1.0 Introduction

1.1 International Valuation Standards (IVSs) Concepts Fundamental to Generally Accepted Valuation Principles distinguish between real estate, the physical tangible “thing” (see Concepts Fundamental to GAVP 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 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 the value of lease interests.

1.3 This class of ownership is, as for the fee simple or freehold interest, common to all types of property assets valued. A piece of real estate may comprise one or more property interests, each of which will have a Market Value providing it is capable of being freely exchanged.

1.4 In no circumstances is it considered proper to value different property interests in the same piece of real estate separately and then to aggregate their values as an indication of the real estate’s total value. Lease contracts establish unique legal estates that are different from fee simple, or freehold, ownership.

1.5 International Financial Reporting Standards (IFRSs) (including International Accounting Standards (IASs)) contain specific accounting requirements for property that is either held under a lease, or subject to a lease.

1.6 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. The diagram on the following page illustrates the relationship between lease interests.

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 IVSs Concepts Fundamental to Generally Accepted Principles and to IVSs 1 and 2, and IVAs 1, 2 and 3.

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. A fee simple estate, representing the perpetual ownership in land.

3.1.2 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.

3.1.3 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.

3.1.4 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.

3.1.5 Headleasehold Interest has the same meaning as Sandwich Lessor Interest. The holder of a headlease or master lease.

6.2

INTERNATIONAL VALUATION GUIDANCE NOTE NO. 2

VALUATION OF LEASE INTERESTS

REVISED 2007
3.1.6 **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.

3.1.7 **Lease Interest,** also known as **Lessee Interest,** **Tenant’s Interest,** or **Leasehold Estate.** The ownership interest that is 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.

3.1.8 **Lessor Interest.** The interest held by the lessor in any of the circumstances set out in paras. 3.1.2, 3.1.4, or 3.1.5 above.

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

3.1.10 **Rent Types**

3.1.10.1 **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. Whenever Market Rent is provided, the “appropriate lease terms” which it reflects should also be stated.

3.1.10.2 **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.

3.1.10.3 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.

3.1.11 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.

4.0 Relationship to Accounting Standards

4.1 Leased property is accounted for differently from freehold property, plant and equipment under IFRSs/IASs. The valuation requirements are summarized in IVA 1 and Addendum A to IVA 1.

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 an operating lease are for accounting purposes generally considered investment property, 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 statutory rights and indicate in the Valuation Report whether or not regard has been paid to them.

5.5 The importance of the distinction between the physical matter and the legal interest in it is critical to valuation. For example, a lease might specify 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. The leasehold value may be expressed in monetary terms but is not a Market Value as the interest cannot be sold in the market. However, the lessor’s interest (leased fee value) does have a Market Value, based on the value of the rental income during the lease together with any residual value remaining at the end of the lease.

5.6 Each legal interest in a property shall be valued as a separate entity and not treated as though merged with another interest. Any calculation of merged interests value or marriage value should be referred to in supplementary advice only and may be undertaken as a valuation based on specific assumptions only and where the Valuer’s Report is appropriately qualified.

5.7 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 on the right to sublet.

5.8 Inter-Company Leases

5.8.1 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, providing the relationship between the parties is disclosed in the report, and that the agreement is on arm’s-length terms in accordance with normal commercial practice. When the valuation is being undertaken for inclusion in a financial statement, it is acceptable to reflect any inter-company leases, providing the interests of one of the parties to the lease are being valued. However, if the interest of the group is being valued for inclusion in its consolidated accounts, the existence of any inter-company leases should be disregarded. (International Accounting Standard 40, para B21)
5.9 Leasehold Alterations

5.9.1 When valuing any property interest that is subject to a lease, it is important that Valuers establish whether any alterations or adaptations have been made to the property by the lessee. If so the following questions need to be addressed:

a) has the lessee complied with any lease conditions or restrictions relating to the alterations?

b) what is the impact of any state laws on the rights of the parties in relation to the alterations?

c) are the alterations obligatory or voluntary? (see below)

d) is there any obligation on the lessor to compensate the lessee for the cost or value of the work, or on the lessee to remove the alterations at the lease end?

5.9.2 Leasehold alterations fall into two main categories:

a) Obligatory alterations: These usually arise where a property is leased in a basic state or constructed to a “shell” specification that is not suitable for occupation without the lessee undertaking further building or fitting-out work. The lease will often impose a condition that such work be carried out by the lessee within a certain timescale.

b) Voluntary alterations: Typically these arise where a property is leased in a completed state ready for immediate occupation, but where the lessee elects to undertake work to improve or adapt the accommodation to suit the lessee’s own particular requirements. Although the tenant may regard these as alterations, the general market may not.

5.9.3 Obligatory alterations will usually have a beneficial impact on the Market Rent. Voluntary alterations may have a beneficial, neutral or detrimental effect on the Market Rent, depending upon their nature and degree of specialisation. The degree to which the impact on the Market Rent is reflected in the value of either the lessor’s or the lessee’s interest will depend upon the answers to the questions in 5.9.1.

5.10 Negative Market Values

5.10.1 Where lease interests are liabilities to an undertaking, they may have a negative Market Value.

5.11 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 31 July 2007.