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Dominant and non-dominant lease structures and their effect on place-based valuation practices

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Abstract

Purpose – This paper aims to examine the experiences of valuers when valuing market dominant and non-dominant standard lease structures. The research compares the perceptions and approaches of New Zealand valuers when valuing gross and net leases, two standard lease types commonly utilised in the New Zealand commercial property market.

Design/methodology/approach – The study employs a structured survey of 87 commercial valuers practising in Auckland (where net leases dominate) and Wellington (where gross leases dominate) complemented by in-depth interviews with senior commercial valuers employed by large national/international multidisciplinary real estate companies.

Findings – The results suggest that valuers find the process of valuing standard non-dominant lease structures more demanding than valuing dominant leases and tend to be comparatively less confident about carrying out valuations of leases with which they are less familiar. This lack of confidence tends to result from the lack of comparable evidence and the added complexity of the valuation process requiring additional valuer expertise and judgement. In addition the study uncovers the adoption of place-based differential valuation practices that have built up over time between the two centres under study.

Originality/value – The paper contributes to the literature relating to valuer behaviour by revealing that even within one country with the same rules and professional standards different valuation practices may evolve. This study specifically identifies different dominant lease structures as being one of the reasons for these differential valuation practices. The findings also highlight the difficulties perceived by valuers when valuing non-dominant leases and in turn this may have implications when comparing the valuation outcomes of similar buildings within different markets.

Keywords Commercial property valuation, Commercial property, Valuation behaviour, Alternative lease structures, New Zealand, Asset valuation

Paper type Research paper

1. Introduction

Property research in recent years has sought to understand the impact of human behaviour in property processes and has increasingly recognised its significance in the determination of market prices (Daly et al., 2003; Diaz, 1999; Hardin, 1999; Leishman and Watkins, 2004; Levy and Henry, 2003; Levy, 2005; Roberts and Henneberry, 2007). Despite the growing diversity in lease structures, there is currently little empirical research on valuer behaviour when valuing alternative lease structures, and how this behaviour may be influenced by the specific market, individual perceptions, familiarity and experience.

Within the context of increasingly dynamic and globalised markets, leases are assuming a more varied and flexible character as the needs of affected parties change (Parker and Robinson, 2000).
Various covenants in leases shift the opportunities, risks and responsibilities between the landlord and tenant and consequently have an impact on income and capital returns. A number of authors have suggested that valuers' understanding of the process and the valuation techniques used in practice is not sufficient to accurately price variations across leases (Sirmans and Miller, 1997; Crosby and Baum, 2007; Baum and Turner, 2004; Crosby and Murdoch, 1994; French, 1996; French, 2001; Hutchison et al., 1996; Lizieri et al., 1997; Rowland, 1996; Rowland, 1999; Rowland, 2000). Previous research has sought to verify through theoretical models the effects of a number of lease covenants on rent (Rowland, 1999, 2000). These models, however, focus on financial aspects of a lease and fail to reflect on the complexity of valuation process and practices.

Most property submarkets consist of one dominant lease structure, with less frequent lettings based on alternative lease forms (Rowland, 1996), this diversity places pressure on traditional valuation models leading valuers to rely on practitioner conventions incorporating heuristic (experienced based) rules of thumb (Seabrooke and How, 2004) and subjective adjustments rather than approaches that rely on comparable transactions (Lizieri et al., 1997). Lizieri et al. (1997) argue that non-standard leases are shunned by investors, funders and developers due to valuation inefficiencies and pricing difficulties which could result in a negative impact upon capital values (see also Rowland, 2000; French, 2001).

This paper investigates the perception and practices of valuers when faced with these pricing difficulties in the context of valuing standard New Zealand leases (net and gross) within markets that are dominated by an alternative lease form. It focuses on two distinct New Zealand office leasing markets; Auckland dominated by net leases and Wellington by gross leases. In particular the following research questions are addressed:

- Do valuers perceive the valuation of market dominant lease structures differently to valuing non-dominant lease structures?
- What issues, if any, do they associate with the valuation process of non-dominant leases?
- How do valuers estimate the rental and market values of properties leased on dominant and non-dominant leases?

The following section gives an overview of the study and reviews the existing literature. The review highlights the importance of acquiring an in-depth understanding of how different lease structures are valued in practice and the effect of experience and familiarity on valuation processes. The methodology is then presented followed by a summary of the results. The concluding section highlights the key findings of the study and comments on the implications of these findings for professional practice.

2. Context and literature review

The New Zealand commercial property market witnessed major changes in the late 1970s with the introduction of the net lease to a traditionally gross lease market. This change was as a consequence of high inflation, the arrival of international property syndicates, and the oil crisis which increased the costs of oil-based building services (Christiansen, 1988; Thompson, 1991). During the 1980s property boom, the use of net leases increased noticeably, especially in the Auckland market (Christiansen, 1991). However, in the property slump from the late-1980s to mid-1990s (Moricz and Murphy, 1997), landlords were forced to negotiate gross leases or more tenant-favoured net leases to attract tenants. Recovery in the office rental market began in the late 1990s with economic growth generating increased demand for office space (Murphy, 2003, 2008) and the net lease re-emerged as an attractive lease form (Bayleys, 2003).

Traditionally within New Zealand the office markets located in the two major urban centres of Auckland and Wellington have adopted alternative lease structures. Auckland, the commercial capital and largest metropolitan area is characterised by net leases and is strongly influenced by the presence of institutional investors and corporate tenants. Wellington, the political capital where 40
per cent of the office space is occupied by public sector tenants, (CBRE, 2008), tends to be dominated by gross leases. In addition, leases in New Zealand are relatively standard in structure and tend to follow one of two distinct formats, the Auckland District Law Society lease, and the Building Owners and Managers (BOMA) lease. Given these characteristics New Zealand offers a significant empirical context for this research.

The major difference between a gross and a net lease revolves around the responsibility for the payment of operating expenses (OPEX) (Mooradian and Yang, 2002; Rowland, 2002). Under a gross lease the landlord pays for OPEX without a separate charge to the tenant (Rowland, 1996). A net lease requires the tenant to pay all, or a portion of property’s OPEX in addition to the agreed rent (Bierschenk et al., 1999; Hollyfield, 1994). Rowland (2000) indicates that both landlords and tenants commonly prefer not to take responsibility for OPEX due to the risk of cost escalations (see Adamshick, 1995) affecting the bottom line. He argues that it is not uncommon for landlords or tenants to surrender part of the rent if the other party accepts responsibility for these outgoings (Rowland, 2000).

Leases are commonly negotiated as a package, yet each lease covenant can have an impact on the rent. The effect of a building’s physical features can be measured by analysing the rental evidence; however there is often, little or no information available to isolate the effect of each lease covenant through comparable rental evidence (Rowland, 2000). In cases where there is a dearth of transactions, for example rent determination within existing lease structures, valuers face problems in accurately tracking values through markets (Crosby and Murdoch, 2000). As a result, traditional valuation approaches such as the conventional “all risks yield” valuation model which relies upon comparable evidence and certainty of cash flows may not provide accurate valuations of non-dominant leases in the market where there is a lack of comparable evidence (French, 2001). Several studies have identified that the conventional “all risks yield” valuation model is still in use even though it has become less appropriate when valuing diverse lease structures with different risk profiles (Crosby, 1991; French, 2001; Hutchison et al., 1996; Lizieri et al., 1997).

In order to accurately price the lack of uniformity endemic in lease contracts a number of authors have suggested the utilisation of alternative valuation models (Oppenheimer, 2002), for example the development of mathematical models to estimate the effects of lease covenants on rent. Covenants that have received most attention are “option to renew or break in lease contract”, “OPEX liability”, “rent reviews”, “leasing incentives”, “limitations on use of premises” and “strength of tenants” covenants’ (Benjamin et al., 1995; Buetow and Albert, 1998; Grenadier, 1995; Rowland, 2000; Ward and French, 1997). Most of these pricing techniques require significant mathematical skills and economic knowledge (Oppenheimer, 2002). As a result, valuers tend to be less enthusiastic in adopting new pricing models even where traditional valuation methods are seen to be failing (Lizieri et al., 1997).

In valuation practice, if the subject property to be assessed is leased on different terms to comparables available in the market then it is anticipated that rents will have to be converted to rentals attained on the dominant lease structure, e.g. gross rents will need to be required to be computed to their equivalent net rent, and vice versa (Rowland, 1996). Comparing gross and net rents has traditionally been done by searching for identical pairs of recent lettings, one of each pair being let gross and the other net (Cryer et al., 1992; as cited in Rowland, 1996). Since a standardised lease structure tends to dominate most property markets, it is rare within one market to find large samples of similar premises leased on gross and net bases (Rowland, 1996). Thus, the simple “paired sales/rent” approach may not provide accurate valuations. Albert and McIntosh (1989) and Rowland (1996) suggest that when valuing gross leased properties, rents should be set at a premium above the total of the net rent and the expected OPEX in order to reflect the uncertainty associated with OPEX. Keogh and D’Arcy (1994) suggest that in more mature markets the party who is responsible for OPEX will often insist on some rental concession. Rowland (2000) further suggests that the impact of several factors need to be converted to a rent equivalent when making adjustments for gross and net rents. These factors include; the changing liability for OPEX, the risk of unexpected
increases in OPEX, potential overspending of OPEX and potential neglect by the party responsible for OPEX. Despite the approaches discussed in the academic literature, valuers often use their own judgments or standard percentages (Crosby et al., 1992) to make adjustments between alternative rents in the absence of required information. The specific adjustments for gross and net leases often do not reflect the thinking of landlords and tenants and may be unrealistically rational (Rowland, 1996). This may be further complicated if one lease type is dominant in a certain market and thus provides comparable evidence of premises leased on the dominant lease structure (Rowland, 1996). It is not uncommon for one specific lease structure to dominate an individual property market, and consequently valuers within that market are therefore often less familiar with alternative lease structures. It could be argued that their behaviour may reflect that of valuers working in geographically unfamiliar markets. The results of research into valuer behaviour in geographically familiar and unfamiliar markets identify a number of differences in the way valuers process information. A tendency towards quicker problem resolution and a greater vulnerability to reference point influences were found to be evident among valuers undertaking valuations in areas unfamiliar to them (see Diaz, 1997; Diaz and Hansz, 1997). However, Diaz et al. (2002) found that valuers from the US, UK and New Zealand when switching from familiar to unfamiliar property settings did not alter valuer behaviour. Generally however it is presumed that real estate professionals prefer to focus their advice on markets with which they are familiar (Seabrooke and How, 2004).

The review of the extant literature highlights a dearth of research into understanding the behaviour and experiences of valuers when valuing standard leases that are either dominant or non-dominant in specific commercial property markets. Previous research has considered the valuation of alternative lease structures by proposing a number of theoretical models, however little research has been undertaken to examine how valuers value alternative lease structures in practice. Given that valuers may behave differently when valuing in geographically familiar and unfamiliar markets, and feel less confident in valuing in unfamiliar markets, it is important to establish whether a similar process is at work for valuers valuing non-dominant market leases. Overall, it is evident that rental adjustments between alternative lease structures are rarely supported by strong market evidence in many property markets as one structure tends to dominate. The unavailability of established methods to value lease structures with little market evidence could have potentially negative implications for the valuation advice provided to landlords and tenants. This situation may also negatively affect the determination of fair rents for lease forms which are not commonly available in the market.

3. Methodology

The study employed a survey supplemented with four one-to-one in-depth interviews. The survey was sent out to all registered commercial valuers practising in Auckland and Wellington (176 from Auckland and 74 from Wellington). Registered valuers were targeted to ensure respondents had a minimum of three years professional practice experience. The survey was designed to collect background information on the valuer, together with their perceptions, confidence and experience of valuing gross and net leased commercial properties. A total of 87 valid responses were received giving an effective response rate of 38 per cent (65 from Auckland and 22 from Wellington). Of the valuers who participated in the survey, 87 per cent worked for New Zealand listed property trusts, national/international multi-disciplinary real estate companies or central or local government institutions, while 13 per cent performed valuations as solo practitioners.

In-depth semi-structured interviews were then carried out with four senior commercial property valuers (two from Auckland and two from Wellington). These valuers were selected on the basis that they had experience of valuing both gross and net leases and that they were senior members of the profession. Three were employed by large international multi-disciplinary real estate companies, and the fourth was employed by a large national valuation and property consultancy company.
4. Results
The results of this study shed light on valuers’ experiences on valuing dominant and non-dominant lease structures. A number of perceived problems were reported including the difficulties encountered in obtaining accurate OPEX data and the reliance on other parties for information. They also reported the difficulties relating to the limited availability of comparable rental and sales evidence. In addition, the interviews and surveys provided insights in the valuation process utilised when valuing dominant and non-dominant leases specifically relating to the determination of rental and market values. These results are now discussed in more detail.

4.1 Valuer experiences of valuing dominant and non-dominant leases
In the survey valuers were asked to indicate the lease type that they considered most difficult to value. As Table I illustrates, their attitudes towards the valuation process of gross and net leases were influenced by the nature of the submarket they practised in. A minority of respondents (31 per cent Auckland, 36 per cent Wellington) perceived no significant difference in the process of valuing gross and net leases. The most common reasons given for this were:

- The bottom line is the same, that is net income being capitalised.
- Both methodologies are straightforward if the required information is available.
- Gross leased properties can be analysed to net basis and vice versa by adjusting rental and sales information of comparable properties.
- As long as the evidence is analysed on one basis of leasing, there should be no issues.

Although these valuers indicated that the valuation of gross and net leases was deemed relatively straightforward, they stressed that this was dependent on adequate comparable sales data and details of accurate OPEX information being made available to them, which was not always the case. Significantly though, the majority of valuers suggested that non-dominant leases were more difficult to value (see Table I). Valuers practising in the net lease dominated Auckland market perceived gross leases as being a more difficult and complicated lease structure to value, whereas valuers practising in the Wellington market perceived that net leases were more difficult and complicated.

In order to further clarify if valuers had significantly different perceptions of gross and net lease valuations, valuers were asked to assess the straightforwardness of the two valuation processes. Their rating of the relative difficulties of valuing leases was measured using a seven-point Likert scale, where 1¼ very complicated and 7¼ very straightforward. Paired-samples t-test results illustrate a statistically significant difference between the mean scores given by Auckland valuers on gross lease valuation (M = 3:69, SD = 1:17) and net lease valuation (M = 5:48, SD = 1:00) emphasising the view that net lease valuation was more straightforward than gross lease valuation (t(64) = -9:835; p<0.05). A significant difference was also found in the context of Wellington valuers (t(21) = 2:215; p< 0.05), who perceived that gross lease valuation (M = 5:00, SD = 1:41) was more straightforward than net lease valuation (M = 3:77, SD = 1:63). The results suggest that valuers find the valuation of the dominant lease structure in the market they practise in as more straightforward than the valuation process of non-dominant leases.

Table I. The more difficult and complicated lease structure to value

<table>
<thead>
<tr>
<th>Lease type</th>
<th>Auckland (%)</th>
<th>Wellington (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross lease</td>
<td>63</td>
<td>5</td>
</tr>
<tr>
<td>Net lease</td>
<td>6</td>
<td>59</td>
</tr>
<tr>
<td>No significant difference</td>
<td>31</td>
<td>36</td>
</tr>
</tbody>
</table>
To explore this further, valuers were provided with a list of statements relating to different components of the valuation process and were asked to indicate how strongly they agreed or disagreed with these when undertaking gross or net lease valuations. The responses were measured using a five point Likert scale where 1 = strongly disagree to 5 = strongly agree.

Overall the results set out in Table II, indicate that Auckland and Wellington valuers have a common view when valuing non-dominant leases. Both groups indicated that they have to “rely more on landlords for information”, “make more assumptions” and “perform extra paperwork and calculations”. Furthermore, when comparing rentals of one building with another, analysing or predicting the actual rent being paid for premises, and advising landlords and tenants on rental rates, they agreed that it was easier if the property was leased on the dominant lease form than on non-dominant leases.

Table II. Valuer perceptions of different components in the commercial valuation process

<table>
<thead>
<tr>
<th>Statement</th>
<th>Location of practising</th>
<th>Auckland</th>
<th>Wellington</th>
</tr>
</thead>
<tbody>
<tr>
<td>I do not have to rely on other building owners or property managers for</td>
<td>Auckland</td>
<td>[M(Gross) = 1.77, M(Net) = 2.83]</td>
<td>[M(Gross) = 2.09, M(Net) = 1.50]</td>
</tr>
<tr>
<td>information when performing the valuation</td>
<td></td>
<td>[t(64) = 6.712, p &lt; 0.05]</td>
<td>[t(64) = 2.947, p &lt; 0.05]</td>
</tr>
<tr>
<td>It is easy to compare the rental of one building with another</td>
<td>[M(Gross) = 3.63]</td>
<td>[M(Gross) = 3.63]</td>
<td>[M(Gross) = 3.37, M(Net) = 2.18]</td>
</tr>
<tr>
<td>I often have to make special assumptions to reach the valuation figure</td>
<td>[M(Gross) = 3.14, M(Net) = 2.71]</td>
<td>[M(Gross) = 2.41, M(Net) = 3.27]</td>
<td></td>
</tr>
<tr>
<td>I have to do extra paperwork and calculations to achieve the final</td>
<td>[M(Gross) = 4.00, M(Net) = 2.58]</td>
<td>[M(Gross) = 2.64, M(Net) = 3.55]</td>
<td></td>
</tr>
<tr>
<td>valuation process is more time-consuming</td>
<td>[t(64) = 10.119, p &lt; 0.05]</td>
<td>[t(64) = 2.438, p &lt; 0.05]</td>
<td>[t(64) = 2.58, p &lt; 0.05]</td>
</tr>
<tr>
<td>Interpretation of the final valuation figure is easy</td>
<td>[M(Gross) = 2.81, M(Net) = 3.58]</td>
<td>[M(Gross) = 2.73, M(Net) = 2.86]</td>
<td></td>
</tr>
<tr>
<td>It is always easy to analyse or predict the actual rent that is being</td>
<td>[M(Gross) = 2.34, M(Net) = 3.25]</td>
<td>[M(Gross) = 3.23, M(Net) = 2.14]</td>
<td></td>
</tr>
<tr>
<td>paid for a particular premises</td>
<td></td>
<td>[t(64) = 6.311, p &lt; 0.05]</td>
<td>[t(64) = 2.48, p &lt; 0.05]</td>
</tr>
<tr>
<td>It is easy to advise landlords about what level of rental to ask</td>
<td>[M(Gross) = 2.83, M(Net) = 3.55]</td>
<td>[M(Gross) = 3.55, M(Net) = 2.82]</td>
<td></td>
</tr>
<tr>
<td>It is easy to advise tenants about what level of rental to pay</td>
<td>[M(Gross) = 2.94, M(Net) = 3.52]</td>
<td>[M(Gross) = 3.64, M(Net) = 2.73]</td>
<td></td>
</tr>
</tbody>
</table>

4.2 Problems associated with the valuation of non-dominant lease structures

Survey and interview respondents were asked why they believed the valuation of non-dominant lease forms in their markets was more complicated than valuing the dominant lease form. The most significant issues identified were:

. Difficulty of ascertaining accurate OPEX.
. Limited availability of comparable rental and sales evidence.
. Reliance on other parties for information.
. Lack of confidence in valuation process and its outcome.
A recurring theme identified by both group of valuers was the problem associated with the ability to obtain accurate and timely information. In many cases the dearth of this information together with an unfamiliarity in valuing particular lease types resulted in valuers being less confident with their ability to come up with an accurate valuation figure. In order to gain a deeper understanding of these issues valuers were then asked to describe the specific difficulties they faced when calculating a building’s OPEX.

4.3 Difficulty of ascertaining accurate OPEX
As the list below indicates the limited availability, unreliability, ambiguity and uncertainty related to OPEX information were consistently identified as the most significant issues when valuing non-dominant market leases:

. Inadequate OPEX information on properties leased on non-dominant leases as submarkets are dominated by one main lease structure.
. Difficulty in establishing the total OPEX.
. Difficulty in deciding which cost items have been included/excluded from OPEX.
. Uncertainty in regard to recoverable and non-recoverable OPEX.
. Assessing OPEX is mainly an assumption or a forecast.
. Higher risk of unforeseen OPEX.
. Landlords and tenants are often vague and dishonest about information on their OPEX.
. Difficulty in comparing the OPEX levels of subject and comparable properties.

An Auckland valuer argued that:

Gross leases are more difficult because if you do a rent review you have to stuff around finding out OPEX, if you do a market valuation, you have to find out the actual net income based on OPEX, which is very frustrating. We probably don’t allow for enough inflation on OPEX although we are more and more doing that. We don’t have a lot of information as a guide, so we’ll have to rely on other sources, if not you just have your own judgments.

All valuers interviewed emphasised that the accuracy of the valuation of non-dominant leases was largely dependent on the availability of OPEX and a valuers’ ability to correctly quantify the OPEX of the property. They argue that due to the professional judgements required to accurately value non-dominant leases their experience and professional expertise, in combination with the type and size of the company they worked for, were integral in this process. Moreover, they believe that variance in OPEX estimation was more likely to increase if the property was a multi-tenant property with a variety of different lease structures. This finding suggests that the limited availability of credible and accurate OPEX information sources may hinder a valuer’s ability to make effective estimations of rental and market values of non-dominant leases. Under these circumstances, it may be argued that reliance on valuers’ subjective judgements in estimating OPEX could increase uncertainty and lead to errors in the valuation outcome.

4.4 Limited availability of comparable rental and sales evidence
In addition to OPEX issues, the survey respondents identified a key problem in valuing non-dominant leases as the limited availability of accurate and timely comparable sales and rental information. The most significant issues were:

. the lack of rental and sales databases for properties leased on non-dominant leases;
. the poor quality, of the comparable evidence, specifically the lack of up-to-date and often incomplete information; and
the difficulties encountered in estimating the comparability between properties leased on dominant and non-dominant lease structures.

All of the interviewees explained that comparable sales and rental databases in both Auckland and Wellington markets were only in line to the dominant lease structure. One Wellington valuer summarised this as follows:

All our rental and sales databases are only on gross basis, as so many deals are done on gross, for instance about 85-90 per cent of rental information I collect in my day are gross. If I’m doing a net valuation, I haven’t got any net comparables to look at. So I forget that it is a net lease for start and look at my comparisons which are all gross.

As a result, Auckland valuers tended to compare all properties on a net rental basis while Wellington valuers tended to compare all properties on a gross rental basis. The interview findings suggest that valuers are utilising transaction-based or evidence-based pricing models when valuing properties leased on non-dominant leases in both markets even though the underlying characteristics of the comparables and the property to be valued diverge. As suggested in the previous literature, inefficient and inaccurate comparable sales selection procedures may produce biased results (Diaz, 1999; Gallimore and Wolverton, 1997). Accordingly, the valuation approaches followed by Auckland and Wellington valuers could be comparatively less satisfactory when valuing non-dominant leases since the lack of appropriate comparable evidence may lead to a lack of credibility regarding the value estimated.

4.5 Reliance on other parties for information

Since the OPEX and comparable evidence on non-dominant leases are less available, the valuers surveyed indicated that they had to rely more on the information generated by landlords, property managers, tenants or real estate agents when valuing such properties. In particular, valuers tend to rely heavily on these parties for OPEX information. As explained by one Wellington valuer:

If you do a net lease valuation in Wellington, you definitely are reliant on the landlord or tenant for OPEX information. If we’re not satisfied as to robustness of that information, we will draw attention to the party that we are reporting to that the information needs to be verified. Without seeing all of the documentation we are reliant on the landlord or tenant.

Interviewees acknowledged that landlords and tenants could potentially influence the valuation outcome of properties leased on non-dominant leases by providing inaccurate or incomplete information or by holding back information. Any withholding of vital information may result in an overvaluing or undervaluing property (Levy and Schuck, 2005) and has a negative impact on the credibility of reported values of property portfolios (Kinnard et al., 1997).

All valuers interviewed emphasised that the size of the valuation company, valuer’s experience, knowledge and sophistication had a significant impact on their level of reliance on client generated information. It was argued that more sophisticated and experienced valuers, working for large valuation companies, tend to rely less on their clients than those with a lack of experience or limited market information. By implication they believe that small-scale valuers with limited access to required information were more likely to encounter problems with the valuation of non-dominant leases.

As well as the characteristics of the valuer, the interviewees believe that the characteristics of the client may also impact the accuracy of valuation of non-dominant leases in particular the size of the company and experience of the client. Interviewees suggested that the information provided by more sophisticated landlords and tenants was often more likely to be reliable and accurate, as they were “not really into the game of fabricating or fudging things” (Auckland valuer). On the other
hand, the information provided by some less sophisticated landlords and tenants could be less reliable as they were “less organized in terms of recording OPEX and breaking them down” (Wellington valuer). Overall, the survey and interview findings suggest that a valuer’s access to accurate information, professional expertise, experience and ability to interpret the available information affects the accuracy of the valuation of non-dominant lease structures. The paucity of comparable data, and the need to rely on external and possibly inconsistent data sources, means that valuers are less confident in valuing non-dominant leases, even when these leases are viewed as relatively standard in nature (e.g. a net lease).

To further investigate valuers’ confidence in valuing dominant and non-dominant leases in their markets, the survey respondents were given a list of key items that commonly appear in valuation reports and asked to indicate their level of confidence when addressing them. The results as set out in Table III suggest that valuers were comparatively less confident about all of the key aspects under the valuation of non-dominant leases. Valuers in both markets were less confident about providing information on comparable sales and rental values and the projections of future market/rental values of properties leased on non-dominant leases. This finding is consistent with the view of Joslin (2005) who suggests that the lack of reliable comparable evidence is the most common factor to affect valuation uncertainty.

Overall, an analysis of the interviews revealed a number of reasons as to why valuers may be less confident in valuing non-dominant leases. These include; the lack of availability of OPEX and comparable evidence, more reliance on client for information, uncertainty of the information provided, large number of assumptions involved and limited experience of valuing such leases. Furthermore, all of valuers interviewed emphasised that the valuation of large multi-tenant properties containing individual tenants on different lease structures was significantly more problematic. This resulted in a lower level of confidence when faced with a valuation assignment relating to such a property.

Table III. Valuers’ confidence in valuing dominant and non-dominant leases

<table>
<thead>
<tr>
<th>Statement</th>
<th>Auckland</th>
<th>Wellington</th>
</tr>
</thead>
<tbody>
<tr>
<td>Details of tenancies</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 4.297, p &lt; 0.05</td>
<td>[21] − 2.531, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.74, M(Net) = 4.14</td>
<td>M(Gross) = 4.50, M(Net) = 3.55</td>
<td></td>
</tr>
<tr>
<td>Valuation method adopted</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 3.474, p &lt; 0.05</td>
<td>[21] − 1.821, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 4.14, M(Net) = 4.48</td>
<td>M(Gross) = 4.48, M(Net) = 4.05</td>
<td></td>
</tr>
<tr>
<td>Valuation calculations</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 5.961, p &lt; 0.05</td>
<td>[21] − 2.001, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.95, M(Net) = 4.52</td>
<td>M(Gross) = 4.47, M(Net) = 4.05</td>
<td></td>
</tr>
<tr>
<td>The expression of any uncertainty regarding the valuation figure</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 4.589, p &lt; 0.05</td>
<td>[21] − 2.630, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.60, M(Net) = 4.00</td>
<td>M(Gross) = 4.23, M(Net) = 3.64</td>
<td></td>
</tr>
<tr>
<td>Valuation calculations</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 7.125, p &lt; 0.05</td>
<td>[21] − 2.832, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.26, M(Net) = 4.14</td>
<td>M(Gross) = 4.14, M(Net) = 3.45</td>
<td></td>
</tr>
<tr>
<td>Information on specific comparables</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 6.019, p &lt; 0.05</td>
<td>[21] − 2.507, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.03, M(Net) = 3.91</td>
<td>M(Gross) = 4.00, M(Net) = 3.23</td>
<td></td>
</tr>
<tr>
<td>Projections of future market/rental value</td>
<td>Net lease</td>
<td>Gross lease</td>
</tr>
<tr>
<td>[164] − 4.290, p &lt; 0.05</td>
<td>[21] − 2.524, p &lt; 0.05</td>
<td></td>
</tr>
<tr>
<td>M(Gross) = 3.26, M(Net) = 3.72</td>
<td>M(Gross) = 3.59, M(Net) = 2.86</td>
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</tr>
</tbody>
</table>

4.6 Determination of rental values

The existing literature has expressed concern that valuers do not have established methods for calculating appropriate differences in rents between different lease types. With this in mind, the interviews carried out in the second part of data collection examined in detail how valuers quantify the effects of landlord and tenant liability for OPEX on rental and market values of properties.
In order to examine how rentals negotiated on a non-dominant lease structure were converted to their dominant equivalent, interviewees were asked to explain how they made adjustments between gross and net rents in their rental valuations. In contrast to previous literature suggesting that the conversion to gross rents should include a premium in order to reflect the uncertainty associated with OPEX (Albert and McIntosh, 1989; Rowland, 1996), the findings reveal that the difference between gross and net rents are calculated simply to reflect the OPEX of the property plus an estimation for inflation with no attempt at incorporating a factor reflecting the lack of certainty. Valuers were of the opinion that variations in OPEX over time were not extreme and therefore a premium for uncertainty was not required. The quotes below were typical of valuer responses:

If you want to get the gross rent you just add the OPEX and gross up the net rent. If we are very worried that the OPEX budget looks a bit skinny then we just add in an allowance for inflation on OPEX (Auckland valuer).

If I am doing a net lease, I just use the gross comparables and I make my assessment on the gross basis. I look at all my comparisons and say “OK, if this is gross, the answer would be this”. Then I go, “hang on, it is net”, then I take off the OPEX and I have the net answer (Wellington valuer).

4.7 Determination of market values
Interviewees were asked to explain how they determined the market value of properties leased on gross and net leases in the markets they practised in. Valuers practising in Auckland when determining whether the OPEX of the property they are valuing fairly reflects the operating costs of comparable buildings generally use information from their own records, the Property Council of New Zealand’s (PCNZ) Operating Expenses Benchmark, their knowledge and experience, and professional judgment. If they are confident that the OPEX of a property leased on the market’s dominant lease (net lease) is reasonably similar to the OPEX of the comparable properties there is a tendency for them to assess its market value by focusing on the net rent of the property, without undertaking an extensive analysis of actual OPEX. It was their view that landlords were mainly interested in the net return on their investment which would be unaffected, as under the net lease OPEX were recovered from tenants. As described by an Auckland valuer:

When doing net lease valuations we do everything on a fully net basis, if the buildings are similar and we know that the OPEX budgets are reasonably similar, it is fine. Investors are only concerned about the net income, who cares about the OPEX? It is not their problem. If it is a net leased building, you just get the net income and multiply by the capitalisation multiplier. We don’t always go to the point of checking out into the last dollar of OPEX.

These results suggest that the adjustments for OPEX between the subject and comparable properties may not always reflect the true cost of OPEX. The interviews highlight that Auckland valuers do not fully examine, and therefore may not have a full understanding of the cost components of OPEX in their valuation reports. This could result in inaccuracies in analysing or predicting the actual rent being paid for properties under differing lease structures. The analysis of these interviews points to a fundamental cultural difference between the Auckland and Wellington markets. Wellington valuers criticise the Auckland valuation methodology emphasising that a detailed examination of OPEX is essential. They argued that total occupancy costs should be more important than the net rental figure alone in terms of the efficient and effective management of premises. They also indicated that the Auckland valuation approach, which focuses on the net return of the property, may not accurately assess different versions of net leases such as leases with capped OPEX or leases which recover only the increases in OPEX.
It is interesting to note however, that Auckland valuers, believe that more in-depth examination of OPEX is necessary when valuing the occasional gross leases in their market. The reason for this was explained as:

... that’s something which affects the performance of the building. You’ve got to make a judgment on whether you think those OPEX is a fair reflection of what it costs to operate that building. So, there is a little bit more skill and science involved in that regard (Auckland valuer).

These results may suggest that valuers carry out more robust analyses when valuing properties leased on non-dominant market lease structures. Valuers’ experience and prior knowledge of valuing properties leased on dominant leases may cause them to perform comparatively less research and in-depth analysis resulting in the potential for bias in valuations. Valuers practising in Wellington contend that they perform all valuations by reference to a comparable gross rental when determining market value. Accordingly, when valuing net leased properties, Wellington valuers first estimate the appropriate gross rental equivalent for the property by using the comparable evidence and then deduct OPEX to get the net return:

In Wellington everything starts with a benchmark of all gross basis. If I’m doing an assessment for premises where there is a net rent, I will ask the tenant “what OPEX do you pay” and I make my assessment on the gross basis looking at my comparisons which are gross and then I go “OK, the rent should be say $175 per m2, the OPEX for this tenancy are $25, so the net rent should be $150 times the square area”, that is my assessment (Wellington valuer).

It could therefore be argued that the accuracy of the valuations of net leased properties in a market dominated by gross leases would be more dependent on valuer judgement and therefore be potentially more open to error than gross lease valuations in the Wellington market.

Overall, the findings indicate a variation in valuation practice in Auckland and Wellington when estimating the rental and market values of properties leased on dominant and non-dominant leases in their markets. This place-based variation, which conditions valuation processes, is determined by the character of the dominant lease type and may ultimately adversely affect the landlords’ and tenants’ understanding of valuation outcomes. This may cause difficulties for landlords when making management and leasing decisions and comparing investment opportunities between the two cities. Difficulties may also arise for landlords and tenants seeking to identify the comparative occupancy costs of premises in the two markets.

5. Conclusion
This paper explores the perceptions, experiences and key issues confronting valuers when valuing dominant and non-dominant lease structures in their home markets. The study focuses on the valuation of gross and net leases in two of New Zealand’s largest commercial centres, Auckland and Wellington. Significantly, the results highlight that valuers perceive the valuation of non-dominant leases as more complex than valuing dominant leases, even though these leases are relatively standard in nature. A number of issues are identified as contributing to this complexity, these include; the limited availability of detailed and reliable OPEX information, the difficulty in obtaining accurate and timely comparable sales and rental information of properties leased on non-dominant market lease structures, and the reliance by valuers on information generated by landlords, property managers, tenants or real estate agents.

Reflecting a perceived increased level of complexity, valuers indicated that they were less confident in valuing non-dominant leases. This relative lack of confidence is further exacerbated by the large number of assumptions involved and the limited experience of valuing such leases. Given that
valuers are key professionals in the nexus of agents operating in a commercial property market, this relative lack of confidence in valuing non-dominant leases could act to reinforce the structural importance of the dominant lease in a market. Reliance on standard practices and standard leases can promote inflexibility in the market and have a deleterious impact on occupiers seeking flexible and innovative leases (Gibson and Lizieri, 1999).

The study clearly demonstrates the emergence of “place based” valuation cultures. Despite operating in a single national market, Auckland and Wellington valuers operationalise the valuation process in different ways, reflecting differences in the dominant leases and the character of the local leasing market. These place-based variations may cause difficulties for landlords when comparing investment opportunities in the two cities and when managing their property portfolios in the two markets. The survey and interview findings indicate that Auckland and Wellington valuers in general adopt relatively unsophisticated and potentially inconsistent valuation approaches that may not accurately price the differential between the rental and market values of properties leased on alternative lease forms.

Although this research highlights the emergence of place-based valuation cultures triggered by different lease structures, anecdotal evidence from informal discussions with the interview respondents tends to suggest that place-based valuation cultures may exist in submarkets that utilise similar leases. Further research is required to investigate these behaviours and alternative factors that may affect valuation practices in different cities within markets with uniform professional standards.

References


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