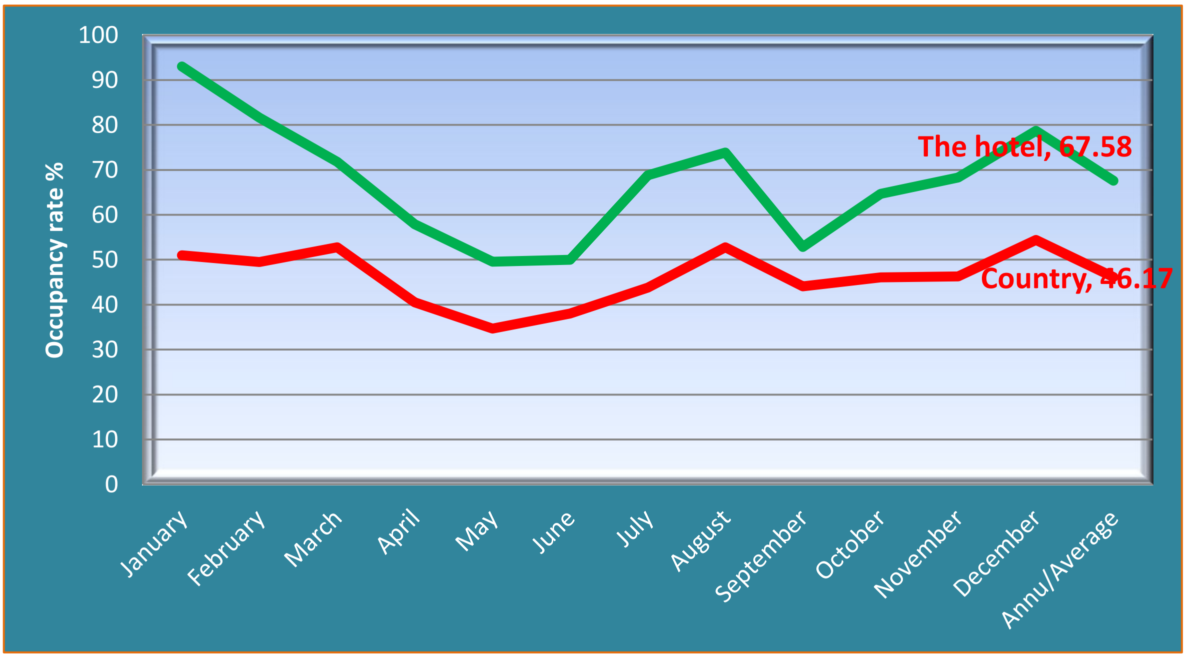


Figure 3: Achieved Level of Occupancy - 2007



Source: Author compiled the figure using the data from financial report of the hotel & the annual report of SLTB – 2007

The above charts and tables are self-explanatory. The performance of the hotel in maintaining occupancy level far exceeds the industry norms even though the average stay is shorter. Also, the Free Independent Travelers (FIT) sector contribution is higher which generally brings about a higher turnover.

Planning aspect of building regulations: As confirmed by the Directorate of Planning of the Urban Development Authority of Sri Lanka, though the subject property occupies a significant place in the history of Sri Lanka, yet it is not declared a listed building which has a salutary effect on the value as the future development is unhindered.

Key Issue of the Study

In this study, the key issue is to maintain the sustainability of the value of the hotel in securing leasehold interest for further term. Critical situation is based on the following factors.

Legal title to the property: The property comprises of two parts each with its distinct title. One part with 50 guest rooms accommodation & common facilities occupying the southern portion of the land with its beach frontage, is subject to a lease granted by the State for a term of 99 years having an unexpired term of 19 years at a pepper corn rent[6]. Other part of the hotel stands on Freehold land. To sustain profitability thereby the value of the property, the extension to the lease had to be sought from the government.

Landlord's statutory authority to divest: The lessor in this instance is the government. The government lands are subject to the Statutory Provisions under State Land Ordinance No. 8 & 9 of 1947 with their subsequent amendments. The Ordinance deals with,

i) Outright grant of land
ii) Leasing of State Land and
iii) Renewal of existing leases.

Grants are made by the President usually for special development programs. Lease and renewal of lease are dealt under the section 6 of the Land Ordinance for a maximum term of 33 years taking into consideration the size of the investment in keeping with the fiscal and monetary policies in addition to development plan of the government. The Statute provides for the renewal of the term. On termination of the lease, the property vests in the government with all the improvements without compensation.

Terms of the lease: Two fundamental clauses deal with the quantum of the rent and the other with the duration of the term. The rent fixed by the State for State lands had been at the discretion of the responsible minister; however, the ratio decidendai in a recent decided case has imposed a "Doctrine of Public Trust and Public Interest "(Wasudeva Nanayakkara and Others vs. Waters Edge Hotel - 2008").

The consequences of the importation of the doctrine into the lease agreement are the Doctrine imposes a duty on State to fix a rent safeguarding the "Public Interest". In other words, rent must be the Market Rent.

[6] Peppercorn rent is a very low rent having no relation to market rent granted purely as to conform to legal requirement of the consideration in a legally binding contract coming from a Feudal time.

Leasehold interest and its impact on the value of the property: The value of the entity is dependent on the ability to use both interest as one unit i.e., profitability of the entity is a product of two interests. Considering the above, the significance of the following factors must be addressed,

- The leasehold land represents approximately 18.75% of total extent of the hotel premises and 13.24% of the total floor area of the buildings.

- The leasehold land contains 40% of the historic building which is synonymous with the name of hotel attracting a substantial number of repeat guests.

- The leasehold land covers 75% of the beach frontage which is considered as one of the hotel's key characteristics and a primary attraction for holiday makers.

- The leasehold land includes key uses such as 54 bedrooms, part of the main kitchen, two banqueting halls, spa, beach restaurant, shopping arcade, 60% of the administrative and operational offices, gymnasium, yoga meditation centre and resident manager's quarters etc.

- It also includes a substantial part of amenities and parking space.

Thus, it was seen that the leasehold part is significant not only in terms of physical aspects but also its effect on the sustainability of profit. As such, there was the necessity to ensure that an extension to the lease term is obtained.

Impact of goodwill on sustainable trade: Considering the sustainability of the turnover, it was necessary to consider the brand name. The brand name is usually considered as personal goodwill and the element of value attached to personnel goodwill[7] is excluded. However, in this case, it has been factored as inherent goodwill[8] as the brand is synonymous with location. Corollary is that the leasehold interest makes a substantial contribution to the profitability therefore the value of the hotel as a Specialized Trading Entity[9].

Options to Secure Leasehold Interest

In an attempt to find solutions for an issue, there can be different options available for parties involved. However, in this particular case, taking into account the ratio decidendai and the statute together with impact of leasehold land on the value of the hotel, the lessee has no option but to request for the renewal of the lease which entitle him for a further term of years. Fundamental to such an extension is the market rent.

The State shall be willing to grant an extension in keeping with its objectives pertaining to private investment however rent has to conform to the doctrine of "Public Interest". The state

[7] Valuation information paper No. 6 – Para 3.1

[8] RICS Valuation Standards – GN 1, Para 2.5

[9] IVSC GN 12, para 3.5

can conform to that requirement by adopting a Market Rent as the other objectives of encouraging private investment is already satisfied in the hotel development.

Basis for Determination of Rent

The current rent passing is a peppercorn rent having no relation to market rent. Under the present circumstances and the doctrine of "public interest", the rent must be Market Rent. In this case, the value of part of the hotel is subjected to leasehold interest. The extension of the lease being the only option available in the given circumstances, the most important & fundamental element to such an agreement is the market rent.

In arriving at the rent, it was decided that the method best suited, having regard to the condition imposed by the aforementioned ratio decidendai, is to rely on the profit as the ability to pay the rent depends on the profit. This made me overcome the paucity of direct comparables and also disregard the off practice contractor's basis.

Current practice – Contractor's Principle: The current practice is to assess rentals for state owned property on the Contractor's Principle precursor to DRC[10] which is more popularly applied in rating practice. However, in rental valuation, such methodology lacks accuracy for,

a) Estimating cost of buildings is subject to conjecture as there is no proper data bank for comparison particularly for specialized trading properties in the market,

b) In any case, the depreciation rates are subject to variations due to lack of consistency in estimating economic, design/functional and physical obsolescence,

c) The sales evidence of land values relate to land used for alternative uses,

d) Contractor's method tries to equate cost to value whereas the value depends on sustainable trade and therefore profits,

e) Profitability is dependent on various assets apart from land and buildings i.e. intangible assets such as franchises, human resources, brand name and goodwill

f) Contractor's method being precursor to DRC is referred to as the method of last resort for above reasons and more so in the context of Sri Lanka where there is no established data base,

This method is flawed as it has no basis. In fact, the basis is not found in financial principles to justify. Therefore, in the given circumstances, a professional approach is expected to be adopted to estimate market rent having relation to the value of the investment rather than the cost. As such, I resorted to employ an alternative method to arrive at market rent being fair and reasonable.

Rent derived based on profit apportioned on equity: The property is a trading entity. The leasehold interest and the freehold interest contribute towards the sustainable turn over and therefore the profitability. Rationale is that the capital value and rental value are based not

[10] IVSC GN 8, para 3

only on the physical assets but also on the market's perception of the trading potential i.e. The ability to pay a rent depends on the ability to make profit.

As the rent depends on profit, it was decided that the rent based on the equity of interest is having best relation to market rent as against the current practice. From the foregoing, it was also seen that requirements of both client lessee and the State could be addressed by the rent based on the equity as conforming to all investment criteria.

Assessment of Rent Based on Profit

The rent is the product of profit, which consists of land lords share (rent) and the operator's share. The rental assessed for the entirety falls to be apportioned between the leasehold and the freehold. This apportionment is based on the basis of physical demarcation of the property.

Assessment of all risk yields: To estimate the value of the entity as a fully operational trading entity[11], capitalization rate was analyzed and adjusted to suit for the subject property. Based on the evidence available, capitalization rate is estimated to 11.74%.[12]

Analysis of YP		
Sale Price		Rs. 1,900,000,000
LL Share		Rs. 223,000,000
YP	8.52	
ARY	11.74%	

This rate is for city hotels located in the heart of the Central Business District (CBD), with other star class hotels such as Hilton, Galadari, Taj Samudra and Galle Face, where the latent demand in the form of un-accommodated & induced demand is available thus, increasing the profitability. Also, this rate is comparable with ARY rates obtained for other types of secure property investments in the market.

In comparison, the subject property being 10km away from CBD is in an inferior location as a city hotel; secondly, the major part of income is generated from other activities such as food & beverage other than room income. The other income particularly in this hotel is highly volatile as it mostly depends on the personal goodwill due to the renowned chef. As the risk is higher, market derived all risk yield rate is adjusted by 1.01% basis point to 12.75% to relate to subject property.

Apportionment based on equity share: The landlord's share is treated as rent for entirety based on which, the market value is estimated using appropriate all risk yield. Then, the Value is divided based on the floor area falling within the two interests, leasehold and freehold to arrive at equity values for each interest. It is reasoned that every square foot contributes equally to the potential to sustain the turnover and thus the profitability. Subsequently, the landlord share (the rent) is apportioned based on the proportion of the equity values held by the two interests to arrive at rent of each interest.

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[11] RICS Red Book GN 1 para 1.1

[12] See Appendix 5 – Valuation of the hotel

Estimation of rent: Value of the equity as a fully operational trading unit Rs. 3,800,000,000.00[13]

<u>Step 1</u> - Apportionment of equity between the lessor and the lessee on proportion of the floor area falling within different interests.

Total floor area	286,946 sq.ft.
Floor area falling within leasehold land	38,000 sq.ft.

Apportionment of value

$$\frac{\text{Rs. } 3{,}800{,}000{,}000.00}{286{,}946} \times 38{,}000$$

Value of leasehold	Rs. 503,230,573.00
Value of freehold	Rs.3,296,769,427.00

<u>Step 2 -</u> Apportionment of Rent between leasehold and freehold

Rent (Landlord's share) Rs. 261,000,000.00[14]

The share of rent attributed to the lessor,

$$\frac{\text{Rs.}261{,}000{,}000.00}{\text{Rs. } 3{,}800{,}000{,}000.00} \times 503{,}230{,}753.00$$

Therefore, rent for lessor's equity **<u>Rs.34,564,006.00</u>**

a) Return on investment based on Equity Value of leasehold

$$\frac{\text{Rs. } 34{,}564{,}006.00}{\text{Rs. } 503{,}230{,}753.00} \times 100 = \mathbf{6.86\%}$$

This is a fair rate of return considering the operator takes on systemic and un-systemic risk.

Critical Appraisal

In this analysis, the critical issue was to maintain the sustainability of the value of the hotel in securing leasehold interest for further term. In an attempt to secure the lease extension, being the most viable option available, the fundamental task is to assess market rent. In this scenario, the rent estimated based on profit is found to be the most viable and which will satisfy investment criteria of both state and the client.

The rent based on equity share has a great chance of success in negotiating for an extension. The operator has the advantage of planning the future operations with the knowledge of the highest he may have to offer by way of rent. Also, he is able to make an offer for an extension with this as a ceiling on rent. Further, the State (the lessor) is able to treat this on the basis of a commercial transaction satisfying the requirement in law to safeguard the "Public Interest".

Important Lesions for Valuers and Property Analysts

It is able to point out number of lessons that was gathered through this empirical case to be useful for property analysts to enhance their professional competence such as,

[13] See Appendix 5 - Valuation of the Hotel

[14] See Appendix 6 - Estimation of Divisible Balance

- An understanding of the client's requirements in terms of the type of work and the timescale within which it is required is essential to meet or exceed client expectations.

- Careful planning of the inspection ensures that the maximum amount of relevant information required for the valuation is obtained on the day of inspection.

- Good communication skills are necessary to obtain maximum knowledge of the market from local surveyors. An understanding of the market is beneficial prior to making enquiries.

- It is important to undertake detailed research into the related industry along with a thorough investigation of all issues relating to the property.

- It is vital to give due importance to planning and legal impacts on the value of the property.

- The necessity not only has the good technical skills in applying theoretical knowledge into practice but also analytical skills is a must in a complex valuation.

- Important lesson learned is that the paucity of market comparable rental data should not hinder the valuation process. Instead, the valuer may adopt an alternative method/s to estimate the rental value.

- Valuer should have proper understanding and wide experience of interpreting and analyzing different issues affecting the value in terms of dual interest in ownership particularly, in the Sri Lankan context, where large number of leases granted on peppercorn rent shall come for renewal in the near future.

- It is necessary to have thorough understanding of Practice Standards and Guidance Notes of RICS Red Book, International Valuation Standards, Valuation Information papers and RICS code of practices and guidelines to provide effective and quality service to clients.

- As a whole, it is necessary to have proper skills such as communication, presentation, negotiations, client care, and data management together with ability to work in a team to deliver quality and productive service to the client.

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n) *Valuation information paper No. 6 – Para 3.1*

Annex 01

Summary of Valuation Report for Mount Lavinia Hotel
Sri Lanka

Property : City Resort Hotel, Swimming Pool and the Land
Request : As per letter dated 4th October 2008

Purpose : Assessment of Market Value for sale purpose

Date of inspection : 7th, 8th, 10th, 24th & 25th October 2008

Date of valuation : 31st October 2008

Property details
Land : Extent – A4 R3 P0
Title : Unencumbered Freehold and Leasehold title to the Property
Guest Rooms : 224 Rooms
Food & Beverage
Restaurant : 200 pak
Pool Terrace and Restaurant : 50 pak
Lounge Bar : 25 pak
Pool Bar : 50 pak
Beach Bar : 200 pak
Banqueting Halls : 5 nos, 1000 pak
Conference Hall : 100 pak

Recreational & other facilities : Swimming Pool, Gymnasium, Fishing, Conference Hall, Laundary, Shops, Beauty Saloon, Babysitting/Child Care, Cyber Café and Holistic Health Spa and Yoga Meditation and Exercise Centre.

Nature of assignment : Ascertain the Market Value for owner operator. The valuation is prepared in accordance with and as defined in the International Valuation Standard Committee which defines Market Value is,

"The estimated amount for which a property should exchange on the date of valuation between (a) willing seller and a willing buyer, (b) in an arm's length transaction (c) after proper marketing (d) wherein the parties had each acted knowlegeably prudently and (e) without compulsion."

Summary of operating data : Rate of occupancy 67.8%
Average room rate Rs. 6750/-

Summary of valuation parameters :All Risk Yield For Freehold @ 12.75%
For Leasehold @ 14%
Sinking Fund rate @ 4%

Reported Value for sale purpose Rs.3800 Million

Annex 02

Valuation of the Hotel

Total Floor Area		sq.ft	286,946	
FA covered by Leasehold part		sq.ft	38,000	
Estimated Net Income			Rs.	522,000,000
Net income per sq.ft (522,000,000/286946)	(Note1)		Rs.	1,819
Net income represented by				
	Freehold land			**Rs. 452,000,000**

Valuation of freehold Property

	Rs.	
Estimated net income	452,000,000	
YP perpetuity Capitalize @ 12.75% (Note 2)	7.84	Rs. 3,543,680,000

Valuation of leasehold property

	Rs.	
Estimated net income	69,122,000	
		Rs.
YP Capitalize @ 14% & 4% for 19 yrs (Note 3)	5.848	404,225,456
		RS. 3,947,905,456
Deduct		
		Rs.
Cost of Refurbishment (Note 4)		112,000,000
	Value of the Hotel	**Rs. 3,835,905,456**

Say Rs. 3,800,000,000.00

Note 1
The divisible balance is the portion available to both operator and landlord and apportioned between freehold and leasehold on the basis that every square foot of floor area contributes equally towards the turnover & therefore the net income.

Note 2
Analysis of sales comparison
The Ceylon Continental Hotel, city hotel at Fort, Colombo with 220 rooms, was sold at Rs. 1.9billion in July 2008,

Analysis of sale,

No. of Rooms	220
Expenses of total income	60%

Estimated occupancy rate		65%
Net Rooms sold		143
Room Rate		Rs. 12,000
55%	Room income	Rs. 626,340,000
45%	Other income	Rs. 512,460,000
	Total income	Rs.1,138,800,000
40%	for Profit	Rs. 455,520,000
Deduct	FF&E 2%	Rs. 9,110,400
	Div. balance	Rs. 446,409,600
	Ope. Share 50%	Rs. 223,204,800
	Land Lord's share	Rs. 223,204,800
	Say	Rs. 223,000,000

Analysis of YP

Sale Price	Rs. 1,900,000,000
LL Share	Rs. 223,000,000
YP	8.52
ARY	11.74%

This is a city hotel located in the heart of the Central Business District (CBD) with other star class hotels such Hilton, Galadari, Tajsamudra and Galle Face, where the latent demand in the form of un-accommodated & induced demand can be available thus, increasing the profitability. Also, this rate is comparable with ARY rates obtained for other types of secure property investments in the market.

In comparison, the subject property being 10km away from CBD is in an inferior location; secondly, the major part of income is generated from other activities such as food & beverage other than room income. This other income particularly in this hotel is highly volatile as it mostly depends on the personal goodwill due to the renowned chef, Mr Publis Silva, whose culinary expertise and personality have a definite influence on the percentage of the other income. Therefore, the risk is higher in achieving that income as such, the ARY, 12.75% is adopted for the subject property.

Note 3
To reflect the insecurity of the lease, a higher ARY is adopted. Also, a cumulative rate 4% to recapture the investment is adopted.

Note 4
Refurbishment cost includes refitting of 210 rooms & refurbishment of 14 rooms in order to maintain the trade & income estimation adopted in the valuation.

Cost Analysis

	Total rooms		224
	No. of Rooms under complete redevelopment 14		
	Floor area of a room		350sqft
	Estimated cost per sq.ft		Rs. 7500
	Total cost	350x7500	Rs. 2,625,000
Add	Cost of refitting		Rs. 2,400,000
	Cost per room		**Rs. 5,025,000**
	Total cost 14x5,025,000		Rs.70,350,000

Total cost for complete redevelopment
Rs. 70,350,000
Estimated cost for refurbishment of balance 210 @ Rs.200,000
Add p/room Rs. 42,000,000

Say Rs. 112,000,000

Annex 03

Estimation of devisable balance

The following assumptions are made based on the factors obtained to assess the Market Value of the hotel. Data from hotel's records has been adjusted to reflect sector wise data obtained from Sri Lanka Tourism Development Authority and applied accordingly.

i) Occupancy rate 60%
ii) Total expenses 65% (of total income)
iii) Income
  Room income 40%
  Other income 60%
viii) Estimated average room rate Rs.13,000/-
ix) Operator's share is determined including the cost of working capital, rates & insurance.

	Available Rooms			224
	Occupancy rate			60%
	Average room rate		Rs.	13,000.00
	Average room yield	13000x60%	Rs.	7,800.00
		say	Rs.	7,750.00
Room Revenue		224x7750x365	Rs.	633,640,000.00
Other income	60% of total revenue		Rs.	950,460,000.00
Total Revenue			Rs.	1,584,100,000.00
Net income	35% of total revenue (Note 5)		Rs.	554,435,000.00
Deduct – FF&I Renewal Fund @ 2% (Note 6)			Rs.	31,682,000.00
	Divisible balance		Rs.	522,753,000.00

Deduct-	Operator's bid @ 50% (Note 7)	Rs.	261,376,500.00
	Landlord's share	Rs.	261,376,500.00
	Say	**Rs.**	**261,000,000.00**

Note 5
Based on the hotel's cost data meaningfully adjusted conforming to comparables of the industry, 35% of total income is taken to reflect market perception of an investor in the hospitality industry.

Note 6
It is the practice in the hospitality industry to set aside 2% of total revenue for replacement of Furniture Fittings & Equipments (FF&E).

Note 7
Considering the intrinsic goodwill attached to the property, the net income is equally apportioned and this is comparable to that in the industry.